Stock Prices Can Move Higher While Bond Bubble Deflates

View from the Observation Deck

1. Since the beginning of our Market Commentary Blog in Q4’11, Bob Carey, Chief Market Strategist at First Trust Advisors, has provided numerous posts warning of the risks of owning bonds in a rising interest rate climate.

2. We have made it known for many years via presentations, newsletters, video commentaries and blog posts that we are most bullish on stocks, particularly U.S. equities, and we remain so.

3. We have also acknowledged the fact that some investors are apprehensive about committing capital to the stock market due to a general lack of trust in the system and/or bad experiences with the bursting of asset bubbles.

4. While some believe that the bond market achieved “bubble” status following the financial crisis in 2008 and the Federal Reserve’s quantitative easing initiatives, we don’t equate it with the two previous bubble scenarios.

5. When the Internet bubble burst in March 2000 (S&P 500 peaked on 3/24) the trailing 12-month price-to-earnings ratio (P/E) on the S&P 500 was a lofty 29.33, so stocks were poised for a correction, in our opinion.

6. When the real estate bubble burst in October 2007 (S&P 500 peaked on 10/9) the trailing 12-month P/E ratio was a more modest 17.33.

7. Beginning in Q4’07, stock prices succumbed to the credit crunch fallout from the subprime mortgage meltdown, which was more of a systemic problem, in our opinion. Portions of the capital markets became illiquid for a period of time.

8. During and after the financial crisis in 2008, investors funneled more than $1 trillion of their capital into bond mutual funds in an effort to mitigate risk, according to data from the Investment Company Institute. These enormous inflows helped shape the bond bubble.

9. In hindsight, the S&P 500 posted a cumulative total return of 176.3% from 3/9/09 (end of bear market) through 9/16/13. The index is up 20.9% y-t-d despite the yield on the 10-Year T-Note rising by 111 basis points to 2.87%.

10. Historically speaking, stock prices have tended to perform best when the economy is expanding and the yield on the 10-Year T-Note is ascending towards the 4.00% level, according to Businessweek.

This chart is for illustrative purposes only and not indicative of any actual investment. The illustration excludes the effects of taxes and brokerage commissions and other expenses incurred when investing. Investors cannot invest directly in an index. The S&P 500 Index is a capitalization-weighted index comprised of 500 stocks used to measure large-cap U.S. stock market performance.