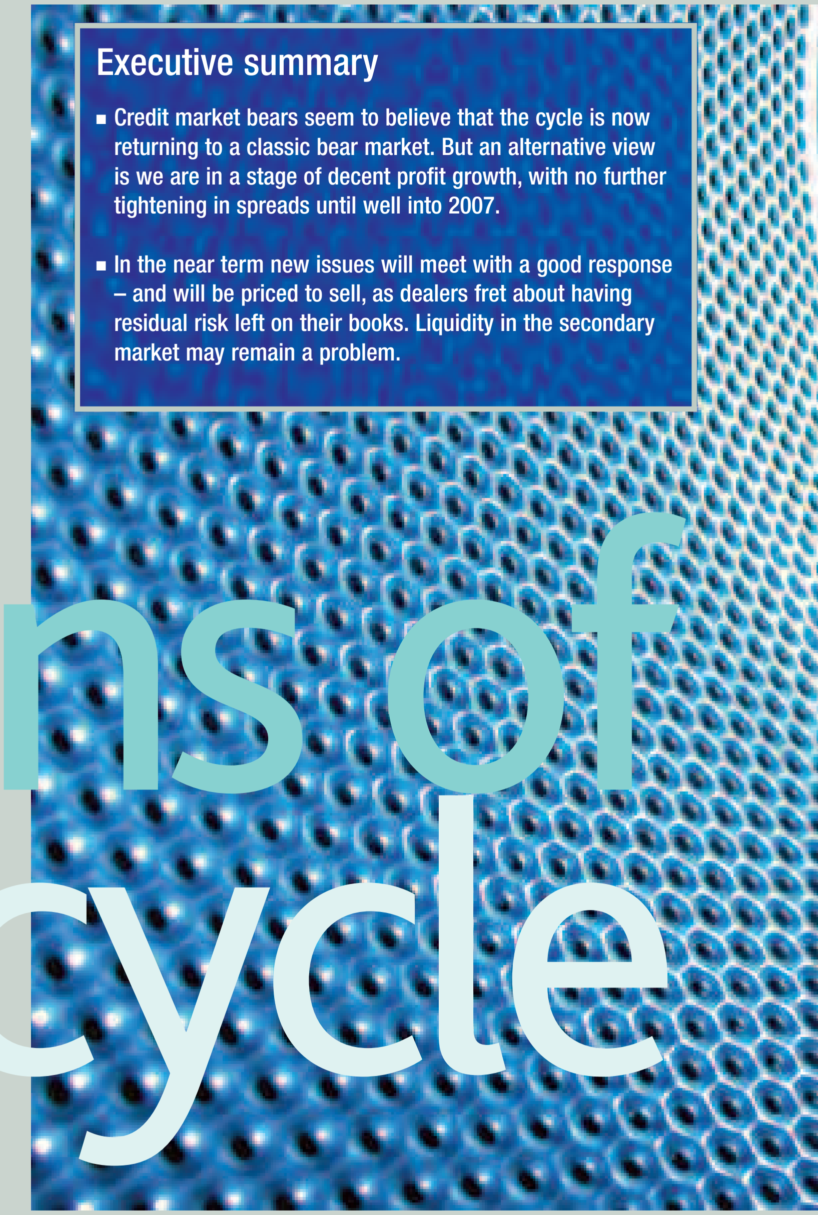
Turns of the cycle



Executive summary

- Credit market bears seem to believe that the cycle is now returning to a classic bear market. But an alternative view is we are in a stage of decent profit growth, with no further tightening in spreads until well into 2007.
- In the near term new issues will meet with a good response – and will be priced to sell, as dealers fret about having residual risk left on their books. Liquidity in the secondary market may remain a problem.

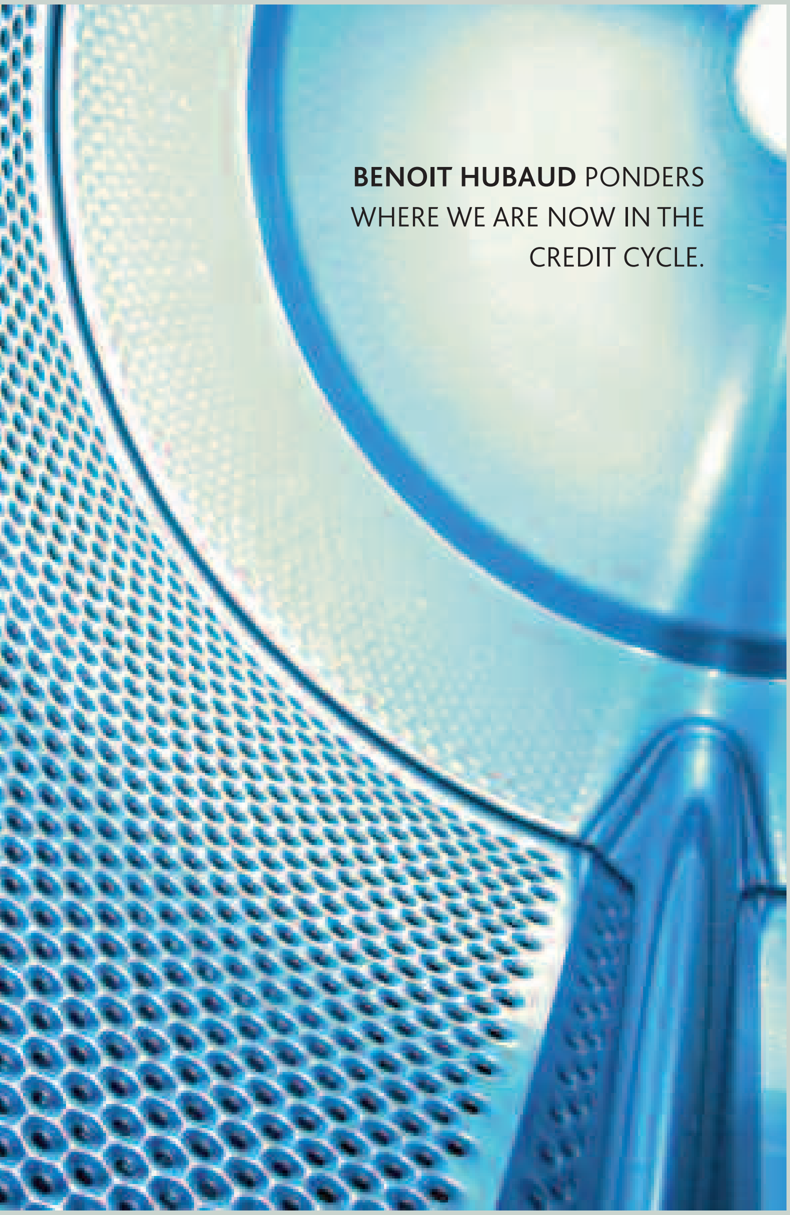
Has the worm turned for the credit markets? Between October 2002 and the fourth quarter of 2004, credit spreads tightened steadily. Last year, they tightened only marginally despite a turbulent patch at the end of the first quarter of the year, driven by the downgrades in the US auto sector. Since the start of 2006, however, credit spreads have widened, often sharply, as the market grapples with fears about higher leverage, growth and profits.

Credit market participants need to take a step back, and assess where we are in the credit cycle. A credit cycle typically has four stages:

- During the first stage (the classic bear market), spreads rise as economic growth and profits slow. Think back to the 2001-02 period for a good example of this type of bear market in credit.
- The second stage kicks off the bull market. In this phase, government yields drop so low that fixed income investors turn to credit markets to generate returns, even if credit fundamentals have not yet improved.
- The third part of the credit cycle extends the bull market – but the justification changes. In this stage, growth and corporate profits begin to recover, so interest coverage ratios (like EBITDA to interest payments) improve.
- Finally, the fourth stage of the credit cycle sees decent profit growth, but no further tightening in spreads. Why? Because companies begin to spend more – in share buybacks, dividend payments, organic investment, and merger and acquisition (M&A) activity – than they are earning in operating profits. This growth needs to be financed, and at least some of it tends to be financed with new debt. Thus, supply increases, leverage begins to rise again, and spreads tend to edge wider, even if growth is strong. This higher leverage sets the stage for a repeat of the cycle, when growth does eventually drop off.

So where are we now in the credit cycle? Credit market bears seem to believe that the cycle is over, and is returning to the first stage – the classic bear market. Our view, however, is that the credit markets are still in the fourth stage, and will be until well into 2007. The real source of event risk is merger and acquisition activity and higher leverage. While other concerns need to be watched, corporate leverage is not high enough (yet) to lead to a new bear market.

DIVIDEND RATIO NEAR HISTORIC LOWS Let's review the situation in terms of leverage, and the areas we ought to be focusing on in this cycle. Companies typically boost spending in four ways – by increasing dividends, boosting share buybacks, making organic investments, or engaging in M&A activity. We expect dividends to continue to rise this year, both in absolute terms and as a percentage of earnings. However, despite the dividend increases of the past two years, the ratio of dividends as a percentage of operating profits for all the non-financial companies in the iBoxx index is still near historical lows. Companies have considerable room to boost dividends further without straining balance sheets. Similarly, the pace of share buybacks has been even more restrained than the pace of dividend increases.



BENOIT HUBAUD PONDERS WHERE WE ARE NOW IN THE CREDIT CYCLE.

Organic investment is rising, but remains well below the heady levels seen in the late 1990s. So where are companies spending money? On acquisitions. The value of M&A deals in Europe hit its highest monthly level in February since the peak of 1999. Although the value of deals has declined in the last six months, it has still been some 50% higher than the deals seen over the same period of 2005. In addition, we expect deals to pick up again over the second half, as deal-making fever spreads from the industrial and utilities sectors to others.

Let's not overstate the threat currently posed by M&A activity. The prices paid for companies remain reasonable, and funding strategies are not yet over-aggressive. This may be necessary, given that the average corporate credit quality across Europe is at the low single-A level. Current ratings compare with double-A at the turn of the millennium – and we think there is still reluctance among many continental corporates to risk a dip into junk category even for a short time. As a result, M&A-related downgrades have been limited to just a notch or two (Bayer, for example). Keep in mind, however, that most M&A waves begin with sensible prices being paid for deals, and end with collective corporate financing madness. We have yet to see whether this cycle will prove to be an exception.

Moreover, the large amounts of funds raised by the private equity firms make this M&A wave somewhat different, since it will contain more leveraged buy-out activity than previous waves. The market woke up to the threat posed by leveraged buy-outs in the spring of last year, with the ISS deal.

Since then, however, credit investors have tended to take a more measured view of the threat posed by leveraged buy-outs. Although leveraged buy-outs can have a devastating impact on portfolio performance, as bonds are usually severely downgraded (a 25% capital loss is not uncommon), there have only been three leveraged buy-outs of investment-grade issuers in Europe since the first quarter of 2005 despite all the speculation. As well as ISS, TDC and VNU have been taken out by a private equity bid and, at the time of writing, Portugal Telecom awaits its fate.

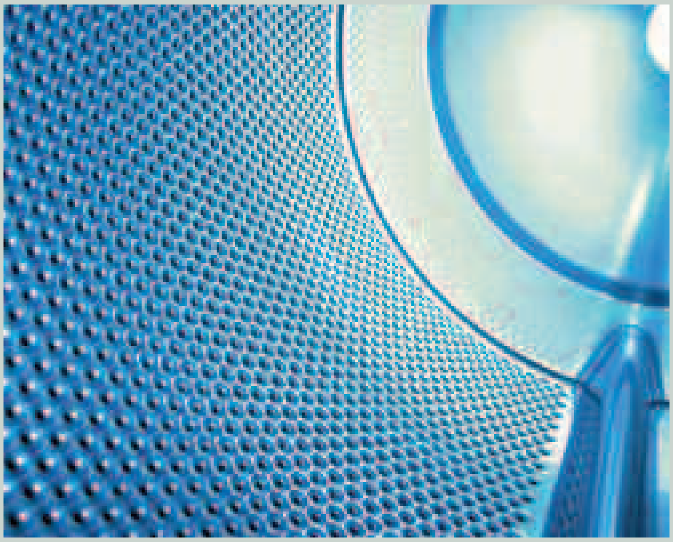
Moreover, private equity funds are increasingly loathe to hurt bond investors – since they will need to turn to these same investors for debt financing as the deal gets under way. With the lines between investment-grade and high-yield investors blurring, the treatment of bond investors is even more cautious. As a result, leveraged buy-outs may ultimately turn out to be less of a threat than traditional leveraged M&A activity by companies.

Higher levels of M&A are leading to higher levels of non-financial supply. Supply over the first six months of this year was up 25% on the same period of last year. Admittedly, 2005 was a particularly weak year for supply – the weakest since the creation of the euro. But non-financial supply in the year to June was still 18% higher than in the first six months of 2004, although we are still 33% below the heady totals of the first half of 2003, and 44% below the total over the equivalent period of supply in 2001 – the highest year ever for European investment-grade debt supply.

ON THE LOOK-OUT FOR GROWTH The critical question for the debt markets over the second half of this year, then, is whether M&A activity will reverse the slowdown seen over the past three months, and return to the strong pace seen in the first quarter. We think this is likely. European corporates have passed the cost-cutting phase; they are looking for growth, and the fastest way to do so is to buy another company. As a result, we do expect another phase of debt-driven M&A activity in the third and fourth quarters, which should end up driving spreads wider.

However, many credit market bears are focusing not just on M&A, but also on the prospect of a slowdown in growth. We think this focus is misplaced, for two reasons.

First, our US and European economists do not see a sharp slowdown in growth over the next 12 months. There are a variety of reasons to worry about GDP growth and corporate profits growth in the medium term: the geopolitical situation, with conflict in the Middle East between Israel and Lebanon; inflation concerns, which are leading to higher interest rates on both sides of the Atlantic; and the fact that corporate profits as a percentage of GDP growth remain very high. But, in the view of our economists, household and business confidence is likely to grow in the near term, while attention to costs and productivity gains will keep profit margins high. Even with higher interest rates, above-trend or trend growth will leave the corporate sector with the ability to continue to generate enough free cashflow to service its obligations. And we continue to expect that the US economy will retain trend growth over the next six to 12 months, with the global economy pulled up by the sustainable growth dynamics in China and India.



Second, even if growth does slow, a bear market in credit may not ensue. We think credit markets are in the fourth phase of the cycle, as opposed to the first (classic bearish) phase. Leverage is not yet high enough for weak growth to get companies into trouble as they still have cyclically high levels of cash as a percentage of assets, and cyclically low levels of leverage. Remember that until the end of April, the 12-month trailing default rate was zero in Europe (a rate not seen since the late 1990s). We do not expect this rate to increase significantly for the remainder of this year, and this cycle should not see a repeat of the carnage that befell the market in 2002 where the rate jumped to over 10%. Even the average cycle default rate of somewhere between 5%-7% looks unlikely as things stand.

Given this fundamental backdrop, and the outlook for the interest rate and equity markets, how do we see credit markets performing in the near term?

After a quiet traditional holiday lull, supply will pick up in September as the market re-opens. New issues will, however, meet with a good response – and will be priced to sell, as dealers fret about having residual risk left on their books. Liquidity in the secondary market may remain a problem, though, and the ability to transact in size or solicit attractive bid-offer spreads will remain elusive in all but newer issues. Overall, we remain fairly comfortable as to where risk is priced right now, and would only anticipate a moderate widening in spreads – at worst – into the end of the year.

CLASSIC SIGNAL OF A WELL SUPPORTED MARKET We are emerging from yet another excellent earnings season, with the corporate sector still managing to shrug off the negative impact of the rising oil price. New issue supply has not been overbearing, and has actually been met with a good bid as many investors have preferred this route back into the market rather than buying secondary risk. At least they have the possibility of forcing issuers to offer covenant protection if they feel uneasy about the prospect of a possible leveraged buy-out bid. Indeed, although we have upgraded our supply forecast from €85bn-€90bn to around €110bn for investment-grade non-financial corporate debt issuance this year, with redemptions running at €120bn, this would still leave us with a third consecutive year of negative net supply – classically a signal that the market should be well supported.

We see spreads on the iBoxx corporate index continuing to tighten. On the iTraxx Europe benchmark contracts, a move back to the 27bp tights from the first half of the year even looks possible. But in the fourth quarter, M&A fears may lead to a slight widening in spreads. This should take the iBoxx Corp index back to the 67bp area (still below current levels), while the benchmark Europe iTraxx contracts could go back up to the 36bp region. Our model portfolio stance reflects our more benign outlook on the markets – we are neutral, but we carry additional duration risk versus the benchmark. This is mostly driven by the quite substantial overweight we are running in subordinated financials – a sector which, itself, came under a lot of widening pressure during May and June. Though the subordinated financials sector has recovered over the summer, valuations remain compelling, even if we do see a slight deterioration in banking sector margins due to stronger competition and rising defaults. Fundamentals in the sector will remain strong, and ratings stable.

Nonetheless, in the short term, it is worth keeping an eye on both the interest rate markets and the equity markets as indicators of how sentiment is evolving on the growth front. Our interest rate strategists believe that the US Federal Reserve will shortly terminate the tightening process initiated in June 2004, which saw federal funds increase from 1% to just above 5%. In this context, the 10-year Bund should trade within a 3.75%-4.25% range, with the lower end of the range likely to prevail towards the year-end. We do not see 10-year Treasuries rising much above the long-standing technical objective of 5.30%. As the US economy slows and market participants reprice the relative path of central bank rates, we also expect intermediate Treasuries to outperform European and Japanese government bonds. But we have shown that higher rates do not necessarily mean that spreads will go wider. Indeed, in the previous three tightening cycles in the US, spreads have gone tighter in one (1986-89), wider in the other (1999-2000) and were unchanged in the 1994-96 cycle.

We expect the European equity markets to rise slightly before the end of the year, and a still-positive trend throughout 2007. Equity funds are flush with cash, and were not affected by the sudden decline observed between early May and early June. There are, admittedly, a few clouds on the horizon.

First, raw material prices are still very high, and this could weigh on monetary policies and on the margins of certain energy-consuming industries. The expected sharp fall in raw material prices might occur only after the hurricane season (September/October).

Second, the dollar continues to be a weak currency, especially given the anticipated monetary policy differential, namely an announced rates increase in the euro zone but an expected stability by year-end in the US. This could weaken European companies' competitiveness and profit growth.

Against this backdrop, shares issued by consumer companies should post a better performance than those issued by industrial companies, as these are usually more sensitive to the dollar. But the risk profile of European shares is now much better than in 2000. Indeed, their valuation is moderate (risk premium above 5%, dividend yield of 2.8%), and listed companies' balance sheets are particularly solid, especially in the banking sector. This should favour a continuation of M&A activity, at a time of improving corporate governance rules and continuing globalisation of the economy. Small caps could be hurt by valuations that are high compared to blue chips, which are much cheaper and less volatile. Our equity analysts therefore recommend focusing investments on large caps.

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