Fixed Income

Fixed-Income Markets for Government Issuers

Exam Focus

- Funding choices for different government issuers
- Comparison of government and corporate fixed-income instruments

Sovereign Debt

- National government issues bonds to raise funds for public goods and services, and investment into public infrastructure
- Highest credit rating in domestic market typically; one of largest debt issuers
- Analyst needs to consider “economic balance sheet” including implied assets and liabilities as well as financial ones in public accounts
- Multiple maturities to maintain split between long term and short term

Sovereign Debt—Developed and Emerging

- **Developed market issuers**
  - Stable, diversified economies with consistent and transparent fiscal policy
  - Debt denominated in a *reserve currency*
- **Emerging market issuers**
  - Typically faster growing
  - Less stable economies; less stable tax revenues
  - Can be *domestic debt* (might not be freely convertible to other currencies) or *external debt* (owed to foreign creditors in home currency or foreign reserve currency)

Sovereign Debt: Example

US-based investors of US dollar–denominated external sovereign debt can still face exposure to currency risk because:

A. sovereign fixed-income securities are denominated in freely floating domestic currencies.

B. the issuer's credit rating may be downgraded.

C. the issuer must be able to generate foreign currency revenue.

-1

Source: CFA Institute. Used with permission.

Sovereign Debt: Example

A sovereign government faced with growing deficits and concerns about rollover risk would *most likely:*

A. lower tax rates.

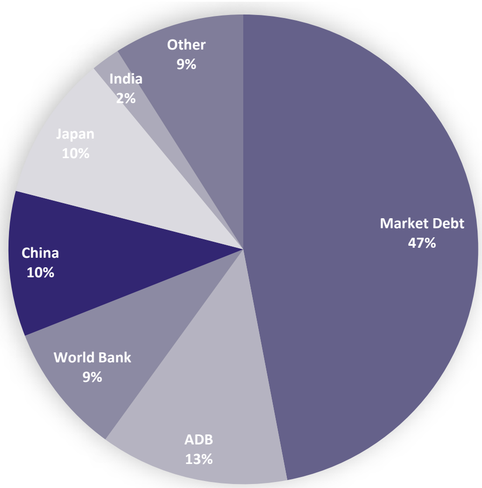
B. stop servicing the debt.

C. issue medium- to long-term securities.

-1

Source: CFA Institute. Used with permission.

Sri Lanka External Debt: Example



Source: CFA Institute. Used with permission.

Nonsovereign Government Debt

- Issued by states, provinces, counties, and entities created to fund and provide services (e.g., construction of hospitals and airports)
- **Agency bonds** or **quasi-government bonds**
  - Issued by entities created by government for specific purposes
- **Supranational bonds**
  - Issued by international institutions (e.g., World Bank)
  - High credit quality
  - Some issues are highly liquid

Government and Corporate Fixed Income

- Public auctions used to issue government debt securities
- **Competitive** or **noncompetitive** bids
  - Competitive used to set price
  - Noncompetitive guaranteed to have volume allocations met
- Bonds allocated first to noncompetitive, then to competitive starting with highest price
  - Yield of cheapest successful competitive bid = cutoff yield

Government and Corporate Fixed Income

- Sovereign issuer typically designates certain financial institutions as **primary dealers** (required to make competitive bids)
- Once issued, trade in OTC dealer markets like corporate bonds

Public Auction: Example

30-year Singapore government bond auction

- 8 September 2021, Monetary Authority of Singapore announced auction of SGD2.6 billion
- Price and coupon/yield to be determined based on cutoff yield

Results announced on 20 September 2021

- Amount allotted to noncompetitive bids: SGD 207,355,000
- Coupon rate: 1.875% p.a.
- Cutoff yield and price: 1.95% p.a. and 98.303

-2

Source: CFA Institute. Used with permission.

Supranational Bonds: Example

Member states of a supranational organization typically share decision-making authority and provide implicit and explicit financial support to the organization, resulting in which of the following levels of credit quality among these issuers?

A. Lowest.

B. Average.

C. Highest.

-1

Source: CFA Institute. Used with permission.

Solutions

Sovereign Debt: Example

US-based investors of US dollar–denominated external sovereign debt can still face exposure to currency risk because:

A. sovereign fixed-income securities are denominated in freely floating domestic currencies.

B. the issuer's credit rating may be downgraded.

C. the issuer must be able to generate foreign currency revenue.

Investors based in developed markets who purchase external debt of emerging and frontier market sovereign issuers face indirect exposure to currency fluctuations, because their returns depend on an issuer's ability to generate foreign currency revenue to meet foreign currency interest and principal payments through international capital, goods, and services flows.

-1

Sovereign Debt: Example

A sovereign government faced with growing deficits and concerns about rollover risk would *most likely:*

A. lower tax rates.

B. stop servicing the debt.

C. issue medium- to long-term securities.

Government budget deficits increase the need for borrowing at a higher level while surpluses reduce borrowing needs. Excessive government reliance on short-term funding introduces rollover risk, or uncertain refinancing costs, increasing the variability of budget costs and therefore tax rates. Therefore, in practice, governments seek to minimize interest rate and rollover risks by distributing debt across maturities while issuing debt in regular, predictable intervals.

A is incorrect because taxes should be raised, not lowered, in such a scenario.
B is incorrect because such an action would put the government in default, with severe consequences for its credit standing and its ability to meet fiscal policy commitments.

-1

Supranational Bonds: Example

Member states of a supranational organization typically share decision-making authority and provide implicit and explicit financial support to the organization, resulting in which of the following levels of credit quality among these issuers?

A. Lowest.

B. Average.

C. Highest.

Member states typically share decision-making authority and provide implicit and explicit financial support to these organizations, resulting in the highest credit quality among these issuers and a strong ability to access capital markets across maturities.

Source: CFA Institute. Used with permission.