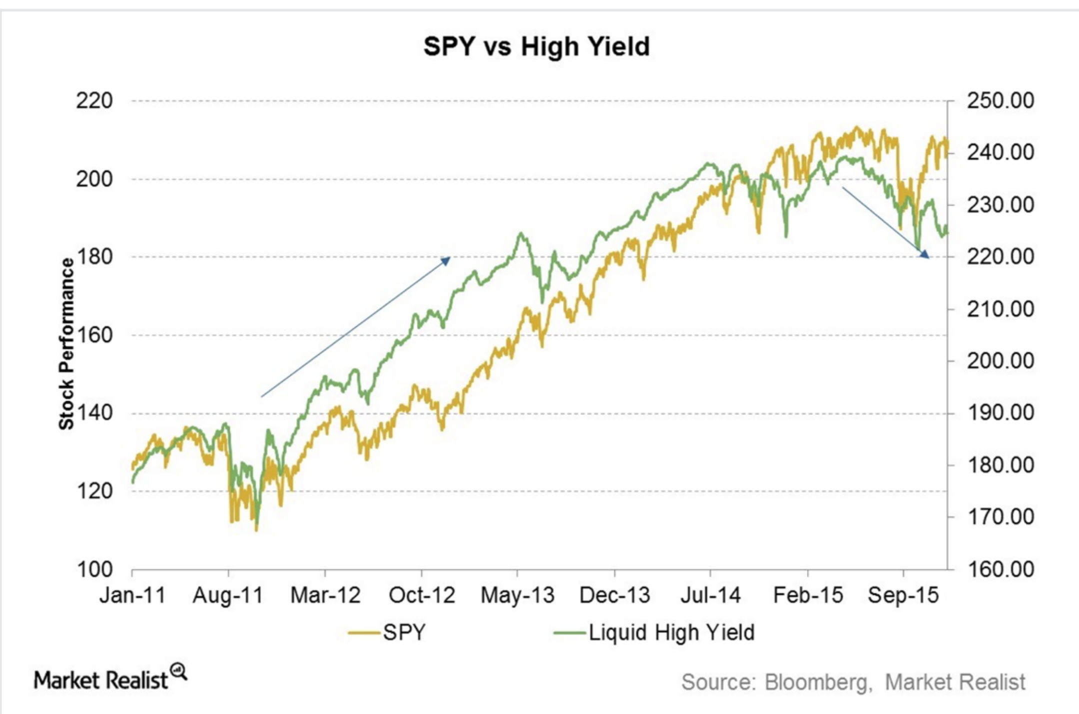
Divergent Equities and High Yield: Short Insurgents Ready to Pounce

High yield usually leads the equities market

High yield and SPY are diverging. The general rule of thumb is that the fixed income (high yield) traders are usually the smarter ones compared to equity traders—and we can see historically that the fixed income market tends to lead equities in terms of “risk-on” and “risk-off” scenarios. Since the beginning of the fourth quarter, the IBOXHY Index (HYG) has been essentially flat while the SPX (SPY, IVV, VOO) Index is more than 7% higher. Part of this move relates to the idea that the Fed will raise rates, which is generally negative for bonds. In turn, this move would signal that things are looking better for the equities markets.

However, valuations are at high multiples while credit concerns are mounting, particularly in the energy space (XOP). The same thing occurred in 2007 as well as prior to to the 2011 European Credit crisis. While there are opportunities to pick spots in particular names, a general long market bias just doesn’t make sense—particularly given what the fixed income market is telling us. Consider lightening up on some longs into year end as many successful fund managers do. (Many turn the books off in December.) Or hedge accordingly.

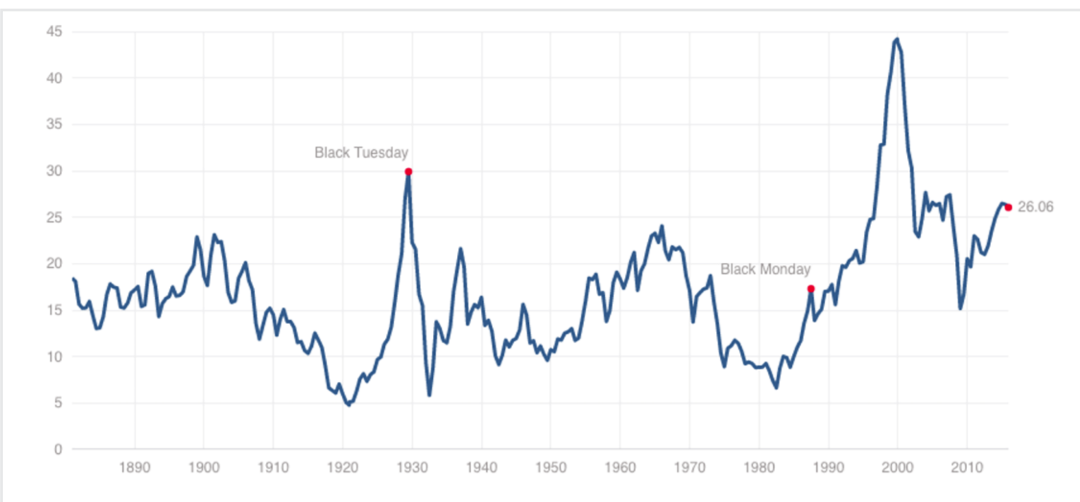


How can you justify owning the market?

The Shiller P/E (CAPE), long touted as one of the best ways to cyclically adjust earnings with inflation over long periods, sits near highs (outside of the 1999 tech bubble). The median levels for the index are in the mid teens (16x) over the last 120 years. For the S&P (RSP, SH) to be trading at median levels—or 16x based on Shiller calculations—we'd need to be at approximately 1,300 or 37% lower. Even a move to a 20x multiple would take the market to 1,600 or 22% lower. It's tough for someone to argue that we'll see multiple expansion through earnings growth. Companies continue to come out and cut forecasts and outlooks for the upcoming year.

Plus, as we've mentioned in previous Market Realist Chronicles, it's becoming difficult for companies to make additional cost cuts through head count reductions, as we've seen over the past five years. They're now stuck trying to create earnings power through mergers and even PE deals (GMCR) since they appear not to be able to grow organically. We know how those PE deals worked out last time around. Feels like 2007!

Shiller PE



Source: multpl.com

With multiples expanded and high yield and junk on the lows, which would you rather own?

If you're in the camp of wanting to be long the market at these levels, we have to ask why you wouldn't just buy the high yield HYG or Junk Market JNK ETFs in lieu of the general market (VV, VOO). Credit spreads in the United States are now out wider than the 2011 European Credit crisis, which subsequently snapped back. However, equity multiples are at the wides. On a risk-adjusted basis, it makes more sense to own the high yield or junk markets right now. If we get into a risk-off scenario, there's likely less downside in high-yield than in the frothy equities. This may also lead the Fed to not raise rates, which could help bond pricing. If the market does continue its move higher, we tend to think the spread between high yield, junk, and the equity market would need to compress.