Ask the Rational Investor: “Which asset class is the most distorted from low-interest rates?”

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Bubbles do not repeat, but they often imitate, and the seeds from one crisis often lead to the next. Since the Global Financial Crisis (GFC) in 2008-2009, governments have reduced interest rates to nearly zero percent. In many cases, they executed additional measures such as quantitative easing (QE) because it was the only medicine available to central bankers.

Like any medicine, prolonged prescriptions or high dosages can have dire effects.

After the crisis, low-interest rates persisted for almost ten years which pushed investors to seek higher yields. At the most basic level, a retiree who was receiving 0% on their savings at the local bank had to purchase 3 or 5-year certificates of deposit (CDs) to get an interest rate that was meaningful. Some retirees shifted their asset allocation away from bonds that yielded 1-2% and invested in more stocks.

Commercial real estate prices have gradually increased year-after-year as new purchasers can borrow cheaply and pay more for their next property.

One asset class that seems ripe for trouble looks to be leveraged loans and high yield bonds. According to mutual fund and ETF fund flow data, many retail investors have purchased leveraged loans, high yield bonds through mutual funds and ETFs.

The high demand for these asset classes has allowed the issuers to weaken the protections that used to be written into these securities. For instance, in April the leveraged loan market reached $1 trillion which was up from $600 billion at its most recent peak in 2008.

According to Moody’s and Guggenheim Investments, covenant-lite leveraged loans, which are usually loans without any financial covenants, are approaching 80% of the leveraged loan market compared to five years ago when they were just 30%. A covenant-lite loan would be like your bank offering money to you without requiring collateral!

In the next recession, covenant-lite leveraged loans and other lower-rated high yield bonds may perform much worse than expected; this could ultimately mean that the recovery rates for debt holders are lower than average.

It is always prudent to be careful with passively managed products as many of them invest in securities that could become illiquid in times of stress and do not trade with the regularity of stocks. If a market dislocation where to occur, erratic price swings might happen as investors sell their positions in illiquid underlying securities.

Beese Fulmer Private Wealth Management was founded in 1980 and is one of Stark County’s oldest and largest investment management firms. The company serves high-net-worth individuals, families, and non-profits, and has been ranked as one of the largest money managers in Northeast Ohio.