Economic Watch

US

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Economic Analysis

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No End in Sight for Financial Bond Slump

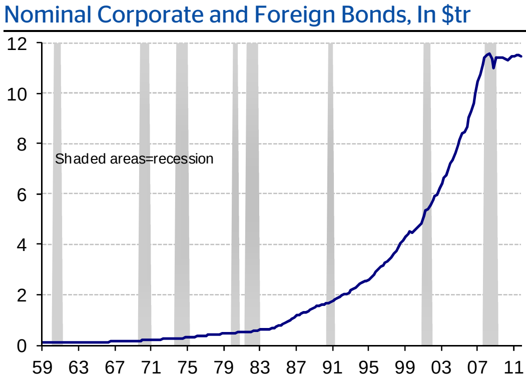
Weaker demand for foreign bonds appears temporary

- **Total corporate bonds declined throughout 2011, financial sector the culprit**
- **On a YoY basis, foreign bonds fell for the first time since 3Q09**
- **Attenuated risks putting downward pressure on corporate spreads**

Outlook for 2012

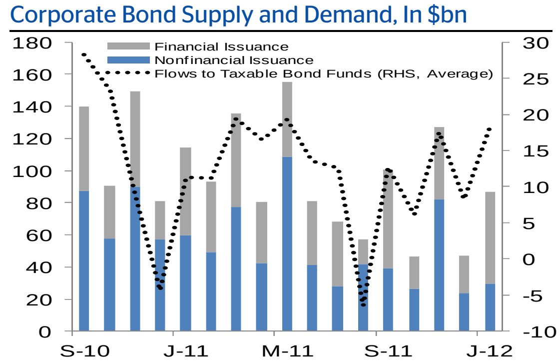
The most recent data from the Federal Reserve Flow of Funds indicates that total corporate bonds outstanding declined in 4Q11 to $10.01tr, a slightly larger fall than expected (-1.9% YoY vs. BBVA: -0.9%). In nominal terms, corporate bonds recovered quickly after the financial crisis but have remained relatively flat, unable to surpass the pre-recession peak (Chart 1). Real bonds outstanding, which have declined for eight of the last ten quarters, reached the lowest point since 1Q07, highlighting the impact of global uncertainties that dominated the economy in 4Q11. As expected, deteriorating activity and the sovereign debt crisis in Europe led to a 2.6% YoY decrease in foreign bonds outstanding, the first such decline in more than two years. However, recent quarterly declines are much less significant when compared to the crisis in 2008, suggesting that the bond market is likely to post a healthy rebound as long as the situation in Europe does not worsen. We expect that the impacts of the crisis might spill over into 1Q12 but should fade considerably as the year progresses. While foreign bonds appear to have declined only temporarily, financial corporate bonds have remained extremely weak over the longer term. In 4Q11, financial bonds fell 8.6% YoY (BBVA: -7.6%) to mark the 14th consecutive quarter of contraction. Continued deleveraging and relatively unstable global financial conditions caused us to revise down our projections significantly. Rather than reaching positive YoY growth by 2013, we expect financial bonds to continue declining at a slowing pace until mid-2014. However, the latest results of the Fed's stress tests may improve banks' reputations and ultimately help boost demand for financial bonds. Strength in nonfinancial bonds helped offset declines in other sectors. Nonfinancial growth has accelerated sharply since the crisis, with no signs of levelling off. Extended commitments by the Fed to keep interest rates low through mid-2014 increases the attractiveness of these bonds and will help maintain steady demand. On a YoY basis, we expect that nonfinancial bond growth will decelerate very slowly as we approach the planned interest rate hikes.

Chart 1
Nominal Corporate and Foreign Bonds, In $tr



Source: Federal Reserve Board and Haver Analytics

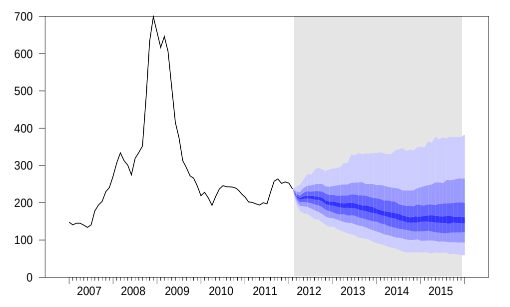
Chart 2
Corporate Bond Supply and Demand, In $bn



Source: Federal Reserve Board and Haver Analytics

Current flows to taxable bond funds are similar to year-ago levels, and aside from the drop in August, flows were relatively stable in 2011 (Chart 2). In our previous report, we expected that further fiscal reform and Fed action could negatively impact the data in 2012. While it is entirely possible that Obama will attempt to make one last push for electoral support, the potential for significant reform is unlikely. The Fed has not ruled out another round of quantitative easing, however, the committee often stays quiet to appear unbiased during an election year. Unless economic conditions deteriorate, we expect that average flows to taxable bond funds will warrant little attention in 2012.

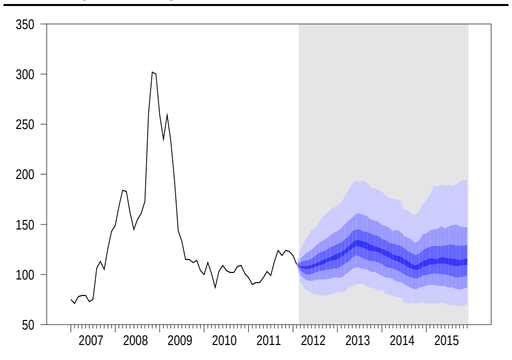
Chart 3
BBB Corporate Spread



Source: Haver, S&P, & BBVA Research

Given the more optimistic Fed communications, decreasing contagion uncertainty, and strong domestic capitalization, the higher risk corporate debt markets will likely become more appealing. Thus, BBB corporate spread dynamics, as risks abate, will reflect investor's willingness to seek higher returns amidst more lucid market risk. Furthermore, if the recent uptick in treasuries persists and the Fed begins to tighten, the downward pressure on BBB corporate spreads will likely accelerate (contingent upon risks remaining attenuated). In other words, our model suggests decreasing BBB spreads over the noted forecast horizon.

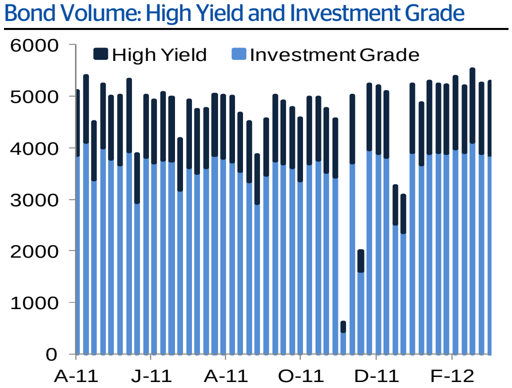
Chart 4
AA Corporate Spread



Source: Bloomberg & BBVA Research

The AA corporate bond market continues to adjust to lower volatility and improved economic expectations. Since January, 10-year Treasury yields have hovered at historic lows of 1.97%, the VIX has plummeted to a 15-day average of 17.7 (as of 7 March 2012), and the Fed in its most recent release shifted their tone to "moderate" rather than "modest" growth. Our forecasts reflect the idea that markets will slowly incorporate the decreased overhang from aggregate market risk and thus AA spreads will decline in the coming quarters. However, in the long-run as markets normalize and the Fed formalizes its exit strategy, we expect AA corporate spreads to revert to their historical average.

Chart 5
Bond Volume: High Yield and Investment Grade



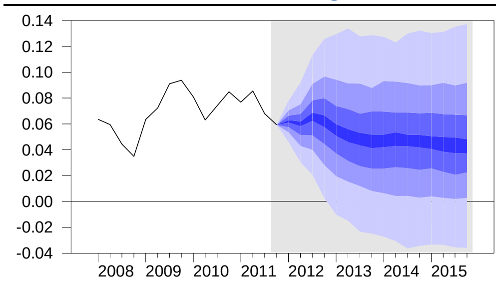
Source: TRACE and Bloomberg

Weekly bond volumes have rebounded from 4Q11 lows, returning to an upward trend and rising above early 2011 levels. Improving economic conditions have increased the risk appetite among investors, particularly for high-yield and investment grade bonds. Furthermore, delaying the first target Fed Funds rate hike has reduced interest rate volatility. High-yield corporations have undergone significant restructuring in the aftermath of the financial crisis, allowing them to be better prepared in the event of another crisis. Defaults are likely to stabilize in 2012, helping to maintain investor sentiments.

Corporate Bonds Outstanding Forecasts

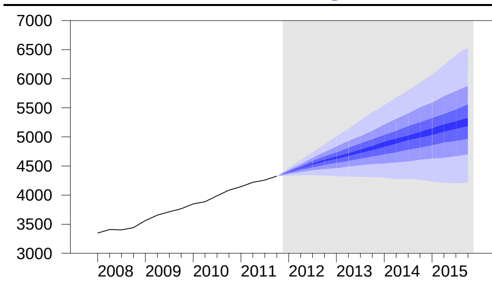
In general, we have revised down our immediate forecasts for total bonds outstanding, though we continue to expect an increasing trend throughout the next few years. The financial sector will weigh on the corporate bond market at least for the medium-term, while nonfinancial bond growth remains strong. The Fed has extended its horizon for the first target rate hike, shifting investor incentives even further toward the nonfinancial sector. The latest developments in resolving the European crisis suggest that foreign bond growth will rebound in 2012, as long as fiscal woes do not intensify.

Chart 6
Nonfinancial Bonds Outstanding, YoY%



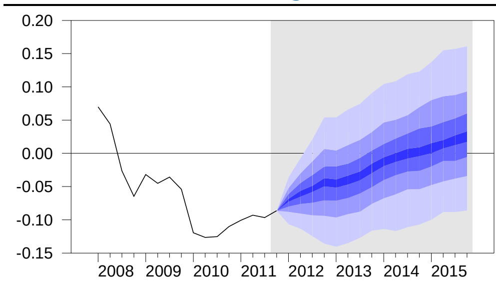
Source: BBVA Research

Chart 7
Nonfinancial Bonds Outstanding, real $bn



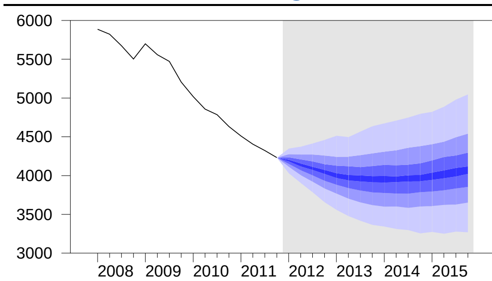
Source: BBVA Research

Chart 8
Financial Bonds Outstanding, YoY%



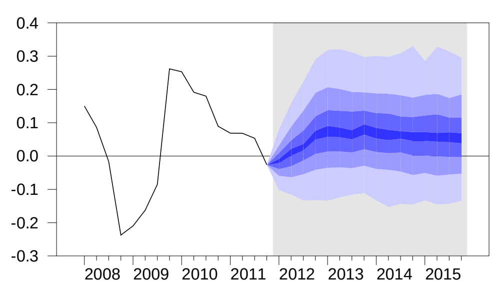
Source: BBVA Research

Chart 9
Financial Bonds Outstanding, real $bn



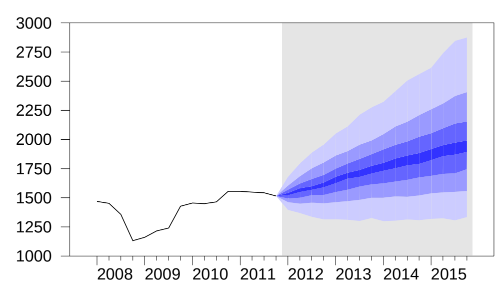
Source: BBVA Research

Chart 10
Foreign Bonds Outstanding, YoY%



Source: BBVA Research

Chart 11
Foreign Bonds Outstanding, real $bn



Source: BBVA Research