



Credit Market Analysis

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Credit boom: the beginning of the end?

Global bond yields have surged...

The global sell-off in government bonds in recent weeks, led by reports of reduced demand from world central banks and exacerbated by technical selling among hedge funds, mortgage investors and others, has led to sharp rises in nominal bond yields and a steepening of yield curves. US bond yields rose to the highest levels since the Fed stopped raising interest rates last year and UK/euro zone yields have been propelled to multiyear highs, see Table 1.

In order to gauge the impact on credit, it is useful to try and identify the reasons for the increase in bond yields. In particular, it appears that the rise in nominal bond yields do not reflect higher inflation expectations, but instead are accounted for by higher real interest rates. This suggests that either real growth prospects have improved or risk premiums have risen.

...but not due to higher inflation expectations

Inflation expectations have not risen significantly recently and therefore have not caused the rise in nominal bond yields. US 10yr breakeven inflation, calculated by subtracting inflation indexed bond yields from nominal bond yields, have risen only marginally to 2.44% from 2.36% a month ago. Similarly, euro zone breakeven inflation, derived from French OAT/OATei bonds, has risen only slightly to 2.21% from 2.19% a month ago. In other words, most of the rise in nominal bond yields was due to higher real yields, rather than higher inflation expectations, see **chart a** (next page).

Real yields have risen: higher risk premiums...?

Instead, most of the sharp rises in nominal bond yields in recent weeks are accounted for by higher real interest rates. In turn, this suggests that risk premium, mainly liquidity premium, may have risen, which could lead to a broad repricing of risk, and that would be negative for credit.

Unfortunately, it is not straightforward to measure the risk premium. Equity and bond volatility indices spiked higher and credit default swaps increased, see **chart b**. However, they have started to come back down again, while corporate credit spreads over treasuries have been stable to only moderately wider recently and remain tighter than three months ago.

Table 1: Key financial market interest rates

| | latest 18 Jun 2007 | 1w ago | 1m ago | 3m ago |
|-------------------------|-----------------------|-----------|-----------|-----------|
| UK | | | | |
| BoE repo rate | 5.50 | 5.50 | 5.50 | 5.25 |
| 1m libor | 5.68 | 5.66 | 5.65 | 5.43 |
| 3m libor | 5.85 | 5.82 | 5.75 | 5.53 |
| 6m libor | 6.00 | 5.97 | 5.87 | 5.63 |
| 2y swap | 6.23 | 6.17 | 5.95 | 5.62 |
| 5y swap | 6.19 | 6.07 | 5.83 | 5.46 |
| 2y govt | 5.77 | 5.77 | 5.62 | 5.30 |
| 10y govt | 5.49 | 5.39 | 5.17 | 4.81 |
| High-grade spread (bps) | 77 | 78 | 78 | 80 |
| High-yield spread (bps) | 202 | 204 | 201 | 240 |
| Eurozone | | | | |
| ECB refi rate | 4.00 | 4.00 | 3.75 | 3.75 |
| 1m libor | 4.11 | 4.11 | 3.92 | 3.86 |
| 3m libor | 4.15 | 4.14 | 4.08 | 3.89 |
| 6m libor | 4.29 | 4.27 | 4.21 | 4.01 |
| 2y swap | 4.73 | 4.69 | 4.52 | 4.17 |
| 5y swap | 4.83 | 4.75 | 4.52 | 4.14 |
| 2y govt | 4.49 | 4.47 | 4.28 | 3.94 |
| 10y govt | 4.66 | 4.57 | 4.31 | 3.93 |
| High-grade spread (bps) | 47 | 47 | 47 | 48 |
| High-yield spread (bps) | 193 | 194 | 189 | 233 |
| US | | | | |
| US fed funds | 5.25 | 5.25 | 5.25 | 5.25 |
| 1m libor | 5.32 | 5.32 | 5.32 | 5.32 |
| 3m libor | 5.36 | 5.36 | 5.36 | 5.35 |
| 6m libor | 5.40 | 5.40 | 5.37 | 5.34 |
| 2y swap | 5.45 | 5.46 | 5.23 | 5.02 |
| 5y swap | 5.56 | 5.60 | 5.22 | 4.97 |
| 2y govt | 4.99 | 5.01 | 4.81 | 4.62 |
| 10y govt | 5.13 | 5.15 | 4.80 | 4.56 |
| High-grade spread (bps) | 95 | 96 | 92 | 93 |
| High-yield spread (bps) | 252 | 250 | 251 | 285 |
| Emerging market | | | | |
| Global EM spread (bps) | 159 | 168 | 159 | 185 |

source: Bloomberg, MLI indices

Table 2: Interest rate and spread forecasts

| | latest 18 Jun 2007 | End Q3 2007 | End Q4 2007 | End Q1 2008 | End Q2 2008 | 5-year avg. |
|-------------------------|-----------------------|----------------|----------------|----------------|----------------|----------------|
| US | | | | | | |
| US fed funds target | 5.25 | 5.25 | 5.25 | 5.50 | 5.50 | 2.75 |
| 2y govt yield | 4.99 | 5.00 | 5.20 | 5.40 | 5.40 | 3.17 |
| 10y govt yield | 5.13 | 5.10 | 5.20 | 5.30 | 5.30 | 4.35 |
| High-grade spread (bps) | 95 | 96 | 98 | 100 | 102 | 116 |
| UK | | | | | | |
| BoE repo rate | 5.50 | 5.50 | 5.50 | 5.50 | 5.25 | 4.50 |
| 2y govt yield | 5.77 | 5.80 | 5.70 | 5.40 | 5.30 | 4.40 |
| 10y govt yield | 5.49 | 5.50 | 5.50 | 5.50 | 5.40 | 4.62 |
| Eurozone | | | | | | |
| ECB refi rate | 4.00 | 4.25 | 4.25 | 4.50 | 4.50 | 2.50 |
| 2y govt yield | 4.49 | 4.50 | 4.60 | 4.70 | 4.70 | 2.88 |
| 10y govt yield | 4.66 | 4.70 | 4.70 | 4.80 | 4.80 | 3.95 |

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...or stronger real growth prospects?

Alternatively, it may be that bond markets have been playing catch-up and have become more positive regarding the global growth outlook. For instance, bond markets no longer expect the Fed to reduce interest rates this year, see **chart c**. However, credit markets had previously already priced in a positive outlook for global growth and, in this case, credit spreads may even narrow back to where they were before the recent market market shock.

The end of an era of easy money?

More generally, a sustained rise in global bond yields may reflect a fall in foreign demand for treasuries, though we may have to wait for the June treasury flow (TIC) data for this to be confirmed. However, last week's US 10-year bond auction received weak indirect bidding, suggesting soft demand from overseas.

In turn, this may reflect strong domestic demand growth and lower savings in Asia and Europe. As our Economics Weekly (18 June 2007) stated, "...the bigger story is that a global adjustment from easy money is underway and the pool of global savings in Asia and oil-exporting countries is being used for investment rather than for consumption in the US".

This seems likely to reaffirm expectations that corporate credit spreads will widen moderately this year and speculative default rates, which have been kept low by the abundance of global liquidity, may, at last, begin to rise. We know that credit quality has deteriorated in recent years, with the proportion of CCC-rated issuance rising.

Further, the recent rise in equity prices, which is usually positive for credit, has been driven by shareholder friendly, but credit quality unfriendly actions such as increased M&A activity financed by more leveraged balance sheets. But the key point is that the adjustment is likely to be gradual, given that we expect global growth to remain solid, global liquidity high and that the likelihood of a global recession remains very small.

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Chart a: Inflation expectations have barely increased

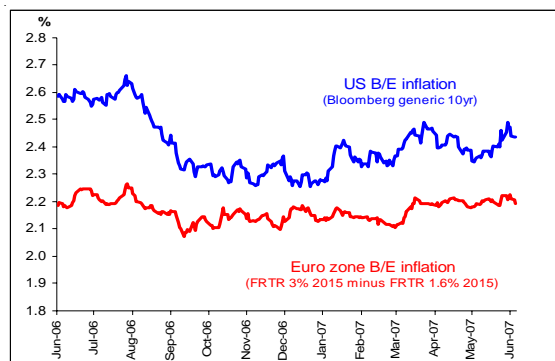


Chart b: Equity and bond volatility spiked higher, but have fallen back

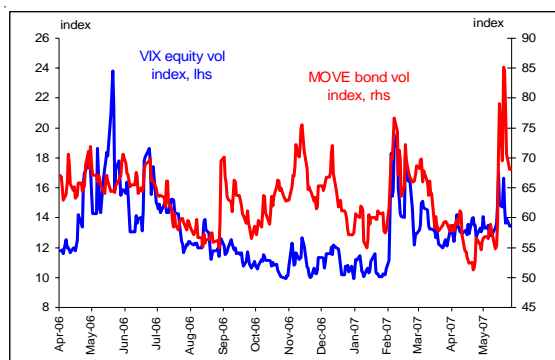
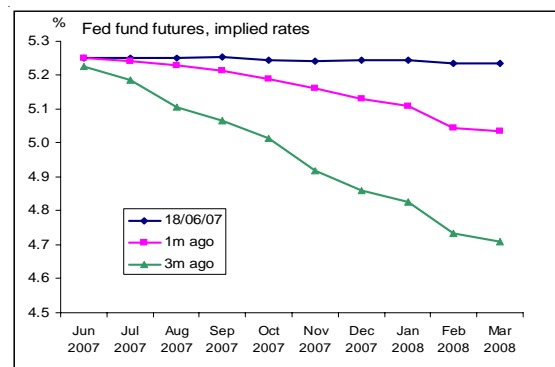


Chart c: Bond markets no longer expect the US Fed to cut interest rates



** All data and charts are sourced to Lloyds TSB Corporate Markets Economic Research, Merrill Lynch and Bloomberg.*

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