Why Are Yield Spreads So Wide?

What has caused yield spreads to widen this year? Answers to this question are all over the map: I could tell you, but you wouldn’t understand. I haven’t the foggiest. Because of the Democrats in Congress. The weak dollar.

I actually have not heard any of these responses used to answer the question of widening spreads, but most explanations I have heard have been equally off base. The truth is that there are a number of influences that have caused yields on everything except Treasury securities to remain—depending on your point of view—maddeningly or alluringly high.

And, as you probably surmise, the answer to my original question is a bit more complicated than a Democratic Congress or a weak dollar. So, in the next 700 words or so, I will attempt to document the Great Yield Bonanza of Early 2008. Here goes:

Textbook Explanation

Spread widening happens virtually every time the debt markets enter this phase of the interest rate cycle. In fact, looking back to the 1980s, today’s credit spreads seem narrow. That was an era in which the typical mortgage lender had no understanding of the secondary market, and terms such as...
callable debt and derivatives had not yet entered the lexicon of community bankers.

The generic answer to this question of widening spreads is that as an economy begins to slow down, the risk of credit default grows. Since the creditworthiness of all borrowers, agencies included, is inferior to that of the federal government, any debt that they carry, at least in theory, is more risky. It is rational that a lender should therefore be entitled to charge a higher rate of interest.

All this theory can be seen in practice simply by looking at our residential housing market in the last two years. Mid-2006 saw a peak in housing prices and record lows in mortgage yields, relative to Treasuries. Mortgage investors are probably not going to revert to their profligate ways any time soon.

**First-Cousin Explanation**

Liquidity risk: It’s related to, but essentially different from, credit risk. In this context, liquidity is the ability to efficiently convert assets to cash, taking into account both the speed and the cost-effectiveness of transactions. I can give a two-word example of this effect: Bear Stearns.

That company was brought down not by assets going bad, but by its inability to meet margin calls by several of its largest financiers. It was understood that there were a lot of exotic mortgage instruments on the balance sheet, against which a pile of cash was borrowed. All this was fine as long as the lenders were comfortable that Bear Stearns could move those assets in time.

As more and more stories describing the difficulties in valuing illiquid mortgage instruments, like collateralized debt obligations, became public, Bear Stearns’ lenders developed cold feet, forcing the company to liquidate certain assets to pay off borrowers. When no one was willing to step up to the plate and purchase the company’s inventory, it became necessary for the Federal Reserve and JPMorgan Chase to ride to the rescue.

The result is that a premium has been placed on liquid instruments; the most liquid are Treasuries. This chain of events has helped keep spreads unnaturally wide.

**Callability Explanation**

Don’t lose me here! We’re almost finished, but a third element must be mentioned. It should be labeled “option risk.” Again, this represents opportunity with a capital “O.”

As interest rates on Treasuries become volatile, and they certainly have been so for the last nine months, anything that has a call feature attached to it will tend to have higher yields.

Currently, somewhere around 80 percent of a typical community bank investment portfolio has some optionality.

Economically, the value of an option increases as rates bounce around, and the parties that are buying the option (the issuers) have to pay more for it. Since you, the investor, are selling the option, you benefit from the higher coupon as a result.

It stands to reason that you should be very mindful of the type of option you’re selling (i.e., the type of callable security you’re buying), as portfolios with a minimum of call risk almost always perform better than those with less “staying power.” In other words, don’t be lulled into buying the highest yielding callable you can find if it has no call protection.

**Take Advantage**

It is highly expected that yields on “spread” products will revert to normal when, and if, stability can be found in the debt markets. That means even if the Fed is winding down its tightening phase, and it’s far from certain that this is the case, today’s yields could continue to drop as spreads narrow.

This would bolster the argument that today’s yields are a bargain. However, even if rates don’t drop from here, the steep yield curve will help support your prices through the “roll down the yield curve” effect.

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