# EUROPEAN BONDS IN PERSPECTIVE

FOR THOSE TREASURERS INVOLVED IN EUROPEAN CORPORATE BOND TRANSACTIONS THIS YEAR **CRISPIN SOUTHGATE** OF MERRILL LYNCH HAS SOME SOUND ADVICE ABOUT WHAT INVESTORS ARE LOOKING FOR.

In 2001, the largest rating category for top European corporate borrowers in all key currencies went down from A2 to BBB1. That was due to rating downgrades, not new issues responding to increased BBB demand. For some issuers, it meant losing the coveted A1/P1 short-term rating, significantly restricting access to the US commercial paper (CP) market. Not surprisingly, this year, treasurer's should expect investors' hunger for timely and comprehensive information to increase. In this article, we set out some of the ideas we have put before investors in European corporate bonds for 2002. Suffice to say, investor relations has never been more important than it is now.

**WHY INVEST IN CORPORATE BONDS?** The main reason investors buy corporate bonds is the excess yield, or spread. Leveraged investors such as banks measure this over their funding costs and track spreads to swaps. Other investors may use swap rates as a benchmark, but they typically aim to beat lower risk alternatives such as government and supranational issues. An increasing number of European investors are specifically benchmarked to a corporate bond index, therefore they aim to beat a particular (and index-defined) universe of fixed rate bonds currently in issue.

Last year, particularly in the telecom sector, investors benefited from narrowing spreads, as well as additional yield. The reverse hurt them in 2000. We do not expect general spread narrowing or widening to play such an important role in excess returns in the first quarter of 2002. In summary, we look to the current yield spread as the main contributor to positive first quarter excess returns in euro and sterling credit.

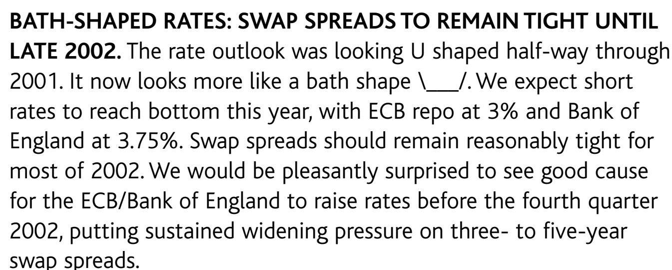
We expect stable credits to do well in early 2002. Some individual names could produce volatile corporate index spread performance in low A/BBB sectors. Compared with government bonds, we would be slightly overweight credit in both euro and sterling. We would put the overweight in the one- to five-year segment of stable AA/A euro credits and in the over 10-year segment of AA in sterling.

The risk of negative excess returns to governments or, say, European Investment Bank (EIB), is the risk of spreads widening. Investors will calculate breakeven spreads to help assess this risk. For a rough approximation, the annual breakeven spread on a bond is the current spread divided by the effective modified duration. Small breakeven spreads mean only a little widening can destroy excess returns. This risk is greater in longer maturities. The term structure of spread is not consistently positive: as duration increases, breakevens decline sharply. So rating stability at the long end is a key requirement.

Our rough estimates of non-financial supply in euro for the first quarter of 2002 at €60bn are slightly more than the corresponding period for 2001. Overall, our view is that strong demand is continuing to build. Augmented by the weaker attractions of equity investment, we expect this amount to be taken up without great difficulty or sustained widening in spreads.

The sterling pipeline is not so abundant. We see a continued shortage of good quality corporate bonds in the face of substantially increased potential demand from pension schemes, especially at the longer end.

## ☐ SWAP SPREADS, RISKS AND RETURNS

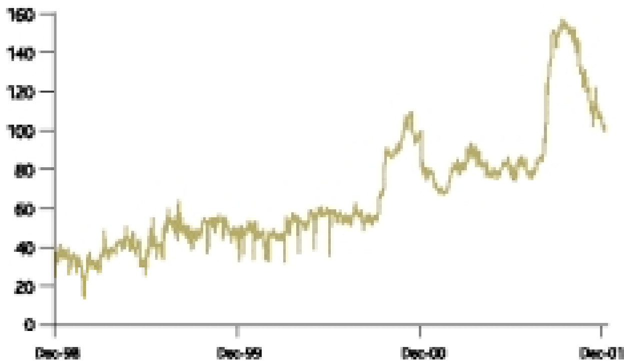


**BATH-SHAPED RATES: SWAP SPREADS TO REMAIN TIGHT UNTIL LATE 2002.** The rate outlook was looking U shaped half-way through 2001. It now looks more like a bath shape ___/. We expect short rates to reach bottom this year, with ECB repo at 3% and Bank of England at 3.75%. Swap spreads should remain reasonably tight for most of 2002. We would be pleasantly surprised to see good cause for the ECB/Bank of England to raise rates before the fourth quarter 2002, putting sustained widening pressure on three- to five-year swap spreads.

**LOOKING FOR THE CASHFLOW SIGNALS IN 2001.** At the time of writing, we are at the beginning of the results season. We expect corporate management to throw everything possible by way of bad news into the 2001 results, clearing the decks and giving 2002 earnings some chance of flattery by comparison. This could include review of intangibles (such as goodwill from those acquisitions in the halcyon days of the bull market) for impairment, with write-offs hitting current earnings. That amounts to an internal corporate

**FIGURE 1**

EJ02 (3-5 YEAR EURO INDUSTRIALS) SPREAD VERSUS EURIBOR (TO 14 JANUARY 2002).




*Source: Merrill Lynch Global Index System*

For a 100% risk weighted asset and a bank risk asset ratio of 10, a spread of 100bps over matched term funding costs is worth 10 times that amount as a marginal return on capital. Funding for four years would typically be about swaps plus 20bps. So early 1999 spreads of 40bps over Euribor for three- to five-year industrials were worth about (40-20)x10=2% in marginal return on capital. Current spreads are worth (100-20)x10=8% in marginal return on capital. Average rating of three- to five-year industrials has dropped from A1 to A3, but return on regulatory capital has increased four-fold. For total return on capital, just add a reasonable risk free medium term rate – for example, 5% – to each of the marginal returns.

reappraisal of earnings prospects that could kill any residual over-optimism of analysts and investors. To the extent that the equity market has not already written off this bad news in lower share prices, expect a negative shock effect on the relevant spreads. Asset write-downs and changes in equity prices matter most for credit investors when they tell us something we did not know – or expect – about future cashflow, from earnings, asset sales or deleveraging issues of equity.

## ☐ LONG RUNNING THEMES

**RISK AND LEVERAGE ARE HIGH, BUT SO TOO ARE SPREADS.** In our view, spreads were wide enough in December 2001 to face rough weather in early 2002. They have come in sharply in the first two weeks of 2002, so the cushion has eroded. But while risk is reasonably high, Euribor spread levels for three- to five-year euro industrials at 100bps remain 2.5 times what they were in early 1999. Three- to five-year Euribor spreads on Industrials now provide four times the marginal return on regulatory capital of early 1999 levels.

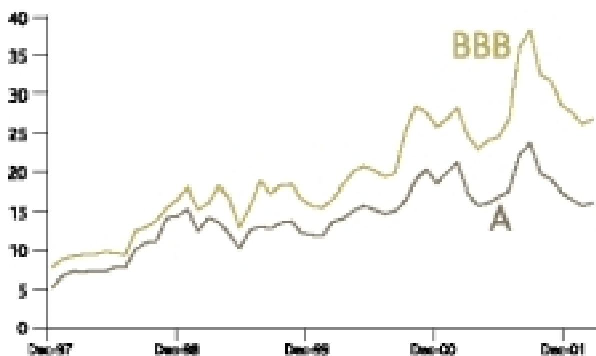
**INVESTORS RECEIVE (ISSUERS PAY) MORE FOR RISK.** Euro non-financial corporates pay a much greater proportion of their total funding costs by way of spread. Option adjusted spread over governments has increased steadily since 1997, from 5% of the yield to 15% for single As and from 7.5% to 25% for BBBs. Absolute yields of about 5% for single As are attractive for both issuers and investors.

**LONG RUN DRIVERS MAINTAIN SHORT END BEST VALUE.** Breakeven spreads over EIB (not far away from swaps, and applicable for those government benchmarked investors that are not able to use swaps) remain significantly higher in shorter one- to five-year maturity than in five plus years. The cautious should stay shorter: duration seekers are paying up for credit alpha (= excess return over risk free). Those that can should explore taking duration in AAA quasi goverments and adding alpha through five-year default swaps.

**OPPORTUNITIES IN CROSS-CURRENCY LIBOR SPREADS.** Both costs of credit line and mark-to-market accounting rules affect many issuers and investors that would otherwise wish to take advantage of cross-currency Libor spread differentials in the same name. These abiding inefficiencies in the market will continue to leave occasional value on the table for investors that can grab it.

**FIGURE 2**

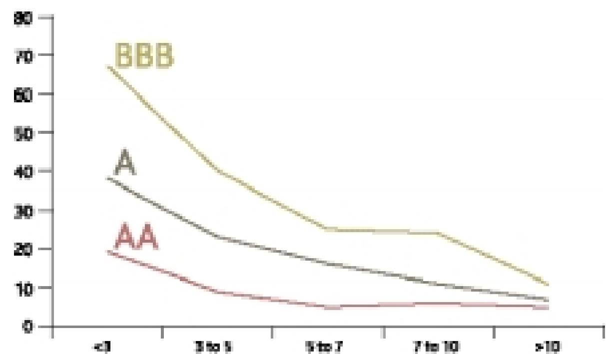
EURO NON-FINANCIAL CORPS OPTION ADJUSTED SPREAD AS A PERCENTAGE OF YIELD.




*Source: Merrill Lynch Global Index System*

**FIGURE 3**

LARGE CAP EURO CORPS – BREAKEVEN SPREADS VERSUS EIB.




*Source: Merrill Lynch Global Index System*