Capital Structure Lines Blurring

"The reasonable man adapts himself to the world; the unreasonable man persists in trying to adapt the world to himself. Therefore, all progress depends on the unreasonable man." – George Bernard Shaw

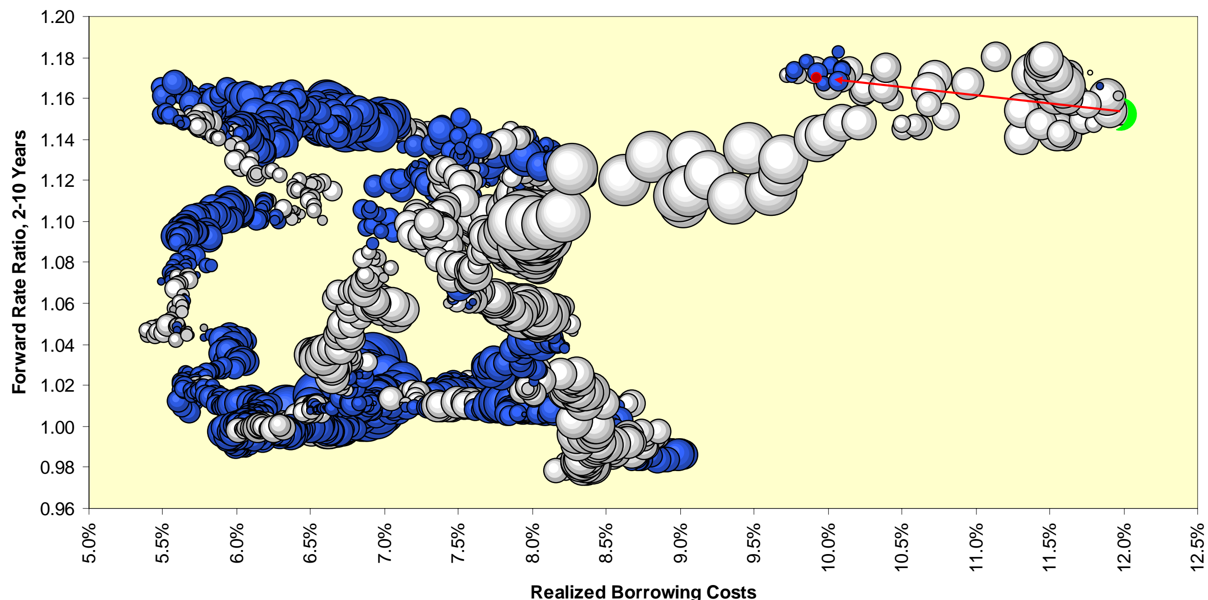
I long have had a corollary to Shaw's maxim in reference to market analysis: All analytic work worth anything is done by those who were wrong or lost, which are not the same thing. Winners, whether by dint of effort or pure dumb luck, head out to the local watering hole at the end of the day and proclaim their majesty to whomever. Blogs and Twittering are more technologically advanced ways of self-glorification, but I digress.

As a case in point, I wrote in February how realized borrowing costs, the sum of Treasury yields and option-adjusted credit spreads (OAS), had not declined sufficiently for a stock rally to begin over the next three months; this analytic technique made good sense economically and more importantly had proven its worth in the past. Six weeks later the rally began; it was time to head back to the drawing board to see where I had been deficient.

First, instead of breaking realized borrowing costs into investment-grade and high-yield components, let's use the consolidated Merrill Lynch Corporate & High-Yield Master index. Second, instead of dividing stocks into large-and small-capitalization wings, let's use the much broader Russell 3000 index.

The chart below maps the three-month ahead total returns on the Russell 3000 index since 1997 against the realized borrowing costs on the X-axis and the shape of the yield curve as measured by the forward rate ratio between two and ten years on the Y-axis; this is the rate at which you can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself. The more this ratio exceeds 1.00, the steeper the yield curve. Three months ago, we were at the extreme northeast corner of this map; I highlighted the datum used in a green crescent. All bubbles in this crescent are white, representing negative returns over the next three months, which is why I was still bearish. We since have moved along the red arrow into a small cluster of blue, positive-return bubbles; the last datum is highlighted in red.

Three-Month Ahead Total Return, Russell 3000



It might have been sufficient to say, "Well, of course we went up! The steep yield curve represents free money, and those record-high realized borrowing costs had discounted a great deal of bad news." But if I am going to be wrong, I want to learn something.

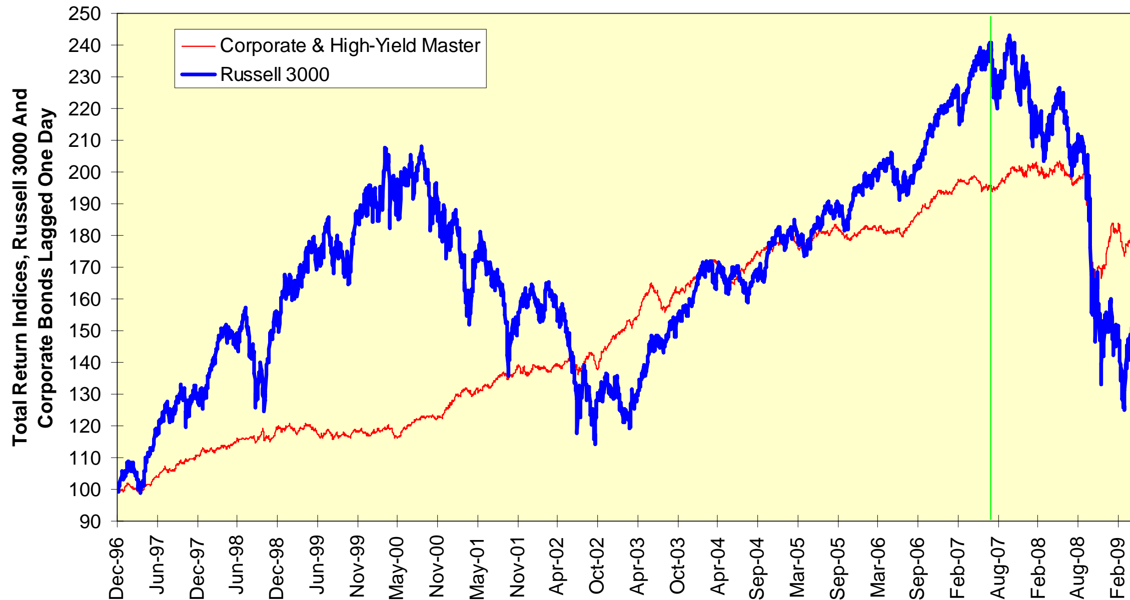
Stocks And Corporate Bonds

Corporate bonds had been outperforming equities, and I fully expected that to continue in the then-distressed environment. In fact, if we compare the total returns for the corporate bonds and the Russell 3000 going back to the

start of 1997, bonds had pulled ahead by the end of November 2008, and are still well ahead of stocks today even after the stock market rally.

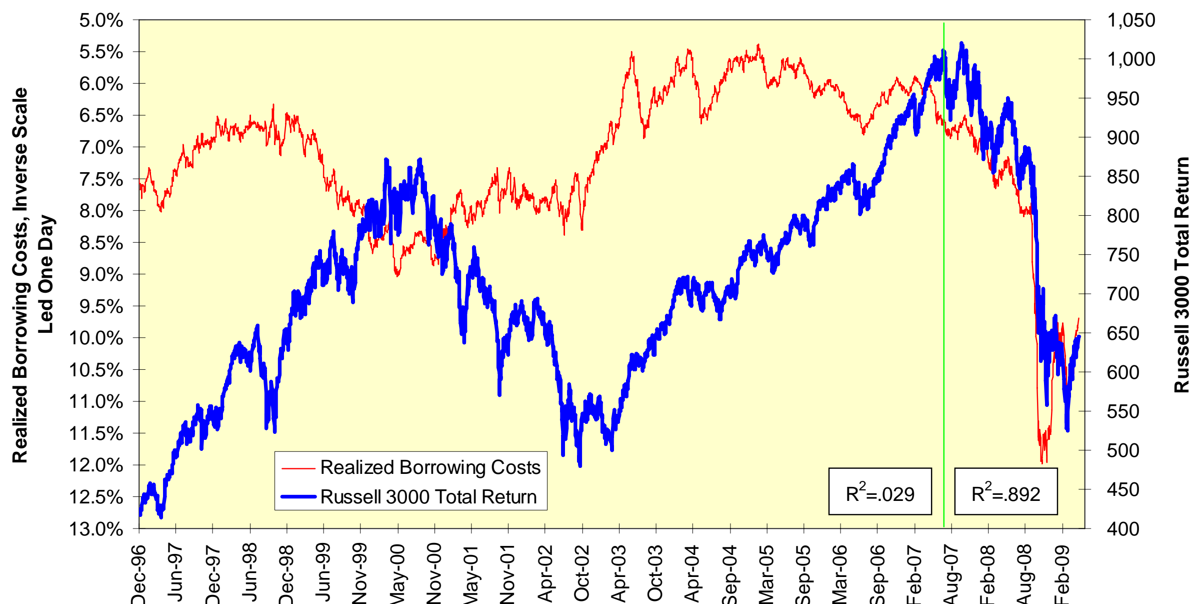
A change in the relationship is visible right at the top of the bull market in July 2007, marked with a green vertical line throughout. Statistically, the stocks lead the bonds by one day after this date, July 19, 2007.

U.S. Equities And Corporate Bond Total Returns



If we shift the comparison to the realized borrowing cost, here plotted inversely, we see a poor relationship prior to July 19, 2007 and a very strong one thereafter. The r-squared, or percentage of variance explained, jumps from 0.029 to 0.892. This screams something: The relationship between stocks and corporate bonds changed dramatically in a short period of time.

U.S. Equities And Realized Borrowing Costs

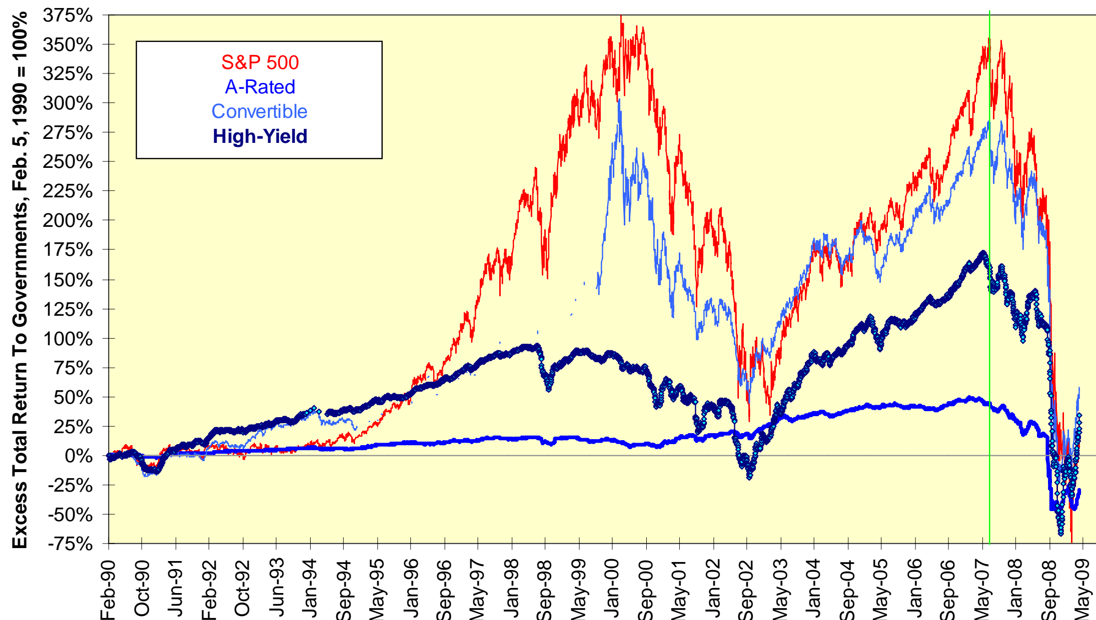


The World Turned Upside Down

Now let's look at relative performance between asset classes; here we can begin the analysis in February 1990. If we compare the total returns of the S&P 500, A-rated bonds, convertible bonds and high-yield bonds to the Merrill Lynch Government Master index, we see convertibles outperforming high-yield, the S&P 500 and A-rated corporate

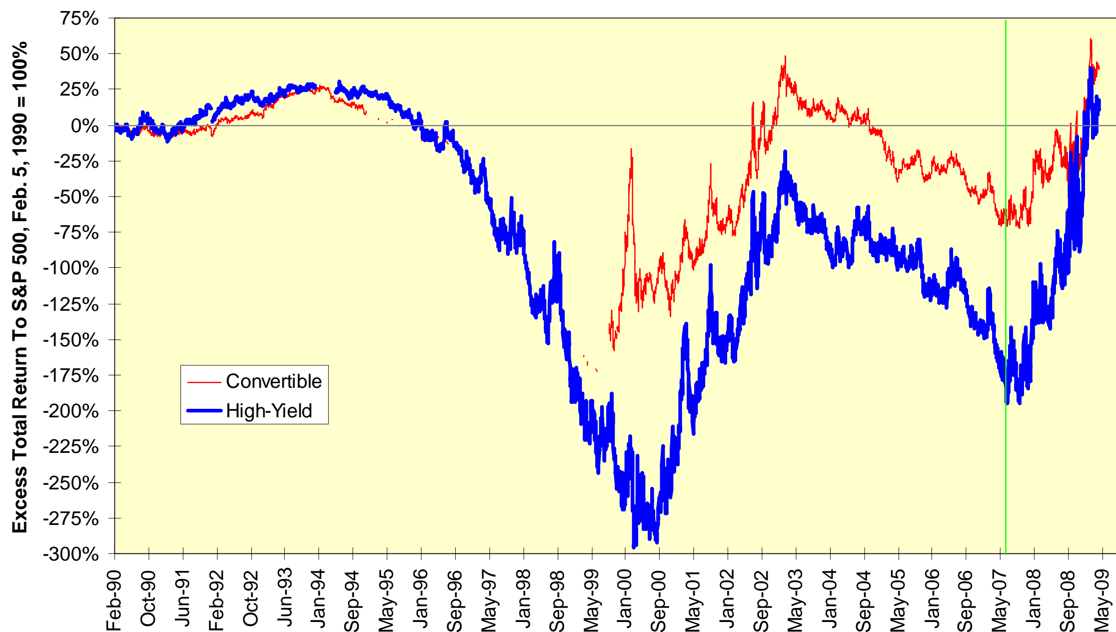
bonds in that order. As recently as early February, high-yield bonds were outperforming the S&P 500, which in turn was underperforming the Government Master. The natural order of things, if return follows risk, should be stocks outperforming convertibles, high-yield, A-rated and governments, in that order.

Returns Vs. Government Benchmark



We can shift the basis of comparison to the two equity-like bonds versus the S&P 500; here convertibles are outperforming high-yield, which is outperforming the S&P 500.

Returns Vs. S&P 500 Benchmark



What Changed?

One change that could account for the changed link between stocks and corporate bonds was well underway in July 2007, and that was the growth of the credit default swap market. As noted back in May 2005, correlation traders were hedging their CDS positions with stocks and forcing a tighter link between the two markets.

The second change was impending, and that was the decision by the world's central banks and finance ministries to backstop financial markets. The first development, the European Central Bank's backstopping of BNP-Paribas on August 9, 2007 was the first of many actions to follow. We now live in a world where the lines between state

enterprise, private enterprise and state-directed private enterprise are blurred. Consider recent actions in the automobile and banking sectors; GM and Chrysler are under effective government control, and I am waiting to see if Vikram Pandit or Ken Lewis has the, um, fortitude to say, "No" to Tim Geithner or Ben Bernanke.

As senior debt holders are browbeat to turn their bonds into stocks or as preferred shareholders are told they want to become common shareholders, the lines between different parts of the capital structure blur as well. Once all investors across the capital structure find the risk and reward they contracted for can be changed at a whim, the risk and return profiles of all investments will converge and, as noted above, may well invert from the textbook order.

If we are entering a brave new world of government control where the private property rights spelled out in bond covenants can be discarded with the morning trash, then the nature of the corporate bond market will change. Actually, it started to change with the growth of CDS and it started to change in July 2007. Let's not, therefore, look for bonds to lead stocks or to underperform stocks; let's not look for any part of the capital structure to out- or underperform any other part. Uncle Sam will be the first among equals, and you and I will be left to fend for ourselves while all the while being told how happy we should be.