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S&P Flouts History in Break With Bonds That Often Ends Badly

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Traders work on the floor of the New York Stock Exchange (NYSE) in New York

As far as credit markets are concerned, U.S. stock investors have lost touch with reality.

That’s seen in the extra yield bond investors demand over Treasuries. The spread has expanded by 0.48 percentage point from a year ago, the most since 2012, even as the Standard & Poor’s 500 Index rallied.

While not without precedent, instances when anxiety in bonds didn’t seep into equities are rare. More than 70 percent of the time since 1996, as spreads widened as much as they have since April, the S&P 500 has fallen, with the average decline exceeding 10 percent, data compiled by Bloomberg show.

“This is something that sooner or later is going to impact the stock market,” said Russ Koesterich, global chief investment strategist at New York-based BlackRock Inc., which oversees $4.7 trillion. “Credit market conditions have not been benign and easy as where they were last summer.”

Bearish signals are flashing in a stock market where five years of earnings growth is at risk of ending and two industries account for all this year’s gains. Stocks just slid for the second week in three amid the worst selloff in cable-television and movie companies since the financial crisis.

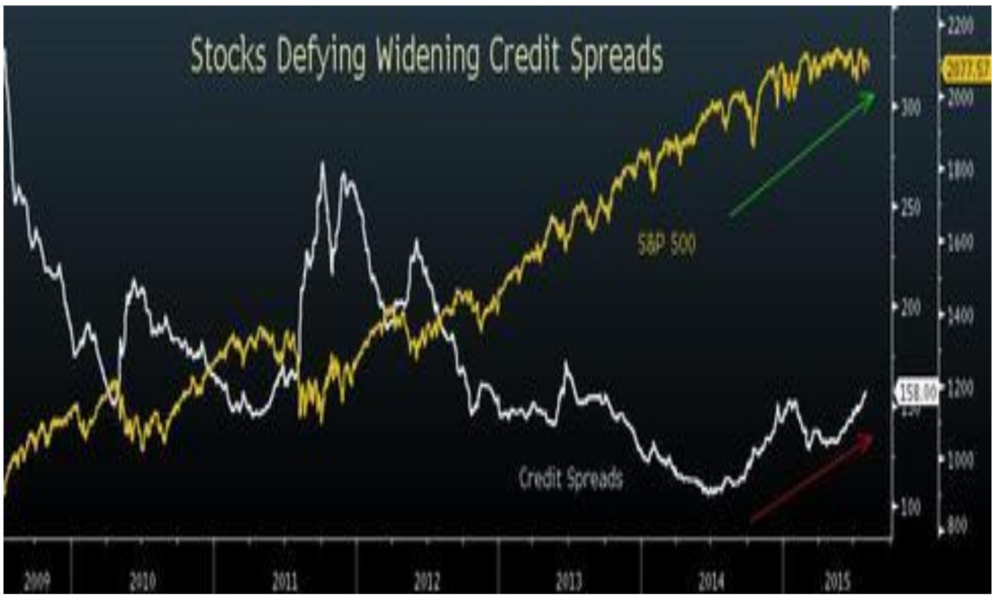
The S&P 500 rebounded Monday, rising 0.9 percent at 9:40 a.m. in New York.

Credit Stress

Prospects for a Federal Reserve interest-rate increase, the worst commodity rout since 2008 and concern companies have borrowed more than they need have contributed to bond-market stress. Yield premiums on investment-grade debt widened to 1.58 percentage points from 1.10 a year ago, according to Bank of America Merrill Lynch index data.

Stocks have kept going up, with the S&P 500 advancing 9 percent in 12 months. More than that, equity investors have been virtually immune to losses, enjoying a year in which the S&P 500 has posted no retreats of 5 percent or more. That's only happened three times since 1964.

As investment-grade companies sold a record $135 billion of bonds in July, credit spreads widened for a third month, adding a total of 0.24 percentage point. Since 1996, there have been 41 instances when rate premium expanded by this much, and out of those, stocks fell 29 times, data compiled by Bloomberg show.



On 10 occasions when stocks advanced, credit conditions improved four times over the next 12 months and the S&P 500 extended gains. In the other instances, when bond spreads widened more, stocks suffered and the S&P 500 dropped an average 18 percent.

Stock Buybacks

Stocks haven't budged this time in part because some of the things that are fraying nerves in credit market are boosting stocks. S&P 500 companies listed buybacks or dividends among the use of proceeds in $58 billion of bond deals in the three months through mid-June, the most on record in data compiled by Bloomberg and Sundial Capital Research Inc.

Since 2009, more than $2 trillion has been spent on share repurchases, helping the S&P 500 triple.

The two industries that have led U.S. equity gains in 2015, health-care and consumer-discretionary, have seen credit spreads expand to the highest level since at least 2012.

Widening spreads aren't necessarily a reflection of heightened credit risk, said Scott Clemons, the chief investment strategist at Brown Brothers Harriman Private Banking in New York, which oversees $26.8 billion. If yields are going up in anticipation of Fed tightening and not a deteriorating economy, that's not bad for stocks.

"Because this cycle has been so protracted to the point where monetary policy and economic cycle are out of sync, that's why you're seeing the lack of synchronization," Clemons said.

McDonald's, Target

McDonald's Corp. shares have climbed 2.9 percent since saying on May 4 that it would return as much as $9 billion to shareholders this year. S&P lowered its credit rating, citing the potential for rising leverage, and Moody's Investors Service put its A2 rating on review for a downgrade.

Moody's also said Target Corp.'s plan to boost share repurchases and dividends is negative for its credit ratings. The retailer's stock is up 4 percent this year.

"Bondholders are being hurt to the benefit of shareholders," said Bruce Falbaum, principal at Cohanzick Management in Pleasantville, New York. The firm oversees $1.7 billion and runs a fund whose strategy is to buy shares of companies that use borrowed money for buybacks while betting against the firm's debt.

"What stops it is if the Federal Reserve raises interest rates and they go up and up to the point where the cost of debt is too high to make economic sense to do it," he said.

Earnings Risk

One risk in the strategy to fund takeovers and buybacks through low-cost borrowings is that plants and equipment are neglected, harming output.

Productivity of U.S. workers, or employee output per hour, fell by the most in more than two decades over the six months through March, according to data from the Labor Department.

That could restrain earnings, which are already decelerating. Estimated at 0.9 percent this year and 11 percent in 2016 by analysts, S&P 500's income growth will slow from an annualized rate of 15 percent in the previous six years.

"The money is being used more for financial engineering. It does come out in a wash of productivity," said Kevin Dachille, an institutional fund manager at Boston-based Eaton Vance Management, which oversees $311 billion. "It may take a while before equity investors start to question earnings that are embedded in the forecast."