AFTER A REASONABLY POSITIVE YEAR IN THE BOND MARKETS, WE ASKED THE EXPERTS FOR THEIR PREDICTIONS FOR 2004. **PIPPA MASON** OF CITIGROUP AND **NICK MEDD** OF HSBC PROVIDE THEIR FORECASTS.

RETURN OF CONFIDENCE PERKS UP THE MARKET

- *What major problems and opportunities do you expect in 2004?*
- *What do you expect to happen to corporate spreads in 2004?*
- *What trends in currency, deal type, structuring and investor appetite do you expect in 2004?*
- *Twenty six investors published a 'wish list' of proposed best practice in regard to minimum covenants, documentation standards, disclosure and the like in October[1]; other investors have dismissed it. Do you think the 'wish list' will take hold, and how do you generally see covenants and terms and conditions developing?*
- *Will high yield issuance keep growing? Will a sterling market develop?*
- *What are your predictions for UK, US and euro government bond yields in 2004?*

[1] See *The Treasurer*, Hotline, p11, November 2003.

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WHAT MAJOR PROBLEMS AND OPPORTUNITIES DO YOU EXPECT IN 2004?

The second half of 2003 has been an issuers' market. Strong investor demand driven by significant redemptions and an increasing demand for fixed income product has been met by insufficient primary market supply. This is despite many issuers pre-funding 2004 and even 2005 debt maturities. This has allowed exceptional new issuance opportunities for issuers across the full credit spectrum. We see this trend continuing in 2004 as economic recovery gathers pace while new issuance levels look set to be fairly static.

Good opportunities across the US dollar, euro and sterling markets should enable issuers to take a 'pick and mix' approach to their funding, by tapping markets that provide best execution and pricing as and when they look to fund.

On the potential problem front, a sustained backup in yields as a result of global fiscal (or US) policy tightening, coupled with hedging and swap volatility as experienced early this summer with the US agencies, could provide a potentially challenging environment for new issuance.

WHAT DO YOU EXPECT TO HAPPEN TO CORPORATE SPREADS IN 2004?

In the absence of market shocks, we expect corporate spreads to remain tight, especially in the first half of 2004, with the prospect of an average tightening in the region of 10bp. Technical factors will underpin this move: large amounts of bonds maturing (five-year corporate euro market anniversary), small positions – both among final investors and trading desks – and a reasonable attitude to risk-taking that is typically strong at the beginning of the year. Expected economic growth in the US in particular will also help. Implicit in our view is a flattening of the curve, resulting in investors moving down the credit spectrum. The degree of spread tightening may be limited by the pace of supply. For example, we may see further pre-funding and/or a pick up in M&A driven financing.

WHAT TRENDS IN CURRENCY, DEAL TYPE, STRUCTURING AND INVESTOR APPETITE DO YOU EXPECT IN 2004?

The 30-year euro sector is here to stay and we should see a re-emergence of issuance at the longer end of the curve. Similarly, the pace of asset backed issuance will continue, with companies using these techniques to re-engineer their financial structures and shed assets.

More debt restructurings are inevitable, either as part of a distressed reorganisation or as more issuers see opportunities for using liability management to alter the mix of their debt maturity profiles, buy-back cheap bonds or move debt around the group. The techniques employed in Europe in this regard are being refined as investors become more familiar with these situations. There may also be further fallen angels, and perhaps a few rising stars, as some credits buck the trend and regain investment-grade status.

Pensions will still be a headache for many, as it will be realised that rising equity markets will not solve the problem, and we will continue to see a diverse range of solutions, given the varying regulatory and accounting landscape that govern measures for these problems. This will continue to confuse the investing community.

Next year redemptions will be high, particularly in the auto and telecoms sectors. The big three auto companies have about $50bn of bonds maturing next year. These issuers have limited room for deleveraging and have pre-funded to a certain, limited extent. To get this amount of funding done, they will have to spread their refinancing across currencies, structures and investors. Conversely, telecoms, with about $42bn of debt maturing next year, will require less refinancing as they continue their success in deleveraging.

Convertibles will play an increasing part in corporate financing, as they continue to provide cheap debt substitutes and funding for acquisitions, building on the activity seen in the second half of 2003.

This year saw a trend towards more bookrunners on a given transaction (in some cases, as high as six or seven). While the wish to reward as many relationship banks as possible is understandable, the erosion of control, in terms of pricing, stabilisation, but also accountability, has potential negatives in terms of investor confidence and liquidity. We would hope this trend reverses.

DO YOU THINK THE 'WISH LIST' WILL TAKE HOLD, AND HOW DO YOU GENERALLY SEE COVENANTS AND TERMS AND CONDITIONS DEVELOPING?

While we do not dismiss the call of some European investors for standardised minimum documentation terms and conditions (indeed, the US market has had this standardisation for some time), we do not believe that the structure of incentives is there to make this happen. A fundamental minimum standardisation would only work if offset by tighter spreads in order to maintain the attractiveness of European markets versus other capital markets globally. Indeed, a broad range of investors feel that the non-standardisation in language further allows for managers to outperform based on their analysis of these covenants. With the large and diverse European investor base, the improvement in corporate credit fundamentals, the backdrop of redemptions and a relative lack of supply continuing, this seems like a continuation of a debate which has been going on for some time and will likely continue.

WILL HIGH YIELD ISSUANCE KEEP GROWING? WILL A STERLING MARKET DEVELOP?

High yield issuance should continue to grow, but perhaps more modestly than the strong growth seen over the past year. More European corporates will likely access the high yield market. The sterling market should develop, but it will remain smaller than its euro counterpart, which will continue to be a deeper and more liquid pool of capital. An improving M&A market would boost supply.

WHAT ARE YOUR PREDICTIONS FOR UK, US AND EURO GOVERNMENT BOND YIELDS IN 2004?

Forecasts for 10-year yields

	End March 2004	End Sep 2004	2004 Average
Euro zone	4.25%	4.50%	4.35%
UK	5.18%	5.52%	5.30%
US	4.50%	5.00%	4.70%
Japan	1.40%	1.30%	1.35%

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WHAT MAJOR PROBLEMS AND OPPORTUNITIES DO YOU EXPECT IN 2004?

This year has been broadly positive for fixed income investors and issuers alike. Investors have benefited from the tightening spread environment and fewer corporate shocks. Issuers have benefited from low underlying rates, low spreads and the greater certainty of execution that comes from issuing into a strong market.

Looking forward to 2004, despite concern that an upturn in world equity markets may harm demand for bonds, we see considerable opportunity in the European bond markets. Investor demand for credit product will continue to increase, driven by accounting requirements and the increasing maturity of the euro markets.

Mergers and acquisitions (M&A) activity will re-emerge as a driver of corporate new issuance in 2004. In the tobacco sector alone, the upcoming privatisation of Turkey's state-owned cigarette assets could necessitate a visit to the bond markets in early 2004 by the successful acquirer. The privatisation of Croatia's state tobacco company is set to follow soon after.

The opportunities for borrowers to diversify their funding sources will increase. In 2003, HSBC has taken a record number of European borrowers to Asia and brought to market the largest euro issue by an Asian corporate issuer (Hutchison Whampoa, a 10-year, €1bn issue). European issuers, notably from the telecoms and consumer goods sectors, have achieved lower funding levels in US dollars, rather than their home markets.

Borrowers will become more sophisticated in their choice of currency and market in order to achieve their funding objectives. This diversifying trend will continue to provide opportunities for banks with global reach that can provide clients with distribution strength in each of the world's major bond markets. In addition, retail investors, in Europe and Asia will continue to provide a further diversification of funding sources to certain issuers.

WHAT DO YOU EXPECT TO HAPPEN TO CORPORATE SPREADS IN 2004?

Corporate spreads are currently trading around their historical tights. In spite of this, the level of oversubscription on recent corporate new issues, even for less well-known names, has continued to be high.

The pronounced supply/demand imbalance has not only brought corporate spreads down but has resulted in very stable markets at these levels. The market has also matured to the extent that specific individual credit events no longer automatically contaminate the rest of their sector. The recent ratings announcements on Ford and DaimlerChrysler, while causing considerable spread volatility among the high beta auto names, did little to affect the broader market.

Investors are increasingly sophisticated in their individual credit analysis and, as a result, are more comfortable in differentiating between borrowers on a name-by-name basis. We expect this trend to continue over the coming 12 months.

WHAT TRENDS IN CURRENCY, DEAL TYPE, STRUCTURING AND INVESTOR APPETITE DO YOU EXPECT IN 2004?

The long-dated euro sector came of age this year. This market has seen major transactions from the telecom, auto and utility sectors. HSBC has been at the forefront of this development with transactions including Suez, Peugeot and Beolia. Suez issued the first 20-year deal. As the 'ultra-long' euro sector has begun to develop, the 12- to15-year sector has matured, with a wider range of borrowers accessing this part of the curve. In 2004, we anticipate increasing investor confidence in the 30-year sector of the curve, albeit tempered with the recognition that rising yields may see borrowers sidelined and investors able to achieve target returns in the shorter maturities.

Despite lower corporate sterling issuance in 2003, compared with 2002, the sterling market, as a whole, has powered on. We expect this trend to continue in 2004. Sterling corporate volumes could well rebound in 2004. The market will continue to provide borrowers (in the UK and overseas) in certain sectors with cheaper funding opportunities and access to a broader range of maturities than in the major alternative markets.

Retail demand will remain strong in 2004. This year, with yields on vanilla debt instruments being so low, retail investors have been attracted by the rates of return available from structured issuance. So far, the strongest demand has been for interest-rate-linked products, such as callable range accruals and inverse floating rate notes (FRNs). As equity markets improve, 2004 could well see a resurgence in demand for debt instruments that offer exposure to equity indices or individual stocks.

DO YOU THINK THE 'WISH LIST' WILL TAKE HOLD, AND HOW DO YOU GENERALLY SEE COVENANTS AND TERMS AND CONDITIONS DEVELOPING?

New issue lead managers have an important intermediary role to play in the debate over 'best practice' in documentation and general investor communication. There are a number of areas where change will happen: the growing use of medium term note (MTN) programmes will ensure documentation is available in a timely manner and the commitment to greater disclosure is starting to take hold. Disclosure is a problem not just in the case of companies that are taken private but also in the asset-backed market. We are already seeing a growing number of borrowers committing time and effort to update fixed income investors. It is clear that the non-deal-specific roadshow is here to stay.

For investors to impose tighter covenant standards, it will be necessary for their views to represent those of the majority. It will also be important for individual markets to retain their competitiveness versus other sources of financing. It is clearly worth striving to attain standards that are acceptable to all parties (including equity holders), and this is an area where the International Primary Market Association (IPMA) could play a role.

WILL HIGH YIELD ISSUANCE KEEP GROWING? WILL A STERLING MARKET DEVELOP?

High yield issuance has increased significantly in 2003. With low underlying yields and tightening credit spreads for much of the year, investors have been forced to become comfortable with taking on greater credit risk to achieve required rates of return. The high yield market continues to evolve. The effects of economic downturn continue to be felt in terms of investment-grade borrowers being downgraded to sub-investment-grade. A further 44 fallen angels have entered the market so far in 2003. The strong name-recognition of these crossover credits has engendered greater confidence among investors. By diluting the amount of leveraged buyout (LBO)-related debt in the high yield sector, crossover credits have brought greater stability to the market.

The number of fallen angels has actually fallen in 2003 versus the same period in 2002. Although we will no doubt see further fallen angels (potentially including some big-name bond issuers) enter the high yield market in 2004, recent global economic data suggests a more benign environment for companies going forward. There is a growing sense that we have reached the bottom of the credit cycle and that the trend is toward generally improving corporate credit quality. As part of the general trend towards the repairing of balance sheets (asset disposals, fewer acquisitions), reviving equity markets may see high yield borrowers raising capital to pay down debt. All of these factors will benefit investor sentiment as we move into 2004.

Development of the sterling high yield sector has been limited in 2003. Of the 44 fallen angels downgraded by Standard & Poor's (S&P), only five (ABB, Ahold, British Airways, Cable & Wireless and Northumbrian Water Services) have benchmark sterling-denominated bonds outstanding. Development of the sterling market in 2004 is likely to continue to be slower than the euro and US dollar markets. The list of borrowers on the verge of investment grade continues to be dominated by US names. CE Electric UK is the only potential S&P 'fallen angel' with sterling-denominated debt. The cost for overseas borrowers of issuing in sterling and swapping back to a home currency will remain a constraining factor.

WHAT ARE YOUR PREDICTIONS FOR UK, US AND EURO GOVERNMENT BOND YIELDS IN 2004?

HSBC continues to forecast that government bond yields will fall in all three currencies. Over a 12-month horizon, we expect gilt yields to fall 20bps-30bps across the curve, with the long end dis-inverting slightly. In the euro zone, we are forecasting that the government curve will steepen, with rates falling 85bps-100bps in the two-to five-year sector, 60bps in the belly of the curve and 30bps at the long end. In the US Treasury market, we anticipate yields to fall around 70bps in the two- to 10-year sector and 50bps at the long end.

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