# Casilio Leitch Investments
A Private Wealth Management Company

# Capital Market Musings & Commentary

**January 25th, 2016**

**Focus on credit markets, not the stock market…**

The wild ride that has epitomized the action in equity markets so far this year continued last week as stocks dropped nearly 4% by mid-week, to then rally 5% from that point – pushing the major averages to their first weekly gain on the year. At its lows on Wednesday the Dow Jones Industrial Average was down 565 points for the day and 1,975 points from where it started the year while the S&P 500 dipped down to 1,812, taking out the 1,867 low reached in last August's turmoil.

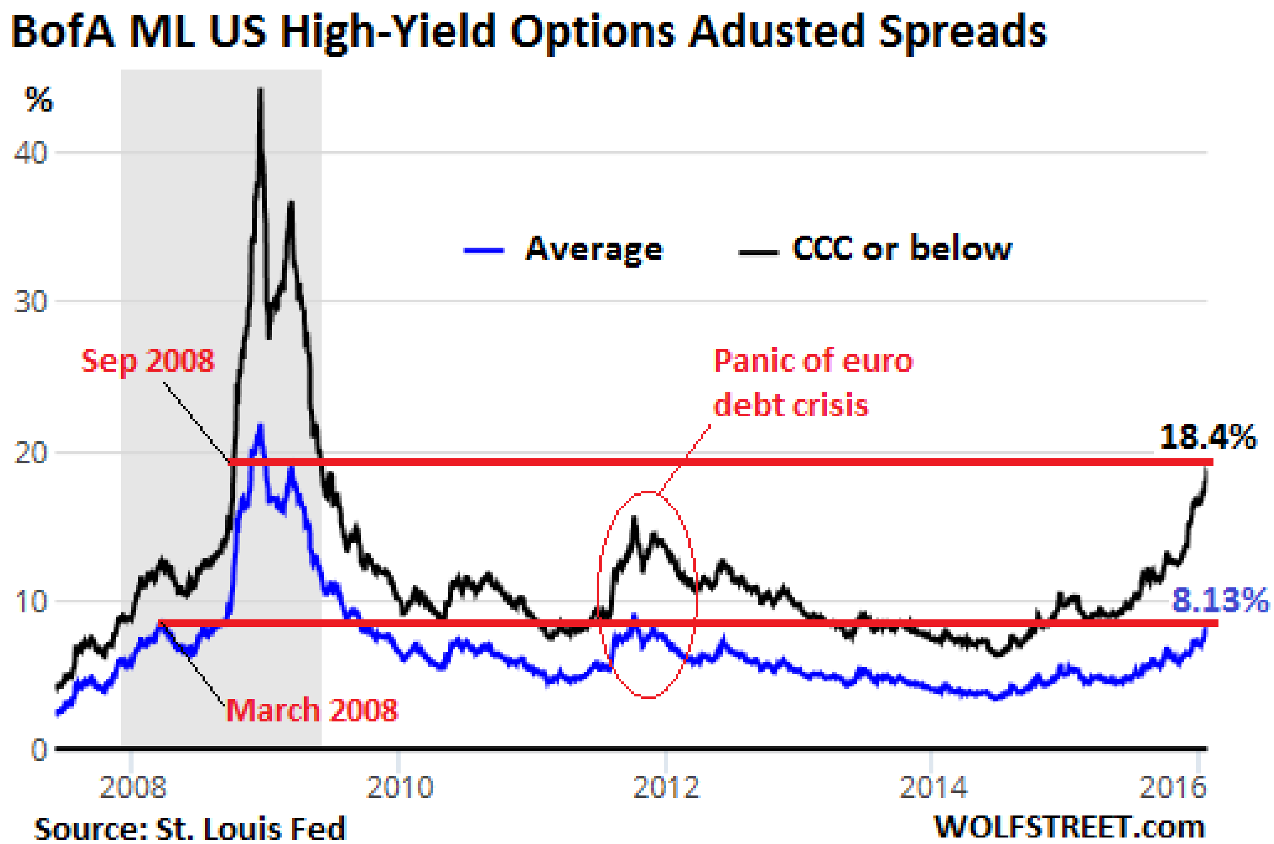
Many narratives can be scripted to explain the about-face in stocks last week with the significant reversal in oil prices garnering the most attention. The price of oil dipped below $27/bbl before rallying 21% from the lows to finish the week at $32.16/bbl – surging 9% on the week. Whether this is a dead cat bounce from deeply oversold conditions or the makings of a long-term trough in oil prices is anyone's guess, but it's difficult to say that last week's rally was based on constructive fundamental data.

After all, it was reported last week that American petroleum inventory levels rose by 4mn barrels (an 80-year seasonal high), and the International Energy Agency said that global stocks soared in the fourth quarter of 2015 by a record 1.8mn barrels a day – this comes at a time when inventories are usually in drawdown during the Northern Hemisphere winter. Furthermore, storage capacity for oil is at its max with the world estimated to add only 230mn barrels worth of additional capacity this year and the IEA estimating that America can only handle another 100mn barrels of land storage, implying that any excess will be forced to go onto already bloated seaborne tanker storage.

As for last week's stock market rally, I hate to be the one to pour cold water on a good party, but it definitely lacked gumption with the most beaten up and heavily shorted parts of the market rallying the most (reeks of just being a short-covering rally and not a commitment by long-term buyers). Moreover, the action on Friday (day 2 of the rally) occurred on volume levels that were 9% below the one-month average, a very tepid decline in the volatility index, and the rally largely bypassed the cyclically sensitive financial sector as it finished the week down 0.65%. Lastly, a sell-off in the bond market (which you would typically see in a pronounced risk-on rally) was non-existent with Treasuries across the curve finishing the week ever so slightly to the downside.

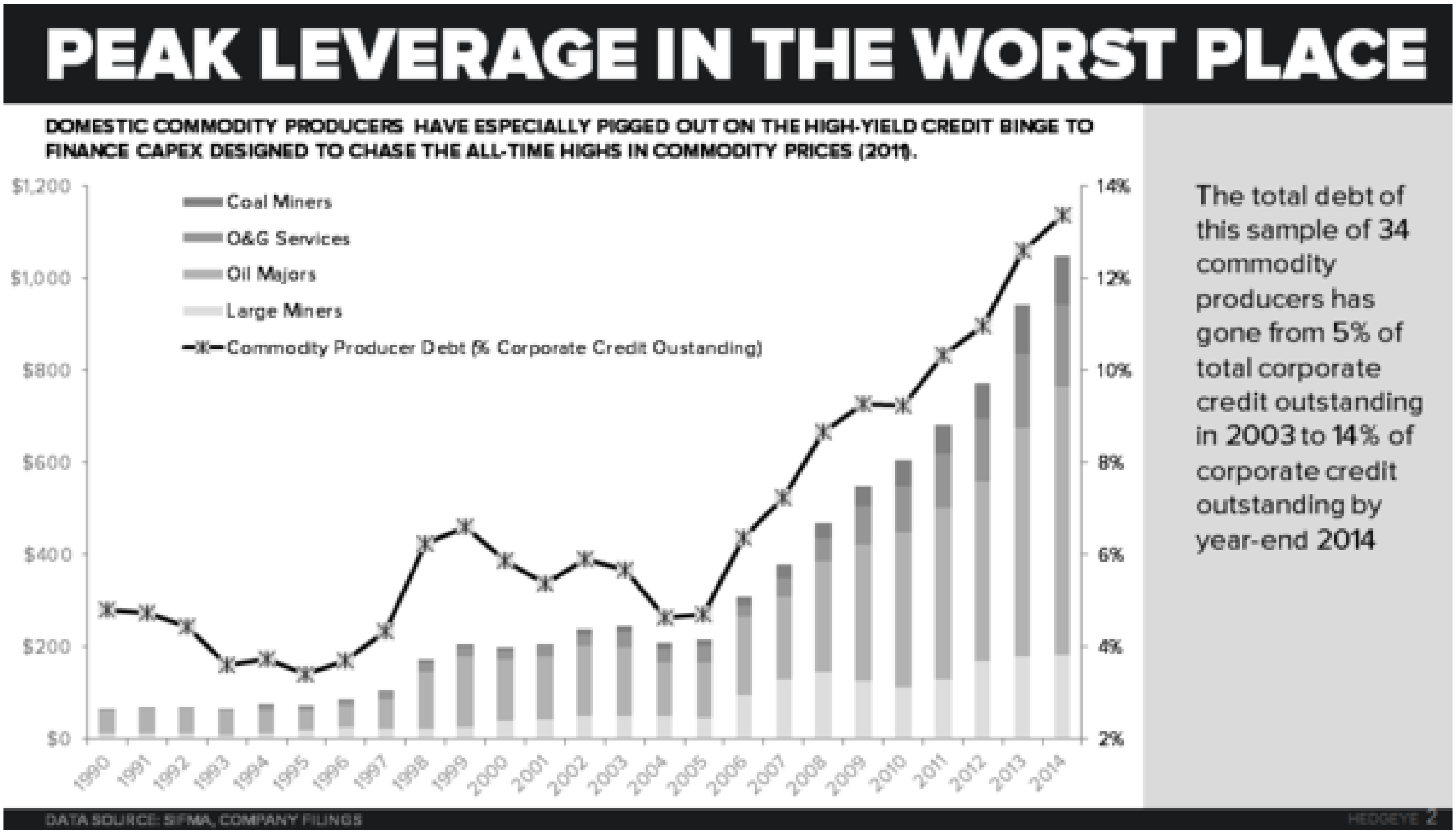
While there are plenty of topics I could discuss during any given week in this commentary (China, deflation, global growth slowing, corporate earnings recession, Fed policy, oil prices, Brexit…), I want to focus on just one issue this week, given the importance I think it carries in contextualizing the current capital market environment: the credit market. Throughout my entire career I've always been taught that the credit markets are a much more consistent (and better) forecaster of what the future holds than the stock market. Thus far, almost fifteen years into my career I have no empirical or anecdotal evidence to dispel the sage wisdom in this advice.

Which brings me to the disconcerting signals that have been emanating from the credit markets for over a year now. Cracks in the high-yield corporate bond market started to appear in the second half of 2014 and have quickly escalated to more of a chasm with the average spread between high-yield bonds and Treasuries widening to 813bps from sub 400bps in early 2014. Just this month alone, spreads have blown out by nearly 100bps as the average coupon on a high-yield corporate bond approaches 10%. What's more, the lower down the credit spectrum you go the worse the carnage is, as junk bonds rated CCC or below have seen their yield spread blow-out to more than 1800bps. The chart below from Wolfstreet illustrates just how far spreads have widened over the last year and provides some context for how current levels compare to where they were during the '08-'09 credit crisis.




With high yield spreads trading at the levels they are today it reflects heightened risk aversion which reduces capital formation, capex spending, and confidence for both businesses and consumers. All of which has consequences for stock prices, i.e. lower multiples which begets lower prices and increased volatility.

A common refrain and pushback I hear downplaying the message from the credit markets is that it's mainly isolated to the energy and mining sector and outside of that everything looks fine. I vehemently disagree with this argument (that the credit bubble is contained to just these segments of the market), but I will acknowledge that the destruction playing out among commodity producers is severe. The following chart highlights how much debt has been piled on by commodity producers over the last decade, with the debt binge going parabolic as interest rates were lowered to zero in December 2008.




Going beyond just the maligned commodity producer segment, as of the end of 2015 the U.S. economy is carrying the highest level of total corporate credit outstanding in its history. Much of this debt has been piled on in the last couple years due in large part from M&A activity and stock buybacks. According to data from Moody's, U.S. M&A activity soared to $3.34 trillion last year which amounted to a record 18.6% of U.S. GDP – the prior record was 17.8% of GDP in Q1 2000.

The level of M&A activity, like employment and wages, is a notoriously late cycle and lagging indicator – historically cresting at the peak of the business cycle. A la, the two prior rolling 12-month peaks for U.S. M&A activity were set in Q3 2007 ($2.213 trillion) and Q1 2000 ($1.745 trillion) – each of these occasions were marked by frothy levels of leverage with a recession occurring within 12 months.

Beyond the U.S., a recent McKinsey study indicated that total global debt has ballooned from $86 trillion in 2005 to over $225 trillion as of the end of 2015. This mountain of debt promises to be a very challenging obstacle for a global economy that is seeing growth estimates continually being revised lower over the last several quarters.

In summary, as was the case leading up to the credit crisis in 2008 and once again back in the summer of 2011 (Eurozone debt crisis, U.S. debt downgrade, threat of government shutdown, and nearly 20% correction in the S&P 500), the high-yield market led equities on the down escalator, and very likely will be the first asset class to turn around. Unfortunately, this leading indicator within the capital markets is showing no indication that a turn is at hand – quite the contrary, it is continuing to show signs of fragility and looming financial stress.

One last thing – keep in mind that while there are many parallels that can be drawn from the history of previous economic cycles, each one has its own idiosyncrasies which differentiates it from the others. For this reason I think it is imprudent for investors to anticipate a 2008 credit crisis part deux. That was the most severe contraction in U.S. economic activity since the Great Depression; said another way that was by far more of an anomaly than the norm when it comes to economic recessions. Since 1929 the U.S. has experienced thirteen recessions with four occurring since 1980 with each one varying in duration and depth. So keep in mind these are a normal part (though never fun) of business cycles that need to be navigated by investors. In my opinion, one of the best references an investor has to assess, analyze, and draw inferences from during these challenging times is the message conveyed by credit markets – which has not been and continues to send a pessimistic message about the current state of the economy and risk assets.

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