

October 22, 2012

from  Montage Investments

Credit Metrics Suggest Bond Markets Could Be Near a Top

In the current low-rate environment in the fixed-income markets, we are now seeing a pronounced “reach for yield” among some investors. As market yields drop, and persist at low levels for some length of time, investors begin to try to capture additional yield in their portfolios by extending maturities (to take advantage of any steepness in the yield curve) and by reaching down the credit spectrum (buying bonds with weaker credit quality that offer higher yields). As investors become more willing to take risk (interest rate risk and credit risk) in return for relatively higher yields:

- The yield curve flattens, as demand for higher yielding longer maturity bonds drives prices up (and yields down);
- Credit spreads tighten (the difference in yield between the highest rated bonds and lower rated or non-rated bonds shrinks) as demand drives prices up (and yields down) for riskier bonds; and
- Issuers react to increasing investor demand by issuing lower quality bonds and by weakening the security features included in the bonds they sell.

Over the course of market cycles, we see certain recurring patterns in fixed income markets. In the late 1990s and early 2000, and again in 2006 and early 2007, we saw the same kinds of developments in credit markets as investors chased marginally higher yields. In those cases, fixed-income markets subsequently experienced rising interest rates that steepened the yield curve and drove credit spreads wider. Investors who bought lower-rated and longer maturity suffered worse performance, and were at higher risk of credit events like downgrades or default as the market corrected back toward more historically normal rates.

We believe that the current tone in fixed income markets feels similar to what we saw during those past periods. We cannot say with certainty that the municipal or corporate markets are at a top (yields bottoming out) or that a correction is imminent – low yield environments can persist for some time, especially when that is the policy of the Fed. However, we have observed a number of indicators that lead us to believe that there is very little additional upside for investors to capture by giving up credit quality or extending maturity to chase yield. In contrast, we see a great deal of downside potential in the current market environment, and expect that weaker credits and longer maturity bonds will perform much worse than a high-quality, low-duration portfolio when the market corrects.

1. In an Oct. 4, 2012 research report, Moody's noted that in the corporate bond market "U.S. high-yield bond issuance reached a record high in September as covenant quality declined toward historical lows." Covenants are those security features in bond issues meant to provide protection to investors by requiring the issuer to maintain certain financial measures or providing security provisions (i.e. liens on assets, mortgages, etc.).
2. The Merrill Lynch High Yield Master II Index – a widely used benchmark for high-yield corporate bonds – reached a cyclical high of 6.20% in late September and has remained very close to that level since. Numerous fund managers and market observers have noted that at these levels, with the Index yielding approximately 5.50% more than comparable maturity Treasury bonds, the credit spread is out of line with historical levels and does not offer much potential for positive performance. In fact, most corporate market observers believe higher yielding corporate bonds are due for a significant correction.
3. In the municipal market, demand for higher yielding BBB category and non-rated bonds is high as investors face historically low yields. Credit spreads between long-maturity AAA and BBB municipal bonds have shrunk by 19% over the past six months. Like their corporate counterparts, some municipal fund managers have noted the strong run-up in lower quality bonds and are now selling lower rated bonds to position more defensively.
4. In the municipal high-yield market, we are seeing what we consider to be extreme risk-taking by investors on new issues. We recently saw large new issues for high-yield (e.g., BB and non-rated) tax-exempt health care issues that sold at yields at or below 5% for 25-year and longer maturities. The 5% threshold for non-rated project and high-yield muni bonds is a red flag for us, as we have seen these levels achieved at the heights of issuing booms that preceded significant market corrections.

The bond markets are currently sending out numerous caution signals that we believe should be heeded. While fund managers may be incentivized to achieve the highest yield possible in the current quarter, we take a longer view for our clients. The current market conditions suggest to us that it is time to do exactly the opposite of chasing yield. We believe that over the intermediate term, investors will be best rewarded by taking conservative positions that will perform well in a market in which interest rates rise.



Brian Tournier
Director of Research
Ascent Investment Partners

Disclosure: This newsletter is limited to the dissemination of general information pertaining to Ascent Investment Partners, LLC's ("Ascent Investment Partners") investment advisory services and general economic market conditions. The information contained herein should not be construed as personalized investment advice, and should not be considered as a solicitation to buy or sell any security or engage in a particular investment strategy. There is no guarantee that the views and opinions expressed in this newsletter will come to pass.

Ascent Investment Partners is an SEC registered investment adviser with its principal place of business in the State of Missouri. Ascent Investment Partners and its representatives are in compliance with the current registration and notice filing requirements imposed upon registered investment advisers by those states in which such registration or notice filing is required. Ascent Investment Partners may only transact business in those states in which it is noticed filed, or qualifies for an exemption or exclusion from notice filing requirements. Any subsequent, direct communication by Ascent Investment Partners with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of Ascent Investment Partners, please contact Ascent Investment Partners or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov). For additional information about Ascent Investment Partners, including fees and services, send for our Disclosure Brochure using the contact information herein.