

Research

U.S. Credit Market Outlook



The Bond Market Association is pleased to present the results of its annual forecast survey of 2005 activity in the municipal, corporate and structured finance markets. This report provides information on anticipated issuance volumes and interest rates and spreads in 2005. The forecast is based on a survey of the Association's member firms conducted during November and December of 2004. Analysts at member firms in each market sector provided the forecasts, as well as key assumptions. Enhancements to this year's survey include a separate section on the CDO market and expanded information about CDO structure trends; a forecast on the 10-year CDX, or credit default swap index, widely followed by institutional investors; and an expansion of money market product coverage.

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Research Department

Michael Decker
Senior Vice President
Research & Policy
Analysis

Steven Davidson
Vice President and
Director
Research

Marcelo Vieira
Manager
Market Statistics

Tiffany CoIn
Research Analyst

Bryan Gross
Research Analyst

Bond Issuance Expected to Be Lower in 2005 as Sustained Economic Growth Leads to Modest Rise in Rates

Commercial Paper, High-Yield Corporate and ABS Sectors Best Positioned to Gain

The median forecast projects total bond issuance in the municipal, corporate, asset-backed, CDO and mortgage-related securities markets to decline 14.6 percent in 2005, to \$2.96 trillion, compared to \$3.46 trillion¹ in 2004. The lower issuance is the result of an expected rise in interest rates fueled by continued and sustained economic expansion. The higher rates are anticipated to have the greatest effect on MBS issuance as the refinancing boom fades from the record pace of recent years. Certain sectors are better positioned to expand issuance in the developing market environment, including high-yield corporates, where issuer funding costs have benefited from significant credit spread tightening, and securitized auto loans and credit card receivables, which benefit from expected personal income and employment gains.

The trends should be viewed within the context of the economic environment and in relation to recent history. A historically low and declining rate environment through 2003 fueled record issuance volume in the bond markets. Beginning in the latter part of 2003 and continuing in earnest with the string of Fed funds rate hikes since mid-2004, a period of moderately higher interest rates began. As interest rates, especially at the short end of the yield curve, have moved up, the yield curve itself has flattened, which is expected at this point in the economic cycle. Longer rates, however, have moved very little. The 10-year Treasury yield at the end of 2004, for example, was actually about where it was at the beginning of the year.

For 2005, the consensus view is one of sustained economic expansion, solid investment and consumer spending growth, strong corporate cash flows acceptable inflation by standards of Federal Reserve policymakers, a "measured" Federal Reserve policy and a lower federal budget deficit in FY05. The stronger economy is favorable to the credit outlook for both consumers and business, though credit quality gains are likely fully incorporated in corporate credit spreads after the protracted period of spread tightening.

Highlights

Median responses to the survey:

- Total 2005 issuance for the sectors covered in this survey will be \$3.0 trillion, 14.6 percent less than the 2004 issuance volume of \$3.5 trillion.
- Long-term municipal issuance will be \$295 billion in 2005, 18 percent less than the \$358 billion issued in 2004.
- Corporate issuance in 2005 will be \$716 billion, 3 percent less than the 2004 issuance of \$741 billion.
- Commercial paper outstanding will be \$1.47 trillion at the end of 2005, compared to \$1.38 trillion on November 30, 2004.
- ABS 2005 issuance will be \$643 billion, slightly above the 2004 issuance of \$637 billion.
- CDO 2005 issuance will be \$116 billion in 2005.
- Mortgage-related issuance in 2005 will be \$1.19 trillion, 26 percent less than the projected 2004 issuance volume of \$1.61 trillion.

Washington Office:
1399 New York Ave., NW
Washington, DC
20005-4711
202.434.8400
Fax 202.434.8456

New York Office:
360 Madison Avenue
New York, NY
10017-7111
646.637.9200
Fax 646.637.9126

London Office:
St. Michael's House
1 George Yard
London EC3V 9DH
44.20.77 43 93 00
Fax 44.20.77 43 93 01

www.bondmarkets.com

¹2004 Issuance volumes are as of December 20, 2004.

MUNICIPAL MARKET

Municipal Issuance Lower Based on Reduced Refunding Opportunities

MUNICIPAL ISSUANCE			
\$ Billions	2004*	Projected 2005	% Change
Short-Term	57	45	-20.6
Long-Term	358	295	-17.6
Total	415	340	-18.0
* As of December 20, 2004 Source: Thomson Financial			

The median forecast projects total municipal issuance to be \$340.0 billion in 2005, an 18.0 percent decline from the \$415 billion issued in 2004. Both short-term and long-term issuance are expected to be lower in 2005. Based on the median forecast, long-term issuance is anticipated to be \$295.0 billion in 2005, down 17.6 percent from the estimated \$358 billion in 2004. The survey respondents' forecasts for 2005 long-term issuance ranged from \$285 billion to \$330 billion. Short-term note issuance is expected to be \$45.0 billion, 20.6 percent less than in 2004, with forecasts ranging from \$36 billion to \$60 billion.

In a rising interest rate scenario, refunding activity usually declines as fewer favorable refunding opportunities. New money municipal issuance is less likely to be affected by the interest rate outlook and more affected by the volume of cost-effective capital projects identified by local and state government issuers and by state and local fiscal conditions.

10-YR MUNICIPAL G.O. AAA TO 10-YR TREASURY RATIO		
	2004*	projected 2005
Ratio	86	85
* As of December 20, 2004 * Source: Bloomberg		

Interest Rate Outlook

There is a strong consensus that the municipal yields will rise in the coming year, with participants estimating 10-year muni yields between 3.75 and 4.20 percent. The ratio of yields on AAA, G.O., 10-year municipal to Treasury securities of comparable maturity is projected to be around 85 percent in 2005, in line with the levels during much of the fourth quarter. Despite ratios of around 88 percent in recent weeks, municipal yields are expected to rise at a slightly slower pace than Treasury yields in 2005.

Risks in the Forecast

Survey respondents also identified risks in their issuance forecast. They note the possibility that interest rates may be lower than many are expecting, which could boost issuance levels. In addition, performance in taxable markets, changes to tax laws and the strength of the dollar were identified as factors that may affect municipal issuance levels in 2005.

CORPORATE BOND MARKET

Total Corporate Issuance to Be Slightly Lower; Increased High-Yield Issuance

CORPORATE ISSUANCE			
\$ Billions	2004*	Projected 2005	% Change
Investment-Grade	602	541	-10.1
High-Yield	107	123	15.0
Convertible	32	52	62.5
Total	741	716	-3.4
* As of December 20, 2004 Source: Thomson Financial			

Based on the median forecast, corporate issuance is projected to be \$716 billion in 2005, a decline of 3.4 percent, as interest rates continue a steady though moderate rise through 2005. The survey respondents point to the effect of potential credit spread widening in a rising rate environment together with strong corporate cash positions as a drag on issuance, offset by some increase in M&A activity and significant growth in business capital investment.

The median forecast has investment-grade corporate bond issuance totaling \$541 billion in 2005, down 10.1 percent from the \$602 billion issued in 2004, with forecasts ranging from \$400 billion to \$625 billion. High-yield issuance is expected to increase to \$123 billion in 2005, a 15.0 percent rise from the \$107 billion issued in 2004, with forecasts ranging from \$115 billion to \$125 billion. Respondents look for high-yield issuers to take advantage of the historically low funding costs as spreads have narrowed over the past year. The median forecast also calls for \$52 billion in convertible debt issuance, a 63

percent increase from the \$32 billion issued in 2004, a reflection of the anticipated attractive economics for hybrid financing.

Credit Spread Outlook

With interest rates expected to rise over the next year, respondents believe that the historically tight investment-grade bond spreads are generally likely to hold during 2005. The median forecast calls for the 10-year AA Financial yield spread to be 67.5 basis points in June of 2005 and increase further to 75 basis points by year-end. The median forecast has BBB Industrial bond spreads at 92.5 basis points by mid-year and 105 basis points by the end of the year. The 10-year credit default swap, or CDX, index is anticipated to reach 51.5 basis points in June of 2005 and 59 basis points by year-end 2005.

10-YR CORPORATE INDUSTRIAL YIELD SPREADS			
	2004*	Jun 05	Dec 05
AA Financial	78	68	75
BBB Industrial	115	93	105
Credit Default Swap	63	52	59
*As of December 20, 2004 Source: Bloomberg			

COMMERCIAL PAPER MARKET

Commercial Paper Outstanding Expected to Rise in 2005

The outstanding volume of commercial paper (CP) rose slightly in 2004, and the panelists expect CP outstanding to continue to increase at perhaps a more rapid rate through 2005. Businesses are seeking financing for account receivables and inventories through commercial paper and should continue this trend over the coming year. Some increase in M&A activity also supports market growth, though panelists expressed a concern about the direction of accounting policy and its impact on the market. Improving corporate credits will also contribute to the increase. The median forecasts also reflect a range of panelist views on quarter-to-quarter GDP growth next year that generally point to solid economic expansion and a steady rise in the target Fed funds rate during 2005 toward "neutrality."

Total CP outstanding is expected to reach \$1.47 trillion at the end of 2005, according to the median estimate, with estimates generally ranging from approximately \$1.40 to \$1.50 trillion. As of November 30, CP outstanding was \$1.38 trillion. The biggest increase in outstanding volume is expected to come from non-financial CP. The median forecast expects non-financial CP to total \$170 billion, an increase of 28.8 percent from \$132 billion outstanding. Panelists believe asset-backed CP will increase 4.7 percent, to \$754 billion in 2005, up from the \$720 billion outstanding. Non-asset backed CP outstanding is expected to total \$550 billion in the upcoming year, a rise of 4.2 percent from \$528 billion. Outstanding CP for A2/P2 or lower investment-grade CP will total \$65 billion, according to median estimates, and total Euro CP outstanding will total \$487.5 billion.

For the first time, the survey asked about certificates of deposit outstanding, which is expected to total \$625 billion, and extendible notes, which are expected to be at \$110 billion at the end of 2005.

Assumptions and Rate Forecast

The CP forecasts assume that 2005 GDP will grow by 3.5 percent in the first quarter, decline during the second and third quarters, in the 3.1 percent to 3.2 percent range, and rise to 3.6 percent by year-end. Short-term interest rates are expected to increase each quarter, with the yield curve steeper in the early part of the year relative to the shape at the end of 2004 before flattening in the second half of the year.

COMMERCIAL PAPER OUTSTANDING			
\$ Billions	2004*	Projected 2005	% Change
Asset-Backed CP	720	754	4.7
Non-Asset Backed CP	528	550	4.2
Nonfinancial CP	132	170	28.8
Total	1380	1474	6.8
* As of November 2004 Source: Federal Reserve System			

ASSET-BACKED SECURITIES MARKET

ABS Issuance Volume to Increase Slightly Over 2004 Record Year, Again Led by the Home-Equity Sector

ABS ISSUANCE			
\$ Billions	2004	Projected 2005	% Change
Home Equity	402	400	-0.5
Credit Cards	52	60	15.4
Auto Loans	70	80	14.3
Student Loans	45	45	0
Other	68	58	-14.7
Total	637	643	0.9
Source: Thomson Financial			

The consensus forecast is that asset-backed securities (ABS) issuance will have another record year in 2005, despite the projected increase in interest rates. Issuance volume in 2004 reached a record because of the strong home-equity loan (HEL) sector, which accounted for 63.1 percent of ABS issuance volume during the year. Consumer credit quality fundamentals are expected to improve in 2005 as the economy continues to expand and the labor market grows, helping to boost consumer related sectors such as the credit card receivable and auto loan markets.

Based on the median forecast, ABS volume will be \$643 billion, slightly above the estimated \$637 billion issued in 2004. The forecasts ranged from \$563 billion to \$790 billion.

The HEL sector will continue to dominate the market in 2005, with issuance expected to decrease by only 0.5 percent, to \$400 billion, from the \$402 billion issued in 2004. The resilience of the sector could be tested as HEL interest rates rise, but home price appreciation during the last few years should be enough to support the sector. Based on the median forecast, securitization of credit card receivables will increase 15.4 percent in 2005, to \$60 billion, up from the estimated \$52 billion issued in 2004, and auto loan issuance will total \$80 billion in 2005, up from the estimated \$70 billion issued in 2004. New issue activity in the student loan sector is predicted to equal the \$45 billion issued in 2004.

CDO MARKET

Collateralized Debt Obligations (CDO) Volume Virtually Unchanged

CDO ISSUANCE	
\$ Billions	Projected 2005
Cash CDO	94
Synthetic CDO	22
Arbitrage CDO	97
Balance Sheet CDO	19
Total	116

CDO issuance is expected to be essentially unchanged in 2005, with the median projection at \$116 billion in 2005, and the individual forecasts ranging from \$90 billion to \$140 billion. However, the consensus view is that there will be some change in the relative volume among CDO structures in 2005. Based on the median forecast, cash and synthetic CDO issuance are expected to account for 81 percent and 19 percent in 2005, respectively. Compared to the available historical data from Thomson Financial for 2004, the panelists' 2005 forecasts suggest a movement from synthetic to cash issuance. Arbitrage CDO new issue activity is expected to be 83 percent of total issuance in 2005, a decline based on available historical data. The median forecast has the balance sheet CDOs at 17 percent of the total in 2005, an increase when compared to 2004 historical data. Finally, the survey results suggest varied and diverse underlying collateral asset classes supporting the CDO issuance.

MORTGAGE-RELATED MARKET

Mortgage-Related Securities Issuance Expected to Be Lower Due to Higher Mortgage Rates, Lower Refinancing Volumes

After two record breaking years, issuance in 2004 was affected by mortgage rate volatility and a decrease in mortgage originations, especially refinancing volume, a trend that is expected to continue in 2005. Survey participants expect the issuance of mortgage-related securities, which include agency and private-label pass-through and collateralized mortgage obligations (CMO), to decrease 26.4 percent in 2005, to \$1.19 trillion, from the \$1.61 trillion estimated issuance of 2004. The total mortgage-related issuance forecasts ranged from about \$1.1 to \$1.3 billion for the coming year. The survey's median forecast for agency MBS issuance is a 27.4 percent decrease, to \$645 billion in 2005. The median forecast has agency CMO decreasing by 24.7 percent, to \$250 billion and private-label pass-throughs decreasing 25.6 percent, to \$290 billion in 2005. Hybrid issuance growth may cushion the projected fixed-rate MBS decline.

According to the Mortgage Bankers Association, mortgage originations are projected to decrease to \$2.30 trillion in 2005, down from \$2.81 trillion in 2004. Most of the decrease in originations will be from refinancing activity, which will account for an estimated 34 percent of all originations in 2005, down from 44 percent in 2004.

Rate and Spread Outlook

Panelists expect the MBS market environment to be characterized by higher rates, a flatter yield curve and wider spreads. The AAA MBS option-adjusted spread relative to Treasuries is expected to widen by the middle of 2005 and continue widening during the second half of the year. Interest rates are projected to gradually increase throughout 2005, with the 30-year fixed mortgage rate expected to reach 6.0 percent by mid-year and 6.4 percent by the end of the year, based on the median forecast. Despite the expected increase in mortgage rates, housing starts and sales are anticipated to remain strong in 2005, according to The Bond Market Association's recent Economic Outlook report.

MORTGAGE-RELATED ISSUANCE

\$ Billions	Projected		% Change
	2004	2005	
Agency MBS	888	645	-27.4
Agency CMO	332	250	-24.7
Private-Label MBS	390	290	-25.6
Total	1610	1185	-26.4

Source: Thomson Financial

FIXED 30-YR MORTGAGE RATE

'04:Q4*	'05:Q1	'05:Q2	'05:Q3	'05:Q4
5.81	5.95	6.32	6.57	6.75

*Source: Bloomberg