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Rising defaults cast cloud over US junk bond surge

Corporate failures on the rise and valuations are starting to look stretched

The Short View

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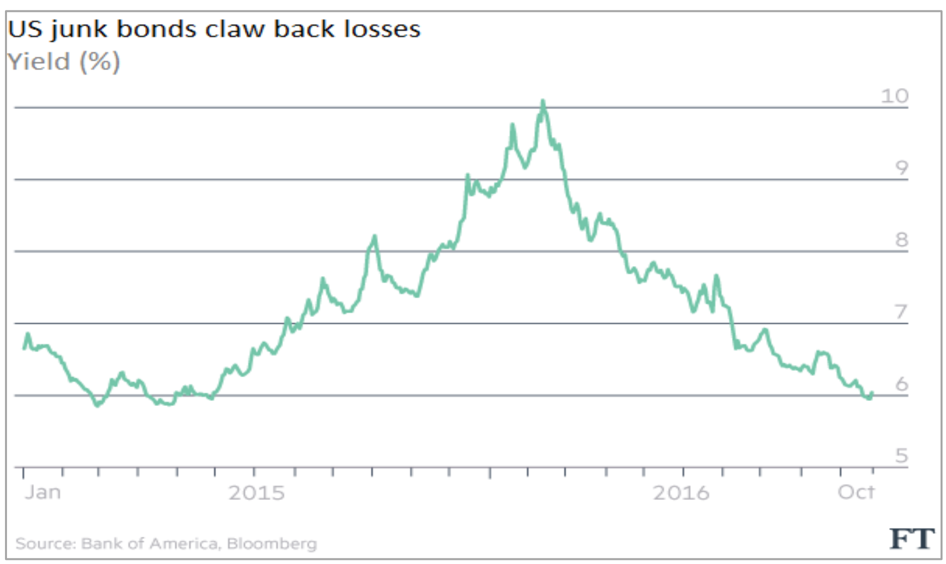
Calvin, the six-year-old modern-era philosopher invented by cartoonist Bill Watterson, once insisted to his stuffed tiger sidekick Hobbes that he wasn't in denial about his homework. "I'm just selective about the reality I accept," he argued.

This may sound familiar to US junk bond investors.

Here is their reality: recovering oil prices mean salvation for many energy companies that had previously looked doomed. An underwhelming but stubbornly resilient US economy has defied fears of a looming recession. Most of all, where else in the world can investors get the sweet, sweet yield that they crave?

As a result, the US junk bond market has already returned almost 17 per cent in 2016 despite a swoon early in the year. If those results are sustained, this will be the sector's third-best year for returns in the past two decades. The junkiest of junk — bonds rated triple-C — have rocketed a staggering 29 per cent.

But this reality has some cracks, and several are widening at the moment. Corporate failures are climbing, lifting the US default rate to a six-year high of 4.8 per cent. While the vast majority of defaults have been in the energy industry, there has been a gentle but ominous increase elsewhere. Valuations are also beginning to look very stretched. The average yield has fallen from a peak of more than 10 per cent in February to a one-year low of less than 6 per cent this week. Marty Fridson, a venerable junk bond analyst, reckons that the market has been more overvalued only once in the past two decades: right before the financial crisis.



The supportive technical backdrop could also be reversed quickly. UBS this week calculated that 70 per cent of the entire $922bn US high-yield market is held by mutual funds and separately managed accounts. It is acutely vulnerable to any shifts in investor flows. The top five investors alone own $264bn — about a fifth of the entire market. This second reality is beginning to assert itself, with the prices of the two biggest junk bond ETFs falling for three days running this week amid a broader bond market slide. If it achieves primacy, things could get ugly.

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