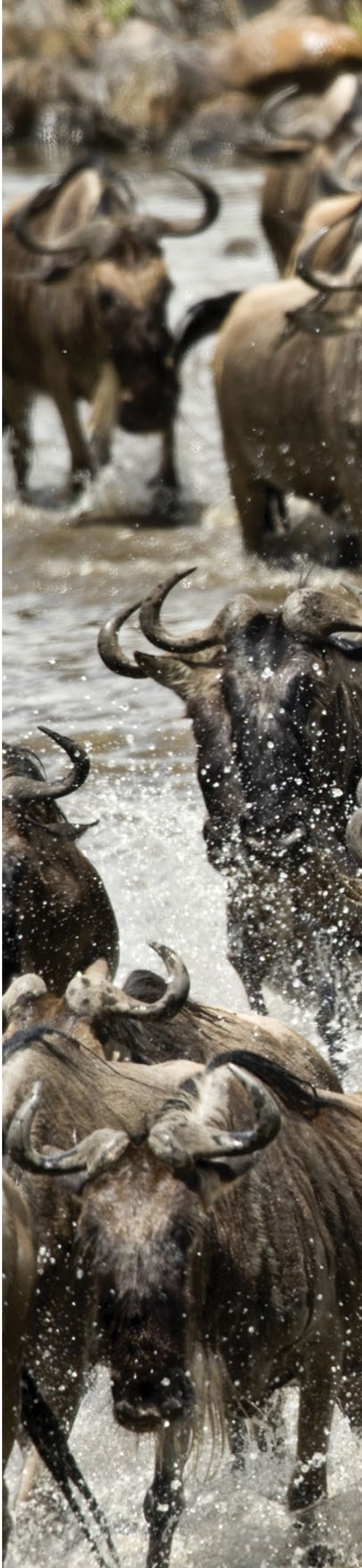
The Great Rotation: animal spirits and the growing appetite for risk



By Simon Mumme

Keynes' animal spirits are moving markets. Driven by increasing risk appetite, investors buy stocks as they seek returns beyond government bonds and investment grade corporate debt. On 2 February the S&P 500 marked a 12.51% annual gain to reach 1513 points. Meanwhile, the FTSE 100 gained 7.56% to close at 6347.

Confident that central banks and governments will further stabilise the US, European and Chinese economies, investors are undertaking what Bank of America Merrill Lynch (BofAML) and others see as a widespread shift from safe-haven assets into equities and high yield debt.

Evidence of this so-called great rotation is the $5.5bn that investors pulled from bond funds in the six weeks ending 9 January while allocating $47.6bn to equity funds, according to investment-industry researcher EPRF Global.

"As much as anything else, this is about investors embracing animal spirits rather than being suspicious of them," says James Klempster, who oversees about $700m in multi-asset funds at Momentum Investment Management in London.

Stock market rallies from the US to Europe to Japan compared with the 2.05% yield on 10-year government debt in early February makes "the opportunity cost of holding safe-haven assets much higher today than it has ever been," says Remi Ajewole, co-manager of the Schroder Multi-Asset fund in London. "If you want 1% over cash, you have to rotate out of safe assets."

The expense and low yields of safe-haven debt may initiate an asset allocation "rotation" into equity and high yield bond markets

Picture: Stockphoto


Picture: Stockphoto

that offer better value for money and stronger returns, says Matt Rubin, director of investment strategy at Neuberger Berman. "The valuation dispersion is simply too large to ignore, particularly for the longer-term investor."

Beginning the move

Clients of JP Morgan Asset Management were first advised in 2009 to move more capital from cash and investment grade bonds into equities, high yield and emerging market debt, says Dan Morris, the fund manager's London-based global strategist.

"We didn't think that the euro was going to break up. That was the opportunity because assets were cheap" and policymakers were unlikely to let economies fail, Morris says. "This idea that people have been waiting for Europe to fix itself, for the fiscal cliff to be averted – by the time these problems have eased all of the benefit is gone."

In mid-January, US investment grade bonds were underperforming equities by the greatest margin in 15 months, according to Bloomberg. The securities gained 56% from the start of 2009 until October 2012 but have since lost 0.1% and lagged the S&P 500 by 4.3% in January, according to the company.

Declining bond yields, which fell to 2.73% on 8 November against a historic average of 5.02%, have created a potential "bond bubble" in which rising interest rates can trigger losses, according a Fitch Ratings note on 19 December.

"Portfolios of assets held by investors are chock-a-block with fixed income of all shapes and sizes on the back of a decade with two bear markets for equity investors, which led to general caution and circumspection," Klempster says.

"Safe-haven bonds are inordinately expensive. You're pretty much guaranteed to lose money over the long term as returns are wiped out by inflation."

The average duration of the high yield market, or sensitivity of bond prices to interest rate moves, currently indicates that a 1% rise in interest rates will erase up to 4% from bond returns, Morris says.

However, coupon rates of about 6% mean that investors can still gain returns of 2%. "At some point interest rates will go up. But these bonds will carry you through" without capital appreciation, he says.

"It's very much about clipping the coupon rather than a capital gains trade," Klempster says. "The majority of big, cyclical gains in debt markets from 2008 onwards are largely behind us." Better yields can be gained from leveraged loans, which promise greater security of repayment than high yield bonds and are available almost exclusively to institutional investors, he says. About €2trn of leveraged loans have been issued since 2006, according to Standard & Poor's, of which three-quarters originates from the US and less than one-quarter from Europe.

Bank loans and listed real estate trusts can be bought at cheaply and derive returns from

> *"Safe-haven bonds are inordinately expensive. You're guaranteed to lose money over the long term as returns are wiped out by inflation."*
>
> James Klempster

Figure 1: Cyclically-adjusted price-to-earnings (CAPE) ratios of world stock markets

Market	Current CAPE	10-year CAPE average
Australia	17.2	22.9
Brazil	15	22.7
Canada	19.1	27.0
China	19.6	25.3
France	13.8	22.5
Germany	17.2	21.0
Italy	8.6	18.6
Japan	18.7	47.9
Spain	9.3	19.4
USA	20.6	23.5
UK	13.8	16.3
Emerging markets	18.1	24.0

Source: Schroder Investment Management (UK)

the recovering US housing market and revived energy industries, says Rubin.

Double-digit equity returns

Equity markets will gain between 10 and 20% worldwide and US and European credit up to 7% in 2013, according to BofAML strategists. Government bond yields will rise modestly.

Optimistic investors, or those who do not anticipate a fourth round of US quantitative easing and 30-year Treasury bond yields to fall to the 2.5% lows of 2008 and 2012, should buy equities, BofAML strategists say in a 10 January note.

"In other words, the unprecedented rise of liquidity from $8trn to $21trn over the past seven years will finally start to have a positive effect on growth in 2013," BofAML says.

The 6.3% year-on-year rise of US home prices, outperformance of financial stocks above all other sectors for the first time since 1993, and the fall in the US unemployment rate to 7.8% indicates that central bank policies are finally providing a stable platform for growth.

Any doubts that the Federal Reserve would curb quantitative easing were dispelled by its recently announced commitment to purchase $85bn in Treasury bonds and mortgage securities each month in 2013.

"2013 will be year where global growth recovers as the eurozone climbs out of recession, emerging market growth reaccelerates and US growth continues to hum along," Rubin says.

European stock indices are more attractively valued than US or emerging markets on measures of cyclically-adjusted price-to-earnings (CAPE) ratios, a way of determining the cost of equities against long-term averages, Ajewole says.

On this metric, bourses in the UK, France, Italy and Spain are cheaper than the emerging markets *(see Figure 1 above)*. These riskier bets can be offset by owning costlier US stocks with strong brands, steady cashflows and pricing power, she says.

Ajewole says stock-picking opportunities have emerged as markets rise and become less correlated. Since 2008, markets have swung on the words and actions of key policymakers such as Ben Bernanke and Mario Draghi, who oversee the US and European central banks, rather than evidence or perceptions of fundamental economic conditions.

"In the last three-to-five years, correlations within equities have been extremely high. Finally, we're getting into an environment where extreme tail risk is lower than in recent years," Ajewole says. "It creates a blank sheet of paper for active managers."

Institutions rotate

Rifts between the funding levels and liabilities of some defined benefit pension funds are forcing them to buy equities as bond yields deliver negative real returns, says Ian Mizrahi, head of portfolio management and structuring at the Funds and Advisory unit of Barclays in London.

Pensions that were not immunised against future payouts before the financial crisis need to invest in assets that will outpace inflation and reduce funding shortfalls.

"They don't have many options. You can't stay in fixed income. You need sources of income with higher real yields," Mizrahi says of funds' interest in allocating more capital to equities. "It's not a matter of whether it will happen but how it will happen."

Most funds seek greater yields from non-investment grade bonds, emerging market debt and dividend-paying stocks that also provide some protection from inflation, he says. Others add private equity and unlisted real estate to their portfolios.

UK pension funds' average 43% allocation to bonds in 2012 exceeded that of equities for the first time in almost 40 years, according to Thomson Reuters. This shows how heavily they have bought fixed income since the financial crisis.

Gradually, funds will invest more in stocks amid declining bond yields, Mizrahi says. "By the end of the year we will see a shift in overall allocations to equities."

Correction risks

The low levels of the Volatility Index, known as the "fear index" as it gauges the prices that investors pay for options contracts insuring against market moves, reflected bullish sentiment by falling to a five-year low of 12.46 in January. That is less than the average reading of 22.74 in the previous seven years and far below the peak 80.86 reading during the financial crisis, according to Oppenheimer Asset Management.

"We're living in a very momentum-driven world," Ajewole says. "The problem with the stock market is that it hides the foundations of what's happening underneath."

Surging equity markets foment a "strong risk" of correcting and erasing up to 10% of their value, she says. "Because growth is so anaemic, because fundamentals are so wonky, you could get a negative pullback," she adds.

Central banks' proven willingness to backstop markets, however, will turn any such fall into a "buying opportunity". Mizrahi says "corrections are likely to be shallow because there is a lot of money flowing into economies through quantitative easing".

"By the end of the year we will see a shift in overall allocations to equities."

Ian Mizrahi

The two most likely causes of a correction would be a rapid rise in interest rates, prompting a bond market sell-off, or moves by governments to devalue currencies to stimulate growth, BofAML says.

For others, the greatest risks to markets remain the US and Europe's chronic debt problems.

"We've all forgotten about Europe because Draghi said he'd do 'whatever it takes' to preserve the euro," Klempster says. "But it is a political project. It requires continued political wherewithal and in the meantime, the ECB has to keep papering over the cracks until it is completed."

Policymakers will continue to be challenged with consolidating the eurozone fiscal union and reducing US public debt deficits, Rubin says. So far, the accommodating stimulus measures taken by central banks have supported markets through this uncertainty.

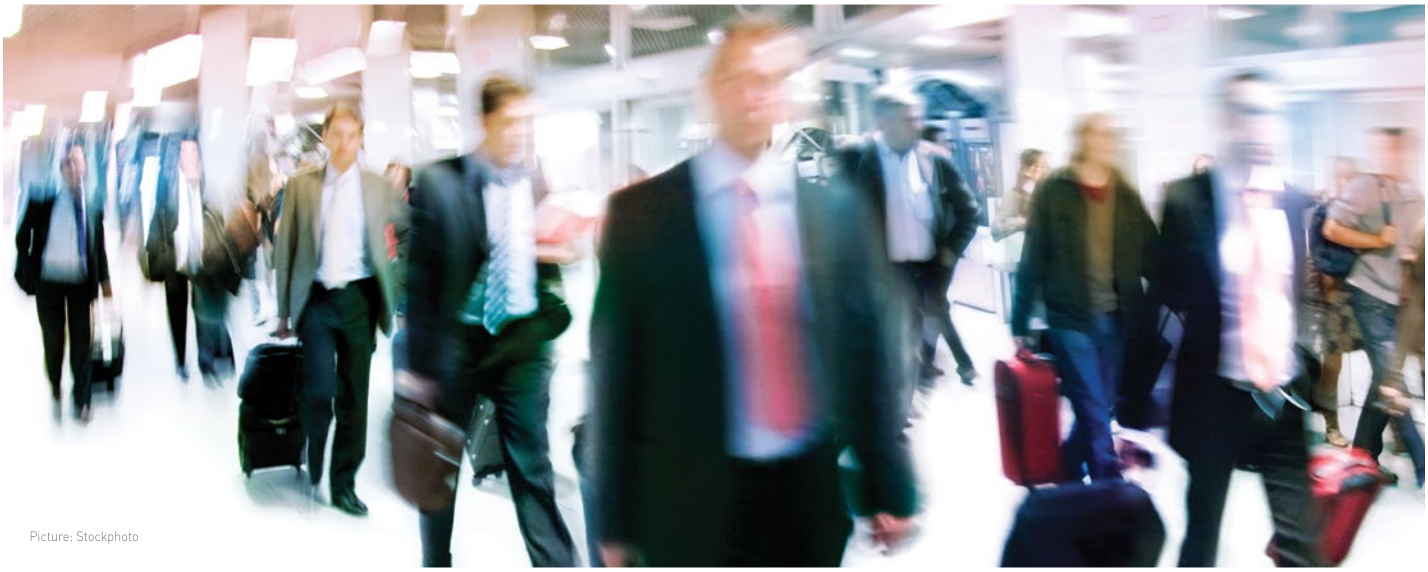
"To a certain extent, near-term systemic risks have been alleviated but the risk is that if necessary changes are not being made, these problems will flare up again in the near future," he says. "The world is far from resolving all of its problems."

Easing risks of sharp economic slowdown in China are countered by the economy's continued reliance on fixed investment and exports. Domestic consumption must become a larger driver of the nation's output to reinforce growth, Rubin says.

"We are closely watching to see if reforms are made by the new government as it determines whether China will avoid the middle-income trap over the longer term."

Macro-economic stability, and the perception that it is achievable, is the bedrock of a sustained rally in riskier assets. Ongoing uncertainty will test investors and policymakers' nerves.

"There will continue to be repeated shocks going forward," Klempster says. "That's the nature of the world."



Picture: Stockphoto