—New Albany—
Investment Management

July 28, 2016

Market Insight: Stocks vs Bonds, Two Very Different Stories

Since the Brexit vote last month, the markets have been on a tear. To the surprise of many, the equity market has rebounded nearly 10% and made new highs in some sectors despite an even more uncertain investment landscape. And not just stocks, but bonds have also made new highs in price (low in yield). This phenomenon of both stocks and bonds making new highs is not only highly unusual, but startling, because these two markets are giving opposite signals concerning the future of the global economy and earnings. New highs in stocks normally indicate a strengthening economic and earnings picture. But new highs in bond prices (lows in yield) normally signal an oncoming recession. So how can both dynamics play out at the same time? For now it appears the quiet summer bliss of lightly traded markets is tolerating the dual scenarios, but eventually these markets will align. The discussion and charts to follow lay out the conflicting stories of the stock and bond markets.

The stock story: A story of Momentum.
The fundamentals stink, but stock prices keep rising. Earnings growth has fallen for five consecutive quarters, valuation is very high, global economic growth is slowing, the political environment is very unstable, but stocks are making new highs. Why? Three reasons:

- Nowhere else to Invest: Make no mistake, the Central Banks are propping up the markets with asset purchases and negative interest rate policy (NIRP) in an attempt to boost growth. So far the effort has had no positive effect on growth, however it has left investors scrambling for a place to put their savings. We are in uncharted waters with NIRP. Today, in Europe and Japan, any entity whether a Bank, Corporation, or individual must pay to hold cash in an account. For now, NIRP is a tailwind for stocks because they 'look' more attractive relative to low yielding bonds or cash. How this will all end, no one knows, but for now, 'it's a good thing', as Martha Stewart would say!

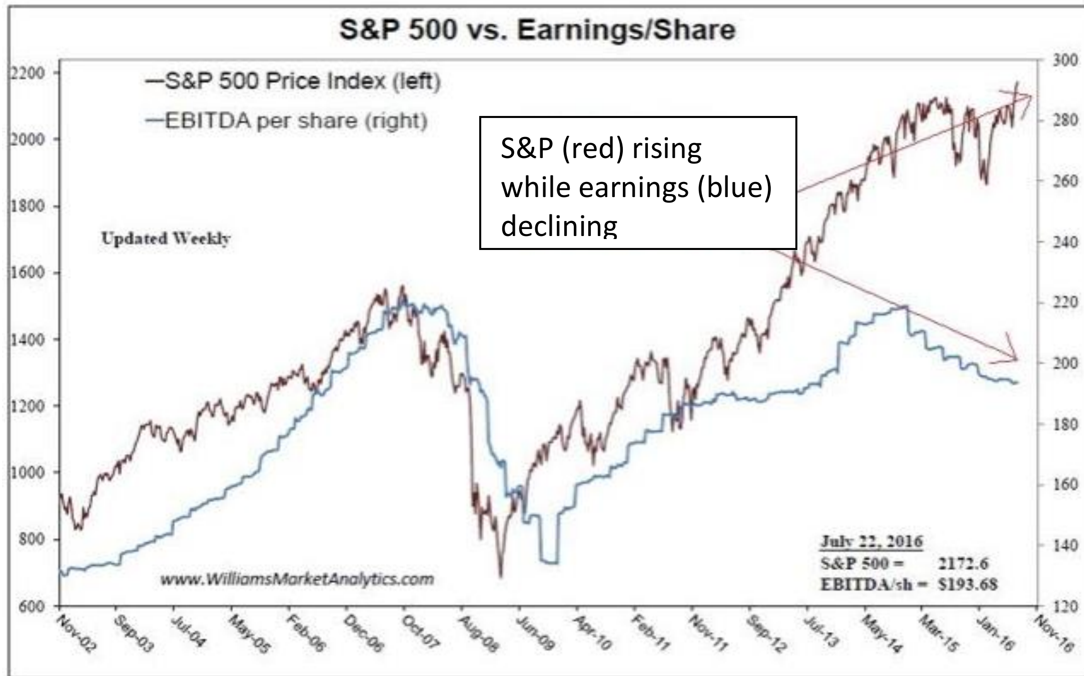
- Forward looking, not back: The stock market is always looking at least six months ahead and currently the picture is quite hopeful for an earnings recovery next year based on two key factors: energy prices have bottomed and the US dollar has peaked. There are many arguments on both sides, but presently the market is believing these factors will be supportive in the months to come. (As of this writing, both oil and the dollar are back to March levels when the market was 8% lower than where it is today.)

- New highs in price force investors to buy. Brexit vote caused both professional and retail investors to lighten up on stocks in anticipation of the market moving lower. When there was no follow through to the downside, investors have been forced to cover and buy again. With light summer trading, the market can be easily pushed and in this case to new highs. This is what is called a momentum or technical rally where the current supply/demand imbalance is allowing for prices to rise. This situation can exist for several weeks to months. Positive momentum is a tailwind to stocks.

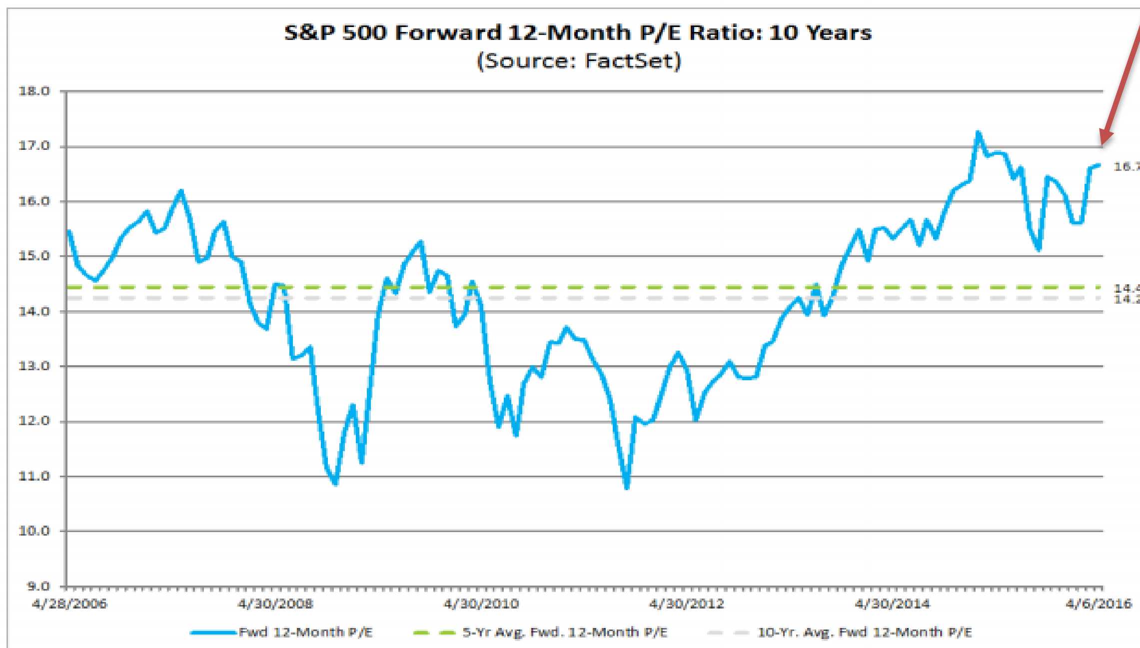
The stock story is about NIRP, hope for a better tomorrow, and momentum. For now, the fundamentals of weak earnings and slow growth have taken a back seat.

A good story is always made better with some pictures. The three charts to follow offer perspective on earnings and valuation of stocks.

Stocks vs Earnings: The chart below shows how prices (red line) have risen but earnings (blue line) have declined .

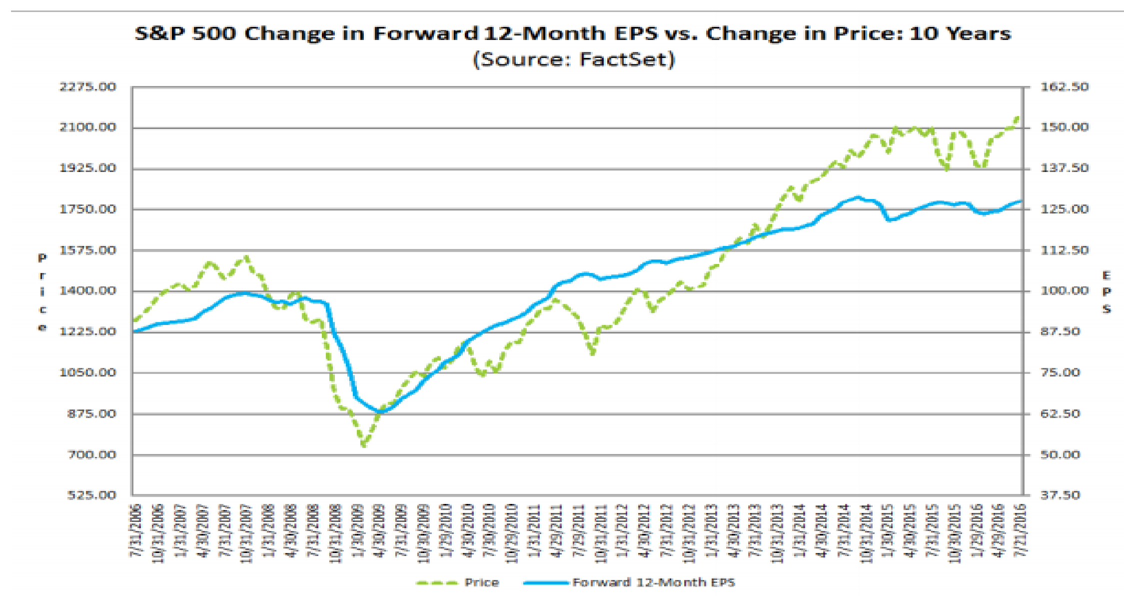


Stocks & Valuation: The recent rise in stock prices have pushed the forward 12-month P/E ratio to 17 (blue) versus the average of 14.4 (green). This means prices have risen but earnings have not. The market would need to decline by -15% to get back to the average.



Source: Factset

Stocks & Future Earnings: The chart below compares the change in price of S&P 500 (green) versus the change in forward 1-year earnings estimates (blue). It can be seen that the expected S&P 500 earnings for the next 12 months - $127.62 - is still below the end-2014 level. The market has seemingly decided to disconnect from the earnings expectations as it remains awash with liquidity.



Source: Factset

The Bond Story: The Upside Down Market.

Weak Growth and Negative Interest Rates. Around the globe, Bonds reached new highs in price, lows in yield, this past month on the heels of a weaker forecast of economic growth and further Central Bank action of targeting negative interest rates. The International Monetary Fund has again cut its forecast for global growth (the fourth time in the past year) and warned of the risks of Britain leaving the European Union, China's slowdown, persistently low oil prices, and chronic weakness in advanced economies as key drivers. Here are the latest revised growth forecasts:

Growth Forecast:	2016	2017
Global:	3.2%	3.4%
China:	6.3%	6.0%
Europe:	1.6%	1.8%
Japan	0.8%	0.3%
US	2.0%	2.3%

Negative Interest Rates: Central Banks are in charge. This year the ECB and Bank of Japan join the ranks of several other Central banks by pushing rates on deposits into negative territory. Yes, savers must pay to save. As of June, there are over $10 trillion in negative-yielding sovereign bonds outstanding worldwide. According to JPMorgan, 36% of the total value of its 'global government bond index has a below-zero interest rate and 74% of these bonds yield below 1%. This dynamic has even trickled into the corporate sector, where there are more than $300 million worth of negative-yielding bonds.

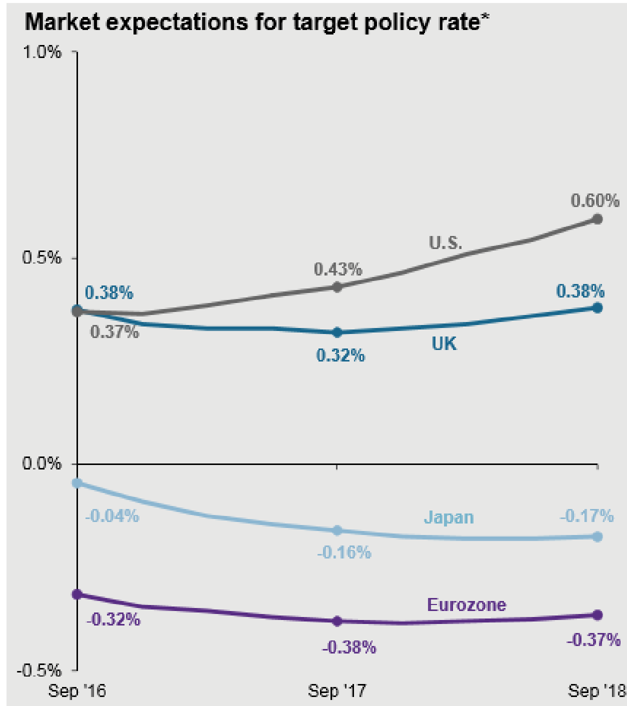
Credit Markets. Negative rates have put more stress on the financial system. Specifically, European banks' earnings are struggling and their capital is being eroded as they must pay to hold required reserves at their Central bank. With the bond market the life blood for all the financial markets, it is important to watch the direction of global credit spreads and the level of defaults. Currently, credit spreads are widening and defaults are rising but have not yet reached alarming levels

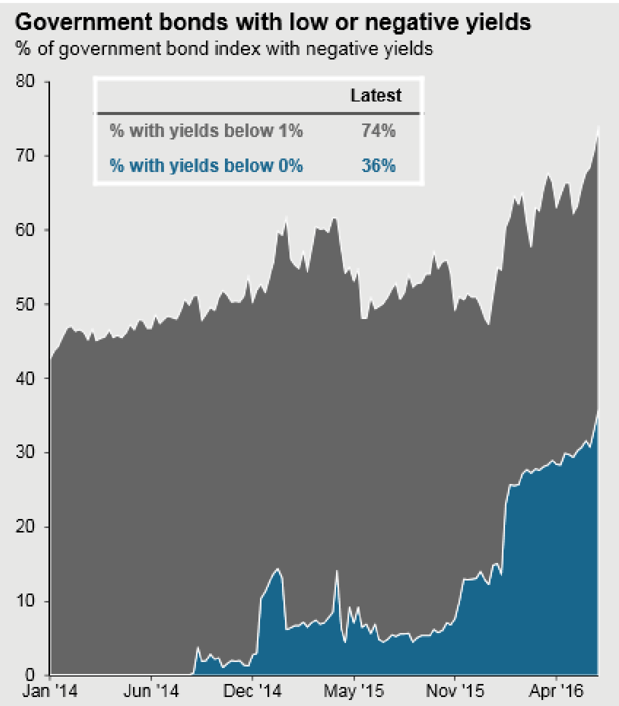
Historical Low in Rates: The chart below shows the 'Nominal' and 'Real ' rate of the 10yr US Treasury note. The 'Nominal' rate is the actual rate paid, and 'Real' rate is adjusted lower for inflation. Today, nominal rates of US Treasuries are at a historical lows.

Source: BLS, Federal Reserve, J.P. Morgan Asset Management.

Below: The left Chart is the current and forecasted targeted rate of Central banks in the Developed Market. Notice the US and UK are slightly above zero while Japan and EU are below zero.

The right chart shows the amount of Developed market government bonds. Gray represents those yielding below 1% and the blue represents those yielding less than zero.





Source: Bloomberg, J.P. Morgan Asset Management; (Right) BofA/Merrill Lynch.

In sum, the conflicting story of the stock market and bond market makes for an interesting investment landscape. At some point, these markets will have to reconcile and the road to reconciliation will likely be choppy. But the summer doldrums are upon us and thus for now, momentum is the friend of the stock market and Central Bank action is the hammer for the bond market.

Portfolio Strategy: Because the fundamental picture remains cloudy, risk is at the lower end of the range but the portfolios are participating in the rally. The strategy has a two prong approach: For stocks, exposure is split between large cap defensive value stocks (US and developed foreign markets), and US Mid Cap blend (for growth). For bonds, exposure is in short term high yield and medium terms corporate and mortgage backed securities.

As always, please contact me with any questions or concerns.

Barbara

Barbara HS Huff

CEO & President
New Albany Investment Management
614-216-6139 www.newalbanyinvestment.com