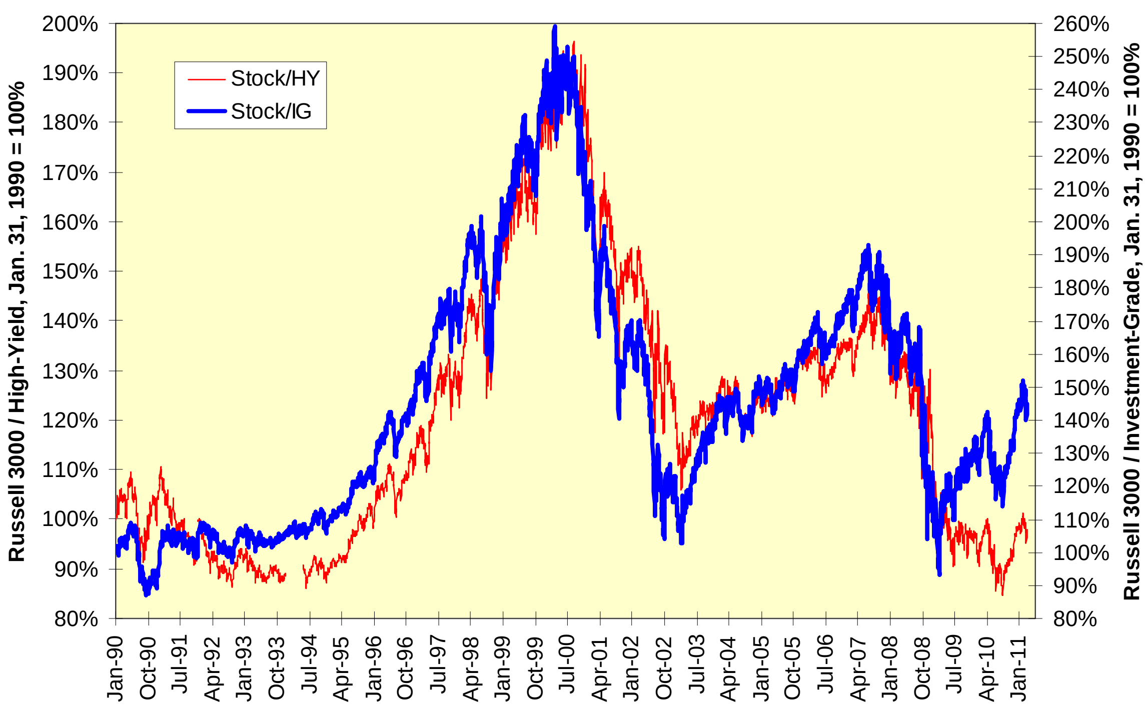
The Danger From Quality

I think we all remember than magical moment in our childhoods when someone special, a parent, a teacher, a coach, whomever, pulled us aside and said, "The dash for cash leads through trash," or something similar. I have my own way of evaluating high-yield and emerging market bond portfolios: I look at their holdings, and if my first reaction is to gasp and recoil in horror, I buy. Otherwise, what is the point? Any fuddy-duddy capable of stirring a scotch-and-soda with his pinky and wearing the old school tie can salt away investment-grade bonds and engage in the pretense of prudence.

Better yet, the proof is in the pudding, which is one more reason to avoid the pudding at most cafeterias: Since January 1990, the average annual total return on the Merrill Lynch High-Yield Master II index of 8.98% has exceed that of both the Russell 3000 index and Merrill's index of A-rated and higher corporate bonds, which returned 8.88% and 7.12%, respectively.

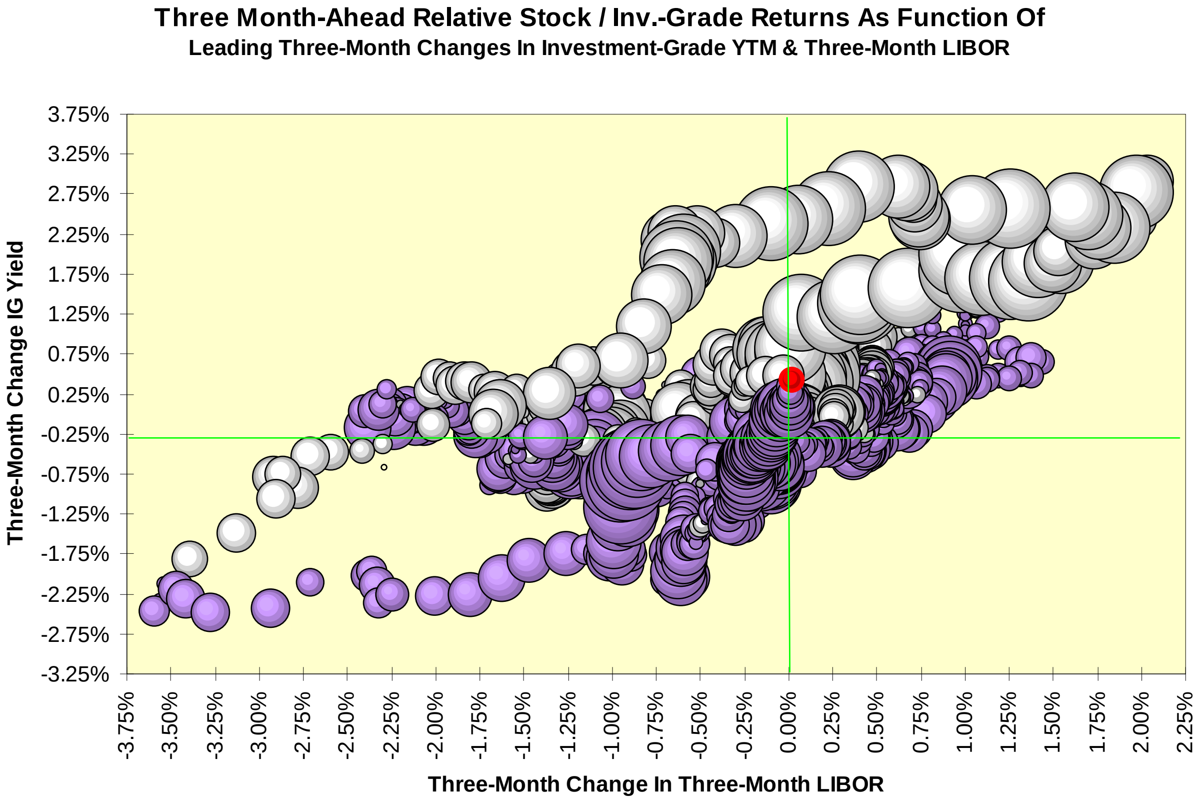
The divergence between investment-grade and high-yield has become markedly more pronounced since the start of the money-printing era in March 2009. Stocks have struggled to keep pace with high-yield bonds, but they have left investment-grade issues in the dust. Both the federal government and the Federal Reserve have, in a twist on Aesop's famous parable, done a marvelous job of rewarding the grasshopper and spraying the ant with Raid.

Relative Total Returns: Russell 3000 Versus
High-Yield & Investment-Grade Bonds



Revenge Of The Nerds

Now let's engage in a little bit of old-fashioned data-mining and map the three month-ahead relative returns for the Russell 3000 relative to investment-grade bonds as a function of three-month changes in investment-grade yields and three-month LIBOR. White bubbles indicate a zone of bond outperformance; colored bubbles a zone of stock outperformance. The current environment is highlighted in a bombsight, and the last datum used, from three months ago, is highlighted in red.



We are right on the cusp of a zone where any move higher in investment-grade yields will lead to prospective outperformance by bonds. We could see an advance in LIBOR of about 100 basis points and not derail the current configuration of stocks outperforming bonds. As an aside, the picture is far less neat for the high-yield issues; this is because their performance has oscillated about stocks' performance for a while.

What would push investment-grade yields higher? The usual suspects here are slower growth, events and an end to the free-money era. The macro shocks now underway, including those emanating from Japan, are putting downward pressure on growth, and we should see at least a decent interval for the end of money-printing after June. Events simply happen; we should remember, however, that while good new and bad news arrive at about the same rate, they are interpreted very asymmetrically in the markets.

This means one thing and one thing only: Keep your eye on the fuddy-duddy bonds. They are in position to call the shots for stocks' relative performance over the next three to six months.