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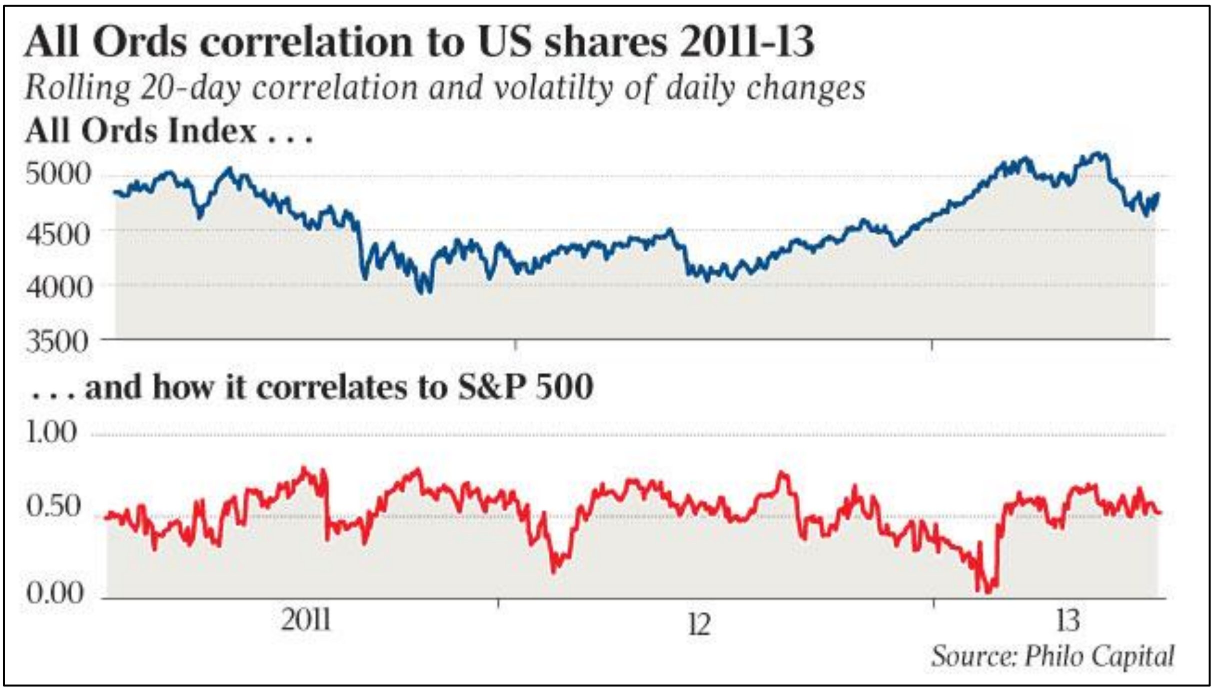
US still calling the shots in markets

DON STAMMER The Australian July 16, 2013 12:00AM



Source: The Australian

WE'VE had abundant reminders recently of how quickly other countries' bonds and shares can follow the leads from US investment markets.

Since mid-May, US bond yields have spiked twice, first in response to misinterpretation of the US central bank's outline of how it might phase down its program of buying fixed-interest securities, and then following strong data on US jobs.

Bond markets in most countries, including Australia, immediately followed the direction of the sell-offs in US bonds. Over the past two months, yields on US 10-year bonds have jumped from 1.7 per cent to 2.8 per cent, and in Australia they've moved up from about 3 per cent to about 3.9 per cent.

Also, most sharemarkets have followed the zig-zag course set by US shares. Our sharemarket has been particularly highly correlated with US shares -- even though, on some negative days for US shares, our market has weakened proportionally more because of fears China's slowing economy will depress prices of iron ore and coking coal.

Since the early days of the global financial crisis, investors in most countries have kept a close watch on day-to-day moves in US shares and US bonds. That's because the crisis first erupted in the US and the US was earliest among the big economies in taking action to deal with it.

There is now a more specific reason for other investment markets to follow the lead from US shares and bonds. Economic prospects in the US are much better than those in other industrialised economies. As a result, many holders of US bonds, especially long-dated bonds, now worry they could face capital loses as the gathering US recovery pushes up bond yields (and reduces the market value of bonds). Investors in bonds issued by other countries, including Australia, have been reminded that the market prices of the bonds they hold are also likely to fall as economic growth picks up and yields "normalise".

Meanwhile, equity investors are asking whether the bull market in US shares, which has helped to rebuild confidence in most other equity markets, is robust enough to continue now that bond yields are higher.

In my view, investment markets around the world will continue to be affected by data on US economic growth and job creation, by US announcements on the phasing down in its central bank purchases of bonds and mortgage debt and by the outlook for US company profits.

Also, we must expect wide swings in market sentiment on US prospects. Were there to be a gold medal in economic performance, the US would be the clear winner -- even though its economic upswing has been patchy. Steven Bradbury won gold in the 2002 winter Olympics when his opponents all tripped. The US economy looks relatively attractive in part because other advanced economies are struggling.

The US is achieving useful growth in job numbers; the budget deficit is significantly reduced; shale oil and shale gas hold the promise of energy independence; the banks have largely been recapitalised; house prices and house building are recovering; and profits are at record levels.

On the negative side: the US recovery has been force-fed by four years of near-zero cash rates and large budget deficits; unemployment and underemployment are high; many businesses are hoarding cash rather than investing in new capital; US real wages have remained flat; and current expectations for profits in the second half of 2013 and in 2014 could be optimistic.

Data on the US economy and US announcements on monetary policy will have big effects on bond and equity markets here. In my view, we should also expect these leads to be generally positive for our shares and negative for our bonds.

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