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Falling junk bond spreads trigger sense of foreboding

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by Eric Platt in New York

Oleg Melentyev, Bank of America Merrill Lynch's new head of high-yield strategy, has been dogged by a question from clients over the past month: what is to stop the extra yield investors demand to own the riskiest corporate debt falling to a record low?

It's an issue animating the $1.3tn US junk bond market as the premium that investors want over US government bonds — or spread — has fallen by almost a fifth this year and is nearing the tightest level since the financial crisis. Accompanied by a rally in US stocks to record peaks, the drop has also seen a refinancing boom in which companies have sharply cut their borrowing costs.

Mr Melentyev's short answer is that "it will just take time".

"This is an illiquid asset class and repricings . . . don't happen overnight. They happen gradually if ripe conditions exist long enough," he says.

It is a conviction strengthened after the European Central Bank last week extended its bond-buying plan into much of 2018, while the Bank of Japan this week showed no wavering from its easing programme. Together, they are propelling investors from Europe and Asia into US markets.

The view that spreads could tighten to record lows is shared by others on Wall Street even as fears grow over the risks. The spread on junk bonds reached 338 basis points earlier this month, just 3bp above a 2014 nadir that remains the lowest since the financial crisis. The all-time low remains 241bp, set in 2007. The asset class has been a winner for investors, generating a total return of 7.4 per cent this year and outperforming investment-grade bonds, according to ICE BofA indices. Leveraged loans have gained just under 3 per cent, data from S&P Dow Jones Indices shows.

S&P Global and Fitch rating agencies project defaults will decline over the coming year. Fitch analysts say the default rate of high-yield corporate bonds could slide to 2 per cent by the end of 2018, its lowest level since 2013.

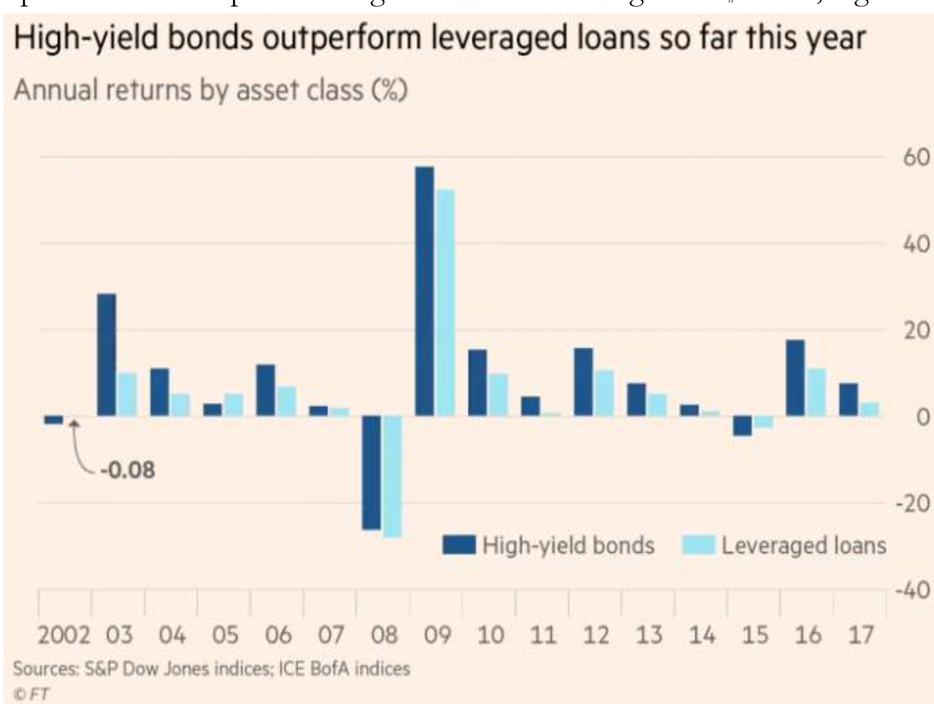
"Spreads should be tight, yields should be low," says Michael Buchanan, deputy chief investment officer of Western Asset Management. "The fundamental backdrop should be supportive for credit and we don't see that changing anytime soon. Look at defaults. They are improving and heading back to post-crisis lows."

But Western Asset is among a number of investors, including BlackRock, DoubleLine Capital and JPMorgan Asset Management, which have reduced their holdings in high-yield bonds, which Mr Buchanan says reflects lofty valuations.

The risks that come with the rally are multiple. Some investors are worried that bond buying from the ECB and BoJ has distorted corporate credit markets. At the same time, investor protections, which take the form of covenants and can restrict the level of indebtedness a company can take on, have been whittled away.

"It is very clear that financial conditions in the world are too easy," says Rick Rieder, BlackRock's chief investment officer of global fixed income. "The ECB is continuing to buy credit assets. The [yields] levels are not sustainable over the long term, but in the interim it also influences the flow of demand into US assets."

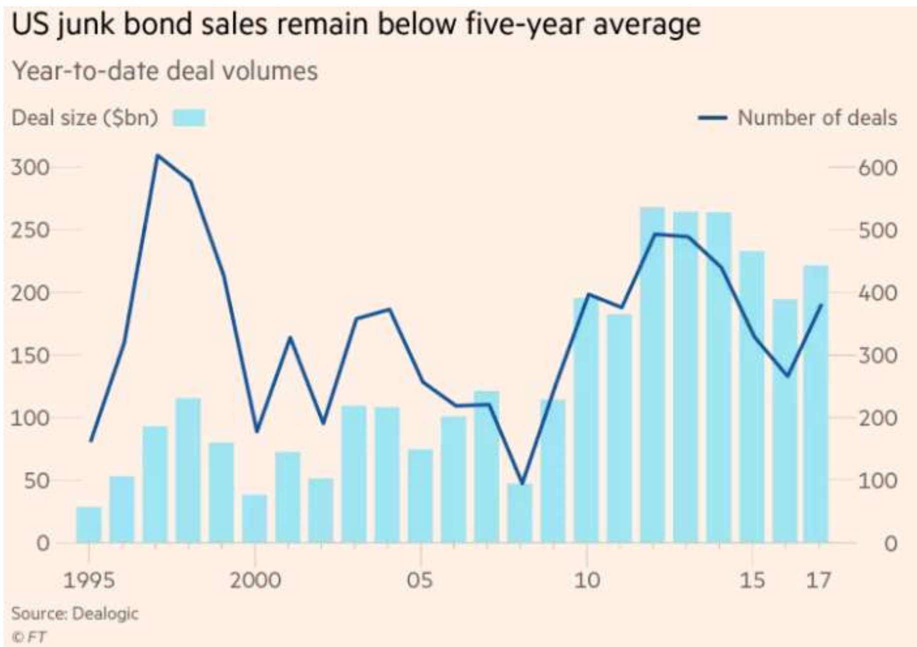
Despite the hesitancy of money managers to pour more money into the asset class, a dearth of new supply is also keeping the pressure on the spread with government bonds tight. At $221bn, high-yield corporate bond issuance in the US so far in 2017 remains below its average of the past five years, according to Dealogic. Strategists at Wells Fargo note that the asset class will be buoyed by inflows of nearly $25bn over the next five weeks through a mix of coupon payments as well as called and tendered bonds. It is money that is likely to



be ploughed back into the market.

"Right now we are in an issuer-friendly environment given the supply demand dynamics as it relates to covenants and terms," adds Gerry Murray, the head of North American leveraged finance for JPMorgan.

The lack of high-yield supply is also down to the loan market, where companies have increasingly turned for funding. Looser constraints on borrowers in the loan market have provided an incentive for companies to tap the money flowing into loan funds. Roughly $18bn has flowed into leveraged loan funds this year, according to EPFR, although the vast majority was added between January and June.



"People are throwing so much money into the loan market," says Gershon Distenfeld, director of credit at AllianceBernstein. "People throw money at that market and allow issuers to refinance at lower spreads. It is going to end up being a mistake."

For Mr Melentyev at BofA, the decline in spreads to near post-crisis lows is somewhat foreboding. Excess returns — or the gain above the return on a risk-free investment — are typically negative in the three to five years after spreads approach or fall below 300bp, he notes. And then there is the simmering worry over how badly the erosion of covenants will hit bondholders when companies do run into trouble and creditors fight for a share of the assets.

"The absence of covenants reflects the relative strength of issuers at the negotiating table," Mr Melentyev says. "The longer-term question — whether eventually we'll find out this was a mistake and default rates will be higher — it is hard to say. We'll have to live through it to figure it out."

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