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Desperate investors turn to US junk bond market

Yield shortage prompts rally in low-rated debt, but caution is warranted

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by: **Robin Wigglesworth**

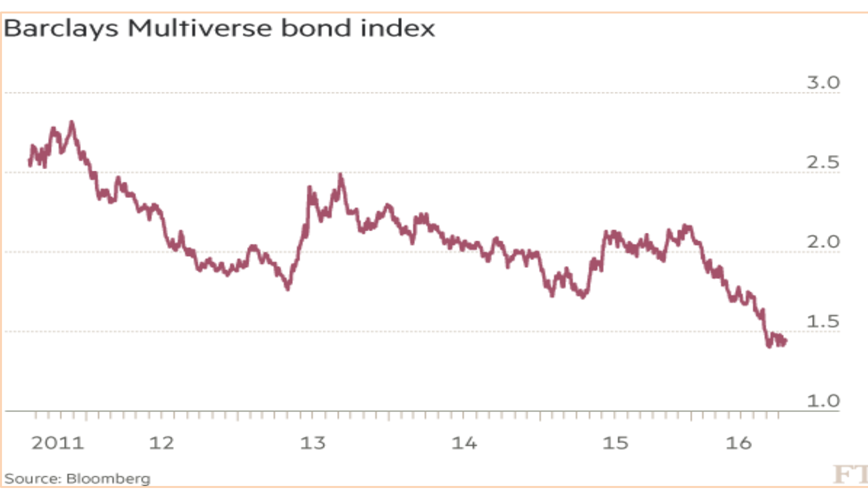
Despite the global economy still swimming in debt, investors are suffering an acute and worsening yield shortage. At the current rate of yield evaporation, bonds with positive returns might eventually go the way of the dodo.

More than $13tn of bonds now trade with yields below zero, and the average yield of the Barclays Multiverse bond index is close to just 1.4 per cent, as central bank bond-buying and negative interest rates have stoked a frenetic grab for any fixed income left in the world. Indeed, the face value of the bonds in the Multiverse index is $45.7tn, but the market value is much higher at $51.1tn because the actions of central banks have caused prices of bonds to rise to unprecedented levels.

The yield drought has pushed many investors towards dividend-paying stocks, leading some to quip that investors are now buying bonds for capital appreciation, and stocks for yield. But where else can they go?

For investors sceptical of emerging markets, the US junk bond market is the obvious answer. Despite accounting for just 4 per cent of the Barclays Multiverse index, US corporate debt rated below "investment grade" now makes up almost a fifth of the world's remaining bond yield, according to TwentyFour Asset Management. Eurozone government bonds account for 17 per cent of the Multiverse gauge, but only 2 per cent of its evaporating yield. Japanese government bonds account for zero of the index's yield.

No wonder then that US junk bonds have enjoyed a tremendous rally, with a gain of 14 per cent this year for investors who kept their cool during January and February's carnage. Investors who bought at the bottom made a return of more than 20 per cent. Even after the 2016 rally, they still yield more than 6.4 per cent on average.



Of course, junk bonds are risky. Another nine defaults in July lifted the trailing default rate to a six-year high of 4.5 per cent. S&P predicts that the rate will hit 5.3 per cent by March, and recently highlighted that the debt burden of low-rated US companies has never been higher.

As long as central banks continue to vaporise yields elsewhere, investors are likely to continue to swallow any misgivings and dive into the US junk bond market. But they should do so with caution.

robin.wigglesworth@ft.com