Stocks Will Say "Give Me Credit"

Of all the many lessons we can relearn from the ongoing Refco debacle is just how much each and every business is built on its credit. Take away credit, and we are back to a barter economy or, in the fondest wishes of the extreme gold bugs, a pure gold standard.

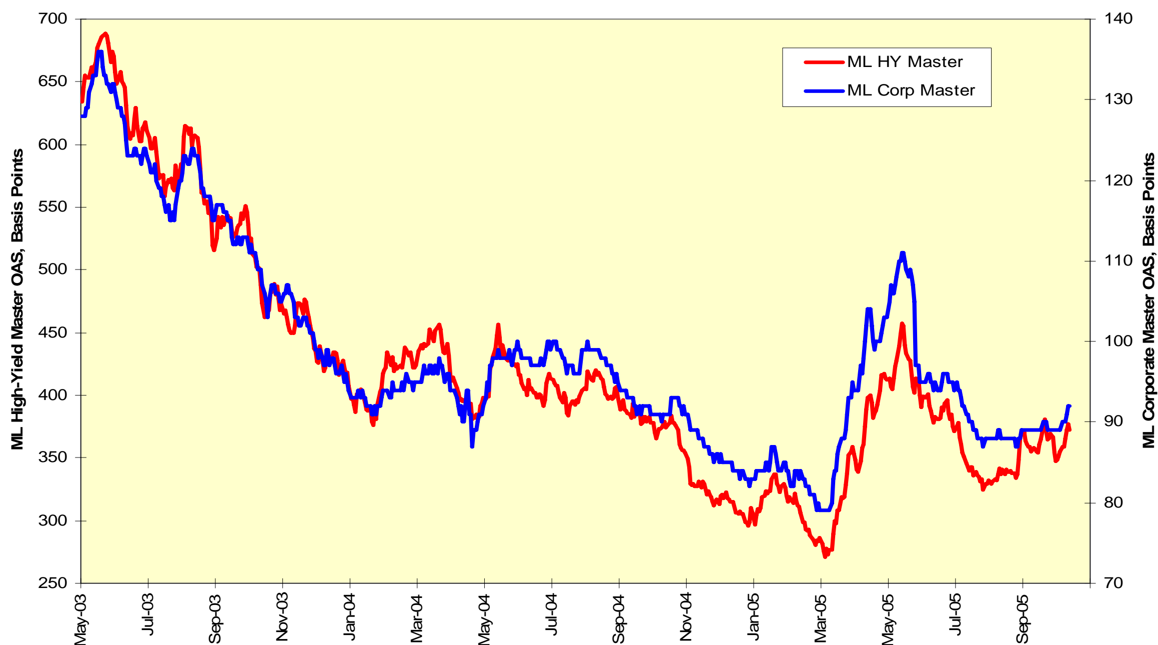
Credit costs do matter. No business can operate profitably and provide complete insurance to its creditors simultaneously once confidence is lost. Refco's 9% bond due August 1, 2012 plunged from $108.625 on October 7th to $34 on October 14th; it closed the week at a 34.962% yield. Is this junky enough for you? For comparison, a six-month Bank of Botswana certificate yields 12.33%.

The money supply, as discussed here in September, depends far more on extensions of credit in the banking system than on Federal Reserve actions. Does this have consequences for stocks? Absolutely: Most market crashes in American history are called the "Panic of [year]." The concept is simple, and was seen in action in Refco's case the same way it was in the Long Term Capital Management and 1994 Kidder Peabody cases. Every creditor has a powerful incentive to get his money out first. This creates the classic negative-sum game situation, defined as a group of players who in their haste to maximize their individual welfare minimize the welfare of the group as a whole. Think of a crowd trying to flee a burning theatre.

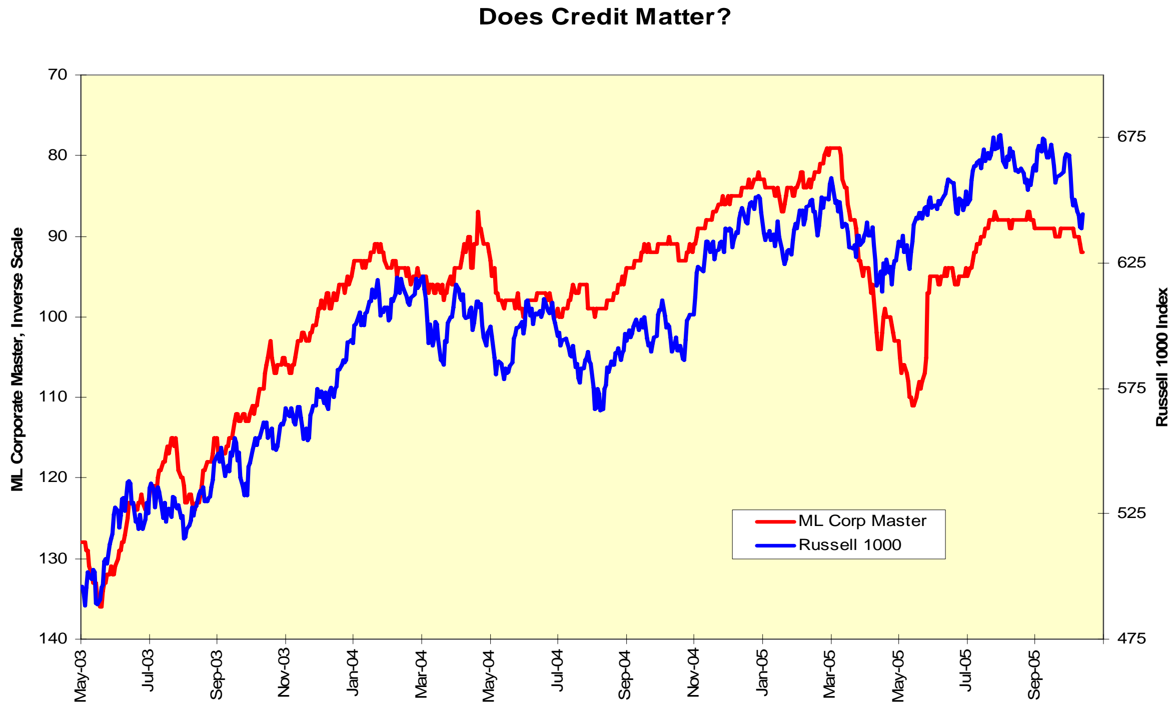
As an aside, this always has created a conceptual conundrum for a free-market Libertarian. The government has extended a series of deposit insurance promises it cannot possibly hope to fulfill if and when The Fan turns on full-blast. The Federal Deposit Insurance Corporation's one enduring effect has been to give banks a funding advantage – they can pay you less for deposits because they are "insured" – and as we saw in the 1980s savings & loan fiasco, deposit insurance can turn into a free put option in the hands of assorted miscreants. But so long as depositors *en masse* feel no urge to run and get their money first, retail banking panics have been consigned to the history books. Can a big white lie be a good thing? Discuss amongst yourselves.

There Are No Different Drummers

There was much discussion on the *RealMoney* site last week whether the stock selloff had extended too far, whether sentiment had reached an extreme, etc. Let's weigh in on the general debate by pointing to the cost of credit in the economy, a topic last discussed here in August. Corporate credit spreads as measured by the option-adjusted spread (OAS, the implied short-term interest rate spread between a risky bond and the Treasury line that accounts for various call, put and sinking fund features) of the Merrill Lynch High-Yield Master index and the Merrill Lynch Corporate Master (investment-grade) index have risen in recent weeks.

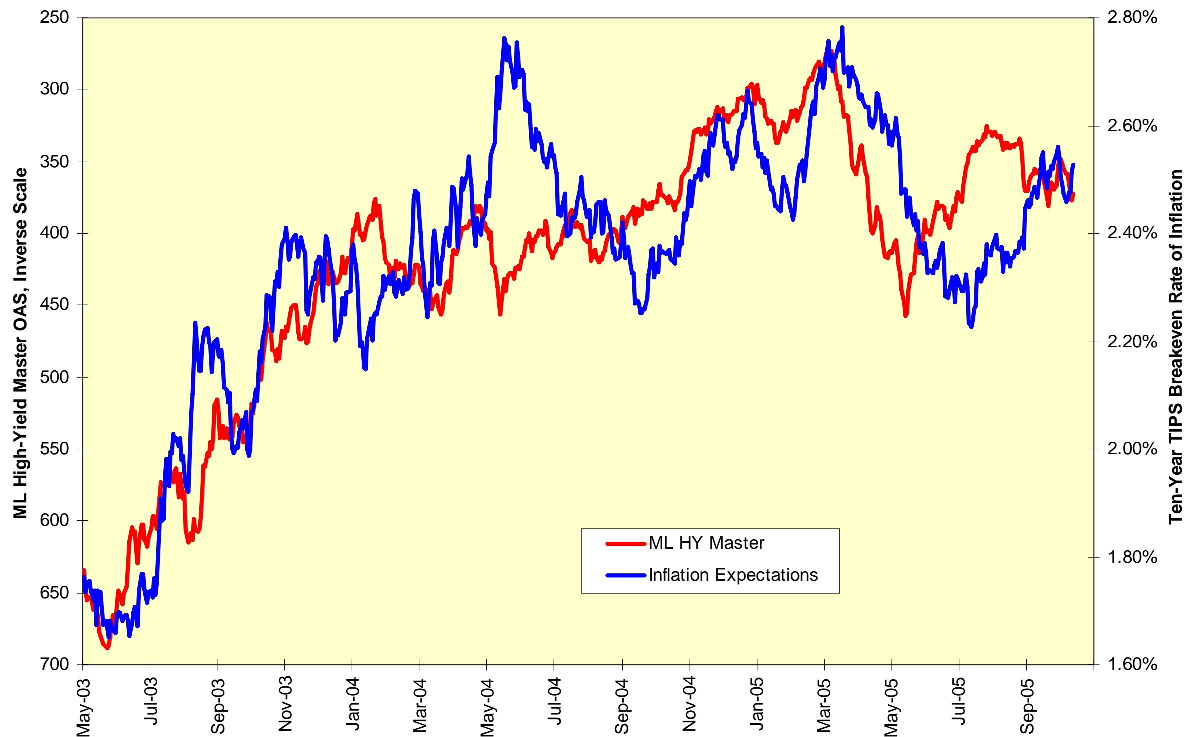


The higher the OAS is, the greater the levels of financial stress in the bond market, and by extension, the greater the headwind for stocks. If we compare the OAS for the Merrill Lynch Corporate Master, plotted inversely, to the level of the Russell 1000 index, an unmistakable correlation emerges. And as the long decline in OAS levels between the start of the bull market in May 2003 and March 2005 illustrates, credit spreads can trend for very long periods of time.



Credit Spread Drivers

The question whether stocks have reached a tradable bottom will be answered by the corporate bond market. The chief, but not sole, determinant of corporate bond OAS is inflation expectations as measured by the spread between nominal Treasury yields and the TIPS market. This relationship is an inverse one; OAS levels fall as inflation expectations rise.



Inflation expectations are, in turn, a function of variables as disparate as the shape of the yield curve and the level of the dollar. Rather than wander through the creation of an econometric model for all factors involved, let's ask ourselves the simple question whether inflation expectations are rising or falling?

To all those who said, "Falling," please see me after class.

Bettors And Debtors

Inflation, as a rule, rewards debtors. They get to repay their debts in a debauched currency, which suits them just fine. The Federal Reserve will, as we are witnessing, react to inflation by raising short-term interest rates and flattening the yield curve, two moves capable of culling the lame from the corporate herd. This establishes a little foot-race in the market: Will the Federal Reserve's inflation-squelching efforts take effect quickly and offset the decline in OAS levels associated with higher inflation?

I am going to take a deep breath and say no, not just yet. Just as stocks can succumb for short periods to "money illusion," the confusion of inflation with increased activity, so can corporate bonds. This is a short-lived phenomenon, though. Longer-term, higher inflation raises interest rates, shortens planning horizons and invites ever-tighter credit policies. Those will be fatal to weaker credits.

This suggests the Federal Reserve has a limited window of time to bare its teeth and do what needs to be done in killing inflation before it gets out of control. A little short-term pain can set the stage for a lot of long-term gain.