Tarheel Advisors Newsletter

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Fall Taper Tantrum

Fall has officially arrived, and if you couldn't tell from the changing leaves and dropping temperatures, then the brisk 1,100 point drop in the DOW on August 24th should have signaled that the seasonal stock market volatility and Autumn were just around the corner.

At the beginning of the year we predicted that the world would begin to enter a small recession and that equities would struggle around the midpoint of the year. While we are pleased with the accuracy of our prognosis, we are frustrated with the fact that there has been nowhere to hide during the current market sell-off. Unless you were invested heavily in cash or U.S. Treasuries (near cash), your investments were down around 6% for the quarter.

Unfortunately, in direct contrast to the normal benefits of a diversified investment portfolio, almost all asset classes fell in tandem, including: U.S. & International stocks, corporate bonds, real estate, and gold. Regardless of how assets were allocated (either aggressively, moderately, or conservatively) during this cycle, investors were losers on paper just for playing the game.

If you're looking for someone to blame for the loss, then look no further than the Federal Reserve. For the past several months the markets have been squarely focused on whether Janet Yellen and the Fed would finally increase interest rates for the first time since 2006. Heading into the Summer, it was becoming nearly a sure bet that we would see at least a 0.25% rate increase by September. However, a hiccup in both the Chinese economy and global stock markets gave the Fed pause and pushed back the onset of rate hikes yet again. This so-called "data dependent" story has been spun multiple times over the last three years, and just as it seems inevitable that we'll finally have higher interest rates, the Federal Reserve sees a short-term market or economic gyration and balks. For some reason they seem to place less weight on the fact that the stock market has more than doubled since the 2009 lows and that we are in an economic expansionary cycle nearing a decade in length.

Whether our appointed officials at the Fed see it or not, It is time for higher interest rates—if only modest in nature. It would seem that the stock market participants are starting to see this as well. On the date of the latest Fed announcement, September 17th, the news of rates remaining unchanged did not produce its normal batch of euphoria. Whereas this type of news in the past would have caused a stock market surge, this time was different, as illustrated by a late day market pull-back. Could it be that the stock market is finally wising up to the dirty secret about **z**ero percent **i**nterest **r**ate **p**olicy (ZIRP)? While free money is great for short-term investments, it can be a destructive long-term policy that complicates an array of business models.

For example, I think ZIRP deserves much of the blame for the recent collapse in commodities prices. In the case of the oil boom in the U.S. over the last few years, low interest rates drastically decreased the cost of capital to enter the business, and as a result, we have seen a surge in oil wells across the country. Naturally, this surge in production helped create a glut in global supplies, and in turn contributed to the price of oil collapsing by 60% over the course of the last 14 months. Cheap capital can benefit industry in the short run, but in the long run, it erodes profit margins and hurts all participants.

While no one likes losing money, as a long term investor it is best to take a step back from the current calamity and realize that the recent pull-back was badly overdue. My genuine hope is that the markets and regulators are wising up to the effects of ZIRP and will begin to slowly ease away from this policy. This pull back won't be a painless process, and the investment results from the past quarter illustrate that case in point. While there are some economic potholes out in the current landscape, there doesn't appear to be the same landmines that existed back in the 2008 financial collapse. Our advice is to weather the current storm and stay the course so that your portfolio will be ready for smoother sailing in 2016.

-Ryan Glover, CFP®

2015 Market Update

S&P 500	**-5.29%**
DOW	**-6.95%**
RUSS 2000	**-7.73%**
MSCI World	**-6.69%**
BONDS	**+1.13%**
GOLD	**-7.39%**

Mortgage Rates

15-Year	**3.00%**
30-Year	**4.02%**
5/1 ARM	**3.40%**

Did You Know?

* Since 1945, September 30th is the worst performing market day of the year. The last day of September has produced positive returns only 38% of the time.

* According to Irish legend, Jack O'Lanterns are named after a stingy man named Jack who, because he tricked the devil several times, was forbidden entrance into both heaven and hell. He was condemned to wander the Earth, waving his lantern to lead people away from their paths

Shaken, not Stirred

I'm a big fan of the James Bond movie franchise, and in honor of the upcoming release of the newest film on November 6th, I think its only appropriate to examine the recent *spectre* (see what I did there…) in the world of bond investment.

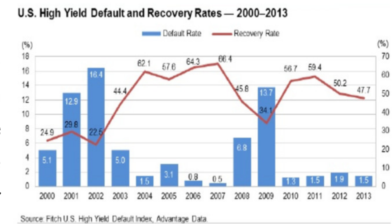
As Ryan noted on the front page, global bond markets weren't immune to the volatility and sell-off in stocks. In fact, many of the indexes that track various categories of bonds suffered bigger pullbacks than equities. One such culprit was high-yield corporate bonds, which were hit with a *thunderball* in the third quarter. If you take a look at the five year chart of the iShares High-Yield Corporate Bond ETF (HYG) below, you'll note that the last time the index was this low came in October 2011. This 15%+ sell-off from the peak in June of last year would translate into the equivalent of the Dow Jones Industrial Average falling 2,782 points!

Now that I've got your attention, what is the root cause of this drop and where do bonds go from here? First off, all bonds are not created equal. So, making a general statement about bonds as they do quite often on TV can get misconstrued. When analysts or market pundits refer to bonds, most often they are broadly speaking about government bonds. U.S. government treasuries, agency bonds, municipal bonds, and mortgage-backed securities make up about 75% of the domestic bond market, and these tend to be highly rated, carry a low interest rate, and have a very long maturity (10-30 years on average). In the current environment we would not recommend you lock in such a low interest rate (sometimes as little as 2-3% can be expected) for that long, since inflation could be as high as the interest you earn, knocking your real return down to nothing. The bonds that most investors own to generate any significant income in their portfolio are corporate bonds, both investment grade and high-yield.

CREDIT RATINGS

		Moody's	Standard & Poor's	Fitch
INVESTMENT GRADE	STRONGEST	Aaa	AAA	AAA
		Aa	AA	AA
		A	A	A
		Baa	BBB	BBB
NON-INVESTMENT GRADE		Ba	BB	BB
		B	B	B
		Caa	CCC	CCC
		Ca	CC	CC
	WEAKEST	C	C	C
		C	D	D

A typical investment grade bond is issued by a large cap company like WalMart, IBM, Apple, etc. These bonds have a similar credit rating to government securities but usually carry a slightly higher yield because a default is possible though still unlikely (historical default rate is 2.1%). High-yield bonds, sometimes referred to as "junk," are any bonds that have a credit rating less than BBB. These companies typically consist of mid and small cap companies, but could be what you and I consider large businesses, such as ADT Security or Dell Computers. The hallmark difference is usually a much greater amount of leverage is used on their balance sheet. Hence, when interest rates go up or business turns south, the debt interest payments become harder to make from normal cash flow. Over the past 15 years, we have seen some pretty big economic swings and the default rate on high-yield bonds and the recovery rate from those defaulted issues has varied greatly. Historically speaking, the average default rate has been around 9% of issues, but we've enjoyed a phenomenal run especially over the last five years with a sub-2% default rate. According to Fitch Ratings in the graph below (*for your eyes only*), recent trends have given them reason to raise their target defaults in 2015 from 1.5-2% up to 2.5-3% by year-end. Even though businesses may be in worse shape than years' past, the high yield bond market is far from a *Casino Royale*.



Why have these type of bonds sold off so much? The answer is two-fold. The primary reason is a lot of the companies in this classification are in the energy sector. When the commodity you sell such as oil, copper, iron ore, aluminum, coal, etc. is trading at a six-year low and off 50%+ from recent peak prices, it's tough to make money. These companies are struggling to keep their cash flow positive and their debt/equity levels within the credit guidelines. As a result, many of the issuers have received credit downgrades of several notches by the rating agencies. This can start a wave of selling by mutual funds and other large institutions that must maintain average credit ratings at a certain mark, such as BBB. This demand imbalance then exacerbates the other major issue plaguing the corporate bond market, which is the lack of liquidity. Unlike stocks, which trade on a centralized exchange with penny increments and ample volume, bonds are traded via a dealer network that consists of only a handful, with the top 10 controlling 90% of trading. It is pretty normal to see a 2-5% difference between the price one can buy and sell the same bond. Given that banks no longer play a large part as market makers due to Basel rules restricting their inventory of debt, it is quite common to shop for quotes on an individual bond for several days without a reply. Given the demand imbalance and supply constraints, it would take a *man with a golden gun* to avoid pitfalls as of late. If held to maturity, many of these corporate bonds may turn out to be great investments. But be prepared to be shaken and stirred in the meantime as regulators search for a more standardized marketplace to pool liquidity and improve transparency and pricing.

–Walter Hinson, CFP®

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