The Bad News Bonds

"The rich are different from you and I."
"Yes, they have more money." – purported exchange between F. Scott Fitzgerald and Ernest Hemingway

The differences between stocks and bonds have fascinated analysts for years. A list for standard-issue corporate bonds includes their seniority in corporate capital structure, bonds having a finite maturity while stocks are a perpetuity, the finite reward structure for a bond as opposed to a stock's growth potential, and bonds' lack of ownership rights prior to bankruptcy.

A secondary debate has raged for years as to which market is "smarter," a metric that should be used with extreme caution in the realm of finance. For what it is worth, I addressed this topic in a pair of articles in May 2003; the first which set up the test of causation between the two markets, and the second of which proffered the conclusion stocks were slightly ahead of bonds in their ability to look forward.

In practice, I describe the relationship as asymmetric. A stock can get slammed on some end-of-the-world tragedy such as missing its earnings estimate by 1¢ per share, but the bond can sail past this awful news confident the credit quality of the firm is safe. The opposite seldom is true: If a corporation's bonds falter - and please note how I said "falter" rather than "get downgraded," the latter condition arising only after the fact - the stock should be in trouble as well. Stocks, after all, represent a claim on earnings after interest payments.

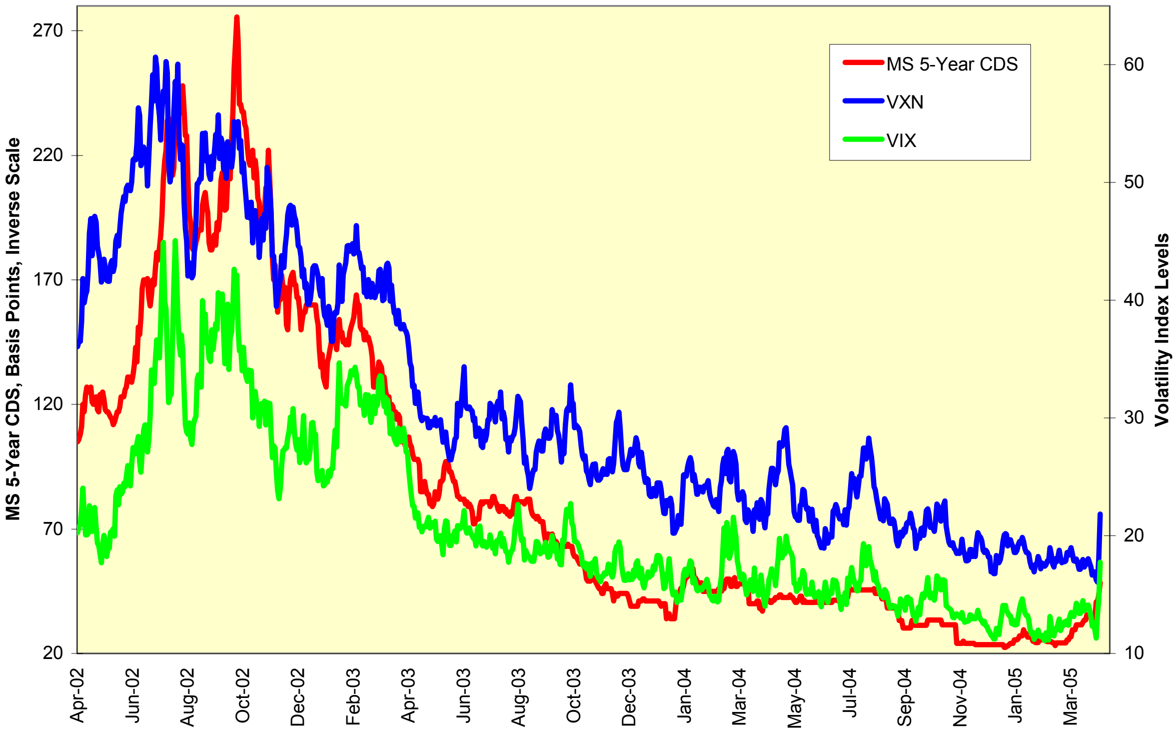
We should note in passing there are situations such as leveraged buyouts in which bondholders get clobbered while shareholders prosper.

Credit Default Market
The columns referenced above looked at the yield spread between corporate bond indices and comparable Treasuries. The market for credit default swaps (CDS), an insurance contract on a specific issuer's default risk, has exploded in recent years. The narrow corporate bond spreads seen since 2003 have reflected the combination of investors buying corporate bonds and CDS. Investors are willing to accept lower bond yields if they believe their default risks have been insured by a creditworthy counterparty.

If we view the above transaction in option terms, the combination of a corporate bond plus a CDS - which acts as a put option - is a synthetic call option on the bond. Anyone writing the CDS protection should in a perfect world hedge their risk by selling a quantity of the bonds themselves, but this is a difficult transaction to execute given the relatively small quantities of bonds available and the costs involved in shorting those bonds such as making the coupon payments. CDS writers instead have taken to hedging their risk by selling the underlying stocks and options on those stocks as a hedge.

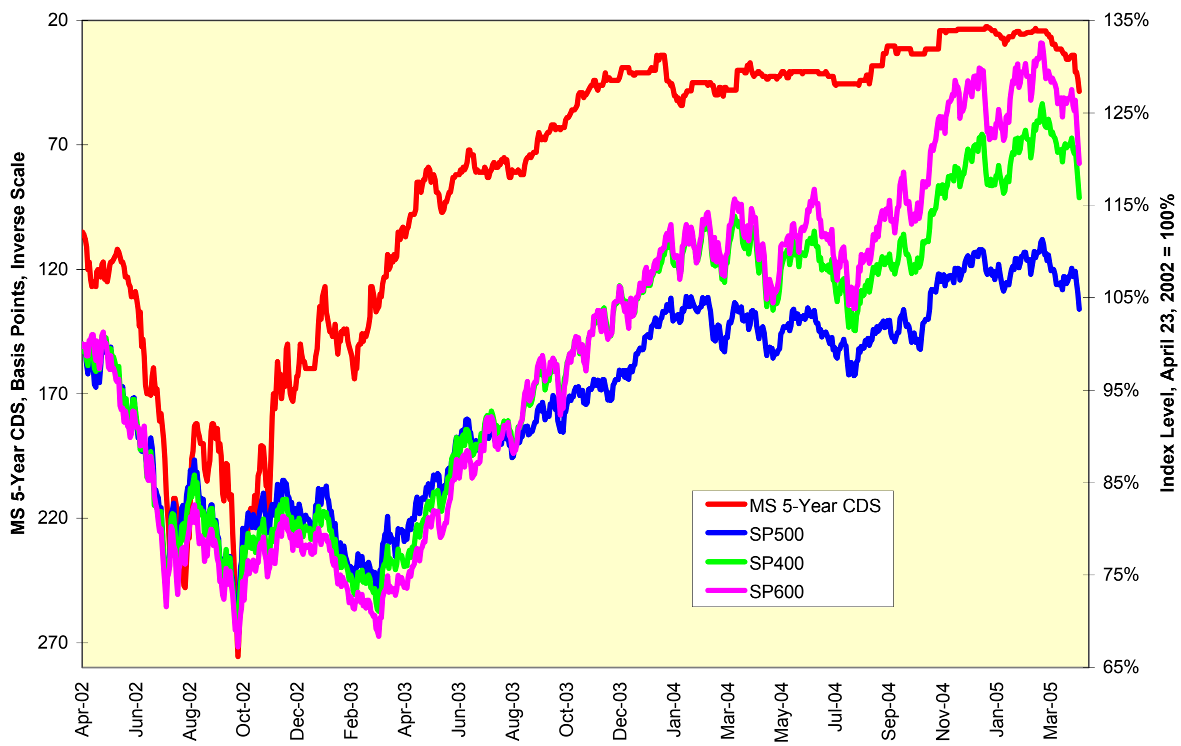
The selling of stock options, calls in particular, have been one reason why the CBOE's Volatility Index (VIX) has been drifting lower for two years. The CDS hedgers should buy the put options in addition to selling the call options, but let's face it: Most investors would rather undergo a root canal without Novocain than pay for put option premium. The relationship between the declining cost of CDS insurance on a Morgan Stanley index of five-year bonds and the VIX and Nasdaq Volatility Index (VXN) is quite visible. The CDS index has been rising steadily since early March, while the stock volatility indices moved higher only when stocks started to break for good in April.

Parallel Risk Dimensions



We can restate the above relationship in terms of index price. If we depict the CDS cost on an inverse scale and compare it to the indexed price levels of the large-cap S&P 500, the mid-cap S&P 400 and the small-cap S&P 600, we can see how declining CDS costs led the stock rally in 2003. As time moved on and CDS costs bottomed near 20 basis points, or .2% of the bonds' face value, the smaller stock indices rose further and faster than the larger ones.

Size Matters: S&P Index Sensitivity To Credit Default Risk



Even though the headlines have focused on the travails of S&P 500 members such as Ford, General Motors, AIG, Fannie Mae and IBM, the S&P 600 that fell the most once credit quality began to deteriorate in March. The small firms have less access to financing than their larger cousins and therefore will be more vulnerable should the credit markets lock as they are wont to do in a crisis. Life is not fair, is it?

Linking Stocks And Bonds

Financial post-mortems usually discover one of three causes. The first is the assumption of continuous and liquid markets; in reality, liquidity is the only asset whose supply disappears when its price is raised. The second is the assumption that past correlations will remain constant during a crisis; in reality, correlations move to 1.00 in a crisis as panicked traders sell risk and buy safety. The third is what option traders refer to as being short gamma: Any insurance writer is short gamma while the insurance buyer is long gamma. Who writes the checks after the disaster and who cashes them?

CDS writers are guilty of all three in some sort of you-have-got-to-be-kidding trifecta. They are short put options on corporate bonds and call options on the stock, they are assuming the stock-bond relationships will remain predictable as a crisis unfolds, and they are assuming they can trade their way out of the situation on the really amusing assumption someone else will care about their plight.

And, to top things off, they have the same risk profile present in 1998 during the Long Term Capital Management debacle: They are long on risk and short the safety of the Treasury curve. If the Federal Reserve backs away from its measured pace of rate hikes, as speculation last Friday had it, this last problem will be worsened as Treasury yields will fall more rapidly than will corporate bond yields. In terms of the risks posed to the financial system, these traders are suicide bombers in pinstripes, if I may date myself with the choice of preferred wardrobe.

If past is prologue, and it usually is, who will be on the hook for any accident? You and me: The CDS writers are the usual too-big-to-fail suspects. If General Motors declares bankruptcy, you and I will own their pension liabilities through the Pension Benefit Guaranty Corporation. If J.P. Morgan gets on the losing end of CDS obligations, we will own those. And we already own the unfunded liabilities of Medicare and Social Security.

We own, we own, we own. That’s why we are the ownership society, is it not?