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Distortion on Zero Rates

When Lehman Brothers imploded six years ago, zero-interest-rate policies were an urgent part of the solution. But their persistence has caused more and more market distortions. That raises the stakes for central banks aiming for the exit.

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The U.S. Federal Reserve and the Bank of England are edging in that direction -- but are clearly concerned about the impact that their moves may have.

The Fed on Wednesday said that it would continue to **wind** down its bond purchases as expected. Those are now expected to stop altogether after its next meeting in October. And it maintained language in its post-meeting statement saying that it would keep rates at near-zero levels for a "considerable time;" economists foresee nudging rates higher sometime next year.

The European Central Bank and Bank of Japan seem likely to be stuck around zero for an extended period yet.

The longer rates are at zero, the more they ripple through markets. Take the German government bond market: Nearly all of Germany's debt, out to its bond maturing in 2042, yields less than 2%. The persistence of ultra-loose policy means Germany has been able to issue a remarkable amount of ultralow coupon debt, locking in cheap financing costs. Excluding bills and index-linked **bonds**, 67 **billion** euros ($86.83 **billion**) of German notes now carry a zero coupon; another 194 **billion** euros pay coupons of 0.25% to 1% and a further 200 **billion** euros pay coupons of 1.25% to 2%. By the end of 2015, another 97 **billion** euros of debt with coupons higher than 2% will mature, and likely be refinanced at lower rates. That is a boon for Germany, but a problem for investors.

Ultralow government-bond yields then influence investment-grade corporate **bonds**. Of the 14 senior financial and nonfinancial benchmark euro-denominated **bonds** sold in the week to Sept. 11, 10 had coupons of less than 2%, data from Societe Generale show. Relative valuation measures are also distorted.

BASF's 750 **million** euro bond maturing in 2019 yields 6.1 times as much as a German government bond with a similar maturity, according to Tradeweb, which might make it sound attractive. But since the German yield is 0.09%, BASF's bond in fact pays just 0.55%. Even high-yield **bonds** are hardly worthy of the name except in relative terms. Bank of America Merrill Lynch's euro-denominated high-yield bond index yields a paltry 3.89%.

Markets are often capable of overshooting. But the effect of persistent zero rates, coupled with plentiful liquidity, is to force them to overshoot constantly. The result is an increasing stock of longer-dated **bonds** with ultralow coupons. That is a toxic combination, as these **bonds** are vulnerable to sharp drops in price if rates rise.

Central bankers, in loosening monetary policy, essentially aimed to boost current demand by pulling it forward from the future. Zero rates, in making cash an unpalatable asset, have done the same for asset prices: Bond markets have brought forward future returns and cashed them in as capital gains. But bond prices can't rise indefinitely. And with coupons so low, there is little protection for investors against losses when policy is tightened.

Ultra-loose monetary policy has proved very good at anchoring short-term rates and expectations. But it has also led investors to discard the anchor of absolute value in favor of the siren song of relative value, storing up losses and volatility for the future. That should make central bankers nervous.

-- Richard Barley

No Clouds Part

For Rackspace

Rackspace Hosting has little choice but to go it alone.

The provider of cloud-computing services has called off its so-called strategic evaluation process that could have led to a **sale** of the **company**. While Rackspace said late Tuesday it had been approached by "multiple parties" under various scenarios, none of the offers matched the value it believes it can create with its own stand-alone plan.

More likely, none of those parties felt up to matching, let alone topping, the $5.7 **billion** market capitalization Rackspace was sporting. That was in large part due to a run-up in its shares after a May announcement that it was evaluating options. The stock had been around a four-year low before that, predictably drawing interest from suitors looking to bulk up their own cloud offerings.

Among those seen as potential suitors were Hewlett-Packard, International Business Machines and CenturyLink. But all those companies would have been hard-pressed to explain such a deal to their own shareholders, who may have viewed Rackspace as a troubled underdog in a business undergoing severe price compression.

Underscoring this: Even after a big selloff Wednesday afternoon, Rackspace remained 20% above its May low and traded at about 43 times forward earnings.

Meanwhile, Rackspace faces intense competition from deep-pocketed rivals. Amazon.com, Google, Microsoft and IBM all cut prices on their cloud offerings earlier this year, leaving Rackspace outgunned with an expensive product. A study from RBC Capital in April found that Rackspace's prices on its various cloud services were 75% higher than peers, on average.

Rackspace still believes it can carve out a profitable niche with high-end cloud services versus do-it-yourself offerings of rivals. The **company** also said Tuesday it has decided against a stock buyback for now. But the cloud business has turned into an expensive party especially for a small player looking to go stag.

-- Dan Gallagher

AT&T Could Struggle in Mexico

AT&T may have caught the travel bug. That could prove to be a strain.

After positioning itself to get a piece of the Latin American video market through its pending **purchase** of DirecTV, the telecom giant may be eyeing a swath of wireless assets America Movil is looking to sell. The Mexican **company** is divesting these to avoid antitrust penalties being imposed by regulators due to its dominant market position.

Owning a Mexican carrier might hold appeal for AT&T, which could theoretically bundle wireless with video service supplied by DirecTV's Mexican joint venture with Grupo Televisa. But financing the trip down south might be another matter.

AT&T and other carriers are preparing to participate in two coming U.S. government auctions of wireless spectrum. These could generate as much as $50 **billion** in combined proceeds, with AT&T accounting for nearly one-third of that, according to MoffettNathanson.

That will have to be financed with debt. Indeed, Moody's is anticipating $10 **billion** to $15 **billion** for AT&T's spectrum purchases over the next 12 to 18 months. The ratings agency already has put AT&T's debt on review and has said a downgrade is likely if and when the DirecTV deal closes, which AT&T puts in the second quarter of 2015.

But to truly lower America Movil's market share, AT&T would also likely need to use debt to pay for the Mexican assets, which could be worth as much as $17.5 **billion**, according to a report by Bloomberg News. Adding the Mexican assets to the picture could further pressure AT&T's credit rating, says Mark Stodden, a telecom analyst at Moody's.

AT&T's net debt stands at 1.8 times 2015 earnings before interest, taxes, depreciation and amortization. That will rise to two times after the DirecTV deal closes, according to UBS. The **firm** estimates AT&T could raise that to around 2.5 times -- the level Verizon Communications reached to buy the rest of Verizon Wireless. This would give AT&T debt capacity of $27 **billion** for spectrum purchases and deal-making.

Making the math more difficult, AT&T's hefty dividend consumes roughly 90% of its free cash flow. That figure will fall into the mid-80s after the DirecTV deal closes as the **company** benefits from some of the latter's cash flow. But the need to maintain and increase the dividend, which AT&T has raised every year for the past 30 years, places another constraint on AT&T's ability to support additional debt.

Granted, the America Movil assets would also come with cash flow, helping AT&T offset some strain of any additional debt. But the **company** may also need the flexibility to spend more on spectrum, depending on how the auctions go.

For investors, an AT&T**purchase** of America Movil's assets could be a source of southern discomfort.

-- Miriam Gottfried

Not Much

Power for

China's

Stimulus

China's latest stealth stimulus is no bazooka.

Though there has been no official announcement, the central bank is reportedly lending 500 **billion** yuan ($81.35 **billion**) to the country's top five banks, after an ugly set of data showed the economy has entered another bumpy patch.

The amount seems large -- equivalent to the liquidity released by a half-percentage-point cut to bank-reserve requirements. And while the money is supposedly earmarked for small businesses and affordable housing, benefits will no doubt trickle to beleaguered property developers choking on a rising inventory of unsold homes.

But unlike a reserve-requirement or interest-rate cut, this move doesn't have long legs. The money comes in the form of three-month, low-interest loans to the banks. The loans could be rolled or augmented, but they could also easily be extinguished at the end of the term.

There are related motivations at play. Liquidity in the banking system typically tightens at the end of September, when cash is in demand for **China**'s weeklong National Day celebration. The central bank would likely provide additional liquidity anyway. The move ensures, however, that an inopportune spike in short-term interest rates won't happen this year.

In the old days, an economy heading for below the government's growth target would necessitate a big-gun approach. This is more of a pistol shot: not enough to have overwhelming effect.

More small-bore measures are likely in the near term to counteract weakness in the property market, including targeted cuts to mortgage rates. For now, Premier Li Keqiang's seemingly anodyne "general principle of making progress while maintaining stability" is what guides Beijing. In other words, reform the economy, reduce reliance on debt, but use modest interventions. That is a tough task.

Of the five banks receiving funds, the money was reportedly given to each in chunks of 100 **billion** yuan, not taking into account the different sizes of the banks. It is no surprise, then, that Bank of Communications, the smallest of the five, saw its stock rise the most Wednesday.

Like its effect on the banks themselves, this stimulus could have uneven results.

-- Alex Frangos

Overheard

It takes time for the dust to settle after big news. But BHP Billiton, which announced plans to spin off a collection of noncore assets nearly a month ago, is still in a hole.

The miner's shares fell in August when it said it would separate most of its aluminum, manganese, nickel and coal assets into a new Australia-listed company. The lack of a widely expected buyback contributed to the reaction.

The market hasn't warmed to BHP's message of simplicity and focus. Both BHP's Australian and London-listed shares have underperformed, in sterling terms, the market by about 10%.

The U.K. stock has fared worse, possibly due to worries about investors being handed shares in the new Australian company. Since April, when BHP first said it was considering a split, the shares are in negative territory.

A slumping iron-ore price hasn't helped. But BHP shares also have been outstripped over the past month by Rio Tinto, which makes most of its earnings from the commodity. No one said breaking up would be easy.

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