Generating income with junk bonds

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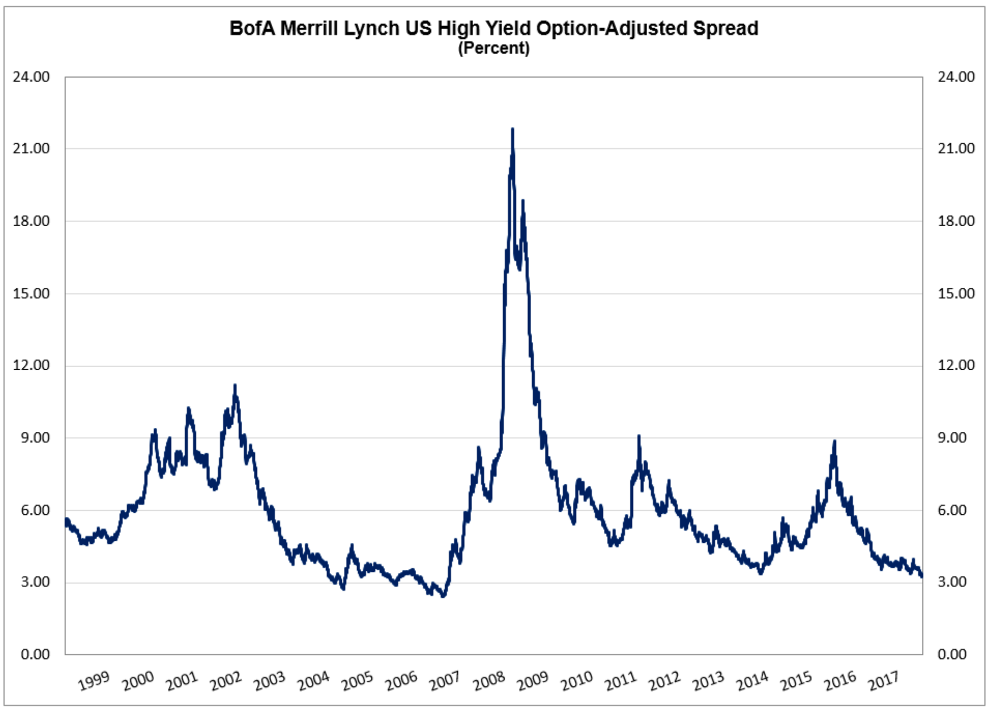
Generating income is difficult these days. As more and more retirees find they need more income, they will engage in a potentially dangerous activity called "chasing yield".

One option for those determined to find higher income is to invest in "high-yield" or "junk" bonds.

Are junk bonds worth the risk now?



Source BofA Merrill Lynch, retrieved from FRED, St. Louis Fed

I'm using the more provocative term "junk" because it gives a sense of the risk but you are more likely to see the euphemism "high-yield". They mean the same thing. A junk bond is a corporate bond that has a Moody's, DBRS or S&P rating lower than BBB on the scale from AAA to CCC.

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As shown in the chart, the spread between junk and U.S. Treasuries is near the all-time low of 2.5 percent reached just before the start of the Global Financial Crisis in 2008. The difference between the returns — the spread — can be used as a measure of enthusiasm for junk bonds. Based on the narrow spread the urge to buy junk has seldom been this strong.

When interest rates are low people, institutions and pension plans find their income shrinking. One option for retirees is to live with less, by cutting back on spending. But in my experience that option is seldom chosen.

The more popular choice is to increase the risk component of their holdings to earn higher income. Without thinking much about the risk most people would say: "Why not choose the higher return?"

Owning junk bonds means lending to corporations with questionable credit. Those corporations have been known to default, usually during recessions. So some borrowers can fail to meet their legal obligation to repay the principal and interest on the loan. At the height of the 2009 crisis the default rate crested at 13 percent. Another smaller wave of defaults hit in 2015 when energy companies struggled with oil at $30.

Does the current narrow spread offered by junk over government bonds justify the additional risk?

Probably not. The central banks are hiking rates. Higher rates will cause trouble for highly indebted companies as they are more likely to default. Many junk-rated companies don't pay taxes so they won't be helped by tax cuts.

Look closely at the spread before and during 2 recent recessions. During the milder 2002 recession spreads widened to more than 10 percent. And the peak spread, probably a record, was reached in 2009 at 22 percent.

If yields on junk soar from the current level of 5-6 percent there will be a substantial capital loss for investors, even without defaults. A yield of 15 percent on junk implies a 5 percent yield on U.S. Treasuries and a 10 percent spread, not far-fetched just before or during a mild recession.

So be careful when choosing income investments to avoid chasing higher yields in the junk category. A higher than normal yield should be considered a warning, not an opportunity. Accepting lower income today on safer investments will allow you to sleep more soundly. Better entry points for investment will appear later when both government and junk bond yields are higher.

The next recession will probably be a good time to invest in junk, when spreads will be high enough to justify the risk. Watch for the spread at 10 percent as a trigger to get interested in junk or high-yield.

Please contact Fraser Betkowski on our team if you'd like help with a free assessment of your exposure to junk. We can also assist in knowing when it's time to get into high-yield bonds. At the right time and with a generous risk premium, junk bonds, or perhaps I should say high-yield bonds, can be a very rewarding investment.

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