

Where next for corporate bonds?

By Tom Stevenson, 16 September 2009

The last six months has seen corporate bonds outperform strongly – has the rally gone too far or is there further to go?

The last six months has been a remarkable period for credit markets. Two things have happened: first, the outlook for the economy has improved substantially, which means investors have been prepared to accept a lower income to compensate them for the risk to their capital; second, the search for income in a low interest environment has seen money diverted from deposit accounts into bonds.

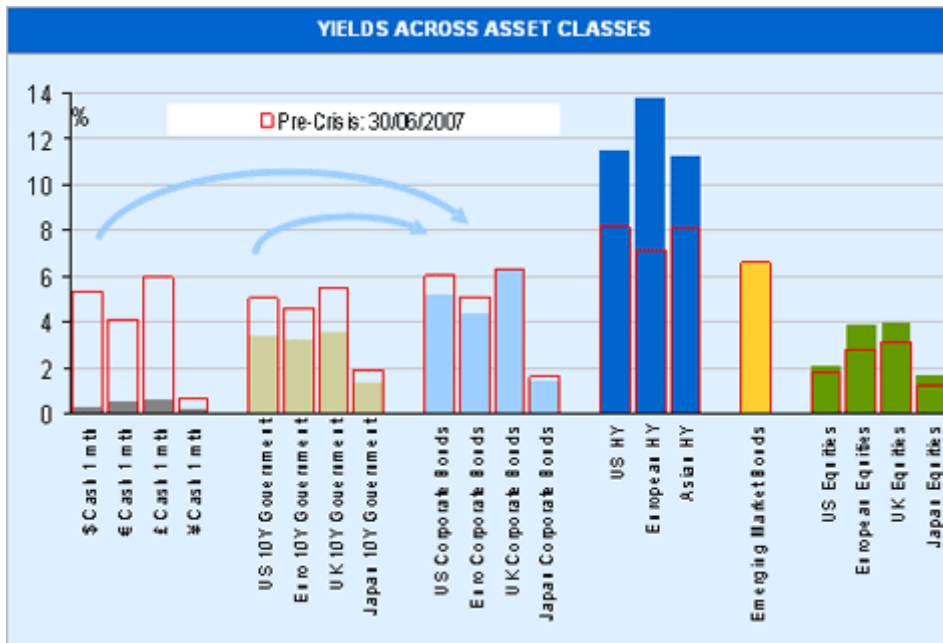


“The last six months has been a remarkable period for credit markets.” Tom Stevenson

The combined impact of these two trends has seen bond prices rise sharply (remember they move the opposite way to income yields). In fact it has been a once in a lifetime rally for bonds, the best performance in a half year period since the Great Depression. It has been described, rightly, as equity-like returns with credit-like risks.

The key question now – especially for the many savers and investors who have dipped their toes into the credit markets in frustration at the meagre returns from their savings accounts – is whether the rally has gone too far too fast.

I believe the answer is no. The principal reason for this is to be found in the chart below which compares the income yields available from various asset classes today with those that were available right before the credit crisis struck in the summer of 2007.



Source: Datastream, Merrill Lynch Bond Indices - Redemption Yields, MSCI Equity Indices - Dividend Yields (to

31/08/2009).

What the red boxes in the chart show is that in the run up to the credit crunch investors were being paid very little or even a negative amount for the extra risk they were taking by investing in corporate bonds or equities rather than "safe" cash. The yields of all these assets were remarkably similar. This was symptomatic of the extreme complacency of that period – nothing had gone wrong for so long that people had simply forgotten about risk.

It is hard to understand, with the benefit of hindsight, why anyone would have been prepared to accept just 2% extra to invest in a high-yield corporate bond (by definition the debt of a riskier company) compared to a rock-solid cash account. For an investment grade corporate bond there was almost no extra income at all and for the average equity the yield was actually lower than cash.

Now look at the coloured bars, which show the current situation. Despite the spectacular performance of corporate bonds over the past six months, there is still a very significant gap (or spread) between the returns on offer from bonds (especially high yield ones) and safer investments such as government bonds or cash. In fact the spread remains higher than it did at the peaks seen in the previous cycle in 2002.

The recent outperformance has taken away the "dislocation premium" that reflected the unprecedented market conditions and forced selling at the back end of last year but spreads are only back to "normal" levels.

This is partly because, in the case of high yield bonds, the yields have not yet returned to the levels of summer 2007. Mainly, it is because the yields from government bonds and cash remain unusually low.

So, on a purely comparative basis, bonds still offer an attractive yield. Other reasons why income investors should still be considering a bond fund include the following:

- Credit spreads continue to offer ample compensation for default risk, which over the long run has averaged just 0.15% for investment grade bonds. This is especially the case for an investor in a well-diversified fund.
- Low deposit account interest rates should ensure that fund flows into corporate bond funds remain positive. Recent comments from the Governor of the Bank of England, Mervyn King, suggest that interest rates will remain low for the foreseeable future.
- The supply of new corporate bonds (which would depress prices) is likely to remain subdued because the cost of borrowing in this way is high relative to expectations for growth in the economy.

Corporate bonds offer three main benefits: a consistent income stream; low volatility; and a good diversification away from equities. It is likely that the best of the "free lunch" of falling yields (and so rising prices) has already been enjoyed this year. But the other reasons for buying corporate bonds remain firmly in tact.

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