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Junk Debt Getting Crowded

Spreads on high-yield bonds are narrowing, eroding a selling point of the investments

By CORRIE DRIEBUSCH
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High-yield corporate bonds have been a hot investment in 2016. Now, some investors are fretting that the debt may have gotten too popular.

Drawn by higher yields than on safer bonds and lower valuations than on stocks, portfolio managers and individuals alike have poured money into junk bonds this year. In 2016, more than a net $6.4 billion had flowed into high-yield mutual funds through the end of August, according to data from Thomson Reuters Lipper. Over the prior three years, $47.7 billion flowed out of the funds.

The tide of money has pushed up prices and returns, attracting additional funds from investors. In 2016, the iShares iBoxx High Yield Corporate Bond fund has returned 12%, beating the 7.8% total return by the S&P 500, according to FactSet.

Thinner Cushion

Junk bonds are trading at a lower premium.*

10 percentage points

*Yield spread to U.S. Treasurys

Source: Bloomberg Barclays

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Bond yields fall when prices rise, so spreads—the amount by which yields on junk debt outstrip those on Treasury debt—have fallen to their lowest levels in more than a year, according to Bloomberg Barclays data.

Some investors worry that surging prices and lower spreads are eroding one of junk bonds' strongest selling points: their tendency to generate positive returns even as rising rates hammer the value of safer bonds. In a refrain all too familiar to investors in the age of low yields and crowded trades, the higher prices could point to more volatility when the Federal Reserve next raises interest rates. That is an outcome a few analysts, including Janus Capital Group Inc. bond guruBill Gross, have pegged for this month.

"When spreads get very tight as they are now, you're not getting paid as much for taking on credit risk," said Kathleen Gaffney, who manages the Eaton Vance Multisector Income Fund. "That means your bond becomes much more interest-rate sensitive."

Sprint Corp., for instance, has a bond due in 2018 that is yielding roughly 4%, according to MarketAxess. In June, the same bond yielded around 6%. The wireless carrier, which has fallen to fourth-largest in the U.S. in terms of subscribers, posted a $302 million loss in its latest period and has lost more than $7 billion over its past three fiscal years.

A rise in interest rates of a given amount would be more significant to holders of debt yielding 4% than it would if the yield were 6%.

Junk bonds tend to be volatile by their nature. Typically issued by lower-rated companies with large debt loads relative to their earnings, the debt's performance is widely tracked on Wall Street as an early warning system for coming economic downturns.

In early February, when the market was plagued by fears of a possible U.S. recession, yields on junk bonds jumped to more than 10% and the spread to Treasurys reached 9 percentage points. High spreads beckon to investors who are willing to ride out volatile periods, giving them income that helps to cushion any losses on defaults. The average high-yield bond spread over the past 10 years is 6.45 percentage points, according to Bloomberg Barclays data.

That signal proved false, as many junk-market signals do, and markets from junk bonds to stocks to commodities have rallied sharply in the intervening six months. The spread between junk bonds and Treasury notes has since narrowed to 5.2 percentage points, a level that some investors say is too close for comfort. In 2007, ahead of the financial crisis, high-yield bond spreads were around 2.5 percentage points.

The junk-bond rally comes at a time when U.S. corporate defaults are low and rising, and the Fed is perceived by the market to be likely to raise interest rates as soon as December. Some worry that buyers at current prices are betting on a so-called Goldilocks economy that may not come to pass.

"Good enough is the only thing that works right now for high yield," said Gene Tannuzzo,senior fixed-income portfolio manager at Columbia Threadneedle Investments. "If you have too-good growth, the Fed will hike. If growth is not good, that's bad for the economy."

Mr. Tannuzzo said he has been selling high-yield debt, citing its price, and worries that investors are complacent about the Fed rate-increase cycle.

Others contend that the high valuations in other markets and the greater perceived stability of the global economy will continue to support junk bonds.

One boost to junk bonds this year has been the 20% rise in crude-oil futures. The gains have left the oil price low enough that it isn't pinching consumers' wallets, yet has stabilized the high-yield energy sector, where bond prices fell, boosting yields, as defaults rose late in 2015.

Another factor has been the expansion of easy monetary policy, in which the Fed has held off from rate increases and central bankers in Europe, Japan and China have taken steps that have supported asset prices. Many investors see this trend as fueling a global reach for yield that has been responsible for large bond-price gains.

The yield on the 10-year Treasury note is 1.597%, the dividend yield on the S&P 500 is 2.11%, according to FactSet, and the yield on high-rated U.S. corporate bonds is 2.81%, according to Bloomberg Barclays.
In comparison, many bond investors say, the 6.29% yield on junk bonds looks like a bargain. They believe the market will benefit in part from increased participation by portfolio managers who consider higher-grade bonds too expensive relative to their yields. **Write to** Corrie Driebusch at corrie.driebusch@wsj.com