Low Treasury yields to benefit HY

Bonds **Worries hit secondary bonds, but drop in Treasury yields might prove positive for high-yield**

BY RACHELLE KAKOURIS

The plunge in global risk assets last week, following the Standard & Poor's downgrade of the US credit rating, triggered the worst day in the high-yield market for more than two years. But far from threatening to derail the asset class, the subsequent flight to quality and drop in Treasury yields could actually work in the market's favour.

High-yield bonds were hit particularly hard as investors – increasingly anxious about global economic growth – pushed the panic button on risk, withdrawing a near-record US$3.4bn from high-yield funds last week, according to data from Lipper.

The CDS index tied to junk bonds experienced its biggest one-day loss on Monday since November 2008 as the average yield-to-worst on the Barclays US high-yield index breached 8.5% for the first time in more than a year.

It was a sharp turnaround for what has been an asset class of choice for investors, who in their unrelenting hunt for yield facilitated record volumes of supply in 2010. And they did not go unrewarded. Junk bonds returned a massive 50% in 2009 and 15% in 2010.

For the first half of 2011, the market returned 6%, placing it on track to meet expectations of returns between 6% and 11% for 2011, although a negative return of nearly 4% in the past month may still challenge that forecast.

Robert Harteveldt, global head of leveraged finance at Jefferies, noted that this time, in contrast to 2008, risk was not off the table.

"Companies are not facing the leverage problems they had during the crisis and fundamentals in the high-yield and leveraged loan markets are strong," he said. "And in any case, there are very few places where one can go to earn yields of 6% to 9%."

Echoing that sentiment, Dave Flaherty, a senior portfolio manager at Peritus Asset Management, said that corporate fundamentals, including profitability and liquidity, had rarely – if ever – been better.

"High-yield credit markets have allowed corporations to refinance at record levels, and corporate cash and liquidity are at record levels," he said. "High-yield defaults are expected to be close to non-existent over the next few years."

Junk bonds are typically the beneficiary of low interest rates and, with the flight to quality pushing short-dated US Treasury yields to new lows, market participants are maintaining that any weakness in high-yield bond prices should be viewed as an opportunity to buy.

"Corporate credit has not lost its opportunities – if anything, the recent pricing pressure just creates better entry points," said Flaherty.

Economic conundrum

However, while low default rates, record low Treasury yields and the US Treasury's pledge to keep rates low for at least two years all point in favour of high-yield bonds, the increased risk of an economic slowdown has cast a dark cloud over the market.

In an interview with Reuters Insider TV, Martin Fridson, a global credit strategist at BNP Paribas Investment Partners, warned that the increased risk of recession in the US may put added pressure on high-yield bonds in the long term.

"However, companies have spent a good part of the last couple of years extending their maturities, so they are not particularly vulnerable to disruptions in the financial market in the short term," said Fridson.

Barclays pointed out in a recent research note that, given the slower growth expectations, investors should also consider adjusting their risk by moving up the quality spectrum, as Double B issuers, particularly those with positive ratings momentum, are much better positioned to weather a prolonged soft patch than their lower-quality counterparts.

"Historical data suggest that only Double Bs can be expected to withstand a prolonged period of slow-to-no GDP growth," said Bradley Rogoff, head of US credit strategy at Barclays.

During Monday's sell-off, the Double B sector fell by about 2.2 points, while further down the credit spectrum Single B and Triple C sectors suffered losses of 3.5 points and 4.0 points respectively.

"I'm still pretty sanguine on the high-yield market," said Michael Collins, a senior investment manager at Prudential. "High-yield has cheapened up quite a bit, while the rally in Treasuries has outweighed the spread widening in high-grade corporates, meaning overall yield in that market is lower. That's resulted in an explosion in the gap between Triple B and Double B yields." ■

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