Money Supports Risky Bonds

When will be stop calling sovereign debt “risk-free” or “low-risk” and allowing its near-automatic inclusion in commercial banks’ Tier I capital? The answer is, “Never,” so let’s move on to bonds we define as risky such as U.S. and European high-yield debt and emerging market bonds.

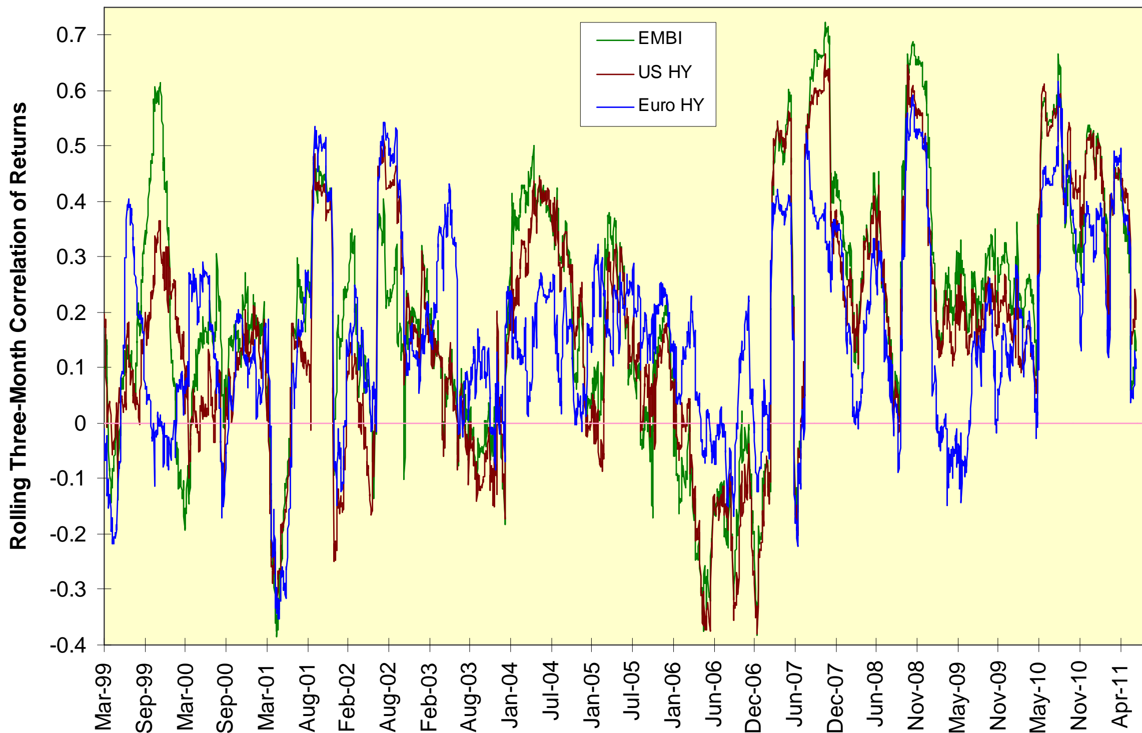
These issues had a bit of a pullback in May and June as part of the annual sell-in-May extravaganza and genuine full-blown frowny-face concerns about what would happen after QE2’s end. What a knee-slapper the last one is; the answer is the Federal Reserve is going to keep the money from the securities’ income and wait for the next market downturn for the markets to beg them to launch QE3. Asking Ben Bernanke what to do about printing money is like asking your barber whether you need a haircut.

Supported By Two Carries

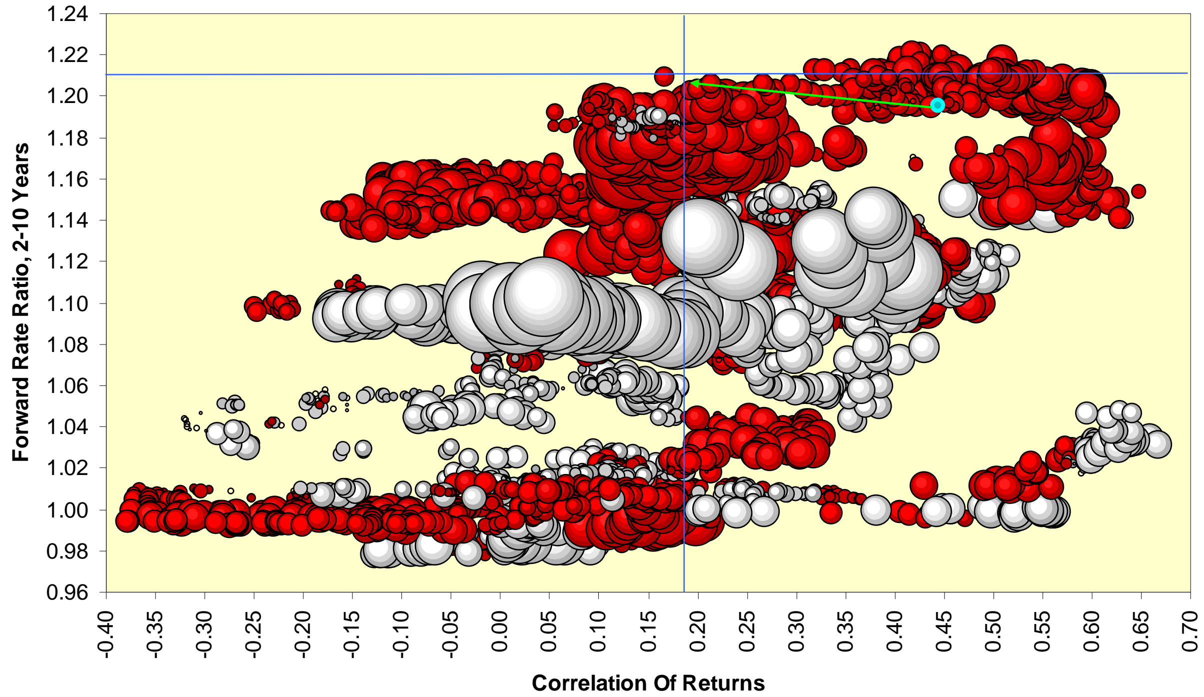
All three of these bond types are supported by two different carry trades, the carry between low- and high-yielding currency futures as measured by the Deutsche Bank G-10 Currency Harvest index and the U.S. yield curve carry between two and ten years as measured by the forward rate ratio ($FRR_{2,10}$) between them. The $FRR_{2,10}$ is 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 ratio exceeds 1.00, the steeper the yield curve is and the greater the carry.

If we measure the rolling three-month correlation of returns between the bond indices and the currency carry index, we see two patterns. The first is these correlations have spike bottoms, “bullish hammers” in candlestick parlance, when they reverse higher. The second is they are reversing higher right now as we speak. Well, as I write; I have no idea what you are doing right now other than reading this.

Currency Carry And Higher-Risk Bond Indices



What do these two carries indicate going forward? If we map three month-ahead returns for the U.S. high-yield bonds – the charts are nearly identical for the other two – against the $FRR_{2,10}$ and the correlation of returns against the currency carry, we see one simple and stark reality emerge: There are no cases for the past twelve years when a yield curve this steep did not lead to positive (red bubbles) returns for the risky bonds. Having a rising correlation of returns helps. The environment three months ago is highlighted with a blue bubble and the current environment is highlighted with a blue bombsight.



If, as Messrs. Bernanke and Dudley proclaim, part of their intention was to chase people out of safe assets into some financial opium designed to make them forget the June payroll number showed that in this great land of ours we added enough jobs to fill a basketball arena, then they are accomplishing their goal. Loose money will support risky bonds and that, by extension, supports stocks.