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CAN PIGS BECOME SWANS?

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The transformation of the ugly duckling into a beautiful swan in the tale by Hans Christian Andersen taught us of the folly of hasty judgments based on initial appearances. The ungainly and unappealing young bird became a beautiful swan before the shocked eyes of those who mocked her. While the title of this newsletter may suggest some impossible crossbreeding it is meant to reflect on the transformation of the sovereign debt of the PIGS (Portugal, Italy, Greece and Spain) into beautiful swans, at least as far as relative yields are concerned. This transformation was fueled by the accommodation of the European Central Bank just as our Federal Reserve has pushed US yields down to what seem to be unsustainable levels.

In early 2010, as the US was beginning to gradually emerge from the financial crisis of 2008-2009 trouble erupted in Europe as the sovereign debt of many countries seemed on the brink of default. Yields on bonds issued by Italy, Portugal, Spain and Greece rose dramatically and Greece was eventually forced to partially default on its sovereign debt. The contagion expected by many after the Greek default thankfully did not spread to the other troubled countries due to the forceful action of the European Central Bank and stronger member countries such as Germany. The debt burden of many of these countries is still a major problem but it is interesting to see how the yields on the debt of these countries have come down in this current financial environment of central bank accommodation both abroad and in the US.

Recent 10 year bond yields on the sovereign debt of the PIGS and the US were as follows:

Greece-5.75%, Portugal-3.43%, Italy -2.88%, Spain-2.65%, U.S.-2.58%

The rates on the 5 year bonds are as follows:

Greece-4.0%, Portugal-2.20%, Italy-1.42%, Spain-1.30%, U.S.-1.67%

While Greece remains the outlier and high yield bond of the group, the slight premium (higher yield) on the 10 year debt of Italy and Spain over the U.S. 10 year note and the discount (lower yield) of the 5 year notes of Italy and Spain to the U.S. 5 year note seem quite remarkable. Without being too overtly nationalistic one might expect the 5 year bonds of Italy and Spain to yield more than the U.S. 5 year note given our relative positions in the world economy and perceived security of the debt. However this is just more evidence of the effects of the central banks on asset prices here and in Europe and makes more critical the question of how all of this unwinds as the central banks reduce their accommodation.

It is important to realize when asking the simple question of what buyer is really attracted to this sovereign debt at these yields, the answer is usually the central banks themselves, at least in the U.S. According to the New York Times the Federal Reserve bought over 70% of the Treasury debt issued in 2014. As this effort was designed to keep interest rates low and inject funds into the economy the Fed was successful. The European Central Bank doesn't directly purchase individual country's debt but their backing encourages large investors to believe that the debt is secure and forces rates down.

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While the European Central Bank may be in the earlier stages of its accommodation our Fed has at least begun to reduce the purchases of government debt. As this huge support for the government bond market is gradually reduced yields are expected to rise as the market seeks a more normal equilibrium.

This inevitable rise in interest rates, even if modest, may cause some dislocation in both the bond and stock markets. If the rise in rates is caused by continued economic growth without significant inflation the transition to higher rates may be a smooth one. Wharton Professor Jeremy Siegel points out that the stock market has sold at Price/Earnings (P/E) ratios of 15-16 when interest rates were far higher so that it would not be unreasonable to expect the stock market to maintain current levels or even continue to advance as interest rates rise. It is also not unreasonable to expect that the first real indication rates may be rising might trigger a long anticipated short term correction in the stock market which might be healthy for the longer term.

In a prior newsletter, we mentioned the Fed Model as a way of looking at comparative valuations of the stock and bond markets. This model (not endorsed by the Federal Reserve) compares the earnings yield of the S&P 500 to the yield on the 10 year Treasury note. The earnings yield (earnings estimate of the S&P 500 divided by price of the index) remains at roughly 6% versus a 10 year Treasury yield of 2.60%. Historically these rates tend to be more closely correlated. Therefore by this measure of long term relative valuation the stock market should be able to withstand higher interest rates, particularly as the economy recovers.

Despite the weather related setback in the first quarter of 2014, the economy continues to improve and the employment picture is getting better. Lower credit costs have spurred corporate spending, either in the form or acquisitions or capital spending and consumers have reduced their personal debt levels. Long term energy costs, assuming no major disruptions in the Middle East, should continue to decline on balance as the natural gas boom in the U.S. could have a significant positive impact on the U.S. economy. Food and gasoline costs continue to rise in the short term but in general inflation seems moderate.

Hence, the stage is set for what should be a very interesting next year or two as we transition from markets bolstered by the Fed to stock and bond markets that must stand on their own. Some analysts are expecting very modest future annual returns as we continue to struggle with anemic growth and high debt levels. Some expect more robust growth as the worldwide economy recovers and there are always those who expect the worst. We remain optimistic but mindful that long term growth is often achieved in fits and starts. We believe many top quality domestic and international stocks are reasonably valued but others seem somewhat overvalued. Certain assets classes such as small cap stocks seem relatively expensive while developed markets such as Europe and Asia and emerging markets are undervalued in our view. Bonds, be they PIGS, swans or something in between seem significantly overvalued.

We welcome the opportunity to discuss our outlook and your thoughts on the markets. We appreciate your support and are very grateful for the faith you have placed in us.

The opinions expressed herein are those of the authors, Knox & Downing Advisors, and do not necessarily reflect those of the Advisory Services Network, LLC.