European Corporate Bonds Bullish For Stocks

When Bonds Get Over-priced Stocks Follow

You have heard the joke before: Two fellows are camping in a tent when they hear a bear rustling outside. One starts to lace up his running shoes; the other says, “You cannot outrun a bear.” To which the first fellow replies, “I do not have to outrun a bear; I only have to outrun you.”

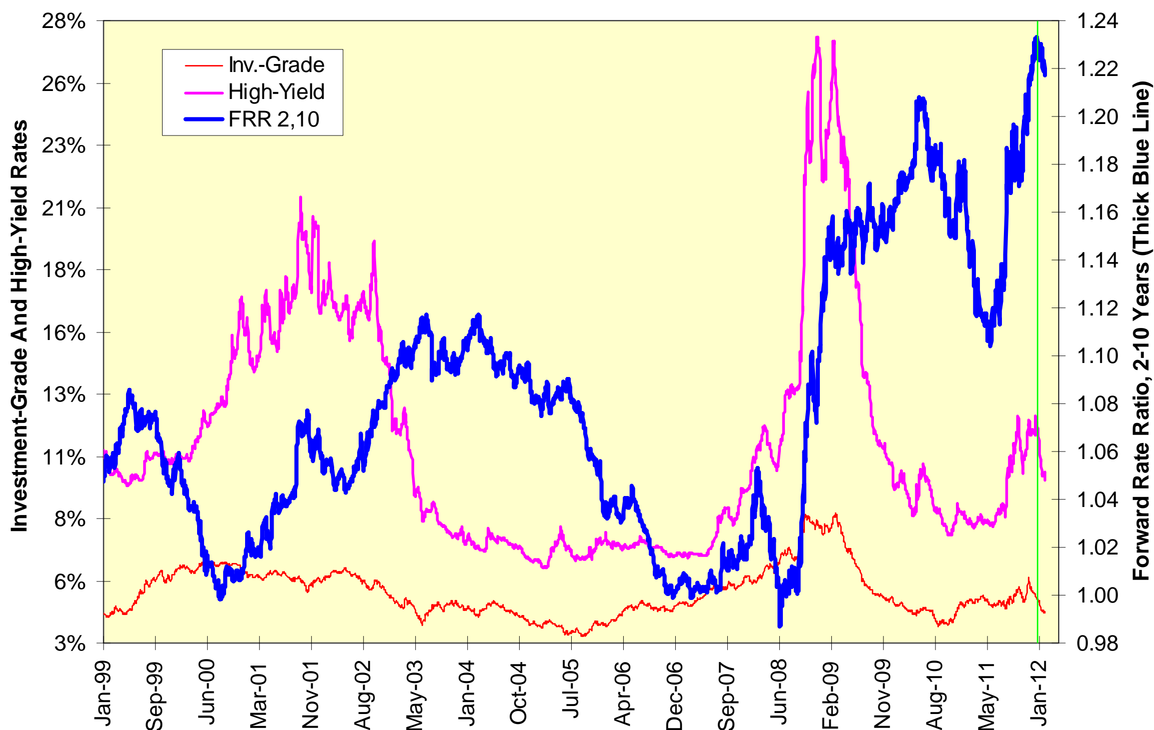
This is a perfect illustration of the relative valuation concept in investing: If an asset’s alternatives are unappealing, it can gain by the process of elimination. No one between now and the end of time will know just how much flows out of cash are motivated by the negative real yields imposed thereon by the Federal Reserve, and no one will be able to say where Treasury rates would be in the absence of official purchases. I think the answers are, “A great deal” and “Higher,” but as I cannot tell you where investment alternatives would be in any such scenario, I would be guessing.

European Corporate Bonds

Our good friends across the pond have provided us all with endless hours of entertainment over the past two years with the sovereign debt crisis. That led to a flight out of European assets, especially into U.S. Treasuries, steeper yield curves in the higher-quality European bond markets and inverted yield curves in the lower-quality ones, downward pressure on European equities and a boom for resort hotels capable of hosting various summit meetings.

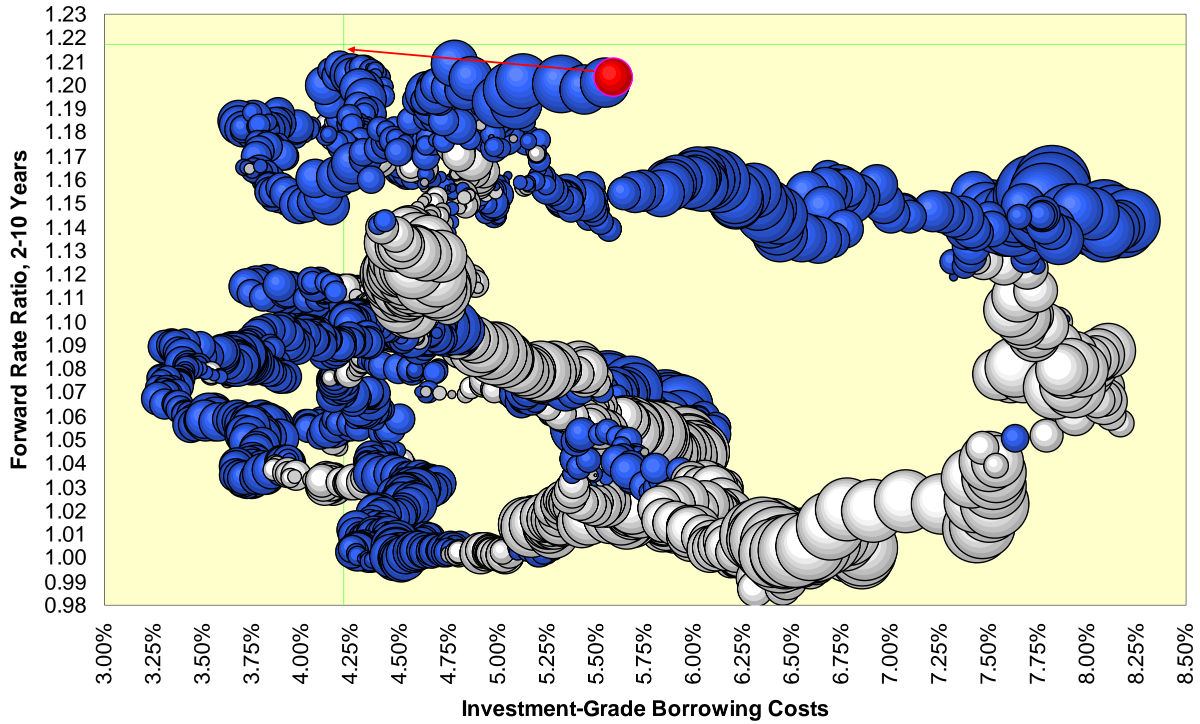
Right now the European corporate bond market is rallying on the belief the sovereign markets will not get – and this is a French term – schnockered. The benchmark yield curve as measured by the forward rate ratio between two and ten years, the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself, has been flattening since January 11, 2012. That is only part of the story; the important part is this flattening has been achieved by higher two-year rates. This is a sign risk-aversion as measured by a panicked inflow into short-term German debt, is abating. It is also one reason why I could write two days ago the pause in the improvement of short-term European banking indicators was not a concern.

European Benchmark Yield Curve And Corporate Bond Yields



As the yield curve flattened, rates on both high-yield and investment-grade corporate bonds in Europe have declined. This raises the price for European corporate bonds and therefore makes stocks a more compelling investment.

I can illustrate this for the three month-ahead return of the MSCI-Barra European Monetary Union index, something you can trade via the iShares MSCI EMU Index Fund (EZU). These returns are mapped below as a function of investment-grade bond yields and the forward rate ratio. Positive returns are in blue, negative returns in white. The last datum used, from three months ago, is in red and the current environment is marked with a green bombsight.



Even if the yield curve flattens, the huge drop in bond yields creates a bullish environment for European equities for the next three months, at least. This is simple and, I might add, the best way of outrunning a bear.