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High yield bonds start living up to their name

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High yield bonds are beginning to re-earn their moniker. After exploring levels that made a mockery of their name and main selling point, the renewed oil price rout has ratcheted up pressure on lowly-rated corporate debt, also called "junk", sending yields spiralling higher again.

The average yield of the junk bonds in Bank of America Merrill Lynch's High Yield index has climbed back above 7 per cent again, much to the chagrin of investors who returned to the junk bond market too soon. The light at the end of the tunnel turned out to be an oncoming train.

Debt issued by lowly-rated energy companies is naturally the epicentre of the latest junk bond quake, with the average yield rocketing to more than 11 per cent this week and smashing through the highs touched at the peak of the autumnal oil crash. Investors and analysts expect a spate of corporate failures in the energy industry, as many cannot survive for long with oil prices at these levels. Royal Bank of Scotland now predicts the US default rate will double from about 2 per cent to 4 per cent by the end of the year.

The question is whether the latest bout of distress is the start of wider carnage or represents another buying opportunity to load up on higher-returning assets, in an environment where many safer bonds still offer insultingly low yields. Even if you shy away from energy junk bonds then surely the rest of the market is a bargain now?

That could be a dangerous bet, however. Higher yields on energy junk bonds should, all things being equal, mean higher borrowing costs for other industries too, due to the shifting relative value proposition. Moreover, losses could spur retail investors who have embraced junk bonds in recent years to beat a hasty retreat, reducing asset managers' ability to arrest the slide. Some are already nursing losses after oil's double-dip, and will not rush back in quickly.

UBS points out that distress in energy bonds has a nasty habit of spreading to other corners of the high yield market. Some companies are exposed to the resulting investment dip and job losses, and the relegation of investment grade energy companies into the junk bond world — becoming so-called "fallen angels" — constitutes a significant technical risk. Dumping positions is far trickier nowadays, with banks no longer acting as backstops and bond market liquidity evaporating, exacerbating sell-offs.

The non-energy high yield market is also far from pristine. Moody's Covenant Quality Index, which measures the strength of the legal protection embedded in junk bonds, fell in June to its weakest level since the gauge was started in January 2011. Riskier, higher-yielding corporate bonds typically do better than investment-grade debt when central banks raise rates, but the Federal Reserve's plans to begin tightening monetary policy later this year still represent another major hurdle.

Ominously, Standard & Poor's global corporate default rate ticked up to a two-year high of 2.2 per cent last month, after two companies — Core Entertainment and Hercules Offshore — failed to make scheduled debt payments in July. Understandably, US junk bond issuance has shrivelled lately, with July's total of $7.2bn the lowest for the month since 2008.

There are also other areas of concern. The number of bank or rating agency analysts tracking junk bonds has not kept pace with the growth of the market. The bigger companies are closely watched but many of the smaller new issuers are not, and there is a lot more "non-dedicated", or tourist, money in the market these days. As Matthew Mish of UBS wrote in a recent note, the turbulence has "exposed several hidden fragilities in the market ecosystem".

Nonetheless, the returns on offer in junk bonds are alluring when the 10-year US Treasury trades at a miserly yield of 2.22 per cent. The probability of a Federal Reserve rate rise — or two — later this year is a risk, but is likely to be more painful for longer-dated investment grade corporate bonds that trade at a far tighter spread to government debt. For now, greed is still likely to trump fear, and do not be surprised if even shell-shocked energy junk bonds attract some buyers soon. But the lows in yields seen in 2013 and 2014 are unlikely to be replicated.