ENJOY IT WHILE IT LASTS

BORROWERS HAVE NEVER HAD IT SO GOOD, BUT FOR HOW LONG CAN IT ALL LAST? BNP PARIBAS' **MURRAY BLACK** AND **DAVID KING** FIND OUT.

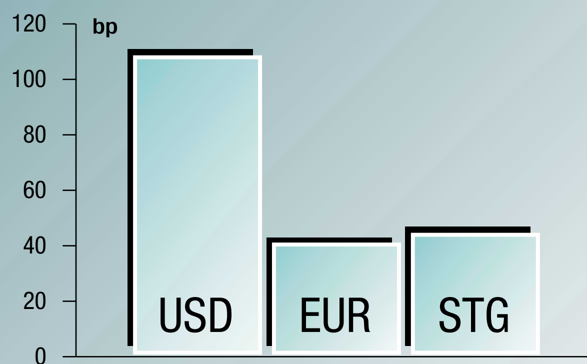
In the first half of 2003, we have benefited from the seemingly contradictory drivers of recovering equity markets, low and falling bond yields, and low and tightening credit spreads. These have combined to make corporate borrowing conditions as good as many of us can remember.

The question that will concern many treasurers, as they consider their funding plans for the balance of 2003 and 2004, is the extent to which these conditions will persist.

Following the ending of the (formal) conflict in Iraq, the bond markets have become increasingly convinced about the prospects for an economic recovery (in the US anyway) and this has accounted for the sharp back-up in government bond yields and the general strengthening of the equity markets (see *Figure 1*). Although this represents a new phase for the corporate bond markets, it should remain a constructive background, given how far investor sentiment for corporate bonds follows that of the equity markets .

It is worth, therefore, looking at some of the key themes of the markets in the final half year and seeing how applicable they are under the new market paradigm.

▪ Figure 1
10-year Government bond yield differentials
1 June 2003 to present



THEMES AND TRENDS

A MORE ACTIVE EURO SECTOR. We have seen, and believe that we will continue to see, a greater proportion of corporate bond financing take place in the euro sector at the expense of the dollar and sterling markets. This is reflective of the enhanced depth and liquidity of this increasingly mature market, generally competitive pricing for most companies and the greater availability of longer maturities (see *Figure 2*). The emergence of accounting concerns (including IAS 39) may also have encouraged certain issuers to fund in their home market.

INCREASED DURATION IN THE EURO MARKET. One aspect of the euro market that has restricted its appeal, particularly for UK businesses, is the relatively short maturities traditionally available. One of the most notable developments this year has been the wide availability of 10- and 15-year maturities and, in some cases, even longer. This has been because of the sharply positive yield curve and the requirement by investors for higher yielding instruments. Given the increasingly positive yield curves in the US and Europe, we cannot see any reversal of this trend, and expect this sector of the euro market to develop and mature further as real money investors gain confidence in the liquidity of longer-dated paper (see *Figure 3*).

OPPORTUNISTIC PRE-FUNDING. The ability of exogenous shocks (such as WorldCom, LTCM, Asia and 11 September 2001) to all but close the corporate bond markets is a lesson that has not been lost on many European treasurers. We have seen a greater willingness to opportunistically pre-fund in the bond markets,

when conditions are good, despite the high cost of carry implied by a positive yield curve.

CORPORATE FLOATING RATE NOTES. Given the shape of the yield curve, short-dated FRNs have and will continue to be attractive funding instruments for corporate borrowers. Issuance levels are more likely to be restricted by the appetite of money market investors to buy rather than by that of corporates to issue. Issuance in the 18-month to three-year maturities fill the gap between commercial paper and longer benchmark bonds, offer access to a different investor base and can substitute financing traditionally supplied by bank loans.

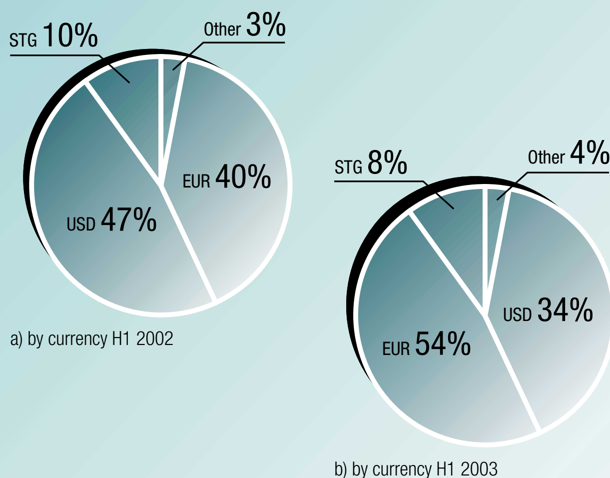
LOOKING FORWARD

PENSIONS. The whole pensions issue will continue to be an important factor for the bond markets going forward. We generally regard it as a positive factor as (particularly UK) investors continue to rebalance their pension portfolios away from equity and into fixed income investments. With a (still) relatively low Government bond yield environment, investors will be forced to look at higher yielding corporate credits.

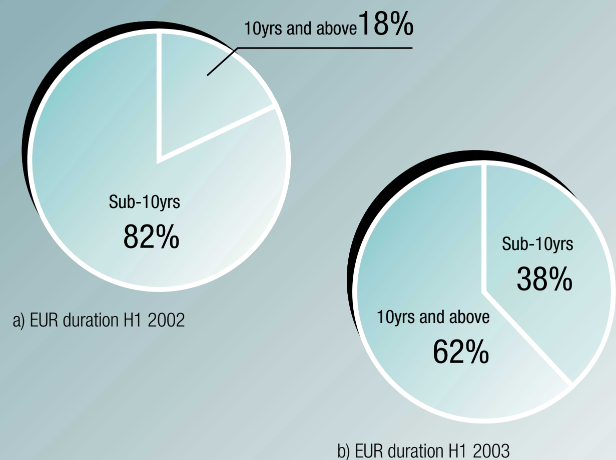
'WE ANTICIPATE THAT A RALLY IN THE EQUITY MARKETS WILL ENABLE HEAVILY UNDERWATER FUNDS TO REBALANCE WITHOUT INCURRING PENAL LOSSES ON THE EQUITY HOLDINGS'

BOND SPREADS. Corporate bond spreads are at their tightest levels since January 2001 (as measured by the iBoxx corporate index). While an economic and stock market recovery are supportive for credit spreads generally, our bond strategists are concerned that higher government bond yields could tempt switching out of corporate holdings, leading to a widening of spreads. This, in our view, remains one of the main risks to the positive scenario.

▪ Figure 2
Corporate Issuance



▪ Figure 3
H1 2003 vs. H1 2002 Euro corporate issuance duration



We also anticipate that a rally in the equity markets will enable heavily underwater funds to rebalance without incurring penal losses on the equity holdings. Equally, a small number of companies may well be forced into the market to fund substantial pension shortfalls, as was the case with General Motors.

SUPPLY/MERGERS AND ACQUISITIONS. Relatively low levels of corporate activity over the past two years have restricted the amount of acquisition-led refinancing in the bond markets, and this at least partially explains the tightening of credit spreads. If a recovery in equity markets does lead to greater activity, we could see some pressure on corporate spreads, as investors anticipate a 'wall of supply'.

LOOKING TO THE FUTURE

Overall, we remain positive about the market outlook for the balance of this year. The pipeline of corporate transactions is beginning to grow but is so far entirely manageable.

However, as we have seen many times before, sentiment can deteriorate swiftly and we would therefore continue to recommend an opportunistic approach to companies in a strong market.

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