Killing Me Softly Or Killing Me Quick: Investing in Default Risk Versus Inflation Risk

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After more than thirty years trading bonds, which became super boring in the last fifteen, I am beginning to feel that the glory days of bond trading are coming back again. The main reason, of course, is that central banks are now fish out of water, grasping for tools in their toolkit. The playbook of "forward guidance"-driven policy is out the window, as is FAIT(H) (Flexible Average Inflation Targeting with "Hope" – my extension), and most important, the confidence in forecasts. This is beginning to create interesting opportunities for investors.

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If the glory days of bond trading are coming back, then like me, you should dust off old bond textbooks and strategy papers and prioritize going back to evaluating risk and return in various bond asset classes from first principles. I have been refreshing myself on stuff that I learned thirty years ago on forward curves, spreads, expectations, defaults, inflation, cross-currency risk, risk-premia, and so on. My livelihood depends on this. Yours probably doesn't, so let me highlight here what I believe are two of the most important things for market participants to consider right now when deciding where to potentially put their money.

The key to the decision is to understand there are two main ways to lose money as a lender, which is what one effectively is when buying a bond. The most immediate way is for the borrower to not pay you back; i.e., an actual default. This is what happens when you buy a junk bond and the company you are lending to goes under. Default kills quickly. The second way to lose money is to lend to a borrower who pays you back later in a currency that is worth less. This is literally what happens when you lend to a country with high inflation. Inflation kills softly with a smile (without the pleasure of the Roberta Flack hit song). This is what is happening right now in the US.

Thus, whenever one invests in a bond, there are three key decisions that have to be made. First, what should be the term of the bond – and the risk of the term decision has both the inflation risk and the default risk in it, which we can sort of disentangle. Parting with your money for longer means you should be paid a higher yield, most of the time. But because right now the Fed is on a mission to quash inflation that has run away from them, short-term yields -- e.g., the 2-year Treasury -- is yielding more than the 10-year Treasury. So decision number one: should you go for longer maturities or shorter maturities. Of course, this depends on what you think will happen to the economy in the short and the long run. If you think the economy will be weaker in the long run, then it might make sense to lock in yield for longer. If you believe, like me, that the recent weakness is largely self-inflicted, then one may want to consider parking their money for the short term to jump on opportunities with ready cash when the Fed pivots (by the way they did a "softish" pivot at Wednesday's meeting). If inflation stays high for a long time, then longer maturity bonds will lose more money than the shorter maturity bonds. I doubt if inflation can come down below the current long-term yields any time soon.

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And there is a possible way to avoid the pernicious, soft death of inflation. Research and consider TIPS! (Treasury Inflation Linked Securities), which promise a guaranteed real yield, which is not very high, but as long as inflation remains high, your principal is guaranteed to grow. Since I wrote a piece on TIPS eleven days ago real yields have collapsed, and the prices of TIPS has jumped up . But many believe there is still room to run as the market realizes Powell is becoming powerless.

Comparing TIPS with junk bonds, we can see that for one of the first times in many years the compensation for default is much lower than the compensation for inflation. Normally, since inflation risk is much lower than default risk, the inflation risk compensation is much lower than default risk compensation. To compare the two, we can look at the indicated yield of the TIP ETF vs. the HYG ETF (as in High Yield Corporate Bond). The TIP ETF advertises an indicated yield of 5.79%, which will of course vary with actual, realized inflation. On the other hand, the High Yield ETF HYG has an indicated yield of 5.08%. So you are being paid more to take inflation risk (slow death), than default risk (quick death). Either way, the yield on both assets is much lower than actual inflation, which clocked 9.1% last month (all data from Bloomberg), so either way you are losing money relative to purchasing power if you invest in bonds. To be sure, the choice is one of damage control.

Which brings me back to the rebirth of active bond trading opportunities. Bond markets are wrestling free of almost two decades of central bank control. In such markets, thinking for yourself pays. Whether it's the choice between inflation risk or default risk, having a framework for relative value will again come into play. For now I will take the risk of short maturity bonds, especially TIPS, so neither inflation nor default can kill me slow or fast.

Important Disclosures

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