More Bad News For Corporate Bonds

You can, or should, only get so fancy at times like these. As we have seen too often during the past year, relationships collapse and correlations move toward 1.00 in a crisis. But even with all of the turmoil, certain relationships such as the ones being corporate bonds and stocks do remain useful.

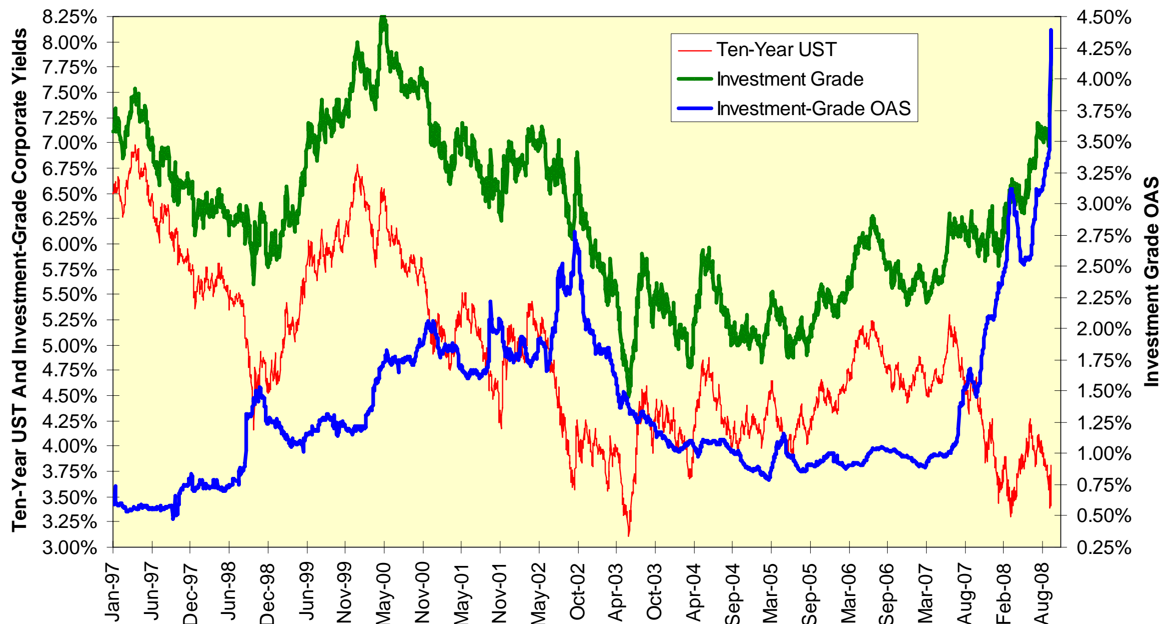
I entitled a column last December, "More Headwinds For Corporate Bonds," and another one this past May, "Realized Borrowing Costs Matter." The gist of both columns was the cost of capital for and risk of corporate borrowers was rising regardless of what was going on with Treasury rates. Those observations are not only valid today, but they worsened significantly last week.

Spreads Are Not Less Risky

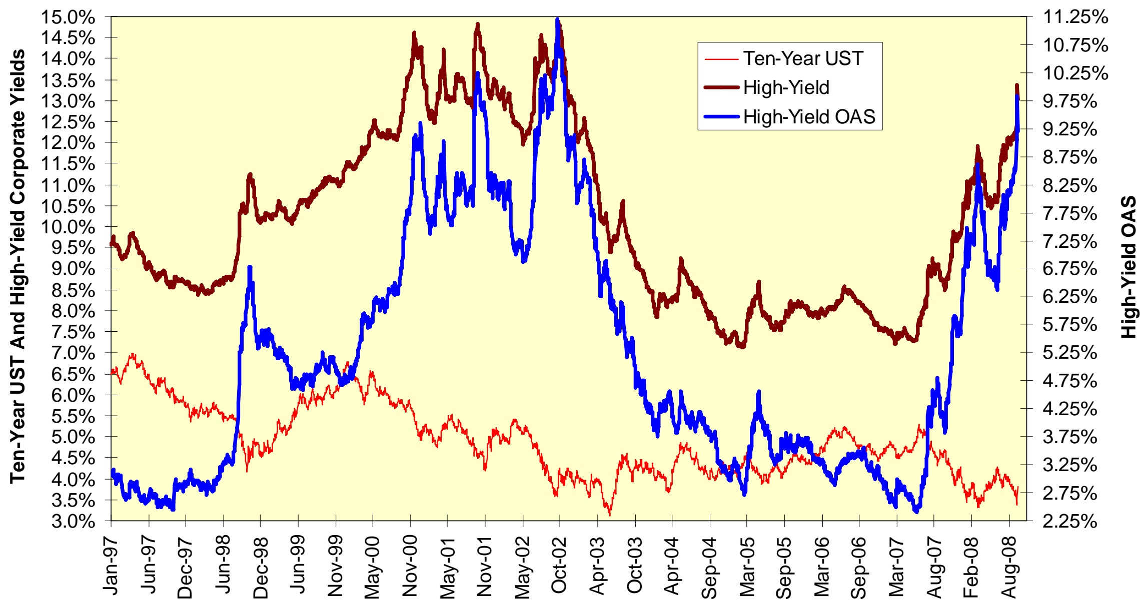
A perennial question on the Series 3 exam for registration in the futures industry is whether spread trades are less risky than outright trades. Everyone spots the trap and answers, "No" correctly, but my teaching experience tells me most respondents do not understand why this is the case. The answer, very briefly, is unless the covariance between two markets is virtually 1.00 and the standard error of estimate between the two markets is virtually zero, there is a probability the markets will not behave as expected. Two markets commonly linked together can diverge at the time when it will hurt you the most.

This has been playing out in the corporate bond market over the past two months. As Treasury yields fell under the flight-to-quality (or, as I dubbed it last week, the flight-to-the-printing press), the option-adjusted spread (OAS) between investment-grade corporate bonds and Treasuries rose even faster. This meant the realized borrowing cost, or Treasury yield plus OAS, of corporate bonds was rising. In fact, investment-grade OAS moved to a record high of 439 basis points on Thursday. This is anything but the desired outcome during a credit crunch.

Investment-Grade Spreads Widening From Both Legs

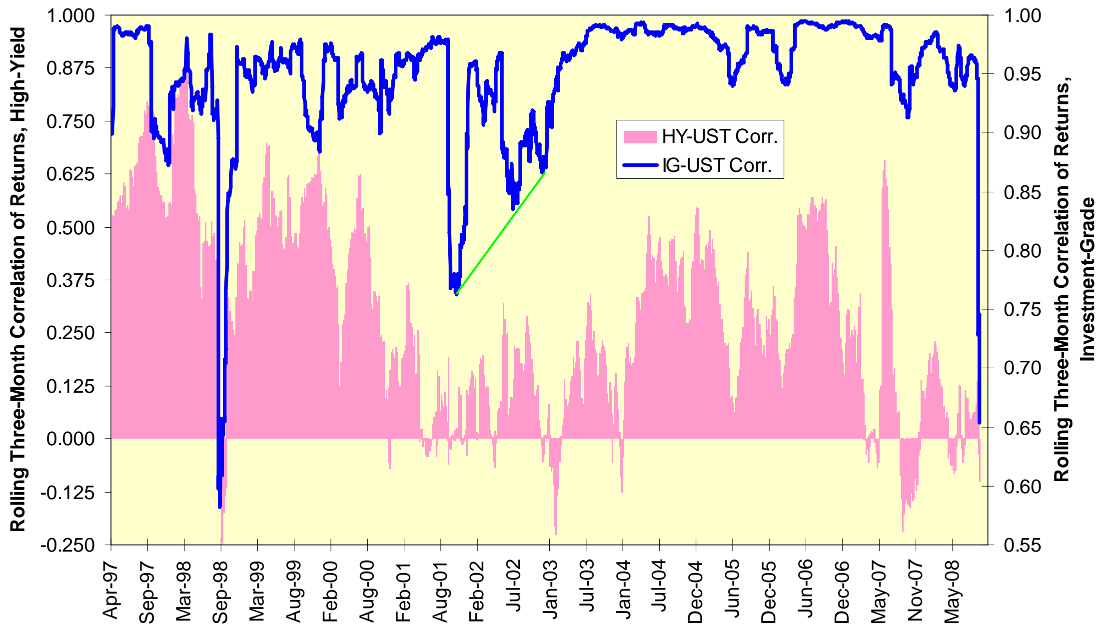


The same phenomenon occurred, but less intensely, for high-yield bonds. Here the realized borrowing costs were rising as Treasury yields were falling, but overall OAS was still under levels seen in the 2002 bear market. If anyone is curious as to why the high-yield market might be in relatively better shape, the answer is high-yield investors know what they are getting themselves into and tend to be less leveraged than investment-grade investors.



The Broken Relationship

Now let's rearrange the data a little and highlight the implications. If we convert the investment-grade and high-yield realized borrowing costs into constant-maturity bonds and compare their the rolling three-month correlation of their returns to those of a constant-maturity ten-year Treasury note, something very striking emerges.



High-yield returns are correlated negatively to Treasuries at the moment, and there is nothing all that unusual here. As I stated above, high-yield investors accept this as part of the deal. But take a look at the heavy blue line representing the correlation between investment-grade bonds' returns and Treasury returns. Only one period, the Long Term Capital Management/Russian default crisis period of 1998, witnessed a collapse this steep. The rebound from that period was equally violent; both of these moves are to be viewed with awe by the mathematically inclined as they involve three months of data at each observation. The S&P 500 rose by more than 35% over the following year.

The second drop, the one following the 9/11 terrorist attacks and extending to the start of the Iraq War in March 2003, took a long time to return to normal levels. Its long climb back was occurred during the context of the bear market prevailing at the time, marked with a green trendline on the chart.

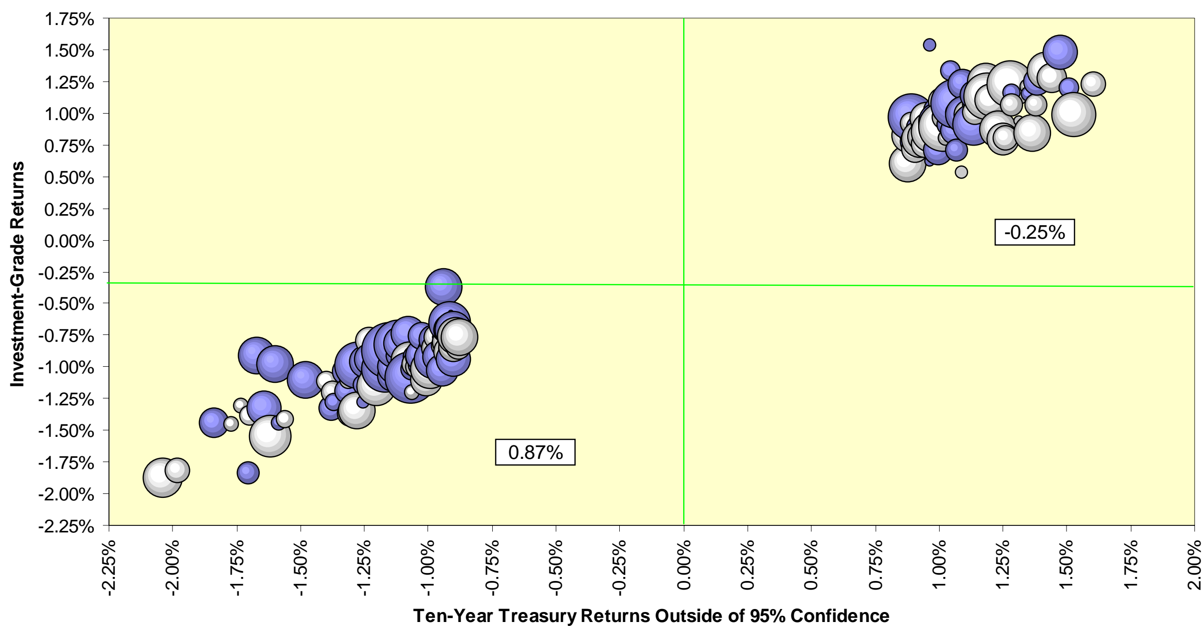
Is the current environment closer to the 1998 market, the 2001-2003 market or is it different completely? The 1998 drop in correlation occurred within the context of a strong economy and within the context of a historic bull market. Neither situation obtained in either the 2001-2003 market or in today's market. The 2001-2003 drop in correlation occurred within the context of a tepid economy and within the worst bear market since the Great Depression. Today's situation is closer to 2001-2003, but the current credit environment is the worst since the Great You-Know-What.

A long climb back, as opposed to a 1998-style quick snapback, is likely to be accompanied by low returns at best in the equity market. Unless we see inflation move sharply higher – a statement, not a forecast as it is hard to see inflation igniting in the short-term with the banking system in such disarray – stocks are unlikely to prosper unless corporate bond markets stabilize. Stocks can outperform bonds, for a short time at least, in inflationary environments.

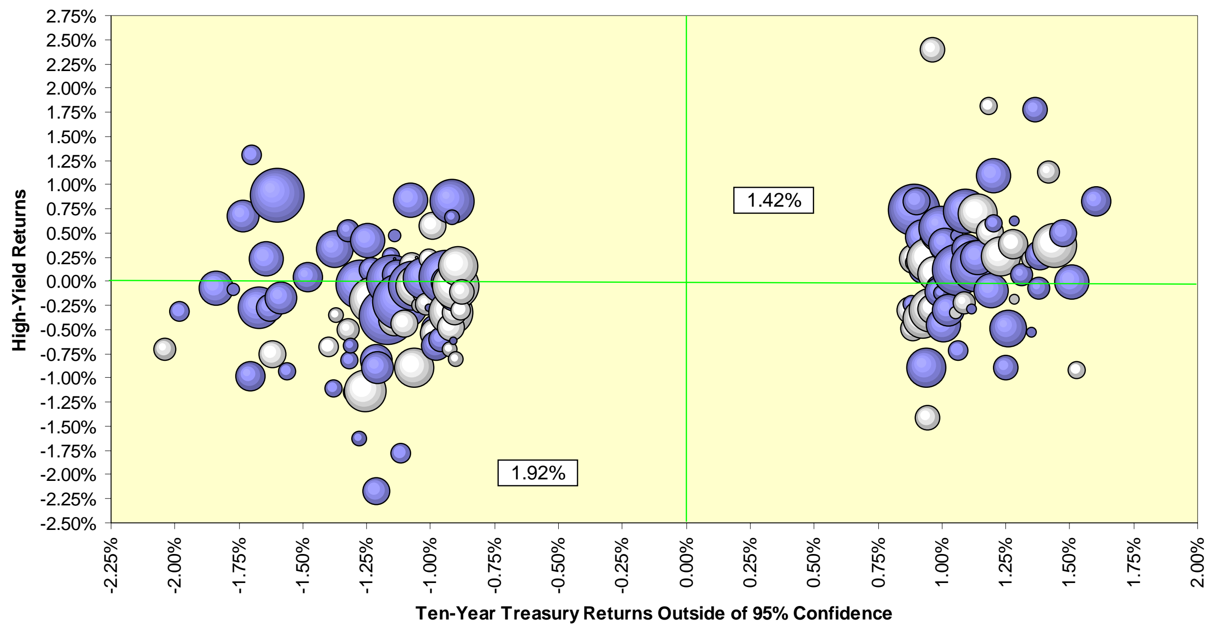
Treasury Linkage

We had the two largest one-day moves in the Treasury market last week since the OAS data became available in January 1997. Monday had the largest rally; Friday had the largest selloff. What can we data-mine out of past large (outside of a 95% confidence interval) moves in Treasuries for subsequent returns in corporate bonds?

If we map the one-day returns on investment-grade bonds against those large moves in Treasuries and depict the three-month ahead returns in investment-grade issues in bubbles, blue for positive, white for negative, something startling emerges. After huge rallies in Treasuries, the three-month ahead returns in investment-grade bonds are negative, -.25%. The opposite is true for large selloffs in Treasuries; here the average three-month ahead return is 0.87%.



The answer for three-month ahead high-yield returns is more confusing: Regardless of whether the large moves in Treasuries are up or down, the three-month ahead returns after large Treasury rallies and selloffs are 1.42% and 1.92%, respectively.



This might suggest high-yield bonds have better potential between now and year's end than do investment-grade bonds or stocks. It would be a sort of flight-to-garbage in a world where we just had to backstop money market mutual funds.

A sarcastic person might say, "Well, if the government is passing out $100 billion bailouts like cookies in a Cub Scout meeting, you might as well buy the worst stuff you can get your hands on because the best stuff or even cash might be worthless soon enough." Too bad I do not know any sarcastic people to confirm whether such a statement is likely.