FINANCIAL TIMES

MARKETS INSIGHT June 10, 2013 10:29 am

Markets Insight: The Fed has turned markets upside down

By David Rosenberg

Equities are being sought for income, and bonds for capital gains: a fascinating reversal

Stellar performance across most asset classes has been the norm until recently. Equity markets are up sizeably and, in some cases, like the S&P 500 and even the German Dax, have hit fresh all-time highs. Corporate bond markets are still offering decent returns as well, especially when measured against government bonds and cash.

Yet, in the past month, more than 60 per cent of the incoming US economic data have come in below expectations versus 34 per cent above expectations. Two months ago, only 42 per cent of data were disappointing and 53 per cent surprising to the upside.

The consensus was looking for 4 per cent US GDP growth for the first quarter; we got 2.4 per cent instead. Estimates for this quarter are approaching a meagre 1.5 per cent annual rate. So it is safe to say that this latest leg in the risk rally does not have a lot to do with what is happening in the real economy.

The case for equities, in particular, lies much more in what the Federal Reserve and other central banks are doing, which is keeping short-term interest rates negative in real terms and making relentless incursions via quantitative easing. In doing so, they are exerting a profound influence on the level of government bond yields, which in turn affects relative pricing in all asset classes.

Just in the past couple of months Bristol-Myers has come to market with a five-year note yielding just 1.06 per cent; Nike floated a 10-year offering at 2.27 per cent; Microsoft used its coveted triple-A ranking to issue five-year paper at 0.99 per cent; and Apple raised a record $17bn in the debt market, with its three-year offering gobbled up at a microscopic 50

basis point yield.

In the stock market, a 2.3 per cent dividend yield on the S&P 500 looks juicy relative to the coupon available in the government bond market.

While there has been some reversal in recent weeks, the defensive segment of the stock market is up nearly 20 per cent so far this year versus just over 10 per cent for the cyclicals in the largest outperformance in a good 15 years.

In addition, the average dividend yield on defensive stocks is now around 3 per cent – significantly higher than the yield on 10-year Treasuries and about in line with a generic triple B coupon.

Cyclical stocks command an average yield of only 1.8 per cent and you can see how income-hungry investors in the stock market are paying up for the yield characteristics: at a price/earnings multiple of nearly 19 times, the defensives command a 20 per cent multiple premium over their economically-sensitive cousins.

One can call them expensive, but another explanation is that the defensive dividend-payers are in a continuum of being re-rated for their stability and yield characteristics in a world still fraught with an unusual amount of uncertainty and economic fragility.

This income theme may well be in its mature stage, but is still working out in an era of minuscule risk-adjusted rates and a soft global macro backdrop. There is also a strong demographically induced appetite for income, and in light of this, the most compelling case for shares is that the yield once so coveted in the bond market is being replaced by the yield available in the equity market.

Within the equity universe, net dividend increases totalled nearly $15bn in the first quarter. Fully 944 publicly listed companies in the US sweetened their dividend policies compared to 677 a year ago, an increase of around 40 per cent. This remains a strong theme and crucial source of total return support.

Everything is ultimately priced off the Treasury yield curve – municipals, corporate credit, high yield, emerging market debt and even the equity market.

A sub-5 per cent generic junk bond yield is puny in absolute terms, but offers a 400 basis point pick-up over Treasuries, which may be appealing in terms of spreads and default rates stabilising near 3 per cent.

Similarly, a 2.3 per cent S&P 500 dividend yield hardly looks attractive on a historical basis,

but again, relative to what you get in the bond market, it has not been this attractive since the late 1950s.

That is how the Fed has turned things so upside down and inside out. Investors in the Treasury market today are not there for the income but for the prospective capital gain should yields decline. And when you look at the sectors that have done best this year on a risk-adjusted basis, they are the stodgy defensives for the most part that carry a 3.5 per cent dividend yield – investors are here not for the capital gain (though it is always welcome) but for the income.

Equities for income and bonds for capital gains. How fascinating.

David Rosenberg is chief economist and strategist at Gluskin Sheff

Printed from: http://www.ft.com/cms/s/0/98fd8666-c79e-11e2-be27-00144feab7de.html

Print a single copy of this article for personal use. Contact us if you wish to print more to distribute to others.

© THE FINANCIAL TIMES LTD 2013 FT and 'Financial Times' are trademarks of The Financial Times Ltd.