BBVA | RESEARCH

Economic Watch

US

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Economic Analysis

US

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Financial sector distorting bond growth

Corporate bonds unable to offset financial weakness

- **Nonfinancial corporate bond growth persists while Fed action looms**
- **Negative growth rates for financial firms' bonds expected through mid 2012**
- **Significant data revisions reflect sluggish growth rates for total bonds outstanding**

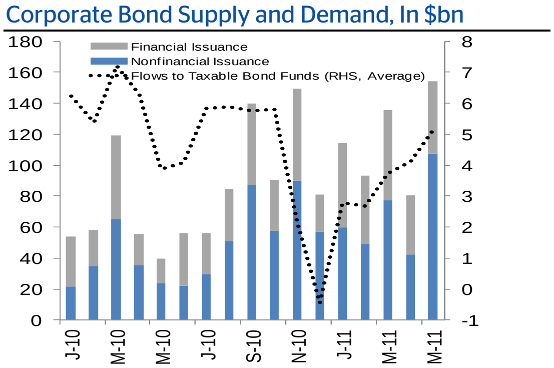
Outlook for 2011

Data from the most recent release of the Federal Reserve Flow of Funds indicate that total bond growth in 2011Q1 was $10.15tr, reflecting a 1.7% YoY decline (BBVA: -0.3% YoY). Despite the fact that overall bond issuance was slightly less than the average over the past 6 months, nonfinancial corporate bonds continued to grow, coming in at 7.8% YoY. As expected, current monetary conditions continue to support nonfinancial expansion as the Fed keeps yields unchanged. However, we expect that nonfinancial bond growth will decelerate towards the end of the year in anticipation of Fed rates hikes in early 2012.

Declines in total bonds outstanding were due in large part to financial firms' bonds, which decreased more than expected at -10.1% YoY (BBVA: -8.5% YoY). Significant data revisions for this quarter indicate that the aftermath of the financial crisis continues to weigh on financial bond growth, as do regulations in the market. The trend for YoY growth rates has only slightly improved since growth hit bottom in 2010Q3, thus we have adjusted our expectations such that we will not see positive growth until 2012Q4. Ultimately, this downward data revision drags down our forecasts for total bonds outstanding, which we expect will show signs of positive growth in early 2012.

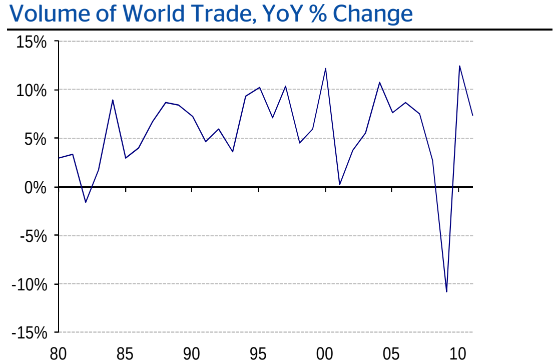
Growth of foreign bonds outstanding dropped significantly late 2010 and did not improve in 2011Q1. At only 2.7% YoY, foreign bond growth is the lowest since 2009Q3. The recent decline in growth is most likely a result of the European debt crisis, as well as general slowing in global economic activity (Chart 2). As a result, we have revised our forecasts down such that we do not expect double-digit foreign bond growth until 2012Q3 when the global recovery should be stronger.

Chart 1
Corporate Bond Supply and Demand, In $bn



Source: Haver Analytics

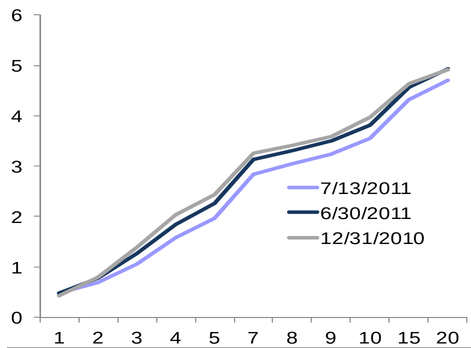
Chart 2
Volume of World Trade, YoY % Change



Source: IMF

Average flows to taxable bond funds have rebounded since the Fed's late 2010 announcement of a second round of large scale asset purchases. In May, average flows approached levels similar to trend over most of 2009 and 2010 (Chart 1). As interest rates increase, we expect that the average flows to taxable bond funds will level off due to interest rate risk of nonfinancial corporate bonds.

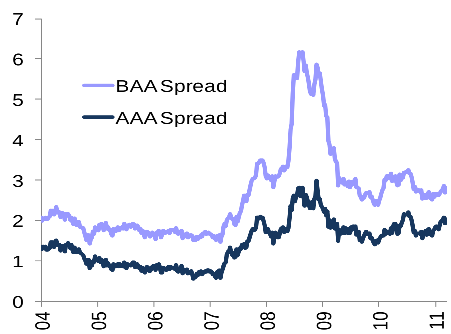
Chart 3
US Corporate AAA Industrial Yield Curve



Source: Bloomberg

The outlook for the US corporate yield curve depends on Fed action and expectations of the strength of the economic recovery, as well as attitudes on future inflation. The Fed's monetary easing policies are increasing inflation expectations which may be reflected by higher long-term interest rates. However, we maintain our baseline scenario suggesting that the first Fed funds rate hikes will occur in early 2012.

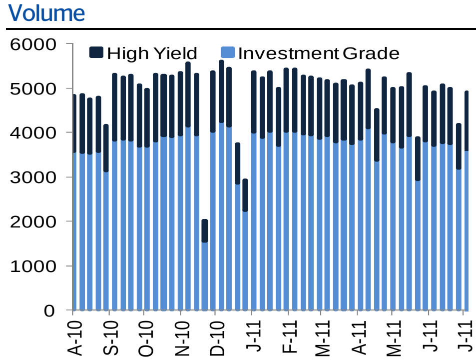
Chart 4
Corporate Spreads Over 10 Year Treasury



Source: Bloomberg and BBVA Research

Corporate spreads in 2011 thus far are slightly higher than in late 2010. Uncertainties regarding European sovereign debt as well as geopolitical events (i.e. political unrest and earthquakes) have contributed to the recent changes in corporate spreads. Furthermore, the looming potential for US government default will likely cause investors to become wary of holding Treasury notes and bonds. If the economic recovery strengthens, corporate spreads could tighten.

Chart 5
Weekly High Yield and Investment Grade Bond Volume



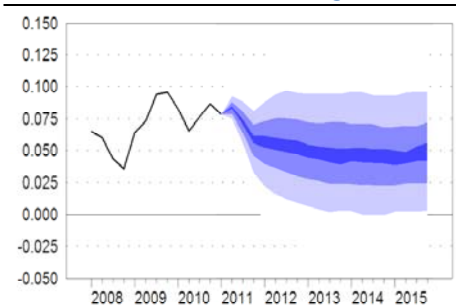
Source: TRACE and Bloomberg

Over the past twelve months, bond volume has trended downwards. Recent declines in the bond market could be attributed to weaknesses in major stock indices and high macroeconomic uncertainties resulting from unenthusiastic employment data. As Fed action approaches and investor's appetite for investment grade bonds decreases, we expect that corporate bond volume will continue to decline.

Corporate Bonds Outstanding Forecasts

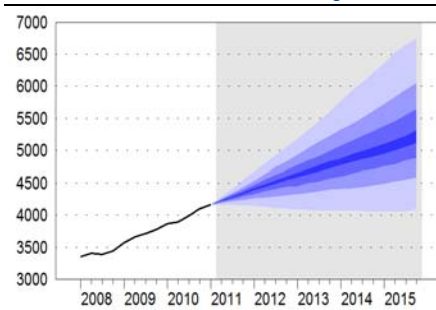
Data revisions from the first quarter of 2011 resulted in a substantial downward shift in our expectations for 2011 financial firms' bonds outstanding, dragging down our outlook for total bonds. Slowing in global economic activity brought down our growth forecasts for bonds attributable to the rest of the world, which we expect to experience only low positive growth through the end of this year. Our expectation for deceleration in nonfinancial corporate bond growth remains essentially unchanged in anticipation of the Fed's first target rate increase in 2012.

Chart 6
Nonfinancial Bonds Outstanding, YoY%



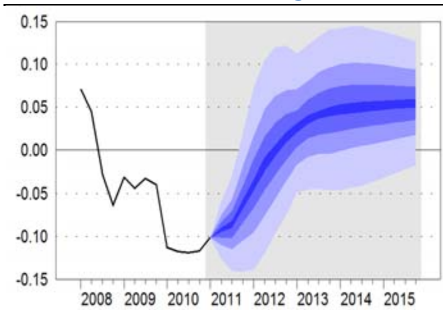
Source: BBVA Research

Chart 7
Nonfinancial Bonds Outstanding, real $bn



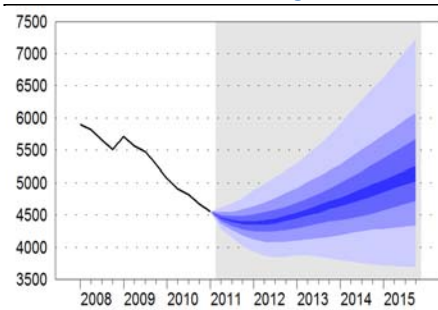
Source: BBVA Research

Chart 8
Financial Bonds Outstanding, YoY%



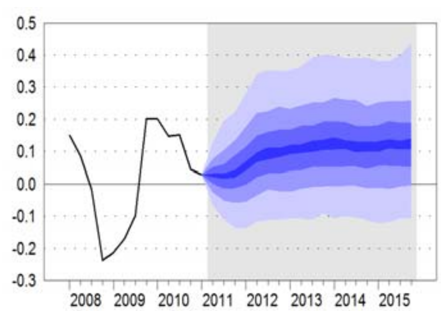
Source: BBVA Research

Chart 9
Financial Bonds Outstanding, real $bn



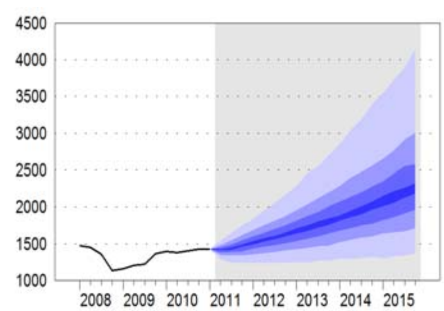
Source: BBVA Research

Chart 10
Foreign Bonds Outstanding, YoY%



Source: BBVA Research

Chart 11
Foreign Bonds Outstanding, real $bn



Source: BBVA Research

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