European Corporate Bonds To Support Stocks

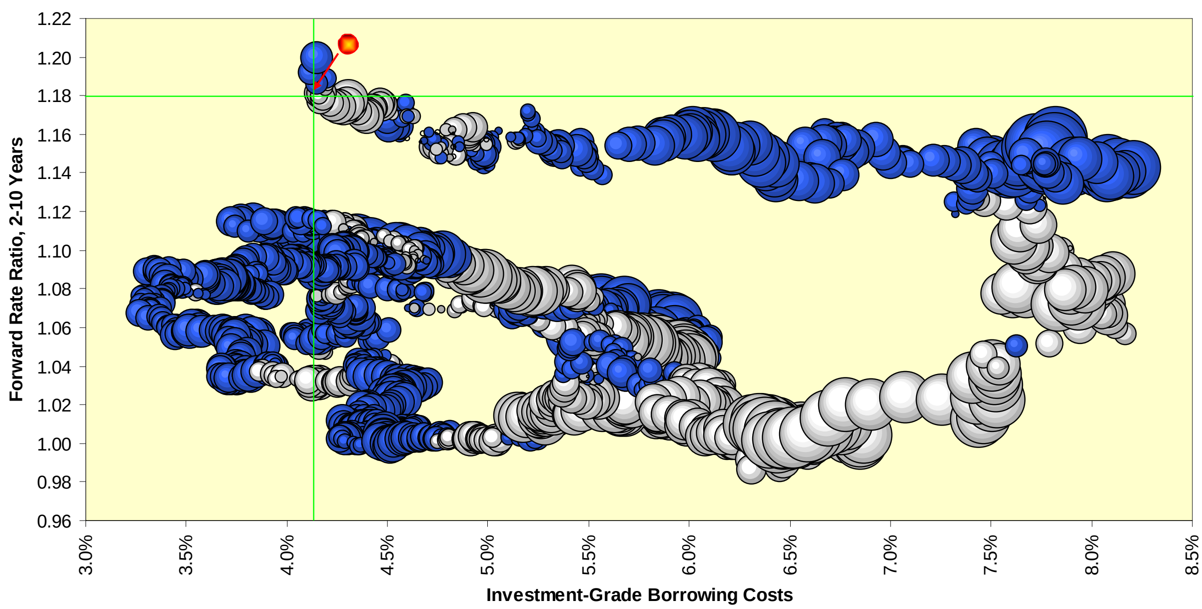
If anything should have been proven to everyone's satisfaction over the past decade it is low interest rates alone will not propel stocks higher. Yes, the fundamental equation for stocks has future dividend streams discounted by the cost of capital, but once you start to knock the numerator of this fraction down, you have to knock the denominator down even faster to do any good (I knew that numerator and denominator thing from fourth grade would come in handy one day).

Let's cross the Atlantic and head on over to the Eurozone, that happy community of people and nations who are forced to pretend they like each other despite centuries of history to the contrary. Our good friends at MSCI-Barra have been thoughtful enough to create an index of Eurozone stocks that you can access through the EZU exchange-traded fund, and our also-good friends at Bank of America-Merrill Lynch have created corporate bond indices for both investment-grade and high-yield debt in the Eurozone.

We can map the three month-ahead total returns for Eurozone stocks against both today's corporate borrowing costs and the shape of the yield curve in the Eurozone as measured by the forward rate ratio ($FRR_{2,10}$) between two- and ten-year benchmark notes. This is the rate at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate itself; the more the $FRR_{2,10}$ exceeds 1.00, the steeper the yield curve is. The data sample begins in January 1999.

The charts below depict positive prospective returns in blue bubbles and negative prospective returns in white bubbles; the diameter of the bubble corresponds to the absolute magnitude of the return. The last datum used, from three months ago, is highlighted in red-yellow and the current environment is noted with a green bombsight. The red arrow marks the path we have taken over the past three months.

Three-Month Ahead Total Return, MSCI EMU



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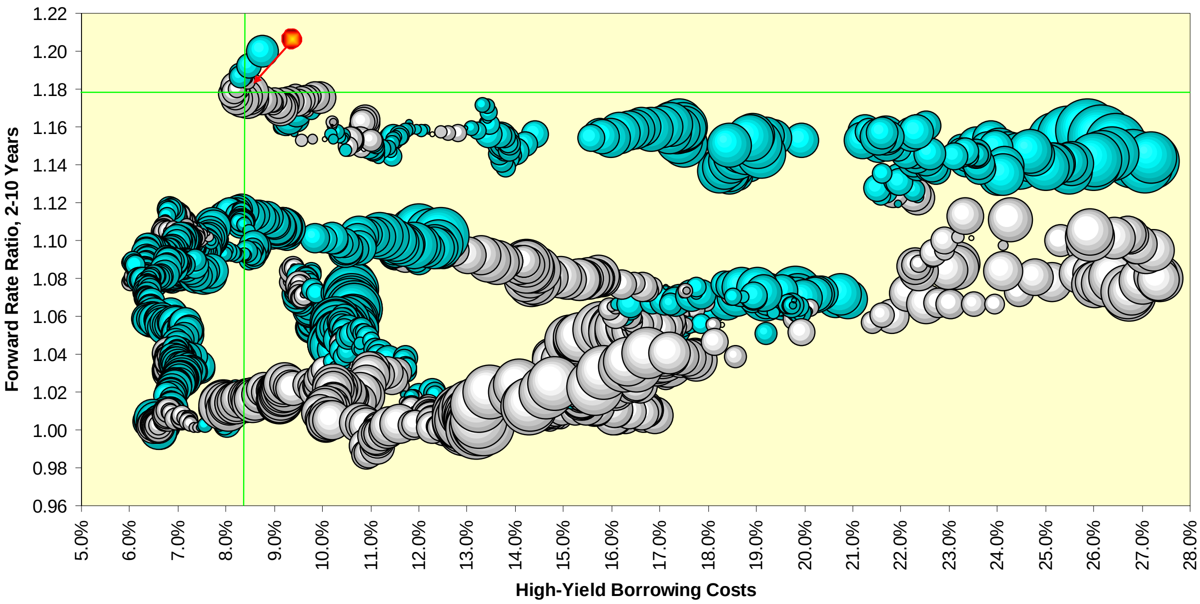

Two things stand out in these charts. First, most of the negative prospective returns occurred when the yield curve was much flatter than today's very steep level. Second, for the investment-grade issues in particular, the present low level of corporate borrowing costs is associated with positive prospective returns.

Of course, the Eurozone has nothing if not event risk. Oddly, the recent kerfuffle with sovereign credit problems contributed to both the ultra-steep yield curve and to the drive lower in corporate bond rates. As the European Central Bank will not be in a hurry to withdraw the stimulus, even though all of those banks passed its rigorous stress tests, the Eurozone will find itself in the same situation we have found ourselves in more than once over the past decade: The money has to go somewhere. That "somewhere" is more likely to be in stocks than in corporate bonds given the skinny yields available.