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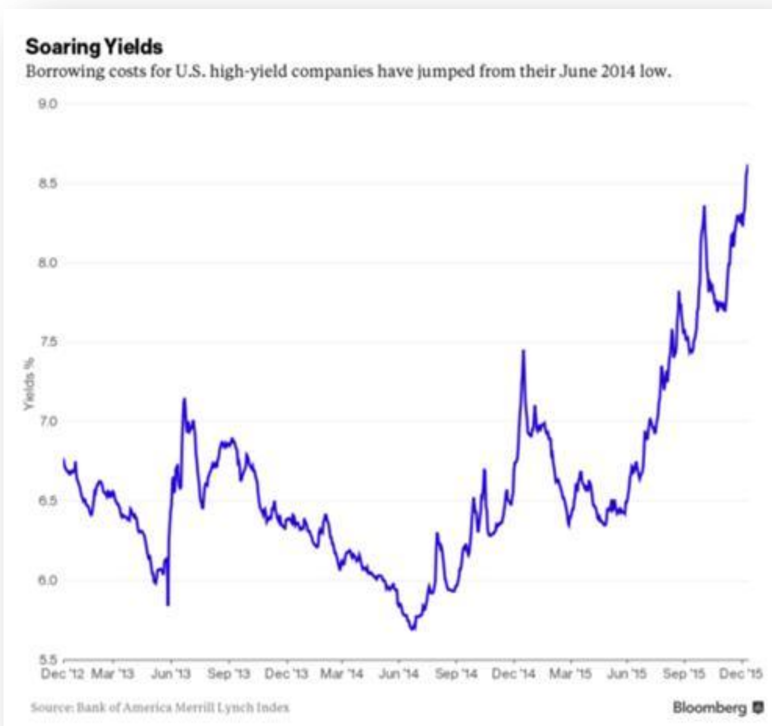
SOMETHING IS BURNING IN HIGH YIELD CORPORATES?

Junk Bond Crisis Starts to Metastasize

MACRO INSIGHTS



Gordon T Long

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A HUGE POTENTIAL PROBLEM

Since the Financial Crisis the US Federal Reserve has increased its balance sheet by approximately $3.5 Trillion. In this same period the Junk Bond (HY) issuers have issued $2.2T of debt which the markets have 'gobbled' up to achieve yield. The question is what happens if they start selling some of that debt to avoid capital losses. This problem is further compounded by regulations since the financial crisis has significantly curtailed banks making markets in these instruments. Many worry that Investment Grade (IG) bonds also issued over the same period will be "infected", especially with a historic $1.3T being sold for the first time in 2015 to significantly fund stock buybacks and dividend payouts. This is a "witch's brew" for a potential disaster.

CORPORATE LEVERAGE

With Corporate Leverage back to the point at which past default cycles started kicking in, there are more reasons to worry as corporate cash flow and EBITDA fall while the Federal Reserve raises rates.

Worsening cash flow to debt ratios normally force credit downgrades making credit more expensive and harder to get. This is coming at a time when major Junk Bond issuers in the Energy and Commodity sector are being hardest hit by falling pricing. They are trapped and investors know this and are now worried about junk bond liquidity.

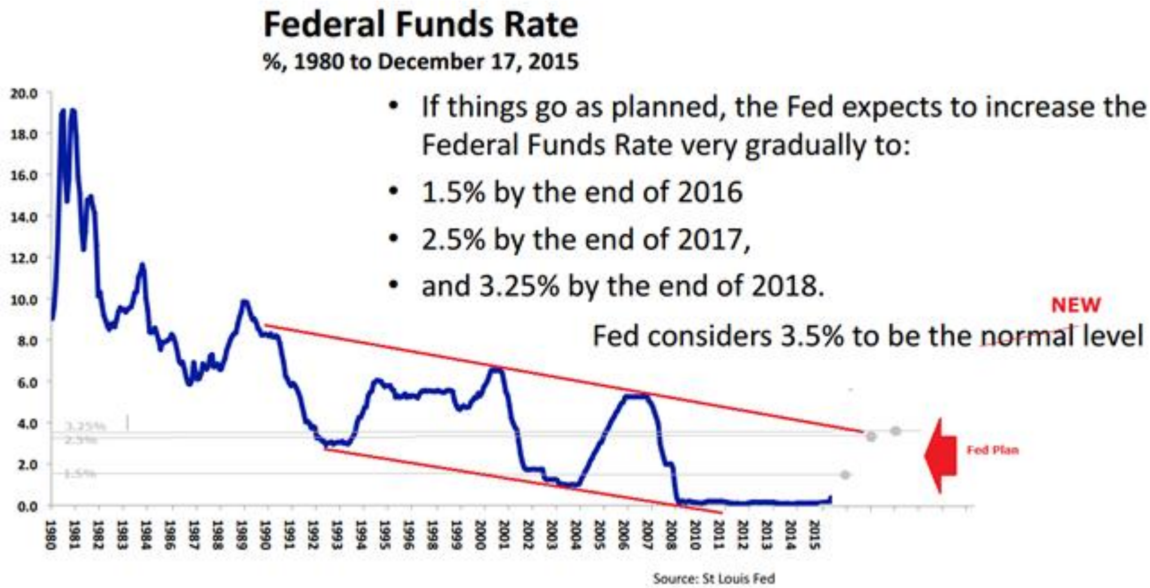
A SLOWING GLOBAL ECONOMY

It gets worse with a steadily deteriorating global economy which will bring further pressures to already troubling situation.

We have experienced a torrent of bad news coming as the Fed begins raising rates:

- Oil slump resumes on U.S. supply build, expected Fed rate hike
- Why the current credit crisis might be 35 times worse than you thought
- Freight Shipments Hammered by Inventory Glut, Weak Demand
- Baltic Dry Crashes To New Record Low As China "Demand Is Collapsing"
- US Markit flash manufacturing PMI slips to three-year low in December
- US industrial output falls as manufacturing stays flat
- Brazil's currency sinks after Fitch cuts rating to junk status

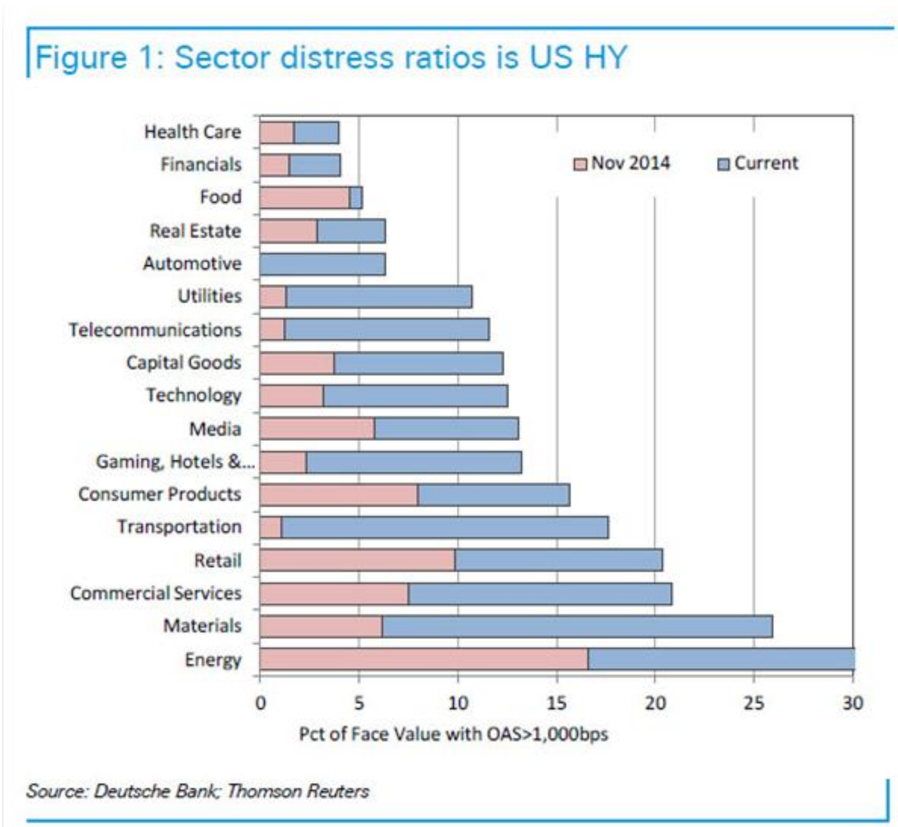
The question is whether the Fed will be able to follow through with its stated policy direction.



SOURCE: MACRO WATCH – *AVAILABLE AT GORDONTLONG.COM*

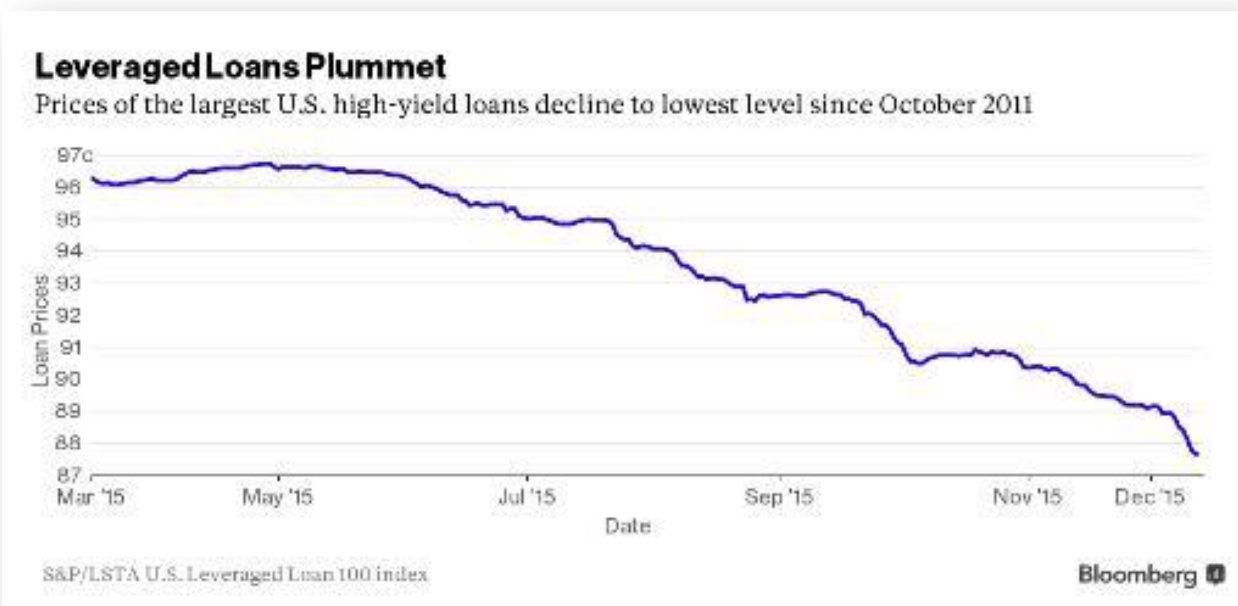
WORRY OF CONTAGION

The problems in the Junk Bond market are not isolated to just the hard hit commodity and energy sectors. The protracted period of "easy money" created by Fed policy has sowed its seeds across all economic sectors.

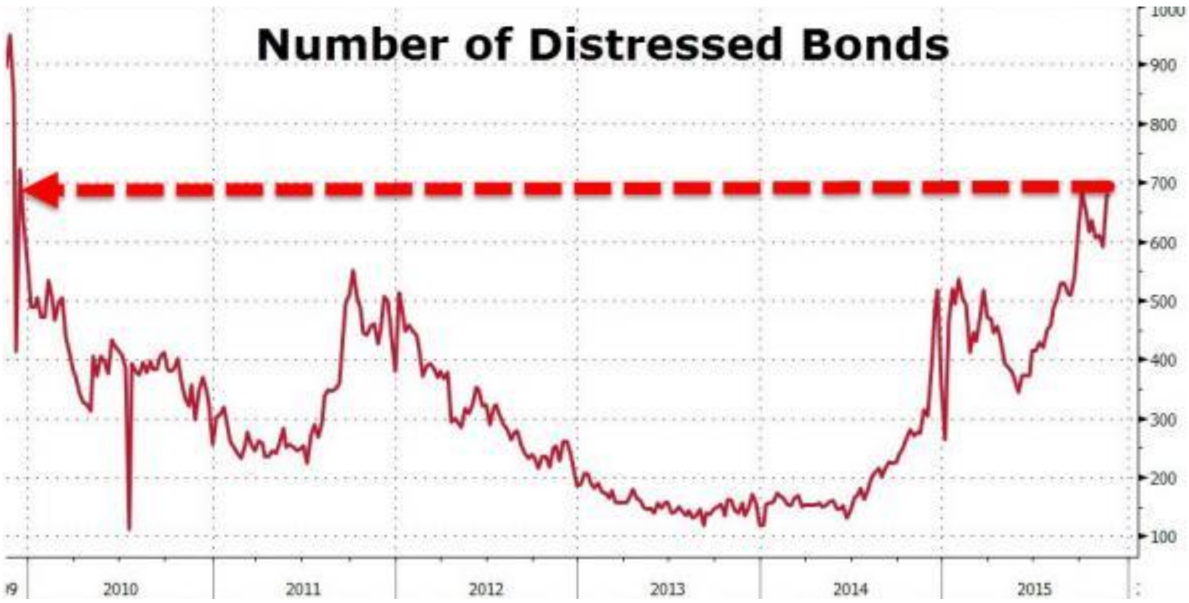


LEVERAGED LOANS

And now we see problems in growing in the Leveraged Loans (CLOs) market:



DISTRESSED BONDS



A CRITICAL 90 DAY WINDOW

The next 90 days are going to be both quite worrying to investors and highly volatile for the financial markets, as the Credit Cycle, Rate Cycle and Business Cycle all send confusing signals before the future economic direction becomes clear.

Let's all hope that is not spelled: "Recession".

There is comprehensive 31 minute video discussion by Gordon T Long and John Rubino available on YouTube: LINK https://youtu.be/tQ96JVERdu0

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