{ FINANCIAL MARKETS }

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Investors have lost all fear to the point of dangerous complacency

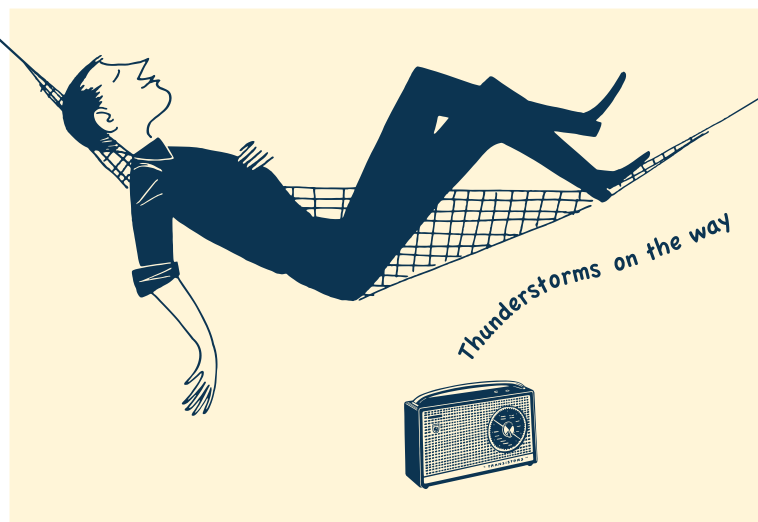
Is this merely the calm before the storm? Financial markets have been unusually benign for a long time now. Even the troubled eurozone has seen spreads narrow, rising equity prices and a general abatement of the extreme levels of risk aversion that were threatening financial Armageddon little more than two years ago.

On one level, this is good. If markets are calm, and expected to remain so, it gives companies and households the confidence to start investing and spending again.

But experience has also taught us to be wary of prolonged periods of exceptionally low volatility. The last time the Vix Index, which measures volatility in US stocks and is therefore sometimes referred to as 'the fear index', was as low as this, was just before the crisis of 2008/9. Investors have lost all sense of fear, to the point, it might seem, of dangerous complacency.

Yet these very low levels of volatility don't necessarily point to impending disaster – the Vix is more often low than high, and since financial and economic crises are comparatively rare, so, too, are spikes in the index.

Nonetheless, we've seen some really quite eye-popping gains in stock markets since the low point of the crisis in March 2009 – the Standard & Poor's 500 has nearly tripled in value – and that in itself should make us worry, for it is not clear that these gains are supported by economic fundamentals.



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More than five years of ultra-low interest rates and post-crisis, central bank money printing may have succeeded in averting a depression, but it has also driven a spectacular surge in asset prices and 'search for yield', raising questions about what happens when these policies are reversed.

Last summer's 'taper tantrum', when markets reacted in horror to news that the US Federal Reserve might begin removing monetary support, may have been only a foretaste of what's to come. True enough, this soon blew over. Yet the fact that the taper tantrum didn't create a longer and deeper period of disruption in financial markets has only reinforced the sense of complacency.

Syria, Ukraine, sabre-rattling in the south China seas, fears of a major credit event in Asia – nothing, it seems, can stop the upward surge in asset prices.

In Europe, monetary policy is still in easing mode, and likely to remain so for some time to come. In Britain and America, however, central bankers have begun preparing markets for tighter policy in future. So far, markets have taken this signalling in their stride. Whether they will remain so sanguine once forward guidance turns to action is anyone's guess, but the betting has to be that the ride is going to get distinctly bumpy from here on in.

Here's where it gets interesting, for the bumpier it gets, the more likely such actions are to derail the recovery, forcing the world's monetary superpowers to ease back again. In any case, both the US Federal Reserve and the Bank of England have indicated that even when rates do rise, it will be only gradually and to a level far below pre-crisis norms.

As long as ordinary price and wage pressures remain as tame as they are, it's hard to disagree with this assessment. We'll see. As for the risks of financial instability, now once more apparent in sky-high asset prices, central bankers believe these can be contained through the use of so-called 'macro-prudential' tools – or, in other words, by regulating particular forms of credit. Good luck with that. The only thing that can be said with certainty is that weaning the world economy off ultra-easy monetary policy is going to be exceptionally tricky. Hold on to your hats.

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