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High yield bonds safe?

Per those who are long, bullish on the gold standard, the entire fiat, economic system will crumble in shambles, as the currency devaluation persists, which was the hallmark of several major civilizations' collapse (i.e. Roman Empire). The FED will not stop their QE program anytime soon, although the FED may take a hawkish stance in light of the events unraveling in Italy. If the FED starts selling off their holdings, rates will go up, and the value of the fixed income securities will in response depreciate. We postulate the premium realized for high yield bonds is capital allocation away from equities to the higher coupon instruments by pension funds, and motivated investors, who have timely obligations and view the risk/reward profile of bonds more attractive than equities.

The real question is, whether we will see a bond bubble burst, or a less dramatic, linear depreciation in light of the developing US real estate recovery and inverse nature of fixed income instruments with respect to interest rate adjustments.

We were members of the bond bubble burst camp, but we have changed our position to one that is less doomsday, and more cycle oriented. Let me explain.

Bond prices appreciated from their lows (50-60s in 2007) to the premium today (110s) over a 4 year period. Bond prices dropped to the 50-60s in a short period of time (less than a year), as the Lehman situation unfolded into a global occurrence. Should the economy rebound, there is a much subtle price adjustment, from the 110s back to the historic 90s to par, as compared to the dramatic price fluctuation from par down to 50-60s then to premium, as we witnessed over the past 5 years.

Therefore, should investors exit from their fixed income to equities, we will not see a burst in the credit space, but rather, a reactionary deflating. Those who choose to hold on to their fixed income securities during this transition phase, should not anticipate returns in excess of 8%. If the average weighted coupon rate of a high yield portfolio is 8%, then one could anticipate a total return of 5-6%.