A CASE OF ROLE REVERSAL

BOND YIELDS ARE FORECAST TO RISE OVER THE COMING YEAR AND CREDIT SPREADS TO TIGHTEN. WHAT THEN WILL BE THE DRIVING FORCES? **JOHN NORMAND** OF JPMORGAN EXPLAINS.

After a year in which government bonds rallied while corporate spreads widened, 2003 is likely to throw both trends into reverse. The global economy has bottomed, the next move by central banks will be to lift rates, and spread products are comparatively cheap. In this environment, government bonds yields should rise modestly and credit spreads tighten over the course of the year.

US RECOVERY TO LEAD GLOBAL RATES HIGHER. As has been the case over most of the past two years, the pace and timing of the US economic recovery will be the main driver of global interest rate and spread movements in 2003. Given the synchronised nature of the US-led global economic downturn, the near lock-step movements in US growth expectations, government bond yields, equity markets and credit spreads (see *Figure 1*) has been unsurprising.

This link is unlikely to diminish going forward. Although global growth is forecast to accelerate in 2003 (from 2.4% to 2.8% Q4/Q4), the US will continue to contribute disproportionately to global momentum, with an acceleration from 2.6% to 3.4%.

Inflation should remain well-contained, given that the US output gap is still significant and growth likely to remain sub-trend over the coming year. We forecast a modest uptick in CPI inflation from 1.6% in 2002 to 2% in 2003, but a continued decline in core inflation to 1.6%.

Though the change in economic momentum is apparent, the downtrend in core inflation and the only gradual recovery of the labour market is likely to keep the Federal Reserve on hold until late 2003. Even then, the normalisation of the Fed funds rates will likely be slow: we forecast only 75bp of Fed tightening by year-end, a rate that will still leave policy quite accommodative by historical standard.

In addition, corporate profits growth will likely remain sub-par, in response to continuing pressures from goods price deflation and rising labour costs. Earnings growth will likely prove less vigorous than in previous cyclical upturns, which will constrain the upside on equities. In such an environment of sub-trend growth, continued disinflation, modest Fed tightening and weak corporate profits growth, the back up in US Treasury (UST) yields will likely prove much more muted than in previous recoveries. We expect 10-year UST rates to rise to 4.9% by year-end.

UK TO KEEP PACE WITH US, OUTPERFORM EURO AREA. The UK economy is expected to accelerate alongside the US and outperform the euro zone, given the strength of domestic demand. But the case for an early tightening of monetary policy is more compelling, given that the housing boom and stimulative fiscal policy could threaten the Bank of England's inflation target – we expect RPIX to rise to 2.4% from 2.2% in 2002.

Accordingly, we expect the Bank of England to tighten policy by 75bp over the course of the year, with risks skewed to the upside. Even with such tightening, the sell-off in gilts is unlikely to be as severe as in 1994 or 1998, given the limited gains expected for equities and the comparatively modest back-up in UST rates. We expect the 10-year gilt to end the year at 5.1%.

> 'THOUGH THE CHANGE IN ECONOMIC MOMENTUM IS APPARENT, THE DOWNTREND IN CORE INFLATION AND THE ONLY GRADUAL RECOVERY OF THE LABOUR MARKET IS LIKELY TO KEEP THE FEDERAL RESERVE ON HOLD UNTIL LATE 2003'

THE MAIN BENEFICIARIES OF RECOVERY. Corporate credit spreads will likely tighten over the coming year. Over the past two years, sterling credit spreads have tended to move in line with equities, as the cyclical downturn pushed earnings expectations lower. At present, equities appear to have bottomed: earnings expectations have returned to more sensible (lower) levels, corporate governance and regulatory issues are being addressed, and economic growth is accelerating. Against this backdrop, default rates are likely to decline in the year ahead.

Diminishing supply should also prove supportive for spread product. Recession and falling profit margins have refocused attention on balance sheet repair, reversed a five-year-long run-up in corporate debt, and prompted a global deleveraging process. Indeed,

FIGURE 1
US, UK AND EURO AREA 10-YEAR BOND YIELDS.

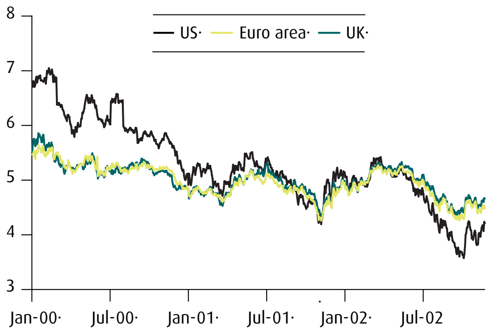
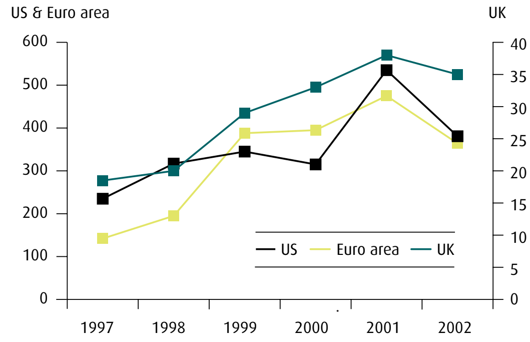


FIGURE 2
US AND UK GROSS CORPORATE BOND ISSUANCE ($BN OR £BN).



over the past year, gross corporate issuance has fallen by 30% in the US, 25% in the euro zone and 10% in the UK (see *Figure 2*). This process is not yet complete, judging from the long-term nature of leverage cycles and our bottom-up analysis of corporates' target debt levels. A further decline in global gross corporate issuance of roughly 10%-20% is likely over the coming year. This diminishing supply will likely be met with fairly heavy demand, given that valuations are still compelling, particularly for lower-grade names. Although credit spreads in aggregate have narrowed back to levels seen, this trend masks significant sectoral divergences: AAA and AA spreads are near their narrowest levels of the business cycle, but BBB and sub-investment grade names still carry a recession premium. We expect this confluence of improving fundamentals, diminishing supply and attractive valuations to promote spread tightening over the year, but only in lower-grade credits.

John Normand is Global Fixed Income and Currency Strategist at JPMorgan in London.
john.normand@jpmorgan.com
www.jpmorgan.com