Mitch on the Markets

Sell in June or Your Bond Portfolio May Be in Ruin

By Mitch Zacks
Portfolio Manager

You are most likely familiar with the old adage "sell in May and go away" warning investors to sell their stock holdings in May in order to avoid a seasonal decline in equity markets. I do not necessarily advise investors to follow this approach. But as June is underway, I believe this time of year is a good time for investors to review their bond holdings.

There are certain types of bonds that I think work in the current environment and other types of bonds that don't. That's why I think it is important for fixed income investors to evaluate their bond holdings from time to time, to make sure your current bond allocations make sense relative to the interest rate environment and also make sense relative to the risk profile of the company or entity issuing the debt. This is what we do for our clients at Zacks Investment Management.

There are two types of bonds in particular that have somewhat of a shaky outlook, in my view, and may actually fit into the "sell in May and go away" mantra. They are long duration U.S. Treasuries and high yield corporate debt.

I'll start with high yield corporate debt. In total, U.S. corporations have amassed some $8.8 trillion in total outstanding debt, which marks a 49% increase since the Great Recession ended in 2009. One of the main reasons debt has ballooned so much is that global interest rates have been kept low by central banks around the world, and yield-hungry investors have looked increasingly to the corporate bond market for fixed income.[1]

In some cases, this influx of new issuance has been positive. Small and mid-sized companies that previously had difficulty accessing debt markets could now raise money at better-than-reasonable rates, allowing for more risk-taking and innovation in the economy. For stock market investors, some corporations used the attractive debt markets to borrow money to buy back shares and increase dividends, both of which typically add shareholder value.[2]

But then there are the not-so-positive cases, where corporations use borrowed money as a band-aid to sustain a failing business model, or to give the appearance of increasing shareholder value in the short-term with no longer-term plan for investment and growth. That's why since 2009, the level of global nonfinancial companies rated as speculative (junk bonds) has surged by 58%, to the highest ever, with 40% rated B1 or lower.[3]

On the opposite side of the risk spectrum from high yield corporate bonds, you find U.S. Treasuries, which I'm also not too bullish on in the current environment. In the month of May, both the 10-year and 30-year U.S. Treasuries crossed over the 3% mark, though yields plummeted in the final days on fears of Italy disrupting the eurozone (another story for another day).[4] The uptick of the yield past 3% seems, in my view, inevitable given the Federal Reserve's gradual path of interest rate increases coupled with a U.S. economy at full capacity and with the effects of the tax cut just working their way through. As the economy continues to grow with a tight labor market and no slack, inflation pressures should take hold, driving yields up even further in my view.

For investors holding long duration U.S. Treasuries, such an outcome isn't exactly ideal – as bond yields rise, the prices of bonds fall, which can show up as a negative return in the near term for bond investors. Of course, bonds held to maturity would typically pay the interest rate as advertised, but there aren't many fixed income investors out there who are actually holding bonds to maturity. These days, bond exposure is gotten through ETFs or mutual funds, many of which are managed according to a mandate that does not take into account changing market and economic conditions. All the more reason to re-evaluate your bond holdings today to ensure they align with your objectives. This is key to our approach at Zacks Investment Management where we design customized portfolios for our clients based on each individual's unique needs.

Bottom Line for Investors

In the high yield bond world, the current default rate is just 3% for speculative-grade credit, but that has been in the backdrop of a healthy and growing U.S. economy.[5] Should the tables turn or growth slow, there could be a massive unwinding and waves of default in my view. Investors should look carefully at the risk profile of your fixed income holdings, as strong investor demand for higher yields in recent years has allowed weak issuers to avoid default by refinancing maturing debt.

In my view, it's not a great time to "set and forget" your bond strategy, just because there is a lot changing with the interest rate environment and the maturing of the economic cycle. Instead, focus on finding an investing strategy that meets your long-term investing

needs. This is what we do for our clients at Zacks Investment Management.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] CNBC, May 25, 2018 - https://www.cnbc.com/2018/05/25/moodys-warns-of-particularly-large-wave-of-junk-bond-defaults.html

[2] CNBC, May 25, 2018 - https://www.cnbc.com/2018/05/25/moodys-warns-of-particularly-large-wave-of-junk-bond-defaults.html

[3] CNBC, May 25, 2018 - https://www.cnbc.com/2018/05/25/moodys-warns-of-particularly-large-wave-of-junk-bond-defaults.html

[4] U.S. Department of the Treasury, May 29, 2018, https://www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yield

[5] CNBC, May 25, 2018, https://www.cnbc.com/2018/05/25/moodys-warns-of-particularly-large-wave-of-junk-bond-defaults.html

DISCLOSURE

Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Zacks Investment Management, Inc. is a wholly-owned subsidiary of Zacks Investment Research. Zacks Investment Management is an independent Registered Investment Advisory firm and acts as an investment manager for individuals and institutions. Zacks Investment Research is a provider of earnings data and other financial data to institutions and to individuals.

This material is being provided for informational purposes only and nothing herein constitutes investment, legal, accounting or tax advice, or a recommendation to buy, sell or hold a security. Do not act or rely upon the information and advice given in this publication without seeking the services of competent and professional legal, tax, or accounting counsel. The information contained herein has been obtained from sources believed to be reliable but we do not guarantee accuracy or completeness. Publication and distribution of this article is not intended to create, and the information contained herein does not constitute, an attorney-client relationship. No recommendation or advice is being given as to whether any investment or strategy is suitable for a particular investor. It should not be assumed that any investments in securities, companies, sectors or markets identified and described were or will be profitable. All information is current as of the date of herein and is subject to change without notice. Any views or opinions expressed may not reflect those of the firm as a whole.

Any projections, targets, or estimates in this report are forward looking statements and are based on the firm's research, analysis, and assumptions. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice. Clients should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed in this presentation.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties. Zacks Investment Management does not assume any responsibility for the accuracy or completeness of such information. Further, no third party has assumed responsibility for independently verifying the information contained herein and accordingly no such persons make any representations with respect to the accuracy, completeness or reasonableness of the information provided herein. Unless otherwise indicated, market analysis and conclusions are based upon opinions or assumptions that Zacks Investment Management considers to be reasonable.

Any investment inherently involves a high degree of risk, beyond any specific risks discussed herein.