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The technology giant is sitting on \$95 billion of cash. MAST IRHAM/ EPA/ SHUTTERSTOCK

Microsoft's Borrowing Costs Are Lower Than the U.S.'s

STREETWISE |

By James Mackintosh

Usually, when investors are willing to lend to companies at a lower yield than the government, it's because the country faces financial armageddon and the government default risk is rising. Two pristine-rated bonds from **Microsoft** that trade at lower yields than equivalent Treasuries tell us something different, though: Demand for corporate bonds is running superhot.

Among U.S. corporate bonds rated AAA, two in the main index trade a little below the equivalent yield on Treasuries, known as a negative spread. This is extremely unusual, because companies are in principle much more likely to default than the government that can tax them, and because the corporate bonds are harder to trade, so should yield a little more to compensate buyers for the difficulty in selling them quickly.

Yet, demand for highquality corporate bonds has been so great that it's driven the ICE BofA AAA U.S. Corporate index to a spread of only 0.3 percentage point over Treasuries, a tiny reward for the additional risks of holding company debt and far below the 2-plus points reached in the past two recessions. It's small enough that some of the best bonds get pushed to yield less than the government. It makes no sense.

"You're getting a lower yield for something that's less liquid too," says Mike Riddell, a bond fund manager at Fidelity International. He thinks Microsoft and other top-rated bonds should offer a yield 0.15 to 0.2 point above Treasuries purely for being harder to trade, without even considering the tiny risk of default.

There are several theories for why anyone would pay more for a bond from Microsoft or, early last week, **Johnson & Johnson**, than for a Treasury.

Start, with a theory no one believes: They're safer. All these bonds are rated AAA,

while the U.S. lost its top rating from all of the major credit-rating firms. Microsoft is sitting on \$95 billion of cash and has \$40 billion of long-term debt. It is immensely profitable and popular with investors for its artificial-intelligence business.

By contrast, the government owes the public \$30 trillion and spent more than it receives every year since 2001.

But if the government ever ran into trouble raising money, it could in principle use the power of taxation to take money off Microsoft and other companies. The threat of tax and other policies being used against them already shows up in the AAA-rated bonds from charitable foundations and top universities, which issue almost half the bonds in the AAA index and offer a yield pickup over equivalent Treasuries ranging from 0.2 to 0.9 points.

However, the bloated federal budget deficit means massive issuance of Treasuries. At the same time, corporate profitability has suppressed the need for the highest-quality companies to borrow. The combination of more Treasuries and fewer top-grade corporate bonds has naturally squeezed the gap between their yields.

“The supply-demand imbalance in [corporate] credit is very unpleasant—there’s just so little supply and so much money on the sidelines trying to chase it,” said Christian Mueller-Glissmann, head of asset-allocation research at Goldman Sachs.

Get the spread tight enough, and it’s much easier for the addition of a few oddities to push some bonds to trade with negative spreads.

Three theories are plausible: indexing, a focus on yield and the power of pension funds.

Index buyers. A lot of money has flowed to passive bond funds, following the earlier success of index tracking in equities. Because they buy whatever’s available in the index, a corporate-bond fund might buy some bonds offering less than equivalent Treasuries, because it doesn’t have the choice to switch to better-value government bonds.

Yield has been much more in focus than spread as interest rates have risen, one reason spreads overall have compressed so much. What’s not to like about a yield of 3.67% locked in until June 2027, from a company as rock solid as Microsoft? Who cares if you could get 3.69% on a recently issued Treasury maturing a month later, or slightly more still on an old Treasury bond maturing a month earlier? Professional bond investors might huff about the risk of the spread rising—a genuine risk—but if you plan to hold to maturity, maybe you don’t care that much.

Pension funds and insurers increasingly look at a different measure than the spread of a bond yield compared with Treasuries, too: They care more about the spread over comparable interest-rate swaps, which they use to hedge out some of the exposure to rate changes. Focus on what’s known as the swap spread, and the fact that Treasuries offer both better yield and better liquidity than some of these bonds might be less visible.

We don’t need to worry about a U.S. default soon, despite the fiscal quagmire the politicians love to wade about in. But anyone buying high-quality corporate bonds should be concerned about the lack of reward for taking on the extra risks.

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