Market Insights for Week Ending Nov 10, 2017

A Shaky Week For High Yield Bonds

Over the past 6 days, high yield bond prices have fallen and are trading right around 7 month lows. While this price movement may quickly rebound, there are reasons to pay attention. High Yield bonds offer a different set of risks than most core fixed income positions. The biggest risk for high yield companies is related to credit. The performance of these bonds is often tied to companies that have less than stellar balance sheets and offer a higher probability of defaulting at some point. Because of this excess risk, the investor is compensated with extra return over the prevailing Treasury bond rate. This difference in yield levels is called the "spread".

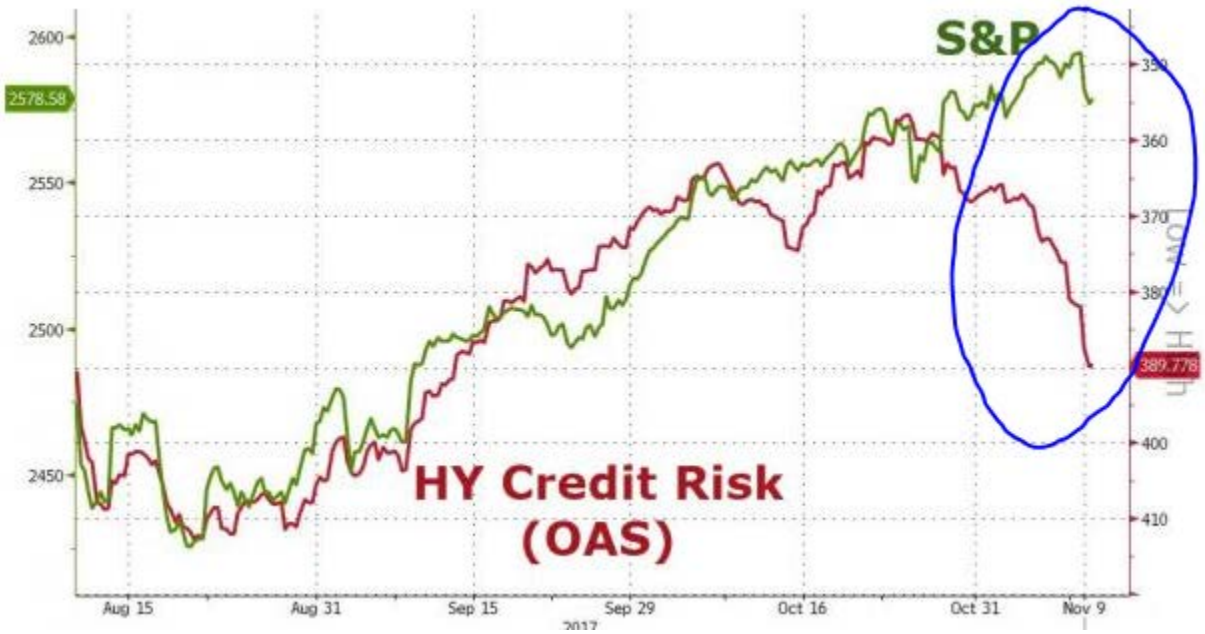
Historically, the average High Yield bond spread is somewhere around 550 basis points or 5.5%.

As you can see from the chart above, High Yield spreads have been trading at some of the lowest levels in the past 5 years. This indicates that High Yield has been bid up in price as the search for income in a low yield environment continues. It also shows that investors have been comfortable taking on the excess credit risk associated with owning these bonds. Even after this week's sell-off, the current spread is around 380 basis points, well below average.

Why do we care?

One of the key tenets of investing in anything is "buy low, sell high". With High Yield spreads currently

almost 2% below average, there isn't much compensation for the higher risk associated with owning these bonds. In addition, the volatility we have seen in the High Yield market over the past few days could indicate that some investors are concerned about the strength of the economy, which could have implications for the stock market. Because High Yield bond prices are more tied to credit risk, they tend to move more in line with stocks. What is concerning is that there is now a significant gap in pricing between those two asset classes. For this relationship to return to normal, either High Yield prices will need to recover or equity prices will fall.



Even before this price move, HCM made the decision to reduce our credit risk exposure in bonds. We felt that high yield prices were too expensive and that downside risk was increasing. We have not yet made any adjustments to our equity allocation but we will continue to pay close attention to the relationship between high yield bonds and stock prices for indications that a change is warranted.

Weekly Focus – Think About It

"Lucky fools do not bear the slightest suspicion that they may be lucky fools-by definition, they do not know that they belong to such a category." -Nassim Nicholas Taleb

Market Activity

Performance last week for the four major asset classes were:

- U.S. Stocks – Russell 3000 (IWV) – Loss of .25%
- Developed Foreign Markets (EFA) – Loss of .42%
- Emerging Markets (EEM) – Gain of .19%
- Fixed Income (AGG) – Loss of .40%

(Note: performance is based on the change in net asset value)

Last Week's Headlines

The yield curve, the spread between 2 and 10-year yields, continued to flatten out as short dated supply was met with expectations for a FED rate increase in December.

Brent Oil prices hit a two year high around $65 a barrel after Saudi Crown Prince Mohammed bin Salman consolidated power in an anti-corruption drive.

US Senate Republicans unveiled their plan for tax reform which delays a reduction in corporate taxes to 2019, among other items that differed from the House version.

Eye on the Week Ahead

Both US CPI and retail sales numbers will be released. CPI is expected to show an increase in the monthly rate of core inflation. Retail sales is expected to post a small increase after a weather-related boost in September and should also suggest household spending is in healthy shape heading into the holiday season.

If you have questions, please contact a member of HCM's Wealth Advisory Team:

Mike Hengehold (Mike@HengeholdCapital.com)

Casey Boland (Casey@HengeholdCapital.com)

Jake Butcher (Jake@HengeholdCapital.com)

Jim Eutsler (Jim@HengeholdCapital.com)

Greg Middendorf (Greg@HengeholdCapital.com)

Steve Hengehold (Steve@HengeholdCapital.com)

Doug Johnson (Doug@HengeholdCapital.com)

Additional Notes:

- The Standard & Poor's 500 (S&P 500) is an unmanaged group of securities considered to be representative of the stock market in general.
- Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance.
- Past performance does not guarantee future results.
- You cannot invest directly in an index.
- Consult your financial professional before making any investment decisions.

• • •