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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

Investors are always looking for the canary in the coal mine. In 2008, the canary was the junk bond market. It started going south in June of 2008, but the stock market didn't top out until September. We all know what happened after that. The canaries began showing some stress again in the middle of last year. By March 1st of 2016, they were looking for oxygen bottles. The spread between B rated corporate bonds and CCC rated bonds had exploded to 11.7%. It was beginning to look like shades of 2008 all over again.

To put this into perspective, bond ratings go from AAA, AA, A, BBB … B, CCC, CC, down to D which means a company has defaulted. So the difference between CCC and B is not that great relative to how many ratings there are. However, in the world of investing, and especially when uncertainty starts to grow, CCC becomes Custer's last stand. They are where speculation really starts to kick in. Junk bonds can be a predictor of the storm clouds of a recession building on the horizon. Sensing this, the stock market began selling off on January 2nd. However, as is often the case, the market sensed more value than lack of oxygen by January 20th. The Dow made this year's current low of 15,450 on that same day. By March 1st, the Dow had recovered to 16,545 or 7%. The spread between CCC and B rated bonds didn't reach its low until March 1st of 11.7%. Though spreads are still above the average of about 4% for the last five years, they are steadily improving. Investors have also become more encouraged, the Dow reached 18,000 last Friday, up another 8%. Why the false signal from the junk bond market?

One answer is that a lot of the carnage in the bond market was confined to commodity based companies. Oil being the largest sector of companies that have lower rated bonds. With the latest improvement in oil prices, some of the immediate pressure has been alleviated. There were also conflicted results of low oil prices, while hurting the oil industry, at the same time it was helping you and I the consumer. Consumers do ultimately drive the economy.

It feels like the best answer comes from interest rates. The 10-year government bond rates for Germany, France, Italy, and the U.S. respectively are .234%, .567%, 1.48%, and 1.88%. Thank the European, Japanese, and U.S. central banks for these putrid rates. Some day we will get back to normalcy, whatever that is at this point. It seems pretty likely that it is not earning $230 over the entire ten years for each $10,000 investment in a German bond. This leaves a low hurdle for stocks to compete against, but investing in something because the alternative is unappealing is not by itself a good long-term strategy.

Another way to look at it is that the dividend yield for the S&P 500 is 2.1%. If history is a guide, there is a 100% chance that the yield will be higher in 10 years. It is probably not different this time, we just don't know if the market will be higher, just that your income will be higher. Higher incomes do tend to cure lower prices in a relatively short period of time. The market is not cheap, and we are in an earnings recession. Earnings are down about 15% from their highs of 2014. A hint of how to invest comes from Jamie Dimon's letter to shareholders in this year's JP Morgan Chase annual report.

In a section of the letter Dimon refers to the liquidity issues of the stock and bond market. He predicts there is less liquidity now, and will be going forward, which creates more volatility. Without going into the reasons, volatility becomes your friend when you are trying to buy something at a cheaper price. You just have to focus on value, not price, when volatility comes, because in today's world of computerized trading and robots, things can change very fast. Fortunately, the economics of investing have not changed, just the way information is distributed. Having some liquidity to capitalize on volatility should be part of one's strategy in our modern internet world.