Since the post-financial crisis era began more than a decade ago, record low-interest rates and the Fed?s acquisition of $4 trillion of the highest quality fixed-income assets has led investors to scratch and claw for any asset, regardless of quality, offering returns above the rate of inflation.

Financial media articles and Wall Street research discussing this dynamic are a dime-a-dozen. What we have not heard a peep about, however, are the inherent risks within the corporate bond market that have blossomed due to the way many corporate debt investors are managed and their somewhat unique strategies, objectives, and legal guidelines.

This article offers insight and another justification for moving up in credit within the corporate bond market. For our prior recommendation to sell junk debt based on yields, spreads, and the economic cycle, we suggest reading our subscriber-only article *Time To Recycle Your Junk*. If you would like access to that article and many others, you can sign up for RIA Pro and enjoy all the site has to offer with a 30-day free trial period.

Investor Restraints

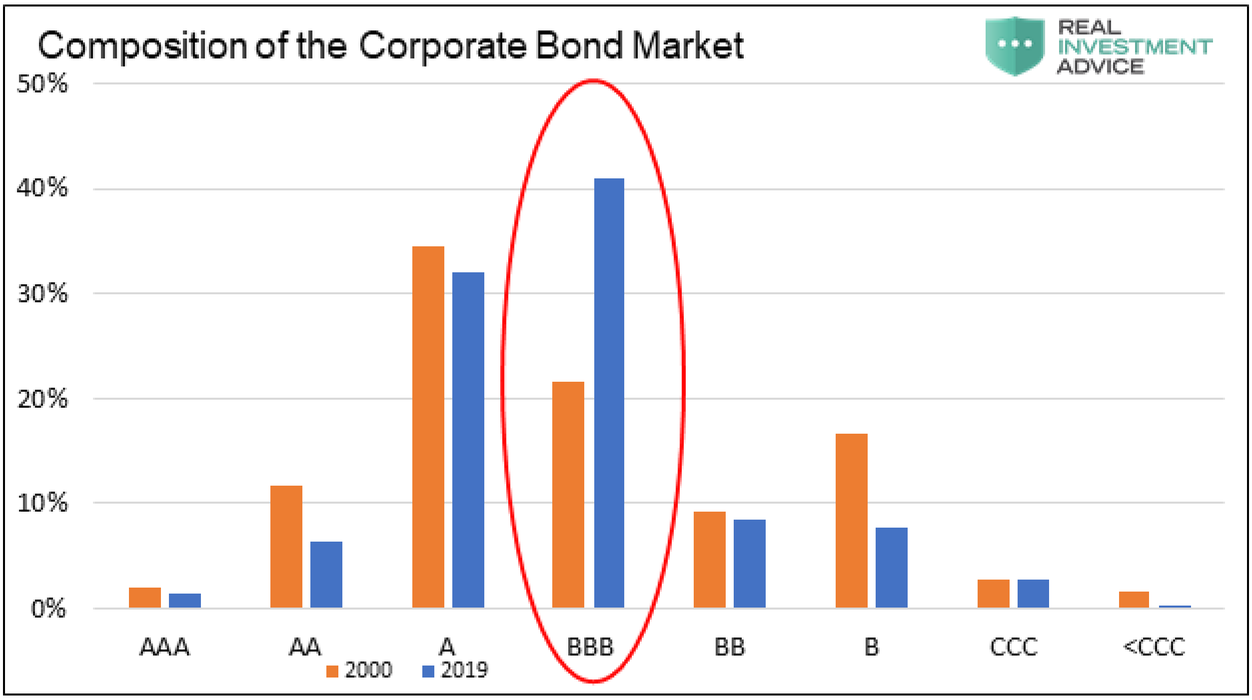
By and large, equity investors do not have guidelines regulating whether or not they can buy companies based on the strength or weakness of their balance sheets and income statements. Corporate bond investors, on the other hand, are typically handcuffed with legal and/or self-imposed limits based on credit quality. For instance, most bond funds and ETFs are classified and regulated accordingly by the SEC as investment grade (rated BBB- or higher) or as high yield (rated BB+ or lower). Most other institutions, including endowments and pension funds, are limited by bylaws and other self-imposed mandates. The large majority of corporate bond investors solely traffic in investment grade, however, there is a contingency of high-yield investors such as certain mutual funds, ETFs (HYG/JNK), and other specialty funds.

Often overlooked, the bifurcation of investor limits and objectives makes an analysis of the corporate bond market different than that of the equity markets. The differences can be especially interesting if a large number of securities traverse the well-defined BBB-/BB+ ?Maginot? line, a metaphor for expensive efforts offering a false line of security.

Corporate Bond Market Composition

The U.S. corporate bond market is approximately $6.4 trillion in size. Of that, over 80% is currently rated investment grade and 20% is junk-rated.This number does not include bank loans, derivatives, or other forms of debt on corporate balance sheets.

Since 2000, the corporate bond market has changed drastically in size and, importantly, in credit composition. Over this period, the corporate bond market has grown by 378%, greatly outstripping the 111% growth of GDP. The bar chart below shows how the credit composition of the corporate bond market shifted markedly with the surge in debt outstanding.



As circled, the amount of corporate bonds currently rated BBB represents over 40% of corporate bonds outstanding, doubling its share since 2000. Every other rating category constitutes less of a share than it did in 2000. Over that time period, the size of the BBB rated sector has grown from $294 billion to $2.61 trillion or 787%.

The Risk

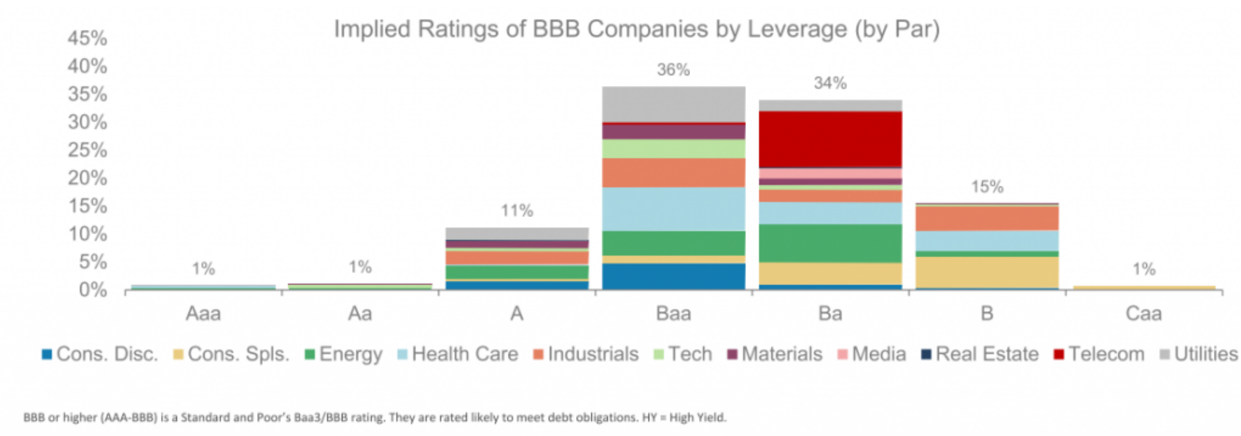
To recap, there is a large proportion of investment grade investors piled into securities that are rated BBB and one small step away from being downgraded to junk status. Making this situation daunting, many investment grade investors are not allowed to hold junk-rated securities. If only 25% of the BBB-rated bonds were downgraded to junk, the size of the junk sector would increase by $650 billion or by over 50%. Here are some questions to ponder in the event downgrades on a considerable scale occur to BBB-rated corporate bonds:

- Are there enough buyers of junk debt to absorb the bonds sold by investment-grade investors?
- If a recession causes BBB to BB downgrades, as is typical, will junk investors retain their current holdings, let alone buy the new debt that has entered their investment arena?
- Will retail investors that are holding the popular junk ETFs (HYG and JNK) and not expecting large losses from a fixed income investment, continue to hold these ETFs?
- Will forced selling from ETF?s, funds, and other investment grade holders result in a market that essentially temporarily shuts down similar to the sub-prime market in 2008?

We pose those questions to help you appreciate the potential for a liquidity issue, even a bond market crisis, if enough BBB paper is downgraded. If such an event were to occur, we have no doubt someone would eventually buy the newly rated junk paper. **What concerns us is, at what price will buyers step up?**

Implied Risk

Given that downgrades are a real and present danger and there is real potential for a massive imbalance between the number of buyers and sellers of junk debt, we need to consider how close we may be to such an event. To provide perspective, we present a graph courtesy of Jeff Gundlach of DoubleLine.



The graph shows the implied ratings of all BBB companies based solely on the amount of leverage employed on their respective balance sheets. Bear in mind, the rating agencies use several metrics and not just leverage. The graph shows that 50% of BBB companies, based solely on leverage, are at levels typically associated with lower rated companies.

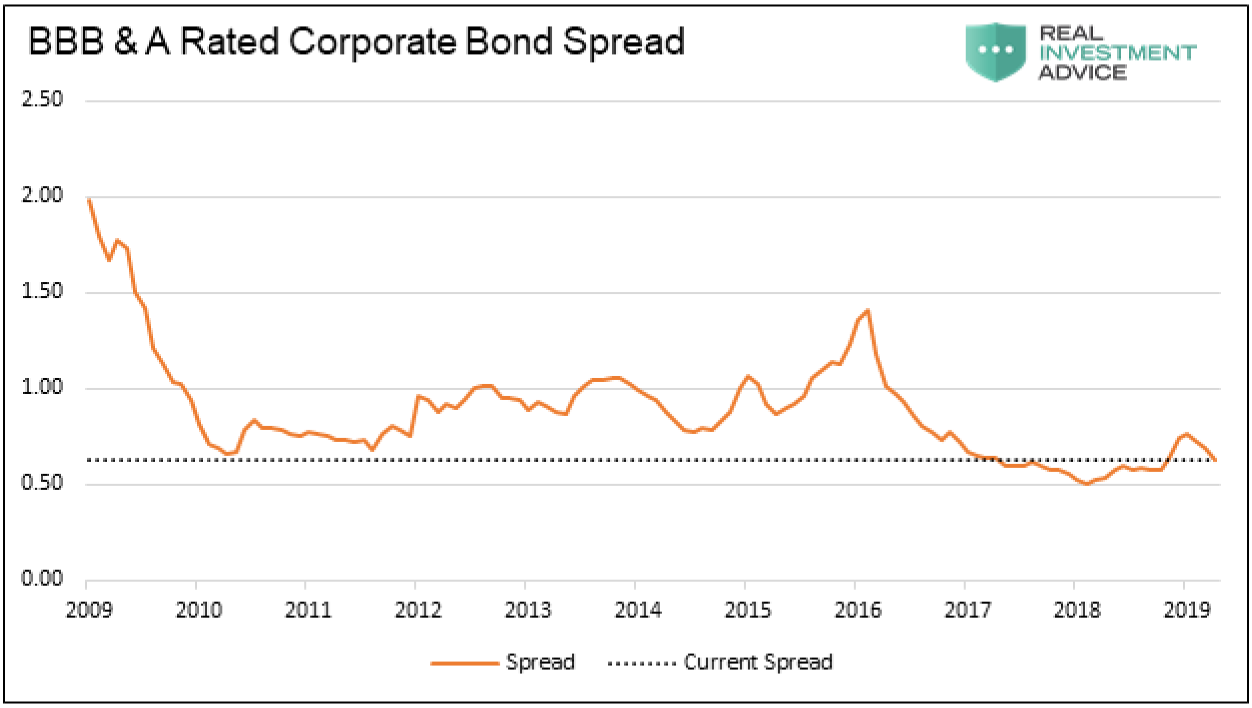
If 50% of BBB-rated bonds were to get downgraded, it would entail a shift of $1.30 trillion bonds to junk status. **To put that into perspective, the entire junk market today is less than $1.25 trillion, and the subprime mortgage market that caused so many problems in 2008 peaked at $1.30 trillion.** Keep in mind, the subprime mortgage crisis and the ensuing financial crisis was sparked by investor concerns about defaults and resulting losses.

As mentioned, if only a quarter or even less of this amount were downgraded we would still harbor grave concerns for corporate bond prices, as the supply could not easily be absorbed by traditional buyers of junk.

Recommendation

Investors should stay ahead of what might be a large event in the corporate bond market. We recommend corporate bond investors focus on A-rated or solid BBB?s that are less likely to be downgraded. If investment grade investors are forced to sell, they will need to find replacement bonds which should help the performance of better rated corporate paper. What makes this recommendation particularly easy is the fact that the current yield spread between BBB and A-rated bonds are so tight. The opportunity cost of being wrong is minimal. At the same time, the benefits of avoiding major losses are large.

With the current spread between BBB and A-rated corporate bonds near the tightest level since the Financial Crisis, the yield ?give up? for moving up in credit to A or AA-rated bonds is a low price to pay given the risks. Simply, the market is begging you not to be a BBB hero.



Data Courtesy St. Louis Federal Reserve

Summary

The most important yet often overlooked aspect of investing is properly recognizing and quantifying the risk and reward of an investment. At times such as today, the imbalance between risk and reward is daunting, and the risks and/or opportunities beg for action to be taken.

We believe investors are being presented with a window to sidestep risk while giving up little to do so. If a great number of BBB-rated corporate bonds are downgraded, it is highly likely the prices of junk debt will plummet as supply will initially dwarf demand. **It is in these types of events, as we saw in the sub-prime mortgage market ten years ago, that investors who wisely step aside can both protect themselves against losses and set themselves up to invest in generational value opportunities.**

While the topic for another article, a large reason for the increase in corporate debt is companies? willingness to increase leverage to buy back stock and pay larger dividends. Investors desperate for ?safer but higher yielding? assets are more than willing to fund them. Just as the French were guilty of a false confidence in their Maginot Line to prevent a German invasion, current investors gain little at great expense by owning BBB-rated corporate bonds.

The punchline that will be sprung upon these investors is that the increase of debt, in many cases, was not widely used for productive measures which could have strengthened future earnings making the debt easier to pay off. Instead, the debt has weakened a great number of companies.