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Market Facts

The Relationship Between Corporate Bonds And Stocks

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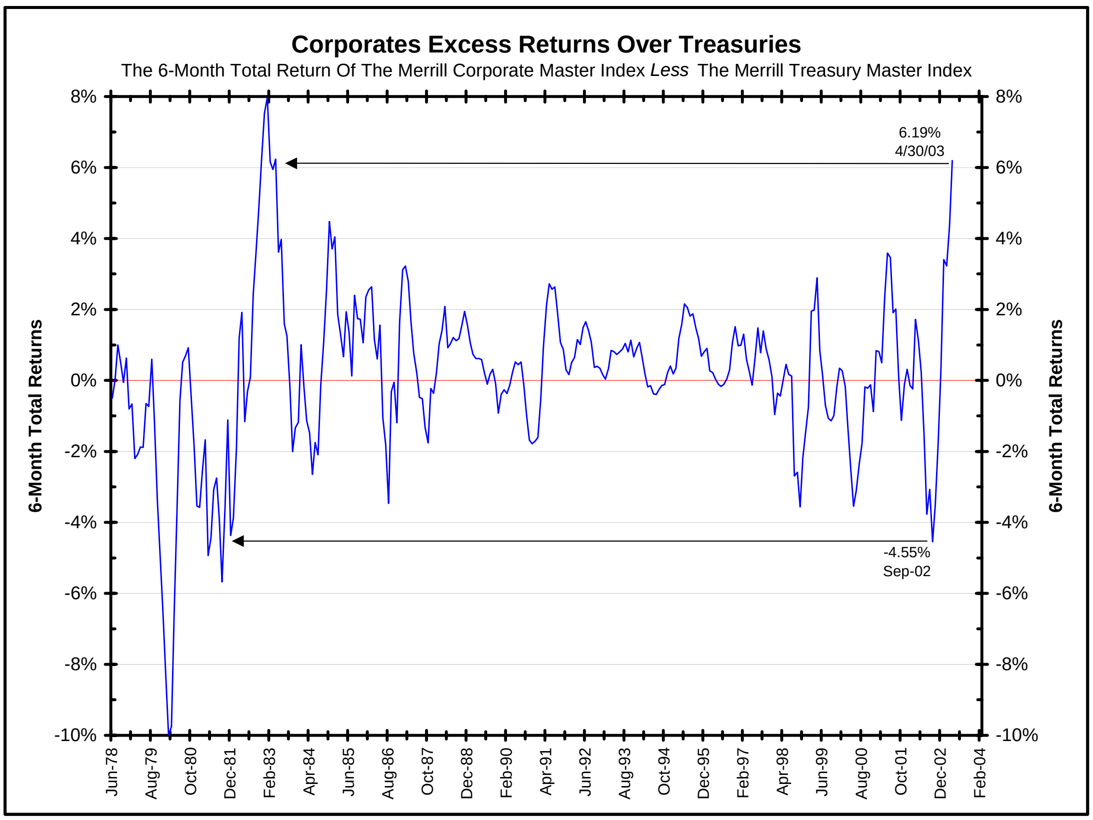
> *In fact, by some counts, the past six months have been the best such period for corporate bonds in at least 20 years. . . . Analysts say the strength in bonds is a signal that stock investors should pay attention to. That is because the bond market has proved its ability to sniff out hints about the future of corporate profits before the stock market. For example, riskier corporate bonds climbed in the early 1990s, as companies trimmed debt and saw improved earnings prospects, even before stocks staged their own record-breaking rise. And there were problems in telecom bonds as far back as late 1999, well before those stocks began to crumble.* – The Wall Street Journal, May 5, 2003

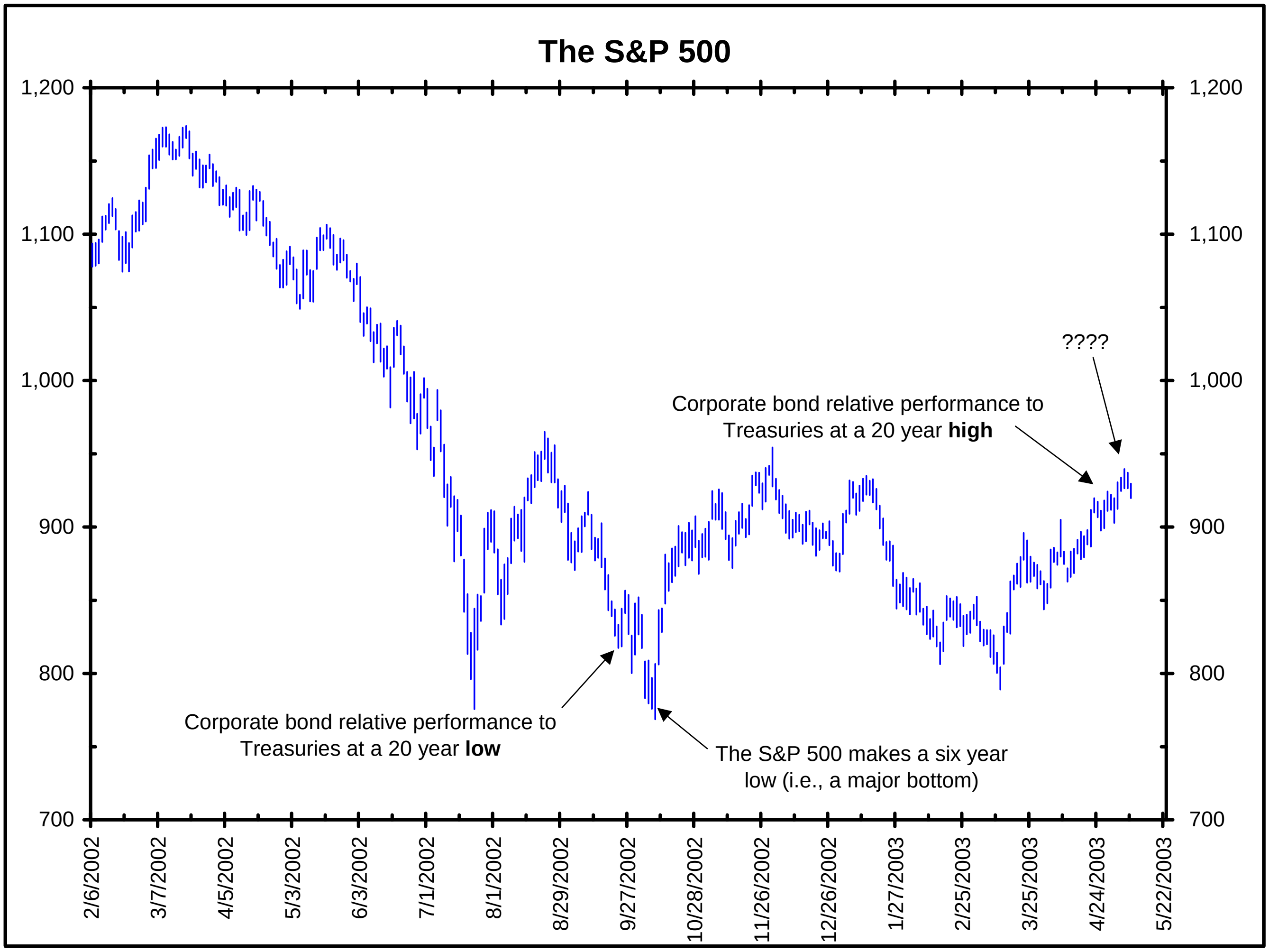
The chart below confirms the first part of the quote above. For the six-months ending April 30, the Merrill Corporate Master Index outperformed the Merrill Treasury Master Index by 6.19%. One has to go back to April 1983 to find a six-month period when corporate bonds did better relative to Treasuries than the previous six-months.



While the recent performance of corporate bonds has been impressive, it should be put in context of recent history. The chart above also shows that, for the six-months ending in September 2002 (7 months ago), the Merrill Corporate Master Index **under**performed The Merrill Treasury Master Index to a degree not seen in the last 20 years. In this context, the recent **out**performance of corporate bonds appears to be "mean reversion" of the prior period of **under**performance.

As the second part of the quote above suggests, many market participants are suggesting this outperformance implies "something significant" for the stock market. In order to answer this question, we must first ask if the prior period of underperformance also implies "something significant" for the stock market. In other words, did the poor performance of corporate bonds through September 2002 suggest stocks were in deep trouble?

The chart below shows stocks were bottoming as corporate bonds were badly underperforming Treasuries. In this case, poor corporate bond performance was **not** suggesting continued stock weakness.



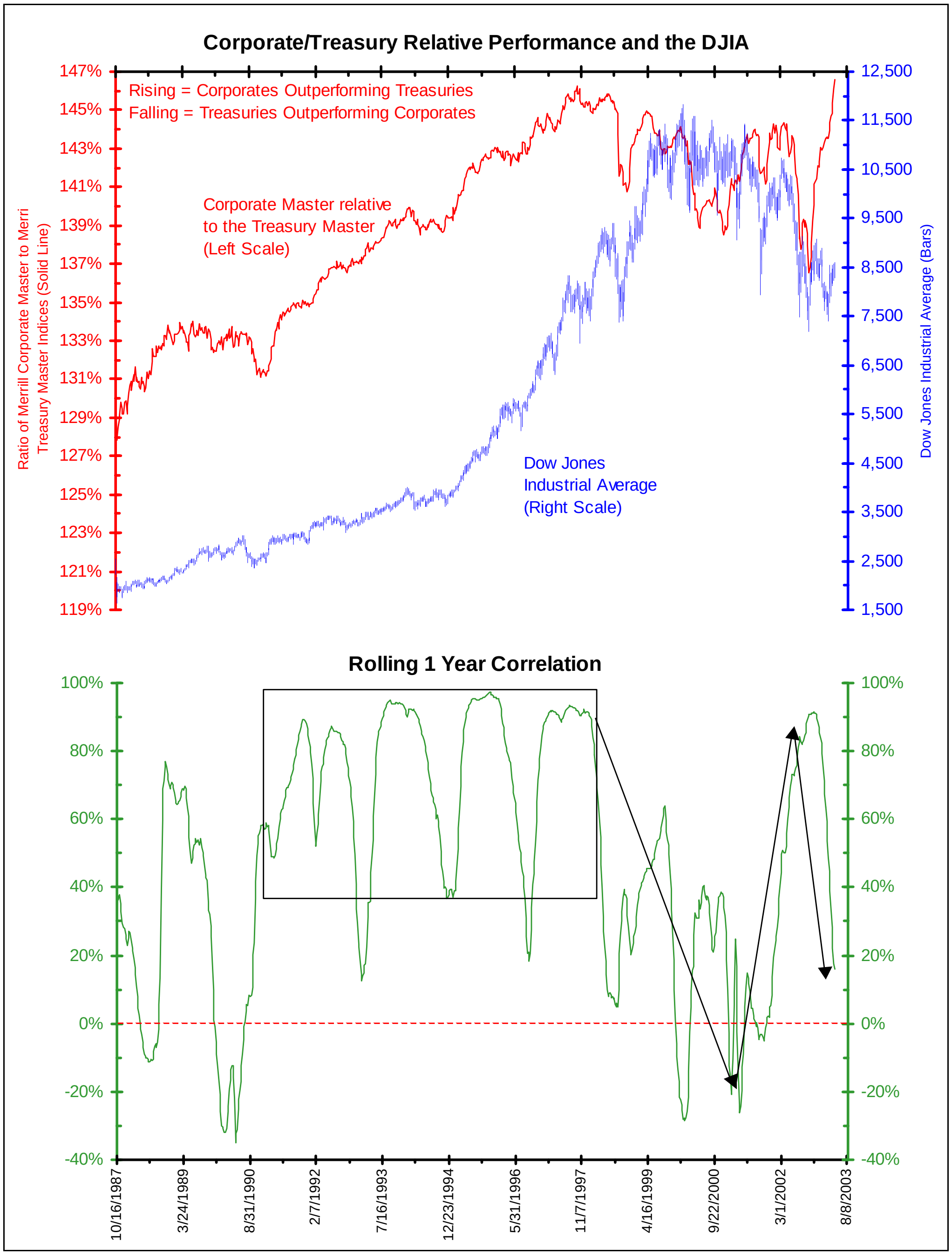
Implying A Relationship

By asking if poor corporate bond performance had "meaning" for the stock market, there is an implication that the stock market and corporate bond relative performance to Treasuries are related. While it makes perfect sense why they **should** be related, this has not been the case.

The chart on the next page shows the relationship between stock prices and the relative performance of corporate bonds. The top panel shows the Dow Jones Industrial Average (blue line) and the "Corporate Master relative to the Treasury Master" (red line). The latter index measures the relative performance of the Corporate Index to the Treasury Index on a total return basis. This means a rising line signifies corporates are **out**performing Treasuries, while a falling line means corporates are **under**performing Treasuries.

The bottom panel shows the rolling 1-year correlation between the Dow Jones and relative performance between corporate bonds and Treasuries. This is our way of measuring the relationship between the two series.

The bottom panel shows corporate bond relative performance and stocks **had** a stable relationship from 1990 to 1998. You can see this by the high and consistent rolling 1-year correlation between 1990 and 1998 (black rectangle). However, over the last five years, this relationship has been very unstable, as the rolling 1-year correlation has gyrated wildly (black arrows).



Conclusion

Comments that share the same logic as *The Wall Street Journal* quote leading this letter suggest a lead/lag between stocks and the relative performance of corporate bonds. This implies a stable relationship between these two markets. This has not been the case for the last several years and helps to explain why corporate bonds' terrible performance relative to Treasuries last fall (worst in 20 years for the six-months ending September 2002) did **not** lead to further stock market weakness. In fact, stocks were making a major bottom while corporate bonds were performing so poorly.

Likewise, the recent superior relative performance of corporate bonds over Treasuries might also mean little for the stock market. **If it did not work six months ago, why should it work now?**

In this environment corporate bonds should be viewed independently of the stock market. Their fortunes neither lead nor lag the stock market.

Only when a stable relationship between the stock market and the corporate bond market is again established can we consider these markets "related."

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