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the investor's choice

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Monthly Commentary 1st May 2014

One third of 2014 is now history, and April actually mirrored how assets have performed year-to-date. That is, equities are largely flat and bonds have been surprisingly strong.

It is rather odd that one of the explanations for listless equities markets is that equities are in bubble territory, and are just looking for the right catalyst to pop. Sure enough, there has been no shortage of bubble-talk in the media, and the latest to join the chorus was David Einhorn, a respected and successful hedge fund manager, who recently wrote that “we are witnessing our second tech bubble in 15 years”. Had he been a lonely voice in the wilderness, we might have been more concerned, but barely a day goes by without someone sounding the alarm. This in itself is reason enough to be sceptical about pending doom.

There certainly has been no shortage of catalysts that could have considerably shaken the markets:

On the geopolitical front, the crisis in the Ukraine has brought back memories of the cold war. In the Middle East, Syria is still a chaotic, the Israeli-Palestinian peace talks have collapsed, violence in Iraq has dramatically increased, Egypt seems to be getting poorer after a false dawn, and Libya is anything but stable; Japan is still making noises that are irking China. Then there is economic news that could have worried investors. The US economy hardly grew in the first quarter; European corporate earnings have in general been disappointing; China still does not seem able to appease investors about a pending credit bust. Other worries are the continuing tapering of QE in the US and the historically high cyclically adjusted P/E ratio of US stocks, indicating over-valuation.

All of the above, and many more worries, could have easily knocked 20% or more off equity markets. And yet, while awkward, declines have been shallow. Another indicator of the absence of a bubble is that trading volumes are down by almost a third from their 2009 peak, indicating that investors are not exactly euphoric.

We continue to subscribe to the view that as long as interest rates remain benign, risk-assets will not roll over, and our portfolios are positioned accordingly. Bill Gross of Pimco recently postulated that the new “neutral rate of interest rates”, which is critical for all asset values, is much lower than it was historically. He summarised a recent paper as follows:

1) Future “neutral” policy rate is critical for all asset values.
2) Current Fed “participants” believe 4% is the neutral rate.
3) PIMCO believes 2% neutral is closer to the mark.
4) If so, asset markets are not bubbly, just low returning.
5) Look to different areas of risk taking if you need higher returns.

This bodes well for equities, but even for bonds, where forecasters viewed them as a one-way negative bet late last year.