Financial Stocks Riding Financial Yield Curve Spreads

We have been so conditioned over the past few months to believing the world of corporate bonds is coming apart at the seams and will be taking stocks down along with it that we forget the world is not composed entirely of energy-linked junk bonds. In the case of the financial sector, the opposite dynamic has been unfolding since the Federal Reserve made its intentions to raise rates known for sure in mid-October

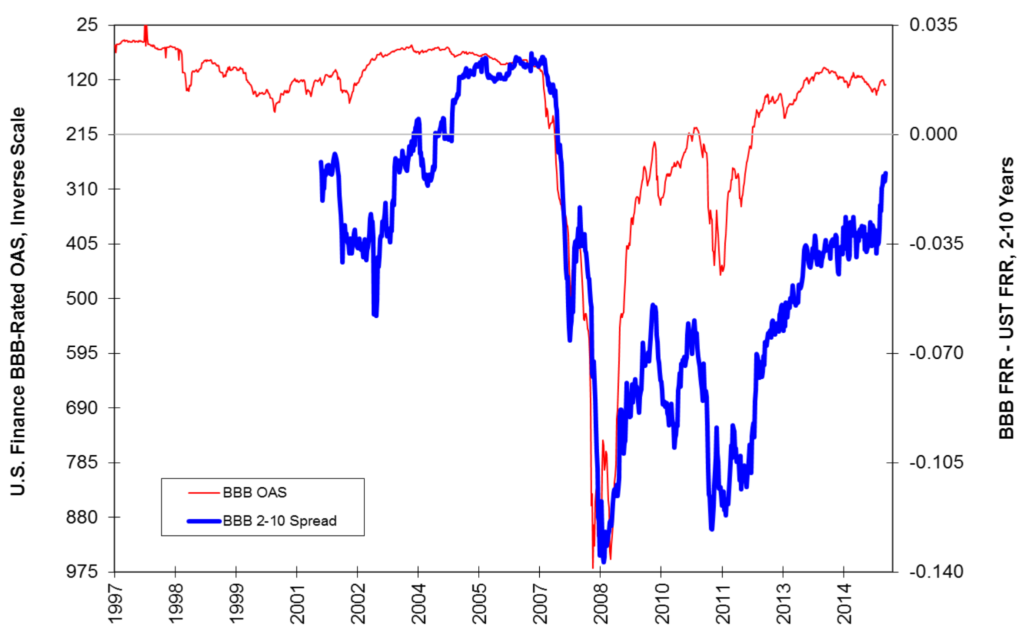
Yield Curve Spreads

We can compare the relative steepness of two yield curves by comparing their forward rate ratios across a segment of the yield curve, in this case the 2-10 year segment.

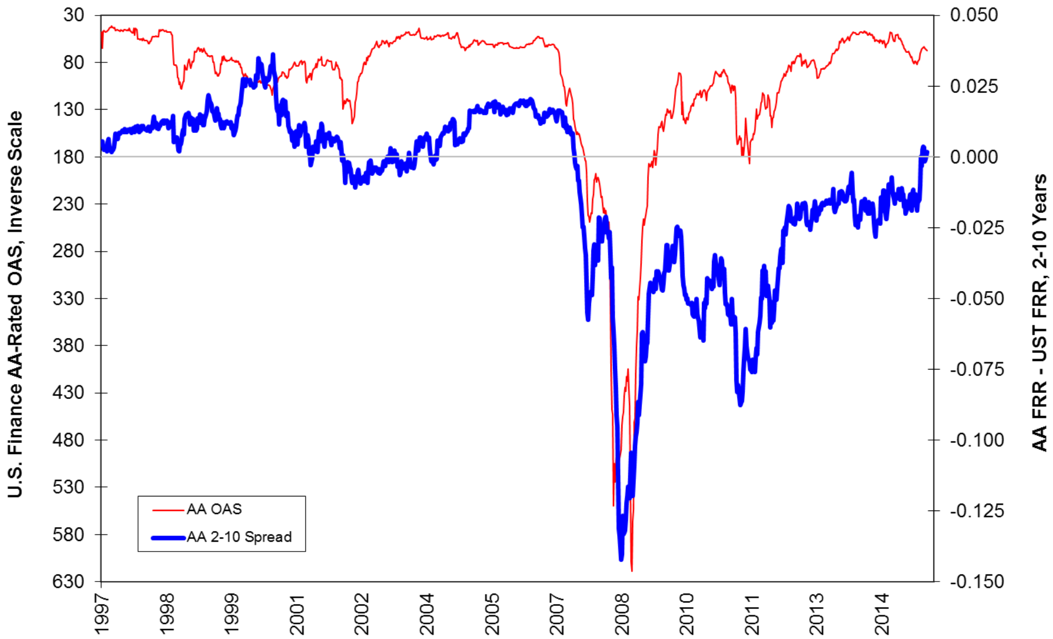
The $FRR_{2,10}$ spreads both for AA-rated issues and BBB-rated issues in the financial sector widened abruptly over the past two months as a function of the UST yield curve's strong flattening. If this relative steepening were the result of higher long-term corporate bond yields, we would have great cause for concern as it would imply a combination of greater risk-aversion and lower credit quality.

However, as OAS levels declined for AA-rated issues and remained stable for the BBB and BB-rated issues, the wider yield curve spreads have to be construed constructively for financial sector debt. The wider yield curve spreads were the result of the Treasury yield curve flattening via higher short-term rates.

BBB-Rated Yield Curve And OAS Comparisons



AA-Rated Yield Curve And OAS Comparisons

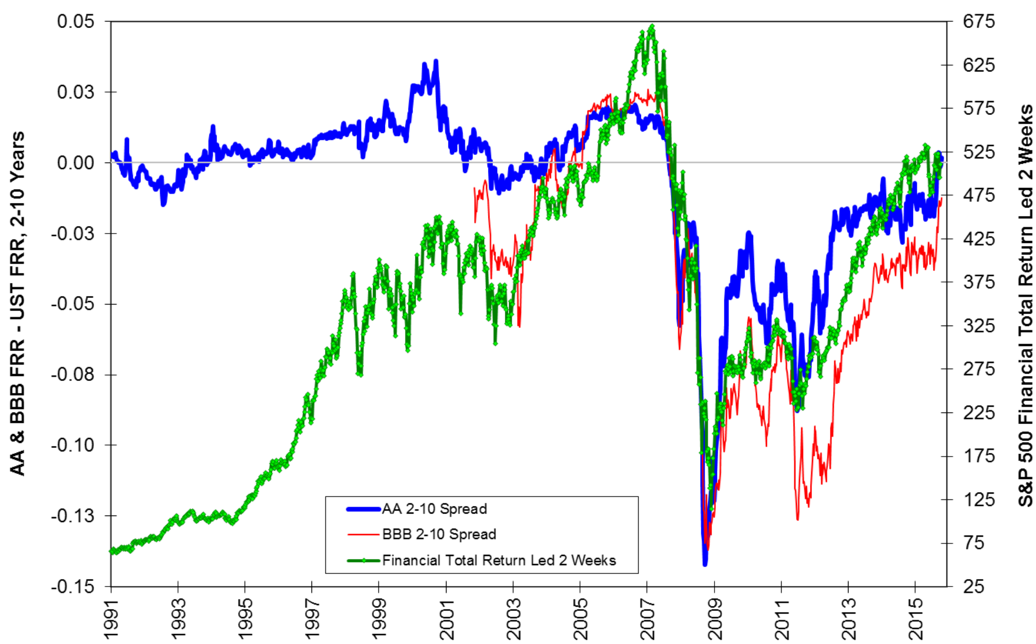


Stock Market Overlay

Now let's turn to the stock market impact. The AA and BBB yield curve spreads have led the total return of the S&P 500 Financial index by two weeks on average. The sector index made a new high on July 23, 2015, and has underperformed the S&P 500 Ex-Financial index -4.37% to -0.60% since then. This underperformance is not a function of financial sector bonds but rather of extrinsic factors such as exposure to the energy sector and the effects of a stronger dollar on global banks with USD liabilities.

Over the short data sample since the yield curve spreads began to widen at the end of October, the financial sector has outperformed the S&P 500 Ex-Financial index, 3.85% to 2.27%.

Finance Stocks And Comparative Yield Curves



Much has been made of the effects of higher short-term interest rates on the financial sector's net interest rate margins. The real gain for the financial sector has come from its long-term bonds becoming more attractive, not from its short-term interest rate funding costs rising; those short-term rate hikes normally would lower interest rate margins in the absence of a steeper Treasury yield curve.

As long as the current situation of flat long-term Treasury yields persists, financial sector bonds will remain attractive and will support financial equities in return.