IT HAS been an emotional time for the family Buttonwood these two weeks past. Your columnist’s two daughters were in a car accident, though luckily escaped unscathed. To such trauma has been added the sort of pride that brings a tear to the eye of any parent with an ounce of feeling: daughter number two played Mary in the school nativity play.

As Christmas is fast approaching and this is the final Buttonwood of the year (and the last by this columnist), readers will perhaps forgive the sentimental segue into the rather less Christmassy topic of financial markets, where the questions on Buttonwood’s mind are: how can risky assets the world over be as expensive as they are? And are they likely to stay that way?

For reasons that will probably remain mysterious, financial markets turned on a sixpence a little over two years ago, on October 9th 2002. Having had their confidence shattered by a bear market—caused in large part by the popping of the technology bubble, a rash of corporate scandals, worries that many firms’ debts were much greater than they had admitted to, and the threat of terrorist attacks—confidence (and its handmaiden, greed) started to replace fear as the motivating force in financial markets. The world, it became clear, would not fall apart after all.

Moreover, many assets were historically cheap. Yields on emerging-market bonds, junk bonds and even some investment-grade corporate bonds climbed, and their prices correspondingly fell. Though still pricey by historical measures, shares, especially those connected in some way with technology, were certainly cheaper than they had been in March 2000.

They aren’t any more. In a successful attempt to stimulate risk, central banks around the world slashed interest rates. At the forefront of these efforts was the Federal Reserve, which cut rates 13 times between January 2001 and June 2003, to a niggardly 1%. At 3.8 percentage points, the spread of both emerging-market and American high-yield bonds over Treasuries is now less than the extra yield offered by American investment-grade bonds in the autumn of 2002. To the question of how much compensation investors should receive for investing in risky assets, Buttonwood has no pat answer. In 2002, it is clear, they were generously compensated. In December 2004, equally clearly, the rewards are too meagre.

But just how meagre? To be sure, the world has proved remarkably resilient in the face of war in the Middle East, the threat of terror, a high oil price, recently rising interest rates in America and a shaky dollar. Growth has been robust; indeed, according to the International Monetary Fund, this
latest recovery in the world economy has been the strongest in 40 years. Corporate profits have been growing at record levels in most rich countries. So, it should perhaps come as little surprise that corporate default rates have dropped precipitously and equities have been putting in a decent performance (though they have struggled a bit this year compared with last).

And yet it does come as a bit of a surprise to this columnist. Financial markets, after all, are meant to be forward-looking, and, barring a miracle—admittedly a possibility not to be dismissed lightly at this time of year—the prospects for the world economy look decidedly gloomy.

The biggest problem is debt, specifically the debts run up by Americans and their government. Though China has accounted for much of world growth in recent years, America and its spendthrift consumers are still the bedrock of the world economy. But they spend borrowed money. At 0.2%, their savings as a percentage of household income have been falling remorselessly for years and are now lower than at any time since the Great Depression. The government deficit is headed for the stars. The dearth of domestic savings means that America has to rely on foreigners: some four-fifths of the world’s float of available savings is consumed by America.

One consequence of this is an American current-account deficit that is now about 6% of GDP—and is starting to give investors the jitters. America has been lucky so far because it is able to borrow in its domestic currency. But the foreign-exchange markets are becoming decidedly nervous about the dollar. What would happen to domestic interest rates were there to be a run on the currency?

Presumably, inflationary fears would mount. Presumably, too, short-term interest rates would have to rise more sharply than the Fed would like—or markets now expect—to reward investors better for parking their money in dollars. Neither would make long-term Treasury bonds an especially alluring investment, at least not in the short term. Rapidly rising interest rates would not exactly be a boon for consumption either. How could they be when consumers are so indebted? The amount that Americans spend on servicing their debts is almost at record levels, despite low interest rates. It used to be that American consumers borrowed long term and at a fixed rate. In recent years, they have increased the proportion of short-term debt, thereby making themselves more vulnerable. Nowhere does this apply more than in the housing market, which, like housing markets in many other parts of the world, looks suspiciously frothy.

Expect, in that case, a sharp increase in bad loans, which would knock some of the wind out of America’s banks. Expect, too, an increase in corporate defaults and a fall in corporate profitability—not least because perhaps half of all corporate profits in America come from the financial sector, which has spewed out money in recent years thanks to benign economic conditions and the huge difference between short-term and long-term rates.

None of this is likely to cause many smiles on Wall Street. American investors have had to buy apparently turbo-charged assets because they save so little. Shares are admittedly not as expensive as they were—the average S&P 500 stock currently sells for about 18 times its per-share earnings, not that far above its historic average. But this is a time when you would expect that number to be lower and falling, because only a fool would expect the record profits of recent times to continue. With a rash of defaults looming, corporate bonds look even worse value.

What all of this means for markets other than America’s will depend in part on the speed with which it happens. If Wall Street falls with a thud, other markets are likely to follow suit. If, on the other hand, it deflates slowly, they may not suffer too badly. Emerging-market debt looks ridiculously expensive either way, though equities, especially in Asia, look better value. Indeed, many Asian markets are sufficiently cheap that they will be cushioned from the worst. They might—whisper it—even prosper.

That is about all the seasonal good cheer that Buttonwood has to offer, except to say thank you to those many readers who have written, even to those who have disagreed with every word. The column will return in January under new authorship. In the Meanwhile, have a happy Christmas.
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