Policy Shocks and Financial Stocks

Distraction can be a marvelous tool for those wishing to pull a fast one on their fellow man. We use it in a ritual manner in sports all of the time; a football offense that failed to disguise its intentions with an elaborate series of ruses and misdirections would not succeed very much and the opposing defense has to take care to hide its schemes. Basketball has its screens; baseball its hidden-ball trick, and so on.

All is fair in love and war, but what happens when your razzle-dazzle gets members of your own team out of kilter? We have a separate set of clichés for that, such as outsmarting yourself. In most endeavors, the simple things work year in and year out, while the elaborate and complex produce multi-year global financial crises whose costs rise into the trillions of dollars.

What if government "solutions," which almost qualifies as an oxymoron, contribute to the expansion, extension and perpetuation of the problem? This demonstrably occurred in the financial sector during the waning days of the Bush administration and early days of the Obama administration. Markets became uncertain over the rules of the game, with the unfortunate result costing investors and the economy additional losses on top of their already awful results from 2007-2008.

Volatility is a two-way street; while we tend to rail against it when it is moving against our positions; the simple fact of the matter is any violent move in your favor should be viewed as dangerous, too. In the first month after the S&P 500's financial index hit its low in early March, the total return on the index jumped 75.8%. If you owned a stock or a bond or a mutual fund that jumped that much in a short period of time, you might think about taking profit for a very good reason: Anything that can rise that quickly can fall that quickly, too. You might think someone, somewhere had been doing something wrong, and you probably would be right.

Debt Cost of Capital

We can return to the exact same analytic tool used last month (see "Utilities Shocked By Carbon Cap," November 2009). We can measure stress in a given industry by measuring the comparing how its yield curves across a range of credit ratings compare to the Treasury yield curve and how these changes have evolved over time.

The slope of any yield curve along the maturity segment between two and ten years can be described with a forward rate ratio (FRR). This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself. The more this number exceeds 1.00, the steeper the yield curve.

As a verbatim reminder from last month, yield curves can steepen in two ways. The first is for long-term interest rates to rise; this generally occurs in periods of strong credit demand, high volatility, high inflation risks or some combination thereof. The second way is for short-term rates to fall; this generally occurs when the Federal Reserve or another central bank deliberately drives short-term interest rates lower.

We can compare financial industry yield curves across credit ratings and compare them to both the Treasury and the dollar swap yield curves. A relatively steeper financial yield curve over time, especially at the long end, indicates the Treasury can claim investor funds at lower rates than can the financial industry. The fancy economic term for this action is "disintermediation."

Ever since the market low in March, the Treasury and swap curves remained relatively unchanged while the financial curves flattened at a lower level. On this measure alone, we could categorize the end results of multiple policy changes designed to rescue the financial system as a success.

Different Measures, Different Interpretations

Now let's compare the financial FRRs against the Treasury FRR over time. In Charts 1 and 2, the spread between the AA-rated and BBB-rated financial bonds' FRR and the Treasury's FRR narrowed with the onset of the global financial crisis in late 2007; much of this narrowing was due to the steepening of the Treasury yield curve itself. The narrowing continued until the AA-rated spread bottom on December 12, 2008 and the BBB-rated spread bottomed on January 16, 2009.

We get a different story, however, when we look at the option-adjusted spreads (OAS) between the financial bonds at the Treasury bonds. This is where the policy circus at the end of the Bush and the beginning of the Obama administrations really took effect. The AA-rated OAS narrowed sharply into mid-February only to surge to a new wide level at the very bottom of the stock market. It then fell just as quickly as it rose and fell steadily throughout the summer of 2009. BB-rated OAS levels fell into mid-January, only to surge back to previous record-wide levels at the stock market's low before narrowing sharply as well.

Chart 1: AA-Rated Yield Curve And OAS Comparisons

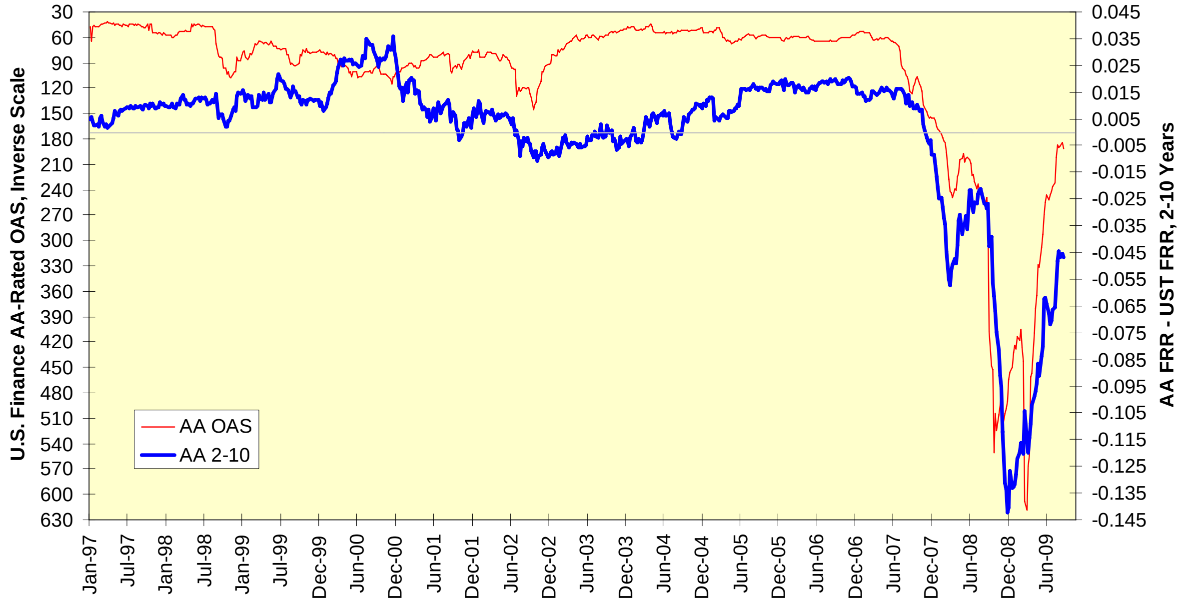
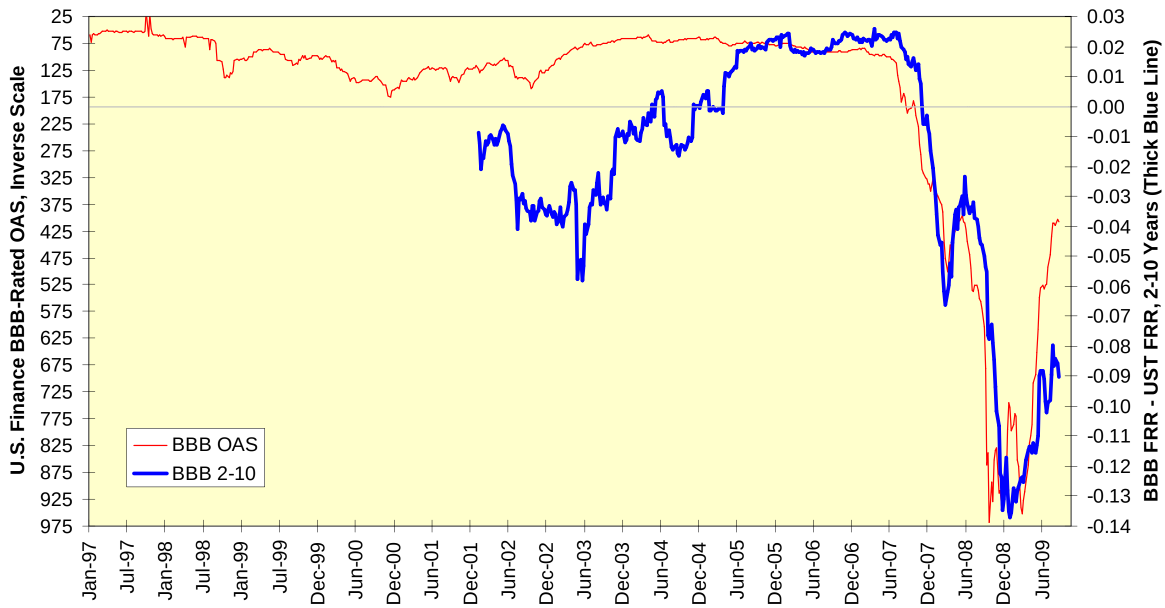


Chart 2: BBB-Rated Yield Curve And OAS Comparisons

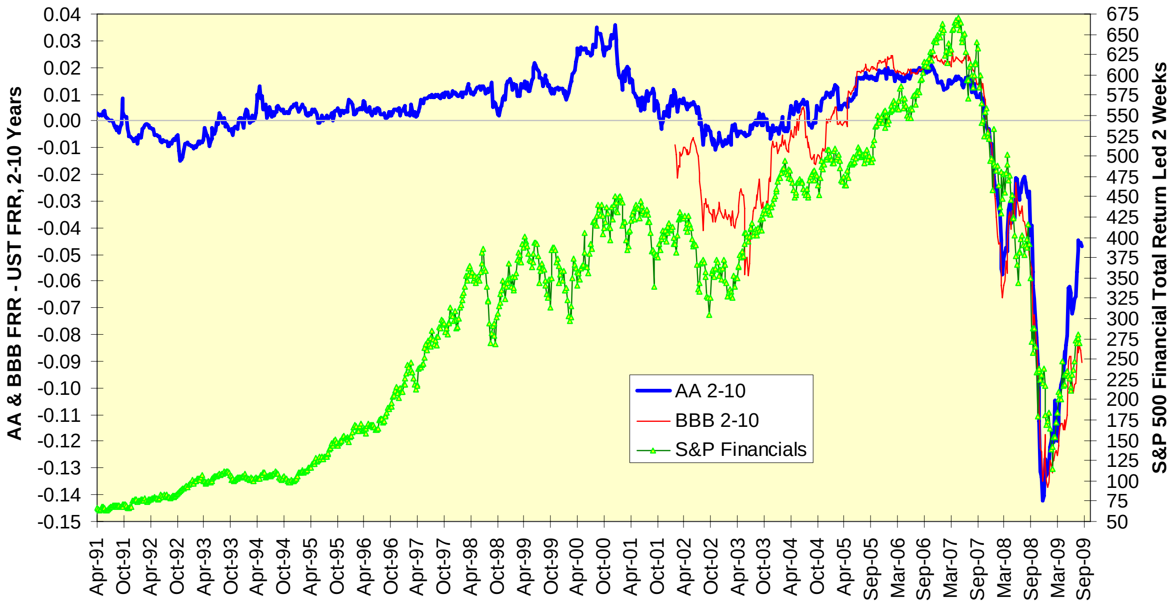


A glance at all of these rapid ups and downs in the OAS levels underscores an inconvenient truth: Policy stability matters. We can link the ups and downs of financial OAS levels to policies, proposals and programs. The only rational conclusion here is the financial sector and stakeholders therein such as employees and shareholders suffered needlessly while Washington, D.C., dithered. Real economic value was lost both during the selloffs and significant opportunity losses have been suffered by those who missed the start of the financial sector's rally. Like all such explosive moves off a long-term market low, much of the gains were realized by the beginning of May, just two months after the bear market's bottom.

The Stock Market Link

Just as we saw last month in the case of utility bonds, the yield curve spreads for AA- and BBB-rated financials lead the total return of their related stock index, in this case the S&P 500 financial sector, by two weeks on average. As we can see in Chart 3, no financial rally over the past two decades has occurred while AA-rated yield curve spreads were narrowing. The BBB-rated yield curve spread, which has a much shorter history, confirms this story.

Chart 3: Finance Stocks And Comparative Yield Curves



We can conclude, as we have so many times before, the stock market is beholden to the bond market. While the same improving business conditions in the financial sector can and will affect yield curve spreads, OAS levels and stock market performance, it is the bond market that leads statistically. And while stock market investors may get their animal spirits up and assign a greater risk multiple to a given sector, the bond market tends to be more sober in its assessment of corporate risk. This is not, and we repeat not, the same thing as saying the bond market is somehow "smarter." Not only is such a statement non-demonstrable with Granger causation analysis, it belies the simple reality the financial crisis of 2007-2009 was first and foremost a creature of complex fixed-income trades, not foolish equity trades.

A second and more sobering conclusion is just how much the financial sector has become indebted, no pun intended, to policymakers' whims. When the federal government bailed out the banks, they muscled into the business in a way low-level gangsters shaking down restaurants and taverns would understand. The federal government gave the banks a put option, but in turn claimed a call option on the sector's future profitability. This is a dangerous trade to say the least. The whole sector is at risk, once again no pun intended, to credit allocations being directed from Washington for political reasons.

If the federal government does in fact own the call option on financial earnings going forward, investors would be served better by emphasizing financial bonds as opposed to financial stocks. After all, non-convertible bonds have no upside equity exposure and at least in theory they stand senior to stocks in the corporation's capital structure; the federal government's depredations with bondholders in the General Motors bankruptcy signals this may not always be the case. This is a simple trade; do not outsmart yourself.