
High Valuations Carry a Cost: Prudential

By Kerry Pechter Thu, Jan 8, 2015

"When rates rise, something always breaks. There's no telling what asset class may start the ball rolling, but it can't come as a surprise," said Quincy Krosby, a Prudential market strategist, at the firm's 2015 Global Economic and Retirement Outlook presentation.

The U.S. may be addicted to low interest rates, relying on them to prop up asset prices and feeling nervous about the potential pain of withdrawal. But at least industry executives are not entirely in denial about the problem. A new release from Prudential Financial speaks candidly—and soberly—about it.

The release reflected views expressed by panelists at the firm's 2015 Global Economic and Retirement Outlook discussion. They expect "uneven" global growth, "prolonged volatility" and a continuation of the status quo in the stock and bond markets as long as interest rates stay low. (The quotes below come from the release.)

"Bond yields have stayed low after the end of quantitative easing for a simple reason: bond demand is very strong, and bond supply is modest. Strong demand and modest supply means high prices in any market, and leads to low yields for bonds," said Ed Keon, managing director of Quantitative Management Associates, Prudential's economic research unit.

"In the short run, stocks can continue to perform well as low interest rates support higher-than-normal valuations, but higher valuations carry a long-term cost," he warned. "Eventually expected returns of stock and bond portfolios might be lower than historical norms, creating challenges for many investors."

The chief investment officer of Prudential Fixed Income, Mike Lillard, agreed with the conventional wisdom that Fed chairperson Janet Yellen isn't likely to raise rates suddenly or sharply and will be guided by data on the strength of the economy.

"June would be my liftoff date for a rate hike from the Fed, but they will do it very slowly and patiently. If the economy begins to soften, however, they will stop to avoid sending us into another recession," said Lillard. "They are going to be highly data dependent, and at the end of the day, our expectation is that they won't be able to get short term rates very high."

Quincy Krosby, a Prudential market strategist, warned that the recent slide in oil may not be as beneficial as Fed members make it out to be. “While consumer spending may have increased in the United States, the Fed needs to worry more about what lower energy prices mean globally. It could be signaling a decrease in demand in places like China, Europe, and Japan, which could lead to decreased production and job cuts in the energy sector,” said Krosby.

“Taking that into account, the Fed also has to keep in mind that when rates rise, something always breaks. There’s no telling what asset class may start the ball rolling, but it can’t come as a surprise. That said, it has been the velocity of the oil price plunge that caught markets off guard. Consumers, however, are net beneficiaries of lower prices.”

John Praveen, chief investment strategist for Prudential International Investments, cautioned that divergent monetary policies from central banks are likely to lead to volatility in the coming year and that current and future geopolitical risk cannot be dismissed.

“The start of quantitative easing in Europe and possibly Japan will allow for greater expansion in those markets compared to the United States, yet any unforeseen risks could derail that proposition,” Praveen said. “Europe was supposed to be on an upswing in 2014, but [Russian President Vladimir] Putin’s actions held any potential rally in check. With such interconnected global economies, any geopolitical or major risk can hold everything back.”

Sri Reddy, head of full service investments with Prudential Retirement, suggested that a prolonged low-growth, low-yield environment might even present a silver lining for his division—if it encourages defined contribution participants to start thinking outside the box for retirement income solutions.

As participants look for new options, “things like automatic enrollment plans, auto escalation options, and enhanced defined contribution plans need to become more of an industry norm to secure retirement income for today’s workers,” he said. Prudential Retirement sells a product that would fill the bill: IncomeFlex, a series of target date funds for the defined contribution plan market that come pre-wrapped with lifetime income riders.