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*advice; judgment; resolution; wisdom

"The Great Rotation"

As this report is being written, the S&P 500 stock index is enjoying its best first quarter performance since… well, since last year's first quarter. In both cases the early-year surge – a 12.6% total return in 2012, and 10.6% this year – was preceded by a late-autumn low that set the stage for a rally into the New Year. In 2011, the market was traumatized by the US debt ceiling fiasco in Congress and the emerging European banking and currency crisis. In 2012, concerns about the "fiscal cliff" dominated investor thinking. But the equity market responded favorably when worst-case outcomes were avoided or delayed indefinitely. These episodes serve as useful reminders that stocks do not always require "good news" to rise; at low points, the news simply has to be "less bad".

After a sharp rise, though, stocks need help – either (a) strong revenue and earnings growth, or (b) an external catalyst – to sustain further gains. While we are not pessimistic about the economy and corporate profits, only modest forward progress seems likely for now, owing to the income and payroll tax increases that took effect on January 1, recessionary conditions in Europe and Japan, and modest cuts in federal government spending. But sluggish earnings growth was no impediment to the equity market last year, as valuations rose. What would justify even higher valuations in 2013 and beyond?

In a textbook sense, stock valuations reflect prevailing interest rates on risk-free alternatives, such as US Treasury bonds, along with a "risk premium" that fluctuates with investor sentiment. Put another way, low interest rates justify high valuations on stocks, after allowing for their higher risks. But the collapse in Treasury rates (from 4% in early 2010 to less than 2% today) since the end of the recession – orchestrated by the Federal Reserve and its program of "quantitative easing" – has not produced a commensurate rise in stock valuations. In fact, the forward price/earnings ratio of the S&P 500 index has declined slightly since "QE" began. This only makes sense if investors believe that stocks have actually become *more* risky over the last few years.

Interestingly enough, investors indicate that this is precisely what they believe, shunning stocks in favor of bonds and bond funds. Despite a very strong advance (up well over 100%) over the last four years, investors have withdrawn $388 billion from stock funds and poured $1.06 trillion into bond funds. And while stock funds enjoyed positive monthly flows in January (for the first time in 15 months, and just the seventh time in seven years), there has been no migration out of bond funds, which continue to attract new money. Individual investors have nearly quintupled their direct holdings of Treasury securities since the end of 2008.

In this context, it is very clear that one path to higher prices is a change in the perceived risk of stocks relative to bonds. A good argument can be made that this is the Fed's exact intention – to drive down riskless rates to a level that makes "riskier" alternatives more attractive by comparison. Merrill Lynch strategist Michael Hartnett dubbed this process "The Great Rotation", and while the data indicates it hasn't yet begun, the ultimate consequences of such a shift could be profound.

Why should a typical risk-averse investor consider moving money from bonds to stocks? One compelling rationale is the prospect for significantly higher total returns. The S&P 500 offers a current yield of 2.0%, higher than that available on 10-year Treasury bonds (1.85%) – but bonds offer no income growth potential, while the dividend on the S&P has risen by over 15% each of the last two years. In fact, any number of high-quality, dividend-paying companies offer current yields in excess of 3% with dividend growth potential of 4-8%. A diversified portfolio built from these stocks could be reasonably expected to deliver total returns in the high single digits over the next five years or more, significantly outperforming bonds.

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A second reason to favor stocks is that bonds are particularly vulnerable to a stronger economy and potentially higher inflation. At the moment, bonds are yielding less than the rate of inflation (1.85% versus 2.0%). This condition is not only anomalous historically, but it also seems to reflect a belief that the economy will remain extremely weak indefinitely, leading to an elongated period of easy money courtesy of the Fed. While it's fair to question whether the economy *will* grow as fast in the future as it has in the past, the fact is that the economy *can* grow faster than it is at present. Should that happen, stocks would likely benefit from rising earnings and dividend growth expectations. But bonds would be punished severely as interest rates normalized at higher levels. Even if rates merely rose to the levels prevailing at the end of the last recession, bonds would suffer price declines of 20-25%.

We conclude that a shift from bonds to stocks may be underway, but it is still in its infancy. A large cohort of investors, disillusioned by their experiences with stock ownership in the 2000-2010 decade, may be several years away from being willing to step back meaningfully into equities. The Great Rotation probably awaits the collective realization that bonds simply aren't as safe as they might appear to be.

Sources: *Baseline, Investment Company Institute, Bank of America Merrill Lynch*

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