Opinion **Lex**

Corporate bonds: record yields are putting the juice back into junk

The advice last year to jump into fixed income was bad and it still makes little sense

Central banks, including the US Federal Reserve under governor Jay Powell, have lifted short-term rates, depressing bond prices © FT Montage: Reuters/AFP/Getty

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For at least a year, market strategists have told investors to pile into fixed income securities. That has generally been bad advice. Central banks, including the US Federal Reserve, have lifted short-term rates, depressing bond prices. Long-term rates have also jumped. Earlier this week the US 10-year Treasury briefly passed a 5 per cent yield for the first time since 2007.

Could this represent a high-water mark, signalling that it is the right time to buy into corporate bonds? Analysts at Citigroup forecast that high-yield bonds will return 7-9 per cent annually on average over the next five years. This is far better than recent results in the era of easy money.

Citi noted that the "yield to worst" (the implied return calculated to the first call date) for the FTSE High Yield index touched 9.63 per cent last week. That is a benchmark that has almost never been seen in the past two decades, outside of the financial crisis.

The analysis also shows that realised high-yield bond returns typically lag point-in-time peak yields by about 2 to 3 percentage points over five and 10 year horizons respectively. That return calculation relative to peak yields factors in defaults and falling interest rates. The latter decrease reinvestment returns of cash coupons. On the flip side, lower interest rates increase the trading price of bonds should they be sold prior to maturity.

Junk bond yields have been inching up overall, tracking the rise in Treasuries and investment grade debt. Spreads — the difference between Treasuries and high-yield bond yields — have stayed in line with historical averages at around 4 to 5 percentage points.

There is an overriding question. Will a weakening economy make it tough for companies to refinance debt or pay interest, pushing up defaults? In this event spreads would widen over base interest rates that are already historically high.

In that case, advice to jump into fixed income will once again have been premature.

The Lex team is interested in hearing more from readers. Is it time to buy high-yield bonds? Please tell us what you think in the comments section below.

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