Credit Spreads Tell A Bullish Story

***e*Research Corporation** is pleased to provide an article by Scott Grannis for his Blog, “Calafia Beach Pundit”.

In this article, Mr. Grannis compares debt yields.

The article is reproduced below, beginning on the next page, or you can go to this specific Blog at the following link: **Credit spreads tell a bullish story**

You can also visit Scott Grannis’ Home Page for his Blog at the link below: http://scottgrannis.blogspot.ca/

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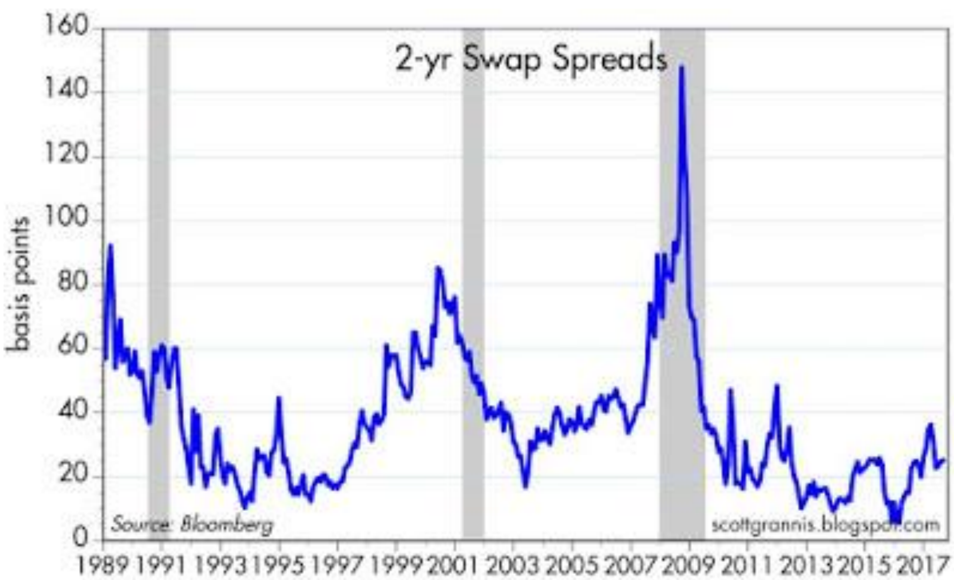
Credit Spreads Tell A Bullish Story

Credit spreads—the extra amount of yield that investors demand to hold debt that is riskier than Treasuries—are uniformly low these days. That tells us that liquidity in the bond market is abundant, systemic risk is low, and the outlook for corporate profits and the economy is healthy.

Swap spreads (see a short primer on swap spreads here) are arguably the bedrock and most important of all credit spreads. "Normal" spreads on 2-yr contracts are roughly 20-40 bps. At today's 25 bps, 2-yr swap spreads are perfectly normal. This tells us that bond market liquidity is relatively abundant. *Fed tightening has not created a shortage of money, as it usually does in advance of recessions*. It also tells us that systemic risk is perceived to be low.

As the chart below suggests, swap spreads tend to be good predictors of conditions in the broader economy; spreads tend to rise in advance of recessions and decline in advance of recoveries.



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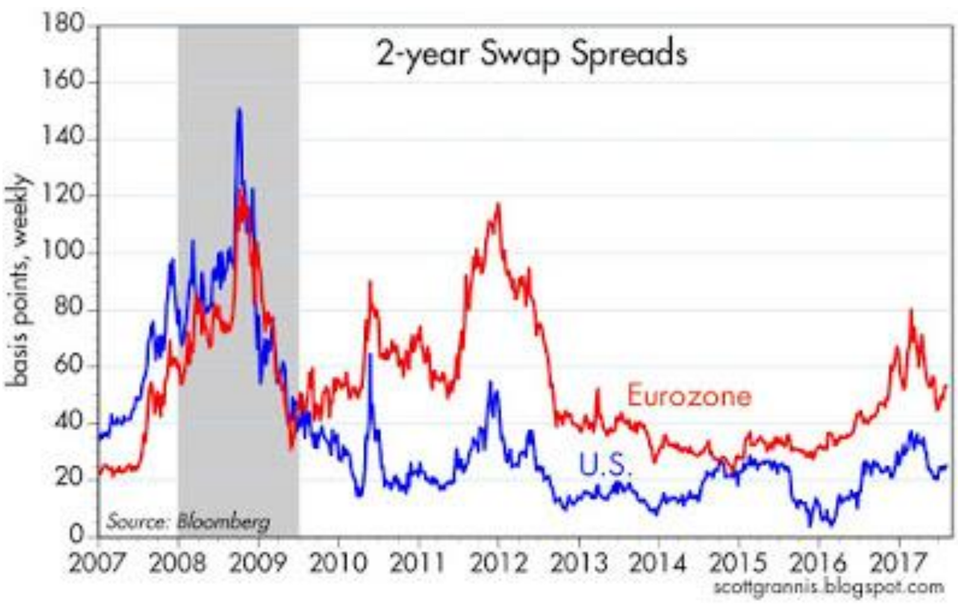
As the next chart shows, swap spreads in the Eurozone are elevated. Conditions are not as healthy there as they are here. Eurozone spreads are not dangerously high, but they do reflect some systemic risk, which is likely related to the perception that the Eurozone still faces existential risks from countries thinking about "exiting" the Eurozone.

Given the higher spreads in the Eurozone, it is not surprising that Eurozone GDP growth has been lagging that of the USA for a number of years.

Riskier markets tend to receive less investment—and consequently less growth—than less risky markets.



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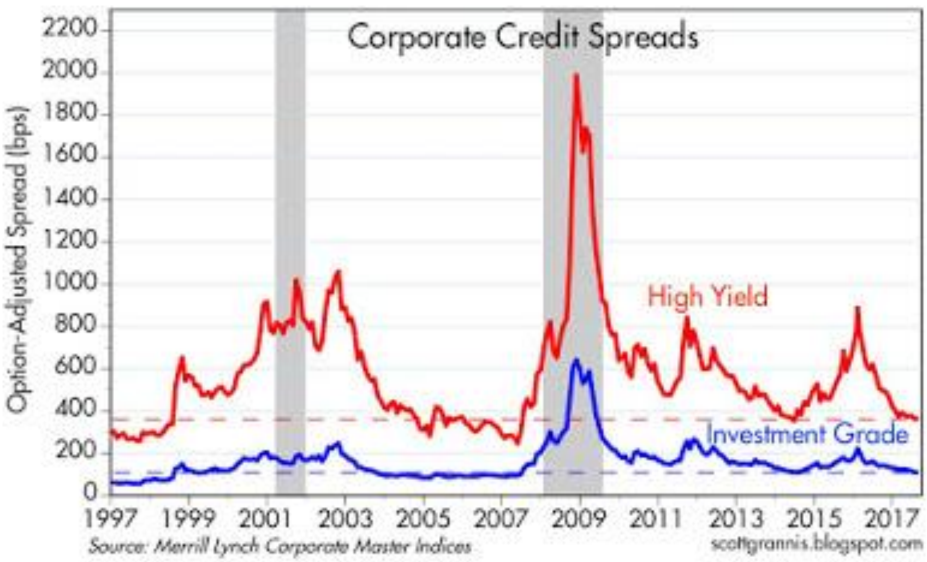
The following chart shows credit spreads as derived from the universe of bonds issued by U.S. corporations: $6.3 trillion of investment grade bonds, and $1.3 trillion of high-yield (junk) bonds.

Both spreads are relatively low, as you would expect them to be in a healthy, growing economy. They are not at record lows, but they are low enough to be impressive.



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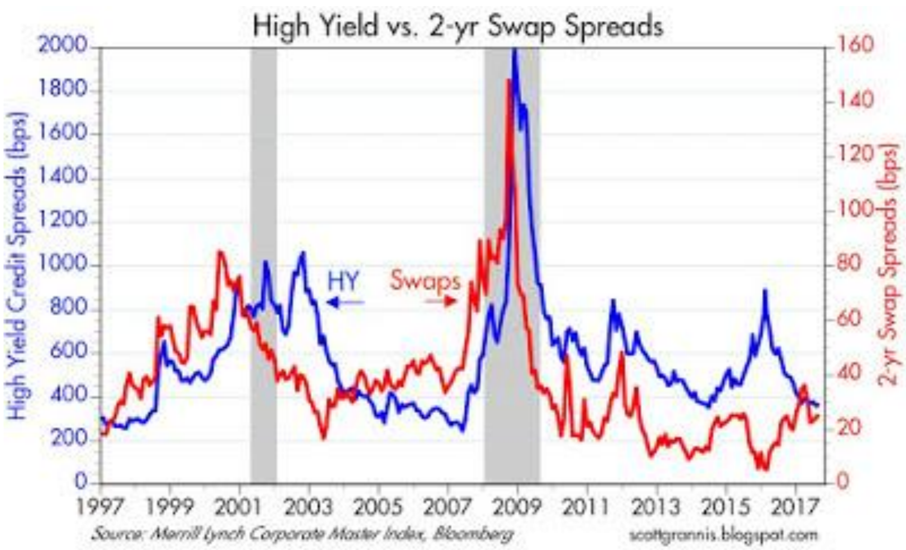
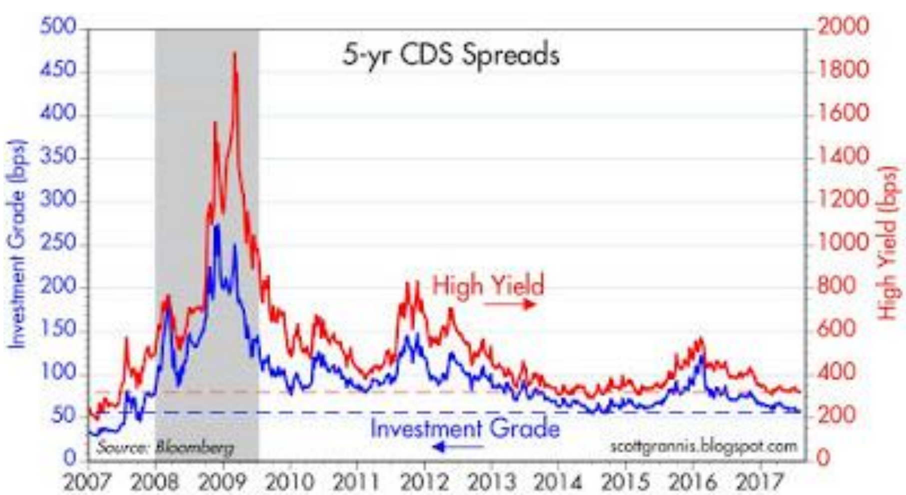
The chart below compares 2-yr swap spreads to high-yield corporate spreads. Here we see further evidence of how swap spreads tend to be good predictors of the health of the economy (HY spreads are particularly sensitive to the underlying health of the economy).



The next chart shows 5-yr Credit Default Swap spreads. CDS spreads are derived from generic contracts representing hundreds of large, liquid corporate bonds, so they are reliably good proxies for overall credit risk. Their message is the same as other credit spreads: conditions are normal, and thus the outlook for the economy and corporate profits is healthy.



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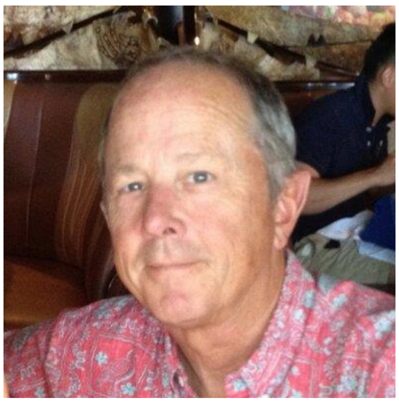
ABOUT THE AUTHOR



Scott Grannis was Chief Economist from 1979-2007 at Western Asset Management, a Pasadena-based, global manager of fixed-income portfolios for institutional clients.

He now enjoys keeping up on economics, markets, and politics from his condo overlooking Calafia Beach on the southern California coast, where he likes to think that he is immune to Wall Street group-think.

Married for 45 years to his Argentine wife, Norma, he has four children and five grandchildren (four boys and one girl).

He is a believer in supply-side economic theory, as practiced by his mentors, the late Jude Wanniski, Art Laffer, and Larry Kudlow. John Rutledge is another of his mentors, from the days that they worked together at Claremont Economics Institute.

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