REGISTERED INVESTMENT ADVISOR

DENEWILER

Capital Management Inc.
1600 Stout Street
Suite 1690
Denver, CO 80202

303.832.7475 / 888.808.7475
Fax 303.832.7484
greg@growmydollar.com
www.growmydollar.com

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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

Is that noise we hear the canaries singing or coughing? We have certainly hit some dirty air in the market recently. This causes everyone to start speculating as to whether this is the beginning of something much worse, or just the pause that refreshes. Unfortunately for the canaries, they are the first to find out. Year-to-date the stock market is basically flat, so it is premature to suggest it has been that toxic yet. Let's not even bring up what the media is telling us.

The U.S. economy is doing ok. Most of the economic indicators are pointing to either a stable economy or one that is improving. The Empire State (New York) Manufacturing and General Business Conditions index is showing improvement. The ISM Purchasing Managers index is off 1% since the beginning of the year, however, the highest reading in 10 years came just three months ago. The Philly Fed Manufacturing Activity survey shows a 20% improvement since the beginning of 2018. Housing starts are at the highest level in 10 years, and retail sales are up 1.7% the year. Finally, there is the U.S. Misery Index. In case you didn't know it, you are feeling great. The high for the most recent decade is 12.8, occurring in September of 2011 (a higher a number is bad). We are currently at 6.7. This number is up slightly from a low of 5.2, but you are still feeling pretty good. A combination of the unemployment rate added to inflation are the ingredients that make up misery - in case you wanted to know. The global scenario is not quite so rosy.

Europe is still growing, but the Business Climate Index in Germany is off 2.6% from the beginning of the year. France's Economic Sentiment Indicator is down 4.8% the UK's Sentiment Index has also declined 4%. Europe's economies have slowed down. China and India still show incremental growth, but their most recent data is probably less dependable and more likely to be revised. Global central bankers confirm that their economies are at least doing ok. The European Central Bank has indicated that they are going to stop buying bonds, a more restrictive action, sometime around the end of the year, and we all know the Federal Reserve is in tightening mode. The Fed has confirmed that the U.S. economy is healthy. All of this sounds great, but we all know the past does not guarantee the future. We want to know what the canaries are doing.

Credit markets, specifically riskier bonds otherwise known as junk, are one place to look to see if there are early signs of trouble. Bonds in general are rated from AAA down to D, which is default. If your credit score is B, it implies that you are in the middle of the riskier bond market which starts at BBB. CCC, which is only one notch down from B, seems to be the tipping point for risk. The difference in yield between B rated bonds and CCC rated bonds in March of 2009 was 19%. The difference between A and BBB rated bonds (again only one rating difference) was about .5% in 2009. Currently, the spread between A and BBB is still about .5%, while the current difference between B and CCC is 3.1%. The recent historic low is around 2.7% and the ten-year average is 5.3%. It is easy to see why CCC bonds are very sensitive to the economy, because history shows that 23% of them end up defaulting.

The phrase – "A canary in the coal mine", according to Wikipedia, is real. Beginning in 1913, coal miners started taking canaries into coal mines as an early detection for toxic gases. Because canaries had a rapid breathing rate, small size, and high metabolism rate, they provided an early warning to miners which gave them time to react before they succumb to toxic gases. The economy is far too complex to even suggest that there is one simple tool for detection of a weakening economy. However, CCC bonds are still singing the joys of a firm economy.