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Cracks in Junk-Bond Market Form as BofA Sees Outlook Darkening

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Junk-bond investors who've been enjoying more than six straight years of gains fueled by easy-money policies may soon find their streak nearing an end.

After the three strongest years on record for issuance and annual returns of 15 percent since the start of 2009, there are growing signs of trouble in high-yield debt.

For every speculative-grade company that has had its credit rating upgraded this year, about two others have been downgraded -- the worst ratio since 2009. U.S. high-yield companies posted two consecutive quarters without earnings growth for the first time since the financial crisis. And their average level of debt-to-earnings is at an all-time high.

All of this is creating what Bank of America Corp., the second biggest underwriter of the notes, sees as a grim outlook for investors because companies have left themselves little room for error to withstand an interest rate hike just as the Federal Reserve is considering such a move.

"The conditions are the worst since the crisis and therefore outlook is the worst since the crisis," Michael Contopoulos, the head high-yield strategist at Bank of America, said in a telephone interview. "The longer-term prospects for the asset class are worrying."

No Growth

Junk bonds lost 1.52 percent last month -- their worst month since September, according to Bank of America Merrill Lynch indexes. The losses wiped out the quarter's gains, putting the returns at 2.5 percent for the year. Contopoulos forecasts returns as low as 2 percent for 2015.

"It's one of the few asset classes that have done O.K., but right now it's looking a little bit 'meh'," Jack Flaherty, a money manager in GAM Holdings AG in New York, which oversees $127 billion, said in a telephone interview.

High-yield companies posted zero growth in earnings before interest, tax, depreciation and amortization in the first quarter of this year, according to Bank of America. That's after earnings slipped 0.06 percent in the fourth quarter of 2014 -- just the second time ever that the measure has fallen along with the first three months of 2013, Contopoulos said.

Nine Defaults

Not all investors are convinced that it's time to dump the debt.

"At some point the day of reckoning is coming for the high-yield market, but that could be a few years away," said Bonnie Baha, who helps manage $73 billion as the director of global developed credit at Jeffrey Gundlach's DoubleLine Capital in Los Angeles.

She said there's "no inflation in the system" to justify the Fed raising interest rates this year.

Even if rates do rise this year, Goldman Sachs Group Inc. sees junk-rated issuers able to withstand the move after they took advantage of cheap borrowing costs to push out maturities. About 64 percent of the outstanding debt doesn't come due until 2019 or later, analysts led by Bridget Bartlett wrote in a June 30 note to clients.

More companies are facing restructurings after the cost of a barrel of oil plummeted by nearly half and iron ore fell by a third in the past year. Nine U.S. junk-rated borrowers defaulted in May, the most since October 2009, as depressed prices plagued the energy, metal and mining issuers that represent the largest contingent of debt from the riskiest companies, according to Fitch Ratings.

Overheated Markets

"High yield doesn't look too compelling, and they are facing the risk of more losses from falling commodities, which have been crushed," GAM's Flaherty said.

Debt levels at U.S. speculative-grade companies are 4.7 times earnings, the highest they've ever been, according to Bank of America. So far this year, credit rater Standard & Poor's has downgraded 224 companies versus 126, the worst ratio of upgrades to downgrades since 2009, according to data compiled by Bloomberg.

Markets are "extremely overheated," particularly U.S. speculative-grade corporate bonds, billionaire investor Carl Icahn wrote on on his verified Twitter account Wednesday.

"If more respected investors had warned about the market in '07," Icahn wrote in a post, "we might have avoided the crisis in '08."