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Strategy Session

Junk Bonds -- About to Live Up To Their Name

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With yields at all-time lows and poor equity selection still stinging, many investors have run to the comforting yields on junk bonds. Given the record of this crowd, this run to junk is misguided.

High yields are not providing the bargains that should get you salivating. The junk bond market's fundamentals are unappealing, due to a likely triple hit from increasing interest rates overall, increasing spreads and rising default rates. If you need a fixed-income fix, consider TIPS (Treasury Inflation-Protected Securities) until valuation and yield spreads make it worthwhile to feed on junk bonds.

Tripping Over the Run to Yield

Compared with the previous runs to yield, this one potentially has more painful consequences than others we have observed. The pain will come from increasing rates (both overall and in spreads) and increased defaults.
As several contributors have pointed out, equity risk premiums are narrow (i.e., stocks are valued to the high end). I believe this mirrors a similar situation in junk bonds as well.

That's not surprising because high-yield debt is heavily correlated to equities. In particular, high-yield returns are most correlated to returns on the smaller-cap indices, because junk bonds are typically from "less-established" companies.

High Yield Correlations
(Quarterly correlation with CSFB High Yield Index, 1986-2003)

Asset	Correlation with High Yield
Russell 2000 Index	0.6426
Russell Midcap Index	0.6035
Nasdaq Composite	0.5501
Russell 1000 Index	0.5470
S&P 500	0.5317
Lehman Aggregate Bond Index	0.1802
Lehman Long-Term Government Bond Index	0.1792
Lehman Intermediate-Term Government Bond Index	0.1283
U.S. 30-day T-Bill	-0.1825

Source: Brian Breidenbach

Junk is not a haven from overpriced stocks. The same forces that overprice the equity market are overpricing the junk bond market, too. Fixed-income investors looking for yields in junk are likely to get hammered by price reductions in the junk market.

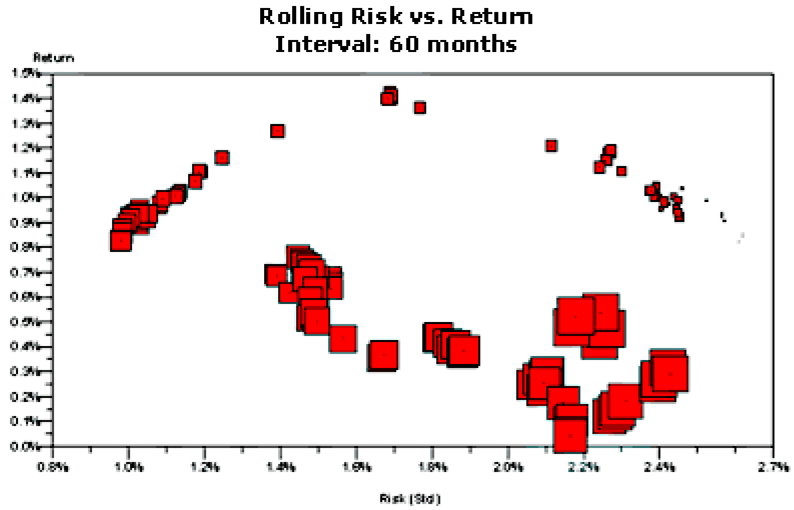
If junk bonds are overpriced, as I believe, then there are only two things that can correct this:

- Option No. 1: A significant reduction in interest rates on investment-grade and government securities -- a reduction that would cause junk spreads to widen enough to reflect the appropriate level of risk.
- Option No. 2: Junk bond prices fall.

I don't think any of us is calling for a Japanese zero interest rate yield curve. That leaves us with Option No. 2: Junk bond prices fall.

The Honeymoon Is Over

There was a honeymoon period for junk bonds in which institutional investors were able to record significant gains at low risk, due to what I like to term "learning curve inefficiencies." The honeymoon period can be seen in the graph below:



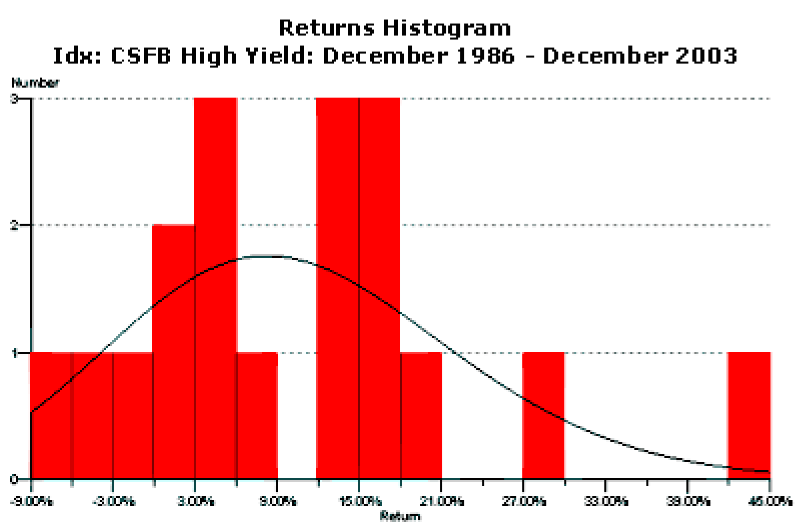
Source: Brian Briedenbach

Here are the details on the graph:

- The index plotted is the CSFB High Yield Index, 1986 to 2003.
- An interval of 60 months (five years) is the rolling time-period return (monthly).
- The larger the block, the more recent the 60-month time period.
- X-axis is risk measured by standard deviation.
- Y-axis is return (average monthly return for the five-year period).

This graph can be best read counterclockwise, starting from the right upper corner. You can see the "start-up" period (2 to 1 o'clock) where "high return / high risk" dominated. As the learning curve and other factors kicked in, you can see the period of "high return/low risk" (upper left-hand corner, about 11 to 9 o'clock). Completing the counterclockwise cycle from 9 o'clock to 6 o'clock, the more recent shift has been to "low return/high risk," the worst place to be. Looking at the most recent time periods (5 o'clock), I'm of the opinion that Gresham's Law has started, i.e., the bad is pushing out the good. The low returns and high volatility demonstrate that the "good" junk bonds are being pushed out by the "bad." The honeymoon is over.

The question that begs asking: "Is reversion to the mean an appropriate assumption?" I think that economic and fundamental issues point to a nice reversion to the mean. In other words, we're going back to higher returns. And as discussed above, the most likely way to get back to higher rates of return is for bond prices to fall. I'd take a pass on junk until valuations merit.



Source: Brian Briedenbach

The **Fed's** fight against deflation -- the push to get some healthy inflation into the market -- is working. But I would contend that, although overall pricing strength by business is showing improvement, it is not as strong as needed to meet current market expectations. As pricing lags expectations, high-yield spreads in the sectors unable to increase prices are likely to widen despite the better economy. In addition, some sectors face the potential onslaught of the bubble popping in China. These pressures should cause the default rate to increase.

Many U.S.-based high-yield managers have been ramping up their nondomestic holdings and improving their credit quality. That's a smart hedge against many of the inflation/dollar issues currently in the U.S. economy. Foreign-denominated bonds are more reasonably priced, as well.

Conclusion: In short, we think high yield is not likely to provide a safe haven for those worried about equities but looking for return.

The reasons are:

- The run to yield has driven the junk bond market to a premium valuation (relative to historical levels).
- The evidence indicates junk bonds are likely to be susceptible to spread reversion and increased default rates.
- Premium valuation and increased risk means junk bonds will need to suffer price declines for returns to become more in line with current market risk.

For fixed-income alternatives to junk bonds, consider TIPS for inflation and default protection.