TRENDS

IN FINANCIAL MANAGEMENT

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Bonding with Buyers

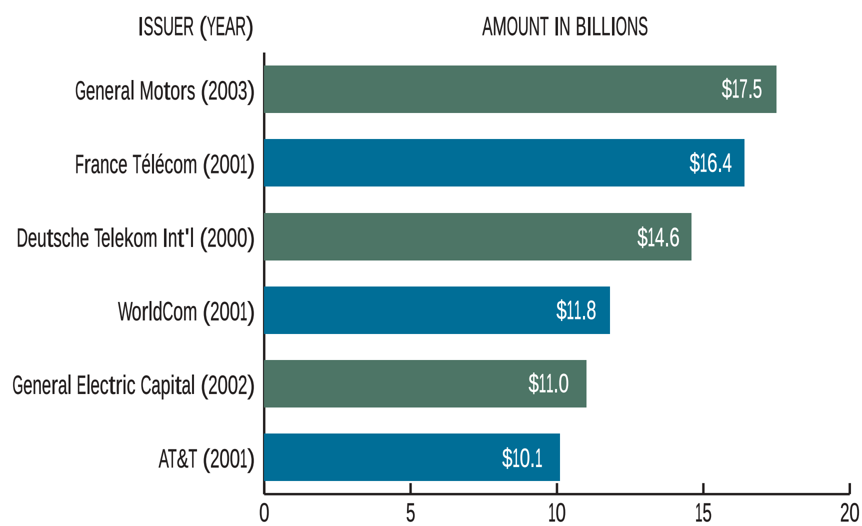
➤ **FOR MANY COMPANIES THAT** want cash, it's the best of times. Corporate bonds are popular with investors, and, thanks to a weak economy and easing of monetary policy, interest rates are very low.

The Federal Reserve Board reduced the federal funds rate target by 25 basis points to 1% on June 25, 2003, the first rate reduction since last November, the 13th cut since mid-2000, and the lowest rate since 1958. The federal funds rate is what banks charge each other for overnight funds, which is the most sensitive indicator of the direction of interest rates. Suggesting that it will maintain a stimulatory monetary policy for the foreseeable future, the Fed indicated in a statement that the federal funds rate would remain at 1% for a long time and intimated another cut would come if the economy doesn't "exhibit sustainable growth" or inflation fell further.

The attraction of bonds for corporate issuers is twofold: Rates are low, and investors are eager. The Fed's statement gave comfort to bond investors because bond prices rise when interest rates fall.

The day after the Fed's rate cut, General Motors sold a multipart debt issue worth $17.5 billion, one of the largest corporate debt packages on record and the largest by a U.S. company, according to Thomson Financial. GM paid lower rates and raised more money than planned, offering four points more than comparable Treasuries were yielding. Because of the demand, it also increased the size of the offering by about $4.5 billion.

LARGEST DEBT OFFERINGS



Source: Thomson Financial

The yield on GM's 10-year notes was 7.22%, 3.75 percentage points above the yield on the 10-year Treasury note. Convertibles, which are preferred shares or bonds convertible to common shares, are also selling well. The $4 billion convertible bond included in the GM package helped make the second quarter the biggest ever for convertibles.

At the close of the second quarter, corporate bonds returned a total of 6.14% and high-yield (junk), 10.0%, compared to the 10-year Treasury note at 4.6%, according to Lehman Brothers. For year-to-date total returns as of July 14, 2003, corporate bonds with 10+ year maturities returned 8.71% and junk, 17.94%, according to Merrill Lynch. Year-to-date, long-term Treasuries returned 4.55%, according to Lehman Brothers. Investment-grade bond mutual funds attracted $21.97 billion in net funds in the second quarter through June 19, and junk-bond mutual funds attracted $20.9 billion in net new money through June 25, more than three times the total that was gathered during the same period in 2002, according to AMG Data Services.

Also, there were fewer corporate defaults and a reduction in the rate of corporate credit downgrades. The number of downgrades fell to 74% of total global ratings changes in the second quarter from 82% in the first quarter, according to Standard & Poor's Corp. The all-time high was downgrades of 88% of all global ratings changes in the fourth quarter of 2001 by Standard & Poor's credit ratings.

Of GM's total sale of $17.5 billion in bonds, $13.1 billion is earmarked for reducing a deficit of more than $19.3 billion in the company's pension and benefit plans. GM is betting that borrowing at today's low rates and investing the money in its underfunded pension trusts will improve earnings per share and cash flow. No company has a pension funding problem that's GM's size. But many face a similar combination of big pension burdens and a depressed share price. The companies in the Standard & Poor's 500 stock Index have combined underfunded pensions totaling about $226 billion. Issuing low-cost debt may be a sensible way to help fund those liabilities.

The next meeting of the Federal Reserve's Federal Open Market Committee, which sets the federal funds rate, is August 12.

Credit Data Bank*

➤ **PROCEEDS FROM U.S. INVEST**ment-grade and high-yield corporate debt in the first half of 2003 jumped 19% over the first half of last year. What pushed that combined total up was a 68% jump in proceeds from high-yield (junk) bonds. U.S. investment-grade corporate debt remained on track during the first half of 2003 with proceeds of $351.4 billion, up slightly from $349.9 billion in the first six months of 2002. High-yield corporate debt climbed to $65.6 billion compared to $39 billion in the first half of 2002.

In the second quarter, corporations raised about $262 billion in debt and convertible securities in the U.S., up from $229 billion during the first quarter and $208 billion during the second quarter of last year. Convertible bonds sold briskly due in part to demand by hedge fund managers.

Issuance of global high-yield corporate debt in the first half of 2003 climbed by better than 69% from the dollar volume completed in the first half of 2002. Issuance in the second quarter of 2003 climbed to $70.1 billion, the most active period since the second quarter of 1998 when global junk bond issuance reached $53.8 billion.

While corporate borrowing in the capital markets was booming in the first half of 2003, commercial bank lending activity headed lower. One factor influencing the drop in syndicated loans was that many creditors were extending capital to only the most highly qualified companies. Past active borrowers such as telecommunication and media concerns were left waiting on the sidelines.

Another factor is the continuing fall in merger-and-acquisition activity. Based on current trends, 2003 is expected to see a third straight year in declining worldwide merger volume. As fewer deals are announced, fewer financing loans are needed. Finally, the heightened degree of investigations and oversight into the financial markets has impacted lending practices.

During the first six months of 2003, global syndicated lending activity fell to $930.5 billion from more than $952.3 billion in the year-earlier period. U.S. syndicated lending activity dropped 16.5% in the first half of 2003 to $498.1 billion from $596.3 billion a year ago. ■

* Source: Thomson Financial