Stocks Surge, Bonds Bleed in 2013’s First Half: Game Plan for the Second Half

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Equity investors had much to celebrate in 2013’s first half. Not only did both the Dow and the S&P set new all-time records, but their year to date returns are stellar. As we approach the year’s halfway mark these indexes are up nearly 13% in the case of the Dow, and 11.7% for the S&P, and that doesn’t include dividends.

Bottom line, investors have recouped all their losses from the 2008 downturn, vindicating a stay the course strategy. Plus, they’ve earned returns in just the first half exceeding the normal for an entire year.

On the other hand, for bond investors, 2013 has been nothing but pain. The broad based Barclay’s Aggregate bond index now sports a loss of nearly 3%, and that’s including interest payments. That makes cash’s return of nil look pretty good in comparison. The difference in the first half returns between stocks and bonds, up 11.7% for stocks and down 3% for bonds, is one of the sharpest on record.

The 10 year Treasury, with a slightly longer maturity than the Barclay’s Aggregate, has fared worse, down a full 5%, even including interest payments. Of course, with the 10 year Treasury yielding a mere 1.76% at the start of the year, many reached for fixed income with more yield.

The Fallout From Reaching for Yield

Investors sought more yield in two ways. The first was by investing in bonds with longer maturities. But, that courts more risk when rates rise, as we saw in the first half. The 30 year Treasury sank a full 10% so far this year, despite the higher yield, while long dated munis, a favorite for investors chasing greater tax exempt income, have dropped over 13%.

Others reached for more yield overseas, particularly in the emerging markets, accepting greater credit risk in exchange for more yield. Unfortunately, that proved costly, too, as bonds from those regions have dropped 9.4% so far this year.

Domestic high yield offered some refuge, but these bonds returned less than their yield, just 1.5% so far this year, a pittance relative to stocks, and not enough to offset their higher credit risk.
End of Half Turmoil

By the end of the half, storm clouds rumbled across both stock and bond markets. The catalyst was the Federal Reserve chief Ben Bernanke’s warning that bond purchases could be “tapered” off by the end of this year, and further monetary stimulus ended by the middle of next year.

Despite everyone knowing that eventually the punch bowl (meaning extraordinary infusion of money into the system pushing interest rates down) would be taken away, markets were jolted by the cry of “last call.” Stocks had their worst two day slide in several years, and markets have slipped 4.6% from their highs. Meanwhile, over in the normally placid bond market, interest rates had their biggest surge since the 1990s.

So, that was the market’s first half. What should investors now expect for the second half, and how should they prepare?

Expect Greater Volatility in the Second Half

Until the 4.6% sell off in the markets this month, 2013 had seen little volatility. Recent years have experienced much bigger sell offs, albeit temporary and followed by rebounds. There’s no reason to expect we are immune in 2013’s second half. In 2009, the market sold off 28% before rebounding. There were also temporary dips of 16% in 2010, 19% in 2011, and 10% last year.

The CBOE volatility index, a key measure of the market’s expectations of near term volatility, has surged from close to 11 to 20, suggesting more turmoil ahead. We don’t think the relatively placid market conditions in most of 2013’s first half will have an encore.

We saw how abruptly the market reacted to changes in the outlook from the Federal Reserve. As it becomes increasingly itchy to reduce the size of its balance sheet amid criticism that it’s pumped too much money into the system, brace yourself for further gyrations as its policies adjust. Indeed, there seems to be internal disagreements within the Federal Reserve; one of its members, James Bullard, came out last week with a sharply worded criticism of Mr. Bernanke’s approach. Keep your seatbelt fastened.

Asset Allocation Strategy: Rebalance Now

Given the size of the differential between the year to date returns on stocks versus bonds, there’s rarely been a more appropriate time to sell some stocks and buy some bonds. At a minimum, you are reducing risk by trimming your exposure to stocks. You would be buying low and selling high, a concept that makes all the sense in the world, but most do not put into practice.
In any event, you certainly wouldn’t want to get more aggressive with stocks, given that you’d be paying 10% or more relative to the start of the year. With the ten year Treasury yield now at 2.5%, up from 1.67% at the start of the year, if you were inclined to exit the bond market, you should have sold at the beginning of the year.

Some would argue that you should have a preset date to rebalance, and that might be, say, at the end of the year. However, with the magnitude of the moves since the start of the year, taking advantage of trimming now your equities given that they are just 4.6% off their all-time highs is compelling. Reinvest equity sales into bonds to get a yield nearly 1% more than was offered at the start of the year.

**Following Rebalancing, Stay the Course**

The rationale to simply sit tight with your first half portfolio: There’s been no change in the fundamentals. The latest gyrations in the markets will not affect the sales of Coca Cola, Merck, or tobacco marketer Lorillard. Economists say the ratcheting up of 30 year mortgage rates from 3.5% to 4% will have little effect on home buying, now that lenders are loosening their standards a bit.

No matter what happens to interest rates, your bonds will still come due at the scheduled time and, absent default, you will profit as planned.

Besides, all the prognostications and warnings of higher rates may not come to pass. The Federal Reserve failed to forecast the subprime crisis, so why is it so prescient now? Bottom line, a very logical response is to ignore the latest tempest over interest rates or Mr. Bernanke, and sit tight with your investments.

**Have Extra Cash to Invest? Buy Quality Stocks at Reasonable Prices**

Stocks today are priced very reasonably, at about 15.7 times forecast earnings, in line with valuations prevailing on average over the last 50 years. Even given today’s higher 10 year Treasury rates (2.5%), earning an effective earnings yield (the inverse of stocks’ price to earnings ratio) of about 7.5% on stocks provides plenty of incentive for investors to continue to buy equities.

Two important reasons why interest rates rise is first, greater loan demand due to a strengthening economy, and second, rising inflation expectations. Either reason would make stock a more attractive opportunity than fixed income.

We favor such venerable Dow names as Chevron, Hewlett Packard, JP Morgan, and Travelers. They are four of the cheapest in the Dow, pay solid dividends, and are likely to fare well relative to the competition no matter where interest rates head.

**Determined to Restructure the Portfolio?**
Consider three themes:

1. **Bet Against Any Interest Rate Tightening**

   You think divining the stock market’s direction is tough? Try to forecast interest rates. You think Bernanke has made it easy to expect higher interest rates, with his talk about “tapering off” bond purchase and then “tightening” monetary conditions. Not really, since he said all the plans are “data dependent.” Absent clairvoyance on the economy, there’s no certainty on his taper/tighten plans, and that makes interest rate predictions simply guesses, particularly as to any time frame.

   Given that in the last two weeks bonds and interest rate sensitive securities like real estate investment trusts and dividend paying stocks have sold off hard, this may be the time to sift through these sectors and pick up some bargains. They’ve lost value simply because of a shift in investors’ interest rate outlook. They might be right, but at least buying these securities now gives you the certainty of a discount of up to 10% over the price paid just four weeks ago.

2. **Bet Against the Lemmings**

   Equity investors have yanked nearly half a trillion dollars net out of equity mutual funds in the last five years. Meanwhile, the stock market rose some 150% from its nadir in March, 2009.

   In the last week bond investors have yanked some $14.45 billion net from bond mutual funds. Instead of joining them, you may want to bet that they’re making another mistake and overreacting.

3. **Worry About Inflation**

   Mr. Bernanke’s expansive monetary policies are predicated on little inflation. Yet, interest rates are soaring, with the 10 year Treasury climbing from 1.6% in late April to over 2.5%.

   Inflation fears are one of the factors that can drive interest rates higher, as lenders demand more interest to compensate for the erosion of purchasing power. The higher interest rates may be due to a shift in investors’ inflation expectations.

   Your best bets to hedge on inflation are equities generally, but especially commodity producers, like energy and mining companies.

**In Sum**
Enjoy your first half returns, rebalance your portfolios, and be open to selectively investing in high quality equities as opportunities emerge. By no means overreact to Mr. Bernanke’s latest comments nor the recent volatility in the market.