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Why Equities Have the Advantage over Bonds

The current economic and monetary policy environment favors owning stocks over bonds. The current Fed policy of near zero interest rates is subsidizing the rebirth of American enterprise, while discouraging investment in fixed income. What makes this point in time remarkable is the growing strength of corporate balance sheets, as measured by cash and low borrowing costs. With improved balance sheets and a low dollar, American corporations are better positioned to compete globally.

Price-to-earnings expansion is inevitable when interest rates are low. Expectations of future earnings growth is driven by the lower associated earnings discount rate, improving cash flows, strong balance sheets and competitive advantage. Another boost derived from low interest rates is a lower valued U.S. dollar that makes exports more attractive and higher foreign earnings translated back into dollars.

When interest rates are high, investors are rewarded with attractive bond coupon levels. In contrast, corporate borrowers are faced with paying more interest to banks and bond investors; resulting in lower earnings. While this was the environment during the 1980s, it is clearly the opposite today.

Bond prices are sensitive to changes in interest rates, as measured by duration. As the bond coupon declines for newly issued bonds, the sensitivity to interest-rate change increases; the result being higher volatility risk. Lower coupons stretch out the payback period of each bond, thus increasing the risk. Duration risk may be managed with owning shorter maturities and higher yielding issues. Higher yielding securities are associated with increased default risk. Selecting a shorter than normal duration today may be defensive, but the drop in expected return is significant.

Domestic stocks are offering dividend yields that are comparable to the five-year treasury, a situation that has emerged over the past year and not observed since the 1950s. Thus, large-cap equities offer bond-like yields, along with the potential to appreciate; even in the face of rising interest rates associated with an improving economy. A stronger economy means higher corporate profits, a formula for improving dividends. In contrast, bond prices decline during these periods.

While the environment favors stocks over bonds for reasons stated above, adding stocks to the allocation adds additional volatility risk to the portfolio.

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