A ROLLER COASTER RIDE

The effect on the corporate bond market following the recent terrorist attack on the US cannot be underestimated. The potential to disrupt the orderly functioning of the market surpasses the immediate halt to trading activity in that it effectively alters the long-term outlook for the global economy and the interest rate environment under which the market operates.

Initially, the direction that equity markets pursue will be important, further sustained weakness, probably resulting in artificially low official interest rates will create a financial environment where investors will seek security for their investments. The obvious winners in this situation will be government and quasi-government bond issuers, who generally carry a triple-A credit rating from Standard and Poor's and Moody's Investor Services. A similar situation prevailed for the three months following the Russian debt crisis of 1998. At the time corporate debt widened versus government debt to historical highs and in what was to become the euro market spreads actually hit their widest levels ever recorded. Currently, at the time of writing (in the immediate aftermath of the attacks) it is still too early to predict that this is the most likely outcome. But the probability does remain high with the implicit forecast that corporate bonds will continue to languish at wider spreads for the remainder of the year.

A second, and we suspect more likely outcome, is that equity and general financial market weakness will only last for a limited time, even in the event of a protracted retaliatory strike by the US against the alleged perpetrators. The reason for this optimism is that central banks are going to pump liquidity into the financial system, mitigating any systemic risks that might have materialised within the financial markets. However, this return to (near) normality will still have a pronounced effect on what we can expect in the corporate bond market over the remainder of the year.

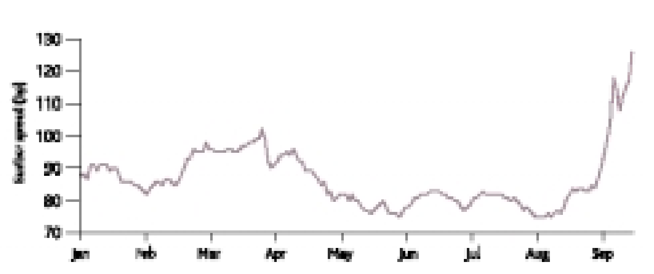
First, although investors will again be willing to re-invest in the market, they are probably going to demand a greater risk premium for doing so. The obvious consequence of this is that spreads between corporate bonds and underlying benchmarks will trade wider for the remainder of the year. Already from *Figure 1* it can be seen that spreads on euro corporate bonds have recently traded at their widest levels this year with little prospect of significant tightening in the short-term.

Second, in addition to demanding wider spreads on issues investors are also likely to become more selective about the type of issuer they would want to hold. Within this scenario there are a number of obvious winners and losers. Of the winners, we expect issuers from the utility, tobacco, oil and gas and pharmaceutical sectors will stand out. In each of these sectors the key point is that they will continue to enjoy a stable cashflow and business outlook, irrespective of the underlying economic environment. To a lesser extent companies involved in food and consumer product manufacturing and retailing will also be similarly in demand, however, competitive pressures within these industries will reduce the relative attractiveness. In contrast, the losers will be autos and cyclical sectors, where the weakened growth outlook will have a direct impact on their future potential earnings stream. In such an environment these companies will need to pay an even larger premium to the market to compensate for ongoing risks.

Where the picture does become more confused is for those sectors and companies that lie somewhere between the stable cashflow winners and cyclical losers. A good example here is the telecom sector, which accounts for a third of the euro corporate bond market. Historically, this sector benefits from 'utility-style' cashflow characteristics, which should put it firmly in the winning camp. However, because of recent expenditure associated with 3G-mobile the industry is now heavily debt burdened, making it vulnerable to negative sentiment. Nonetheless, those companies that have controlled their debt exposure (eg Vodafone, Telefonica) or have made concerted efforts to reduce leverage (eg BT) should still do well and see their issues trade at comparatively better levels than those on offer from other incumbents (eg DT, FT, KPN and Sonera).

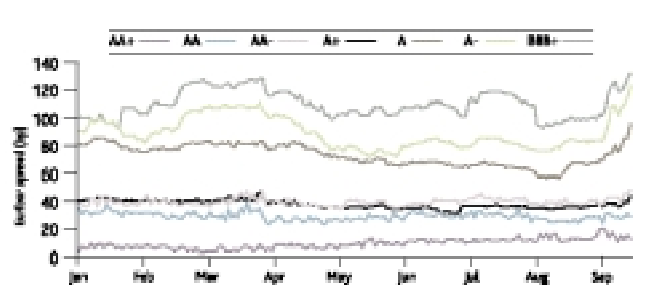
Finally, we would also expect higher rated companies to do relatively better in spread terms over the remainder of the year, as investors will now look to 'trade up' the credit curve. With higher rated corporates in the single-A and double-A rating category doing comparatively better than weak single-A and triple-B rated companies – see *Figure 2*.

FIGURE 1
COMPOSITE WEIGHTED AVERAGE EURO CORPORATE BOND SPREADS.



Source: WestLB Research

FIGURE 2
EURO CORPORATE BOND MARKET PERFORMANCE BY RATING CATEGORY.



Source: WestLB Research

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