Viewpoints: The Great Rotation or Great Frustration?

Asset Allocation & Investment Strategy

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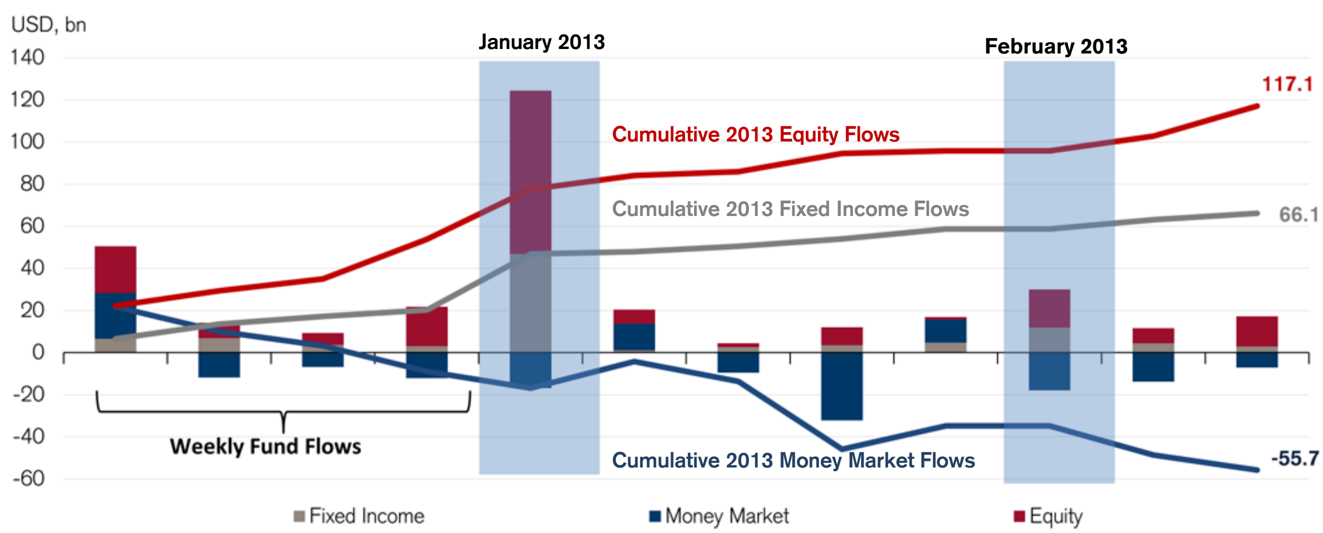
- Investors waiting for the great rotation out of fixed income into equities are going to have to wait a while longer – a long while, in our view.
- We do not anticipate large scale losses in fixed income due to rising rates this year, but we do expect returns to be very muted, in the low single digits, at best.
- On a strategic asset allocation (6-12+ month investment horizon) basis, we expect equities to outperform fixed income, and our favored region/country is the US.

For the better part of the past two years, market participants have been waiting for the great rotation from fixed income to equities. What exactly is the great rotation? It is the thesis that the long era of fixed income outperformance versus equities has ended. Faced with the choice of very low bond yields and the potential for losses if bond yields rise, market participants would rotate their portfolios toward equities and away from fixed income in search of returns, hence the "great rotation". At the start of the year, many investors looked at the fund flow data and noticed the meaningful thrust of new capital being committed to equities. What we found interesting was that the flows to equities were not because market participants were giving up on fixed income; quite the contrary: the flows to equities were at the expense of money markets. As seen in Figure 1, fixed income flows have continued to be positive this year.

While a rotation out of fixed income sounds logical, the great rotation thus far has been elusive and is turning out to be the great frustration for those who have been waiting for it. In our opinion, it is likely to remain that way for quite some time.

Figure 1 – No Great Rotation in the Flow Data Thus Far



Source: PB Americas Asset Allocation & Investment Strategy, Strategic Insight Simfund, EPFR Global, ICI
As of: 3/13/2013; Note: Data includes mutual funds and exchange traded funds

Three key reasons shape our view that investors are unlikely to abandon their fixed income holdings. First, the Federal Reserve has stated it is going to remain committed to an accommodative monetary policy stance until the unemployment rate falls to 6.5% – it currently stands at 7.7% – and that may take quite some time. The growth trajectory for the US is being heavily influenced by the contraction in government spending. Our Credit Suisse forecasts for US economic growth for 2013 and 2014 are 1.6% and 2.3%, respectively, and include a 1-2% fiscal tightening each year. Thus, growth is not likely to be strong enough for the Fed to change its accommodative stance. Second, inflation expectations are not at problematic levels, which could cause a meaningful climb in bond yields. As seen in Figure 2, inflation expectations are well anchored in the range they have been in since the recovery began in 2009. Third, investor psychology is still smarting from the aftermath of two secular equity bear markets in the last decade. The bear markets that ended in 2003 and 2009 were so severe in nature it may take several more years of solid equity market returns for market participants to feel confident enough to return to the asset class. Therefore, it is likely to remain more of a great frustration for those waiting to see a great rotation out of fixed income and into equities.

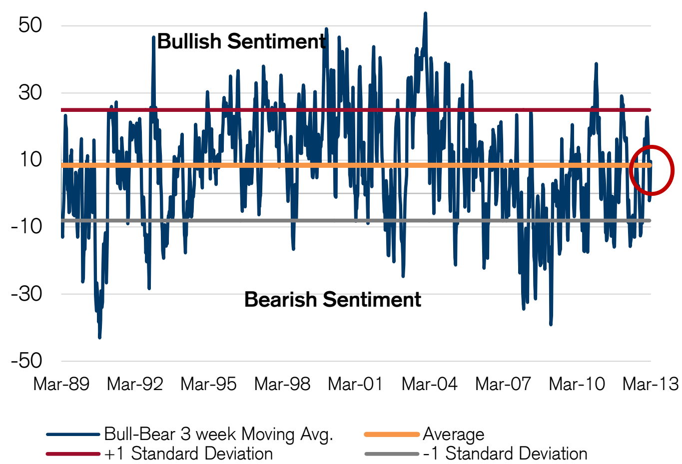
While we do not anticipate large scale losses in fixed income due to a sudden surge in interest rates over the near term, we do think fixed income is in for lackluster returns. During the ten years that ended in 2012, the Barclays Aggregate Bond Index gained 5.2% on a compound annual growth rate. During that same period, the yield on the US Treasury 10-year note went from 3.8% to 1.8%, hitting a mid-cycle high point of 5.3% in June 2007. Given that we expect yields to remain at subdued levels in the near future, we think market participants would be well served by anchoring their expectations for fixed income returns to be no better than the return received from the coupon payments, meaning very low single digits.

We have long anticipated that equities, as measured by the S&P 500 Index, would be able to return to all-time highs (see Viewpoints: Making a Run for the Highs? dated September 24, 2012). Where do we go from here? The equity market can move higher, but it would not be surprising to have fits and starts along the way. Durable equity bull markets tend to have four common features: low or negative real interest rates, high unemployment, attractive valuations, and quite a bit of investor skepticism. All these features are still in place, but to various degrees, of course. How do bull markets generally end? They tend to end with tight capacity, extended valuations, central bank tightening, and a great deal of investor enthusiasm. While there are likely to be setbacks along the way to sustainably breaking and staying above the previous all-time highs, we think they will be just that: setbacks.

Figure 2 – Inflation Expectations Remain within Long-Term Bands
Annual US inflation expectations for the next 5 years

Note: Inflation expectations are calculated by subtracting the 5-year TIPs yield from the 5-year Treasury yield
Source: PB Americas Asset Allocation & Investment Strategy, Bloomberg
As of 3/22/2013

Figure 3 – Investor Sentiment Is at Neutral Levels
AAII Bull Survey Less AAII Bear Survey, 3-week moving average



Source: Bloomberg
As of 3/28/2013; Last data point: 9.6

Among our favored countries or regions within equities in our Strategic Asset Allocation portfolios is the US. Our global Investment Committee sees that the US has the best potential growth profile in the developed world economy: while the public sector is still extended, it is furthest along in its private sector deleveraging cycle. The recovery in US residential real estate is helping repair consumer balance sheets, and the potential for energy independence as a result of shale gas is a game changer. Europe looks inexpensive on some measures, but the competitive pressures on wages and continued recession are keeping us on the sidelines.

Cyprus has been messy, but it is unlikely to unravel the Eurozone, as the support from the European Central Bank to hold the monetary union together is a very powerful force. Emerging market equities have been lagging the performance of the US, which has been a disappointment. We are watching for signs that the tide is turning before we will increase our exposure to emerging market equities.

So, is the great rotation turning into the great frustration? We see more frustration for investors waiting for significant outflows out of fixed income. In the meantime, we think the opportunities present in equities, even though we are back at the highs, remain compelling.

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