STILL CHASING YIELD WHEN YOU SHOULD BE CHASING SAFETY?

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Complacent investors got a rude wake-up call early in 2018. The con!uence of a strengthening economy, a big tax cut, and a budget deal calling for $300 billion in additional spending was more “good news” than the markets could take.

As often is the case, bond investors reacted ?rst, sending interest rates up and bond prices down sharply in January. Stock prices continued to power higher until the Labor Department reported on February 2 what some investors have long feared: wage in!ation had returned. Average hourly earnings for all employees grew 2.9% year over year in January. And that news sent stock prices into a violent decline.

It’s not that investors begrudge the average worker a pay raise. Rather it’s that wage in!ation had been remarkably tame last year, despite an improving economy and price increases in oil and other industrial commodities. Investors know that the Federal Reserve closely watches “core in!ation,” i.e., in!ation excluding food and energy. The Fed doesn't necessarily want to raise interest rates if in!ation is being driven by higher gasoline and food prices. These prices can be jerked around by the weather and geopolitics. But the Fed will react to higher core in!ation, which is largely driven by rising wages.

The Feds 2% solution

In pursuit of its mission to maintain price stability, the Fed would like to see core in!ation hover around 2%. For the last decade, the Fed and most other central banks didn’t worry about in!ation because they were ?ghting *de!ation* with low interest rates and easy money. Now, in!ation has returned. And the higher wage in!ation goes, the harder it is for the Fed to keep core in!ation at 2%.

I view the recent turbulence in the stock and bond markets as a wake-up call to investors. The investment landscape has changed. Higher volatility and higher interest rates are the order of the day. Investors should forget about the so-called new normal of persistently sluggish economic growth and low in!ation. Rather, they should try to remember the old normal—a time when easy money begat higher in!ation and higher in!ation begat tighter money and higher interest rates. Sometimes the Fed’s tight money policies strangled the economy and sent it into recession.

Of course, the prospect for higher interest rates has been long anticipated: ultra-short bond funds have reported massive in!ows over the past 18 months. It is important to remember, however, that not all substitutes for money market funds are created equal. During the great ?nancial crisis of 2008-2009, one money market fund “broke the buck,” a few ultra-short bond funds experienced double digit declines, and popular substitutes for cash equivalents like structured investment vehicle notes and auction rate securities ran into severe liquidity problems. The common thread linking all these disasters was the lack of attention to the quality and structure of the debt securities owned in these funds.

Repercussions for lower quality credits

In the ultra-low interest rate environment of the past decade, many ?xed income investors successfully chased yield by lowering credit quality or using leverage or exotic ?nancial structures to enhance their yields. But, as the Fed continues to tighten the monetary screws and interest rates march higher, there likely will be economic repercussions. Credit spreads — the gap between lower quality bond yields and higher quality bond yields — will eventually widen as lower quality, debt-addicted companies begin to experience ?nancial di?culties.

In my view, it is time for investors to stop chasing yield and start chasing safety. To be sure, the US economy is still in good shape and credit market conditions remain favorable. But there are some worrisome “straws in the wind” regarding the debt markets. Last year, US corporate debt as a percentage of Gross Domestic Product (GDP) hit an all-time high. (Yes, higher than the level reached before the Great Recession of 2008-2009.)

Zombies on the rise

Last October, renowned Wall Street economist Nancy Lazar published a piece titled, “The Rise of Zombie Firms—A Problem for the Living.” She noted that zombie ?rms—American companies which couldn’t service their debts from cash !ow and thus were kept alive by borrowing money—had tripled over the last 15 years. Today the zombies represent 7.6% of the Russell 3000 universe. (No telling how many private companies are in this condition.) Lazar concludes that “super-accommodative central bank policies certainly contributed to the rise of the zombies, by making capital cheap and investors hungry for yield. The undead are thus less inclined to innovate and invest, weighing on economy-wide productivity.” What’s more, I would conclude that these zombies will be a signi?cant source of ?nancial distress during the next recession or credit crisis.

With interest rates on the rise, short and ultra-short ?xed income should have a prominent place in a diversi?ed portfolio. But care should be taken to ensure that portfolios aren’t increasing credit and liquidity risks while decreasing maturity/duration risk. Most “enhanced yield” ?xed income products have some degree of credit or liquidity risk. So look under the hood of ?xed income portfolios to ensure that unintended risks are not present.

How can investors spot an ultra-short manager who can successfully navigate an increasingly risky economic environment? Look at how the manager performed during the last two recessions. There are ways to enhance yields without taking on too much credit or liquidity risk, however, the number of managers pursuing such strategies is limited. After all, chasing yield has been a top performing ?xed income strategy for the past ?ve years. But remember the old saw: Past performance does not predict future results.

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