Fantasyland for Europe's bonds

Dr Robert Gay | Fenwick Advisers | 28 May 2015 |

This week, on the day after the European Central Bank announced it would step up monthly purchases of debt securities under its ambitious plan to expand its balance sheet by one trillion euros by September 2016, Portugal's sovereign bonds traded on negative yield. This remarkable development flies in the face of any sensible assessment of credit risk. Portugal's debt has junk bond status, with credit ratings of BB from S&P and Ba1 from Moody's. Even these ratings seem generous for a country with net foreign liabilities exceeding 100% of GDP, well into the danger zone for a financial crisis if foreign creditors decided for whatever reason to take their money and run. Granted, Portugal has made great strides in recent years to turn around its fortunes. The current account has swung from a huge deficit of 12% of GDP in 2009 to a small surplus, thanks in part to an internal devaluation, shrinking budget deficits and its economy expanding, albeit fractionally, for five consecutive years. Nonetheless, it seems farfetched that anyone would willingly pay for the privilege of loaning money to such a heavily indebted country unless something extraordinary was in the works.

THE ECB'S QE – TOO LATE AND TOO BIG

In reality, nothing of that sort is happening. Few, if any, real money investors are buying new debt issues on negative yield. German insurance companies, for example, cannot buy bonds on negative yield because that would lock in an unacceptable capital loss, contrary to their fiduciary responsible to policyholders. Rather, the situation in Europe looks disturbingly similar to the run-up in US bond prices prior to the taper tantrum in May 2013. Because the ECB is buying more bonds than governments are issuing and, by law, the ECB cannot buy them directly from governments, carry traders know that the ECB must buy back their bonds at elevated prices. So the game is to front-run the ECB's purchases by buying any euro zone sovereign bond, especially those with larger coupons, regardless of credit quality (Greece being the only special exception), leveraging the trade with essentially zero-cost funding and holding as long as possible or until the next major redemptions trigger another round of new issuance. Hence, Portugal – a huge debtor – trades on negative yield.

Notwithstanding the alleged benefits of this charade of refinancing budget deficits through secondary market purchases, the bottom line is that the European bond market is becoming less liquid and more distorted, especially with respect to the pricing of credit risk. Hence, it is more vulnerable to a sudden sell-off as the ECB's QE program winds down, as it inevitably will.

Ignore for a moment the sanguine statements from ECB officials regarding the bond buying program and consider the circumstances. First, the ECB's asset purchase program in 2015 is slated to buy euro 60 billion of marketable securities per month on average, of which euro 38 billion is targeted at sovereign debt held by the public. That adds up to about euro 380 billion in securities – but governments plan to issue only euro 272 billion in net new debt to cover their budget deficits. Purchases of German bonds are likely to pose a particular problem as time passes. About 20% of the ECB's purchases are supposed to be bunds, but German is not issuing any net new debt now the government's austerity has balanced the budget. Indeed, the ECB already has had to alter its monthly plan in recognition of a dearth of new issuance during the summer months and will frontload its purchases in May and June when issuance is high. For carry traders, this is a dream come true – an oversized buyer willing to pay whatever price amidst limited supply.

Still, the situation need not run amok if leverage was expensive – but it is not. The ECB has dawdled so long in introducing QE that the cost of funding is low or, for some, zero. A more effective program would lower long-term interest rates to facilitate refinancing and deleveraging by the private sector. By contrast, the ECB belatedly lowered short-term rates in the name of "easing monetary conditions" with little or no impact on the cost of borrowing for the real economy. Moreover, an inherent contradiction arises as the ECB amasses securities. Namely, QE reduces liquidity of marketable securities. The whole idea is that central banks are removing a lot of bonds from circulation and in doing so, raising prices. By capping the premium they are willing to pay on the best bonds – that is, those of creditor countries with little new issuance – the market bids up the prices of less creditworthy entities.

WHEN WILL IT END?

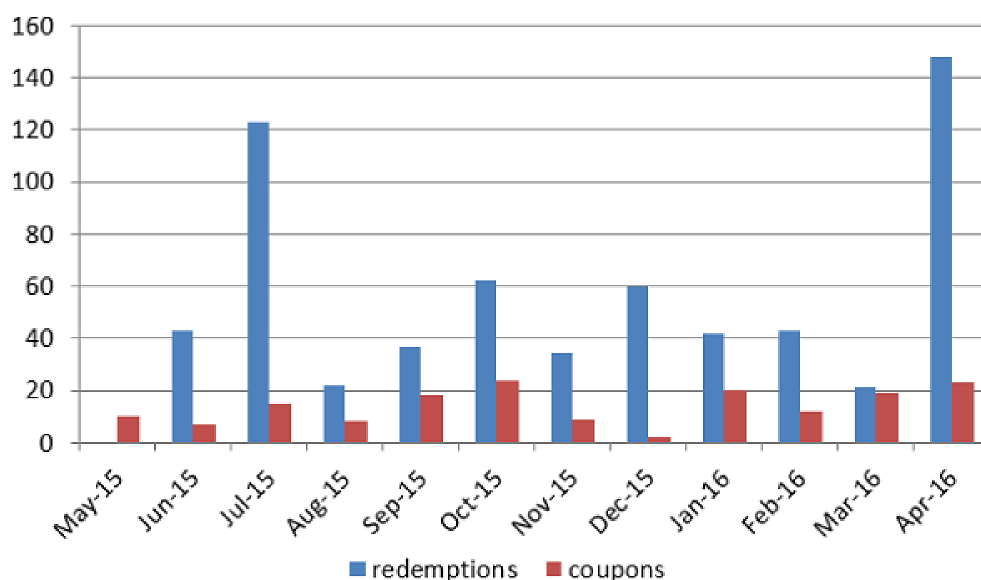
Unlike the Fed's QE program that is destined to end before end 2015, the ECB's ill-advised plan could extend well into 2016 – although I am skeptical that it will reach the scheduled end date of September without a major bout of market backlash. Clearly, the puny size of the euro zone bond market limits how far the ECB can push its purchases. Figure 1 shows that outstanding amounts for the EU-10 total only about euro 6 trillion compared to the more than $17 trillion in US Treasuries. It seems likely the ECB can continue through this autumn when new sovereign issuance again should pick up to fill the void left by redemptions (Figure 2).

Figure 1: Size of EU bond market (fixed rate & inflation-linked)

	2yr	5yr	10yr	15yr	30yr	Total
Germany	463	264	197	88	93	1,105
France	465	384	280	173	99	1,401
Netherlands	123	71	67	23	37	322
Italy	607	414	261	180	97	1,560
Spain	252	179	152	63	53	699
Belgium	87	72	63	55	21	298
Austria	62	61	37	12	21	193
Finland	28	23	21	8	4	83
Ireland	24	38	25	5	6	98
Portugal	31	29	29	4	9	102
Total						5,861

However, by early 2016, redemptions and new issuance again are likely to fall short of the ECB's planned purchases, especially after a bunching of maturing bonds in April.

Figure 2: EMU-10 sovereign cash flows (in billions of Euros)



Sources: Citibank

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Imagine what will happen when the ECB admits that they cannot source enough bonds or that its program is ending because the euro zone economy is recovering, which will happen by 2016. Credit quality suddenly will matter. High yielders and long duration will blow out the most, just as they did during taper tantrum. Non-euro zone credit likely will be affected to some extent as forced sellers will dump whatever has a bid. I expect these knock-on effects to be short-lived and of second order to those on euro zone bonds that now are the most over-positioned by carry traders.

In short, markets may be lulled to sleep if they survive the Fed's first rate hike without much collateral damage. The probability of market participants being caught off base seems very low. No one is carry trading US treasuries into that event. The grossly over-positioned euro zone trades may be forgotten temporarily - until, of course, the ECB reaches the end of its tether. In any event, there seems to me to be little chance that the ECB's belated and oversized QE program will end gracefully. Policy blunders never do.

Dr Robert Gay is managing partner of Fenwick Advisers, a financial consultancy serving global investment banks, hedge funds, and other fund managers and financial institutions including fixed income manager, Stratton Street Capital. Prior to forming Fenwick Advisers, Dr Gay served as international economist and global strategist Morgan Stanley, Bankers Trust and Commerzbank AG. He spent eight years as Senior Economist with the Board of Governors of the Federal Reserve System in Washington, DC, primarily during the chairmanship of Paul Volcker.