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Something to Think About

OAKWORTH CAPITAL BANK

COMMON CENTS

Well, the Fed finally raised the overnight lending target rate. I have to tell you, when people literally stop me on the street to ask me about the short-term future of monetary policy in the US, perhaps we have all become a little too preoccupied with the subject. Now, we can quit wringing our hands and gnashing our teeth, and move onto something else. The only problem is: how are all the numerous news and market channels on the TV now going to fill the day?

You have to wonder.

The markets rallied like gangbusters after the Fed announced the rate hike on Wednesday. They have been in a nosedive since. The reason? Well, there is no shortage of theories, but there seems to be a shortage of conviction. Shoot, when one of the most oft-given 'reasons' why the market is falling is a decline in crude oil prices, you have a general feeling of having fallen through the looking glass. Couple this today with a weakening US dollar getting some blame for stock weakness, and it might be time to quit reading the screens and watching the idiot box.

Moving forward, the bigger news item to me, and I mean more than the Fed and crude oil prices, is the effective collapse of the Third Avenue Focused Credit (TFCIX) mutual fund. This was/is a high yield bond fund, which in simpler days we would have balled a junk bond fund. When investor withdrawals exceeded the fund's ability to pay out cash without selling securities in a panicked fashion, the fund company basically shut it down so it could liquidate holdings in an orderly manner. Believe it or not, this really was in the best interests of the holders.

You see, TFCIX wasn't your run of the mill BB rated corporate bond fund. Those things are a dime a dozen. Nope, it searched out real distressed stuff, as the average credit rating of the portfolio was/is CCC according to my Bloomberg. For those of you not terribly familiar with bond ratings, consider the table below:

Cumulative Historic Default Rates (in percent)

Rating categories	Moody's		S&P	
	Municipal	Corporate	Municipal	Corporate
Aaa/AAA	0.00	0.52	0.00	0.60
Aa/AA	0.06	0.52	0.00	1.50
A/A	0.03	1.29	0.23	2.91
Baa/BBB	0.13	4.64	0.32	10.29
Ba/BB	2.65	19.12	1.74	29.93
B/B	11.86	43.34	8.48	53.72
Caa-C/CCC-C	**16.58**	**69.18**	**44.81**	**69.19**
Investment Grade	0.07	2.09	0.20	4.14
Non-Invest Grade	4.29	31.37	7.37	42.35
All	0.10	9.70	0.29	12.98

As you can see, there is pretty huge increase in default rates once you get below Baa/BBB. Just take a look at the default rate in C rated debt! Granted, you can make a lot of money playing in that arena, but, over the long haul, the odds are against you.

This is dicey stuff, with a limited number of potential buyers if and when you get into a liquidity pinch. Which is exactly what happened to TFCIX. The folks at Third Avenue could be the absolute best junk managers in the world, but if they are having to sell large chunks of CCC rated debt to meet outflows? Let's just say that doesn't work very long.

Inside this issue:

I don't particularly like equities, but I think equities are a better space to be in than bonds.

Marc Faber

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But what does this mean for the broader economy and markets? Well, one fund does not a financial crisis make, far from it. However, it is enough to perk up your ears, and start doing a little homework. Instead of reinventing the wheel, let me cut & paste what I submitted to the Montgomery Advertiser for my column in that newspaper this week:

> "Last week, a troubled junk bond mutual fund sent shockwaves through the markets when it froze investor redemptions. That is investment speak for it didn't have enough cash, or the ability to raise enough, to satisfy all the people looking to get their money out. Obviously, this is a problem, but just how widespread is it?
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> I called a friend of mine who works in, let's call it, creative debt solutions for companies. His department moves hundreds of millions of dollars around the world, so he has a pretty good grip on the situation. I wish I could tell you he made me feel better, but he told me what I had already suspected.
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> Simply put, the formal US corporate bond market has ballooned since the 2008 financial crisis. Due to ravenous investor demand and easy monetary policies, companies have been able to borrow at historically low interest rates. Couple this with the tax advantages of debt financing, and CFOs around the country have tacked on debt for just about any reason imaginable.
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> According to the Securities Industry and Financial Markets Association (SIFMA), the size of the US corporate bond market was $5.42 trillion in 2008. This was equal to about 36.8% of Gross Domestic Product (GDP). During the 3rd Quarter of 2015, SIFMA estimates it has grown to $8.25 trillion, or around 43.4% of GDP.
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> This means that while the economy has grown roughly 22.7%, in current dollars, since 2008, the corporate bond market has grown a whopping 52.2%. While a little leverage can boost returns, a lot of it can really weigh down the balance sheet.
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> Now, debt can be effective IF it enables you to increase output by more than the amount of the leverage. For instance, if I increase my borrowing every year by 2%, but increase my wealth by 10%, I am using debt effectively. However, what happens if I increase my debt load by 10% each year and my assets only grow 2%? That's right, my equity will eventually evaporate.
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> When you look at the total, formal US bond market, including Treasuries, etc., the US has borrowed some $6.37 trillion in the secondary markets to generate an additional $3.20 trillion in GDP since 2008. This suggests we have either burned or eaten the cash as our IOUs stacked up, at least figuratively. But, hey, so far we aren't much worse for the wear.
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> But what happens if that ravenous investor demand vanishes? What if investors decide to dump all their corporate bonds, particularly so-called high yield corporate bonds? What if guys like my friend can't find a home for their deals? Basically, what if what happened to the subprime mortgage market in 2008 happens to the junk bond and corporate bond markets in the not so distant future?

Disclosure

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> Thanks to changes in the rules, banks now have less ability to provide the necessary liquidity if a fire sale in corporate debt occurs. Officially, it is referred to as a restriction on proprietary trading, and is intended to shift investment risk from bank balance sheets to investors. While arguably the way it should be, it does means the big pots of money will probably be on the sideline if things get ugly.
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> We aren't there yet, but, trust me, individual investors won't be able to backstop the $8.25 trillion corporate bond market if all hell breaks loose. That is more than a little worrisome, but I haven't started losing sleep yet."

Those last two paragraphs are key here. Thanks to the so-called Volcker Rule, part of the Dodd-Frank regulation package, banks no longer have the ability to bid on most securities for their own portfolios or inventories. For instance, imagine Fund X wants to sell a B rated credit which it prices at 85¢ on the dollar for accounting purposes. The traders at Firm Y might know the bond, like it, and be willing to pay, I don't know, 75¢ for it for the firm's investment portfolio. While less than the pricing services, it is decent enough to not wreck the Fund's net asset value, so X sells it to Y and moves onto something else….liquidity provided. Voila.

Well, that can't happen. Firm Y has to find buyers for thing, and basically act as a middleman. As such, in a distressed market like the one in 2008, guess what happens? Fund X ultimately sells the bond at maybe 35¢ on the dollar, which impacts the fund's value, which prompts more investors to sell the fund, which necessitates more trades like this one, and so on. You can call it a death spiral.

Now, IF we get to a corporate bond crunch, the well-meaning regulation(s) will only exacerbate the pain. Hey, the banks might be healthier, but the bond market and individual investors certainly won't be. Which is worse? I will tell you this: it is easier to bail out a few big banks and get back on track than it is to repair millions of individual investment accounts across the country.

Whew.

I would be remiss if I didn't spend at least a little time discussing the current markets; the last couple of days have been disenhearting. Frankly, it has been sloppy and frustrating. If things are so stable as to warrant a rate increase, thank you Fed, why is everything falling apart? Let me give you a paragraph from Bloomberg News:

> "The S&P 500 extended declines in the final 15 minutes of trading and volume soared Friday because of a quarterly event known as quadruple witching, when futures and options contracts on indexes and individual stocks expire. More than 12.5 billion shares changed hands across American exchanges, 71 percent above the three-month average and the most since the height of the summer selloff on Aug. 24."

Do you know who is the most active on days like today, when options and futures traders/investors have to make whole their positions? That's right, high frequency traders, and they can make a bad situation worse. Here is what a Terry Ponick had to say about it, and I thought it excellent:

> "Stocks have just become too damned volatile for individual investors, unless they can afford to devote seven days a week to researching the market. But even then, all the research and reasoning in the world can't derail the mindless activity of the accursed and likely illegal activities of high-frequency trading firms (HFTs).
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> These outfits—or rather their carefully programmed supercomputers—trade not on value or trend but strictly on rumor, innuendo and news headlines, all of which at times seem to be one and the same. Worse, by spoofing and/or pulling massive trades before they execute, they draw hedge funds, mutual funds and individuals with slower computers and longer latency periods into placing trades based on phony data.
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> HFTs are at it big time today, which is, as we predicted, the biggest quadruple witching Friday in recent memory with all manner of contracts about to terminate officially this afternoon. Given the general market battering in December, we can guess that the HFTs are carefully hunting down those unfortunate in-

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> vestors holding out of the money puts and will dump a ton of stock on them this morning and afternoon as a result.
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> That, for us at least, is why, save for a midweek short-squeeze respite, HFTs have been driving stocks down, down, down so they can exercise the puts against those who wrote them. It's a dirty trick. But it's who the HFTs are and it's what they do. No wonder fewer and fewer investors, including many pros, no longer trust these markets—markets that are allegedly "regulated" by the SEC. Talk about a toothless tiger."

There is a lot of truth to that….that and funds taking losses here at the end of the year.

With that said, expect things to stabilize next week, as the quadruple witching options/futures day probably stole a lot of the market volume from the remainder of the year. As a result, we will likely get back more to the basics for the last couple of weeks….which continue to be okay, but not great, making a robust forecast for 2016 difficult to make.

Have a great weekend.