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Economic Watch

US

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Economic Analysis

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Corporate Bond Market Hits a Snag

Threat of European contagion weighs on bond growth

- **Post-recession nominal bonds stuck at zero-growth**
- **Gradual normalization of spreads dependent on European outcome**
- **Nonfinancial bond growth decelerating over the long-term**

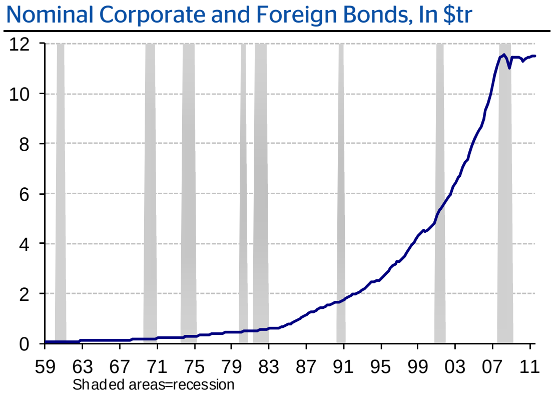
Outlook for 2011

The most recent release of the Federal Reserve Flow of Funds notes that total corporate bonds outstanding declined 1.2% YoY (BBVA: -1.2%) to $10.12tr in 3Q11. Rising fears of a spillover from the European sovereign debt crisis have impacted corporate borrowing, which is at its slowest pace all year. In nominal terms, total corporate bond growth has stagnated for the past 4 years (Chart 1), a concerning point for the bond market given more than 50 years of steady growth beforehand. However, data for the previous two quarters were revised up slightly and could hint at a more positive nominal trend in the years to come. Surprisingly, data on financial firms' bonds were revised up. The financial sector has dragged on total bond growth since the recession, yet QoQ declines have decelerated throughout the past year. With the economic recovery gaining momentum and the aftermath of the financial crisis weighing less on growth, our mid-term outlook for financial bond growth has improved. While the European crisis will continue to impact the sector in the short-term, we expect a flatter trajectory with positive growth toward the end of 2012, assuming an orderly resolution to Europe's problems.

Foreign bonds also declined in 3Q11 to $1.54tr despite expectations for a modest increase (BBVA: $1.56tr). On a YoY basis, growth of foreign bonds was lower-than-expected in large part due to the increasing intensity of the debt crisis in Europe. Fourth quarter data is likely to be further impacted by global uncertainties, although we expect growth to accelerate again after mid-2012 as long as conditions do not worsen.

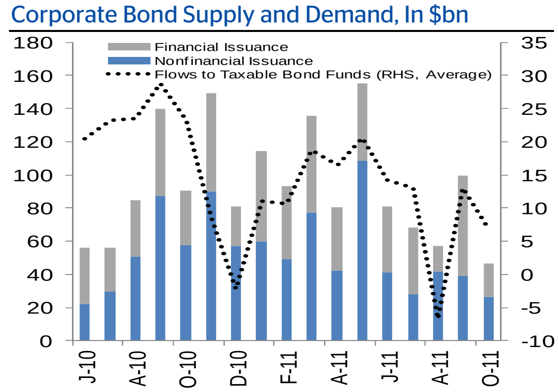
As expected, nonfinancial corporate bonds outstanding continue to expand but at a slower YoY pace (actual: 6.7% vs. BBVA: 7.5%). Current monetary conditions continue to support nonfinancial growth as the Fed keeps rates unchanged, maintaining the relative attractiveness of bond issuance. We expect that real growth, which has decelerated since January 2011, will continue along this trend.

Chart 1
Nominal Corporate and Foreign Bonds, In $tr



Source: Federal Reserve Board and Haver Analytics

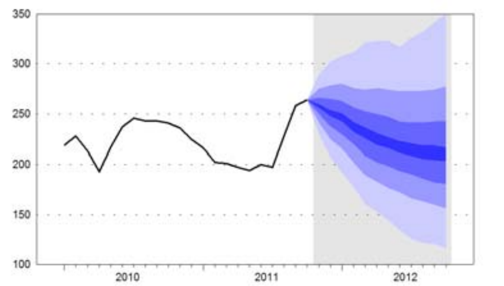
Chart 2
Corporate Bond Supply and Demand, In $bn



Source: Federal Reserve Board and Haver Analytics

The summer debt ceiling negotiations and increased severity of fiscal issues likely contributed to the sharp decline in average flows to taxable bond funds in August (Chart 2). Levels recovered near the 2011 average in September but are vulnerable to future policy changes. Further fiscal reform and a third round of quantitative easing could negatively impact flows to taxable bond funds, although these events are more likely to occur near mid-2012 or later. In general, we could see more volatile flows in 2012 compared to the stability witnessed this year.

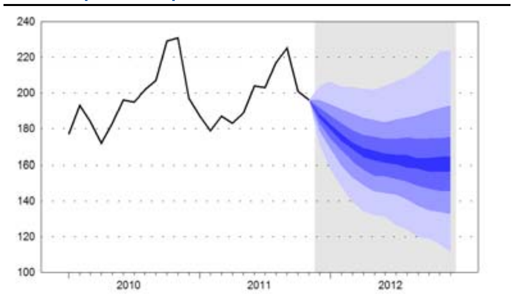
Chart 3
BBB Corporate Spread



Source: Haver, S&P, & BBVA Research

Given the uptick in 3Q11 GDP and upwardly revised expectations for 4Q11, corporate spreads are likely to decline. The Fed's decisions to "twist" the yield curve should also promote downward pressure on spreads, if investors are pushed to riskier assets. However, the downside risk to BBB spreads will intensify if the threat of European sovereign default renders higher risk debt unpalatable to markets.

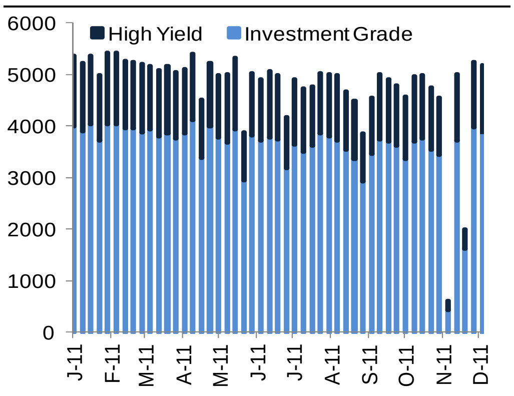
Chart 4
AA Corporate Spread



Source: Bloomberg, Moody's & BBVA Research

The higher graded AA industrial corporate spread displays less procyclical persistence than the BBB spread, or in other words, this debt is less prone to fluctuations in business cycles. Input prices, specifically West Texas spot oil prices (WTI) are one major determinant of future spreads. The AA forecast incorporates an approximately linear increase to oil prices over the forecast horizon. Thus a spike in oil prices— in response to strong Iranian sanctions, for example— could enhance the downside risk over the 12-month horizon.

Chart 5
Weekly High Yield and Investment Grade Bond Volume



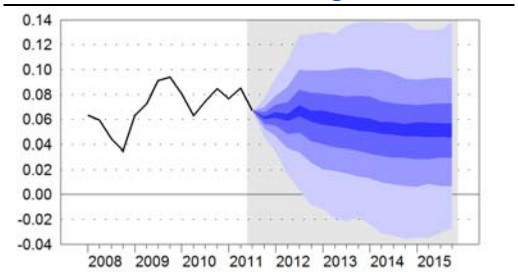
Source: TRACE and Bloomberg

Throughout the past few months, bond volumes have declined to some of the lowest levels seen in nearly three years. Increased risk stemming from the European debt crisis has pushed investors toward safer assets, despite general macroeconomic improvements in the US. Since 3Q09, overall securities lending has trended upwards in the form of total securities credit reported by the Federal Reserve Flow of Funds Z.1 Release. If European pressures ease and investor sentiment builds, we could see modest increases in corporate bond volume throughout 2012.

Corporate Bonds Outstanding Forecasts

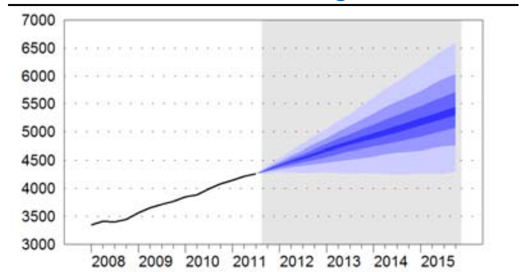
In general, projected trends for total corporate bonds outstanding remain similar compared to our previous estimates. The threat of a European contagion will likely contribute to slower bond growth again in 4Q11, but we expect that the impact will lessen in the mid-term as long as global fiscal conditions do not worsen. The Fed has maintained its commitment to keeping interest rates unchanged until mid-2013, limiting significant changes in investor incentives. We continue to expect steady growth in nonfinancial bonds throughout the next few years, although at a slowing YoY pace as Fed action approaches. Financial bonds outstanding are likely to remain flat as global financial uncertainty and regulatory pressures continue to weigh on growth. Forecasts for foreign bonds have shifted downward given the increasing intensity of the European crisis.

Chart 6
Nonfinancial Bonds Outstanding, YoY%



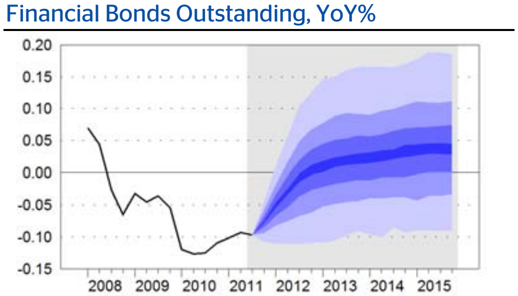
Source: BBVA Research

Chart 7
Nonfinancial Bonds Outstanding, real $bn



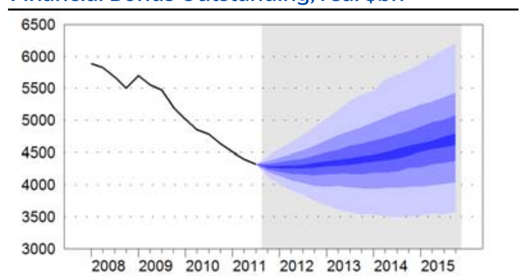
Source: BBVA Research

Chart 8
Financial Bonds Outstanding, YoY%



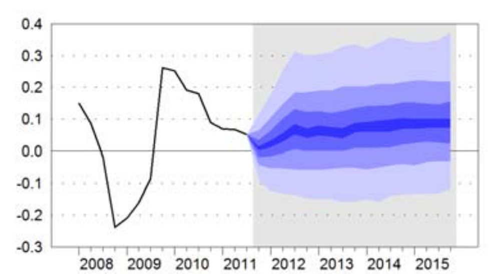
Source: BBVA Research

Chart 9
Financial Bonds Outstanding, real $bn



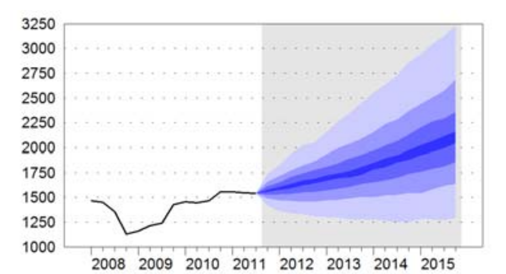
Source: BBVA Research

Chart 10
Foreign Bonds Outstanding, YoY%



Source: BBVA Research

Chart 11
Foreign Bonds Outstanding, real $bn



Source: BBVA Research