What Happens if the Government Pays Off the Debt?

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With all the recent talk of a tax cut and/or paying off the government debt with the projected surplus, a question has been bouncing around in my head for a while. As many of you know, corporate bond yields are typically quoted as some spread to Treasuries. For example, if the 10-year Treasury is yielding 6.00% a single-A corporate might be quoted as "+75 to the 10 year." This means that the corporate bond is yielding 75 basis points (one hundred basis point is equal to 1%) or .75 of 1% higher than the corresponding Treasury, or 6.75%. The question I've been considering is this. What happens to the corporate bond market if there are no Treasuries to price them from? I'm not sure, really, that this question currently has an answer, nor am I sure that it really needs one, given the propensity of our leaders to spend every dime they take in rather than actually paying down the debt. I do think, however, that it is something we should at least ponder between now and then. How do you price a corporate bond (or any non-treasury bond) if there are no Treasuries?

For purposes of discussion, a few things came to mind. Do we price corporates off of agency securities? Do we price corporates off of the other AAA corporates which are naturally in very limited supply? Do we price corporates off of some other well recognized and accepted standard of yields, say, fed funds? I don't know either, but it got you thinking didn't it?

As I continued to think about this conundrum, the answer began to take shape. If you truly are a credit-research driven purchaser of corporate bonds you don't buy your corporates based on the spread to Treasuries anyway. You buy them based on your credit research - what you think they are worth given your expectation of risk - and only then do you relate the yield to a spread to Treasuries as a matter of convenience and tradition.

Undoubtedly this phenomenon would cause some confusion within the market for a while and no doubt it would be a gradual shift, as the debt will probably not be paid off at once. Nevertheless, if you buy by yield spread and rating you may experience some clouded vision for a while. If you conduct thorough credit research, having no Treasuries to benchmark your corporates off of remains much less of a problem.

Fortunately the only way we know how to buy corporates at Garner Asset is to do the credit research and evaluate the risk in terms of absolutes (rather than relative to a Treasury by spread alone) and then only as an after-thought relate a corporate bond yield to that of a corresponding Treasury bond. Given the nature of many of our clients, a good majority of the bonds we evaluate and disapprove would not be approved for purchase at any yield, so spread to Treasuries becomes even less important. Credit worthiness is what counts.

We will continue to conduct our credit research like we always have and the market will eventually sort out how to price corporates if there are no Treasuries. Until then, stay focused on quality research and let the spread be an "oh, by the way, the spread to the ten year is..."