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Junk-Bond Bears to the World: We're Still Doomed: Gadfly

By Lisa Abramowicz

(Bloomberg Gadfly) -- The junk-bond bears have been terribly wrong this year. But they're sticking with their pessimistic calls.

Distressed-debt investor Anchorage Capital, for example, which lost 1.48 percent in the first six months of the year, has urged clients to start preparing for a downturn, Bloomberg News reported Thursday. The founders of rival King Street expressed a similar sentiment in a recent letter to clients after posting a 1.5 percent return in the three months ended June 30, according to ValueWalk.

Gain in Dollar-Denominated Distressed Debt This Year

34.4%

Just for perspective, dollar-denominated distressed debt has gained 34.4 percent so far this year, and 21.6 percent in the second quarter alone.

Meanwhile, Morgan Stanley credit strategist Adam Richmond has advised clients to sell riskier credit in recent months -- giving up some big returns if they took his advice -- but is sticking with his gut and reiterating his belief that bond buyers should steer clear of buying U.S. speculative-grade credit simply for its higher yield.

It's easy to see why they're worried. Earnings are stagnating and debt-to-earnings ratios have climbed to concerning levels. The Federal Reserve is trying to tiptoe away from the stimulus program that it started after the 2008 financial crisis. The Bank of Japan appears to be quickly running out of ammunition. Politicians are becoming more radical. Russia is getting scary again.

But just because the market is fragile and global leaders are fickle doesn't necessarily mean that riskier corporate credit will collapse. The big question is what could bring this market down?

Here are some possibilities:

1) The Bank of Japan could hint to markets that it's nearing the end of its sweeping bond-buying program. That day is coming. After all, the central bank's balance sheet is almost as big as the Fed's even though Japan's economy is less than one- fourth the size of that of the U.S. But any such admission would cause Japanese yields to surge, as they did a few weeks ago on the mere whiff of a policy change.

2) China could have a hard landing. If China's economy were to materially slow or even contract, that would curb global growth projections significantly and would disrupt investor appetite for riskier assets.

3) U.S. rates could rise abruptly. Traders aren't expecting the Fed to raise rates soon, but some big money managers say markets are too complacent. Any sudden rise in benchmark yields would reduce demand for the least-creditworthy bonds.

4) The Italian banking system could collapse, which would certainly ripple through markets, especially in peripheral Europe where sovereign bond yields keep falling to new record lows.

It's hard to see how the market will rapidly deflate without some sort of significant disruption. The more likely scenario is that riskier asset prices stay flat for a while or fall gradually. But a single shock could make the bears look prescient.

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