

NICHOLAS INVESTMENT PARTNERS

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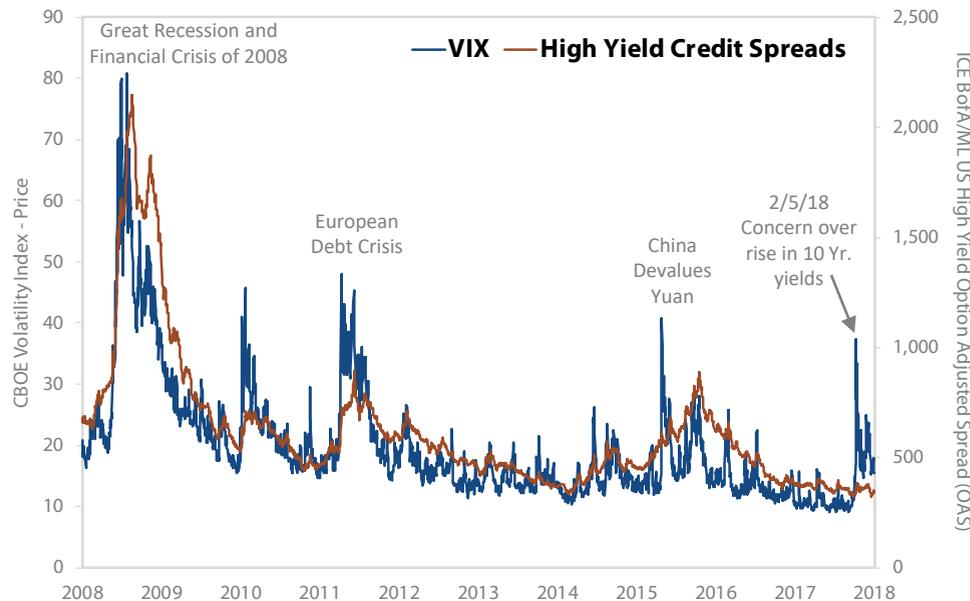
Investment Insights:

Surprising Divergence Between VIX and High Yield Credit Spreads Signals Economy and Corporate Earnings Stronger Than “Fear Gauge” Suggests

As a specialist in small- and mid-cap companies, investing in both equities and convertibles, we keep a close eye on the credit markets as an early tell on sentiment toward risk assets. In early February, the Chicago Board Options Exchange (CBOE) Volatility Index or “VIX”, sold off dramatically. Equity markets also sold off, entering correction territory defined as a drop of 10% from a previous high. Surprisingly, despite a few 1000-point daily swings in the Dow Jones Industrial Average (DJIA) and record volatility in the VIX, high yield credit spreads barely budged.

As shown in the chart below, the VIX and high yield credit spreads have historically been highly correlated, trading similarly in “risk-off” events such as the Global Financial Crisis of 2008 and the European Sovereign Debt Crisis of 2011. For example, when the VIX hit a high of 80.86 in 2008, high yield spreads blew out to +1337 bps above 10-year Treasuries, as measured by the ICE BofA ML High Yield Option-Adjusted Spread.

VIX versus High Yield Credit Spreads – 10 Years ending March 8, 2018



Source: FactSet, Nicholas Investment Partners. Supplemental information. Results may vary for different time periods.

The Monday, February 5th spike in the VIX was likely more a result of crowded trade and structural issues with products tracking the VIX than broader economic or market concerns. The VIX had been trending down over the last two years to hit record lows. The sharp rise in the VIX caught a subset of investors off guard, including short-volatility strategies implemented through ETFs and ETNs, strategies betting on the inverse of the VIX or continued low or falling volatility. That trade worked well, until it didn't. It particularly hurt investors in the VelocityShares Daily Inverse VIX Short-Term ETN (XIV), issued by Credit Suisse, and the ProShares Short VIX Short-Term Futures ETF (SVXY), which were both down over 80% in the hours after the VIX spiked.



John Wylie
Portfolio Manager
Convertibles
Convertible Arbitrage
Back-up PM, equity strategies

KEY TAKEAWAYS

- February spike in VIX was likely due to trading inefficiencies, not fundamentals
- High yield credit spreads remain relatively low and stable, suggesting fundamentals are strong



Importantly, the volatility was not a flash-point for broader, sustained selling of risk assets. In fact, the sharp February move may be construed as a healthy reset of the VIX back to its historic and more sustainable average of 19.

We believe that volatility is likely here to stay as this business cycle enters its final innings and the Fed seeks to balance growth with growing inflation, prompting the possibility of four interest rate hikes by the end of 2018. Global synchronized growth remains on solid footing with the IMF raising their global GDP forecast to 3.9% for both 2018 and 2019. Q4 earnings and revenue growth has been strong, with broad-based earnings beats. 2018 earnings revisions also continue to rise with expectations of continued economic strength and tax relief.

We have strong conviction that the fundamental strength of the companies held across our convertible and equity portfolios will sustain the earnings and revenue growth acceleration we forecast. We believe that the combination of equity and credit research we do provides differentiated insights that benefit our portfolios, especially in regards to assessing potential risks. In a time of increased automated trading activity and heavy use of passive instruments like ETFs and ETNs, we believe selectivity and active management are increasingly important.

ABOUT US

- Nicholas Investment Partners, L.P. is an independent, employee-owned and majority women-owned investment boutique focused on investing in dynamic, less efficient markets such as US small- and mid-cap equities and convertible bonds. We believe that change creates opportunity. We invest in dynamic companies with accelerating revenue and/or earnings growth in which our research confirms the company's growth is sustainable and the company's stock is a timely investment.
- Our edge comes from combining fundamental equity and credit research with the objectivity and efficiency of quantitative analytics. We have a results-driven and client-centric culture centered on building lasting and value-added relationships with a select group of institutional and private wealth clients and consultants.

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Meredith Genova

Director of Sales & Marketing
mgenova@nicpartners.com
858-381-8176 (direct)
646-573-9248 (cell)

Laura DeMarco

Partner/Director of Client Service
ldemarco@nicpartners.com
858-381-8181 (direct)
858-692-5194 (cell)

Tammy Wiseman

Partner/Client Service & Marketing
twiseman@nicpartners.com
858-381-8183 (direct)
619-857-1195 (cell)