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Q4 2015 Market Outlook

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Covered in this Issue:

- Economic Data
- Commodities Sell-Off
- China's Slowdown
- Fed Interest Rate Hike
- High Yield Corporate Bond Market
- Equity Market

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Be Careful What You Wish For… Whatever That May Be

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Investors are living through that old adage "Be careful what you wish for, it might come true." All year long, the markets have been nervous about the Federal Reserve lifting the federal funds rate off its "low as you go" 0.00% to 0.25% range. The Fed meeting on September 17th was anticipated with trepidation, many viewing it as the first date that a rate lift-off was likely to happen. And then the Fed blinked, deciding to wait it out due to "recent economic and financial developments" that "may restrain economic activity somewhat." Risk markets responded to this dovish stance by running for cover. Maybe the Fed was on to something. Maybe the economy is not so strong. The stock market certainly seemed to indicate as much in the announcement's immediate aftermath. In retrospect, maybe a rate hike would have been an endorsement by the Fed that the economy is in a good place and that the future is bright. Maybe some were wishing for the wrong things.

What investors end up wishing for is of course governed by their beliefs and views about the future. Trying to put some perspective on the recent market moves, my thoughts as we start the fourth quarter are as follows:

- **The data may indicate otherwise.**
  The recent weakness in payroll and manufacturing numbers does not mean that the U.S. economy is rolling over. There was much hand-wringing over the most recent payroll data. But the payroll numbers are historically volatile and are still averaging a respectable 198,000 jobs created per month for the first nine months of 2015. From a bigger picture perspective, unemployment sits at 5.1%, Q2 GDP was revised upward to 3.9%, and GDP growth for full year 2015 is estimated at 2.5%. Auto sales are booming and home prices continue to move upward. Consumer spending is estimated to have grown 2.9% in the third quarter and lower energy prices are putting more money in people's pockets. Yes, the labor participation rate is low, but this in part reflects an aging population, the "gig" economy, and Obamacare, which gives Americans the opportunity to obtain healthcare coverage without having to work.

- **What about the dip in commodities?**
  The plunge in commodity prices is a poor representation of underlying demand. The drop in oil, for example, was precipitated by innovation-driven production increases in the U.S. Worldwide demand is still growing. Is that bad? Pricing in base metals, such as copper, does reflect weakened demand, particularly in China. But the prices of metals are coming off of bubble-like levels that were propelled by frenzied Chinese production and inventory accumulation. In the case of copper, Chinese demand more or less doubled between 2008 and 2014 and accounted for somewhere between 40% and 50% of worldwide demand - 2.4x to 3x its share of worldwide GDP. While the price of copper has almost been cut in half from its peak five years ago, it is still up an annualized 6.7% over the last fifteen years.

- **Can we stop worrying about China then?**
  Not at all: the downturn in China is perhaps the biggest issue hanging over the market. Rather, as the price action in copper indicates, underlying trends can be opaque and a number of China-related bubbles have already burst. For instance, the Shenzen stock index is off 45% from its 2015 peak but is still up 21% on the year. The ripple effects of these bursts will be felt for some time, Brazil's woes and the recent concerns about Glencore being prime examples. The weakened state of commodity-dependent emerging markets is a cause for worry, particularly for large multinational companies.

- **What about that rate hike?**
  A Fed hike of 25 basis points on its target funds rate in December would be a good thing if economic numbers between now and then come in "OK." A possible rate increase has been hanging over the market all year. The Fed has been clear that the pace of future hikes will be data-dependent. There is one thing that the Fed *has* shown and that is that it is very cautious. Is a quarter of a percent increase in short-term interest rates all *that* meaningful in the grand scheme of things? I find it hard to believe that a rate bump will alter underlying economic activity in the U.S. in any meaningful way. A "one and done" for a while by the Fed, so long as the economic data is "OK" and on trend, would be positive for risk assets in my view.

- **The world can be a scary place.**
  Politics, both here and abroad, are a disconcerting risk to the markets. The potential for bumping against the debt ceiling and the prospect of a government shut-down are real issues. One always hopes cooler heads will prevail, but dogma could trump common sense. Overseas, the possibility of a mishap in Syria given American and Russian involvement is just plain scary.

High Yield Corporate Bond Market

The high yield market is now blinking "cheap" to me with a yield-to-worst call of just under 8% and a spread-to-worst call of +655 basis points (Bank of America Merrill Lynch High Yield II Master Index). The 655 basis-point spread is 74 basis points wide of the average over the last twenty years, which includes the 2008 financial crisis spread spike that peaked at 2145 basis points. Yes, the current averages include the troubled energy sector, but contagion has filtered through the high yield market as fund liquidations have pressured bond issuers with still solid fundamentals. Spreads this wide will act as a cushion if and when the Fed raises rates. And if the rates rise is modest, as we expect, a yield of 8% looks appetizing in the context of a sub-1.5% five-year Treasury. There has been much talk of liquidity (or the lack thereof) in the high yield market. Certainly, liquidity can be an issue on a day-to-day basis for both issuers and investors. However, high yield issuers have by and large termed out their debt and most do not need to issue at present. Similarly, while it can be difficult to "trade" the high yield market at present, long-term investors can take advantage of the price inefficiencies that may occur in less liquid markets.

Equity Market

Equities as a whole appear more fairly valued to me with a price/earnings ratio of 16.7x expected 2015 S&P 500 earnings. The growth in earnings has flattened out but again the aggregates are heavily energy-influenced. Third quarter S&P earnings are expected to be down 6.9% year-over-year but up 0.1% excluding energy. Granted, this is still not a scenario to get all that excited about. In fact, few are. Equity bulls are an endangered species these days, and it appears that negative investor sentiment is acting as a price floor for the market. In the new normal of low interest rates, dividends also provide support for equity levels. The S&P 500 is currently yielding 2.18%, with the ten-year Treasury yielding just 2.06%. Since interest rates plummeted in 2008, the S&P has occasionally yielded more than the ten-year Treasury. Prior to 2008, such occurrences were rare, with the last time being in 1962. Moreover, dividends on the S&P are growing at roughly 12%. Markets like the last couple of months can test the resolve of investors. More than anything, 2015 feels like a year when equities have hit the pause button, waiting for earnings to catch up to prices. Even with the recent swoon in prices, the S&P is still up 18% over the last two years. A similar high single-digit return over the next twelve months may be difficult but not impossible to achieve, given the aforementioned dividend yield and as year-over-year energy and commodities earnings comparisons become easier.

Randy Masel manages a high yield corporate bond strategy that he created and launched upon joining Granite Springs Asset Management in January 2014. He also manages Granite Springs' Tactical Equity strategy.

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