A lead article titled "Junk-Bond Rout Deepens" in the Business & Finance section of the Wall Street Journal dated December 12-13, 2015 opened, "U.S. junk bonds posted their steepest decline since 2011, intensifying fears that a six-year bull market in stocks and other risky assets is nearing an end." During the following week various financial publications and TV programs ran pieces highlighting the sector's poor performance and noting high yield's historical foreshadowing of recessions. The jittery news was augmented by reports of funds closing down and redemption requests being halted due to poor liquidity. In a year that brought many unexpected developments in financial markets, this news, days before the Fed's rate hike, put many investors on edge.

The high yield market delivered negative returns in 2015, only the third full-year negative performance since 2002. The worst year was 2008 when the market suffered a (26.2%) decline, which was followed by the most painful global recession since the late 1920's. In 2009, high yield corporate defaults exceeded 10%, the worst year since 1991, and spreads reached 1800 basis points, a level at which the market expected many of the companies in the sector to default. By comparison, at year-end 2015 the return was (4.55%), spreads were 693 basis points, and historical defaults were just 1.82%.

The key question as we begin 2016 is whether high yield's first negative year since 2008 marks the end of the U.S. economy's seven years of growth, or whether something else may be happening. We believe it is something else.

Including the second half of 2014, the high yield market declined (8.3%) over 18 months. During that same time period oil prices declined (60.4%), copper declined (33.4%), iron ore declined (53.5%), and corn declined (21.8%). High yield energy bonds, which made up 10.8% of the high yield index, declined (33.4%) and high yield metals and mining bonds declined (34.5%)[1]. J.P. Morgan's year-end 2015 performance data shows their high yield index ex-Energy and Metals/Mining had positive returns for the year. The sharp and prolonged decline in commodity prices affected all companies in those industries and led ratings agencies to downgrade many of them. Now strategists expect increases in defaults by companies in these industries. However, expectations for defaults outside of energy and metals are modest. J.P. Morgan is forecasting a default rate of 10% in energy and only 1.5% ex-energy and commodities. The aggregate default rate forecast works out to 3.0% for 2016, below historical averages. Even if 20% of the energy and metals/mining universe defaults, the market's aggregate default rate would rise to 4.5%, only marginally higher than historic averages.

Perhaps the most damaging part of the high yield story is the evaporation of liquidity. Since the enactment of the Dodd-Frank bill, banks have reduced their willingness to apply capital to markets intermediation. At the same time, investment strategies like ETFs and credit hedge funds have flourished. Without intermediation, a big risk fixed income investors have been forced to bear is coincident directionality. Investor flows have begun to move in the same direction and in large quantities known in street parlance as "risk-on and risk-off." With diminishing bank participation, cushioning mechanisms like credit default swaps and bank proprietary trading desks no longer help. When investors go "risk-off," valuations may not matter and any trades, no matter how small, can set new pricing levels. During the second half of both 2014 and 2015 the high yield market experienced approximately $42.2 billion of investor outflows. These withdrawals had particularly severe market impact in September and December, months in which banks must report their exposures for capital adequacy purposes.

[1] Historical performance data, Bank of America Merrill Lynch and J.P. Morgan Indexes.

One way to measure the impact of flows is to observe the relationship between the trading levels of ETFs and a high yield index, as a proxy for the market. Below is a graph that shows the price performance of JNK, the SPDR Barclays High Yield Bond ETF over the last three years compared with the Bank of America Merrill Lynch High Yield Cash Pay Index (J0A0).[2] During the second half of 2014 the ETF returned (4.38%) (including dividend reinvestment) compared to (2.94%) for the index. For 2015, second half returns were (8.54%) for the ETF versus (6.87%) for the index. Over the last two years the cumulative performance was (6.06%) for the ETF while the index was down (2.22%). Even in a year of positive returns, like 2013, the ETF returned 5.86% compared to 7.38% for the index. Since an ETF is intended to track the performance of a market sector, it might be argued that the cost of liquidity is approximately the difference in performance. Ironically, investors are willing to pay that cost to own a vehicle that transfers liquidity to them.

If the poor performance of the high yield market is not an economic indicator, as we believe, a logical ensuing question is why investors withdrew so much money from the sector over the last eighteen months. This question is harder to answer as withdrawals occurred when many economic indicators were improving. In particular, employment data, consumer confidence, housing, and service sector output all have supported a more optimistic outlook. Perhaps investors worried about the sizeable weight of commodities and energy in the high yield index, or they perceived the Fed's policy shift to be unappealing for fixed income investing. Whatever the reason, we believe the shift in sentiment has produced a compelling investment opportunity. On balance, we believe global conditions, while not excellent, are good enough to support a more favorable outlook for 2016 than recent market turmoil suggests. Despite some pockets of distress in energy and commodities, overall conditions do not appear ripe for a recession. There does not seem to be excess leverage in the financial system, in real estate markets, with consumers, nor with non-energy businesses. Furthermore, with the exception of some tech stocks, it is hard to argue we have visible asset bubbles. We are not economic bulls, but it would seem that for the economy to be entering recession, there should be more visible stresses on the economy.

[2] ETG graph is price only. Cited performance information includes dividend reinvestment to make it comparable with the index.

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We have a thorough understanding of fixed income investments and their role in a globally diversified portfolio, which has rewarded our clients throughout market cycles.

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