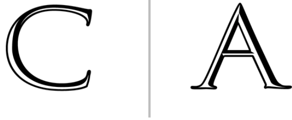

CAMBRIDGE ASSOCIATES LLC

EUROPEAN MARKET COMMENT: THE NAME IS BOND, BUT WHICH BOND?

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The Name is Bond, but Which Bond?

European investors deserted equities in droves, shifting assets to sovereign debt and high-grade corporate bonds. September was the worst month on record for withdrawals from equity funds, with some €12.2 billion in net outflows across Europe. This response was perhaps predictable, given the tendency for capital flight to high-quality investments during periods of crises, but as more recent data emerge, it appears that capital continues to flow into bonds even as the flight from equities slows. In Italy, for example, net inflows into bond funds topped €2.8 billion in October, whilst net inflow into equities reached only €321 million.

Pension fund experts are forecasting that at least 10% of the £800 billion U.K. pension fund industry will shift from equities into fixed income over the next two years driven by changes in pension fund accounting. In the United Kingdom, as falling equity prices erode pension funds' capital bases, companies constrained by minimum funding requirements have had to pump cash into their employee retirement schemes. This increase in cash outflows, together with the balance sheet impact of equity market volatility leaves these companies vulnerable to downward revisions of their credit ratings. In some cases the response has been dramatic. Boots, the retailer, shifted its entire £2.3 billion pension fund that previously had a 75% allocation to equities, into bonds, including a 25% allocation to inflation-linked debt, with an average maturity of 30 years. The move enables them to maintain their S&P long-term credit rating, reduces dealing costs by approximately £10m (€16m) a year, and ensures that company cash contributions will become more predictable and stable. Royal & Sun Alliance, Coats Viyella, and Sainsbury, all companies with large U.K. pension funds, also plan increased bond allocations. The story across Europe is directionally similar, driven by regulatory and funding pressures caused by extreme market volatility. Since pension fund contributions are the biggest source of demand for shares on the exchanges, any wholesale trend in the same direction will have significant long-term impact.

EU government bonds have been a first port of call, as they offer relatively attractive yields, and maintain a 30-year bond, which is no longer available in the United States. As the global economy slowed, euro yields tended to decline, taking the lead from the more pronounced yield contraction across the Atlantic. Despite these declines, euro yields remain higher today than in the spring of 1999, when economic prospects appeared rosier. While much capital will likely flow to EU government bonds, it is unlikely that the sovereign sector will satisfy the massive expected demand for bonds, given that relatively small, or nonexistent, budget deficits largely limit government bond issuance to rolling over maturing debt. So, where else can the money go?

Euro high-yield bonds are a likely candidate for more speculative investors. Yield spreads over government bonds of comparable maturities stood at 1,294 basis points (bps) on 30 November, down

from an all-time high of 1,547 bps at the end of September, but still high relative to the brief history of yield spreads in this market (Table A). Yield spreads increased for two primary reasons—declining credit quality and increased investor risk aversion. Moody's, the rating agency, reports that credit quality in Western Europe declined for a fifth consecutive quarter in the third quarter of this year, with downgrades outnumbering upgrades by almost two and a half times. Yield spread increases in the telecommunications sector were even more significant at the end of September 2001, as increases in leverage to support M&A activity and the acquisition of 3G licences by European telecom companies resulted in a decline in credit quality. Telecom issues represent a significantly reduced share of the euro high-yield bond market, falling from 45.8% of the market at the end of first quarter 2001 to 29.0% at the end of November (Table B). While yield spreads on these issues are very high, they underestimate the defaults that will occur should the recession prove to be significantly longer and more severe than currently anticipated.

More risk-adverse investors may be better served by another emerging asset class, index-linked bonds. The first eurozone inflation-indexed bond (OATei) was auctioned in October by the French government. Although France has issued inflation-protected debt since 1998, this is the first bond linked to the eurozone harmonised consumer price index, excluding government controlled tobacco prices. The French Trésor, keen to enhance liquidity in the index-linked market, plans a fairly regular programme of issuance. If the appetite for bonds increases as predicted, pension and insurance funds across Europe are likely buyers that would do much to improve liquidity and encourage other government issues.

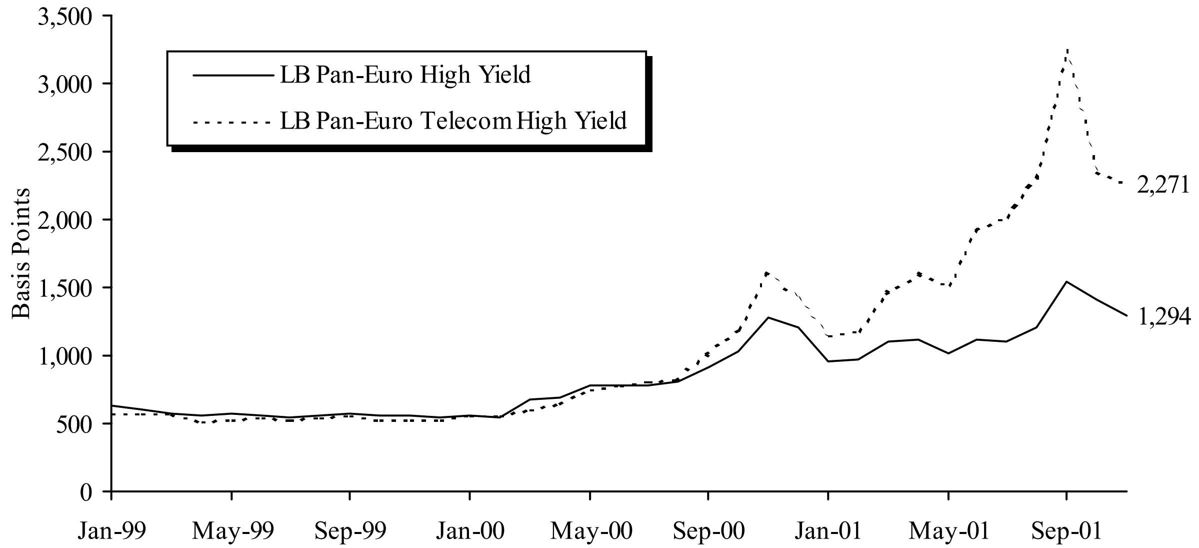
In the United Kingdom the corporate index-linked bond market has emerged over the last 18 months. At present, the market remains small, with £5 billion in debt outstanding in fewer than 40 issues, but is expected to grow. There are three types of active borrowers: regulated utilities with an incentive to build an inflation-linked cost of capital into their balance sheets to reduce financial risk; special-purpose issuers looking to securitise inflation-linked revenue streams, and supranational entities responding to the more hospitable demand for inflation-linked debt. A new type of corporate inflation-linked bond, the LPI bond (limited price indexation), also has gathered a following. In addition to providing higher returns than government linkers due to their corporate credit risk exposure, these bonds provide improved liability matching for pension plans with benefits only partially indexed to inflation. Essentially, the bonds provide a yield increased by inflation, but subject to a maximum increase of 5% per annum and a corresponding minimum of 0% per annum. Recent corporate bond deals, among them those issued by Glas Cymru and National Grid, included LPI tranches. For the moment these markets suffer from poor liquidity and small issue size, and the natural buyers of these instruments have "buy and hold" inclinations. However, market liquidity should improve provided demand for bonds in general increases as predicted.

The increased incentive to invest in bonds across Europe comes at a time of low interest rates coupled with high credit spreads. Provided the economic downturn does not result in a higher than

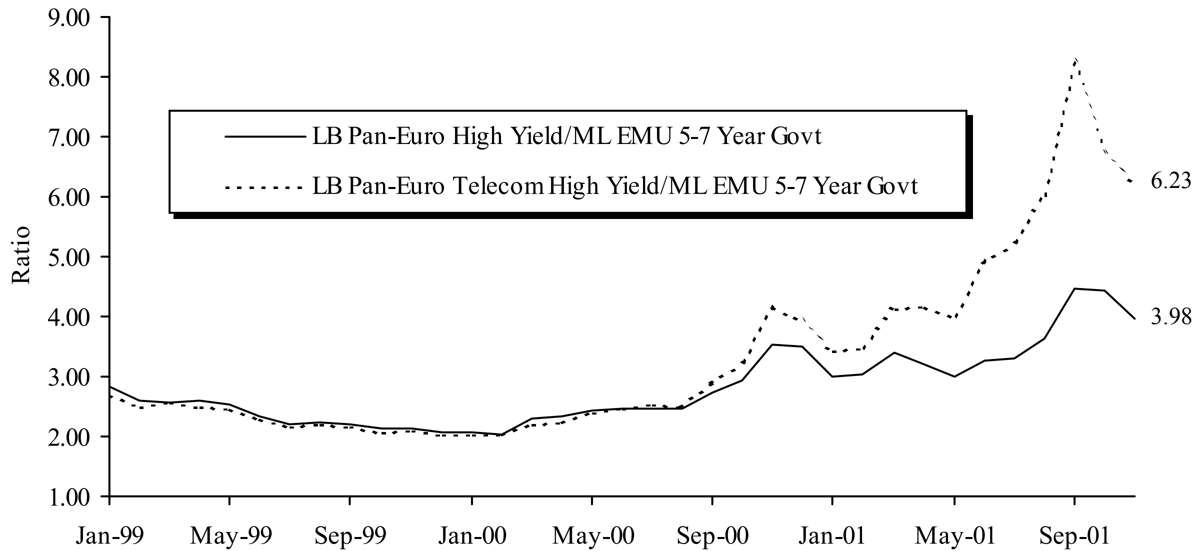
expected level of bond defaults, the high-yield market may provide opportunities for those inclined to invest in high-risk strategies. For the more staid, the embryonic euro inflation-linked bond market and U.K. corporate inflation-linked bond market provide opportunities for those willing to accept some illiquidity in their portfolios.

Table A

EUROPEAN HIGH-YIELD BOND SPREADS



YIELD RATIO OF EUROPEAN HIGH-YIELD BONDS

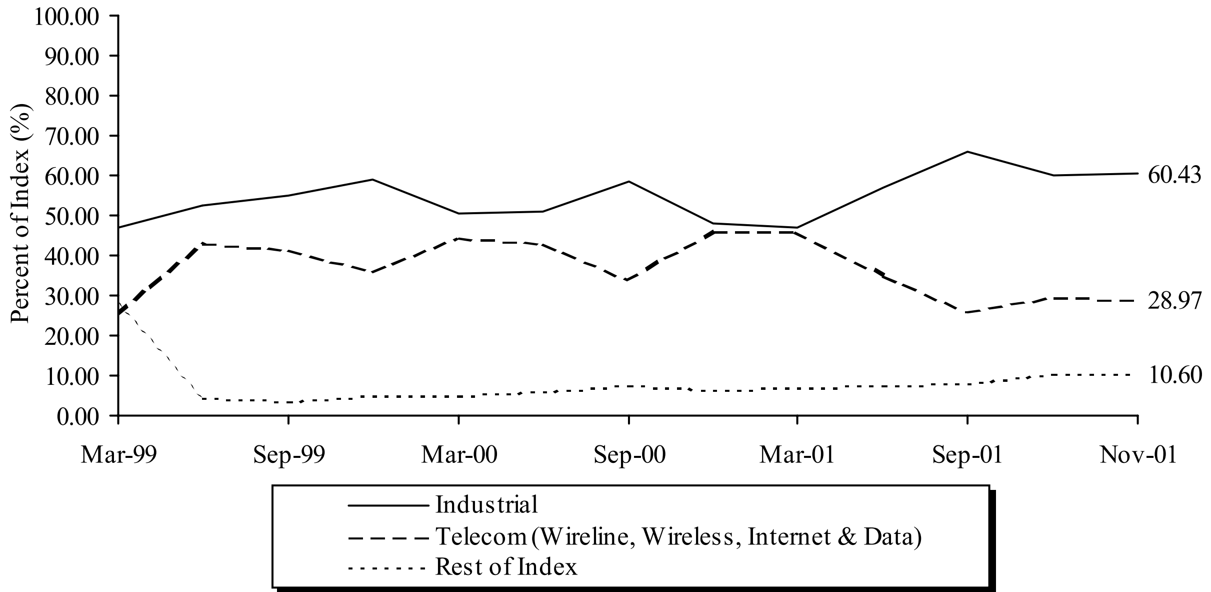


Sources: The Bloomberg and Lehman Brothers, Inc.

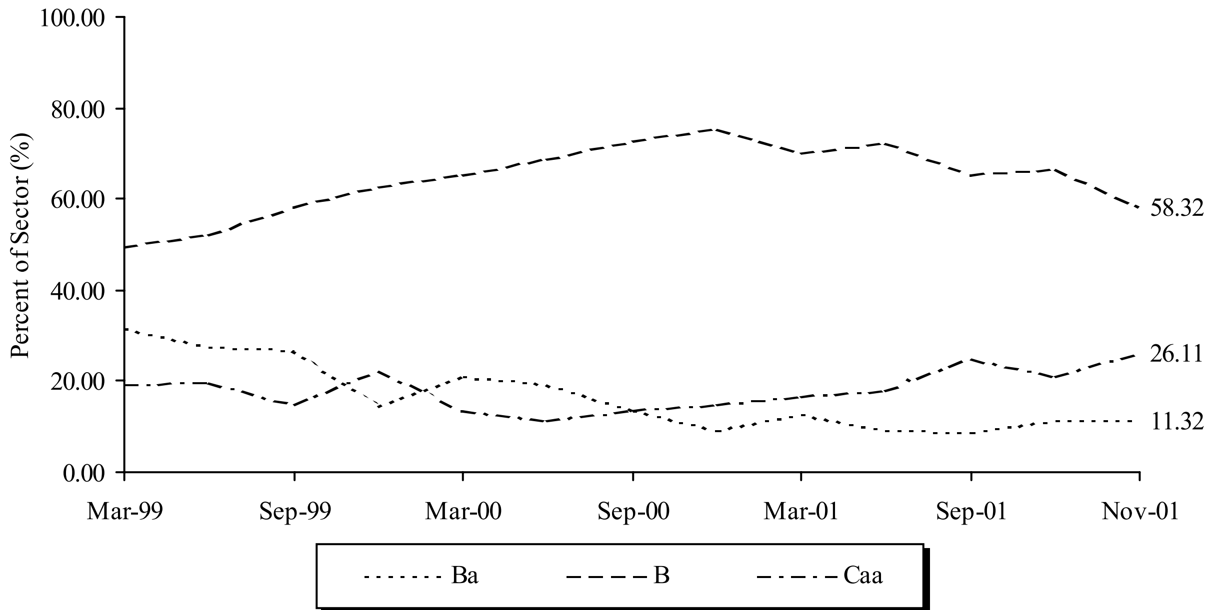
Notes: Data are from 1 January 1999 through 30 November 2001. The yield spread is the difference between the Lehman Brothers Pan-European High Yield Bond Index and the Merrill Lynch EMU Direct 5-7 Year Government Bond Index. Yield ratios are based on the ratio between the weighted-average yield-to-worst (the lower of yield-to-maturity and yield-to-call) for the Lehman Brothers Pan-European High Yield Bond Index and the yield-to-maturity for the Merrill Lynch EMU Direct 5-7 Year Government Bond Index. Telecom yield spread and ratio data represent the telecom issues within the Lehman Brothers Pan-European High Yield Bond Index.

Table B

EUROPEAN HIGH-YIELD BOND SECTOR ALLOCATION



EUROPEAN TELECOM HIGH-YIELD BOND: PERCENT OF TELECOM BY GRADE



Source: Lehman Brothers, Inc.

Notes: Data are from 31 March 1999 through 30 November 2001. Sector allocation data represent the Lehman Brothers Pan-European High Yield Bond Index. Telecom grade allocation data reflect weights by grade for the telecom sector. As of 30 November 2001, telecom issues rated Ca and C accounted for 3.72 and 0.54 percent of the telecom sector.