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**Subject:** High Yield Market correlation to Equity Markets

When most people hear that the High Yield Bond Market “may be” sending near term signals to the direction of Equity markets, many seem to be dismissing its importance following the FOMC meeting. Historically, The stock market and high-yield bond market (junk-bond market) do move in similar directions. Wall street lore says bond investors are often ahead of (and more intelligent than) those who trade equities, which is why many tend to look towards the High yield market as a *leading indicator* as to where stocks may be headed.

Some may ask what Bonds have to do with Stocks? Those who trade “High Yield bonds” understand the “Junk Bond market” (High Yield and Junk Bonds are synonymous – though “High Yield” sounds less intimidating - Marketing at its finest) is more about credit/risk over a specified time period than the level of the 10 year treasury bond - while the stock market direction is a function of numerous factors, at its core, it more often than not, comes back to risk/reward over time vs. other investment options.

To illustrate the above, please see the attached Image (HYG vs. SPX):

This is an overlay of the iShares High Yield Bond Index and the S&P 500 Index.

Please Note the red circles denoting the HYG (High yield Index) crossing over its 50 day moving average (to the downside) heading into what is often referred to as an “intermediate bear” cycle. As the chart illustrates, the last 4 times this has occurred in the past year – an S&P “downturn” has trailed that of the HYG by a few weeks, but none the less, has indeed followed with anywhere from a 3%-7% sell off in the S&P 500.

So - again, the stock market and High yield market tend to move in the same direction, it’s referred to the classic “risk on/risk off” relationship. “risk off” in the high yield space, means high yield bond buyers want MORE yield (or a higher interest rate) for the capital they are willing to commit for a specified time. In demanding higher yields, prices of bonds will SELL OFF or Break down, given the inverse yield/price relationship – As high yield traders/investors take “risk OFF” the table by looking for higher yields, not committing capital to investments unless higher yields come - rates go higher, prices sell off and Equity traders who see this pattern occurring over a relatively quick period of time view this trend as a signal to lighten their own exposure to equities, too. Leaving the equity markets for a more risk adverse asset class (money markets or short term treasuries), lead to the downturn in equity prices – this explains the typically delay in the equity markets lagging the High Yield market.

The above is all well and good – but what should you do if the ride gets a little bumpy? While there is no single canned answer but a few thoughts follow below:

1. There are very few “absolutes” in this world. The above scenario is NOT always the end result just because it’s happened before, so selling all holdings and sitting in cash is **NOT recommended** given the current scenario.

2. Being aware of this relationship and what is more than likely happening is important – you’ll more than likely never know the definitive “driving force” behind the fluctuations, ***so ignore the noise***. Is this Greece, too much borrowing, the fed raising rates, not raising rates, etc. or a combination of? HOW to react, protect and profit from the downturn should be the focus.
3. If you own our asset allocation model, great – we already have our seat belts on and will look to ***add more money*** to current positions. We will very rarely pick the absolute bottom, and do not want or claim to be traders, though investing alongside higher percentage trends can often add alpha to our portfolios. Additionally, clear signals regarding when may or may not be a better time to invest are not always absolute (see #1), which is why more frequently than not, item #4 is the more consistent recommendation.
4. For those of you in a “model” or proper “investment plan”, if you don’t already, we recommend making an effort to contribute additional funds ***systematically (monthly if possible)*** – investing systematically into a proper asset allocation model, with some of the best money managers available – these managers will allocate funds within their respective asset classes in many of the strongest, well run businesses available – additionally, they will do this as asset prices go “on sale”. If your favorite retailer had a once a year 25% - 50% sale advertised, you’d need police on horseback holding people back (see Black Friday or Cyber Monday videos where available) – in our business – it’s called a bear market or a crash. This business is one of the very few where people feel more comfortable adding more money to investments when markets trade at or near all-time highs – every other business I can think of, people want some form of a “discount” or “sale”. The best way (I believe) to take advantage of a discount is buy ***SOLID ASSETS*** through the ***Best of Breed money MANAGERS*** as asset prices go on sale – ***SYSTEMATICALLY*** – over time. A proper asset allocation model often reduces Beta (volatility) while increasing returns (historically), insert the best of breed managers and you’ve more than likely fared pretty well. If you can’t add money systematically, then stay the course, again - preferably in a well-diversified, properly allocated portfolio.
5. Asset allocation and Diversification are different in nature, if all of your assets are correlated to stocks and bonds, you’re more than likely not as diversified as well as you may think – if you’d like more information regarding this statement and our asset allocation model, please give a call.
6. Unless you are retired, retiring and/or need this money in the short term, today’s prices are NOT your prices. If things get choppy, hold on and Stay the course.
7. If you need your money today, financial markets may not be the right place for you, don’t invest money you can’t afford to watch fluctuate or lose.

We are here to help, please let us know if you have any questions, concerns, or if there is anything we may be able to assist you with.

\*\*\*It should go without saying, but all scenarios are unique in nature as individuals have different personal wants, needs, and risk tolerance based on their personal scenarios. Market scenarios will always change, this is what we see at this moment in time, should there be a more prolonged sell off, each individual must re-evaluate their own individual risk tolerance\*\*\* For more information on our current asset allocation model, please don’t hesitate to call or write\*\*\*

Many thanks,  
Mitchel

