Nightmare scenario

Alan Kohler looks for an upside to world disasters

THERE ARE JUST TWO THINGS investors need to watch at the moment, apart from what's going on in the specific stocks they own, and if you say these two things quickly enough it seems pretty simple. They are: energy and interest rates. Two things, three little words, but a whole world of complications and troubles. And now the Japanese tsunami has made what was already complicated and troubling even more so.

Before I look in detail at the parts of these two icebergs that are under the water, I want to repeat something I heard my friend Roger Montgomery say at a conference the other day. "Volatility represents opportunity, not risk," he said. Wise man, Roger. In other words, big moves in the market, up or down, are usually – not always – irrational and therefore opportunities to buy or sell. That was true of the October 1987 crash, and of the US market after the internet crash of 2000, although you had to wait three years before buying.

It wasn't true of the Japanese market after the 1989 crash. After the initial 50% collapse in 1989-90 it just kept trending down. And that's the context of the 20% fall in the Nikkei index in the days after the tsunami: the Japanese economy was already the most fragile in the developed world. Share investors were bitterly disillusioned and it would have taken a lot less than $US100 billion worth of earthquake and tsunami damage and several nuclear power stations blowing up to send them back into bonds.

As I write, the jury is out on whether initial panic selling was irrational and therefore a buying opportunity. There remain diametrically opposed views on this. We will only know once the aftermath is clear from the complex set of effects on power generation, insurance, the building industry, government finances and, perhaps most importantly, the national psyche.

But back to energy and interest rates. Before Japan there were two big events shaping global markets: unrest in the Middle East and the US Federal Reserve's program of buying bonds and other fixed interest securities called "quantitative easing" (QE). There was QE1 in 2009-10 and late last year QE2, another $US600 billion worth of cash handed over to banks and other financial institutions in return for, first, their mortgage-backed securities, and then their government bonds.

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The Fed now owns $US2 trillion of this stuff and the cash created from thin air to buy it has pumped up the markets. When QE1 ended last April, and before QE2 was foreshadowed three months later, the global share index fell 16%. It then rose 30% in six months, inflated by the Fed's liquidity.

In February the US economic recovery looked strong enough for QE2 to be the end of the "money printing". QE2 ends in June and markets are listening carefully to Fed chairman Ben Bernanke for what follows.

In February there was plenty of optimism about the US economy, so, as usual, this led to a sell-off in the sharemarket as investors thought it would be the end of loose monetary policy. Now some people expect a third round of QE because it's thought the Fed will want to ensure the disaster in Japan will not disrupt the recovery.

The European Central bank (ECB) was fairly clear at the beginning of March that it intends a new cycle of rate hikes. This may now also be delayed, maybe even until 2012. In Australia, after the floods and growth slowdown, there is considerable debate about rate hikes. Most market economists think there will be at least one, maybe two, but I'm not so sure. I think rates may be on hold for the rest of the year.

Before civil war in Libya, and the shutdown of most of its oil production, the oil price was already above $US95 a barrel because of fundamental demand and supply. Peak oil has been passed, output is in long-term, inexorable decline. Meanwhile the developing world, led by China, is increasingly hungry for it.

Then Saudi Arabia intervened in Bahrain and things became even more volatile and unpredictable for oil. And then the Fukushima nuclear facility in Japan blew up. Suddenly nuclear power doesn't look as viable an alternative to fossil fuels as it did a month ago. Thinking about the complexities of energy politics and global monetary policy at the moment is truly a nightmare, but as Roger says, volatility usually presents opportunities.

Alan Kohler is publisher of Eureka Report (eurekareport.com.au) and Business Spectator (businessspectator.com.au).

JOHN TIEDEMANN