OPINION | Feb 17 2017 at 4:00 PM | Updated Feb 17 2017 at 4:10 PM

Central banks 'have been asleep at the wheel', says Schroders Investment's Conlon

The "great moderation" is bollocks, Schroder Investment Management's Martin Conlon says. **Nic Walker**

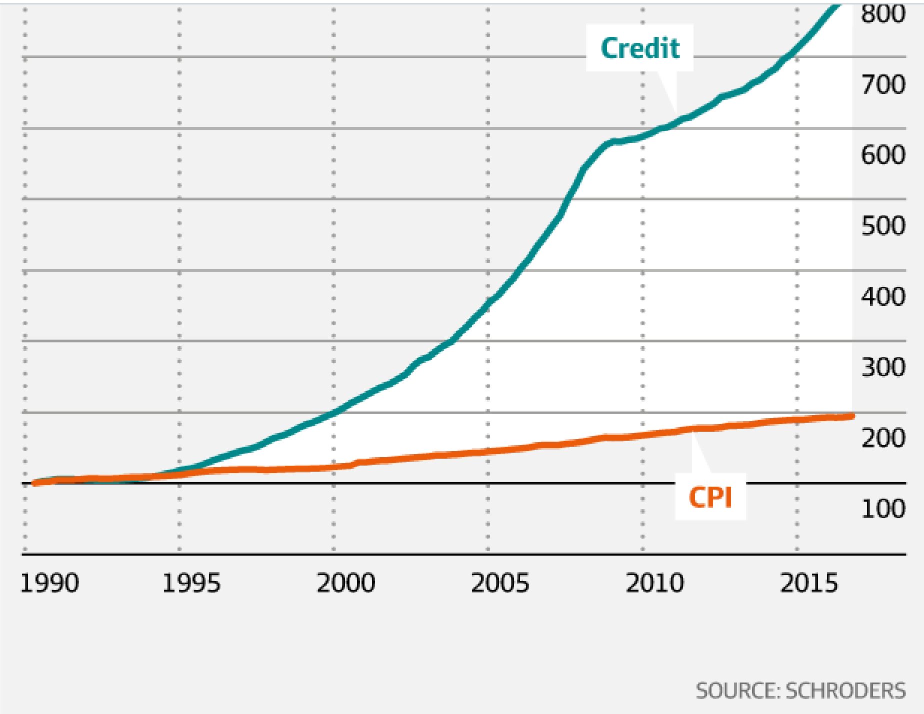
by **Patrick Commins**

Martin Conlon reckons the so-called "great moderation" of the past two decades is, not to mince words, "bollocks". And investors need to wake up to that fact if they hope to get anything out of the local sharemarket in the coming years.

At this past week's Portfolio Construction forum in Sydney the head of Aussie equities at Schroders Investment Management told a packed auditorium that "we have been sold down the river" by central bankers who "have been asleep at the wheel for 25 years".

This may all sound like old hat to you, but it's worth taking that little trip down memory lane to appreciate where Conlon is coming from and why it still matters now.

It was once common currency that central bank mathemagicians had tamed the business cycle. The developed world was growing at a solid and stable economic growth, and those damaging inflationary outbreaks were a thing of the past.



The GFC came along and exploded that conceit. Rather than fostering stability, low rates had fed a massive run-up in debt that, via the US housing market and helped along by dodgy lending and misincentives, almost crashed the world's financial system.

But instead taking a new tack, central bankers doubled down via quantitative easing and pushing rates to zero and below.

Conlon's biggest bugbear is how this has happened thanks to the narrow definition of inflation as the movement in a basket of consumer prices. CPI growth has indeed been low and contained for many, many years.

But he finds it "anomalous to say the least" (read: bollocks) that we can say that building material prices going up is inflation, and is therefore bad, but you put them all together in a house, and when the price of that goes up, it's good.

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For Conlon you're better off looking at money supply, and credit growth in particular. As he says, if you pump more money into the system, it either turns up in LED TV prices, or it turns up in house prices. The point is, it turns up somewhere. But, again, while the former is inflation, the latter is not.

Look at the RBA's measure of inflation, indexed to 100 from 1990. This has broadly doubled, as the chart shows. Now look at the index showing the amount of credit in the system over the same period – it's up eight-fold. These, as Conlon says, "are pretty different numbers".

"In my opinion inflation has been double digit every year, it's just how you define it."

Why does all this matter? Because when you look at price appreciation from broader perspective, you start seeing the market through a different lens and "you get a very different answer as to how you should invest", Conlon says.

The environment of lower rates and higher debt has had a "huge impact on the sorts of businesses you own, and who's done well", he argues. Again, this might not sound like a new theory – but after all of that financial asset inflation, "we sit here with our highest ever weight to bond sensitives in Australian equities", Conlon says. "And this is broadly the case for most places around the world."

The second chart shows how this massive run-up in credit and drop-off in rates has manifested itself in the Aussie sharemarket. The winners of the past 25 years are stocks that "are exactly like bonds", Conlon says, including financials (predominantly the banks), utilities, telcos, IT, property and healthcare.

through a traditional sectoral one.

"The businesses we like most are the ones that haven't seen that inflation over the past 20 years," Conlon says. "If you have been selling building materials, your revenues have not been growing at anything like the same pace as CBA's."

Resource richness

It's for these reasons that Conlon has been betting on resources for the past two years – a bet that has only come off over the past 12 months, over which time the Schroder Equity Opportunities Fund has generated return of 34 per cent, after fees.

He still likes miners like Rio Tinto. In recent years resources companies have suffered through the usual commodity price cycle peaks and busts and now have low debt and mines and equipment that are in reasonable condition.

At the other end of the scale are what he calls the "defensive industrials", companies like Sydney Airport that have used their "purportedly" stable cash flow streams to borrow and boost dividends through an era in which investors have been obsessed with yield.

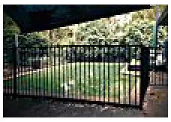
"The primary drivers of [Sydney Airport] are exactly the same as what drove your bond portfolio," Conlon says.

"Most problematic" for Conlon and his team are the big banks. Whether we like it or not, they make up a massive part of the sharemarket, he says, suggesting that his team feel the need to include them in their portfolio (CBA is in there).

In valuation terms, Conlon says, they are cheaper than those defensive industrials, but more expensive than resources. But they have obviously been massive beneficiaries of the "great moderation", which makes Conlon "incredibly cautious" about recreating their index weight within a portfolio.

After surveying the history of banking crises, he notes that analysts and economists consistently failed to appreciate how damaging a sharp correction in house prices can be.

"No-one has overestimated how much they'd lose."



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