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Junk Bonds Are The New Haven Assets

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A record 84 percent of professional investors in a Bank of America survey released in April said bonds were overvalued. More than half also thought both stocks and bonds are too expensive, the most in 12 years.
Photographer: Robert Caplin/Bloomberg

The new fixed-income haven is, of all things, the market for junk bonds.

With government securities in Germany to Japan and Ireland yielding less than nothing, money is pouring into exchange-traded funds that buy speculative-grade debt, traditionally the riskiest of fixed-income assets.

The pace is staggering. So far this year, about $9 billion has flowed into the funds globally, a significant chunk for the $44.4 billion market in junk-debt ETFs.

In the land of negative yields, even the most conservative firms such as Zurich Insurance Group AG and Assicurazioni Generali SpA, the biggest Swiss and Italian insurers, are planning to invest in sub-investment grade debt for the first time. One of the bond market's brightest luminaries, Jeffrey Gundlach, says you're better off in junk because the only money to be made on German bunds is from betting against them.

While last week's sudden selloff in euro sovereign debt gives investors all the more reason to crowd into high-yield assets, the lingering concern is that buyers are exposing themselves to even greater losses. And with the European Central Bank's bond purchases still keeping government yields close to historic lows, many bond investors have few other options.

"Investors are being forced by the central bank to assume more risk," Jens Vanbrabant, a money manager at ECM Asset Management, which oversees $6.5 billion, said from London. "They're trying to adapt their investment parameters to the new situation of zero or negative yields."

Taking Chances

Bond markets around the world are being distorted as central banks step up cheap-money policies to bolster growth and prevent deflation. About $2.36 trillion of government bonds globally have negative yields, data compiled by Bloomberg show.

That means investors effectively pay a dozen governments when they borrow. The situation is particularly acute for the nations that share the euro. In Germany, Europe's largest economy, quantitative easing has left about 40 percent of the nation's securities tracked by Bloomberg with sub-zero yields.

That's prompted investors to take more chances on debt of the least-creditworthy borrowers. Flows into junk-bond ETFs in the first four months of the year exceeded any comparable period since EPFR Global began compiling the data in 2007.

The iShares Euro High-Yield Corporate Bond UCITS ETF, the largest of its kind in Europe with 4.2 billion euros ($4.7 billion) in assets, amassed more than 1.5 billion euros alone over that span, data compiled by Bloomberg show.

Worst Selloff

"I'm long high yields right now," Gundlach, the founder of Los Angeles-based DoubleLine Capital, which oversees $73 billion, said in an April 28 interview on Bloomberg Television. "They've done quite well lately."

Gundlach went on to say he's looking to short two-year German notes, which yielded minus 0.22 percent. The yield on five-year securities was 0.06 percent, after reaching an unprecedented minus 0.17 percent less than three weeks ago.

Investors got a wake-up call last week, when 142 billion euros was wiped off of euro-area government debt in the worst selloff since at least 1993.

Globally, junk bonds have outperformed government debt with a 4.4 percent return this year. That's a reversal from 2014, when the lowest-rated bonds underperformed by the most since the financial crisis.

Part of the attraction has to do with the advantage of junk-bond yields, which have risen in the past year as those on government debt kept falling. Speculative-grade securities yielded an average 6.37 percent last week, versus 0.99 percent for developed-market sovereign bonds tracked by Bank of America.

'Very Tricky'

High-yield bonds represent "some of the best strategies to generate total return in today's low-return environment," said Payson Swaffield, the London-based chief investment officer for fixed income at Eaton Vance Investment Managers, which oversees $300 billion.

Junk bonds aren't the only higher-risk assets in greater demand. Michael Riddell, a money manager at M&G Investments, which oversees $411 billion, bought local-currency bonds issued by Colombia and Thailand for the first time this year.

AXA SA, France's biggest insurer, will boost holdings in "illiquid" assets such as real estate and infrastructure projects to 20 percent from 15 percent last year, according to Chief Investment Officer Laurent Clamagirand.

"It's very tricky" for insurers, said Bruce Porteous, an investment director for insurance solutions at Standard Life Investments, which oversees about $370 billion. They're making a shift because "they can't earn enough money on the assets they hold to provide the benefits that they offer."

Fewer Options

Giving up on government bonds in Europe may still be premature, said Stefan Kreuzkamp, the Frankfurt-based chief investment officer for Europe, the Middle East and Africa at Deutsche Asset & Wealth Management. That's because the ECB's debt purchases have just gotten started.

"German 10-year bond yields could go to zero," said Kreuzkamp, whose firm oversees about $1.25 trillion. "We expect further gains for 2015. The same is true for peripheral bonds such as those issued by Italy and Spain."

Yields on German 10-year bunds, which were closer to 1.5 percent a year ago, were at 0.52 percent on Tuesday.

At the same time, the prospect of the Federal Reserve raising interest rates in the U.S. this year may ultimately sap demand for riskier assets such as junk bonds.

For an increasing number of investors, there are few good choices left as six years of easy-money policies by global central banks inflated prices of almost every asset imaginable.

A record 84 percent of professional investors in a Bank of America survey released in April said bonds were overvalued. More than half also thought both stocks and bonds are too expensive, the most in 12 years.

"There are very few assets out there that you look at and think are cheap," said Chris Rule, chief investment officer at London Pension Funds Authority, which manages $7.3 billion.