Good News From Corporate Curves

The inverted yield curve may not be the most misunderstood financial phenomenon – my personal nomination for that dubious distinction is the contango in crude oil in the midst of an identifiable bull market – but it certainly ranks high on the list. Perhaps, as noted here in January, so many persist in associating the inverted yield curve with an impending recession, a bear market in stocks, or both. These are headline-grabbing topics beloved by the professional hyperventilators amongst us, so a little misunderstanding is understandable.

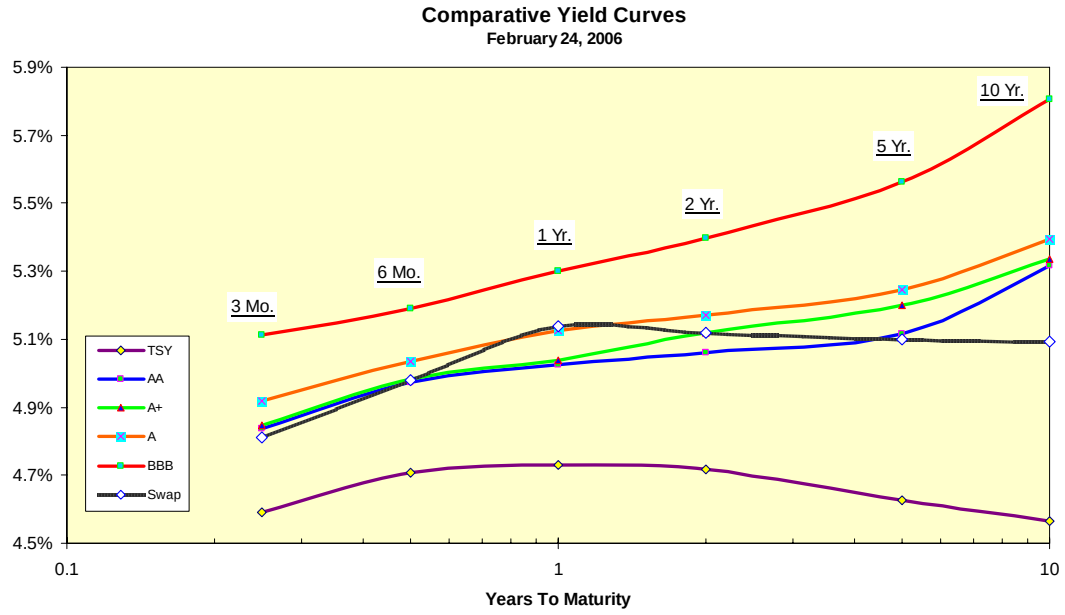
Regardless, the focus always is on the Treasury yield curve, and this, too, is understandable: The Treasury rates are defined as risk-free and they establish the capital market line against which all other U.S. bonds trade as a spread. In addition, many global and corporate spreads are set against the swap curve, which is just as flat-to-inverted as the Treasury curve.

But as we shall see, the yield curve for corporate bonds contains valuable information for both the health of the economy and for the stock market.

It Takes Two To Lend

We usually focus on the behavior of lenders when we discuss the level of interest rates and the shape of the yield curve. Great attention is paid, for example, to the purchases of Treasury bonds by Japanese or Chinese investors and to their relative maturity schedules. But borrowers matter, too, especially in the corporate market where demand for capital is far more variable than it is in the Treasury market. After all, the Treasury has to be in the market continuously to finance the government's profligacy, but corporations only borrow at the long end of the yield curve to finance new plant and equipment. Corporate borrowing at the short end of the yield curve is for more day-to-day operating considerations such as the financing of inventories and receivables.

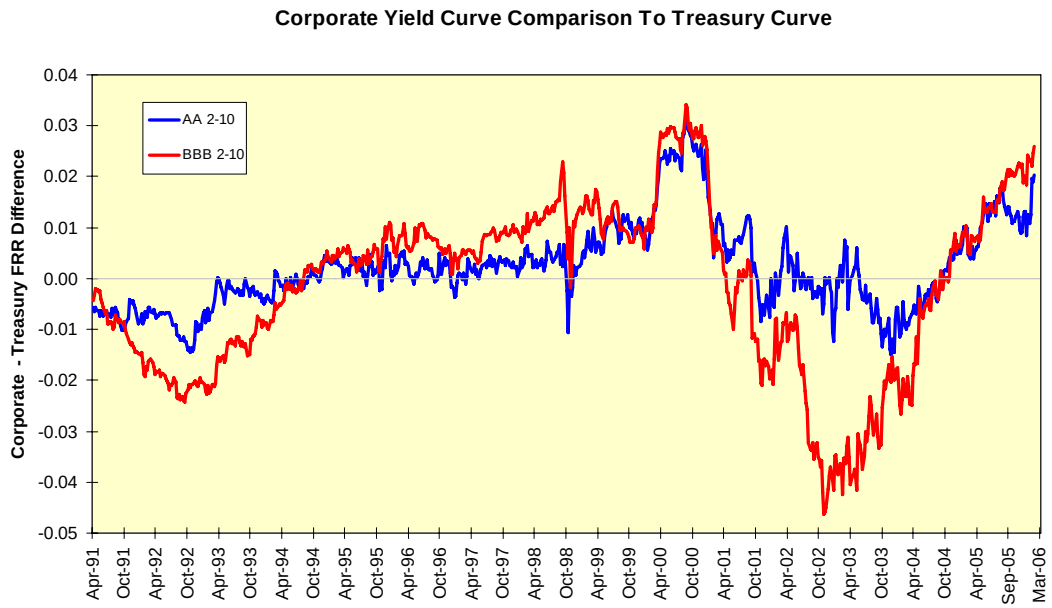
Let's look at the generic yield curves for investment-grade industrial borrowers. We can start from AA at the top as there are fewer than ten AAA credits left in corporate America, and go down to the BBB rating. The inversion of the Treasury curve is visible at the bottom of the chart as is the flat swap curve at a higher yield level.



Comparing The Curves

How can we compare these different yield curves? One way would be to measure the shape of each using the forward rate ratio between 2 and 10 years. This is the rate at which we can lock in borrowing for eight years beginning two years from now, divided by the ten-year rate itself. The steeper the yield curve, the more this ratio exceeds 1.00; an inverted yield curve has a forward rate ratio less than 1.00.

Next we can take the difference between various forward rate ratios and the Treasury forward rate ratio. Let's limit ourselves to the AA and BBB ratings for simplicity. When the differences are positive, the corporate yield curves are steeper than the Treasury yield curve. When the differences are negative, as they were during the loose money episodes of 1991-1993 and 2001-2004, the Treasury yield curve is steeper than the corporate yield curves.

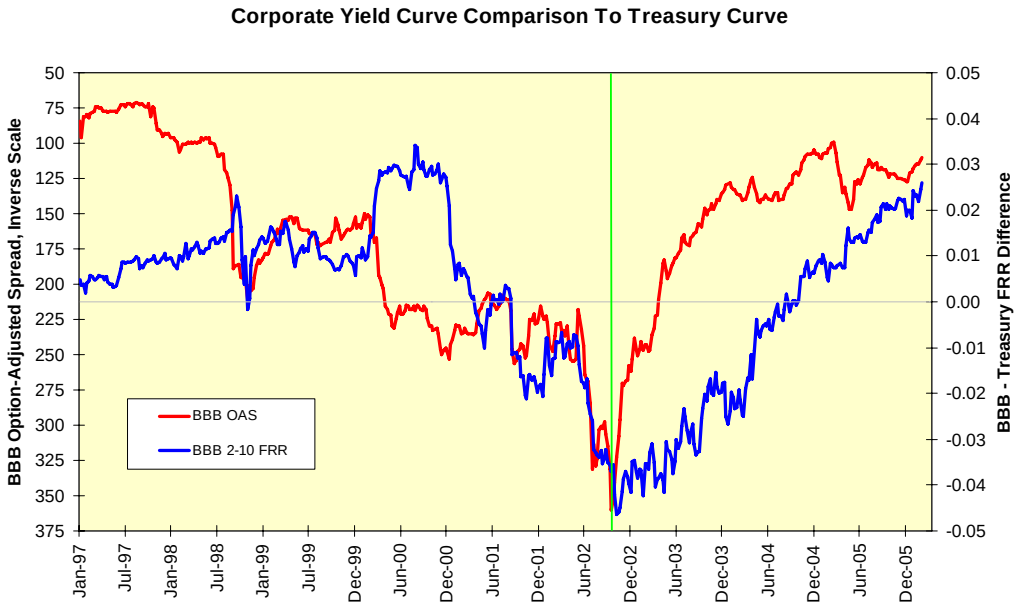


We can interpret these numbers by saying, "if corporate borrowers have to pay more for investment capital during a period of Federal Reserve tightening, these borrowers may be facing trouble." And if the weaker borrowers, the BBB and lower, are facing steeper yield curves than high-quality borrowers, we should sound some alarms.

Rates And Stress

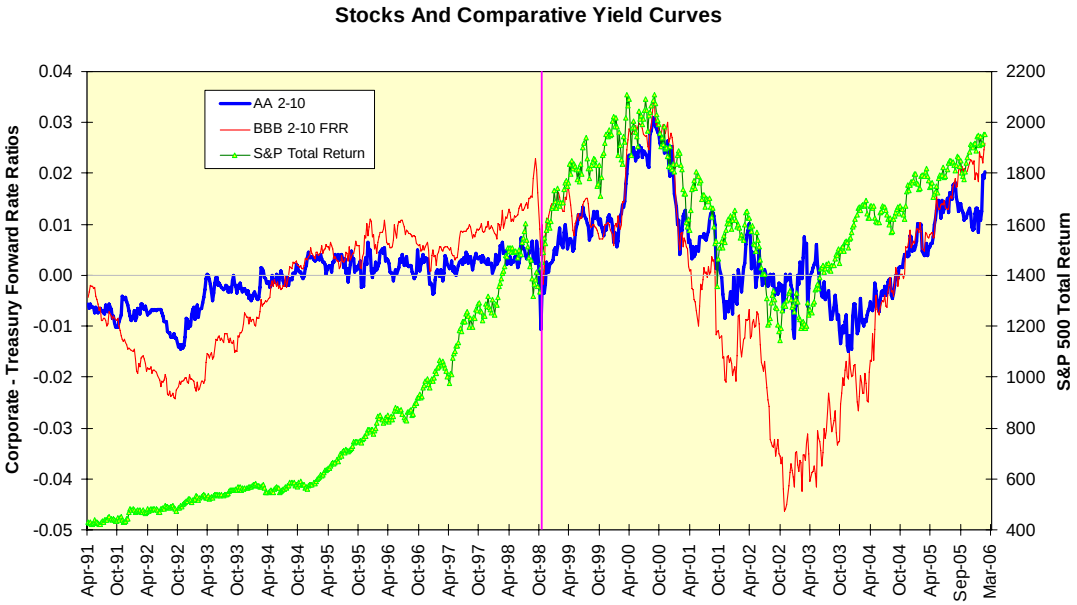
A glance at the chart above shows we are at the difference levels reached before the market mishaps of 1998 and 2000. And corporate borrowers in general and lower-quality borrowers in particular are facing ever-higher costs for long-term money. Should we be worried? Would I be asking this question if the answer were, "Yes?"

Higher rates can result from stronger demand for investment capital, the borrowers' behavior discussed above, as well as a deteriorating corporate financial position. How can we know which factor is operating? One measure is the option-adjusted spread of corporate bonds; the higher a bond's OAS expressed in basis points, the riskier it is. If OAS were rising along with the corporate yield curve steepening, we could classify the present steep corporate yield curve environment as one of high stress. Instead, we can see how BBB OAS levels, plotted inversely, have fallen sharply since the October 2002 stock market low even as the corporate yield curve has steepened relative to the Treasury curve.



This is very strong evidence that the steeper corporate yield curve is simply the result of strong corporate investment demand, not of financial risk. In some circles, this is called good news. It is.

How important is it for stock investors? Ever since the October 1998 Long Term Capital Management fiasco, the total return of the S&P 500 has been a mirror of the differences between corporate and Treasury yield curves.



Unless corporations have, en masse, decided to emulate Uncle Sam and borrow billions of dollars just to see what it feels like, we have to regard their credit demands as a self-assessment of their own financial health. So long as it persists, both the economy and equities should continue to chug along just fine, thank you.