Credit Spreads and Business Cycles

by Simon Gilchrist & Friends

Discussion by Dave Backus
Becker-Friedman Institute MFM Meeting | September 13, 2012
Executive summary

What we knew about credit spreads

- Credit risk is priced
- Variation in spreads unrelated to firm characteristics ("puzzle")
- Most of the variation is common across firms ("price of risk")

Some of Simon’s contributions

- Spreads carefully constructed from individual corporate quotes
- Adjusted for call provisions and default probabilities
- Significant correlation with future economic growth

Suggested interpretation

- Credit spreads reflect "strains in financial system"
Questions someone else might ask

Too much of a good thing?
- Why is BMA weight on credit spreads so high?
- Does forecast horizon matter?
- Why doesn’t housing get more weight?
- Why are BMA weights so different for GDP and investment?
- Is the last decade different? The crisis?

Similar to – or different from – related work?
- **Stock and Watson (JEL, 2003)**
- Mueller (ms, 2009)
- Hatzius, Hooper, Mishkin, Schoenholtz, and Watson (MPF, 2010)
What I’m interested in

Cyclical properties of asset prices
  ▶ Often different from quantities — esp timing

Including: variation in the price of risk
  ▶ In $E(mr) = 1$, the action seems to be in $m$
  ▶ Same $m$ applies to all $r$’s

Obvious question
  ▶ Do we see similar cyclical properties in other asset prices?
Cyclical properties of credit spreads (GZ)

Aaa–Baa spread

GZ spread

GZ excess bond spread

GZ excess bond spread (raw)
Cyclical properties of credit spreads (Bloomberg)

Bloomberg AAA 3m

Bloomberg AAA 5y

Bloomberg AAA 2y

Bloomberg BBB 5y
Cyclical properties of term spreads

Term spread (10y–FF)

Riskfree rate

Term spread (raw)

Real riskfree rate
Cyclical properties of returns

Equity return

Equity excess return

Equity return (raw)

Bond excess return
Cyclical properties of corporate bond returns

![Graphs showing cyclical properties of corporate bond returns for different credit ratings and maturities.](image-url)
Cyclical properties of corporate bond returns 2

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Where does that leave us?

Summary

- Simon’s credit spreads clear improvement on Moody’s/Fed version
- Open question which maturities/ratings are most useful
- Roughly contemporaneous with IP growth
- Whereas equity returns show pronounced lead ...
  Ditto corp bond returns?

Questions

- Do returns all show the same cyclical pattern?
- Due to financial stress? Or some other cyclical mechanism?
Related work (some of it)

Credit spreads
- Elton, Guber, Agrawal, and Mann (JF, 2001)
- Collin-Dufresne, Goldstein, and Martin (JF, 2001)
- Chen, Collin-Dufresne, Goldstein (RFS, 2009)

Forecasting with financial variables
- Estrella and Mishkin (RESTat, 1998)
- Gertler and Lown (OREP, 1999)
- Mody and Taylor (IMF, 2003)
- Stock and Watson (JEL, 2003)
- Mueller (ms, 2009)
- Hatzius, Hooper, Mishkin, Schoenholtz, and Watson (MPF, 2010)