If Bill Gross is Right

With a steady second quarter under its belt, the stock market is well on its way to reaching our year-end target of 2053 for the S&P 500. For the first half of the year, the S&P 500, Dow Jones Industrial Average and NASDAQ Composite have risen 6.05%, 1.51% and 5.54% respectively. With the S&P 500 closing the first half of 2014 at 1960, the stock market is less than 5% away from our year-end target.

As we enter the second half of the year within such close range of our year-end target, especially after such a strong move in 2013, it is important to pause, take inventory of where we are and re-evaluate our forward expectations. At current prices, the S&P 500 trades at a forward 12-month PE multiple of 15.5, the highest forward PE multiple in nine years, and a 2015 PE multiple of 14.8. And while the average length of time between corrections of at least 10% is 18 months during bull markets, this bull market hasn't witnessed a 10% correction in the S&P 500 for 32 months. The CBOE Volatility Index (better known as the VIX), the so-called "fear index", recently hit a seven-year low and has remained below its long run average for 74 straight weeks now. Meanwhile, investor sentiment surveys are reaching high levels of optimism historically associated with market tops.

The S&P 500 has made 25 new all-time highs this year and is on the cusp of surpassing the 2000 milestone. Interesting to note, the current bull market has run for 64 months and is the fourth longest on record. With volatility low, complacency high and the market so close to our year-end target, we decided to lock in some gains for clients whose allocation to equities had grown somewhat extended.

To be sure, the stock market reflects the ongoing recovery in the economy as it moves to "escape velocity", a level of economic growth sustainable without manipulation from the Federal Reserve. The private sector has created roughly 200,000 jobs per month for the last four years and the unemployment rate has declined to 6.1%. Consumers have deleveraged en masse and debt payments as a percentage of disposable income is at a multi-decade low. Overall leverage for U.S. households as a percentage of total assets is back down to levels not seen since the 1990s and delinquency rates on consumer loans have fallen to its lowest level in decades. Industrial production is rising and both the ISM Manufacturing and ISM Services indices point to continued economic expansion. Residential construction is rising and the recovery in the U.S. housing market continues to gather momentum. Government spending has reached a plateau, tax revenues have risen sharply and the U.S deficit is no longer the black swan it was only several short years ago.

As the employment picture brightens and the economy gathers steam, it should be no surprise that inflation is showing signs of percolation. Headline inflation has accelerated in the past few months from 1.5% in February to 2.6% in May, on a six-month annualized basis, while core inflation has accelerated from 1.6% to 2.1% over the same period. Inflation has been running at a 2.4% annualized rate throughout the past ten years, so the recent pick-up may merely be a reversion to the mean rather than the start of something more onerous.

Despite the recent rise in inflation and the Fed's continued march toward an October completion of its QE tapering, interest rates remain historically low as the yield on ten-year Treasury bonds hovers below 2.6%. The fact that yield on sovereign debt in Europe and Japan is even lower than here in the U.S. helps explain why interest rates remain low even as inflation perks up. In a world of financial repression and government-induced low yield, the hunt for any income that is also deemed safe continues. This explains why the spread between yield on junk bonds and Treasury bonds has narrowed to a seven-year low and why investors have plowed $50 billion into U.S. corporate bonds funds so far this year, double the rate of 2013. This insatiable demand for income and safety is testament to the extraordinary fear that accompanied the Great Recession. With the 2.6% recent annualized pace of inflation matching the 2.6% yield of the ten-year Treasury bond, investors are destined to lose money but seemingly willing to "lose money safely".

That is, unless Bill Gross is right…As PIMCO founder and CIO, Bill Gross is arguably the world's most well-regarded bond investor and overseer of more than $1.9 trillion at PIMCO. Gross recently authored an investment outlook article titled "One Big Idea" whereby he advises that the "New Neutral" real federal funds rate is 0% rather than Fed's currently presumed 1 ¾%. Gross calls the New Neutral the "biggest, most critical, most significant, most important" element in asset pricing today. If the New Neutral is closer to 0% real than the 2% rate historically implied by the so-called "Taylor Rule", then *all* asset markets are less "bubbly" than they may otherwise appear at the moment. PE ratios of 16 to 17 seem reasonable with a 0% real rate policy and ten-year Treasuries yielding 2.6% is similarly appropriate. If the New Neutral is significantly lower, PE expansion should be expected for stocks, home prices should move higher and credit spreads should be tighter. Gross believes that asset returns will be low and less volatile during this cycle and it will take at least 5-10 years more before the real Fed Funds rate reaches the historical 2% threshold. This new neutral period will be characterized by persistently slow economic growth and usher in an era of income that replaces the era of capital gains.

If Bill Gross is right, both stocks and bonds are reasonably priced in the current environment. If Bill Gross is right, stocks that pay dividends and consistently increase that dividend each and every year will be precious. If Bill Gross is right, the Osher Van de Voorde investment strategy will prove to be especially rewarding for clients (see back page). Bill Gross is a reputable investor with serious influence and his thesis deserves thoughtful consideration. Perhaps conveniently, his New Neutral thesis elegantly explains the current environment for stocks and bonds. There is good probability that Bill Gross is right. However, in case he is wrong, we will continue to err on the side of caution and invest our client's abundant cash cushion opportunistically as bargains present themselves. After all, Bill Gross himself cautions that if the real federal funds rate is closer to 2%, then "bear markets in all asset classes await".