



LET'S TALK ABOUT...

FINANCIAL LEXICON EDITED BY THE SWISS ASSOCIATION OF ASSET MANAGERS

Corporate Bonds

(Part Three) We have cited the risks connected with the huge amounts of very high yielding corporate bonds which have been issued in the past months. Their standing volume is estimated at about one trillion USD. A risk may indeed arise, should a weak or much delayed economic growth, and related poor corporate earnings, make it difficult to “service” the debts, both in terms of coupons and even principal: that would take to defaults and restructurings, with fresh problems for many investors. On the other hand one major rule is that high actual or expected returns always go together with high risk profiles. However an “escape way” exists in managing heavy interest charges, that not so much companies, but mainly governments, have abundantly and impudently run in all times: it is currency devaluation, through which debt is repaid by the borrower (the instrument issuers in this case) at a lower real value. Inflation and the related money devaluation obviously favour the borrower at the lender's expense, but it is all the same obvious that only governments have the power to “generate” inflation and currency devaluation by fuelling their debts and distressing their public finances. Companies may just benefit from side effects, in their commercial operations as well as in making their debt service lighter in real terms. But today there is another side of the play between corporate and government bond issues: it is a potential emerging and much stronger competition. Governments, mostly unable (or unwilling) to increase fiscal pressures, are on the verge of issuing huge amounts of bonds in order to finance their massive interventions aimed at the banking, mortgage, automotive industries, and so on. And most likely such issues will come with higher coupons than current ones, due to that competition and the higher premium risks that investors are going to require. Thus governments may shortly come to experience a similar situation as companies, despite the still low central banks' reference rates and still gloomy economic scenarios. And if default risks really exist for some companies, governments themselves may no longer be considered immune from such dramatic outcomes. *(End)*

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(Part Two) The huge numbers and volumes of corporate issues is the result of many factors: the long critical phase of stock markets, the credit crunch that has made bank borrowing difficult, and of course the pressing need of liquidity for many companies. But the main feature of such issues has been the high yields they have offered: very rich coupons, indeed, often skyrocketing ones, which clash with the historically low levels of reference rates (the ones fixed by central banks) and the current meagre returns of most government bonds. If that may be good news for the investors, it may also be viewed as a signal of distress, or caution at least. In general terms high proposed yields mean high risk levels, and the rule is supported by a lot of past and today's instances. The question arises about the destiny of such issues should the economic upturn be delayed or not sustainable enough to generate massive corporate profits in order to pay such high returns (and the related principals). Answers are easy and well documented too: defaults, postponements and debt restructurings. There are at least two warning signals which point to that worrying outcome, besides the widening spreads among the different bond categories, government, investment grade and high yield: the recent downrating of several issuers, even prominent ones in their industries (although such moves have come at least with some delay, after the previous laxism of the rating agencies) and, more important the evolution of CDS (Credit Default Swaps) levels, that is the cost for insuring the repayment of a given debt at the time of its expiration. The CDS level had previously come down from very high levels, they had reached when the financial crisis had climaxed; now they have not only stopped their falls, but in many cases they are on the upturn again. It is a signal that the investor should consider, despite his/her appetite for rich returns, just to evaluate, and possibly avoid, incidental and unpleased surprises. *(to be continued)*

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(Part One) We come back to this subject we have already discussed in more technical terms some time ago, because it is now topical and of great interest for many investors. A corporate bond is a kind of fixed-income security which is issued by a private institution, e.g. a company, group, and quite different from similar instruments issued by governments and supranational organizations, such as the World Bank, the European Bank for Reconstruction and Development, and so on. The long phase of stagnation in equity markets after their falls and corrections, the hard environment banks have faced, the liquidity crisis and the related crunch in lending, the “sterilization” of most hedge funds, all of that has obliged many companies to turn to the capital market for getting the fresh money they need. In the past months a shower of new corporate bonds has been issued, and, apart from their huge amount, one feature of such issues is particularly relevant. Within a scenario of historically low reference rates (that is the ones fixed by central banks) and very low yields for high-quality government bonds, many of such corporates have actually offered extremely high coupons. Suffice it to remind the case of a leading European auto maker, which has offered a yearly coupon abundantly over 9% for a 3 year issue, so that when such figures showed up on the screens, they could be thought as mistakes. If this case may be viewed as an extreme one, many companies have however issued their bonds with extremely high yields both in absolute and relative terms, if compared with “normal” current market returns. And if such conditions may be appealing and exciting for many investors, all the same they inspire some more comments. *(to be continued)*

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