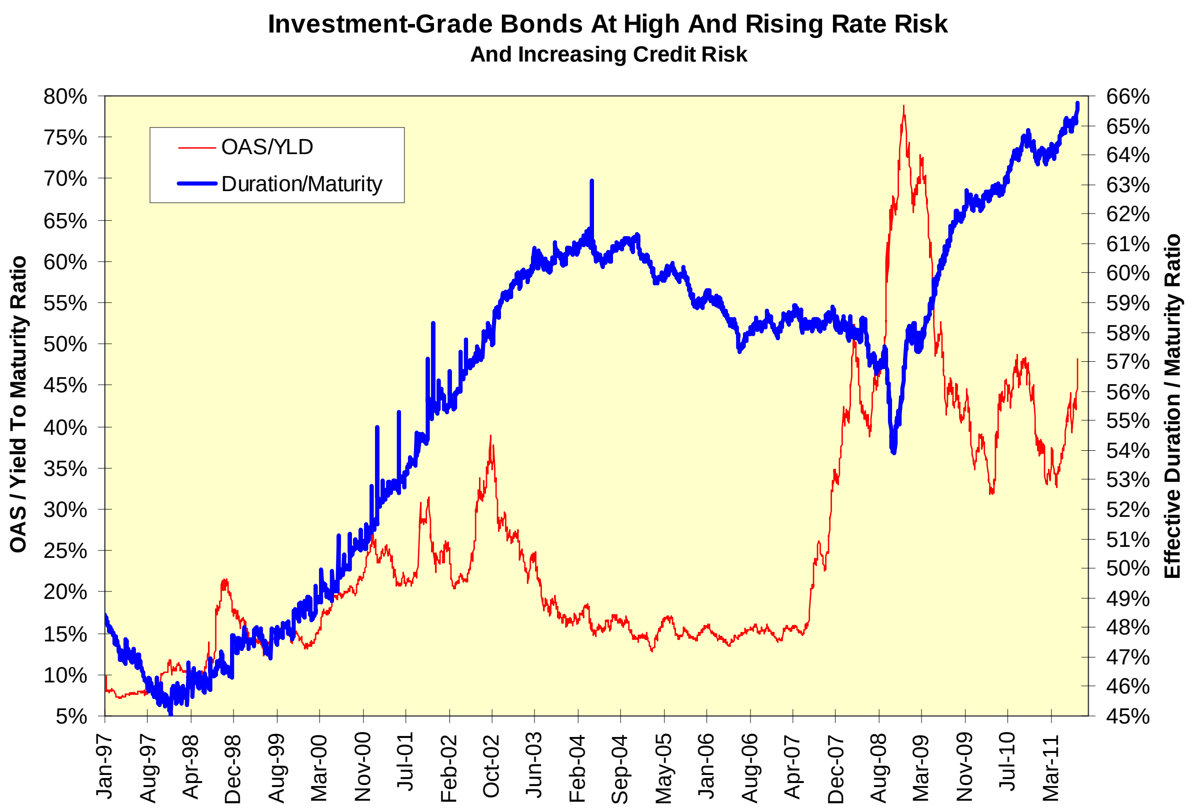
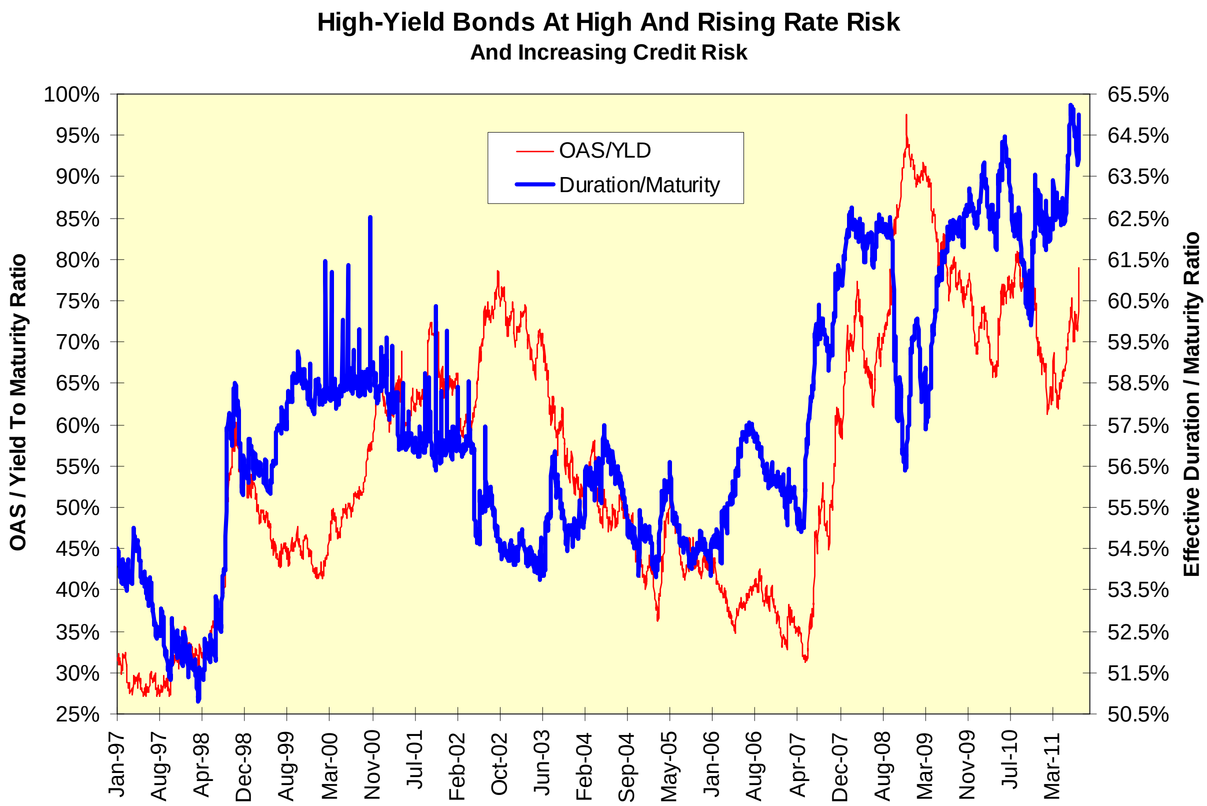
Corporate Bond Risks Rising

Please note how I say, “risks” and not the singular “risk” in the title, not that there was either a reward or a penalty associated with your initial reading. We can decompose a corporate bond into its Treasury-linked interest rate component, the part we used to call “risk-free” until we were disabused of that notion and the corporation’s specific credit risk along with a generic asset-class risk linked to the spread between Treasuries and interest rate swaps.

Let’s construct two ratios to measure interest rate risk and credit risk, respectively, on a normalized basis. The first will be the ratio of effective duration to maturity. As yields fall, the effective duration of a bond rises toward its maturity; the duration of a zero-coupon bond is its maturity. This measure has reached its post-1997 high for both the Merrill Lynch investment-grade index and is just below its recent high for the high-yield index.

The second measure is the percentage of a bond’s yield represented by its credit spread, here measured by the option-adjusted spread (OAS). Once again, the maximum ratio here is 100%; this would represent a Treasury yield of 0% with the bond’s entire yield representing credit risk. These ratios are rising for both the investment-grade and high-yield indices, but they would have a long way to go before they hit 2008 levels.





In some further analysis, not shown graphically, we can project three month-ahead returns for these bond indices as functions of these two risk measures. They are negative for the investment-grade index and indeterminate for the high-yield index. The indeterminate part derives from the current combination being so unprecedented on an interest rate risk basis that we have no past reference points.

A similar conclusion, also not shown graphically, can be made for realized bond volatility: We should expect higher volatility for the investment-grade issues and are unable to make a projection for the high-yield issues.

Corporate bonds are now faced with a serious risk: Should their credit spreads expand faster than Treasury rates decline, almost a given in any risk-averse environment, especially one wherein Treasury rates have plunged, returns will be negative and realized volatility will increase.

As both stocks and corporate bonds are claims on the same corporate cash flow stream, it makes little sense for investors to flee stocks and embrace bonds. That they are tells us all we need to know about how badly investors have been scalded over the past decade. A similar development after the Great Depression led to a prolonged period in the 1940s where dividend yields had to be greater than bond yields to induce investors to shift to stocks.