

The QAM letter that highlights recent developments that we think either affect the markets or are important to understanding them.

“The cult of equity is dead.” – Bill Gross, CIO of PIMCO & manager of the world’s largest bond fund

“It is not so much what you believe in that matters, it's more the way in which you believe it and proceed to translate that belief into action” - Lin Yutang (1895-1976) Chinese Author

From a cult to a guide: the case for equities

In the most recent edition of his widely read Investment Outlook, Bill Gross comments: “Now in 2012, however, an investor can periodically compare the return of stocks for the past 10, 20 and 30 years, and find that long-term Treasury bonds have been the higher returning and obviously “safer” investment than a diversified portfolio of equities. In turn it would show that higher risk is usually, but not always, rewarded with excess return.”

The August 13, 1979 edition of Business Week titled “The Death of Equities” was written just after the stock market had suffered severe losses. There were grave concerns about the long-term shape of the U.S. economy. Notwithstanding a similar forecast that “The cult of equity is dead”, the stock market made a strong comeback just a few months after this article was published; the S&P 500 rose 2,635% from 1980-99 in one of the greatest bull markets in history.

Sentiment today is very negative towards equities, the same as in 1979. A Gallup poll shows that the number of Americans invested in the stock market dropped to 53% as of April 2012, down from 65% in 2007. This 53% reading is the lowest since Gallup started asking the question in 1998.

Clearly, equity markets are getting very little admiration despite the fact that the S&P 500 is only 10% from its all time high set in 2007.

But Bill Gross is not new to the financial world. And he knows the basics too. He goes on to say: “With long Treasuries currently yielding 2.55%, it is even more of a stretch to assume that long-term bonds – and the bond market – will replicate the performance of decades past. The Barclay’s U.S. Aggregate Bond Index – a composite of investment grade bonds and mortgages – today yields only 1.8% with an average maturity of 6–7 years. Capital gains legitimately emanate from singular starting points of 14½%, as in 1981, not the current level in 2012. What you see is what you get more often than not in the bond market, so momentum-following investors are bound to be disappointed if they look to the bond market’s past 30-year history for future salvation instead of mere survival at the current level of interest rates.”

Gross subtly ends his article by suggesting that the real threat to a financial portfolio now is inflation. We share this concern.

Is the cult of fixed income dead?

Since the first round of Quantitative Easing, the Federal Reserve has expanded its liabilities from a little under \$900 billion to over \$2,700 billion while its capital only increased from \$40 billion to \$54 billion. In other words, the leverage ratio of the Fed has more than doubled. The Fed is not alone here. Other Central Banks (Bank of England, European Central Bank, Bank of Japan) have seen their balance sheets expanded in a similar way since the crisis of 2008.

The Bank of Canada's balance sheet is an exception more than the rule. As the crisis of 2008 hit its highest point, the financial system in most developed countries saw a credit freeze and a dramatic decrease in the level of credit creation. Central Banks stepped in by expanding their balance sheets in an effort to jump start the credit market and avoid a catastrophic deflationary scenario that would ultimately affect employment and growth. Given the solvency of its banking system, Canada's credit market recovered very quickly. The Bank of Canada didn't need to expand its balance sheet as much as other Central Banks.

The logic behind Central Banks balance sheet expansion is to provide liquidity until the financial system recovers and the private sector resumes its credit growth. Once the financial system recovers, the risk of excessive money growth - that leads to inflation - is higher with every new loan created by the private sector that is not offset by a reduction of the Central Bank liabilities. In order to reduce liabilities the Central Bank needs to sell assets, but if those assets are mainly IOU's from a deficitary state (like the USA and most European countries) chances are this could not be accomplished without seeing interest rates rise in a significant way affecting employment and growth (that were intended to be protected in the first place).

This leads to two types of scenarios: structural changes without fiscal deficits that create the conditions that permit sustainable growth that would naturally allow Central Banks to gradually reduce their balance sheets, or an inflationary environment. Life is never black or white and there are always different shades of gray but, given the current state of affairs, QAM sees more probability in the latter scenario – expect inflation.

Against the back drop of a slower recovery in world economies and the threat of inflation around the corner, investors need to ensure their return expectations for asset classes are reasonable. We concur with Bill Gross's observation that the bond market's 30 year history had a different starting point and cannot be relied upon to repeat those gains. We believe that the core of a long-term portfolio continues to be equities that provide sustainable growth even in an inflationary environment.

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