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CAPITAL MANAGEMENT

Animal Spirits – Real or Ephemeral?
Fixed Income Outlook
January 2017

Investors would have done well in 2016 to heed the words of Heraclitus, paraphrased: "Expect the unexpected." Brexit and the U.S. election results were two glaring examples of the unexpected becoming reality. We imagine if investors were polled at the end of 2015, not many would have correctly predicted the events of 2016. After getting off to a rough start, high yield was a standout performer. Equities were quite subdued until after the election and investment grade bonds were looking to notch up a pretty good year until animal spirits released the ghost of inflation and rising interest rates. Looking at 2017, the real question for investors is: Is the rally we have seen in equities and high yield sustainable, or is it a head fake?

The Bank of America Merrill Lynch U.S. High Yield Index (BofA ML U.S. HY) returned 17.5% in 2016 following a -4.6% return in 2015. Excluding energy, metals and mining, the return was 12.8% vs. -0.4% in 2015. This means that sectors representing about 14% of the total index at year end 2015 were responsible for more than a quarter of the performance in 2016. In 2015 those same sectors represented about 90% of the negative return in the high yield market; quite a snap back! To help answer the question of what 2017 may bring for high yield, a look at history may help. It is interesting to note that as far back as the calendar year data goes (since 1987), every time the high yield market returned over 10% following a negative return year, the subsequent year's return was also greater than 10%. This has happened four times. In fact, in two of those instances, the third year was also up more than 10% and in all cases the third year had a positive return. What would need to happen for a repeat in 2017 and how does this market today compare to those at recent peaks? At year-end 2016, the high yield market yields 6.2%, comprised of a 6.5% average coupon, an average price of $99.6 and an average spread of 439 basis points (bps). This compares to the 2014 peak, where the average yield was 5.2%, the coupon was 7.1%, the average price was 105.96 and the spread was 353 bps. The 2007 peak, while not fully comparable, given that the Federal Funds (Fed Funds) rate was 5.25%, had a yield of 7.4% and average price of 101.04 but only had a 252 bps spread. As you can see, it would not be a stretch, assuming the recovery continues, that slightly rising bond prices, coupled with a moderate tightening of spreads added to the current coupon, could give us another good year. We will have to wait and see how things develop.

Equities were late to capture the spirit of recovery in 2016. Through Election Day, the S&P 500 Index (S&P 500) had returned about 6.2%, although by year end the return had jumped to 12.0%. As you can see, about half of the return for the year occurred following the election. We believe that in order for equities to continue their upward trajectory, evidence of durable improved economic data will be needed. Higher Treasury yields alone are not proof of improving economic growth, and could be merely discounting higher inflation expectations.

Investment grade bond returns peaked for the year on July 10th, at over 7.4%, and it was looking like 2016 would be another solid year as the Federal Reserve (the "Fed") was on hold and the economy was continuing its sub-par recovery. Fed chatter about the possibility of a rate hike in September caused a bit of a wobble, but when it did not materialize (like in 2015), the disappointment was muted. Up until the election, returns were similar to equities, around 5.4%. However, following the surprise victory by the pro-business, pro-growth candidate, investment grade bonds and equities parted ways. The full year return for investment grade was 2.9% for 2016, with most of the weakness occurring post-election. The question for 2017 is whether the Fed actually raises rates according to the latest dot plot, which indicates that three increases to the Fed Funds target rate are possible, or will they return to the dove nest and slow the pace of normalization? This will, of course, depend entirely on how robust the economy grows and how persistent the increases in inflation are.

Looking at the economy, we have been seeing gradual improvement and slow growth for the past few years. Recently, some measures have reached levels that typically indicate that the economy is starting to operate at near full capacity. Unemployment has fallen to 4.6% and wages have started to climb at the fastest rate since 2009. In fact, according to Bureau of Labor Statistics, the number of unemployed people per job opening is 1.4, which compares to 6.6 in 2009. At some point, labor shortages may become a headwind for the economy, but our suspicion tells us that the "unofficial" applicant pool may be larger than the "official" numbers indicate, given how many people have stopped looking for work and have been dropped from the "official" rolls of job seekers. Consumer confidence, albeit a soft data point, reached 113.7 in December, which is as high as it's been since August of 2001. In addition, the measure of consumer expectations, a gauge of how consumers feel about the next six months, also hit a high not seen since 2003. Internationally, we are seeing better growth from China, which is responding to recent government stimulus and commodity prices that seem to have bottomed as well. The euro has reached near parity with the U.S. dollar and that should hopefully lead to growth in Europe, likely led by exports, capital flows and tourism.

We think it is premature to attempt to quantify how much the new administration's fiscal stimulus will boost output for 2017. What makes it difficult is that we do not know the timing, magnitude or mix of what will likely be a combination of tax cuts, deregulation and infrastructure spending. 2018 may end up being the inflection point when animal spirits actually lift economic growth beyond the tepid levels of the past few years as these measures become known. If that is the case, there may be some further anticipatory discounting by the markets later this year. This would likely benefit both the high yield and equity markets while hurting the investment grade bond market. Given the uncertainty of the political process here and abroad, we feel it is rational to take a wait-and-see approach while keeping an eye on some important variables.

One area of possible surprise is the result of a series of European and Asian elections to be held in 2017. In Asia, we have presidential elections in Singapore and South Korea. We do not expect the Asian elections to result in a major sentiment shift, but those in Europe could. There we have a general election in the Netherlands in March, followed by France in April-May and Germany in September-October. While we do not currently expect any big upsets (Sound familiar?), we may do well to remember the words of our friend Heraclitus. The rise in popularity of more nationalistic, Eurosceptic parties may even affect monetary policy at the European Central Bank (ECB) prior to the elections. While all of these parties have in common their anti-Brussels sentiment, they differ in their fiscal and social platform priorities. Putting aside their social aims for now and focusing purely on the financial ones, in the Netherlands and France, the upstart parties are firmly anti-austerity and resent the controls and weakening of safety nets put upon them by the bureaucrats in Brussels. In Germany, the opposite is the case. While also Eurosceptic, they feel that too much has been given away to financially irresponsible countries at their expense and actually want more financial discipline imposed on what they feel are reckless policies of the more socialist countries in the European Union (EU). Germany's dilemma is more nuanced because economists and rational politicians know that they have been the biggest beneficiary of the EU, given the weak currency, so while they may posture for the voters at home, they are not really serious about dismantling the EU. While the ECB is continuing with quantitative easing for the time being, this may have more to do with appearing to maintain a looser, more accommodative monetary policy going into the first two elections. This gives the nationalist politicians one less thing to rail about. We would not be surprised if, after the French elections, policy (or at least the rhetoric) turns decisively less accommodative (read: tighter) leading up to the German elections. If this turns out to be the case, then we could see rates in Europe begin their normalization in 2017 if we are correct in our assumption of increased growth due to the weak euro.

Where does that leave U.S. investors today? The choice is really one of either believing that we will break out of our slower, sub-par recovery, enabling rates to normalize over the next few years or a continuation of the vicious cycle of low growth begetting very low interest rates. If one believes the first, then the choice is fairly straightforward: focus on assets with performance that is positively skewed to economic growth and avoid those without. This would mean sticking with equities, high yield bonds and convertible bonds, while avoiding longer duration investment grade bonds, particularly Treasuries. If the second were to be the case, then it means that there should be a reversion in Treasuries and investment grade bonds to yields prevalent before the election. After that, it would be slow growth and low yields for what could be a very long time. High yield bonds would not necessarily sell off in this scenario as we would still have some growth and the relative yields would likely be higher as spreads widen. Equities are really the wild card here as valuations are not particularly cheap and rising interest rates could eventually hurt valuations.

One strategy would be to shift some equity weighting to high yield bonds. While this sounds a bit radical, when we look at past correlations and returns of these two asset classes, it may not be as far-fetched as it sounds. For the past 20-, 25- and 30-year periods ending December 31st, 2016, the annualized returns for both equities and high yield (as measured by the S&P 500 and the BofA ML U.S. HY) have been surprisingly close. Over the past 10 and 15 years, high yield bonds have outperformed equities. Over the past five years equities have done better, aided by the stellar returns for equities in 2013. When one considers the higher current income, lower volatility and higher position in the capital structure that high yield enjoys over equities, the idea may be worth exploring.

In closing, we would like to thank our investors for their faith in our ability to navigate these choppy waters. Going forward we still feel that the best strategy is to garner yield through investments in short- to intermediate-term non-investment grade bonds, coupled with a select number of convertibles that could generate some equity-like returns while also providing income. If in fact we are in the higher growth first scenario above, this should be the right strategy. If there are a few hiccups along the way, we also have an above average cash position with which to buy the dips. Here is to 2017 and beyond!

Sincerely,

Carl Kaufman | Simon Lee | Bradley Kane

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The S&P 500 Index is an unmanaged index that is widely regarded as the standard for measuring large-cap U.S. stock market performance.

It is not possible to directly invest in an index.

Yield is the income return on an investment.

Quantitative Easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply.

A basis point is a unit that is equal to 1/100th of 1%.

Duration measures the sensitivity of a fixed income security's price (or the aggregate market value of a portfolio of fixed income securities) to changes in interest rates. Fixed income securities with longer durations generally have more volatile prices than those of comparable quality with shorter durations.
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