Investment Strategy Update

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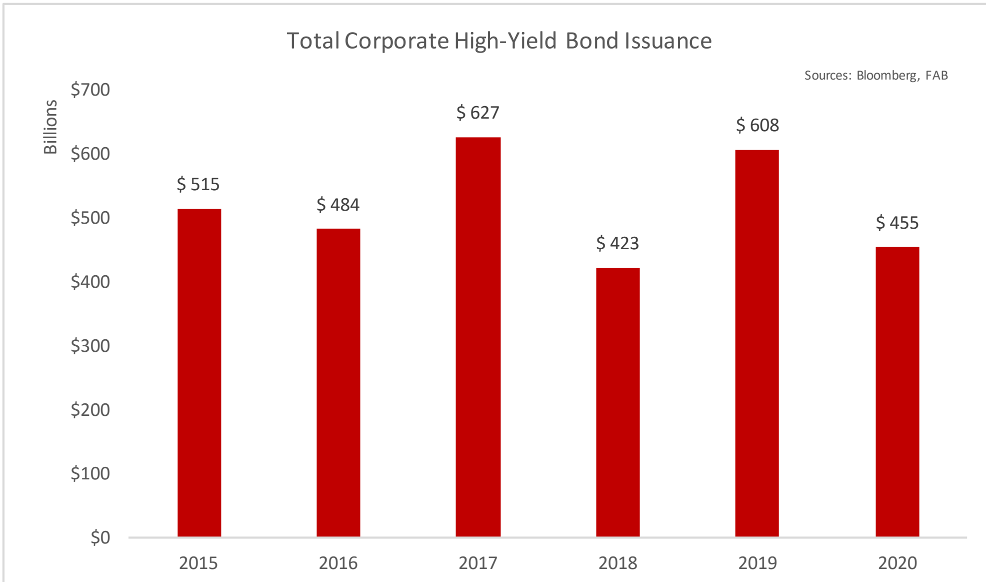
Low rates and Fed buying prompt near-record junk issuance

- **Federal Reserve's decision to buy high-yield bonds and ETFs has reduced yield premiums for junk bonds by 625 basis points so far.**
- **Junk bond yields are reaching record lows but their premium over US Treasuries is still above historic lows.**
- **Reduced supply and continued demand could still push the prices of junk bonds higher.**
- **Lower-rated bonds in some areas of the world are still offering higher returns than they should historically.**
- **The FAB AAC remains overweight in investment grade corporate bonds and emerging market dollar debt.**



Long-term US Treasuries saw significant volatility this week, with the yield on the 10-year bond increasing 14 basis points, or 25%, in a week. Yet, that same note is now yielding 0.68%. This is how much an investor would get paid for lending money to the US for 10 years, nearly zero.

The result has been that investors have instead sought better returns in riskier bonds and other securities, including stocks. That, in turn, is making it cheaper than ever for risky companies to get cash.

This week, aluminium producer Ball Corporation raised US$1.3 billion in 10-year bonds at 2.875%, the lowest yield on record for a junk-rated company. That explains why this has been the busiest August for junk-bond issuance in history. Year-to-date, non-investment grade rated borrowers have already sold US$455 billion in notes, according to Bloomberg, more than in all of 2018.

At this rate, 2020 is set to be a record year for junk bond issuance, even after taking out March and April, when total issuance was close to zero. So many bonds, however, may be partly why junk bonds have not performed even better.

They have done well, to be sure. The Bloomberg Barclays Global High Yield bond index is up almost 28% since its low on 23 March and has just turned positive for the year. It now yields about 5.84%, much less than the 12.44% it logged on that first quarter low.

Yet, that number is still 85 basis points higher than the lowest yield in the history of the index, 4.99%, recorded in the fourth quarter of 2017. And the index's premium over US Treasuries remains at 546 basis points, 136 basis points higher than its all-time low marked in early 2018. In other words, perhaps if there were less bond supply, the index's yield could be even lower, which would mean higher prices for its constituent bonds.

The amount of junk bonds issued so far this year is already higher than all of 2018

That is even more true about some corners of the market which not only have seen a lot of issuance, but also have faced headline risks. The yield premium on the Bloomberg Asian High-Yield index remains at 661 basis points, more than double its all-time low of 278 basis points. This has been a result of the concerns surrounding the US-China tensions. Middle-Eastern junk bonds have also underperformed their western peers as oil prices remain volatile.

Eventually, though, with interest rates low for the foreseeable future and the yields on the safest bonds not enough to cover inflation, investors are likely to look even at these less-coveted corners. Higher-yielding assets are becoming gold, even if they continue to be called junk.

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