**Box 3**

**RECENT INCREASE IN CORPORATE BOND SPREADS**

After reaching very low levels by historical standards in early 2005, corporate bond spreads across the globe have increased sharply over the past few months. Thus, by late May, BBB corporate bond spreads in the euro area stood at levels not observed since mid-2003. This box discusses the factors behind this development.

The importance of the corporate bond market as a source of finance for firms in the euro area is growing, although it still has a limited weight as compared with loans and the issuance of shares. Nevertheless, close monitoring of this segment is warranted from a monetary policy perspective. First, inasmuch as corporate bond spreads give an indication of how the market
assesses the credit risk premium faced by corporations when raising external funding, they can provide some insight into future growth prospects for the economy and on the balance sheet situation and soundness of the corporate sector. Second, it is possible to gauge changes in market sentiment from the developments in BBB spreads. For instance, periods of financial turmoil usually coincide with higher corporate bond spreads, triggered by portfolio shifts away from risky assets to safer and less volatile instruments. For these reasons, it is important to cross-check developments in corporate bond markets with other sources that may provide information on the background to changes in corporate bond spreads.

Focusing on the euro area, the difference between the yields on BBB corporate bonds and those on comparable risk-free government bonds more than doubled between the beginning of March 2005 and late May (see Chart), following several years of declining spreads. The strong upturn over recent months may have originated from several different factors, of which changing fundamentals, firm-specific news and factors related to market dynamics can probably be deemed the most important.

First, at the macro level, there has been an increase in the rate of growth of debt in the course of 2005, indicating that the improvements in corporate balance sheets in the euro area observed over the past few years may have come to a halt (see also Section 2.6). In addition, while earnings growth has so far been very robust, data on analysts’ twelve-month-ahead earnings growth expectations for euro area corporations have followed a downward trend since early 2004 (see Chart 23). This may indicate that earnings growth among euro area corporations, while expected to remain relatively strong, has reached its peak. At the same time, implied stock market volatility – an indicator which is in theory closely related to corporate bond spreads – increased concurrently with the upturn in the BBB spreads in April, but subsequently returned to very low levels by historical standards.

Second, at the micro level, the increase in euro area corporate bond spreads seems to have been triggered by concerns about the credit quality of certain firms. In this respect, market reactions to General Motors’ profit warning announcement in March 2005 triggered the rebound in corporate bond spreads. Standard & Poor’s subsequent decision to downgrade General Motors’ bonds to “junk” status on 5 May fuelled a further increase in the spreads. In addition, a

1 The rise in corporate bond spreads in recent months has not been isolated to the BBB-rated segment (although in terms of percentage changes it showed the largest increase). In particular in the high yield segment (i.e. the bonds with the lowest credit rating) corporate bond spreads have also increased considerably since mid-March 2005.

2 For a more detailed explanation on the linkage between corporate bond spreads and implied stock market volatility, see the box entitled “Determinants of the fall of corporate bond spreads in recent years” in the January 2005 issue of the Monthly Bulletin.
significant widening of the spreads on bonds issued by a Danish company specialising in industrial cleaning, ISS, has also contributed to the increase in the average spreads of the bonds included in the BBB index. All in all, from the beginning of March to end-May more than one-third of the overall increase in the euro-denominated BBB corporate bond index was due to the combined effect of these two companies. The large drop in the BBB spreads on 31 May can largely be explained by the exclusion of General Motors and ISS from the overall index (see Chart). Overall, between the end of February and 1 June BBB corporate bond spreads increased by 33 basis points, a level which was relatively low by historical standards.

Third, it cannot be ruled out that the recent increase in corporate bond spreads may also partly represent a normalisation of the pricing of corporate default risk. Over the past couple of years investors may, in their “search for yield” in a low interest rate environment, have driven up corporate bond prices to a level above sustainable values. An unwinding of some of those positions may have contributed to the recent upturn in corporate bond spreads. Market factors in a phase of re-adjustment may have amplified movements. However, it is worth stressing that the corporate segment of the bond market is very volatile and that short-term movements in prices should therefore be treated with some caution.

3 See Box 9 entitled “Corporate bond spreads and default expectations in the euro area” in the June 2005 issue of the ECB’s Financial Stability Review and Section 2.6 of the March 2005 issue of the Monthly Bulletin.