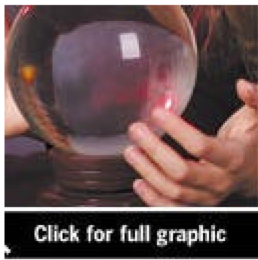

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Long-term bonds raise new bubble worries

By Steve Johnson
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How will Goldman Sachs be faring in 2060? How robust will the public finances of Mexico be in 2110?

These, and other equally imponderable questions, are among those being posed to investors amid a flurry of high-profile very long-dated bond issues.

Alongside 100-year Mexican debt and 50-year Goldman paper, investors have been offered, and readily accepted, 50-year issues from utility group GDF Suez, railroad operator Norfolk Southern, Rabobank of the Netherlands and the Italian government.

To some, a willingness among investors to take on the often extreme inflation, interest rate, credit and sovereign risk embedded in these securities, in exchange for a modest uptick in yield, is a surefire sign of an overheated bond market.

“We are definitely at the early stages of a corporate bond bubble. Companies and governments are taking advantage of it by issuing long-dated debt,” says Stuart Ratcliff, chief investment officer of the Matrix Credit Opportunities fund.

“I think it’s akin to covenant lite [which arguably signalled the top of the bull market in credit in 2007]. The fact that investors are prepared to invest for 50 or 100 years shows they are desperate for yield and are buying anything.”

Horacio Valeiras, chief investment officer at Allianz Global Investors, raises his eyebrows at the deals, given how few companies survive 50 years and the fact that, during the past century, sovereign bond investors in countries such as Argentina, Germany and Russia have suffered heavy losses.

“The Mexico one was just puzzling to me, but somebody bought it,” he says. “The issuers are just taking advantage of a low interest rate environment.”

However, data from Dealogic suggest that, despite the media attention recent deals have attracted, issuance of long-dated bonds is not running at elevated levels.

Admittedly $7.8bn of 50-year plus sovereign paper has been issued so far this year, a figure exceeded only in 2005 and 2009, according to Dealogic, whose data stretch back to 1995.

But 50-year plus issuance by financial institutions has reached just $894m so far this year, the lowest figure for five years and well down on the $10.3bn of such paper issued in 2007.

For other corporate investment-grade companies, long-term issuance has been $1.3bn in 2010, against a peak of $14.9bn in 2007.

"For non-financial corporates we have had quite low issuance. A lot of them were just making sure last year that they had lots of credit in place.

"They rushed towards the bond market to issue more than they needed," says Willem Sels, head of investment strategy for HSBC Private Bank, UK.

"That issuance has collapsed but banks and sovereigns continue to issue.

"The demand for long-dated issuance is reasonably high from institutional investors and even from private clients as well. People are looking for yield."

From a corporate treasurer's perspective, it is widely perceived to be a good time to issue long-dated debt, with investors happy to accept historically low yields.

But some argue this should ring alarm bells.

"If it's a very good time to issue debt it's not a very good time to buy debt," says Mr Ratcliff. "Smart companies are taking advantage of the very low yield environment to secure financing whether they need it or not. Yields probably will rise in the next year or so."

Mr Sels warns: "When corporates start to feel that they should lock in yields, that is a signal that we are close to the turn in the bond market."

With 30-year US Treasury yields now around 4.2 per cent, he believes the 3.9 per cent yield seen earlier in November may prove to have been "very close to the lows," potentially limiting further long-term bond issuance.

"If you start to have really significant inflation fears and the Fed[eral Reserve] doesn't manage to lock the 30-year yield where it is now, then issuance is going to drop," he argues.

The Fed's latest $600bn quantitative easing programme has bolstered inflation expectations, pushing up long bond yields; the Mexican century bond issued in October with a 6.1 per cent coupon fell below 90 per cent of par on November 16, before edging up to 92.5 last week.

This aptly demonstrates one of the risks to long-term nominal bonds. "Our view is that this is not a deflationary environment. If it was then we would be buying," says Mr Valeiras.

With corporate spreads over government debt relatively tight – Goldman's 50-year bond was priced at 6.125 per cent, Rabobank's 100-year paper at 5.8 per cent – these bonds are also vulnerable to interest rate risk.

"When spreads are very tight [corporate bond yields] just move up and down one for one with the relevant government benchmark," says Mr Ratcliff.

However, the greatest concern at present, for corporate as well as government debt, could be the risk of a eurozone sovereign debt default.

“In 1997/98 people started to feel less comfortable about corporate risk. This time around the sell-off risk comes more from sovereign bond yields rather than corporate bond spreads widening,” says Mr Sels.

However, some are more upbeat. Suki Mann of Société Générale points out that investors in the Rabobank bond, for instance, will get their money back (in nominal terms) in dividends after just 17 years of the instrument’s 100-year life.

And Jim Cielinski, head of fixed income at Threadneedle, says the historically low yields on long-dated bonds could simply be a sign of confidence that interest rates will remain low for a long time to come, rather than necessarily being a harbinger of doom.

“We have opportunistically participated in some of these bonds,” he says.