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Giving Corporate Credit Its Due

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New research shows corporate bonds have been far better at predicting where the economy is headed than anyone thought. Unfortunately, that suggests the economy is going to get much worse.

In the fall of 2007, before the economy began to falter, corporate-bond prices were signaling all was not well. The spread between corporate-bond yields and Treasury yields, which had begun to widen amid that summer's mortgage woes, showed little improvement even as the Dow Jones Industrial Average clocked record highs.

It wasn't the first time bonds had signaled something was awry. One of the head scratchers of early 2000 was why stocks were surging when high-yield bonds were wavering. In retrospect, the bonds had it right.

Bond investors are intensely focused on companies' ability to pay down debt. If they see signs business is slowing, they demand higher returns, and thus higher bond yields. Widening corporate-bond spreads can also reflect disruptions in the credit supply -- say, because banks are mired in bad mortgages -- that eventually sap the whole economy. Finally, widening spreads can induce companies to cut back on expansion plans, which also has economic consequences.

Bonds' forecasts haven't always seemed to come true. Many corporate-bond indexes showed spreads widening significantly during the 1998 Russian debt crisis, and yet the economy soldiered on.

Such false signals mightn't be because of corporate bonds themselves, however, but the way corporate-bond indexes are constructed. The bonds in them tend to have much shorter times before they will mature than the 10-year Treasurys that their yields are usually compared with -- which makes for a faulty comparison.

To compensate for that, economists Simon Gilchrist and Vladimir Yankov at Boston University, and Egon Zakrajsek at the Federal Reserve constructed credit spreads over the 1990-2008 period from monthly price data on the corporate debt of about 900 U.S. nonfinancial companies. They divvied up the bonds based on both expected default rates (a more timely measure of quality than ratings) and time to maturity.

In a forthcoming paper in the Journal of Monetary Economics they show that spreads on low- to medium-risk corporate bonds, particularly those with 15 or more years until maturity, predicted changes in the economy phenomenally well, forecasting the ups and downs in both hiring and production a year before they occurred. Since writing the paper, they extended their analysis back to 1973 and found bonds' predictive ability still held.

It would be better for everyone if it doesn't hold in the future. With the massive widening in corporate-bond spreads last fall, the economists' model predicts industrial production will fall another 17% by the end of the year, and the economy will lose another 7.8 million jobs on top of the 5.1 million it has shed since the recession began. Ouch.

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