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There Are Signs of Trouble in Junk Bonds and That Could Be Bad for Stocks

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Based on UBS Group AG's analysis of the junk-bond market, Janet Yellen's warning of danger in U.S. stocks has some merit.

The speculative-grade debt market is starting to show some cracks. Investors are less willing to finance the lowest-rated companies, with borrowers such as Cliffs Natural Resources Inc. and Capital Product Partners LP struggling to attract lenders. Relative yields for the riskiest portion of the market have been increasing, and it's getting harder to trade the notes, according to UBS's analysis.

Historically, this sort of backdrop has signaled trouble ahead for stocks. During downturns, junk-bond prices tend to start falling three months ahead of equities, data compiled by the Swiss bank show.

"There are clear signs that we may be approaching a turning-point in the credit cycle," UBS analysts Ramin Nakisa, Stephen Caprio and Matthew Mish wrote in a report Wednesday. Given corporate-debt markets have swelled way beyond their size before the 2008 financial crisis, stock pickers need to pay even more attention to what's happening in bonds this time around, they said.

The bottom line is that credit markets suggest the Standard & Poor's 500 Index's 13.6 percent rally in the past 12 months -- fueled by near-zero interest rates from the Fed and a brightening economic outlook -- just can't last.

Yield Demands

Fed Chair Yellen, who's been warning of risk-taking in high-yield markets for some time, said Wednesday that equity-market valuations are "quite high."

UBS sees the potential equity selloff happening one of two ways: Either inflation picks up more than markets expect or the economy deteriorates at a time when central bankers are out of new ways to boost growth.

Meanwhile, credit buyers are already becoming more discerning as they prepare for the market to turn. They're demanding 9.04 percentage points in extra yield over benchmarks to own junk bonds with the lowest grades, up from 8.6 percentage points at the end of February, according to Bank of America Merrill Lynch index data.

While companies are still selling loads of debt, the least credit-worthy ones are starting to fall off the map. Their contribution to total issuance has declined to the same levels as during the global financial crisis, when appetite for risk plummeted, the UBS analysts wrote.

The question these days isn't if the market will turn, but when. For the answer, equity investors just may want to keep a close eye on junk bonds.