

Credit Spreads in Pictures.

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Without considering fundamentals, lets look at some pictures...

The global economy is in relatively rude health. The US continues to grow and employment is becoming broader based. The UK is one of the faster growing economies in the developed world. China is recovering nicely as the PBOC eases. The ECB is underwritten the Eurozone economy and is cleaning up the banks. LatAm and some other emerging markets are flirting with stagflation but China, India, Indonesia, are healthy. The MENA is in turmoil and but this is in part a consequence of their waning energy importance. On balance, the world economy looks alright. But there is a right price for everything. Sadly we just don't know what it is until after the fact. So here are a few pictures for you to make up your own minds.

Are equities expensive? The yield gap between US equities and UST 10 year yields is still reasonable if you use 12 month trailing earnings. However, the Shiller PE is at 26X against a long term average of 17X. Which one is appropriate is a matter of inclination.



What is the relative valuation between US equities and US corporate bonds? Here is the spread between US equity yields and the yield on Baa rated corporate debt. Looks like a toss

up.



What does the relative valuation between US HY and IG look like? Looks like HY is trading tight to IG and could widen.



What is the spread between Baa and UST 10 years? IG does not appear as tight as one might have expected.



How steep is the US term structure? The 2 – 10 spread looks pretty healthy. In fact, there appears to be room to flatten.



The 2 – 30 spread certainly looks like it has room to flatten.



What are inflation expectations? Here are the 5 year breakevens (spread between TIPS and USTs). Inflation does not appear to be a concern. However...



The Fed balance sheet is a bit big. And inflation can rise if the velocity of money picks up and multiplies through the

balance sheet.



What can we infer from all this?

- Equities are not expensive if you use 12 month trailing earnings but are expensive based on the Shiller PE which adjusts for profitability.
- Investment grade credit is not as stretched compared with treasuries.
- High yield is over valued relative to investment grade.
- The yield curve is still quite steep. This bodes well for the economy and for equities. There is room to flatten which is actually good for carry trades and duration.
- All can be well if inflation doesn't suddenly pick up.

Things that make you go hmmm...

Post 2008, the S&P and the Fed balance sheet seem to be going in the same direction. And now what is the Fed up to?

