

The search for yield and return – has it gone too far or is there more to go?

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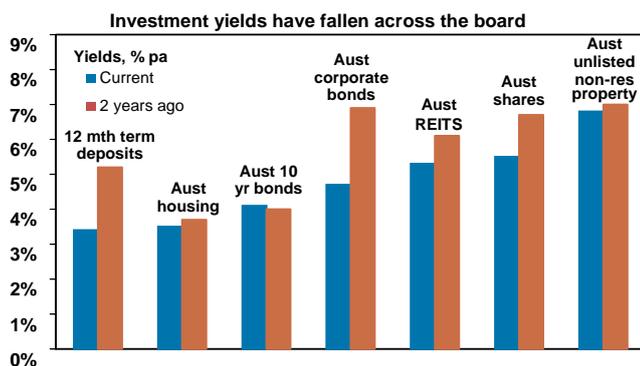
Key points

- > Helped in part by a search for yield various asset classes have rallied strongly, but it is doubtful that the rally so far has gone too far. Valuations remain reasonable, credit growth is not excessive and interest rates are likely to remain low for some time.
- > A range of assets continue to provide attractive yields relative to low cash and term deposit rates.
- > There is a case for those who can take on a bit more risk to consider a higher exposure to parts of the share market that have underperformed and yet will benefit as global and Australian growth picks up.

Introduction

The collapse in short term interest rates and associated fall in long term bond yields has seen investors seek out decent investment yield in assets as diverse as corporate debt, property, infrastructure and shares. And more recently this has broadened into a general search for higher returns as confidence in the economic outlook has improved.

When assets are in strong demand their price goes up and their investment yield (or the cash flow the investment provides relative to its price) falls. This is certainly evident over the last two years. The chart below shows the yield available on various assets today versus what they offered 2 years ago. Bond yields have increased slightly after earlier sharp falls. But the yield on all other assets have fallen, although – corporate bond yields excepted – not quite as much as the plunge in term deposit rates.



Source: Bloomberg, REIA, RBA, AMP Capital

But what's driving this chase for yield? Has it gone too far? If it has further to go what warning signals should we watch? And what does it all mean for investors?

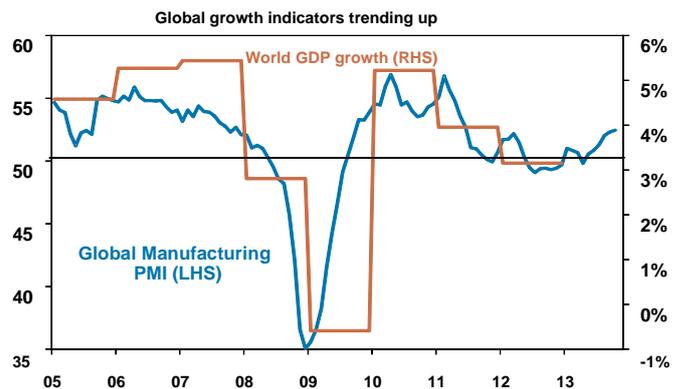
Drivers of the chase for yield

The search for yield, and more recently higher returns generally, is being driven by a range of factors:

- Low interest rates have pushed bank deposit rates down and bond yields are very low, all of which is encouraging investors into higher yielding alternatives;
- Reduced fear of an economic meltdown has helped investors feel comfortable taking on more risk. Initially, fresh memories of share market falls saw this concentrated on assets providing

high yields as this provided a degree of certainty that returns would be positive. Assets such as property, infrastructure or high income shares like bank shares in Australia all benefitted.

- However, as past sharp share market falls recede in time and are replaced by ongoing news of rising markets – and as indicators such as business conditions PMIs have started to signal stronger global growth – investors have started to focus more on shares for capital growth.



Source: Bloomberg, AMP Capital

- Finally, interest in yield is receiving a longer term push from the aging population. This started last decade as the first baby boomers moved into their pre-retirement phase and is intensifying now as they are starting to retire. This is driving demand for investments paying decent income in the form of dividends, rent, interest payments, etc.

Demographic influences likely have a long way to go. However, the first three drivers noted above are a normal cyclical phenomenon. In other words in the early stages of an economic recovery it's quite normal to see investors start to take on more risk by moving out of bank deposits as interest rates get lower and lower and the economic outlook brightens. Initially this focuses on investments providing a high yield given the certainty of return this provides but eventually investor interest moves on to growth oriented investments. In other words what we are seeing is nothing new. It's just more pronounced this time around because interest rates are lower than normal and GFC related share market falls have been deeper.

Moving out of bank deposits & taking on more risk is exactly what central banks like the Fed and the RBA want investors to do, because by taking on more risk this helps make capital available for investment in factories and buildings. And the rise in value of risky assets like shares and property helps boost wealth and hence spending. So nothing new here.

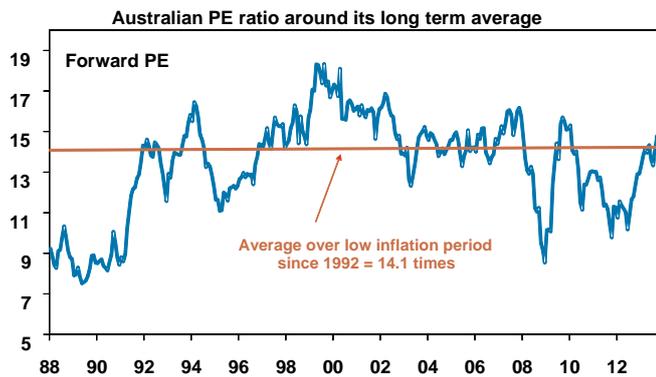
It should also be recognised that part of the rebound in asset prices reflects a return to normality as the risk of economic catastrophe gets unwound. This has seen the price to earnings multiple of shares return to more normal levels.

The danger, of course, comes when it all goes too far.

Has it gone too far?

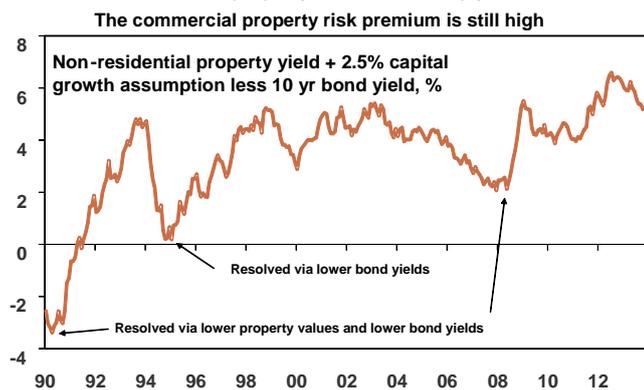
The typical investment cycle eventually sees the chase for yield and surge in asset prices pushed too far as rising levels of debt and overvalued asset prices leave investment markets vulnerable when central banks adopt tight monetary policy to head off inflationary pressures or other imbalances in the economy. Right now we are a long way from that point.

- First, while Australian house prices are bit extreme, asset prices generally are not. The yield available on Australian investment grade debt still offers a spread over that available on cash and term deposits. Share market price to earnings multiples have increased significantly over the last two years but only to around their long term average for Australian shares (see chart below) or to still below long term averages in the case of global shares.



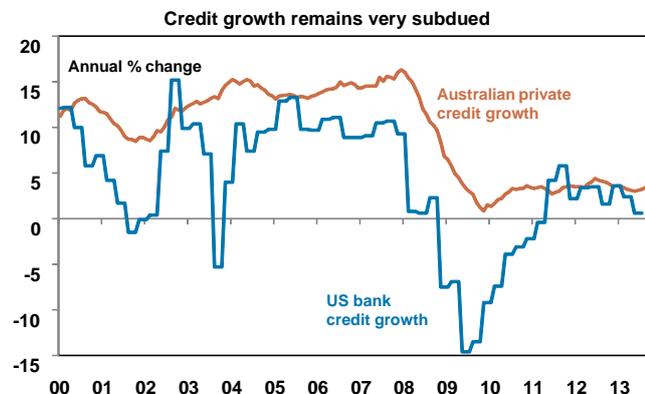
Source: Thomson Reuters, AMP Capital

The gap between the distribution yield on Australian real estate investment trusts remains above the negative levels reached in 2007, ie before the GFC. Unlisted non-residential property yields also remain relatively high such that commercial property continues to offer an attractive prospective return premium over bonds. In fact it is substantially higher than in the early 1990s & in 1997 after which property values fell sharply. See next chart.



Source: Bloomberg, AMP Capital

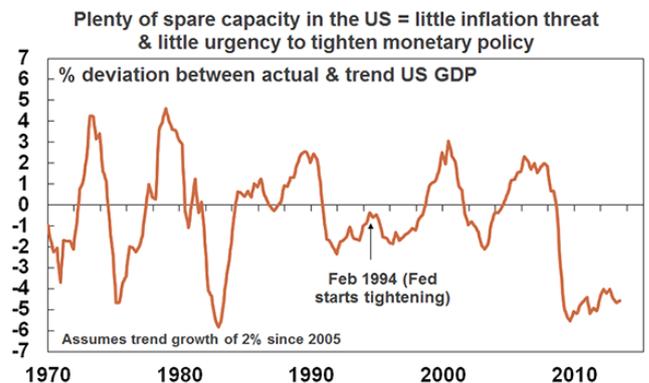
- Second, we are a long way from the sort of debt surge that was occurring prior to the 2008 global financial crisis. Credit growth remains very weak globally and in Australia suggesting little risk of another debt blow-up at present.



Source: Bloomberg, US Federal Reserve, AMP Capital

- Finally, while global growth is improving and the US Federal Reserve may soon start to slow its monetary stimulus program – possibly starting next month – a shift to tight monetary conditions looks to be a long way off. Inflation in the US, Europe and

Australia remains low at just 1.2%, 0.7% and 2.2% respectively. Moreover, spare capacity as measured by output gaps (or the difference between actual and potential GDP) remains significant suggesting little inflationary pressure ahead. As indicated in the next chart, the output gap in the US is a long way from where it was in 2007, just before the GFC. So interest rate hikes are still a fair way off. In fact rate cuts are still possible in Europe.



Source: Bloomberg, AMP Capital

In other words the chase for yield and returns has not pushed asset values to an extreme. It looks fine as long as interest rates remain relatively low and investment markets don't become too overvalued or geared. At this stage we still look to be a long way from that, suggesting the chase for better yields and higher returns still has further to run.

What to watch?

The previous section basically highlighted the three key groups of indicators to watch for signs that the chase for yield and higher returns has gone too far:

- Valuation indicators such as price to earnings multiples for shares, yield spreads for bonds and the return premium property offers over bonds;
- The rate of growth in private sector credit or debt.
- Indicators of inflationary pressure and hence future interest rate hikes.

So far so good, but they are all worth keeping an eye on.

What does it all mean for investors?

There are two key implications for investors.

First, while the yields and return potential across most assets have fallen following recent strong rallies, there are a range of assets providing more attractive income flows than available on cash and bank term deposits. These include corporate debt, real estate investment trusts, shares and unlisted non-residential property.

Second, with yield related investments having performed so strongly over the last year or two and bond yields likely to gradually trend up, there is a case for those who can take on a bit more risk to consider a higher exposure to parts of the share market that have underperformed and yet will benefit as global and Australian growth picks up, eg, resources shares.

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