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# The pain and gain in chasing the junk bond rally

*Rising default rate and doubts over long-term outlook worry analysts*

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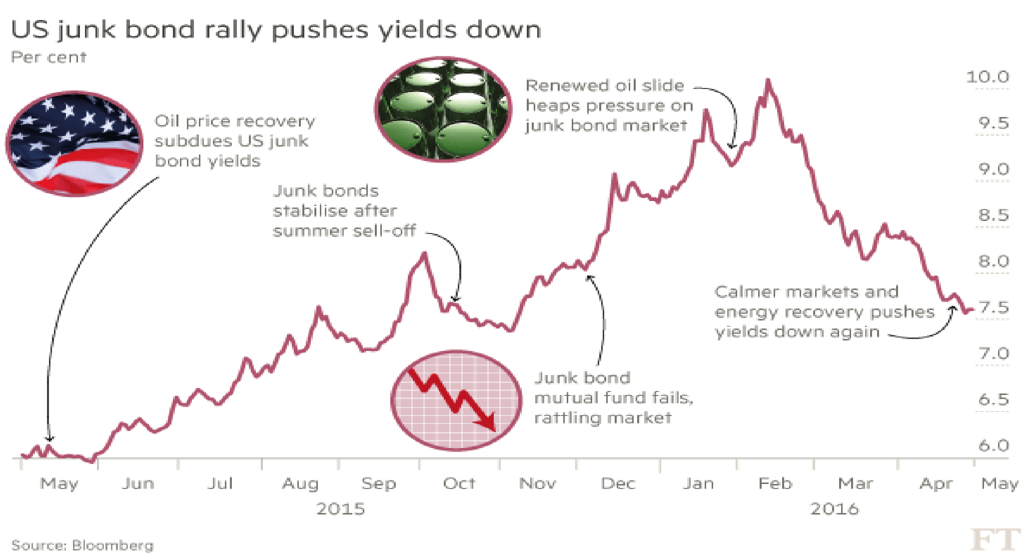
The US junk bond market has snapped back in recent months, handing investors who kept the faith some juicy returns. But disquiet over the extent and strength of the rally is mounting.

Debt issued by US companies rated below investment grade — commonly called junk or high-yield — was pummelled by rising concerns over a rash of energy sector defaults and the health of the US economy, culminating in a painful crash in December, when one high-profile mutual fund had to suspend investor redemptions.

The turbulence of January and February then rattled the market further, causing investors to dump riskier assets and sending the average US junk bond yield to over 10 per cent. But the mood music abruptly shifted from a funeral dirge to an upbeat jig in March, and the market has now handed investors a total of return of 7.3 per cent this year. Energy junk bonds have returned over 15 per cent.




Big borrowers are naturally pleased. “The financing markets are back — they’re back in all their glory,” Josh Harris, the co-founder of Apollo Global Management, said last week. “The good times are rolling again, at least for this month.”

Nonetheless, with the average yield now back to below 8 per cent, some investors and analysts are concerned that the junk bond market has run ahead of itself. Some measures of corporate indebtedness have been climbing to pre-crisis peaks, and the amount of cash holdings compared with interest payments are at the lowest since 2009, according to Bonnie Baha, head of developed market credit at DoubleLine, the bond fund manager.

“It’s rallied a long way in a short space of time, and there hasn’t been a commensurate improvement in the fundamentals,” she says. DoubleLine missed out on the rally but “we’re fine with this, as without an improvement in the fundamentals it’s not sustainable”.

Indeed, while US earnings have generally beaten expectations, the bar was set exceptionally low by gloomy analysts. Both revenues and earnings are falling — and it is not just the energy sector that is struggling — something that can presage a recession.

Some analysts are therefore waving their warning flags. UBS credit strategist Matthew Mish points out that the number of bonds with a triple-C rating has rocketed from 430 in 2007 to 1,350 today, or 40 per cent of the entire market. He predicts that as much as $1tn of debt rated below investment grade will end up in some form of distress.

That is already beginning to manifest itself. Another four defaults last week raised the global total to 57 so far this year, of which 43 were in the US. Among the latest defaulters tallied by Standard & Poor's are Oklahoma-based White Star Petroleum and Perpetual Energy, a Canadian oil and gas explorer, but a smattering of non-energy companies are also in a pickle. New York grocer Fairway filed for Chapter 11 bankruptcy last week.

The US default rate is still below its long-term average of about 4 per cent, but heading north. S&P's trailing 12-month default rate hit a six-year high of 3.9 per cent in April, and the rating agency predicts it will climb to 5.3 per cent by

March next year — or as high as 7 per cent in its pessimistic scenario. Mr Mish argues that the "recovery rates" are also likely to be much lower than in the past due to the deteriorating quality of the bonds.

Nervousness over another summer reversal is now coming to the fore. The average US junk bond yield has crept up from a low of 7.5 per cent late last month to 7.8 per cent this week.

Nonetheless, the junk bond rally is backed by robust "technical" factors that counter much of the fundamental deterioration.

Bond yields have been beaten down by super-easy monetary policy across much of the world, and nearly $10tn worth of sovereign debt has yields below zero. That burnishes the lustre of US junk bonds that still offer juicy yields markedly higher than a year ago.

Moreover, many fund managers need extra income to make up for an underwhelming start to the year. About 90 per cent of high-yield bond fund managers have underperformed the market in 2016, according to Goldman Sachs, which will probably compel them into riskier parts of the bond market.

"As funds play catch-up to their benchmarks, bond managers are more incentivised to step down the quality spectrum to find alpha," Goldman Sachs analysts wrote in a recent note. "We believe this will intensify the 'search for yield' that has already been set in motion by easy global monetary policy."

But it is the longer-term outlook that primarily worries DoubleLine's Ms Baha. She estimates that there is nearly $10tn of US corporate debt coming due in the next five years, and expects this "maturity wall" to be tricky for some weaker companies.

"The 'come to Jesus' moment will be when these companies have to refinance their debt," she says. "Some will do so at much higher rates, and others will be unable to … Quantitative easing has just deferred the default cycle."