Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Sorting Out the Spreads

Monday, April 27, 2009

David Gitlitz

High yield spreads say the worst is over, but they're not yet fully predicting recovery.

Update to strategic view

US MACRO: The rally in high yield debt is a welcome sign of some restoration of risk tolerance, but not sufficient to indicate that a return of growth is underway. Should the high yield recovery be sustained, with spreads heading back down to single digits, it will be an unmistakable harbinger of imminent expansion.

[see Investment Strategy Dashboard]

One of the more encouraging phenomena now taking place in the markets is the rally in high yield debt. Year to date, the Merrill High-Yield Index spread has contracted by some 300 bp, and about 370 bp since its spike in the panic of February and early March. The reemergence of a healthy degree of risk tolerance is absolutely essential to any hopes for getting the economy back on track. Should the present trend continue, it would be a solid indication that the present recession is nearing an end.

But as yet, it would probably be premature to take an unambivalently optimistic view of that proposition. For one thing, while junk yields have come down and spreads have narrowed, they remain well above their levels at the outset of the most intense phase of the credit crisis late last summer. At that time, the spread was below 900 bp, and eventually blew out to nearly 2,200 bp in the panic. It's now at about 1,500 bp, which outside the events of last fall would still stand as the all-time record.

Signs of continuing fragility in the credit markets remain apparent. The LIBOR-OIS spread has steadied at around 90 bp since early this year, down sharply from 360 bp at the peak of the chaos. But that compares to less than 10 bp, which was considered normal prior to the earliest onset of the credit crisis in summer 2007, suggesting that systemic risk has not entirely abated. Safe-haven demand can still be seen in the 3-month T-bill yielding less than 10 bp.

Also, unlike earlier high yield rallies, lesser quality investment grade issues have not yet joined the party. Baa-rated paper has been trading around 8% all year, although it did not get hammered nearly as hard as high yield in the fourth quarter. And while the high yield cash market has posted nice gains year to date, spreads on high yield credit default swaps have risen on net by nearly 100 bp.

To some extent, this spread contraction in high yield debt is explained by factors other than just performance. As would be expected given the economic climate, defaults are on the rise. Those

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

issues facing default are among the highest yielding in the index. As they default, they leave the index, bringing down the aggregate yield and the aggregate spread (all else equal).

That said, the fact that yields and spreads have kept falling even in the face of rising defaults points to one of the more encouraging aspects of the rally. During the worst of it last fall, high yield pricing implied default rates that would have exceeded the worst of the Great Depression, approaching 25% -- expectations which we said at the time bordered on the absurd (see "It's a Recession -- Not the End of the World" November 21, 2008). Now that the default rate is actually rising, the market is absorbing the news and rallying into it. This is an indication that in the fear gripping the high yield market there was a substantial exaggeration of downside risks. Those risks have gone through a process of reassessment, and it has become clear that the extreme pessimism was overdone, creating a buying opportunity. There will be more defaults, which is what happens in recessions. But as we said last November, it's not the end of the world.

It is in this context that we view the significance of this rally. In itself, it's not yet sufficient to point to as overcoming all negative influences and sounding the "all clear" signal. But it does suggest relief from the worst fears about the economic outlook. We can offer no guarantees against another episode of the intensified risk abhorrence seen in February and March. That was sparked by waves of extraordinary policy uncertainty (see "Quantum of No Solace" March 10 2009). Congress and the administration seem to have recognized the risks they were creating, and pulled back from that brink (see "Stress Test Stress" April 21, 2009). But a revisiting of those circumstances certainly cannot be ruled out, as the tentative recovery in markets emboldens politicians to re-accelerate the agenda of "change." Friday's news that mandatory universal health insurance is to be rushed through Congress using filibuster-proof "reconciliation" process is an alarming example.

At the same time, the high yield market is gaining from the exceedingly easy posture being maintained by the Fed. Continuing to anchor the yield curve with the funds rate essentially set at zero, the Fed is creating an inviting target in higher yielding non-Treasury issues, and is likely to continue doing so indefinitely. As well, the Fed's stance is steadily relieving the deflation risk that was a key factor in the market's undoing. These props should continue to provide support to high yield debt.

BOTTOM LINE: The rally in high yield debt is a welcome sign of some restoration of risk tolerance, but not sufficient to indicate that a return of growth is underway. Should the high yield recovery be sustained, with spreads heading back down to single digits, it will be an unmistakable harbinger of imminent expansion.