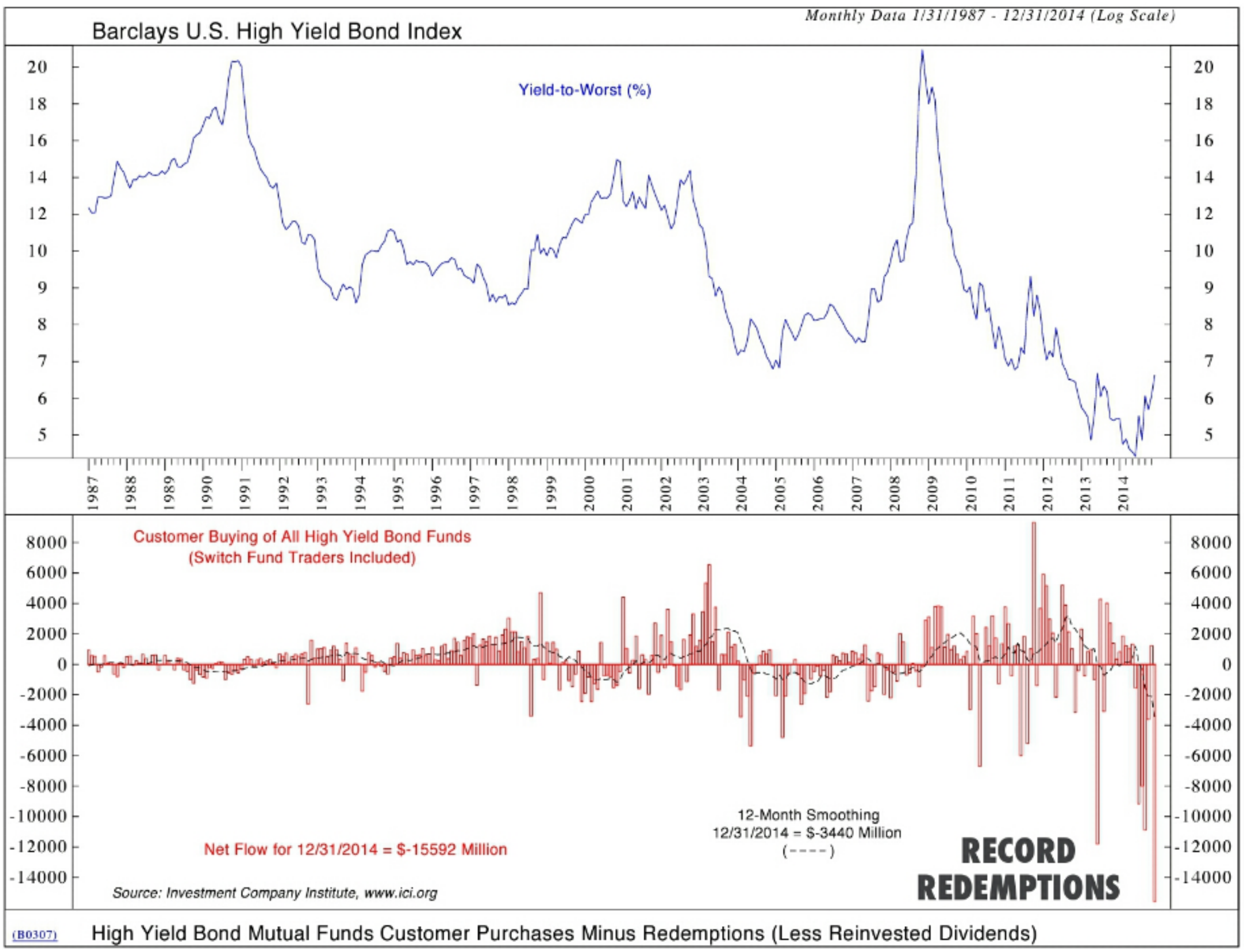
High Yield or Junk: Is a 7% yield enough?

In today's world, labels, categories, and designations are very often being redefined, and, not surprisingly, this phenomenon extends to those of us working in the business of finance. Brokers are now frequently referred to as consultants and junk bonds are being categorized as high yield. In terms of the bond market, very often the high yield classification will suddenly change if these bonds are in the midst of a selloff. Over the last few months, the high yield asset class has been experiencing signification volume in the form of redemptions (chart 1). In December alone, high yield bond mutual funds recorded over $15 billion in redemptions. While as a percentage of the total high yield assets these redemptions only amounted to 4%, the associated price action and resulting volatility was substantial. Today yields stand at approximately 7% (chart 1), but the question is, are these levels high enough to justify the risk? Let's look at the risk in high yield currently.

Chart 1



Most high yield cycles hit a trough as rates inch up or overall defaults rise in one or several sectors of the market, bringing with it selling pressure across the entire space. The current cycle is developing differently; not only is the energy sector under severe stress, but liquidity is unusually low.

Chart 2

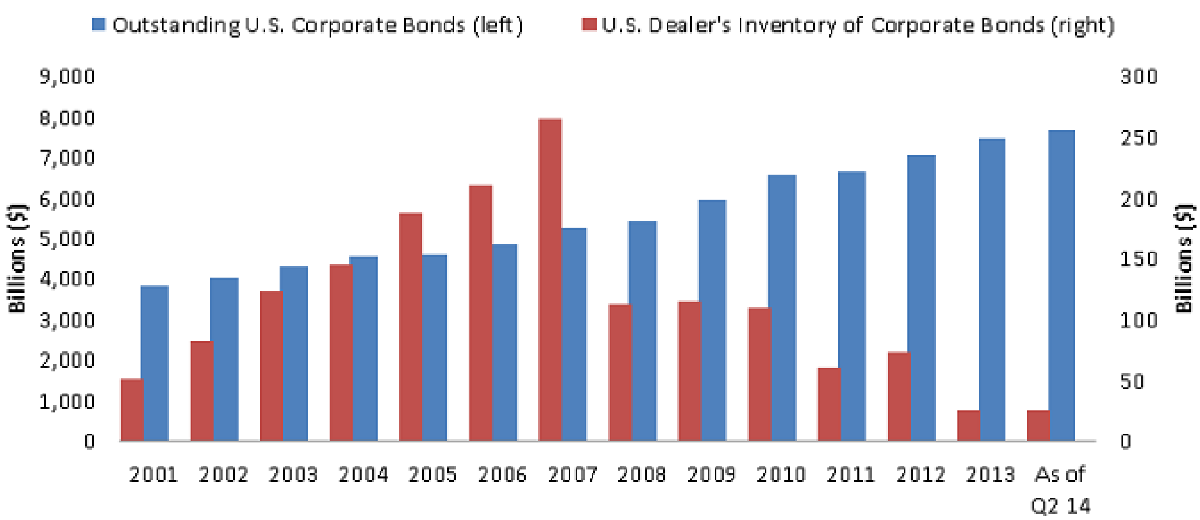
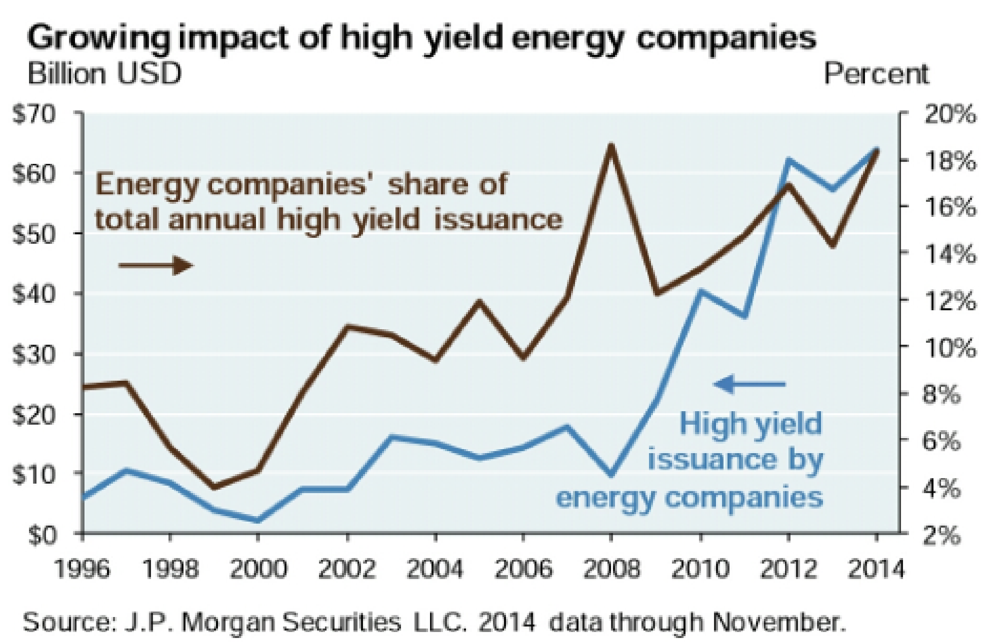


Chart 2 indicates that the liquidity as measured by corporate bond dealer inventory has been declining since the financial crisis of 2008. The reduced inventory is primarily the unintended consequence of new regulations and fewer players (remember Bear Stearns, Lehman etc.). The decline in inventory is creating a less liquid environment as redemptions persist.

The energy boom, based on the increased use of shale fracking, has primarily been financed through bonds, the majority of which are rated junk. Since 2008 over $50 billion in high yield new issuance has come from the energy sector, this growth has caused the share of energy companies issuing high yield bonds to increase to slightly over 18% (chart 3) of the total high yield market.

Chart 3



So, what does this mean for an investor? We believe now is simply not the time to go bottom fishing and that oil prices will determine the fate of the high yield market. If the price for oil continues to slide, it will become tough for many companies focused on shale oil to continue servicing their bonds. As a result, the dislocation in the junk bond market will be even more pronounced given today's low liquidity environment. It is our intention to wait for either the oil price to stabilize or to see more capitulation in the high yield space if oil prices fall further before any type of recovery. For those with existing high yield allocations, we believe it is prudent to rebalance to no more than 4-5% total high yield exposure, while the aforementioned market dynamics play out over the next weeks or months. Stay tuned…