

THE OMNIVEST MARKET VIEW

Investments



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Stocks Outpacing Bonds

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Stock returns are beginning to cause difficulty for those investors who remain too conservatively positioned by being overweight fixed income assets. Investors who missed the equity market rally last year were able to enjoy equity-like returns from fixed income portfolios such as investment grade and high yield corporate bonds. While we continue to like corporate bonds for cash flow sensitive investors, we believe that equity returns will continue to surprise with very strong returns.

The S&P 500 has now gained 4.8% since the start of the year versus 4.3% for high yield bonds and 2.96% for investment grade bonds. Support for higher stock prices derives from four sources: (1) Price/Earnings estimates for next year are 12.4 times; (2) Corporate borrowing costs have been cut in half over the past 15 months; (3) The weak US dollar is rebuilding exports; and (4) The Federal Reserve continues to be accommodative.

It is our view that the S&P 500 has a strong probability of reaching its previous peak of 1565 on October 9, 2007, with financials, industrials and materials leading the charge.

The fact that investors remain underweight equities and hold a very high level of skepticism towards both the economy and the equity market should be sufficient to push the market higher. Expected equity returns in excess of 20% compare quite favorably with expected returns of high single digits for investment grade bonds and low double digit returns from high yield bonds.

Another important reason to stay bullish towards the equity market is its ability to climb the proverbial wall of worry. The lack of resolution for Greece's financial rescue package has kept many investors sidelined because of mounting fears about Spain, Ireland, Italy and Portugal, all with similar financial difficulties. Investors also remain uncertain about the terms of the bank reform bill and its potential impact on the financial sector.

Double dip recession fears continue to linger, dampening expected returns for financial assets. Fears that the economy cannot maintain positive growth without the help of fiscal stimulus also help nurture investor skepticism. While all of these concerns have a certain amount of legitimacy, they have not been urgent enough to push stocks broadly lower.

As fears ease, risk aversion should ease as well and risk assets should be expected to add to their already healthy gains. We have written in the past that investors remain overweight bonds at the expense of equities. In fact, the ratio of stock ownership versus bond ownership has not been this low since 1995. The imbalance of stocks versus bonds suggests that at some point, stock ownership will rise relative to bonds. Finally, with the Fed expressing the view that it will keep interest rates low for a considerable period of time, we suggest that the Fed will probably not surprise the market with an unexpected increase in the Federal Funds rate.