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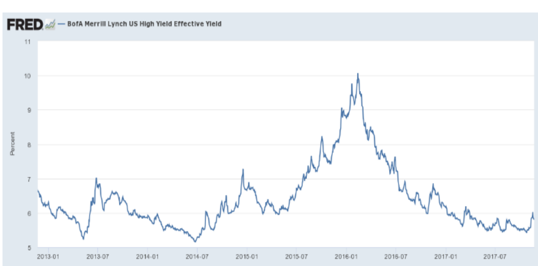
OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

What, me worry! As the market continues to make new highs, let us muse as to what could go wrong. Let's examine a list of the usual suspects, and interrogate the high yield debt market. The iShares High Yield fund currently yields 5% and has a total return of 6% for the year. In a world of ultra-low interest rates, 6% looks pretty good. However, it doesn't matter how pretty it looks, what matters is what's under the hood.

The high yield debt market has been a benefactor of the global central bank easy money policy. It has allowed companies with lower credit ratings to raise capital at attractive interest rates. Investors have been very willing to reach for higher yields, and the only way to get them is to except lower credit quality. When the sun is shining, and the forecast is for clear skies, nobody carries an umbrella. Banks and investors are currently demanding very little collateral from high yield borrowers. This is the environment we are in now. The chart below shows how the high yield bond market has performed for the last five years. It has had a strong run, yields have been steadily declining since the first half of 2016. What should an investor worry about in the high yield market? Here are a few points to consider.



The first and obvious one is that this market is volatile. Investor sentiment really moves this market. In 2016 yields reached a high of 10%, however, in 2009 they hit a high of 23%. The lower rated bonds in this sector performed much worse. They act more like stocks than they do bonds. The volatility is like stocks, but their returns are not. If you buy a stock, it may go down 20% from your purchase price, but it can also go up 20% or more. When you buy a high yield bond at a 5% yield, it can't get any better than 5%. In 2007 the iShares High Yield fund was at $106, by March of 2009, it had declined to $61, or a 42% drop. This is not an attractive trade off.

Dodd Frank imposed regulations on banks after the recession of 2009 with the intentions of trying to create more stability in the banking sector. Banks have had their trading businesses severely curtailed with the idea that banks should not be putting their capital at significant risk. However, banks before 2009 were market makers in the bond market. Meaning they would buy bonds for their own account. Dodd Frank has mostly eliminated that practice. Effectively what has happened is that a major provider of liquidity to the high yield market has been eliminated. The high yield bond market which is much less efficient is now subject to even more volatility. In times of stress, it is the lower quality investments that get hit the hardest. Investors are then forced to sell higher quality assets because they have a more liquid market. We saw the market experience this in 2016. Fortunately, it was mostly contained to the energy sector. In a recession, we will not be as lucky.

The high yield bond market is a train wreck that you know is coming, but it is impossible to know when. It doesn't make any sense to continue to own high yield bonds currently. High quality stocks may decline as much, but they will rebound in a recovery. Many companies borrowing money in the high yield bond market will not be around for the recovery. The time to high yield bonds is when they offer equity-like returns, which is when they yield closer to 10%, not 5%. It is a simple value proposition.