



## The Yield Hunt

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“America has, for sure, the most powerful credit machine in the world, as Mr. Greenspan likes to boast. However, under the twofold influence of radically new thinking about successful corporate governance and Alan Greenspan’s novel monetary policies, this credit machine has become exclusively geared to unproductive credit for asset shuffling, financial speculation and consumption.”  
Kurt Richebacher (2005)<sup>1</sup>

The world lost a valuable voice when Kurt Richebacher passed away in August 2007, just as the epic financial crisis he had long predicted was unfolding. Among Dr. Richebacher’s contributions was his argument that production, not consumption, makes a country wealthier. Capital – most of it in the form of credit – was grossly misallocated toward consumption in the thirty years leading to the 2008 financial crisis. Unfortunately, not only has nothing changed in that respect in the last four years, but the creation of debt has only accelerated and increased. The explosion of debt in the public sector is well-known. Federal debt is about to hit \$16 trillion, will hit \$20 trillion by 2016 regardless of who occupies the Oval Office during the next four years, and will end up somewhere between \$23 and \$25 trillion by 2020 without radical entitlement reform. Those numbers, by the way, assume that interest rates do not rise during that period.

The private sector has hardly done better in reducing its debt burden. Corporate balance sheets are in good condition due to high cash balances and extended maturity schedules, but the levels of corporate debt are still relatively high. The good news is that the interest rates on this debt are very low for all but the weakest companies. The explosion of debt issuance since the debt crisis illustrates that corporations are every bit as reliant on credit as they were before they had their near death experiences in 2008. During the first nine months of 2012, U.S. corporate bond issuance was 20% higher than the same period in 2011 at \$984 billion and should easily break 2007’s record of \$1.13 trillion. Europe and Asia are also seeing high levels of issuance. For the most part, companies are not borrowing to finance new projects or thankfully – new leveraged buyouts. Instead, they are

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<sup>1</sup> Quoted by Dr. Marc Faber in *The Gloom, Boom & Doom Report*, July 31, 2012, p. 11.



intelligently taking advantage of low interest rates to reduce their borrowing costs and extend their debt maturities. But nobody should pretend that there is less debt in the system than before the financial crisis.<sup>2</sup>

All of this is great for borrowers and trouble for lenders. In fact, it has been absolutely devastating for investors and savers who rely on the yield from their investments for income. As a proud resident of the swing state of Florida (no hanging chads in Palm Beach County this year!), the impact of low interest rates are painful to witness. As an investor in credit, the distortion of securities prices caused by the Federal Reserve's zero interest rate policy is a fact of everyday life. Anyone who does not understand that the price of every stock and every bond is being artificially altered by the fact that interest rates are being manipulated by the Federal Reserve should not be risking any money in the markets.

Monetary policy has driven investors to search for yield in the riskiest assets. Both subprime mortgages and Greek bonds have rallied to some of their highest levels in years on the back of central bank policy. In the U.S., the Federal Reserve is taking a lot of mortgage paper out of the market, which is forcing investors into riskier subprime paper. At least there are signs that the housing market has stabilized and is beginning to recover. In Europe, the European Central Bank (ECB) has somehow convinced some investors that Greek bonds are worth buying. But the Greek economy is continuing to fall into the abyss, and another bailout would just be throwing (more) good money after bad. If Greek bondholders are not forced to take losses – even if they are German and French banks – there will be little chance of Europe solving its debt crisis. But just as investors who speculated on an upset in Venezuela's election are licking their wounds if they didn't sell fast enough, those who are betting on a payoff on Greek bonds are likely to be injured here (more on Venezuela below).

### **The high-yield bond market**

I have written before about the dichotomy between low bond yields and relatively normal bond spreads. To remind my lay readers, spreads are the risk premium over Treasuries that investors demand for owning a particular bond. Today, the average high yield bond yields about 6.5%, which means it is priced at a spread of about 575 basis points over Treasuries. This is slightly higher than the 6.15% yield that the market traded at in September. The average spread has historically been a little over 600 basis points. Broken down by ratings category, BBs trade at a spread of 397 basis points, Bs at 535 basis points, and CCCs at 1,014 basis points. Marty Fridson, the pre-eminent high yield market researcher (and provider of these numbers), argues that all three sectors are overvalued, with CCCs being the most overvalued. This view is consistent with the fact that investors have been desperately seeking yield, and there has been very little yield to find outside of the CCC sector. My view of the high yield market is that current long opportunities are, for the most part, credit specific and short and/or hedging opportunities are largely macro in

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<sup>2</sup> For a more complete discussion of the fallacy of deleveraging, see Doug Noland, "The Myth of Deleveraging," October 12, 2012 at [http://prudentbear.com/index.php/creditbubblebulletinview?art\\_id=10718](http://prudentbear.com/index.php/creditbubblebulletinview?art_id=10718).



nature. The default risk has crept back to about 3.5%, but that is still below the historic average of about 4.5%. The risks to the strong rally in credit are far more likely to come from macroeconomic factors (i.e. Europe, the fiscal cliff, a Middle East war) than company-specific events such as defaults or credit ratings downgrades.

Nonetheless, signs of over-exuberance are creeping into the corporate credit markets. Moody's Investors Service reports that the covenant quality of U.S. high yield bonds reached historical lows in September.<sup>3</sup> "Bonds rated single-B, which rank the 'weakest' in covenant quality, comprised almost three times the historical percentage [in September]," according to the ratings agency. B-rated bonds with the weakest covenants comprised 28.6% of new issuance compared with an historical average of 9.4% according to Moody's. But that is not the worst of it. In the past month, four issuers sold \$2.1 billion bonds bearing the infamous PIK-toggle feature (who comes up with these names?): Bonds that can pay interest in either cash or additional bonds at the option of the issuer. The companies in question were all owned by private equity firms: Jo-Ann Stores, Petco Animal Supplies, Inc., Emergency Medical Services and Pharmaceutical Product Development. All of these bonds were rated Caa1/CCC+ and are subordinated to bonds issued by the operating companies of these issuers. The companies are all doing reasonably well, and they will have to be because they now have \$2.1 billion more debt to service and repay in a weak economy, and their private equity owners have far less at stake if they fail.<sup>4</sup> For too many reasons to recite here, I wouldn't touch any of these bonds with a ten foot pole. In the past, rising issuance of these types of low-quality bonds has been a warning that a market rally is coming to an end. With defaults picking up and the economy weakening, investors need to be on their toes. Today's new issues will be the troubled credits of tomorrow.

The CCC-ratings on these bonds contrast with similar ratings on bonds issued in some of the large LBOs that occurred just prior to the financial crisis, such as First Data Corp., Caesars Entertainment, Clear Channel Communications, etc. The latter weathered the financial crisis, stabilized their businesses under the weight of huge debt burdens, and extended their debt maturity schedules. In many cases, their private equity owners increased their financial commitments to the companies by purchasing large amounts of debt at a discount (a wise move since their equity investments were largely wiped out because they overpaid for the asset). While these companies bear the same triple-C ratings as these newly minted PIK-toggle notes, I would argue that they are far less risky (and in many cases have much shorter maturities). All triple-C rated notes are not created equal. These newly minted ones are heading into rough waters, while the triple-C notes created in the last cycle are steaming out of their most challenging passages. This is why investing in high yield credit can only be done on a company-specific basis, and why an

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<sup>3</sup> Moody's: US Covenant Quality Near Record Low as High-Yield Bond Issuance Surges in September, October 4, 2012.

<sup>4</sup> In the case of Petco, simultaneous with the sale of the PIK-toggle notes, Leonard Green & Partners and Texas Pacific Group sold their remaining 6,946,909 shares and no longer hold any equity in the company.



experienced manager is needed to evaluate each investment in relation to the many non-quantifiable and experiential factors that determine credit quality.

My bottom line is that the high yield market is not in danger of imminent collapse as some have argued. As long as defaults remain relatively low, and interest rates remain invisible, investors will continue to chase yield. What would cause a sharp sell-off in the near future? The most likely causes would be a sharp sell-off in the U.S. stock market and/or a systemic event that leads investors to flee from risk assets. High yield credit portfolios should be structured with shorter durations (under four years) and healthy amounts of bank loans in order to provide downside protection. Investors are not being sufficiently compensated for taking duration risk (which in high yield credit should be understood as another type of credit risk).

## **Europe**

Europe is getting worse, not better. Greece is getting worse, not better, and so is Spain. It doesn't help that European economic officials remain in deep denial about their plight. Over the weekend, German Finance Minister Wolfgang Schauble told the world that Greece will not default. That is like saying Germany didn't lose World War II. I ask myself how these people expect to be taken seriously when they make statements like that. Then I calm down and tell myself that those statements are what create investment opportunities.

The Greek unemployment rate hit 25% two days after German Chancellor Angela Merkel braved a 6-hour journey to Athens to check on her impoverished minions. She was greeted by 50,000 or so protesters, some donning Nazi regalia, one running through the streets wearing nothing at all (presumably to throw the riot police off guard). Greece is undertaking another €13 billion of budget cuts, which is like scraping blood from a stone. Regardless of their previous spendthrift ways, the Greeks should not be asked to bear any more pain at present. You cannot starve a starving man back to health. The unrelenting austerity demands of Germany and the ECB are extinguishing the economic growth that is needed. Greece is sinking further into depression; Spain and Portugal are not far behind. Italy is in better shape than most people think because it is a far wealthier nation than the others, but it is hardly out of the woods. On October 10, Standard & Poor's (S&P) downgraded Spain to BBB-, one level above junk. This rating is long overdue (as all judgments of the credit rating agencies are) and still too generous since Spain cannot pay its bills without external support. Unfortunately, the price of that support has been set at additional austerity that is crushing the Spanish economy. This vicious cycle is forcing Europe to chase its tail into a downward spiral of economic collapse. Until European sovereigns and their banks start writing off the debts that they can never hope to repay, the crisis will not end. And they can't do that without taking more pain right now.

For this reason, investors who have profited from speculative investments in European sovereign debt should be thinking about taking their profits and moving on. Some Greek



bonds have rallied into the 30s. Considering they are worth far less – maybe nothing – that isn't bad, but holders should sell while they can. The smartest thing those investors could do is take their profits now, before they evaporate, and swap them into gold. Gold will massively appreciate against the euro as the ECB prints untold amounts of the European currency in a hopeless attempt to keep the European Union afloat. Sooner or later, the ECB is going to force bondholders to take losses. Investors do not want to be the last passengers standing on deck when the ECB finally admits that it is running a printing press inside the engine room of the *Titanic*.

## **The U.S. economy**

The September jobs report was weak in virtually every respect except one: the unemployment rate, which dropped to 7.8%. If the unemployment rate were measured against the workforce that existed when Barack Obama took office, the rate would be about 10.7%. The desertion of millions of people from the workforce has moved the jobless rate downward, but the actual number of unemployed is still about 23 million. Moreover, U6 – which includes underemployed and discouraged workers – was unchanged at 14.7% in September. The labor force participation rate remained a disappointing 63.6%, back where it was in 1981. The massive 873,000 surge in household unemployment consisted of 582,000 people taking part-time jobs for “economic reasons” (i.e. people couldn't find full-time work). Coupled with the fact that this household figure is notoriously volatile, it is difficult to believe that it was more than a statistical anomaly. One can only wonder how much more people would be employed had the Obama administration focused 100% of its efforts on the jobs crisis instead of forcing through its profoundly flawed healthcare plan.

Data confusion was compounded by the weekly jobless claims number reported on October 11. The reported number, a surprisingly low 337,000, was basically meaningless since “one [unnamed] large state didn't report some quarterly figures.” The state in question was not California or New York apparently. Whether or not it was a swing state remains to be seen. The weekly jobless claims figure looks like it will continue to creep downward unless, like every other economic statistic, the U.S. tumbles over the fiscal cliff.

The U.S. economy is going to be weak until businesses see whether Congress is going to drive over the fiscal cliff or do something rare and act responsibly and intelligently and stop the financial train wreck known as America. A roadmap for a responsible and balanced deal has already been set forth by the Bowles-Simpson Commission. The proposal set forth by that group would provide political cover for both parties and allow them to move on to the real business at hand – rewriting the tax code. Further, the constructive feelings arising from a budget deal could create momentum for a tax deal. While it is probably a leap of faith to be optimistic about such an outcome, one can always be hopeful that our leaders will rise to the occasion.

Without a new tax code that better aligns incentives with economic growth and eliminates the distortions that favor debt over equity and speculation over productive investment,



even a Bowles-Simpson type of deal will not accomplish very much. Moreover, it is time that tax policy eliminated the differential treatment of capital and labor. This differential lies at the heart of the economic and social inequities that flow from the tax code. As long as capital is taxed at a lower rate than labor, the gap between rich and poor will continue to widen. A tax code that lowered rates from their current levels to a range of 20-25%, eliminated most deductions, and erased the differential treatment between capital and labor would go a long way toward promoting economic growth and evening the playing field between rich and poor. A fundamental change like this would further equality of opportunity, not promote equality of result as second order policies such as affirmative action (which is likely to be issued a setback by the Supreme Court during its current term) are forced to do.

The U.S. stock market has taken a pause from the rally that started in June. The technology sector has really been taking it on the chin, with Apple trading off by about 10% after releasing the iPhone 5 with a map application that consumers don't like and experiencing some supply chain problems. I have written before about my concern that Apple stock would suffer from the laws of large numbers that have hit other stocks that have risen to where they constitute as much as 4% of the S&P 500 (i.e. Exxon, Microsoft) and reach a gargantuan market capitalization. That is not to suggest that Apple stock is "expensive," or that the company will stop growing, or that the stock cannot recover. But it is going to be difficult for Apple to maintain its previous pace of new product introductions and innovations on such a large business base, and growth was a big factor driving the stock price above \$700/share. Accordingly, while the stock may be tempting at these levels on a valuation basis, I would advise investors who can't resist playing it to do so through the options market in order to limit their downside. I am going to sit this one out for now.

## **Venezuela**

Hugo Chavez is a thug, and his re-election is a tragedy for the Venezuelan people – who, by the way, did not vote him back into office, regardless of the "official" vote tally. The election was a farce; Chavez controls the Venezuelan media and has unlimited financial resources as a result of looting untold billions of dollars from PDVSA, the Venezuelan oil company. (By the way, traders who were betting on a Capriles victory were exhibiting their complete ignorance of the realities of Venezuelan politics and are now paying the price.) Chavez is well on the way to destroying a country rich in both human and mineral resources. He traffics with the likes of Iran and China and is a clear and present danger to both the United States and Israel. He imprisons his political enemies on false charges and has completely corrupted the Venezuelan political and legal system. He now has license to steal more assets from foreigners and his own people through his bogus nationalization program. More than 1000 businesses have been "nationalized" under his rule, and more will be stolen now that he has stolen the election. He can also continue to abuse the international arbitration system to protect these thefts as long as the Swiss and others allow him to do so.



The Obama administration has allowed Venezuela to act with impunity to undermine U.S. interests in its own backyard. That is hardly surprising since this administration has turned its back on all of Latin America; the State Department has demonstrated an abject inability to multi-task. The one piece of good news that has emerged from Caracas over the past year is that Chavez is terminally ill with cancer. He was supposed to be dead by now, but the Gods are cruel and he remains alive. While the U.S. should have acted a long time ago to deal with the scourge of Chavez, it must take steps now before he does more damage. The U.S. government should ban further imports of oil from PDVSA. We should not be purchasing oil from a country that is actively working against our interests. Second, our government should take steps to protect the interests of the businesses and families whose assets have been frozen or stolen by the Chavez government. It is time that this country engages in the kind of *realpolitik* that will make him understand what real power is. If we are trying to play some complex geopolitical game involving Iran and China, I have some news for our President and Secretary of State: we are losing. Where is Henry Kissinger when we need him?

### **Investment recommendations**

*This section is available only to paid subscribers.*

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