U.S.

Economic Watch

March 14, 2011

Economic Analysis

Jeffrey Owen Herzog
jeff.herzog@bbvacompass.com

Corporate sector supporting bond growth

Monetary conditions still backing nonfinancial expansion

- **Burgeoning growth in nonfinancial bonds outstanding to eventually meet Fed rate expectations**
- **Financial sector deleveraging continues to drag on growth of total bonds outstanding**
- **Flows to taxable bond funds and decreased bond trade volumes show less appetite in 2011 so far**

Outlook for 2011

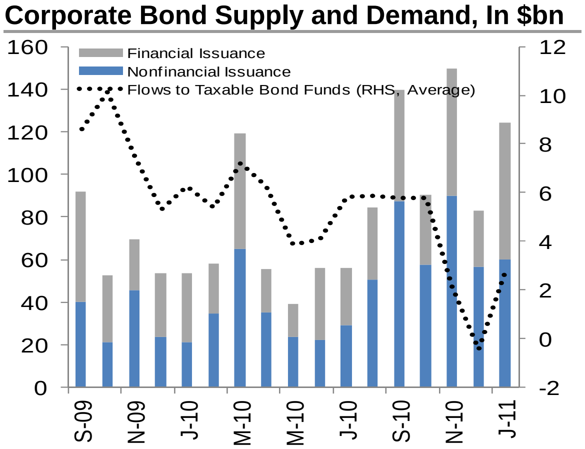
With the 2010Q4 release of the Federal Reserve Flow of Funds, the data indicates that overall real corporate bond growth arrived at -1.3% YoY or $10.2tr (BBVA: -0.6% YoY). Over the course of 2010Q4, nonfinancial corporations added to their considerably-rapid increase in bonds outstanding. We expect nonfinancial firms to continue to grow at a heightened clip, but with expectations of Fed action getting closer each quarter (Chart 2) the relative attractiveness of bond issuance will begin to decline. It is entirely possible that with higher yields for shorter-term corporate debt like commercial paper, some additional life may return to these markets as yields will be more attractive for money market funds and investors alike. Nonetheless, we do not expect a more robust commercial paper market until early 2013.

Financial firms' bonds outstanding demonstrated continued deleveraging. Although financial firms declined more than expected at -9.7% YoY (BBVA: -7.6% YoY), the result is consistent with our expectation of an improving trend for YoY rates of change in financial bonds outstanding and that a bottom occurred in 2010Q2. Over the longer term regulatory pressures may predominate in this category. On a positive note, January issuance of financial corporate bonds is higher than the average over the past 12 months. We maintain our presupposition that the financial sector is about 4 quarters away from the end of deleveraging in terms of financial bonds outstanding.

Bonds outstanding attributable to the rest of the world met with expectations and grew at a 3.8% YoY rate (BBVA: 3.5% YoY). The forecast quickly converges to trend; in reality, fluctuations of the dollar, world trade, and transportation costs should cause more frequent innovations in the longer-term forecast horizon.

Chart 1

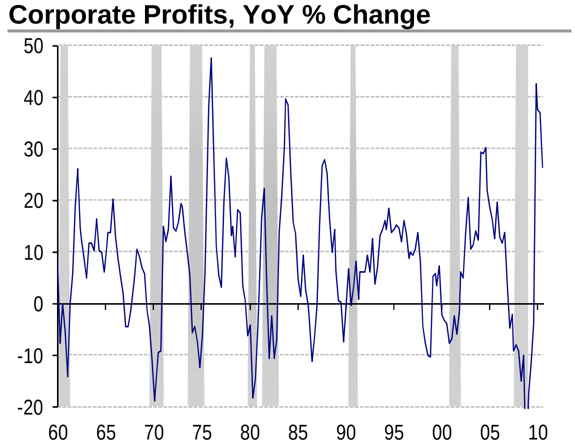
Corporate Bond Supply and Demand, In $bn



Source: Haver Analytics

Chart 2

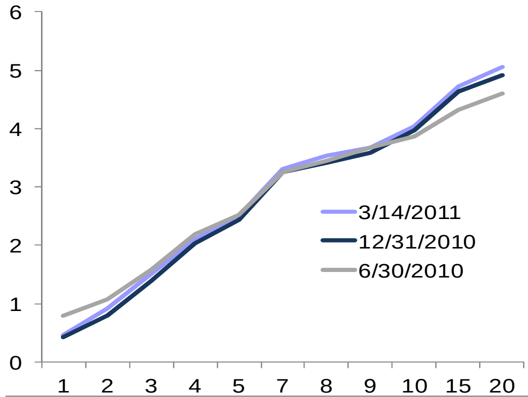
Corporate Profits, YoY % Change



Source: Bloomberg

In December, the average flow to taxable bond funds slowed markedly and briefly flirted with negative territory. December also witnessed a new tax cut deal between Congress and the Obama administration that prompted a surge in long-dated government bond yields. Ever since the announcement of a second round of large scale asset purchases by the Federal Reserve in November, average flows to taxable bond funds have been lower than the trend over most of 2010 and 2009 (Chart 1).

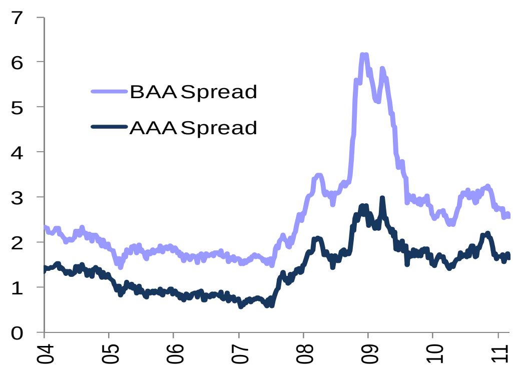
Chart 3
US Corporate AAA Industrial Yield Curve



Source: Bloomberg

The outlook for the US corporate yield curve depends on Fed action, expectations of the strength of the economic recovery, and the outlook for inflation. The Fed's current program of Large Scale Asset Purchases (LSAPs) is successfully incrementally increasing inflation expectations and this may be consistent with higher long-term interest rate levels compared to previous AAA industrial yield curves. However, our baseline scenario remains centered on a first increase in the Fed funds rate in 2012.

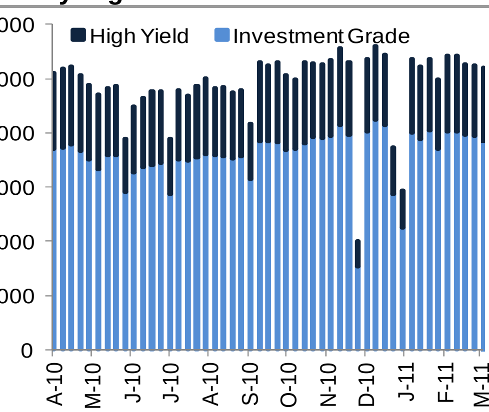
Chart 4
Corporate Spreads Over 10 Year Treasury



Source: Bloomberg and BBVA Research

Corporate spreads in 2011 are lower than late 2010, but are also still higher than in late 2009. At the end of last year, concerns swirled around European sovereign debt and the outcome of the Federal Reserve's LSAP. The risk premium today is reacting in the near term to geopolitical events (political unrest, earthquakes). However, these other issues have not really disappeared and overall spreads face multiplicative risk conditions.

Chart 5
Weekly High Yield and Investment Grade Bond Volume



Source: TRACE and Bloomberg

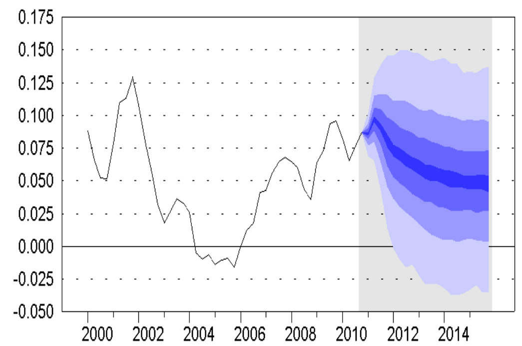
Over the past twelve months, volume has trended downwards compared to an upward trend over the second half of 2010, with the exclusion of holiday weeks. Overall securities lending has trended upwards in the form of total securities credit reported by the Federal Reserve Flow of Funds Z.1 Release. However, with weakness emerging in major stock indices, we expect total securities lending to decline. Lower corporate bond volume is largely related to reduced investor appetite in investment grade bonds.

Corporate Bonds Outstanding Forecasts

This quarter's data resulted in a slight downwards revision in our expected 2011 total bonds outstanding growth to 1.6% YoY and we remain essentially unchanged for our 2012 forecast of 4.8% YoY. As previously asserted, financial bonds will represent the primary drag on total bonds outstanding. From a historical standpoint, our average forecasted quarterly YoY growth rate for total bond growth until 2015 is about two-thirds the average YoY growth rate between 1982 and last quarter. For medium-term forecast horizons, risks are to the downside for the rest of world component of bonds outstanding.

Chart 6

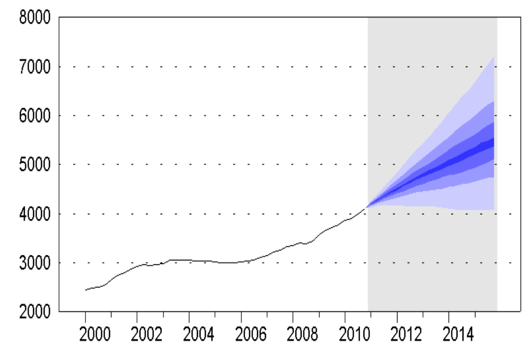
Nonfinancial Bonds Outstanding, YoY%



Source: BBVA Research

Chart 7

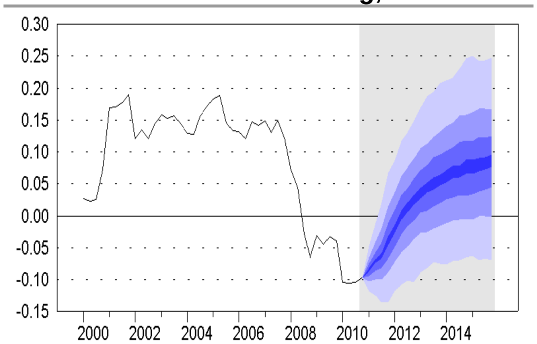
Nonfinancial Bonds Outstanding, real $bn



Source: BBVA Research

Chart 8

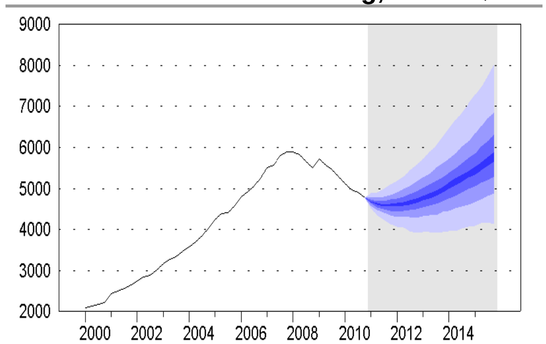
Financial Bonds Outstanding, YoY%



Source: BBVA Research

Chart 9

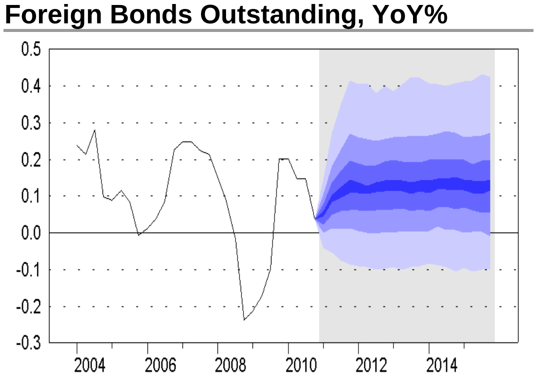
Financial Bonds Outstanding, In real $bn



Source: BBVA Research

Chart 10

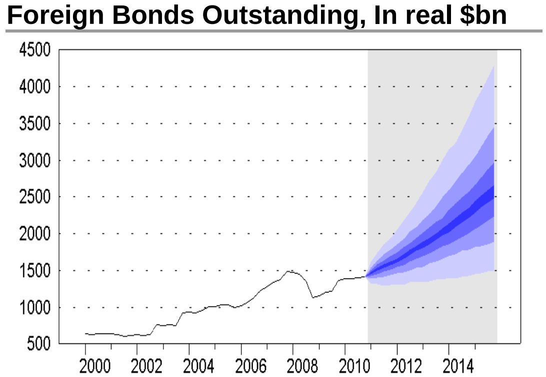
Foreign Bonds Outstanding, YoY%



Source: BBVA Research

Chart 11

Foreign Bonds Outstanding, In real $bn



Source: BBVA Research