

Government bonds and spread products

Face aux obligations d'Etat américaines, les obligations corporate ont subi selon les périodes des évolutions contrastées. Dans le climat fiévreux des marchés financiers, les produits de spread pourraient générer des opportunités intéressantes pour les investisseurs dans les années à venir.

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■ Among the various methods for allocating investment funds across fixed income instruments, institutional investors often privilege a capitalization-based approach; by following this concept, investors allocate more to fixed income instruments with a higher market cap within their reference universe.

In the case of traditional US-based investors, one of the most used universes is the one represented by the Lehman US Aggregate index; this index is often chosen as a reference benchmark for the allocation and the management of pension assets by US Dollar-based institutions.

The amount of US Treasury securities in the above-mentioned index (which is indeed market cap-driven) has been declining over the past few years, in line with the better performance of the US budget. US government bonds now account for only approximately 30% of that index, the rest being represented by instruments trading on a

spread-basis, such as agencies, mortgages, asset-backed securities and corporate bonds.

Forecasts about the future balance between Government bonds and spread products within such an index are delivering a disturbing picture, with the share of US Treasuries falling to a mere 7 % of the entire universe within the next 10 years (1). A similar development is expected in Europe, as various governments are projecting budget surpluses in the future years.

Such a situation has enormous implications for investors, as the need for understanding and managing "credit" products will grow exponentially in the coming years.

Implications for the future

The above-mentioned events have determined a dramatic cheapening of all spread products, which could now be considered attractive under many as-

pects. How could institutional investors take advantage of the current market conditions? And which are the risks associated with an exposure to credit securities? Let's examine the situation for US dollar securities.

• Market valuation

High-quality spreads (Aaa/Aa) spreads in the global credit markets are attractive, as the market is already discounting the new paradigm of a world with limited availability of US Treasuries. Ten-years US dollar swap spreads above 100 basis points over Treasuries represent an attractive entry level on US\$-denominated Sovereigns and Agencies.

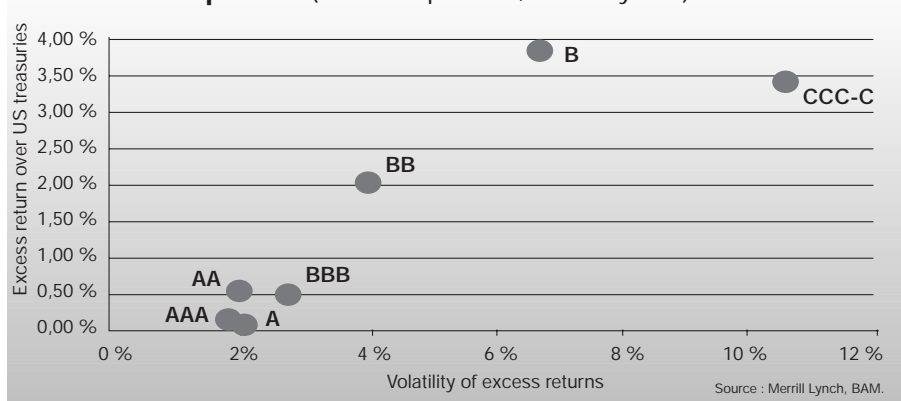
Traditional corporate bonds rated in the mid rating classes (A/Baa) are probably an interesting investment opportunity, given that they have experienced widening spreads over both US Treasuries and swaps. However, most of the sectors (telecoms, retailers, heavy industry) have recently come under renewed pressure, as various factors posed question marks on the sustainability of their current ratings.

High Yield securities (Ba/B/Caa) have been recently hit, as the difficult market conditions will de-facto prohibit further funding to many companies; spreads are extremely wide, but only companies with proven management and with a funded business plan should be considered.

• Market liquidity

Since 1997, liquidity in corporate bonds has been deteriorating. This phenomenon is not so much determined by

Risk-return profile (US \$ Corporates, last 10 years)



The past performance of credit

Credit products have been in existence for a long time, but it was only in the 80s that a sizable market developed in the US, and significant investments were made by the institutional investor community. Driven by the takeover-mania of the mid 80s and by the rapid developments of the financial markets, corporate bonds prospered, until a series of negative events hit their fortunes: the scandals related to Drexel Burnham Lambert and the beginning of the US recession in 1989-1990 were the major drivers, which caused panic among investors. Corporate bonds, however, made a terrific comeback, delivering very attractive returns and outperforming US Treasuries until 1997; the period between 1997 and today should be analysed separately, as it is extremely complex and has major long-term implications for credit fixed income investors.

1997-2001 :

a tale of two forces

In the last years, as the US economy expanded, the US Treasury was able to drive the public accounts towards a

surplus; this resulted in the absence of any need to fund a deficit, and limited the issuance of US Treasuries securities to the re-funding of maturing debt. In addition to that, the size of the US budget surplus made possible the reduction of the stock of Treasury debt, through buy-back operations. The 1997-2001 period has been characterised by shrinkage of the universe of US Treasuries securities available, and by a consequent "scarcity" effect. On the other side, corporate risk was negatively affected by a series of events, which I will briefly describe here:

1. Asian crisis of 1997

A series of factors did lead to a credit and currency crisis in Asia during 1997 ; the weak structure of the banking sector, an un-adequate regulatory framework and the overvaluation of the local currency in many Asian economies lead to a massive outflow of capital, and determined a market shock. The reaction in the global markets was a push towards risk-averse investment

strategies, which increased the demand for credit risk-free securities (i.e. US Treasuries).

2. Russian default of 1998

While the Asian crisis increased the awareness for credit risk, it was only with the Russian default of 1998 that the investors' community really appreciated the risks involved. Definitely linked to the 1997 events in Asia, the Russian default had a dramatic impact on credit risk exposure in investment portfolios; the volatility caused by the degree of market leverage was massive and impacted investors' sentiment. The 1998 events, seriously hit the market, basically wiping out the majority of hedge funds credit investors. These events were major determinants of a more risk-averse investment policy on behalf of the investors' community.

3. Y2K

An additional problem was represented by investors' policies in 1999, which have been extremely conservative, due to the uncertainties related to the Y2K transition.

4. Inversion of the US yield curve in year 2000

The fear that demand for US Treasuries securities would out-strip supply, worsened by the aggressive monetary policy by the FED, determined a dramatic inversion of the yield curve in January 2000 ; that determined a negative dynamic for credit spreads in general, and seriously dented investors' confidence.

5. The US economic slowdown

More recently, fears of an economic slowdown in the US contributed to a further "flight-to-quality", with consequent pressure on credit spreads and uncertainties about the potential attractiveness of credit as an outperforming asset class. After having observed these two major forces (scarcity of US Treasuries and negative credit events), it is easy to understand why the relative price of credit versus Government bonds cheapened (i.e. why credit spreads widened).

the lack of participation by investors, but by the reduction in capital that market-makers are allocating to credit. Commercial and investment banks were the major losers in the credit crisis of 1997 and 1998, and reviewed their exposure to credit risk along new risk parameters. This determined a situation in

which market-makers try often to run a squared book, with very few net positions outstanding: they do not function anymore as a buffer able to absorb flows generated by institutional investors activity. The situation has been deteriorating recently, with some of the mergers between banks (CSFB/DLJ and

Chase/JPM) having a negative impact on liquidity.

Opportunities in a difficult environment

Some trends are, however, specific to some currencies, and should be ana-

lysed to understand the dynamic in the relative credit markets.

- **US Dollar Credit**

The institutional investor base is already well diversified into credit securities, and no new particular support is arising for the credit markets. However, as valuations are discounting a worst-case economic and liquidity scenario, the market should be considered as attractive.

- **UK Sterling Credit**

Strong pension funds inflows into credit securities out of Gilts can be observed as a strong support for the credit market; this dynamic is related to particular developments in the UK regulatory framework, with the potential modification of the Minimum Funding Requirement and the introduction of a new accounting standard (FRED 20/FRS 17). Valuations are attractive/

«Investors should be aware that there is an attractive investment opportunity, mainly determined by the negative sentiment for credit risk».

- **Euro Credit**

Investors are cautiously diversifying into spread products out of Government bonds. This is a gradual process, with investors taking a progressive exposure first to Pfandbriefe, Suprationals and Agencies, and only later to corporate bonds. Valuations are in line with fair-value.

In the last 15 years, credit securities have outperformed Government bonds . This should encourage investors to rely on spread products more heavily, even given their growing share of any fixed income universe. The environment is however difficult, with liquidity scarce and credit quality deteriorating in many sectors, such as telecoms, retail and heavy industry. Investors should be aware that there is an attractive investment opportunity, mainly determined by the negative sentiment for credit risk; but should also notice that credit investments deserve respect and attention, especially in the current market environment. ●

(1) Source : Lehman Brothers.