Awaiting proof of the "Great Rotation"

By Mike Dolan

LONDON (Reuters) - The jury's out on the big investment theme of 2013 - the so-called "Great Rotation" out of expensive bonds back into undervalued equity - and don't hold your breath for a verdict any time soon.

Only six weeks into a new year is early to judge what many see as a glacial shift that could take more than 10 years to play out, reversing a move into bonds by major pension and insurance funds that itself took a couple of decades.

But with market pricing seemingly playing the "rotation" tune already this year, strategists are scrutinizing every piece of news on fund flows for hard evidence of a turn in this mega cycle - an inflection point that could signal an end to the virtually unbroken 20-year bull run in bonds.

Market pricing certainly suggests a corner has been turned. MSCI's developed market equities index has clocked up almost 7 percent returns year-to-date, with emerging markets shares underperforming but still in the black to the tune of 1 percent.

The flipside has been rare negative returns on core government debt, with both U.S. and German 10-year bonds about 2 percent in the red. The Merrill Lynch corporate bond index is also about 1 percent lower, with only high-yield or junk bond returns still in positive territory - just.

But do investment fund flows back all that up?

Funds' preference for equity in 2013 is undisputed. About $70 billion net flowed to equity mutual and exchange-traded funds, often seen as a proxy for retail or household savings activity, in the first five weeks of the year. That surpasses the previous historic peak in 2000 and is more than three times the $23 billion of inflows seen for the whole of 2012.

"Our core 'Great Rotation' theme remains in play," Michael Hartnett, chief investment strategist at Bank of America Merrill Lynch, which has advocated the theory, said this week. He acknowledged that periodic market wobbles were possible.

Skeptics, however, counter that that money does not yet appear to reflect a flight from bond funds.

Bonds of all types have continued to attract hefty inflows in 2013, even if - unusually - demand has been less than for stocks, and despite general agreement that they are unlikely to match four-year annual average inflows of $550 billion.

JPMorgan's latest deep-dive into high-frequency mutual fund and ETF data shows net inflows into global bond funds, and emerging market bonds in particular, still robust at about $30 billion in the first five weeks. That is not far off the $40 billion of inflows seen in the same period last year.

"There is no evidence of a rotation, year-to-date, away from bonds into equities by retail investors," JPM analyst Nikolaos Panigirtzoglou told clients this week.

Rather, the source of the new money appears to be cash reserves or deposits, according to many analysts - although relatively steady flows to cash-like money market funds also throw a dampener on any 'dash from cash' argument.

"In a way it seems that retail investors are deploying their surplus funds or savings into both bonds and equities and less so into money market funds," wrote Panigirtzoglou.
TOO EARLY TO TELL

So if retail money is still streaming into both equities and bonds - despite market price action, warnings from the likes of the Bank of England about rising inflation and fears of a bubble in the junk bond market - is the idea of a rotation misplaced?

Reuters global asset allocation survey shows there has been some rebalancing of model portfolios. **Equity allocations rose to a nine-month high of 52.1 percent in January and bond holdings fell to a five-month low of 37.2 percent - the biggest monthly shifts in at least three years.**

Thomson Reuters mutual fund tracker Lipper also has recent allocations data for about 2,800 mixed asset products, sometimes called balanced funds, managers of which are freer to adjust their equities and bond holdings according to their market view. That makes the sector a useful proxy for the mood and decision-making of investors than more restricted mutual funds.

This data tends to back up the idea of an exit from the negative real yields of cash, with a big 5 percentage point drop in cash holdings since the middle of 2012, to less than 9 percent in the three months to January. It also shows some lowering of bond allocations over the past year as equity holdings have climbed.

But retail investor activity is only one, though highly visible, part of the market. Deutsche Bank data for 2012 shows the global pool of mutual and exchange traded funds, at some $28 trillion, is less than half the combined $57 trillion of slower-moving, more conservative pension and insurance funds.

**The nub of the "Great Rotation" idea is that we are in the final throes of a 20-year bond bull market that began with a gradual "de-risking" of portfolios by these institutions, under pressure from regulators, trustees and demographics.**

That long-term shift, underpinned by years of low inflation, has been supercharged over four years of the credit crisis by a dash for "safe" liquid assets, and exaggerated further by central bank bond-buying as part of monetary stimulus policies.

Although the target allocations of these institutions will not change quickly, they may well "normalize" over time as risks to their returns from holding "core" government bonds with negative real yields - which also affect other bonds - rise.

JPMorgan's Panigirtzoglou points to data from the U.S., euro zone, British and Japanese central banks - the G4 nations - showing a jump in pension and insurance funds' bond allocations to about 50 percent from 40 percent at the onset of the crisis. They have held stable at historic highs since then, with equity allocations at less than 30 percent, the numbers show.

These target allocations need to change to deliver the predicted seismic shift in flows, but they are often reviewed only quarterly or even annually.

In the meantime, if target allocations remain the same and bond prices fall, lowering their value within portfolios, these funds will actually have to buy more bonds to fulfill existing mandates and keep overall holdings at 50 percent.

Under this scenario, "G4 pension funds and insurance companies will likely put a brake on any potential bond selloff," Panigirtzoglou said.

Even if the rotation is afoot, it looks likely to be slow.

(Additional reporting by Joel Dimmock and Ingrid Melander; Editing by Catherine Evans)