Sovereign Credit Risk Declining

I entitled a November 2008 column on the declining credit quality of government bonds around the world, "Risk-Free in Name Only" to reflect the then-rising anxiety about government finances. Those credit risks would continue to rise into late February 2009; peaking in the U.S. on February 23, 2009, the day when the Federal Reserve and Treasury issued a joint statement they would not allow any further financial failures in the U.S. This joint statement was something reminiscent of Stalin's July 1942 Order 227, also known as the "not one step back" order decreeing anyone retreating would be subject to court-martial.

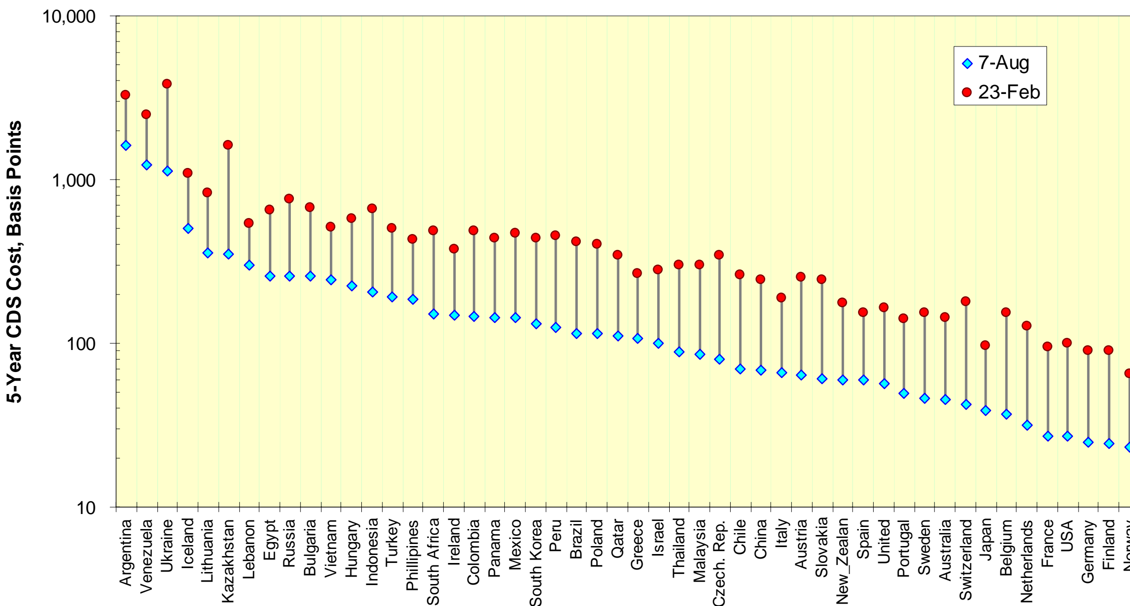
You are invited to read both statements and compare their tone. Tim Geithner and Ben Bernanke share something in common with Stalin: Their orders, in both cases issued at the low point of a rout, helped reverse the course of battle. And, so far as we know, while Tim Geithner apparently lost his cool in a bureaucratic meeting recently, he has yet to resort to courts-martial in the field and followed by summary execution.

Stop And Drop

The credit default swap market for U.S. Treasuries took the joint statement as a guarantee the U.S. would not default nominally as it would print the money if necessary and worry about inflation later, if at all. Within a month, the U.S., U.K. and Switzerland all announced quantitative easing. Inflation has arrived, not in the form of higher price indices but in terms of a global asset bubble. However, people like bubbles, free whiskey and $4,500 checks for cars, and there are those amongst us who regard these as manifestations of good public policy. Here again, Stalin's history is instructive: Old Bolsheviks such as Zinoviev shouted praise unto his name in the seconds before the firing squad pulled their triggers.

If we map the change in five-year CDS costs for a wide range of countries since February 23, 2009, we find all have fallen significantly. The Y-axis is on a logarithmic scale, which means equal vertical drops correspond to equal percentage changes in CDS costs.

Change In National 5-Year CDS Costs After U.S. CDS Peak

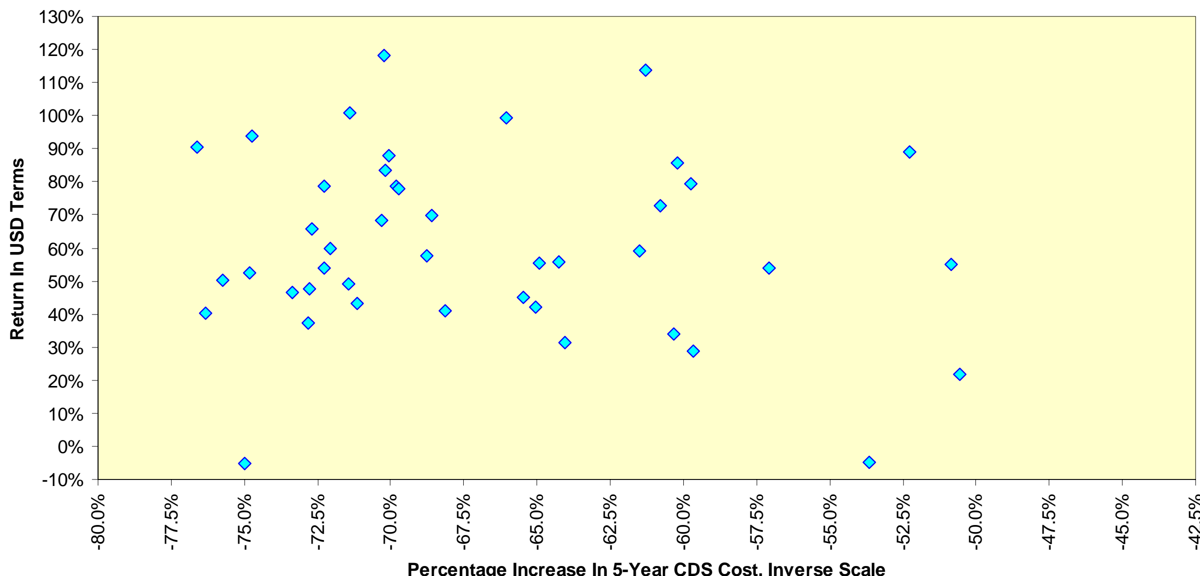


Stock And Currency Effects

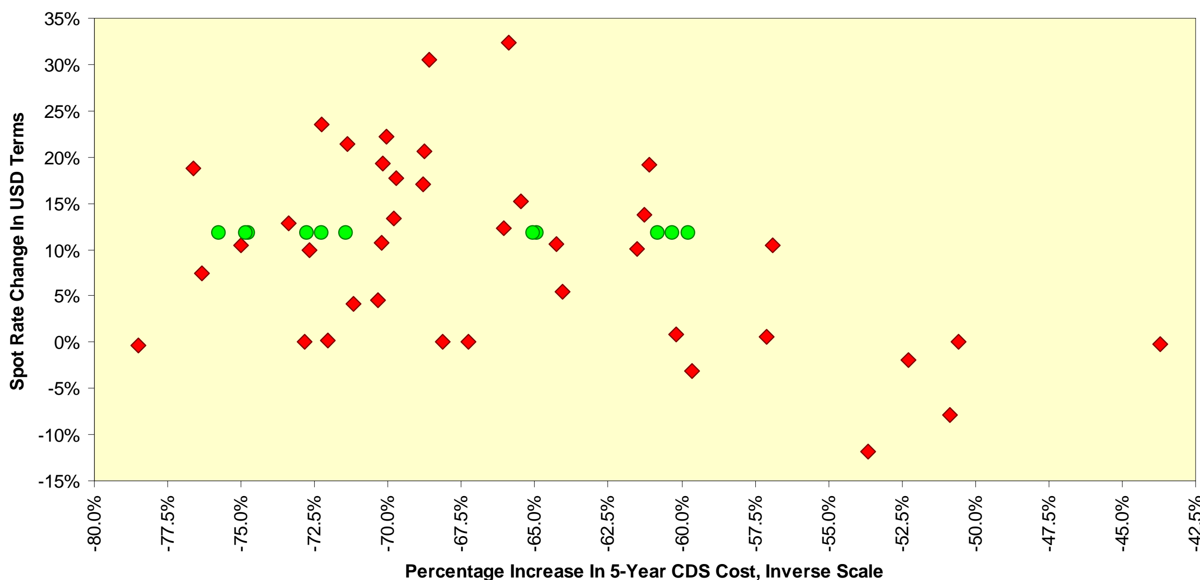
When we last looked at this topic, we found rising CDS costs were associated with weaker stock market performances and weaker currencies. This really was unsurprising; what do you expect a stock to do if and when the corporation's bonds deteriorate?

The answer is not symmetric, however. If a bond improves in credit quality, the stock should rise, but as the decrease in borrowing costs is limited, we should expect a diminishing equity market response to improving credit quality. The exact same thing happens on the sovereign CDS level. As CDS costs plunge, we do not see a general

trend from upper left to lower right on the chart. On a national basis, we have reached the point of no significant return to decline in CDS costs.



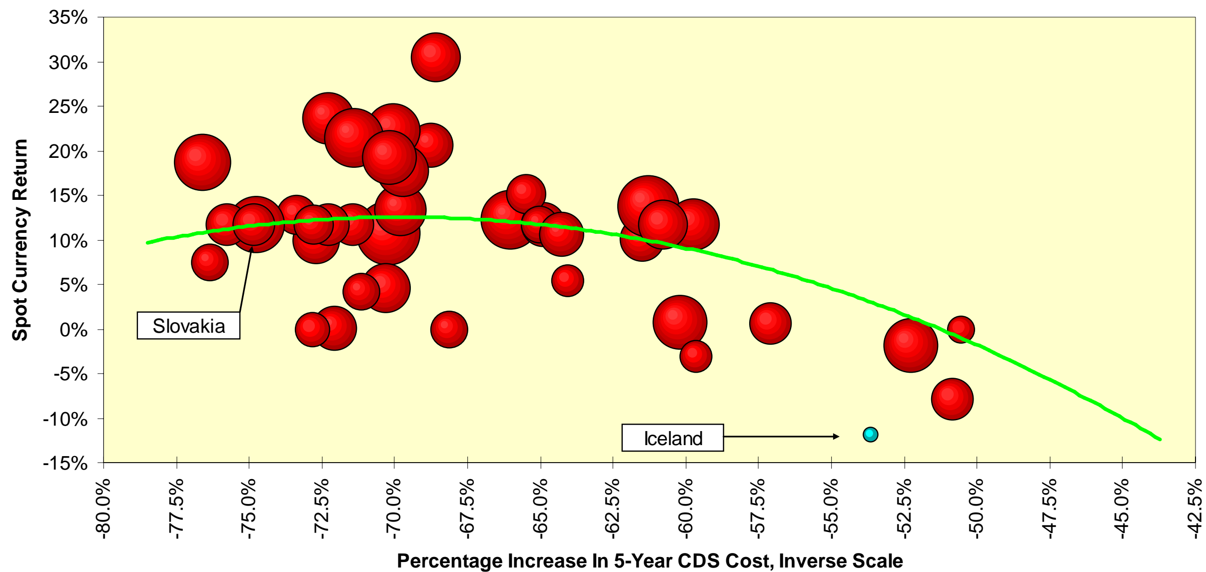
The currency response is similar. Declining CDS costs do not lead linearly to a stronger currency; this often is the case because declining CDS costs are associated with lower interest rates and a flatter yield curve in that country. The countries using the euro are highlighted in green on the chart below.



Combined Effects

Now let's combine all the responses and measure the equity market response as a function of the currency and the change in CDS costs. The bubbles represent the magnitude of the total return for each stock market in USD terms over the period. Two markets, Iceland and Slovakia, have negative returns and are highlighted in blue (Slovakia is masked behind other countries).

If declining CDS costs and a stronger currency contributed to a stronger stock market, we would see a general trend from the upper left to the lower right with much larger bubbles in the upper left-hand corner of the chart. We do not.



Testing The Limits

The ongoing global equity rally is going to test the limits of governments' ability to stimulate the real economy with free money. The short-term yield curve has moved into a dangerously unstable zone, and could flatten much sooner and further than we think if the evidence of macroeconomic improvement becomes incontrovertible. Higher short-term interests will raise government borrowing costs, and with the deficits in the U.S. and elsewhere off the edge of the map, this could place private and municipal borrowers at a real disadvantage in competing for available funds.

If short-term interest rates do not rise, the inflation now ranging in asset markets will move into price indices. Then the Federal Reserve and its sister central banks will be faced with withdrawing liquidity just as the party is starting. That is their job, but where is the evidence since Paul Volcker they actually want to do this?

This is all rather remarkable in its time compression. The credit crunch was getting underway two years ago, was about to hit a crisis level less than a year ago, hit its low points in a series of markets between November 2008 and March 2009 and now has come full circle to where we have to be warning about an asset bubble forming. Someone pushed the fast-forward button on history and is having a great deal of levity at our expense.

The next phase of all this is when investors discover the other aspect of risk-free in name only, and that is how much a long-term Treasury bond can lose when interest rates rise. The present duration on a ten-year Treasury is 8.22, meaning it can be expected to lose 8.22% for a 100 basis point rise in interest rates. That will hurt those who sought safety and it will push government finances into an interesting corner.