No safe bond?

Thanks to the sovereign debt crisis, fixed income is no longer seen as a risk-free investment, writes Sally Percy

There was a time when fixed income, particularly sovereign debt, was seen as a safe bet, the closest thing to a risk-free asset other than a house with its mortgage paid off.

And that time wasn't so long ago. In 2008, Greek 10-year bond yields were nearly on a par with German 10-year bond yields, with both hovering around the 5 per cent mark. Just four short years ago investors apparently believed that debt guaranteed by the Greek government was virtually as safe as that guaranteed by the German government. With hindsight, it seems a mad presumption. So how did it come to pass?

"When European yields were similar, the perception was that the European Monetary System was an unbreakable bond and the markets were all in it together," says Jeremy Cunningham, a senior portfolio manager at global asset management firm AllianceBernstein. "That perception was not accurate."

Since then, Greece has descended into bankruptcy, looked as if it would crash out of the euro and twice been rescued by its European partners (to the tune of €110 billion (£89.3 billion) in 2010, with a further hand-out this year of €130 billion). As part of the recent bailout deal, holders of Greek debt agreed to a 'haircut' that saw them suffer losses of up to 74 per cent as their existing bonds were converted into new, less valuable loans that paid lower interest rates. Passed off as a 'credit event', it was a default in all but name.

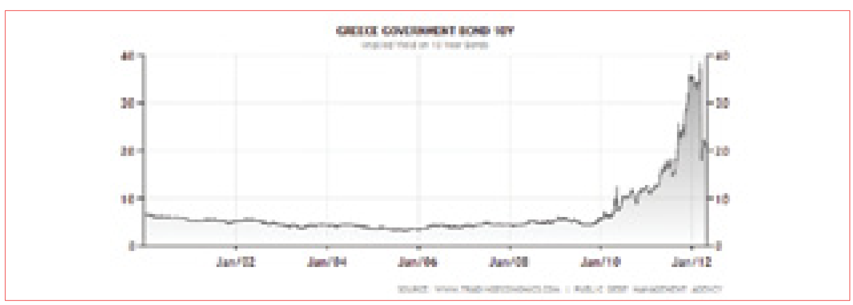
Unsurprisingly, Greek bonds have now assumed junk status and 10-year bond yields were 20.55 per cent by the start of May according to Trading Economics, although that's still a steep fall from their astonishing high of nearly 40 per cent earlier in the year, while German 10-year bunds return a measly yield of 1.7 per cent. The myth that the debt of one European country is as good as another's has been well and truly exploded. 'Risk-free' is a term that is used to mean an investment that is free of credit risk. But is the debt of any country, even Germany, ever 'risk-free'?

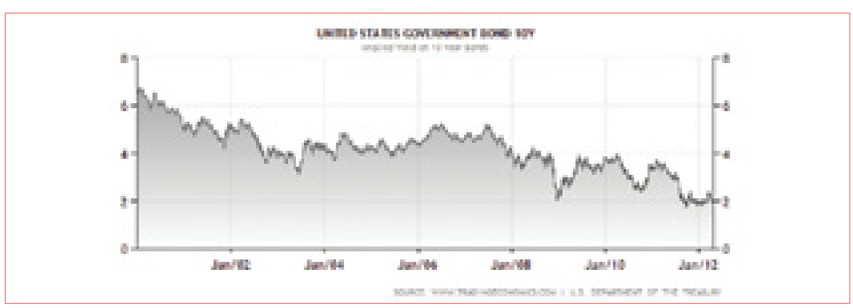
"Not all European sovereign debt is equal," observes Nick Gartside, head of fixed income at JP Morgan Asset Management. "The market has discriminated. Germany has generationally low yield. Other places have generationally high yield. Countries that are perceived to be higher risk offer a higher reward."

"European sovereign debt can be trusted," says Nicola Marinelli, portfolio manager at Glendevon King Asset Management. "But we do not trust it right now. We think there could be more problems with Spain and Italy in the second half of the year."

Pain in Spain

With the Greek crisis seemingly contained, at least in the short term, Spain has now emerged as the danger nation. The world's





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twelfth largest economy has a relatively modest government debt of 68.5 per cent of GDP, according to the European Union Statistics Office, but its private non-financial debt is a frightening 220 per cent of GDP and its banking system is on the brink of collapse after financing a real estate bubble that has since burst. House prices have fallen by over 20 per cent since 2007, the country has slipped back into recession and its unemployment rate is nearly 25 per cent. In the US, Spain has been described as 'the Titanic of Europe', the country that could sink us all.

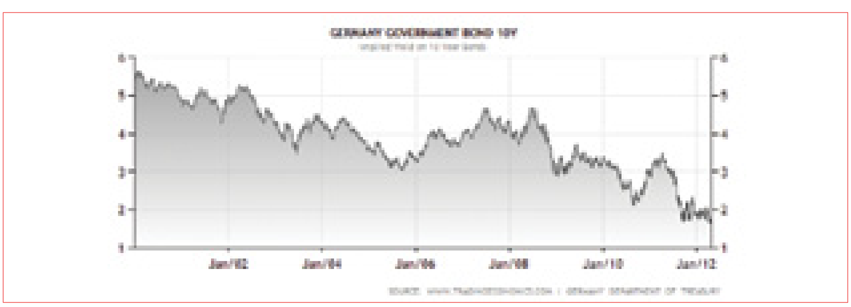
On top of this, rating agency Standard & Poor's (S&P) spooked the financial markets at the end of April by downgrading Spain's debt by two notches, putting it on a BBB+ rating ('adequate payment capacity'), only a few notches above a junk rating.

"The European sovereign debt crisis has now reached critical mass," says Ranvir Singh, CEO of market analyst RANsquawk. "Spain's banks appear completely reliant on emergency European Central Bank loans, and its government could soon be forced to pay unsustainably high yields on its bonds."

Spanish bond yields were already nudging the psychologically critical 6 per cent mark prior to its credit downgrade and if they rise above 6 per cent for a sustained period over the coming months, Spain's borrowing costs could accelerate to a level where it needs to be bailed out. The problem, though, is that Spain may be too big to bail out. So what will happen then?

It's the multi-billion-euro question and nobody knows the answer.

$7.75trn
Non-financial companies' cashpile



In good company

With sovereigns looking an unattractive investment prospect, either because the risk is too great or the yield is too low, many investors are turning to corporates. Non-financial companies in the US, Europe and Japan are sitting on an estimated cash pile of $7.75 trillion (£4.78 trillion), according to global banking association the Institute for International Finance. It's no wonder, then, given the abundance of cash-rich companies, that corporate bonds seem a more enticing prospect than government bonds right now.

Corporate bonds typically offer higher yield than government bonds (a bond issued by a FTSE 100 company, for example, is likely to have a yield of 2 per cent-3 per cent above a UK government gilt). But most corporate bonds are debentures, meaning they are not secured by collateral, and investors in those bonds must bear the risk that the issuer may default on its debt obligations, potentially to the extent that it virtually eliminates the value of the bond investment. Corporates also vary widely in their credit worthiness.

Still, the rewards appear to outweigh the risks. AllianceBernstein's portfolio is now underweight in government bonds and overweight in corporates, according to Cunningham, with both investment grade and high-yield (also known as 'junk') bonds favoured. This is because the firm has carried out extensive credit analysis that suggests there will be relatively robust global growth in the foreseeable future, particularly in the US, Asia and northern Europe.

Marinelli says: "For financials [bank bonds] we still see scope for appreciation in selected names and tiers. We see investment grade and high-yield as no longer cheap, but still fairly valued in terms of spreads and we think that high-yield in particular still has some room for price appreciation and carry [income return]."

"When you compare government balance sheets with companies' balance sheets, companies seem a better bet," acknowledges Gartside, but he emphasises that the fates of governments and companies are intertwined. If the government of a country is in financial trouble, it can drag down the companies based there.

"That linkage is very pronounced, certainly with bank bonds," says Gartside, adding: "Governments can tax companies as well."

The impact on institutions of a sovereign's rating downgrade is aptly demonstrated by Spain. On 30 April, S&P cut the credit ratings for 11 Spanish banks, including Banco Santander and Banco Bilbao Vizcaya Argentaria, citing 'potentially negative implications' from the nation's downgrade the previous week.

Risk and reward

Despite the problems in countries such as Greece, Spain and Italy (Italian government debt is 120 per cent of GDP), fixed income is still seen as safer than most of the alternatives. "In very general terms, it's safer than equity," says Gartside, "because you are on a very different bit of the capital structure."

Overall, fixed income is performing strongly at present and this is set to continue. In fact, research by Bank of America Merrill Lynch revealed that in April 2012 fears over slowing global growth and financial contagion in Europe meant that bonds were the only investments to provide positive returns – for the first time since January 2008. Government bonds gained 0.57 per cent in April, including reinvested interest. Meanwhile, investment-grade corporate bonds gained 0.63 per cent and high-yield bonds grew 0.54 per cent.

US treasuries and German bunds, in particular, are still seen as virtually risk-free investments, says Cunningham – even though Standard & Poor's downgraded the US credit rating by one notch to AA+ last August over budget deficit concerns.

"The US economy has its own printing press, which is more than you can say for the European market," he points out. "Despite the underlying fiscal problems in the US, it is still regarded as the safe haven in the global fixed income market, along with Germany."

Risks exist, nevertheless, and these risks existed even before the financial crisis took hold. Interest rates and inflation have historically been the two main enemies of fixed income. If interest rates rise, the value of the bond in the open market will almost certainly go down while high inflation undermines the capital value of the investment. But there are other risks such as credit spread volatility (the risk that the difference in yield between government and corporate securities will widen), liquidity (the risk that an investor will not be able to find a buyer for the bond before it matures) and currency (the risk of loss on a foreign bond investment due to fluctuations in the exchange rate).

There is no 'one-size-fits-all' financial

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instrument for hedging the risks of fixed income. An interest rate swap with a bank, when a fixed-rate investment is converted into a floating-rate investment, can be used to hedge interest rate risk. A credit spread option protects against credit deterioration while currency forwards can be used to hedge currency risk. Liquidity risk can be managed by investing in more liquid assets, such as investment-grade bonds, and holding a diversified portfolio.

But now, with the sovereign debt crisis reigning, it is credit risk that is hogging the limelight.

“Credit risk is seen as the biggest risk at the moment, and quite rightfully so,” says Krishnan Iyengar, vice president global solutions at treasury and risk management software company Reval. “In Europe, most people are focusing on the fact they might not get their principal back.”

3.8%
Australian 10-year yield

Credit default swaps (CDSs) are typically used to hedge against the risk of a sovereign default. They can also be used to hedge against defaults by companies, banks and other financial institutions. In a credit default swap, the seller of the CDS, usually a bank, agrees to compensate the buyer with a specific percentage of the value of the bond once the issuer has defaulted. But CDSs have flaws. The definition of a ‘default’ can vary; in the case of Greece there was much uncertainty around whether and when sellers of CDSs on Greek sovereign bonds would have to pay out to buyers. Then, of course, credit default swaps themselves carry credit risks – as the financial crisis has shown.

“Entering into a credit default swap contains inherent credit risk,” says Iyengar. “I might not know how many other agreements of that nature the bank has. For example, if the Spanish government did default, would the bank be able to pay?”

He points out that this is how American insurance giant AIG came unstuck in 2008, when it emerged in the early days of the financial crisis that it did not have enough money to pay out on all the CDSs it had sold.

Iyengar also warns that it is important to consider bank counterparty risk when buying a CDS. “Doing a credit default swap within the country you’re trying to insure against would not be very prudent,” he observes.

Cunningham agrees that CDSs have been ‘stress-tested’ as a result of the crisis and says that it’s important to be careful when using them, even though

they have since improved. But he points out that CDSs can be an expensive option and it might be better to sell the underlying bond.

Future-proof?

So fixed income is still fairly safe, but is it safe enough? And what does the future hold for it in a very uncertain world?

Gartside says that besides the obvious safe havens of the US and Germany, Canada, Australia and the Nordic companies all offer some of the safest debt in the world. He says that Australia, in particular, offers a good risk-reward ratio since the yield for a 10-year bond is currently around 3.8 per cent. For those more inclined to take a punt, he cites Mexico as a good opportunity with yield of 5.25 per cent. Corporate bonds also seem a good choice.

"Investors will be surprised by the returns they get from bonds," he notes.

Low interest rates and reasonably low inflation, which are set to be the prevailing market conditions over the next couple of years, will favour fixed income, says Gartside. But he warns that investors must take responsibility for their own decisions.

"As a bond investor, you have to do your own homework. You have to get your hands dirty. You can't just rely on the rating agencies. Investors will have to think a little more out of the box and a little more globally."

Singh is less optimistic, believing that "the awkward questions about the future of the eurozone are getting louder".

"As a result, value in European fixed income is getting harder to defend and the eurozone risks falling into a Japanese-style liquidity trap," he warns, adding that he thinks that gold prices could continue to climb.

And Marinelli raises the spectre of more bailouts, which could have the effect of weakening the perceived creditworthiness of Germany.

So the only thing that's certain is there will be more uncertainty in fixed income for the foreseeable future. And while there may be no such thing as a safe bet, some bets are safer than others. ●

SALLY PERCY, Journalist

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