High-Yield Bonds Have Their Limits

If I had to come up with one major difference between the psychological make-up of stock and bond investors, it would have to be stock buyers can dream of trees growing to the sky while bond buyers really cannot. The interest rate on any bond designated as risk-free – and who, after the experiences of the past five years, believes this designation is anything other than a fiction? – can only go to 0%. This becomes exponentially more difficult to do as rates reach low levels. The only good part if bond prices rise at an increasing pace during this process.

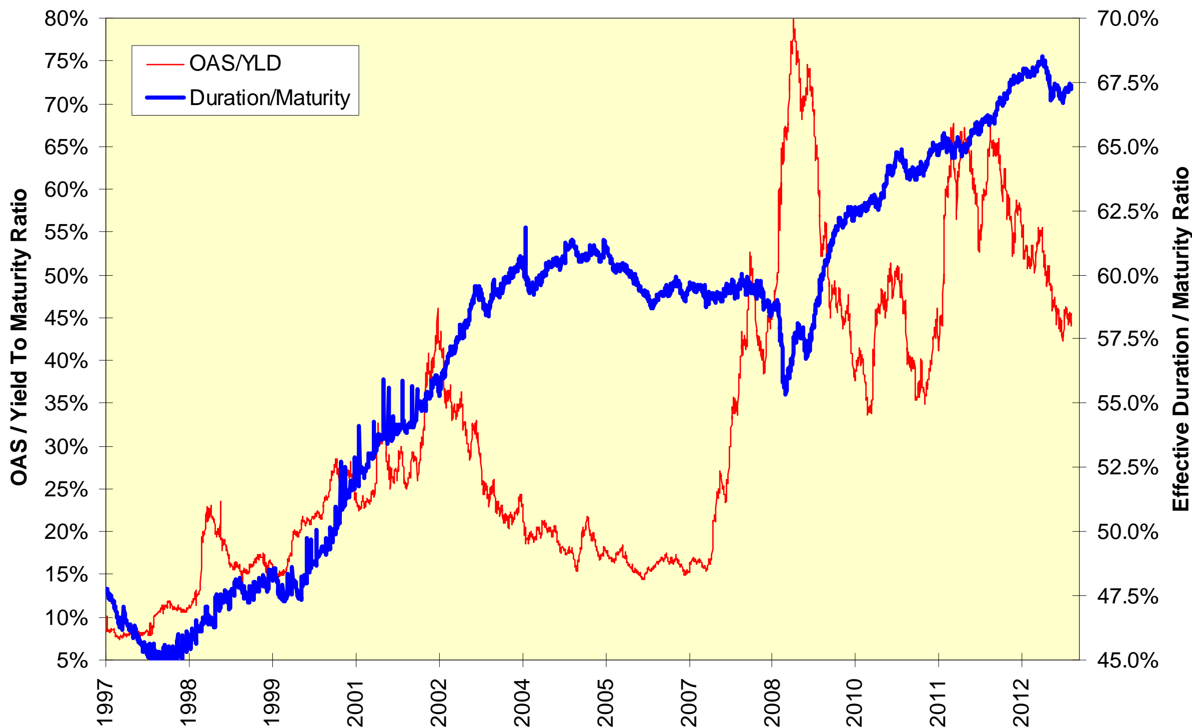
If we shift out the risk curve to corporate bonds, we find the same process applies to both investment-grade and high-yield credit spreads (OAS). Just as trees do not grow to the skies, their roots do not go to the center of the earth no matter how much money central banks shove into the system. By last Wednesday, the OAS for the Bank of America-Merrill Lynch High-Yield Master II index was at 4.35%; this compares to 5.34% on June 24, 2013, the time when FOMC members embarked on their so-sorry-for-mentioning-tapering tour of 2013. The high-yield index returned 5.71% over this period. High-yield ETFs such as the iShares iBOXX high-yield index (HYG) or the SPDR Barclays High-Yield Fund (JNK) did even better than the unmanaged index, returning 7.11% and 7.22%, respectively.

Rate And Credit Risks

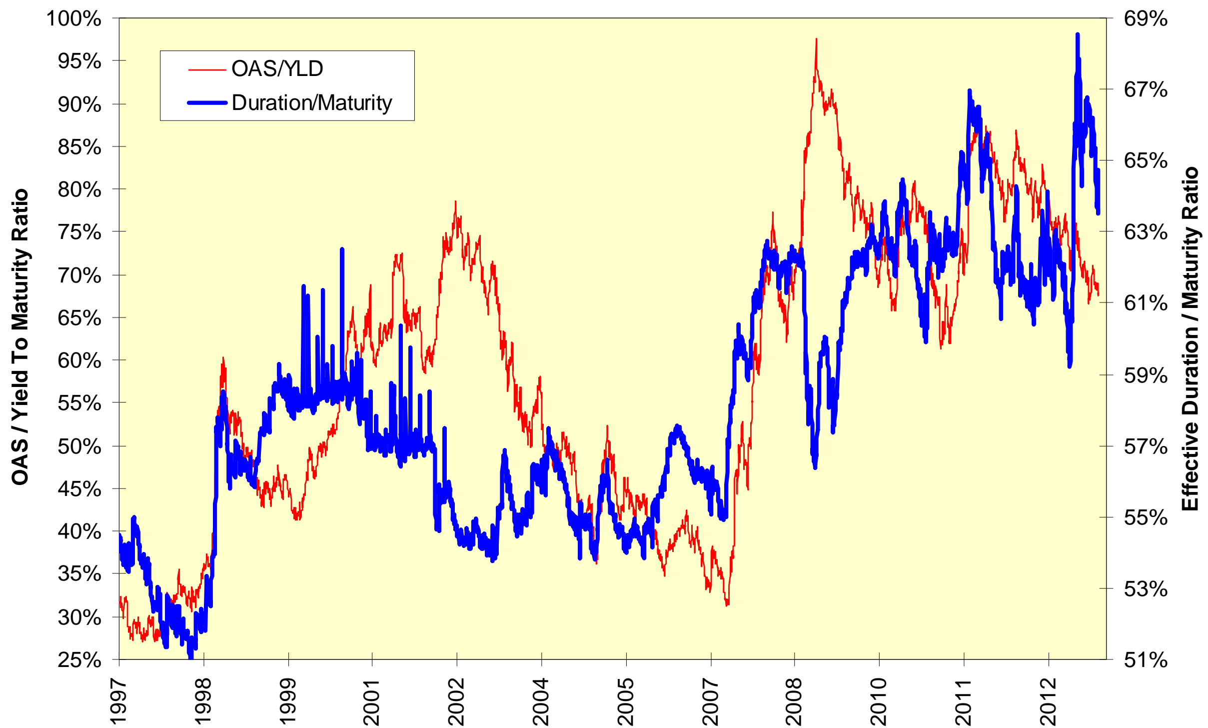
Let's take a look at both investment-grade and high-yield indices risk histories along two dimensions. The first, measured by a ratio of effective duration to yield, tells us how the index is approaching the 100% limit defined by a zero-coupon bond. The second, measured by a ratio of OAS to yield, tells us how the index is approaching the 0% limit defined by a Treasury bond.

Risks for investment-grade bonds peaked on the interest rate risk front in May and hit a local maximum on the credit risk front in early September.

Investment-Grade Bond Risks



Risks for high-yield bonds look different as the nature of the index changes more with various index reconstitutions. Its interest rate risk peaked in June and as in the investment-grade case, its credit risk hit a local maximum in early September.



While Wall Street keeps itself amused by talking about a tapering of QE, that move is unlikely anytime soon. This will keep interest rate risk high. A further decline in high-yield credit risk, that OAS/yield ratio, would require an improvement of economic and earning conditions inimical to lower interest rates. This suggests prospective positive returns for high-yield bonds are going to be constrained because investors are not getting paid enough today to take on more credit risk at a time when interest rate risks remain high historically.

We are not yet in a "sell" zone for high-yield bonds. But we are in a diminishing return period similar to 2006-2007 that exposes us to downside surprises.