US corporate floodgates open

The US corporate bond market's recovery appears to be in full swing. Cash-rich investors absorbed a near record-breaking $18bn of supply in mid-June, driving credit spreads tighter even as swap spreads widened. Secondary flows picked up, too, bolstering impressions that this recovery is for real.

Bankers involved in the deals said well-structured offerings that were priced correctly flew off the shelves and tightened in secondary. Plenty of cash is still waiting to come into the market from US insurance companies and state funds, which is leading bankers to believe this recovery is sustainable.

Investors have turned bullish on bonds following signs the US economy is slowing and the Fed may have finished, or nearly finished, its tightening cycle. With yields at the short-end of the Treasury curve almost higher than the Fed funds rate, investors are more inclined to buy corporates in hope of outperformance. "At these levels you owe it to yourself to overweight corporates in a fairly heavy way," said one New York-based portfolio manager who has been selling Treasuries in favour of corporates.

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For the first time in months, investors avoided the short end of the curve in favour of adding duration. New deals will need to be concentrated in the five and 10-year parts of the curve. Investors are full of three-year paper, especially from finance companies.

Concessions

Capital markets officials also estimate that very little, if any, new issue premium would be required to sell a high-quality 30-year bond. Concessions elsewhere along the curve have also come in from the 10bp or more that was common in May. A 4bp-7bp premium is likely to be required for a new 10-year issue; 3bp-5bp for a five-year; and 5bp plus for a three-year deal.

The mid-June tally of investment-grade corporate supply is unlikely to be duplicated but estimates call for up to $10bn of supply per week through the end of June. A $50bn month is not out of the question. That is especially impressive following just $16bn in all of April and $32bn in May.

The breadth of issuance during the recent spate is impressive. It included acquisition financing such as IP, first time global bond issuers such as Hewlett Packard, telecoms paper from Sprint and US West, utility paper in PPL and finance paper from Ford. Credit ratings ranged from AAA to BBB, which performed exceptionally well as evidenced by IP's jumbo. Most of the upcoming supply is expected to be from the finance sector.

Europe offered a stark contrast to the US buoyancy back in late May, when the corporate bond market had been far from buoyant, despite €2.5bn of supply. Even so, three deals of €500m and several small issues had focused the market's attention on the primary sector and on supply lined up for the following month. However, for borrowers raising large sums, even paying the necessary premium for international placement is not enough to ensure success.

The European market failed to gain momentum after the Easter break, thanks to a combination of interest rate uncertainty – in Europe and the US – the poor performance of the euro and renewed awareness of event risk in Europe and North America. However, European corporates, led by Rhodia, VNU and Iberdrola, attempted to sell bonds to European institutional investors and the pace of supply into June has been better.

Premium

Companies looking to the bond markets include Dutch food retailer Ahold (€2bn), German industrial gas producer Linde (€1bn), Unibail, a French property company (€500m), Australian telecom Telstra (€1bn) and US tyre company Goodyear.

Borrowers are, as ever, keen to sell bonds to a wide range of investors. To sell bonds outside their domestic market, corporates are paying a premium of up to 5bp. Iberdrola could have sold bonds solely into Spain at Euribor plus 32bp-34bp, but the company's new issue priced at plus 38bp to reflect the best bid from bond funds, banks and insurance companies elsewhere in Europe. IFR

Tempting private placements

Companies that find the public markets closed to them may be tempted to opt for a privately-placed convertible bond. But they should be careful. A convertible private placement could put the buyers of the bonds in a very advantageous position, and subsequently crush the stock price. With look-back and reset clauses, issuers may rue their choice of financing.

There are certainly investors – both banks and funds – offering this sort of deal. In the US, hedge funds have been approaching companies in this position with the offer of Reg D issues. These deals are usually for between $15m and $150m.

Now European companies are taking the same route, although deal sizes are smaller – the upper limit is closer to €50m. UK-based information provider Scoot.com has done two Reg D-type issues, at least one of which involved the hedge funds Citadel and Global Emerging Markets (Gem).

Investors include convertible arbitrage funds looking to set up an aggressive hedge on the stock. For these players, the appeal of the deal is the opportunity to make 15% to 20% from an investment situation in which they hold most of the cards.

Citadel has reportedly been contacting other European corporates and offering to do more private deals. Bankers confirmed that they were getting calls from companies asking for an opinion on the offers. IFR

Documentation mismatch threat

Bankers fear documentation mismatches in credit derivatives trading books could be a ticking time-bomb. Some players in the credit derivatives market are said to be building up basis risks in their trading books due to contract mismatches, which could lead to substantial losses in the event of an economic recession.

Officials point out that the problem was much more serious before the introduction of the International Swaps and Derivatives Association's standardised credit derivatives contracts and the sovereign default of Russia in 1998, which put documentation in the spotlight.

However, the great complexity of credit derivatives, in combination with their ever growing trading volumes, is putting documentation issues back to the forefront. Moreover, several recent trends in the market, such as the synthetic securitisation boom and easy trading access via electronic platforms for a wide variety of new players, have again raised the spectre of basis risk and low-probability, catastrophic loss.

Most derivatives transactions that trade in massive volumes on a daily basis, such as interest-rate swaps and foreign exchange contracts, are highly standardised and, by comparison, very simple. Even though credit derivatives deals are increasingly standardised, the documentation and legal issues involved still are subtle and far more complex than for most other products.

Bankers are unaware of any concerted regulatory effort to curb the problem of documentation mismatches. Although national regulators, such as the UK's Financial Services Authority (FSA), are addressing obvious problems, like maturity and asset mismatches, the intricacies of contractual differences have not yet been tackled. A spokeswoman at the FSA in London said this is not a new issue to the regulator and that the FSA was in the process of dealing with it.

Bankers argue that basis risk associated with contractual inconsistencies is a strong factor in favour of regulatory adoption of an internal models-based approach to capital charge setting, as the risk of documentation mismatches can be assessed and managed most effectively by the banks themselves.

Some bankers dismiss this basis risk, however. One head of credit derivatives at a major bank in London noted that, since the Russian crisis, banks have paid much attention to documentation. If there are contractual mismatches, they are reflected in pricing, he said. IFR

Peregrine ruling casts doubts

An English court ruling has cast doubt over the ability of derivatives counterparties to use market quotes to close out swaps and options in the event of bankruptcy, though banking industry insiders hope that the decision will prove to be inapplicable in terms of setting a precedent.

The English courts ruled in a dispute between bankrupt Asian investment bank Peregrine Fixed Income and Thailand's Robinson Department Stores in favour of the bank. In essence, the surprise move by the court means that a defaulting party can challenge market quotes for close-out valuations that were obtained by a non-defaulting counterparty. Market quote gathering is in accordance with the International Swaps and Derivatives Association (ISDA) master agreement. In contrast to last week's court ruling, the ISDA contract clearly puts the ball in the court of the non-defaulting firm, industry officials said.

Industry representatives deplored the court's decision, as it could – if applied other than to the narrow facts of the case – create uncertainty over derivatives contracts and could generate more, rather than less, litigation in liquidation procedures involving derivatives positions. "The market would be concerned about any case that raises the prospect of more litigation," said one observer. IFR

FAS 133 to boost price awareness

As US companies start operating under the Financial Accounting Standards Board's new hedge accounting regime, which became effective from 15 June, OTC derivatives salespeople see a threat to their trading margins.

To qualify for hedge accounting under FAS 133, an end-user must have a policy statement outlining its risk mitigation strategy as well as documentation on the purpose of the hedge and how it ties to the hedge policy.

However, FAS 133 is a privilege, not a right. The SEC has stated that the correlation between the derivative that is used to hedge a risk and the value of the contract must be 80% to 120% in order to be deemed an effective hedge.

Advisable

Although daily fair market valuing is not required under the new standard, it is advisable since a hedge that ventures out of bounds must be marked to market and then factored into the end-user's earning statement. On the flip side, a hedge that is unwound opens up risk exposure.

Until now, corporate end-users have relied on calling dealers to get prices, and there has been no need to put fair value hedges on the balance sheet.

While corporates running large, complex books are adding systems that post bid and offer spreads in order to paint a more detailed picture of true market conditions, those with less complicated books are implementing systems that price mid-point spreads, said FAS 133 pricing model systems vendors. IFR

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