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OBSERVATIONS ON THE MARKET

By Greg Denewiler, CFA

What do you do when the numbers don't add up? Nothing. Not that long ago, if oil prices had moved to five-year highs, the market would be worried about inflation. If wage growth was trending higher and approaching 3%, there would be some concern regarding inflation. Gold, the once standard asset of choice to protect against inflation, has declined by about 7% since the beginning of the year. A few years earlier, higher interest rates would throw cold water on investor enthusiasm. Political uncertainty was once a major market fear. Remember the predictions leading up to the 2016 election? They did come true for about 12 hours following the election outcome. Uncertainty, after all, is what markets least want to see, and these numbers don't seem to add up!

There are some numbers that do add up. Economic growth is accelerating. Earnings have doubled since the previous pre-recession high. Trade wars wreaked havoc on the economy in the 30's. Fortunately, at least so far, headlines of $200 billion in tariffs are just that, headlines. They only represent 1% of a $20 trillion economy. However, a few hundred billion here and there, and soon you are talking real money. Even with bond yields now clearly trending higher, the spread or difference between high yield bonds and U.S. Treasuries, are near record lows. This continues to enable riskier companies to raise and refinance their debt. Consumer confidence is now at an 18-year high. All hurricanes start someplace, some off the coast of Africa. Is our symbolic debt hurricane off the coast of Africa?

Corporate debt growth has exploded. From 2010 to 2017 corporate debt issuance has increased by 96%, compared to our economy, which has grown by 40%. Over the same period, the high yield portion of the corporate debt market has grown by 151%, from $106 billion annually to $266 billion. The corporate debt market which is divided into two tiers, investment grade and high yield, consists of BBB rated bonds at the lower end of the investment grade sector. Here we have seen credit quality decline. In 2009, BBB bonds consisted of 32% of the investment grade sector, now, they are up to 44%. The next step down which is BB, is only 19% the size of BBB. Finally, we currently have $320 million of corporate bonds maturing in 2018. Between 2020 to 2024 the number becomes $1 trillion. This all has several implications.

First, the amount of bonds maturing in the next several years is likely to put upward pressure on interest rates. We haven't even touched the topic of the number of Treasuries that will need to be sold to finance the deficit, or the Fed's desire to sell bonds purchased over the last several years to help force interest rates down. Second, the bond market has enabled lower quality borrowers to borrow more. The covenants, or terms, that borrowers are required to maintain have all but disappeared. An example is the amount of profits the borrower is required to have to cover their interest payments, it is now much lower. There is a big difference between a tropical storm and a 4 or 5 strength hurricane. The conditions are there for the high yield debt market to develop into a very bad storm.

In a recession, there becomes what is known as a fallen angel. This was not an original lower quality debtor, but a company that was once an investment grade credit that has since fallen on hard times and becomes downgraded to high yield. Recessions have a way of exposing a company's weakness. With so many more companies that are one step away from falling into junk status, an already much larger high yield market could easily be overwhelmed with bonds that become fallen angles. Then, if that wasn't enough, we have the final ingredient to experience a full-blown financial hurricane.

Congress, in their infinite wisdom to protect us from ourselves, has removed the very thing that we will need most when there are a lot of sellers, and few buyers. The major banks can't buy these bonds any more. They are restricted from "speculating" with their capital. Whether you consider that a good thing or not, it doesn't matter. The high yield debt market has a history of turning bad very quickly, and now we have fewer buyers to buy more bonds. However, there is a ray of sunshine, only 4% of the companies in the S&P 500 are considered high yield. The core of our economy is strong. We have all the numbers adding up, but the storm that is building is still way out to sea. If it hits, we will clean up, and then move on until the next one strikes.