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Signs of Credit Market Improvement

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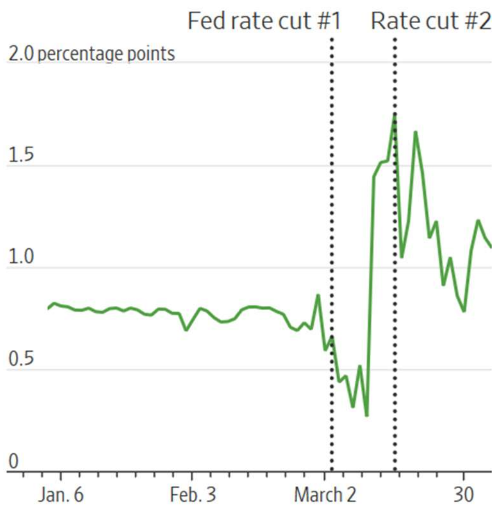
The Down Jones Industrial Average ended slightly lower Tuesday giving up a robust 800+ point opening to the trading session. The Dow was not able to hold on to what would have been two days of impressive gains and fell sharply at the close to end up basically where it started at 22,654 – down 26 points, or 0.12%. The S&P 500 and the Nasdaq followed similar paths with the S&P 500 closing down 4.3 points, or 0.16%, and the Nasdaq Composite closing 25 points lower, or 0.33%.

Clearly most of the attention is being paid to the stock market, and rightfully so giving the aforementioned volatility. <u>However, there have been encouraging signs in the bond, or credit markets that things are calming down.</u> Critical parts of the U.S. debt market are functioning again, according to the Wall Street Journal, a sign that the Federal Reserve's assertive and sometimes creative actions are working to reduce credit market stress.

The Federal Reserve's goals are: 1) create liquidity, which maintains calm, 2) reduce borrowing costs across the economy so large corporations, small business and individuals will be encouraged to borrow and spend money. We've written previously about the Fed's effectiveness in creating liquidity, but they have also been effective reducing borrowing costs. The Federal Reserve is particularly interested in reducing long term yields, such as the 10-year U.S. Treasury Bond because other long-term rates (like mortgage rates) are impacted by its yield.



However, not only does the Federal Reserve want the treasury rates to go down, it wants other debt products like mortgages to go down too. The difference between the treasury yields and the mortgage yield is referred to as a spread. The Fed wants this yield spread to maintain at a normal level. If treasury yields go down and mortgage rates rise, then the spread between the two rises and that doesn't benefit individuals trying to refinance their mortgages.

Spreads stay stable in time of calm but change dramatically in times of turbulence. As show by the adjacent Tradeweb graph, the spread of the mortgage-backed securities yield compared to U.S. Treasury yields is trending toward the pre-crisis levels seen in January and early February. While not back to where it was, the trend toward that level is encouraging. And it is <u>further evidence that the Federal Reserve's actions are successfully reducing credit market stress.</u>

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