RESEARCH

Economic Watch

US

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Economic Analysis

US
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Nonfinancial expansion thrives

Weaker financial outlook drags on total bond growth

- **Data revisions accentuate declines in financial bond issuance**
- **Monetary conditions continue to back nonfinancial corporate bond growth**
- **Slower-than expected global recovery will weigh on foreign bonds**

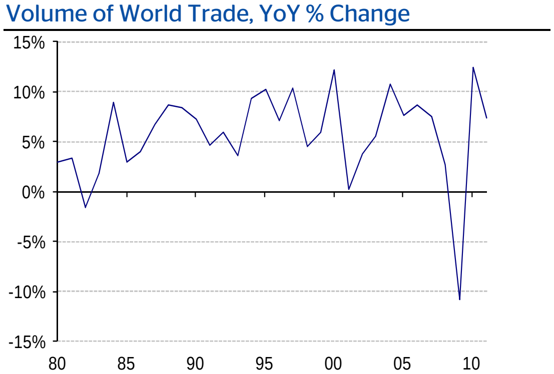
Outlook for 2011

The most recent data from the Federal Reserve Flow of Funds report indicate that total corporate bonds outstanding in 2011Q2 was $10.14tr, reflecting a 0.8% YoY decline (BBVA: -1.0% YoY). The bond market has struggled to regain momentum since the recession, mostly due to financial firms' bonds which declined more than 10% YoY for the sixth consecutive quarter. Significant data revisions for real GDP growth in the first quarter (from 1.9% to 0.4%) dragged down our forecasts for financial bonds, suggesting that the recession was deeper than previously thought. However, we maintain our view that financial bond issuance will improve gradually, approaching positive YoY growth by 2013Q1.

Despite the struggling financial sector, nonfinancial corporate bond expansion continues to support overall bond issuance. Nonfinancial growth accelerated to 8.5% YoY (BBVA: 8.4% YoY) in the second quarter, and with the Fed's commitment to keep interest rates unchanged through mid-2013, we have revised our projections upwards. We continue to expect that nonfinancial bond growth will decelerate slowly in anticipation of Fed rates hikes in 2013.

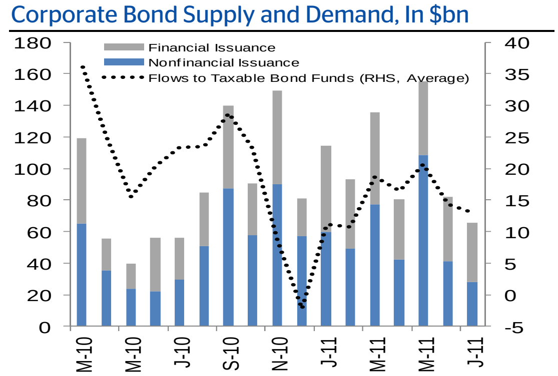
The Federal Reserve revised upwards data on foreign bonds outstanding for the past few quarters, impacting our short-term forecasts. In 2011Q2, foreign bonds grew more than expected at 6.9% YoY (BBVA: 2.6% YoY), matching last quarter's revised growth rate and at less than one-third the rates in late 2009 and early 2010. Global economic activity continues to slow (Chart 1), and with little resolution to the US and European debt crises, we expect foreign bond growth to decelerate through the end of 2011. Our forecasts suggest acceleration beginning in 2012, however we do not expect double-digit foreign bond growth until 2015Q1, much later than our previous estimate of 2012Q3.

Chart 1
Volume of World Trade, YoY % Change



Source: IMF

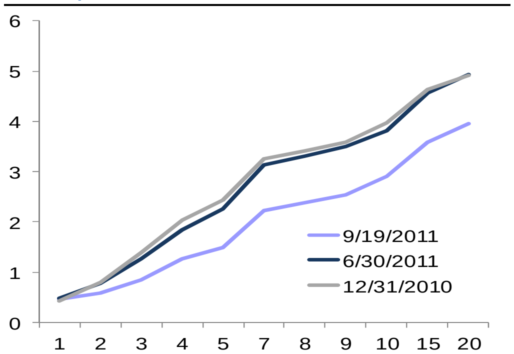
Chart 2
Corporate Bond Supply and Demand, In $bn



Source: Haver Analytics

Average flows to taxable bond funds have remained relatively stable throughout 2011 (Chart 2), although much lower than the peak in 2010. As Congress and the Obama administration approach a strategy for fiscal restructuring (via reduced government spending and/or tax reform), we could see significant changes in the trend. Furthermore, a third round of quantitative easing could have a similar impact on average flows to taxable bond funds as the QE2 announcement in late 2010.

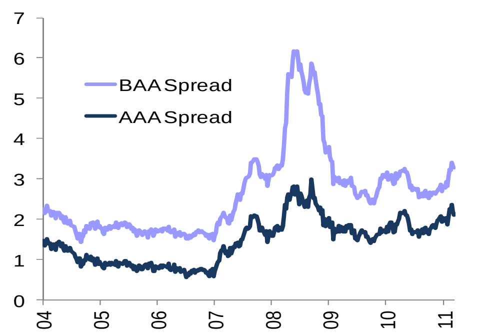
Chart 3
US Corporate AAA Industrial Yield Curve



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 has committed to keeping interest rates unchanged until mid-2013, and inflation expectations have stabilized. However, we expect that the Fed could implement additional monetary easing policies or adjust the size of its balance sheet in order to influence long-term yields. Ultimately, Fed action could be a risk factor to our forecasts as lower long-term rates make nonfinancial bonds even more attractive.

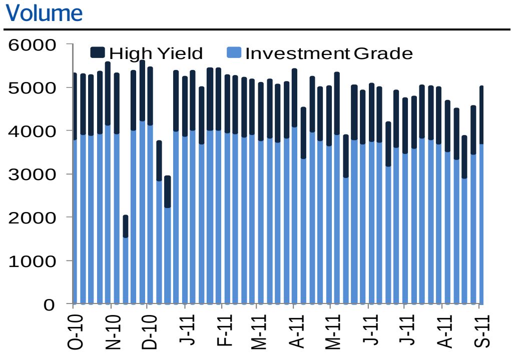
Chart 4
Corporate Spreads Over 10 Year Treasury



Source: Bloomberg and BBVA Research

Corporate spreads in mid 2011 are slightly higher than in late 2009 and 2010. Recent increases in corporate spreads likely reflect instability in the US and European fiscal situations, causing investors to become wary of holding government bonds. Despite prolonged slowdowns in global activity, we expect corporate spreads to tighten as governments implement resolutions to debt crises and the economic recovery strengthens.

Chart 5
Weekly High Yield and Investment Grade Bond Volume



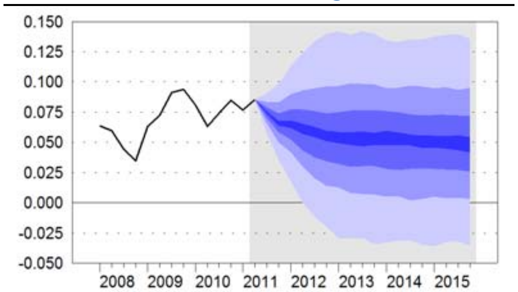
Source: TRACE and Bloomberg

Weekly bond volumes have recovered from the usual summer weakness, however overall volume has trended downward throughout the past year. The bond market has suffered in recent months as major stock market indices have shown extreme volatility. Furthermore, disappointing macroeconomic indicators have increased concerns regarding the future outlook of economic activity. In general, we expect that corporate bond volume will continue to decline as Fed action approaches and investor's appetite for investment grade bonds decreases.

Corporate Bonds Outstanding Forecasts

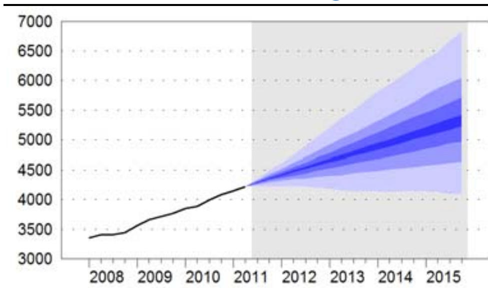
Recent macroeconomic data and GDP growth revisions for the first quarter suggest a slower-than-expected recovery, so it is not surprising that our projections for bonds outstanding have shifted downwards. Financial bonds outstanding were significantly impacted by the data revisions, and we do not expect issuance to rebound from deleveraging in the near future. The volume of foreign bonds outstanding has been revised up slightly, however we expect that slowdowns in economic activity will continue to weigh on the bond market, keeping foreign bond growth low for the next few years. In the short-term, we expect nonfinancial corporate bond growth to decelerate at a slower pace as a result of the Fed's announcement to delay the first target rate hike until 2013.

Chart 6
Nonfinancial Bonds Outstanding, YoY%



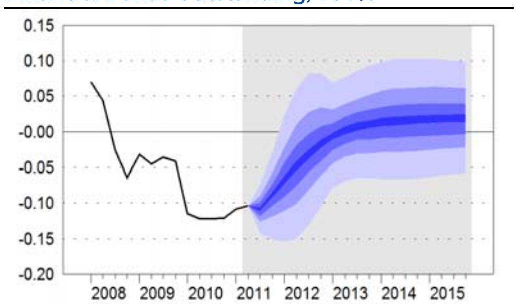
Source: BBVA Research

Chart 7
Nonfinancial Bonds Outstanding, real $bn



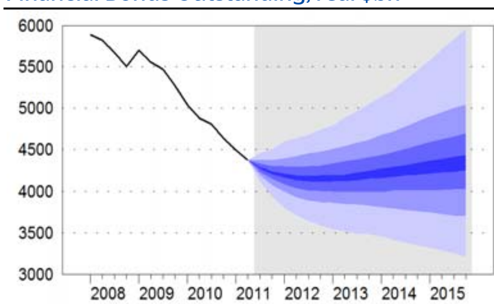
Source: BBVA Research

Chart 8
Financial Bonds Outstanding, YoY%



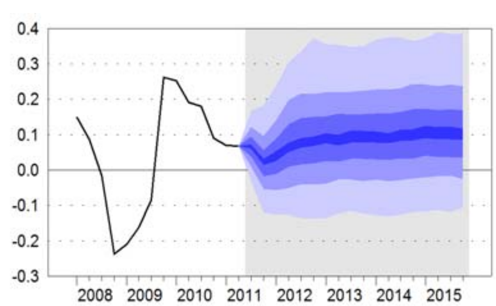
Source: BBVA Research

Chart 9
Financial Bonds Outstanding, real $bn



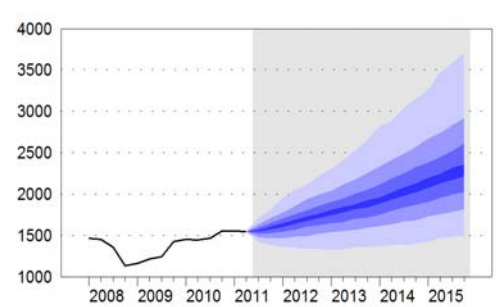
Source: BBVA Research

Chart 10
Foreign Bonds Outstanding, YoY%



Source: BBVA Research

Chart 11
Foreign Bonds Outstanding, real $bn



Source: BBVA Research