Investment Grade Junk

By: Jeff Hybiak, CFA | May 23, 2019

"One person's financial assets are another's financial liabilities (i.e., promises to deliver money). When the claims on financial assets are too high relative to the money available to meet them, a big deleveraging must occur." – Ray Dalio, Big Debt Crises

To fight the financial crisis, the Federal Reserve resorted to unprecedented measures in their attempt to save the financial system and spark economic growth. They cut interest rates to 0% and created nearly $4B of money to purchase bonds from the Wall Street banks. Stocks recovered, but the economic expansion has been the worst on record.

Low interest rates have hurt investors relying on fixed income. With rates low, they were forced to seek out investments that offered higher dividend or interest payments. With money easily available and rates low, corporations sold unprecedented levels of bonds. This combination has created a bubble in the overall bond market, but the biggest area of concern are those rated "investment grade" (AAA down to BBB).

Investors are looking for signs that are similar to 2000 or 2007 to avoid the next bear market. Unfortunately, market history shows us the symptoms of an asset bubble are always different. The cause however, is simple — **too much easy money pouring into assets that make them seem safe**.

It may seem strange to look at "investment grade" bonds as the primary risk investors should be concerned about, but keep in mind it was the "AAA" rated mortgage-backed securities that nearly brought down our entire financial system. Assessing our current economic and market environment, all investors should be worried about this misunderstood portion of the investment markets.

Investment Grade Bond Concerns

Here are the reasons I belive investment grade bonds are likely to cause the next financial crisis:

1.) Over half of the "Investment Grade" bond market issues outstanding are rated 'BBB'. This is **one notch above junk**. Over 85% of new Investment Grade bonds in the last two years were BBB rated (Brons & Lin).

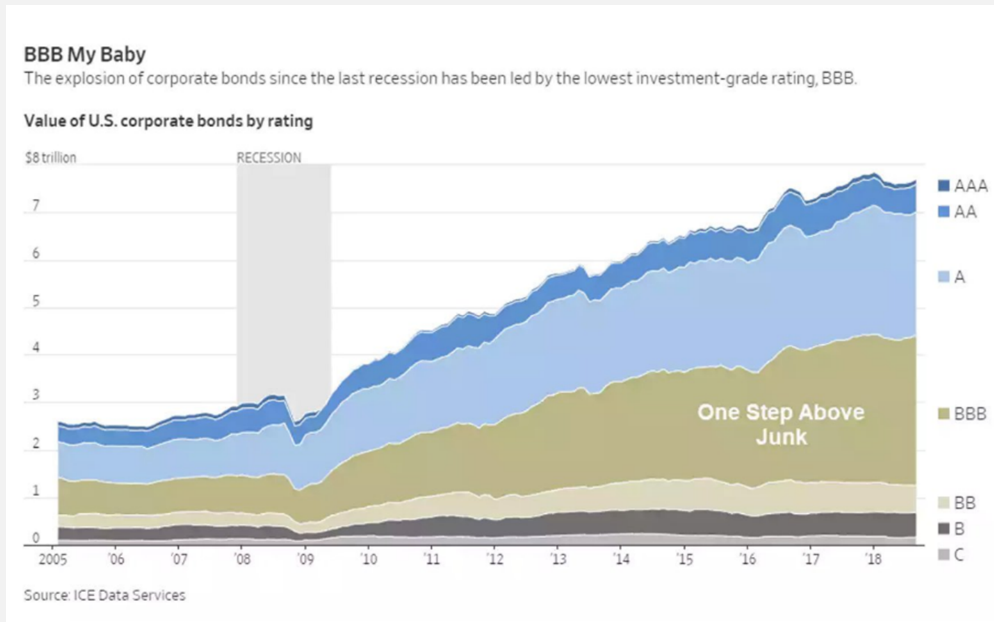
2.) In the next 3 years there are **$3.5 Trillion of corporate bonds that will mature** (Oh).

3.) The US Government **is scheduled to borrow at least $1 Trillion per year for the next 3 years** (without a recession). This is DOUBLE the average per year in 2014-2016 (McCormick et. al).

4.) Central Banks around the world **have stopped buying debt**. Some (like the Federal Reserve) have started unwinding their debt-filled balance sheets.

With so much debt being issued, insurance companies have stepped in to supply the money to purchase the bonds. Investors on a fixed income have gobbled up annuities that "guarantee" a certain level of income. Insurance companies are required to hold the vast majority of their assets in "investment grade" securities. They purchase investment grade bonds with the premiums and then use derivatives to generate the additional income they need to provide the protection promised in their contracts. The interest payments from the bonds are used to buy additional derivatives as the contracts expire. Pension funds do something similar to provide

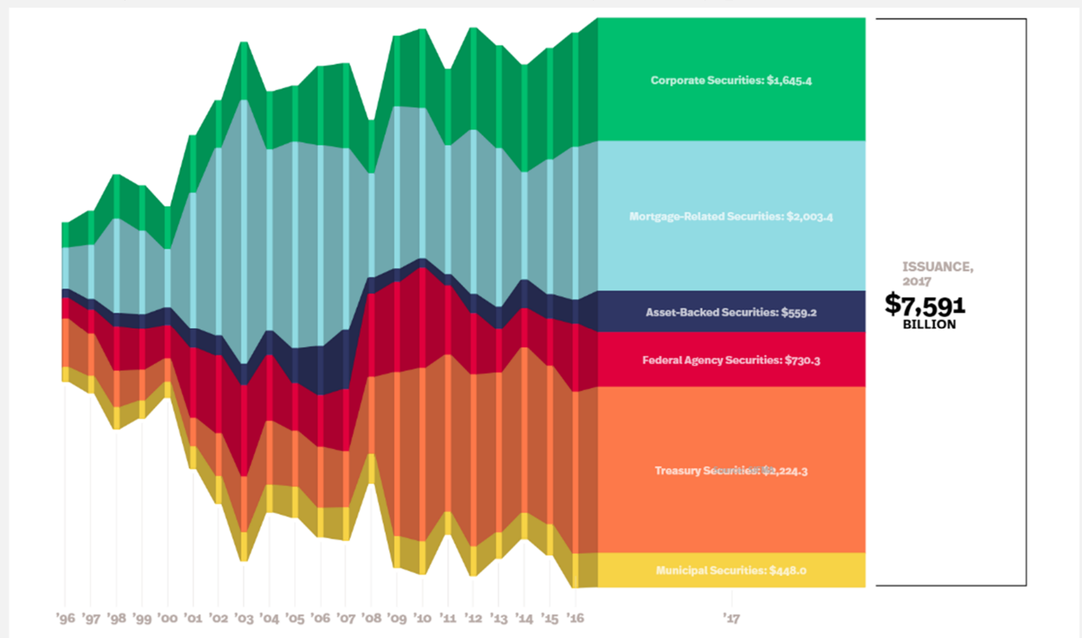
their promised payouts to retirees. **The "assets" of the insurance companies are "liabilities" of the corporations**. If those companies struggle to re-pay their liabilities, those assets will suddenly become worth significantly less.



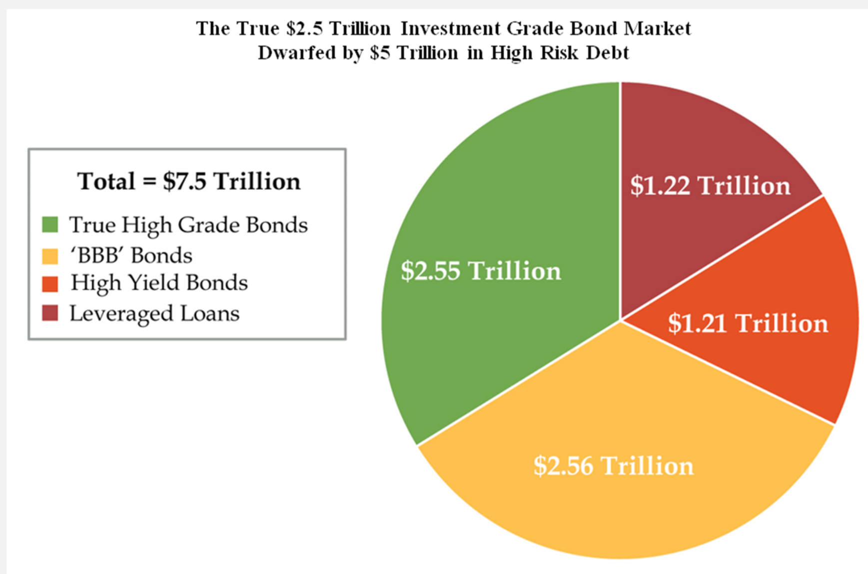
Let's focus on items #2 &3 on the prior page. We are **about to hit a wall of bonds that will be maturing at the same time the US government will need to borrow an increasing amount of money**. Companies did not issue debt to invest in projects that would boost future profits, such as capital improvements. Instead, they used it to buy back stock and issue dividends. In other words, they did nothing to improve their balance sheets, but instead made them weaker. The economy cannot avoid a recession at some point. The 10-year expansion has been the worst on record in terms of growth, and the excessive debt has given policy maker few tools to fight the next recession. Recessions are always bad for over-leveraged companies.

The Bond Bubble

The Federal Reserve has been the great enabler of all this debt. Not only did they push interest rates low and allow companies to borrow at rates far below where they should have been, they created so much liquidity at the same time they bought up most of the stock of Treasury Debt. Fixed income investors had no other place to go. Here's a look at bond market issuance through 2017. The total issuance was a new



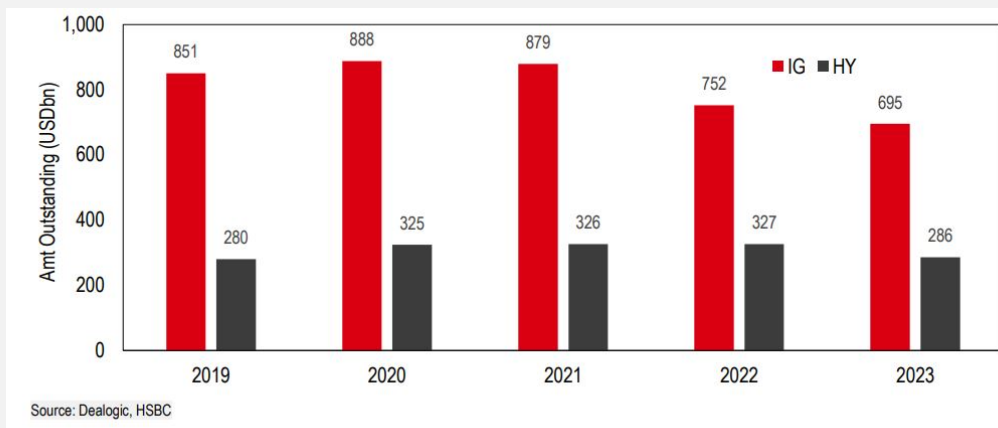
record and was gobbled up in part thanks to the strong demand for debt from the insurance companies selling fixed products.



Danielle DiMartino Booth, a former advisor to the Dallas Federal Reserve, highlighted the real issues with the corporate bond market – **67% of the corporate bond market is HIGH RISK** if you remove BBB from the "investment grade category" (DiMartino-Booth).

Maturity Wall is Coming Up Fast

Given the amount of debt coming due, the "maturity wall" about to smack all these bond issuers who did nothing to improve their balance sheet with the debt they used is going to be a SIGNIFICANT problem for bond investors (stocks will also be hammered if we start to see downgrades in the corporate bond market).



Companies borrowed trillions over the last ten years. This boosted the economy a little, but it caused the stock market to grow at nearly twice the long-term average over that time. At its core, debt is future spending pulled forward. If somebody making $50,000 borrows $10,000, they now have $60,000 of spending power.

Here's Ray Dalio again in his book, *Big Debt Crises:*

"Eventually the debt service payments become equal to or larger than the amount debtors can borrow, and the debts (i.e., the promises to deliver money) become too large in relation to the amount of money in existence there is to give. When promises to deliver money (i.e., debt) can't rise any more relative to the

money and credit coming in, the process works in reverse and deleveraging begins. Since borrowing is simply a way of pulling spending forward, ***the person spending $ 60,000 per year and earning $ 50,000 per year has to cut his spending to $ 40,000*** *for as many years as he spent $ 60,000, all else being equal."*

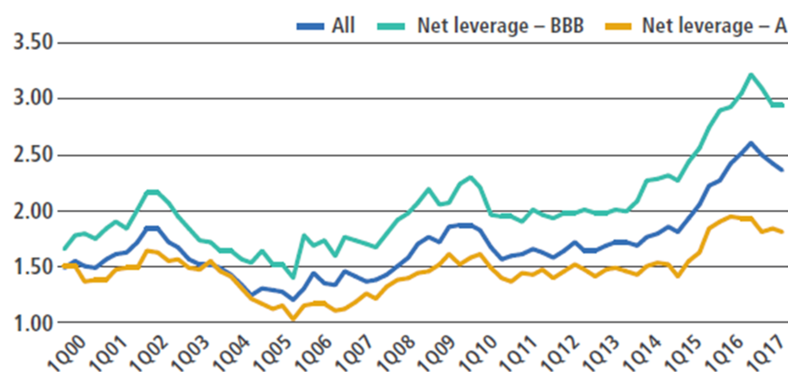
Another way to think about it – when you borrow money you have more money to spend, but when you haver to start paying it back you have less. Corporations were flush with borrowed money the last ten years; they have to pay most of it back in the next five years.

[Side note: Ray Dalio is the founder of Bridgewater, one of the largest hedge funds in the world. He has been managing money since 1975. He's seen all kinds of various bubbles during his career. If you're a market historian/nerd like me, I'd encourage you to pick-up his book.]

The Risks in the BBB Segment

Pimco, one of the largest bond managers in the country, recently posted a report titled "Be Actively Aware of BBB Bonds." In it they walked through the already deteriorating quality of the investment grade bond market. Interest coverage (net cash flow divided by interest payments) has been declining rapidly in recent years. Worse, the **amount of leverage investment grade issuers are using has increased significantly** across the board. The biggest concern is in the BBB segment. Issuers there are now sitting at a leverage ratio of 3 to 1. They were at a 2 to 1 ratio just ahead of the credit crisis.

Jeffrey Gundlach, the founder and Chief Investment Officer at Doubleline, one of the most renowned bond managers in the world, also recently voiced his concerns for the investment grade bond market (Huebscher).



"Corporate bonds are not as overvalues as sub-prime mortgage debt was prior to the financial crisis, accounting to Gundlach. But because the corporate market is so much larger than the sub-prime was, the overall exposure to investors could be of the same scale. Indeed, ***'We could easily see $400 billion in losses****,' he said.*

Gundlach's fear is rooted in the excessive amount of corporate debt, particularly bonds that are rated BBB, the lowest investment-grade rating, just above high yield.

Corporate bonds have been rich by one standard deviation for most of the last three years, he said, and now are at an 'outright sell' level. A massive amount of corporate debt is weighing on the corporate bond market, and a lot of bonds are 'complacently owned.'

Gundlach cited a Morgan Stanley report that showed the oversupply and weak ratings standards that could lead to downgrades. Based on corporate leverage ratios, ***38 - 45% of the corporate bond market should be rated junk****, according to Gundlach.*

'This could mirror what happened to the sub-prime market during the financial crisis*, in terms of the mis-rating of bonds,' Gundlach said."*

If the credit ratings services start to see companies struggling to pay back their debts, we will start to see downgrades of BBB issuers. We are already starting to see some storm clouds on the horizon. Deutsche Bank reported recently $150 Billion of BBB rated bonds are on "negative credit watch".

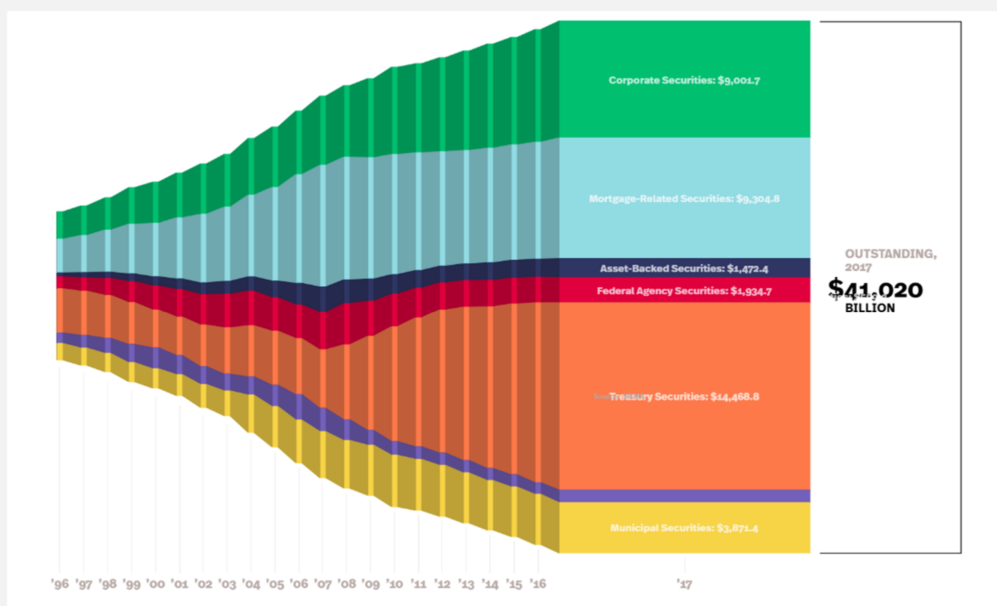
This means **22% of BBB bond issues are in danger of being pushed into the junk category**. If even half of these issues are downgraded as we run into the maturity wall, it will get ugly.

This will make it close to impossible for those companies to issue any new debt. Worse, because insurance companies and pension funds cannot own more than a small amount of assets rated below investment grade, not only will they have to SELL their existing holdings, there won't be a market for the now junk-rated companies to sell their new bonds. **Defaulted bonds lead to bankruptcies, which lead to more downgrades, which cause more bankruptcies, and even more bonds being downgraded**. It's a horrible spiral, but one that cannot be stopped until the excesses are taken out of the system.

Side Note: At some point I do suspect the Federal Reserve would do what the European Central Bank & Bank of Japan did the last 10 years -- buy junk rated bonds in an attempt to prop up the market. I also expect regulators to relax the regulatory requirements on insurance ratings restrictions after the carnage has already begun. When that happens and how much it helps is not something I would be basing my retirement plan on.

Different, but Potentially Worse than the Last Crisis

Speaking of the last financial crisis, I continue to hear pundits say, "things aren't as imbalanced now as they were in 2008." They are partially right -- households are not as leveraged as they were back then..............in terms of mortgage debt. According to a report from the Federal Reserve, **household debt set a record** (Spicer). Student loan defaults continued to climb, but the biggest cause of concern in the household segment is the **record number of Americans (7 million) who are now 3 months or more behind on their car loan payments**. This is often a leading indicator of financial strain on consumers.



Worse, however is the fact both governments and corporations have significantly more debt than they had before the financial crisis. Total bond market debt is 39% higher overall since 2007, but **US Treasury Debt has grown by 220% & Corporate Debt by 69%!**

These numbers are staggering and should keep you up at night if you do not have a plan to protect your assets from this crisis. Stocks of course will not be a safe haven given how much of the rally the past 10 years has been fueled with easy credit allowing companies to buy back stock and issue dividends. Many insurance companies will survive the next crisis, as will many fixed income issuers (we just

don't know which ones and aren't willing to risk being right or hoping the Fed saves them all.) **The people that will be hurt the most are the ones in passive (or near-passive) buy & hold stock investments who are not ready, willing, or able to go through another debt crisis**.

Our Plan for Action

I don't know how bad things will get or when they will start; however, I do know each bear market starts with a different catalyst. My job is to look at all potential issues, inform our advisors and clients about the risks, and then stress test each of our investment models to make sure they are set-up to do their job. I hope I'm wrong, but a **simple study of market and economic history should tell you nothing can be done to avoid a bear market or recession**. Both are designed to wash out the excesses created during the past up cycle. Anything that is weak will be wiped out, but the aftermath should allow for strong, healthy growth.

Our current situation is analogous to the *Pending Forest Fire* I used to describe what happened in the tech crash and then to predict what would happen in the looming housing crash. I was early then and probably early now (although I've been sitting on the idea for this article for at least 9 months because I didn't see any signs of looming stress.) The signs are starting to increase and while we never invest money based on my "gut", it is telling me **the odds are increasing rapidly of some sort of credit event in the next 12 to 18 months bringing in unknown collateral damage to the markets**.

I hope I'm wrong, but hope is not a strategy. As the Outsourced Chief Investment Officer (OCIO) of a group of advisors we call the SEM Platinum Advisor Group, I take my job seriously. They have hired SEM to perform all due diligence on potential investment managers and create custom portfolios based on the clients' financial plan, cash flow strategy, and true risk tolerance. They also ask for assistance in crafting their message to current and potential clients. My message to them is simple -- **the stimulus used to fight the financial crisis went on for too long. It has created massive excesses in the fixed income market that has created a situation that is dangerous for anyone depending on their investments over the next 10 years.**

Setting Expectations & Making Portfolio Adjustments

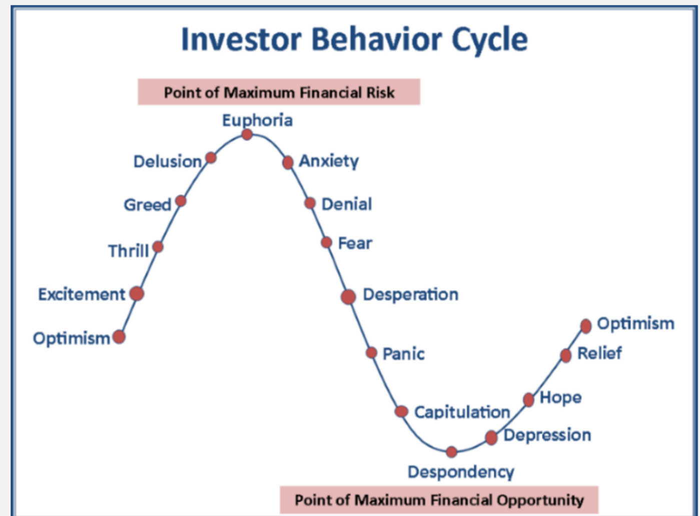
Returns could be lean for SEM's models the next year or two because we focus first on keeping risks within the client's true risk tolerance. For most people we test, they begin getting uncomfortable around a 20% or lower loss. [**Go to WhatsMyScore.net to find your risk comfort level**.] When you get uncomfortable, you tend to become a little more emotional. When you become emotional, you tend to make mistakes and do not always think rationally. This can blow-up the well-thought-out financial plan. We want to have cash available (and our clients still invested where they should be) to take advantage of what will be some tremendous buying opportunities. Especially for our lower risk fixed income models, I start to get excited thinking about all the "good" investment grade bond issues that will be downgraded for no reason other than they look like other bonds that defaulted. This will allow us to buy so many bonds at "fire sale" prices.

Regardless of whether I'm right or wrong, markets do not go up forever. If I'm wrong, our customized approach based on the overall financial plan, cash flow strategy, and true risk tolerance often leaves clients with some potential to participate in the upside of the market. I'm especially not advocating moving money all to cash. I am, however advocating EVERY advisor and client to take a look at their true risk tolerance and then stress test their current portfolios.

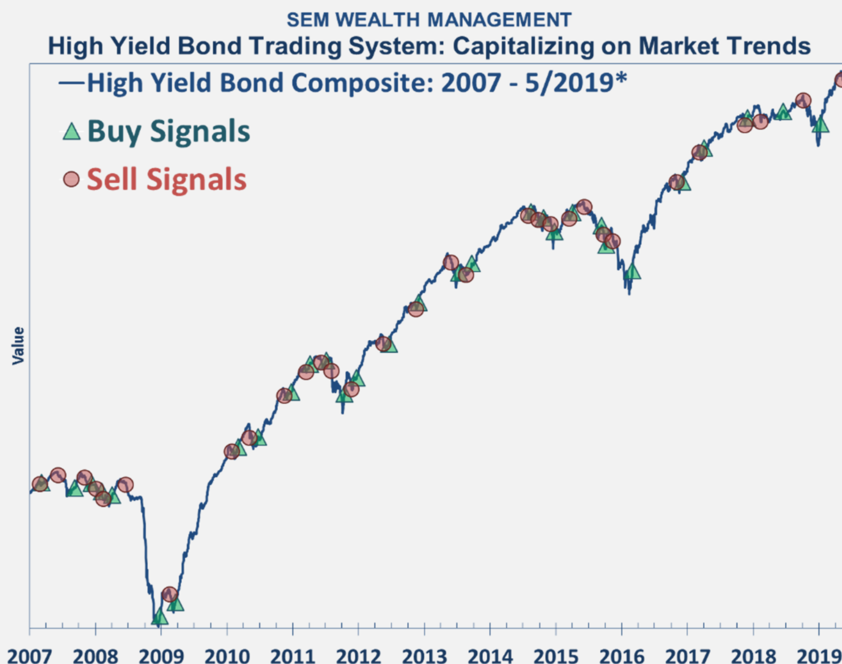
Why you would use SEM to Manage Your Retirement Assets

It is human nature to take the current environment and project it into the foreseeable future. Whether it is a situation on the job, something with your kids, a sports team's performance, or the stock market, this "recency" bias shapes the way we view most situations in life. The best way to overcome this human tendency is to use data & history as a guide. Life tends to move in cycles, and a study of history can help us identify where we are in the cycle.

This is especially true with the stock market. Throughout history, researchers have studied the behavior cycle investors go through when it comes to investing. These scientists have identified some of the emotions that occur during each phase. **Since 1992, SEM has provided investment portfolios designed to overcome the more common behavioral biases most of us exhibit at times**. In addition, we help our financial advisors identify specific biases that may be present in order to structure a portfolio in such a way to diminish our emotional response to the markets.



Several of our investment portfolios are designed to actively adjust the asset allocation to the various segments of the bond market based on proprietary indicators which measure the strength of those assets. The core of our high yield bond trend following model has been used in real-time since 1992. While there will be many "false" signals that are quickly reversed, the purpose of the system is to capture the bigger moves in the high yield (junk) bond market while missing the majority of the inevitable downside. **Note the red circles indicating the sell signals before the major decline in the summer of 2008**. There were other key sell signals in 2011 & 2015. (The scale of the losses in 2008 skew the 10% declines in those years.) If things progress as we believe is likely, this system will be invaluable for most clients with a low risk tolerance or time horizon of 10 years or less. We have a wide range of investment models which utilize this concept, from Tactical Bond & Income Allocator along with our Platinum Preservation Portfolio (PPP).



** Indicates the actual BUY/SELL dates of a High Yield trading system. This chart was not used by Strategic Equity to generate buy or sell decisions. It should not be assumed that recommendations made in the future will be profitable or will equal the performance presented above. Please see our disclosure document for more information.*

In addition, our Dynamic Income Allocation (DIA) investment model utilizes our quantitative economic model to adjust the allocation to income investments. During periods where the model indicates accelerating economic growth, DIA will have heavy exposure to dividend growth stocks and high yield (junk) bonds. During periods of

decelerating growth, all dividend growth stocks are eliminated along with high yield (junk bonds). Allocations during this phase are to US government bonds and other highly rated fixed income investments.

Combining our Tactical Bond model with our Dynamic Income Allocation model **gives investors the potential to generate higher returns while still providing a systematic way of reducing the risks that will come during the next recession/financial crisis**. If you wait until the signs of the crisis are upon us to re-allocate your portfolio, it may be too late. **The time to prepare for the next crisis is BEFORE the next crisis begins**. Talk to your advisor about the suitability of these investment models and where they fit in your overall financial plan.

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About the Author

Jeff is a CFA charterholder and received his Bachelor of Science degree in Business Administration (Finance & Accounting emphasis) from the University of Northern Colorado, where he was a member of the Financial Management Association National Honor Society. He has worked in the field of accounting and finance since 1992. Jeff was one of the minority of advisors warning others about the looming financial crisis. SEM first warned about the upcoming recession in December 2006. In addition to helping his clients successfully navigate the dot-com bubble bursting, his piece, *The Pending Forest Fire* was widely criticized as 'doom & gloom' marketing by advisors throughout 2007 and early 2008. Instead, it correctly predicted how easily the crisis could spread due to the bubble cycles created by the Federal Reserve. Prior to joining SEM, Jeff served as a Fund Manager/Analyst for the UNC Alumni Foundation Fund, a balanced portfolio consisting of equity, fixed income, and cash securities. He joined SEM Wealth Management in October 1998.

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