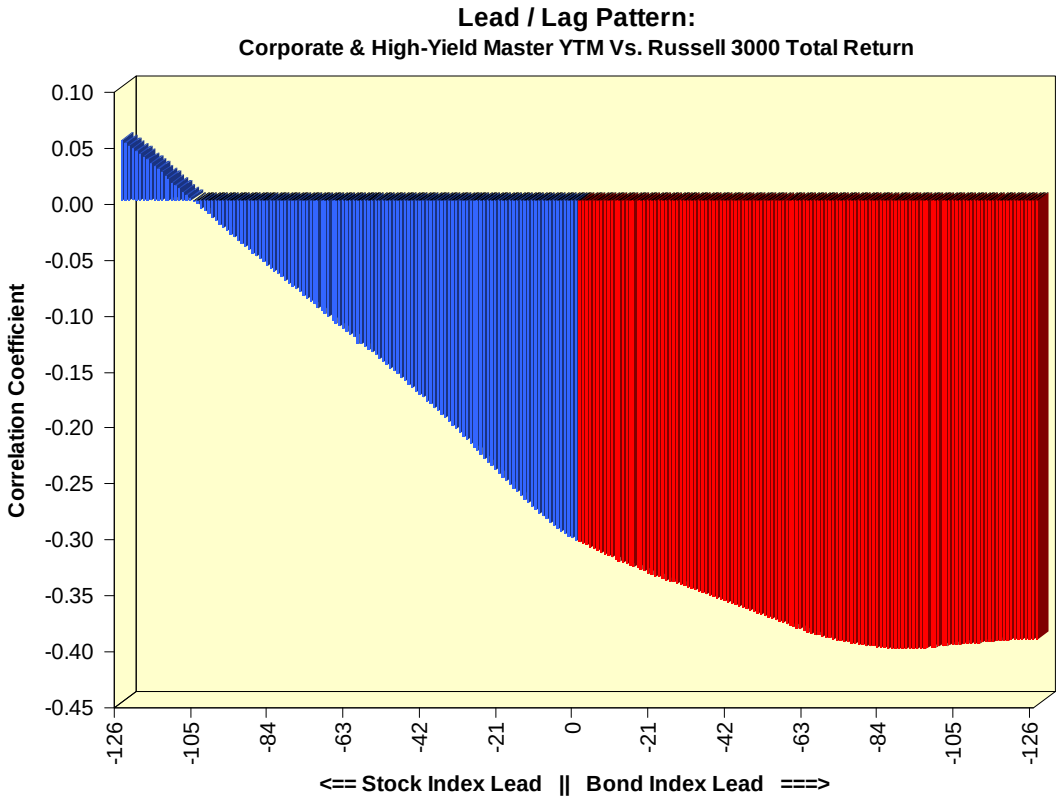
Another Look At Stocks And Bonds

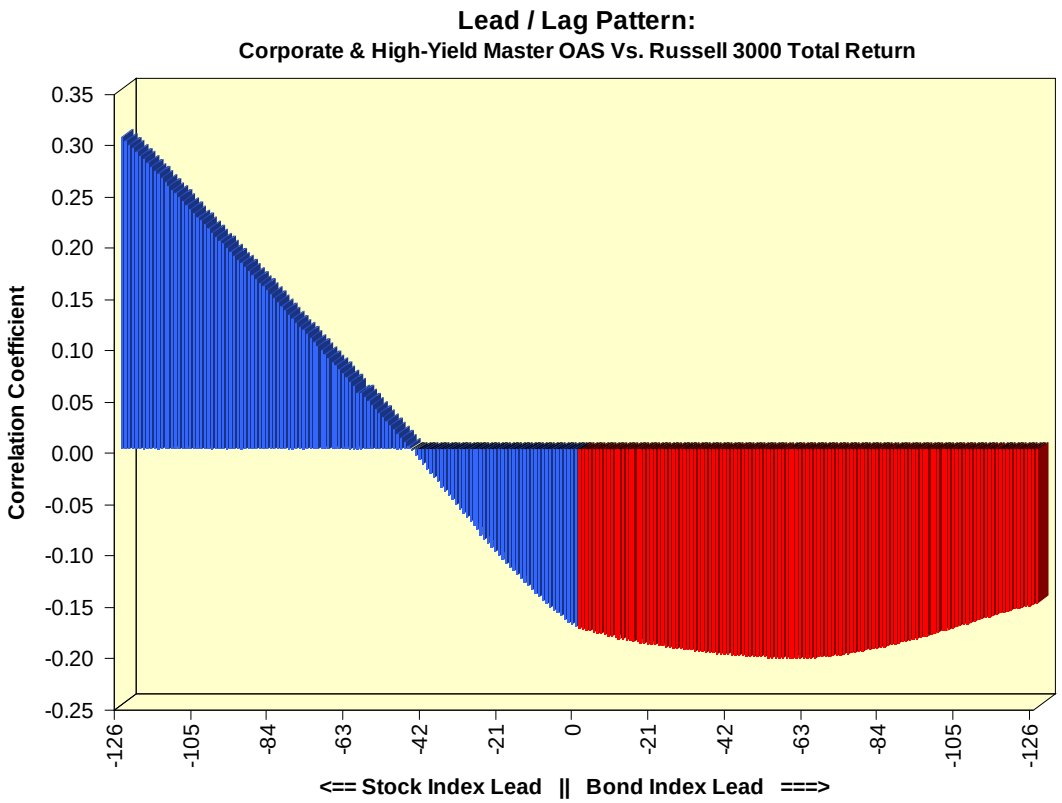
I addressed the issue of whether corporate bonds lead stocks last week, but the topic is broad enough to revisit it from other standpoints. That analysis was based, as it should be, on comparative total returns at the index level and looked at the issue from one direction of causation, whether corporate bonds lead stocks but not vice-versa.

Most bond traders look at the option-adjusted spread (OAS) even though the fair-value comparison between stocks and bonds involves the yield to maturity (YTM) for bonds and not just the risk component. As Treasury rates have decline significantly over the past year, the yield for corporate bonds at a static OAS level had to decline therewith.

Let's expand last week's look to include both OAS and YTM and to take a look at the lead/lag relationship from both sides. While the underlying analysis looked at eighteen different index-level pairs between the Russell 1000/2000/3000 indices on the stock side and the Corporate & High-Yield Master, A-Rated+ and High-Yield Master II indices on the bond side for both OAS and YTM, let's limit things to the broadest comparison, the Russell 3000 and the Corporate & High-Yield Master indices.

The charts below depict the correlation lead/lag structure between the indices over 126-day (six trading month) periods. As you move from left to right along the blue columns, you see the correlation of stocks against bonds from 126 days ago to no lag at all. The process reverses as you move from left to right along the red columns; here you seen the correlation of bonds against stocks moving from lag zero to 126 days ago. The first chart is for YTM; the second for OAS.





What we see in the stock case for YTM, the more important measure, is increasing correlation as we move to lag zero; in other words, until the relationship has no lead value at all. So much for the notion stocks lead bonds. In the bond case, the levels do not change very much over time and reach their minimum values between three and four months. This lag distribution is much too broad and shallow to be of much value statistically.

We are left with a conclusion so many find unappealing, that neither stocks nor corporate bonds have a strong leading relationship to one another using these yield measures just the same way they did not "Granger-Cause" one another on a total return basis. Both markets seem to have advocates; oddly, it is the bond market's fans who really want to believe, as they always do, their market is somehow smarter than the stock market.

I will return to my previous conclusion: Both stocks and corporate bonds are claims on corporate cash flows over different parts of the capital structure. The information is available to both markets at the same time. If one market led the other systematically, it would be evidence the "smarter" market's players were ignoring a major arbitrage opportunity to prey upon their more dull-witted cousins in the slower market. The world does not work that way, nor should it.