CREDIT COMMENTS

RISING INTEREST RATES CHALLENGE FINANCIAL MARKETS

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Rising interest rates in the U.S. have sent both the corporate and municipal bond markets downward, with the municipal market experiencing its worst sell-off in more than seven years following the Federal Reserve's March 22 decision to hike rates by 25 basis points. International markets, particularly in emerging countries, also have been affected by the sharp increase in interest rates. For example, on April 3, the Mexican stock market experienced a 6% decline, its second largest of the year.

S&P chief economist David Blitzer believes that short-term interest rates will climb through 1994 as the Federal Reserve continues to tighten. Mr. Blitzer expects there will be occasional periods of turmoil in the stock and bond markets; however, he is convinced that both markets will adjust fairly well to an environment of rising interest rates.

Their performance last week seemed to bear him out, as both markets recovered after declining sharply on Monday. Bond markets, in particular, have less to fear from the Fed's policy than is generally believed. Mr. Blitzer does not expect long-term bond yields to exceed 8%, with the peak likely to come some time in the second half of 1995 when a slowing economy will likely encourage the central bank to ease up.

In the interim, both issuers and investors are having a tough time adjusting to higher interest rates.

INTERNATIONAL INVESTORS' RESPONSE

The response among international borrowers and their investment advisors has been either to postpone their new issues until the markets settle down and conditions improve or to access the floating-rate sector. According to Hendrik Kranenburg, executive managing director of S&P's International Finance Dept., the total volume of new Eurobond issuance in the first quarter was not substantially lower this year compared with last, despite rising interest rates. However, almost a third of the new issues thus far this year are floating-rate notes (FRNs), compared with 14% for all of last year. FRNs provide both issuers and investors a mechanism for hedging against further interest-rate volatility.

On the other hand, for emerging markets—particularly Latin America—the recent turbulence associated with rising U.S. interest rates has exacerbated an already difficult situation. After a strong performance in 1993, emerging debt markets are slumping. The Solomon Brothers' Brady bond index, which tracks the restructured debt of countries such as Argentina, Mexico, and Venezuela, declined 20% in the first quarter after it rose 44% in 1993. In addition, yield spreads of Latin American bonds over U.S. Treasuries have widened substantially.

Consequently, some Latin American borrowers who were ready to go to market have postponed doing so. In some cases, political instability and slow economic growth have contributed to the market's volatility, though rising U.S. interest rates have clearly been the primary catalyst.

However, the situation should stabilize in the near term, according to David Beers, director of S&P's sovereign ratings group. In particular, Mexico, which is seen by investors as the benchmark for the rest of Latin America, is likely to continue to make progress reforming its economy. Mr. Beers noted that the United Mexican States' rating ('BB+' foreign currency debt, positive outlook) was affirmed following the recent assassination of Luis Colosio, the presidential candidate of the ruling party, in part because the government's financial position is strong enough to withstand financial market instability. In addition, Brazil is close to signing a Brady deal to restructure its debt, which should bolster investor confidence in the region.

MUNICIPAL MARKET IMPACT

In the municipal market, the average yield of G.O. bonds went above 6% at the end of March for the first time in 14 months, up from 5.2% last October. In response to the spike in interest rates, municipal bond prices have dropped, some as much as 17 points, since the Fed began nudging up rates early this year.

Some market participants have suggested that the decline has been accelerated by municipal securities' increasing use of derivatives. While growing, derivatives still constitute a small percentage of the entire municipal market, according to Gail Fleischman, a director in S&P's municipal structured group, particularly when compared with the corporate debt market. According to Parry Young, a director in S&P's municipal structured group, S&P rated a little more than $4 billion in municipal derivatives last year out of a total of $290 billion of rated municipal debt. The impact of derivatives is probably more indirect in that the market may seem to be moving downward quicker and further than it actually is because ▶

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derivative bonds fall faster than regular bonds when short-term interest rates rise, according to Ms. Fleischman.

The slump in the tax-exempt market has affected individual investors the most. They own more than 75% of all municipal bonds, a sizable portion through mutual funds, according to Sandy Bragg, head of S&P's Managed Funds Group. During the first quarter of 1994, tax-exempt funds had their poorest performance since 1981, declining 5%, while taxable funds experienced their worst decline since 1987, down 3% on a total return basis, notes Mr. Bragg.

The municipal market's troubles have, in turn, spurred investors to pull out of municipal bond funds—more than $500 million was taken out during the last week of March alone. The influx of money from bond funds was critical to the run-up of the market; by pulling out in such large numbers, investors clearly have exacerbated the market's decline.

Municipal bond funds were particularly hard hit in the first quarter, according to Mr. Bragg. This occurred, in large part, because these funds have longer durations than equivalent taxable funds and the municipal market is not as liquid as the corporate debt market.

Long-term municipal funds had average durations of 8.3 years, compared with 6.8 years for long-term government funds. A fund with a duration of 8 years will experience an 8% decline during a 1% increase in interest rates, with all else being equal, says Mr. Bragg.

RATED BOND FUND PERFORMANCE

While the financial markets' severe reaction to the Federal Reserve's latest move has thrown many investors into uncharted waters, S&P-rated bond funds responded as expected during the run-up of interest rates, according to Mr. Bragg. Funds rated 'aaa' and 'aa+' experienced the lowest volatility, declining 0.2% compared with the 3% decline of the market overall. Funds rated 'aa' and 'aa-' declined 2.3%, while funds rated 'a' and 'a+' performed the same as the market.

On the other hand, high-yield bond funds, although extremely volatile during deteriorating economic conditions, are less sensitive to interest-rate rises than other bond funds when the economy is improving. This was made evident during the first quarter, as they declined by only 1%.

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