Infomail

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"QE" – To Infinity and Beyond

"One of the great mistakes is to judge policies and programs by their intentions, rather than their results."

Economist Milton Friedman

Last week's announcement out of the US Federal Reserve of the latest Quantitative Easing program ("QE3") was beyond anything any central bank has attempted…..ever. Besides announcing the extension of "Operation Twist," the open ended bond buying program, they also announced the extension of the low interest rate commitments into 2015. On top of that, they announced a $40 billion <u>per month</u> mortgage purchase program (about $500 billion).

All this is especially significant given we are trading at historically low yields in most bond markets all over the world. These massive declines we've experienced in interest rates make any future gains in bonds challenging to obtain. The only area which still makes sense from a risk-reward perspective is equities, especially high yielding/growth names.

But as daily volumes indicate, investors are still avoiding equities. In September 19th's issue of the National Post, they quoted the latest statistics, and despite "ok" markets of late, gross sales of equity funds were up 3% during August, but net redemptions rose to $1.158 billion from $900 million.

Year over year redemptions of Canadian equity funds continue almost on a monthly basis. In the USA, retail investors have not been net purchasers of domestic equities on an annual basis since February 2007. As of May 31, 2012, 57% of all mutual fund assets were in equities versus 33% for bonds. While this seems like a large percentage devoted to equities, it is the lowest percentage in 17 years.

An issue of Business Week discussed that with "stocks averaging a return of less than 3% throughout a decade," investors were fleeing equities in favour of cash, and "real" assets like real estate and gold. It goes on to claim: "for better or worse, then, the US economy probably has to regard the death of equities as a near-permanent condition." The famous article, called "The Death of Equities" concluded "Today, the old attitude of buying solid stocks as a cornerstone for one's life savings and retirement has simply disappeared." Sound familiar? September 2012? The article was published in August 1979, right before one of the greatest equity runs in history.

Equities are no more likely to be dead now than they were in August 1979. Actually, the expected return advantage of stocks vs. bonds is unusually high at present. Equities are the alternative to zero interest rates and to running out of money. Modern retirement cannot be funded with today's interest rates.

Everything seems priced as if nothing will ever go right but consider the following: Despite everything we've been through the last decade, the US equity markets are 8% off ALL TIME highs (Based on S&P 500). Corporate cash balances are at levels not seen since 1952. The Standard and Poor 500 stocks yield about 2.20% today, vs. 1.80% for the US 10 year Treasury Bond – the last time this happened was 50 years ago, in 1962. The last time the earnings yield of equities was 5 times that of bonds as it is today? Never has happened.

As an advisor, I've learned the value that is implicit in any asset class at any given time is perfectly correlated to the public's enthusiasm for that asset class. It is 100% based on basic human nature.

Since 1982, we have never seen such a disdain for equities.

Stay tuned,

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