Relative Performance And Short-Term Rates

While financial wits might regale each other by saying no one can spend relative return, a true statement, the simple fact of the matter is all investment decisions have to be made on a relative basis. Sometimes, as when short-term interest rates dropped toward zero percent in December 2008, marked on the chart below with a green line, and stayed there since then, all choices start to look bad. An investor may be faced with the choice between bonds yielding less than the expected rate of inflation or stocks in a low-growth environment. No one said life was fair.

Self-Image Matters

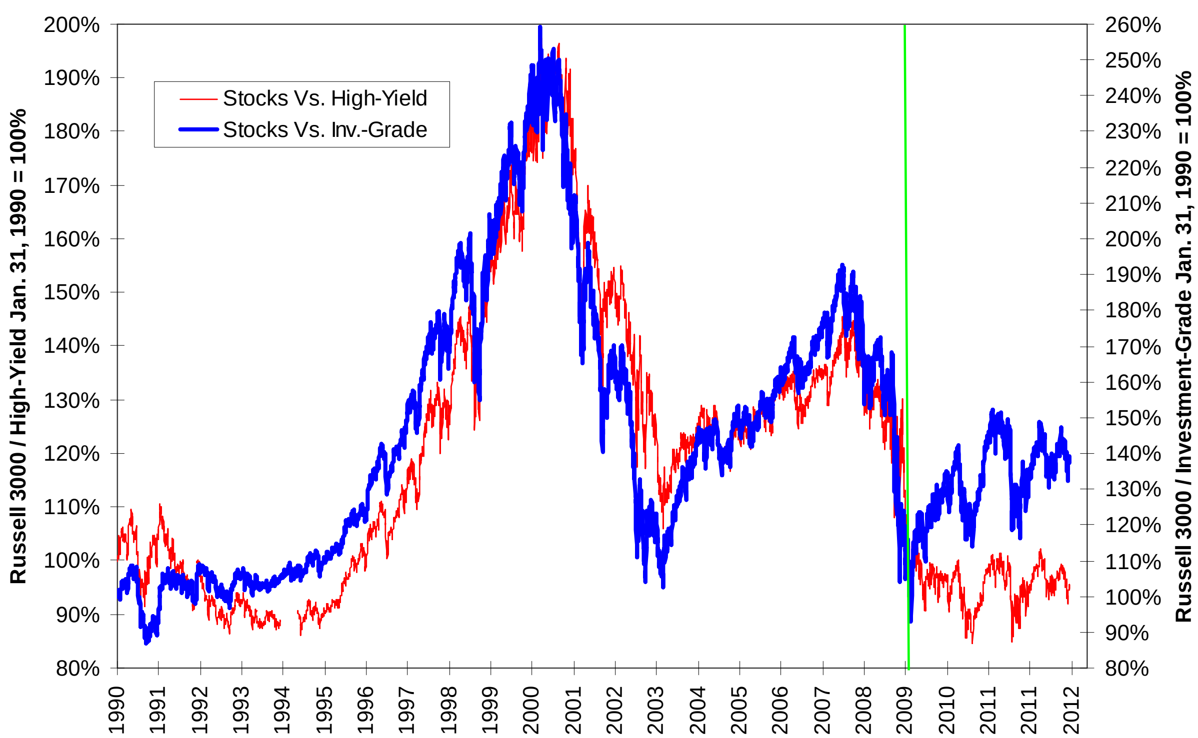
Bond traders view themselves as models of sobriety and prudence; they tend to be more interested in staid things such as current income and capital preservation and regard stock traders as perma-bullish cowboys. The odd thing about this self-image is every financial disaster of the past three decades started out in the fixed-income world, from the Third World debt crisis to the municipal bond collapse of the mid-1980s to the mortgage debacles of 1986, 1994 and 2007-2008 and yet it both persists and is reciprocated by stock traders. A more accurate assessment of financial history might be stock traders pay more heavily for bond market errors than for any silliness on their part.

The fixed-income world has a psychographic split itself. High-yield bond traders are regarded as daring risk takers eschewing safety for the possibility of return while investment-grade traders are regarded as staid coupon-clippers who spend their days toiling in the backrooms of pension funds and life insurance companies.

Reality has a way of asserting itself. If we compare the total return paths of the Russell 3000 index against the Merrill Lynch high-yield and investment-grade indices since January 1990, we see stocks have outperformed those fuddy-duddy investment-grade bonds by a small margin and have barely outperformed high-yield bonds.

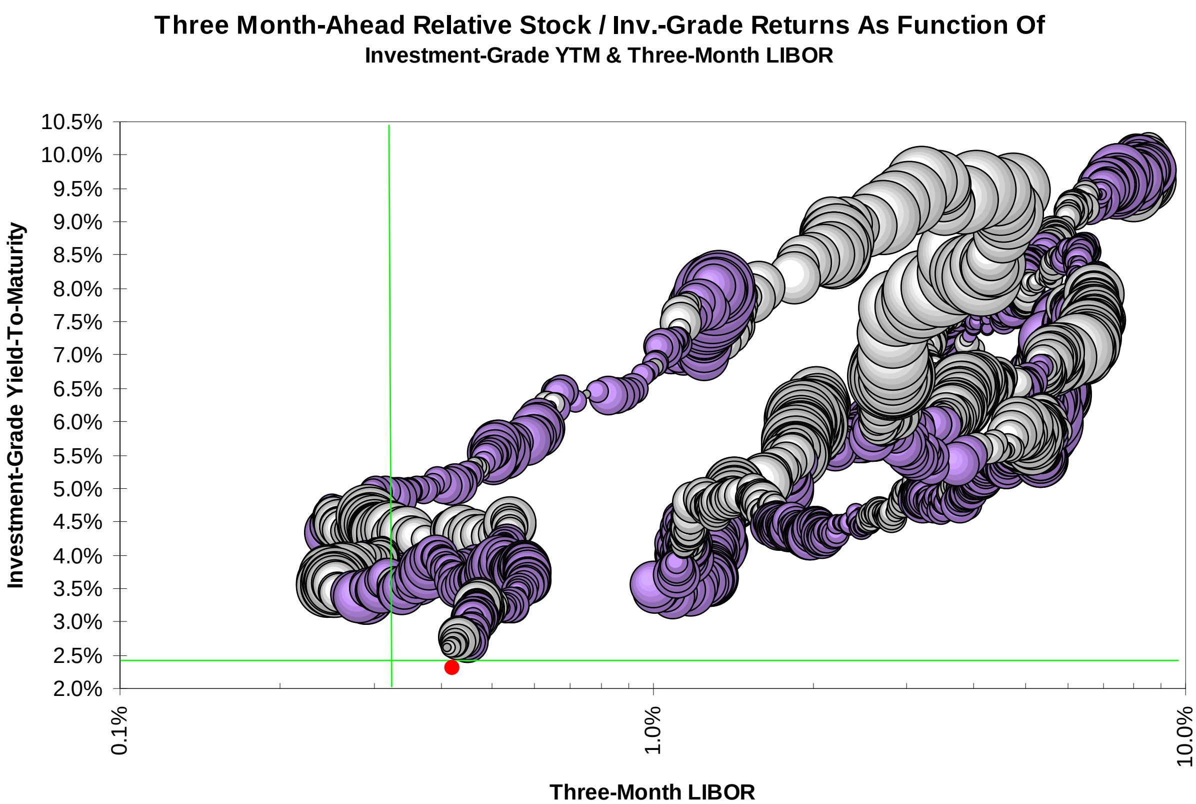
The relative paths of comparative performance cleaved together closely until the Federal Reserve embarked on its zero interest rate policy (ZIRP) in December 2008. Then and only then did stocks start to outperform investment-grade bonds at the same time they were underperforming high-yield bonds. This provides us with a clue as to the importance of short-term interest rates to relative performance.

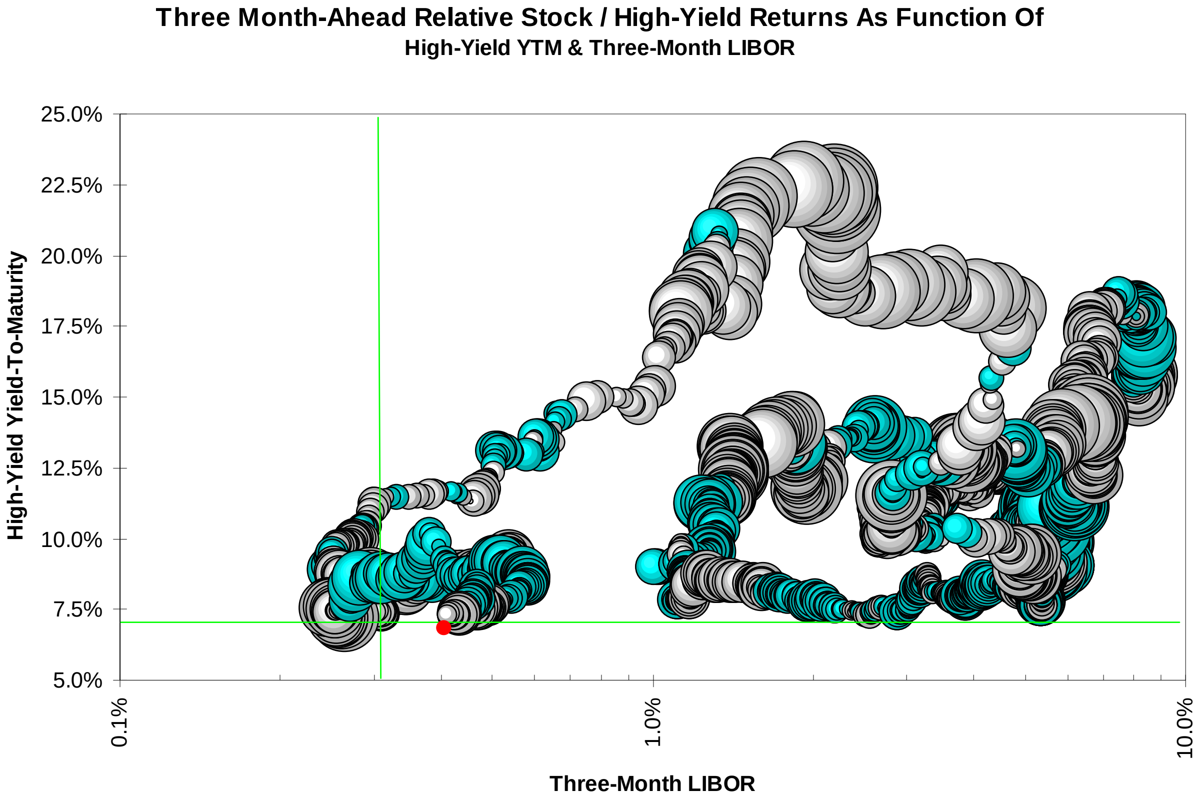
Relative Total Returns: Russell 3000 Versus
High-Yield & Investment-Grade Bonds



Prospective Relative Performance
Let's remind ourselves stocks are a growth instrument and have an embedded call option on future profits; corporate bonds' prospective total returns are limited by both the ordinal level of interest rates and the ability of spreads to compress further.

Both credit spreads and interest rates have lower bounds of zero percent (see "other Views Of Corporate Bond Risk," April 2013). We can map three month-ahead changes in the relative performance of stocks vis-à-vis both investment-grade and high-yield corporate bonds as a function of three-month LIBOR and yield-to-maturity for both high-yield and investment-grade bonds. The colored bubbles represent stocks outperforming bonds; white bubbles represent bonds outperforming stocks. The current values are marked with a green bombsight; the last datum used is highlighted in red.



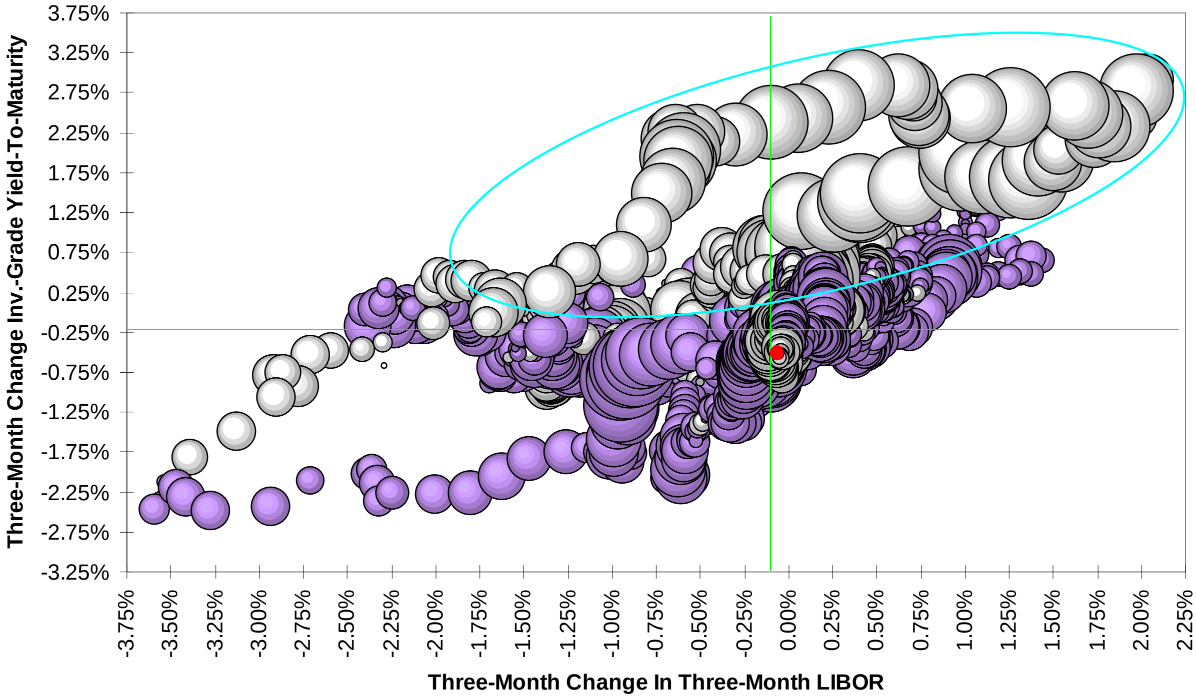


What do we see? First, even on a logarithmic scale the decline in LIBOR in 2009-2012 is impressive. Second, global policies designed to push short-term rates lower succeeded in pushing corporate credit spreads lower, and for both classes of corporate bonds. The cost of capital for American corporations declined rather significantly over the period in question, and this certainly was a major contributor to the bull market between the March 2009 low and the re-emergence of another fixed-income crisis, that of European sovereign debt, in May 2011. Third, no one repealed the law of diminishing returns: Low rates can go only so far in propelling relative stock market returns higher; once that stimulus has been received and absorbed, relative prospective returns can and do turn negative. Drowning in money is still drowning. QE∞ anyone?

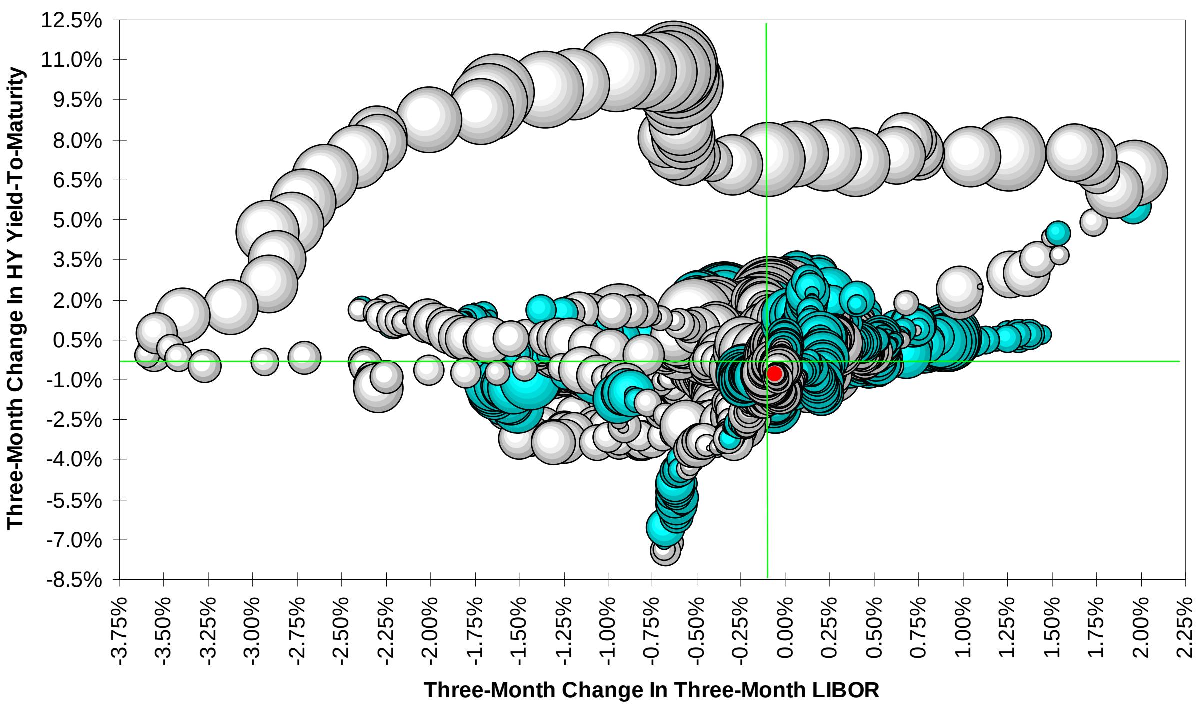
Rate Of Rates' Change

The rate at which financial markets change can be more significant to investor psyche as the level of the market. We can rearrange the data in the charts above to the absolute change over the previous three months of both corporate bond yields and three-month LIBOR.

Three Month-Ahead Relative Stock / Inv.-Grade Returns As Function Of
Leading Three-Month Changes In Investment-Grade YTM & Three-Month LIBOR



Three Month-Ahead Relative Stock / High-Yield Returns As Function Of
Leading Three-Month Changes In High-Yield YTM & Three-Month LIBOR



Unsurprisingly, the dynamic picture is different than the static one. In the case of investment-grade bonds, a large swath of stock market relative underperformance is visible as investment-grade yields shift higher and three-month LIBOR remains stable or rises; this zone is highlighted with an oval. This tells us in no uncertain terms the rise in both short-term interest rates and investment-grade cost of capital affects stocks proportionately more negatively than it does bonds.

What about the high-yield case? Here almost any move higher in high-yield bonds' yield to maturity leads to stocks underperforming bonds. Once we get those credit-crunch moves out of the way, the effects of short-term rate changes and bond yields become more random. The largest cluster of stocks outperforming high-yield bonds occurs when LIBOR increases, presumably under the weight of rising credit demand in a strong economy, and bond yields remain stable.

Sample vs. Universe

The two decades-plus of data used above is a large sample, to be sure, but it is hardly all-encompassing. Many an error has been made on this basis; for example, no one thought a nationwide housing downturn was possible prior to 2007 because no one had seen it. A caution is advised: Even though a two-decade data sample is large, it does not include anything for corporate bond performance during the high-inflation and high-interest rate years of the late 1970s and early 1980s. In addition, the sample lies within what has been a three decade-long bull market in bonds.

Investors still have to make a decision between stocks, bonds and other assets. It seems as if stocks are the dominant investment only during those periods when earnings growth outpaces the combination of moves higher in short-term interest rates and the cost of capital for investment-grade bonds and simply short-term interest rates in the case of high-yield bonds. Over time, these distinctions can dissipate and you are left with risk-adjusted returns far more homogenous than those you had hoped for when you started to diversify.