Company Bonds Top Stocks First Time Since 2012: Credit Markets

By Charles Mead and Matt Robinson - Apr 1, 2014

Lenders from JPMorgan Chase & Co. to Bank of America Corp. warned that corporate-bond buyers were in for another year of rising yields that would erode returns. China, the polar vortex and Vladimir Putin are upending those forecasts.

Bonds of companies worldwide tracked by Bank of America Merrill Lynch indexes returned 2.7 percent in the first quarter through March 31, compared with a 1.42 percent gain for the MSCI World Index of stocks, the first time the debt beat equities since the second quarter of 2012. The gain follows a 1.45 percent loss for debt investors last year as shareholders reaped a 27 percent windfall.

“It wasn’t perhaps the one-way bet that people thought it was,” said Andrew Chorlton, a New York-based money manager for a Schroders Plc unit that oversees more than $90 billion. Bonds beating stocks is “contrary to what virtually every investment bank you care to mention had on their outlooks for 2014.”

Corporate debt benefited as investors sought the safety of Treasuries amid slower-than-anticipated growth in China, the Russian annexation of Ukraine’s Crimea region and masses of arctic air known as the polar vortex that curbed everything from home construction to auto sales in the U.S. Even as the Federal Reserve reduced bond purchases that have suppressed yields, gains were bolstered by rising demand from pension funds seeking to lock in last year’s equity gains.

JPMorgan Forecast

“When people are uncertain, they’re going to gravitate to Treasuries, and then instruments that are benchmarked off of Treasuries are going to get that benefit,” said Thomas Chow, a Philadelphia-based money manager at Delaware Investments, which oversees about $190 billion.

JPMorgan strategists boosted their initial estimates for returns on investment-grade company bonds to 2.3 percent on Feb. 7, from 1.4 percent in November, according to a March 27 report. The bank last year projected “another year of little return” as 10-year Treasury yields climb to 3.65 percent, an estimate the bank has since revised to 3.4 percent.

The rates through yesterday had instead dropped 2 basis points since the November report. They were at 2.75 percent as of 11:29 a.m. in New York. A basis point equals 0.01 percentage point.

‘Challenging Year’
In November, UBS AG analysts led by Matthew Mish said investment-grade securities were at risk of dropping an additional 0.9 percent in what the bank expected to be a “challenging year.” Bank of America used the same phrase to characterize fixed-income returns in a Dec. 10 statement that forecast a 1.5 percent gain. Both lenders are maintaining their forecasts for 2014.

The extra yield investors demand to hold corporate debt worldwide instead of government securities with similar maturities has shrunk 9 basis points this year to 174 basis points, 2 basis points from the least since 2007 in Bank of America Merrill Lynch’s Global Corporate & High Yield Index. Yields have fallen to 3.49 percent from 3.67 percent.

At the same time, new sales of the debt last quarter declined 3.2 percent to $1.08 trillion from the $1.1 trillion in the same period last year, according to data compiled by Bloomberg.

Junk bonds, or obligations ranked below Baa3 at Moody’s Investors Service and BBB- by Standard & Poor’s, gained 2.86 percent the past three months, compared with 2.67 for investment-grade debt, the Bank of America Merrill Lynch index data show.

**Telecom Italia**

Media companies led all sectors, gaining 4.8 percent, followed by a 3.6 percent increase by insurers, the index data show. Auto companies trailed the index with a 1.7 percent gain, followed by banks’ 1.9 percent.

Bonds of Telecom Italia SpA, Italy’s largest phone carrier, led returns among the 50 biggest issuers in Bank of America Merrill Lynch’s global corporates index with average gains of 4.6 percent, followed by 4.47 percent for debt of Italian utility company Enel SpA. Debt of Westpac Banking Corp., the Australian lender, trailed the group with a 1 percent increase. Toyota Motor Corp. debt advanced 1.02 percent.

Securities that felt the brunt of last year’s selloff are outperforming in 2014. High-grade debentures due in 10 years or more are now leading the asset class with a 6.6 percent gain last quarter. The notes lost 5.6 percent in 2013. A bigger decline in 30-year (USGG30YR) Treasury yields to 3.56 percent has aided the performance of longer-maturity corporate debt.

**‘Nice Tailwind’**

“When you have Treasuries rally as much as they have in the back end, it’s a nice tailwind to have,” said Kent White, a money manager at Thrivent Financial for Lutherans. “We were looking for higher rates in 2014 too, so there’s no question it’s been a bit of surprise how we’ve started the year.”

The gain in equities helped the 100 biggest U.S. corporate pension funds narrow their deficits by a net $319 billion last year, according to Milliman Inc., a pension advisory firm based in Seattle. The plans are now 91.8 percent funded after reaching 95 percent at the end of last year, the highest level since 2008.
Pension demand has helped reduce average yields on the $3.9 trillion of investment-grade bonds tracked by Bloomberg to 3.05 percent, down from 3.55 percent in September, though still 0.5 percentage point higher than the record-low 2.54 percent recorded last May. That reduces the potential for further outperformance, and leaves investors vulnerable to losses should interest rates climb, according to Scott Colyer, chief executive officer of Monument, Colorado-based Advisors Asset Management.

“A very small change in interest rates to the upside -- which I’d say is the most natural thing to expect -- has the ability to wipe out all of your positive upside and dig into your principal,” said Colyer, whose firm oversees about $12.5 billion.

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