Investment Strategy Update

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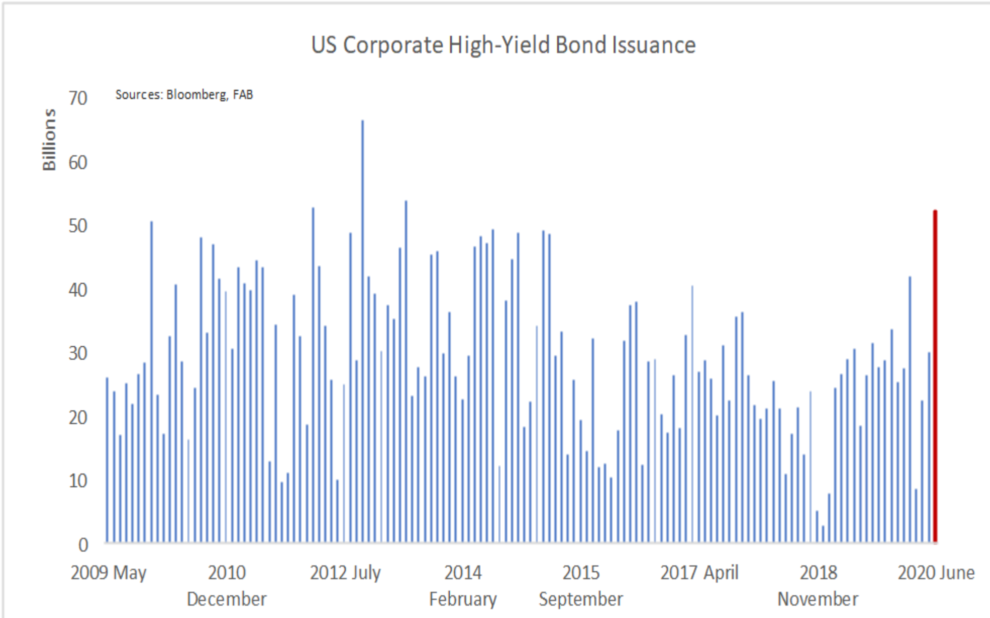
The Fed is buying high-yield so everyone is issuing bonds

- **June has seen more than US$52 billion of junk bond issuance in the US alone, according to Bloomberg.**
- **This has been the busiest month for such deals since at least May, 2013.**
- **Despite the record issuance, the Bloomberg US Corporate High-Yield index has rallied 2.6% this month, and is up nearly 12% for the quarter so far.**
- **To be sure, nearly US$50 billion of bonds have defaulted in the US alone this year, the highest amount since 2008, when US$97.2 billion defaulted.**
- **FAB AAC remains overweight high quality investment grade bonds.**



Of all the various quantitative easing programs the Federal Reserve has announced since mid-March, buying corporate bonds is perhaps one of the most controversial. It was also without precedents in the United States. Yet, by many measures, it has been one of the most effective in restoring the calm in financial markets.

In fact, the first announcement of the "Secondary Market Corporate Credit Facility", the program that ventured first into investment-grade bonds and then into those that had just been downgraded to junk, was announced on 22 March. The next day, the stock market halted its tailspin and began what has now become a record rally. Again, the Fed's announcement that it would move into buying individual corporate junk bonds instead of only exchange-traded funds of the asset class on 16 June helped stem a sudden and sharp fall in the US stock market that began on 8 June.

These announcements generated a fair share of criticism that the Fed was creating a moral hazard and supporting "zombie companies", which would fail otherwise. Perhaps, in the Fed's defense, there has been no shortage of company failures. Despite the central bank's support, since the beginning of the year, nearly US$50 billion of US corporate bonds have defaulted, the highest amount since 2008, when a total of US$97.2 billion defaulted in the whole year. Arguably, were it not for the Fed buying junk bonds, the number would be much higher.

The undisputed fact is that this move has had a significant impact on loosening financial conditions. The Bloomberg US Financial Conditions index, which measures how easy it is for companies to raise cash, touched –5 on 31 March, its lowest since the 2008 crisis. It was still slightly negative at –0.56 today, but much better than then. Much of that was thanks to tighter spreads.

June has seen the highest amount of junk bond issuance in the US since May, 2013

The average yield premium on the Bloomberg US Corporate High-Yield index has dropped by 525 basis points since 23 March to 575 basis points over US Treasuries. That is still far from its all-time low of 303 basis points, but US Treasury yields are also at all-time lows.

All these moves have happened even though the Fed has barely started to deploy the US$250 billion it has in hand to invest in junk bonds. Apart from allowing many companies to avoid bankruptcy, so much issuance will also be a boon for investment banks, which could report much higher than expected fee revenues in the second quarter. It is all great, but there is a catch: the program ends in September, and then what?

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