January High Yield and Equity Market Commentary

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I have used this quip before and 2016 certainly proved it to be true: It is difficult to make predictions, especially about the future. Prognosticators got it all wrong last year: Brexit- wrong; presidential election-wrong; high yield up 17.5%- nobody was thinking that last year at this time; Cubs win the World Series- even true believers like me were never sure they would see the day. Most market pundits also incorrectly called the market's reaction to last year's events: after perceived 'bad news" like Brexit or the presidential election, stocks rallied. Given the extraordinary events of last year and the tremendous uncertainties surrounding this year, the only prediction I feel safe in voicing is that 2017 will be interesting.

What is Known

Performance of risk assets in the U.S. improved in 2016. The S&P 500 posted a total return of 11.8% in 2016, while the Bank of America Merrill Lynch High Yield Master II Index (BAML HY II Index) generated a 17.5% return over the same period. It is worth noting that index inclusion/exclusion rules and friction costs made topping the high yield index a tall task last year. In fact, 95% of the funds tracked by Morningstar lagged the BAML HY II Index in 2016.[1]

Valuations of equities and corporate bonds are rich on a historical basis. The P/E ratio on the S&P 500 on trailing 12 month earnings is 20.7 compared to the 10-year average of 16.1x, according to *FactSet*. On a forward (2017) basis, P/E's look a bit better- 17.1x versus the 10-year average of 14.4x. Similarly, the spread to worst on the BAML HY II Index is +421 basis points over comparable Treasuries compared to +638 for the last ten years.[2]

[1] Source: Morningstar
[2] Source: Bank of America Merrill Lynch

The U.S. Economy is on firm footing at present. Third quarter real GDP grew 3.5% quarter over quarter; unemployment stands at 4.7%, and the Citi Economic Surprise Index stands at +41.5 versus -22.6 a year ago.[3]

The Federal Reserve has forecasted three rate hikes in 2017. The Fed had projected four rate hikes for 2016 at this time last year; it hiked once.

Corporate Earnings started growing again in the third quarter, up 3.1% year over year according to *FactSet*. Earnings are expected to grow by a similar amount for the fourth quarter of 2016.[4]

Technicals for U.S. risk assets appear positive. According to the *Wall Street Journal,* the number of U.S listed companies has declined by more than 1/3 since peaking at 9,113 in 1997. Similarly, *FactSet* reports that at the end of the third quarter of 2016, the share count of the S&P 500 was at its lowest level since the first quarter of 2009. In the high yield bond world, the face value of bonds in the BAML HY II Index is 3% lower than where it stood a year ago. Treasury net issuance did rise a tad in 2016 but U.S. Treasuries are yielding substantially more than government bonds in most developed countries. The only two major countries in the EU whose 10-year government bonds are yielding more than the U.S's are Portugal and Greece. The U.S. 10-year Treasury note is yielding 2% more than its German counterpart; five years ago their yields were equivalent.[5]

<u>What is Not Known</u>

The new regime in Washington is largely viewed as being pro-business and that it will deploy fiscal, regulatory, and tax policies that will be supportive of economic growth and stimulate corporate earnings. Indeed, the rally in equities post the election has rested on these ideas. But the how and when are huge unknowns.

For example, increased infrastructure spending could give the economy a significant boost. But the use of public/private partnerships to fund infrastructure spending, as has been suggested, is loaded with questions such as how funding will be raised, what the economics will be, etc. Tax reform is a priority of the new administration. But will changes in the tax code reduce revenues or be revenue neutral? The new administration and congress contain plenty of fiscal hawks to which the concept of large fiscal deficits is heretical. There has been a lot of discussion regarding "border taxes", which could result in a large series of unintended consequences for retailers and manufacturers that rely on imports. Reducing the regulatory burdens on business certainly should aid economic growth. But the strain of populism that is running through politics may limit what actually transpires. For example, would a major relaxation of Dodd-Frank be popular with people other than those that work on Wall Street? Moreover, will President Trump use his bargaining power to lower prices in the defense arena or propose direct negotiation of drugs purchased by Medicare?

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[3] Source: Bloomberg
[4] Source: Factset
[5] Source: Bloomberg

The knock-on effects of potential policy changes are even more mind-numbing. Will “pro-growth” economic policies cause interest rates to rise and the dollar to strengthen, offsetting the benefits of stronger economic growth on corporate earnings? Could efforts to protect U.S. jobs and companies result in retaliatory measures that end up hurting corporate earnings? I could go on but at this point I am sure you get my drift…

What I Think

Interest Rates - The Federal Reserve has suggested that it will raise rates more than once this year and this time I think they mean it. With unemployment low, inflation picking up, and the economy on firm footing, the Fed has run out of excuses. That being said, the move in rates over the last few months (10-year Treasury rates are up almost 100 basis points off their lows) indicates that the market has not been caught napping over potential rate hikes. At the same time, we live in a relative value world and the gravitational pull of much lower rates in most developed economies will help put a lid on upward rate pressure here in the United States. Unless inflation increases materially in 2017, I expect the impact of two or three Fed rate hikes to be felt in short-end Treasuries, resulting in a somewhat flatter yield curve.

High Yield Corporate Bonds - On the surface, historically tight spreads and rising interest rates do not make a good recipe for total returns in high yield. However, high yield spreads have tended to tighten in rising rate environments as the reason for higher rates - an improving economy - is good for high yield issuers’ fundamentals. High yield spreads are still 68 basis points wider than their recent tights of mid-2014. At the same time, a solid economic backdrop, an energy sector that has regained its footing, and very modest upcoming maturities, should all help keep default rates contained. But what could really give the high yield market a boost in 2017 are possible tax law changes that could meaningfully improve technicals in the corporate bond market. A tax holiday on repatriated corporate cash held overseas could reduce corporate bond issuance. Moreover, repatriated cash could be used for stock buybacks. The potential repeal of interest expense deductibility in exchange for immediate 100% depreciation of capital expenditures could also result in a significant reduction in corporate bond new issuance. Any reduction in corporate tax rates will lessen the tax shield and hence the attractiveness to corporations of issuing bonds to finance stock buybacks, acquisitions, etc. At the same time, any reduction in personal income tax rates will increase the appeal of corporate bonds as an investment by improving their after-tax returns relative to municipal bonds and qualified dividend income-producing stocks.

Putting it all together, I expect rising rates will not be completely offset by tighter spreads and therefore there will be some slight degradation in high yield prices in 2017. This slight drop in prices should result in high yield returning a bit less than its market weighted coupon of 6.52% (BAML HY II Index). If some of the aforementioned tax proposals are enacted in 2017, returns should be enhanced from my base levels (quantifying the impact at this point in time is just too speculative).

Equities - As mentioned earlier, U.S. stocks do not look cheap on the basis of price/earnings ratios. But it is all about the “E” in the P/E ratios at this point. Consensus expectations for 2017 S&P 500 earnings growth is 11.5% in 2017 (*FactSet),* driven by the expected rebound in earnings in the energy and financial sectors. But the “E” could be much higher this year and next depending on what happens in Washington.

For example, a drop in the effective tax rate for S&P 500 companies from 33.3% to 28% would boost earnings growth by an additional 5%. 16.5% growth in earnings results in a forward P/E of about 16.3x with a 2% dividend yield when 10-year Treasuries are yielding 2.35%. Moreover, any tax holiday on repatriated overseas cash would likely result in more stock buybacks and boost earnings per share.

Given all the potential catalysts, I think most investors (including me) are reluctant to pare equity exposures until a somewhat clearer policy picture emerges. Given the wide variety of outcomes that could emerge given a Trump presidency, I think the best strategy for long-term investors is to keep it simple. Staying diversified makes sense given all the wild cards out there. An overweight in small and mid-cap stocks makes sense to me as smaller companies will be less impacted by a strong dollar and will also be prime beneficiaries of lower tax rates and a more relaxed regulatory burden. We remain overweight the consumer discretionary sector as increased consumer confidence, greater household wealth, and the benefits of lower tax cuts will keep consumer spending robust. We established a position in regional banks this past September and despite the rally in financials, I think maintaining an overweight in the bank and finance sector still makes sense as earnings are poised to rise and as interest rates increase, capital markets activity stays elevated, and the regulatory burden that has so heavily weighed on financials is eased. Finally, I like the idea of keeping some cash on hand to take advantage of the bouts of volatility that seem inevitable as the year unwinds.

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