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What Bond Yields Say: We've Hit the Credit Limit

Stock valuations can get elevated, frothy, ridiculous, bonkers—insert adjective here.

Credit is a different world, and that is a distinction worth remembering right now. While the multiple of earnings or, in their absence, of revenue or eyeballs that investors will pay for a share of a company's future knows virtually no limit, there is a mathematical one for borrowing. We have pretty much reached it.

Take one measure of how risky investment-grade bonds in the most-crowded and lowest-rated BBB category are thought to be: This gauge, their option-adjusted spread, was near an all-time low this week at 1.01 percentage points. That doesn't tell you actual borrowing costs but instead how much higher their yield is than the risk-free Treasury equivalent.

At that level, almost everything has to go right—risk with hardly any reward. Unlike Uncle Sam, companies can't print dollars to repay you and their bonds can't be bought and sold as easily.

Scary headlines can send credit investors scurrying, but exuberant ones will no longer push spreads lower. The BBB spread briefly hit 1.5 points around "Liberation Day" in April. When Covid-19 arrived, the spread went from 1.3 to 4.9 points before the Federal Reserve bought corporate bonds to calm markets. During the financial crisis it topped 8 points.

That meltdown seems like ancient history, but measures taken to prevent a repeat could create fresh problems today. Bank trading desks can't step in to buy as many bonds as they used to, even as bond mutual funds are much bigger.

Those bond funds have proved to be durable. Newer structures haven't yet. In addition to corporate bonds and bank loans, the \$2 trillion private credit market has been opened to mom-and-pop investors. It is even coming to staid target-date funds popular in 401(k) plans.

Many loans are owned by collateralized loan obligations that slice and dice risky credit into different categories, including super-safe tranches. Some of that repackaged debt is now owned by yield-hungry ETF investors, too.

But for that magic to work, rules limit how much speculative debt can be part of those structures. If many companies face financial strains and get downgraded—for example, because of the trade war—CLOs may be forced to sell junkier debt.

Analysts at Rosenberg Research see more weakness in the junky part of the market than prices reflect. They calculate that speculative credit spreads imply a significantly lower default rate and higher economic growth than recent actual numbers.

Individual investors can usually be counted on to buoy swooning stock prices or to send them even higher. The credit market is different. It is trickier to buy the dip and, after the recent rally, almost impossible to chase the rip.

—Spencer Jakab