Risk Ahead - What the Credit Markets and Bank Shares May be Signaling

Credit markets are extremely important to consider.

When assessing the risk of financial markets, credit market signals are often overlooked (and underappreciated) by commentators. I have assembled a few key graphs that show how stress is becoming evident in the credit markets. This is important because virtually all asset prices can be significantly affected by credit availability and borrowing costs. So let's get started…

Below is a chart which shows the risk premium that corporate bonds require above the risk free rate. As you can see, risk premiums have risen materially over the past couple of months. In fact, risk premiums are approaching levels where corporate borrowing becomes harder to secure and much more expensive. The economy and financial asset prices suffer as a result.

Below is a price chart of a Credit Default Swap (insurance) on a diverse portfolio of corporate bonds. Price increases reflect growing default risk. Note that a price rise above 60 basis points historically signals stress in the corporate bond market. We are currently at 78 basis points, so the market is beginning to anticipate higher default risk.

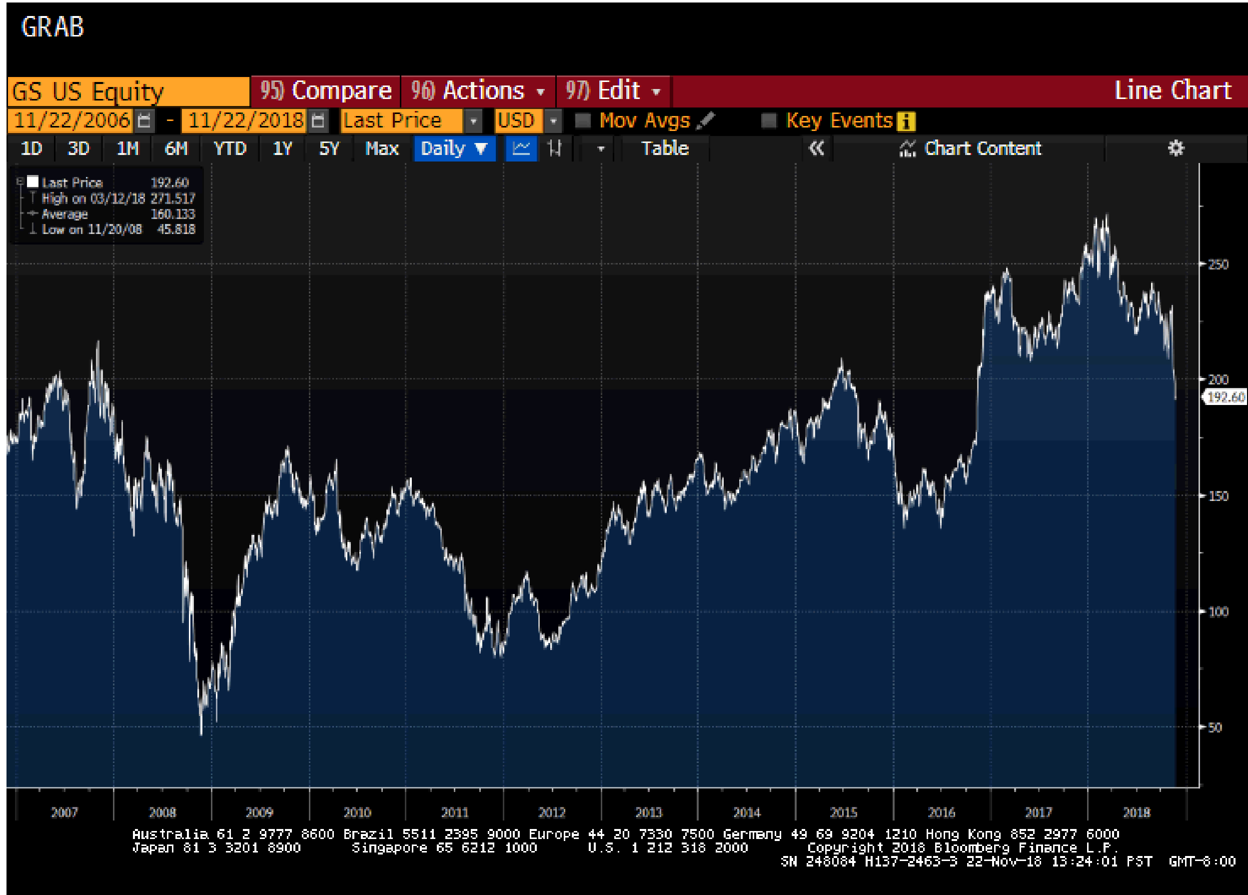
The next chart below shows the yield differential between the U.S. 10 year yield minus the U.S. 2 year yield. The yield spread has some predictive power because when it has fallen below 40 basis points, a recession has followed in the next year. We are currently on the verge of that happening now in 2018-2019. Again, more danger being signaled.

Global banking giants are also important.

Share prices represent the outlook of any given company – global banking giants are no exception. Historically, falling share prices of large banks can have predictive power for the outlook of stocks and bonds generally. In fact, they can be viewed as "canaries in the coal mine." I have included three global banks as evidence.

The chart below is a twelve year chart of Deutsche Bank. As you can see, the declining share price in 2007 was a good predictor of things to come in 2008-2009. The share price is currently hitting new lows, pointing to a poor outlook.

The chart below is a twelve year chart of Goldman Sachs. Again, a falling share price in 2007 was a precursor to the financial crisis in 2008-2009. Currently, the price is in a steady decline so caution is warranted.



The chart below illustrates the share price of HSBC since 2006. It is noteworthy that a share price below $45 U.S. has been associated with broader market corrections in 2008-2009, 2011, 2015-2016. Given it is currently at $41.80, the shares seem to be signaling stress ahead.

So in summary, the price signals being sent from the credit market and share prices of investment banks certainly warrant attention. At this point in time, investors need to exercise some degree of caution.