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Yield to hope

Last week's oversubscribed issue of 10-year notes from the Republic of Kazakhstan shines a bright light on the world's needy income-seekers. Setting up a clamor for $11 billion of Kazakh paper, the capitalists reluctantly settled for $2.5 billions' worth (including a tranche of long-dated debt). They bid despite falling energy prices, crude oil being Kazakhstan's top export. And they bid despite the legal certainty that, come a default by the former Soviet captive state, the debtor, not the creditors, would be up in the driver's seat (on which important observation, more below). In compensation, the note holders earn a promised yield of all of 4.16%.

The weight of debt in the world is one topic at hand. The puny yields attached to that debt is a second. Skipping down to the bottom line, we judge that the time is ripe for spread widening in the market for emerging market sovereign bonds. At year-end 2013, according to Blackrock, total sovereign debt of the up-and-coming nations amounted to $6.5 trillion, of which $733 billion was denominated in foreign currencies, much of it in dollars.

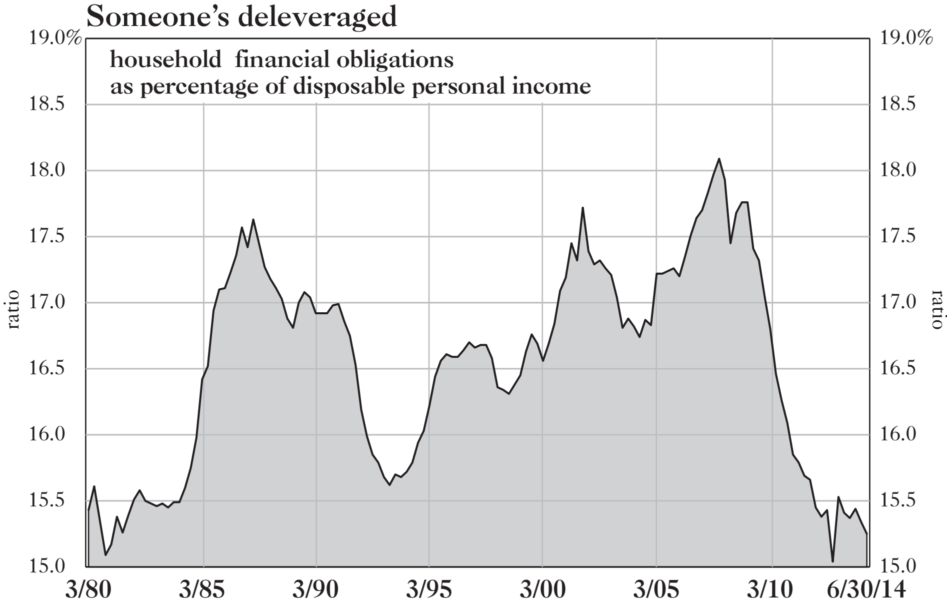
You stop and stare at what the fates and the central bankers have wrought in government debt. Ireland's two-year note returns two lonely basis points. The two-year notes of Austria, Belgium, Denmark, Finland, France, Germany, the Netherlands, Slovakia and Switzerland yield less than zero. Borrowing more and more, governments pay less and less.

We write in the capacity of a critic, not a portfolio manager, of course. Portfolio managers deal in the real world of relative values, not the Utopia of absolute ones. Still less do they deal in existential questions about the nature of fiat currencies or the over-the-horizon prospects for debt repudiation by countries to which the newspapers still flatteringly refer to as "oil rich." (How much longer before the falling price of crude forces a shift in nomenclature to "oil poor"?) The money comes in, and the PMs invest it. Some PMs invest by hewing to an index. They pay the prices they have to pay, not the ones they would like to pay.

The Republic of Ecuador, for one, can have no complaints about 21st-century institutional investment protocols. A banana republic—the world's top exporter—Ecuador was able to raise $2 billion in dollar-denominated 10-year notes in June. Fairly panting at the 7.95% coupon, investors put it out of mind that Rafael Correa, the Ecuadorian president, had not only led his country to a 2008 default but also had refused his creditors the face-saving gesture of pretending that he wanted to pay them. Correa declared that he wouldn't pay because the debts were "immoral" (he is a trained economist). Suppressing this unpleasant memory, the eager investors seemingly did themselves a favor. The 7.95s change hands at 104.16 to yield 7.34%.

It's a favor they'll come to rue, we think. What they have to gain is nothing like an equity return, though they face an equity kind of risk. They would lose if Correa defaulted again. They

Someone's deleveraged



source: Federal Reserve Board

would lose if interest rates went up. And they would lose if, in the event of a true deflation, banana prices collapsed and credit broke down.

We say "true" deflation. A definition is in order: Deflation is a derangement of credit, only one symptom of which is falling prices. It's a mercifully rare occurrence. Prices usually fall for other reasons. For instance, they fall because the world is becoming more efficient (anything wrong with that?). A deflationary decline in prices is brought about by people who can't raise a loan. Unable to borrow, they sell assets or inventory; financially strapped companies discharge employees. In response to forced selling, prices and nominal wages fall. In a full-strength deflation, even government securities' prices fall. They fall because leveraged holders can't finance their positions.

Deflation, as defined, isn't America's current problem. Credit may be mispriced—we contend that it is—but there is no crisis of credit. Ultra-low interest rates flatter the credit profile of any who borrow. Thus, in the United States, speculative-grade corporate defaults in the year to date are running at 1.6%, significantly below the 1981-2013 average of 4.3%. In the second quarter, the Federal Reserve's "Household Financial Obligations Ratio"—total debt payments to disposable personal income—registered a reading of 15.25, just off the 34-year low set in 2012. No credit-induced liquidation is under way, rather the opposite. "Don't Hate Credit," a Sept. 9 Bloomberg bulletin was headlined. "Just Use More Leverage for 10% Returns, Says Citi." You didn't read much of that kind of advice in New York in 2008, or in Athens in 2012.

Deflation, then, isn't a fact in America. It is a theory, a fear and a conversation starter. It isn't even a fact in Europe, where so many wring their hands over a signal emanating from a derivatives market to indicate that the rate of inflation for the five years *starting in five years* will come in at 1.82%. Note that is a positive 1.82%. How much anybody could possibly know about the future starting in five years (or, for that matter, five months) is another question. "Deflation is already knocking at the door," Andrew Roberts, credit chief at RBS, was quoted as saying in the *London Daily Telegraph* last week. "We think it could happen as soon as next month given the last fall in food prices. We are reaching the end game in Europe. If they don't launch real QE and start reflation by the end of the year or soon after, the consequences are too awful to contemplate." We can only begin to imagine the level of hysteria if the rate of change in prices actually did turn negative.

To give them credit, the deflation-phobes intuit that the world is over-encumbered, that zero-percent interest rates only facilitate the slathering on of new debt and that at some not very distant date a breakdown of credit could ignite an actual deflationary episode. The investment point we wish to make is that the holders of low-rated, low-yielding sovereign bonds would likely be losers even in that event. At, say, $50-per-barrel oil, Kazakhstan might be willing to service its debts. Given that oil revenues are projected to account for 52% and 49% of 2014 and 2015 government revenue, respectively, according to the World Bank, a question presents itself: Would Kazakhstan be able to service its debts? In the next crisis, would Ecuador be any more punctilious about meeting its obligations than it was in the last one?

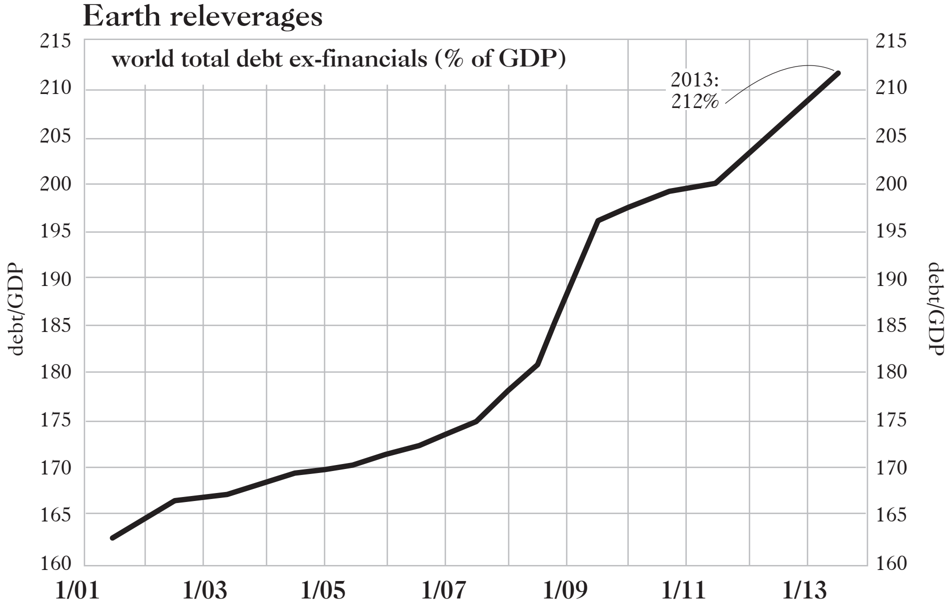
Which brings us to a new, much buzzed-about paper from the International Center for Monetary and Banking Studies. Since 2001, relate the authors of "Deleveraging? What Deleveraging?" the ratio of world debt to world GDP, excluding financial debt, has climbed to 212% from 160%. Up until 2007-09, developed countries borrowed the most; post-crisis, emerging market governments have carried the debt torch.

"Contrary to widely held beliefs," the authors argue, "the world has not yet begun to de-lever and the global debt-to-GDP [ratio] is still growing, breaking new highs. At the same time, in a poisonous combination, world growth and inflation are also lower than previously expected, also—though not only—as a legacy of the past crisis. . . . Moreover, the global capacity to take on debt has been reduced through the combination of slower expansion in real output and lower inflation."

The crux of the problem is China, the authors assert (and we assert along with them): "Since 2008, Chinese total debt (ex-financials) has increased by a stunning 72% of GDP, or 14% a year, a shift almost double that experienced by the U.S. and U.K. in the six years that preceded the beginning of their financial crisis in 2008. This brisk acceleration has brought the overall leverage of the Chinese economy to almost 220% of GDP, almost double the average of other emerging markets."

The level of borrowing in China is worrying. As much so is the uses to which the debt has been put. In times past, China borrowed to export. Since 2008, it has borrowed to stimulate. Construction of new apartment blocks in uninhabited cities gener-

Earth releverages



source: International Center for Monetary and Banking Studies

Forgiving and forgetting

source: The Bloomberg

ates no income. What it does generate is new investment in cement, steelmaking and the other must-have inputs to apartment house building. "In turn," the "Deleveraging" narrative proceeds, "overcapacity in a number of key sectors [has] led to downward pressure on production prices. Since 2008, the slowdown in measures of growth to about 7% has been accompanied by a fall of underlying domestic price pressures and slower growth in nominal GDP."

Altogether, the China leverage story is one of the weak getting weaker. Deterioration in the quality of the borrowers, e.g., local governments, is matched by deterioration in the quality of the lenders, e.g., trust companies. On the bright side, China, like Japan, owes virtually everything it borrows to indigenous creditors. Ecuador and Argentina defaulted on foreigners; China would default on Chinese.

Not that the People's Republic is anything like a financial island, or that a Chinese credit crisis would be a domestic event of no consequence to us barbarians. A deceleration in Chinese lending and borrowing caused either by crisis or by government directive would surely reverberate. Quoth "Deleveraging": "[T]he international transmission of deleveraging in China would primarily operate through lower demand for global exports. Given the prominence of China as a source of export demand in recent years, this would have a material impact on global growth performance. Furthermore, the combination of a trade slowdown and a renminbi depreciation could also generate international political economy tensions by triggering renewed debate about 'currency wars.'"

Though China issues no dollar-denominated debt, other nations borrow enough to fill the void. Since 2008, the share of EM debt in cross-border bond portfolios has more than doubled, according to "Deleveraging." Let's take a look under the hood of one representative EM portfolio. It's the $4.7 billion market cap iShares JP Morgan U.S. Dollar Emerging Markets Bond ETF (EMB on the NYSE Arca).

The iShares fund deals in crossover credits, mainly of the sovereign kind. Ratings cluster in the high junk to low investment-grade portion of the quality continuum. The shares yield a little over 4 ¼%. The managers, who promise daily liquidity, hold not much more cash in the till than they need to pay the rent and keep the lights burning. Plainly, their liquidation strategy is to sell bonds when the need arises. The rub, we think, is that that is nearly everyone's plan. "Sell to whom?" will be the operative question one of these days (*Grant's*, July 11). The rush for the exits at Pimco in the wake of the Bill Gross kerfuffle may provide a foretaste of a bona fide future liquidity event.

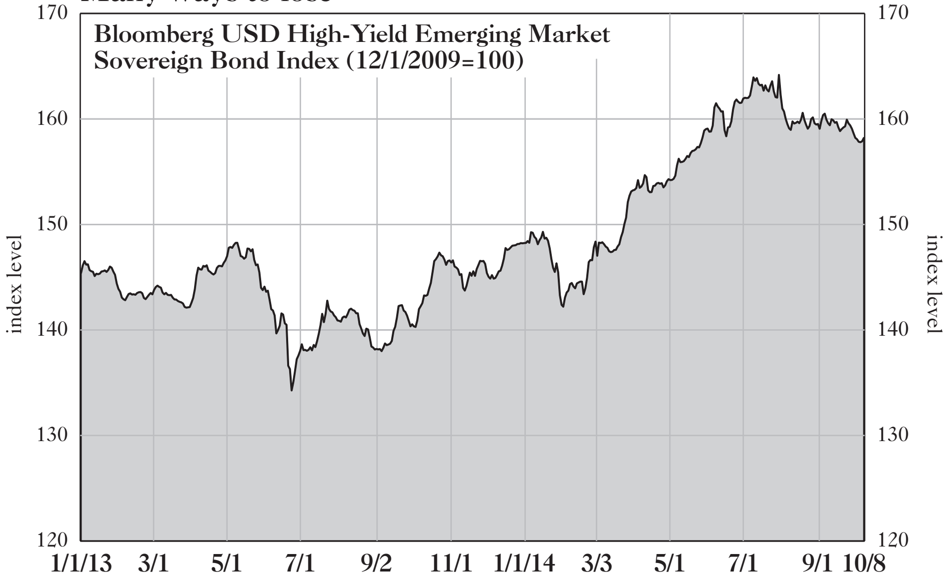
The "Deleveraging" authors distinguish between the EM sheep and the EM goats, the former showing a broadly improving trend in their external financial position, the latter a deteriorating one. Mexico, the Philippines, Colombia, Hungary and Poland are typical of the better cut of EM borrower; Turkey, Brazil, Indonesia, Russia and South Africa—constituent members all of the so-called fragile eight—typify the weaker credits. Among its top 10 country exposures, the iShares Morgan fund evenhandedly counts five sheep and five goats; Baa3/BB-plus Turkey, a goat, ranks first among the 10.

The managers can only control so much, naturally. More than 11% of the iShares portfolio is exposed to oil and gas. Some 36% of the bonds mature in more than 10 years. The PMs can root energy prices higher and interest rates lower, but that is as much influence as they can reasonably be expected to exert on big micro- and macroeconomic trends. Neither do they have a say in what the professors call behavioral finance. How others invest—how heedless they may be of risk and financial history—is out of their hands.

"You have to wonder," comments colleague Charley Grant, "how many EM investors bother to compare the tenor of the bonds they buy with the frequency of the defaults of the governments to which they lend. Certainly, in 2010 the mind of the market was on other things. Peru in that year raised nearly $1.5 billion for 40 years at an historically meager coupon of 5.625%. Those bonds today—they're rated BBB+/BBB+/A3—trade above 115 to yield 4.71%. Granted, in 2013, Peru was one of the fastest-growing economies in Latin America, but a lot can happen in four decades. Peru has defaulted six times since 1826 or once every 31 years, on average. It defaulted as recently as the year 2000 (this one was cured within the grace period). Is everyone quite sure that the End of History is an operative concept in sovereign credit?"

Mexico, one of the "Deleveraging" authors' prize sheep, has raised more than $8 billion in the debt markets this year, including in March a 100-year sterling-denominated issue in the sum of £1 billion. It's been 20 years since Gert von der Linde was quoted in these pages correctly forecasting the 1994 Mexican financial crisis, and what a difference those years have made.

Many ways to lose



source: The Bloomberg

Mexico today is an investment-grade credit whose bonds claim top honors for depth and liquidity of turnover, according to the Trade Association for the Emerging Markets. Still and all, 100 years is hardly the blink of an eye. In the past century, sterling has lost more than 99% of its gold value. Since 1828, Mexico has defaulted on its debt five times, which is to say on an average of every 37 years. Is history bunk? The Mexico-cum-sterling bulls seem to be betting that way.

Bulls on Pakistan, the Dominican Republic, the Ivory Coast and Jamaica are similarly inclined to forgive and forget. Jamaica defaulted on $9.1 billion in domestic-pay bonds in February 2013, yet, in July, managed to place $800 million in U.S. dollar debt maturing in 2025. Investors may thank BNP Paribas and Citibank for bringing those bonds into the world. The Jamaican 7 5/8s, rated Caa3/B-minus, are quoted above par to yield 6.58%.

Single-B-rated Cote D'Ivoire, scene of two 21st-century civil wars (2002-04, 2011), and now a threatened outbreak of the Ebola virus, also floated a 10-year dollar issue in July. It raised $750 million. Godspeed to the Ivory Coast, we say, but is 5.93%, the currently quoted yield, adequate compensation for the evident risks? You may reply that that depends on the comps. For perspective, then, the Bloomberg High Yield Emerging Market Sovereign Bond Index trades at a yield to worst of 7.75%. Argentina, the top borrower in the index, is charged with yields as high as 15.2%. Ukraine, the third-largest borrower in the index, is charged with yields as high as 15.9%. The Bloomberg Investment Grade Emerging Market Sovereign Bond Index fetches 3.88%; corporate junk returns 6.44%.

"As worrying as the rate of pay for risk in emerging markets debt," Grant observes," is the supine attitude of the professional investors towards legal risk. The new Kazakh issue, mentioned above, is the first to include clauses that bind all bondholders to decisions made by a 75% majority of investors. This is a bid to avert a scenario similar to the one in which Elliott Management has for so long disturbed the peace in regard to Argentina. As might be expected, the international financial establishment is all for the self-neutering innovation. The IMF endorsed it in language that is unnecessary to quote—you could almost write it yourself. The terms elicited no significant investor opposition, a person close to the Kazakhstan deal informed the *Financial Times*. Justice is what the creditors wouldn't mind having. Yield is what they crave, and 4.16% (before tax) will have to do."

Ecuador's default provoked an acid comment on the conduct of both the defaulting debtor and the "bovinely passive" bond trustee. Writing in the September 2009 issue of the *International Financial Law Review*, Lee Buchheit, a partner of Cleary Gottlieb Steen & Hamilton, had this to say: "It was the first time in modern history that a sovereign debtor had demanded that its external commercial creditors write off most of their claims (65%, as it turned out) without advancing a plausible argument that financial distress warranted such extraordinary debt relief."

Last week, this publication asked Buchheit for comment on the emerging markets' debt situation. "I don't think anyone should be surprised about what is happening in the EM sovereign markets," the lawyer replied. "After six years of zero interest rate policies by the major central banks, the need to generate yield has driven some investors to buy sovereign bonds at interest rates that an historian would say are not remotely commensurate with the risk."

While the current environment for borrowers might be placid, observe the authors of the "Deleveraging" report, "the emergence of concerns about a debtor's willingness or ability to service her debts may lead to a funding crisis, in which creditors are unwilling to extend new loans or rollover existing commitments. Since such concerns may be driven by expectations about a debtor's future ability or willingness to service the debt, there is scope for multiple equilibria in which the beliefs of creditors take on a self-fulfilling quality: if creditors retain confidence, risk premia are low and the debt is sustainable; if panic sets in, risk premia shoot up and the debt is no longer sustainable."

Not long ago, the investor (*and* paid-up subscriber) Leon Cooperman warned on CNBC that U.S. Treasury bond investors are "playing with dynamite." Then what kind of explosives might the investors in Ecuadorian, Jamaican, or Khazakh debt be trifling with?

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