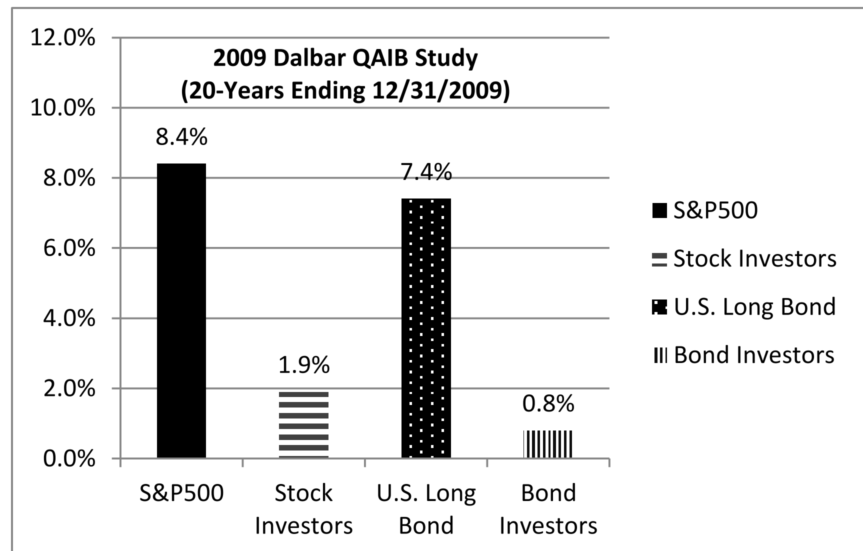
MARCH 2012
MARKET COMMENTARY

As we move through 2012, stock markets around the globe continue to climb rapidly. Since early October, the S&P500 is up around 25% and gains this calendar year are already approaching 10% before dividends. Emerging markets have risen even more with gains exceeding 25% since the beginning of fourth quarter with a 16% rise since January 1st. Even foreign developed markets have seen similar gains with increases of nearly 20 percent over the same time period.

If you've been reading my newsletters over the past several months, the increases should come as no surprise. Low valuations, record corporate profits, cheap access to funding, and a myriad of other factors created a very favorable environment for stock prices barring major economic or political disasters.

Fortunately, even if recent increases in equity prices have moved stocks out of the bargain bin, valuations are still reasonable. And the same remains true for most other risk based assets ranging from real estate to private equity. However, some of the safety net is gone. Stocks were so cheap entering fourth quarter of last year that even major economic disruptions or catastrophes probably wouldn't have driven prices a lot lower. Today's prices are not high, but major scares or perceived problems could cause a sell-off.

Unfortunately, far too many individual investors missed the recent rally through avoiding exposure to stocks of any kind. While savvier, or at least braver, investors have reaped recent rewards, far too many investors have been watching from the sidelines waiting for all the signs to turn positive. The graph illustrates investor's penchant to mistime their investments thereby earning vastly substandard performance.



Why bring this up now – after stocks have already gone up? If you read this newsletter, you've hopefully enjoyed nice recent gains. But, my concern now is bond investors, and the above chart highlights their terrible history. Bond fund inflows have set records over the past several years. But, while bonds have performed reasonably during recent turmoil, performance has resulted from investor flight to safety, not intrinsic value or reasonable yields.

Inflated bond prices seem to have created a U.S. bond bubble, and most U.S. bonds should probably be considered one of the most dangerous assets for investors to hold. Rather than the risk-free return so many assume with bonds, the asset class offers nearly return-free risk.

Through the past 30 year bond bull-market, returns have been solid as interest rates steadily declined from record highs. Now, yields continue to reach record lows. Government bond yields recently dipped below the S&P500 dividend yield for the first time in history. But of course, this can't continue forever. Yields must climb, and when they do, bondholders could get creamed (a highly technical term).

In today's environment, yields also offer no compensation for inflationary risk. During past periods of high inflation, bonds yields were often high enough to compensate investors for current and potential future inflation. The 1980s provide a great example. Inflation was high and so were interest rates. And as rates fell, investors enjoyed higher rates in a declining interest rate environment, a near perfect scenario for bonds.

By contrast, today's situation is almost exactly the opposite. Not only do investors earn very little current return, risk of principle and purchasing power loss has to be considered extremely high making this "safe" investment potentially very risky.

Policy makers recognize that they're creating a potential time bomb. Fed Chairman Ben Bernanke noted at his November 2011 post-FOMC news briefing that "we are quite aware that very low interest rates, particularly for a protracted period, do have costs for a lot of people." The most adversely affected are likely to be savers or people who don't hold investments that will appreciate in value as inflation picks up. He rationalized "there is a greater good here, which is the health and recovery of the U.S. economy, and for that purpose we've been keeping monetary policy conditions accommodative." This approach may help the economy, but it could also inflict much pain on poorly positioned investors. As an investor, your job is to protect yourself from this ticking bomb and potentially even benefit from its likely affects.

If investors want to avoid bonds, where can they go? Stocks continue to offer good value, although they're not trading at the tremendous discounts they were a few months ago. Real estate remains discounted, and various credit based investments – especially those tied to LIBOR or some other floating rate – also offer good opportunities given the continued dislocation of the credit markets. Months ago, China stopped buying our debt and instead started investing in various risk oriented assets including farmland, private equity, commodities, emerging markets, distressed debt and so on. While these other investments may not have the perceived safety of bonds, many diverse risk-based assets will likely provide far better returns over the next five to ten years than bonds, particularly if inflation picks up as expected.

More enlightened investors will probably want to seize the opportunity to protect their portfolios from likely future inflation while simultaneously benefitting from potential increases in future asset prices. There's some risk in every action, but investors who make intelligent choices regarding expected future asset prices should be well rewarded. And again, bond holders beware. The 30-year bond bull market is most likely over, and the shift into an expected bond bear market could be quick and ugly.

Daniel Wildermuth and the Kalos Team
CEO/Money Manager

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