Research

Bond Market Leaders See Continued Growth in Electronic Trading and a Short-term Economic Slowdown

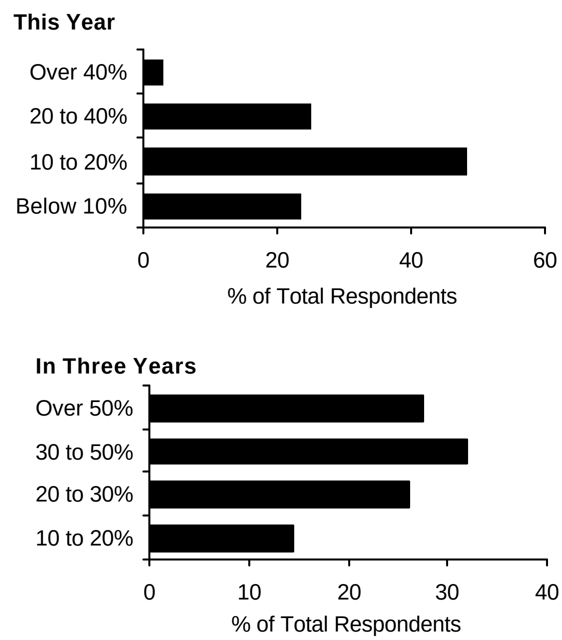
Bond market leaders anticipate a changing landscape for fixed income securities over the next three years, as respondents to The Bond Market Association's 2001 Personal Opinion Survey on the Outlook for the Fixed Income Markets predict brisk growth in electronic trading. Respondents also overwhelmingly believe in the resilience of the U.S. economy and foresee the economic slowdown will last only one year or less. Major factors identified as affecting the fixed income markets this year include the economic slowdown and the stock market slump. The majority of respondents believe that short-term interest rates will be lower in one year, but there was no consensus regarding the direction of future long-term rates with respondents equally divided as to whether long-term rates will be higher or lower one year from now. Respondents expect U.S. bond issuance across all sectors except for U.S. Treasuries to increase or remain the same, and similar expectations hold for Europe. Respondents expect European sovereign debt issuance to remain flat, but the majority of respondents expect increases in other European sectors. The vast majority of respondents believe that current consolidation trends will continue, citing diversification of earnings sources and combining origination and distribution strengths as the main factors fueling consolidation.

Survey respondents are fixed income leaders serving on The Bond Market Association's Board of Directors, the leadership of its governing committees, and attendees of the Association's 2001 annual meeting. The response rate was approximately 15 percent of those surveyed and is well distributed by size of firm, region, and markets of responsibility.

Technology Growth Predicted

Electronic trading is cited as an area expected to have a great effect on the U.S. fixed income markets especially over the next three years. Consistent growth is predicted in electronic trading across all markets, as nearly 60 percent of respondents believe electronic trading will account for over 30 percent of overall fixed income trading over the next three years. Twenty-eight percent of respondents believe over 50 percent of fixed income trading will be conducted electronically. Nearly half of the respondents agree that, for this year, electronic trading across all markets will be 10 to 20 percent of total trading.

Fixed-Income Trading Across All Markets Sectors Conducted Electronically



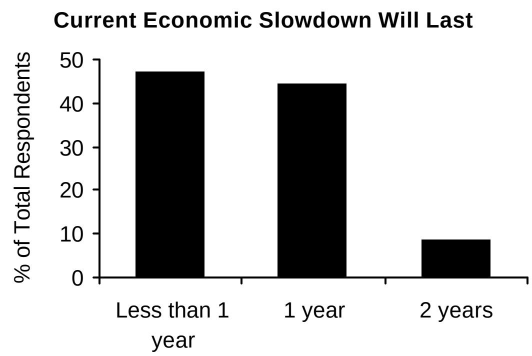
When broken down by market focus, the treasury market is the most enthusiastic about the adoption of electronic trading, with 44 percent expecting the percentage of trades executed electronically this year to be 20 percent or higher. Comparatively, the majority (62 percent) of municipal respondents believe the percentage of trades conducted electronically this year will be 10 to 20 percent.

Eighty-one percent of respondents expect direct issuance of fixed income securities electronically to total less than 25 percent in 2001. The majority of survey participants, especially those responsible for municipal markets, anticipate that retail participation in the bond markets will increase as a result of electronic trading capabilities. The growth in electronic trading capabilities corresponds with growth in the number of electronic trading systems. Currently, there are over 85 such systems identified in The Bond Market Association's Electronic Transaction Systems Survey. As a result of technology, 70 percent expect trading in the bond markets to become more centralized.

Besides electronic trading, another important factor affecting the fixed income markets is the public reporting of trade information. Sixty-nine percent of respondents believe that trade reporting will have a large effect on the U.S. debt markets in three years. By comparison, 74 percent believe the effect of electronic trading will be significant in three years. In contrast, in last year's survey, only 26 percent of respondents cited trade reporting as having a major impact over the next three years.

Economic Slowdown Predicted to Last One Year or Less

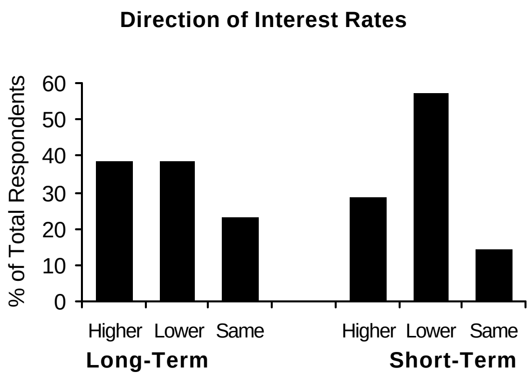
Respondents are overwhelmingly optimistic that the current economic slowdown will be short-lived, with 91 percent predicting a slow-down of one year or less. Nine percent believe the slowdown will last at least two years. However, the respondents believe the biggest effect on the U.S. fixed income markets for 2001 will be the economic slowdown and the stock market slump.



The weak short-term economic outlook does not dampen hopes that dealer profitability will be higher in 2001, with 46 percent expecting higher fixed-income profits. Thirty-nine percent of respondents believe that profitability will be lower than last year. In addition, 46 percent of respondents agree that the level of fixed income staffing will remain the same, while 32 percent think it will decrease and only 22 percent anticipate an increase.

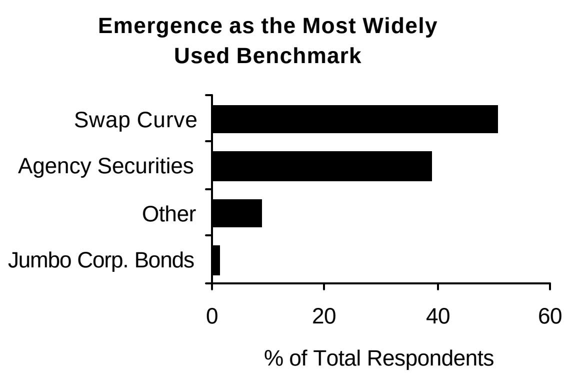
Short-Term Interest Rates Expected to Decline

Respondents are hopeful about the future of short-term interest rates, with nearly three-fifths of respondents believing that short-term interest rates will be lower in one year, while almost 30 percent believe short-term interest rates will rise. Respondents are equally divided on the prospect of long-term interest rates being higher or lower in a year, with nearly 39 percent each, whereas 22 percent expect long-term rates to remain at current levels.



U.S. Treasury Issuance Predicted to Fall

Seventy-two percent of respondents believe that U.S. Treasury issuance is expected to decline in 2001. The shrinking Treasury market is a significant issue fueling an ongoing debate over what will emerge as the most widely used alternative pricing benchmark. In last year's survey, 79 percent of respondents expected that agency benchmark securities would supplement U.S. Treasuries as benchmarks over the course of 2000, while only 39 percent of respondents this year expect that agency securities will emerge as the most widely used benchmark. Instead of agency securities, the swap curve has now emerged as the benchmark of choice with half of respondents expecting the swap curve to arise as the most widely used benchmark. Seven percent wrote in a response that the most widely used benchmark would remain treasuries.



In markets other than Treasuries, over half of respondents anticipate issuance increases in 2001, with the exception of the high-yield corporate market where respondents are decidedly mixed. Forty-four percent of respondents expect issuance in the high-yield corporate market to increase this year, whereas 35.5 percent predict a decrease.

European government issuance is expected to remain flat by the plurality of respondents (46 percent) while the remaining respondents are evenly divided in predicting an increase or a decrease. Over three-quarters of respondents predict an increase in investment-grade corporate issuance in the European market, while only 48 percent predict an increase in high-yield issuance and 31 percent expect a decline in high-yield issuance. Issuance across the other European markets (supranational, sub-sovereign, pfandbrief, and commercial paper) is not expected to decline compared with last year according to most respondents.

United States Cited as Providing Greatest Growth Opportunities

Nearly 40 percent of respondents believe that of all the global markets, the United States holds the greatest growth opportunities. Their positive attitude shows their belief in the resilience of the domestic economy. Thirty percent believe Europe holds the greatest growth potential and 23 percent believe Asia to show the strongest growth.

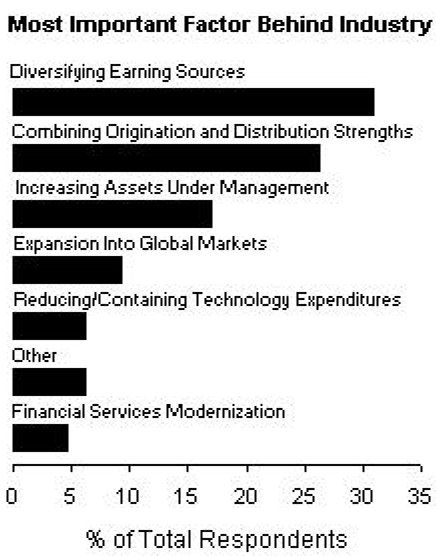
Respondents were asked, "What is the [single] most important issue Congress and the new administration should address?" A plurality of respondents, 46.4 percent, chose tax reduction. That was followed by education (23.2 percent), Social Security reform (11.6 percent), economic performance (7.2 percent), foreign policy and campaign finance reform (4.3 percent each), and medicare reform (2.9

percent). It is interesting to note that tax measures to utilize the municipal bond market to spur school construction--an important component of education reform--and housing are high on the Association's legislative agenda for 2001.

Consolidation Trend Expected to Continue

Virtually all respondents, 90 percent, anticipate industry consolidation to continue this year. However, 62 percent expect to neither acquire another firm nor be acquired. About one-third, the same percentage as last year's survey respondents, predict that they will acquire another firm, while 5 percent expect to be acquired, compared to last year's response of one-quarter.

Diversification of earning sources is considered by nearly one-third of the respondents as the most important factor driving the wave of industry consolidations. The opportunity to combine origination and distribution strengths is the most important consideration for 26 percent of respondents.



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