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Risking the Spread

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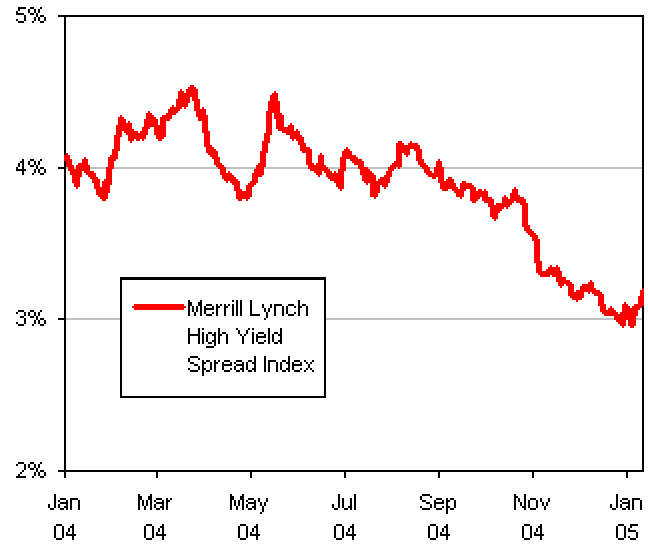
The junk spread can't get much narrower, and the curve won't get much flatter.

After chalking up total returns of some 11% last year, the high-yield bond market's slight downturn in the early going of the new year might hardly seem to merit much notice. From all outward appearances the bullish dynamics which enabled spreads to contract on net by more than 100 basis points in 2004, pulling the Merrill Lynch high-yield benchmark to its lowest levels in five-and-a-half years below 300 bps, remain in place. Yet so far this year, with spreads backing up about 20 bps from the late '04 lows, there are signs that at the margin portfolios are adapting to a changing reality that also presents asymmetric risk/reward tradeoffs across a range of fixed income instruments.



The current high-yield debt rally dates to late 2002, when **the Fed's** deflationary siege was finally lifted, leaving spreads at eye-popping levels above 1,000 bps. At that time, we suggested that as the asset class that suffered most under the grip of the Fed's calamitous mismanagement, relief from the deflationary burden left the junk sector poised for a strong recovery. To an important extent, that has continued to be the story of the rally, as the restoration of growth encouraged a growing risk tolerance while at the same time helping heal the wounds of deflation-ravaged issuers. In the last year alone, the default rate on junk debt dropped by half, from 5.4% to 2.7%. In 2002, it was above 10%.

But while that positive fundamental setting remains largely intact, the other key element in the bull case for junk appears increasingly tenuous. With short-term rates held at generational lows the past two years, "the Fed is your friend" were words to live by in the universe of higher risk debt, as the "search for yield" continued to draw capital into assets offering increasingly thinner risk margins. It appears, though, that the upside in that play may well have run its course. In the minutes of its December meeting released last week, the Fed, referring to its "prolonged period of policy accommodation," specifically cited "signs of potentially excessive risk-taking in financial markets evidenced by quite narrow credit spreads."

From our perspective, this is part and parcel of a belated recognition by the Fed that rates were kept too low for too long, and suggests the central bank now anticipates a sustained period of catch-up. The Fed's concern about "excessive risk-taking" was also closely connected to its apparent awakening to rising inflation risk, as it was presaged by an acknowledgement that its easy policy stance "generated a significant degree of liquidity."

If junk has been the first market segment to begin reflecting this new reality, it's not likely to stand alone indefinitely. High-risk debt, in fact, can be seen as the canary in the mineshaft for risks facing the entire credit market spectrum at this point. In the Treasury space, the search-for-yield dynamic has been apparent in the curve-flattening trade, as the 10/2 spread narrowed from nearly 250 bps to just over 100 bps in the past year. As the 10-year note hugs levels around 4.25%, it appears that the head room in this trade is also nearing practical limits. For one thing, trading at the longer end of the curve seems to take as gospel the notion of the Fed continuing to remove its accommodation at a "measured" pace. Interest rate futures now show the funds rate as likely to reach 3% to 3.25% by mid-year, but little more than 3.5% by year-end. In other words, while the Fed might well raise rates at all four **FOMC** meetings through June (putting the rate target at 3.25%), the market's current bet is that there would be no more than one move at the four subsequent meetings this year.

We view that as highly unlikely. Indeed, given the budding awareness of growing inflation risk at the Fed, it's more likely that a 50 bp move would be sanctioned at one of the forthcoming FOMC sessions, which would put the funds rate no lower than 4.5% by year end. Conceivably, it's true that longer maturity issues could continue to outperform even as the rise in short rates is more accelerated than expected. That would suppose, however, that inflation expectations and risk remain contained even as the Fed adopts a more expedited "normalization" schedule. Not likely. As it is, the year-on-year rate of core CPI inflation has doubled over the past year and, at 2.2%, is already beyond the Fed's professed comfort range. While the forward-looking indicators we watch most closely -- including gold and the dollar's forex value -- have come off their worst levels, we have seen nothing signaling a shift in the near-term trend for measured statistical inflation. The Fed's new-found inflation concern will be highlighted when, perhaps as soon as its meeting early next month, it finally removes the assertion from its statement that upside and downside inflation risks are "roughly equal," and finds some way of acknowledging inflation reality. We'd expect that to precipitate a reversal of the curve-flattening trend, as well as the onset of a long overdue sell-off at the long end of the curve. For high yield bonds, the robust economic environment likely augurs against a complete blowout, but it seems a safe bet that spreads have seen their near-term lows. TM