

Real And Un-Real Corporate Bond Rates

One of the more vexing problems facing both economists and casual pedestrians in Las Vegas alike is deciding what is and is not real. If we simply subtract a measure of inflation based on a price index, we miss out on the whole [psychology of inflation](#) and its role in affecting investment decisions. Moreover, all reported measures of inflation are backward-looking and the allegedly forward-looking [TIPS market](#) tends to follow, not lead, other indicators.

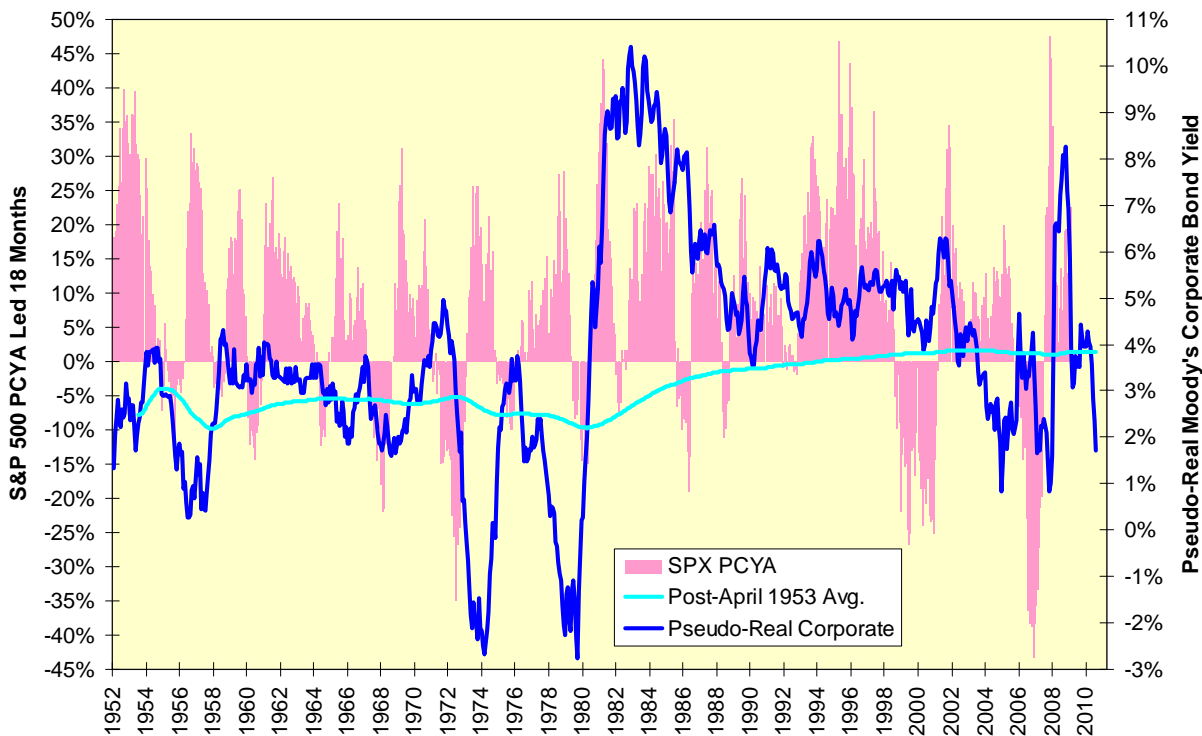
You might be wondering why this is an investment problem. The answer is simple: If you, in defiance of Polonius' dictum, either are borrowing or lending you have to decide whether the interest rate involved adequately reflects expected inflation. Borrowers hope it does not; lenders hope that it does and that, my friends, is why we have a market.

Pseudo-Real Rates

Most analysts solve the problem by ignoring it; the more personable out of this group then enter political life. The conventional approach is to take a nominal interest rate, such as the Moody's average corporate bond rate, subtracting the one-year trailing rate of inflation from it, and hoping people forget a one-year trailing rate is an arbitrary backward-looking subtrahend from the forward-looking minuend of corporate bond rates. I dub the result a "pseudo-real" corporate rate in honor of assorted pseudo-intellectuals I have known.

What does it look like? While I can take the series back to the end of World War II, the CPI measures after the removal of post-war price controls and then the suppression of long-term interest rates into the Korean War distort the data badly. The chart below starts in the early 1950s; the continuous average of the pseudo-real rate begins in April 1953.

Pseudo-Real Corporate Debt Rate Not Unusually Cheap



Three things of interest emerge. First, the average pseudo-real rate converged on 3.8% almost twenty years ago and has remained there. While there is no reason to believe this value has any intrinsic significance, we should never ignore a surprise in the data. Second, while the pseudo-real rate leads year-over-year returns in the S&P 500 by 18 months on average, the relationship is weak; you really need something more than cheap debt, such as rising earnings, to propel stocks higher.

Finally, let's take a look at where we are on the pseudo-real level as of May. The 1.7% rate is higher than levels reached during September 2005 or July 2008 and is certainly higher than levels reached during the inflationary outbursts of the 1970s. What does this imply for stocks? The first three episodes of negative or low pseudo-real rates were followed by higher stock market returns after the 18-month lag. The fourth, July 2008, did see higher returns 18 months later after some intervening unpleasantness.

However, the relationship is weak and I do have to note other periods of high pseudo-real rates, such as the mid-1990s, were associated with stronger stock returns to follow. The linking variable was, of course, strong growth leading to both good earnings and higher demand for funds. The best thing here is to note low corporate bond rates are not signaling the end of the world or anything close to it.