The junk bond market's early warning signs are all flashing red for the global economy

The antennae of high-yield investors are particularly sensitive to the danger signals swirling around the financial ether

Yields on debt issued by US companies with a credit rating of BB or lower have continued to rise Photo: Getty

By Ben Wright

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While it is broadly true that most financial activity is powered by a heady cocktail of fear and greed, the exact mix of those two principle emotions varies greatly from market to market.

In the equity markets, for example – where the upside, and therefore returns, are theoretically limitless – avarice often overpowers anxiety. In the bond markets, where investors mostly just want to get back the money they lend to countries or companies (plus interest), it’s the other way round.

This naturally pessimistic streak can be broken down further. Those who lend money to countries are relatively phlegmatic because governments only rarely default on their debts; those who lend to big, credit-worthy companies are a touch more jumpy; those who invest in high-yield (or, depending on how polite you feel, junk) bonds are as skittish as new-born colts.

High-yield corprote bonds in 2015

This high level of risk aversion makes the antennae of junk bond investors particularly sensitive to the danger signals swirling around the financial ether. And that’s particularly pertinent right now because multiple warning signs are flashing in the US high-yield market, which, true to form, is acting as an early warning mechanism for the global economy.

The naturally pessimistic streak of bond investors can be broken down further: those who invest

The first red light on the dashboard appeared in July, when analysts at Bank of America Merrill Lynch *in high-yield bonds are as skittish as new-born colts.*

pointed out the huge gap between high-yield spreads and equity volatility – a good proxy for the level of complacency among equity investors. On August 14 the gap reached its widest level since March 6, 2008 – less than a fortnight before the financial crisis kicked off in earnest. The equity market sell-off over the summer closed the chasm a bit but not completely. The question now: was this the quake or just a pre-tremor?

The signs are not good. Yields on debt issued by US companies with a credit rating of BB or lower (and therefore not classed as investment grade) have continued to rise. Prices (which move in the opposite direction to yields) are down 2pc for the year (even when you factor in interest payments) and are on course for their first yearly loss since the financial crisis.

High-yield investing used to be a niche activity. But that was before global interest rates hit record lows, forcing investors to forage further afield in search of yield. Many found it in junk bonds, which pay a higher rate of interest to compensate for the higher risk of default. But with the US Federal Reserve about to raise rates, investors are growing concerned that the six-year bull market in credit is about to come to a juddering halt.

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Normally, central banks would be tightening when the economy was growing strongly. But the high-yield markets also tell us that these aren't normal times. Defaults, which were running at 2.1pc last year, have inched up to 2.6pc so far in 2015. Worse, they could jump to 4.6pc next year, according to Edward Altman, the finance professor who invented a widely-used formula that predicts defaults. That doesn't sound like a huge leap but the 30-year average is 3.8pc and hasn't been breached since 2009, in the immediate aftermath of the credit crunch.

So far this year there have been 102 high-yield defaults around the world, according to Standard & Poor's, up from 62 in the whole of 2014. Moody's has 37pc more companies on its "distressed list" than it did this time last year. Rising corporate defaults are usually a pretty accurate harbinger of coming recessions.

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Some analysts note that a lot of the pain is being felt by companies in the energy and mining sectors as the low price of oil and China slowdown begin to bite. But, equally, borrowing costs for the lowest rated non-energy companies are also rising and non-commodity companies are carrying record levels of debt. Bankers report that investors, who until recently were gobbling up any new bonds that came their way, are now turning their noses up at those securities issued by the very riskiest triple-C-rated companies – another cause for concern.

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The good news is that the US corporate bond market is traditionally pretty resilient in the face of Fed rate hikes. On average, they fared better than lower-risk Treasury bonds during the past three big tightening cycles in 1994, 1999 and 2004, according to Capital Economics. However, the fear could spread. Investment grade companies have been trying to "front run" a rate rise by the Fed, taking advantage of low interest rates to releverage and buy back stock while they still can. This has, in turn, helped push equity prices higher. But such activity could soon be cut dead. What will happen to equity prices then?

This is a particular concern given the high levels of volatility buffeting the financial markets so far this year. Some have put this down to the fact that banks have been made to hold more capital and therefore have been withdrawing from their traditional market-making activity, which helped smooth out the peaks and troughs of price movements. But there is potentially something far more fundamental going on.

The relatively high global equity prices point to expectations of strong economic growth Photo: © Guy Corbishley / Alamy Live News

The relatively high global equity prices point to expectations of strong economic growth; the historically very high bond prices point to expectations of weak economic growth. How does one reconcile these two wildly inconsistent worldviews? The short answer is quantitative easing, which has pumped up asset values far beyond what the fundamentals would justify. Any bad news that comes along – and there has been a fair bit of that in recent months – merely serves to highlight that growing disconnect.

With the paths of the US Federal Reserve, the Bank of England and the European Central Bank starting to diverge as we enter the new year, it is clear that, at the very least, investors are in for a bumpy ride in 2016.