What now for credit spreads?

For years it was easy. If you asked the question, "Where can you bring a 10-year Eurosterling deal for a single-A issuer?" The reply would invariably be, "Seventy over gilts". Eurosterling trading desks were happy to hold inventory and if they saw any signs of nervousness in the market they would simply hedge with gilts or gilt futures. However, in the summer of 1997, the Thai baht devaluation and subsequent crisis temporarily broke the cosy relationship between gilts and Eurosterling bonds and spreads widened to 100 basis points (bp) by the end of the year. Many desks registered significant losses.

Learning from their mistakes

In 1998, the banks were determined not to repeat the losses that had occurred in the previous year. They had noted that swaps rates tended to move very much in line with Eurosterling yields. They realised that hedging a Eurosterling portfolio with swaps would be more efficient than hedging with gilts. They did not have to wait long for their theories to be put to the test. In the long term capital/Russian crisis of the autumn of 1998, 10-year, single-A, Eurosterling spreads blew out by 90bp to an unprecedented 175bp over gilts. Those banks hedged with swaps heaved a sigh of relief because swap spreads had moved out by 80bps.

An imbalance

This use of swaps to hedge corporate bond portfolios has created an imbalance in the swap market. Any sign of stress in the credit markets creates one-way demand to pay fixed on the swaps. Swap traders will automatically raise the swap rates they receive at, if the flow is all in one direction. Thus, the spread between swaps and gilts rises.

Where next?

Today, with 10-year, single-A, corporate spreads at 125bp and 10-year swap spreads at 110bp, the question is, where next? In our studies, high stock-market volatility and low public sector borrowing requirements are associated with high swap and corporate spreads. Stock market volatility is currently falling and public finances are moving into deficit, which means that spreads should fall. Against this is the overhang of Y2K, which is forcing corporate borrowers to bring forward their fourth quarter borrowing programme to September and October. Expect spreads to remain wide due to supply but, barring unexpected crises, the fundamentals are for spreads to narrow in the medium term. ■

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INTERNATIONAL BONDS

These are a selection of bonds announced recently. The details, updated to the middle of last month, were supplied by *IFR Securities Data, London* and other sources.

Issuer	Launch rating M	Launch rating S&P	Amount (m)	Coupon (%)	Price	Maturity	Launch Spread (bp)	Fees (%)	Bookrunner
De Nationale Investeringsbank NV	Aa3	AA-	GBP125	6.75	99.413 99.413R	27 Sep/04	100	0.300	Greenwich NatWest
General Motors Acceptance	A2	A	GBP200	6.875	99.3680 99.368R	9 Sep/04	117	0.325	Barclays Capital Merrill Lynch International
Kingfisher	NR	A	GBP150	6.875	99.386 99.386R	23 Mar/10	145	0.375	Barclays Capital Warburg Dillon Read
Oresundskonsortiet	Aaa	AAA	EUR100	3.4	99.768 99.768R	28 Sep/14	24	0.400	CDC Marches
Statoil	Aa2	AA	EUR200	*	100.050 100.050R	1 Oct/00		0.050	Credit Suisse First Boston
Telia AB	Aa3	AA	EUR150	5.50	99.879 99.879R	10 Sep/10		0.400	CDC Marches
Thames Water Utilities Finance	NR	NR	CHF60	*	100.00 100.00R	31 Aug/00		0.050	Deutsche Bank AG

** Floating rate note. Launch ratings are from Moody's (M) or Standard & Poor's (S&P). NR = Not Rated. R = fixed re-offer price. Launch spread is over comparable government bond.*