HCWE
Worldwide Economics

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Interest-Rate Outlook

Is it finally time to get out of junk bonds?

> **The return from investing in junk bonds depends on the extent to which the prevailing economic winds are blowing their way. Whether they are "expensive" or "cheap" is secondary.**

Last September, the yield on junk bonds, 6.47 percent at the end of the month for a prominent Merrill Lynch index, had declined far below historical norms. However, a *Wainwright* report at the time chose to place little weight on that and concluded that the prospects for junk bond performance were "good."[1] Indeed, in the seven months since that time, Merrill Lynch's index has returned 7.3 percent, or 12.9 annualized. During that period the corresponding yield index declined nearly a full point to 5.53 percent.

No question, yields and spreads are closely watched as valuation indicators for the junk bond market. But should they be? Recent experience continues to challenge the widespread perception that historically low readings are adverse for future performance. Figure One illustrates the uncomfortable fact that, despite deepening investor skepticism about valuation, yields and spreads have continued to hit historic lows all the way to the present.

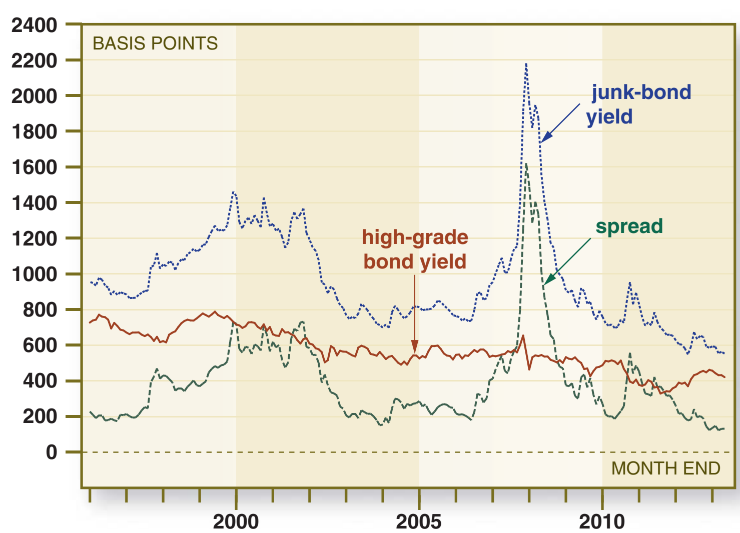
No doubt the absence of a serious and adverse turn in the US or world economies during the past few years goes some way to explain how valuation measures of the high yield market can keep getting further and further away from perceived historical norms. Many investors would think, instinctively, that the Ukraine-Russia crisis would be sufficient to bring on a turning point in both growth and credit spreads, but that still shows no signs of happening. During stable economic times, the high-yield investor is left without a compass, so to speak. And getting out of a market too early can be as damaging to investment success as getting out too late. This report explores earlier findings that economic indicators may provide better market signals than valuation indicators.

Recent performance of junk bonds compared with high-grade corporates. Changes in yield spreads are a poor indicator of relative performance. For example, the yield spread between high-grade and high-yield bonds narrowed from 191 to 134 basis points over the last seven months; yet the annual-

Figure One

Junk Bond Yields and Spreads relative to High-Grade Bonds

from the end of 1996



Data: Month-end yields for B- and C-grade high-yield corporate bonds (Bank of America Merrill Lynch) and high-grade corporate bonds (Moody's/Federal Reserve Board).

1. "The hiccup in high-yield debt markets," *Interest-Rate Outlook*, H. C. Wainwright & Co. Economics Inc., September 20, 2013, p.3.

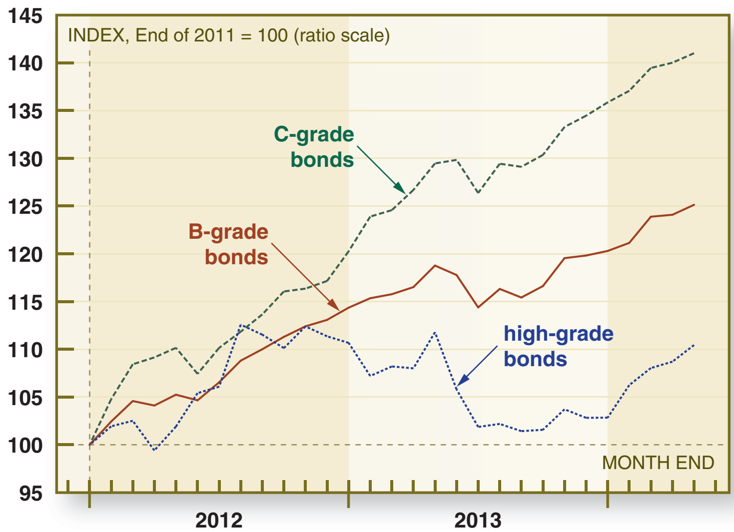
ized total return from the high-grade index was still superior by a margin of 2½ percentage points. Since the yield on top-quality bonds is always lower than the yield on junk bonds, the former can outperform the latter even when the yield spread between them contracts – especially when the general level of interest rates is low.

Figure Two compares cumulative returns from these asset classes over the past couple of years. While junk bonds are much more volatile than high-grade bonds, the opposite was true in 2013. There was little reason to expect this from historical patterns or valuation data, but it does have an explanation. The following paragraphs re-tell the story in terms of economic indicators emphasized in our multi-asset classification model, namely the price of gold bullion and credit spreads in the investment grade bond market.

Figure Two

Cumulative Returns from High-grade and High-Yield Bonds

from the end of 2011



Data: Month-end total-return indices for B- and C-grade high-yield corporate bonds (Bank of America Merrill Lynch) and high-grade corporate bonds (University of Chicago/Dimensional Fund Advisors).

Economic *versus* valuation leading indicators to anticipate high-grade and high-yield returns. High-quality bonds thrive on low inflation and, to a lesser extent, on low economic growth. Earlier *Wainwright* research reports classified them accordingly within the scope of an asset-allocation model based on movements in the price of gold (interpreted as an indicator of future inflation) and investment-grade credit spreads (interpreted as an inverse indicator of future growth). We used the same criteria to classify B-grade and C-grade bonds separately. Figures Three, Four and Five update and re-illustrate our conclusions in the form of bar charts.

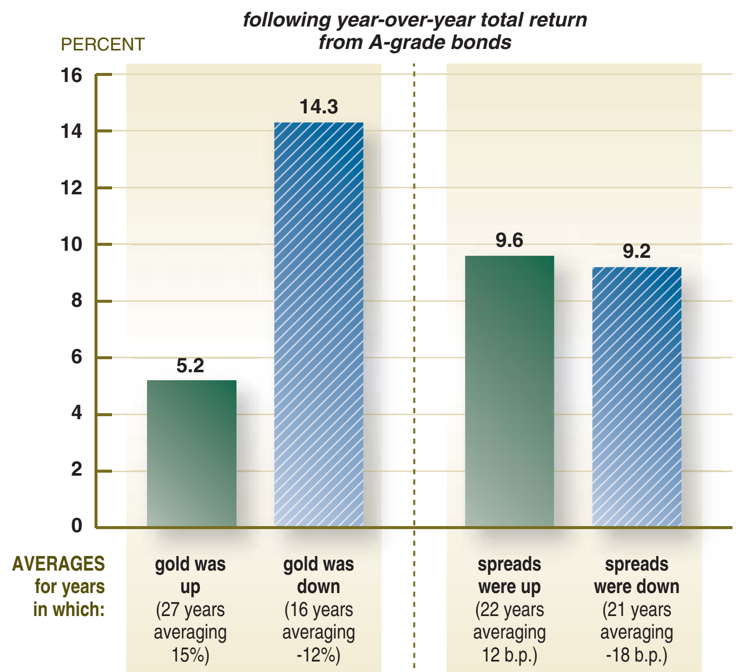
Analyzing the period from 1969, when gold was first volatile, least-squares analysis suggests that the most favorable conditions for high- or A-grade bond performance are a decline in the price of gold coupled with a rise in credit spreads. On closer inspection, however, while a decline in gold is strongly favorable, the impact of spreads is barely perceptible in historical averages, as shown in Figure Three.

Unfortunately, available data histories for B- and C-grade junk bonds are much shorter than in Figure Three, dating from 1997, and confidence in classifying these specific assets cannot be so confident. We begin with the lowest-quality junk bonds, those graded C or below. Figure Four analyzes the average response of C-grade bond returns depending on whether

Figure Three

Gold Prices and Credit Spreads as Leading Indicators of A-grade Bond Performance

calendar-year average data from 1949



Data: Calendar-year averages of month-end quotations for spot gold (*Metals Week*), yields on Baa and Aaa corporate bonds (Moody's/Federal Reserve Board), and of total-return indices for high-grade corporate bonds (University of Chicago/Dimensional Fund Advisors).

the gold and spreads indicators were up or down from the year before, and also depending on whether the yield on C-grade bonds was above or below its historical average.

The pattern we see in the first and second panels of Figure Four is the opposite from Figure Three. A rise in gold is strongly favorable for C-grade bond performance, while spreads again have relatively little impact. In the third panel, attractive valuation tends to result in higher return, but the sensitivity of performance one-year-ahead to that is much smaller than sensitivity to the gold-price indicator.

In Figure Five we repeat these calculations for B-grade bonds. We again see quite a different pattern. A decline in spreads is moderately favorable for B-grade bond performance. A rise in the price of gold is favorable as well, but much less so than for the C-grade category. As a predictive indicator, valuation is less powerful than gold or spreads.

Further tests of valuation indicators produced similar results for both B-grade and C-grade bonds. We found that the yield spread between C- and A-grade bonds is an inconsistent and inferior predictor of C-grade relative to A-grade returns one year forward. The yield spread between B- and A-grade bonds is equally weak as a predictor of B-grade relative to A-grade returns.

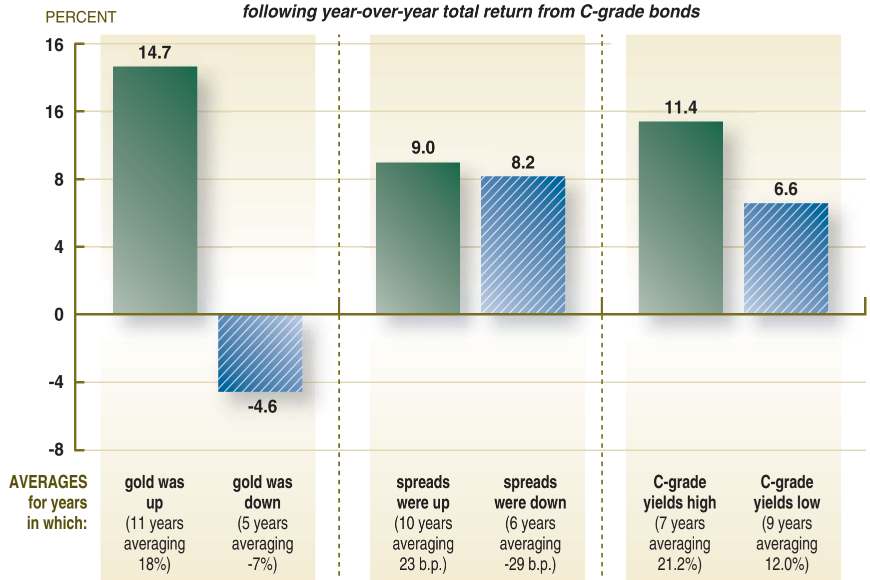
It is entirely possible that the time to get out of the junk-bond market has yet to arrive. Based on the decline in both gold and spreads from last year, the outlook for junk bonds remains favorable even today.

Investment conclusions. The performance of the junk-bond market has been a puzzle to investors in recent years. In hindsight, short-term reversals turned out to be misconstrued as turning points. As yields pushed lower and lower, the market looked increasingly expensive, and deterred more and more investors. Despite these dropouts, performance persisted. The tightening of yields has continued right up to the present, and junk bonds have continued to produce healthy returns.

Figure Four

Gold Prices, Credit Spreads and Valuation as Leading Indicators of C-grade Bond Performance

calendar-year average data from 1997



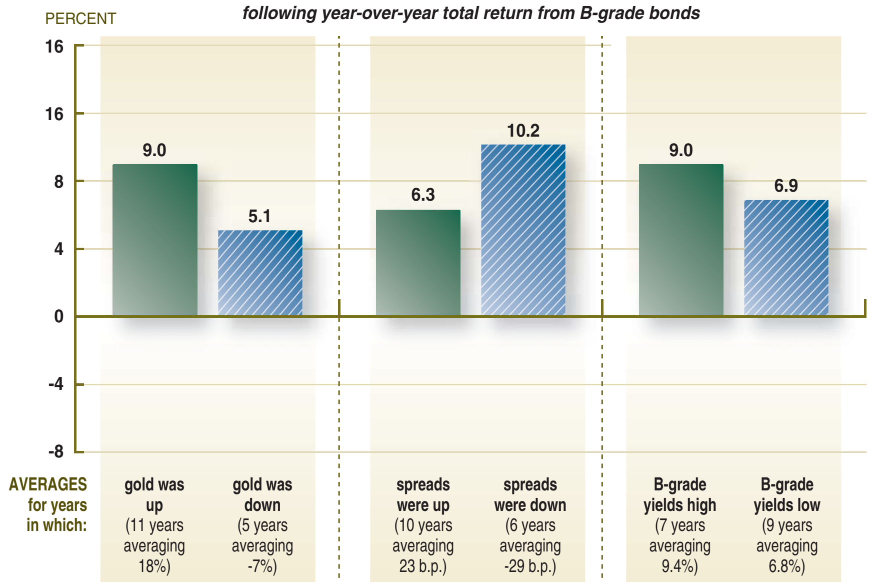
Data: As for Figure Three, together with calendar-year averages of total-return indices for C-grade high-yield bonds (Bank of America Merrill Lynch).

History suggests that junk-bond yields are not good predictors of future performance. When performance is driven persistently in the same direction by other factors, what are interpreted as extreme valuations are the result. The

Figure Five

Gold Prices, Credit Spreads and Valuation as Leading Indicators of B-grade Bond Performance

calendar-year average data from 1997



Data: As for Figure Three, together with calendar-year averages of total-return indices for B-grade high-yield bonds (Bank of America Merrill Lynch).

information these valuation indicators contain is more a statement about the past than a prediction of the future. To understand why they are sometimes "cheap" and sometimes "expensive," it is more constructive to imagine that valuation is more an outcome of performance than the cause.

What are these other factors? They include economic leading indicators such as the price of gold (interpreted as measuring of the performance of the dollar) and credit spreads in the investment-grade bond market (interpreted as a leading indicator of economic growth). rise in the price of gold leads to superior performance in the C-grade category of junk bonds, but has little effect on the B-grade category. A tightening of credit spreads moderately enhances the performance of both categories.[2]

The short-term outlook for junk bonds, taking into account all these predictive factors, is still favorable today.

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1. "Quality bets in junk bonds," *Interest-Rate Outlook*, Wainwright, February 28, 2011; and "A trading-rule test of risk bets in high-yield debt," *Interest-Rate Outlook*, Wainwright, March 23, 2012.

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