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US junk debt regains high-yield status

Eric Platt in New York


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After years of investor enthusiasm, US high-yield debt is once again living up to its name. Yields on lower quality rated securities have soared since January as investors ask a pivotal question: are they being paid enough for the risk of owning junk-rated bonds?

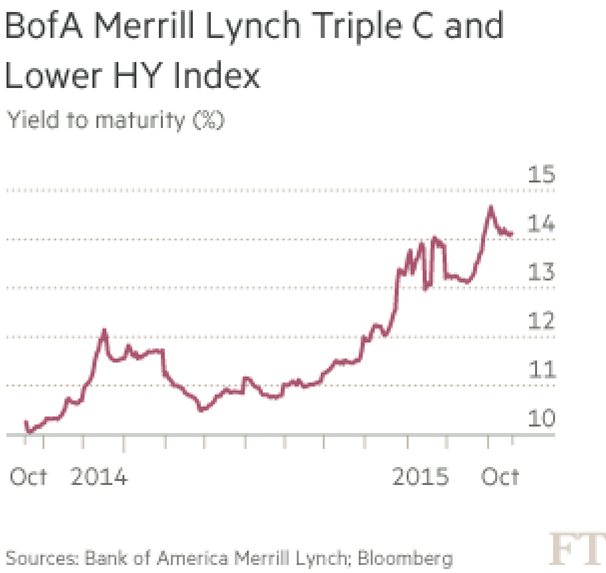
Junk bond yields, which move inversely to price, rose above 8 per cent in October for the first time since 2012 as investors retreated from funds focused on speculative debt, accelerating a four-month sell-off fuelled by fears of weaker growth hitting highly indebted companies in the sector.

Investors who in years past eagerly sought exposure to the sector against a backdrop of low global interest rates and easy central bank policies, are now heading for the exit. The junk market in the past has often signalled big turning points in risk appetite among investors, and lowly rated companies are finding difficulty securing financing as investors demand greater compensation in the form of higher yields.

“The thing that we underestimated and the market missed a little bit was that when the Federal Reserve stopped its quantitative easing programme, it truly was a beginning of a tightening cycle,” says Christine Hurtsellers, chief investment officer of Voya. “That coupled with the dollar going up has really tightened credit conditions. It tells you we’re not in the first inning of the Fed draining liquidity.”

Sales of new bonds issued by junk-rated groups in 2015 are down 9 per cent from a year earlier, while leveraged loan origination has fallen by more than a third, according to UBS. That comes as investors have pulled $14.3bn from mutual funds and exchange traded funds for the sector since the middle of April, according to Lipper. The withdrawals have pushed yields on the weakest companies, those rated triple C and lower, to 14 per cent, according to Bank of America Merrill Lynch.

Against that backdrop, the sale of up to $15bn in debt by Dell, to fund its takeover of EMC, looms as a major test of investor sentiment. Portfolio managers believe the PC maker, rated BB plus by S&P, will probably sell bonds above the current 5.8 per cent yield for companies holding that rating.



While the pain in the junk bond sector has been concentrated in commodity linked industries — junk-rated metal and mining, independent energy and oilfield services paper have fallen by more than a tenth this year — other areas of the market have also come under pressure, including aerospace and defence, pharmaceuticals and chemicals companies.

"The flight from energy and the reluctance to step back in even at today's highly distressed levels among investors has been stark," says Michael Contopoulos, a strategist with BofA Merrill Lynch. "Even the erstwhile 'safer' places to hide may not make the cut going forward."

Notably, higher yields have yet to attract investors back to the sector. Lipper counted roughly $132m of inflows to junk bond funds in the past week, following the largest two-week outflow since January when $2.7bn exited the asset class. In contrast, $29.7bn has flowed into the perceived haven of money market funds in the past four weeks.

High-yield bonds are beginning to re-earn their moniker. The average yield of the junk bonds in Bank of America Merrill Lynch's High Yield index has climbed back above 7% again, much to the chagrin of investors who returned to the junk bond market too soon.

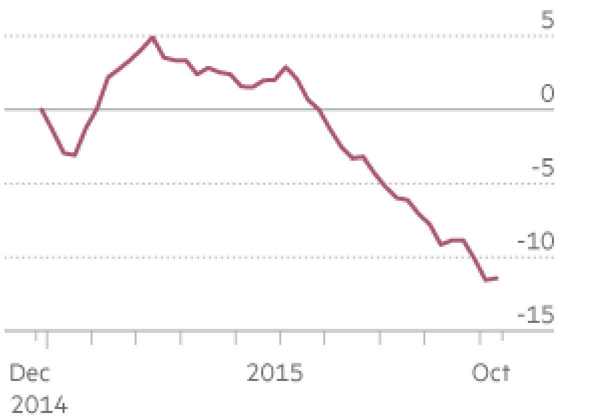
"The steadfast belief that low rates and the central bank put will continue to mean a reach for yield, never mind it's quality, seems absurd and contrary to evidence," Mr Contopoulos says.

Investors are also monitoring a string of disappointing earnings and revenues from companies during the current third-quarter reporting season. Credit fundamentals have broadly deteriorated, as companies levered up to fund acquisitions, share buybacks and dividends during the easy money era.

This year, Standard & Poor's has downgraded more companies than in the past two years combined, lowering its view on $211bn of debt in the third quarter. The list of companies cut by S&P in the last quarter is a long roster of energy names, but includes investment grade groups such as United Technologies, eBay and Aflac, as well as junk-rated companies such as Getty Images and Arch Coal.

Failures are expected to tick higher over the coming months, with S&P expecting the trailing 12-month default rate to near 3 per cent by the middle of 2016 from 1.8 per cent in 2014. Data from Fitch show spreads on credit default swaps, insurance against possible default, widening 8 per cent in the third quarter from a year earlier.

Cumulative flows into US junk bond funds
$bn



Source: Lipper

Concerns that the credit cycle is getting long in the tooth has manifested itself via a rotation into higher quality junk names. While prices of debt rated double B, single B and triple C have all fallen, the decline has been most acute for the most speculative rated tier.

Since its peak in April, the Merrill Lynch Double B index has fallen 2.3 per cent. Over the same period, Merrill's index of triple C names has slid 8.9 per cent. Investors have pointed to signs that the cycle is maturing, including the jump in M&A activity as executives seek out growth.

"We are believers in economic cycles and credit cycles," says Tom Stolberg, a portfolio manager with Loomis Sayles. "Certainly there are behaviours being exhibited by management suites that make us sense we're heading towards the late stage."

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