If you’ve been wondering about the incredible shrinking credit spreads of the last four years, you’re probably darn tired of the matter; so much so, in fact, that you’re possibly prepared to buy some securities that have structures that you’d never heard of until the last six months or so. Agency and corporate issuers have devised a new genre of structured notes, and along with them come new layers of complexities.

There, of course, is an undercurrent of investor demand that is fueling these new concoctions. Flat yield curves, shrinking core deposit bases and maybe deteriorating credit quality are in turn feeding the demand. There is also the reality of less credit spread.

Credit Spreads
Going back to Investments 101 we are told that everything yields more than a Treasury security, due really to three main risks: option risk, price risk and credit risk. The combination of the three in a given bond, along with supply/demand effects, by and large determine the bond’s yield and, in effect, its “spread.”

It’s also worth mentioning that agency and corporate borrowers have pretty much behaved themselves from a governance standpoint over the last five years, auto makers notwithstanding. Fannie Mae and Freddie Mac, which absorbed broadsides from the rating agencies and investors in the early part of the decade, are now seen as white knights in the subprime debacle. Their respective preferred stocks’ performance in the last year, which has been quite impressive, is widely seen as a public proxy on investors’ stance on these government-sponsored enterprises’ credit risk.

Hundreds of community banks have benefited from this phenomenon as well. Issuers of trust preferred securities (TRUPS) have noticed a dramatic tightening of margins in the last five years, as well as the virtual elimination of underwriting fees. The TRUPS issuance market is part and parcel of the overall corporate debt picture.

If we track a given corporate issuer that has not had a recent change in its credit ratings, over time we can see if its credit spreads have changed. We would want to use larger issuers that are non-callable, so we take out option risk, price risk and supply hiccups.
**Test Case**

Lehman Brothers Holdings is a good test case. This is the holding company of a primary Wall Street dealer and has a lot of paper available in the primary and secondary markets. Its credit rating has been A1/A+ for many years, which makes it a solid investment-grade credit. As of June 30, 2007, you could buy a Lehman medium-term note with a five-year maturity at a spread to the curve of about 62 basis points or .62 percent over the five-year Treasury note (see Table I).

For most of 2001 through 2003, the spread was over 100 basis points. The shrinkage of spread of 38 basis points may not seem significant, but it has far-ranging implications.

For one, it means that high-grade corporates have far outperformed Treasuries over the last four years on a total return basis.

For another, it means the owners of these issues have seen their market values hold very well during the Fed hike cycle that began June 30, 2004. (Part of that equation is the positive slope of the corporate debt curve, which is another story unto itself.)

Finally, the credit spread shrinkage has been partly responsible for the improvement in overall corporate earnings, which has in turn fed the recent stock market rally.

**MBS Nuances**

Mortgage-backed securities (MBS) of all flavors have likewise seen a narrowing of spread. It is harder to identify the part of the narrowing that is related specifically to credit because we have prepayment (option) issues to deal with, along with supply issues. Balloon MBS, for example, have been practically non-existent since 2005, and prepayment risk is seen as less onerous in 2007 than it was in 2003.

Still, we can review a sector that has a lot of supply depth and gain some understanding. A popular community bank product, a two-year sequential collateralized mortgage obligation (CMO) was available at more than 110 basis points of spread in 2002-2003. Today spreads of 50 basis points are more realistic (as shown in Table II). The same can be said for 15- and 30-year MBS, many types of hybrid adjustable rate mortgages and other CMO structures.

**Investors’ Reactions**

In recent columns, I’ve mentioned new agency and corporate products like range notes, non-inversion notes and curve steepeners (see November 2006 ICBA Independent Banker). Product development, in any functioning market, results from an exchange of ideas between producers (underwriters) and consumers (investors). While range notes are not new, their recent popularity in some part stems from the need for additional net interest margin. The other products mentioned above are offshoots of the range note concept.

It’s also necessary to mention that the global debt market’s volatility in mid 2007 caused a dramatic widening of credit spreads. At press time, the spreads mentioned above, while tight on an historical basis, were still 40 basis points to 60 basis points wider than earlier in 2007. Whether the near-universal tightening of credit spreads will continue its trend will be determined by the actual, and perceived, financial health of both the public and private sectors of the credit market.

Jim Reber is president and CEO of ICBA Securities, ICBA’s portfolio management services corporation. Reach him at (800) 422-6442 or jreber@icbasecurities.com.

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**Table II**

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<th>Basis points</th>
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<td>30</td>
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Source: Vining Sparks