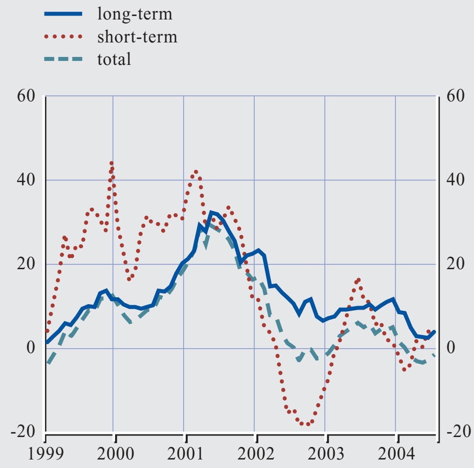
Box 5 Hunt for yield and corporate bond issuance

Issuance of bonds by euro area corporations tapered off, on aggregate, after mid-2001 (see Chart B5.1). This pattern was common across the credit quality spectrum (see Chart B5.2). Notably, even after late 2002, when corporate bond spreads began to respond to the efforts made by corporations to repair their balance sheets, issuance activity only picked up mildly. However, differences in the issuing patterns of firms with high and low credit ratings became apparent after mid-2003. In particular, while the issuance activity of firms with investment-grade ratings increased somewhat, signs began to emerge that the issuance of bonds by firms with sub-investment-grade ratings – debt securities that are sometimes termed "junk bonds" – was increasing significantly. Issuance of these bonds in the second quarter of 2004 surpassed the levels that were seen at the zenith of the boom in euro area corporate bond markets in 2000.

The fact that issuers with low and sub-investment-grade ratings have been accumulating additional debt does not necessarily raise financial stability concerns. Default rates in this corporate bond market sub-segment declined significantly after mid-2003 (see Chart B5.3). Indications of easier access to finance by sub-investment-grade issuers may simply reflect a broadening of euro

Chart B5.1 Annual growth in debt securities issued by euro area non-financial corporations

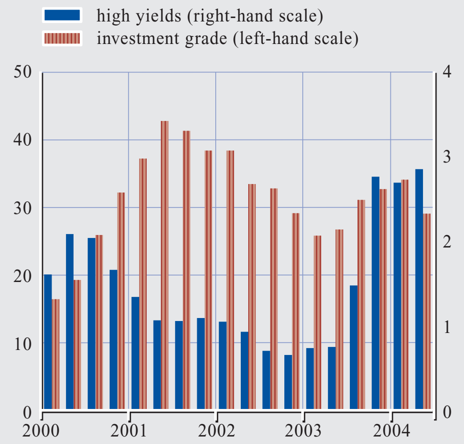
(% change)



Source: ECB.

Chart B5.2 Euro area bond issuance by non-financial corporatings by ratings

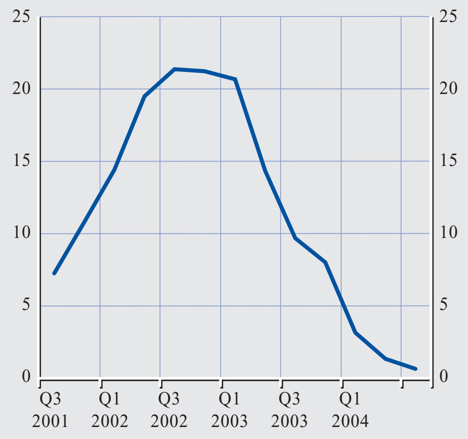
(EUR billions, four-quarter moving average)



Source: Thomsom Financial Deals.
Note: Investment grade covers the ratings between AAA and BBB-. High yield refers to sub-investment grade ratings.

Chart B5.3 Western European speculative-grade default rates

(12-month moving average)



Source: Moody's.
Note: Data are issuer weighted.

area capital markets, facilitating the financing of high risk but potentially highly profitable projects that might not otherwise have been undertaken. It might also reflect that firms which found it more difficult to restructure their balance sheets on account of inadequate profits and cash flow continued to have greater financing needs. However, the fact that this issuance activity took place at a time when high yield corporate bond spreads have been unusually narrow and when issuance by higher quality issuers was subdued raises questions about the extent to which a "hunt for yield" among investors may have made investors less discriminating. To the extent that this has been the case and has raised the leverage of issuers that were already heavily indebted, this may have sown the seeds of balance sheet vulnerabilities for the next cycle.