

# Has the “Great Rotation” Finally Begun?

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In 2013, fixed income sold off on the back of Chairman Ben Bernanke signaling an end to the Fed’s bond purchasing program. This led to just the third negative calendar year return for bonds since 1970! Since this “taper-tantrum,” investors have been calling for, and anxiously awaiting, a tidal wave of fixed income assets to reallocate into stocks. The market was convinced the Fed would be marching furiously towards its path of a normalized interest rate environment of 3%, ensuing a multi-year sell off in bonds. The talking heads were predicting fixed income investors would be running for the exits in a hurry, with equity funds waiting with open arms. Since then stocks have outperformed bonds. The Fed has raised interest rates three times over the past fifteen months and has become more hawkish, but investors continued to allocate funds to fixed income. With volatility in the equity markets calm, and based on the continued strength of the jobs and wage growth in the monthly jobs report, the Fed’s plan of three rate hikes in 2017 is well underway. Will this be the tipping point for investors to rotate out of bonds and into stocks?

According to Fidelity, from 2009 through October 31, 2016, domestic and international equity mutual funds and ETFs combined saw \$600 billion of net inflows, while \$1.4 trillion of net assets poured into bond funds and ETFs. This is despite a recovering economy, depressed yields, and global central banks committed to jump starting inflation. Over the same time, the S&P 500 (SPY) produced a cumulative total return of 187.6% and the Barclays Aggregate Bond Index (AGG) returned 35.1%. ***Stocks massively outperformed bonds, yet investors allocated nearly two and a half times the number of assets to bonds over stocks!*** The safety of bonds has been the zeitgeist of the investment community. The S&P 500 has now reached 97 months without entering bear market territory (defined as a 20% sell off from a recent peak). The longest bull market lasted 115 months, from October of 1990 ending in March of 2000. Can this bull market continue to run higher?

Typically stocks do not rally in the face of rising interest rates, but if this is a concern of equity investors, what must the investors that added \$1.4 trillion of assets into bonds over the past eight years be thinking? Bonds have been a major laggard since the election, with the AGG down 3.5%, and the SPY up 14.5%. Yet, according to the Investment Company Institute, \$78 billion in net flows have gone into bond funds and ETFs, compared to the \$90.7 billion net funds that have gone into equities, since the election. ***The “Great Rotation” is well underway, but it’s from global investors continuing to put cash to work, rather than making a major shift in asset allocation.*** Could a reallocation out of bonds into stocks be next?

Stocks may not be table-poundingly cheap on an absolute basis, or relative to historical standards, but compared to bonds and cash, equities are very attractive. Although the yield on the US 10 year bond has risen from 1.47% pre-election, to 2.6%, with rising interest rates putting pressure on bond prices, stocks should outperform bonds on a total return basis, more than 2.6% per year, over the next ten years. Cash, the next alternative, remains unattractive.

***A stock's price is what you pay, but a stock's value is what you get.*** The S&P 500 is up 23.6% over the past twelve months. However, when looking at valuation, the market is not overpriced, though certainly not cheap. The market is trading at 18 times 2017 price-to-earnings (P/E) multiple; an 11% premium to its 25-year average P/E of 15.8. Comparatively, this is nowhere near the 27 times P/E seen in March of 2000 at the dotcom bubble apex, nor the 10 times P/E during the doldrums of the 2008/09 financial crisis. With the US economy continuing to improve, inflation percolating, oil prices stabilizing, global stock markets rising, and if President Trump and the Republicans are successful at passing corporate tax reform, stocks should continue to move higher as the "E" in the P/E is likely understated.

Although the market as a whole is not cheap, certain sectors and stocks are very attractive. Healthcare continues to be a standout. It was the only sector that finished negative in 2016. Nefarious individuals such as Martin Shrekli, and fears of drug price regulation have weighed on the sector. Yet the long-term fundamentals of the industry remain intact.

***Dissecting the sector further, we favor the large cap international pharmaceutical stocks.***

Not only have these stock prices suffered along with the entire sector over the past 18 months, but they also face currency headwinds from a very strong US Dollar, which is hurting returns, and depressing valuation, making them an attractive long term investment idea. One idea to consider is **GlaxoSmithKline (GSK)**. The British company is one of the largest pharma companies by market capitalization. The stock is down 25% from its all time highs. GSK has three attractive business segments in HIV, consumer, and antiviral. In its current form, patents, economies of scale, and a powerful distribution network support GlaxoSmithKline's wide moat. However, at current valuation, the company's parts appear to be worth more than GSK as a whole. Splitting the company into three separate entities could be a way to unlock enormous value for shareholders. The stock is attractive, trading at 16x P/E and offers a 4.8% dividend yield, a dividend has grown 6.5% annually over last decade.

Where do you go from here? First, don't get caught watching the paint dry. Remain diversified and disciplined to rebalancing your portfolio. Don't fall in love with one asset class or sector. Secondly, stick to a total return strategy. Don't shun stocks because the dividend yield might be low, or chase a high yielder, but rather look at how the management team has returned cash to shareholders over a five year period or longer. Finally, keep focused on the long term. Since 1980, with the exception of the major collapses such as 1987, 2000, or 2008, stocks have sold off on average 7% from peak to trough during the course of a given year. Yet, during this time, in 28 of those 37 years, the market finished up! Take last year as a learning lesson. Don't panic when stock prices sell off. Look for the value you can buy at a cheaper price!

