

2009, was just 3.1% by the end of 2010. Moody's expects it to fall further this year to 1.9%, the lowest in two decades. High-yield strategists predict that 2011 will be a solid year, with returns of 8-10%.

Optimists also point out that spreads over Treasuries, which investors care about more than absolute interest rates, are near their historical average and double their pre-crisis lows. Using a model that crunches default risk, credit availability and other measures, Martin Fridson, a veteran junk-watcher at BNP Paribas, deems the market pretty fairly valued. "Whatever the future may hold, pundits who are bear-

ish on high yield cannot justify their stance on grounds of valuation," he asserts. "Given where the fundamentals are, the spread is actually a touch more than it should be."

Perhaps, but risks lurk. Investors should worry about the loosening of bond covenants (restrictions that borrowers accept on leverage and the like) over the past year—an echo of the frothy days of 2006-07. Novelis negotiated an "extremely attractive" package that gives it more flexibility in some respects than it would have had before the crisis, says Mr Fisher.

Some strategists are telling clients to shift into equities, which tend to outper-

form corporate debt in economic expansions, not least because acquisitive firms bid up targets' share prices. And if the recovery stumbles, so might junk bonds. A deepening of the euro crisis could push high-yield default rates back above 6%, reckons Moody's. Jim Casey, co-head of leveraged finance at JPMorgan Chase, the leading underwriter, sees no bubble but admits that "the opportunities have diminished in recent months and the risks have grown."

Some see higher interest rates and inflation as the big threats. As rates rise, older bonds with lower coupons are worth less ▶▶

Buttonwood | Worlds apart

Two contrary views on the outlook for markets

Goldman Sachs vs SocGen

INVESTORS could visit two very different worlds on January 17th, provided that they worked in London. In the morning Goldman Sachs held its global strategy conference in its Fleet Street offices; in the afternoon the strategy team at Société Générale, a French bank, held a seminar in a Grosvenor Square hotel.

The presentations differed vastly in manner, as well as matter. The Goldman team was formally dressed in suits and ties; its book of graphs was bulky enough to be an aid in fending off muggers. The SocGen team appeared to have dressed either for an outward-bound course or a company disco; its slidebook could fit into a back pocket. The regulatory disclosures accompanying just one Goldman speech were longer than the entire supporting material presented by Albert Edwards, SocGen's global strategist.

The overall messages could not be farther apart. In the Goldman world the forecast is for eternal sunshine; visitors to the SocGen world would need to carry an umbrella and a gas mask. But at least SocGen visitors could smile while they suffered; one slide focused on the resemblance between Ben Bernanke, chairman of the Federal Reserve, and Rudolf von Havenstein, president of the Reichsbank during Germany's hyperinflation.

Goldman believes that global economic growth will be stronger than expected this year, inflation will stay low and investors in American equities will earn returns of 15-20%. In America, consumer spending will grow by 3.5% as unemployment falls while businesses will improve their profit margins, even as commodity prices rise.

Goldman's view of the world seems dominated by its faith in the emerging economies, notably the BRICS (Brazil, Russia, India and China), an acronym



coined by Jim O'Neill, a strategist who has been promoted to head its asset-management division. Western observers constantly underestimate this development, in Mr O'Neill's view; for example, the value of Chinese consumption has risen by \$1.6 trillion over the past decade and could rise another \$400 billion this year.

Equities are cheap in Goldman's model, which focuses on the risk premium over government bonds. There is no graph of the cyclically adjusted price-earnings ratio, another valuation measure, in its presentation book, although the subject did arise in questions at the conference: David Kostin, a strategist, said Wall Street was slightly above fair value on this measure. That will be a surprise to anyone who follows the website of Professor Robert Shiller at Yale (www.irrationalxuberance.com). It puts the ratio at 23, about 40% above the long-term average.

Indeed, all four speakers at the SocGen event used a chart of the cyclically adjusted ratio. In the past it has been a very useful long-term tool. Andrew Laphorne,

SocGen's quantitative strategist, points out that buying equities when valuations are at current levels has delivered average historic real returns of just 1.4% a year.

Mr Edwards and his team have long propagated their "Ice Age" thesis, in which deflationary pressures drive down the valuation of equities relative to government bonds, as occurred in Japan. At times, for example during the dotcom bubble in the late 1990s, this view has been wholly out of fashion. But if Mr Edwards can be dubbed a perma-bear, most investment-bank strategists tend to be perma-bulls.

Which group is right? There was no sign that investors were playing favourites; both meetings were packed. The mood is not yet reminiscent of 2000-style euphoria or 2008-style despair.

In Goldman's view the bears are not taking sufficient account of the growth of the developing world and are focusing too much on crises in small countries like Greece and Portugal. Fiscal and monetary stimulus will cause the world to recover, as it has many times in the past.

The SocGen case is that the outlook was fundamentally changed by the financial crisis of 2007-08. The debt-fuelled model is broken. Central banks are trying to revive it again, by keeping interest rates low so that asset prices will rise and consumer confidence is restored. But the result will just be another bubble and another bust. In the words of Mr Edwards: "Basing economic growth on loose monetary policy driving up asset prices is simply doomed to failure."

Buttonwood is inclined to side with the SocGen team. But in the short term, cheap money is a potent force. Experience suggests it can drive asset prices well above the levels that cautious investors are willing to stomach.