Why We Still Prefer Equities over Bonds, Dollars over Euros and Devon Energy

Barron's has a couple of interesting articles this weekend. They lead with "Buckle Up", and make the case for equities by highlighting the very wide equity risk premium (the S&P500 earnings yield of 8% minus the yield on ten-year treasuries of 2%) something we've also noted in the past. This spread is historically wide and, it can be argued, makes a compelling case for stocks. What seems more clear is that the spread will narrow but that could just as easily be through bond yields rising. We do think equities represent an attractive long-term investment but we are more sure that bonds do not. Public policy in the U.S. is to effect a transfer of real wealth from savers to borrowers, so while stocks look attractive bonds look positively ugly.

Of course noting that bond yields are low and can only really move up is scarcely a contrarian view. Randall Forsyth notes in Barron's a solid agreement among forecasters that bond yields will be higher a year from now. While it makes a great deal of sense, presumably the Federal Reserve will respond to higher yields by increasing its purchases unless rising yields are accompanied by an upside surprise in GDP growth. They're likely to maintain negative real rates of return for a considerable time.

A hedge fund, QB Asset Management, forecasts "face-ripping inflation", a term likely to catch your attention. The output gap (such as the difference between current unemployment and the natural rate) seems too high for that – there still appears to be plenty of excess capacity in the labor force. It's hard to see how inflation (at least as measured by the Bureau of Labor Statistics) can take off when so many people are available to be employed. QB could be right, but it hasn't happened so far and without an increase in money velocity the jump in money supply isn't likely to become inflationary. But similar to the wide equity risk premium, while low current inflation may persist it's not worth betting on a continuation of the status quo.

Shorting Euros is another crowded trade. It's just hard to see how any of the solutions on offer will promote growth within the region. The Real GDP differential is likely to be 2.5% next year in favor of the U.S. European governments are following pro-cyclical policies during a time of slowing growth. The Euro has weakened in recent weeks but really ought to be far lower. However, we run this risk in our hedge fund in combination with long equities from a number of different trades. We think the Euro will depreciate, but if we're wrong it'll most likely be in a scenario that is good for stocks. Borrowing Euros to buy U.S. equities represents an attractive opportunity. Mike Platt, co-founder of BlueCrest, a global macro hedge fund, offered a most dire outlook on Europe and its banks. BlueCrest is one of the most successful hedge funds around, and the TV interview is worth a look. Platt is frustratingly vague about how he's positioning for what he expects will be a continued deterioration but leaves little doubt about his overall view. If European banks valued their positions the way hedge funds have to they'd all be declared insolvent. I can't really see why anyone would lend anybody in Europe any money, except perhaps in Germany and the UK.

Finally, I'd note that JPMorgan issued revised valuation estimates for large cap E&P names. Devon Energy (DVN) remains one of the largest positions in our Deep Value Equity Strategy, trading at close to the value of its proved reserves. The continued shift from natural gas to oil production in the U.S. in response to relative pricing should work to Devon's advantage given its asset mix.

Disclosure: Author in Long SPY, EUO, DVN