

BIANCO RESEARCH, L.L.C.

AN ARBOR RESEARCH & TRADING, INC. AFFILIATE
1000 HART ROAD • SUITE 250 • BARRINGTON, ILLINOIS 60010
E-MAIL: jbianco@biancoresearch.com • WEB SITE: www.BiancoResearch.com
TOLL FREE 800-876-1825 • PHONE 847-304-1511 • FAX 847-304-1749

James A. Bianco, CMT

Volume, 4 No. 16

Last Market Facts: August 23, 1999

MARKET FACTS

A Historical Look At The Markets
September 21, 1999

Corporate Supply – The Big Lie!

Heavy Calendar Looms for Corporate Market . . . participants said an anticipated calendar of heavy new supply over the next month could limit how far secondary spreads will move. --Wall Street Journal, 8/25/99

All year, participants in the bond market have fretted and worried about issuance of new bonds. Every time bond prices sink, they instinctively blame dealer hedging of coming supply. This idea of heavy supply sinking the bond market reached it zenith late last month, when stories suggested that as much as \$60 billion of new corporate supply would come to market over the next month.

With this month about over, we find that exactly the opposite has occurred -- corporate issuance has totaled about \$25 billion. See Chart 1. Not only is this less than half of what was projected, but September is shaping up as the lightest month of the year!

Price Drives Supply

As of June 30, 1999 total "private" (non-governmental) credit market debt totaled \$15.69 trillion. (See chart FoF-6 in the flow-of-funds chart section of our website) So far total corporate supply this year has totaled about \$485 billion. This is only 3% of the amount outstanding (and much smaller if netted against maturing debt). So, the total amount of supply in relation to the amount outstanding is very small.

This makes the supply situation in bonds very similar to the supply situation in the gold market. The amount of new supply every year in the gold market is also a tiny fraction of the amount outstanding. Participants in the gold market have come to understand that new supply is only a minor factor in moving gold prices. The main factor that drives gold prices is demand – how badly do people want to own gold?

Likewise, we believe that demand is the main issue in moving both spreads and bond prices. How badly do people want to own fixed-income instruments?

In other words, it is not corporate supply that drives corporate spreads. When corporate treasurers believe interest rates are low, they borrow. When they think they are high, they don't. Since every corporation has different funding requirements, we would expect them to have different opinions about the right time to borrow. In general, however, we would expect less activity at extremely wide spreads and more activity at extremely narrow spreads.

Chart 2 illustrates our point. It shows that supply and spreads have exhibited little or no correlation to each other. Supply has a tendency to disappear when spreads are very wide (see last fall) and increase when spreads are very narrow (see last May). What drives these spreads? Demand for spread product!

Finally, Chart 3 shows that corporate supply is running at much lower levels this year relative to last year. While agency supply is higher, total supply is about the same. Even though the amount of supply this year is similar to last year, the story in the marketplace was again demand – or a lack of demand. No one wanted to own spread product last fall.

Conclusion

First, *Wall Street* does a lousy job at predicting supply.

Second, supply doesn't drive spreads, demand for spread product does. Within this context, a major influence on the demand for spread products is one's forecast of the movement and direction of interest rates (see our 9/2/99 *Commentary*).

Finally, it appears that the supply story has turned into the "big lie" in the bond market. It not as heavy as many claim and it is not as influential in setting prices as many believe.

Chart 1

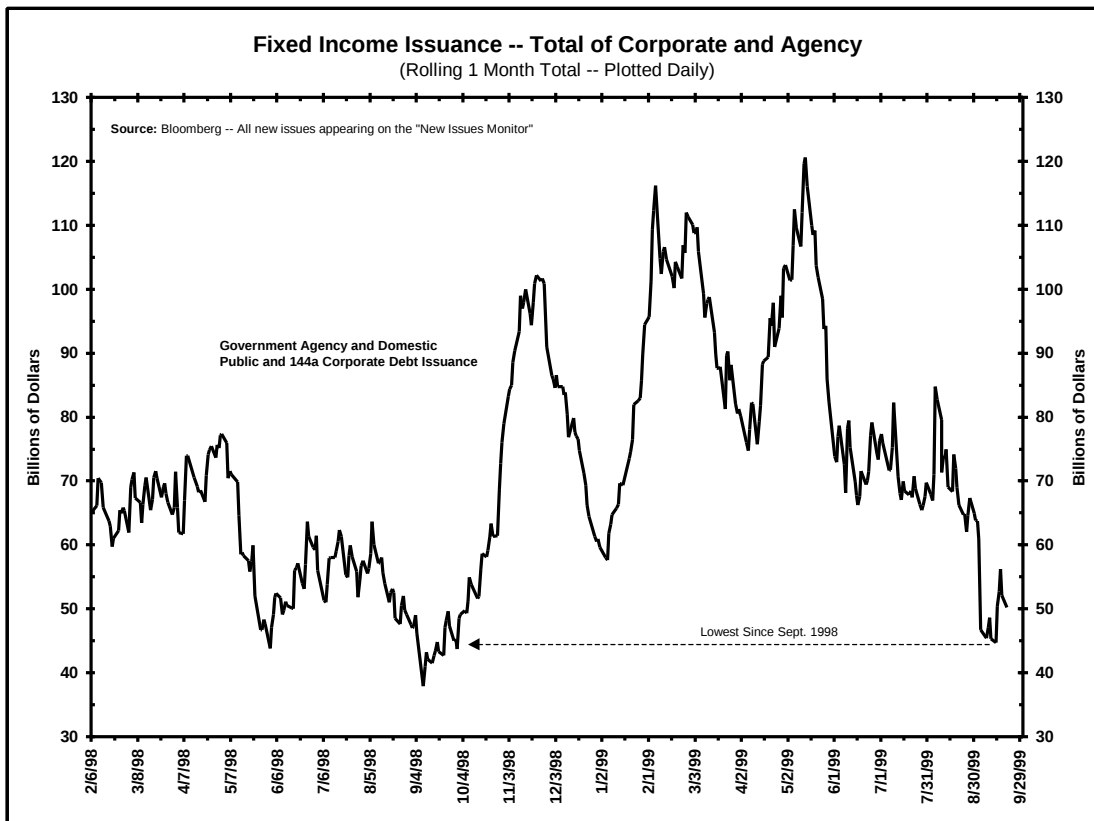


Chart 2

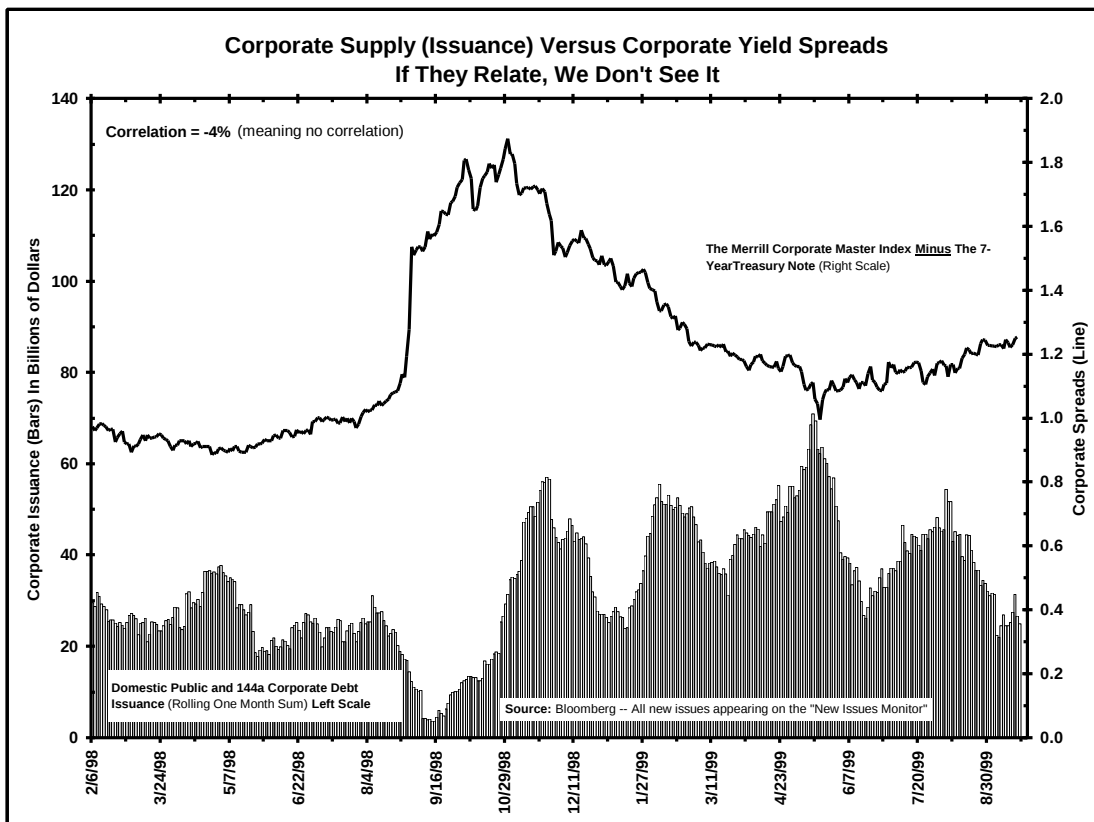


Chart 3

