More Headwind For Corporate Bonds

Let's assume just for the sake of argument there are people who when given the slightest chance to do so will call upon the Federal Reserve to lower interest rates just to see what happens. You know, kind of like a cuckoo clock that does not tell time, but we digress.

Oh, and for those of you keeping score, here are few of the things that have happened since the close of business on August 16, 2007:

Period Total Returns
In New Rate-Cut Era

Russell 3000	5.57%
Dollar index	-6.83%
Spot gold	20.21%
Ten-year TIPS breakeven rate	0.14%
ML Government Master	4.72%
ML Investment-Grade	3.16%
ML High-Yield	1.87%

You knew the dollar got hit and both gold and inflation expectations rose. Were you aware the total return on stocks, even with the carnage in the financial sector and the prospects of a weakening economy and lower profit growth, exceeded that for bonds?

One explanation for this, first raised in a May column on equity shrinkage, is American assets are being priced more for control than for mere ownership. With American stocks underperforming most of the world, a sorry state of affairs addressed a few weeks ago, and the dollar on its derriere, deals such as the Abu Dhabi Investment Authority's infusion of capital into Citigroup will become more common.

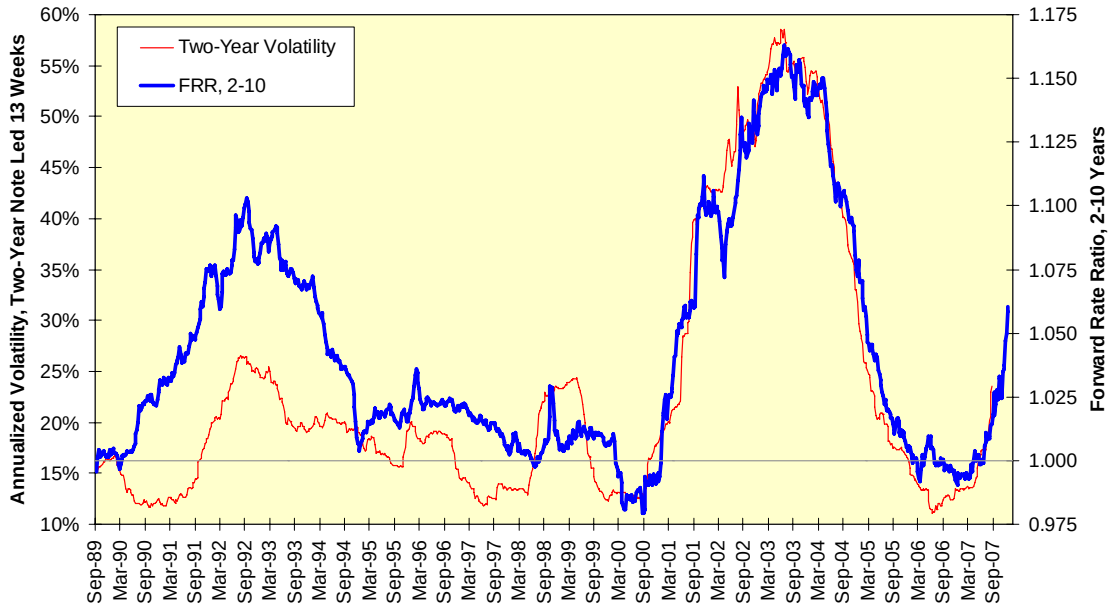
And were you aware that high-yield bonds, often posited to be more equity-like in their return profile, underperformed investment-grade bonds even as stocks outperformed Treasuries? This violation of my maxim, "stocks float on a sea of bonds," accelerated after the Federal Reserve's mid-August action and negated an early-August call for a narrowing of corporate credit spreads, not that I take such things personally.

Truth Or Consequences
What we are living with now are the consequences of the Federal Reserve's ad hoc policies and the concomitant loss of transparency I predicted in September. The chain of causation, detailed below, is this:

1. Increased credit stress and a flight-to-quality led to both a steeper yield curve and to higher short-term interest rate volatility;
2. Higher short-term volatility expanded swap spreads, the difference between Treasuries and LIBOR-based interest rate swaps;
3. As money fled to the safety of the short-end of the yield curve, swap spreads expanded faster there than at the long-end of the yield curve; thus
4. Leading to an inversion of swap spreads, which lead in turn to
5. Wider credit spreads for corporate bonds and their underperformance relative to Treasuries as noted in the table above

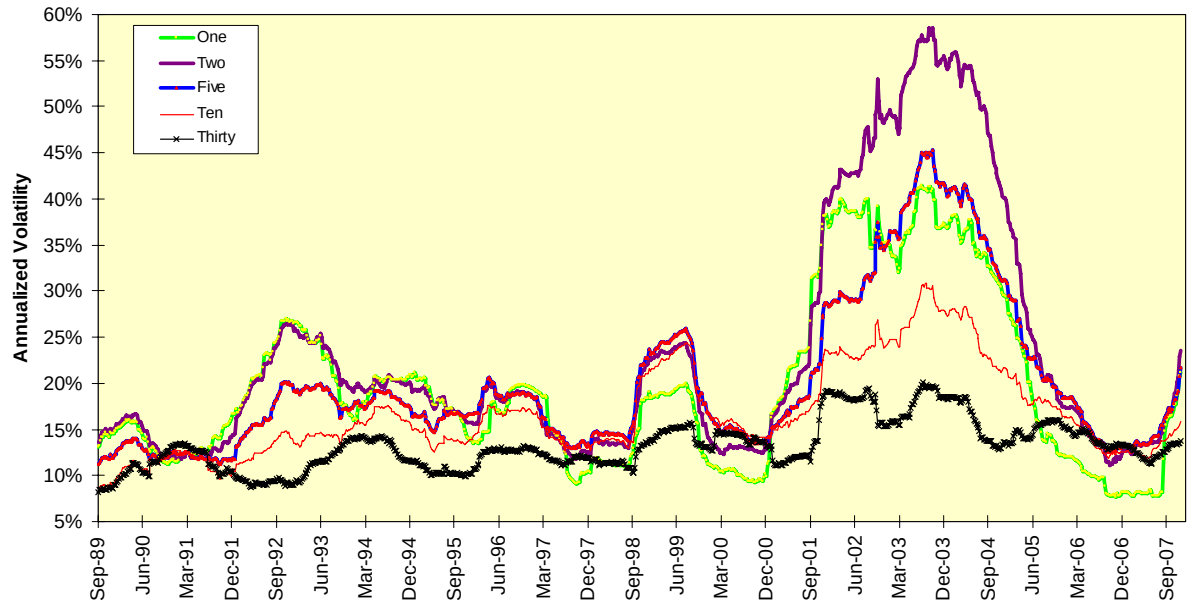
The steeper yield curve as measured by the forward rate ratio between two and ten years, the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself, leads the implied volatility on zero-coupon two-year Treasuries by thirteen weeks on average. This should be unsurprising; bond traders get nervous when yields plunge, and the steepening of the yield curve under the weight on easier monetary policy and a flight from risk makes the current level of the two-year note seem unsustainable.

The Yield Curve Leads Volatility

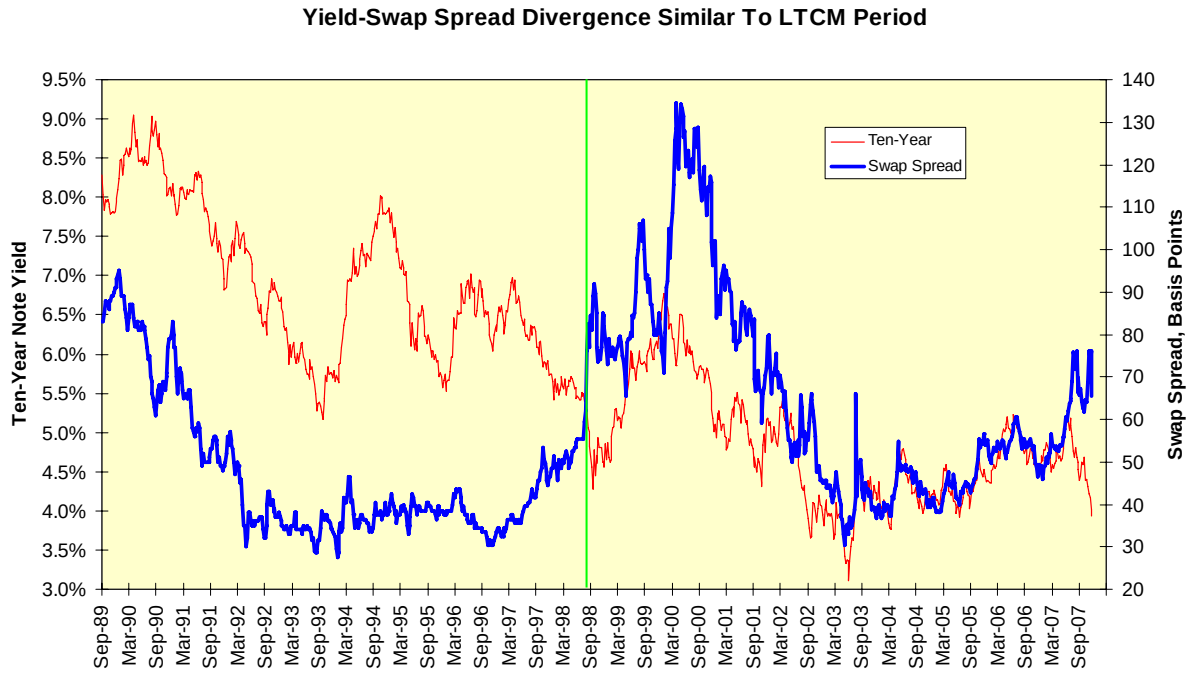


As noted above, the increase in interest rate volatility was higher at the short end of the yield curve. Indeed, one-year volatility has jumped over ten- and thirty-year volatility. This inversion of the volatility term structure occurred during other periods of Federal Reserve loosening, such as 1991-1992 and again in 2001-2003.

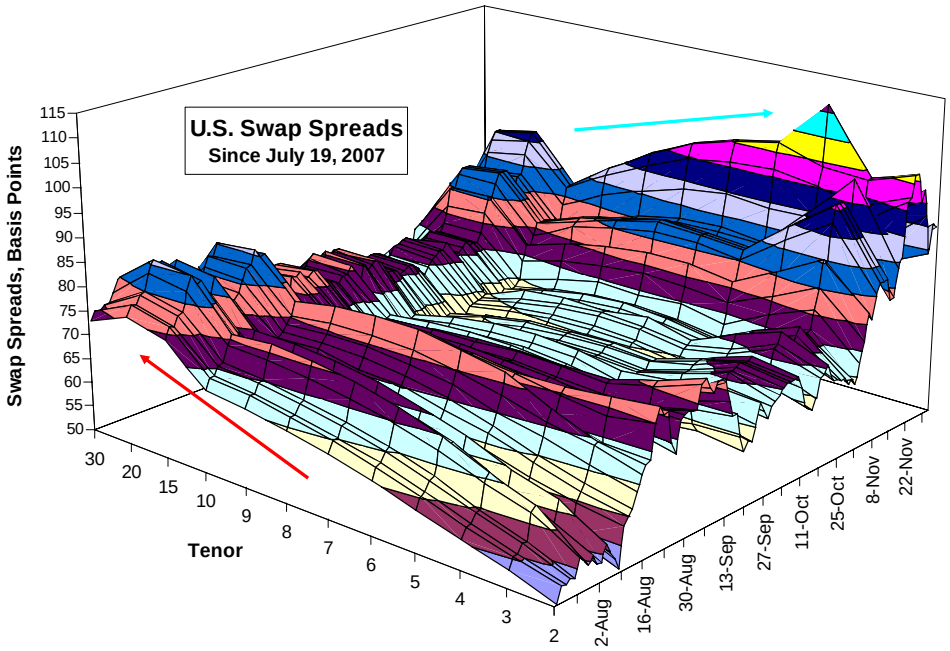
The Term Structure Of Interest Rate Volatility



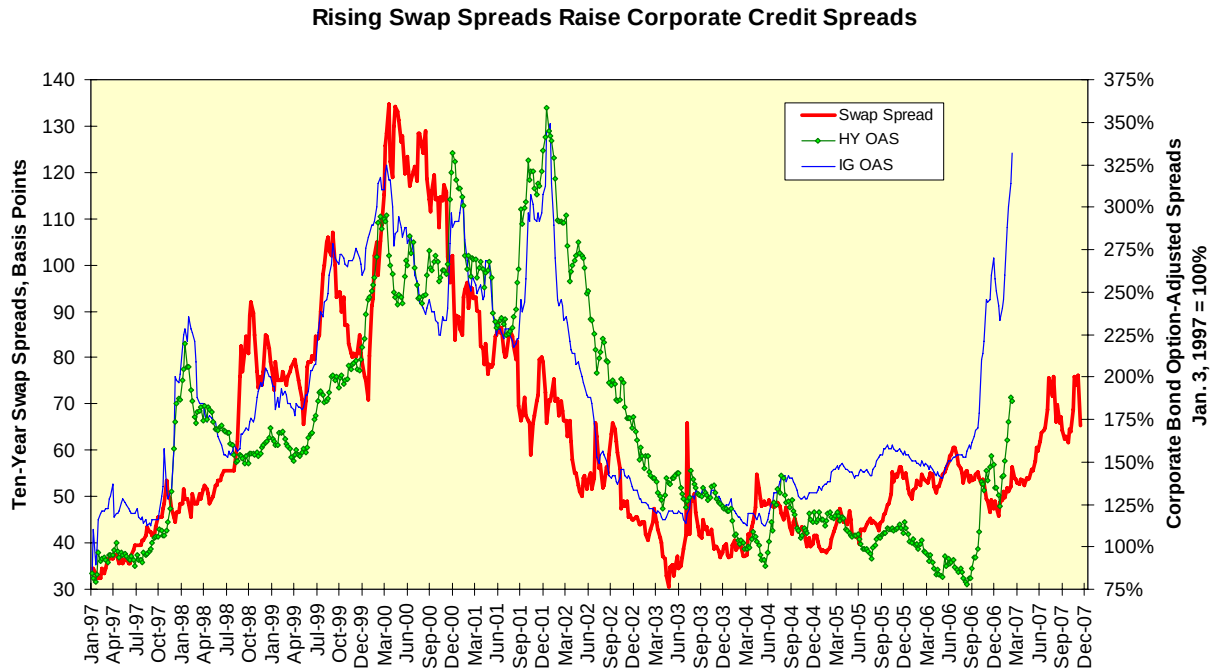
Ten-year swap spreads rose as volatility jumped and Treasury yields fell. The divergence was reminiscent of market conditions during the 1998 Long Term Capital Management debacle, noted with the green vertical line.



The large jump in volatility since the mid-July stock market high – and please do not confuse this with the mid-October stock market high – pushed swap spreads higher. But this was not a case of a rising tide lifting all boats so much as a few big waves knocking about a raft. While long-dated swap spreads were greater than short-dated swap spreads in July, noted with the red arrow, that relationship reversed into November, noted with the turquoise arrow.



So where does all this leave us? Higher swap spreads lead corporate credit spreads by about nine months on average. The recent increases in these credit spreads are still reflecting previous increases in swap spreads, which in turn reflect increases in volatility which in turn reflect the steeper yield curve which in turn reflects the Federal Reserve's rate cuts and the aversion to risk engendered by the credit crunch.



Until this situation unwinds, corporations are going to be paying more for debt and you are going to suffer a rockier road for holding those corporate bonds, high-yield ones especially. Oddly enough, this will not apply to convertible bonds, which are equity-linked and as discussed in July, benefit from higher volatility.

Monetary policy is a blunt tool; I have likened attempts by central banks to control short-term gyrations in the economy to performing brain surgery with a garden hoe. Their attempts to restore some semblance of order to the banking system by lowering short-term funding costs have been largely ineffective to-date and they have not been free. The consequences of higher inflation, the loss of their own credibility and higher funding costs in the corporate bond market will be felt for years to come.