Growth, yields and swap spreads

So far, 2000 has proved a difficult year for fixed income market participants – not only have they seen tremendous volatility in bond yields but a number of conventional relationships between economic fundamentals and the bond markets have broken down.

Specifically, the impact of strong growth on the government yield curve and on swap/credit spreads has been different in this cycle than in the past. While many fixed income investors were right to assume that the US economy would remain strong in Q1, their decision to overweight the front end of the Treasury curve and dollar credit on the basis of this expectation was disappointed.

In the event, the announcement of a programme of Treasury buybacks in late January as result of the better-than-expected fiscal outlook saw a dramatic inversion of the government curve and a widening of dollar swap and hence credit spreads. The latter trend was surprising since strong growth has typically been credit market positive.

In the past an inverted yield curve has been a clear sign that growth was about to slow, because short rates had been hiked to levels beyond which were required to contain inflation. In this business cycle, by contrast, the yield curve inverted more from the long-end than the short-end. Once the economy shows further signs of weakness, however, there is good reason to believe that the yield curve will normalise.

Inversion

The primary reason for our bearishness on swap spreads for much of this year was the expectation that short rates would have to go up significantly from current levels. Higher short rates would have caused further inversion in the Treasury curve and hence widened long-dated swap spreads. A move towards a positive Treasury curve implies that this process works in reverse. Indeed, the more bearish one's view on US growth, the more likely it is that we have seen the peak in dollar swap spreads, and that the trend widening in swap spreads seen since 1998 is over.

This raises the interesting conclusion that high-grade credit spreads might tighten, along with swap spreads even as the US economy slows. This seems counter intuitive from a macroeconomic perspective, as corporate creditworthiness might normally be expected to fall as growth slows.

However, this line of reasoning implicitly assumes that credit spreads are fair value prior to the onset of any slowdown. This is, of course, not the case at the moment, as credit spreads are cheap based on assessment of underlying credit and default risks in the economy. Hence, we believe that the impact of weaker growth in unwinding the richening in Treasuries will have a bigger impact on tightening credit spreads than any perceived increase in default concerns from a growth slowdown. ■

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INTERNATIONAL BONDS

These are a selection of bonds announced recently. The details, updated to the middle of last month, were supplied by *IFR Securities Data, London* and other sources.

Issuer	Launch rating M	Launch rating S&P	Amount (m)	Coupon (%)	Price	Maturity	Launch Spread (bp)	Fees (%)	Bookrunner
Rhodia	Baa1	BBB+	EUR500	6.25	99.437	31 May/05	(a)	(b)	Bear Stearns UBS Warburg
Rolls Royce	A3	A-	EUR500	6.375	99.67	14 Jan/07	(c)	(d)	Deutsche Bank Goldman Sachs
	A3	A-	GBP200	7.375	99.475	14Jun/16	(e)	(f)	Goldman Sachs Greenwich NatWest
Saint Gobain Nederland	A2	A	GBP300	7.375	140	7 Jun/05	(g)	0.30	JP Morgan HSBC
Smiths Industries		A-	GBP150	7.25	98.964	Jun/16	(h)	0.50	Barclays Capital UBS Warburg
Telstra	Aa3	AA	EUR1,000	5.875	99.647	21 Jun/05	(i)	0.30	BNP Paribas Deutsche Bank
Vivendi into BSkyB*	NR	NR	EUR1,200	1	24.22	5 Jul/03		1.2	BNP Paribas

**Equity linked. (a) Euribor plus 68bp, governments plus 112bp. (b) 0.375% (0.125% management and underwriting, 0.25% selling). (c) 118bp over bond due July 2007. (d) 0.375% (0.175% management and underwriting, 0.2% selling). (e) 235bp over 8% December 2015 gilt. (f) 0.50% (0.25% management and underwriting, 0.25% selling). (g) 147bp over gilts. (h) 220bp over gilts. (i) 108bp over obl 135.*

Launch ratings are from Moody's (M) or Standard & Poor's (S&P). NR = Not Rated. R = fixed re-offer price. Launch spread is over comparable government bond.