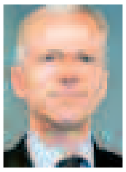


GILES KEATING EXPLAINS HOW COMPANIES THAT SECURE CHEAP LONG-TERM FUNDING WILL NOW GAIN A COMPETITIVE ADVANTAGE.

Bonds surprise

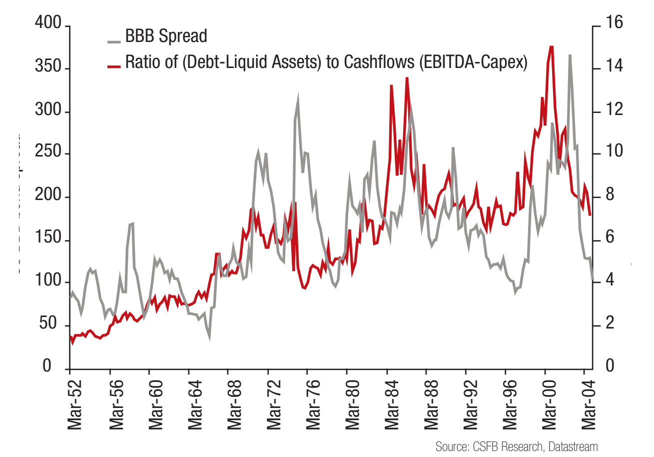
The performance of global bond markets over the last year has surprised investors and analysts alike. Almost every leading Wall Street pundit has argued that bond yields are far too low. Most of them have predicted that US ten year yields should reach between 5 and 5.5% or even higher, but in practice the yield has spent much of the last twelve months trading in the lower part of the 4 to 4.5% range, and at times even dropping below. Equally, calls for Euro-zone government bond yields to rise sharply have been confounded. The reasoning of the analysts is not complicated – after all, the Fed itself predicts that US nominal GDP will rise 5.5-5.75% this year, and historically it is unusual for bond yields to be far below nominal economic growth. But on several occasions over the last twelve months, investors who have followed this analysis have gone short of their target duration, only to see the market moving against them and so finding themselves forced back in at lower yields.

In our view, bond yields are being pulled upwards by one pair of powerful forces, and simultaneously being pushed downwards by an opposing pair. The market action that we have seen reflects the balance between these forces. As 2005 progresses, our view is that the upward forces will gain a significant advantage, but not to the extent of pushing the US ten year yield above 5%. Indeed, we expect the rise to peter out around 4.75%, with corresponding euro-zone rates in the 4-4.25% area, and a modest rise in gilt yields.

One force pushing yields up is the current cyclical rise in US inflation, which is not yet apparent in headline rates but is very clear in the detailed data. Consumers are now facing small but accelerating increases in goods prices (other than food and energy), in stark contrast to the outright deflation that they had been enjoying over the previous four years. Mr Greenspan has made a similar point in recent speeches. He has warned that foreign companies importing goods into the US were absorbing the impact of the weaker dollar until the middle of last year, but are now starting to pass its effect through into higher selling prices within the US.

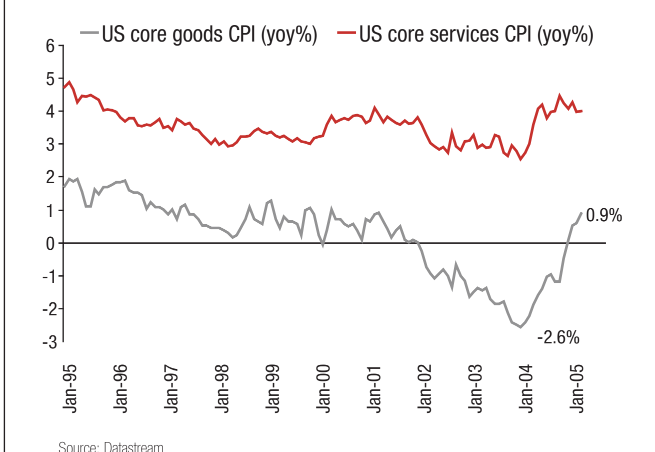
RATES RISE A second force pushing yields up is the Fed's progressive rise in interest rates, partly in response to this cyclical uptick in inflation. Our view is that the Fed will raise rates 25bps at every

Figure 1. Pulled in different directions.



Source: CSFB Research, Datastream

Figure 2. US Consumer Price Index.



Source: Datastream

meeting this year, taking the Fed Funds rate to 4.25%. Recent Fed speeches have in our view been consistent with this, avoiding any mention of a pause in tightening, but the market has tended to lag behind these comments, with forward curves predicting a smaller increase. If we are right, then bond yields would have to rise from current levels to prevent a dramatic curve flattening or even an inversion.

Executive summary

- For the last year bond yields have been much lower than most experts have predicted as a result of conflicting upward and downward pressures.
- Upward forces are US inflation and interest rate rises, while the downward pressure comes from strong demand meeting weak supply, and the impact of the investment boom in China.
- During 2005 the upward forces will start to dominate and bond yields should start to rise, to a maximum of around 4.7%.
- Credit spreads have also been relatively low, due to sharp falls in gearing ratios, reduced uncertainty over income streams, and high demand for credit assets.
- Signs are emerging that credit spreads may start to widen as 2005 progresses.
- The indications are that now is a very good time to issue longer-term debt as companies that obtain cheap long-term funding now will be at a significant competitive advantage.

STRUCTURAL DEMAND Going in the opposite direction, there is strong structural demand for bonds, at a time of cyclically weak supply. Demand is boosted by insurance companies, which face much tougher asset-liability matching rules than in the past, requiring them to hold more longer-duration bonds, and fewer equities. Pension funds, which in the 1990s loaded up their portfolios with equities at the expense of bonds, are now being told to re-build their bond holdings by regulators in one European country after another, with the US potentially following. Meanwhile, bond issuance is low and likely to stay depressed for some time, because US and European companies currently enjoy very high levels of free cashflow.

Also tending to depress yields, the current investment boom in China implies that capacity is being increased substantially, with the increased output likely to become available in big size during 2006 and 2007. For example, by the end of 2007 we estimate that China's automobile output, net of its demand, will be equivalent to about 8% of the global market. This, and similar surplus capacity in other sectors such as steel and chemicals, will probably trigger a new round of deflation in some industrial prices. This would reverse the cyclical rise in inflation that seems likely in 2005, helping to hold bond yields down.

In the early part of 2005, the impact of the downward forces was in our view magnified, as investors whose portfolios were positioned for rising yields saw the opposite happen and have hurried to buy. This was apparent in data showing that US investors at that time held too few bonds relative to their benchmarks.

As the year progresses, we believe that the forces pushing bond yields up will gradually start to dominate. Over time, we expect the cyclical rise in inflation to become more apparent in headline numbers, and in response we envisage the market adjusting upwards its expectations about the amount of Fed tightening that is needed. So we see yields rising, accompanied by softer equity markets. But our view is that the rise in yields will peter out at around 4.7% for the US ten year, rather than moving well above 5% as widely expected by the Street, because the powerful forces pulling yields down will not have disappeared. Similarly, euro-zone government ten year yields would be expected to rise to perhaps just above 4%, while corresponding gilt yields moved up somewhat without breaching the 5% level.

At the same time that government bond yields have persistently been lower than analysts or investors expected, so also credit spreads have been at low levels by historical standards. There are a number of good reasons for this. Corporate balance sheets have been strengthened greatly over the last two years, as companies have used very strong free cashflow to pay down debt, allowing gearing ratios to fall sharply. Alongside this is the effect of reduced uncertainty. Financial theory suggests that the cost of credit is higher when the borrower's income stream is very uncertain, lower when it is less volatile. At the macro-economic level, the current cycle is proving to be relatively mild, reducing the uncertainty of income streams, and at the micro level, the volatility of equity prices has fallen.

CREDIT ASSET Alongside these fundamentally favourable factors, there is also a bullish, supply-demand situation for credit assets. As with government bonds, demand is boosted by insurance companies' and pension funds' appetite for fixed income assets. Meanwhile supply is restrained by the corporate sector having ample internal funds at a time when its investment spending is rising modestly rather than aggressively. Moreover, the still very low level of short-term rates in both the US and euro-zone helps push investors into riskier assets.

All of this helps explain why spreads have been so narrow, but there are now some signs that, at the very least, there is no scope for further narrowing, with some risk of a widening starting to appear. The continued march upwards of US short rates, and the likely start of euro-zone tightening later this year, will progressively dampen investor appetite for risk. Aggregate corporate investment is starting to rise, and could accelerate further as 2005 progresses. And meanwhile, the M&A boom in the first quarter of this year, together with the tendency towards share buy-backs and increased dividends, has produced some net drain on company cashflow. In the high yield market, after a strong run for over two years, January 2005 saw spreads widen on the month, as a kind of advance warning that the environment is changing. Overall, even if it is unlikely that spreads in investment grade move out dramatically this year, they are more likely to be wider than narrower by year-end.

There is a clear message from all of this for corporate investors: now looks to be a very good time to issue longer-term debt. The problem, of course, is that not many companies feel that they need the cash. But in effect, the market is trying to signal that companies should be intensifying the search for profitable investment opportunities. Certainly, if we are right in arguing that both government yields and credit spreads are set to rise this year – but by nowhere near enough to prevent a continued economic expansion – then companies that obtain cheap long-term funding now will be at a significant competitive advantage compared to those who do not.

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