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Shifting markets make for interesting opportunities

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Bonds and gold may be on the ropes but still some potentially rewarding areas in a resurgent economy

That was some second quarter. Look beyond major stock market indexes and instead focus on the seismic shifts beneath them, and what you see are sweeping moves that won't settle down any time soon.

The investment landscape has been shaken as investors contemplate an end to extraordinary central bank stimulus.

In particular, the Federal Reserve has said it plans to taper its bond purchases, potentially ending its program of quantitative easing, or QE, next year. Rate hikes could follow.

Those plans are by no means written in stone, but the market is taking them very seriously. The yield on the 10-year U.S. Treasury bond has surged to 2.5 per cent, up a full percentage point in a month.

As yields rise, prices fall – and that has translated into the worst six-month performance for U.S. bonds since the first half of 1994.

Record amounts of money are now flowing out of bond funds.

Gold, once seen as a natural defence against the downside of Fed stimulus (inflation and dollar erosion) has cratered, falling 23 per cent in the second quarter alone.

That marks its worst quarterly performance in at least 45 years, according to Reuters.

Emerging markets are also suffering, as money flows out of these countries. The iShares MSCI Emerging Markets Index Fund has slumped 13 per cent since May.

For sure, there's always a danger in extrapolating too much from recent market performance, or betting that what's moving now will continue to move in the same direction.

But we're not witnessing the moves of trendy stocks or a hot sector, but rather the first steps toward normal monetary policy – and normal is something that hasn't been seen during the 140 per cent runup in the S&P 500 over the past four years.

The bull market has coincided with a combined 520 rate cuts by central banks and $12-trillion (U.S.) in asset purchases, according to Bank of America.

Given the upheaval ahead, the third quarter of 2013 is going to look a lot like the second quarter: Bonds will struggle, with many observers expecting the yield on the 10-year bond to rise to 3 per cent next year. Even that could be conservative – the yield was as high as 3.5 per cent as recently as 2011.

It's hard to imagine much of a spark from gold either, since withdrawn stimulus should ease inflation concerns. Campbell Harvey, a professor at Duke University, believes that if gold moved with inflation it would be worth $800 an ounce right now. On Friday, it traded at $1,215 an ounce, suggesting more downside ahead.

But the third quarter should bring opportunities for investors as well. For all the concern about the end of Fed stimulus, the drive behind the policy shift is entirely positive: Employment is rising, the housing market is providing a tailwind and the U.S. economy continues to expand.

That points to potential gains in stock market sectors that have a high exposure to the economy. U.S. financial and consumer discretionary stocks rose about 7 per cent each in the second quarter, and it's not hard to see the gains continuing, especially with many financial stocks still recovering from the 2008 crisis.

In Canada, insurance companies stand to benefit from rising rates. Already, Manulife Financial Corp. has risen 22 per cent from its April low and Sun Life Financial Inc. has risen 18 per cent.

Their record highs are still far away, though – providing yet another hint that a shifting market is a long-term process that is going to challenge, and reward, investors for many more months.