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Capital Markets Update:

Is 2013 The Year Interest Rates Start Rising On U.S. And European Bonds?

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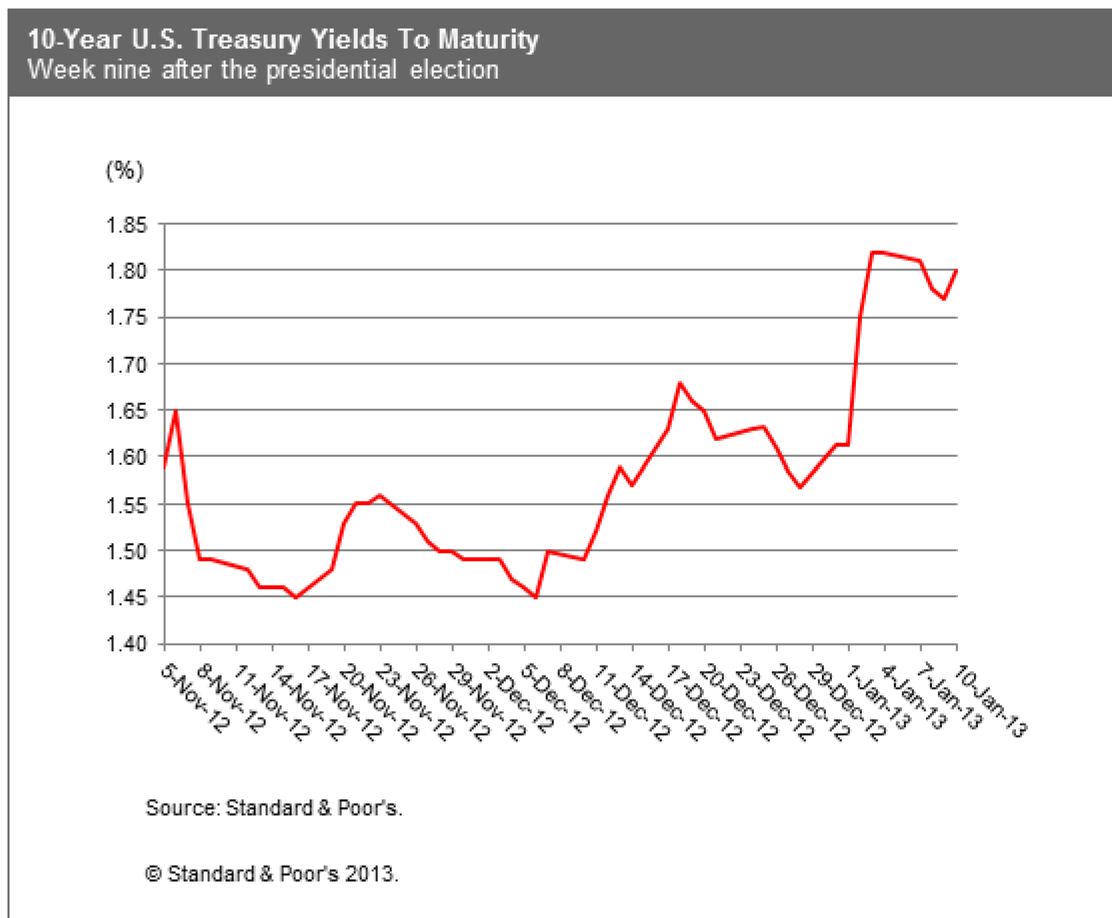
Is 2013 The Year Interest Rates Start Rising On U.S. And European Bonds?

After years of falling bond yields, the question in 2013 is whether interest rates on corporate bonds will start rising. It is possible. As 2012 ended, stock markets in Europe and the U.S. had registered solid gains for the year. The S&P 500 is now up almost 14% for the year and last week showed a record surge of investment in global equities. Some market watchers are warning that investors could start moving capital out of bonds and into equities. That could cause interest rates to rise on bonds. The possibility that the Federal Reserve could end its bond purchasing program by the end of 2013 may also be having an effect on rates. In fact, Standard & Poor's economists forecast the yield on U.S. 10-year Treasuries to rise to 2.1% this year and 2.6% in 2014. (Watch the related CreditMatters TV segment of "Capital Markets Update," dated Jan. 15, 2013.)

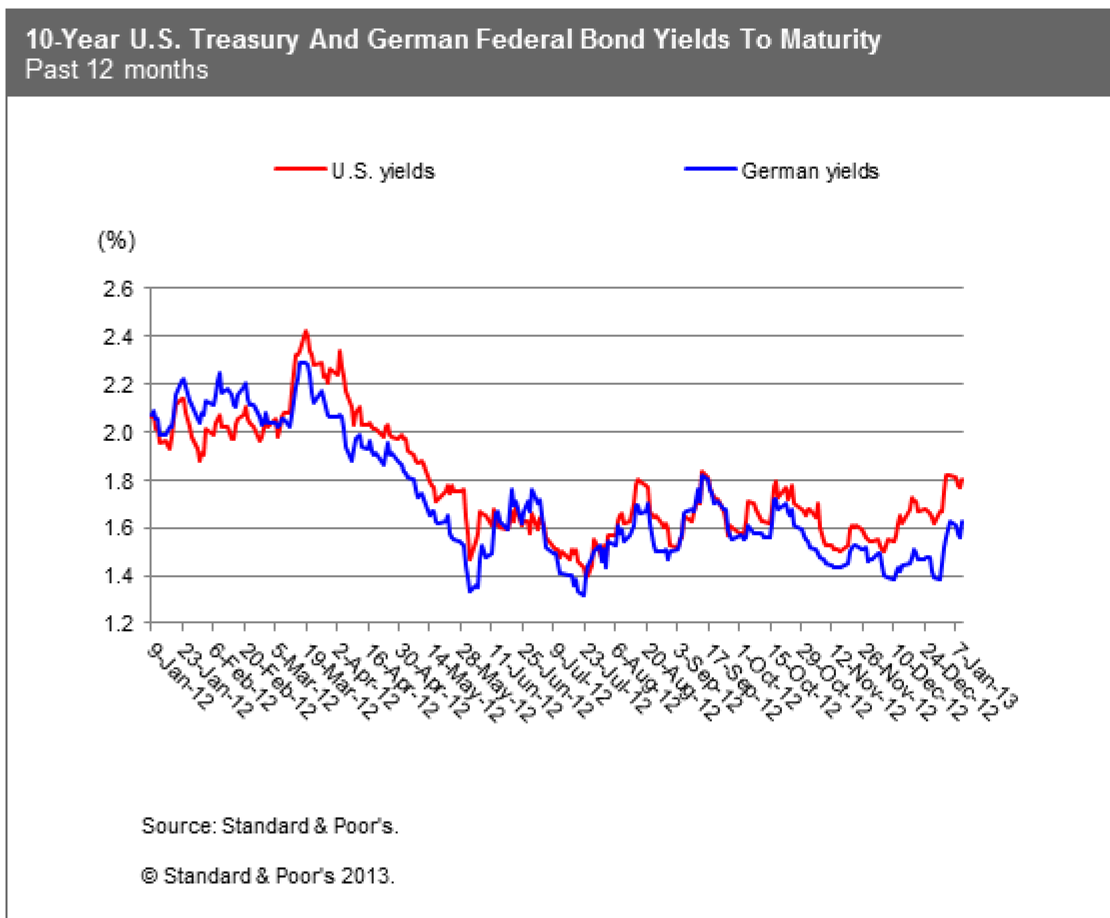
Over the short term, it does indeed appear that rates might be rising. Since the election, yields have gone from as low as about 1.45% to 1.8% last week (see chart 1). Nine weeks, however, is a short period from which to draw long-term conclusions.

Chart 1



Over the past 12 months, yields on 10-year U.S. Treasuries and German federal bonds (known as "bunds") have fallen about 60 basis points (bps) to 70 bps from their March 2012 highs. U.S. Treasuries peaked at about 2.4% and are now at 1.8%. German bunds peaked at almost 2.3% and are now about 1.6% (see chart 2). Yields on both have been very volatile since June and are starting to rise again. But yields on U.S. Treasuries have exceeded those on German bunds since August and could be rising faster. The recent changes look entirely consistent with the year's movements and actually offer little insight about interest rates. There are any number of explanations for the differences.

Chart 2



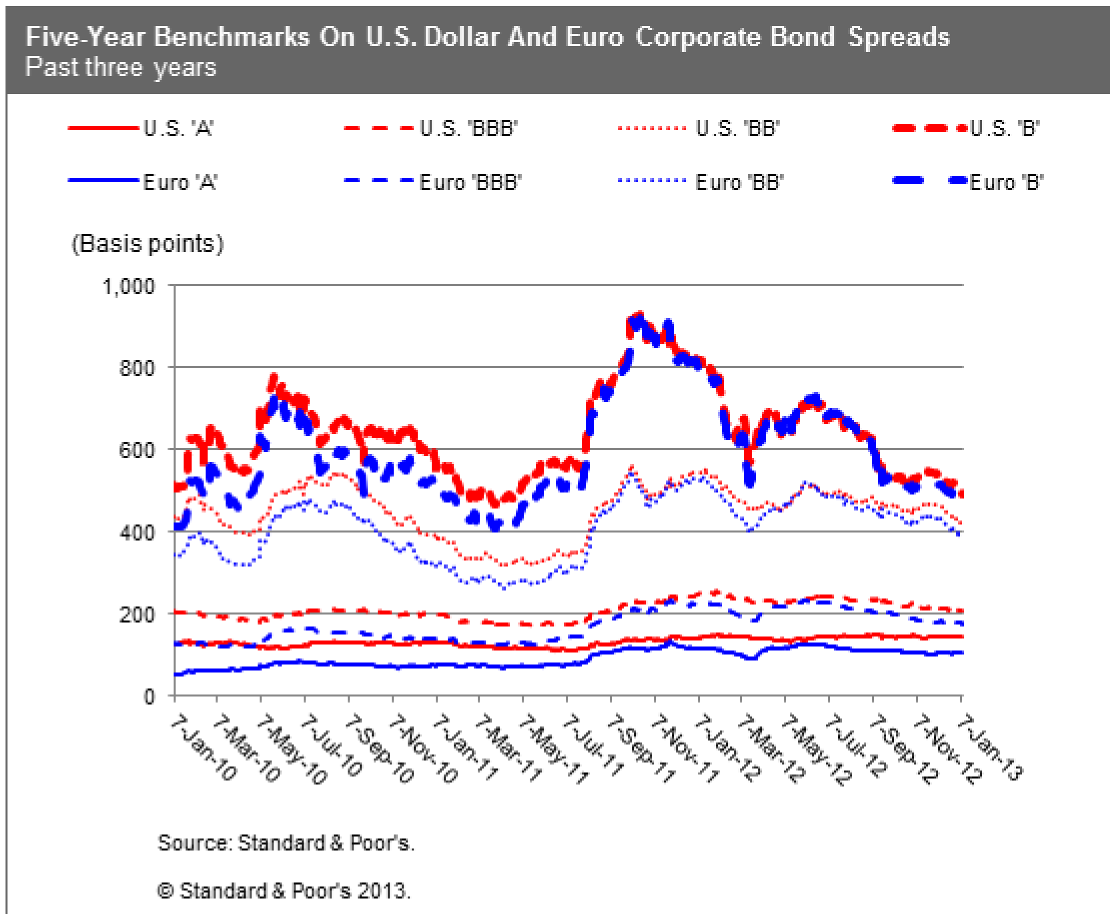
For one, our sovereign rating on Germany is 'AAA' with a stable outlook. And our rating on the U.S. is 'AA+' with a negative outlook. So, all else being equal, the higher rating on Germany would explain the lower yields on German bunds.

For another, Europe is progressing toward greater political and economic union, and the risk of a messy breakup of the eurozone has diminished despite a bleak outlook for a number of member countries. In contrast, investors may be less attracted to U.S. Treasuries as the President and Congress once again start a contentious, last-minute debate on the debt ceiling.

The rise in yields on sovereign debt in Europe and the U.S. seems to be having negligible effects on the spreads and

yields on corporate bonds in the two regions, despite the fact that many corporate bonds are priced off Treasuries and bunds. Our five-year benchmarks for European corporate bond spreads against the asset swap curve have remained inside of our U.S. dollar benchmarks across all rating categories for the past three years (see chart 3). The U.S. dollar 'A' benchmark, at 142 bps, and the 'BBB', at 207 bps, price just about where they were in January 2010. But the spreads on both euro counterparts have increased by about 50 bps during the same period. The euro 'A' benchmark prices at about 103 bps, and the 'BBB' is at 174 bps. All four investment-grade spreads, however, are slightly higher than their three-year lows as investment-grade investors have become more risk-averse.

Chart 3

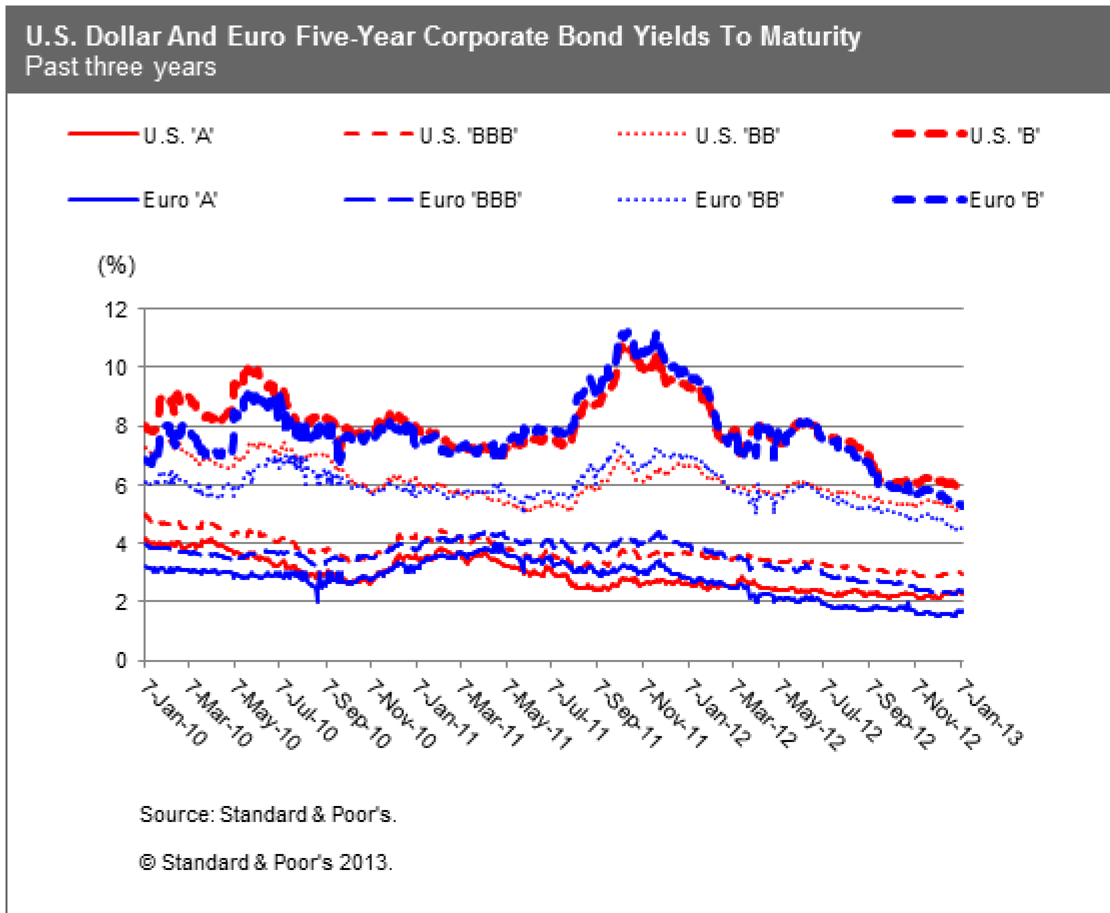


The speculative-grade 'BB' and 'B' curves are also just about where they started in January 2010 but are well off their November 2011 peaks, when the eurozone crisis briefly squeezed liquidity. But unlike the investment-grade curves, the high-yield benchmark spreads continue to contract. Both the dollar and the euro speculative-grade curves have retreated to levels not seen since mid-2011. The bull market for high-yield investments looks as strong as ever.

That is good news for high-yield issuers because this will help contain borrowing costs. This trend likely reflects the attractive yields that speculative-grade bonds offer for yield-hungry investors. In Europe, it also likely reflects how the bond market has stepped in to fill the void left by banks repairing their balance sheets.

Our five-year corporate dollar and euro benchmark yield curves, not surprisingly, show a similar picture (see chart 4). Marginal borrowing costs in the secondary bond markets are at three-year lows and show no definitive signs of increasing. That is also a good indication for corporate bond issuers.

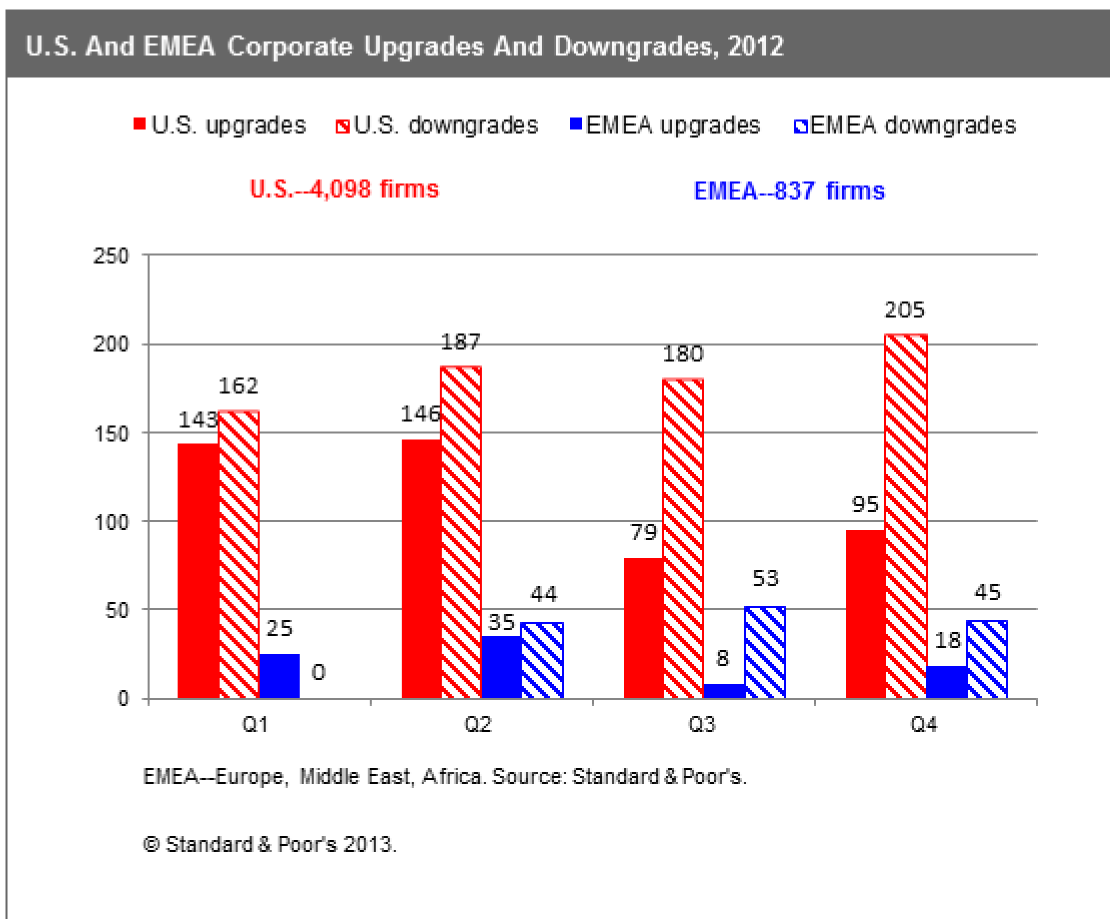
Chart 4



Our dollar and euro 'A' corporate benchmark yields have fallen about 45% from three years ago, and our 'BBB' benchmark yields are about 40% lower. In addition, the 'BBB' yields are significantly lower than the 'A' yields of 2010. 'BB' yields are down between 26% and 31%, and 'B' benchmarks yield about 22% to 28% less. Similarly, today's 'B' yields fall well below the 2010 'BB' yields. And 'BB' curves price very close to the 2010 'BBB' yields.

Such broad compression in bond yields and spreads might raise the question of whether ratings are another indicator of reduced credit risk in 2013. During the last two quarters of 2012, however, downgrades outnumbered upgrades in Europe and in the U.S. by more than 2 to 1 (see chart 5).

Chart 5



So right now, it is difficult to say whether corporate bond coupon rates will begin to increase significantly this year. We do think the global economy will continue its recovery in 2013, but it is a fairly precarious situation. After more than three years of economic, financial, and budgetary stress in the eurozone, some signs of stabilization emerged in the latter half of 2012. Yields on European sovereigns, such as Italy, Ireland, and Spain, have fallen as access to the markets and liquidity have improved. We think the U.S. economy will continue to recover in 2013 at a real GDP growth rate of 3.0%. But, as we recently pointed out (see "2013 Global Credit Outlook: The Ball Is In The Policymakers' Court," published Dec. 17, 2012, on RatingsDirect), more corporate issuers are struggling to maintain operating margins amid nominal to flat revenue growth, and cost-cutting measures are becoming less effective. In addition, leverage is increasing from a combination of issuers raising cheap, long-term financing opportunistically and some sectors experiencing weaker earnings trends. Corporate borrowing costs still look pretty low. Yet, bond markets can move very quickly for any number of reasons--and in directions that surprise everyone. So stay tuned.

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