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Wealth Manager Outlook: The big bond to equity shift approaches

Wealth managers are braced for a reversal in the 30-year trend of bond outperformance versus equities as unlimited quantitative easing (QE) in the US begins to feed through to long-term inflationary expectations.

Following US Federal Reserve chairman Ben Bernanke's commitment to carry on printing money for as long as it takes for the economy to stabilise, most managers have cautiously upgraded their expectations for the next 12 months and reorientated their portfolios towards risk assets.

That commitment had a polarising effect on respondents to Wealth Manager's Quarterly Outlook, however, with a minority fearful that central bank policy had baked unrealistic risk premiums into equity markets, which would ultimately run up against economic reality.

'Sell any form of fixed interest, especially corporate bonds,' was the uncompromising view of Charteris chief executive **Ian Williams**, when asked what would be the most critical call over the next 12 months.

Most clients are currently 'wondering whether equities will ever resume their outperformance over bonds,' added **John Clarke**, chief investment officer at GHC. 'They will in 2013.'

After marginal portfolio changes during the second quarter of 2012, the stark move towards easing has helped solidify conviction, with managers putting their money where their mouth is. While underweight positions in Western equity stayed more or less unchanged over the quarter, there was a stampede out of neutral positions.

Out of neutral

Neutral European equity positions fell from 40.7% to 29.6% and neutral UK positions from 50% to 40.7%. Overweights rose from 14.8% to 25.9% and from 34.6% to 44.4%, respectively.

In an illustration of the faultlines over monetary easing, this happened in tandem to managers buying back into developed sovereign debt, with underweights falling from 85.2% to 77.8% over the quarter, while overweights rose from 3.7% to 7.4%.

Leading the charge of the QE-sceptics is **Robert Jukes**, global strategist at Collins Stewart, who said that regardless of extended valuations, central bank policy is more likely to nail ultra-low sovereign yields in place for the foreseeable future than to keep the bulls running.

'Quantitative easing is largely about supporting risk assets through periods of market turbulence, but the transmission mechanism for translating that into economic growth is far from clear to us,' said Jukes.

'So while we expect this stimulus to underpin government bonds over the next year or two, we are not confident that risk assets, which are ultimately linked to economic growth, are underpinned in the same way.

'In fact, while risk premia remain so high and economic growth prospects continue to deteriorate, we are not at all confident that risk asset values are at all underpinned.

'Fixed income offers further upside in our opinion. It's clearly very expensive relative to historic standards but it's also well underpinned by central bank policy. Risk-adjusted, that kind of security is hard to beat when used dynamically within a multi-asset portfolio.'

This view was echoed, albeit in slightly more direct and technical terminology by Austyn James Consulting director **Austyn James**.

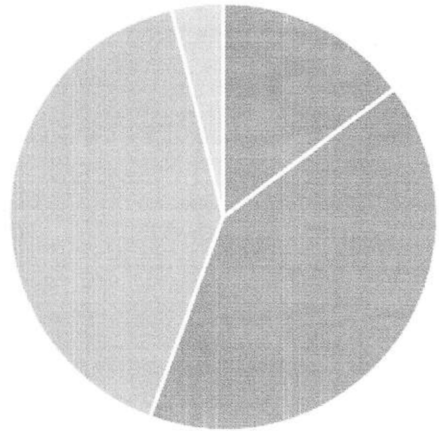
'I went to a Bank of England luncheon recently and it's no secret that massive stimulus is only having the effect of keeping the economy on an even keel,' said James.

'In real terms the economy is flatlining, and the efforts of QE to stimulate markets no longer work. At best, QE is a drug that has worn off and when re-administered, no longer has the desired effect. Banks that lend are the key and until they do, the current position will continue.'

Growth bulls

Do you expect global growth to:

Fall	14.9%
Change little	40.7%
Rise	40.7%
Rise significantly	3.7%



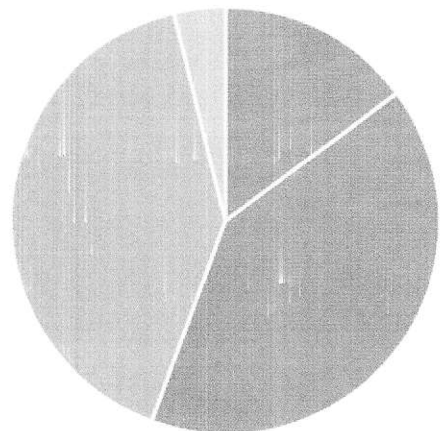
Overall, however, the quarter was marked by a remarkably rapid resurgence of optimism. The number of managers who said they expect global growth to rise has almost doubled, from 22.2% to 40.7%.

For the first time since May 2011, when the euro crisis first began to feel like an existential threat to the eurozone, 3.7% said they expected global growth to rise significantly.

This has fed through directly into inflationary expectations, and hence into the outlook on equity versus bond reversion. The number of managers expecting the rate of inflation to rise has increased from 25.9% to 40.7%, and 3.7% expect it to increase significantly for the first time since May.

Do you expect the rate of inflation to:

Fall	14.9%
Change little	40.7%
Rise	40.7%
Rise significantly	3.7%



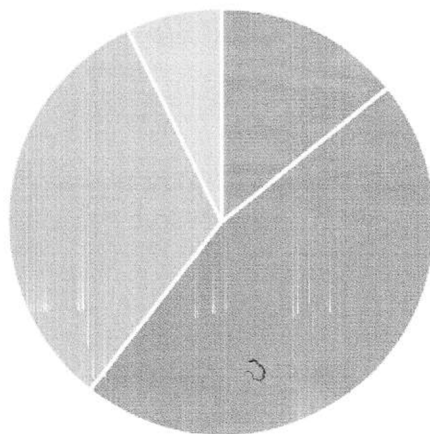
Perhaps unsurprisingly as the business cycle and earnings seem to be peaking, managers have registered less of a bullish shift on the outlook for corporate profitability.

While the number expecting a short-term drop in profitability fell from 22.2% to 14.8%, those expecting little change or an increase remained essentially static, at 48.2% and 33.3%, respectively, from 48.1% and 33.3% in the previous quarter.

'Investors are being squeezed, especially those seeking income, and so the real call is when to reduce your bond and cash exposure further, in favour of global equities,' said **Peter Lowman**, chief investment officer at Investment Quorum.

Do you expect corporate profits to:

Fall	14.8%
Change little	48.2%
Rise	33.3%
Rise significantly	7.4%



'Given that over the next 12 months investment returns on core Western government bond markets, and cash, will give investors negative real rates of return, adjusted for inflation, it may now be necessary for them to consider investing in a growth and income strategy. Indeed, investors will need to consider increasing their risk appetite by focusing on high-yielding bonds and global equity income, given that interest rates will remain lower for longer and that equities look better value than sovereign bonds.'

Some improvement expected

There was also only a marginal improvement in expectations on broad investor sentiment. The number of managers saying they expect little change slid from 37% to 33.3%, while those saying it will improve rose from 37% to 40.7%.

'Investor sentiment is often late to change unless evidence starts mounting up,' said **Manish Singh**, director and head of investment at Crossbridge Capital.

'US macro data are already indicating the bottoming of a slowdown. Autos, housing, jobs, consumer confidence, manufacturing, retail sales – all have improved over the last quarter and will continue to do so.'

Do you expect investor sentiment to:

Worsen	25.9%
Change little	33.3%
Improve	40.7%
Improve significantly	3.7%