


The euro credit market – the year ahead

A rival to the dollar credit market has been born and is growing rapidly. Clive Parry of Morgan Stanley looks at euro credit – a once-in-a-lifetime opportunity.

 The most important feature in global bond markets is the continuing expansion of the euro credit markets. All other changes in the market are being dwarfed by this once-in-a-lifetime event.

We can also see that Y2K issues are causing concern. These concerns have been most acutely felt in the US, but they also extend to other parts of the world to some degree.

The euro credit market

The fixed-rate credit market denominated in euro has grown dramatically since the start of this year. The forces driving this expansion are set to remain in place for several years to come – what we have seen so far in 1999 is just the beginning.

This growth has been 'demand-led' with fixed-rate investors (insurance companies, pension funds and mutual funds) expanding their investment horizons beyond government bonds to include all investment-grade credit and, in some cases, high yield, too.

This desire to add spread to bond portfolios is not generated by Emu itself, although Emu certainly accentuates the two important forces: low interest rates and competition.

Low interest rates are problematic for the insurance and pension industry, with many institutions struggling to meet (implied or explicit) minimum guaranteed levels of return. Although past efforts to match assets and liabilities were clearly inadequate, there is no going back. Most are taking the credit risk route to add return to fixed-income portfolios.

Competition is also important. Mutual funds may not have to match liabilities but it is a competitive business in which money managers must make every effort to add return. Credit is one of the few avenues left open to add performance in a single currency fund.

Indeed, our discussions with investors throughout the euro area suggest that virtually all fixed-rate investors are looking to increase credit exposure in their portfolios.

The typical investor who, in the past, had mainly government bonds and a Double A lower limit for rating, is now actively buying Single A and Triple B names too. High yield is also getting increased focus from many investors although involvement is still limited.

Currently, the market (and therefore investors' portfolios) consists mainly of government (or government-related) paper and financial issues. Thus, the push to add credit exposure is concentrated in industrial names. This is reflected in the increasing share of new issuance industrial names represent.

In addition to increased credit exposure we also see maturity extension. For some, this represents a move that allows them to more closely match their liabilities, for others it is a way to increase yield. The steep yield curve in Europe is very tempting.

This means that the European credit market is offering borrowing opportunities for weaker credits in longer maturities at competitive spreads. A rival to the dollar credit markets has been born and is growing rapidly.



Clive Parry

Obstacles to development

This is the theory but there are some practical obstacles. Investors' existing holdings typically trade at a large premium to the purchase price and liquidation is impossible for tax reasons. So, on the whole, increased credit exposure and diversification is happening only with new money and reinvestment of coupons and redemptions.

In some cases, fiscal issues are a barrier to credit investment. For certain types of investor, some countries discriminate against foreign bonds through the tax system. Customers forced to remain geographically concentrated tend to be more cautious in taking additional credit exposure.

Resources also remain a problem for many investors. Credit investment needs skilled analysts to monitor the names and risks of the portfolio – skills that are in short supply in Europe.

These are barriers to the development of a truly pan-European single credit market and may take some time to overcome. Nonetheless, a huge level of demand for corporate credit has been generated in Europe which has been, to some degree, matched by a substantial rise in corporate issuance (see *Figure 1*). This important trend is set to continue.

Outlook for spreads

Global credit spreads have recovered (tightened) sharply since the crisis of 1998 although the ride has not always been smooth. One feature of the market is that euro credit spreads (versus European government bonds) are far tighter and less volatile than their counterparts in the US and the UK.

This is due principally to tighter spreads between government bonds and swap rates rather than narrow spreads between swap rates and corporate bond yields.

Taking swaps as the benchmark, we see that European corporate spreads

are roughly equal to US corporate spreads. European industrial names tend to trade a little tight in euro simply because European investors are keen to diversify away from the financial sector. Some lesser-known credits trade a little cheap in euro because US investors tend to be a little more adventurous. However, a broad equilibrium has and will be maintained by arbitrageurs who will asset swap bonds if spreads move out of line.

It is the difference in swap spreads – versus government bonds – in euro and in dollars that is the apparent anomaly. However, there are several factors that will keep this spread tight in euro:

- first, European government bonds, because of the loss of monetary sovereignty, are not ‘credit-risk free’ like US or UK government bonds;
- second, the European government bond market, with ten different issuers, is more fragmented than the US or UK market. This means that, relative to their respective swap market liquidity, European government bonds are less liquid than US treasuries. This leads to a greater ‘liquidity premium’ for US treasuries than for European government bonds;
- third, the ECB accepts a large range of non-government paper as collateral in its open-market operations. This reduces the scarcity value of government bonds in the euro-zone (relative to US treasuries or UK gilts); and
- fourth, the new buyers of credit in Europe are fixed-rate buyers, but the issuers still want their liabilities in floating rate form. Whether this is a

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hangover from when they borrowed from banks or an interest rate and yield curve view, it still means that most new issues are swapped. This causes swap spreads to remain tight versus government bonds.

In the near-term there is unlikely to be a change in this equilibrium. A general change in interest rate and curve view may cause issuers to ‘fix’ their borrowing costs and permit swap spreads to widen. However, we view this as unlikely this year. In the meantime, we still expect good demand for credit product and continuing growth of the market.

Y2K

The millennium bug has been on most people’s minds in the run-up to Y2K.

For the financial markets the major issue will be year-end liquidity and operational issues. Although huge preparation has been made with encouraging testing results to date, how markets will perform in the end is unclear. Nevertheless, we can see

how market participants’ behaviour has been altered already.

It seems clear that central banks will do everything they can to keep the system liquid and this will most likely keep rates low over the year-end. However, this does not mean that these low rates will be available to borrowers. As a result, borrowers are ‘front-loading’ their issuing programmes to ensure that they are not forced to come to the market late in the year, with potentially negative consequences.

This is one possible explanation for the huge supply calendars in the US and Europe for corporate bonds. The suspicion is that the pace is unsustainable and that the seasonal summer lull in activity might extend to year-end.

With borrowers planning ahead it might be investors who find problems putting their money to work. It may be the case that tighter spreads result later in the year – although it would be a risky game for borrowers to wait.

One final thought on Y2K. Whatever the impact, it will be greater in the US than in Europe. The US financial markets are, on the whole, better developed than those in Europe. This has allowed a much greater degree of disintermediation as borrowers and lenders meet in the capital markets rather than through the banking system. In Europe the process is happening but is currently at a less advanced stage.

The result is a European banking system that is far larger than that in the US and a European capital market that is dwarfed by its US counterpart.

Even though many borrowers are thinking ahead, some will still have to borrow late in the year. If they find poor liquidity in the capital markets (as some commentators predict) they may turn to the banking system. Given the difference in size of the two systems, the European one is more likely to be able to absorb the additional demand.

As in many areas, the less sophisticated systems may prove more robust under the stresses imposed by Y2K.

Personally, I believe that Y2K will not cause the huge level of disruption that some fear but, whether I am right or wrong, it will dominate market thinking until we are well and truly into the new millennium. ■

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FIGURE 1

