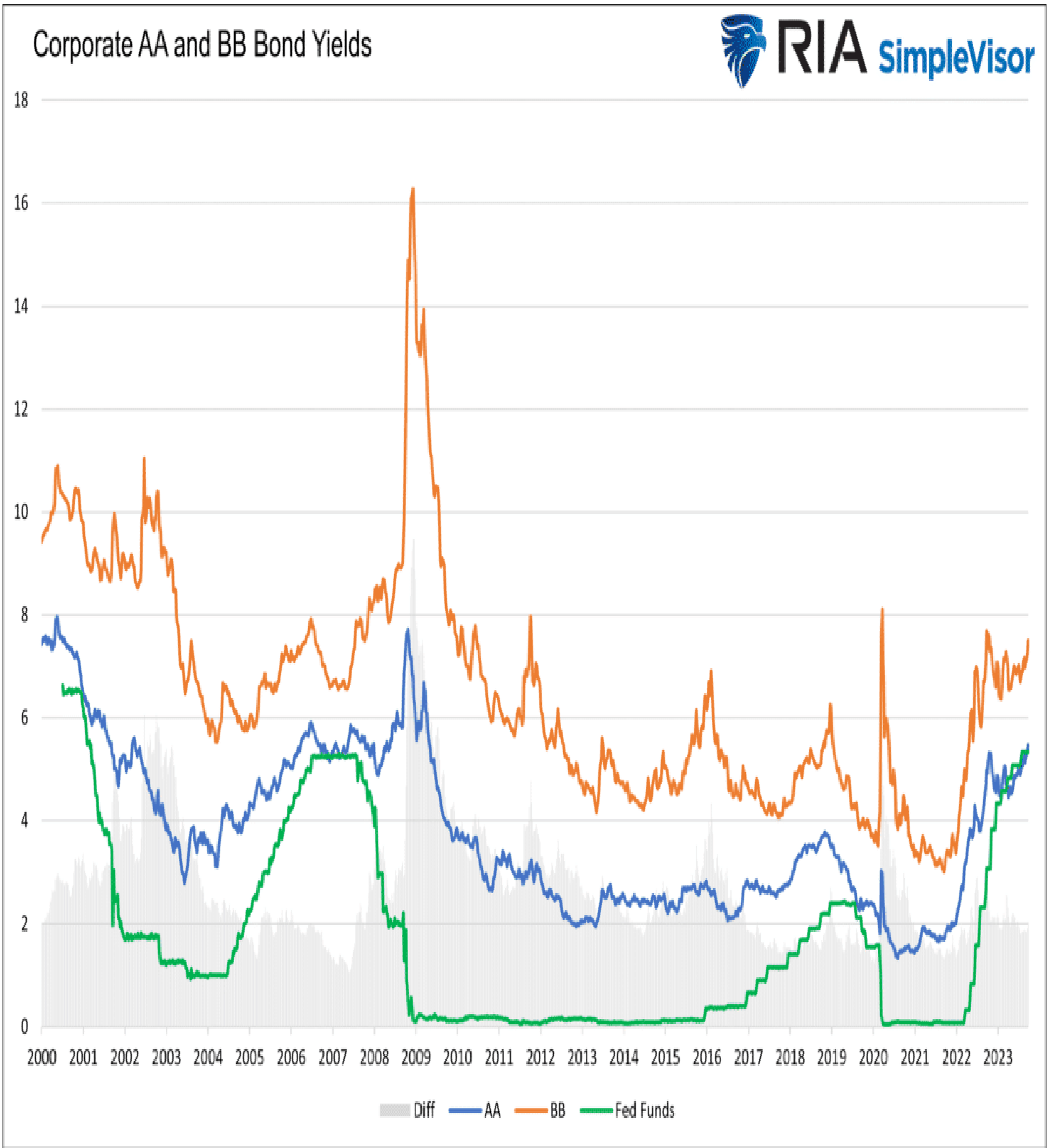
Are Junk Bonds Immune To Higher Rates?

Monday?s Commentary shared a graph showing Fed Funds have risen by 5.25% over the last year and a half, yet the difference, or spread, between junk bond and Treasury yields has remained the same. Corporate bond spreads are a measure of implied default risk. Essentially, the junk bond market says that despite much higher borrowing costs for financially impaired companies, the risk of default is unchanged. While that may seem strange, the corporate bond market is often lulled to sleep while the Fed is hiking rates. It?s the cutting of rates accompanied by recessions and financial crises that quickly awaken junk bond investors.

One might counter that massive Treasury debt issuance is offsetting the increasing risk of holding junk bonds. The following graph says that is not the case. It compares junk bond yields to those of highly rated AA corporate bonds. Once again, we find the change in implied risk between highly-rated AA bonds and junk-rated BB bonds is more or less unchanged despite higher rates. Therefore, once we remove the Treasury issuance risk, we continue to see no concerns for junk bond defaults. Regardless of what the market implies today, yield spreads between junk and investment-grade bonds and U.S. Treasuries will widen when the Fed starts cutting rates.


Corporate AA and BB Bond Yields
RIA SimpleVisor
18
16
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2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022 2023
Diff
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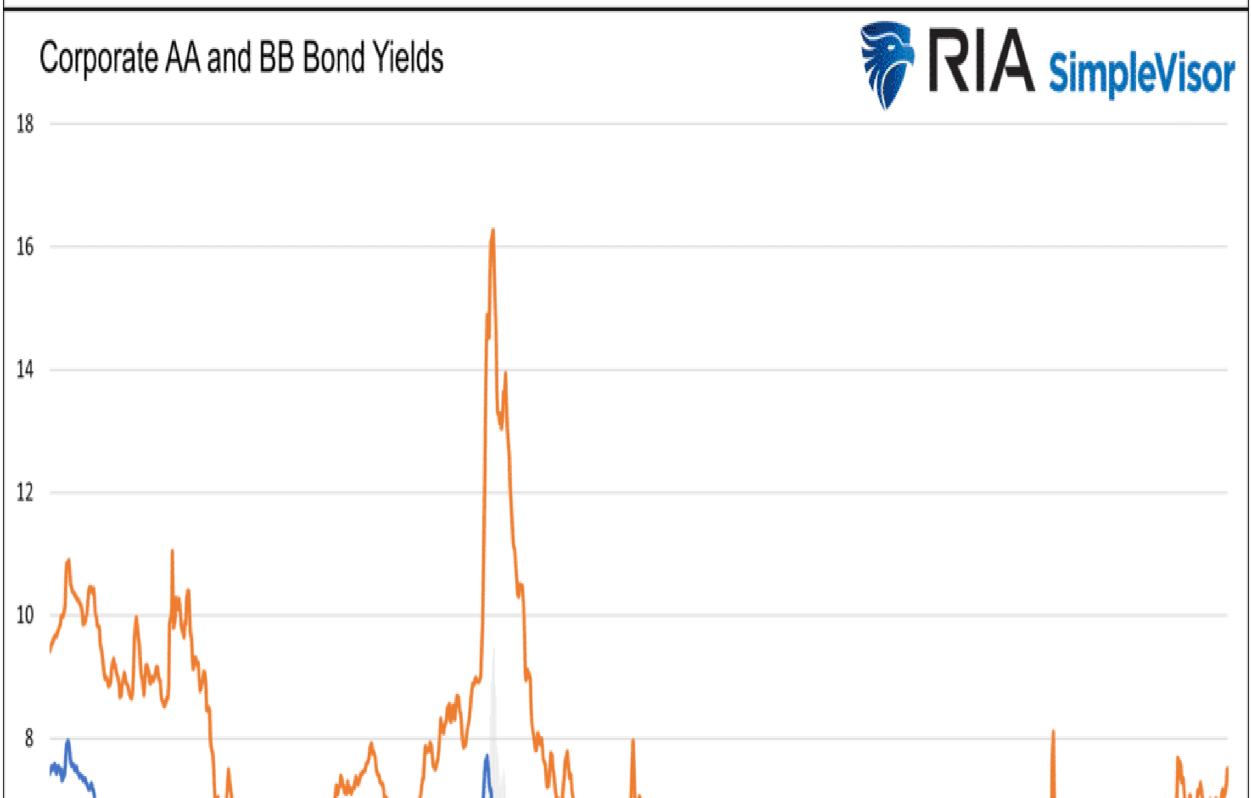
Fed Funds


Corporate AA and BB Bond Yields
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10
8

What To Watch Today

Earnings

Time	Symbol	Company Name	Market Cap ▾	Fiscal Quarter Ending	Consensus EPS* Forecast	# Of Ests	Last Year's Report Date	Last Year's EPS*
	MKC.V	McCormick & Company, Incorporated	$21,158,119,493	Aug/2023		N/A	N/A	$0.69
	MKC	McCormick & Company, Incorporated	$20,288,206,184	Aug/2023	$0.65	6	10/06/2022	$0.69
	CALM	Cal-Maine Foods, Inc.	$2,371,807,652	Aug/2023	($0.01)	1	9/27/2022	$2.57
	NG	Novagold Resources Inc.	$1,282,493,483	Aug/2023		N/A	10/04/2022	($0.05)

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Economy

Time	Event	Impact	Actual	Dev	Consensus	Previous
TUESDAY, OCTOBER 3						
12:55	USD Redbook Index (YoY)(Sep 29)		-	-	-	3.8%
14:00	USD IBD/TIPP Economic Optimism (MoM)(Oct)		-	-	-	43.2
14:00	USD JOLTS Job Openings(Aug)		-	-	8.83M	8.827M
15:30	USD 52-Week Bill Auction		-	-	-	5.12%
19:30	USD Total Vehicle Sales(Sep)		-	-	-	15M
20:30	USD API Weekly Crude Oil Stock(Sep 29)		-	-	-	1.586M

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Market Trading Update

Yesterday, the market traded a bit wildly as the new quarter got underway. The return of hedge funds shorting oil and bonds and buying the top-7 mega-cap stocks looked like positioning by managers to chase performance. As noted this past weekend, the market remains oversold, and the overall sentiment and positioning are negative. Despite yesterday?s sloppy trading, the market seems set up for a rally in the short term. The 200-DMA remains key support for the market at 4200. A break below that, and 4000 becomes the next logical support level.

As noted, we still think the bias is to the upside for now, but nothing says it can?t get worse before it gets better. Continue to run risk management as needed.

TradingView

TradingView

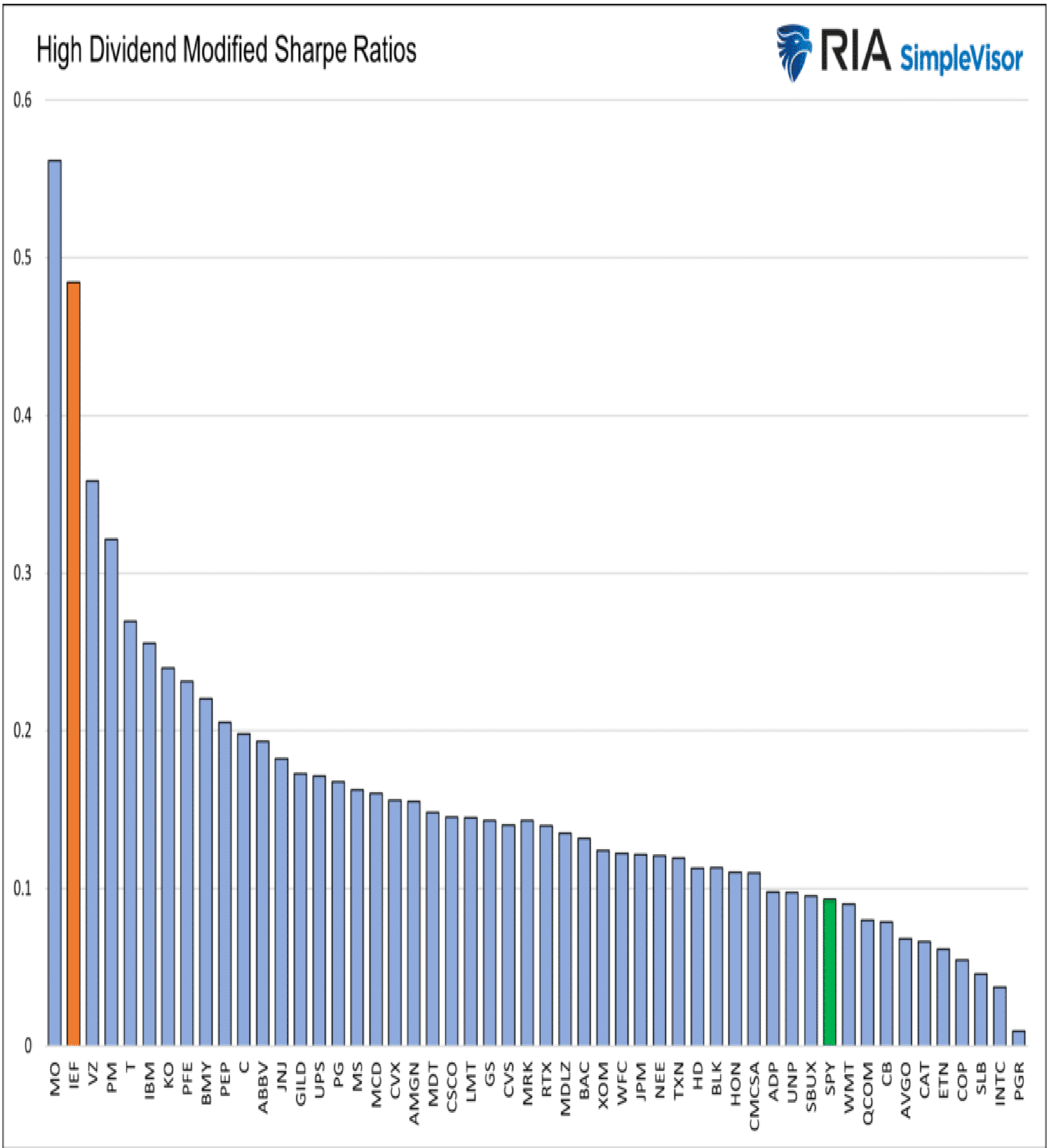
High Dividends With Minimal Price Risk

Every Friday, we publish Five for Friday in SimpleVisor. The weekly article scans for stocks that best meet certain criteria. Each week, the theme changes so we can present a wide variety of stocks meeting many different potential outcomes. This past week, we looked for stocks with high dividend yields and low share price volatility. The goal was to present five stocks that may act as a surrogate for bond holdings.

We took a unique approach to find stocks meeting these criteria. Per the article:

> *Our starting point for this scan is the top fifty holdings of the Vanguard High Dividend Yield ETF (VYM). We then calculate a modified Sharpe Ratio for each stock based on daily prices over the last year. The Sharpe Ratio measures a stock?s total return as a function of risk, aka volatility. The higher the Sharpe Ratio, the more the investor gets paid per unit of risk.*
>
> *Our modified Sharpe Ratio uses the dividend yield, not the total return (price and dividend), in the numerator. Like the Sharpe Ratio, the denominator is annualized volatility.*

The graph below shows our modified Sharpe Ratios for the top fifty holdings of VYM. The Sharpe Ratios for bonds (IEF) and stocks (SPY) are plotted as well to provide context.


High Dividend Modified Sharpe Ratios
RIA SimpleVisor
0.6
0.5
0.4
0.3
0.2
0.1
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MO
IEF
VZ
PM
T
IBM
KO
PFE
BMY
PEP
C
ABBV
JNJ
GILD
UPS
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CVX
AMGN
MDT
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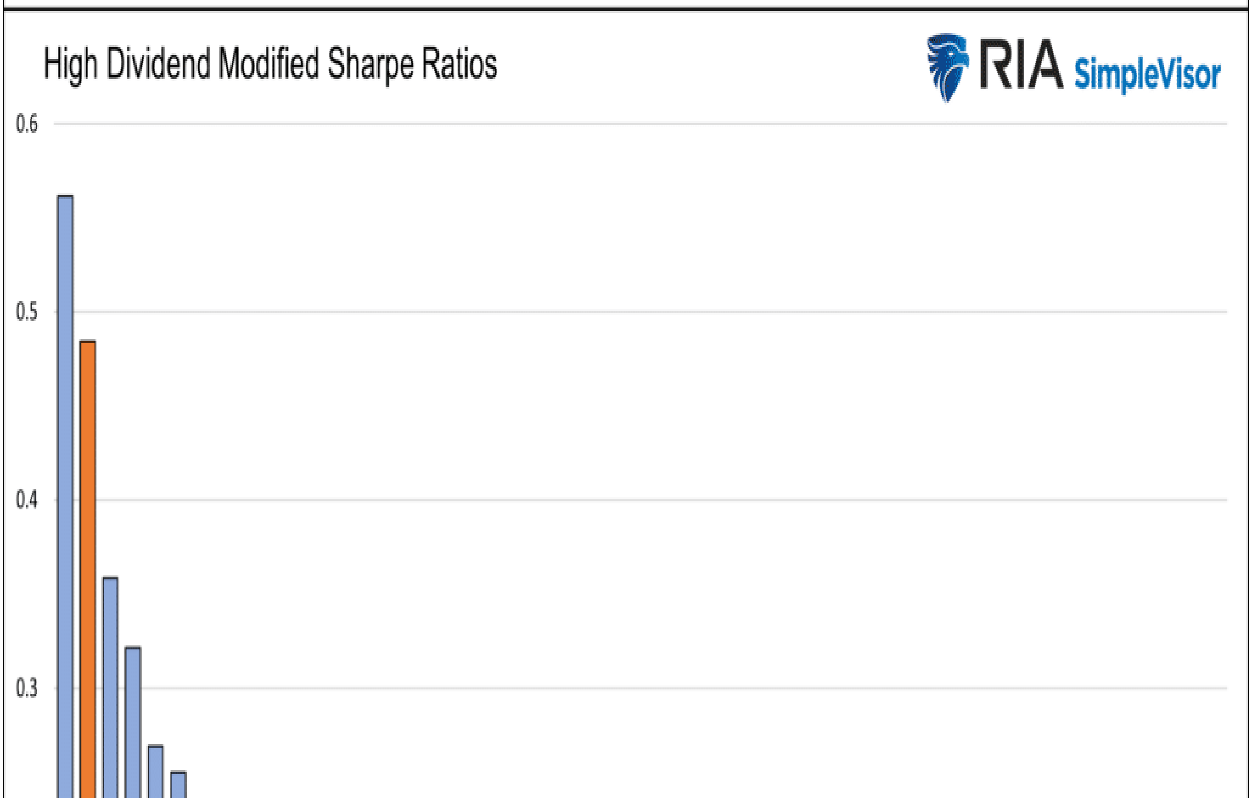
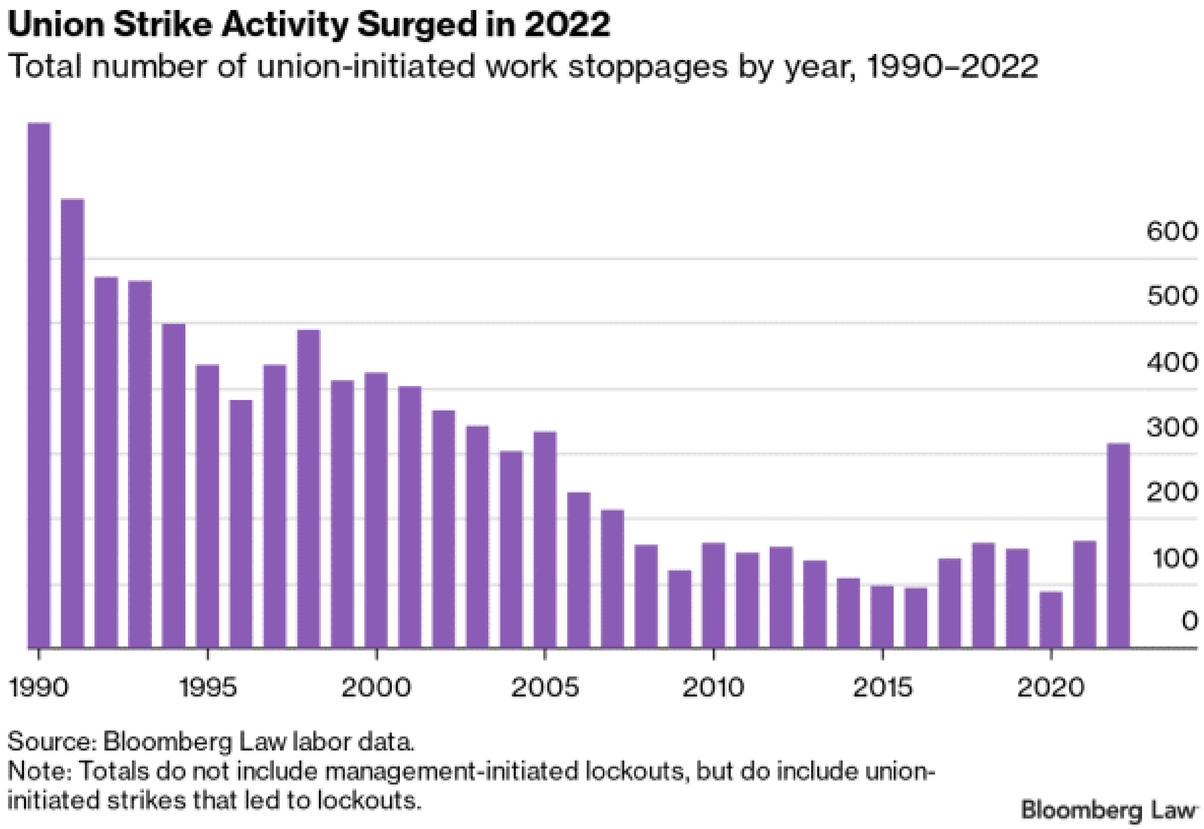
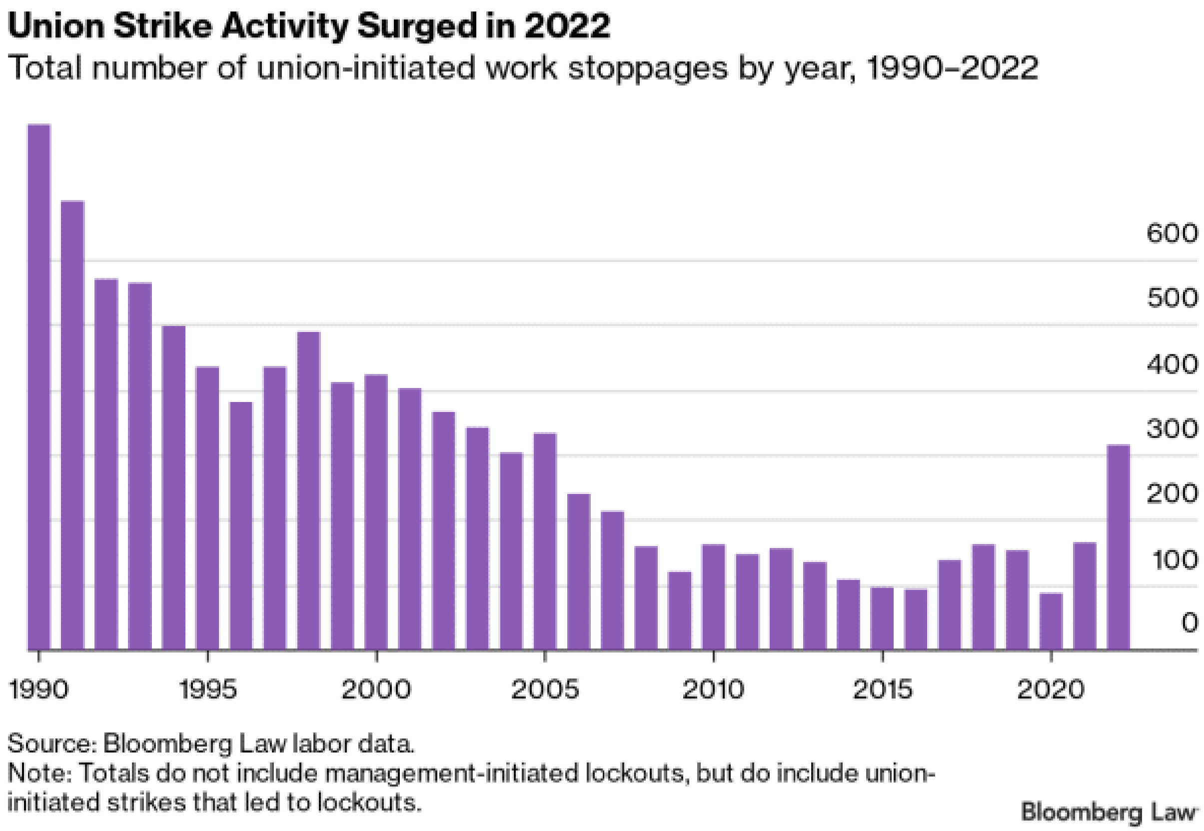

High Dividend Modified Sharpe Ratios
RIA SimpleVisor
0.6
0.5
0.4
0.3

Kaiser Permanente Workers Are Set To Strike

Following the recent UPS threatened strike, resulting contract agreement, and the current UAW strike, Kaiser Permanente is threatening to strike on Wednesday. If the 75k Kaiser Permanente workers strike, it would be the largest health care strike in history.

While an agreement is still possible, the broader message is clear. Workers have newfound leverage. The historically low unemployment rate and flat to negative real wages empower unions to seek higher wages and better benefits. The Bloomberg graph shows that starting in 2022, union strike activity rose rapidly. This year, the number of strikes is already over 310k and could rise significantly if Kaiser strikes. Further, the UAW strikes may continue to increase. If both occur, union strike activity could rise to 20-year highs.





Fear Of The Fed

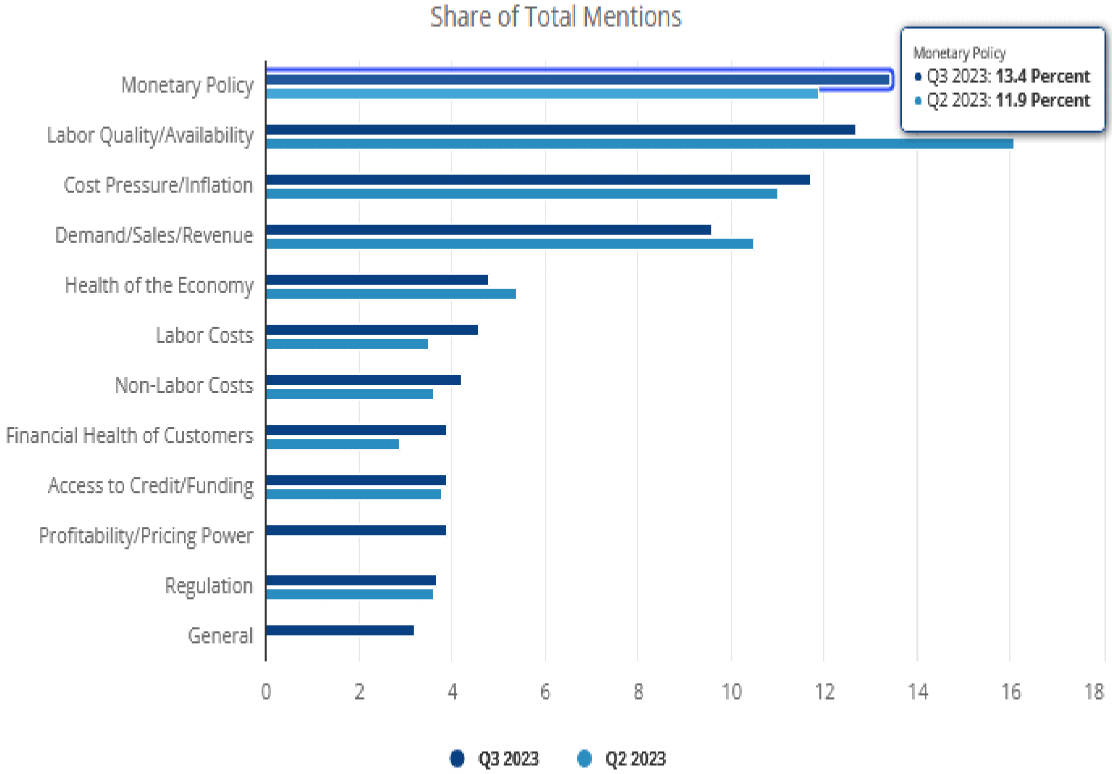
The following comes from the most recent Richmond Fed CFO Survey.

> *For the first time in over a decade, respondents to The CFO Survey cited monetary policy as their most pressing concern, slightly ahead of labor availability, inflation, and demand for their products/services.*
>
> *Perhaps not surprisingly then, around 40 percent of respondents reported that the current level of interest rates has caused them to pull back on capital and non-capital spending, a sizeable increase from the roughly 30 percent of firms that responded similarly in the Q4 2022 survey.*

Companies are becoming increasingly sensitive to higher interest rates. The lag effect is finally taking hold. Firms are now pulling back on spending and increasingly fretting that rates will stay higher for longer.

Firms' Most Pressing Concerns

Share of Total Mentions



Note: Percentages do not sum to 100 because only the top ten topics (and ties) are shown. Results from Q2 2023 survey (May 24 - June 9, 2023) are shown for comparison. A topic without a Q2 frequency of mentions is one that moved into the top ten in Q3 2023.

Source: Duke University, FRB Richmond and FRB Atlanta, The CFO Survey - Q3 2023 (August 21 - September 8, 2023)

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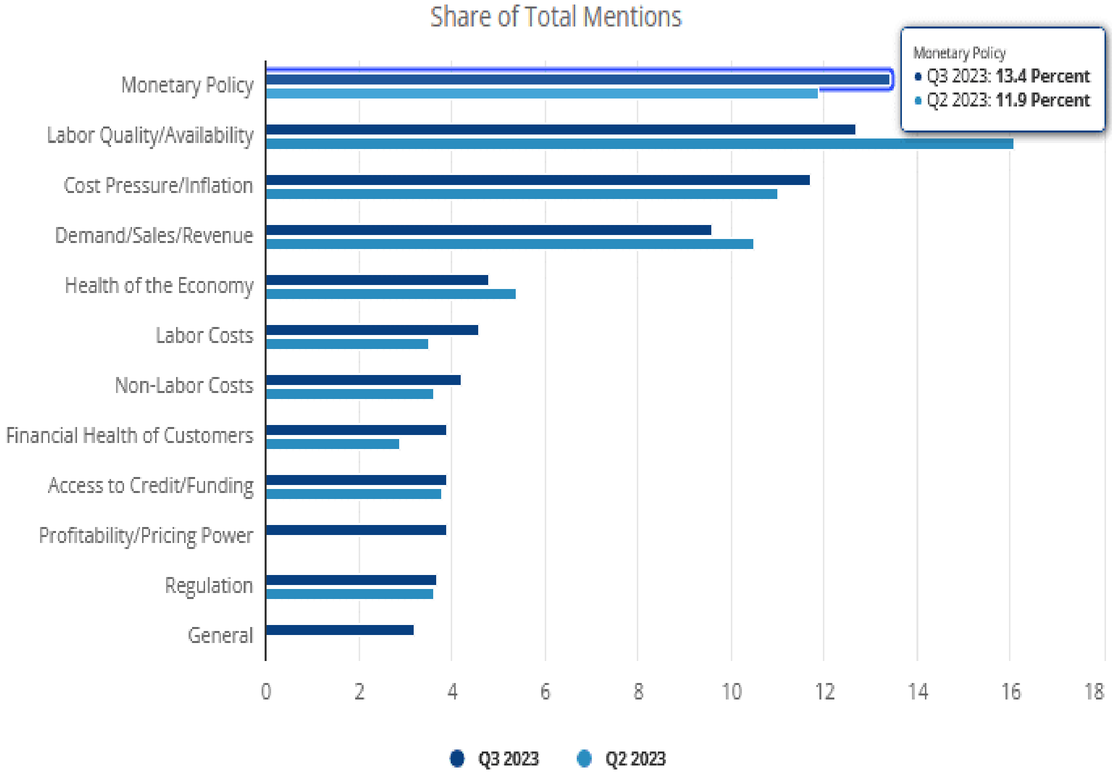

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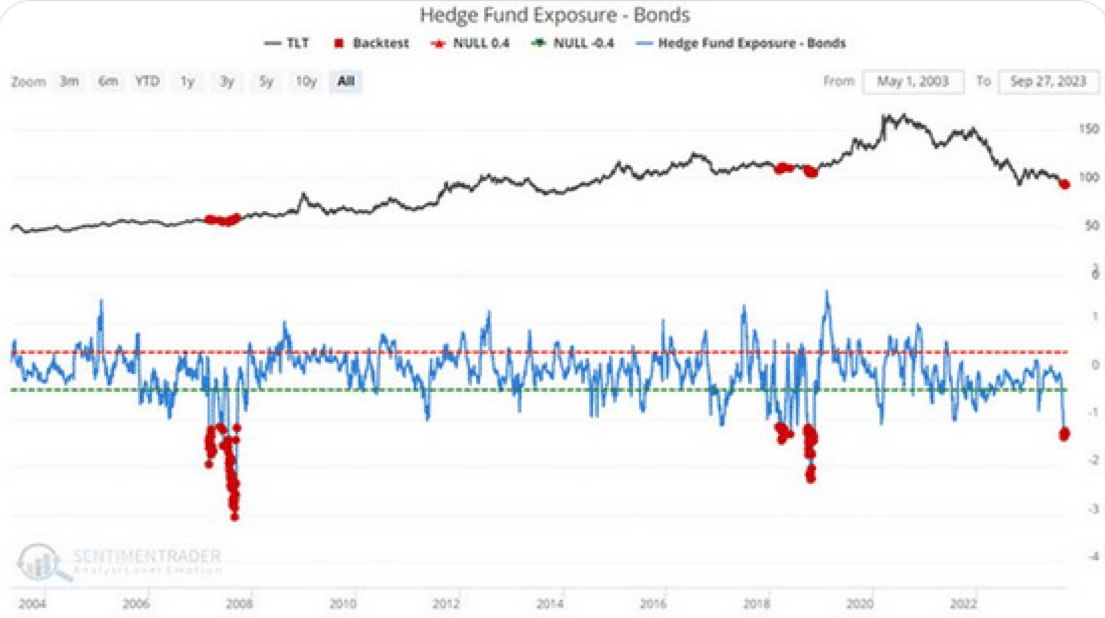
Tweet of the Day

Jay Kaeppel @jaykaeppel · Sep 27

Hedge funds are net short bonds.
Is it time to buy? Not necessarily
Is it time to open your mind to the possibility of buying? History suggests "Yes"
@sentimentrader



TLT	1 Week Later (%)	2 Weeks Later (%)	1 Month Later (%)	2 Months Later (%)	3 Months Later (%)	6 Months Later (%)	1 Year Later (%)
Average Returns	0.07%	0.06%	0.33%	2.25%	3.54%	6.72%	14.29%
Median Returns	0.18%	-0.32%	0.00%	2.36%	5.23%	8.23%	11.59%
Win Rate	53%	46%	50%	66%	82%	86%	100%

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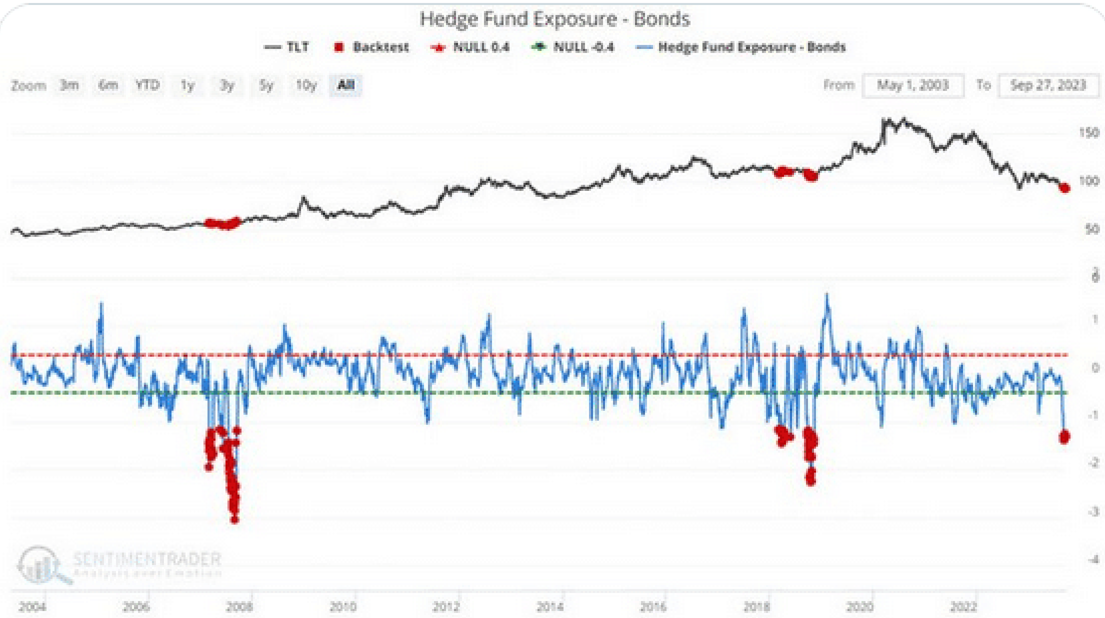

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2023/10/03

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