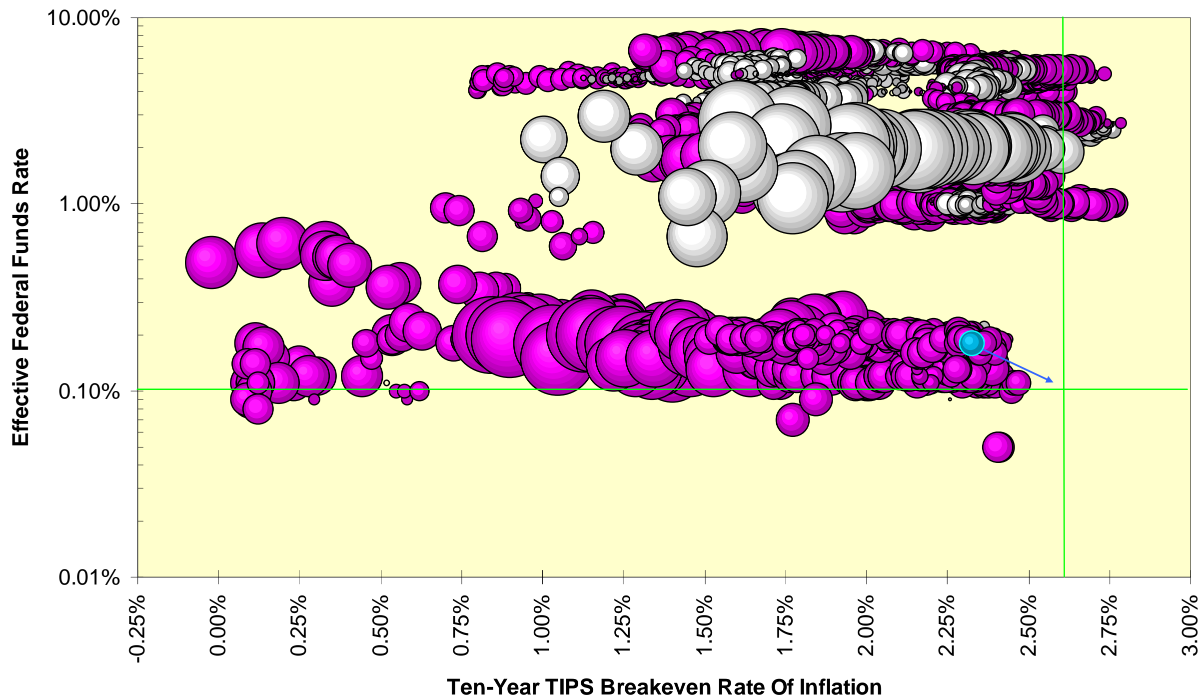
# High-Risk Bonds And Inflation Expectations

Yesterday's discussion of money illusion ended with the admonition high-risk bonds such as emerging market and U.S. high-yield bonds could benefit from rising inflation expectations until such point as short-term interest rates begin to rise. This raises the question whether we have reached that backward-bending point when too much of a good thing turns ugly.

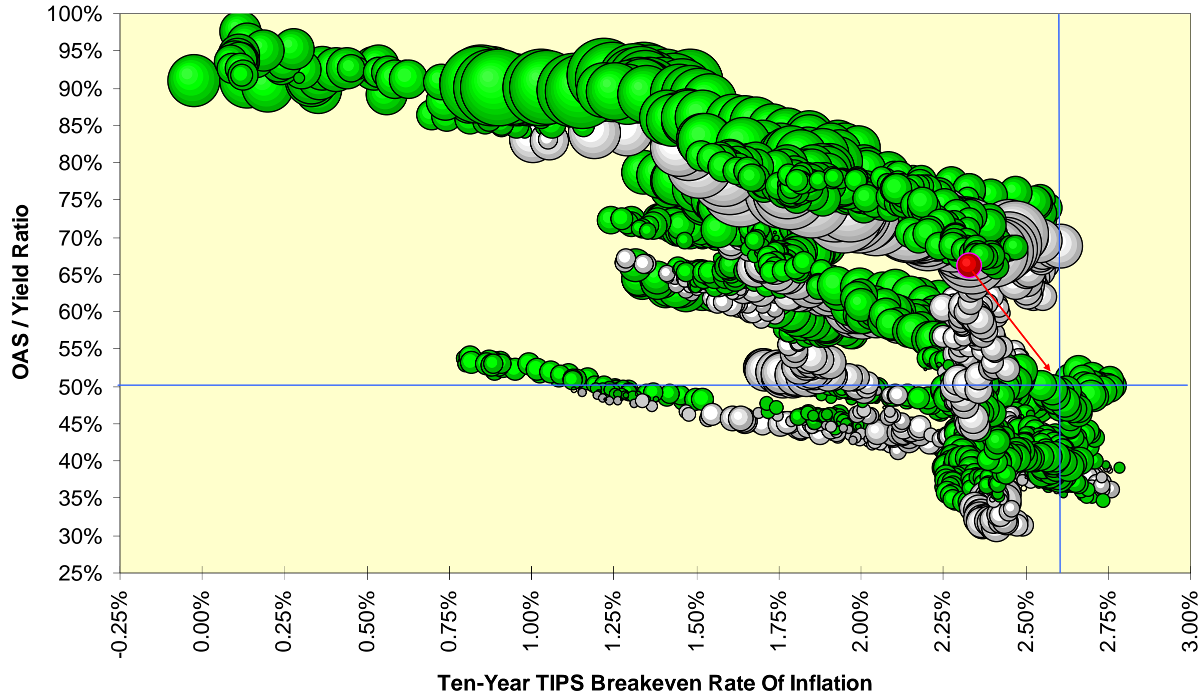
This can be answered by mapping the three month-ahead returns of high-yield bonds along the dimensions of ten-year TIPS breakeven rates and two other dimensions, short-term interest rates as measured by the effective federal funds rate and the ratio of the option-adjusted spread (OAS) to yield-to-maturity (YTM). As the argument proceeds the same way whether we are using U.S. high-yield or emerging market bonds, it will be illustrated only with high-yield bonds.

The charts below depict positive three month-ahead returns with colored bubbles. Negative returns are in white. The last datum used, from three months ago, is highlighted and the present conditions are denoted with a bombsight. The data sample goes back to the very end of 1998.

First, let's take a look at the combination of expected inflation and the effective federal funds rate, a number that has to be plotted on a logarithmic scale with three cycles. This chart has a bright and clear division at 0.65%: At no time when the effective federal funds rate was below this level did high-yield bonds lose money over the next three months. That takes cares of the Y-axis. If we move along the X-axis of TIPS breakevens, we can see higher expected inflation is essentially meaningless.




Now let's switch the Y-axis to the ratio of OAS to YTM. The higher this ratio is, the riskier the bonds are. As the red bubble and arrow indicate, this ratio has been declining over the past three months as the economy continues to recover and as excess liquidity makes the bonds cheaper to carry.




In both charts the bombsight is either at an effective federal funds level where returns should be positive or at a risk content measure where returns should be positive. If this sounds like a win-win outcome for high-risk bonds over the next three months, a period that will put us about a month after the anticipated end of QE2, it is.

If high-risk bonds gain, it is almost a given equities will gain as well. All of this will be a nice warm afterglow of all the money-printing. The hard part will come, as it always does, when credit conditions start to tighten and short-term interest rates start to rise.

Unless, of course, they start telling us why QE3 is just what the doctor ordered. I do not anticipate this until after a decent interval, but I have been wrong before on how much money they are willing to print and how low they are willing to keep short-term interest rates, and I do not care to be wrong again.