FT SPECIAL REPORT

Debt Capital Markets

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Illustrations: Daniel Mitchell

White-knuckle ride

Market volatility continues to sow seeds of doubt in the minds of nervous investors **Page 2**

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Fed creates atmosphere of uncertainty

Investors are waiting anxiously for the next market manoeuvre, writes *Ralph Atkins*

Global debt markets are on edge. Historically low interest rates and a revival in economic fortunes across the developed world encouraged a flood of issuance in 2013. But there is nervousness about the next twist in the rollercoaster that markets have been riding since the US subprime mortgage crisis erupted more than six years ago.

An attempt in May by the US Federal Reserve to reduce its large-scale asset purchases – or quantitative easing – jolted markets, and cast doubt over whether central banks would be able to manage a smooth exit from emergency crisis-fighting policies. Yields, which move inversely with prices, rose sharply, indicating – perhaps – the end of a 30-year bull run in bond markets. In 2014, such bouts of volatility could re-erupt as larger storms. Emerging markets, in particular, remain fragile – as does the financial stability of much of the eurozone.

Mark Bamford, head of global fixed income syndicate at Barclays, says: "You see the continuing ability of markets to digest rising interest rates. You can see a path where growth improves and issuance continues to be stable. At the same time, you're acutely aware of all the potential ways of falling off that path."

As investment banks prepare to close their books for 2013, they will nevertheless reflect on a busy year punctuated by blockbuster deals. Global corporate bond issuance from January 1 to early November was almost $1.9tn – a record for the period, according to Dealogic data.

Issuance of lower credit-rated, high-yield corporate debt soared – particularly in Europe. Shrinking bank balance sheets, however, led to another fall in global bank debt issuance – which at less than $700bn in the first 10 months of the year, was the lowest for the period since 2003.

Activity was interrupted in May when Ben Bernanke, chairman of the Federal Reserve, hinted that the US central bank would soon start to "taper" its asset purchases. Coincidentally, the Bank of Japan was heading in exactly the opposite direction, with Haruhiko Kuroda, its new governor, aggressively gearing up quantitative easing to drag Japan out of deflation.

The result was a spike in volatility to levels not seen since for at least three years on some measures. US Treasury yields hit 3 per cent – a two-year high. Corporate bond issuance went into a summer lull.

In the event, markets bounced back spectacularly. Early in September, Verizon, the US telecoms company, sold $49bn in bonds – the largest corporate debt issue on record – to finance the $130bn acquisition of the 45 per cent stake in Verizon Wireless that it did not already own.

Verizon's mammoth deal demonstrated the depth and capacity of debt markets. It also overshadowed April's $17bn bond issue by Apple – previously the world's largest – and the iPhone maker's first debt offering since 1996.

But the Verizon deal did not demonstrate that markets were convinced about the strength of the US economic recovery.

Policy makers were not convinced either. Later in September, Mr Bernanke shelved the Fed's tapering plan amid worries about the strength of the US economic recovery and the impact of the political wrangling over US fiscal policy. Its decision in September was cheered by markets; US Treasury yields tumbled again.

It has been an uneasy calm, however. Across the world, investors remain fixated on the Fed's next move – and stuck in the "risk-on, risk-off" mentality that has characterised markets during the financial crises, with single dominant factors driving trading. They are unsure, moreover, whether "tapering" or an eventual rise in interest rates would reflect stronger economic growth prospects – or be a trigger for fresh disruption.

Andres Sanchez Balcazar, co-head of global and regional bonds at Pictet, says: "I worry that we're back in the situation we had in April – where correlations were so high that if there was any unexpected development, many risk markets would be in danger of a sharp correction – and it will be hard for investors to hide."

The fear is of a repeat of 1994, when the Fed triggered global market turmoil after embarking on a tightening of its monetary policy. "History tells us that when the Fed tightens, bad stuff happens. The bond sell-off this summer on the mere announcement of QE 'tapering' is a case in point," wrote Paul Mortimer-Lee, chief market economist at BNP Paribas in a recent note.

Still, the relative calm could continue for some time. A common view is the Fed is trapped and will struggle to withdraw from its large-scale asset purchase programmes – Mr Mortimer-Lee compared the central bank with the *Hotel California* in the 1977 Eagles song, where "you can check out anytime you like, but you can never leave".

Low growth prospects will reduce the need for global interest rate rises.

Mr Sanchez Balcazar says: "We think we're still in multiyear deleveraging process in the developed world. That is going to keep growth fairly low and mediocre."

Claus Skrumsager, European co-head of global capital markets at Morgan Stanley, adds: "May's experience shocked central bankers. They saw that they have to be careful about unwinding the stimulus."

A yardstick for central bankers' ability to maintain global financial stability could come in emerging economies' debt markets, which sold off heavily after May's turmoil.

Such debt markets continue to expand – but face possible further withdrawals of funds from international investors taking fright at losses incurred on their portfolios.

"If the growth in liquidity [global QE] is proportionately smaller and flows decline," says Ewen Cameron-Watt chief investment strategist at BlackRock investment institute, "then the pressure will come on those most leveraged and most dependent on capital inflows." But developing economies may have learnt from past crises. "The recipient countries are responding to pressure for reforms created by the reversal of flows," says Mr Cameron-Watt.

Moreover, this year's turbulence did not derail emerging market deals for long. Corporate emerging market debt issuance surged in September and October – and at $236bn the total so far this year has already exceeded last year's $217bn.

"Rumours of the demise of emerging markets were greatly exaggerated," says Mr Bamford at Barclays. "The facts do not support all the headlines. When you look at the countries that are big users of capital markets, they have had a good year."

'Rumours of the demise of emerging markets were greatly exaggerated'

Debt Capital Markets

MMFs Clinging on through low rates

Money market funds form a multi-trillion dollar club of ultraconservative investment vehicles that acts like a network of interconnected pipes and funnels that delivers cash to banks and companies when they need it.

They were catapulted to infamy during the financial crisis, when an investor run on some money market funds – seen as a key barometer of investor sentiment – led to a worldwide credit freeze.

Since then, however, they have faced a more fundamental challenge: how to make a return in a world where record-low interest rates squeeze their wafer-thin margins.

Roger Merritt, a managing director at Fitch, says: "The last several years have been an incredibly challenging environment for MMFs and most are engaging in some level of waivers, such as management fees, to continue to make the product attractive to investors."

The damage has been significant, as investors searching for yield have taken their money elsewhere.

In the US, for example, MMFs' assets under management have declined from $4tn in 2009 to about $2.7tn, according to HSBC.

But some sector watchers are surprised that they have not declined further.

"We might have expected to see more of an exit [by investors] because there's no return on your money," says Peter Burger, head of Americas debt syndicate at HSBC. "We're at zero!"

Fitch said last year that euro-denominated MMFs faced the same fate as US funds in 2008, with closures accelerating after the European Central Bank cut its deposit rate to zero.

Some funds have closed their doors to new investors and reduced their fees so as to maintain positive returns.

These included JPMorgan, one of the world's biggest providers of money market funds, Goldman Sachs and BlackRock.

At the time, Goldman Sachs warned that Europe's money market industry was in "uncharted territory".

Cue another cut in the ECB's refinance rate this year and speculation the bank could yet move another key rate into negative territory.

"There are headwinds all around us," said Jim Fuell, from JPMorgan.

"The concern is that the ECB could take the deposit rate negative or the refinance rate lower . . . although that would have implications broader than just for MMFs."

Many MMFs still boast important advantages.

In an uncertain world where markets, to a large extent, gyrate according to the asset purchasing programme of the US Federal Reserve, many investors see MMFs as a safe, reliable alternative to cash or US Treasury bills.

"The focus for investors remains capital preservation and the ability to access capital when they want it," said Mr Fuell. "MMFs will always provide these core things."

In spite of their reliability, regulators nevertheless want to change the status quo.

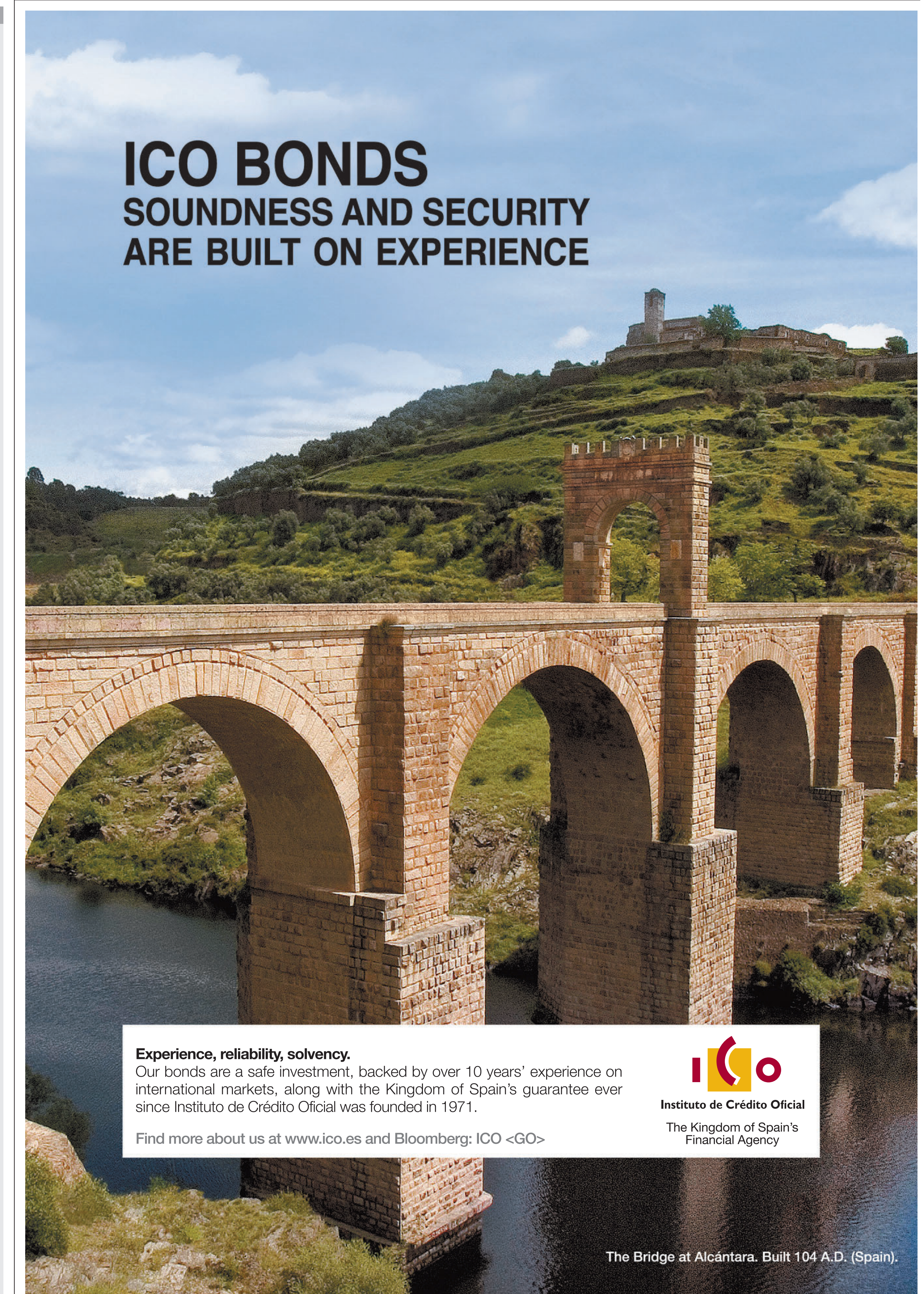
Since the financial crisis when the Reserve Primary fund, one of the oldest US MMFs, famously "broke the buck", or could no longer guarantee that investors would get $1 back for every $1 they put in, the US and European authorities have proposed some far-reaching reforms.

But if a European recovery has proved a relative boon for MMF activity, analysts project an even greater silver lining on the horizon: rising US interest rates.

"We are going to see a recovery in assets under management over next three to five years, as the US economic recovery accelerates and [interest] rates go up," said Mr Burger.

"As other assets begin to look frothy, investors will return to MMFs."

Christopher Thompson



Europe's junk issuance enjoys a bumper year

High yield Investors are willing to accept greater risk if they receive strong returns, writes *Andrew Bolger*

The search for yield while global interest rates remain low has led to a bumper year – particularly in Europe – for corporate bonds designated high yield, junk, speculative or sub-investment grade.

Global high-yield debt issuance so far this year has reached $419bn, almost as much as 2012's full-year total of $425bn, and six times the post-crisis low point of $68bn touched in 2008, according to Dealogic.

Europe's share of the global high-yield market has increased to 26 per cent from 19 per cent last year and, so far, year-to-date returns of 8.2 per cent for holders of European high-yield bonds compare with 6.3 per cent from the US and 6 per cent globally, according to Bank of America Merrill Lynch.

Analysts say that, with corporate default rates below historical averages, investors are willing to overlook the weaker credit quality of high-yield bonds in exchange for higher returns.

The sector has also been boosted by "fallen angels" – companies that have slipped below investment grade – and a recent influx of small companies.

Mitch Reznick, head of credit research at Hermes Credit, says the European high-yield sector is no longer dominated by telecom groups, with automotive, service and retail groups all now figuring prominently.

The European market has also benefited from the desire of US investment fund managers to rebuild exposure to the region, as concerns over the eurozone crisis recede.

EPFR, the fund data provider, says there was a surge of money into European high-yield credit funds after the recent US debt crisis and it estimates that, so far this year, cumulative inflows exceed $17bn for high yield and $27bn for European equities.

Analysts say that pension funds and insurers are also now more willing to go below investment grade in search of yield.

Another driver is the need for companies to tap the bond markets for finance, as capital-constrained banks shrink their balance sheets by refusing to renew loans to traditional customers.

Moody's says there has also been a flurry of small European companies issuing high-yield bonds for the first time, with six companies, each with core annual earnings before interest, tax, depreciation and amortisation of less than $50m, raising about $2bn. "It is encouraging to see the success of these small companies in issuing bonds at the bottom of the ratings spectrum," says the agency. "However, it remains to be seen if this is a temporary consequence of investors' search for yield, that will diminish as interest rates rise."

Pramerica Fixed Income, the investment manager, says Verizon's $49bn bond issue in September, the largest corporate bond offering on record, illustrates the growing level of event risk in the US industrial sector. Verizon issued the investment-grade bonds to finance its buyout of Vodafone's stake in its wireless operations.

Pramerica says: "While overall credit fundamentals generally remain strong and debt cover ratios solid, revenues and earnings growth have slowed across a number of industries, and shareholder-friendly activities and leverage are on the rise."

Bond markets dislike "shareholder-friendly" activities, such as share buybacks and special dividends – another reason to favour Europe, where managements remain cautious and focused on maintaining balance sheet strength.

Opinion is divided over how long this strong performance by high yield will last.

David Newman, head of global high yield at Rogge Global Partners, says that, when the market woke up in June to the fact that quantitative easing would not last for ever, a knee-jerk reaction saw a wide variety of assets classes being sold – including high yield, emerging markets and gold.

"If rates do go up, we will see a sell-off of high yield, but not so marked as in June, because tapering is only going to happen if there are good things happening in the world: economic growth," he says.

But Standard & Poor's urges caution, even though the bond default rate and the rating agency's measure of companies' potential for credit downgrades are at multiyear lows.

The agency estimates that the US's October shutdown shaved 0.6 percentage points off fourth-quarter growth, and it has accordingly reduced its 2013 GDP growth forecast to 1.6 from 1.7 per cent.

"In this environment of slowing growth, companies with the weakest credit strength may be challenged by macroeconomic headwinds," says S&P.

Most likely destination of stimulus path is inflation

The US

Fed's caution on 'tapering' will push prices up, says *Michael Mackenzie*

The outlook for the US government bond market is directly tied to its biggest buyer, the Federal Reserve.

As a bruising year for bonds, marked by a sharp rise in yields over the summer, enters its closing stages, investors are measuring the temperature of incoming economic data in an effort to gauge when the central bank may elect to start buying fewer bonds.

A reduction, or what traders have dubbed a "taper", in the Fed's quantitative easing policy of buying $45bn of Treasury and $40bn of mortgage bonds each month, is expected to push yields much higher over time. That risk explains why many bond managers have sought to limit their exposure to long-maturity bonds, because they perform poorly in a rising rate environment, as seen this year.

Talk of a taper by Fed officials in May prompted a near-doubling in the benchmark 10-year Treasury yield to 3 per cent over the summer. That pushed up mortgage rates for homeowners, weighed on the economy and ultimately forced the Fed to step back from a widely expected taper in late September.

As bond investors wait to see whether it may come after the Fed's December policy meeting, there are signs that the central bank is looking at ways to contain long-term yields.

In recent weeks, expectations have grown that, under the pending leadership of Janet Yellen, the Fed will seek to soften the blow of any bond taper, by aggressively emphasising that it will delay raising interest rates until unemployment has fallen below 6 per cent, while tolerating a higher rate of inflation.

Janet Yellen is expected to soften the blow of a bond taper

Whether that works remains to be seen, but it highlights how policy makers do not want to see a renewed rise in yields.

"The Fed can't afford to have another episode of rising bond yields like we saw in May and June," says Jeffrey Rosenberg, chief investment strategist for fixed income at BlackRock.

"Monetary policy supports the economy through easy financial market conditions that keep mortgage rates low and boost the value of equities and homes."

Also muddying the economic outlook for early 2014 is the expected revival of fiscal issues in Washington, as Congress only postponed addressing the debt ceiling impasse in October.

Michael Cloherty, strategist at RBC Capital Markets says: "The Fed will continue to tiptoe around tapering. Our call remains an April taper."

As the Fed plots a cautious path between tapering QE and strengthening its commitment not to tighten policy until 2016 or longer, the danger of a policy mistake, such as sharp jump in inflation worries some investors.

Jack Ablin, chief investment officer at Harris Bank, says: "Policy makers want to keep the monetary spigot open as long as possible to ensure the economy can sustain itself on its own, but, at the same time, US central bankers realise they run a serious risk of inflating asset bubbles and setting off a crash once stimulus is removed.

"Eventually," he adds, "massive monetary creation will probably win, ushering in higher price growth. It's probably not a matter of if, but when."

That leaves a place for Treasury inflation-protected securities some. argue

Robert Ostrowski, chief investment officer at Federated Investors, says: "We believe there is still value in Tips, even though they've had a nice run and look relatively expensive. This is because among the many things it is telling us, the Fed says it will allow its inflation band to creep up."

For now, the inflation bond sector is still experiencing fund outflows. That may change, as more investors fear the Fed will ultimately succeed in pushing inflation towards an annualised rate of 2.5 per cent.

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Buyers struggle to find a safe landing

Global liquidity Banks' withdrawal from trading leaves a mismatch in the bond market, says *Tracy Alloway*

From Boston to New York and Washington, liquidity in the fixed-income market is a hot topic among the big investors who buy bonds and the banks who sell the debt to them.

Battered by new regulation and scarred by their recent experience during the financial crisis, banks have quietly retreated from the business of trading bonds. That has cut into investors' ability to trade fixed income assets, market participants say, and prompted a wide-ranging search for ways to boost liquidity in the market.

But months of searching for a fix have yet to yield a solution. That has exacerbated worries that the mismatch between the growing fixed income assets of investors, and the increasing unwillingness or inability of banks to trade the bonds on behalf of their customers, could worsen a sell-off in the debt market.

"The inventory held by the dealers has shrunk," says Fred Ponzo, managing partner of GreySpark Partners, a capital markets consultancy. "There's a lot less liquidity because the banks aren't providing it any more and that's a problem."

Investors have poured more than $500bn into investment-grade corporate bond funds since September 2008, hoping for better returns while interest rates remain at historic lows. Meanwhile, the amount of bonds on banks' balance sheets has dropped more than 70 per cent from a peak of $235bn in 2007 to about $62bn now, according to data from the US Federal Reserve.

Buyside investors and sellside banks agree that the growing mismatch between the two sides of the market is a problem, but they cannot agree how to fix it.

At issue is the way bonds have historically been traded, with investors calling up or requesting a price quote from a dealer bank, which then "warehouses" the debt on its balance sheet. That has become increasingly difficult for the banks to do, as new regulation makes it more expensive, or trickier, for them to hold the bonds.

"There's all these highways and banks historically have been the parking lots where the securities would pull into and warehouse the risk," says Lee Olesky, chief executive officer at Tradeweb, which has been building up its own bond-trading capabilities. "The parking lots are shrinking. The big question now is will new capital be attracted into this space to build new parking lots?"

In private industry gatherings, investors have debated with banks about how best to attract that new capital. So far, the meetings have yet to yield a viable solution.

"The industry gatherings have been somewhat unrealistic because there has been this emphasis on one magic solution," says Rick McVey, chief executive of the trading platform, MarketAxess. "In the past year, we've learned more about what doesn't work than what does."

Efforts to move bond trading to an electronic platform – similar to a stock exchange – remain inconclusive. While many other assets trade comfortably on electronic exchanges, thereby improving liquidity, fixed income assets are more difficult to shift. "You have bonds which go through a cycle. When they come out of new issue, they can be very actively traded and then later on they find a home and aren't traded as much," says Mr Olesky. "You're dealing with very different liquidity characteristics."

The issue has not gone unnoticed by regulators. This month, the Treasury Borrowing Advisory Committee, which advises the US government on the sale of its debt, discussed efforts to encourage electronic trading of fixed income securities.

"Presenters noted that a singular electronic trading platform was unlikely to emerge in the fixed income market due to the varying product sets and needs of market participants," the TBAC said in its latest quarterly minutes.

Banks including Goldman Sachs, Morgan Stanley and UBS have been experimenting with their own "single-dealer" electronic bond trading platforms as one way of boosting liquidity, but investors remain sceptical.

Some investors have been pushing for a trading venue that would allow the buyside to trade directly with each other, or for companies to standardise their bond issuance. But banks are loath to give up the profits they make from facilitating trades, and corporate treasurers don't want to sacrifice flexibility in their funding plans.

Many in the market are now talking about smaller changes.

MarketAxess, which handles about 15 per cent of investment-grade bond trades, says it is increasing the functions available to fixed income traders on its platform.

"In no way, are we trying to cut anybody out, but we're trying to help dealers and investors move into the new world," says Mr McVey. "Because if we don't move there, there will be a huge problem in terms of liquidity drying up."

Algomi, a London-based start-up, says it has built a system that allows banks to keep better track of the bonds they buy and sell, essentially creating a social network from which they can source new trades.

The company has attracted investment in the "tens of millions of dollars" from Lakestar, a venture capital firm best known for investing in internet companies including Skype, Spotify and Facebook.

"It's not revolutionary. We're not changing the market structure," says Stu Taylor, Algomi chief executive. "But the little bit of [bank] balance sheet that is left is now much more optimised, because it's used to facilitate trades."

Volatility is part opportunity and part trap

Emerging markets

Timing is the way to beat losses, reports *Robin Wigglesworth*

The US Federal Reserve triggered a storm in developing countries this year when it announced plans to scale back its monetary stimulus. The market reaction was quick, violent and indiscriminate.

Currencies tumbled, borrowing costs soared, stock markets nosedived and bond sales choked up. No country proved immune from the turmoil. Several looked like they could suffer a repeat of the emerging market crises of the 1990s.

An almost palpable wave of relief washed over the developing world, therefore, when the Fed decided in September to maintain its stimulus scheme. Losses were clawed back and issuance rebounded, despite the chilling effect of the government shutdown and political wrangles over the federal budget in the US.

With the end of the year in sight, fund managers, considering what is in store for emerging markets in 2014. But there is little agreement on what lies ahead – except that it will be interesting.

Many asset managers expect the US central bank to maintain the size of its $85bn-a-month bond buying programme for this year at the very least. "The Fed clearly wants to see a stronger recovery before it cuts back on stimulus," says Ramin Toloui, global co-head of emerging markets at Pimco.

That gives countries a chance to replenish central bank reserves depleted by currency market interventions and capital outflows; take a hard look at government spending; and perhaps even push economic reforms that would make them more resilient to any renewed turmoil.

Indonesia, for example, saw its foreign currency reserves fall from $107bn in late April to $92.7bn at the end of July. But the central bank's safety funds have risen to $95.7bn by the end of September.

Ramin Toloui: forecast

"It's prudent for countries to take advantage of the more benign environment and rebuild their firepower," Mr Toloui points out. In the meantime, the higher yields offered by developing country bonds have continued to tempt fund managers, and issuance has rebounded.

After collapsing in May and June, and staying sluggish over the summer, bond sales in emerging markets bounced back to $108bn in September and October according to Dealogic. Overall issuance has now gone above $440bn, bringing a record within reach. Corporate issuance has broken the previous record.

But the Fed will eventually "taper" its quantitative easing programme, a move likely to put bonds under renewed pressure.

Sergio Trigo Paz, head of emerging market debt at BlackRock, reckons the reaction will be less violent, given the time investors have had to prepare. But many are warier and predict turbulence and rising bond yields.

That will make the investment environment more challenging for asset managers and, as a result, make it tougher for countries and companies in the developing world to issue debt.

The main concern is whether larger countries fail to take advantage of the current calm. Among the most vulnerable are Turkey, Brazil, India, Indonesia and South Africa. But any country with a large current account deficit will be tested.

Tapering constitutes a serious "technical" danger for emerging markets, but there are also deeper, more fundamental reasons why the developing world could be facing a difficult 2014. Economic growth has been slowing for several years.

The International Monetary Fund expects the developing world's output to expand by 4.5 per cent this year. That's 0.5 percentage points lower than its July forecast, and down from the 6 per cent growth predicted in April 2012.

Much will depend on China, which has been a big driver of economic expansion for emerging markets for the past decade. Beijing has acted to prop up its economy this year, and most analysts expect it to attain or exceed its 7.5 per cent growth target this year. But next year is more uncertain.

"China is stabilising, but we think we'll get more negative newsflow next year. And that's not good for emerging market fundamentals," says Mr Trigo Paz.

But timing a more defensive stance is the tricky part for fund managers.

"No one wants to be the last to sell, but no one wants to be the first either," Mr Toloui observes.

'Balkanisation' remains a serious concern for currency bloc

Eurozone

Banks are on the retreat, while interest rates vary widely, reports *Ralph Atkins*

This was the year the eurozone bounced back from its near-death experience.

Since Mario Draghi, the ECB president, promised in July 2012 to do "whatever it takes" to prevent a break-up of Europe's monetary union, the region has moved from an existential crisis to a more of an equilibrium.

Yields on the sovereign debt of countries such as Spain and Italy in the eurozone's "periphery" have fallen sharply. Stressed markets have reopened, and bond issuance has accelerated, especially in the high-yield sector – although the total remains below pre-eurozone crisis levels.

Signs of economic recoveries across the region have emerged.

The relative calm masks underlying tensions, however. Economic growth remains weak, with unemployment acute in some regions – posing long-term risks to the sustainability of public debt. Investors worry about the systemic dangers of the financial links between banks and governments in the weakest economies. Progress towards a European "banking union" to buttress the monetary union has been slow.

Meanwhile, debt deleveraging will continue to hamper the recovery – as will the eurozone's financial "Balkanisation" banks' retreat behind national borders and still-large differences in interest rates paid by households and companies in various member states. The eurozone remains a story of the "periphery" versus the "core".

Mr Draghi admitted this month: "Fragmentation is basically a little better than it was four months ago, but rather than observing dramatic improvements month by month, we are observing, by and large, a static situation."

Benjamin Brodsky, head of fixed income allocation at BlackRock, says: "You cannot consider periphery debt as risk-free and put it on a par with France's and Germany's.

"Although spreads have come down, they remain large and vulnerable. 'Balkanisation' is the number one issue for Draghi."

> As the eurozone crisis has receded, there are signs of normality returning – even in Greece

Against that backdrop, a main force driving European debt capital markets this year has been the structural shift towards "disintermediation", with companies turning directly to capital markets rather than relying on loans from a weakened banking sector.

Before the crisis, eurozone bank debt issuance was higher than for the corporate sector – now it is the other way around in the core and periphery.

Eurozone corporate bond issuance has exceeded $300bn this year – up from $290bn in the same period in 2012 and the strongest since 2009. The surge in high-yield corporate bond issuance is part of that trend. Some two-thirds of companies issuing in the sector this year have been making their market debut.

By contrast, Europe's financial sector continues to shrink balance sheets, with bank debt issuance barely half pre-crisis levels.

Nevertheless, as the eurozone crisis has receded, there are signs of normality returning – even in Greece, its original epicentre.

"In the first quarter of 2014, we could see some stronger [Greek] banks returning to wholesale funding markets," says Claus Skrumsager, European co-head of global capital markets at Morgan Stanley.

"They have gone through at least three years of restructuring and have been recapitalised. It will mean they can expand their loan books – and it would crystallise that there are international investors willing to invest, which will support the credit story."

Turmoil in other parts of the world has encouraged investors to buy European assets. When emerging markets were selling off this year, Italian and Spanish government bonds yielding 4 per cent looked more attractive.

Also helping sentiment has been evidence that worst hit eurozone economies are finally turning the corner and reaping the benefits of structural reforms, helped by the financial stability ensured by the ECB.

Ireland is expected to exit its international bailout programme in December. Spain, meanwhile, has returned to growth, with lower unit labour costs boosting its competitiveness and exports. The shift by countries such as Spain from current account deficits to surpluses has reduced their vulnerability to foreign capital outflows.

The stream of credit downgrades across the eurozone may also have reached a turning point.

This month, Standard & Poor's downgraded France another notch to AA. But a week earlier, Fitch had removed its negative outlook on Spain – raising hopes that the country would avoid being cast into junk territory by one of the big rating agencies.

A reminder of the fragility of the eurozone's recovery came at the ECB's November meeting, when its governing council decided to cut its main policy rate to 0.25 per cent and extend, until at least mid-2015, its offers of unlimited cheap liquidity to eurozone banks.

Still, the ECB's action did not change the eurozone story, argues Mr Skrumsager at Morgan Stanley.

"Am I surprised that Europe is slow coming out of the crisis? No. An economy that is deleveraging does not jump out of recession. But there are structural changes taking place in Europe and the tail risks have been removed."

Mario Draghi: steady

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Appetite for paper grows

Corporate bonds

Verizon's autumn rise follows Apple's spring fall, says *Vivianne Rodrigues*

With hindsight, Apple's groundbreaking $17bn bond issue in April may have been the high-water mark in a multi-year rally in corporate bonds.

At the time, the demand for the "iBonds" highlighted the enormous appetite among retail investors for higher-yielding alternatives to government debt after the US Federal Reserve's massive quantitative easing policy had pushed borrowing costs to record lows.

The debt sale was one of the most frenzied on Wall Street for many years and there were three times as many orders as there were bonds sold.

As part of the multi-tranche offering, Apple sold $3bn of bonds maturing in 2043, locking in a low interest rate of 3.9 per cent for the next 30 years. Investors in the offering paid 99.418 per cent of face value for the new bonds, but institutional and retail demand was so strong that they traded as high as 101.97 in the secondary market soon afterwards.

"Apple's bond sale was an event," says Matt Toms, head of US public fixed income for ING Investment Management. "They were a new entrant, offering debt of several maturities, including long-term, at a time when debt markets were wide open for issuers, and investors were starved for liquidity."

But just a couple of weeks later, comments by Fed officials suggested that the US central bank was going to start to taper its purchases of government debt soon, thanks to an improving economy. Traders across the globe reacted by sending interest rates on US Treasuries sharply higher, causing a sell-off in corporate bonds and wiping hundreds of millions of dollars off the value of Apple's offering.

Bonds with longer maturities suffered the steepest falls, although even Apple's five-year and 10-year debt declined in price.

Some investors were reminded of the basics of corporate bond market mathematics: bonds sold at low yields suffer when rates rise.

At its lowest point, the market price of Apple's 30-year debt fell to 81.59 per cent of face value in September, according to data compiled by Bloomberg. While the price has since rebounded, investors who snapped the company's bonds that day in April are still sitting on losses.

"Unfortunately, some investors forget that bonds, even high-grade ones, can and do lose in value," says Michael at for Prudential Fixed Income.

"That's one problem with buying bonds at very low yields: the risk-return equation is asymmetric."

The sell-off hit other big global corporate bond issues from this past spring, including those from Vodafone of the UK and Petrobras of Brazil. Corporate bond funds experienced large redemptions, and some recorded losses for the first time since the financial crisis.

Analysts started to question whether fixed income assets had lost their lustre as investors favoured the stock markets, where the broad S&P 500 rose to record highs.

But another turning point in the corporate bond market was just around the corner. In early September, the US telecoms group Verizon started to market the largest corporate debt sale in history, seeking to raise funds for its $130bn acquisition of the 45 per cent of Verizon Wireless that it did not already own.

The company stoked demand for the deal by selling the debt at generous levels compared with that of other similarly rated bonds. The group sold its 10-year bond at a yield of 5.19 per cent – about 57 basis points higher than its existing debt for that maturity, a substantial amount for bond buyers.

As a result, investors across the globe lined up to buy the bonds, and orders reached $100bn. That was almost double the size of the order book for Apple's $17bn offer in April. US pension funds and insurance companies, hedge funds and Asian and Middle East investors all bought Verizon's securities.

"It is interesting that these two large deals ended up coming just a few months apart," says Mr Collins. "In terms of pricing, Apple got the low ticket, while Verizon probably got the high ticket."

Verizon sold $49bn worth of bonds in a combination of fixed and floating-rate debt spread across six maturities that ranged from three to 30 years. The bonds jumped in secondary markets, rewarding investors who bought the securities at discount prices. The gains generated up to $2bn in profit for investors on the bonds in 24 hours, analysts estimated.

Verizon's successful sale helped end the summer sell-off and paved the way for an upswing in the market for US corporate bonds. The Fed's decision later in September to keep its bond-buying programme in place added a new enticement to corporate borrowers as well as investors in fixed income assets.

"There were talks earlier this year about a 'great rotation' out of fixed-income and into other asset classes," says Alex Gennis, a credit strategist Barclays. "Indications point to a very strong and healthy appetite for paper in the corporate bond market. The 'great rotation' has yet to happen."

ETFs Tipped as liquidity source

At a time when big banks have reduced their inventories of corporate bonds to their lowest levels in years, fixed-income exchange traded funds have expanded their assets to a record high, as big and small investors use the funds to ride the great bull run in bonds.

The diverging fortunes have prompted some proponents of ETFs, which seek to replicate the returns of a variety of assets, to suggest they might help replace some of the bond market liquidity lost by the retreat of dealer banks.

"There's a lot of discussion about ETFs as an alternative source of liquidity," says Rob Friend, head of the fixed income business at Bloomberg, which has been bulking up its functions for fixed income ETFs. "As balance sheets get reduced on the sellside, the buyside is looking for other sources of liquidity in bond markets."

ETFs promise investors the ability to dart cheaply and easily into and out of assets that might otherwise be more expensive or difficult for them to obtain.

This promise has attracted swarms of "mom and pop" retail investors as well as larger institutional investors such as pension funds, insurers and hedge funds. These investors have poured more than $1tn into fixed-income ETFs over the past few years.

The growing size of fixed-income ETFs has not gone unnoticed by bond traders at the big dealer banks. They say that the movement of money into and out of fixed-income ETFs can magnify swings in bond prices in an already thinly-traded market. "ETFs are definitely a part of our market," says Rob Smalley, US credit strategist at UBS, the Swiss bank. "Large inflows or outflows do have a perceptible impact."

That volatility was on full display this summer, when talk of the Federal Reserve "tapering" its emergency economic policies caused a sharp sell-off in bonds.

At least two of the big financial companies that support ETFs curbed "redemptions" on some of their fixed-income funds amid heavy one-way selling. Mr Friend says: "It's hard to know exactly what's going to happen. If the market decides that fixed income asset exposure needs to reduce, then people will need to think about selling those assets."

Tracy Alloway