In 1955, Federal Reserve Board Chairman William McChesney Martin, compared the Federal Reserve to a chaperone for the financial markets:

“The Federal Reserve ... is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up.”

There is considerable evidence that markets today are “misbehaving.” Yet there seems to be no chaperone ready to take the punch bowl away. Financial markets tend to exhibit dangerously bad behavior when valuations reach extreme levels. Real yields, as shown in Figure 1, are now at historic lows – and even these yields may be overstated. They are calculated by deducting headline inflation – which includes energy prices from nominal yields. Given the sharp fall in energy prices over the last two years, core inflation – which excludes food and energy costs – is generally higher than headline inflation. In the U.S., for example, core inflation is 2.3% while headline inflation is 1.1%. Using core inflation, real yields on 10-year U.S. Treasuries would be negative and therefore unlikely to attract long-term U.S. investors.

1 Address of Wm. McChesney Martin Jr. before the New York Group of the Investment Banker’s Association of America, October 19, 1955.
**The risks of lax chaperoning**

Ironically, it turns out that the central banks themselves – the supposed chaperones – have been encouraging the bad behavior that has driven yields to extreme lows. Having found a lack of “animal spirits” in their economies, they stimulated their charges with invigorating cocktails of nontraditional monetary policy to push down interest rates and boost their lethargic economies.

While this may work in the short term, it also carries significant negative consequences. First, mispricing in one asset class can spread to others. Price-earnings ratios, both globally and in the US, are high by historical standards, suggesting overvaluation for world equity markets (Figure 2). As of 31 August the forward looking PE for the S&P 500 index was 16.3 and for MSCI AC World it was 15. The histogram in Figure 2 shows these are noticeably above average suggesting potential overvaluation.

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**FIGURE 1**

Real yields for the U.S., Germany and Japan are at historic lows

10-year bond yields minus one-year headline inflation

(Yield %)

Source: Bloomberg. Real yields on US, Japan and German 10-year government bonds as of 7/31/2016.

**FIGURE 2**

Equity valuations are high vs history

Distribution of P/E ratios of S&P 500 Index (1990-2016)

Distribution of P/E ratios of MSCI AC World Index (2001-2016)

Past performance is no guarantee of future results. Source: Bloomberg; as of 09/15/2016; this data is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. See disclosure section for index definition.

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3 “Animal spirits” was a term used by John Maynard Keynes to describe the emotions and instincts that guide human behavior. “Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities.” Keynes, The General Theory of Employment, Interest and Money, 1936.
Some may argue these valuations are justified by the low levels of current bond yields, because equity prices can be interpreted as the discounted value of the future earnings of the companies issuing the equity. If bond yields are low, then the effective discount rate would be low and hence the “fair value” of the equity prices would be higher. In this sense, Figure 2 illustrates the potential degree to which bond mispricing has spread to equities. The risk is that if bond yields rise to more normal levels then equities would become genuinely overpriced and would potentially decline until P/E ratios settled at more normal levels.

Even if equity prices are “fair” for the moment – as long as yields remain artificially low – the situation is not reassuring. This is because distorted yields, as a result of lax monetary chaperones, risk causing significant misallocation of resources: Artificially low bond yields reduce a company’s cost of capital, thereby encouraging economically inefficient use of capital. Companies may continue to use obsolete inefficient capital equipment that would ordinarily have been scrapped in a higher cost of capital environment and invest in sub-par inefficient projects.

In a normal, higher-rate environment, such investments would not be undertaken because they would not meet the profitability hurdle rates. But using inefficient and obsolete capital equipment has significant economic costs, including lower labor productivity. Current low levels of U.S. labor productivity may well be an indirect result of artificially depressed bond yields. (Figure 3). Low labor productivity, in turn, has the negative consequence of making an economic recovery harder to achieve, a result that paradoxically is the exact opposite of the monetary authorities’ objective when they initiated extremely loose non-traditional monetary policy. The situation is made worse if wage rates start to rise as appears to have been happening recently. Companies are being forced to pay more for less productive labor. This is hardly a recipe for a robust economic recovery.

Worse, in addition to encouraging companies to use inefficient and obsolete capital equipment, unduly low bond yields may encourage entirely unproductive changes in capital structure if companies issue debt at very low cost and use it to finance buybacks of their equity. For example, in the U.S. buybacks have soared in recent years (Figure 4). This high level of equity buybacks helps explain why equities are trading at what appear to be exceptionally high PE ratios. It also encourages leveraged capital structures for corporations that may reduce the resilience of corporations in stressed economic conditions and raise the risk of bankruptcy over time.
Credibility: Key to effective central bank policy

A chaperone must have credibility if her charges are not to misbehave. Central bankers understand this. In a NBER Working Paper, Central Bank Credibility: Why do we care? How do we build it? Alan Blinder reports on a survey he did of 127 central banks. On a scale of 1 (“unimportant”) to 5 (“of the utmost importance”) the mean score of central bankers in the survey when asked about the importance of “credibility” was 4.83. In Blinders’ view, “central bankers accept the notion that greater credibility improves the short-run inflation-unemployment tradeoff.” That is to say a “credible” central banker would be able to reduce unemployment with lower inflation than a central banker who was not credible.

In Blinder’s survey, the highest score was given to having a “history of honesty.” In other words, “a history of doing what it says it will do.” Given that, since 2008, central banks from the Fed to the ECB and the Bank of Japan have said they want inflation to hit 2%—and have consistently missed this target—it’s not surprising that central bank credibility is at a low point.

Unable to achieve that target inflation rate, central banks appear to have shifted to a new tactic for achieving credibility: transparency. Central bankers are lining up to give their views. In the last month, we have heard from virtually all key members of the Federal Reserve Board. This wouldn’t be a problem if they all had the same message, but unfortunately they’ve been contradicting each other.

President Eric Rosengren of the Boston Federal Bank suggested on September 9 that he felt interest rates are set to rise because waiting too long creates the risk that some asset markets may “become too ebullient.” The MSCI World Index promptly dropped almost 2.5 percent. On Monday, September 12th, Federal Reserve Governor Lael Brainard said that the Fed’s caution on rates “has served us well” and that in the current environment, “the case to tighten policy preemptively is less compelling.” Markets recovered.

In terms of building credibility, transparency ranked low in Blinder’s survey. At critical moments, transparency can be harmful (it’s as if Julius Caesar had expressed doubt about the validity of crossing the Rubicon with his troops just before he marched). Central bankers used to be known for holding information tight until the moment of an announcement. But in their quest for credibility, they have been far less secretive and may be erring too much on the side of transparency. By providing too much insight into their thought processes, they are confusing the markets.

Low-credibility central bank chaperones are most prevalent in the developed markets, which appear overvalued and are trending toward higher core inflation and higher growth.

U.S.: From uncertainty to volatility

With clearly mispriced bond yields and a reasonably healthy economy, the United States is getting to a point where yields probably need to go up. But because of this lack of central bank credibility, there’s confusion about when the “punch bowl” will be taken away. When the central banks finally do so by raising rates, which could be very soon, the confusion could lead to significant volatility.

Europe: Draghi losing credibility

ECB President Mario Draghi started off with a healthy store of credibility, thanks to keeping the eurozone together in 2012 with a single remark, pledging to do “whatever it takes” to save the monetary union. But his credibility as a chaperone of stability has declined. The market expected him to extend quantitative easing last week; when he didn’t, it started dropping. The lack of clarity has had a destabilizing effect on global markets.

Japan: Let’s see what else we can do

The Bank of Japan has promised to issue a complete review of their monetary policy, which again reduces the credibility of central banks. In effect, they are saying, “It looks like our policy isn’t working any more, let’s see what else we can do.” And this has affected Japanese bond yields: the 30-year bond yield has started to move back up as a result.

Emerging Markets: More insulated

Once interest rates do move higher, emerging markets will undoubtedly experience volatility; however, they are likely to recover more quickly. Because their bond yields are less directly tied to those of developed markets, they are somewhat insulated from rate increases in the developed world. Many of their currencies are still significantly undervalued relative to purchasing power parity, which means they may not be as vulnerable to a rise in interest rates as they otherwise might be.

- **Latin America**
  Growth in developed markets will give a boost to emerging market exporters, who rely on demand from abroad. Latin America, though, more volatile than other emerging markets is a likely beneficiary.

- **China and Emerging Markets Asia**
  As long as China remains in reasonably good condition, which appears to be the case right now, the emerging markets in Asia appear

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5 Ibid, p.15
attractive. In China’s “socialist market economy,” the central bank’s role is different from those in capitalist nations. The Chinese government as a whole, rather than an independent central bank, is the chaperone of the economy. If the government wants to finance an industry, it can simply funnel money from the Bank of China, through the banking system, to the target industry. Without market discipline about productivity and investments working, resources will be misallocated and the government will continue to build things that don’t really make sense, but those problems will likely come in the long term. In the short term, the government is effective in keeping the economy ticking and people working.

• Eastern Europe, Middle East and Africa
  We are still cautious on Eastern Europe, Middle East and Africa, primarily because the region is dominated by a troubled Russia. Poland and other individual nations are in reasonably good shape, but oil prices are too low to finance Russia’s global ambitions. The Russian population is feeling the brunt of the shortfall, and their economy is not going to improve until something changes. Turkey and South Africa, two other big players in the region, also are suffering from political instability.

Fixed Income: High yield bonds may offer a cushion
  In the fixed-income arena, high-quality bonds – including investment-grade corporate bonds – are the most vulnerable to an upturn in rates. Lower-rated high-yield bonds often prove to be the most robust in periods of rising rates because they have a yield advantage. The best kind of environment for high yield usually is one of modest economic growth, when risk of default is relatively low and interest rates are stable. And if the underlying economy is in good shape, there is no reason for credit spreads (the differential between investment-grade and high-yield bonds) to increase drastically. The flip side is that when investors get nervous, as they might when rates rise, they sell high yield bonds. Overall, though, we believe the high-yield sector is in better shape than the high-quality sector, where the majority of mispricing has occurred.

Conclusion: Looking for a firmer footing
  Lax chaperoning by central banks across the globe – including too much stimulus, a hesitation to withdraw it and a failure to set clear expectations – has contributed to generalized market anxiety. When the punchbowl is finally removed, market participants may suffer a hangover in the form of higher market volatility.

  With the underlying global economy in reasonably good shape, though, the hangover could be brief. And, for those with cash on the sidelines, an interim selloff would present an opportune time to get back into the market. Ultimately, the volatility is likely to result in a much-needed correction in mispriced bond yields and set a stronger foundation for future market gains.
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Headline inflation is a measure of the total inflation within an economy, including commodities such as food and energy prices (e.g., oil and gas), which tend to be much more volatile and prone to inflationary spikes.

Core inflation is a measure of inflation which excludes transitory or temporary price volatility as in the case of some commodities such as food items, energy products etc.

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