

## No Good News From Corporate Curves

Here's a question to ponder: Do they try to set the land speed record in a place like the Bonneville Salt Flats or on some twisty mountain road like Bolivia's infamous Highway of Death? The answer should be obvious.

Now here's a second question: Should you evaluate a market analysis tool in a smooth trend with few reversals or in a choppy market full of sudden reversals, false breakouts and all sorts of tests? Here the answer is a little less obvious. A short-term mean-reversion system can handle the sideways markets well, but will fail you miserably once a trend establishes itself.

But what we can agree on is any system, trend-following or mean-reverting, should perform well in a trend change. This dictum applies to fundamental analysis as well: If you fail to get the market's turns, you are worthless.

I say this as a windup to something that has perplexed me twice in the last year. If we go back to last August, the overriding market sentiment was neutral-to-bearish. The feeling was once the adults returned from their vacations they would put an end to all that silly buying, yes sir, and restore some rationality to an overheated market. When the market continued to march higher with scarcely a downtick for the next six months, the overriding sentiment was bullish-to-even-more-bullish.

Restated, we all failed ourselves. I would like to see a show of hands, backed by account statements, of all those who were massively long in August only to shift to neutral or short in mid-February.

### Corporate Bond Signals

Let's return to an analysis from [February 2006](#) on the information contained in corporate bond yield curves. While the mechanics of the analysis are somewhat complex – who, *moi?* – the interpretation actually is pretty straightforward. We can compare corporates and Treasuries on three bases, only two of which will be discussed here. The omitted basis of comparison is credit default swap (CDS) costs, last seen lurking around these parts in [June 2006](#).

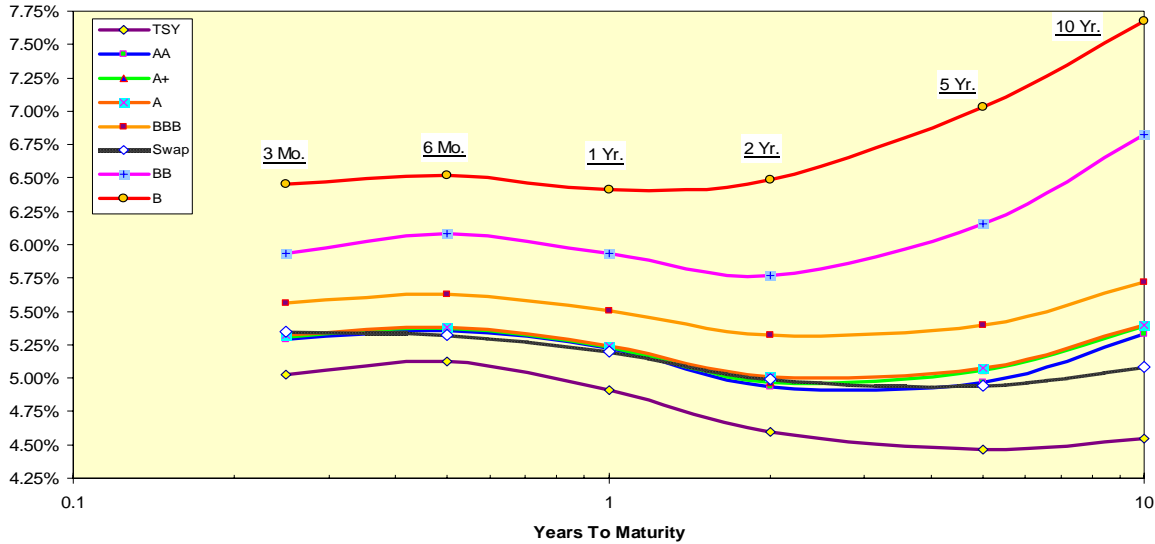
The two we will focus on are option-adjusted spreads (OAS), the credit spread between corporates and Treasuries with embedded options taken into account, and differential yield curve shapes, as measured by the forward rate ratios between the two bond markets. The forward rate ratio between two and ten years ( $FRR_{2,10}$ ), for example, 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 a FRR exceeds 1.00, the steeper the yield curve is; a FRR less than 1.00 indicates an inverted yield curve.

We only need to watch two things now, first whether OAS levels are rising or falling, corresponding to increasing or decreasing corporate stress levels. Stock prices benefit from lower OAS levels. The second thing stock investors want to see is increasing steepness of corporate yield curves relative to the Treasury yield curve, especially at lower credit rating levels. This indicates strong credit demand, a measure of health, in the corporate sector.

### The Present Situation

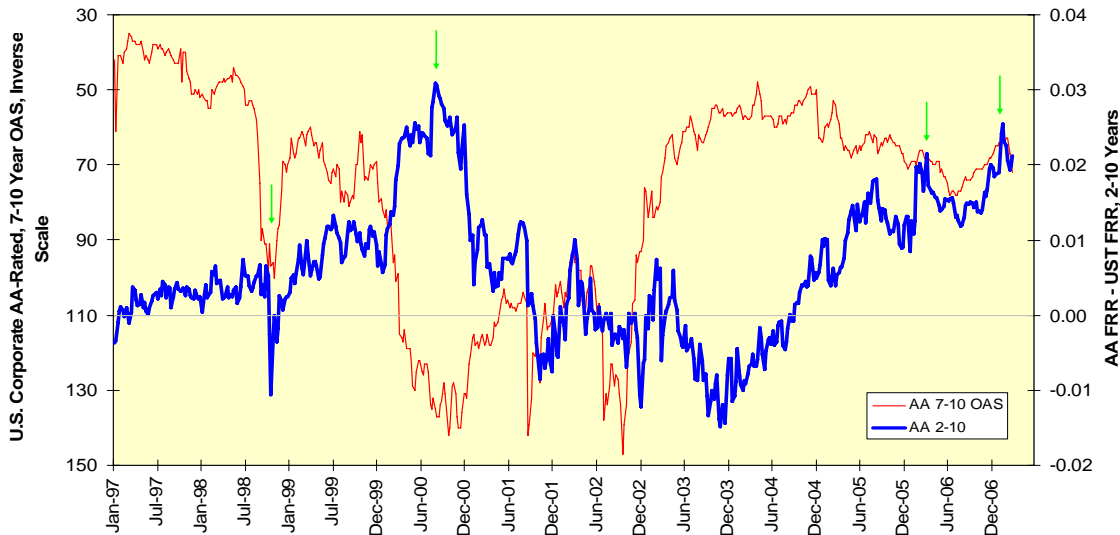
The chart below depicts yield curves for the Treasury, for swap yields, for two high-yield grades (B and BB) and four different investment grades; I wrote a column relating these ratings to corporate size last [December](#). Please note that while the Treasury curve is inverted, each step down the credit-quality curve leads to a more positively sloped yield curve. This is as it should be; investors should demand additional yield to compensate for both longer maturities and lower qualities.

### Comparative Yield Curves March 16, 2007



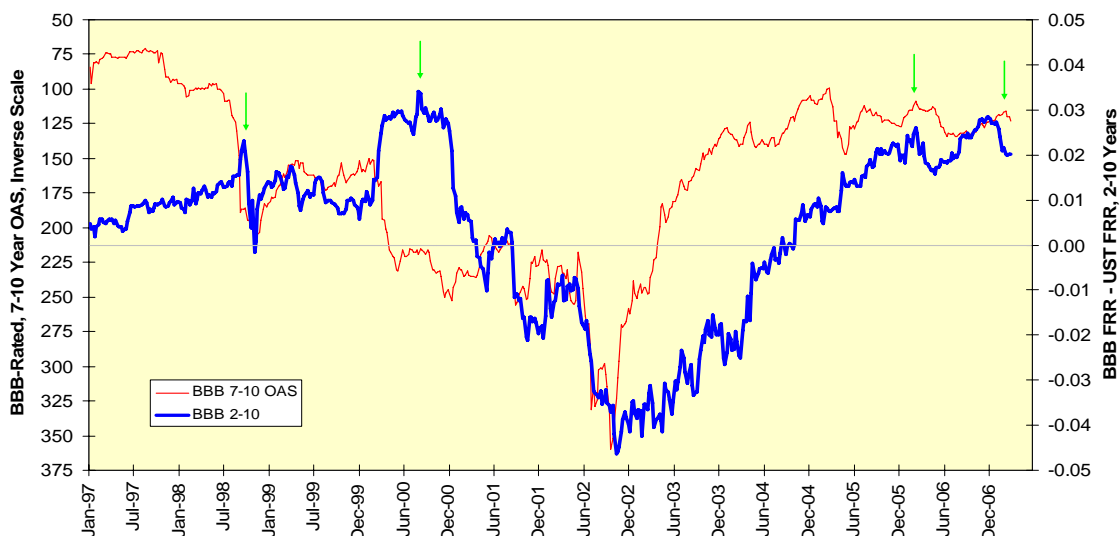
Next, let's isolate two investment-grade ratings, AA and BBB and map their OAS levels, plotted inversely, against their FRR differentials against Treasuries. Four periods are noted in each chart, the 1998 Long Term Capital Management debacle, the late August-2000 peak in the stocks, the March 2006 period where the Bank of Japan made its intentions of ending [quantitative easing](#) known, and the late-February 2007 market peak. In all four cases for the AA bonds, OAS levels rose and FRR differentials narrowed.

### Corporate Yield Curve Comparison To OAS



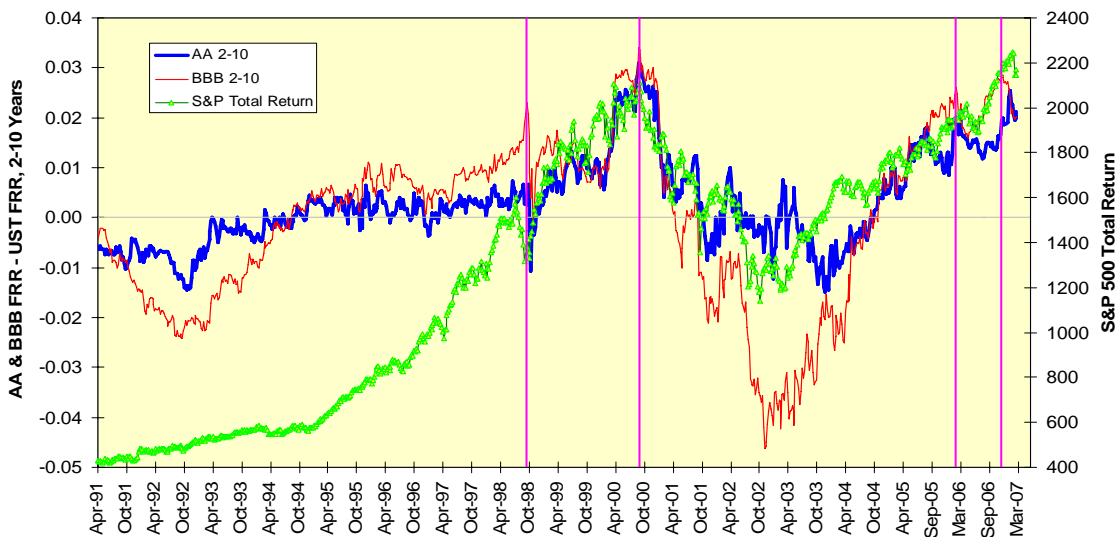
The picture for the BBB issues is slightly different. OAS levels did not rise in either March 2006 or in February 2007. This suggests weaker borrowers, for all of the hand-wringing about sub-prime lending and too-narrow credit spreads, simply have been staying out of the corporate bond market. This is consistent with a slowing macroeconomic growth outlook.

### Corporate Yield Curve Comparison To Treasury Curve



If we overlay the FRR differentials on a chart of the S&P 500 total return index, we see how each of the episodes noted above coincided with at least a short-term funk in stocks. The market snapped back quickly in late 1998 and again in mid-2006 when monetary authorities stepped in to ease credit. However, a longer and more-aggressive easing between 2001 and 2003 did little to arrest what turned out to be the worst bear market since the Great Depression.

### Stocks And Comparative Yield Curves



Where do we go in this episode? The corporate bond measure has yet to enter a sustained downturn; it has only emitted a loud warning. Central banks in Europe are raising rates, the Federal Reserve has given no indication it is going to ease and the Bank of Japan is unlikely to reverse course on its most recent and internally controversial tightening of credit.

Given this situation and background, a bullish conclusion is impossible to draw.