ARE BONDS A GOOD PLACE TO HIDE?

OR IS IT A BUBBLE?

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A year ago, 30-year US or Canadian government bonds provided a yield of more than four percent. By the end of the year, interest rates had fallen to below three percent, providing investors with a total return of more than 25 percent. The government of Canada four percent bond due in 2041 had surged to a price of $130 per $100 bond, as investors' demand continued to push up the price.

Investors seeking safety from stocks have poured record amounts of money into bond mutual funds and Exchange-traded funds (EFT). But are the investors jumping from the frying pan into the fire by purchasing bond funds when bonds are valued at such a high premium?

A year ago, the general consensus was that the economy was well on its way up to recovery and that interest rates would rise in the second half of 2011. As bond prices move in an opposite direction to interest rates, many investors shied away from bonds. By the fall of 2011, with problems in Europe, stocks falling and bonds surging, bonds seemed like the obvious choice. Furthermore, the US Federal Reserve chairman Ben Bernanke pledged to a senate banking committee early in 2012 to keep borrowing costs close to zero at least through late 2014.

Ironically, so far in 2012, long-term government bonds in both Canada and the US have fallen roughly five percent as long-term rates have inched higher. Global stock market averages have gained more than five percent. As US short-term interest rates are close to zero, it is a little easier to understand why investors would choose to purchase 10-year bonds at two percent. In Canada, short-term interest rates are close to one percent, but with no interest rate hikes in sight. 10-year rates have also traded around two percent. Moreover, most pension funds or life insurance companies have been mandated to have a fixed portion invested in government bonds, so they have to keep buying.

Analysing the relative value of investing in stocks as opposed to bonds is more challenging. While bonds are typically quoted on a yield-to-maturity basis, stocks are typically valued by a price-to-earnings (P/E) ratio. While this might be relevant when comparing one stock to another or to a company's historical value, the P/E ratio does not provide a useful comparison to bonds.

In order to make a better comparison, it is far more relevant to express stocks in the same way that one uses to value bonds; that is instead of using the price/earnings (P/E), one should compare earnings to price. This little-used valuation method is referred to as the earnings yield of the market, and it gives us an apples to apples comparison between bonds and stocks: reported earnings or profits over price, just as a bond calculation reports annual interest over price.

Historically, stocks have usually traded at an earnings yield quite close to that of 10-year US treasury yields. As major market turns, however, there have been some significant valuation discrepancies.

Consider the major bear-market bottom, which occurred in 1982. US 10-year government bonds yielded 14.6 percent while the P/E of the market was six. Expressed as an earnings yield, stocks represented a 16.7 percent yield, which meant they were an even better value than bonds. Stocks would gain more than 1900 percent in the next 18 years.

By comparison, in the year 2000, 10-year bonds yielded 6.4 percent while stocks traded at a P/E of more than 40. There was far too much optimism about profit growth such that the earnings yield of stocks fell to a record low of 2.5 percent. There was really no comparison between bonds and stocks and, at the first speed bump, investors began to flee stocks for bonds. The next 10 years would produce no return for stocks.

Fast forward to today. The S & P 500 (500 largest US traded stocks) was recently at the 1361 level. The actual reported earnings of the 500 companies weighted to the index was 86.98 for a P/E of 15.65 and an earnings yield of 6.39 percent (Barron's: Market Lab).

The reported earnings of the 500 companies

Earnings:	86.98
Index:	1361.23 = 6.39 percent (Earnings Yield)
Alternatively, the yield on the US 10-year note is currently around 2.00 percent.	
10-year US Treasury Bond par $1000 interest:	20
Current bond price:	998.12 = 2.0038 percent

The Wall Street Journal recently reported that, despite the latest rally in stocks, individual investors have put $10.6 billion into bond funds so far this year, while pulling $8.3 billion out of equity funds (The Wall Street Journal – 'Investors' Sell Signal: Surging Stocks.' Friday March 2/12). In 2000, stock market values were at bubble levels, based on an assumption of overly optimistic profit growth forecasts. Today, the tables have turned. Investors' concerns about eroding profit levels have pushed bond values to record high prices, producing record low yields. Despite the subpar economic growth in the western world, profits for 2011 in the S & P 500 grew by 12.7 percent, while dividends grew by 18.3 percent. Comparing stocks to bonds, stocks appear to be better value in today's market.

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That being said, there are tremendous headwinds in the global economy today. Investors need to choose carefully what sectors and what stocks to buy. Although the Greek debt problem might have been contained at least temporarily, austerity in the rest of Europe will likely mean a deteriorating economic landscape for some time to come. The property bubble in China appears to have run out of gas as sales and prices of property have begun to fall in many regions. This could all lead to an economic hard landing in China, and investors need to be careful with industrial commodities.

With this in mind, I continue to favour sectors such as consumer staples, health care and utilities. I believe we are in the eighth inning of the preferred share market, but should be able to continue to find a few select bargains. Investors seeking high yields should be cautious in the high-yield or junk-bond sectors. Like government bonds, junk bonds are trading near record-high prices, thus record-low yields. ■