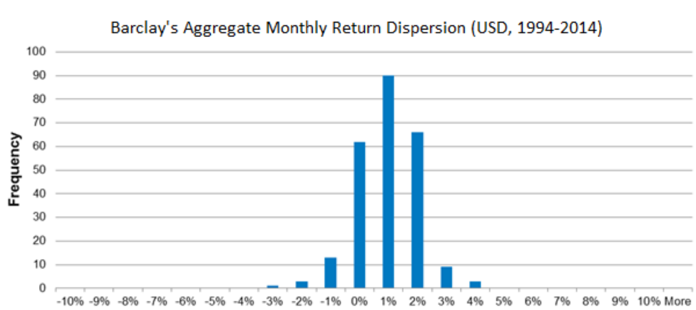
Expectations

Normally a floor full of traders is all go all the time. To bring all that activity to a grinding halt takes some doing. Every sixth Wednesday the U.S. Federal Reserve Committee makes their pronouncements on short term interest rates and the economy, and every sixth week finance stops for a brief moment to absorb the news. At 2:15pm the press release hits the wire, markets move, traders trade, the pattern for the last six years has been largely the same, no change in rates, just changes in tone. But sometime soon, there will be a change; sometime soon things will be different.

For the moment, the Federal Reserve is continuing to taper. Tapering involves reducing the amount of stimulus they are applying to the system, so far the Fed has been reducing the size of their buying program by ten billion per month. Soon enough, they will no longer be applying stimulus through their buying program, though they will be encouraging risk-taking by keeping their inter-bank borrowing rate steady at near zero; tapering is not tightening, at least not in the traditional sense. With rates having been at nearly zero for going on six years, the eventual pronouncement that the Fed will follow a non-zero policy will make for an eventful and memorably busy day.

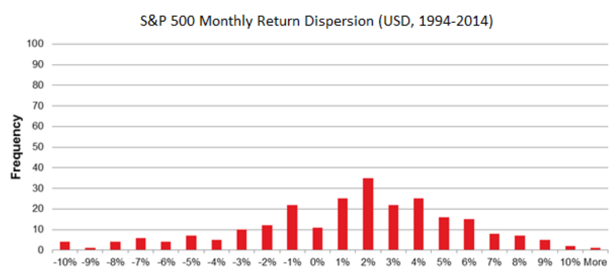
Investments have always carried interest rate sensitivity, a fact that has only been magnified for the depth and duration that rates have been low. Which begs the question, if the traders are watching carefully, how worried should long-term investors be? Worry would be a natural state for those who were not prepared; being perfectly prepared for rising interest rates is possible through only two scenarios. The first would be clairvoyance, while this would be highly lucrative; being able to see into the future with perfect clarity is merely wishful thinking. The second, and simpler, way is to understand why bonds and stocks are held in a portfolio, and set expectations around what each of those asset classes should deliver.

Many expect that the thirty-plus year secular run in bonds to be at or near its end; the implication being that as interest rates rise, the value of any bond should fall. While mathematically this should always be the case, the fortunes of an investment are not merely formulaic; the inputs into the value of an asset are manifold. In fact, for more than four years the conventional wisdom has been that interest rates have nowhere to go but up. Most recently, in June of 2013, the Federal Reserve clumsily announced their intent to taper, leading to a short and sharp sell-off in bonds, as investors demanded more yield for holding fixed income in their portfolio. And yet, fixed income investors, those who held on through the ‘taper tantrum’ have seen their portfolios recover all of those losses and more.



Source: Barclays, monthly returns from 1/31/1994-7/31/2014

As bond prices have recovered to near highs again, do we revisit this thirty year rally, driven by the fall in interest rates from the early 1980’s to today? The unwinding of massive Global quantitative easing programs is not something done in the short term, and may be years, or longer, to create the desired ‘soft landing’. Barring a run on the U.S. dollar, sharp rises in rates, and bonds suffering on the back of those rises, seem unlikely versus a measured, concerted, and well telegraphed program from Central Banks from around the globe. There is a very plausible case for bonds that sees rates on fixed income go higher than today, but a return to anything other than mid-single digit yields in the next ten years would seem a stretch; with Governments globally swimming in debt, the ability of debtors to afford significantly higher rates simply is not there. While expectations for bond yields should remain muted as the recovery continues, they remain an important asset class for investors, providing important cash flows, and ballast for portfolios in difficult stock market environments.



Source: Barclays, Blackrock, monthly returns from 1/31/1994-7/31/2014

Stocks have enjoyed a tremendous run from their bottom in 2009, although with corporate profitability now at all-time highs, and balance sheets being flush with cash, much of the gains on equities have been due to price-to-earnings multiple expansion. Share repurchases, regardless of share prices, have continued – often on the back of cheaply financed debt. When exactly the six-year rally in stocks ends is still unclear, but having seen a near double on the Canadian SPTSX and a near treble on the S&P500, it seems more and more likely that we are closer to the end of this cycle than the beginning. Which is where holding high-quality fixed income will be beneficial.

In the best year for the S&P 500 in the last twenty, 1995, the equity market returned 37.5%, and bonds, as measured by the Barclay’s Aggregate returned 18.5%. An allocation of thirty percent to fixed income would have brought the total return down to 31.8%. In the worst year, 2008, the S&P took a 37% decline, versus a 5.2% gain for bonds, the same allocation would have seen a loss of 24.3% in aggregate.
While both 2008 and 1995 represent historical outliers, and extreme ones at that, the case made by the math nonetheless stands. Owning bonds may come at a modest cost to overall portfolio returns, but when – not if – markets turn sour, the returns on fixed income can offset some of the loss in an equity portfolio.

Meagre yields - comparatively - have made dividend stocks more popular today than perhaps any time since perhaps before the Great Depression. In the 1920’s stock dividends were roughly three times higher and typically much closer to all of the company's cash flow. Stocks are now counted upon both for their growth characteristics and to replace some of the income simply not available on high quality fixed income today. Are equities equal to this dual task? The answer is both a yes and a no, and how expectations are set determines how one answers the question.

Equity markets do have room to grow earnings from here, but over a time horizon appropriate for an investor, rather than a trader. The S&P 500 trades to a relatively high price-to-earnings multiple today,

at least if history is our guide. The P/E multiple is determined simply by dividing the price of a stock by projected earnings, the higher that ratio, the longer an investor will have to wait to earn back the value of their investment. But earnings can continue to grow, emerging markets can continue to build their economic scale in line with their population, capital expenditures can be funded through cheap debt, and balance sheets can be loosened to create fuller employment and expansion. While that addresses earnings, the multiple of price to earnings can also be reduced by the price of the equity falling; either the Price or the Earnings in the P/E ratio can moderate, and bring the market closer to its historic trend. Re-pricing or earnings gains remain the purview of the trading set; the investor knows it is far more prudent to wait, to keep an eye out for valuation mismatches, and to be paid while doing so.

Just as quality fixed income provides a safer harbour for long-term investors, quality stocks provide the same edge. Leaders in market spaces, those companies that engage in sure bets rather than coin flips, those with strong balance sheets, those with repeated and sustained competitive advantages, those with dividends – and in particular those with the confidence and earnings ability to continue to grow their earnings, dividends, and advantages – represent the most prudent places for investors.

There is uncertainty ahead, though this is always true. Will Europe re-enter a recession? Will the Chinese debt and housing markets finally succumb? Will the United States be able to repay and unwind their borrowings? These are the known unknowns, and the market has priced a great deal of this in. How will bonds react when the Federal Reserve stops buying? Which political party will take control in America? All of these uncertainties represent an opportunity for the skilled or lucky trader. But there are also certainties ahead, investment grade bonds will pay their coupons and provide reinvestment opportunities, profitable dividend payers will provide cash flows – and likely more each year. These certainties represent an opportunity for the investor.

In the coming weeks and months news will hit the wire, markets will move, traders will trade. And investors with a long term plan and reasonable expectations, they will sleep soundly. Of that, we can be certain.