MAKING THE MOST OF THE CLIMATE

AFTER A YEAR OF EXTRAORDINARY VOLATILITY AND EVENTS, **MICHAEL TURNBULL** OF MORGAN STANLEY BELIEVES TREASURERS HAVE A LOT TO LOOK FORWARD IN 2002.

As we enter the last six weeks of 2001 we can look back on a remarkable year in the bond markets. We benefit from the most benign interest rate environment in the US for 30 years and a UK curve that has visited levels not seen since the 1950s. The market has already distributed more bonds this year than ever before, with issuance at $1.78trn. Much of this has taken place in the last few weeks as corporates, particularly in the US, have been unable to resist the market environment to lock-in extraordinary fixed rate levels in five,10 and 30 years. The return of the 100-year bond cannot be far away.

Many firms have steered clear of the bond markets and their wide credit spreads and have, instead, used caps, collars and fixed rate swaps to extract value and lock-in low fixed rate levels, leaving them with portfolios at the upper limit of their fixed/floating policies. This leaves the market with some interesting dilemmas as we identify some potential trends that may shape the coming year.

CASH-RICH INVESTORS. Investors who continue to be cash-rich will consider how much more performance there can be in corporate bond spreads. Given that underlying government rates have fallen so far, the inevitable question is, when will the interest rate environment turn? Recent data suggests that such a risk – particularly in the US and to a lesser extent in the UK – has receded and is likely to be a concern for the third or the fourth quarter of 2002. This leaves a buoyant underlying environment for spread products. How bonds perform sector by sector will reflect the performance of the underlying businesses and we are not here to stock-pick, but it would seem there will continue to be cash available for corporate bonds as we start 2002.

Furthermore, in the UK, the continued portfolio shifts in UK pension funds towards corporate fixed income assets will drive demand for bonds and for asset swaps. But who will be issuing, given the reduced capital expenditure programs and limited M&A activity? True, capital expenditure continues to be constrained but certain sectors will have continuing capital requirements that will need to be financed. Furthermore, maturities will be running at $182.3bn for corporates in Europe and bank credit spreads will continue to edge wider as banks limit their exposures.

More interestingly, the volatility in funding costs available in the US and European commercial paper (CP) markets, combined with attractive levels available in the short end of the bond and MTN markets, may tempt corporates to stabilise funding costs and reduce reliance on banks by terming out core CP balances. More generally, as asset values continue to fall and highly leveraged companies become more cash constrained, the opportunity develops for the more conservatively managed companies with lower leverage to buy assets at attractive prices from their more cash constrained competitors. This will generate more bond issuance as acquisitions are prudently termed out in the low interest rate environment.

RESTRUCTURING. This activity combined with the continued restructuring of certain key sectors in Europe such as utilities and transportation infrastructure may generate a significant amount of issuance. In the UK, this has already been in evidence with Welsh Water/Glas Cymru and the announcement of Southern Water restructuring. The application of securitisation as a method of extracting under-utilised capital to help support constrained balance sheets is already in evidence in the property, leisure and utility sectors.

As the technology develops to meet broader needs this will also develop as a major source of funding. A final trend is the introduction of new corporate credits into the markets. As European corporate bond funds look for further diversification, particularly at A and BBB ratings levels, we anticipate that more firms will take the opportunity to reduce maturity risk and diversify their sources of capital in these uncertain times. This will definitely be the case if the cost of doing so continues to diminish.

A further trend in 2002 is the use of derivatives to manage interest rate risk and control interest cost, particularly in the context of interest cover ratios. We believe treasurers will continue to focus on the opportunities to manage down interest cost by careful and opportunistic use of derivatives and that the bond market will continue to offer a viable liquid source of capital well into 2002.

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