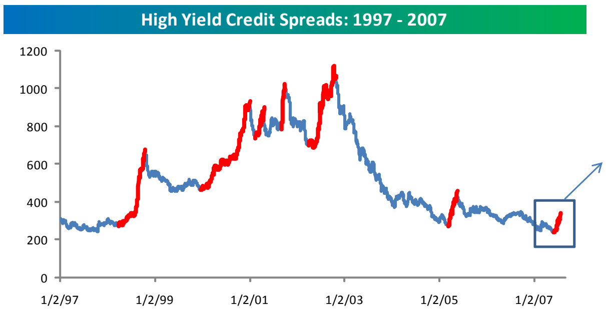
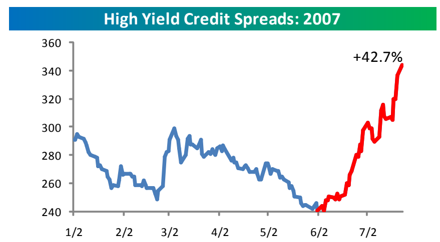
Tags: High Yield Spreads

High Yield Spreads: A Cloud on the Horizon?

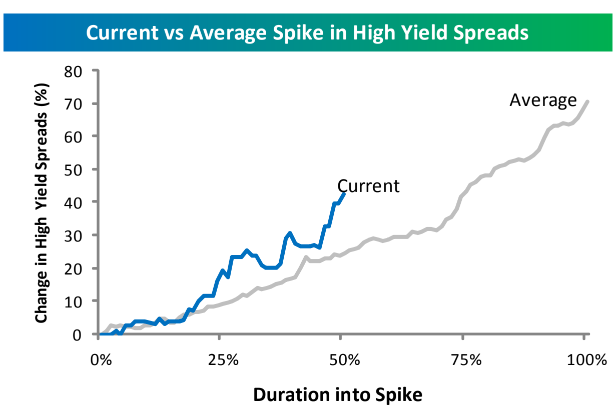
According to the Merrill Lynch high yield corporate bond index, the spread between high yield corporate bonds and Treasuries has widened by 43% since hitting a low of 241 basis points on June 1st. We looked back over the history of the index in order to find other spikes in the spread to see if there are any comparisons to the current period.

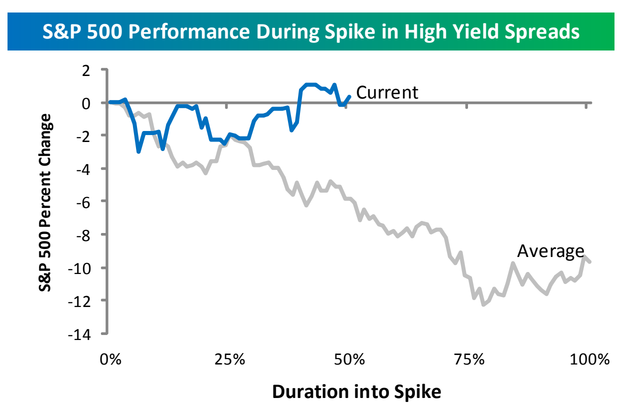




After identifying these spikes, we calculated the performance of the S&P 500 during each period, and found that the index declined during each one (see page two for charts of each individual period).

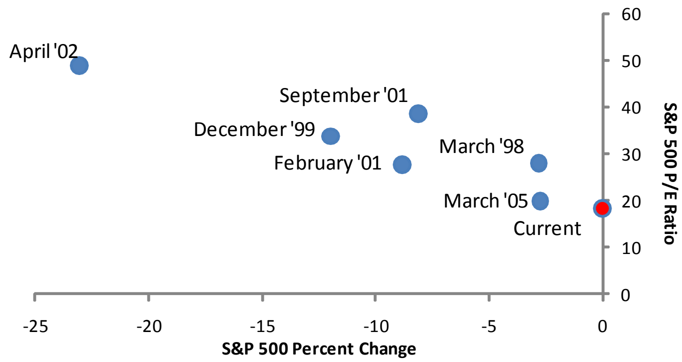
Below we combined each period in order to create composite charts of the 'average' spike in high yield spreads and the change in the S&P 500. When we compared the results to the current period, we found a disconnect between prior periods. While the current rise in spreads is similar to the average of the prior periods, the pattern of the S&P 500 bears little resemblance as it has yet to show any decline. This implies a negative environment for equities going forward as they play catch up, although given the more attractive valuation of the S&P 500 relative to prior periods, any declines should be limited (see chart on page two).





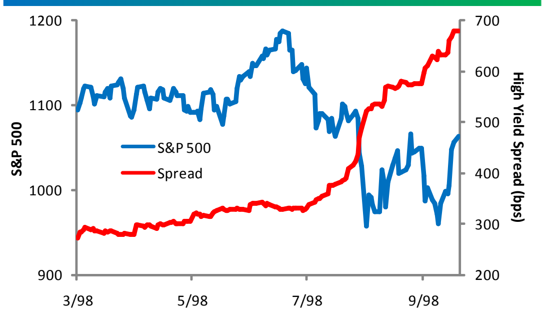
Current Duration into spike is calculated by comparing the current spike to the duration of the average duration.

S&P 500 Performance During High Yield Spread Spikes vs P/E Ratio

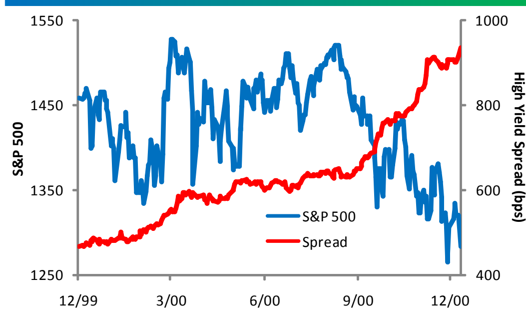


The magnitude of the S&P 500 decline during other spikes in high yield spreads is correlated to the valuation of the market heading into the decline. Since the current P/E ratio is lower than at the start of any other spike, any downside in the stock market is likely to be below average.

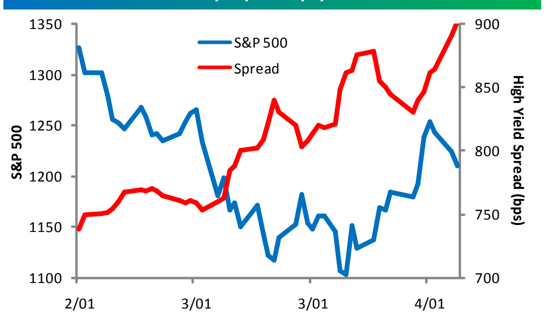
3/30/98 - 10/19/98



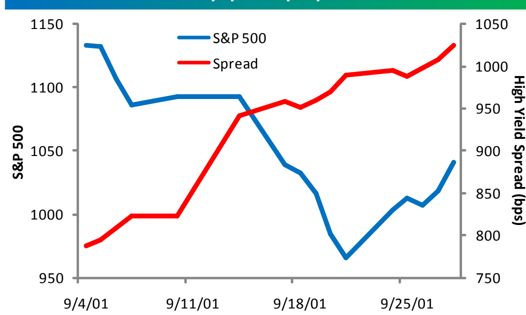
12/23/99 - 1/2/01



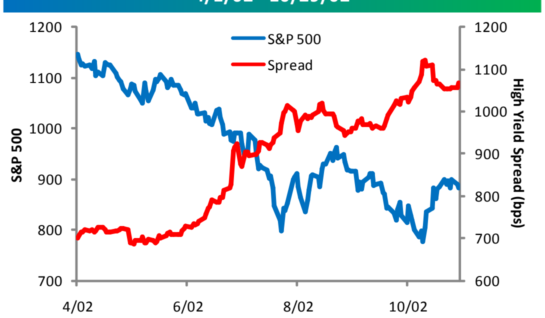
12/23/99 - 1/2/01



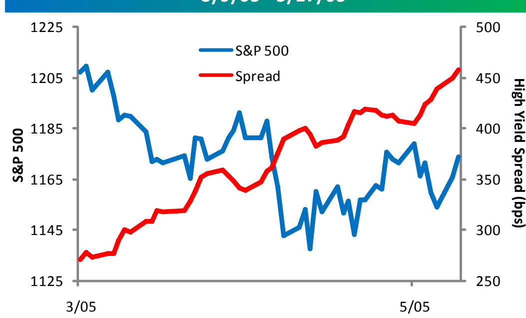
9/4/01 - 9/28/01



4/1/02 - 10/29/02



3/9/05 - 5/17/05



Bespoke Investment Group