BESPOKE Investment Group
B.I.G. Tips
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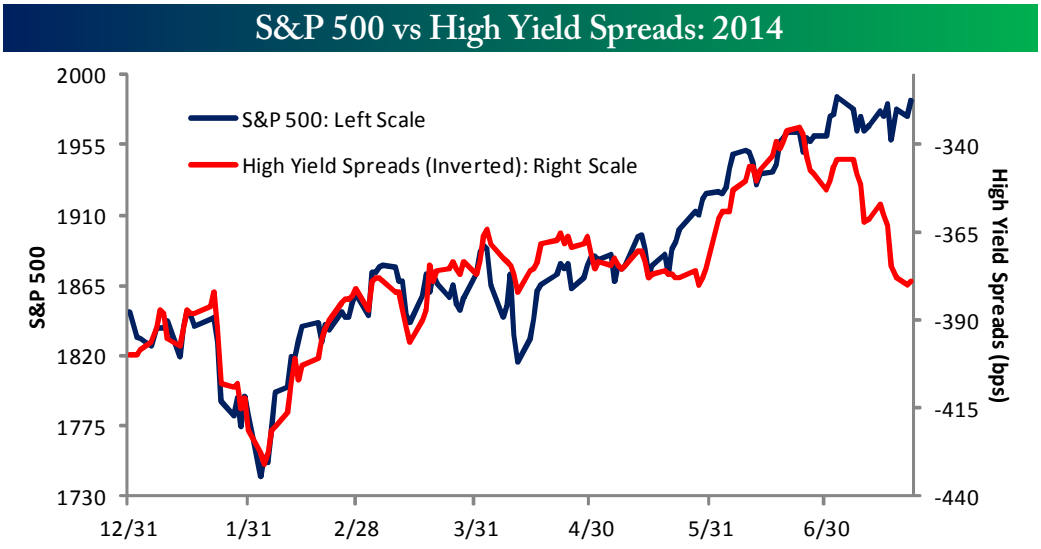
High Yield Spreads Widen

One area of the financial markets that we constantly monitor for signs of confirmation or divergence in the trend for equities are spreads between interest rates on high yield debt and comparable treasuries. High yield debt is far out on the risk spectrum of fixed income, so it tends to have a closer correlation to equities. Therefore, when stocks are rising, we typically see spreads on high yield debt tighten as investors have a bigger risk appetite. Conversely, when equities decline you see spreads on high yield debt normally widen as investors demand more in the way of yield to compensate for the added risk.

Given the 'typical' relationship between spreads on high yield debt and the equity market, recent moves in the two asset classes are noteworthy. The chart below shows the S&P 500 and high yield spreads so far this year (using the Merrill Lynch High Yield Master Index II as a proxy) on an inverted basis. From the end of last year through late June, the two moved step for step with each other. As equities (blue line) rallied, spreads on high yield debt (red line) narrowed (shown in the chart on an inverted basis as rising). Since 6/23, however, there has been a notable divergence where spreads on high yield bonds have widened by 13%, even as equities have gone on to hit new highs. Just today, in fact, the S&P 500 hit an all-time high. *Continued…*



So, with high yield spreads widening while equities are hitting all-time highs, are equity investors just oblivious to a looming threat of an equity market downturn? Going back to the late 1990s, there have been 16 other periods where we saw a similar divergence with spreads on high yield debt (using the Merrill Lynch High Yield Master Index as a proxy) widening by 10% or more over a four-week period even as equities rallied. The table on page three highlights each of those periods and also includes the S&P 500's performance over the following one and three months.

Following these prior 16 periods, there have certainly been some sizable short term declines for the S&P 500. In fact, in the month following these prior 16 periods, the S&P 500 was down more than 1% over half of the time, and in five of those periods the decline was larger than 5%. The average performance of the S&P 500 in the following month was a decline of 2.0% (median: -1.1%) with positive returns less than half of the time (43.8%). For the sake of comparison, the S&P 500's average one month return since 1997 has been a gain of 0.55% with positive returns 61% of the time.

While the one month returns of the S&P 500 have been weaker than normal, the S&P 500's returns over the next three months are much improved, and more inline with the historical average. As shown in the table below, the S&P 500 has averaged a gain of 1.8% (median: 1.7%) with positive returns 63% of the time. For all three month periods since 1997, the S&P 500 has averaged a gain of 1.6% with positive returns 61% of the time.

Finally, we have also included the S&P 500's maximum percentage gain and decline in the three month period following each of the dates in the table. The largest decline was in the period that followed 11/4/08 when the S&P 500 tumbled 25.2%. That period was also one of three where the index saw a maximum drawdown of at least 10%. There was only one period (5/13/05) where the S&P 500 never looked back. Overall, in all but two of the 16 periods shown, the S&P 500 saw a decline of 3% or more from the date highlighted at some point in the next three months. In terms of maximum gains, there were two periods where the S&P 500 saw a maximum gain of 10%+ and only one period where the S&P 500 was never up from the first day listed (11/4/08).

All in all, the fact that high yield spreads have been diverging from the performance of equities is not an automatic signal that equities are due for a pullback. For the time being, however, bulls cannot point to this area of the financial markets as being in their corner given the fact that prior experiences show a tendency for the market to have weaker than average short term returns following similar divergences.

High Yield Spreads Up 10% and S&P 500 Also Up Over Trailing Four Weeks

	Four-Week Percent Change (%)		S&P 500 Performance (%)		Next Three Months	
Date	**S&P 500**	**High Yield Spreads**	**One Month**	**Three Month**	**Max Gain (%)**	**Max Decline (%)**
11/20/97	0.9	13.3	-1.3	7.8	7.8	-3.3
9/25/98	0.2	22.6	2.5	17.4	17.6	-8.2
3/16/00	5.1	11.1	-7.0	0.4	4.7	-7.0
10/31/00	0.2	15.6	-8.0	-3.9	0.2	-11.5
4/24/01	4.9	10.0	6.9	-3.1	8.5	-3.1
10/11/01	1.1	19.3	2.1	4.4	6.8	-3.4
8/14/02	1.5	11.0	-3.2	-1.7	4.7	-15.5
2/6/04	1.0	12.1	1.2	-2.5	1.3	-4.5
5/27/04	0.7	12.8	1.2	-1.2	2.0	-5.2
5/13/05	1.0	12.9	4.1	6.6	7.9	0.0
9/22/05	0.4	12.7	-2.9	4.4	4.8	-3.1
7/5/07	0.5	17.7	-6.1	2.1	2.1	-7.8
11/4/08	1.0	22.8	-16.0	-17.3	0.0	-25.2
9/1/11	0.4	17.9	-6.1	3.3	6.7	-8.7
6/14/12	0.3	10.1	2.1	10.3	10.3	-1.2
6/4/13	0.9	11.4	-1.0	1.3	4.8	-3.6
7/18/14	1.0	11.5				
Average			**-2.0**	**1.8**	**5.6**	**-7.0**
Median			**-1.1**	**1.7**	**4.8**	**-4.8**
% of Time Positive			**43.8**	**62.5**		