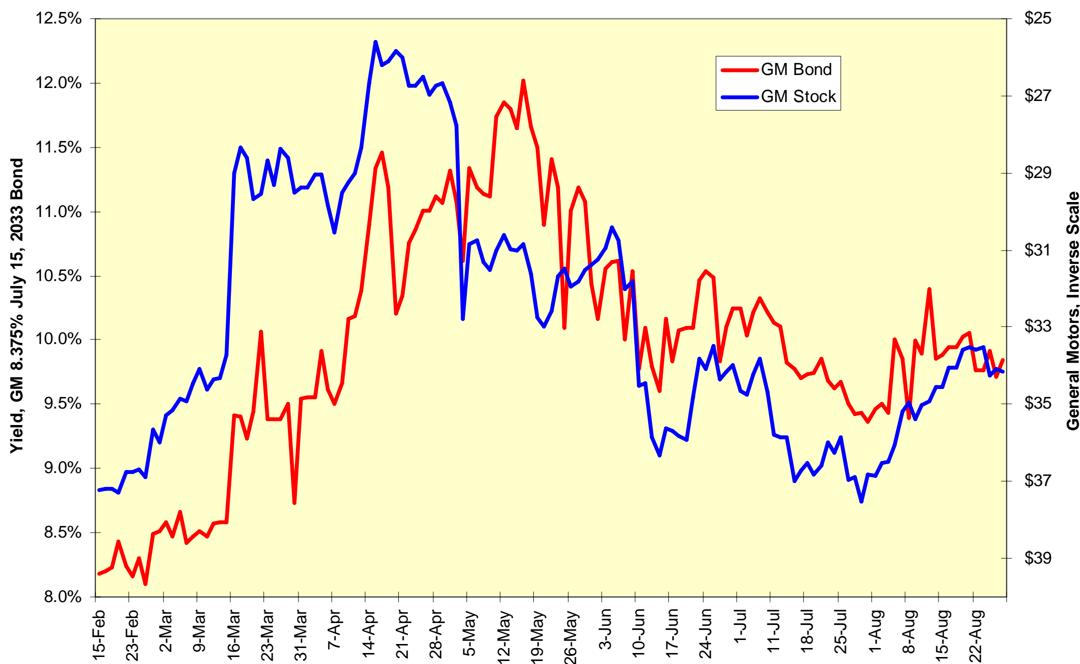
Keep Your Eye On Corporate Bonds

Financial markets have a way of producing the same sort of short-term amnesia that vexed the quivering miscreant in Clint Eastwood's classic *Dirty Harry*: With all of the excitement, sometimes we just lose count.

The hiccup in the corporate credit market this past spring associated with the difficulties of the automotive sector in general and General Motors in particular was one of those moments. The downgrades in Ford and General Motors bonds, the politics and confusion amongst rating agencies and bond index managers as to what mandated an issuer's removal from investment-grade to high-yield indices, and then finally Kirk Kerkorian's over-the-market tender offer for General Motors all contributed to a difficult situation.

By the end of it all, the automakers' bonds were oversold. A few venturesome high-yield managers gobbled them up and lived to tell the tale. At that point, the mechanics of indexation then kicked in: Once the few early risk-takers in the high-yield world started to beat the index, everyone else had to pile in to maintain benchmark performance. The bonds were bid higher. By mid-June, the yield on the GM 8.375% bond due in 2033 returned to mid-March levels and the stock was more than $5 over Kerkorian's tender price.



Indexation makes smart people do stupid things. It also beats most forms of active management. You are left to contemplate the metaphysical implications for yourself.

Insured Risk

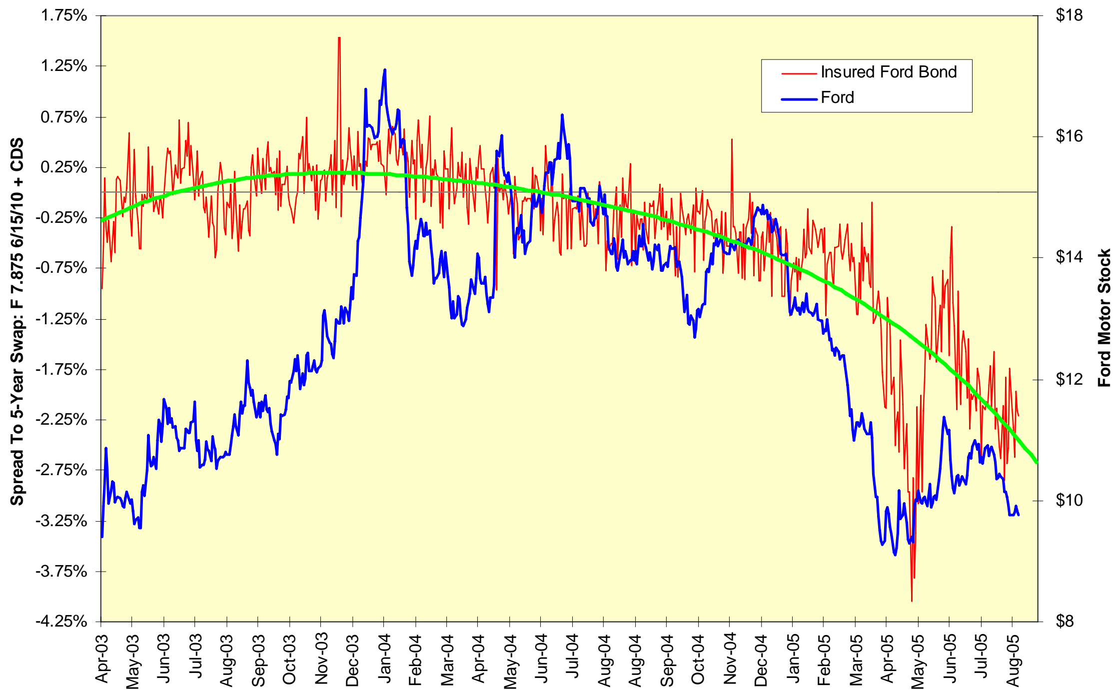
The topic of credit default swaps was addressed here in April and again in May. A credit default swap (CDS) is really nothing more than an insurance contract written by a dealer to a bond investor that pays the bond at par in the event of default. Stock investors may conceive of them as put options on the bonds.

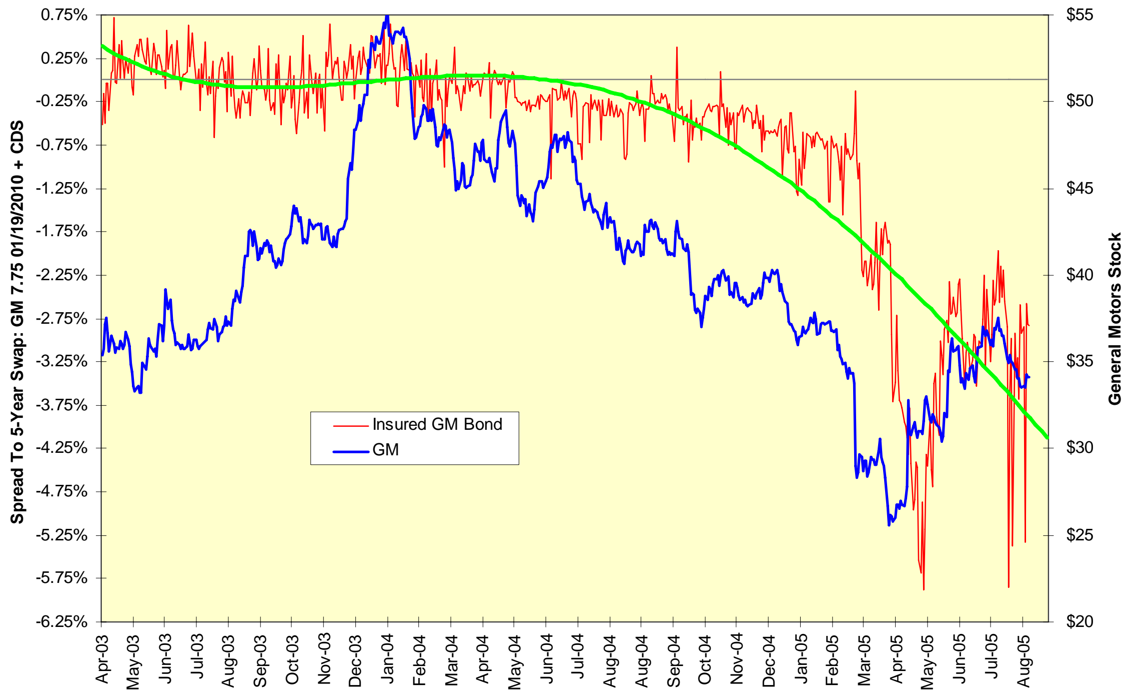
A common maturity for a CDS contract is five years. If we add the cost of a five-year CDS to the yield on a five-year corporate bond, we get the net return on an insured bond; once again, stock investors can view this as buying a put option on a stock. The net return, the bond's yield minus the CDS cost, then can be compared to the base case of being a fixed-rate receiver – a lender at a fixed-rate – in the five-year swap

market. A positive comparison is supportive for the corporate bond and by extension for the underlying stock.

What about a negative comparison? Why would the owner of a bond buy a CDS at such a cost so that being a fixed-rate swap receiver would be the better deal? The answer is simple: There are times when the bond market for corporate issues becomes illiquid. It is actually cheaper to take the known insurance loss than to try to sell the bonds themselves. As an aside, the assumption of infinitely elastic liquidity at a single price leads to trading disasters; anyone loading up on real estate should contemplate the implications for being able to sell.

How have representative bonds of the two automakers fared in this comparison? The good news from a modeling standpoint is the insured corporate bond comparison for both Ford and General Motors track the stock well, and vice-versa. The bad news is both companies' credit is deteriorating anew.

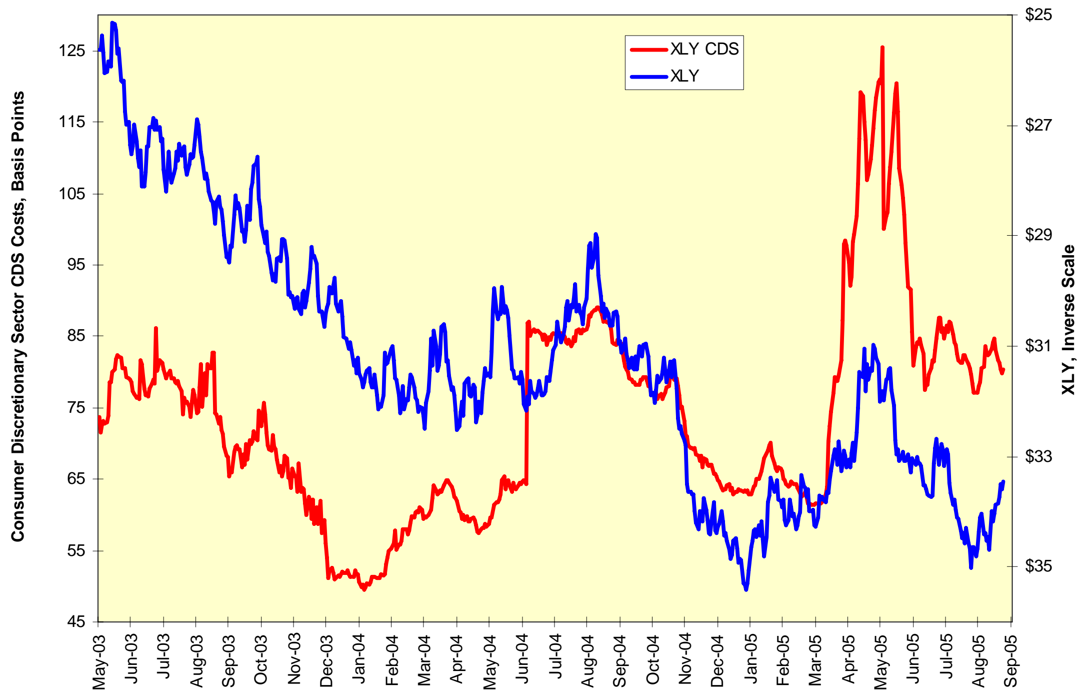




From Companies To Sectors

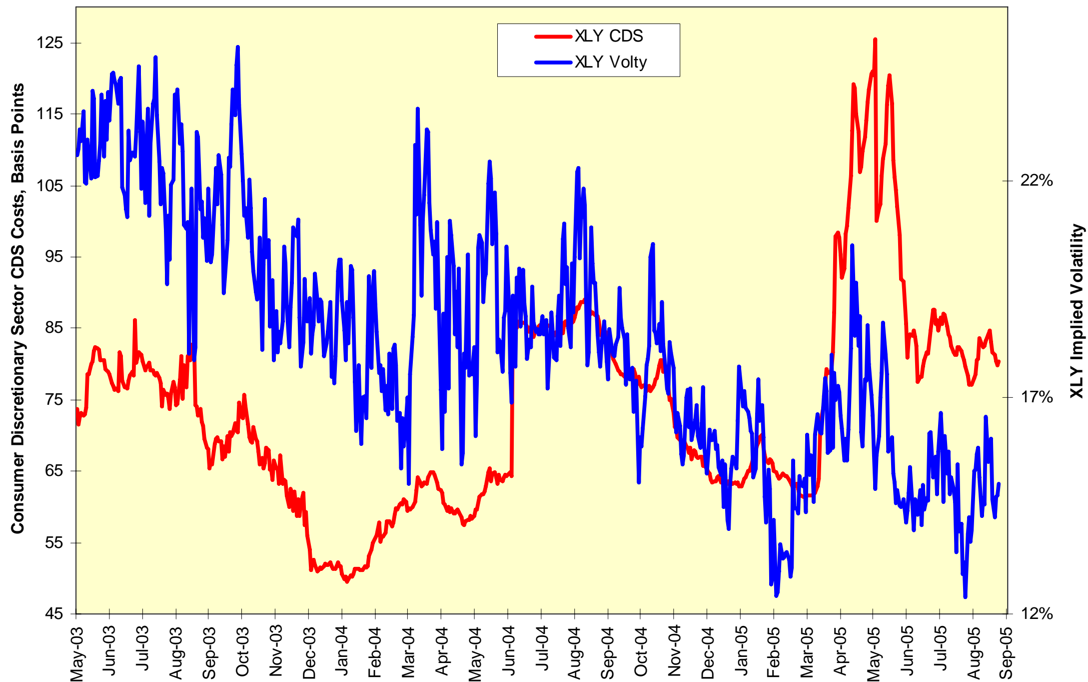
Both automakers are in the Consumer Discretionary sector, a list inclusive of Home Depot, Time Warner, Comcast and other businesses designed to satisfy your need to consume. If consumers, an untrustworthy crowd if ever there was one, decide to retrench under the double whammy of higher energy prices and short-term interest rates, these stocks will come under financial stress. And as an aside we will delve into no further at this time, it is the shape of the yield curve and short-term interest rates that are more important than energy prices to this sector.

One way to monitor the condition of this sector en masse is through an exchange-traded fund, the Consumer Discretionary Select SPDR, which trades under the ticker XLY. If we plot the XLY inversely against an index of five-year CDS costs for the entire Consumer Discretionary Sector, we see how jumps in CDS costs do in face precede downturns in the XLY price. The opposite does not appear to be true; the stock does not lead the sector CDS.



What if you cannot or do not watch CDS prices? It is, after all, a fairly specialized market wherein the individual investor is not particularly welcome. A good proxy for CDS costs across the sector is the implied volatility of the XLY options. And, by extension, the implied volatility for a given stock seldom goes in a direction opposite of its CDS costs unless a corporate event such as a leveraged buyout or merger is underway. Both the CDS market and the equity options market measure insurance costs.

Insurance Comparisons For S&P 500 Consumer Discretionary Sector



To conclude with another movie analogy, it was 30 years ago this summer that *Jaws* debuted across the silver screen. But the most memorable line of the movie sequence came not from the excellent original but from the first sequel, "Just when you thought it was safe to go back in the water."

The quick rebound from the spring CDS encouraged many to go back in the corporate bond market and into the stock market as well. Now that the easy buying is over and done with, the CDS sequel may be coming back.