The Outlook's Market Insight

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Bonds Away

Bernanke s billions bode well for equities, commodities.

In the wake of QE2, the second round of quantitative easing by the Federal Reserve, professional investors remain optimistic about riskier assets, specifically stocks and commodities.

Beyond increased liquidity, we think the Fed s willingness to pump $600 billion into the economy, and possibly more should it be needed, as signaled by its intent to regularly review the pace and size of QE2, offsets investor anxiety regarding sluggish growth in the world s largest economy, and helping fuel a rally in risk assets, says Alec Young, an equity strategist for Standard&Poor s. In addition to stocks, commodities of all stripes soared as the dollar weakened amid fears of rampant Fed money printing, in our view.

The S&P Investment Policy Committee advises a 65% weighting to equities in its recommended asset allocation. For specific ETFs and other asset allocation advice, please see the cover table.

Many asset management and mutual-fund firms also think stocks generally remain undervalued.

Duane McAllister, vice president and investment manager at M&I Investment Management, says riskier trading has been in vogue since the QE2 announcement, so if you were to pick asset classes that would do well here, we think it is equities and commodities.

It s kind of ironic since the Fed announced it will buy government bonds, quips McAllister, who is also the portfolio manager of a municipal bond fund, the Marshall Intermediate Tax Free Fund (MITFX).

I wouldn t lend the federal government money for 10 years at 2.5%, says Mark Travis, the president of Intrepid Capital Funds. As of November 8, the fund he co-manages, the Intrepid Capital Fund (ICMBX) maintained about 18% in cash and Treasuries, 25% in corporate debt, and the rest, 57%, in equities.

Even Gibson Smith, co-chief investment officer (CIO) of fixed-income investments at Janus Capital Management, proclaims he is bullish on equities.

When I talk about equities it s kind of perverse coming from a fixed-income guy, but overall when you look at what we ve been through post-crisis the amount of liquidity in the system, there are reasons to be bullish here, Smith says.

Although not all of the buy-side executives were in agreement over whether another round of quantitative easing will be necessary, they all agree that the Fed s QE2 plan to buy an additional $600 billion of longer-term Treasury securities from the market by the end of June 2011, if implemented, would be positive for the vast majority of large quality multinationals over the next year or two. The announcement alone reflected positively on stocks. The markets applauded the November 3 Fed news by bidding up the S&P 500 nearly 2% that day alone.

Managers at firms that manage a blend of funds point out that QE2 s effect on the stock market in the near term should be the result of keeping money flowing in the system, holding down interest rates to ease debt burdens and spur lending, and preventing prices on finished goods and services from depreciating further.

I don t know how much of QE2 is going to have an impact, but I consider it more of an insurance policy, says Thomas E. Villalta, CFA, president and chief investment officer at Jones Villalta Asset Management. Additional liquidity has the ability of being inflationary, but I think QE2 is more of an insurance policy against deflation and that has played well for the market over the last few days since QE2 was announced. he adds.

I think the purpose of QE2 is to prevent Japan 2, agrees Brian Barish, CFA, president and chief investment officer at Cambiar Investors. The Fed wants to avoid a structural weak period of growth in the U.S. that begets stagnation and a liquidity crisis, just like what Japan experienced, he adds.

The longer-term view they espouse is that QE2 is very likely to help boost equity prices over the next few quarters. Gibson at Janus sees good valuations in the equity markets, and he expects those investors with cash sitting in money market funds or fixed-income investors who learned bitter lessons in 2008 and 2009 to return to stocks for better returns over time.

The London Company s Managing Director Stephen Goddard, CFA, points out that many American companies are offering cash-flow yields that are as high as or higher than bonds, an unusual scenario that speaks to the attractive relative value of stocks, and suggests that long term investors in stocks should enjoy superior returns, especially relative to bonds, he wrote in a recent note to investors.

Fund strategists and asset managers agree that investors who want to put new money to work in stocks just need to be selective. Professional investors believe that certain stocks could reflect the effects of tighter margins and lower profitability into 2012 due to commodity-price increases. Many buy-side participants are concerned that some companies, especially those that depend on slower-growth developed economies for sales, may see their sales drop at the same time that their raw-material costs rise.

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