Mind the Gap
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Almost all investor's portfolios, either directly or indirectly, include stocks and bonds. Both provide an investor with future cash flow – bonds with fixed interest yield and stocks with a profit yield plus potential growth from companies' regular operations. Over time, however, investors are sometimes willing to pay much more for one type of cash flow than the other.

At the end of 2007, stocks and bonds were priced at relative parity with only a 1 percent "gap" in stock to bond yields. You could buy a 10-Year Treasury note and receive a fixed 4.6 percent yield or you could buy the S&P 500 stock index and receive a 5.6 percent profit yield plus any potential growth. These were prices for normal economic conditions, but unfortunately we proceeded to experience something far from normal. In 2008 we lived through increasing mortgage defaults, a recession, financial company failures, and a frantically executed TARP. By the time the worst news began to recede in March of 2009, you could buy a 10-Year note at a 2.8 percent yield or a stock index profit yield of 5.4 percent plus growth potential. The gap had widened to 2.6 percent.

Historically, after stock and bond yields diverge for a time they will then narrow to more normal spreads. But since March of 2009, interestingly, the gap has continued to widen. As of the date of this writing, a 10-Year Treasury pays a 1.6 percent yield while the stock index pays a 7.6 percent profit yield plus growth potential.

Reviewing data going back to 1960, the magnitude of this 6 percent gap has never been wider. One reason for this is profits (+128 percent) have been rising faster than stock prices (+75 percent) since March of 2009. Another is investors have pulled money out of U.S. stock funds for 48 of the last 64 months and have deposited over $1 trillion into bond funds over the same time frame. This will not continue forever. The yields on bonds are well below what an average investor needs from their investments, and that's not even taking into consideration that inflation has been running at about 2.5 percent to 3 percent, which erodes investors' real returns.

The gap will eventually be narrowed by one of three events: stock prices rising, bond prices falling, or company profits falling – or any combination of these. It is important to note that all other things being equal, stock prices falling will not close the gap – that would make it even wider.

The market continues to have very low expectations for stocks, and companies have been more than able to easily meet those expectations over the last 3 years. They set a profit record in 2011, and are on pace to set another record in 2012. The gap has often been closed in the past by stock prices rallying, and the odds are the gap will be closed in this way again.