November 27, 2017

High-yield shakeout ; a canary in the coal mine?

A recent sell-off in European and US high-yield (HY) bond markets led some commentators to speculate that this could be a sign of trouble around the corner for global equity rally. On the contrary, though stock markets have gone through a brief tough spell, the outlook remains positive, with equities still able to take sap from the global economic rebound. Over the next week, we continue to monitor developments in HY and in global stock markets, but believe that markets are more likely to drift steadily sideways rather than sell-off in the short-term, at least until US tax reforms are announced.

Around mid-November, there was a shake-out in the high-yield bond market; a small market correction translated into a waterfall of outflows. In one week alone, funds and exchange traded funds (ETF) investing in HY instruments suffered outflows of $6.6 billion - the third largest weekly outflow amount on record. From peak to trough, the US high-yield market fell -1.5%, whereas the European equivalent fell -1.2%.

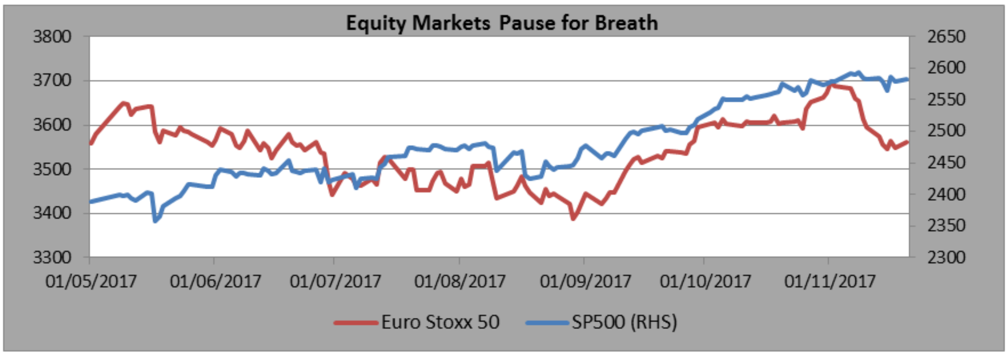
As a result, pessimistic headlines emerged, and some feared that the ominous developments in the high-yield space were a talisman of trouble in global equity markets given the historical correlation between the two asset classes.

However, looking at HY on a more granular level shows that much of the correction has been driven by individual names or sectors. In Europe, much of the spread widening in HY yields was attributable to individual issuers with company-specific problems (yields increase when prices fall). Whereas in the US, spread widening was largely contained to the telecom sector. In short, it seems investors have re-priced the risk of certain HY holdings, rather than switching wholly into a 'risk-off' mode.

Albeit, high-yield is not an asset class we favour, as we believe that investors are not adequately rewarded for the inherent risk therein, and we see more value in equities.

Equity markets; still some juice left in the orange

Though equity markets have hit a slight bump in the road lately, we believe this is somewhat due to portfolio re-balancing at the end of what has been a fruitful year for many investors and portfolio managers.



Source: Bloomberg, *BIL*

Furthermore, in Europe, the euro's appreciation has been a headwind for European stocks, as well as the fact that earnings surprises were not as pronounced those in the US.

However, economic momentum remains strong. In Europe, the composite Purchasing Manager Index (PMI) reading for October was 56; comfortably far north of 50 (the level between economic expansion and contraction). Indeed, the eurozone remains on track to record its strongest year since 2007 with GDP growth in the third quarter tallying in at 0.6%. Strong growth coupled with favourable financial conditions and a prolonged period of monetary stimulus from the ECB creates a benign landscape for equities. It is also worth noting that analyst expectations around earnings revisions have historically correlated closely with PMI readings.

In the US, the LEI (Leading Economic Index, made of 10 components) increased sharply in

October, suggesting that solid economic growth will persist into 2018. If Trump's administration continues to valiantly push through on tax reform, this should inject further sentiment into the market. JP Morgan predicts that if the statutory rate were to fall from 35% to 25%, the average S&P500 earnings-per-share could increase by more than $10.

Further still, tactical risk indicators, which can be considered as another type of 'canary in the coalmine' - are not signalling imminent danger, and are currently flashing neutral, suggesting that in the short-term we shouldn't expect large swings in either direction. All eyes are now on the roll-out of Trump's tax reform which should be instrumental in dictating the trajectory of markets in the medium term.

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