Corporate Bonds Not Yet Bearish For Large-Capitalization Stocks

We should all be able to agree a higher cost of debt for any corporation is not a good thing for its stock. After all, bondholders are senior to stockholders in a corporation's capital structure and stand to get paid first, ignoring little things like the expropriation of General Motors' bondholders back in the days when we were not letting crises go to waste.

If interest rates start to rise for corporate borrowers while they are falling for the Treasury, we will see a wider spread between their two yield curves across the 2-10 year segment. We can measure these yield curves by their respective forward rate ratios ($FRR_{2,10}$). These are the rates at which we can lock in borrowing for eight years starting two years from now, divided by the ten-year rate. The steeper the yield curve and the greater the long-term cost of debt, the more this $FRR_{2,10}$ exceeds 1.00.

Credit Quality Matters

The well-publicized problems of the high-yield market show up in these yield curve spreads. They have been diverging along the lines of credit quality throughout 2014. While the A-rated $FRR_{2,10}$ yield curve spread has been flat since October 2012 and the BBB-rated yield curve spread has encountered resistance to further narrowing after April 2014, the BB-rated yield curve spread has been widening bearishly since January.

I might add these yield curve spreads' messages are consistent with 7-10 year option-adjusted spreads (OAS) levels. Those have been increasing since crude oil prices began their downturn in late June, with the lower-rated BB OAS increasing 64.9% and the BBB- and A-rated OAS levels increasing 41.4% and 28.7%, respectively. The Russell 2000 peaked two weeks later, at the start of July

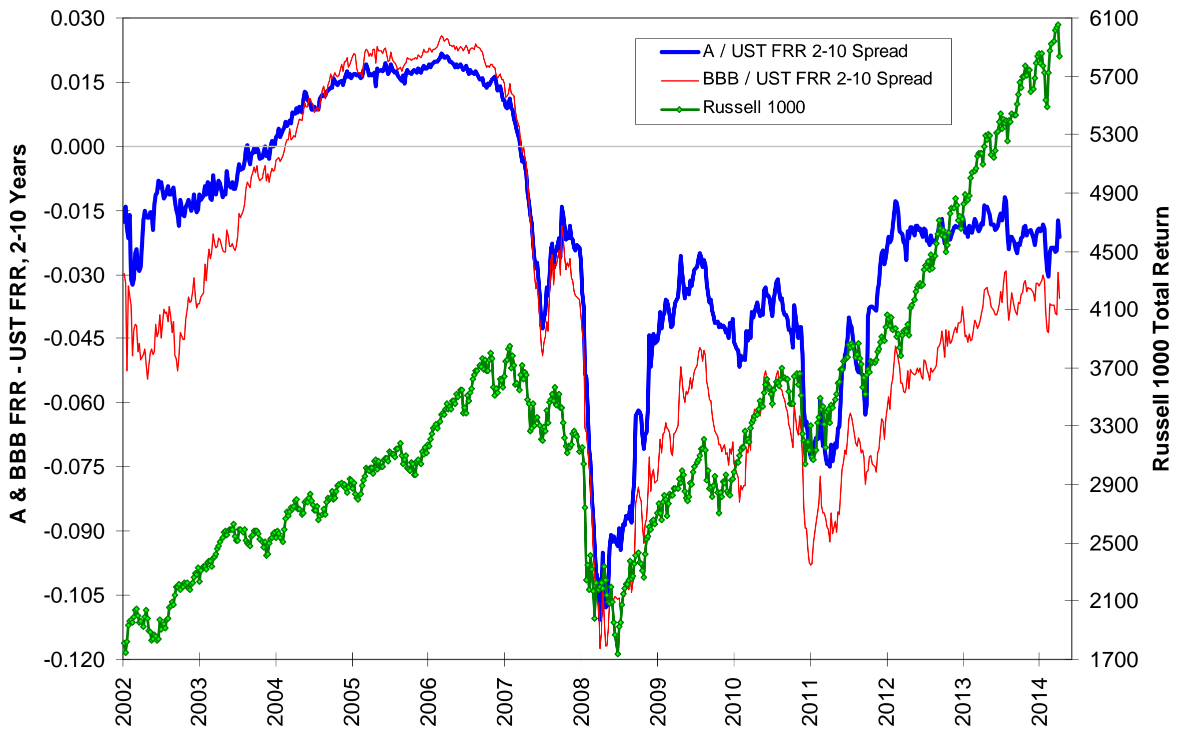
The U.S. equity market in general and the large capitalization Russell 1000 in particular have been able to grind out new nominal highs for the past two years with the A- and BBB-rated yield curve spreads ceasing their bullish narrowings in October and April 2014, respectively, and with the BB-rated yield curve spread widening bearishly since January 2014.

The last time the A- and BBB-rated yield curve spreads widened bearishly for any period of time was April – December 2011. The Russell 1000 and Russell 2000 indices declined 13.72% and 21.42%, respectively. As the equity market has shown it can withstand risk-aversion in the high-yield market, we should concern ourselves first and foremost with the investment-grade market.

If we map the total return of the Russell 1000 against the investment-grade yield curve spreads, we see how large-capitalization stocks have been able to gain steadily since late 2012 without help from lower borrowing costs. However, we can see on the second chart below how the small-capitalization Russell 2000 has struggled with a widening BB-rated yield curve spread.

Where do we go from here? Unless monetary policy starts to turn hostile, long-term swap spreads widen or improving business outside of the energy sector reverse, there is little reason to believe investment-grade yield curve spreads will widen and push large-capitalization issues lower.

The picture is different for the high-yield sector, though. The increasing risk-aversion seen here throughout 2014 in a favorable environment has little intrinsic reason to reverse at this point. The illiquidity of high-yield bonds in the post-crisis era has been demonstrated twice since October and is enough to make investors demand compensation for the risks involved.


Stocks And Comparative Yield Curves
A / UST FRR 2-10 Spread
BBB / UST FRR 2-10 Spread
Russell 1000
A & BBB FRR - UST FRR, 2-10 Years
Russell 1000 Total Return
0.030
0.015
0.000
-0.015
-0.030
-0.045
-0.060
-0.075
-0.090
-0.105
-0.120
6100
5700
5300
4900
4500
4100
3700
3300
2900
2500
2100
1700
2002
2003
2004
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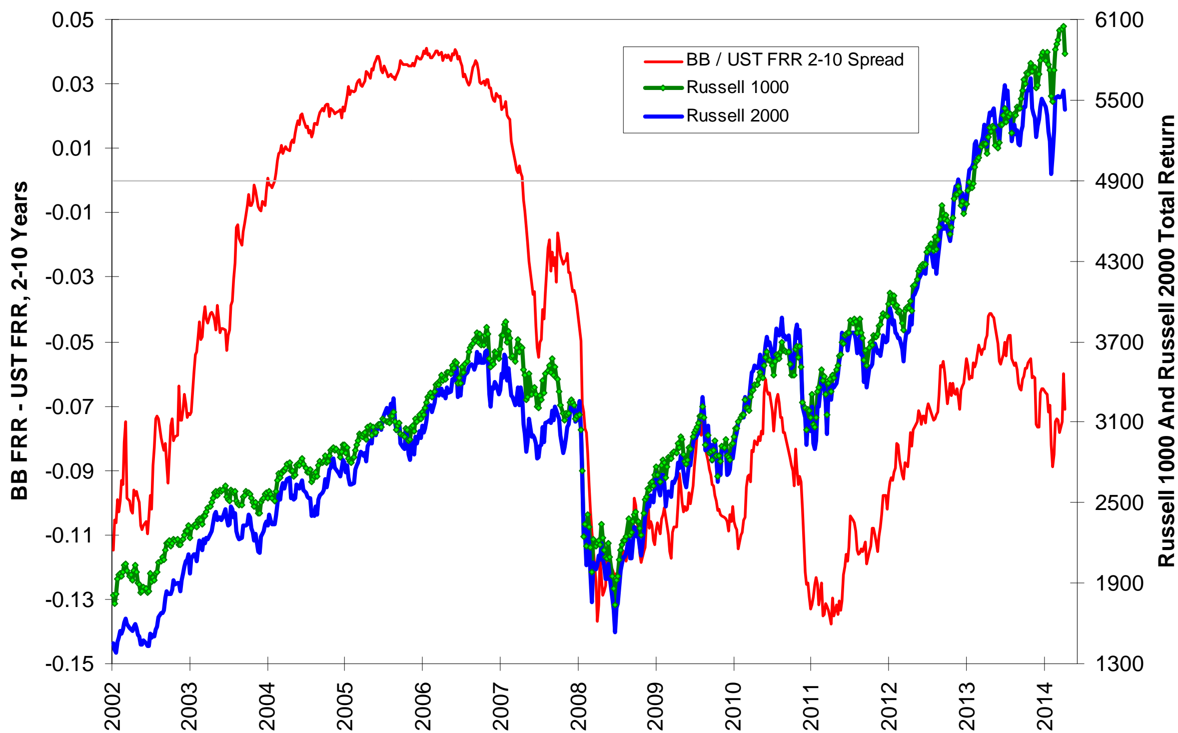
2014


Stocks And BB Yield Curve Spread
BB / UST FRR 2-10 Spread
Russell 1000
Russell 2000
BB FRR - UST FRR, 2-10 Years
Russell 1000 And Russell 2000 Total Return
0.05
0.03
0.01
-0.01
-0.03
-0.05
-0.07
-0.09
-0.11
-0.13
-0.15
6100
5500
4900
4300
3700
3100
2500
1900
1300
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014