

## Rates: Warning signs that equities might have it all wrong

Most financial instruments are present values of a discounted stream of future income. For equities that is earnings, for core bonds it is coupons, plus principal payback. For high yield, a spread is added to compensate for the non-systemic risk. The equity discount is upbeat, the rates discount is ominous, high yield one is in between. Something must give



Federal Reserve

Source: Shutterstock

### Relative optimism in equities - should we buy into it?

The rates (or bond) market has a better record than most at discounting the future. For example, as the great financial crisis unfolded, bond yields fell for months before equities finally got the message that things were looking a bit ropery. And there are many other examples. Not that the bond market is perfect, but it has typically done a much better job than equity markets.

Equity market valuations are a function of forward earnings, typically heavily influenced by the immediate year ahead, through corporate guidance. Beyond that, things get quite fuzzy. And even with prospects for 2020/21 far from certain, equity markets are looking into that fuzziness and are

tending to see more positive than negative shadows.

## What is the Rates market discounting? Not a pretty picture

The bond market discount is quite different.

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This is being partly driven by a Federal Reserve that has been unwaveringly apprehensive on the future. That has anchored the 2yr rate at sub-20bp, literally for months now. And the prognosis is for it to remain there. The 10yr did manage to jump to 90bp a few weeks back as the risk-on mood became almost persuasive, but it has since drifted back to the magnet of 60-65bp.

The talk now is of a potential test of the all-time low at 54bp hit in early March as the crisis really took hold.

Either way, one thing is for sure. This bond market does not look anything remotely like a bear market. We assert that not purely based on the level of yields, but more on the structure of the curve. Specifically, we note the richness attached to the 5yr area (a combination of the 2yr and 10yr returns a higher yield than the 5yr outright). This is an important signal. The 5yr area is not as slavish to the fed funds rate futures as the 2yr is, and tends to have a better nose for what is coming down the line than the 10yr does (its nose, is too long).

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## What is the credit market telling us exactly? Stresses lie ahead

Very often credit spreads correlate with equity markets. As equity markets bottomed in late March, credit spreads peaked, just as the VIX did.

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*Here we find that the current theoretical default rate is in the area of 8% for one year. How does this compare with the great financial crisis? Well through 2008/2009 cumulative defaults were in the region of 15%.*

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The USD high yield CDS hit almost 900bp at the extreme, before falling back to a low in the area of 425bp. That is still above the pre-Covid levels in the sub-300bp area, but well below the explosive highs. That said, in the past month the spread has drifted wider by some 100bp, to the 530bp area.

So what does a 530bp spread tell us?

Well the spread itself is a repercussion for being in a default-prone asset class. It provides compensation for taking business risk above and beyond the systemic risk-free rate. By the same token it can be used to back out a default rate expectation, and in fact as the spread changes over time, so too does the implied future default rate.

## The default rates as backed out from USD high yield CDS



Source: Bloomberg, ING estimates

We find that the current theoretical default rate is in the area of 8%. The low was 7%, but it is in any case well down from the 14% default rate that was being predicted when spreads approached 900bp.

How does this compare with the great financial crisis? Well through 2008/2009, cumulative defaults were in the region of 15% (over two years). Typically default rates are quoted over a 12-month period. Here it was 5.5% in 2008 and 9.4% in 2009. The cumulative measure overstates when compared with a one year measure, but provides a deeper impression, and helps to fully contextualise the current implied default expectation.

[A more detailed discussion on corporate default rates, credit rating agency estimates, and views from our credit team see here.](#)

## Something must give - and bonds have the far better predictive pedigree, unfortunately

We've been impressed with the fact that the Nasdaq is up some 10% year-to-date. But we should also remember that the rally seen in equity markets since end-March still leaves most bourses well down year-to-date. The Dow Jones is now down some 10% and the likes of Spain's IBEX is down over 20%.

So, while equity markets have turned in a remarkable improvement since end-March, absolute valuations are still stressed. The fact that rates markets have not bought into the relative optimism remains an underlying drag.

## An uncomfortable path ahead

While equity markets have toed and froed, and credit markets have done a bit of the same, there is one constant here - the unwavering discount coming from the core bond market. The low level of rates plus bond bullish curve structures that impute maintenance of low rates paint a picture of more negative shadows than positive ones as we gaze into the fuzzy future.

It's a world of negative real core rates, and minimal pull coming from inflation expectations. Reverse engineer that into a real economy prognosis and an uncomfortable picture of the path ahead gets sketched.

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