BULL & BEAR BULLETIN

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Red Flag Warning:

A Red Flag Ocean Warning is defined as a "high hazard, high surf and/or strong currents", cautioning potential swimmers that they should take extreme caution if entering the water. Similar to the beach warning flag system, there are signs that a red flag warning may be warranted for both the equity and high-yield bond markets. Investors' funds may be exposed to increased volatility, high risk, low returns and strong foreign exchange currents.

The stock market volatility index hit a 4-year high during the August and September market decline and the high-yield credit spread – the interest rate difference between what the market charges for a risk-free bond and a company that is similar to a subprime borrower – is more than 1.50% greater than the 5-year average spread (Chart 1). Both measurements are a way to gauge market fear and uncertainty. Traditionally, volatility events are quick in nature, but the expanding credit spread may be a sign of credit market deterioration and a pending decline in credit availability. If credit becomes more scarce as investor confidence declines, it may act as a significant headwind to the overall economy.

Despite the market volatility this year, market returns are relatively flat. The S&P 500 Index is up only 0.13% at the time of this writing and the Citi Corporate Bond Index is up just 0.09%. Both of these figures may lead an investor into believing that flat returns are healthy after several strong market years, but that may not be the case. On the bond side, the widening credit spread, as previously discussed, is a concern. On the equity side, the limited scope of market leadership is worrisome.

Broad weakness in the S&P 500 Index has been masked by a handful of stocks that have achieved superior returns year-to-date (Chart 2). When excluding the influence from these names, the overall Index would be down for the year. To demonstrate this point, the S&P 500 Equal-Weight Index, which negates a company's weighting to the Index and makes every stock's contribution to the overall performance equal, is down 3% YTD.

Finally, strong foreign exchange rate trends are producing a significant influence on most major markets. Following the conclusion of the Federal Reserve's monthly asset purchases, the U.S. dollar has strengthened significantly. The stronger dollar has popped the oil bubble, wreaked havoc on commodity-based economies like Canada and Australia and left many emerging markets with no choice but to raise interest rates (at the expense of their economic growth) in order to keep capital from leaving their borders. The net affect has left the global economy in a more fragile state and intensified deflationary forces. If the Federal Reserve follows through with its first interest rate hike in 9 years, there are concerns that it could lead to additional shifts in foreign exchange rates and several unexpected consequences.

While it is true that the labor market remains constructive in the U.S. and foreign central banks are still injecting liquidity into the global economy, it does not mean that markets remain without heightened risks. Investors should be mindful of these red flag warnings, with the novice investor better served to wait for a calmer environment before trying to navigate the markets. With risks elevated, any small policy mistake or further crisis in confidence could lead to the Double Red Flags closing of the beach.

Chart 1

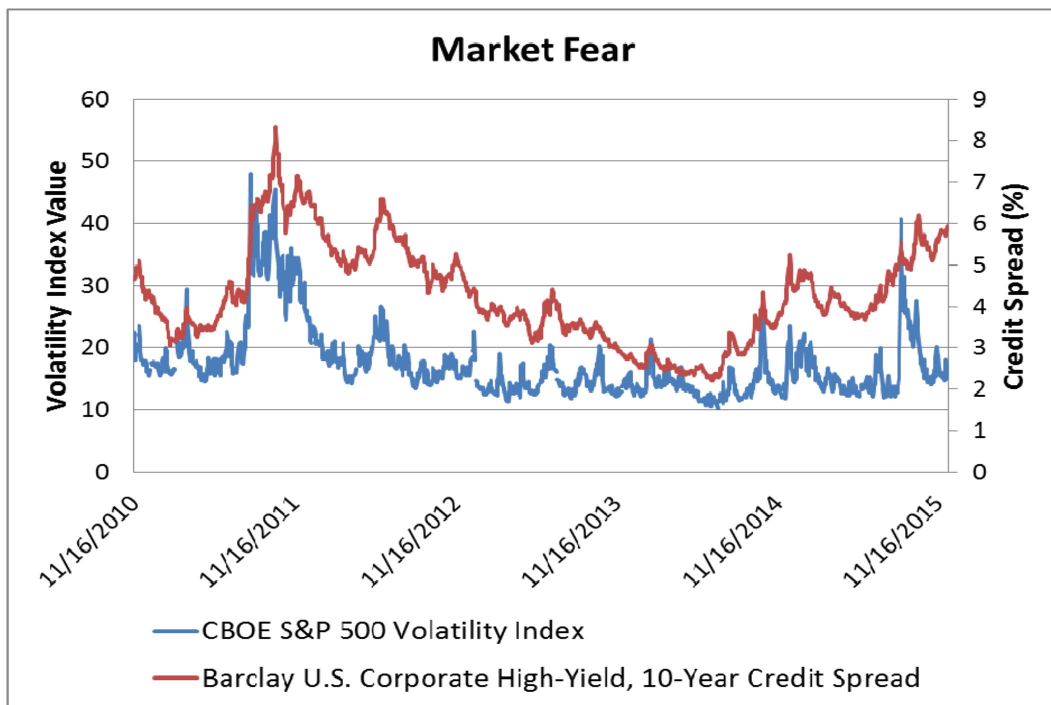
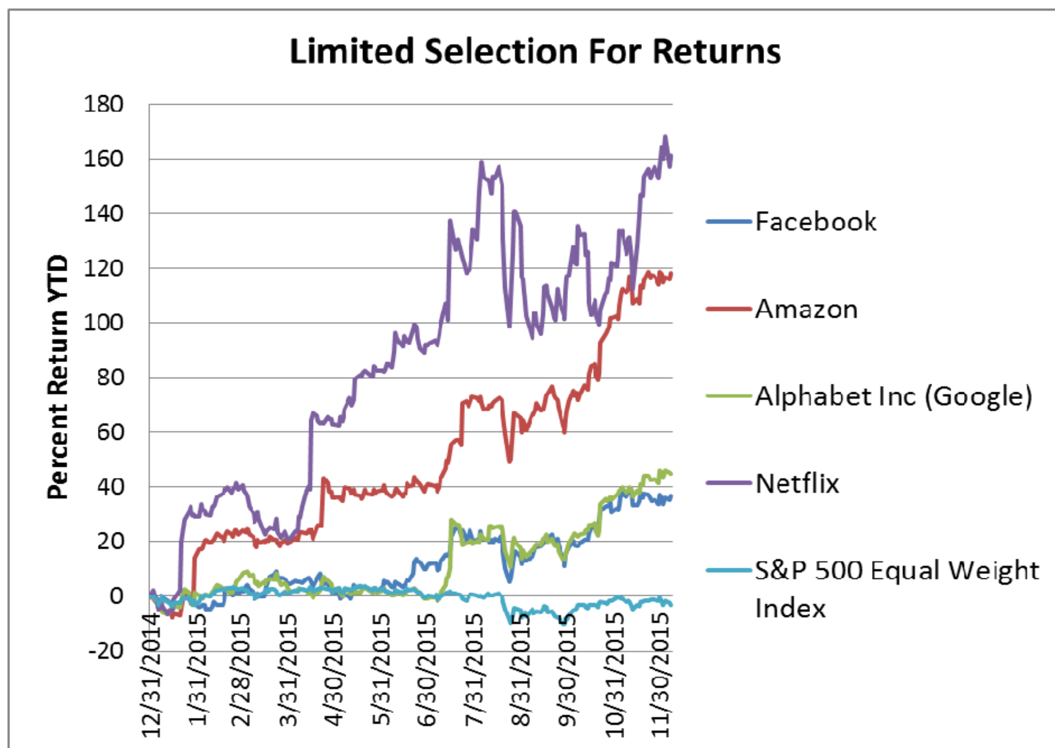


Chart 2



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