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WEEKLY INVESTMENT COMMENTARY

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Bonds Rally, But Stocks Still More Attractive Long Term

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Stocks Go Up ... Then Down

Stocks started the week on a strong note with the major U.S. and global indexes reaching all-time highs, only to give back the gains in a big mid-week selloff before stabilizing on Friday. Overall, U.S. equities were down marginally for the week: The Dow Jones Industrial Average declined 0.55% to 16,491, the S&P 500 fell a nominal 0.03% to 1,878, and the tech-heavy Nasdaq Composite lost 0.46% to close at 4,091. At the same time, bond yields continued their slide, with the plunge in yields starting to look excessive. The yield on the 10-year Treasury fell from 2.64% to 2.52%, as its price correspondingly rose.

In some respects, the week was emblematic of the year so far. Last week's losses left stocks up only nominally year-to-date, while a broad measure of the U.S. bond market is up around 3.50%. Given the sharp reversal from 2013, when stocks were up strongly while bonds struggled, this has left many investors wondering: How should I be positioning for the long term?

The Grand Reversal Continues

It's worth taking a moment to look at some of the factors that drove market action last week.

There was some good news on the economic front: Initial U.S. jobless claims fell to a seven-year low and U.S. housing starts surged in April. But it came with a dose of less-encouraging data: Retail sales were weak in April and industrial production unexpectedly fell 0.6%. In addition, Walmart, an important bellwether for the market, forecast second-quarter earnings that missed analysts' estimates, shaking investors. Sentiment was further dented by U.S. small caps entering correction territory (down more than 10% from their record high reached earlier in the year). Adding to the pressure on stock prices was evidence that several hedge funds and broker-dealers are liquidating their positions.

As stocks floundered, bonds continued to rally. The yield on the 10-year Treasury note broke below 2.50%, a six-month low, while yields on the German bund hit their lowest point in a year. Surprisingly, the drop in yields occurred despite higher-than-expected U.S. inflation. Producer inflation rose by 0.6%—the biggest gain since September 2012—while consumer inflation rose from 1.5% in March to 2.0% in April.

Typically, one would expect yields to rise with higher inflation. But inflation expectations remain stable, and real yields—in other words, adjusted for inflation

—continue to collapse. Several factors are helping to drive yields lower, including lingering geopolitical uncertainty, some evidence of sputtering global growth, continued bond buying by pension funds and some recent concerns about housing growth.

Stocks Not Cheap, But More Attractive Than Bonds

Despite the strong performance of bonds year-to-date, we remain cautious and would maintain a long-term overweight to stocks. To be sure, stocks are no longer cheap—and we would continue to avoid the more expensive areas of the market such as small caps and social media—but they still look inexpensive relative to bonds, particularly given the recent drop in yields.

Based on current inflation expectations, real 10-year bond yields are less than 0.5% before taxes. In other words, for most areas of the bond market, investors are receiving very little yield for increasing risk. Should interest rates rise even modestly, the recent gains will quickly evaporate. And given the current low level of yields, bond prices are simply more sensitive to rising rates than they typically would be.

Bottom line: Although we think yields will remain low relative to history, at current levels, bond prices, particularly on long-dated Treasuries, look expensive. Municipals offer better value, but we see few areas of the bond market compensating investors for the current implied risk. In short, we maintain our long-term preference for equities and suggest investors exercise caution before adding to positions in bonds.

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