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Risk Premiums among Corporate Bonds

To help insure against lower-than-expected returns, investors in speculative projects generally insist on commensurate risk premiums in required yields. In early 1997, prior to the financial crisis in Asia, the Federal Reserve noted that "risk premiums for advancing funds to businesses in virtually all financial markets had declined to near-record lows" (1997 Monetary Policy Objectives, p. 8). Federal Reserve reports questioned whether investors, emboldened by high current profits and incomes, were adequately accounting for the risks associated with marginal investment projects and capital goods that might not yield their expected returns in the future. Low risk premiums on business obligations in early 1997 may have been "based on a perceived environment of persisting low inflation and balanced economic growth that would lower the odds of disruptions to economic activity" (Report to Congress, Feb. 26, 1997, p. 20).

In the U.S. economy, one of the most visible risk premiums is the difference in yields between corporate bonds that belong to different risk categories, depending on the strength of the issuing company. Aaa ratings are for high-grade bonds and Baa ratings are for medium-grade bonds. (So-called junk bonds are corporate bonds not considered to be of investment grade.) The risk premium in the yield required of Baa corporate bonds above the yield on Aaa corporate bonds has averaged about 1.15 percentage points since 1970. Since 1984, the risk premium has averaged somewhat less at 0.95 percentage point, perhaps because the U.S. economy has had comparatively fewer recessions since 1984 than between 1970 and 1983. Since the beginning of 1994, the risk premium has averaged only 0.64 percentage points. Following Russia's default on sovereign debt in mid-August 1998, however, the risk premium on Baa corporate bonds has risen by about 20 basis points to roughly 0.8 percentage points, as the accompanying chart of daily data through Oct. 7, 1998, shows.

Both Aaa and Baa corporate bond yields have fallen since August 1998, but investor preferences have shifted in favor of Aaa bonds, mirroring the flight to quality that has caused U.S. Treasury bond yields to fall by an even larger amount. The wave of financial crises in numerous emerging markets overseas has apparently heightened concern among bond market participants that turmoil in emerging markets could disrupt economic activity in the United States through the loss of export markets and capital losses on investments in those countries. To date, however, the risk premium on Baa bonds is still below its average level since 1984. Thus, while financial problems in emerging markets have reminded investors that the U.S. economy is still bound to experience negative shocks, investors do not seem to believe that American corporations face any unusual threat to their survival.

—Michael Dueker

Baa Yield Less Aaa Yield