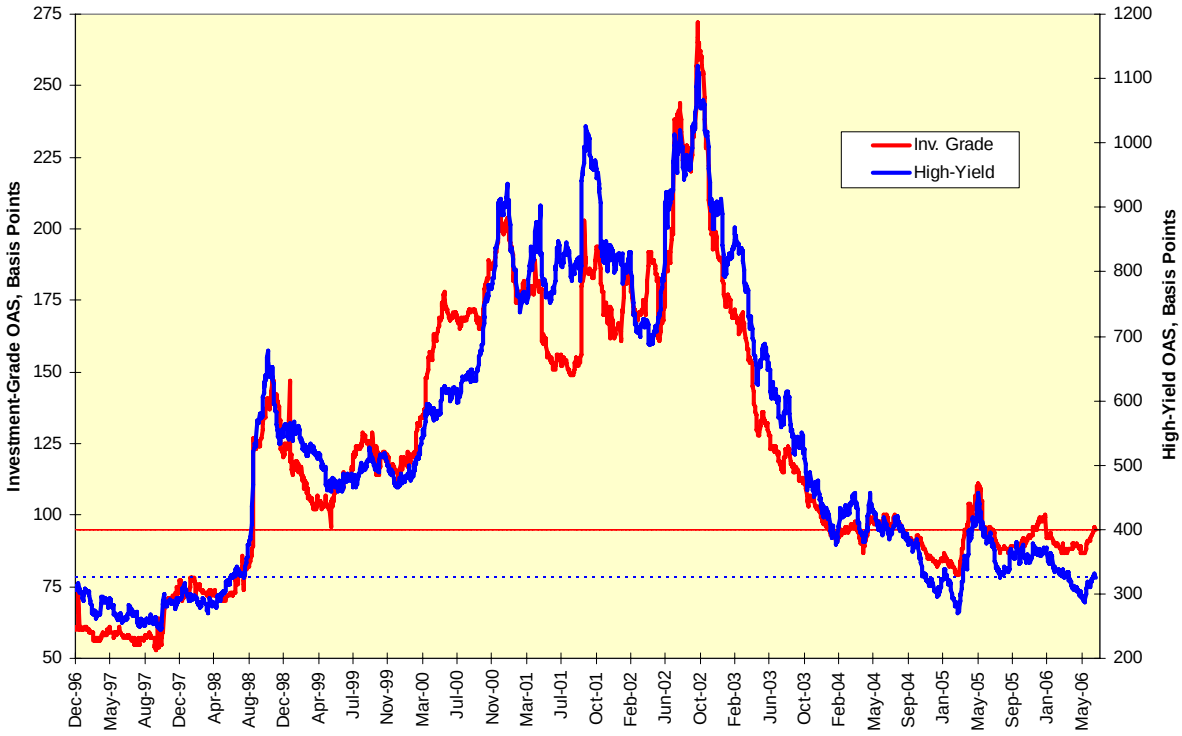
All Stressed Out From What?

"You can observe a lot just by watching." – Yogi Berra

The baseball literature is silent on Yogi's talents as a bond trader, but we could assume the observant backstop would have noticed all the talk about how tight credit spreads have been during the past three years. Just as the narrow VIX was asserted to be a sign we collectively were cruising for a bruising, tight credit spreads were cited as prima facie evidence corporate credit was priced incorrectly. Hellfire and damnation were sure to follow.

Of course, the alarmists have to address the issue of why we have been chugging along for more than two years with spreads for both high-yield and investment-grade bond spreads near current levels. In essence, credit spreads have not changed since it became apparent the Federal Reserve would have to start raising the federal funds rate.

U.S. Corporate Bond Spreads



The Bend At The End

Just as paranoid people have real enemies, alarmists occasionally are in tune with the market. Credit spreads have risen unmistakably since late February, the very time the yield curve came out of an inversion. Are these two events linked, or are there other factors behind rising financial stress?

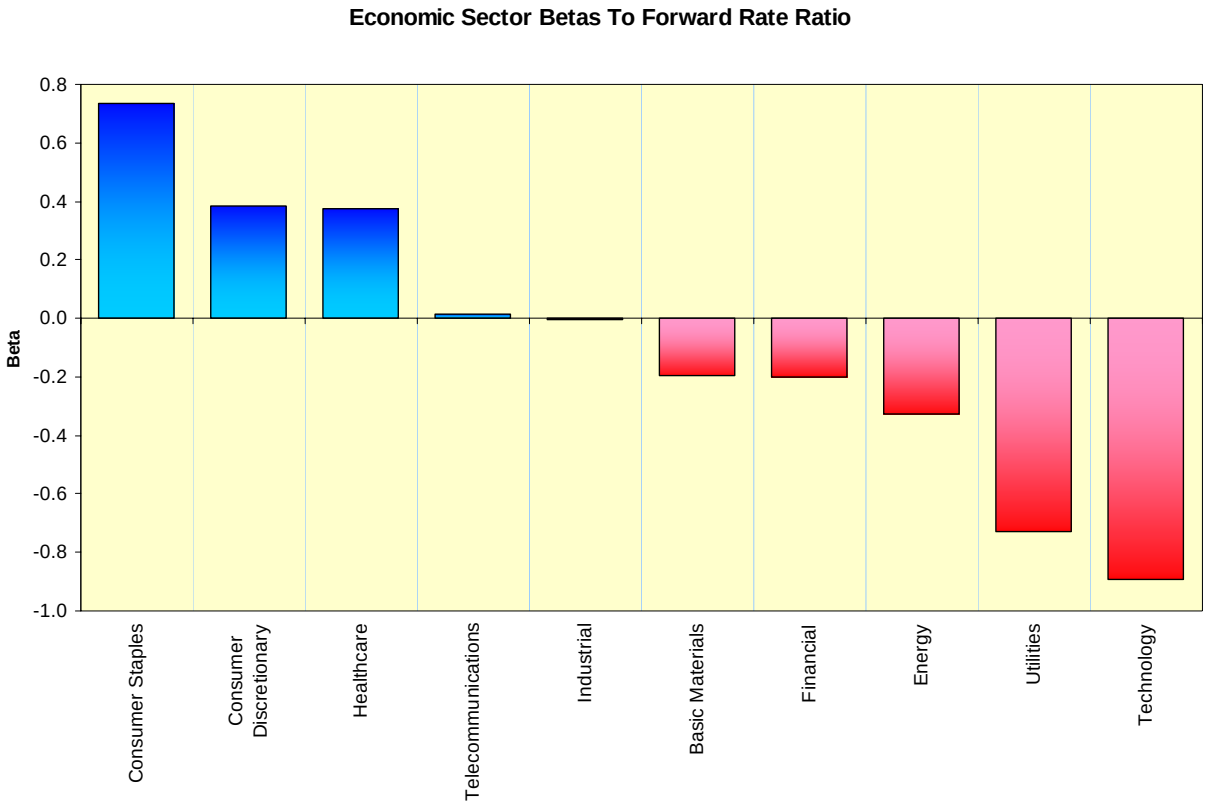
Let's return to an analysis introduced in May 2005 on the relationship between Standard & Poor's economic sectors and combine it with constructed indices of credit default swap (CDS) rates also introduced in May 2005 and the family of primal market factors first introduced in February 2005.

The idea here is simple even if the execution is not. The depth and liquidity of the CDS market, last discussed here in the context of Dana's bonds in March, has risen to the point where active corporate bond traders do not need to sell the bonds. They buy the CDS instead. As a result, the apparent yield spread between corporates and Treasuries remains static while the risk is transferred to the CDS market.

If we can link the movements in these CDS costs to primal market factors such as commodity prices, currency rates or interest rates and if we can extend the linkage to S&P economic sector ETFs and options thereon, we can analyze stocks, bonds, option volatility and credit quality together. Let's work through an example using the forward rate

ratio (FRR) between 2 and 10 years as a market factor. This is the rate at which we can lock in borrowing for eight years starting two years from now; the more this number exceeds 1.00, the steeper the yield curve. As of June 16th, the FRR was .9986, indicating a small inversion of the yield curve. If the Federal Reserve does indeed tighten one time too many – one of the fears behind the global selloff of recent weeks – the curve will invert further and this FRR will move further below 1.00.

If we regress the returns on the sector CDS costs against the FRR, we can get a picture of which economic sectors have been stressed the most by the flatter yield curve produced by the series of Federal Reserve rate hikes. Three sectors, consumer staples, consumer discretionary and health care, have seen their sector CDS costs fall as the yield curve has flattened (the positive beta results from matching falling CDS costs to a flattening yield curve). This suggests the Federal Reserve has yet to affect the consumer's pocketbook; even though short-term interest rates have risen, the key long-term rates on big-ticket consumer items and housing have yet to rise significantly.

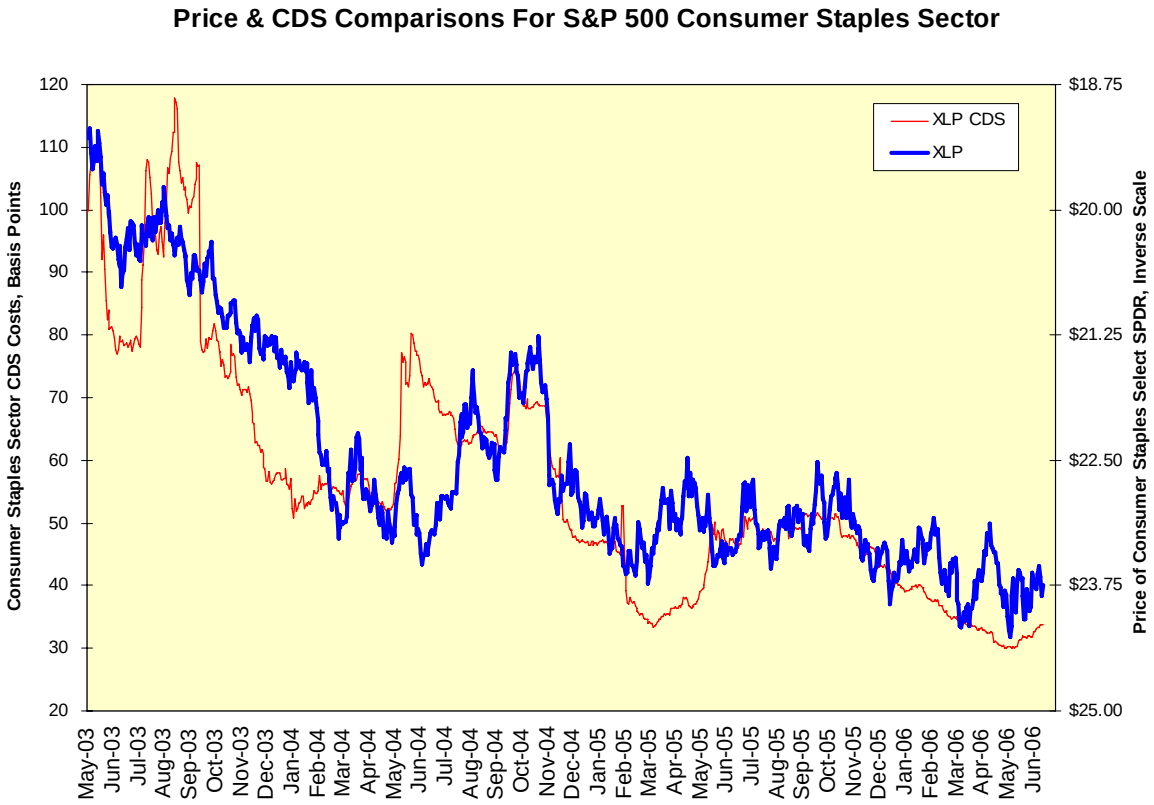


Which sectors have seen their CDS costs rise as the FRR has fallen? The list includes technology, utilities, energy, financials and basic materials. These relationships have existed throughout the past three years; strong sectors such as basic materials and energy were affected negatively by the yield curve even though this effect was overwhelmed by factors such as higher commodity prices.

Consumer Staples

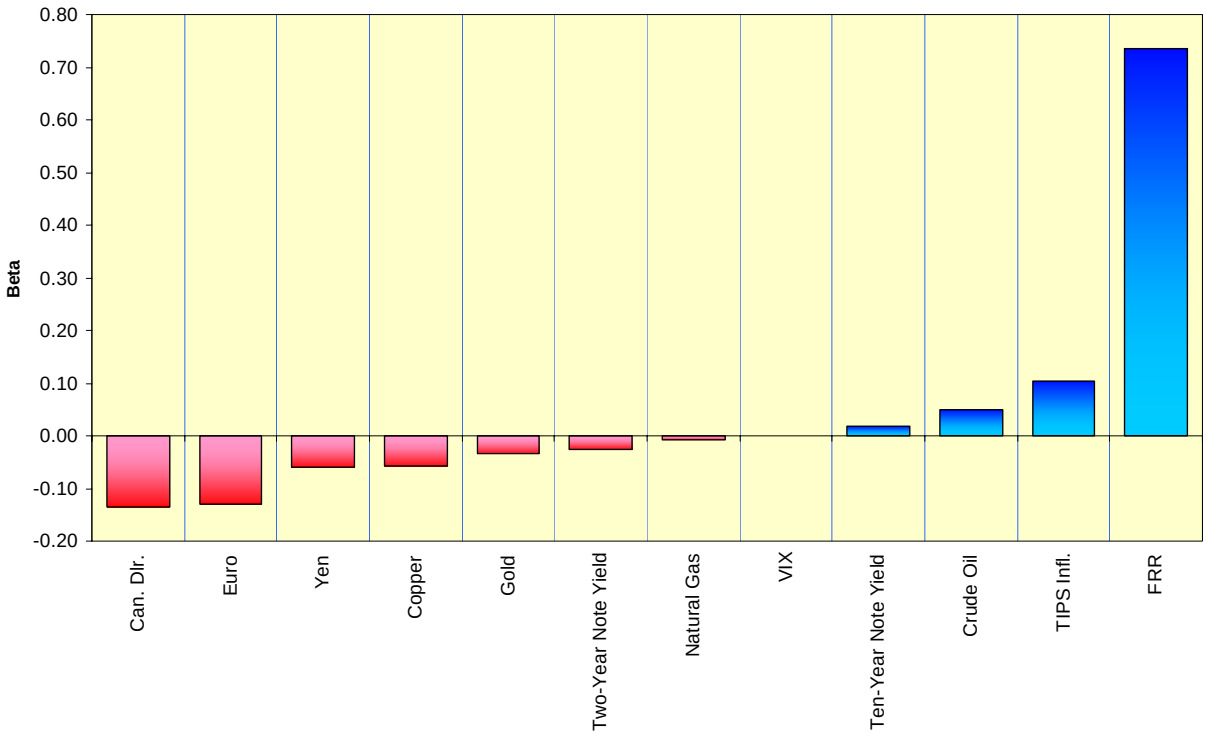
Let's focus on the consumer staples group and its sector ETF, which trades under the ticker XLP. This sector includes stalwarts such as Procter & Gamble, Altria, Wal-Mart, PepsiCo, Coca-Cola, Walgreen's, Anheuser-Busch and Colgate-Palmolive. This sector always is cited as a favorite of defensive investors on the theory we all have to eat and attend to other daily activities.

Over the past three years, the XLP's price, depicted on an inverse scale, has been led by its CDS costs. This is exactly what we should expect: As the sector's collective bonds trade with higher CDS costs, the functional equivalent of saying at wider credit spreads, the XLP turns lower. This has been happening of late.



Moving Beyond The Yield Curve

Now let's complete the analysis by seeing which primal market factors in addition to the FRR move consumer staples' CDS costs. These costs move higher as ten-year note yields, crude oil and the expected inflation embedded in the TIPS market rise. Both natural gas and the VIX have little impact on the sector's CDS costs. In addition, we should expect CDS costs to fall as the dollar weakens against the Canadian dollar, the euro and the yen, and to fall if gold and copper prices resume their bull markets. Finally, if two-year note yields continue to rise, we should expect sector CDS costs to fall.



We can get a flavor from these small snapshots above of just how many moving parts there are in linking outside markets to stocks via CDS costs for just one sector. Hopefully they illustrate why analysts and public personae in financial markets need to say more than the usual flippant comment about credit spreads being tight or rising. The simple fact is they are rising across many sectors and we need to know what is driving them. Otherwise, we are no better than Yogi saying, "It's tough to make predictions, especially about the future."