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Third Party Research **January 24, 2018**

Stocks and Bonds in Perspective

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, "Calafia Beach Pundit".

In this article, Mr. Grannis examines the U.S. equity market compared to the U.S. bond market. He also compares the U.S. equity market to global markets.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Putting bonds and stocks into perspective**

You can also visit Scott Grannis' Home Page for his Blog at the link below:
http://scottgrannis.blogspot.ca/

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Bob Weir, CFA: Director of Research

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Friday, January 19, 2018

Stocks and Bonds in Perspective

There are some big things happening in the financial markets. Stocks are hitting record highs and bond yields are bouncing off record lows. The S&P 500 index is up almost 35% since just before the November 2016 election. 10-year T-bond yields are now 2.64%, almost twice as high as their all-time record low of 1.36% in July 2016.

For some valuable perspective, I offer the following charts:

Chart #1

In Chart #1, I have drawn some admittedly arbitrary trend lines on this long-term chart of the S&P 500 index. The trend rate of growth they represent is a bit conservative compared to the 9.4% annualized long-term total return (including dividends) of stocks since 1927, according to Bloomberg.

Stocks appear to be pushing the upper limits of growth, according to this chart. However, further gains cannot be ruled out. After all, last year's tax reform slashed the corporate income tax rate from 35% to 21%, making future earnings streams suddenly worth 21% more.

<continued>

Chart #2

Chart #2 adjusts the S&P 500 index for the rate of consumer price inflation. The trend lines I have drawn represent 3% annualized real growth, which is very much in line with the economy's long-term trend growth rate. There is still room on the upside, considering recent tax cuts. If businesses respond to their new investment incentives, we could see the economy grow by substantially more than 3% in coming years.

Chart #3

Chart #3 gives you the long-term history of 10-yr Treasury yields, with the green dashed line marking the all-time closing low of 1.3% (July 2016).

Chart #4

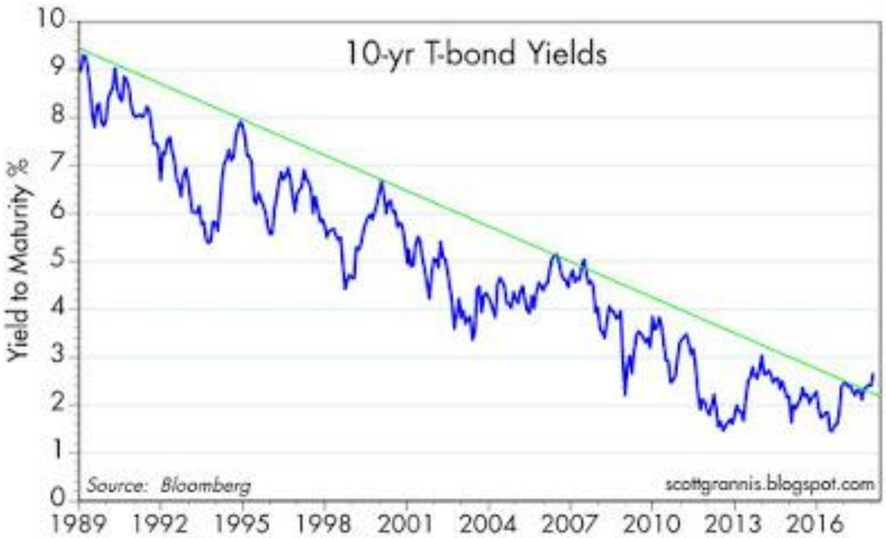


Chart #4, above, zooms in on the last 28 years of Treasury yields. The trend line I have drawn suggests that the bond market is in the early stages of reversing its long-term declining trend. This would make sense if, indeed, the economy is on the cusp of a new wave of investment-led growth. If would also make sense if inflation is 2% or more, as it is today.

Chart #5

Chart #5 shows how 10-year yields have been unusually low relative to inflation in the past decade. Since 1960, the average spread between 10-year yields and inflation has been 2.3%, whereas today it is only 0.5%. If consumer price inflation averages just over 2% ahead, as the breakeven spreads on TIPS and Treasuries suggest, then I expect to see the 10-year yield average at least 3.5% - 4%.

Chart #6

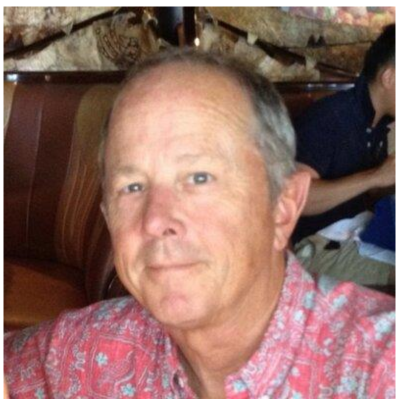
Chart #6 compares the equity market capitalization of global equities and U.S. equities, according to Bloomberg. A lot of wealth has been created in recent years.

Chart #7

Chart #7 shows that it is not just the U.S. equity market that is on fire. For the past several years, U.S. and non-U.S. equity markets have appreciated by roughly the same amount. Since 2004, U.S. equity capitalization has actually fallen significantly relative to the rest of the world. We are in the middle of a global equity market boom and the U.S. market does not stick out like a sore thumb.

BW: See ABOUT THE AUTHOR below.

ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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