{ EQUITY MARKETS }

JEREMY WARNER

Investors may be hungrier for risk, but the crisis rumbles on

Stock markets around the world got off to a barnstorming start to the year. This may have had more to do with relief that the US managed to avoid plunging over the fiscal cliff than belief in a rip-roaring economic recovery. Nonetheless the year has started on a more positive note than many dared hope back in the doldrums of 2012.

Much of the tail risk posed by a disorderly break-up of European Monetary Union appears to have been removed, the jobs data out of the US are looking ever more encouraging, central banks have committed to keeping monetary policy highly accommodative for some time to come and China seems to have avoided the hard landing widely anticipated. Along with other emerging markets, it now appears ready for another growth spurt.

The scene seems set for cyclical recovery. Will this one be for real, or is it just another of the false dawns we have seen so often during this long post-crisis hiatus in economic activity?

There are good reasons for scepticism. Virtually all countries outside China, and possibly Japan, will be engaged in fiscal consolidation of some sort this year. Even without the fiscal cliff, there's a fiscal contraction amounting to 1% of GDP pencilled in for the US, and in many eurozone countries it is much bigger. Excessive public and private sector debt remains a big problem for most advanced economies, so it may be premature to think that contractionary deleveraging has run its course.

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Timely action by the European Central Bank may have prevented financial meltdown in the euro area, but the patient can hardly be said to be off its sickbed. Imminent death on the operating table has merely been replaced with a form of acute, long-term illness, where growth appears denied to all but Germany.

All the same, a big surge in equity markets is always a positive sign because it means that investors are beginning to recover some of their risk appetite. Animal spirits may be starting to stir, after a near five-year hiatus.

The flip side of any recovery in equity markets would be a bear market in government bonds, with long-term interest rates rising. Many regard the extreme lows to which sovereign yields have fallen as an anomalous bubble, and in some ways it is hard to disagree.

As things stand, government debt in many of the major advanced economies offers a negative real rate of interest, a state of affairs brought about in part by very substantial central bank buying. Other forms of financial repression, such as forcing banks to hold much bigger liquidity and capital buffers, also abound.

The main reason for very low bond yields, however, is risk aversion – that, and hunger for 'risk-free' assets among fast-maturing final salary pension schemes. As this risk aversion eases, you would expect to see some upward movement in yields. But whether we are about to observe a 'great rotation' out of bonds and back into higher-yielding equities, is another question.

A concerted rotation requires much greater certainty about sustainable recovery than we have seen to date. The problem is that many advanced economies, Britain included, are still too weak and debt-encumbered to withstand a significant rise in interest rates. In such circumstances, it is quite hard to see central banks slapping on the brakes. So whereas it's possible to see some limited rise in market interest rates this year, and possibly a quite pronounced rise in equity markets, without sustainable growth it's hard to see a seminal change back to pre-crisis norms.

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