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Junk Yields Flashing Back To '01 Slump

By SCOTT PATTERSON
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As Federal Reserve officials discuss the economic outlook today, they might want to turn their attention to junk bonds, which are flashing red.

In June, the Merrill Lynch High-Yield Bond Index showed junk bonds yielded about 2.4 percentage points more than low-risk Treasurys, an all-time low that suggested investors saw little risk in the sector. Last week, "spreads" over Treasurys reached 7.5 percentage points, the highest level in more than five years and very near levels in 2001, a recession year. The amount spreads have widened the past several months -- five percentage points -- is also in keeping with their move over 18 months in 2000 and 2001.

Investors are demanding higher premiums on junk bonds because they fear defaults will rise.

Junk-bond issuance is evaporating. Through yesterday, $850 million in high-yield debt had been issued for the month, compared with $8.5 billion for all of January last year, according to Thomson Financial. Barring a last-minute surge, it will be the slowest start to a year for junk since 1991, another recession year.

"High yield is the canary in the coal mine," says Greg Hopper, manager of Julius Baer Global High Income Fund.

The worry is striking because only 0.9% of outstanding junk bonds defaulted last year. Though defaults recently have started creeping up, the default rate is still well below its long-term average of 4.4%. The rate at the start of the last recession was 8% and peaked at 11.2% in January 2002. In other words, investors are pricing in a dramatic deterioration.

The drop in junk issuance is problematic for stocks. The past few years, many companies used junk bonds to finance share buybacks. Private-equity firms used them to help finance takeovers. Those tailwinds for stocks are gone for now.

Costlier junk also means many companies will pay more to refinance debt. There are about $900 billion in U.S. junk bonds outstanding, according to Moody's.

Perhaps investors have pushed junk bonds too far. If they're right, though, the corporate outlook is going to get very bad, very fast.

Fourth-Quarter Profits: Dead Weight Financials

Before companies started reporting fourth-quarter earnings, analysts braced for dismal news, estimating earnings fell by more than 9% from a year earlier. Still, they were too optimistic.

By the end of the week, more than half of the companies in the S&P 500 will have reported. Earnings per share are on track to fall 20.4%, year-over-year, according to Thomson, the worst performance since the fourth quarter 2001.

It's almost all financials. The sector went from a $56 billion profit in the fourth quarter of 2006 to a $2.5 billion loss at the end of 2007, largely due to another wave of write-offs. Not since the fourth quarter of 2001 -- when transports collapsed -- has an entire industry's gone into the red, Thomson's David Dropsy says.

Earnings for the rest of the S&P 500 aren't bad. They're on track for an 11.4% gain. But be wary of analysts who advise you to ignore financials. That's sort of like ignoring food and energy prices when talking about inflation: Nice in theory, but not terribly indicative of reality.

--Mark Gongloff