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THE LAST WORD

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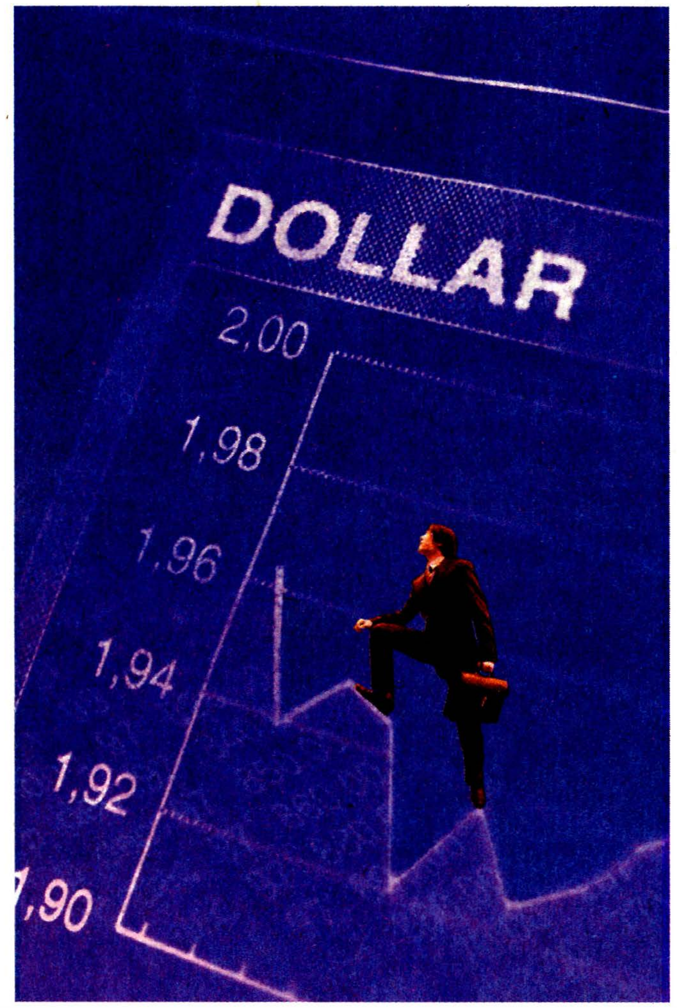
Forecasting the future: Where are stocks headed?



EVERY now and then, people ask me really hard questions, like these four about the stock market:

Question 1: Are today's stock prices too high?

Answer: No. They are about right. Most stock markets are within 1 per cent of their all-time highs. That includes the US, most of Europe, China and Singapore.

Does it mean stocks are over-priced? Or are they on their way to even higher highs? Keep in mind that stock indices usually don't just hit one new high and then retreat. On average, they keep going and hit four more highs before pulling back for a correction.

Question 2: The world's interest rates are sitting at all-time lows. How important is that?

Answer: It explains everything. It means there are fewer places to go to find a decent return. Most investors have given up on low-risk investments since they yield practically nothing. They have shifted to higher risks and returns, like shares and property.

Since the Great Depression in the 1930s, we have always had the choice between low and high-risk investments. Low-risk investments are mostly bonds, which have returned from 3 to 10 per cent over the past 75 years.

Those rates are now zero and sometimes negative. US rates are key since it has 50 per cent of the world's assets, and its benchmark rate for 10-year US government bonds is at an all-time low of 1.9 per cent. The lowest short-term US rate has remained at 0 to 0.25 per cent for the past six years.

The next important region is Europe, where most economies are doing less well and interest rates are the lowest in the world. Europe's biggest economy, Germany, pays only 0.1 per cent interest on its 10-year government bonds. A dozen European countries have interest rates that occasionally dip to become negative. Switzerland and Denmark, for example, are at minus 0.60 and minus 0.75 per cent.

Here in Singapore, our interest rates have risen but not much. Fixed deposits at major local banks, like DBS, are 0.25 per cent for a 12-month FD. OCBC is an exception and has a promotional rate of 1.4 per cent for a 12-month FD. Foreign banks still pay the most, like 1.6 per cent at Bank of China.

These low rates generate little excitement. Even our highest fixed deposit rate of 1.6 per cent means you have to wait one year to earn $16 on a $1,000 deposit. It's not much.

No wonder many have given up and said: "Phooey. I'll take my chances with the stock market. Fluctuations are greater but at least there is a chance of earning a decent return, like 10 to 15 per cent."

This explains the shift of trillions of dollars from safe to risky investments, which has pushed world stock prices to all-time highs.

> *Quick***Quote**
>
> **"Always borrow money from a pessimist. He won't expect it back."**
>
> Oscar Wilde, playwright, 1854 – 1900

Question 3: Does it mean since there is a good reason for stocks being at all-time highs, they are not over-priced?

Answer: Exactly.

Question 4: Aren't interest rates rising? If so, doesn't it mean the ridiculously low rates we now have will no longer hold up stock prices?

Answer: Yes, that is correct IF interest rates really rise. But it's not happening everywhere since many economies remain in the doldrums. To fight that, central banks are holding interest rates down or cutting them further.

Low rates make business investments cheaper. More importantly, especially for exporting countries like Singapore, low rates make it less attractive to buy that country's debt, so foreign money stays away. That reduces demand for Singapore dollars, lowers the exchange rate and reduces the price of everything in the country. This boosts exports, reduces imports and drives GDP higher, which is the goal.

At the moment, there is a "race to the basement" as many countries compete to weaken their currency. It is especially true in Europe and Asia, but not in the US where the economy is finally recovering from the 2008 recession. US interest rates are rising and money is flowing into the US to grab higher yields, which is pushing up the US dollar. The US Central Bank is making no effort to stop it.

Look for the low interest rates worldwide to keep stock prices high. The exception may be the US where rising rates could lead to a stock market decline.

But even there, it might not happen since the increase in interest rates has been "about to happen" for the past three years. So far, nothing. US base rates are still at 0.00 to 0.25 per cent, where they have been for the past six years. It means the US stock market's all-time highs may still be justified.

The other thing supporting stocks is that risky assets always return more than safe ones. In the long run, stocks will always return more than bonds. Research from Wharton professor Jeremy Siegel showed that stocks have always out-performed bonds over any 30-year period during the past 200 years.

Stay invested.

An adjunct professor at SMU, Dr Haverkamp contributes this column weekly to help our readers understand money matters better.