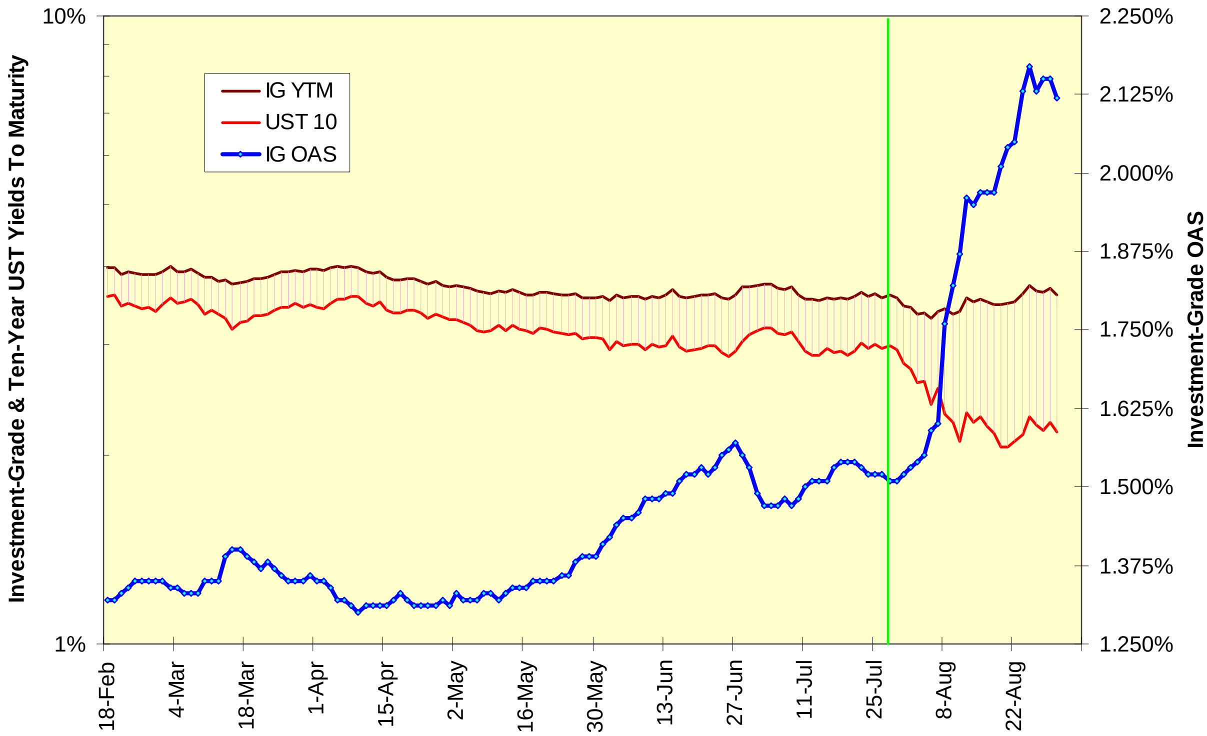
Dissecting Credit Spreads

As Zen masters have observed for centuries, financial spreads operate differently than your jaws do. Only your lower jaw, the mandible for those of you keeping score, moves; whether it does so too often is for others to decide. The upper jaw, or maxilla, remains fixed.

However, common financial spreads such as the option-adjusted credit spreads (OAS) discussed below involve two moving parts quite capable of moving independently of each other. Once we look at the two legs separately we can decide whether the August jump in both investment-grade and high-yield OAS levels signals a re-entry into a 2008-like horror show or is something far more benign.

Let's start with the investment-grade case and plot the IG index' yield-to-maturity and the yield on the ten-year Treasury on a logarithmic scale and the OAS of the index on a regular scale. The date of July 27, 2011 is highlighted on both charts below as it marks the takeoff point for credit risk.

Treasury Yields Fell Faster Than IG Yields Rose



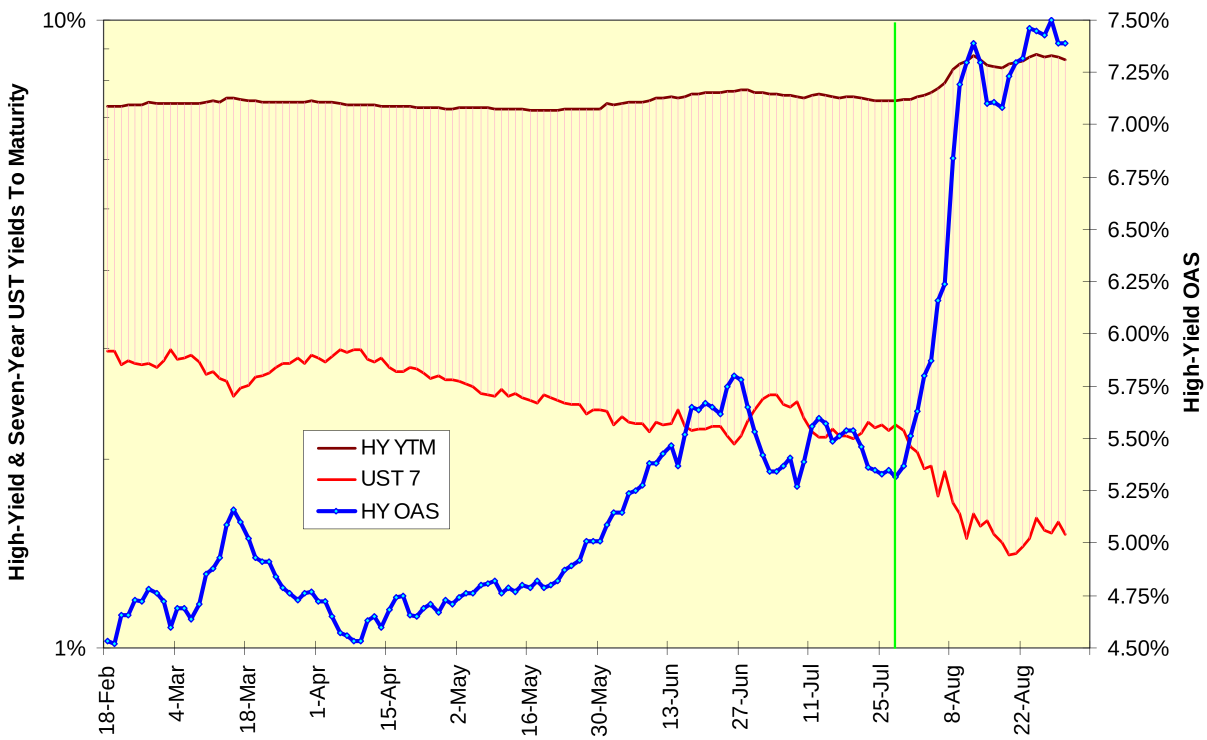
If you look at the IG yield line and think to yourself, "Hmmpf; it does not look as if anything changed," you are correct. The two periods are identical at a 92.75% confidence level. If you shift your focus lower and look at the ten-year Treasury line and think to yourself, "That thing fell out of bed so hard it woke the downstairs neighbors," you would be correct once again; the two periods' probability of difference is 84.05%.

Restated, that jump in investment-grade OAS levels that scared so many of the easily scared was more an artifact of falling Treasury yields than of rising corporate bond yields.

If we now shift focus to the high-yield index and use the seven-year Treasury to account for the HY index' much shorter weighted-average life the picture changes somewhat.

Here the HY index' yield rose more than 120 basis points, or 16.2% of its starting level over the second period. However, seven-year Treasury yields fell 74 basis points, or 32.9% of their starting level. Both jaws moved, but the mandible moved more.

Treasury Yields Fell Faster Than HY Yields Rose



The obvious question is whether the causes behind the Treasury rally, such as the flight out of European sovereign debt, the flight into Treasuries as default risk rose, (I cannot believe I just wrote that) the pledge by the Federal Reserve to keep short-term interest rates low for another two years and a string of weaker-than-expected economic data contributed to the move away from riskier assets such as stocks and high-yield bonds even though these factors had little measurable effect on investment-grade bonds.

The simple fact, noted in early August, was corporate bonds were overpriced along two different dimension, interest rate risk and credit risk. I wrote at the time:

> *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.*

What we saw over the past six weeks was a Pavlovian reaction to bad news; investors sold first and asked questions later. That they fled into Treasuries was not much of a risk reduction, but it felt like a risk-reduction. Viewed in that light, the rising credit spreads, for high-yield bonds especially, should not be viewed as an intrinsic increase in systemic risk but simply as a transfer of risk from a scary-sounding label to a safe-sounding one.