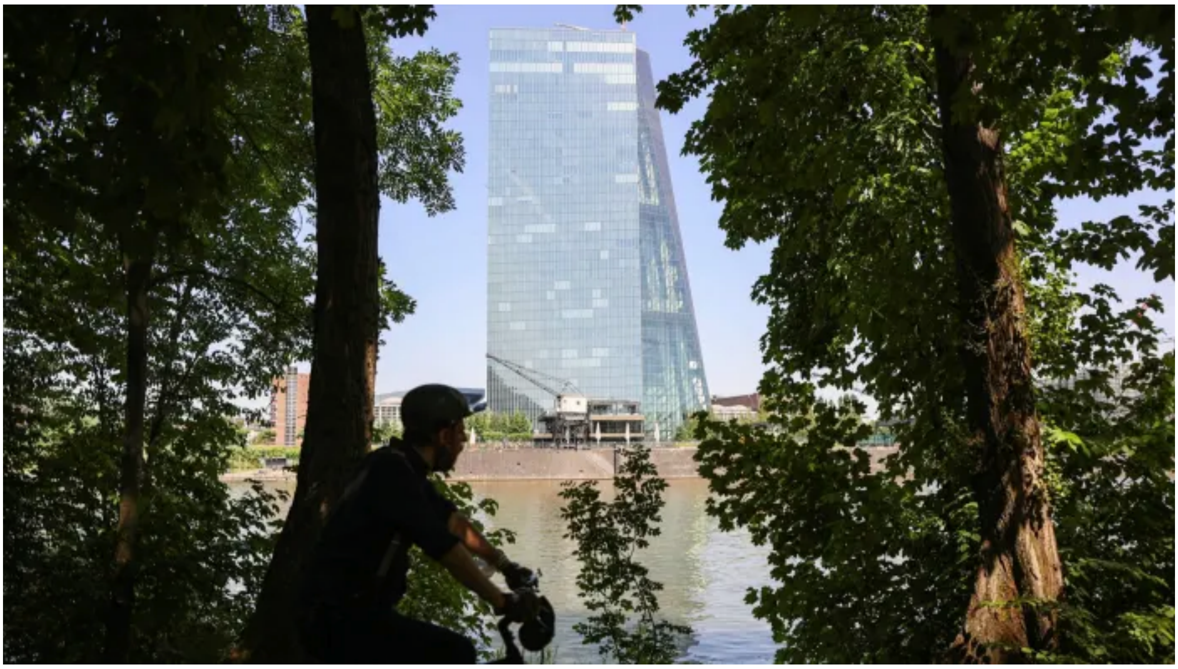
High yield bonds

Real yields on European junk bonds go negative for first time

Investors willing to take on higher risk debt while losing money relative to inflation



The European Central Bank's ultra-loose monetary policy has already driven other yields on other kinds of eurozone debt into negative territory © Alex Kraus/Bloomberg

Naomi Rovnick in London and **Martin Arnold** in Frankfurt YESTERDAY

Investors in European junk bonds have begun accepting interest payments that are lower than eurozone inflation levels for the first time ever, in the latest sign that central banks' crisis-era debt purchases have shifted the balance between risk and reward.

The yield on ICE BofA index of European high-yield bonds was pushed down to 2.34 per cent this week, marking the first time buyers of so-called high-yield European currency bonds have accepted payments below consumer price inflation in the eurozone, which hit a decade high of 3 per cent in August.

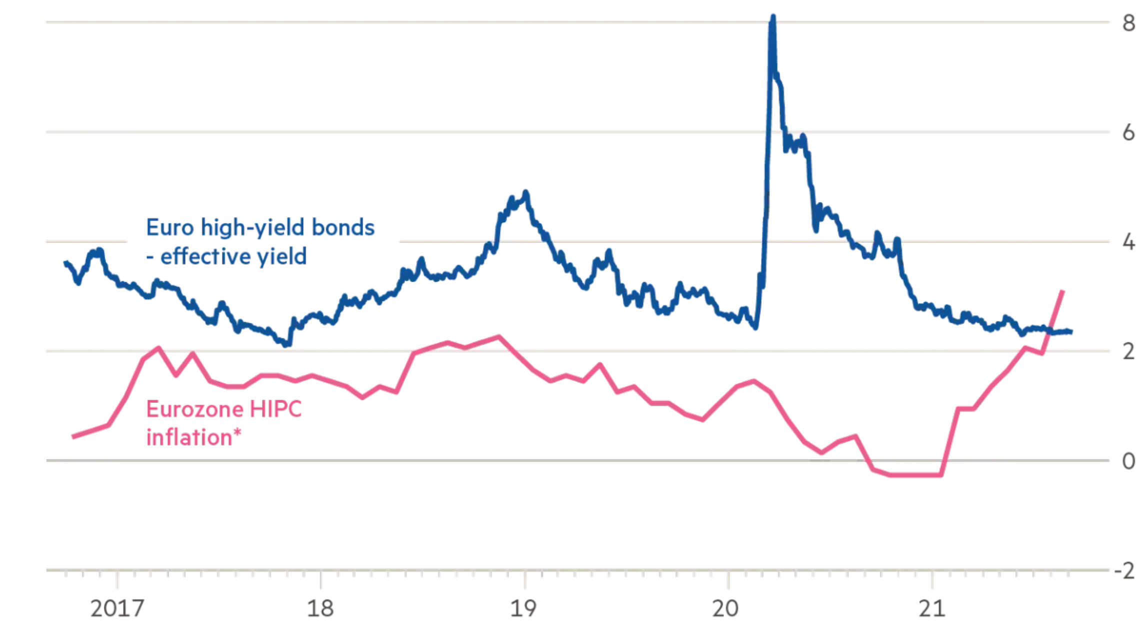
Analysts said investors' willingness to extend credit to the riskiest borrowers while losing money in real terms reflected the scarcity of other opportunities to earn returns in debt markets. At the same time, Europe's strong recovery from the pandemic following a bumper earnings season has reduced the risk that junk bond issuers will default.

"It is a reach for yield," said Ian Samson, multi-asset fund manager at Fidelity International. "High-yield bonds are one of our preferred ways to take risk at the moment because the investment outlook may be strong enough that we don't get a big default cycle."

The European Central Bank meets on Thursday and investors expect it to announce a slowdown in the pace of bond purchases in response to a recent improvement in the economic outlook and a drop in financing costs for governments, businesses and households.

Eurozone inflation rates move above yields on euro-denominated junk bonds

Per cent



* August 2021 figure represents a flash rate   Source: Refinitiv/ICE Data Indices

The ECB's €1.85tn pandemic emergency purchase programme, its flagship crisis-fighting policy, has been buying €80bn of bonds a month for much of this year with the stated objective of keeping financing conditions favourable. Analysts widely expect these to slow to about €60bn.

However, most investors still believe it will be several years before the ECB stops buying bonds and starts raising its deposit rate from its record low level of minus 0.5 per cent, especially after it changed its strategy in July to set a higher bar on inflation for policy to be tightened.

The central bank's ultra-loose monetary policy has already driven other yields on other kinds of eurozone debt into negative territory, leaving investors rushing to earn a return on their capital.

The yield on Germany's benchmark 10-year bonds has risen from close to record lows in recent weeks but is still running at about minus 0.35 per cent. The effective yield on the ICE BofA index covering investment-grade European corporate bonds stands at 0.2 per cent.

Barnaby Martin, credit strategist at BofA, said the brightening eurozone economy had inspired some investors to buy junk bonds because they believed some issuers' fortunes could improve to the point they would obtain investment-grade ratings.

"There is an expectation of downgraded names going back into investment grade," he said.

Credit rating agencies have been upgrading bonds from junk status at an unusual rate, he added, with a net €7bn of European high-yield issues having been pushed up to investment grade in the past 12 months. This stands in contrast to the average €7bn worth of bonds that had been downgraded in each of the past five years, on average, he said.

Duncan Lamont, head of research and analytics at Schroders, said junk bond investors believed recent rates of eurozone inflation were likely to fall, making current negative real yields less of a problem.

"If you buy a bond and hold it until it matures, the after-inflation return will depend on what inflation turns out to be over the life of the bond, not what inflation was in the 12 months before you bought it," he said.

Investors in US junk bonds are also accepting yields that are below recent rates of inflation. The average yield on the ICE BofA US high-yield index is just over 4 per cent, while US consumer prices rose 5.4 per cent in July compared with the same month last year.

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