THE OMNIVEST MARKET VIEW
Investments

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Fear is Consuming Strong Return Potential

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Investor sentiment remains quite subdued in the context that the S&P 500 Index is sitting on an annualized return of 20.98% with a year-to-date return of 11.99%. Sentiment reading for bulls is a full 20% below the 52-week average in contrast with bearish sentiment which is still above its 52-week average. What has caused us to look at sentiment and returns is the expectation that the market is on the precipice of a significant decline.

And while we cannot rule out a market reversal from the strong gains of the past two months, what we can do is provide historical data that portends a continuation of strong performance for the balance of the year. Since 1992 (20 years), there have only been six periods when a positive June was followed by a positive July for the S&P. The seventh period occurred this year. In the previous six episodes, the average annual return for the calendar year was 28.4%. It seems to us that the lack of bullish sentiment currently may be sufficient to push the market higher from here.

From a longer term point of view, the next set of data points also suggests that equities should broadly outperform bonds. From the start of the year 1990 through July of 2012, the total return of the 30-year Treasury bond has been a significant 537% of which only 77% has come from price appreciation. Conversely, the S&P has gained 531% over the same time period with a significant 290% coming from price gains and 241% from dividend income.

With the 30-year bond currently yielding 2.64%, it seems almost impossible to produce the same amount of return income (460%) since 1990. Remember that long term yields were falling from 9% at the start of 1990 and currently are at less than 3%. The average yield over this time period was 5.68%. Investors in long term bonds will have to suffer inordinate losses before yields reach a sufficient level to be able to offset further price declines.

How much of a total return loss would investors expect if 30-year yields were to rise to only 5.68% by the end of 2014? The answer is a loss of 16.77%. If we extend the horizon to 2015, then the total return loss shrinks to 10.62%.

Given the greater prospects for higher rather than lower yields over the course of the next several years, investors may actually find the equity market to offer a much higher risk/reward ratio than owning Treasury bonds. It may seem counter intuitive but a return to a more normal interest rate environment would actually signal the end of risk aversion and likely lead to a multiple expansion for stocks. From current levels, an increase in the P/E multiple from 13.5 to 14.5 would result in pushing the S&P to 1493, producing a return of 7.4% before dividends.