July 2013

Is a Major Shift Coming?

June was a very interesting month in which both bonds and stocks sold off in unison. This correlation break caused havoc in the markets and didn't leave many places for investors to hide. Since we have crossed the midway point for the year, I think it is a good time to review the major asset classes and discuss what could be in store for the rest of the year.

I think most US investors are not aware of how poor a year it has been for almost everything but US and Japanese stocks. As you can see in the chart below, Japan (red line) was up almost 50% in the first five months of the year. As I write the S&P 500 (blue line) is up 13% as the second best major asset class that I track. What is amazing is that the other six asset classes on the chart below are all negative! The other six asset classes are China (green), Brazil (brown), High Yield Bonds (light green), 20+ year US Treasury Bonds (light blue), Emerging Market Bonds (purple) and Gold (pink). With year to date losses in almost every asset class, diversification has been a large drag on investor's year to date performance.

First half performance. Japanese and US stocks were the only game in town. Source: Yahoo! Finance

What has me particularly concerned is the losses in almost all bond categories. They say that more money has been lost reaching for yield than at the point of a gun and Bernanke and the ilk at the other central banks have manipulated interest rates so low that many people have felt like they had no choice but to take some kind of risk with their money. Many of the people reaching for yield are so accustomed to making money in their bond funds every single month that they will be surprised with seeing losses. I am concerned that they are going to head for the exits all at once if they see any continued losses. Bonds don't trade on exchanges like stocks do. You have to call a dealer to match buyers and sellers. If everyone receives redemptions at once, it could become disorderly.

In early April I wrote, "The chart below is telling me that either the US stock market has gone up too much and needs to correct or Treasuries are way too expensive (yield is too low) and investors are going to lose a lot of money in bonds as yields rise back up to around 4.4% where they should be at this point in the recovery."[1] So far it appears that bonds were wrong and June's bond drop quickly reduced the extreme imbalance between US Government bonds and US stocks.

I have started the chart below on May first to show you exactly how far and fast this move has come. The blue line shows that the ten year treasury yield has gone up 50% in two months and the yield on the 30 year treasury (red line) is up over 20%. I can't express enough how big of deal this is to the normally sleepy treasury market. This has a lot of investors on edge and is likely to startle more than a few seniors when they receive their June statements in the mail.

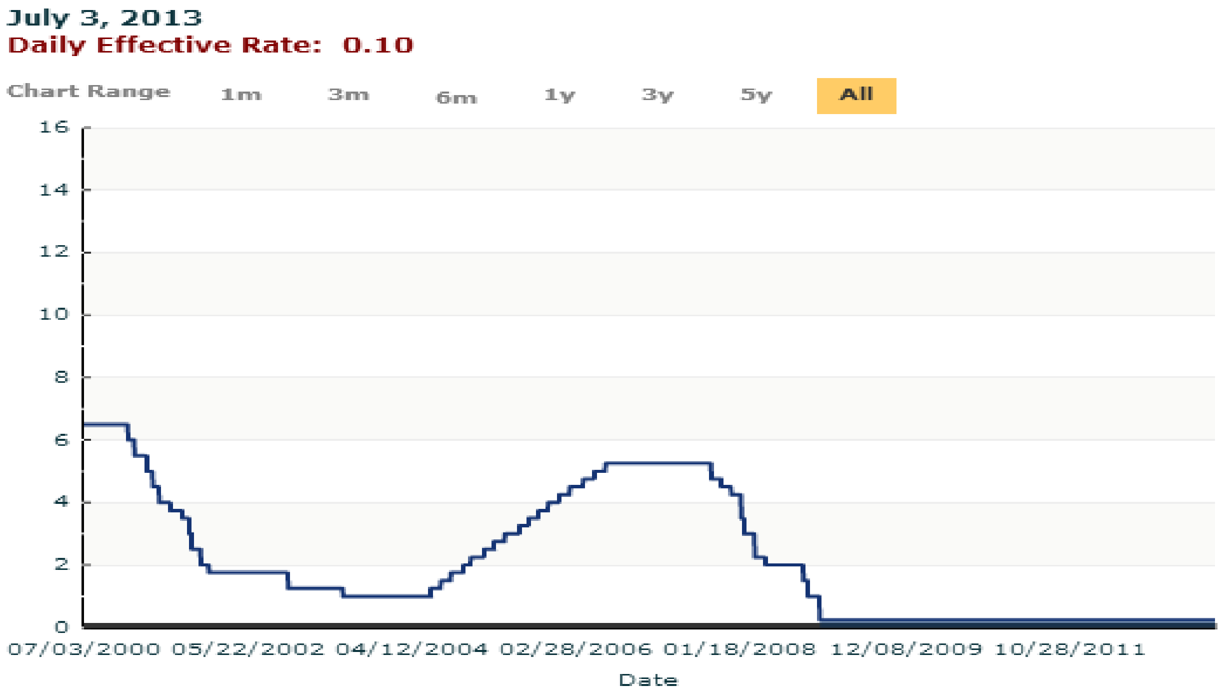
The amazing ascent in interest rates. 10 year rates = blue line, 30 year rates = red line. Source: Yahoo! Finance.

You may be wondering what these higher rates are going to mean for the economy and home prices. To answer that, let's take a look back at the last cycle. In 2001 the Federal Funds rate was 6.5% and the economy was in a recession and the technology, media, and telecom stocks were in a massive bubble. The Federal Reserve started lowering the Federal funds rates to an unprecedented 1% to try to boost the stock market and economy. They unfortunately left the Federal Funds rate at 1% till mid 2004; providing the fuel for the biggest housing bubble in US history.

Although rates began to rise in 2004, home prices continued to rise until 2006 and the stock market didn't top out until late 2007. Rising or falling interest rates do not instantly affect the economy. There is a lag. In the current cycle, most businesses have already had the chance to refinance their debt at really low rates and I don't think rising interest rates will harm many companies until they

[1] http://www.domestiquecap.com/files/44859/April%202013.pdf

are much higher. Mortgage rates have moved very quickly for 30 year mortgages, but they are still relatively low for 15 year mortgages and adjustable rate mortgages. Borrowing costs are rising, but I don't think it is enough to slow the recovery in housing yet. It is impossible to tell right now at what point rising interest rates will cause the next recession, but if history is a guide, it is probably a couple of years out.



The Fed Funds Rate. I never thought it would hit zero in my lifetime. Source: New York Fed.

In a May 10th research note, Marketfield Asset Mangement sent out a chart of the BAG Index. They created this index to track how a portfolio of Bonds, Apple, and Gold was performing. The crisis of 2008 caused many investors to fear owning US stocks and Marketfield believes too many funds were trying to get acceptable returns in bonds, Apple, and gold instead of owning the very volatile U.S. stock market.

The Bond-Apple-Gold Index compared to the S&P 500. Source: Marketfield Asset Management, Bloomberg.

The black line is the BAG index divided by the S&P 500. As you can see in September of 2011 it had been the place to be since the crash of 2008 and the investors and hedge fund managers were clearly right to own those asset classes over US stocks. Marketfield has thought for awhile that the pendulum would turn and the S&P 500 would eventually massively outperform the BAG Index they created. With gold and Apple experiencing dramatic corrections, they continue to predict that bonds will now provide the last remaing drop for BAG index to underperform the S&P 500.

So where are we today? It is very clear that the economies of China, India, and Brazil are in the midst of a multi-year deleveraging process. These economies grew like made from 2003 to 2008 and unfortunately much of their growth in the last few years has been fueld by debt and is not real. The U.S. economy (although drunk on stimulus) is possibly in much better shape than people realize. Companies here have dealt with two terrible crises and have increased productivity and off shored everything they could. Many firms are sitting on piles of cash and their debt is locked in at fixed low interest rates. I don't see any immediate concerns in the United States and would not be surprised at all if U.S. stocks made another all time high in the second half of this year. The redemptions from bond funds could also add fuel to higher U.S. stock markets.

Most of Europe is in a recession, but there are begining to be some signs of life there on the continent. Once Europe begins to recover, it is likely that their stock markets will take leadership from the United States. Even after the increadible move in the Japanese stock market this year, Japanese stocks are still historically cheap and their stock market may finally be in a long term bull market. At 14,300 the Nikkei 225 index is still 63% below its bubble peak in 1989 when it topped out at 38,900. Markets rarely go straight up or down. Corrections will take place and nobody can time each and every single one of them. I eagerly await the Q2 earnings season that is about to begin. Have a great month.

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