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# Walking on a Tightrope without a Safety Net

## Frank Moon discusses how low interest rates are encouraging investors to take risks

"Rapidly rising pension and healthcare spending will reduce the debt status of the world's richest industrialised countries to junk."

Borrowing costs for companies and governments are unusually low due to strong demand for higher-yielding, but riskier assets. The spreads on corporate bonds - the premium investors demand over benchmark government bonds - are at the same low levels seen just before the collapse of Long Term Capital Management, the hedge fund, in 1998. Emerging market debt also looks like a bubble with spreads over US Treasuries at 3.30 per cent. This is the lowest level since 1997 and compares to an average of 7.3 per cent since 1998.

Default rates and volatility have fallen to historic levels. Investors have been encouraged to take risk by low official interest rates and low returns from other investments (equities and government bonds). According to Standard and Poor's in its annual review, credit quality has shown a strong improvement this year but the prospects for 2005 are limited.

There has been a feeding frenzy for a recent issue of French government 50 year debt despite concerns over the long term status of European nations. Rapidly rising pension and healthcare spending will reduce the debt status of the world's richest industrialised countries to junk within 30 years unless their governments move quickly to balance budgets and reduce outgoings. Standard & Poors, the credit rating agency, says if fiscal trends prevail, the cost of ageing populations will fuel downgrades of France, the US, Germany and the UK from investment grade to speculative or junk category - France by the early 2020's, the US and Germany before 2030 and the UK before 2035. They are currently in the top triple A category ensuring that they can borrow at low rates.

The sharp reduction in corporate bond spreads has owed more to a steep decline in new issues rather than any improvement in the quality of the bonds on offer. Lower issuance has pushed investors further down the ratings scale in search of yield. This has been good for issuers and their private equity sponsors but investors are not being adequately compensated for the subsequent increase in default risk. The recent downgrade of General Motors to junk status rattled bond markets. General Motors is one of the largest corporate borrowers and its debt is among the most liquid.

Investors should also note the remarkable resilience and popularity among hedge funds of the "carry trade" - the practice of borrowing money at low interest rates and investing it in higher-yielding issues such as junk bonds, emerging market debt and mortgage-backed securities. Hedge funds and other investors have made vast sums over the past two to three years on the spread between short-term US Treasuries and the longer-dated issues.

The spreads have narrowed considerably in the past year, making the trade less profitable. Rather than unwind their positions, it is widely believed that many hedge funds have

simply used leverage, which sustains the significant profits on a diminishing trade but heightens downside risks considerably. Meanwhile, the carry trade has spawned substantial capital appreciation in junk, mortgage notes and emerging market debt. It is hard to imagine that the spread between short-term Treasuries and junk bonds will narrow any further, unless one expects junk to start yielding less than Treasuries.

The value of junk depreciates for many reasons, including disappointing corporate earnings, rising interest rates, a loss of confidence in a struggling company's ability to right itself or an economic recession. The first three have weighed on the markets in recent weeks, and the latest rash of economic data suggesting a weakening US economy has some on Wall Street considering the possibility of the first consumer recession in the US in 14 years.

Hedge fund managers have a very quick trigger finger. When things start going against them, they get out. If there is any sort of rush to the exit there is no easy way out. And because our financial system is interconnected as it never has been before, everybody is going to get hurt.

However, currently there is little sign of hedge funds unwinding their leveraged trades - or of governments backtracking from regulatory changes - which are supporting bond markets. Nevertheless, spreads this tight leave no margin for error when conditions eventually turn. Investment grade bonds will not be immune to a sell-off in the high yield market but will be affected to a lesser degree and whereas high quality bonds will provide something of a safety net, high yield corporate bonds will not.

We have detailed the yields currently available on higher quality Sterling Eurobonds below:-

| | Composite Credit Rating | Price £ | Redemption Yield |
|---|---|---|---|
| EIB 4½% 07.12.07 | AAA | £99.55 | 4.68% |
| KFW 4½% 07.12.08 | AAA | £99.25 | 4.73% |
| Kommunalbanken 4½% 28.01.10 | AAA | £99.89 | 4.77% |

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**MPR Asset Management Limited**
PO Box 119, Commerce House, St Peter Port, Guernsey GY1 3HB
Tel: 44 1481 714161 Fax: 44 1481 724723
Email: investment@meespiersonreads.com www.meespiersonreads.com

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