Granite Springs
Asset Management, LLC

# October High Yield and Equity Market Commentary


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**Covered in this Issue:**

- Summer 2016 High Yield and Equity Performance
- Central Bank Policy Impacts
- Rate Hike Selloff as Entry Point


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## Summer Vacation Is Over

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The financial markets decided to go to the beach and enjoy themselves this past summer. Brexit? Let's have a Corona with lime instead. Lousy earnings? Surf's up. August swoon? Not this year – too nice outside. The laid back attitude was evident in how stocks traded. Surprising almost everyone, the S&P 500 bounced higher post the Brexit vote shock, and then proceeded to trade in a very narrow range from mid-July through September (touching a new high on August 15th). For the third quarter the S&P 500 posted a total return of 3.85% and was up 7.73% for the first nine months of the year. The high yield market more or less mirrored equities' chill attitude in the third quarter. The Bank of America Merrill Lynch High Yield Master II Index (BAML HY Master II Index) posted a 5.49% return for the quarter and was up a scintillating 15.32% through the first three quarters.

The sanguine attitude of investors appears to be fully rooted in the concept that central bank policies around the world will remain highly accommodative, depressing interest rates and making other asset classes – equities, corporate bonds, real estate – look more attractive by comparison. It has been hard to argue with this logic, particularly as foreign central banks take more desperate measures to stimulate economic activity. The European Central Bank and the Bank of England launched their corporate bond purchase programs over the summer, compressing spreads further and distorting market dynamics. The Bank of Japan (BOJ) continues to buy exchange-traded stock funds, and Bloomberg has estimated that the BOJ is a top-five owner of 81 companies in the Nikkei 225.

More recently, there has been some rethinking of the central banks' policies by investors and the banks themselves. The Bank of Japan has indicated that it wants to steepen its yield curve. The Federal Reserve seems more likely to raise its target rate before the end of the year. There are rumblings that the European Central Bank may begin to taper its bond buying programs. This noise created turbulence in the markets in September and appears to have caused some investor queasiness.

From my perspective, however, changes in the thinking of central banks cannot come soon enough, as the distortions caused by their actions have become more manifest. Depressed interest rates and flat yield curves have pressured earnings of banks and insurance companies around the globe. Low interest rates have pushed some individuals to buy houses and cars, while others are saving more for retirement – the stimulative nature of interest rates this low is far from clear. Public and private pension plans have been hit with the double whammy of rising life expectancies and extraordinarily low interest rates. Corporations have used the benefits of low rates to buy back stock, not invest in their businesses.

I remain skeptical that the next few measured bumps in the Federal Funds rate will have any meaningful impact on activity in the real economy. Yes, economic growth here in the U.S. is not robust, but nor is it sickly. The years following the financial crisis of 2008-2009 have laid bare the secular issues that are challenging the U.S. economy: an aging population, the slowing of overall population growth, and a shift to a mature service economy where productivity gains are more difficult to come by and/or measure. It does not mean the economy is stunted: it just means it is different than what it used to be.

While a bump (or two) in the Federal Funds rate is unlikely to derail the economy, the risk to financial markets is that investors do not wait around to find out if this is the case. Previous "rate scares" in the past (the taper tantrum, e.g.) have triggered short but material sell-offs. I still think such a sell-off is likely to be a good entry point to add risk and we have been shortening durations and building cash in our high yield portfolios in expectation of such an event. The high yield market is pretty well picked over at present. The BAML HY Master II Index's yield-to-worst call is 6.13%, but finding solid credits actually yielding 6% or more has become a real challenge. With yields so low, the opportunity cost of waiting things out does not seem that high to me.

**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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