MoneyNews

Markets Are Sprinkled With Lots of Fairy Dust

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Financial markets sure did well in the first half of the year, despite an unexpected share of economic disappointments, policy misses and geopolitical drama. They will need better news in the next six months to sustain that performance, and if they succeed it is unlikely that they will repeat those same, broad-based gains.

At the start of the year, few expected the U.S. economy to shrink by a stunning 2.9 percent in the first quarter, Russia to annex Crimea, and Iraq to fall victim to a sectarian insurgency — all of which served to amplify the challenges facing already-weak economies.

More predictable was the series of policy slips such as disappointing progress on Japan's "third arrow" reforms and a persistently unbalanced macroeconomic stance elsewhere that relied excessively and for too long on monetary tools alone.

Yet you would be hard pressed to point to many markets that suffered any meaningful consequences. Rather than sell off, global equities have gained, as have corporate bonds, commodities and emerging-markets securities.

Historically, such broad-based gains would suggest that the global economy is improving. Not this time. Instead, analysts spent much of the first half not only lowering their growth estimates for 2014 but scaling back their assessment of even longer-term growth for a number of countries — including the U.S.

The answer to this puzzle is found in yet another asset class that did well in the first half — government bonds,including those issued by Germany and the U.S., the benchmark risk-free assets. The fact that government bonds rallied in the first half of the year speaks to the continued influence that central-bank policy wields in financial markets.

Motivated both by long-standing concerns about sluggish growth and newer worries about price deflation, the European Central Bank joined others in committing to a more stimulative monetary policy over a longer period of time.

In addition to loosening credit and monetary conditions, this put to rest the notion that the

Federal Reserve's gradual exit from quantitative easing (its large balance-sheet expansion program) signaled the immediate end of central-bank support for markets.

Instead, central banks effectively signaled a willingness to prolong their multiyear quest to boost asset prices and suppress market volatility, amplifying the effects of lower structural growth and weaker inflationary forces. No wonder the private sector is also keeping the party going by loosening credit — illustrated by declining lending standards, eroding bond covenants, surging mergers and acquisitions activities and an increasing appetite for debt and leverage.

With central banks continuing to be a large part of the explanation for the wedge between asset prices and the underlying fundamentals, many investors feel that they are in a win-win situation: Either the unconventional policies of central banks will prove successful in achieving economic liftoff or these institutions will have to sign up for even more and longer support of the markets.

As investors continue to bask amid this comforting monetary-policy landscape, they shouldn't be so foolish as to dismiss too quickly this weekend's blunt warnings from the Bank for International Settlements, commonly known as the central bank of central banks. The BIS described the current environment as worthy of caution, like all "financial booms [that] sprinkle the fairy dust of illusionary riches."