Bond spree slowing, brace for a bumpy ride on equities front

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Investments expert John Nolan says equity markets are entering a period of increased volatility as expansionary monetary policies around the developed world are wound back.

Nolan said it was impossible to predict the consequences of the end of so-called quantitative easing programs.

"Quantitative easing drove the price of every asset and the end of that will have similar consequences," he said.

In recent months, the US central bank has been scaling back its bond-buying activities, commonly referred to as quantitative easing, and is expected to halt buying altogether before the end of the year, ahead of possible interest rate increases next year. Last month New Zealand's central bank became the first major developed nation to increase its key interest rate from record lows. Most local economists are now expecting official rates to rise in Australia over the next 12 months.

Nolan, managing director of Warakirri Asset Management and a member of the investment committee of top-performing industry fund REST, said the possibility of a 50 per cent swing either way in equity prices was "higher than history would suggest" because of the winding back of the unprecedented stimulus.

Two years ago, Nolan was more upbeat about the prospects for equities because of expectations at the time of a sustained period of record-low interest rates.

In August 2012, Nolan was quoted as saying equities could rise 30 per cent. "I think there is a massive mis-pricing between equities and fixed interest today," he was quoted as saying.

It wasn't a universally held view at the time. "A number of prominent Australians were saying buy fixed interest, not buy equities, I had a contrary view. I have been around the market and know the time to get excited about equities is when everyone else is saying not to buy them."

Since August 2012, Australia's S&P/ASX 200 Index has risen 32 per cent and Nolan says the market re-rating has now "significantly taken place".

Nonetheless, the extended period of record-low interest rates engendered some perverse outcomes.

Nolan noted that an extended period of low interest rates typically engenders a rash of corporate mergers and acquisitions, which can be good for equity investors. It does not seem to have happened in this instance - perhaps because companies have been too "fearful". Nolan says some structural challenges lie ahead for the Australian economy, for instance the pricing of key export commodities such as iron ore moving back towards its marginal cost of production.

"You won't always be able to make a high ROE [return on equity] by digging iron ore out of the ground. It's not a sophisticated process."

Nolan also says the pricing of housing in major Australian cities has been distorted by investment out of China.

"It might be rational from their perspective but it's hard to make the numbers look sensible from an Australian perspective."

He noted that asset price booms in Australia had historically been accentuated by monies flowing from foreign capital markets. The latest boom in house prices is seemingly no different.

These days Nolan spends much of his time championing the importance of focusing on after-tax investment returns.

He says that for too long retail investors were denied the opportunity to assess managers' performances with a view to their own tax circumstances.

"Pre-tax returns are not that relevant to what investors end up with in their pocket," he said.

In July 2007, Warakirri introduced unique after-tax benchmarks to measure the performance of its own funds. These days Warakirri measures the performance of more than $40 billion worth of Australian equities across almost 100 portfolios on an after-tax basis for a variety of clients.

Stewart Oldfield is a research analyst at Wilson HTM. Opinions expressed in this article should not be construed as personal advice.

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