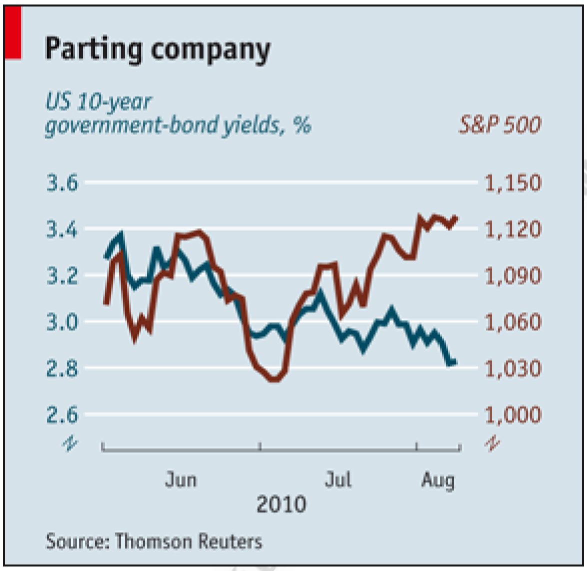
Bad news bulls

THERE are times when the equity and bond markets can both do well at the same time, for example when inflation is falling from a very high level or when a country is recovering from some kind of natural or political disaster. With inflation already low, this would not appear to be one of those times.

But as the chart shows, the stockmarket has rallied strongly in recent weeks while bond yields have fallen (yields are a better way of illustrating the issue than bond prices). A fall in bond yields suggests either that investors are becoming more risk-averse or that they fear a double-dip recession and/or deflation. A rise in equity markets suggests they are worried about neither.



Source: Thomson Reuters

So what is going on? This reminds me a bit of the late 1990s when, as a tech sceptic, I wondered why the stockmarket kept surging to stratospheric valuations. Whatever the headlines the market went up. Good news on the economy meant profits would be strong while bad news meant that central banks would cut rates, and thus profits would eventually be strong. This rally is of course on a much smaller scale but I think Jim Reid of Deutsche Bank is right when he writes that:

risky assets have traded over the last month in a manner that suggests that good US news indicates the economic recovery is intact and bad news is interpreted as increasing the probability of imminent QE. A kind of win, win for risk assets.

In short, the bulls hope the Fed is going to ride to the rescue and print more money. The Fed's statement turned out to be a compromise; it will keep its holdings of Treasuries constant by rolling them over as they mature. But I also wonder at the serene faith of equity investors in the Fed's ability to revive the economy. A mountain of stimulus has produced a molehill of recovery. As the statement says

Bank lending has continued to contract..,,,the pace of economic recovery is likely to be more modest in the near term than had been anticipated.

Given the lack of success so far in generating a V-shapred recovery, will maintaining QE really change the outlook? Surely if QE was going to work, bond investors should be a bit more nervous. Yes, in the short-term, the Fed is supporting Treasury bond prices. But in the long-term, all that debt will either have to be sold back into the market, (or stop rolling over the debt when it matures). The choice for the bond market is either a lot more debt, or a bigger money supply, neither of which would seem attractive.

So the bond market is surely betting that the Fed's actions won't work and that Japan is the template; the equity market is betting that the Fed will be successful and the Goldilocks economy will return.

Fonte: The Economist, Aug. 10th 2010. Disponível em <www.economist.com>. Acesso em: 11 de ago. 2010.