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US junk debt rated triple C yields 20%

Rising expectation of defaults by highly indebted companies shakes investors

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An investor exodus from the lowest-quality US corporate bonds has sent yields to their highest levels since the world's largest economy emerged from recession in 2009.

Yields, which move inversely to prices, on debt issued by US companies that carry a rating of triple C or lower hit 20 per cent for the first time in more than six years this week, a watershed for investors who had piled into the asset class over the past three years in the hunt for yield.

The sharp drop in commodity prices and a rising expectation of defaults by highly indebted companies have shaken investors and closed the door on new debt sales. Investors say the dearth of liquidity has made it even more difficult to own paper rated triple C. Late last year several bond funds closed that held high amounts of low-rated and unrated debt.

"You are seeing a lack of appetite in the new issue market for these types of issuers," said Matthew Mish, credit strategist with UBS. "[Funds] have outflows and the Federal Reserve is no longer printing money.

"The tide is going out and you would expect the lowest-quality borrowers who benefited the most … to suffer first."

Portfolio managers are also experiencing a wave of redemptions from investors. US junk bond mutual and exchange traded funds have counted more than $20bn of withdrawals since mid-November, according to Lipper.

Investors have instead turned to US government paper, with funds invested in Treasuries counting more than $9bn of inflows over the past eight weeks.

"We expect a shakeout this year in the US oil and gas market, as highly leveraged companies will be forced to declare bankruptcy," said Bronka Rzepkowski, an economist with Oxford Economics.

TCW, an investment group, notes that only 12 per cent of bonds that trade in the high-yield universe have a spread — the difference between the yield on the bond and a comparable Treasury — within 1 percentage point of the index average. The spread on nearly a fifth of the bonds is more than 500 basis points above the average.

“You go from widening credit spreads … to an accelerating level of downgrades,” said Bryan Whalen, a portfolio manager with TCW. “High-yield default rates will move from low single digits to upper single digits, and that impacts investor preferences.”

Investors have shifted into higher-quality junk paper, with a preference for bonds rated double B issued by companies that are not exposed to the energy or metals and mining industries.

Paper rated triple C has declined 3.9 per cent so far this year, following a 15 per cent drop in 2015. In contrast paper rated double B is off less than 1 per cent in 2016, according to Bank of America Merrill Lynch.