Re-Dissecting Credit Spreads

Central Banks' Money Shower Washing the Dirt Off of Junk

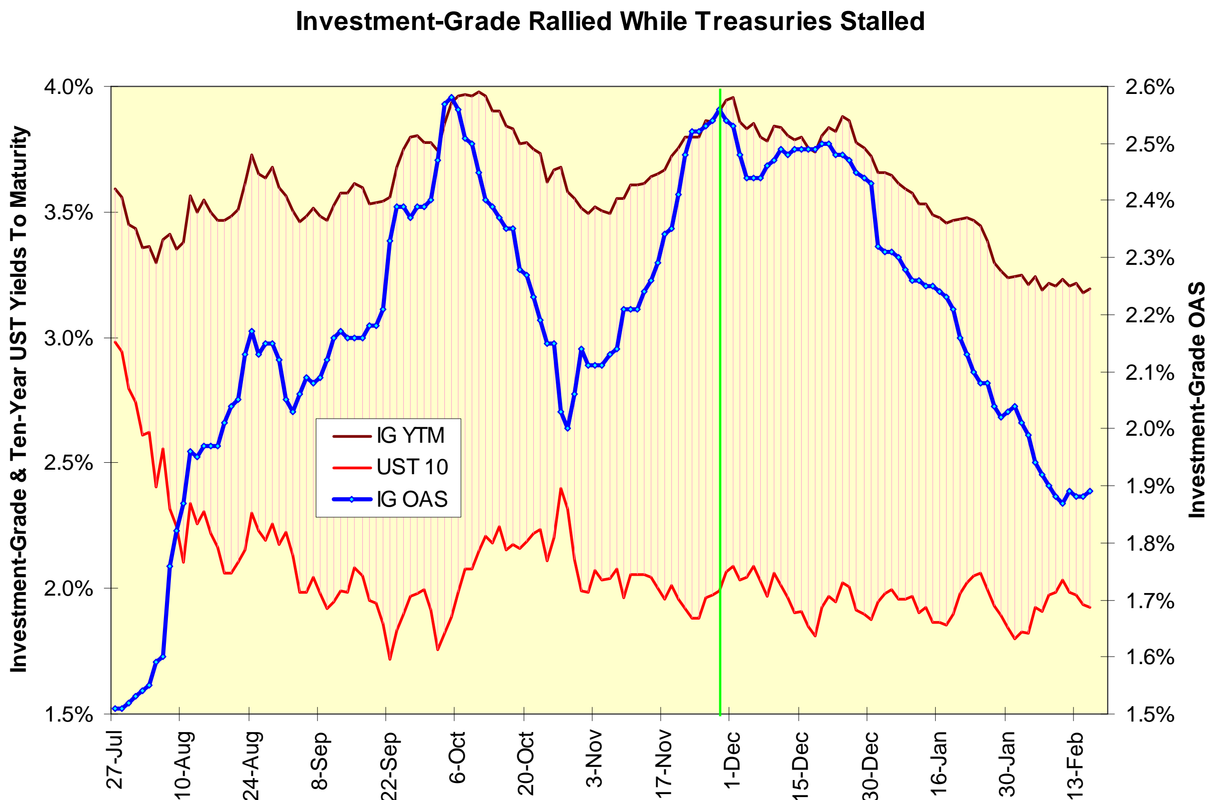
Let's jump in our time machines and take a trip all the way back to last August when the world was reeling from the combined effects of a dysfunctional U.S. political process, a downgrade of U.S. Treasuries, a credit crunch in the Eurozone and for all I know the hopeless position of the St. Louis Cardinals in the National League.

The option-adjusted spreads (OAS) on both U.S. investment-grade and high-yield corporate bonds were expanding, leading the sky-is-falling crowd to proclaim gloom and doom. However, as I noted in Dissecting Credit Spreads, those spreads were widening not as a function of investors shunning the corporate bonds but rather fleeing into the perceived safety of U.S. Treasuries.

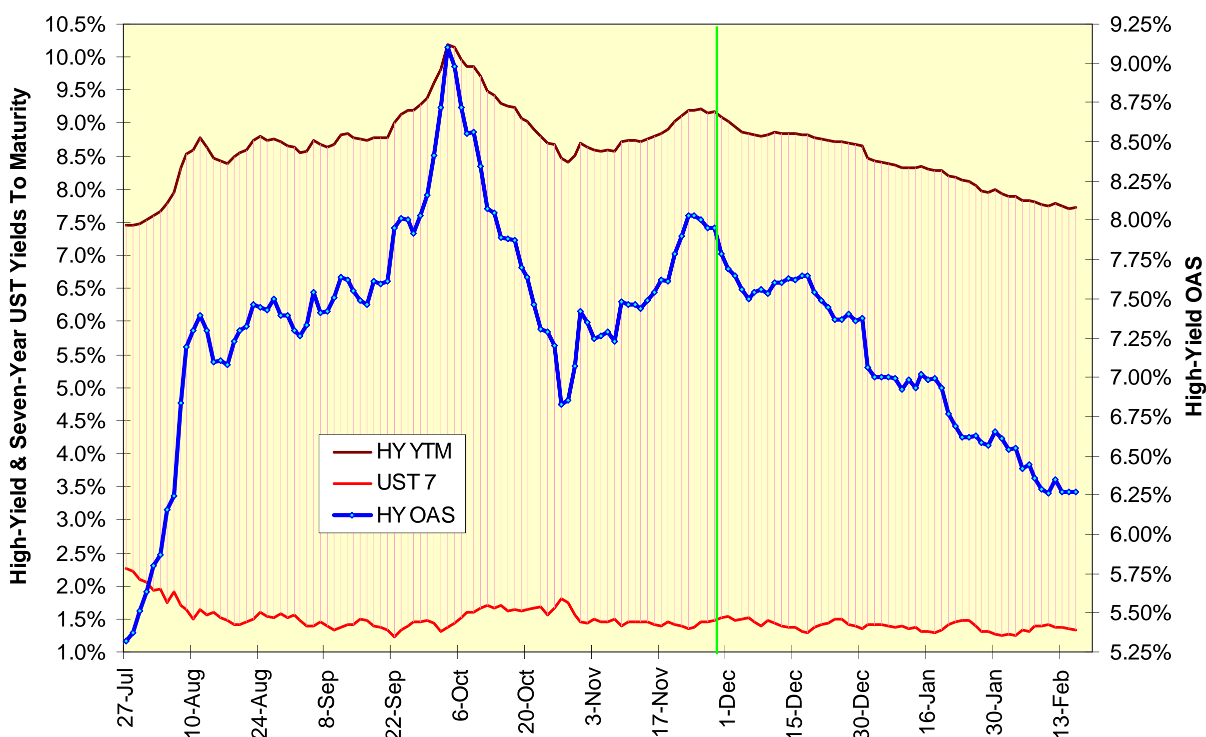
The shoe is on the other foot now: Credit spreads, especially for high-yield, are narrowing not as a function of Treasury yields, but rather as a function of declining yields on corporate bonds. Now that Ben's Bunch has chased everyone out the yield curve – you have to go out to a six-year Treasury to get 1% - they are chasing everyone out the risk curve as well.

A Little Help From Ben's Friends

The key date in all of this, especially for the investment-grade issues underlying ETFs such as the iBOXX Investment-Grade Corporate Bond Fund (LQD), is November 30, 2011. This is the date when a whole group of central banks (Herd? Flock? Covey?) expanded currency swap lines into the Eurozone and started breaking the credit crunch. Ten-year Treasury yields did not do much, but look at how the OAS started to collapse after that date.



If we move over to high-yield, which you can access via ETFs such as the iBOXX High-Yield Corporate Bond Fund (HYG) or the SPDR Barclays Capital High-Yield Bond ETF (JNK), the effect is even more pronounced even though the contraction in high-yield OAS actually began in early October. Once again, yields on seven-year Treasuries, a better maturity-match for this index, did little.



For you stat-hounds out there, the probabilities the return paths before and after November 30, 2011 are different are 99.83% and 67.20% for high-yield and investment-grade issues, respectively. A similar measure for the Bank of America-Merrill Lynch 7-10 year Treasury index is 53.60%. In absolute yield terms, high-yield and investment-grade yields fell 168 and 67 basis points, respectively.

As the debate remains whether central banks are going to accelerate, as opposed to ease, their money-printing programs, there is little reason to believe we will not see OAS levels retreat toward the credit bubble territory of May 2007. That is bullish for corporate bonds and bullish for equities. I would be remiss, though, not to add the usual caveat this will not be pretty when it ends.