Cortland Credit Group Inc.
Distinct Debt Capital

Market Commentary
August 22, 2014

High Yield and Equity Returns – Birds of a Feather …

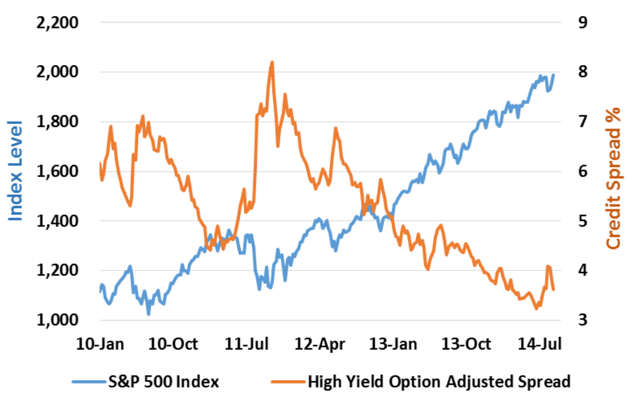
An important component of the job of *professional investment managers* is understanding relationships across classes of securities in the capital markets. It is critical to understand which risk categories tend to move in sync and what could drive the relationship to change. Such a relationship is that of equity returns and high yield credit spreads, depicted in Chart 1, below. There is a strong inverse relationship - spikes in high yield credit spreads (and associated declines in high yield bond values) have regularly occurred simultaneously with sharp drops in the major equity indexes. These are clearly birds of a feather that flock together.

However, the relationship is not perfect and further declines in credit spreads may be limited by minimum premiums required by the debt markets for taking on default risk.

The catalyst for change may be a second order relationship to volatility in the option markets - the correlation between credit spreads in the high yield sector and equity returns tend to move closely with declines or spikes in the VIX index (which tracks volatility implied by prices for short term options on the S&P 500 index). In other words, periods when the market is willing to pay more for options – such as for put options that provide downside protection - tend to coincide with a tightening relationship between tolerance for risk in corporate bonds and equities. A case in point was the recent spike in the VIX index from 10.3 early in July 2014 to 17.0 on the 1st of August 2014; at roughly the same time high yield credit spreads spiked from 3.23% to 4.09% - a 27% backup in the price demanded for taking on default risk.

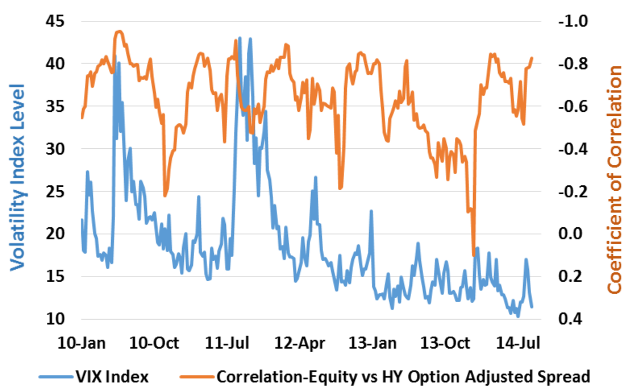
The inverse correlation between high yield credit spreads and equity returns has been rising sharply, reaching negative -0.82 in the last week. Cortland Credit's view is that the relationship will become less symmetrical going forward – credit spreads are so low that they can decline little if equity returns continue to be strong but those same spreads will rise quickly if we see a pullback in equity performance.

Chart 1:
High Yield Credit Spreads Have Declined With Rising Equity Returns But Have Little Room To Fall Further



Source: Bloomberg, Barclays US Corporate High Yield Average Option Adjusted Credit Spread.

Chart 2:
Correlation Of Equity Returns To High Yield Credit Spreads Has Been Tied To Market Volatility



Source: Bloomberg, Barclays US Corporate High Yield Average Option Adjusted Credit Spread, S&P 500 Total Return Index, Cortland Credit.

At Cortland Credit our team has deep expertise in the global debt markets and would look forward to your comments – send us your insights on what's happening in these charts and questions on how to invest in fixed income markets when rates are low and potentially rising.

Tel: +1-(416)-274-9992 | 2044 Bloor Street West, Suite 596, Toronto Ont., Can. M8X 2Y8 | www.cortlandcredit.ca

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