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High-yield bonds: Attractive yields, even now

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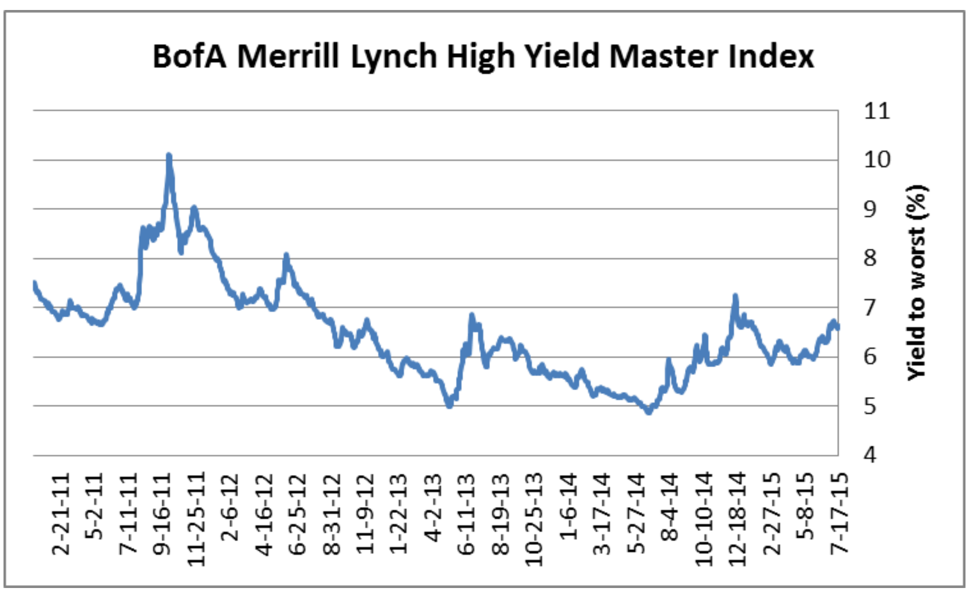
Summary

- Yields in the high-yield segment of the corporate bond market are now, on absolute and relative terms, as attractive as they have been in the past three years.
- If the bond market reacts adversely when the Federal Reserve (Fed) raises the federal funds rate, the Fed will likely pause in its policy normalization process, which we think will keep rates low into the near future.
- Today, yields in the high-yield bond market, in our view, are sufficient to allow it to perform reasonably well in the type of slowly rising rate environment we envision for 2015–2016.

It has been trendy these past few years to joke that *high-yield bond* is an oxymoron. In this view, bond yields have been so low, no bond should be called high yield. Years ago, these below-investment-grade issues were called junk bonds. Should we revive that name because yields are low? That might have been advisable a year ago, but not today. Yields in the high-yield segment of the corporate bond market are now, on absolute and relative terms, as attractive as they have been in the past three years.

The chart shows that since mid-2012, the yield to worst from the Bank of America (BofA) Merrill Lynch High Yield Master Index has been higher than the current 6.65% only briefly. As recently as a year ago, that yield was a record low of 4.85%, and a yield almost that low in 2013 also proved to be unsustainable. Apparently, at those yields, investors decided that they were not being compensated adequately for the risks associated with owning below-investment-grade bonds.

Yields in the high-yield bond market have increased significantly since last year



Source: BofA Merrill Lynch High Yield Master Index

Spreads to Treasuries also were exceptionally low a year ago, when the spread between the index yield and the 10-year Treasury yield was approximately 225 basis points (bps; 100 bps equals 1.00%)—even narrower than in 2007.

Spreads that narrow were unsustainable in 2007 and again last year. Now, however, that spread is almost 450 bps, near the peak of the past three years and above the postcrisis average of 435 bps.

A bear market in bonds: Signs point to "no" for the high-yield market

We often hear that the 30-year bull market in bonds ended in 2012 and that a bear market likely will begin when the Fed starts raising the federal funds rate later this year. We have argued that in a slow-growth, low-inflation global economy, the cyclical rise in short-term rates and in bond yields is likely to be slow and relatively moderate. Fed officials have said that they do not want to push bond yields sharply higher. Indeed, according to several Federal Open Market Committee members, if the bond market reacts adversely when the Fed starts raising the federal funds rate, the Fed will probably pause in its policy normalization process. This, we believe, will keep rates low into the near future.

In our view, as the Fed tightens, sharply higher bond yields are unlikely, but a moderate rise in Treasury yields would not be surprising. In that event, the higher yields and wider yield spreads now in place could make the difference between positive and negative total returns. For example, since reaching the low of 1.40% in July 2012, the yield on the 10-year Treasury note has risen to around 2.40%. To some, that might qualify as a bear market. Over this three-year period, the total return on that note was -0.80% cumulative or -0.25% annualized, while the total return from the BofA Merrill Lynch High Yield Master Index was 20.33% cumulative or 6.45% annualized. When the 10-year Treasury yield was 1.40%, the high-yield index yield was 7.15% and the spread was almost 575 bps. Thus, the high-yield market was well cushioned against a rise in Treasury yields.

Today, yields are not as high and spreads are not as wide, so the performance of the high-yield market over the next three years might not be as formidable as it was over the past three years. For example, if we assume that the Fed's projections are accurate and the federal funds rate reaches 3% by the end of 2017, the yield on the 10-year note could be around 4% and yields on BB-rated 10-year notes might increase from around 6% today to around 7%. Under those (in our opinion, reasonable) assumptions, the cumulative return from the high-yield note would be around 9.40% versus -4.15% on the 10-year Treasury three years from now. This type of scenario analysis illustrates the importance of incremental interest income to total returns in a rising-rate environment.

Default risk is not a near-term concern for high-yield investors

A cyclical rise in interest rates is typically not the greatest risk to investors in high yield. An increase in defaults is usually much more damaging. History shows that the principal cause of a rise in defaults is a recession. Recessions are almost always preceded by the emergence of capacity constraints, a significant rise in inflation rates, and Fed tightening that pushes short-term rates sharply higher. Because in today's cyclical expansion, gross domestic product growth has been at approximately half of the rate seen in previous cycles, none of those recession predictors are yet in view. The economy is operating well below capacity, inflation remains very low, and the federal funds rate is likely to stay unusually low for the foreseeable future.

To be sure, noncyclical events can create credit problems. The drop in oil prices last year is an example. It increased the risk of defaults in the oil and gas industries, and that contributed to the rise in yields in the entire high-yield market late last year. Such events tend to be most damaging when yields and yield spreads are relatively low. At the higher yields and spreads now in place, the market is better able to absorb narrowly focused credit problems.

Compounding interest income is the best defense against potential price declines

By past standards, yields in the 6%–7% range for BB/B credits maturing in 10 years may not seem high, but in a slow-growth global economy, low bond yields are the norm, not an anomaly. Yields will probably not stay this low indefinitely, so preparing for a slow cyclical rise is appropriate. The best defense against the price declines that would accompany a rise in yields is compounding interest income. Today, yields in the high-yield bond market are significantly higher than a year ago and, in our view, are sufficient to allow the high-yield segment of the corporate bond market to perform reasonably well in the type of slowly rising rate environment we envision for 2015–2016.