

GANSALO CAPITAL

Credit Spread Tail

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A strong indicator that the economy is overheating is when the relative credit spread for junk debt falls near or below the risk-free rate...

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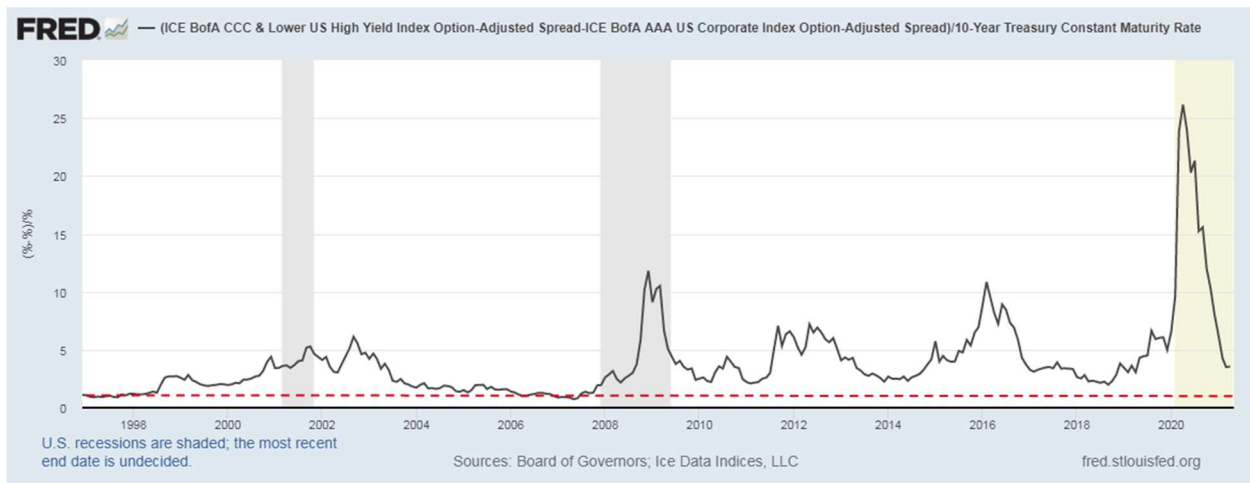
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In an earlier paper, we explained how credit supply drives the economy: when abundant, spending increases along with debt, the economy expands, and the conditions for a contraction are set in motion. The opposite is true when credit supply tightens. In that paper, relative credit spread, defined as the spread between investment grade debt and high yield debt, was shown to be a reliable measure of investors' risk appetite and potential credit supply, as well as a reflection of the economy's current state. What it does not tell, however, is when the economy has reached its peak – there is a long gap of four years or more between the extreme relative credit spread and the peak of the economy. A better indicator of economic peak is when the “tail” of the credit spread, comprised of junk debt, is extremely low.

At a point in the credit cycle, the economic fundamentals for junk securities (rated CCC or worse) are looked upon favorably by investors who will readily accept lower yields for such securities. The economy reaches an inflection point – and a dangerously extreme level – when the spread for these securities falls near or below the risk-free rate. A recession is imminent within two years thereafter.

Tail Spread relative to Risk-free rate



The red line in the above chart represents parity between the tail spread and the risk-free rate. Over the past two decades, the tail spread fell below the risk-free rate twice in August 1997 and in April 2006, and recessions ensued 3.5 and 1.5 years thereafter, respectively.