Economic News

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# UNITED STATED – CANADA

## Corporate bond spreads retreat as the default rate falls

In early 2014, tapering of bond purchases by the Federal Reserve and hope for an acceleration in activity in most advanced countries pointed towards another difficult year for the bond market. Yet clearly this has not been the case so far, when, for example, the DEX Universe index in Canada has been posting a nice return of more than 4% since the start of 2014.

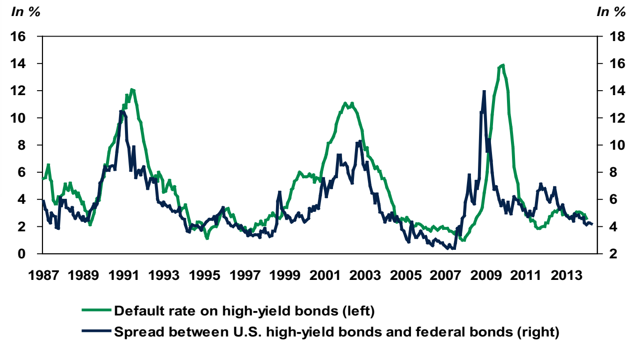
The search for yield is certainly a phenomenon that boosts the bond market. For many years now bond investors have had to deal with extremely low money market and short-term government bond returns. This, combined with ample liquidity, inflates demand for more risky and longer-term bonds.

The most obvious example of the search for yield is the spectacular plummet in yields on bonds from euro zone peripheral nations, which we recently addressed in an *Economic News*.[1] North American corporate bonds have also done really well in recent years. The sharp drop in the premium demanded on corporate bonds has led to over-performance of this bond category since the financial crisis.

The risk to investors is that the search for yield drives risk premiums to such a low level that they do not sufficiently compensate for the risk of default, which is when the issuer is unable to honour its commitment to make interest or principle payments. This is particularly important for high-yield (junk) bonds.

As the following graph shows, the yield spread between high-yield U.S. bonds and federal bonds has diminished sharply in recent years, dropping back below its average of the recent decades. This change in the risk premium appears to be wholly justified by the reduction in the default rate on this type of bond, however, which is also sharply below its historic average. We also noted that the yield premium on high-yield bonds remains above the lows of the mid-2000s.

**High yield spreads and default rates are low**




Sources: Moody's, Datastream and Desjardins, Economic Studies

**Implications:** The major reduction of risk premiums on North American corporate bonds does not seem too exaggerated for the moment, given low default rates and economic conditions that are relatively favourable to businesses. However, these bonds are still risky, as they expose investors to significant losses if economic and financial conditions deteriorate or if there is a widespread surge in bond yields.

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[1] Desjardins, Economic Studies, *Economic News*, "Are low yields justified in Europe?", April 3, 2014, www.desjardins.com/ressources/pdf/nf140403-e.pdf?resVer=1396538894000.

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