Are Credit Swaps Squeezing High-Yield?

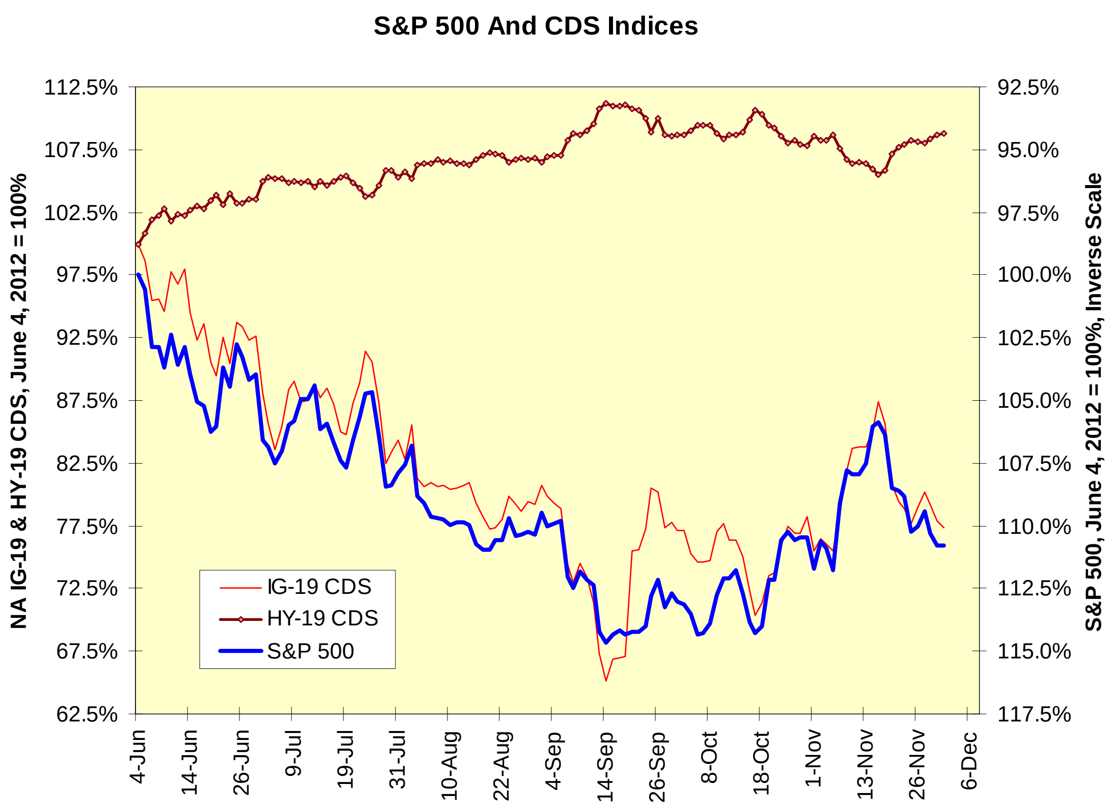
The four years of U.S. zero interest rate policy (ZIRP) may have killed risk-averse savers but certainly have been very good to investors in high-yield bonds. The average annual total returns on such popular high-yield ETFs as the iShares iBOXX High-Yield Corporate Bond Fund (HYG) and the SPDR High-Yield Bond Fund (JNK) have been 18.88% and 22.53%, respectively.

While we all know, or are supposed to know, past performance does not predict future results, we should know past returns have a way of affecting future returns; just ask anyone who was extrapolating their stock gains forward when the clock struck midnight and the calendar struck Y2K thirteen too-long years ago. The same thing is happening right now with high-yield bonds.

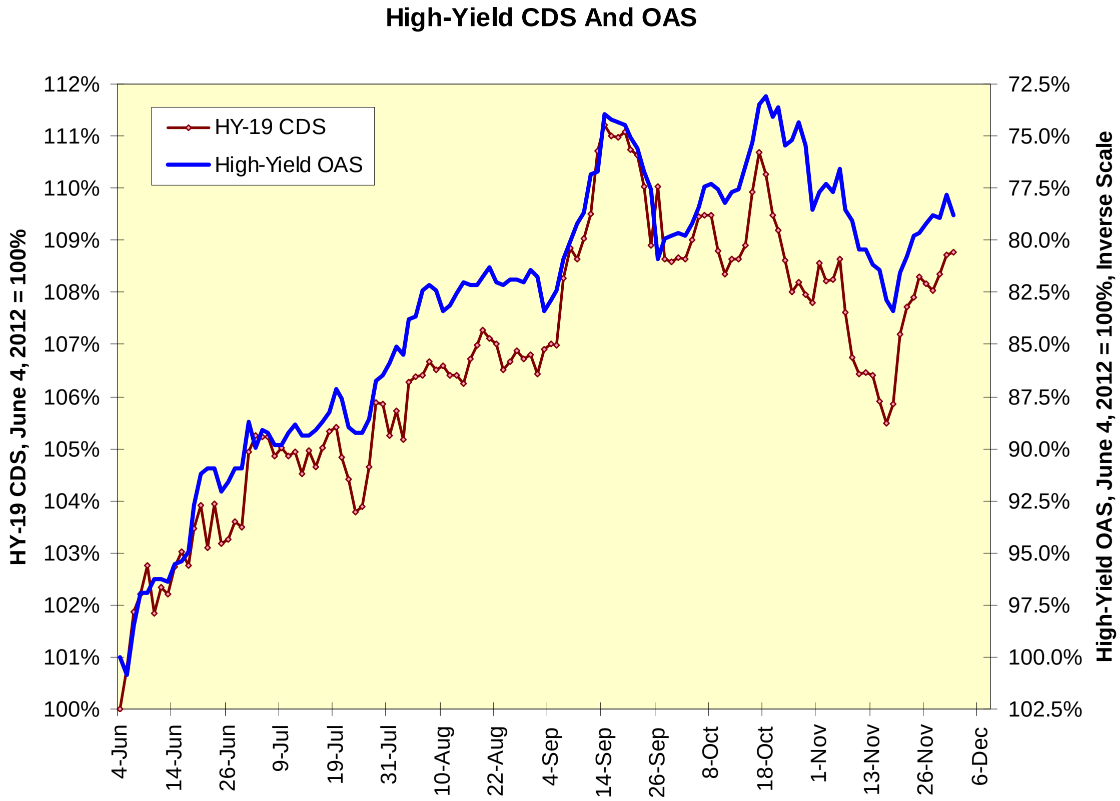
CDS, Volatility And Stocks

While the VIX and credit default swaps (CDS) measure different things, the former tracking price volatility of the S&P 500 and the latter the default risk of corporate bonds, they tend to rise and fall together for obvious reasons. If the default risk of a company increases, its stock price is likely to fall and its put option volatility is likely to rise. No one should expect otherwise.

But if we look at the behavior of two current Markit North American CDS indices, the IG-19 for investment-grade bonds and the HY-19 for high-yield bonds, we a divergence between the IG and HY CDS indices relative to where the S&P 500 has been over the QE3 era. I define this era as starting with the May employment situation report released in June.



The IG index has been tracking the S&P500 as expected, but the HY index has remained stubbornly high. What is even stranger is the HY-19 CDS index has been rising even as the option-adjusted spread (OAS) for high-yield bonds has been falling.



The implications here are troubling. If we think of a CDS as a being similar to a put option on a bond, protection costs for high-yield have been rising even as the yield on these bonds relative to Treasuries, the OAS, has been falling. Restated, high-yield buyers are receiving less interest income while they are willing to pay more for default protection.

This does not sound like a sustainable situation, does it? If money inflows are chasing the yield out of high-yield while the default risk of the bonds are rising, then the net insured return on these bonds is falling. Of course, as we have seen in the cases of Treasuries and TIPS with their negative real returns, just because bonds lack value does not mean investors will avoid them.

Take heart, though, in the case of the much larger category of investment-grade bonds. Even though the yield has been squeezed out of these as well, at least their CDS costs are declining.