The High Yield Canary is Singing Again

In technical stock analysis, simple moving averages (arithmetically calculated by adding prices and dividing by the number of time periods, e.g., daily or weekly) are often cited as "lines in the sand" providing key support or resistance to a given security's price movement. Investors typically look at varying time periods, with 50 and 200-day moving averages the most used indicators for tactical trend following. The 50 and 200 are monitored independently as support or resistance, e.g., "is the security trading above or below the 50-day?" but also together to assess the strength of the overall trend. When the shorter (50-day) moving average crosses above the longer (200-day) moving average, this indicates that recent prices have been strengthening and is generally considered bullish. You may have heard the bullish 50/200 crossover referred to as a "Golden Cross" and when the opposite occurs it is commonly referred to as a "Death Cross." In the chart below, we can see that the S&P 500 has just experienced a "Death Cross" as the 50-day breached the 200-day.

Exhibit 1. S&P 500 Index, 50 and 200-day moving averages.

Chart courtesy of Stockcharts.com, commentary by Hanlon Investment Management.

While the S&P 500 Death Cross will be widely discussed, it was preceded by a similar bearish crossover in the high yield bond market, unsurprising since directional shifts in the corporate debt market often precede similar moves in equity markets (hence the old Wall Street adage, "the bond market is smarter than the stock market"). In the below chart of the iShares High Yield ETF (HYG) we can see that the Death Cross in high yield occurred more than a month ago.

Exhibit 2. iShares US High Yield ETF (HYG), 50 and 200-day moving averages.

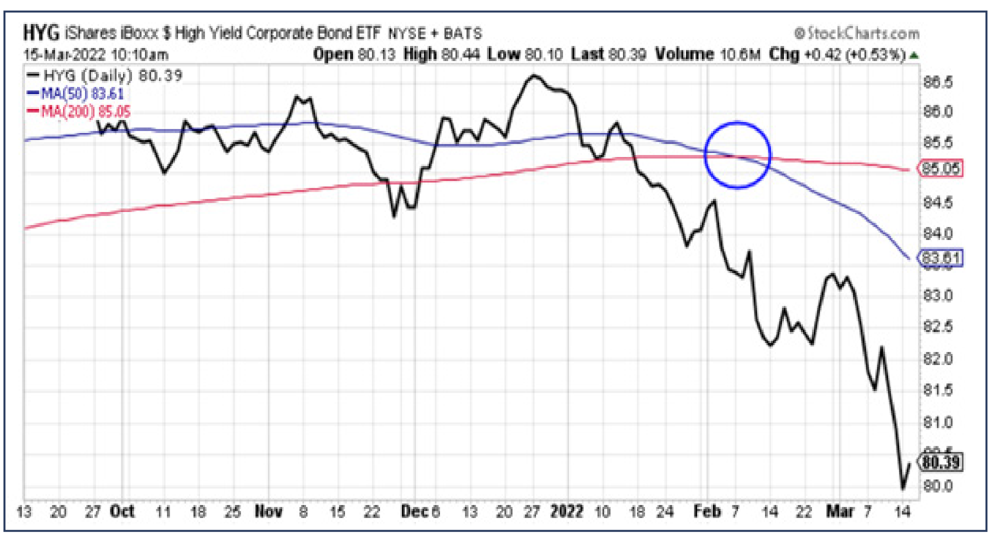
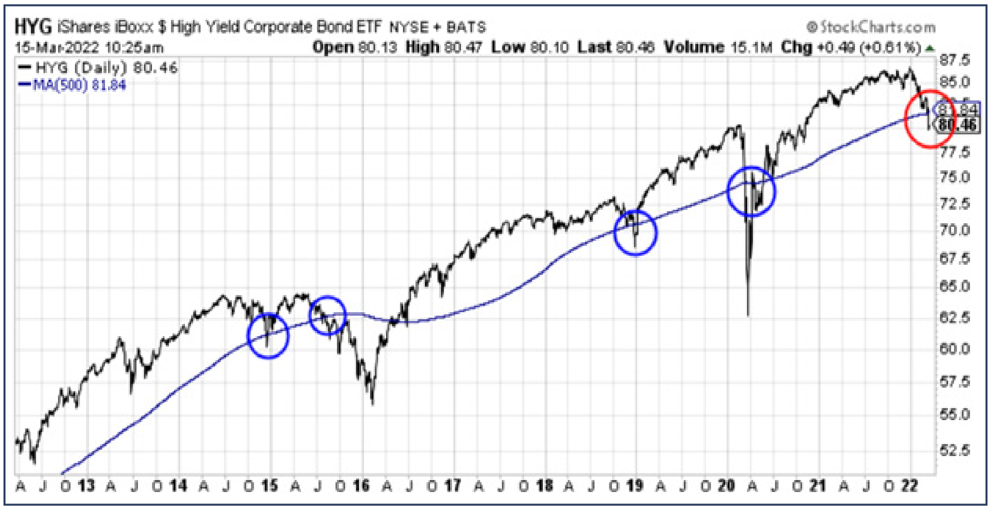


Chart courtesy of Stockcharts.com, commentary by Hanlon Investment Management.

If we step back from the crossovers and look at the moving averages purely from a support and resistance perspective, we see that the cracks in high yield emerged back in late November of 2021, when the 200-day (red line in the above chart) was first breached, although the price quickly recovered. The second breach in mid-January was more concerning, given the converging 50 and 200-day lines. Since then, we have seen a sustained downtrend with lower lows and lower highs in the price of HYG, and both the 50 and 200-day lines are now resistance levels (meaning a recovery to those levels could be met with selling).

If prior support levels now represent resistance, then where do we find new support? Typically, we extend the moving average length and look for longer term price support. The 500-day moving average is a good start, as it represents almost two full trading years of price data. Unfortunately, the 500-day has also now been breached, a potentially ominous and infrequent occurrence. In the below chart, we can see that HYG has broken below the 500-day just 4 times prior in the last 10 years. Two of the trips below the 500-day were brief but two were severe. In August 2015, HYG fell -9.4% after breaching the 500-day, and in the COVID selloff of 2020, HYG sold off by nearly -17% after breaking below the 500-day.

Exhibit 3. iShares US High Yield ETF (HYG), 500-day moving average.



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Presently, it is uncertain whether this most recent breakdown of the 500-day moving average portends a major high yield crash or a near-term bottom. High yield certainly faces intense headwinds, as the government support during COVID fades, borrowing costs rise, inflation runs unchecked, and war in Ukraine threatens market, economic and global stability. The high yield bond market is coming off arguably its best run ever; after the Federal Reserve rescued it in 2020, declaring for the first time ever that they would be buyers of high yield corporate bonds, default rates plunged to historic lows and high yield borrowers feasted on cheap credit and refinanced existing debt at rock-bottom rates. The Fed party is over, however, and rumblings of recession are growing. If high yield is once again acting like the proverbial canary in the coal mine, it would be foolish to ignore what the moving averages are telling us.

Note on Hanlon's current model positioning:

For those clients in Hanlon Tactical Models, we exited our high yield positions in November 2021. We also incrementally sold off our equity exposure in late 2021 through early 2022 and as of this writing, are fully defensively positioned (holding cash) in our equity allocations. For clients in Hanlon All-Weather models, we eliminated the tactical high yield allocation in August 2021, and the tactical equity allocation (via the Hanlon Tactical Dividend and Momentum Fund, ticker HTDIX) has moved to cash giving All-Weather clients approximately 10-25% cash exposure, depending on their model risk allocation.

Thank you, as always, for the opportunity to let us serve you.

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