Pendulum Is Seen In Swing to Stocks

Investors’ Fixation With Bonds May Finally Be Ending as Crisis Climate Eases

By MATT PHILLIPS

In the tussle between stocks and bonds, the former are regaining the upper hand, at least among close observers of the market.

As the debt debacle in Europe continues to fade, along with other financial crises in recent years, investors and analysts are sizing up a drastically reshaped financial landscape and wondering whether a growing focus on economic recovery and risk taking may overtake the fixation on safety and sluggish growth that has dominated investor thinking in recent years.

In this environment, some see stocks as having much better prospects than bonds. Some analysts even suggest that a three-decade bull market in bonds may be coming to an end.

That doesn't necessarily mean analysts expect bond prices to fall sharply amid a mad dash into the stock market. But as confidence in the U.S. economy grows, the tide may slowly turn in favor of stocks.

That would be a departure for investors, who have seen the bond market consistently trump returns from stocks over the past decade.

The Barclays Capital U.S. Aggregate bond index—which covers the investment-grade-bond markets, including government and corporate bonds as well as mortgage-backed and other asset-backed securities—has returned roughly 113% to investors since Dec. 31, 1999. By comparison, the Standard & Poor's 500-stock index returned 19%, including share-price gains and dividends.
Stocks vs. Bonds

Compare the performance of a bond index against the total return of the S&P 500 stock index.

At PineBridge Investments, an asset manager with more than $67 billion under management at the end of last year, executives have noticed a recent uptick in interest in stocks among institutional clients, notwithstanding last week’s selloff.

"You're starting to see more faith in the equity markets," said John Baumann, Pinebridge's managing director and head of institutional sales and client services.

Wall Street has noticed. Goldman Sachs, UBS and Barclays recently published reports arguing in favor of stocks over bonds.

In a note last week titled "The Long Good Buy; the Case for Equities," Goldman strategists argued the prospects for returns in stocks are as good as they have been in a generation.

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Stocks are likely to "embark on an upward trend over the next few years," wrote Peter Oppenheimer and Matthieu Walterspiler, London-based strategists at Goldman.

Such calls incorporate myriad assumptions. But at their heart is the growing conviction that the worst of the crises of recent years has passed.

That should limit the chances of a Japanese-style deflationary spiral, one of the few outcomes analysts think could drive interest rates lower and keep the decades-long rally in bonds going.

There are still plenty of reasons to be cautious about the stock market. Expectations for earnings are dropping, as profit margins look stretched. There are signs of softness in demand for commodities in Asia, and rising oil prices could cut into U.S. consumer spending. And while quiet now, the European debt crisis hasn't been conclusively resolved.

The 151.89-point decline in the Dow Jones Industrial Average last week suggests investors are cautious. Stocks have already risen sharply this year. The Dow is up 7% and is up more than 100% since bottoming in March 2009.

Some market observers also caution that Wall Street by nature is bullish, making it less surprising that they would be cheering for the stock market.

"The industry, as a whole, both sell side and buy side, is genetically optimistic," said Albert Edwards, a global strategist at Société Générale in London, who holds a bearish view of stocks. "Some of these guys, because of the bias in the industry, even if they're about to be hit by a truck would still be optimistic."

And investors are still mindful of the risks in stocks, having witnessed the plunge in 2008 and the bursting of the technology bubble in 2000.
From January 2008 through January 2012—the last month for which complete data are available—mutual-fund investors pulled nearly $400 billion out of stock funds, while pouring roughly $800 billion into bond funds, according to estimates from the Investment Company Institute, an industry trade group.

Bonds have generated returns of 7% to 8% in recent years, thanks to a long decline in interest rates. When rates fall, bond prices rise.

But now interest rates are near the lowest they have been since World War II. Because they can't fall below zero, they don't have that much further to fall, said Peng Chen, president of Morningstar's global investment-management division.

"It's pretty clear that the chance of bonds outperforming stocks over a reasonably long period of time going forward is minimal," Mr. Chen said.

Larry Hatheway, chief economist at UBS Investment Bank, published a research note earlier this month stating flatly that the 30-year bull market for bonds, which commenced in the early 1980s, was over. As a corollary to that call, he suggested that equities should trump bonds going forward.

Still, Mr. Hatheway noted the low-volume nature of the recent rally, which suggests participation has been relatively limited.

Interest in stocks is picking up, though, said David Kelly, chief market strategist with J.P. Morgan Funds. Mr. Kelly said that recently, he has seen increased investor interest in balanced funds, which invest in stocks and bonds. That could suggest investors may be starting to ease up on their single-minded focus on bonds.

"Things are beginning to move," Mr. Kelly said.

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