Corporate Bond Interest Rate And Credit Risk

The discussion whether markets are overvalued or not should be a short one; if something yields more than 0%, it has been increasingly overvalued as the zero interest rate policy (ZIRP) and quantitative easing (QE) eras are more than five and one-half years old, depending where you want to put the start date. The more something yields, the more it has been valued and the greater the embedded call option in that asset the more it has been valued. This is why high-yield and convertible bonds have done so well. You could make the very simple argument stocks remain undervalued relative to overvalued corporate bonds.

As we have exited a very short-lived hiccup in high-yield bonds where primarily individual investors pulled money out of dedicated mutual funds and ETFs, let's take a look at where both investment-grade and high-yield bonds stand along two dimensions of risk.

Interest Rate Risk
The first is the ratio of effective duration to maturity. As yields fall, the effective duration of a bond rises toward its maturity; the duration of a zero-coupon bond is its maturity. The duration/maturity ratios for investment-grade and high-yield bonds reached their respective maturities in May and June 2013, but neither one has retreated very much since then. This has been especially true for investment-grade bonds; they have been acting increasingly like allegedly risk-free Treasury securities for most of 2014, and for good reason: Their credit risk as measured by the option-adjusted spread (OAS) of the Bank of America/Merrill Lynch Corporate Master index is a mere 112 basis points at the time of this writing, and that is up from 106 basis points in late June.

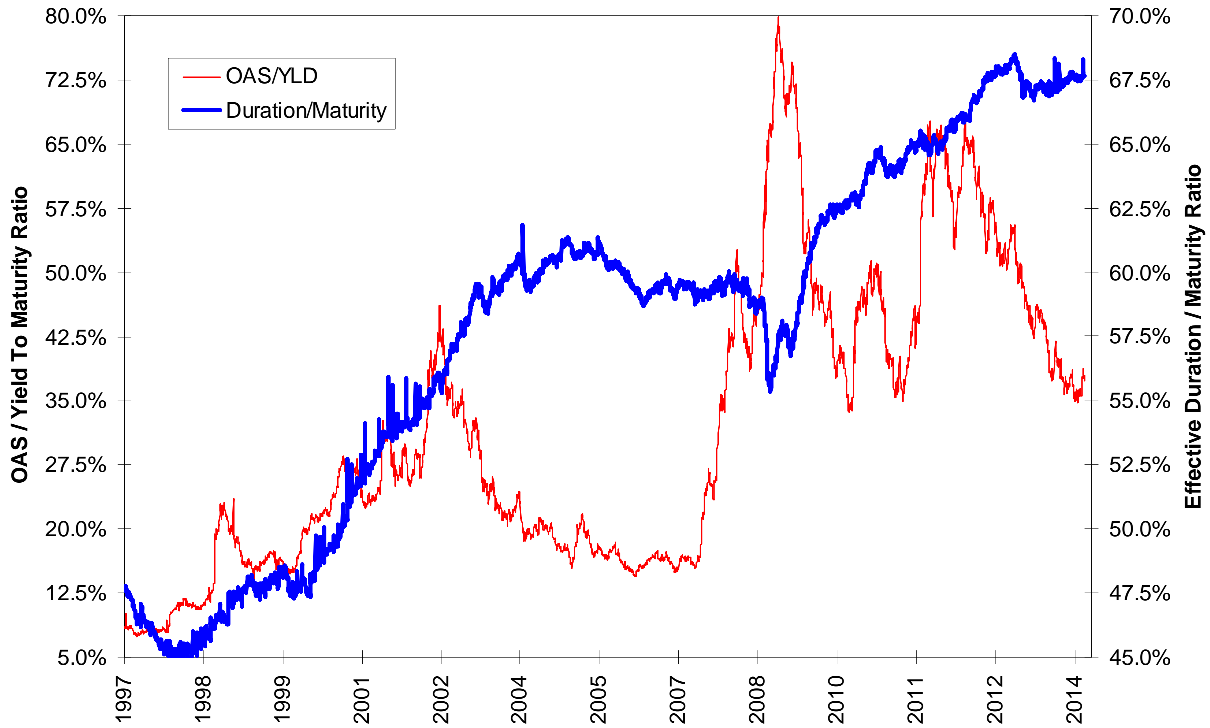
If you ever have had the urge to be a corporate borrower, now is the time to follow the voices in your head. If we add those 112 basis points to the 25.1 basis point implied real yield of a ten-year Treasury, we get 137.1 basis points. The TIPS market, for better or worse, is expecting a ten-year average rate of consumer inflation of 215 basis points. This means investment-grade corporate borrowers are being paid 137.1 – 215, or 77.9 basis points in real terms to borrow money from you and the interest they pay is tax-deductible to boot. Small wonder corporations have been keeping their foreign earnings offshore and borrowing money to buy back their own stock; oh, and did I mention how most executive compensation is linked to the share price?

Lenders, a category that very well might include you, get a little more yield cushion over the Treasury with high-yield. Here the OAS of the BofA/ML High-Yield Master II index is 379 basis points. As the real yield on seven-year UST is -2.2 basis points at the time of this writing, the real borrowing cost is 379 – 2.2, or 376.8 basis points.

Credit Risk
Now let's add the second measure of risk, the percentage of a bond's yield represented by its OAS. The maximum ratio here is 100% and would occur with a 0% Treasury yield of 0% with the bond's entire yield to maturity represent its credit risk.

This ratio hit its post-crisis low for the investment-grade index in June 2010, but the high-yield index' ratio hit is low in June 2014. Both ratios were lower on numerous occasions prior to the financial crisis, including both the dotcom era and 2007. The simple fact the ratios are low by post-crisis standard is not a warning sign of any kind; we would need to see deterioration of corporate credit quality and rising default rates to make that assessment. Restated, there are many reasons to sell something, the fact its price is high out of context is seldom a good reason for doing so.

The charts of the two risk measures are attached below for the investment-grade and high-yield indices, respectively.


Investment-Grade Bonds At High Rate Risk
And Low Post-Crisis Credit Risk
OAS/YLD
Duration/Maturity
OAS / Yield To Maturity Ratio
Effective Duration / Maturity Ratio
80.0%
72.5%
65.0%
57.5%
50.0%
42.5%
35.0%
27.5%
20.0%
12.5%
5.0%
70.0%
67.5%
65.0%
62.5%
60.0%
57.5%
55.0%
52.5%
50.0%
47.5%
45.0%
1997
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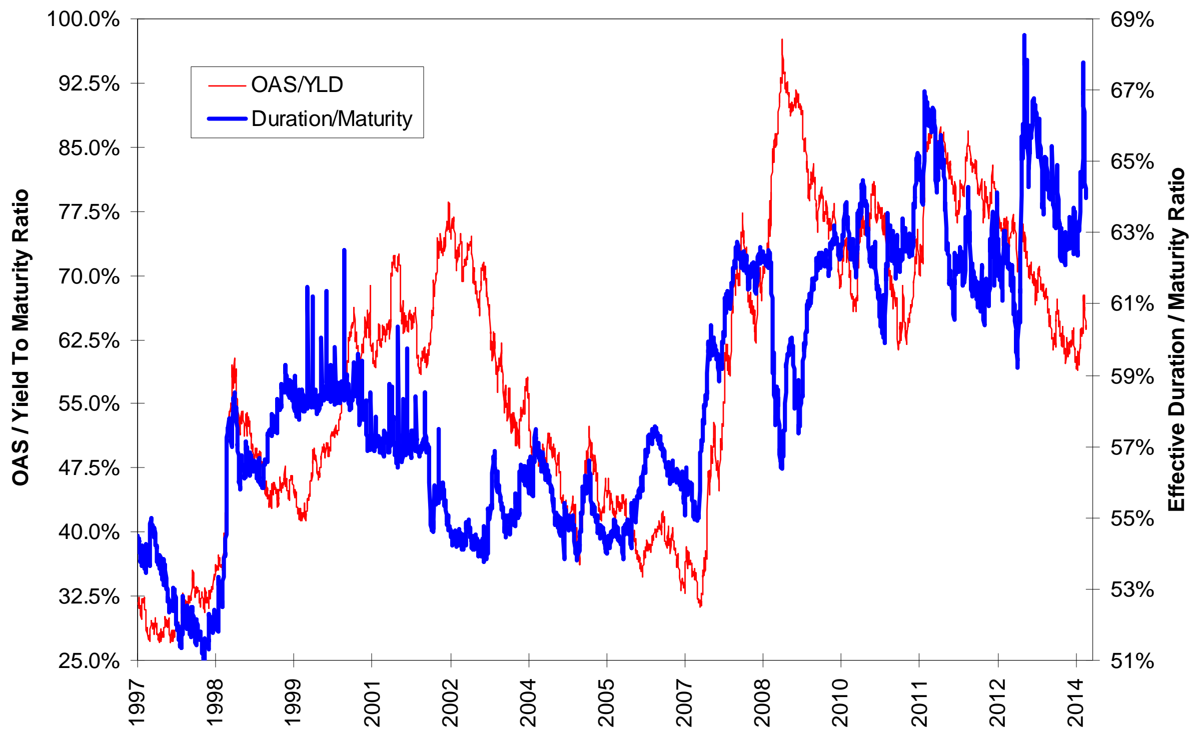
2014


High-Yield Bonds At High Rate Risk
And Still-Low Post-Crisis Credit Risk
OAS/YLD
Duration/Maturity
OAS / Yield To Maturity Ratio
Effective Duration / Maturity Ratio
100.0%
92.5%
85.0%
77.5%
70.0%
62.5%
55.0%
47.5%
40.0%
32.5%
25.0%
69%
67%
65%
63%
61%
59%
57%
55%
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51%
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