DT | Dewhurst Torevell

Down the Rabbit Hole – Fixed Interest Market Update

Argentina issued a 100-year bond this week with a coupon of 7 1/8% and a yield of nearly 8% (which will change in line with the price of the debt and is not guaranteed). It was extremely oversubscribed with $9.75 billion of orders placed for the $2.75 billion actually issued. In our view the excess demand for such a long maturity bond issue from a country with a very problematic credit record is a good example of the dislocation and irrationality which prevails within bond markets.

We have already seen corporate debt issued in the last few years with maturities of anything from 40 to 100 years for mega caps such as Microsoft, Petrobras, BAT and Siemens. This makes perfect sense for the companies as a source of cheap funding but for investors, the yields are not impressive. There is also no guarantee the company will still exist in its present form at maturity, as indicated by a quick check of the largest companies 50 and 100 years ago and the largest companies today. Many of today's largest companies such as Apple and Google/Alphabet were founded quite recently. Indeed IBM is the only recognisable technology company in the Fortune company ranking for 1967. Others in the top 50 from that year have merged to form new megacaps such as Conoco, Exxon, Mobil, Kraft, GM and Chrysler. More worryingly in the context of very long term debt, others are now defunct, such as Bethlehem Steel.

Argentina is unlikely to disappear or be taken over but has defaulted on its sovereign debt 8 times in its 200 year history, including five defaults in the last century and two defaults since 2000. In 2001 Argentina defaulted on $100 billion of bonds, at that time the largest sovereign default on record. More recently, in 2014, a technical default occurred when hedge fund manager Elliott Capital demanded a full pay-out on $1.3 billion of bonds purchased in 2005 for less than their face value. Argentina's centre right President Macri resolved this legal issue last year. $4.65 billion was paid out to Elliott Capital and other "holdout" creditors. Notably, the investors only received 75% of the par value of the debt they held. The settlement allowed Argentina to return to capital markets with a record $16 billion debt issue. Although a more benign economic and political environment has emerged for companies in Argentina, MSCI did not upgrade the country from "frontier" to "emerging" status when it reviewed its indices this month.

History would suggest that investors in Argentine sovereign debt are unlikely to be repaid their principal at maturity. It is, however, likely that most purchasers of the debt issue are only intending to hold it for a short period. They are relying on the "greater fool theory" to find another investor willing to pay a higher price for it in a few months or years despite the inherent risks. If the price falls, or if the government once again defaults, irrecoverable capital loss may occur.

Over the last few years we have repeatedly voiced concerns that investors are being encouraged to take on increasingly high levels of risk in their search for yield. The demand for the Argentine 100 year sovereign bond, despite the worrying historical precedents, is another example of this trend.

A reminder of the 10-year sovereign debt yields available for sovereign debt from various developed countries with robust credit records helps to explain what drives demand for a 100-year bond from a country with a poor credit history. Taking the UK gilt yield as an example, 20 years ago in June 1997 a yield of 7.1% was available. In June 2007 the yield was 5.3%. Fast forward to today and the yield is 1% despite rising inflation, the possibility of an interest rate increase and political uncertainty. This is the aftermath of

an era of extraordinary monetary policy featuring vast levels of quantitative easing globally and low and even negative interest rates.

To give some context, current 10-year sovereign debt yields in Argentina, Greece and Russia are as follows: 4.7%, 5.6% and 7.8%. In each case we do not consider the yield to be sufficient to offset the significant risks associated with the debt. Large scale overseas investor demand has also recently been seen for 15-20 year debt issued in frontier markets such as Senegal, Egypt, Rwanda and the Ivory Coast. All of these countries have complex political and economic factors in play which could adversely impact their financial markets. Within Europe, Italian 10-year sovereign debt has a yield of just under 2%, despite the country having a debt:GDP ratio of 130%, a stagnant economy and ongoing political pressures to reform the constitution. It is also notable that S&P recently downgraded municipal debt for the US state of Illinois to just above junk status. The yield on this municipal debt remained unmoved at 4.4% despite the increased risks implied by the downgrade. These examples indicate that bond prices remain priced for perfection. There is no guarantee this complacency will continue if interest rates or inflation increase and investors in these debt issues could be in for a turbulent ride.

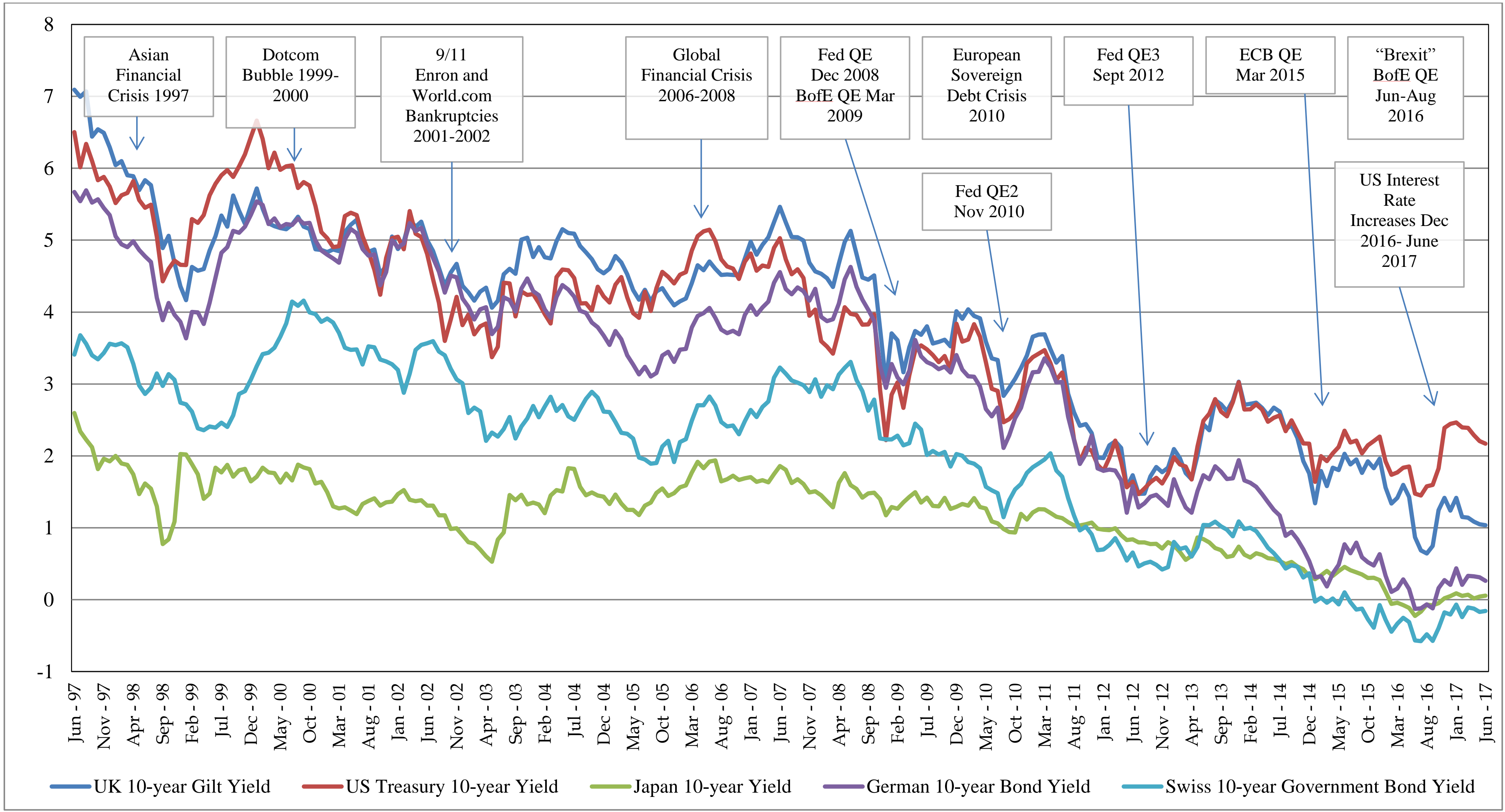
Investment grade sovereign debt offers such poor yields that some investors have found sufficient appeal in a yield of nearly 8% to take a chance on the 100-year Argentine debt issue. They are presumably hoping they will have the foresight to sell the bond before the capital value of their investments falls. This is not a risk we wish to take. Nor do we wish to hold overvalued developed market sovereign debt which could leave investors with irrecoverable capital losses should prices fall and yields rise. So at this time we simply continue to observe the extraordinary conditions in fixed interest markets, which look increasingly “down the rabbit hole” to our eyes. We await more reasonable valuations in investment grade rated debt to emerge before the asset class becomes potentially “investable” once again.

Georgina Ogilvie-Jones

This document reflects the general views and opinions of Dewhurst Torevell & Co Ltd only and these are subject to change without notice. This document and its contents do not constitute advice or a personal recommendation and do not take into account individual client circumstances or needs.

Our research is undertaken and views are expressed with all reasonable care and are not knowingly misleading. Any information provided in this document is obtained from sources that we consider to be reasonable and trustworthy but accuracy cannot be guaranteed.

Issued by Dewhurst Torevell & Co Ltd, 5 Oxford Court, Manchester M2 3WQ. Tel 0161 281 6400. www.dewhurst-torevell.co.uk. Dewhurst Torevell & Co Ltd is a company registered in England 3279315 and is authorised and regulated by the Financial Conduct Authority (FCA number 183210).



Appendix: Sovereign Bond Yields for Selected Developed Market Countries June 1997-June 2017