Declining Credit Risk Reinforcing Stock Market Rally

Narrowing Could Silence Bond-Market Sourpusses

I had a long conversation last year with someone I had not spoken to since college days; just one of those things, really. He is an anesthesiologist, which can really put you to sleep, but I did not have to press him on what it was he did for a living, exactly. I never am afforded that luxury and, curiously enough, never really have been for thirty-five years.

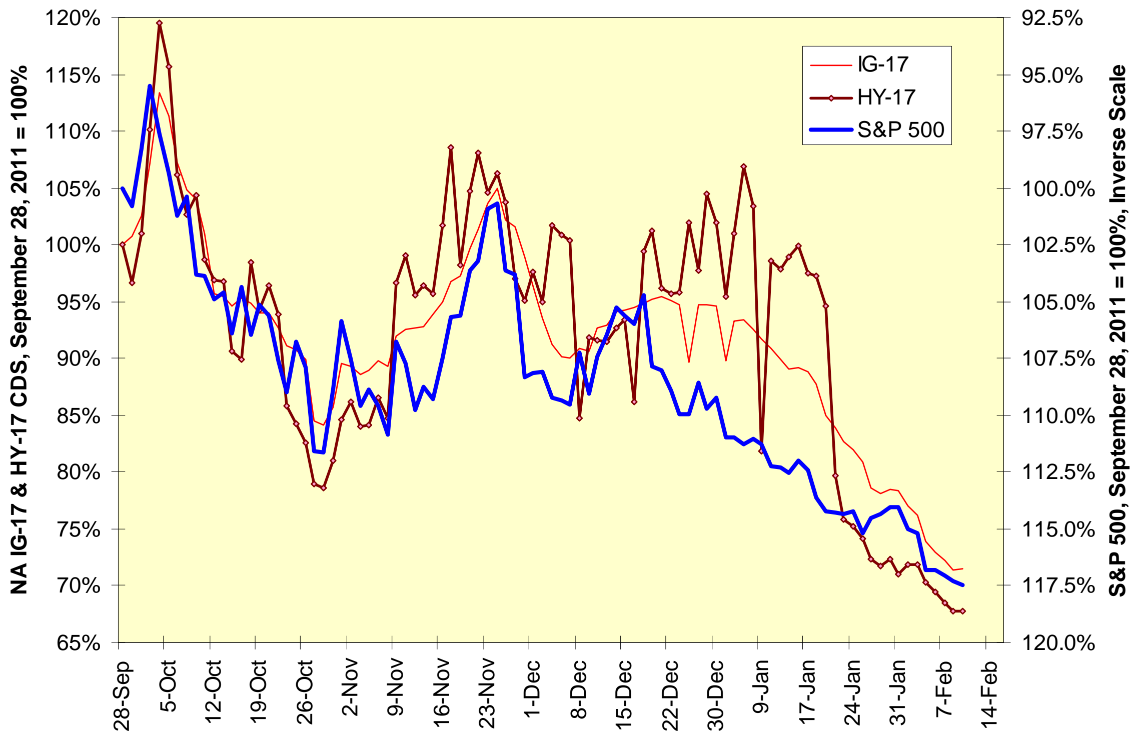
After describing my life as an economist and market analyst, he asked me the bomb of a question: Are you right? I laughed and gave him the one answer he never expected: My clients do not care so much whether I am right or wrong, something no one will know until after the fact; however, they do care deeply whether I am intellectually honest and rigorous.

Rally Monkeys

That is a long-winded way of getting to the point – "burying the lead" in journalistic parlance – of why you seldom see me joining the debate about whether the stock market is headed higher or lower. It always is, but not necessarily in that order. If you have a substantial portfolio and a long-term investing horizon, you pretty much have to be along for the ride: How are you going to bang in or out with anything more than a piker's stake, mad money as it were, without taxes and execution costs eating you alive?

But I thought I would enter the fray just for old times' sake, if for no other reason than I am tired of hearing the perpetual naysayers saying nay, or whatever it is they really say, about the stock market's move higher since early December. This is the crowd always nit-picking (they have nits, I guess) about some detail in the employment report or about government or central bank policies or about the quality of earnings versus expectations. But as one recent American president might say, the time has come for them to ceasify and desistificate: Their beloved bond market is confirming the stock market rally, and then some.

This is illustrated easily enough by mapping Markit's Series 17 five-year credit default swap indices for both North American investment-grade and high-yield bonds have been declining since their inception at the end of September 2011. If we re-index them and the S&P 500, here plotted inversely, to that time, the connection between declining corporate credit risk and rising stocks is visible for all to see.



And enough about the carping all of this is the result of central banks spraying cash hither and yon: Yes, it is true, and yes, that is why they are doing it. Money-printing, as I have said so many times before, cannot create output and employment, but it sure can lower debt service costs and inflate financial assets for otherwise doomed pension plans, endowments and other investors.

I remember when the Bundesbank finally stopped raising interest rates in September 1992. It was bullish for global assets and it propelled markets higher until a pause in 1994. That was followed by the stupendous bull market of the late 1990s. Was it cash-fueled by such factors as the yen carry trade? Yes, of course it was. Was it real? Yes, of course it was. Did it eventually end badly? Yes, of course it did.

The present party has a long time to run before its inevitable bad ending. There will be up days and down days, up weeks and down weeks, up months and down months. But at the end of it all, only those along for the ride have a chance to gain.