Cash Is Prince
Markets tremble at prospect of diminishing central bank support

After a highly range-bound summer, financial markets met with sudden volatility in September. We look at the causes and consider whether the recent market tumult is a sign of things to come.

From mid-July through the end of the first week of September, the yield on 10-year U.S. Treasury Notes never strayed more than ~8 basis points (bps) from 1.55%. They were not alone in their low-volatility world; S&Ps traded within a 1.6% range while the Chicago Board Option Exchange Volatility Index (VIX), otherwise known as the fear gauge, lay dormant between 12 and 13, close to its all-time lows.

Markets were not only stable but also, from a fundamental basis, rich. The S&P 500 touched new all-time highs in mid-August. More importantly, the cyclically adjusted price-to-earnings ratio (CAPE) moved north of 27, just a hair below its 2007 peak and in the 95th percentile for the past 140 years. Of course, rich is relative. Stocks may be expensive relative to their own historical norms, but they are arguably attractive relative to bonds. With some $12 trillion (that’s $12,000,000,000,000) in global sovereign debt trading with negative yields, it’s not difficult to look cheap by comparison. At 2.1%, the dividend yield of the S&P 500 is over 30% higher than 10-year U.S. Treasury yields.

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There are plenty of examples of markets that are rich but look cheap in comparison to alternatives. Consider Treasury Inflation Protected Securities (TIPS), long the punching bag of the U.S. Treasury market. As of the end of September, 10-year TIPS traded with a real yield of zero. Yet when compared with nominals, 10-year TIPS traded at a breakeven rate of 1.60%, some 70bps below current, and rising, core CPI. 30-year TIPS trade at 0.59% — scant return for the highest duration bond issued by the U.S. Treasury. But compare them with UK 50-year linkers (UKTi), which trade with a real yield of -1.77%.

Years ago, a colleague of mine compared the assets in the global relative value matrix to stones in a bridge, with the valuation of each supported by that of the asset next to it. No asset is evaluated in a vacuum, and every market looks attractive when put side-by-side with another. That is, of course, until you get to the keystones holding global markets and our metaphorical bridge together: Japanese government bonds (JGBs) and German bunds. 10-year JGBs and bunds closed September trading on either side of -0.10%, having cheapened from their yield lows of -0.30% and -0.19%, respectively, reached in the weeks following the Brexit vote. (As an aside, sales of wall safes in Japan are through the roof. Is it any wonder – at least the safe gives you 100% of your money back.) The extreme valuation of global financial assets begs the question — what happens to our metaphorical “value bridge” if the twin keystones cheapen further? At one point does the whole thing collapse? For a few days in mid-September, it seemed as though we might find out. As Commonwealth Financial Network CIO Brad McMillan said, “Volatility doesn’t go away. It gets stored up.”

On Thursday, September 8, the S&P 500 Index closed just 0.3% from the all-time record set in August. The index dropped by over 2.5% that Friday and fell even further early the following Monday, trading down 3.3% from Thursday’s close before finally finding support. In the span of just over one trading day, the market fell by more than twice the entire trading range of the prior seven weeks. The VIX jumped to over 20, a level last reached in the immediate aftermath of the Brexit vote. Emerging markets plunged 5%. Stocks weren’t alone as all financial assets were hit. U.S. Treasuries sold off by close to 30bps, with the long bond’s value dropping 5% in a week. 10-year bunds sold off 20bps, back into positive territory. Even 10-year JGBs reached positive yields, briefly trading 30bps above their post-Brexit lows.

To understand the September sell-off we must first acknowledge the primary factor driving both market valuation and low volatility: central banks. Through zero and negative interest rate regimes and asset purchase programs, monetary policy has pushed financial markets to the extreme levels discussed above. Incredibly, net sovereign safe-haven bond issuance minus central bank purchases is zero. In other words, there are no “safe” assets left for savers to buy. This forces return-seeking investors, through former Federal Reserve Chairman Ben Bernanke’s portfolio balance theory, to take on more risk – credit, duration, liquidity, etc. – than they would otherwise tolerate. Given current asset valuations, investors might argue so far so good, other than a “hiccup” three years ago when the Fed announced the eventual tapering of its asset purchases. But where do asset valuations go from here? Monetary stimulus was supposed to bridge the gap until the global recovery took over, but that recovery has taken longer than anticipated. Eight years after the financial crisis and global growth is anemic, inflation remains stubbornly below target, corporate profits are declining and the risks of the next recession loom just over the horizon.

Moreover, the dearth of worthy investment options isn’t just impacting savers. Corporations have increasingly chosen to return cash to investors – through share buybacks – rather than invest in plants and equipment. This, in turn, has weighed significantly on productivity growth, currently a paltry 0.7% YoY in the U.S. As several Fed speakers have noted in recent months, including Chair Janet Yellen at the Jackson Hole Symposium in August, weak productivity growth brings down potential GDP growth and, in turn, the long-run neutral interest rate (r*). Fed officials have emphasized the need for growth-friendly fiscal policy and regulations and, in doing so, the limits of monetary policy. They are not alone as their counterparts in the European Central Bank (ECB) and Bank of Japan (BoJ) have voiced similar reservations.

Against this backdrop, at his press conference following the ECB meeting on September 8, ECB President Mario Draghi equivocated while expressing his commitment to further monetary easing. With traders already nervous about the limits of central bank accommodation, overvalued markets – stocks and bonds alike – quickly came under pressure. Adding significant fuel to the fire, Fed Governor Lael Brainard was listed as the keynote speaker at the Chicago Council on Global Affairs the following Monday, the final day before the Fed blackout period ahead of the Federal Open Market Committee meeting the following week. Speculation that she could signal a September hike sparked a sell-off in fed fund futures that spilled over into every asset class.

In the big picture, the resulting 3–5% market corrections were not huge. They seemed bigger in part due to the period of pronounced market calm that preceded them. But for a few days in September, panic crept into traders’ psyches as the prospect of repricing every asset class without the benefit of central bank support sparked concerns of a 2013 “Taper Tantrum” redux. Since all asset classes had benefited from excessively easy money, no asset class would be spared with its removal. Cash was king.

Except, of course, it wasn’t – at least not yet. Governor Brainard turned out to be as dovish as ever, the Fed held rates steady at its meeting the following week, and the BoJ introduced a 0% 10-year rate target, sending interest rate volatility back into the witness protection program. The Fed indicated a clear preference to hike once later this year – call her “Yearly Yellen” – but it also lowered its guidance for the path of future rate hikes and continues to make every effort to avoid disrupting markets and thus triggering an overtightening of financial conditions. As September came to a close, 10-year yields traded at 1.60%, comfortably back within their narrow August range. The S&P 500 closed within 0.5% of its record and the VIX was back to trading with a 12-handle.

As for cash? Cash remains prince. One day, maybe soon, it will be king. But with global central banks still backstopping financial markets, that day is not today.

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1 Otherwise known as the Shiller P/E or P/E 10 ratio, the CAPE is defined as the price divided by average earnings over the past 10 years, adjusting for inflation.
2 The Wall Street Journal
3 Bloomberg
4 Morgan Stanley Rates Research
5 Indeed, with monthly purchases of €80 billion, the European Central Bank is running out of qualified assets to buy under its current rules, prompting ECB President Mario Draghi to state in his September press conference that ECB committees have a “full mandate” to redesign quantitative easing going forward.
Significant Opportunities Exist to Capitalize on the Favorable Financing Environment

- Amid low interest rates and loose covenant protections, borrowers continue to capitalize on the favorable financing environment.
- Total leverage through 3Q 2016 for middle-market issues with less than $50 million of EBITDA averaged 5.1x, which is down slightly from the 2015 average of 5.4x, but still well above historic levels.
- Senior stretch loans (hybrid asset-based and cash flow loans) are prevalent given current market dynamics.
  - Conditions exist for debtors to cover all leverage needs with senior debt at senior debt pricing (versus higher mezzanine debt pricing).
Market Snapshot: Municipal Bonds

Municipal Bond Fund Flows and Municipal Market Data (MMD)

Over the last several months there have been positive fund flows averaging more than $640 million per week. 20-year MMD has remained attractive based on a historical basis. We expect future Fed decisions to have an impact on weekly fund flows going forward.

Credit Spreads

- After nearly a year of positive cash flows into the municipal bond fund complex, the trend began to reverse in October. A back-up in interest rates (U.S. Treasury 10-year yields) that began in July had a second leg during the last week of September, setting the stage for the reversal of mutual fund flows that materialized during the first week of October.

- High-yield fund flows have been more strongly negative, and spread widening can be expected to be correspondingly strong in the BBB sector. Inefficient price discovery on non-investment grade bonds generally obscures any measurable market reaction in the early days of a trend reversal, but continued negative high-yield flows can be expected to expose widened spreads over time.

30-Year Credit Spreads

Source: The Municipal Market Monitor (TM3)
Market Snapshot: Corporate Debt

Corporate Debt Spreads – Finance Market Summary

- Corporate yields and spread levels continue to be at or near historically "low" levels across the credit spectrum.
- Despite commentary predicting a sell-off in the corporate debt arena, year-to-date interest rates and spreads have remained stable, though the future is unclear due to political and global economic factors.

Strategic Opportunities Involving Real Estate Are Worthy of Consideration Given Favorable Market Conditions

Opportunity Knocks:

- Routinely structuring subordinate debt tranches on a zero amortizing or partially amortizing basis has enabled borrowers to realize greater proceeds than realized historically. This has increased transaction volume over the past few years, with the trend continuing.
- Many corporations are considering sale-leaseback or acquisition opportunities due to favorable real estate valuations, favorable leasing terms and strong capital market conditions for all financing capital tranches.
- Capital availability on favorable terms for acquisitions and refinancings of strategic properties remains robust for involved borrowers.
Featured Mesirow Financial Deals

**Acquisition Financing for Verizon Regional Headquarters**

Mesirow Financial successfully acquired the 51.2-acre, 1.15-million square-foot Verizon regional headquarters located in Irving, Texas, valued at $344 million. Verizon will lease back the full property for a 20-year term with options to extend. Mesirow Financial's Sale-Leaseback Capital group arranged for the purchase of the facility and the acquisition financing was structured in collaboration with Mesirow Financial's CTL and Structured Debt Products and Institutional Sales and Trading groups. The CTL financing, together with last year's Verizon operations center sale-leaseback, are among the largest non-government single asset credit tenant lease transactions ever consummated. “This transaction provides our company with immediate financial benefits and does so in a way that supports our continuing interests in the development of Las Colinas,” said Verizon’s senior vice president and head of global real estate.

**M&A Sell-side Advisor to Sypris Solutions**

Mesirow Financial acted as the exclusive financial advisor to Sypris Solutions (NASDAQ: SYPR) in the divestiture of the Cyber Security Solutions (CSS) business of Sypris Electronics to Analog Devices (NASDAQ: ADI). Mesirow Financial's Investment Banking group marketed CSS, a leader in secure system and software products and technology, to both strategic buyers and financial sponsors. Sypris Solutions ultimately entered into a purchase agreement with Analog Devices, a designer and manufacturer of analog, mixed-signal and DSP integrated circuits, and the transaction closed in August 2016. The president of Sypris Electronics commented on the transaction, “Our CSS capabilities coupled with ADI’s solutions have the potential to transform the levels of trust that can be achieved in the next generation of secure solutions at the intersection of the physical and digital worlds.”

**Sole Senior Manager for East Aurora Illinois School District 131**

Mesirow Financial’s Public Finance group recently completed an $85 million multi-phase finance plan that enabled East Aurora School District 131 to take maximum advantage of a Qualified School Construction Bond (QSCB) federal tax credit borrowing program. The QSCB program originated under the Federal Stimulus Plan of 2009-10 and the District received an allocation of QSCBs from the Illinois State Board of Education after submitting a strong application. The initial phase entailed a $34.5 million non-rated interim limited institutional offering that was marketed to sophisticated investors and enabled the District to obtain maximum tax levy-backing. The final phases of $15.5 million and $35 million were sold as 25-year bullet maturities to maximize the federal subsidy and lock in net borrowing costs of well under 1%. The Bonds were rated A+/A1 by Moody’s and Standard & Poor’s, respectively, and carried an enhanced AA by virtue of an insurance policy issued by Assured Guaranty Municipal.
Capital Markets
Established broker-dealer offering a suite of innovative financial products and services combined with extensive market expertise to serve the unique liquidity needs of your institution.
- Credit Tenant Lease Finance
- Fixed Income Sales and Trading
- Public Finance
- Sale-Leaseback Capital
- Structured Debt Products

Investment Banking
Boutique M&A advisor serving the middle-market and providing customized solutions to meet the unique needs of our clients.

About Mesirow Financial
Mesirow Financial is an independent, employee-owned firm founded in 1937. As specialists in investment, risk management and advisory services, we are committed to helping our institutional, corporate and individual clients achieve their objectives. Our professionals are inspired by an entrepreneurial desire to develop tailored solutions that deliver measurable results. To learn more, please visit mesirowfinancial.com.

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