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Investors Wary About Overreaching for Yield

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The Breakfast Briefing

Investors sure want yield, but they're not willing to reach as far to get it anymore.

That's showing up in the market for U.S. junk bonds, where the contrast between the strongest and weakest borrowers is growing more stark. Companies with BB ratings, the highest range in the speculative-grade category, have been issuing debt this year at a faster pace than last. But further down the rating scale, sales by CCC-rated issuers are lagging 50% behind last year, according to Bank of America Merrill Lynch. The share of CCC issuers accessing the market is at its lowest level since 2009, staying muted all year, even amid the market calm during the summer.

The shift reflects fears about rising interest rates that have ebbed and flowed throughout the year, but also the role higher rates and other factors could play in accelerating a turn in the credit cycle, where more low-rated companies struggle to repay their debt.

"Capital markets just do not seem to be open to the lowest echelons of HY at the moment, underscoring the lingering concern that investors have against credit losses despite the collective efforts of global central banks to enhance risk taking," said Merrill Lynch strategists, led by Michael Contopoulos, in a Wednesday report.

For years, investors gobbled up the riskiest of risky debt, spurred by easy-money policies from central banks that were seen to make safe assets so unattractive that investors were forced to buy assets like the lowest-rated junk bonds. But now they're becoming more discerning, even as benchmark government bond yields remain at or near record lows globally. The hesitency could be self-perpetuating.

"If the penchant of HY investors to lend to CCCs remains muted, we think this will be disastrous for the corporates that arguably are in the most need of the funds, precipitating a HY default cycle in next couple of years," the Merrill Lynch strategists wrote.

By many measures, the reach for yield is still in full force. Investors are shelling out for anything that offers a hint of income, from high-dividend stocks to preferred shares to emerging market debt. Even junk bonds have returned 15% this year, according to a benchmark maintained by Bloomberg Barclays.

But the slowing CCC issuance is a sign credit is tightening around the edges for the riskiest borrowers. If the Federal Reserve lifts interest rates more aggressively, corporate profits fall further, oil prices take another dive, or another unforeseen factor upsets the global markets, more issuers could struggle to access the market.