Risky Bonds And Crude Oil

No single commodity, not even gold, has produced so many schizophrenic reactions in financial markets over the years as crude oil. It was blamed for causing the inflation of the 1970s, even though Richard Nixon unwisely felt it necessary to impose wage and price controls in August 1971 and the first oil shock of the decade did not arrive until October 1973. It was blamed for contributing to recessions in 1973-1974, in 1979-1980 and again in 2001. We were told, solemnly, every time crude oil went over $30 per barrel, bad things would follow.

Then came crude oil's upside breakout in 2004 and spectacular run to more than $140 per barrel by July 2008. As that run was accompanied by a rising stock market, a tame bond market and steady if unspectacular economic growth, we started to realize rising prices induced by rising demand in general and Chinese demand in particular might not be such a bad thing.

By the time we entered a bear market in crude oil at the end of June 2014, falling crude oil prices were seen as a bad thing for both the economy and for financial markets. Much of the U.S.' relative economic strength in the aftermath of the financial crisis was attributable to the fracking boom, its associated demand for construction & engineering services, steel, chemicals, transportation and skilled labor. Forty years of misinformed caterwauling about energy shortages were replaced by an abundance of supply. The downturn in price threatened to strand investments made in anticipation of higher prices, to end the fracking boom and to threaten energy-dependent economies globally. Investors who once wished for lower crude oil prices were reminded once again of the adage about wishes coming true.

Risky Bond Returns

Stocks float on a sea of bonds; if you are not willing to assume the credit risk of a corporation, you probably are not willing to bet on its earnings and implied dividend stream rising over time, either. Of course, this seemingly innocuous observation can come unglued spectacularly when a firm gets into such hot water it puts itself up for sale to escape its debt burdens and its shareholders are rewarded with a takeover premium. Life is good, at least sometimes.

Assessing the prospects for higher-risk corporate bonds has become a much more difficult game in the post-crisis world. Not only has the market for single-company credit default swaps shrunk as fewer commercial banks can participate therein for regulatory reasons, but the relentless drive lower in short-term interest rates has allowed many of the worst businesses to refinance their debt at levels once reserved for governments. Moreover, investors in a yield-starved world have proven willing to overlook a lot of sins just to get paid. To those who have been saying for years, "This will not end well," we have to rejoin, "Who said it must end at all?"

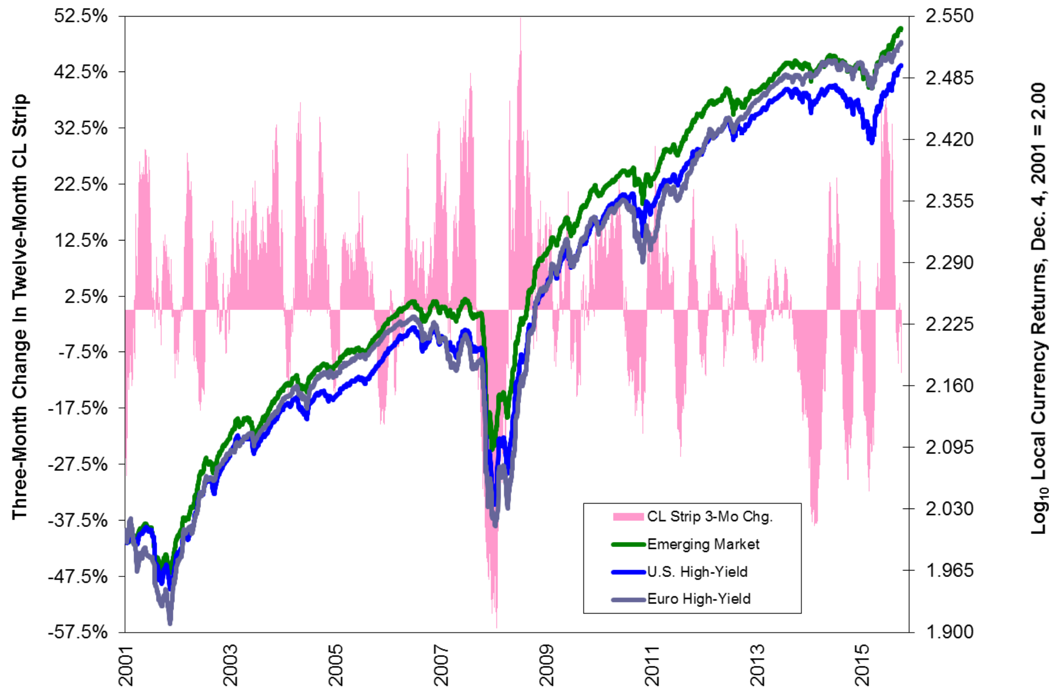
The influence of the U.S. dollar and the shape of the U.S. yield curve on prospective risky bond returns was the subject of last month's column (see "Risky Bonds And The Dollar Index," December 2016). Now let's take the same three classes of bond, U.S. and Eurozone high-yield bonds and emerging market bonds, and examine the influence of changes in twelve-month strip prices for West Texas Intermediate crude oil and levels of expected inflation as measured by the TIPS market.

To repeat verbatim from last month, these three higher-risk bond indices are not as comparable as we might think. The U.S. high-yield market has developed over the past three decades from the repository of lapsed investment-grade bonds, so-called "fallen angels," to a vibrant market of original issue bonds used to finance start-ups, leveraged buyouts, private equity and mergers & acquisitions. European firms traditionally have relied less on the bond market and more on commercial bank credit for lending; as a result, this market is far less developed than its U.S. counterpart. Emerging market bonds are defined as much by their currency, political and commodity risks as they are by their credit risks.

First, let's map the local currency total return streams for the bond indices on a common logarithmic scale against the rolling three-month change in twelve-month crude oil strip prices. The two periods where declining crude oil strip prices coincided with declining risky bond returns, the 2008-2009 financial crisis and the 2014-2016 bear

market in crude oil are visible. However, not every downturn in crude oil strip prices is matched with a downturn in risky bond returns, nor is every downturn in risky bond returns accompanied by a downturn in crude oil strip prices, either. For example, risky bonds declined in 2011 as a function of ongoing credit stress in the Eurozone matched by the self-imposed U.S. budget default crisis, but crude oil strip price changes were not to blame.

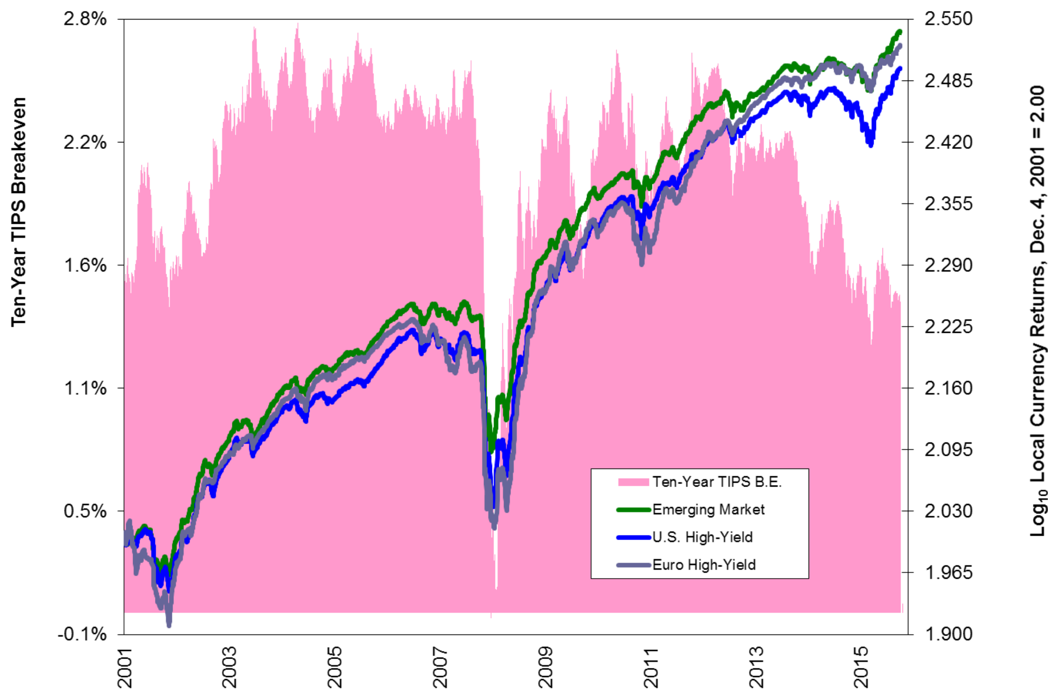
Risky Bond Returns And Crude Oil Price Changes



Source: Bloomberg

Now let's substitute the ten-year TIPS breakeven rate of inflation for three-month rolling changes in crude oil strip prices. Prior to the financial crisis, the widely held assumption was risky bonds benefited from rising inflation expectations as the debtors might be able to repay the bonds in a debauched currency. In addition, too many people associated rising inflation expectations with rising crude oil prices. We should know better now.

The financial crisis knocked both TIPS breakevens and risky bond returns lower, and both followed a rising path into early 2013. Then wave after wave of global quantitative easing pushed both nominal interest rates and inflation expectations lower; excess cash sitting on central bank balance sheets has a deflationary effect.

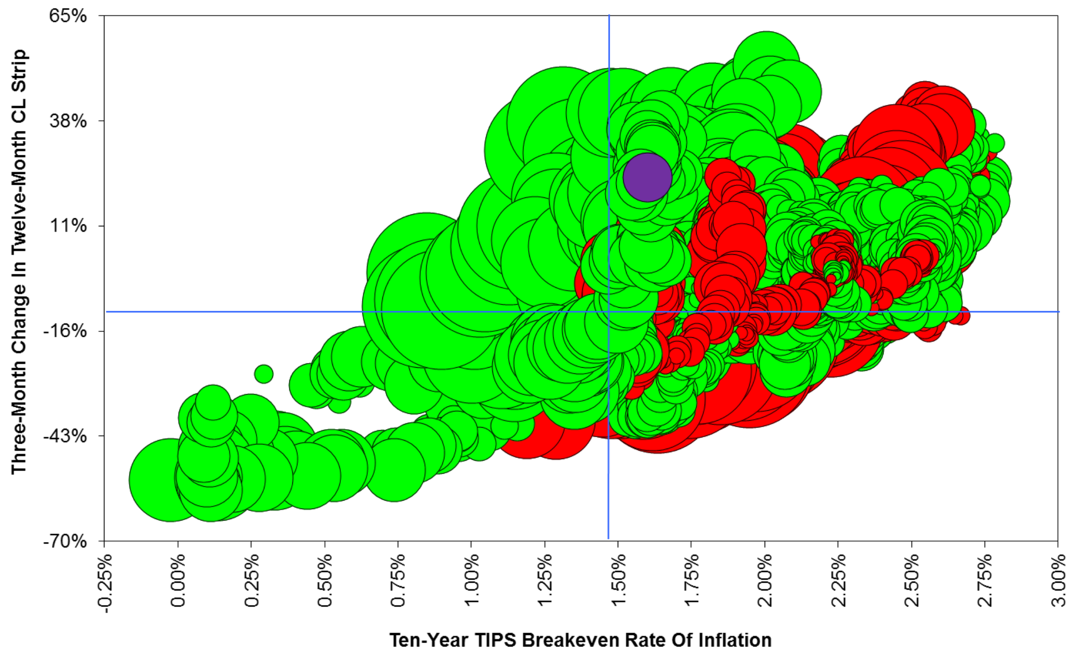


Source: Bloomberg

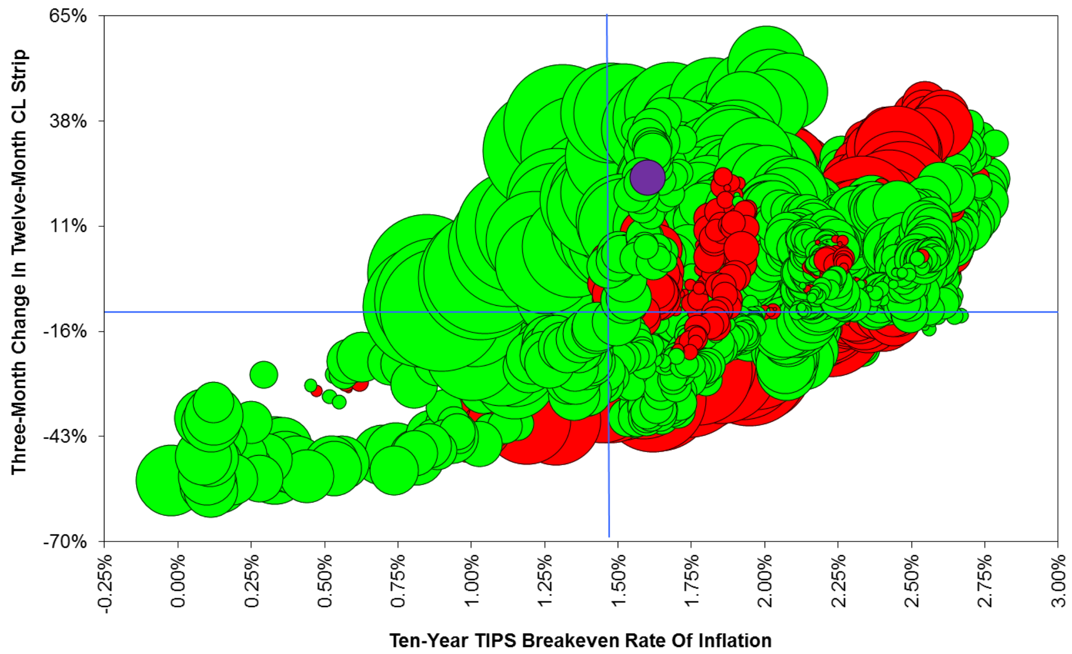
Prospective Risky Bond Returns

Now let's map the three month-ahead returns in USD terms of these bonds as functions of ten-year TIPS breakevens and the rolling three-month change in crude oil strip prices. In all cases, positive prospective returns are depicted in colored bubbles and negative returns in red; the diameters of the bubbles correspond to the absolute magnitude of the return. The last datum used, from June 7, 2016, is highlighted and the environment on September 1, 2016 is marked with a bombsight. The data sample begins in December 2001.

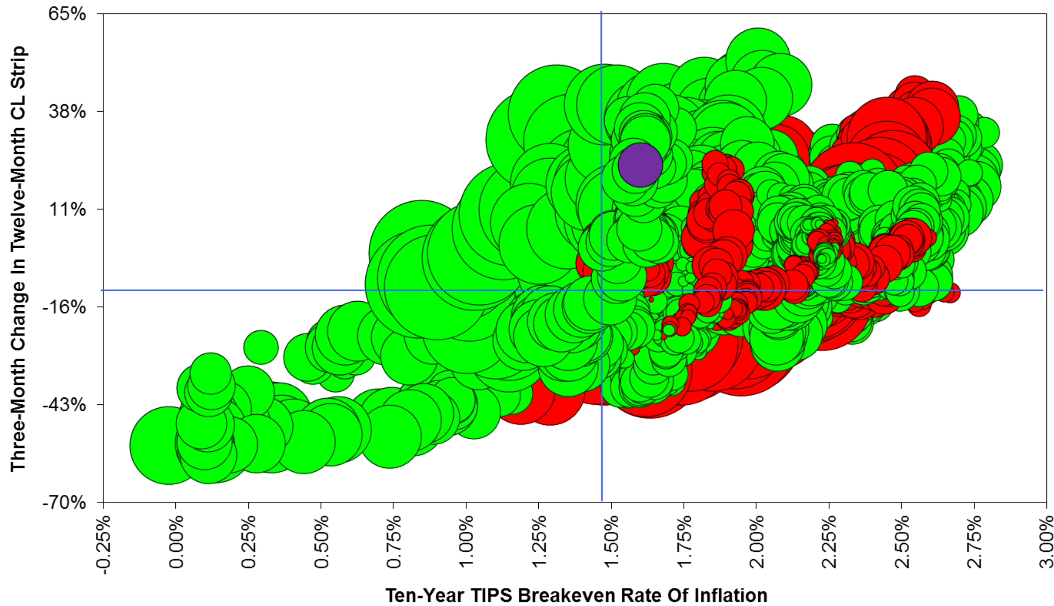
The environment shifted sharply to the south-southwest over the last three months used. While all three classes of bonds remain in zones of positive prospective returns at the time of this writing, all are subject to the risk of a combination of lower crude oil strip prices combined with higher TIPS breakevens. Both halves of the previous statement would have been unthinkable over large portions of recent financial history. To sound like a dreary inspirational poster, the only ironclad rule of intermarket analysis is there are no ironclad rules of intermarket analysis.



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

Both A Borrower And A Lender Be

The Bard had it all wrong with that "neither a borrower nor a lender be" drivel. Both the borrowers in the risky bond market and those who have lent them the money have done quite well this century and indeed this entire millennium. Perhaps this has been the result of policies designed to reward borrowers with lower interest rates regardless of poor evidence this is a pathway toward greater economic growth. Regardless of motive, the holders of existing debt have done quite well by these policy props.

Yes, one day both borrowers and lenders might find payback is a, um, awkward situation. It will be, if and when policymakers fail in their efforts. However, the Bible is filled with prophesies warning darkly, "It shall come to pass in the end of days…" We have yet to reach the end of days, and if and when we do, your holdings of high-risk bonds will be the least of your concerns.