Granite Springs
Asset Management, LLC

July High Yield and Equity Market Commentary

Randy Masel
Portfolio Manager,
Corporate High Yield and Tactical Equity
rmasel@granite-springs.com

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Contact Granite Springs
25 Deforest Avenue, Suite #308
Summit, NJ 07901
(855) 212-0955
contact@granite-springs.com

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What, Me Worry?

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At the end of 2015, amidst the doom and gloom of the financial markets, if some genie appeared and offered to guarantee a 7.1% return for your S&P 500 Index fund (SPY) for all of 2016, would you have taken it? How about a juicier 9.6% on your high yield exchange traded fund (HYG)? I would have, and I think most investors would have as well. But as I write this today, with those returns actualized and already in the books and five and a half more months left in the year, the genie's deal does not look so hot in retrospect.

High yield's strong performance in 2016 is understandable given its negative return of over 9% from mid-2014 through January 2016. A lot of bad news was already priced into the market, oil and other commodities started to rally, and though not robust, economic data indicated that the U.S. economy was not rolling over. Still, high yield's 2016 performance is exceptional, with the Bank of America Merrill Lynch High Yield Master II Index up 5.9% in the second quarter and another 2.7% in July. For all of 2016 the index is up 12.2%. It is important to note that given friction costs, inclusion and exclusion rules, liquidity issues, etc., virtually all large high yield funds have had a tough time beating their high yield index benchmarks in 2016. For example, the two largest high yield ETFs have lagged their indices by an average of 1.6% year-to-date.

Although not quite as impressive, U.S. equities have also posted solid returns in 2016. The S&P 500 Index was up 2.45% in the second quarter and 3.7% so far this month. Strong earnings are not driving this performance. Second quarter 2016 S&P 500 earnings are expected to decline 5.5% year-over-year, according to FactSet. This would mark the fifth consecutive quarter of year-over-year declines in earnings. While the energy and materials sectors continue to weigh on earnings, four of the other eight sectors in the S&P 500 are also expected to post earnings declines (consumer staples, industrials, financials, and information technology). Earnings comparisons will get easier in the energy and materials space and earnings growth is expected to resume in the third quarter based on bottom-up analyst estimates. Still, forward-looking valuations do not appear cheap by historical standards – FactSet estimates the S&P 500 forward P/E at 17.1, well above the ten-year average of 14.3.

The willingness of investors to shrug off lousy earnings and historically high valuations is a function of the fact that while the backdrop for stocks here in the U.S. may not look so great, things generally look worse in other parts of the world and in other asset classes. The recent Brexit vote made it evident that the U.S. market is the best house in a bad neighborhood. It is far from clear how the U.K. exit from the European Union will play out and how significant the business and economic impacts will be over the longer term. It does seem clear, however, that over the shorter term, European and U.K. businesses are likely to be more cautious regarding hiring, capital spending, and expansion plans. This will weigh on economies that are already in slo-mo mode. 2016 Eurozone GDP growth is projected at 1.5% (source: Bloomberg) and European banks, which did not take the hard medicine like their U.S. counterparts, are struggling. In Japan, negative interest rates and Abenomics have created unintended consequences and failed to stimulate economic growth. As for China, the economic picture looks as murky as ever. Does anyone else find it curious that China's reported GDP has been tracking so closely to its growth targets?

High yield and U.S. stocks continue to benefit from the global interest rate famine. The yield-to-worst call date on the Bank of America Merrill Lynch High Yield Master II Index is down to 6.67% from 8.76% at the beginning of the year. Spreads to comparable Treasuries sit at +5.59%, just below the twenty-year average of +5.81%. However, with 5yr Treasuries flirting with historically low yields of 1.14% as I write this (high yield historically has a duration similar to a 5yr Treasury), the spread alone represents a return of 5.1x the underlying Treasury. At the beginning of the year, this ratio was just under 4x. Similarly, I have previously written about how rare it was until recently for the dividend yield on the S&P 500 to exceed the yield on the 10yr Treasury. But just last week the S&P 500 was yielding more than the 30yr Treasury – an even rarer occurrence historically.

I will admit that buying a security because everything else around it looks worse in comparison is not the most compelling argument. But it does seem that the lower growth/low rate environment we find ourselves in is not a blip. It may not be the "new normal" either, but it will be the normal for a while. Money has to be put to work; institutional investors such as pension funds have no choice. With pension return assumptions generally north of 7%, and 30yr Treasuries yielding 2.3%, it seems to me that equities and high yield will be the beneficiaries of reallocations to potentially higher returning assets. And at the same time, U.S. economic data is showing more vigor. In fact, the Citi Economic Surprise Index is at its highest level in a year and a half.

I am not suggesting investors need not worry given current market technicals. Sentiment can change and there are plenty of issues lurking that could cause a shift. Oil prices have started drifting downward, a number of European banks need capital and are in the intensive care unit, there appears to be no do-over for the Brexit vote, and the upcoming U.S. elections could provide more drama than Game of Thrones. And although many market pundits think that the Federal Reserve Bank is on hold for the rest of the year, I would not be at all surprised to see at least one rate hike by year-end. A rate hike that is not well telegraphed could throw the markets into a tizzy, which ultimately could provide a great buying opportunity. I am not convinced that another 25 basis point hike in the Fed Funds rate will have any meaningful impact on economic activity. Moreover, the Fed hiked last December and since then the 10yr Treasury has fallen 70 basis points in yield. Given how well equities and high yield have done this year, I would rather harvest a little cash than chase prices here. I think it will help me worry less.

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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