

Bonds Today, Stocks Tomorrow

Every industry has a jargon unto itself. Not only does this inside-speak save a lot of time, but it helps mystify the outsiders. Let's face it, what is the point of being the high priest in any religion if every ordinary Joe can shrug and say, "Yeah, I knew that?"

Even more to the point, most industries have an odd characteristic of what looks to be important to outsiders is a distraction to the real nuts and bolts inside. As an old acquaintance from the Air Force observed in reference to the military, "Amateurs talk tactics; pros talk logistics." In many trading endeavors, we can modify this to "Amateurs talk price; pros talk spreads."

But, to quote Clemenceau, "War is too important to be left to the generals." The downside of too much inside knowledge and mastery of minutiae is that famous inability to see the forest for the trees. Let's take the world of corporate bonds. Here investment-grade bonds commonly are quoted as a spread to Treasuries, and while individual high-yield bonds are quoted as their own yield, the benchmark indices for high-yield bonds are quoted as spreads to Treasuries as well.

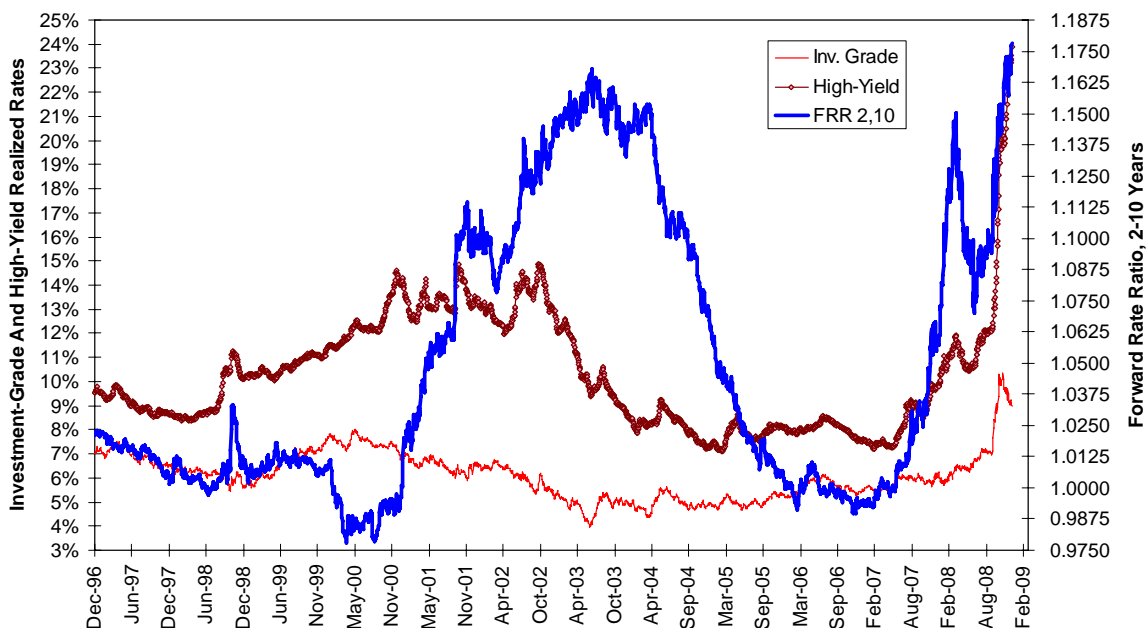
As a result, both bond managers and stock traders often look at narrowing and widening spreads and assume corporate borrowing costs are falling or rising accordingly. On the surface, this should make sense only if Treasury yields were static somehow. The rate corporations pay for their money is the Treasury yield plus the option-adjusted spread (OAS), and if Treasury yields rise more than the spreads narrow, the corporation faces a higher realized cost of capital. Amazingly for an industry steeped in total return analysis, this simple reality tends to be ignored.

Realized Borrowing Costs

Let's map the realized borrowing costs for the Merrill Lynch high-yield and investment-grade corporate bond indices along with a measure of the Treasury yield curve. The yield curve is described as the forward rate ratio ($FRR_{2,10}$) between two and ten years; that is, the rate at which we can lock in borrowing for eight years starting two years from now divided by the ten-year rate itself. The more this measure exceeds 1.00, the steeper the yield curve; a $FRR_{2,10}$ less than 1.00 describes an inverted yield curve.

The measure has swung around wildly this decade as the Federal Reserve has driven short-term interest rates lower twice and raised them once. The $FRR_{2,10}$ kept expanding in the fall of 2008 as the Federal Reserve kept driving short-term interest rates lower.

The Yield Curve And Realized Corporate Borrowing Costs



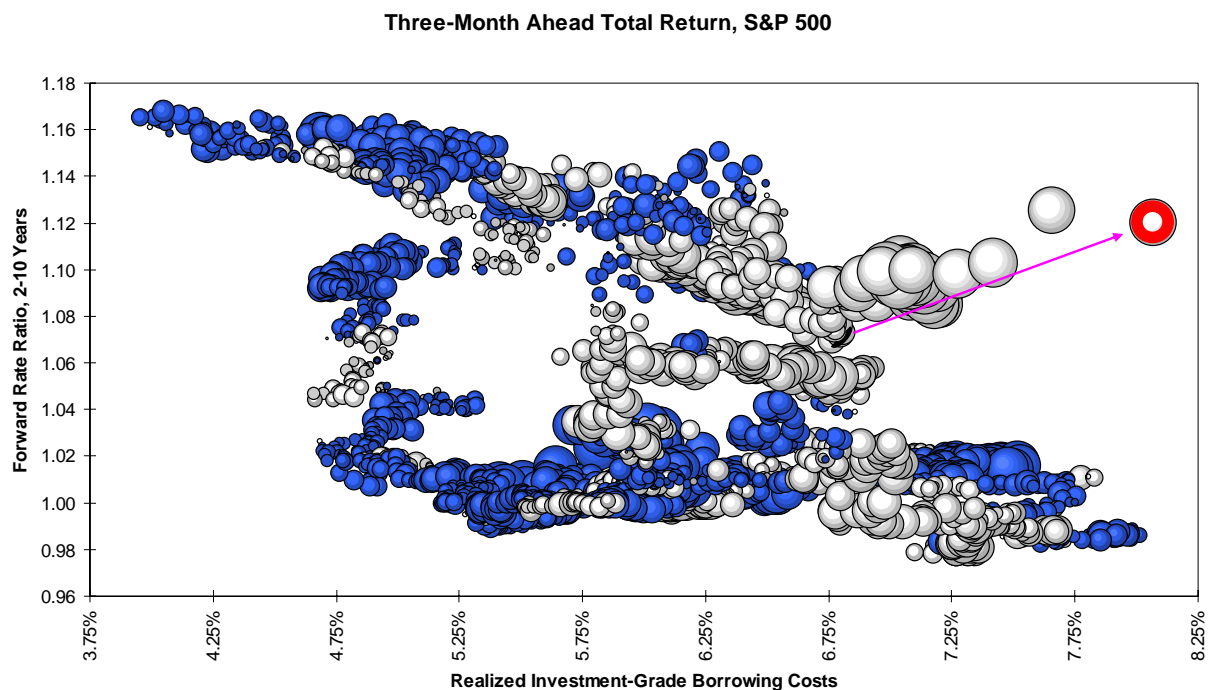
We should make two observations from the above chart. The first is investment-grade American corporations have been facing steadily rising realized borrowing costs since the summer of 2003, and that was true before the Lehman Brothers bankruptcy in September 2008. This may qualify as one of the stealthiest bear markets extant; it seems to get no attention whatsoever. The second is the Federal Reserve's manic monetary policies of the past decade take a long time, almost two years, to affect the realized borrowing costs for high-yield bond issuers. Realized high-yield borrowing costs surged higher even as short-term interest rates fell and the yield curve steepened. Restated, if the Federal Reserve believes it can rescue low-quality borrowers by printing money, it is simply ignoring reality.

Prospective Equity Returns

What do these realized borrowing costs mean for stocks? If we add three month-ahead total returns for stocks to the mix, we can see what trends in the current realized borrowing today have meant for equity returns going forward. The next set of charts maps these realized cost/yield curve combinations going back to 1997 with the three month-ahead total return displayed as a colored bubble for positive returns and a white bubble for negative returns. The size of the bubble corresponds to the magnitude of those returns. Two bubbles are marked separately. The red one represents the stock market total return over the three months ending on December 12, 2008; the black one represents the same for the three-month period ending on September 12, 2008. This last date marked the day before the Lehman Brothers bankruptcy. An arrow highlighting the progression from September 12 to December 12, 2008 is included.

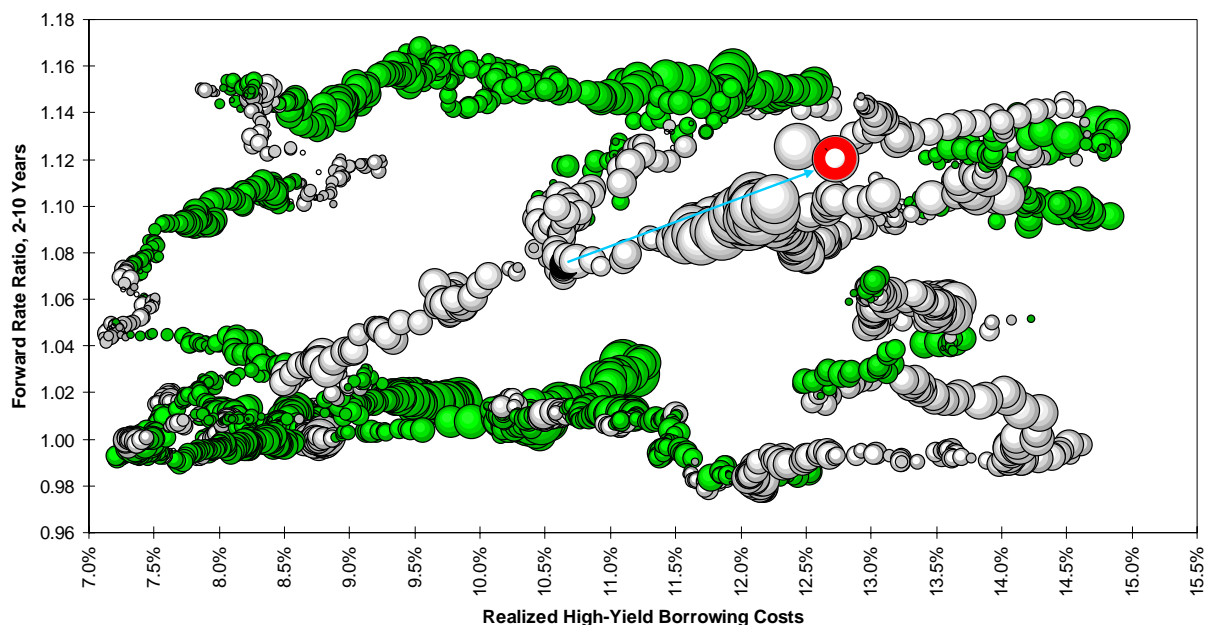
The environment over this period can be described as a bearish steepening for all corporate borrowers; ten-year borrowing costs have risen and the yield curve has steepened as central banks remained accommodative. The high-yield environment

First, let's map the investment-grade realized borrowing costs and the lagged returns for the S&P 500. The red bubble is off by itself; the nearest neighbors to its southwest all have negative three-month forward returns.



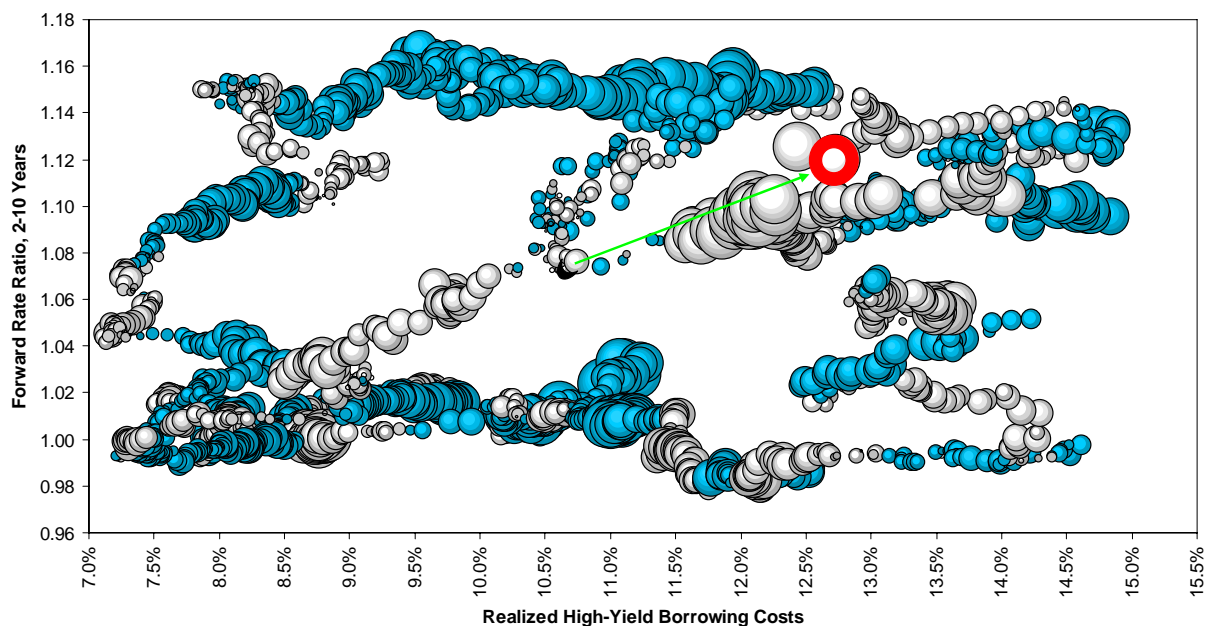
A similar map using the realized borrowing costs for high-yield bonds produces a more definite outlook. The red bubble is in the middle of a trend of negative prospective returns.

Three-Month Ahead Total Return, S&P 500



Does the picture change much if we substitute the small-capitalization Russell 2000 index for the large-capitalization S&P 500? Not especially; we can conclude when it comes to the effects of realized borrowing costs in the high-yield market on U.S. equities, size does not matter.

Three-Month Ahead Total Return, Russell 2000



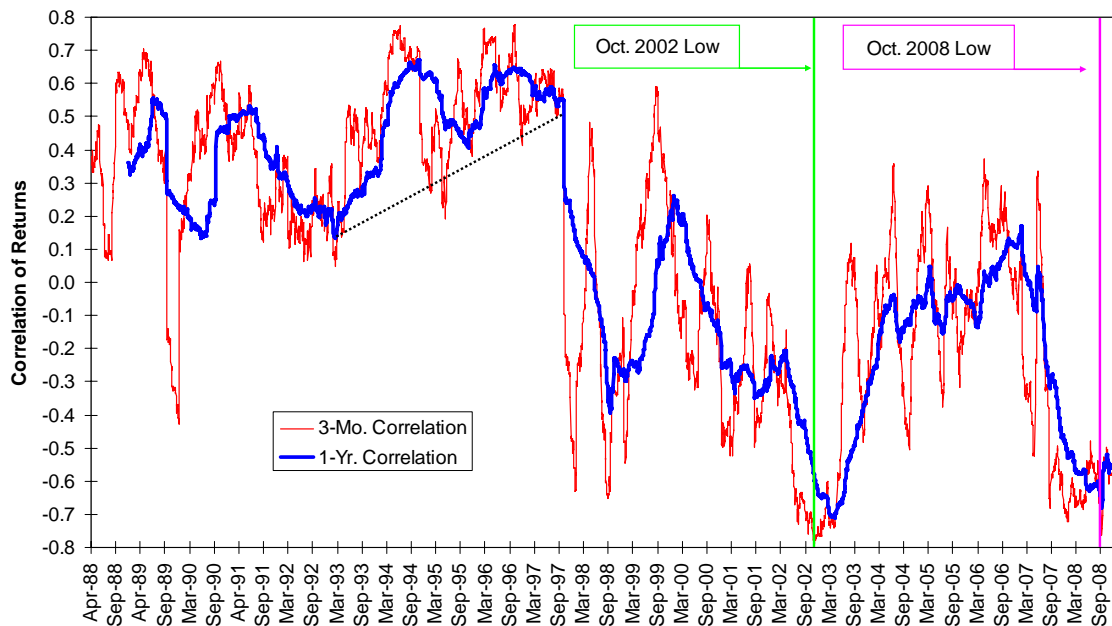
Stock-Bond Relationship

These observations may confound those who persist in defining a one-way relationship between stocks and bonds. Anyone who cut their trading teeth in the early phases of the 1982-2000 secular bull market in equities might be forgiven for thinking low interest rates are a tailwind for stocks; that bull market in stocks was really nothing more than a hitchhiker to a bull market in bonds. The opposite sentiment might be equally excusable for anyone who grew up during the late 1990s bull market; here bonds and stocks tended to move in opposite directions.

The truth is there is no singular relationship. Even though the fundamental descriptive equation for stocks has them as being the discounted stream of expected dividends, that interest rate component can get overwhelmed by both the expected earnings component of stock prices and especially by the risk multiple investors are willing to assign to corporate earnings.

Let's take a look at the long-term relationship between stocks as measured by the S&P 500 total return index and ten-year Treasury notes. The chart below depicts their rolling three-month and one-year correlation of returns, and what is striking is the wide range these values take. Correlation coefficients are bounded by -1.00 and 1.00; here the range extends all the way from -.80 to .80. That exceptionally wide range of values in two markets with a common factor between them, long-term interest rates, should tell us right away a single-equation model of stocks' fair value based on interest rates simply does not work.

Stock/Bond Relationship: Comparison To October 2002



Please note how the correlation regime changed once the Asian Crisis came on the scene in the fall of 1997. The Federal Reserve shifted into a “risk management” mode, one wherein it assigned itself the modest mission of saving the world from every downturn by creating a series of financial bubbles. A dotted black trendline highlights this change.

Correlations of returns hit extreme negative values during both the October 2002 and October 2008 lows. This is a fancy way of saying that bonds, whose yields have been tracking along near their multi-decade lows, rally only when the stock market collapses and whenever stocks rally, money flows out of bonds and back into stocks.

What will it take, then, to produce another long-last secular bull market in stocks? Low interest rates alone will not suffice, nor will low inflation alone or narrowing corporate bond spreads. The answer appears to be a combination of all the above along with stable monetary and prudent fiscal policies and rapidly growing earnings. This combination cannot be willed into existence and it certainly cannot be created ex nihilo by manic central bank and reckless Treasury policies. Just as traders realize sooner or later the market does not owe you a trend, long-term investors have to realize the outsized returns of 1982-2000 are not tossed into their laps as a reward for filling out the account papers.