

# Bond Market Perspectives



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## European Cloud Hangs Over Corporate Bonds

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### Highlights

Stock and corporate bond performance diverged sharply last week as corporate bond investors eye European banks and potential contagion to the United States.

Bank funding pressures have increased but remain modest in our view.

A number of policy options could reduce bank fears and be a catalyst for corporate bond performance.

High-yield bonds lagged stocks last week causing investors, us included, to question the discrepancy. Although performance of high-yield bonds and stocks can diverge, it is rare to see high-yield bonds decline in value while stocks increase and the 5% total return differential between stocks (as measured by the S&P 500 Index) and high-yield bonds (as measured by the Barclays High-Yield Bond Index) last week was particularly noteworthy. What does one market, high-yield bonds, see that the other, stocks, does not? The answer perhaps lies in the root cause of market weakness this summer: European debt problems. More specifically, we believe the bond market is paying greater attention to the financial health of European banks and whether troubles at European banks will spread to banks in the United States.

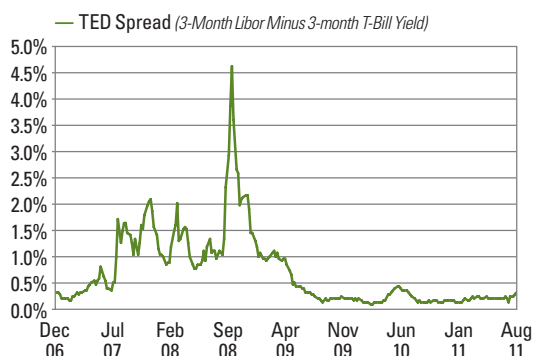
The health of banks and financial institutions is critically important, given their position at the heart of the day-to-day functioning of financial markets and the economy itself. Without healthy banks to serve as the nuts-and-bolts of financial markets, liquidity in the bond market—the ease with which investors can buy and sell investments—may deteriorate. If liquidity deteriorates, then investors are less likely to hold, let alone buy, riskier segments of the bond market such as high-yield bonds, which are less liquid than high-quality bonds. Therefore, the ability of the banks to obtain necessary funding and continue to provide liquidity to financial markets has become of utmost important to bond investors.

### Measuring Liquidity

There are a number of ways to measure liquidity in the banking system and money markets, and the degree to which banks may be having difficulty in obtaining funding for normal functioning:

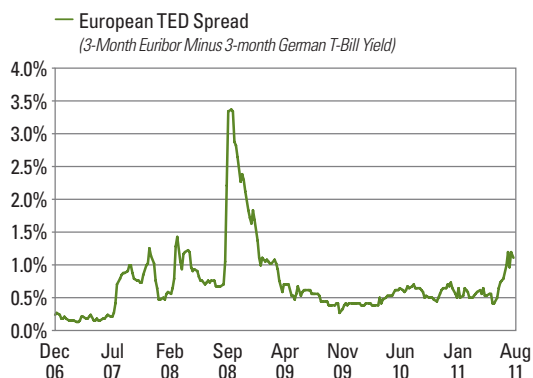
- 1) The TED spread measures the interest rate differential between 3-month Libor (the London Inter-bank Offered Rate in U.S. dollars), an intra-bank borrowing rate, and the 3-month Treasury-bill, a risk-free rate. If 3-month Libor rises, it reflects bank funding fears as banks demand a higher interest rate to borrow from one another. At a current rate of 0.32% [Chart 1], the TED spread is elevated but below the peak of spring 2010, when European debt fears escalated, and well below the 4.5% peak witnessed during the peak of the financial crisis in late 2008. The TED spread is reflecting modest funding pressures but there are a couple factors blurring the meaning of this indicator. First, T-bill yields have been

### 1 Bank Funding Pressures is up Modestly in the U.S...



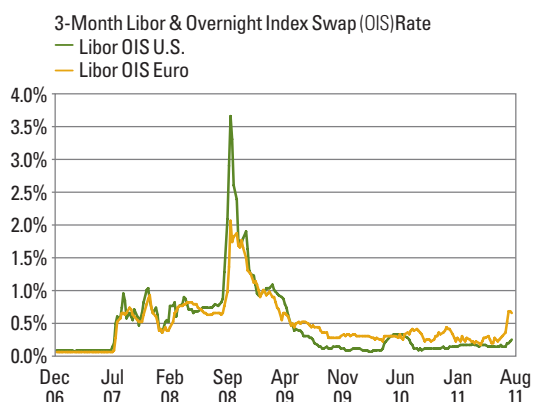
Source: Bloomberg, LPL Financial 8/26/11

2 ...But Elevated in Europe



Source: Bloomberg, LPL Financial 8/26/11

3 Increased Cash Deposits and Expectations of a Rate Cut are Behind an Increase in European Libor-OIS Spreads



Source: Bloomberg, LPL Financial 8/26/11

4 Banks Have Modestly Increased Reliance on ECB Lending



Source: ECB, LPL Financial 8/26/11

pressured lower from a lack of supply as the Treasury Department has preferred to issue longer-term debt, to lock-in low interest rates, at the expense of short-term debt including T-bills. In response, T-bill yields have declined to 0.0% for all maturities within six-months. Second, due to significant cash holdings among domestic banks (a positive and more on that below), banks have a need to borrow in the inter-bank market and Libor rates are less reflective of underlying borrowing habits.

- 2) The European version of the TED spread simply measures the interest rate differential between 3-month Euribor (3-month Libor denominated in euros) and the rate on German Treasury bills, the risk-free benchmark for European-based investors. This measure has risen sharply recently [Chart 2]. On a positive note, the current level is well below the peak during the financial crisis of 2008 but is unquestionably elevated and reflects a degree of funding pressures on European banks.
- 3) Rates on 3-month Libor, both the U.S. rate and the European rate, can also be compared against the overnight index swap (OIS) rate. OIS is the projected interest rate on an overnight interest rate swap agreement but it is highly influenced by future expectations of central bank interest rate changes. The European Libor-OIS spread is elevated [Chart 3] but like the TED spread it is below the peak of the financial crisis. Importantly, much of the increase is simply due to European OIS rates coming down by more than 0.4% in part due to market anticipation of the European Central Bank (ECB) perhaps reversing one or both of their recent interest rate hikes. Three-month Euribor, the inter-bank borrowing rate, has remained relatively stable in August. Therefore, while this measure is elevated it too must be taken in correct context.

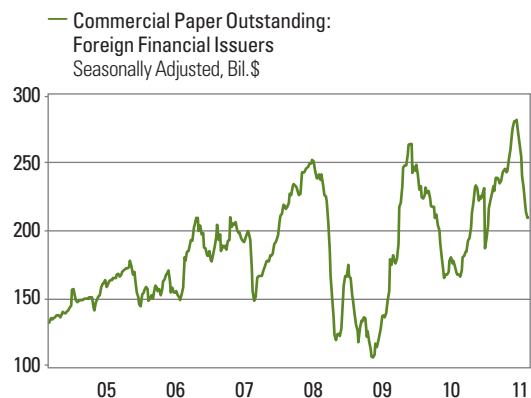
Relying on the Central Bank

European banks' reliance on the European Central Bank (ECB), Europe's version of the Federal Reserve, has increased. Usage of ECB lending facilities has increased lately as banks have increasingly looked to the ECB, rather than the marketplace, for borrowing needs. Similar to the liquidity measures above, ECB lending remains well below financial crisis levels and even declined slightly last week [Chart 4]. In mid-August, news that a financial institution paid 1.08% to borrow \$500 million from the ECB for seven-days, rather than in market at the prevalent 0.18% rate for 7-day U.S. dollar funding, raised alarm bells. However, over 6000 institutions are eligible to borrow from the ECB, and while the borrowing could be indicative of funding stress it too must be taken into context both for the dollar amount and also the number of institutions who could potentially borrow but so far have not.

Less Reliance on Market-based Funding

The commercial paper market serves a key role for corporations to obtain short-term funding and U.S. branches of European banks have sharply curtailed borrowing [Chart 5]. In an attempt to reduce risk, domestic money market funds have shied away from money market instruments issued by

**5 Foreign Banks Have Had Trouble Accessing the Commercial Paper Market**

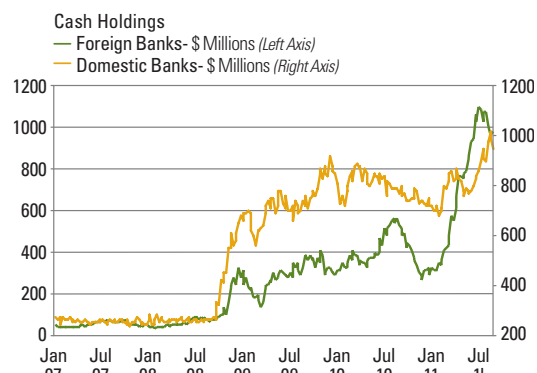


Source: Federal Reserve Board/Haver Analytics 08/30/11

European financials, thereby creating higher short-term borrowing costs for European financials and a source of funding stress. This partly explains the recent increase in ECB lending facilities as European financials seek other avenues for funding.

Similarly, hostile market conditions have prompted a sharp decrease in corporate bond issuance from both domestic and European financial issuers over the past several weeks. The lack of issuance has increased funding fears as investors question how financial institutions will not only obtain funding but also rollover maturing bonds in coming months. This indeed creates pressure on the banks. However, it is important to note that financial institutions issued significant amounts of debt over the first five months of 2011 and contributed to a surge in overall corporate bond issuance over the period. Banks on both continents have already obtained much of the funding needed for 2011 and can wait out market turbulence. Nonetheless, if hostile market conditions persist, it increases risks for 2012 and beyond when financial issuers will likely have a more pressing need to access debt markets.

**6 Banks are Better Able to Withstand Pressures Now**



Source: Federal Reserve, LPL Financial 8/17/11

**Summing it Up**

An overall review of the data reveals that bank funding strains are certainly evident in the measures we and most market participants track, but they remain modest. More importantly, bank funding strains are nowhere near the levels witnessed during 2008. In Europe, ECB lending facilities provide a key backstop to prevent another Lehman-like event. Heightened bank funding fears in the marketplace appear based upon perception rather than fully understanding the context. Large banks both domestically and in Europe, have increased minimum capital reserves and also maintain significant amounts of cash [Chart 6].

Still, until we see improvement across these measures, corporate bond markets are likely to be preoccupied with bank fears. We believe any of a number of policy factors could improve market perception.

- The launch of Eurobonds would be viewed as a more robust and holistic solution to the European debt problem. See this week's Weekly Market Commentary for details. If not Eurobonds, then a special agency with the authority to issue debt and the backing of the European Union would also be viewed as a more united front to address European debt issues and reduce bank funding fears.
- Related to the above, the ability of banks to issue government-guaranteed debt. Allowing banks to issue higher rated debt, with the backing of the local government similar to the Temporary Liquidity Guaranty Program (TLGP) used in the U.S. during the financial crisis, would help alleviate bank funding fears.
- An expanded European Financial Stability Fund (EFSF). The European version of TARP is viewed as far too small at 440 billion euros. An increase to 2 to 2.5 trillion euros would be viewed as significant enough to contain potential funding worries for Italy and Spain and relieve bank solvency fears.



- Increase ECB bond purchases. The ECB has reluctantly increased government bond purchases recently to help stabilize Spanish and Italian government bond markets. Still the ECB's net total bond purchases, through its Securities Markets Programme (SMP), has totaled 115 billion euro (\$166 billion) so far, well shy of what the Fed accomplished during QE1 and QE2 with purchases totaling just over \$1 trillion.

## Conclusion

Corporate bond markets, high-yield in particular, have lagged the recent bounce in stock prices choosing instead to focus on European bank fears. We believe bank fears are overdone but corporate debt markets may not see material improvement until these fears subside. We also believe that late summer, illiquid trading conditions may have contributed to weak performance as investors sell first and look to revisit corporate bond markets when market participation improves after the upcoming Labor Day weekend. Aside from an improvement in economic data, a greater policy response out of European leaders could serve as a catalyst to get investors to recognize the value represented in corporate bond markets.




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**IMPORTANT DISCLOSURES**

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of a fund shares is not guaranteed and will fluctuate.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.

Credit Quality: One of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

Commercial Paper is a short-term unsecured promissory note issued by a finance company or a relatively large industrial firm. The notes are generally sold at a discount from face value with maturities ranging from 30 to 270 days. Although the large denominations (\$25,000 minimum) of these notes usually keep individual investors out of this market, the notes are popular investments for money market mutual funds. Used interchangeably with the term paper.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Securities Markets Programme is European Central Bank interventions in eurozone bond market segments that are deemed to be dysfunctional.

The Barclays Capital High Yield Index covers the universe of publicly issued debt obligations rated below investment grade. Bonds must be rated below investment-grade, or high-yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds must also have at least one year to maturity, have at least \$150 million in par value outstanding, and must be U.S. dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

The TED Spread measures the difference between 3-month LIBOR rate and the yield on 3-month Treasury bills. This is an effective measure of the liquidity available to banks. With bank capital adequacy near the center of the current crisis this is an important gauge of the stress in the banking system. A rise in the TED Spread acts as a negative on the CCI.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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