Granite Springs Asset Management, LLC®

April High Yield and Equity Market Commentary

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If You Slept Through the Movie, You Missed A Lot

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The first quarter of 2016 (at least as far as the financial markets go) reminds me of an old-fashioned horror movie with a foreboding opening scene, a lot of violence in the middle, and a happy ending in which the bad guys have been seemingly vanquished. The 1.3% total return of the S&P in Q1 belies the violent moves that preceded it, with the index down 10.5% less than half way through the quarter before popping back up as quickly as it fell. Similarly, the Bank of America Merrill Lynch High Yield Master II Index was down 5.8% in price before snapping back much harder; the index ended up 3.2% for the quarter.

What to make of the first quarter's events? As I wrote in January, market sentiment starting the year was very negative, particularly in high yield, where an awful lot of bad news had been baked into spreads. As 2016 kicked off, investors' concerns were not soothed by falling commodity prices, a weakening Chinese Yuan, and downbeat earnings guidance. The negative sentiment became infectious and risk assets sold off. There has been lot of discussion about causation and correlation in the financial markets and I do not want to delve into that conversation in a short commentary, but it is worth noting that oil bottomed on February 11th, the same day that the S&P 500 and high yield indices also put in lows for the year. A few days after February 11th, the Chinese markets reopened after a weeklong holiday for the Chinese New Year. Investors had been holding their collective breaths while the Chinese markets were closed. While the Chinese equity markets and currency did not take off when they reopened, they did not collapse either. Fourth quarter earnings for the S&P ended up being down 3.3% (source: FactSet) but better than the 3.9% estimated decline. The Federal Reserve Bank helped to further calm the markets in March with a dovish statement that implied two rather than four rate hikes over 2016.

So the bad guys are gone and it should be a less scary rest of the year, right? Given the Fed's dovish stance and its new fixation on international economic and market developments, a scenario of rates spiking in 2016 seems unlikely at this point. This has in turn helped weaken the dollar and prop commodity prices and emerging markets. The Yuan has also stabilized and is now stronger on the year versus the dollar. Moreover, the weaker dollar will help earnings of U.S. multinationals going forward.

Other boogeymen that spooked the market earlier this year remain, however. Oil prices are well off their lows, but $39 oil is still going to cause a number of bankruptcies in the oil patch. Bank borrowing base redeterminations are coming up and the result will be decreased liquidity for many troubled E&P companies. Economic growth in the U.S. and abroad remains anemic. U.S. GDP forecasts for the first quarter have been slipping and real GDP growth may end up below 1%. In fairness, in seven of the last twelve years, the first quarter has been the weakest quarter for GDP growth in that year. There may be some additional seasonality that is not effectively being captured in the numbers. In any case, the average estimate for full year real GDP growth for 2016 is now just 2%. Looking abroad, the Chinese economy is the true riddle wrapped in a mystery inside an enigma. Europe faces the possibility of a Brexit *and* a Grexit this year. At the same time, as of this writing, 5-year government yields are now negative in 14 different European countries, including Ireland. Those with short memories may not remember that less than six years ago the Irish government was forced to accept a bailout program to avoid a banking collapse. Finally, bottoms-up Q1 S&P 500 earnings estimates for the first quarter of 2016 now indicate an 8.5% earnings decline year over year. I guess the good news about these earnings forecasts is that a very low bar has been set.

Suffice it to say that there are enough scary issues out there that markets are likely to remain volatile and we have probably not seen our last white knuckle "risk off" moment this year. Nonetheless, a slow growth, low-rate environment should create a benign backdrop for high yield over the remaining course of 2016. The BAML High Yield Master II Index is now more or less where it was when the year began with a yield to worst and spread to worst of 8.39% and +7.19%, respectively. There will be numerous energy-related high yield companies that go bankrupt but this is largely reflected in current bond prices. The high yield market has absorbed the influx of investment grade energy companies that have tumbled into high yield and the new issue calendar will be less robust than recent years. With a 5-year Treasury sitting at 1.17% (near the 2 ½ year lows), high yield at 8.39% will prove alluring to many. If the high yield market just earns its coupon for the rest of the year (no price appreciation), total return for the market would approximate 8.4%. Is this whistling past the graveyard, given the macro concerns, weighing on the market? Maybe, but the high yield index peaked in dollar price just about three years ago and is off 16% from that peak. The bulk of high yield returns come from coupon, and fat coupons cushion returns in scary times.

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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