

August 19, 2010

“Good investors gather information, put that information into current and historical context, then make sound decisions.”

Equity markets have narrowed their scope over the last four weeks, but remain trapped in the lower level of their two-tier trading range. Exactly one month ago the S&P 500 closed at 1071.25. For most of the past four weeks equities traded as much as +4.65% higher than current prices, with the S&P 500 pushing north through its 50-day moving average for 20 days and above its 150-day moving average for 10 days. Things were definitely looking up. But the intermediate resistance at 1130 prevailed and equity markets misfired on August 11th, with the S&P 500 falling 27.42 pts., or -2.45%, and the Dow Jones Industrial Average dropping by 253.07 points, or -2.38%. Today the S&P 500 closed at 1075.63 after another ‘pile driver day’ losing -1.69%, with the Dow Jones Industrial Average falling 139.94, or -1.34%. Equity markets continue to be ‘out of tune,’ resulting in sluggish relative performance.

On the other hand, bond markets have continued to show price increases, surging higher during the equity markets’ ‘pile driver days.’ Bond markets are now markedly overbought, which presents investors with a bit of a conundrum. At some juncture, bond markets are going to have to sell off and relieve the buying pressure that has been driving them higher. This is not an ‘if’ but a ‘when’ question. At what point does the bond market become ‘too high to buy?’ Since April 1, 2010, the Barclays 20+ Year Treasury Bond Index has risen by +23.77%! Even the normally docile Barclays 7-10 Year Bond Index is +13.56% higher. Barclays Aggregate Bond Index, which include treasury, municipal, corporate, and high yield bonds has climbed by +7.21% over this period. The current yield on the 10-year U.S. treasury bond is only +2.64%, while the current yield on the 5-year U.S. treasury note is only +1.44%.

From a technical perspective, the two most attractive sectors at this juncture are high yield bonds and real estate securities. Both of these sectors are in long-term uptrends, yet not overbought. These sectors have particular niche characteristics which also make them attractive to us from the fundamental perspective. High yield bond prices can get mired in sluggish equity markets even when high quality bonds are soaring. Real estate securities may be perceived as ‘safe havens’ when equity markets are crawling out of difficult economic cycles. In an investment environment when dividends may prove to be the difference between breakeven and positive performance, both of these sectors normally offer above-average current yields. Certainly they are not without risk, but in an overbought bond market, a misfiring equity market, with good technical pictures, and a history of providing ‘maverick returns,’ they are intriguing.

‘Maverick returns’ refers to when a sector produces investment results that defy prevailing economic conditions, and prevailing market returns. Occasionally, when the economic planets align and institutional palates are wetted, certain sectors forge ahead in spite of conventional wisdom. High yield bonds and real estate securities have both demonstrated such capabilities in the past. High yield bonds live in the twilight zone between equities and bonds, and we consider them as tactical candidates in equity allocations. High yield bond prices tend to rise as equity prices rise, though not as much. Their prices also tend to decline as equity prices decline, though not as much. Today, when the S&P 500 declined -1.69%, the Barclays Capital High Yield Bond Index declined by -0.20%. The index is up +7.35% YTD and has a dividend yield of over 9%. Real estate securities may also get head starts from institutional investors who anticipate longer than normal recovery periods for the general economy. This resonates with the current general outlook.

“At what point does the bond market become ‘too high to buy?’”

SELECTOR® asset allocations remain allocated to Stage Yellow levels. For reference, Stage Green is a full ‘green light’ for equities. Stage Yellow is cautionary, with an additional 20% allocation to bonds by style, relative to Stage Green. Stage Orange is defensive, with an additional 40% allocation to bonds by style, relative to Stage Green. Stage Red is fully defensive, with an additional 60% allocation to bonds by style, relative to Stage Green. In our current Stage Yellow allocations SELECTOR® Aggressive Growth models are 100% equities. SELECTOR® Growth models are 80% equities/20% bonds. SELECTOR® Conservative Growth models are 60% equities/40% bonds, with SELECTOR® Balanced Growth models 40% equities/60% bonds. SELECTOR® Income & Growth models are 20% equities/80% bonds.

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