

Buying opportunities seen as bond spreads widen

Volatility pushes corporates' premiums to four-year highs

By **David Hoffman**

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Bond spreads have reached levels not seen since 2003, which is bad news for those holding bonds but good news for those looking to buy.

That's because wider bond spreads mean lower prices and higher yields.

For months, many industry experts have complained that bond spreads between corporate bonds and U.S. Treasuries were too tight.

Not only were investors not being rewarded for buying high-yield bonds, but they weren't being rewarded for buying investment-grade corporate bonds.

That, however, is changing.

High-yield spreads widened 0.85 percentage points in November and stood at 5.14% as of the publication of a Nov. 19 report from Standard & Poor's of New York.

Investment-grade spreads followed a similar pattern, widening 0.2 percentage points in November to 1.83%, according to the report. In each case, the premium over Treasuries is the highest since April 2003.

Heavy October issuance and market volatility are the main reasons spreads widened out, the report said.

The current economic climate has created buying opportunities, said Eric Takaha, senior vice president and director of corporate/high yield at Franklin Templeton Investments in San Mateo, Calif.

"On high yield, we have moved from being in a defensive position ... to more of a neutral profile," he said.

With regard to investment-grade corporate bonds, Mr. Takaha said, Franklin is looking to take advantage of the "dislocation" in the market that is causing investment-grade financials to trade at wider spreads than perhaps is warranted.

It's an opportunity that may not last long, S&P suggested.

"Spreads could tighten if investors are convinced that the large majority of the write-downs are done," the S&P report said about financial stocks affected by the subprime-mortgage crises. "Moreover, investor sentiment toward the sector could improve if some institutions can provide greater transparency to their current exposure to various risky asset classes and structures."

Or sentiment could go the other way, depending on what happens in the markets. That is why Franklin is being very selective about what it buys, Mr. Takaha said.

It's a careful approach based on the assumption that spreads can go wider. "I think in the short-term, volatility will continue," he said. And volatility leads to wider spreads.

Some financial advisers agree with Mr. Takaha.

It may be a good time to selectively scan high-yield bonds for bargains, said Morris Armstrong, president of Armstrong Financial Strategies in Danbury, Conn.

"The marginal buyers are backing off," he said. "I think you can take advantage of that."

Other advisers, however, aren't so sure.

"My thoughts are [corporate and high-yield bonds] will become attractive, but we're not there yet," said Don Peters, principal of Wichita, Kan.-based Central Plains Advisors Inc.

There are still fears that the market may be headed for a recession, he said.

Given such fears, it makes more sense to "hide out" in government bonds, Mr. Peters said.

A recession, however, seems unlikely, Mr. Takaha said, adding that the fundamentals underlying the bond market remain relatively strong.

Bond defaults are currently at a 25-year low, according to the S&P report. While the report anticipates that defaults will pick up next year, they are still expected to remain historically low, Mr. Takaha said. Defaults are expected to increase to 3.4%, from the current rate of 0.98% over the next year, according to the S&P report. That's "relatively benign," given the average since 1983 is 4.5%, the report said.

The report also noted that even a benign increase in defaults, however, could lead to wider spreads.

The belief that the weak dollar and uncertainty in the financial sector may precipitate a foreign sell-off of U.S. corporate bonds is another challenge the bond market faces, according to the report.

Also, good economic news, such as stable inflation, has had little positive effect on nervous bond buyers, the report said.

Those are all reasons why bond buyers should be cautious, said Bob Kargenian, president of TABR Capital Management LLC in Orange, Calif.

"There's really not a whole lot of value anywhere in the bond market," he said.

David Hoffman can be reached at dhoffman@crain.com.

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