Q&A-Short-duration high-yield bond spreads to stay tight in 2022 as Fed tapers; Energy sector debt attractive: Bruce Monrad, Northeast Investors Trust

High-yield bond spreads are likely to stay compressed in 2022, supported by low default rates and the economic recovery from coronavirus even as the U.S. Federal Reserve begins to taper its asset purchases, **Bruce Monrad, portfolio manager at Northeast Investors Trust,** told the Reuters Global Markets Forum on Thursday, December 9.

"The bond market will have to stand on its own two feet," Monrad said

He preferred shorter duration bonds that are subject to fewer risks, "where both spreads and yields are relatively pinned at low levels."

Monrad likes debt issued by natural gas and oil companies as they have cut back on major drilling programs, but has limited exposure to sectors favored by the reopening trade due to the large amounts of debt on their balance sheets.

Following are edited excerpts from the conversation:

Q: What's on your radar for the high yield market in the upcoming year?

A: We'll be focused on the continued recovery, which is keeping credit issues low, and of course interest rates, we will be thinking about what the Central Banks will be doing. It just should be an interesting year ahead and maybe even an interesting week ahead. Three major centrals banks to watch. So we should all stay tuned!

Q: What's your outlook for central bank policy? What impact are you anticipating on demand in the high-yield sector as the U.S. Federal Reserve starts unwinding its asset purchases, especially given the likely faster pace of tapering?

A: The Fed is flipping toward a more restrictive monetary policy. As you mentioned, the first step is so-called tapering, the reduction in bonds purchases. So, this will be interesting. We really don't have as much experience in tapering as we do in raising interest rates, and it means that the bond market will have to stand on its own two feet, so to speak. Here in high yield, we do take some cues from the Treasury market, and we tend to like the short-end of the high-yield market, where both spreads and yields are relatively pinned at low levels.

Q: Do you expect spreads to remain compressed in 2022?

A: At the short-end, we think so. It's easier to predict company earnings and financial conditions in the short-term than it is in the long-term. And current conditions are that default rates are exceptionally low. Spreads would react negatively to a worst case Covid scenario, but that's not our base case.

Q: What's your take on the inflation debate, and how do you see price pressures impacting income-focused investors?

A: Here in high-yield, we pay a lot of attention to what our companies are saying, some bottom-up analysis in addition to the top-down/macro statistics, and we are just finishing up the 3Q (third quarter) earnings calls. There was a constant theme of cost pressures, as well as a constant theme that companies express confidence that they will be able to pass those cost bumps onto consumers. So, we think inflation pressures will persist, even if there is some modest offset from base effects and some relief from bottleneck pressures. That means that inflation is something that the Fed is paying attention to, and so, income-focused investors should do the same thing.

Q: You've mentioned you like the shorter end of the curve -- any particular sectors you see as most attractive right now?

A: We are optimistic on energy pricing -- natural gas and oil -- because their companies have cut back on drilling and supply. We also like titanium dioxide producers -- that's a chemical. Even though we think we are grinding our way out of Covid, we do not have a big

exposure to so called reopening trades, such as cruise lines and airlines, because they have added so much debt during the pandemic. And in any event, we do like controlling risk by staying short in terms of our maturities.

Q: Do you see the trend of large issuance continuing, particularly in energy and commodities as the Fed tightens policy?

A: We do expect a lot of issuance, mostly to refinance existing debt. But we do think that energy companies are more disciplined than they were in 2010-2014, and they really want to see the whites of their eyes. With regard to sustained energy pricing before they commit to major drilling programs, their shareholders won't allow it.

Q: Do you anticipate the trend of covenant-lite loan issuance to continue? And is this concerning from a risk standpoint?

A: Indeed, covenants on new deals are weak, and issuers are more aggressive in their interpretations of covenants. Would prefer that that was not the case.

Q: Has this made you more cautious when evaluating issuers/investing as a whole?

A: We are focused at the short-end of the market. And it's tough to be creditor unfriendly if you need creditors to refinance and roll over into the new deal. So, we like that part of the market and enjoy collecting the extra income over Treasuries.

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