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Why Holding 'Safe' Assets May Be Unsafe

1. Safe assets are over-owned. Since January 2008, $496 billion has left stock mutual funds and $1.1 trillion has gone into bond funds, according to the Investment Company Institute. We believe that this trend has been driven by fear of the fallout from the 2008 global recession, especially the high levels of government debt (see Weekly Chart), causing a search for safety and yield. We now fear bonds and cash offer neither. With historically low yields on cash and bonds, stocks do not need good news to go up, in our view; they just need an absence of bad news.

2. Safe assets are overpriced. The S&P 500 currently has a 2% dividend yield and a 2% 'buyback' yield, i.e., companies are spending as much buying their own stock as they spend paying dividends. We believe buybacks are a good deal because current prices are reasonable. Combining these two yields, stocks are yielding 2% more than 10-year Treasury bonds and 4% more than cash. In non-US markets, the 4% comes largely in the form of dividends. We think stocks are a better value as long as the world avoids recession.

So long as the developed world's central banks can offset the effects of deleveraging with approximately the right amount of balance sheet expansion the global economy will continue to deleverage.

3. Safe assets are likely to underperform. Developed world central banks are keeping interest rates low to encourage risk taking and to lower government debt-servicing costs. This is hurting cautious savers. So long as the developed world's central banks can offset the effects of deleveraging with approximately the right amount of balance sheet expansion (i.e., quantitative easing, or QE), the global economy will continue to grow at a below-average rate and gradually deleverage. The US household and corporate sectors have been deleveraging for more than two years, but the government is just starting. Too little QE and economies fall into deflation, which is good for bonds and bad for stocks (e.g., Japan 1990-2012, Europe 2008-last summer). Too much QE and some inflation becomes a threat, which is bad for bonds/cash, good for commodities, and OK for stocks as long as inflation stays below 4% (e.g., US in the 1950s and 1960s). We think a sustained bear market for stocks would require high single-digit inflation (as in the US during the 1970s). We strongly believe policymakers fear deflation more than inflation, hence our preference for stocks over bonds.

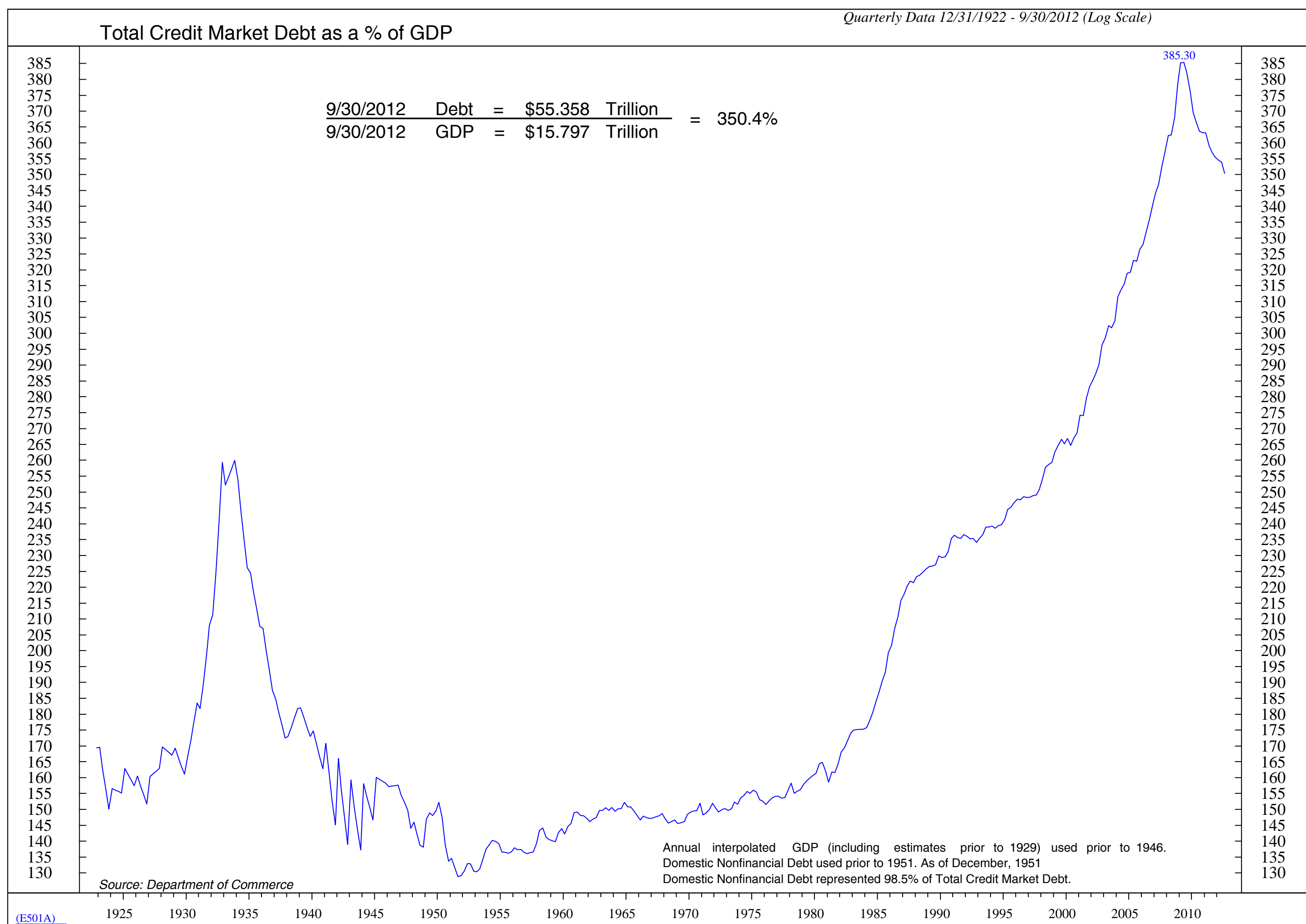
Cautious savers are losing 1% to 2% of purchasing power every year and missing a bull market in stocks.

US stocks have more than doubled in the bull market that began in 2008, supported by a doubling of earnings. John Templeton once said that a bull market is "born on pessimism, grows on skepticism, matures on optimism and dies in euphoria." In our view this bull market is still 'growing on skepticism'. Cautious savers are losing 1% to 2% of purchasing power every year and missing a bull market in stocks.

RiverFront's five portfolios (optimized for risk tolerance and time horizon) hold only as many 'safe assets' as necessary to meet their objectives.

4. At current yields, safe assets' lower volatility creates an illusion of safety. Stocks' volatility creates a sense of risk, but the greater risk is allowing volatility to cause investors to abandon a well thought out investment plan, in our view. The lack of volatility in short-term bonds and cash provides a sense of safety, but returns below inflation will cost investors over the longer term. Whenever the financial markets think that QE policy in the US or abroad might change or need to change, markets generally move. This helps explain stocks' negative reaction following the Fed minutes and Italian elections that we wrote about last week and the positive reaction by Japanese stocks since Prime Minister Abe campaigned and won with a mandate to boost nominal growth.

THE WEEKLY CHART: DELEVERAGING – THE DEBT MOUNTAIN PEAKS



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Our Weekly Chart features the 90-year history of the US debt cycle as measured by total credit market debt (both government and private debt) as a percentage of GDP. US debt/GDP went through a complete up and down cycle from 1925 to1950, twenty years of stability from 1960 through 1980, a huge expansion from 1980 to 2009, and the current deleveraging cycle of the last four years. We expect deleveraging to be the dominant theme in the global economy for years to come.

Historically, it has been unusual for policymakers not to make mistakes trying to unwind such a mountain of debt, so there are plenty of worried long-term investors with higher cash/bond allocations. However, history shows that when policymakers are determined to achieve a specific result, and back that determination up with action, they usually succeed. Current policy is intended to prevent deflation and promote growth. In this environment we believe stocks will continue to do better than cash and bonds, albeit with more short-term volatility. Thus, RiverFront's five portfolios (optimized for risk tolerance and time horizon) hold only as many 'safe assets' as necessary to meet their objectives.

Information provided in this report is for educational and illustrative purposes only and should not be construed as individualized investment advice. The investment or strategy discussed may not be suitable for all investors. The Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market. It is not possible to invest directly in an index. Dividends are not guaranteed and are subject to change or elimination.

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