THOUGHT FOR THE WEEK
ARE HIGH YIELD BONDS THE CANARY IN THE COAL MINE?

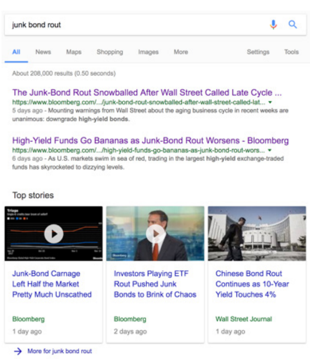
Global Financial Private Capital

SYNOPSIS

- One of the more perplexing front-page stories is the recent weakness in the high yield sector of the bond market.
- The real reason why this story is getting so much attention is most likely due to the high yield sector's tendency to move in line with the stock market.
- Few illicit tactics in this business get under my skin more than a blatant misuse of charts and historical relationships.

CANARY IN THE COAL MINE

One of the more perplexing front-page stories is the recent weakness in the high yield sector of the bond market. Headlines like these have blanketed both digital and print media over the last week:



Source: www.google.com/search?q=junk+bond+rout

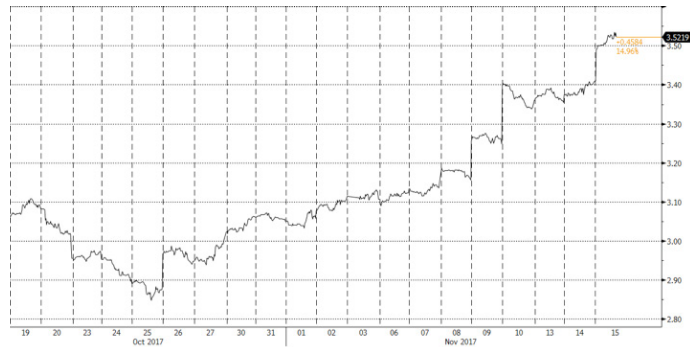
The high yield sector, often referred to as "junk bonds", comprises bonds issued by companies with lower credit scores. These bonds get their name from the higher yield they pay to compensate lenders for the added risk.

This sector has been on fire over the last several years due to its attractive yield relative to higher quality (a.k.a. "investment grade") bonds. As a result, the high yield sector has grown from a niche holding to a vital asset class for those investors hungry for income.

The recent headlines point to one of two potential leading indicators. The first is the price decline of the larger high yield bond funds, and the second is a gauge of investor sentiment on the sector, which is depicted in the chart below.

This chart tracks the difference in yield between the high yield sector and the 10-year Treasury bond, which is a benchmark for risk-free return, over the last month. This "spread" has

ONE MONTH HIGH YIELD SPREAD



Source: Bloomberg. High Yield represented by Barclays Corporate High Yield Index.

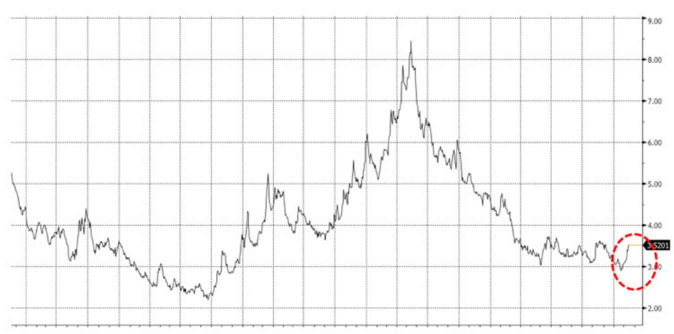
risen 15% in a short amount of time, and the media has taken notice because it indicates that investors now consider high yield to be riskier today than a month ago.

But the real reason why this story is getting so much attention is due to the high yield sector's tendency to move in line with the stock market. Hence, the media appears to be using it as a canary in the coal mine for an impending stock market crash.

CORRELATION VS. CAUSALITY

Few illicit tactics in this business get under my skin more than a blatant misuse of charts and historical relationships, and this current ruse is particularly egregious because it has only been a month. Push the spread analysis out five years, and the chart below tells a very different story.

FIVE YEAR HIGH YIELD SPREAD



Source: Bloomberg. High Yield represented by Barclays Corporate High Yield Index.

Under this lens, the recent change in investor sentiment towards the risk in the high yield sector is practically lost without the red circle.

> **"...most of this attention is nothing more than fear-mongering."**

Furthermore, just because a relationship between two asset classes exists does not make their association inextricably fixed over time. The chart below shows that the relationship, or "correlation" between the high yield sector and the stock market has changed dramatically over the last decade (as indicated by the varying size of the green section).

HIGH YIELD CORRELATION TO THE S&P 500

Source: Bloomberg. High Yield represented by Barclays Corporate High Yield Index.

Not only does the strength of the relationship change, more recently it has been cut in half. When correlations fall in such a manner, it indicates that what is driving one sector is not driving the other, and this instance is likely no different.

Simply put, even though there is a historical relationship between the two asset classes, it is way too early to say that the recent weakness in the high yield bond sector is indicative of a larger, more systemic issue.

IMPLICATIONS FOR INVESTORS

My criticisms are not intended to act as a defense for the high yield sector, nor am I suggesting this recent dip is a buying opportunity. A thorough analysis of this sector is another subject for another time.

Instead, I am pointing out that the level of analytical sloppiness being used to take such a small move over such a short time period and extrapolate it out is most likely intentional. This begs the question of why so many in the media who should be experienced enough to avoid these mistakes would do such a thing.

While some may have a vested interest in the high yield sector falling further or the stock market crashing, I would wager that most of this attention is nothing more than fear-mongering.

Think about it this way. The more frightening the headline, the more viewers will click to read more. The more clicks an article receives, the higher the traffic to that website. The more popular the website, the more advertising revenue it can attract.

THE BOTTOM LINE is that the world does not end all that often, so anytime I encounter a pundit preaching doom and gloom, I immediately assume guilty until proven innocent pending my own analysis and a better understanding of the true intent of the author.

SINCERELY,

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Index Definitions

All indexes are unmanaged and an individual cannot invest directly in an index. Index returns do not include fees or expenses. Past performance does not guarantee of results. Index returns do not reflect fees or expenses and it is not possible to invest directly in an index. The Standard & Poor's 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The Bloomberg Barclays US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

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