Eurozone High-Yield Benefited From ECB Shift

No matter how often you say it, it cannot be said enough: The real reason we should not delegate so much power to central banks is monetary policy does not have deterministic outcomes. You would not drive a car where turning the steering wheel clockwise might send you off to the left or might not do anything at all, but we just go on blithely assuming lowering interest rates somehow stimulates economic growth or puts inflation at that 2% level we are told we want despite our experiences.

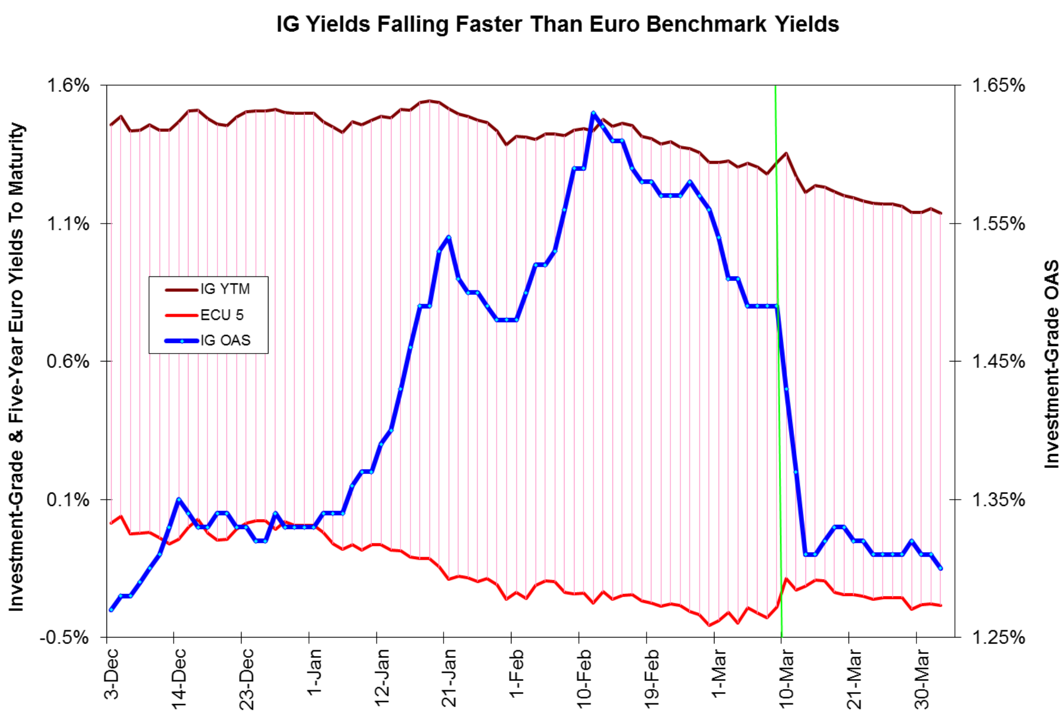
And so the farce continues. The Bank of Japan has destroyed its national bond market and claims victory. The European Central Bank's negative interest rate policies have so damaged the commercial banking sector that the ECB effectively will pay a commercial bank to make a commercial loan. The Federal Reserve says it wants to raise short-term interest rates, then backs away from legitimate reasons for doing so.

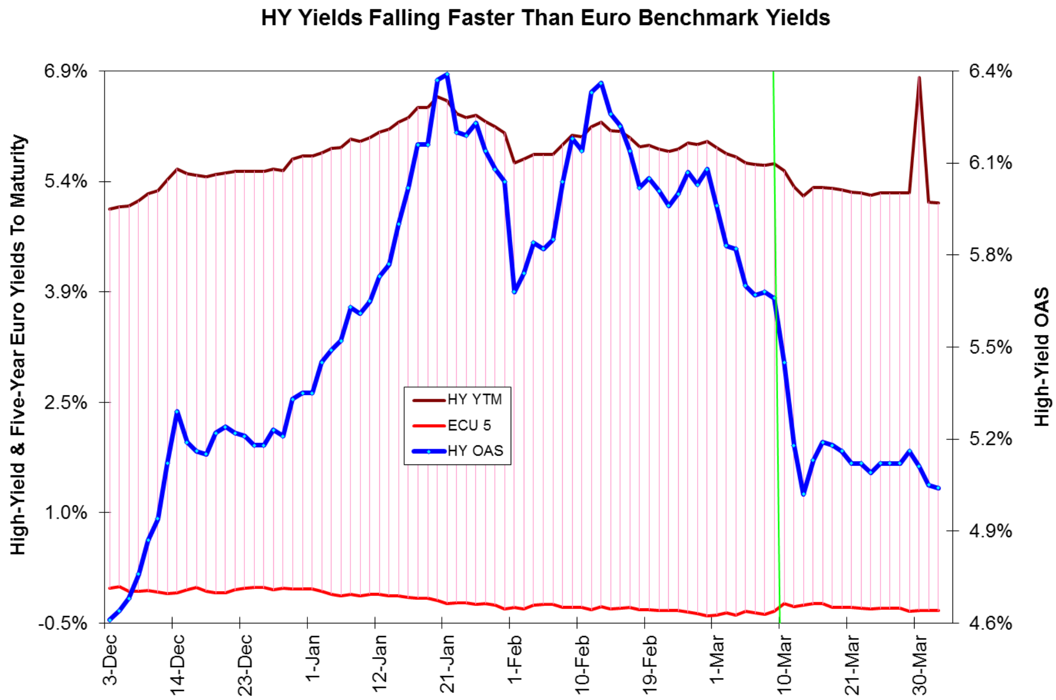
Buy Bonds Where You Work

The European Central Bank announced a shift in policy on March 10, 2016 (green line) allowing for purchases of investment-grade corporate bonds. Eurozone high-yield bonds have outperformed both investment-grade and Eurozone 5-7 year sovereign debt ex-Greece in the three weeks since then. The sovereign bonds have returned 0.70% as compared returns of 0.65% and 0.92% for investment-grade and high-yield bonds, respectively.

OAS levels for both classes of corporate bonds have declined abruptly on the date of the decision and have maintained those declines. Yields for both classes of corporate bonds have fallen more rapidly than have sovereign yields since the March decision. None of the yield involved made a new nominal low after March 11, 2016; sovereign yields bottomed on February 29, 2016 and investment-grade and high-yield yields bottomed in February and March 2015, respectively.

High-yield bonds' outperformance suggests a portfolio channel adjustment is taking place. Negative sovereign yields and the potential for artificially low investment-grade yields have pushed investors out along the risk curve even as Eurozone equities have lost 1.38% in EUR terms since the day prior to the March 10th announcement.





There you have it. Once again a central bank targeted one asset class, investment-grade corporate bonds, and wound up hitting another asset class, high-yield bonds, more effectively. Markets tend to thwart policymakers' best intentions via these portfolio adjustment channels, by changes in the yield curve or by unexpected changes in the currency. I remember being amused as a child by Elmer Fudd's backward-pointing shotgun and how it allowed Bugs Bunny to live one more day. Who knew this would be an apt metaphor for rooms full of academic economists experimenting with real money.