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U.S. corporate bonds may face tough autumn

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By Jonathan Stempel

NEW YORK, Aug 30 (Reuters) - High-quality corporate bonds are having a tough year. There might be more pain to come.

"Corporates are very cheap for very well understood reasons," said Jim Shallcross, who helps invest $6 billion for Independence Fixed Income Associates in McLean, Virginia. "It is tempting to go running into the sector and have a very aggressive overweight, but one needs to be cautious."

U.S. corporate bonds carrying "investment grades" are interest-bearing IOUs rated "Baa3" or higher by Moody's Investors Service and "BBB-minus" or higher by Standard & Poor's. Most of the bonds are normally not too volatile, and investors get their principal back when the bonds mature.

Yet accounting scandals, credit rating cuts, defaults and the slide of once investment-grade WorldCom Inc. WCOEQ.PK and Kmart Corp. KM.N into bankruptcy have soured many investors -- notably Bill Gross, who runs the category-beating $61.2 billion Pimco Total Return PTTRX.O fund -- on many corporate bonds.

Investors worry now about the economy's health, an expected post-Labor Day spurt of bond sales after investors return from vacation, and the anniversary of the Sept. 11 attacks.

September and October are often weak months for corporate bonds. Now, if stocks rise, bond prices might fall, hurting returns. But if stocks fall, investors might buy safer U.S. Treasuries, and corporate bonds might underperform.

"We could be in for a rough autumn," wrote Peter Petas, managing director for CreditSights Inc., an independent fixed-income research service. "The market will shift focus to the economy and there we don't see much good news."

SAFETY SELLS

Investment-grade corporate bonds have been a decent place to invest this year. The bonds through Wednesday are up 4.18 percent including interest, Lehman Brothers Inc. data show.

Yet the entire bond market, measured by the Lehman U.S. Aggregate Bond Index, is up 6.5 percent.

Blame the fallout from WorldCom, which disclosed its improper accounting on June 25. Corporate bonds lagged Treasuries, which have no credit risk, by 1.51 percentage points in June and 2.93 percentage points in July. Last September, the bonds lagged by 2.22 percentage points.

In August, corporate bonds revived. The Aug. 14 deadline for hundreds of chief executives to certify their companies' financials passed quietly, and investors tired of sub-4 percent Treasury yields. A typical bond now yields 5.8 percent, or 2.19 percentage points more than Treasuries, down from 2.39 percentage points on Aug. 13, Merrill Lynch & Co. said.

Mark MacQueen, who helps invest $2.2 billion for Sage Advisory Services Ltd. in Austin, Texas, said the current market is bifurcated. Bonds from "safe" sectors such as defense and supermarkets are faring extremely well. Others look cheap.

"People say interest rates are low until you see AT&T T.N (bonds) at 8 or 9 percent (yield)," he said. "Good quality bonds have performed beautifully ... and most of the value has been achieved. In the second-tier market, investors will remain credit- and economically-sensitive, especially in telecom."

"LUCKY" TO HOLD ONTO GAINS

Shallcross said to expect fewer big accounting blowups, yet added "we have some significant unknowns, such as a potential military conflict in Iraq, the employment report (due on Sept. 6) and how the Federal Reserve will respond." He said he owns small amounts of beaten-up AOL Time Warner Inc. AOL.N , Sprint Corp. FON.N and Verizon Communications Inc.VZ.N bonds.

There is also worry about possible further attacks, and about Sept. 11 itself. MacQueen said: "September 11 will in my opinion be very much like the millennium -- a lot of nerves and anticipation up to the date, but the day will pass quietly."

What will not end, he said, are tight capital markets and credit quality woes resulting from 1990s spending excesses. MacQueen said corporate bond investors might fare well if the economy improves, but said they would be "lucky to hold onto their capital gains for the rest of the year."

Morningstar Inc. (http://www.morningstar.com) recommends these no-load bond mutual funds that own corporate bonds: Dodge & Cox Income DODIX.O ; Fremont Bond FBDFX.O ; Metropolitan West Low Duration Bond MWLDX.O and Total Return Bond MWTRX.O ; SSgA Yield Plus SSYPX.O ; T. Rowe Price Spectrum Income RPSIX.O and Vanguard Long-Term Corporate Bond VWESX.O , Short-Term Bond Index VBISX.O and Total Bond Market Index VBMFX.O .

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