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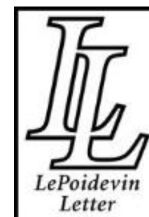
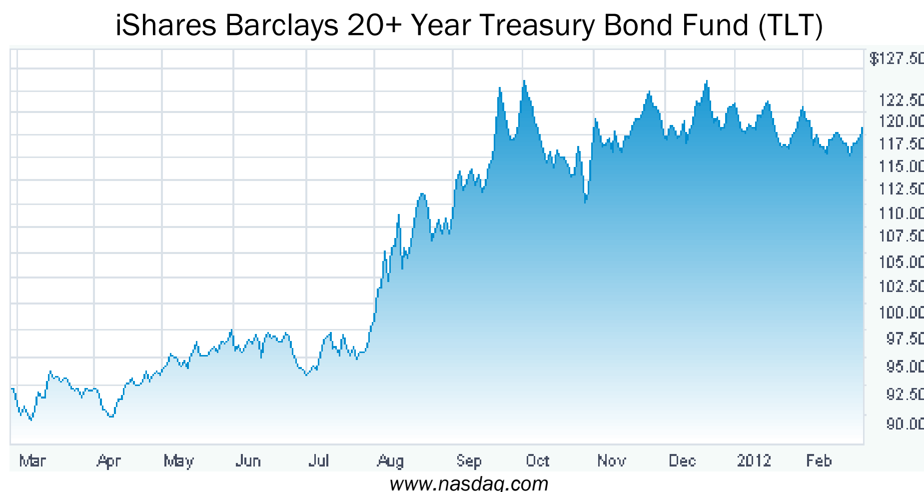


Bonds: A Good Place to Hide or a Bubble?



It's easy to see how investors have fallen in love with bonds. One year ago, 30-year US or Canadian government bonds provided a yield of over 4%. By the end of the year, interest rates had fallen to below 3%, providing investors with a total return of over 25%. The government of Canada 4% bond due in 2041 had surged to a price of $130 per $100 bond, as investor demand continued to push up the price. Investors seeking safety from stocks have poured record amounts of money into bond mutual funds and ETF's (Exchange Traded Funds). But are investors jumping from the frying pan into the fire by purchasing bond funds when bonds are valued at such a high premium?

Remember that one year ago, the general consensus was that the economy was well on its way to recovery and that interest rates would rise in the second half of 2011. As bond prices move in an opposite direction to interest rates, many investors shied away from bonds. By the fall of 2011, with problems in Europe, stocks falling and bonds surging, bonds seemed like the obvious choice. Furthermore, the US Federal Reserve chairman, Ben Bernanke pledged to a senate banking committee early in 2012 to keep borrowing costs close to zero at least through late 2014.

Ironically, so far in 2012 long-term government bonds in both Canada and the US have fallen

roughly 5% as long-term rates have inched higher. Global stock market averages have gained more than 5%.

As US short-term interest rates are close to zero, it is a little easier to understand why investors would choose to purchase 10-year bonds at 2%. In Canada, short-term interest rates are close to 1%; but with no interest rate hikes in sight, 10-year rates have also traded around 2%. Moreover, most pension funds or life insurance companies have been mandated to have a fixed portion invested in government bonds, so they have to keep buying.

Analyzing the relative value of investing in stocks as opposed to bonds is more challenging. While bonds are typically quoted on a yield-to-maturity basis, stocks are typically valued by a price-to-earnings (P/E) ratio. And while this might be relevant when comparing one stock to another, or to a company's historical value, the P/E ratio does not provide a useful comparison to bonds.

In order to make a better comparison, it is far more relevant to express stocks in the same way that one uses to value bonds; that is, instead of using the Price/Earnings, one should compare earnings to price. This little-used valuation method is referred to as the earnings yield of the market, and it gives us an apples to apples comparison between bonds and stocks: reported earnings or profits over price, just as a bond calculation reports annual interest over price.

Historically, stocks have usually traded at an earnings yield quite close to that of 10-year US treasury yields. At major market turns, however, there have been some significant valuation discrepancies.

Consider the major bear-market bottom which occurred in 1982. US 10-year government bonds yielded 14.6% while the P/E of the market was 6. Expressed as an earnings yield, stocks represented a 16.7% yield which meant they were an even better value than bonds. Stocks would gain over 1900% in the next 18 years!

By comparison, in the year 2000, 10-year bonds yielded 6.4% while stocks traded at a P/E of over 40. There was far too much optimism about profit growth; such that the earnings yield of stocks fell to a record low 2.5%. There was really no comparison between bonds and stocks, and at the first speed bump, investors began to flee stocks for bonds. The next 10 years would produce no return for stocks!

Fast forward to today. The S&P 500 (500 largest US traded stocks) was recently at the 1361 level. The actual reported earnings of the 500 companies weighted to the index was 86.98 for a P/E of 15.65 and an earnings yield of 6.39%.[1]

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[1] Barron's: Market Lab

Earnings: 86.98 / Index: 1361.23

$$\frac{86.98}{1361.23} = 6.39\%\ \text{(Earnings Yield)}$$

Alternatively, the yield on the US 10-year note is currently around 2.00%.

10 year US Treasury Bond par $1000 interest: 20 / Current bond price: 998.12

$$\frac{20}{998.12} = 2.0038\%$$

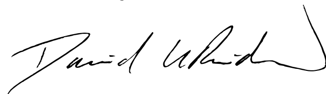
The Wall Street Journal recently reported that despite the latest rally in stocks, individual investors have put $10.6 billion into bond funds so far this year, while pulling $8.3 billion out of equity funds.[2] In 2000, stock market values were at bubble levels, based on an assumption of overly optimistic profit growth forecasts. Today, the tables have turned. Investors' concerns about eroding profit levels have pushed bond values to record high prices, producing record low yields. Despite the subpar economic growth in the Western World, profits for 2011 in the S&P 500 grew by 12.7%, while dividends grew by 18.3%. Comparing stocks to bonds, stocks appear to be better value in today's market.

That being said, there are tremendous headwinds in the global economy today. Investors need to choose carefully what sectors and what stocks to buy. Although the Greek debt problem may have been contained at least temporarily, austerity in the rest of Europe will likely mean a deteriorating economic landscape for some time to come. The property bubble in China appears to have run out of gas: sales and prices of property have begun to fall in many regions. This could all lead to an economic hard landing in China, and investors need to be careful with industrial commodities.

With this in mind, we continue to favor sectors such as consumer staples, health care and utilities. I believe we are in the 8th inning of the preferred share market, but we continue to find a few select bargains.

Investors seeking yield should be cautious in the high-yield or junk-bond sectors. Like government bonds, junk bonds are trading near record-high prices, thus record-low yields.

Sincerely,



David LePoidevin, CIM
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[2] The Wall Street Journal – "Investors' Sell Signal: Surging Stocks." (Friday March 2, 2012)

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