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New junk bond investors put safety first

Appetite is growing for debt rated one notch into high-yield territory

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Investors have long recognised one essential rule about the bond market: if you want a bigger reward, you need to take on more risk.

Central bank policy is driving investors further into riskier areas of fixed income. Negative and ultra-low interest rates have persuaded more pension funds, insurance companies and wealthy people to lend not only to safe governments and companies but to the junk bond market as well.

The latest version of quantitative easing — launched in the UK last week and in the eurozone at the start of the summer — involves buying investment grade corporate bonds. This has pushed down the yield on highly rated private sector debt, just as previous versions of quantitative easing did for government paper.

To those worried about the potentially distorting effects of QE, this shift from investment grade into junk is more evidence of how central bank policies are increasing financial system risk.

For the moment, exiles from the safer parts of the market are mostly sticking to so-called crossover debt — bonds rated only one notch into junk territory.

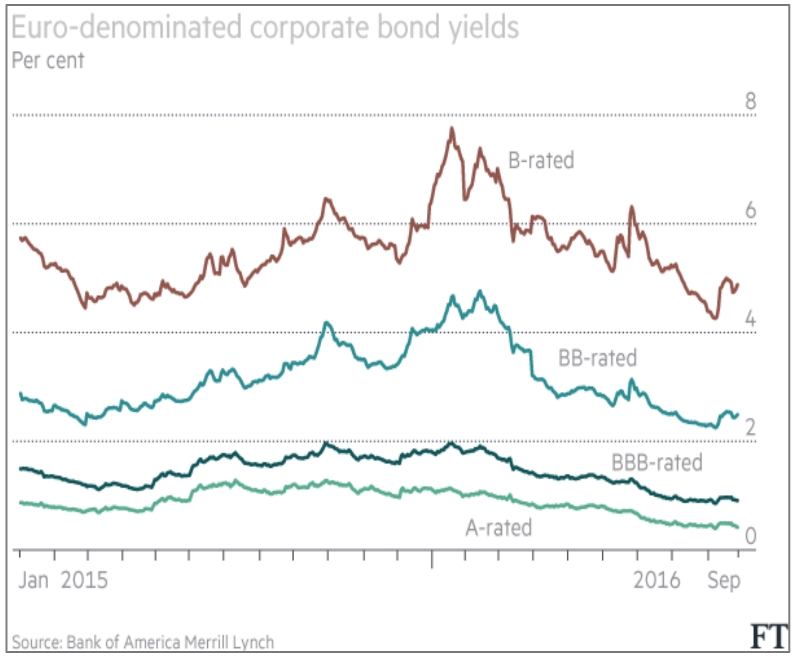
“Certainly, for the new investors in the market, it has been safety first,” says Mark Kemp, a portfolio manager at BlueBay Asset Management. Many of the non-traditional buyers who are playing in the junk bond market have constraints on their ability to buy the riskiest kind of debt, he says, “forcing more traditional high-yield buyers down the curve”.

Since the end of June, euro-denominated junk bonds included in the Bank of America Merrill Lynch BB index have returned 2.8 per cent, he says. This total return comprises both the appreciation in price of the bond and the interest rate payments.

By contrast, single Bs have returned 4.7 per cent and triple C bonds have returned 3.2 per cent.

“Single Bs are the sweet spot,” says David Newman, head of global high yield at Rogge Capital Partners. The weight of money coming into “crossover” bonds has bid up prices, which rise as yields fall, but investing in even riskier bonds would need stronger economic growth than he thinks likely.

If the traditional investment grade buyers do want to try something more exotic they may struggle. Triple C bonds account for only a small portion of the European high-yield market. According to Dealogic, more than 55 per cent of outstanding euro-denominated junk bonds are rated double B and 27 per cent have a single B rating.



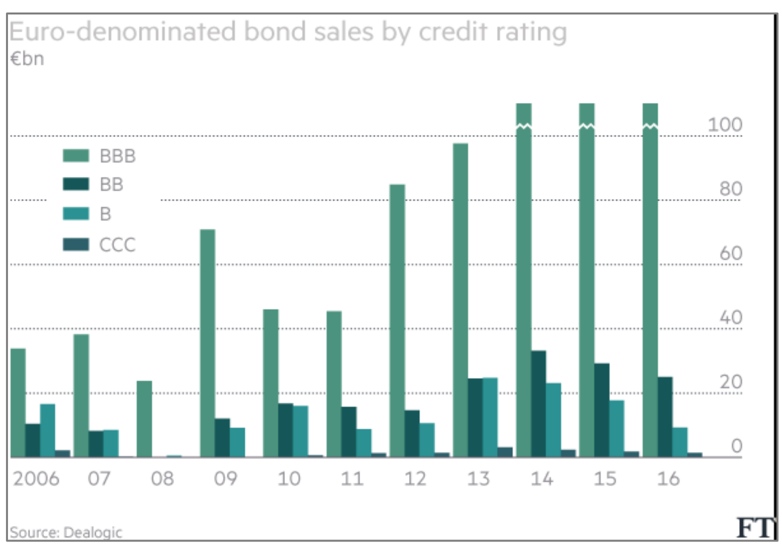
The trouble is that "everyone is trying to go through a door that's not getting bigger," says Barnaby Martin, head of European credit strategy at Bank of America Merrill Lynch. Despite growing appetite for junk bonds, the supply is somewhat limited. While more investment grade bonds have been sold than have been repaid this year, the opposite is true for high yield.

Even within high yield, new bond sales have mostly been limited to the relatively safer portions of the market — so far this year €25bn of double B-rated bonds have been sold compared with €9.3bn of single Bs and just €1.4bn of triple C.

At the same time as the European Central Bank has been buying corporate debt, it has run a policy known as targeted longer-term refinancing operations, effectively paying banks if they want to borrow from the central bank long term. The ECB has also set the deposit rate on overnight deposits to minus 0.4 per cent.

Mr Martin says that means normally junk-rated companies and private equity firms can get hold of cheap bank loans instead of needing bond markets. "High-yield companies, they now have an embarrassment of riches."

So for the moment European investors cannot take too much risk because of the limited supply available. But they will be hoping that some of the most fragile companies react to the signals from the debt markets and start levering up and selling more bonds.



If that happens QE will increase the total amount of risk in the system but potentially growth too.

For US-based investors looking for income, there is a different problem. The US recovered from the recession following the financial crisis much earlier than the eurozone, meaning the world's largest economy has less idle capacity to use up.

"We expect to see the US economy grow 2-2.5 per cent, along with an increase in wages, but we're not expecting to see a corresponding rise in productivity. This should lead to upward pressure on US inflation," says Mark Kiesel, chief investment officer for global credit at Pimco.

While the ECB is still using quantitative easing to boost demand and grow the economy, the Federal Reserve is more likely to raise rates this year. So while yields on junk are higher in the US, the combination of lacklustre growth, higher inflation and a potential rate rise is bearish for the asset class.

"Now is not the time to be reaching for yield," says Mr Kiesel.

In theory, current yields on both sides of the Atlantic should reflect market participants' best guess of growth, inflation and the future direction of interest rates and compensate for them. Beating the market will require either extraordinary powers of foresight or just a greater tolerance for risk.

Investors say they want good-quality bonds that pays them high yields, says one European debt banker. "Everyone wants money for nothing."