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Market Ethos

The latest market insights from Richardson Wealth

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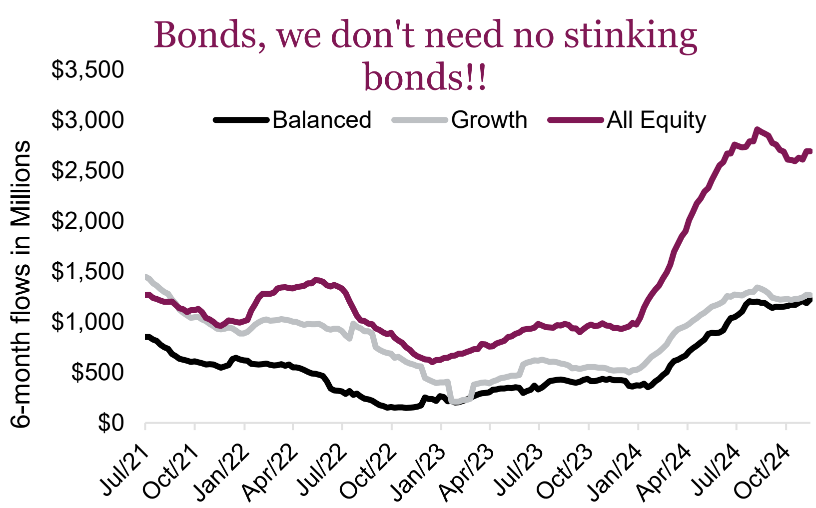
Bonds: Where's the love?

Summary: Investors have been piling into all-equity one-ticket solutions. Call it performance chasing perhaps. These vehicles are more tilted to DIY investors as this trend is less evident across the broader market flows. But the all-equity approach may prove challenging as the post-election honeymoon fades with sentiment and positioning extended.

Suppose it should not come as too much of a surprise, but investors are loving equity exposure lately. In 2022, both bonds and equities dropped double digits – about 15-20%. That's expected from the equity side of the portfolio on occasion, but bonds were supposed to be the ballast during troubling times and they clearly dropped the ball. Given this experience was followed by two years of really strong equity market returns, recency bias appears to have kicked in big time.

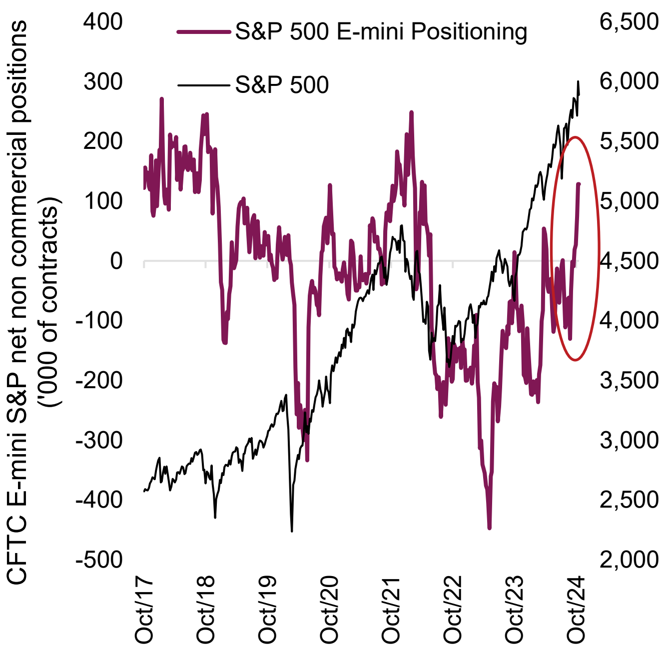
This behaviour is very evident in the single solution ETF market in Canada. The flows into all-equity one-ticket solutions have ballooned higher over the past few years while the appetite for more 'balanced' solutions, even the 'growth' tilted portfolios, has lagged. The chart below shows the trailing six months of flows into a handful of these ETFs, broken down by asset class mix. All equity flows have generally been tracking double the others. We could have included the flows into 'conservative' tilted solutions, but it barely registered on the chart.



Source: Bloomberg, Purpose Investments, universe include Fidelity,Vanguard, Can you blame investors? Global equities have appreciated by 22% annualized since the start of 2023. And since the election, markets have bounced even higher, led again by U.S. equities. The S&P 500 briefly had a 6,000 handle. Investors have become exceptionally optimistic. Take your pick – AAII sentiment of bulls at 50% eclipse bears at 28%, which has the undecided remarkably low. We should note the bulls have been consistently outnumbering the bears for a while, and the market has gone up. This is a survey though, and surveys are not as reliable it seems … kind of like political polls.

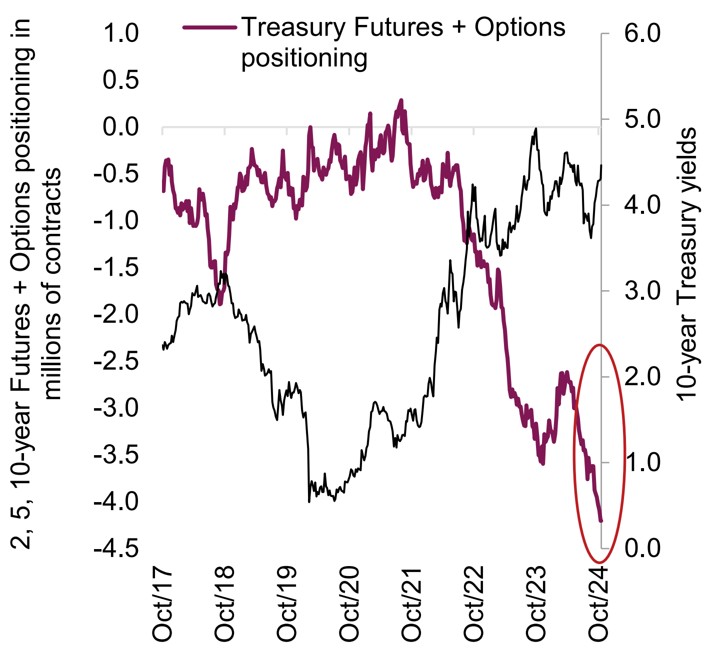
Looking at where the money is, this is perhaps a bigger concern. Over the past month, the trend has been for more investors to place bullish bets or positions on equities and more bearish positions on bonds, based on the futures and options market. These trends seemed to accelerate following the election results. And now they're maybe getting to rather extreme or extended levels.

Speculators now very bullish



Source: Bloomberg, CFTC, Purpose Investments

Bond speculators very bearish



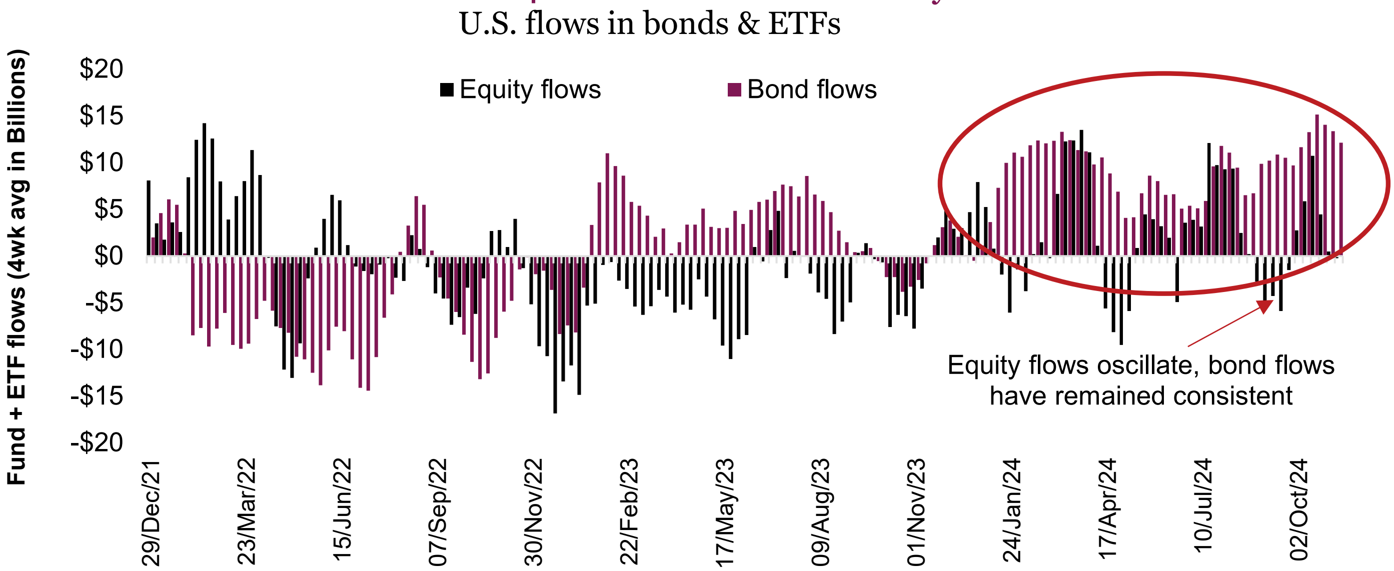
Source: Bloomberg, CFTC, Purpose Investments

A few reasons it is worth paying attention to futures/options positioning. When overly tilted in one direction, like everyone bullish or bearish, things can reverse very quickly. First because if everyone (or most everyone) is bearish, it is harder for more people to become bearish. For example if 100 people include 90 bears and 10 bulls, well, there are only 10 people who could change their mind and add to the bears. But there are 90 that could add to the bulls. There is a mechanical factor as well. When an investor puts on a bearish futures/options position, the folks facilitating this will hedge their side by shorting a bit. As such, when those positions start to unwind, the dealers tend to feed the momentum as they unwind their hedge.

Extended sentiment and positioning raises the risk of a counter trend move in markets. That would be lower for equities and higher for bonds. Maybe it started last Friday, as we write this Ethos, a poor end to the week.

Another factor to consider is who is doing the buying. Our first chart was fund flows into single line solution ETFs. While both DIY investors and advisors use these vehicles, it is tilted much more towards DIY. Switching to U.S. data that tabulates all ETF & mutual fund flows, it would seem there is lots of money flowing into both. Perhaps this is the most insightful piece: could the rampant performance chasing be primarily DIY investors while advised investors are allocating with more of a balanced approach?

U.S. flows in 2024 have been dominated by bonds



Source: Bloomberg, ICI, Purpose Investments

This may be comparing apples and oranges, as the DIY investors piling into more all-equity solutions may be on average younger with a longer time horizons compared to the dollar-weighted average age of all investors. Still, a proxy for more retail flows does appear to be very 'all-equity' tilted. This has also been the right call over the past year+.

Final thoughts

Perhaps we are in the post-election honeymoon phase, as it did remove uncertainty from the market. And we could argue that at this time of year markets go up more often than down. But come January when the headlines start to fly, the market could easily become more fragile to headlines it doesn't like. We expect this to be a more volatile time as market become accustomed to headlines. And then there is tax. Many investors, sitting on gains thanks to the past two years of outsized gains, may be waiting to sell in the new year to defer the tax hit a bit longer.

Markets – they are always entertaining one way or another.

Source: Charts are sourced to Bloomberg L.P., Purpose Investments Inc., and Richardson Wealth unless otherwise noted.

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*This report is authored by Craig Basinger, Chief Market Strategist at Purpose Investments Inc. Effective September 1, 2021, Craig Basinger has transitioned to Purpose Investments Inc.

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