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High Risk for High Yield

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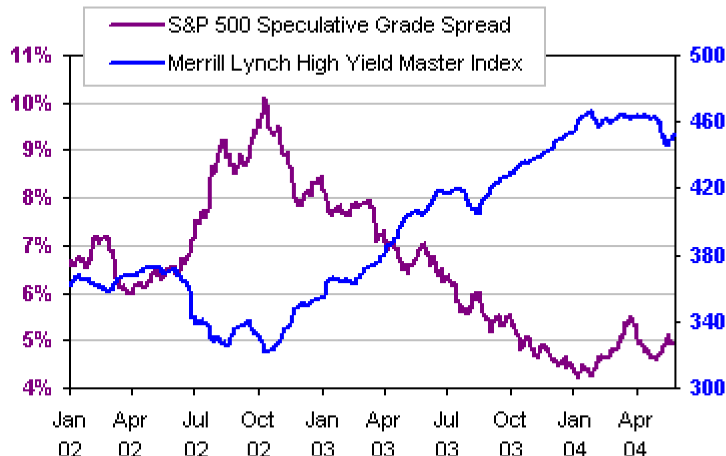
Junk bonds could soon face a double-headwind from inflation and Fed rate hikes.



Considering all the doom and gloom surrounding the market, we find it encouraging that high yield debt has held up as well as it has these past several weeks. Amid widespread sentiment that junk bonds are an accident waiting to happen ("Junk Bond Bubble Starts to Deflate" is how one ***Financial Times*** headline put it) the Merrill Lynch High Yield Master total-return index is down just 2.2% since late April. At less than 500 basis points, the S&P speculative-grade spread is actually marginally tighter, on net, than it was two months ago, when expectations of **the Fed** shifting into rate-hiking mode first began buffeting bonds across the credit quality spectrum.

On one level, this relatively benign performance stands as a reality check on the irrational fear that Fed action to finally begin normalizing its abnormally low 1% overnight rate target poses a threat to continued economic expansion. As the highest-risk domestic private debt, junk is one of the most growth-sensitive sectors of the financial market. Were the prospect of Fed tightening plausibly considered a significant risk to sustained growth, high yield spreads would be gapping higher to reflect the increase in default risk. As it is, on a relative-spread basis, junk has outperformed the highest-rated investment-grade paper over this period.

Still, the present environment undeniably presents challenges for high yield that should not be minimized. All things equal, junk should be a relative outperformer in a Fed rate-hiking cycle if the higher rates come as a response to rapid growth. As an asset class, high yield debt has attributes more characteristic of equities than higher-rated debt, including the fact that it's more growth-sensitive than interest-rate-sensitive. In earlier tightening episodes, junk was hurt only when the Fed went too far and pushed rates up to the point where they choked off growth. Current circumstances however, are hardly typical of previous tightenings. By anchoring the term structure with such low rates over the past few years, the Fed engineered an arbitrage play that pulled yields down to unsustainably low levels on debt issues of all ratings and maturities. Junk, by the way, is hardly getting the worst of it in the blowback of the carry trade. Emerging market debt, for example, is down some 8% since April. Nevertheless, even assuming that spreads stabilize in current ranges, downside risk likely will dominate in the period ahead as all fixed income yields move higher in the rate-normalization process. Bear in mind that at current

yields around 8.8%, five-year junk remains about 70 bps below the best levels of the previous bull market in early 1999.

A considerably darker prospect cannot be ruled out either. As we have discussed on several occasions in recent weeks, the bigger risk now is not the Fed doing "too much," but that in taking a "measured" and "gradual" approach to hiking rates, they will get dangerously behind the inflation curve. If so, by the time the reality of their error is confirmed in backward-looking official inflation data, the Fed will have no choice but to raise rates more aggressively and extensively than if they took firm action now to quell the inflation impulses they have unleashed. At that juncture, the cocktail of rapidly rising rates and sharply higher inflation would in all likelihood gut growth prospects and decimate the market's risk propensity, putting junk bonds -- as well as all other high risk asset classes -- in bear market territory.

We have held a **Model Position in high yield debt** since early last year, embodying our call at the time that junk bonds would be the prime beneficiaries of relief from monetary deflation, and that economic prospects, though largely unappreciated, were brightening considerably. A year ago, concluding that the easy money had probably been absorbed, we cut the position by 50% and booked some profit. At this point, the overall position shows a total return of 19.3% on a cash basis, and 740.0% on a levered basis. Given the current risk/reward environment, this seems an opportune time to take all our profits by closing the remainder of the position. TM