Commodity Bust Continues to Drag Markets Lower

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Equity markets worldwide have declined sharply since the commencement of 2016. Through January, the S&P 500 and the High Yield Bond Markets are down -7.26% and -1.96% respectively. This is a result of deteriorating credit markets and a contraction in global liquidity.

In the credit markets, lower bond prices reflect investor concerns over potential bond defaults or bankruptcy of companies in the energy and other commodity related sectors. Their concerns are not unwarranted. In the first three weeks of January, oil declined almost 30%, primarily due to an increasing glut of additional Iranian oil supply, just as Saudi Arabia and Russia (the world's largest producers) continue to produce at a record rate. [In addition, US shale supply did not decline as much as previously anticipated.]*

The High Yield market was especially hard hit, as energy comprises as much as 15% of the outstanding debt. High Yield spreads widened by over 100 basis points since the start of the year and now match the levels of 2011. We are happy to report that SSI was under-weighted in Energy, which lead to favorable results when compared to the Index and many of our peers.

Another major factor was the contraction of global liquidity. Last year the Fed was signaling that it would be normalizing monetary policy by hiking interest rates. This resulted in considerable dollar appreciation in 2015 relative to the Euro and Yen at a time when both Europe and Japan have been pursuing monetary easing. Meanwhile China, that was already suffering a sharp slowdown as it transitions from investment lead growth to a consumption based economy, has been trying to unpeg the currency from the ever appreciating US dollar. The combination of slowing growth in China and expectations about the path of the currency, has led to a capital flight from China to the tune of $1 trillion in 2015. The Chinese Central Bank (PBOC) has contracted its balance sheet as it has been losing its foreign exchange reserves. The Federal Reserve did not help in this environment of tightening liquidity when it decided to hike the fed funds rate by 25 bps on 12/16/2015. This global liquidity contraction has accentuated the selloff in risk assets both in the credit and the equity markets.

The good news is that the U.S. economy is not highly dependent on energy, commodities and natural resources, nor is it highly dependent on exports. Because of this, a domestic recession is unlikely. Nonetheless, pressures continue in the Energy sector, manufacturing is weak, the US Dollar is strong, and the Fed is becoming less accommodative. While corporate earnings have a strong foundation, generating growth will be increasingly difficult. Equity investors should expect modest returns with greater volatility.

The Convertible market is well positioned in this environment. Convertible issuers skew towards sectors like health care and technology and generally have stronger balance sheets and lower debt profiles than high yield issuers. In addition, the income and valuation profile is better than it has been for some time- convertibles trade at a discount to theoretical value, and are cheaper than their long term average, a scenario that has historically produced significantly positive returns.

While no guarantee of future performance, when we consider the valuation metrics, we believe SSI's Convertible Portfolios are positioned to perform well in 2016 and beyond. Long Only Convertibles have the ability to capture broad equity market upside while establishing a soft floor that limits downside risk through the bond component. SSI's Hedged Convertible Portfolios provide investors with enhanced income while hedging out the risk of the equity market. Both strategies are structured to benefit diversified asset allocation in these volatile times. We encourage you to visit our website and learn more about SSI's Convertible Strategies. www.ssi-invest.com

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