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Equities Remain Attractive as Bond Investors Face New Era, Strategists Tell Attendees at CFALA Annual Forecast Dinner

LOS ANGELES – An improving U.S. economy, continued monetary easing and low interest rates are creating favorable conditions for equities while bond investors face new challenges, top investment strategists told attendees at the 11th annual Economic and Investments Forecast Dinner hosted by the CFA Society of Los Angeles (CFALA).

Providing the macro outlook was Andrew Spence, Multi-Strategy Portfolio Managing Director at OMERS, one of Canada's largest pension plans. Spence said recent investor preoccupation with the fiscal cliff had overshadowed the reality of a pickup in the pace of economic recovery that includes a true bottom for housing, falling unemployment and rising consumption. The remaining impediment to growth in the private sector – pent-up business investment – will commence once companies are more confident about the economy, he said.

"Private sector healing here in the U.S. is over," Spence told about 300 members of the Southern California investment community gathered at the Omni Hotel Wednesday evening. "Only government deleveraging is left, and that can play out over several generations. Fiscal drag peaks this year. In sum, headwinds are blowing less fiercely, central banks are doing the right thing, and volatility is suppressed. So, what's an asset allocator to do?"

Spence said investors should ask: "Where's the value proposition, and what's my downside risk?" The answer, he said, is: "The value is in equities, and the risk is in central banks. With that in mind, what is the most likely macro outcome, and what is priced in?

"The only near-term drag now is fiscal consolidation, which is doubling to 2.0% of GDP in the first half but eases off in the second half," he said. "But what's priced in? Deleveraging and the half-speed recovery. The market is not priced for a U.S. economy that is capable of reaching escape velocity, and this is a great opportunity."

Noting that bond prices are extremely high, Spence said the much-anticipated "great rotation" out of bonds and into stocks likely will occur rapidly when investors are certain that economic growth is robust again. Even though equities have advanced due to successive rounds of quantitative easing, "there is still value to be had," he said, and

astute asset managers will position now for what may be a rapid shift to the risk-on trade.

“The first half of 2013 will give us some great opportunities, and will be a traders market,” he said. “Beneath the surface, growth is recovering, there is lots of pent-up demand and the burden on central banks will lessen. Investors are under-invested in risk assets, and there is lots of cash to be put to work. My sense is we should get out ahead of the pack and reap the benefits of lots of money looking for scarce and well-priced assets.”

Fixed income investors need to embrace a new set of parameters and expectations for 2013 and beyond, said Jeffrey Rosenberg, CFA, Managing Director and Chief Investment Strategist for Fixed Income at BlackRock, Inc.

“Fixed income returns benefited from everything going right in 2012,” Rosenberg said. “The atypical situation of declining interest rates and declining credit risks led to an index return for ‘core’ fixed income of 4.2%, but provided the average bond fund manager the opportunity to nearly double that return to just over 8%. However, achieving similar results in 2013 will be much harder. Investors should adjust their fixed income return expectations lower for 2013 – much lower. For 2013, we expect ‘core’ fixed income benchmark returns only in the region of 1-2%, with returns only in the 2-3% region for the average bond fund.”

The immediate outlook for fixed income returns depends primarily on the next phase of debt ceiling-induced uncertainty, Rosenberg said, with the possible derailing of the economic recovery determining whether rates are higher or lower by yearend. He urged investors to recognize that what he called the “old era” of fixed income has ended and to adopt “New World” investment strategies that utilize a more flexible approach.

“’Old era’” strategies in fixed income typically contain too much duration exposure through overconcentration in Treasury, Agency and MBS sectors – sectors likely to underperform in 2013,” Rosenberg said. “But here’s the ‘real’ kicker: even if interest rates do nothing at all in 2013, traditional ‘old era’ fixed income investments – that is, investments that concentrate allocation to interest rate sensitive fixed income sectors – will suffer negative returns after inflation. That means investors need to look beyond the era of traditional core fixed income investing. Where a typical ‘old era’ fixed income portfolio held two-thirds interest rate risk and only one-third credit risk, tomorrow’s ‘New World’ strategy should reverse those weightings, holding two-thirds credit risk and only one-third interest rate risk.”

Rosenberg said overweighting credit segments of fixed income in areas such as high yield, bank loans, emerging markets, municipals and credit portions of the mortgage market offer the opportunity for better returns in 2013.

Commenting on widespread descriptions of bonds as being in a “bubble,” Rosenberg disagreed.

“An asset price bubble is when the expectation that the price can only go higher forms the only rationale for purchase,” he said. “But the main motivation of investors for buying fixed income is the opposite of typical bubbles – the fear of losing money rather than the greed of potential profit has fueled the historic shift of assets into fixed income. The risk for investors in 2013 is that even with our outlook for only modest increases in interest rates, returns in core fixed income will not keep up with inflation. However, rates at the higher end of our scenario may lead to negative returns, even before considering the impact of inflation.”

On the equities front, Shelby Notkin, Chairman of Capital Group Private Client Services, noted that stocks around the world did well in 2012 despite various uncertainties and said his firm is generally upbeat about the year ahead.

The annual forecast dinner benefits the California Council on Economic Education, which this year honored Sasha Guzman, who teaches at the Student Empowerment Academy in South Central Los Angeles, as CCEE’s teacher of the year. Guzman, the council said, is committed to closing the educational gap and changing the learning culture in order to empower and develop competent, committed young adults who are ready to learn and lead, as socially responsible citizens, in a multicultural society and demonstrate the ability to succeed in an increasingly competitive global economy.

Moderator for the evening was Gregory A. Peeke, CFA, CIO and portfolio manager of Skrimshaw Investment Management, LLC. Event sponsors included Payden & Rygel and Barclays Capital.

Founded in 1931, the CFA Society of Los Angeles (CFALA) is a network of investment management professionals that works to disseminate useful financial information and increase awareness of the value of the Chartered Financial Analyst (CFA®) designation, which is intended to lead the investment profession by setting the highest standards of ethics, education, and professional excellence. Additional information is available at www.cfala.org.

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