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Turning of the Tide?

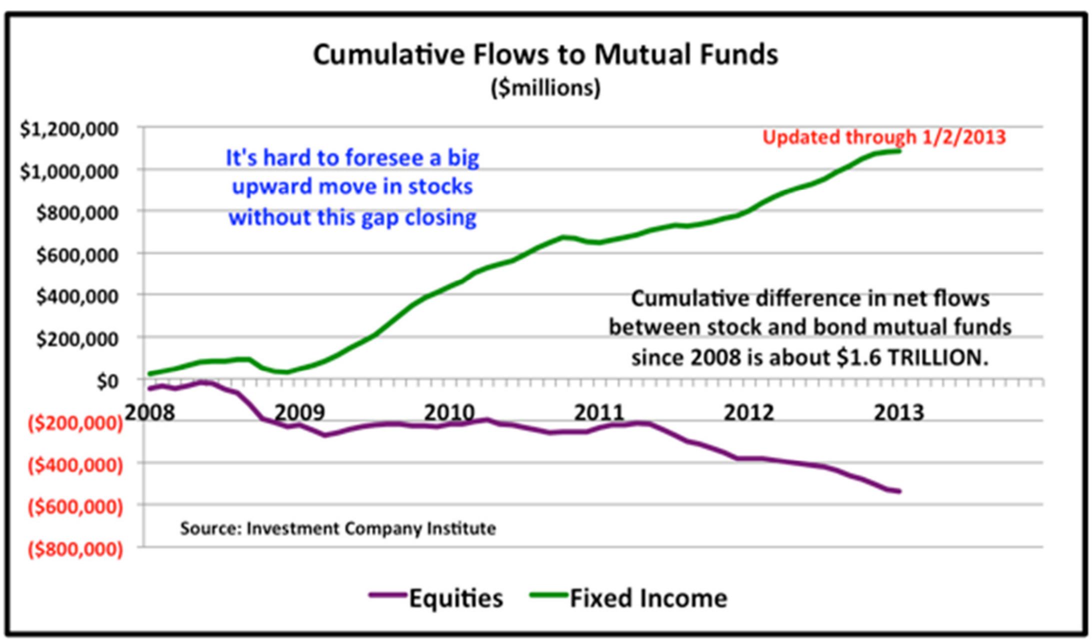
January Market Review From Your Portfolio Management Team—February 13, 2013

The so-called market experts have been calling for the death of bonds for several years now. With yields on a 10-year Treasury bond only yielding 2% per year (close to record low levels), these pundits have been convinced that higher yields (and thus lower prices) were imminent. Nevertheless, bond yields have remained low and investors have continued to pour money into them—preferring steady returns to the rollercoaster ride of the stock market.

Well, for the first time in two years we are seeing positive money flows into US equity funds, to the tune of $20 billion in January. (For all of 2012, US stock funds saw their assets reduced by over $150 billion.) This positive money flow correlated nicely with a strong performance by stocks in January. The S&P 500 stock index rose 5% for the month, the best start to the year since 1997.

On the other hand, bond funds saw another $30 billion in inflows for the month of January, on top of the $300 billion that flowed to bond funds for all of 2012. Nevertheless, those strong inflows could not prevent most bond indexes from falling in value during the month of January as interest rates rose.

The chart below shows the dominance of money flows into bond funds over the past five years:



Source of Chart: www.bearseatbulls.com

And, of course, during this 5-year stretch, the S&P 500 index (proxy for stocks, in general) rose 9% (1.7% annually) while the Barclays Aggregate Bond Index (proxy for bonds, in general) rose 34% (6.0% annually). So, it was clearly a good time for investors to shift from stocks to bonds.

But, what to do now? Bond yields are at historic lows (which suggests that there is little return available from them). At the same time, however, stocks aren't exactly undervalued these days. We are about to enter the fifth year of this stock market rally (which suggests we are closer to the end than the beginning). In addition, investors are complacent (as suggested by the readings of the VIX volatility gauge), in spite of the looming debates on the mandatory budget cuts sets to take place in March.

At this point, bonds have not rolled over enough to suggest we've seen the top. We have begun to trim back in a few areas, but we've seen similar pullbacks in the past, so we will exercise some patience with our bond funds. We have increased our stock positions, but are sensitive to the factors mentioned above. In addition, some technical signs indicate the rally is getting extended, so we will tread lightly here.

Bonds also began 2011 with flat or negative returns only to break out to new highs as the year went on. At the same time, stocks began that year on a nice rally, only to stumble mid-year. So, maybe 2013 will be the year that the bond bull market finally ends; however, there are plenty of reasons to give this asset class the benefit of the doubt until the evidence gets more clear.

Ronald Rough
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