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What junk bond credit spreads reveal

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The yield premium on US high-yield bonds has been moving up steadily this year ahead of a possible Federal Reserve interest rate rise, and as falling commodity prices put pressure on miners and oil companies.

Investors use so-called credit spreads — the percentage point difference in yields between junk bonds and investment-grade corporate or Treasury bonds — as an indicator of the overall creditworthiness of the private sector. A deterioration in companies' ability to service their debt is likely to be felt first among junk-rated companies.

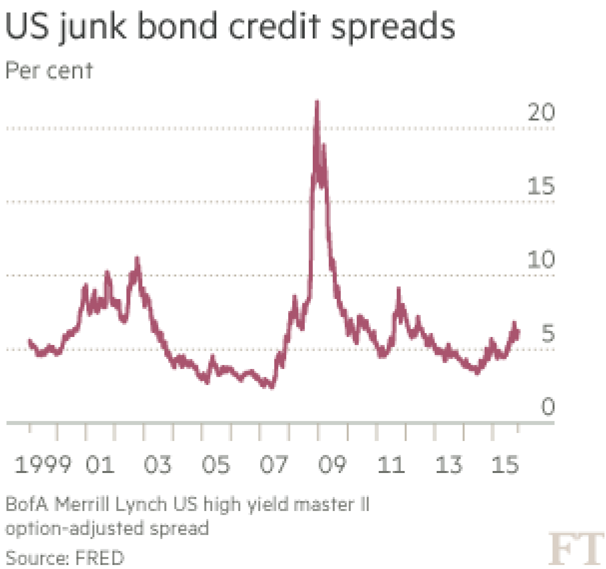
What are credit spreads?

The credit spread is a risk premium that can be used as a barometer of the health of an underlying corporate balance sheet.

The higher the risk of default by a company, as judged by rating agencies, the more it has to pay lenders when it sells debt. The yield on corporate debt, which varies with the price at which it is trading in the secondary market, is set partly in relation to the yield on government bonds, often described as the risk-free rate, and partly on the premium, or spread, investors demand based on company-specific risk.

To calculate the credit spread an investor earns for taking the risk of losing money if a company goes bust, compare the yield on a corporate bond to a government bond. For example, Vodafone has a bond maturing in 2020 that pays investors a fixed 1 per cent coupon. The bond currently trades at 101 cents on the dollar and yields 0.72 per cent.

A German government bond of similar maturity currently yields -0.17 per cent. Subtract that negative yield from the Vodafone bond yield and the spread is 89 basis points.



So where does the junk come in?

There are two main categories of corporate debt: investment grade and high-yield, or junk. Gradations within the categories denote the likelihood of default, as judged by credit rating agencies. Any bond rated below BB by Standard & Poor's or Ba by Moody's falls into the junk category.

Credit spreads tend to widen the further down the ratings ladder a bond falls. Government bonds are often given the safest triple A rating, followed closely by big blue-chip companies. Highly indebted private equity companies and small shale gas drillers tend to have among the lowest ratings.

Junk bonds are therefore seen as the riskiest — and most rewarding — class of bonds.

What sort of risks do investors face?

There are several. The first is default risk, the company goes bust and lenders end up negotiating over how much of their money they get back.

Second is credit spread risk, due to a change in the perceived credit risk of the company. For example, a company could take on too much debt in an acquisition spree or be downgraded. A macroeconomic shock such as lower oil prices might affect a wide range of companies negatively. In these cases spreads are said to "widen", with yields rising and prices falling.

A third could be a general change in the market. If credit spreads reflect an assessment of risk, a change in the market's attitude to risk taking can be damaging. If investors take fright and want to hold less money in corporate bonds and more in safer government bonds then spreads would widen indiscriminately.

But lenders consider other risks as well, such as currency movements or the depth of the corporate bond market — what would it cost to sell a bond in a hurry.

And what about when interest rates go up?

In the past, investors in junk bonds were better off than those holding investment-grade bonds when interest rates rose. The size of the credit spread provides a bigger cushion to absorb changes to the interest rates. Central banks also generally raise rates when the economy is growing, not at times when large numbers of companies might struggle to pay lenders.

This time, quantitative easing programmes have pushed yields on government debt to very low levels, and into negative territory in Europe. The response has been a so-called search for yield, pushing down borrowing costs for all sorts of bond issuers. If this represents an excess of risk taking, then perhaps this year's rise in credit spreads may not be the most accurate gauge of corporate credit risk.