

## As a general rule, high risk is associated with high reward.

But not always: sometimes high risk induces calamitous loss; the trick is knowing when!

Asset valuations are rising rapidly.

Global equity markets rose again last week. They may have begun the first quarter nervously, but they ended it confidently. Tokyo was the star performer: up 5½% over the three months. London, with a 5%, advance was not far behind—though its surge was largely a reaction to the pound's 2009 slide.

It's the consequence of liquidity . . .

What drove the appreciation? Excess liquidity, of course. Central banks created the cash and investors were unable to resist the temptation to use it to acquire longer-term assets. There'd been a few commentators who were cautious at the turn of the year, but the sustained levitation in valuations subsequently was sufficient to convert all but the most intransigent of them.

. . . rather than fundamentals.

Analysts and economists, like investors, donned rose-coloured spectacles as the quarter passed: their forecasts seemingly driven more by the momentum of the indices than the fundamentals of the data. The reality may have been that economics activity and earnings per share quickened only slightly, but the popular prejudice was that both were advancing exuberantly. Gloom was dismissed; euphoria reigned.

Equities are faring best, but other asset classes are also rising.

Nearly all asset classes were lifted by the rising tide of sentiment (and liquidity). Bond prices climbed impressively, for instance. Investors were unfussed by huge increases in Government issuance, and enthused by continuingly low rates of inflation.

Bonds impressive; commodities likewise.

Commodity valuations also picked up. China decided to create strategic stockpiles—and, in doing so, drove up prices. Speculators elsewhere in the world were quick to jump on the bandwagon.

Amazingly, property too made ground!

Even real estate valuations, so great was the magic of liquidity, edged ahead. It didn't matter that the number of empty properties was high and rising. Nor that rents were low and sliding. Liquidity burned holes in investors' pockets: nobody could resist the allure of the prospective capital gain.

The advance is likely to continue as long as credit stays expansive.

Will the trend continue? For the remainder of 2010, it may. The world's major central bankers (the Fed, ECB and BOJ) won't be eager to tighten credit conditions until economics growth is thought to have become self-sustainably brisk. They'll acknowledge that it'd be better to raise interest rates later than earlier: preferable that inflation be faster than recession deeper.

And that'll be the case as long as economies are dull.

But what if anaemia should turn to debility? Will liquidity gush even faster?

Not if history is anything to go by. Central bankers tend to tighten at the worst possible time.

At the top of the current cycle in 2011?

Prior to that, investors might sensibly become more wary.

Crystallise gains this year and don't play next year.

But what if this cycle weren't capable of producing satisfactorily brisk growth? What if, even at its peak, the rate of progress were to be unacceptably slow—implying that, at the next trough, it would become substantially negative again? Would central bankers, in that event, dare pursue monetary orthodoxy? Would they forget exit-strategies and focus on the world as it was rather than as they would have it be?

Nobody knows. Hitherto, they've been assuming an imminent return to economics "normality." They've not (in public anyway) considered the possibility of protracted debility. If the worst should occur, however, (the critical period being 2011) it's likely that policy would for a while become even looser—the authorities trying desperately to revive sentiment.

The problem is that very accommodative credit, set in the context of very dull economics, may induce financial misbehaviour again. The "respectable" parts of the commercial and financial community would not be able to absorb the liquidity, and "disrespectable" parts would emerge to do so instead. That's what happened in the States in 1929; in Japan in 1989; and in the States again in 2007! And, on all three occasions, though it wasn't part of their mandate, the central bankers hiked interest rates to re-impose financial probity. They judged that the benefits would outweigh the costs. Dozos!

Will they make the same mistake again? Nobody knows. But it'd be foolish to discount the possibility of their triggering another calamity. What they say is mostly banal. What they do inspires no confidence.

Perhaps, therefore, investors should ride the bull only during 2010. In 2011, when the cycle is due to peak, it might be sensible to be cautious, to take some money off the table. It's possible, of course, that the authorities would respond to an economics deceleration with an intensification of the monetary relaxation. But it's possible as well that they'd tighten in a fatuous attempt to forestall impropriety.

The losses consequent upon the latter response would be much greater than the gains from the former. So, it'd be right to sell some stock, or buy a put, or write some calls. Not until 2012 is it likely that the smoke will have cleared; not until then will investment strategy become a little easier.

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