Two Cheers For Corporate Bonds

As the school year approaches, let's consider some scenarios for Career Day. If one group of students confronts a barroom brawl and responds by intervening, asking questions and trying to narrow down the list of guilty parties, they should be directed toward police work.

The students who respond to the above situation by spraying the room with machine gun fire and then walk over a kick one or two bodies and say, "OK, you guys can leave," should be directed toward Wall Street.

Whether we like it or not – and I do not – the correlation between financial markets moves toward 1.00 in a crisis as good and liquid assets are sold indiscriminately to fund poor and illiquid assets. Many of the late-afternoon selloffs seen in stocks over the past two weeks appeared to be hedge funds selling to raise collateral to fund their more exotic positions.

The Dust Also Settles

As night follows day, this selling creates buying opportunities in higher-quality issues. Such has happened in the corporate bond market. Let's take the option-adjusted spreads (OAS) for two different corporate bond indices tracked by Merrill Lynch, American A-rated corporates and Eurozone A-rated non-financial corporates. Both of these spreads had been on a widening track for a while, and both exploded higher in July as the subprime mess began to engulf more market participants.

For all of those who had spent the better part of three years sounding the alarm that credit spreads had become too narrow, this was your broken-clock-is-right-twice-a-day moment. However, a set of models I developed for these investment-grade credit spreads – and I will be merciful in not describing them – for these credit spreads reversed this past week.

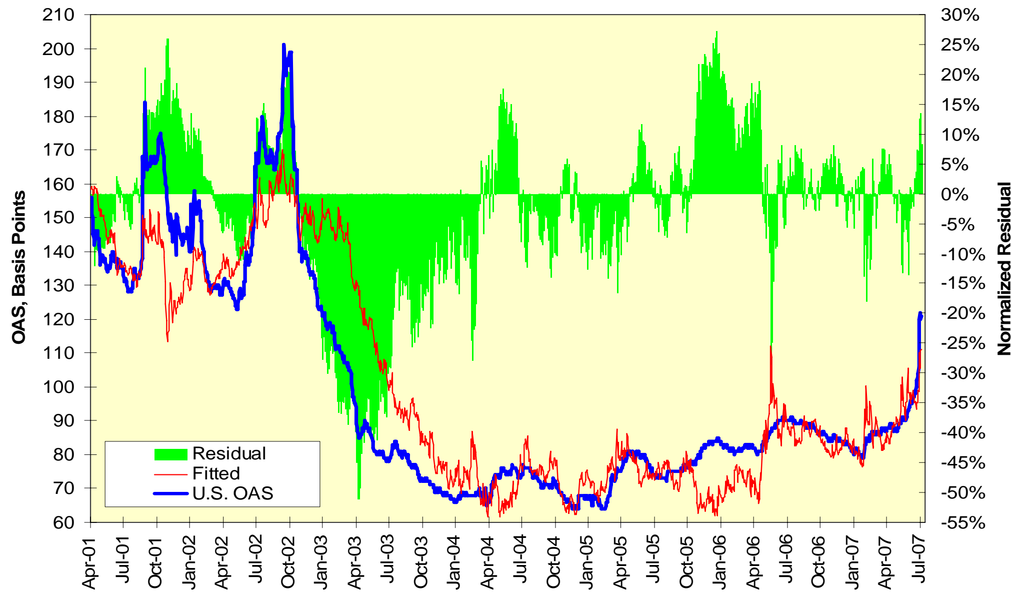
High-yield, which I do not model explicitly, may be a different matter. And as the threats to financial markets have been originating in the dark corners of the credit markets, any narrowing of investment-grade credit spreads by themselves may be a Pyrrhic victory at best. So let's have two cheers for corporate bonds and hold the third in reserve.

Models, Supermodels And Me

Let's map the OAS of each credit market against a succession of fitted values from their respective models. For the econometricians reading this, these fitted values are the last datum from a walk-forward process, not a backcast of the model as currently specified. There, I have done my part for full disclosure.

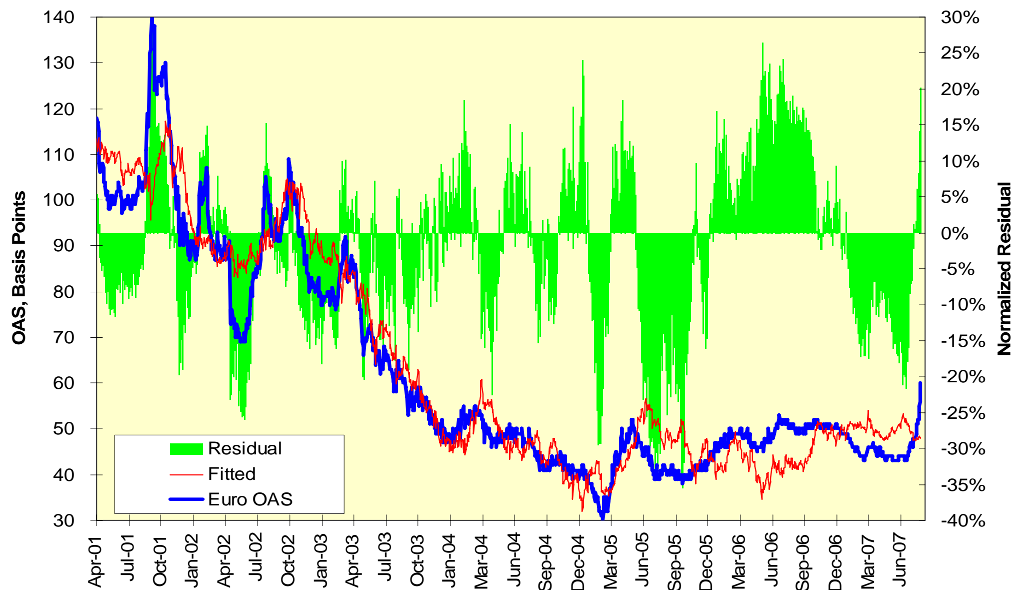
Included on each graph are the model's residuals, or the difference between the actual and fitted values, divided by the actual value itself. These normalized residuals will give us a sense of where credit spreads are relative to expectations prevailing at the time. Positive values, such as those seen most recently, tell us the market is over-pricing credit, or accepting too little risk, relative to expectations. Negative values, such as those prevailing spectacularly in 2003, tell us the market is under-pricing credit, or accepting too much risk, relative to expectations.

U.S. A-Rated Corporate Spreads



The European bond market was in far more of a bubble than was the American market for most of 2007. Its sudden shift toward overpricing risk in recent weeks was more abrupt than ours; score another one for *savoir faire*.

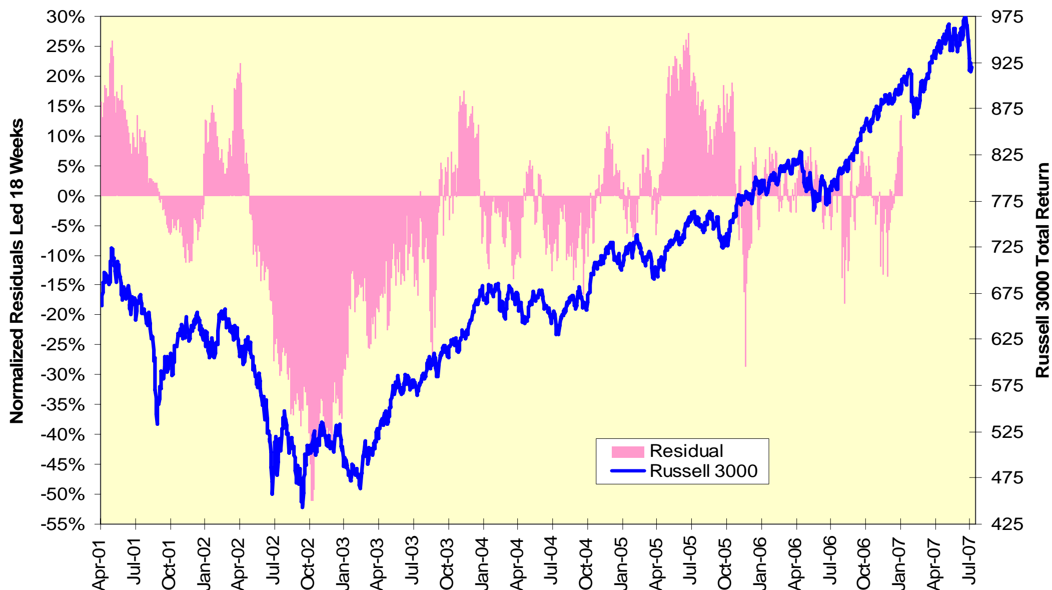
Euro A-Rated Corporate Spreads



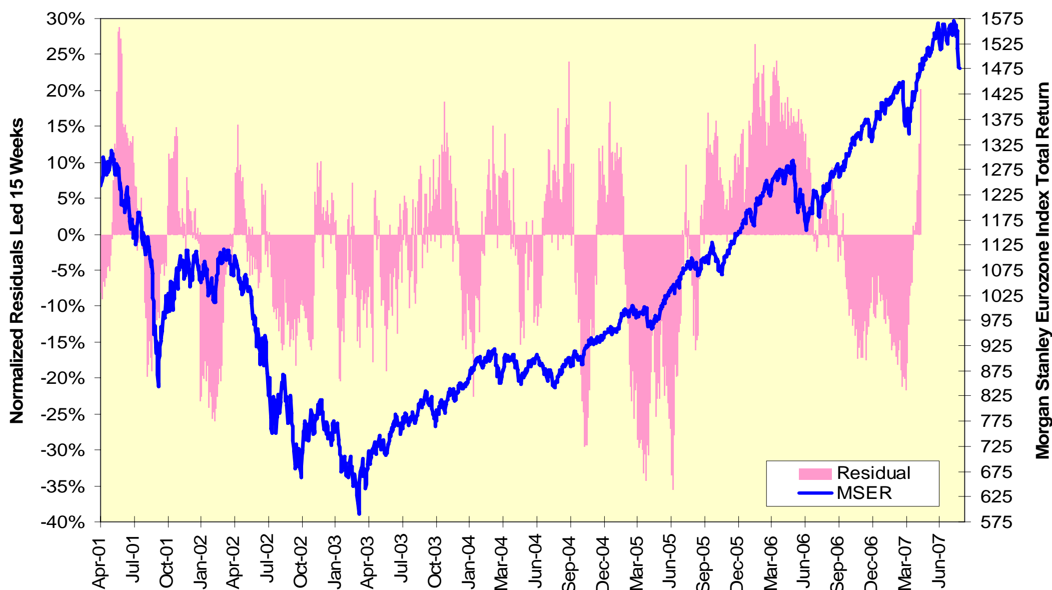
Bond Expectations And Stocks

Now let's get to the fun part, whether a shock to corporate bond expectations is reflected in stock prices. Let me emphasize I am talking about the normalized residuals of the model, not the corporate bond OAS itself. I had expected these residuals to influence stock prices, but the opposite is true: American stocks as measured by the total return on the Russell 3000 index anticipate corporate bond shocks by 18 weeks, while European stocks as measured by the total return on the Morgan Stanley Eurozone index anticipate corporate bond shocks by 15 weeks.

The chart below indicates that any contraction in the U.S. model's residuals should be relatively short… unless, of course, other factors and developments intervene as they did in late summer of 2003 or early summer of 2005 to convince the market the current state of affairs is to be expected.



The European model can be interpreted similarly. The shock to the corporate bond market was so abrupt and so violent we should expect a short-term retreat, but the message of a long stock market rally is the normal state of affairs should be wider corporate credit spreads. We should note the European market is far more jittery than the American market; we have numerous instances of credit spread shocks that dissipate quickly.



While I believe stocks float on a sea of bonds and you should not buy the stock of a firm whose bonds you would not buy, we reach a different conclusion when we compare unexpected changes in credit spreads to stock prices. Here the (unexpected) conclusion is perceived credit stress is led by the stock market. It takes two to tango, and the stock market is leading this dance.