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Too Hot for Treasuries, Too Cold for Stocks: An Outlook Just Right for High Yield

Bruce H. Monrad, Chairman, Northeast Investors Trust

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Host: We're here with Bruce Monrad, Chairman and Portfolio Manager of Northeast Investors Trust, (ticker symbol: **NTHEX**), which is a pioneer in high yield investing. Bruce has managed the Trust for more than 30 years, making him one of the most experienced fund managers in the country. Bruce, the Fed slashed rates to near zero amid the COVID crisis. And it seems to be in no hurry to raise them again. In fact, to appease the markets, the Fed has indicated that rates could stay near zero through at least 2022. Is this an example of what they call the Greenspan put?

Bruce Monrad: It's exactly that. Famously, nearly two decades ago, Alan Greenspan lowered interest rates and it was referred to as the Greenspan put. He was focused on supporting the economy through the markets and that's very much something akin to what we are seeing today, which is that the Fed is very focused on keeping the financial markets functioning and that's all in support of the economy.

Host: Now, stock investors have historically taken comfort in that Greenspan put — to your point, the Fed's willingness to kind of slash rates to put wind in the sails of equities. But the Fed rate cuts haven't really just benefited stocks in recent market crises. Right? Other asset classes have benefited, too.

Bruce Monrad: Well, yes. And, you know, today the Fed is explicitly targeting — and this is a little bit new — the high yield bond market and trying to make sure that things are calm there. In the past, the Fed has approached this very generally, but now it's very explicit that they care about high yield bond spreads, yields over treasuries, and they're focused on that and they really are very concerned and don't want things to get out of control. They've watched high yield spreads in the past, and it's been a factor, but this is pretty explicit. And so, you know, this is very helpful to the high yield market.

Host: Bruce, can you describe a little bit more in detail what the Fed is specifically doing with high yield? I know that they've talked about wanting to support the high yield market, but are there actual programs that they put in place that you think will benefit high yield investors directly?

Bruce Monrad: Yes, there are two major prongs. One is that the Fed explicitly allowed itself as part of its quantitative easing, that is to say the purchase of assets as part of its quantitative easing program, to buy the fallen angels, the bonds that are now high yield bonds but were high grade bonds back before COVID hit the country. And that's been very therapeutic because large issuers like Ford Motor, which wound up being downgraded, they did enter the high yield universe, but it didn't produce the disruption that people would have feared, of an avalanche of supply, because some of these names are very large issuers.

The other prong is that the Fed has expressed a willingness to go out and buy the high yield market through ETFs, which is indirect, but it also could be very effective. And so they are in there trying to support the market and we think those are two very interesting and new programs that we haven't seen before.

Host: Bruce, to your point, the Fed is publicly supporting risk assets like high yield, and they're actually literally buying high yield bonds. In your mind, does that sound like a Goldilocks kind of scenario for this asset class?

Bruce Monrad: We think it's probably very favorable. I mean high yield is now an explicit policy tool, not just a market, but you know, it's not just a market of buyers and sellers, but it's also a policy tool. And the Fed has stated that they want to make sure that the high yield market, as a market, is stable. And so they're not going to let things get out of hand. So it's quite favorable to know that there is, again the word, "the put," out there, that the Fed wants to make sure that the market never ceases to function. And, you know, that's a bit of a new development because in recessions in years past, you know, 1991 and beyond, I've been through several of them, you've always had to worry that the markets would be dysfunctional for a period during a recession. And that's just not the case now. The Fed really is in there and paying attention, and we get a collateral benefit because the Fed has identified that the high yield market is important to making the economy function well.

Host: So, in light of that, how do you think high yield will actually perform going forward, especially relative to equities?

Bruce Monrad: We're pretty sanguine on that relationship. The period that this reminds us of is that of the late '90s, the early 2000s, when equities had had a very, very good run, valuations were extended, and, you know, you could make the argument that valuations in equities are extended. And right after that period, from say 2000 until 2006-07, the stock market pretty much went nowhere, particularly the parts of the market that had done so well in the late '90s. And in contrast high yield did pretty well over that period because locking in that income coupon, at the time 6-7%, proved to be the difference in terms of the total return between the two asset classes.

So you wanted to own high yield at the moment of the bubble in equities in 2000. There's one other factor going on right now that affects that, which is that there is a high likelihood that there will be some sort of tax increase on corporations to pay for all the deficits that we're seeing now.

And taxes, of course, would affect corporations and would drive income, net income earnings per share, for many corporations down, and high yield is just not vulnerable to that form of risk. So, you know, we would say that it's very arguable that this could be a Goldilocks period for high yield here, and in the half decade to come.

Host: Let's explore that a little bit more. Now, obviously the big fear for investors who are thinking about high yield, is that what if the economy is too cold to support this asset class. Could you give us a sense of what you think the economy will be like, during this COVID phase and then post-COVID?

Bruce Monrad: Well, of course everything comes back to COVID and if we are not able to tame it, then that's one thing. But in a scenario where we're fighting brush fires for the foreseeable future, we would say that that's not too threatening to the economy. And we here at Northeast have a relatively sanguine view on the economy. We think people will go back to work. The metaphor we would use is that after 9/11, when the unemployment rate ground it's way lower, and there was nothing self-reinforcing about the hiccup that happened to the economy after 9/11. And that's where we would view it today. We have a relatively sanguine view on the economy going forward. We've had a bit of a "V" shape. It will slow down on that, but that's how we see things going forward.

Host: It sounds like you're saying, Bruce, that the economy should be warm enough where high yield is expected to do better than at least treasuries, right?

Bruce Monrad: Yes, that's our view. Though, obviously the base case is that the economy will continue to grind its way higher and better. But there's another phenomenon at work here, which is that the Fed is actively encouraging banks to work with their borrowers. And this is different. Right now the Fed is saying to banks, work with your borrowers, they may have had weak earnings in the 1Q 2020 to 2Q 2020, but please work with them. Don't do anything draconian, don't invoke covenants on them. And that's very different than we've seen in the past. You know, most particularly in 2008, when the entire financial sector was under considerable scrutiny, and there were a lot of criticized loans — that led to a lot of pressure on banks to foreclose, to trigger covenants on their borrowers. And so this is a very favorable environment for high yield. Add to that, the economy is doing well, but we also have interest rates low. So, for companies to make their interest burden, that's a lot easier now with interest rates at rock bottom levels.

Host: And we should note that since the Fed really started to step in amid the COVID economic crisis, we have seen high yield substantially outperform treasuries in the last three months. So, there's evidence that that's taking place already. Now, at the same time, Bruce, a better-than-expected economic rebound should bode well for stocks. But the fear, at least with regard to equities, is that the stock market has been too hot lately, that valuations are too frothy, right?

Bruce Monrad: Yes, it is. I mentioned earlier that we would worry if we were thinking about the stock market, we would worry about the possibility of tax increases and then valuations are another matter too, as you say. There are several overlaps between the high yield market and equities. And some of the valuations that we do see in the equity market are quite lofty. So again, it just might be a Goldilocks period for high yield in which it makes sense to lock in the income at today's level. And we might be viewing it as a very favorable half-decade ahead for high yield.

Host: Again, this would seem to put high yield really in that sweet spot, that Goldilocks scenario. But we should ask, Bruce, aren't there risks with high yield, too? For instance, nearly a quarter of the SPDR Bloomberg Barclays High Yield Bond ETF (JNK) is comprised of a lot of consumer stocks, including retailers and energy. So, there are risks that investors ought to be aware of, right?

Bruce Monrad: Yes, and it certainly pays to be selective. We would think there are areas in the high yield index that you may or may not want to own. And you mentioned energy, you know, that's a complicated one because COVID has impacted demand for oil, a couple of percent. In general, we are staying away from these parts of the market where there are large fixed costs and a little bit of demand destruction to the underlying products. So, we're not buying cruise lines, we're not buying hotels and we've been cautious on the energy side, as well. So, we do think it makes sense to be selective just because of the risk/reward there. But in general, we do tend to think that it's probably a very interesting period for high yield right now with all the things that we've spoken about.

Host: Bruce, in many ways, you're talking about a lot of the benefits of active management, but I wonder, you know, in addition to active management, are there other kinds of attributes or tendencies of a high yield fund that an investor who's interested in this asset class ought to be thinking of? Are there other types of limitations or styles that you think are appropriate at this juncture for the market?

Bruce Monrad: We're very happy with the way our portfolio is structured right now. And one dimension of that is our over-weighting of non-ETF bonds. Now, the ETF bonds have had a very good run since March. And in part that's because the technicals, they're the first ones to go and get bought if money flows into high yield and indeed they've moved up with a little bit of a lag. The more off-the-run-securities, we think that there's an opportunity there. And we have what we think are a number of bonds with pretty good coupons, interest rates of 6%, and the like, and prices below par. And we would expect those to go up. So, we would think that there are parts of the market that are more attractive.

And, as I say, we're relatively happy with the way our portfolio is positioned. We're looking for the parts of the market that we think still have the most room to run.

Host: Bruce, you've been doing this for longer than pretty much any other high yield manager in the industry. Have you ever seen a market like this?

Bruce Monrad: No, this has been, this is very interesting. We've never had the Powell put or the Greenspan put like that. We've never had the authorities take such an interest and link the success of the high yield market to their policy objectives. And that's just great. And it's probably good policy as well, to make sure that the market helps support the economy. And then obviously this is one-of-a-kind. When I started, interest rates on high yield bonds were 14%, and to have the long-term treasury, the 10-year treasury, well below 1%, very interesting times, and very unique. But there are many things that we've learned over the years that we applied to it and hopefully we'll get that right.

Host: Well, Bruce, thank you for sharing your thoughts. That was Bruce Monrad, Chairman and Portfolio Manager of Northeast Investors Trust (ticker symbol **NTHEX)**.

Bruce H. Monrad is chairman and portfolio manager of Northeast Investors Trust (ticker: NTHEX), a no-load, high-yield fixed income fund whose primary objective is the production of income. Bruce is among the longest-tenured bond fund managers in the industry, having run Northeast Investors Trust for more than 30 years.

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