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Are stocks and bonds skating on thin ice?

VIEWPOINT
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I'm not really a sports guy, but a famous Wayne Gretzky quote keeps rising to the top of my mind: "I skate to where the puck is going to be, not where it has been." Hackneyed? Yes. Insightful? Also yes. And, a particularly apt warning for stock and bond investors for today's shifting economic environment.

Stocks are up a lot over just about every period. They have earned annualized returns of 16% over the past decade, well ahead of historic norms. Just like during the 1990s, the performance has largely been driven by gains in U.S.-based, large technology stocks, and valuations in many parts of the stock market have risen to extreme levels. The run up in stocks may be attributed to a long period of muted inflation, historically low interest rates, unprecedented fiscal and monetary stimulus, low corporate tax rates, and a relatively benign regulatory environment.

Bonds have also enjoyed an extraordinary bull run. Interest rates have been in a downward trend since the 1980s, driving prices higher and earning strong returns for bond investors.

However, as we look forward, the environment appears to be changing, and the puck may not follow a linear path. Most of the tailwinds we've enjoyed since 2009 are becoming headwinds. While inflation has not been a problem for investors since the 1980s, prices have increased lately. Rising energy prices and material and labor shortages are pushing up prices for finished goods across industries. This results in a higher overall cost of living, which means that employees need to earn more. Rising wages cause corporations to further raise prices, and the cycle feeds on itself. The Fed has assured us that inflation will be transitory, but so far it has been higher and lasted longer than anticipated, and it appears to be a global phenomenon. Until supply and demand come into balance, inflation is a risk, and unprecedented global liquidity combined with labor and material shortages don't bode well for that balance.

Another problem with high inflation is that rising interest rates tend to follow, and interest rates directly impact the returns of the bond market. As rates rise, bond prices fall. We've been in a 40-year period of falling interest rates, making bond investments quite profitable. However, with rates now at historically low levels, but starting to tick higher, we may be entering a long-term cycle of rising rates.

Rising interest rates are not only bad for bonds, but also for stock investors. Many stock valuation models include interest rates as the discount rate for corporate earnings. So, as interest rates rise, valuations decline. More practically, higher rates mean higher borrowing costs for corporations, making it more expensive for them to invest and grow. So, rising interest rates could present a problem throughout the capital markets.

Additionally, corporate earnings have remained surprisingly resilient during COVID-19, and profit margins remain at high levels, thus supporting relatively high valuations within the stock market. However, higher interest rates and proposals for higher corporate tax rates and increased regulation could weigh on earnings and margins in the future. Stocks and corporate bonds could face a double whammy if earnings fall at the same time as higher interest rates crimp stock market valuations.

Other areas of concern include a slowdown in China, a government shutdown in the U.S. as we again face the debt ceiling in December, a global energy shortage, a slowdown in global growth as we work through unprecedented government debt and countless others. There are so many issues in so many parts of the world that any one of them could become a significant threat to our safety, economy and markets. This of course has been true many times throughout history, with any adverse outcome. We therefore caution about becoming overly concerned, but certainly these issues bear watching.

On a more upbeat note, there are actions we can take to address economic uncertainty. Diversification, which has been a liability the past 10 years as large-cap tech stocks dominated the market, should offer higher returns and a smoother ride in the years ahead. Valuations for small-cap stocks, international stocks and particularly value-oriented stocks are much lower than those of the overall U.S. stock market, so adding these asset classes could provide stronger future returns as market sentiment shifts. Whereas, sticking with the hot tech stocks that have dominated over the past decade could be risky if history is a guide. The tech-heavy NASDAQ Index declined by almost 75% from its peak in February 2000 after the popping of the Dot Com bubble.

Similarly, expecting bond returns to continue generating the 7.5% annualized return they have enjoyed since 1980 seems unrealistic with the 10-year treasury yielding only 1.5%. Rather than maintaining a 60% stock, 40% bond asset allocation, greater creativity will likely be rewarded. There are alternative investments, such as catastrophe bonds, private loans, private real estate and other strategies that have low correlation with stocks and higher expected returns than bonds. Diversifying outside of traditional asset classes could help keep portfolio risk and return characteristics at acceptable levels if stocks and bonds falter.

While the outlook for stocks and bonds is not rosy, that doesn't imply that investors should sell out and hunker down. First off, the erosion of purchasing power from inflation can be just as damaging as actual market losses, so cash is a poor choice these days. Second, it can be expensive to sell out of investments if there will be capital gains taxes to pay. Finally, it is possible that the stock market continues to rally far longer than seems possible or rational. Markets certainly move in mysterious ways, and stocks and bonds could continue to rise if interest rates drop further and other concerns are averted. The better approach is to stick with a long-term asset allocation plan but consider additional diversification to reduce risks and reach for market-beating returns.

It seems unlikely that the strategies that dominated over the past 10 years will continue to do so in the coming 10 years. Those betting otherwise may be skating on thin ice.

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