Research
U.S. Market Outlook

THE BOND MARKET ASSOCIATION

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The Bond Market Association is pleased to present the results of its annual bond issuance forecast for 2004 in the municipal, corporate and securitized markets. This expanded survey provides information on anticipated issuance volume, and for the first time, interest rates spreads. The forecast is based on a survey of the Association's members firms conducted in early December 2003.

Bond Issuance Will Slow as Rates Rise and Economy Grows; Issuance Increases in Selected Market Sectors

Market trends that began in the second half of the year are expected to continue into 2004—specifically, member firms expect rates to rise and the economic growth that began in earnest in the latter half of 2003 to gain strength. The stronger economy improves the credit outlook for issuers, and higher rates raise funding costs, which leads to a reassessment of capital raising strategies. The higher rate, faster growth environment has differential effects on the various bond market sectors.

FORECAST HIGHLIGHTS FROM THE SURVEY

1. General decline in issuance from record levels in 2002-2003—bond issuance for refinancing and refunding will show the sharpest drop; new capital issues will be less affected. The median total issuance forecast in the municipal, corporate, ABS and MBS markets for 2004 is $3.05 trillion compared to an estimated $4.96 trillion in 2003.
2. Housing finance secondary markets will show the sharpest drop after accounting for the largest share of issuance gains over the last few years.
3. Issuance is expected to increase in the high-yield corporate bond and some ABS sectors.
4. Within the anticipated rising rate environment, mortgage security and investment grade corporate bond spreads are expected to widen, while municipal and high-yield corporate spreads are expected to narrow.

MUNICIPAL MARKET

Municipal Issuance Volume to Recede from 2003 Record Based Largely on Rising Rate Expectations

The consensus forecast is that municipal issuance peaked in 2003 and will decline despite the continuing fiscal pressures at state and local governments. The median forecast projects total municipal issuance to decrease in 2004 to $401 billion, a decline of 11.3 percent from the full-year 2003 record estimated at $451 billion. The issuance volume will also be lower than the 2002 level, the previous record volume of $430 billion.

Both short-term and long-term issuance is expected to be lower in 2004. Based on the median forecast, long-term issuance is anticipated to decrease to $340 billion in 2004, down from the estimated $382 billion issued in 2003. The survey respondents' forecasts for 2004 long-term issuance range from $305 billion to $350 billion. Short-term note issuance is expected to be $61 billion with forecasts ranging from $49 billion to $70 million. The median forecast for short-term notes is about 11.6 percent less than the $69 billion issued in 2003.

The lower projected issuance volume in 2004 is largely based on an expected rise in overall interest rate levels during 2004. Municipal yields, however, are expected to rise at a slower rate than Treasury yields. As the economy continues to gain strength—presumably creating the potential for increased flow of tax revenue, it is expected that less municipal debt will be needed. Additionally, in a higher rate environment, there is more uncertainty whether new capital spending projects are feasible at least on the margin.

Higher rates also reduce the opportunity to refund higher cost debt with lower cost debt. The expectation of higher interest rates, especially in the latter part of the year and as an increase in target rates by the Federal Reserve becomes more imminent, will lead to a decrease in the demand

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MUNICIPAL ISSUANCE			
$ Billions	2003	Projected 2004	% Change
Short-Term	69	61	-11.6
Long-Term	382	340	-11.0
Total	451	401	-11.3

Source: Thomson Financial

10-YR MUNICIPAL G.O. AAA TO 10-YR TREASURY RATIO		
	2003*	2004
Ratio	85	82

* Source: Bloomberg

for refunding activity. Lower refunding issuance volume explains the decline in total municipal new issue activity in 2004. Another element incorporated into the 2004 issuance forecast is the likely absence of large tobacco and pension related deals seen in 2003. Issuance will also be restrained by political reluctance to expand deficit financing, according to survey participants.

Survey respondents highlighted risks to the issuance forecast. They note the possibility that interest rates, especially Treasury yields, will rise more than expected, and therefore have a more adverse affect on issuance volumes. The extent to which states are able to constrain spending is also an important variable that affects issuance volumes.

Municipal Bond Yield to Treasury Yield Relationship

While a modestly rising rate environment is anticipated in 2004 as the economic recovery gains strength, municipal yields are expected to rise less than Treasuries. The median forecast calls for the ratio of 10-year AAA general obligation municipal bond yields to 10-year Treasury yields to fall to 82 percent, a significant drop from the ratio in 2003 when the ratio averaged 90 percent for most of 2003 and in the mid 80 percent range as 2003 drew to a close.

ASSET-BACKED SECURITIES MARKET

Auto, CDO ABS Issuance Volumes to Rise, Home Equity Sector to Cool Off as Housing Finance Sector Expected to Slow from Record

ABS ISSUANCE			
$ Billions	2003	Projected 2004	% Change
Home Equity	233	175	-24.9
Credit Cards	66	70	6.1
Auto Loans	79	85	7.6
Manufactured Housing	1	1	0.0
Student Loans	39	40	2.6
CDO	67	75	11.9
Other	96	60	-37.5
Total	581	506	-12.9

Source: Thomson Financial, JP Morgan Securities

ASSET-BACKED SECURITIES SPREADS		
	2003*	2004
3-Yr AAA HEL	98	95
3-Yr AAA Credit Card	52	47
2-Yr AAA Auto Loan	38	51

* Source: JP Morgan

Based on the median forecast, ABS volume, including public issuance and private placements, is expected to decrease by 12.9 percent to $506 billion in 2004, down from the full-year 2003 preliminary issuance volume estimate of $581 billion. The individual responses of total ABS market projections range form $440 billion to $550 billion. The ABS market reached record issuance levels in 2003, as the historically low interest rate environment and strong primary market origination, especially in housing finance, led issuers to seek funding through securitization.

Non-real estate consumer loan originations should benefit from a growing economy and increased consumer spending. This suggests a potential for higher consumer-related ABS products such as credit card receivables and auto loan backed securities.

The survey respondents' median forecast has issuance of collateralized debt obligations (CDO) increasing 11.9 percent, to $75 billion in 2004, up from the $67 billion issued in 2003. Auto loan issuance is also expected to increase and total $85 billion in 2004, up 7.6 percent from the $79 billion issued in 2003. After a very strong year, issuance in the student loan sector is projected to be $40 billion in 2004, relatively unchanged from 2003.

The big winner in recent years has been the home equity loan (HEL) sector, benefiting from unprecedented origination growth in the primary market and the result of record home sales and price appreciation, low mortgage rates and product expansion. Rising interest rates in 2004 will reduce homeowner appetite for refinancing and slow the red-hot mortgage market of recent years. With the expectations that home sale volume will subside and mortgage rates will begin to climb, the HEL securities sector is projected to have the largest decrease in issuance volume within the ABS sector decreasing 24.9 percent to $175 billion in 2004, based on the median projection.

Spread Outlook

Yield spreads for 3-year credit cards and home equity loans are expected to finish 2004 slightly tighter than their 2003 year-end levels, while spreads of 2-year auto loans will widen by the end of 2004.

MORTGAGE-RELATED MARKET

Higher Mortgage Rates Expected to Slow Mortgage-Related Securities Issuance in 2004

Issuance of mortgage-related securities, which include agency and private-label pass-throughs and collateralized mortgage obligations (CMO), reached a record in 2003 as the historically low interest rate environment during the first half of 2003 contributed to record levels of refinancing and mortgage origination activity. Survey participants predict that issuance in the mortgage-related securities market will decrease, with the median forecast at $1.63 trillion in 2004, or 48.0 percent lower than the $3.14 trillion in 2003. The individual forecasts range from $1.29 trillion to $ 1.74 trillion.

The median forecast has agency MBS issuance decreasing by 47.8 percent, to $1.06 trillion in 2004, down from the $2.03 trillion in 2003. The survey's median forecast has agency CMO issuance decreasing 45.9 percent to $316 billion and private-label pass-throughs decreasing 51.3 percent to $256 billion in 2004.

MORTGAGE-RELATED ISSUANCE

$ Billions	2003*	Projected 2004	% Change
Agency MBS	2034	1063	-47.8
Agency CMO	585	316	-45.9
Private-Label MBS	525	256	-51.3
Total	3144	1635	-48.0

* As of December 15, 2003
Source: Thomson Financial

Spreads and Interest Rate Outlook

Expected higher rates will particularly affect refinancing activity and, to some extent, purchase mortgage originations as well. According to the Mortgage Bankers Association, mortgage originations are projected to decrease to $1.65 trillion in 2004, down from $3.36 trillion in 2003.

Mortgage rates are the most important factor driving issuance volume. The fixed 30-year mortgage rate is expected to gradually increase in 2004 from its historical lows in mid-2003 and reach 6.32 percent by the end of the second quarter and 6.75 percent by the end of 2004, based on the median projection. The 30-year mortgage rate stood at 5.81 percent in December 2003. Most participants expect a steep yield curve in the first half of 2004, but flattening in the second half as short-term interest rates continue to rise, which could cut into ARM as well as fixed-rate production. Most participants expect MBS option adjusted spreads to Treasuries to widen by the end of 2004.

FIXED 30-YR MORTGAGE RATE

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

* Source: Bloomberg

CORPORATE BOND MARKET

Overall Corporate Bond Issuance Volume to Decrease Modestly in a Rising Rate Environment; High Yield Issuance to Rise Moderately in '04

As a result of an expected rise in interest rates, especially during the latter part of 2004, corporate bond issuance is projected to decrease 31.1 percent in 2004, based on the median forecast. Issuers took advantage of the low-interest-rate environment to issue new debt or refinance existing debt during 2003. By contrast, in 2004, issuance is expected to slow as rates rise, internal cash flows improve and there is increased access to other corporate funding sources.

The median forecast for investment-grade corporate bond issuance is a 39.3 percent decrease from the $375 billion issued in 2003. High-yield issuance is expected to rise to $125 billion in 2004, up 2.5 percent from the $122 billion issued in 2003, according to the median forecast. The median forecast for issuance in convertible bonds is expected to slip to $60 billion, down from $73 billion in 2003.

The corporate bond issuance forecast is driven by the broader underlying financial market and economic assumptions. The survey participants anticipate interest rates to remain steady around the current level at least through the first quarter of 2004 with rates rising later in the year as a by-product of economic and employment growth, as well as increased issuance in the Treasury market. These elements are also expected to lead the Federal Reserve Board to increase target Federal Funds rates in the second half of 2004. Higher rates affect corporate cost of funds and reduce the benefit of restructuring existing debt.

CORPORATE ISSUANCE

$ Billions	2003	Projected 2004	% Change
Investment-Grade	618	375	-39.3
High-Yield	122	125	2.5
Convertible	73	60	-17.8
Total	813	560	-31.1

Source: Thomson Financial

10-YR CORPORATE INDUSTRIAL YIELD SPREADS

	2003*	2004
AAA	32	55
BBB	119	120

* Source: Bloomberg

Survey participants took into account various risks and assumptions in their forecasts, arguably the most significant of which is any adverse change in the global political situation, including possible future terrorist attacks.

Spread Outlook

While rates generally are expected to rise, survey participants are anticipating investment-grade corporate bond spreads to remain relatively tight in 2004 after the dramatic tightening of 2003. The tight corporate bond spreads at the end of 2003 may already reflect expectations of stronger growth and higher profits for 2004. The 10-year AAA Industrial yield spread is expected to be 55 basis points at the end of 2004, compared to 32 basis points at the end of December 2003. The median forecast is for a 10-Year BBB Industrial yield of 120 basis points at the end of 2004, relatively unchanged from the 119 basis points as of December 2003. After the dramatic high-yield sector tightening in 2003, the median forecast calls for high-yield corporate bond spread to remain in a similar range in 2004.

COMMERCIAL PAPER MARKET

Commercial Paper Outstanding Expected to Rise in 2004

COMMERCIAL PAPER OUTSTANDING

$ Billions	2003	Projected 2004	% Change
Asset-Backed CP	717	760	6.0
Non-Asset Backed CP	471	500	6.2
Nonfinancial CP	101	170	68.3
Total	1289	1430	10.9

Source: Federal Reserve System

Commercial paper (CP) outstanding is expected to rise in 2004. The 2004 increase is likely to be driven by GDP growth, the expected rise of interest rates and increased mergers and acquisitions activity. The median forecast is for aggregate CP outstanding to reach $1.43 trillion in 2004—an increase of 10.9 percent from 2003. The biggest increase is expected to come from the non-financial company sector, as companies take advantage of improvements in credit quality. The median estimate has non-financial CP outstanding increasing by 68.3 percent to $170 billion outstanding during 2004.

Increases are expected across the various CP product market segments. Asset-backed CP of financial companies is expected to increase 6.0 percent to $760 billion in 2004, up from $717 billion in 2003, based on the median survey response. Unsecured (that is, non-asset-backed) commercial paper of financial companies is expected to rise 6.2 percent to $500 billion in 2004, according to the median survey response. The median survey response is for total CP outstanding rated higher than A2/P2 investment-grade paper to increase 11.1 percent to $1.38 trillion, and A2/P2 or lower investment-grade paper to rise 13.4 percent to $72 billion, versus $64 billion outstanding at the end of 2003. Total Euro CP outstanding is expected to be $500 billion.

Rate Forecast

The CP forecasts in the survey were driven by a number of key assumptions. The median survey response projects GDP to grow 4.4 percent in the first two quarters of 2004 and 3.7 percent in the latter two quarters of 2004. Survey respondents expect fast economic growth to be accompanied by rising interest rates. With respect to the interest rate environment, the yield curve is expected to steepen in the first part of 2004, with the Federal Reserve's target Federal Funds rate increasing from the current 1.0 percent to 1.5 in the third quarter of next year. The survey respondents' anticipated changes in the rate environment are expected to make shorter term CP-type financing more attractive in the coming year.

Merger and acquisition activity and new tax laws should positively affect CP market growth, according to the survey. Despite the anticipated economic growth-driven interest rate movement, the improving economy and higher valuations in the equity markets will lead to increased merger and acquisition activity as firms seek to capitalize on improving financial conditions. In addition, respondents view possible tax policy changes in 2004 as potentially having a favorable effect on the CP market. Changes to accounting policy standards with respect to financial statement consolidation of variable interest entities— specifically, the adoption and implementation of FIN 46-R— could have a negative impact on the 2004 CP market, particularly for asset-backed CP.