# Shares priced for good times but what of bonds?


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- THE AUSTRALIAN


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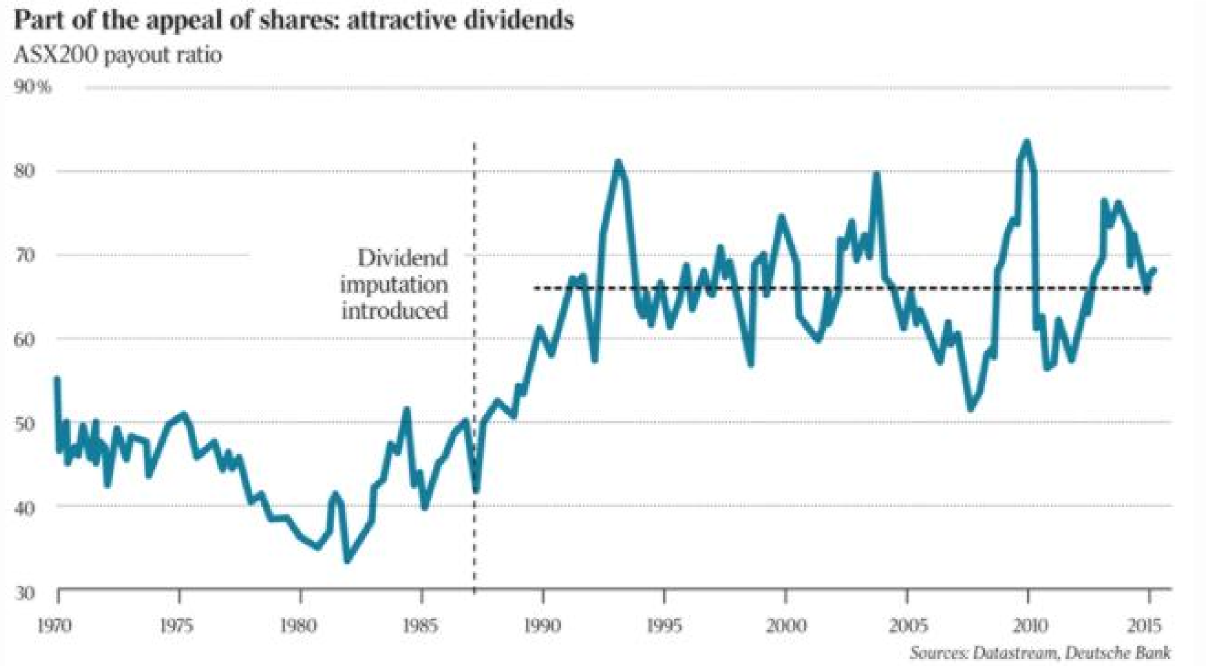


Dividend attraction. *Source:* TheAustralian

**THE gap in investor sentiment between the sharemarket and the bond market is the widest I've known. The two asset classes have delivered good returns over the past few years, but shares are now priced for mainly good times ahead while bonds are priced for an extended period of stagnation and disinflation. Something has to give.**

This is what I think.

● At present yields, bond investors are not being rewarded for the risks of the losses they may suffer when yields rise. Separately, valuations in sharemarkets have moved more modestly above "normal" levels.

● In my view, shares will deliver positive returns over the coming 12 months, thanks to easy money, low cash rates, and modest growth in earnings and dividends. The US sharemarket is, once again, likely to outperform ours — but set the direction our market moves in.

● In both the US and Australia share selection will be the big challenge — and defensive high yield is likely to remain a good theme.

● Investors should allow for some serious bumps in sharemarkets, especially when sentiment in the bond market starts factoring in a modest pick-up in global growth or inflation.

● There's likely to be an abundance of volatility. Investors should avoid extrapolating ahead the latest wobble in market pricing as a new trend.

I've come to these views after reviewing the remarkable range of recent developments in the market. They include the 10 per cent gain in the main indices for Australian shares in late January/early February (despite the hammering of resource shares), and the strong rebound in our real estate investment trusts (returns were 7.4 per cent in January).

Then there was the dramatic move in the US 10-year bond yield within a few days, from 2 per cent to 1.65 per cent and back to 2.15 per cent.

And the narrowing in the spread between Australian and US 10-year bond yields to a less than half a percentage point (a third of where it was a year ago), as well as the big moves in the Swiss franc when its cap against the euro was removed, to mention just a few recent developments.

No wonder it's hard for investors to stay focused on key trends. The main force driving shares and bonds up in price is the easy setting of monetary policy, particularly in the major economies. Cash rates are mostly near-zero. The US central bank is expected to normalise its cash rate in a patient and gradual way, and the major central banks are printing money. The hunt for yield remains alive and well.

Sharemarkets have taken additional comfort from recent indications that average profits a share are a little above earlier expectations — helped in the US by share buybacks and in Australia by cost cutting. Average dividends are also a bit higher than expected. And the Australian dividend payout ratio is seen by most investors as comfortable and favourable.

Bond investors have been responding to the program of bond purchases announced in January by the European Central Bank — and bonds are now priced for expectations of a long period of stagnation and disinflation, fed by excess capacity, the slump in energy prices, and modest increases in average wages.

In my view, shares are now somewhat overpriced, but bonds seem significantly overpriced.

To make things even more challenging for bond markets, many investors say they'll be quick to lighten their holdings of bonds once yields start moving up cyclically — they can't all do that.

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