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A Winter Squall in Credit Markets

Lack of liquidity, high leverage, and low quality are a difficult combination in markets these days, particularly when short-term interest rates are expected to rise. The inevitable result is downward pressure on bond prices. Last week, the gating of a mutual fund that invested in risky, high yield debt created a stir in financial markets. The positions the fund held had fallen so far in value and were increasingly hard to trade, the fund manager had little choice but to close the fund to redemptions and then liquidate it over some period. If the incident had been isolated, the financial markets likely would have moved on from it in due time. However subsequently, two hedge funds gated their funds for similar reasons: their positions were becoming increasingly hard to sell (becoming less liquid!) and the fund managers could not meet the redemption requests by investors. These announcements coming so close together have raised the spectre of 2008: a liquidity crunch that takes markets and portfolio values down sharply. What is different this time is bank sector leverage is lower and we currently do not believe we are headed into a liquidity-driven tailspin in markets. However, for reasons outlined below, now is the time for Advisors and clients to work together to review portfolios and it's holdings for liquidity, credit and other risks as the Federal Reserve (Fed) begins to raise interest rates.

When situations like this one develop, investors must make an assessment of whether there is potential contagion risk and whether the recent fund gates and liquidations are symptoms of some larger issue. We believe the current news flow from the funds is specific to them, and specific to the riskiest part of the junk bond markets—CCC-rated debt, distressed debt, and bankruptcy plays. A look into the performance of these types of investments year to date in 2015 confirms this view: Junk bonds, as measured by BofA Merrill Lynch U.S. High Yield Index, on average, are down about 5%; however, an index of some of the lowest grade of debt, that rated CCC, is down more than 14% (BofA Merrill Lynch CCC and lower Index)! The energy sector has been the most stressed in this risky segment. As oil prices have fallen precipitously, highly leveraged energy companies have fallen on tough times. Moreover, as it has become clear to market participants the oil story is one of "lower for longer," the willingness to step up and buy the bonds from these now distressed companies has faded, leading to much less liquidity and making bonds in this space harder to trade. All of this indicates markets have been separating the wheat from the chaff throughout 2015. It also suggests the recent news is really about the specific funds that either focus on riskier segments of the credit market or have veered into them in search of yield and returns.

While the recent news is much more specific to the funds, we believe the broader, more relevant issue is bond market liquidity. Part of the funds' challenges stemmed from an inability to quickly and efficiently move out of their investments to meet their investors' demands. In hindsight, this should not be a surprise, as the lowest rated part of the bond market is also not that large: only about $160 billion out of a $1.2 trillion high yield bond market, according to BofA Merrill Lynch Credit Research. Illiquidity comes with the territory. Investors may wonder then, could other sectors of the bond market suffer a similar fate, with bonds becoming harder to trade? With the U.S. central bank embarking on its first rate hiking cycle in 10 years and indications it is prepared to remove substantial amounts of liquidity from markets over time, we would expect to see pockets of the bond markets go through bouts of illiquidity, ultimately leading bond markets to reprice the cost of liquidity through higher rates. Indeed, if the U.S. economy

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continues to grow in 2016 as we expect and the cost of money and capital rises, we would expect the weakest credits and the most leveraged companies to be flushed out through corporate restructuring, asset sales and, ultimately, bankruptcy. Along the way, the bonds of these companies would become more difficult to trade and investors who purchased these low rated credits would see losses. This is all part of the process of getting capital markets back to functioning more normally.

Nonetheless, investor psychology post-2008 is still fragile, and the risk of markets operating with a "shoot first, ask questions later" mentality is an important consideration in portfolio construction. As a result, we are advising investors to address anticipated illiquidity by upgrading fixed income portfolios by switching to high quality bonds and allocating only small portions of portfolios, where necessary, to low credit rated (high yield) bonds. Our preference is for investment grade over high yield corporate bonds in 2016, as we believe higher quality bonds are more desirable and more liquid and reflect our preference for portfolios to keep bond risks well within a prescribed approach. In light of the anticipated rate hikes in 2016, we also recommend investors rebalance their portfolios to their long-term strategic objectives and in line with their goals. This suggests three important actions to consider: reducing any overweights to high yield back to long-term objectives; reviewing bonds and bond strategies with your advisor to understand the quality and potential liquidity characteristics of your portfolio, and ensuring you keep a diversified approach to generating income.

In a portfolio context, sharp deteriorations in one area, like credit, can have a knock-on effect in other risk assets, such as equities. In the near term, we expect a risk-off mode in equity markets, with volatility remaining higher than it has been in recent history until stability develops in the credit markets, likely through the Fed's upcoming actions. As we move past the historic change to the zero percent interest rate policy and additional data confirm the economy is improving, fears of an overall crisis should subside, in our view. Although we would expect defaults to unfold in the riskiest areas of the bond market, we believe an improving economy, led by the consumer and housing (benefitting from the dramatic move lower in energy prices and positive job growth) ultimately supports asset prices, particularly in the high quality areas within asset classes. As we head into 2016, we believe this "shadow and substance" environment will play out numerous times in different markets, creating opportunities to rebalance and upgrade portfolios.

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