

Box 4

THE OUTLOOK FOR CORPORATE CREDIT SPREADS IN THE EURO AREA

Credit spreads are a measure of the risk premium corporations pay investors to compensate them for a number of risks associated with corporate debt. Default risk, which materialises when issuers are unable to make interest and principal payments on time, features prominently among these risks. The ability of corporations to honour their obligations hinges essentially on their net worth and earnings prospects, which are affected by the current stage of the business cycle and by investors' expectations about the future strength of the economy. Information derived from credit spreads may therefore contribute to an understanding of the view of the market regarding the economic situation of firms. At the same time, several financial factors contribute to the level of credit risk, as signalled by credit spreads.

In particular, firms with greater asset volatility are more likely to default. Bond investors will then require additional compensation in the form of a larger yield spread over the risk-free rate. Thus, a strong and positive relationship between credit spreads and implied stock market volatility should be expected. Spreads of BBB-rated corporate bond yields over comparable

government bond yields and the implied volatility extracted from the EURO STOXX 50 index seem to share common trends (see Chart A). When implied volatility decreases, credit spreads narrow, and vice versa.¹

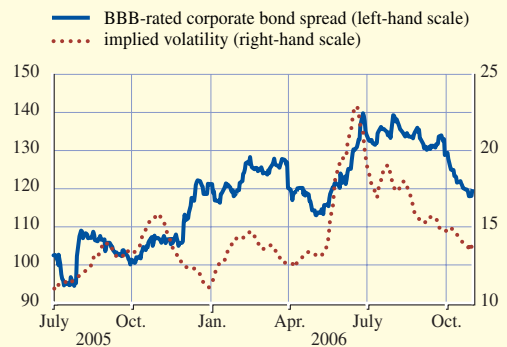
In May 2006 there was a reversal in investors' appetite for risk and, as implied equity market volatility increased markedly, corporate debt markets became the most vulnerable to a repricing of risk. The widening of spreads was significant for corporate bonds and credit default swaps. However, after end-June, credit spreads started to narrow again and, in tandem, stock market volatility dropped significantly.

Another factor that provides support for tighter credit spreads is the strong earnings growth which has seen profitability rising to repeated highs across all major markets. Indeed, September data suggest annual growth of around 10% in earnings per share for companies on the Dow Jones EURO STOXX index over the next 12 months. This, together with low levels of stock market volatility, can be seen as the main factor currently causing credit spreads to remain at relatively subdued levels. Developments in expected default frequencies² suggest that the credit outlook remains favourable, although those for less creditworthy firms (as indicated by the probability of default of the 75th percentile) have picked up slightly over the last four months (see Chart B).

1 See also Box 2, entitled "Determinants of the fall of corporate bond spreads in recent years", in the January 2005 issue of the Monthly Bulletin.
 2 Expected default frequencies are defined as the conditional probability that a firm will default within a given time horizon (typically one year) by failing to make an interest or principal payment on its outstanding debt.

Chart A Corporate bond spreads and implied stock market volatility

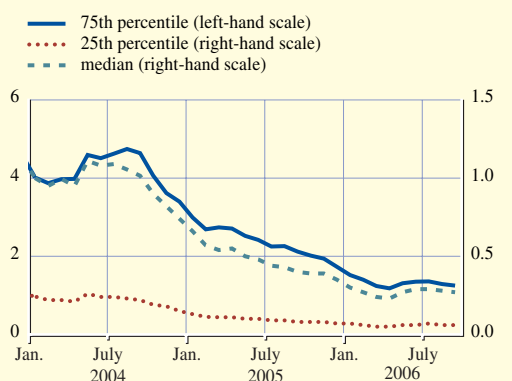
(credit spreads in basis points and implied volatility in percentages)



Sources: Thomson Financial Datastream and ECB calculations.

Chart B Expected default frequency of non-financial corporations in the euro area

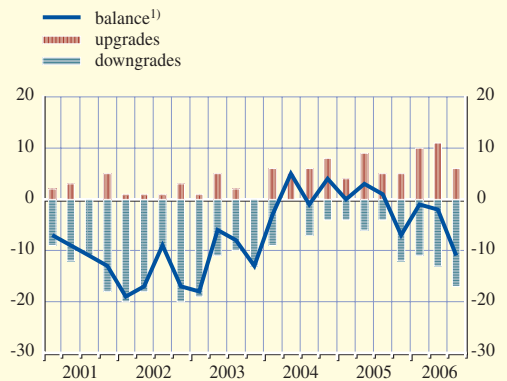
(percentage probability of defaulting within the next 12 months)



Source: Moody's KMV.

Chart C Non-financial sector rating changes

(number of up- and downgrades)



Source: Moody's Credit Trends.
 1) Balance refers to the difference between upgrades and downgrades of credit ratings.

However, despite the relatively benign performance over the past three months and the low level of spreads, the general corporate and credit market environment could point to a slight deterioration of the situation. The balance between upgrades and downgrades of credit ratings of non-financial corporations has been negative in the last four quarters, thereby reversing the upward trend observed until the third quarter of 2005 (see Chart C). The possibility cannot be ruled out that credit quality may be deteriorating somewhat in the wake of the increasing number of debt-financed merger and acquisition activities and leveraged buyouts, share buybacks and special dividend payouts, which often have an adverse effect on the leveraging positions of the firms involved. Increasing leverage by corporations is also evident in the rise in demand for loans by non-financial corporations recorded over the past few quarters, as also revealed by the October 2006 bank lending survey.

Overall, the low level of implied stock market volatility, together with a continuation of strong profitability, provides evidence that credit spreads could remain at low levels in the near future. Even though the outlook for corporate credit quality remains benign, there are some indications that, over time, some adjustment may occur as a result of increased indebtedness.