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European scavenger hunt

Under the spell of Mario Draghi, the once rugged terrain of European credit is today a flat, bleak tableland. You, the fixed-income investor, are condemned to buy something on that featureless plain. For the most part, your choice boils down to a yield of less than nothing or a yield of just a little more than nothing. Preserving capital, sanity and self-respect are the topics at hand.

Danish mortgages, Italian 10-year notes, Italian bank stocks, Greek sovereigns, bank-issued perpetuals and property REITs are among the securities on the agenda. "Safety" and "risk" are the concepts that correspond to the securities. In general, we are bearish on "safety"—Italian government securities being the most glaring non-starters—and bullish on a certain kind of "risk."

In a crowded field, Danish mortgages may stack up as the top Continental head-scratcher. The Danmarks Nationalbank sets its intervention rate with the single purpose of fixing the exchange rate of the Danish kroner with respect to the euro. To bar the door to an unwanted influx of euros, the central bank has posted an interest rate of minus 65 basis points. And so it has come to pass, in Denmark, the land of Hans Christian Andersen, that the mortgagees pay the mortgagors, rather than the other way around.

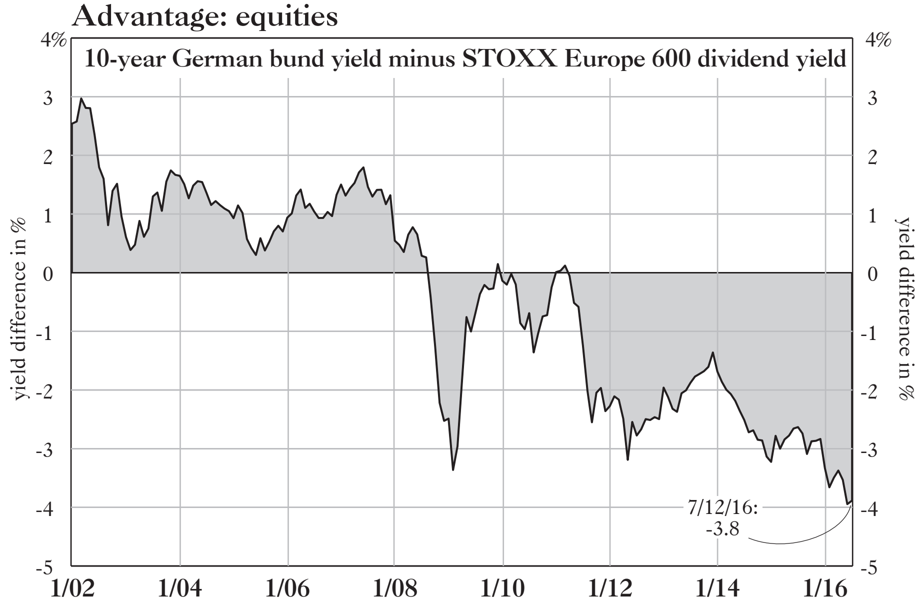
You are reminded of the bizzaro Swiss sovereign yield curve, negative all the way to 50 years, except that Switzerland can print its own money. Danish homeowners have no such capability, and they can and do default. Indeed, there is no more encumbered people in the world than the Danes, whose collective borrowings (mortgage, revolver, everything) work out to 305% of their collective disposable income. The runner-up debtor, the Netherlands, weighs in at 274% and the United States at slightly over 100%.

Like the United States, Denmark suffered a burst housing bubble in 2008 (Grant's, Aug. 10, 2012). And now rises another Danish housing bubble, yet unburst. In the first quarter, the quoted value of Denmark's owner-occupied condos soared by 10%, lifting it above the fateful 2006 high.

Knowing only this much, one might pity the European bond-fund managers. Withhold, for now, your pity, as colleague Evan Lorenz discovered in conversation with a member of that Draghi-oppressed guild. "It is very difficult today," allowed the investor—we'll call him Monsieur X—"but it is easier than in the summer of 2014, which was peak pain for me and probably when I was most pessimistic for the total return of my fund. That was before the Fed really stopped expanding its balance sheet and before the dollar bull market took off and oil cracked. That in my view is when the hunt for yield peaked.

"It is more difficult to buy short maturity triple-A sovereign bonds today, but back then everything was compressing across the board on a cross asset basis," X went on. "It didn't matter how much credit risk you were taking, or how much subordination, or how long the maturities, the spreads compressed across the board. That is the worst-case environment: the Japonification, and no matter

Advantage: equities



source: The Bloomberg

how much extra risk you take there is no risk premium at all. You are really just in trouble. Everything compresses to zero and you have nothing to do."

Today's illiquid and volatile credit markets do kick up tradable opportunities, X said—in February and March, for instance, the bonds of the reeling commodity producers. (There were similar opportunities on this side of the Atlantic, too: See, for instance, the bullish analysis of Atwood Oceanics, Inc. and Transocean Ltd. in the March 11 issue of *Grant's*.)

One fire sale ends, another begins. Banks are the scene of the new conflagration, X related. Year-to-date, the STOXX Europe 600 Banks Index has dropped by 29%, paced by the 49% plunge in the FTSE Italia All-Share Banks Index. The Italians change hands at the equivalent of 37% of book value, the STOXX Europe 600 Banks Index at 60% of book (and the domestic-bank component of the S&P 500, which is lower by 11% this year, at 91% of book).

The mauling of bank contingent convertible bonds (CoCos), the second most junior security in a bank's capital structure, mirrors the sell-off in bank shares. You'll recall that CoCos convert into equity or dissolve into nothing when bank capital levels fall below certain thresholds (or when regulators drop a yellow penalty flag; see *Grant's*, July 11, 2014 and Feb. 12, 2016). Perpetual in name, CoCos are typically callable at some date well short of eternity, sometimes on the fifth anniversary of issuance.

Consider, for instance, the Banco Bilbao Vizcaya Argentaria SA euro-denominated 8⅞s junior subordinated perpetuals; €1 billion's worth came to market on April 14. The coupon, fixed until the April 14, 2021 call, resets on that date to the five-year euro swap rate (currently negative 0.14%) plus 9.177%. Quoted at 101.28, the securities yield 8.84%.

"These are, in essence, preferred stock with capital event triggers," X pointed out. "These are risky securities, but we bought them at 95 on the euro for a 9.3% or 9.4% yield to maturity for a boring, retail-focused franchise. This is not a highly levered black-box investment banking model. It is a retail model. This bank went through a depression in its home market and absorbed the blowing up of their real estate bubble. . . . The risk of a capital event here is low and the risk of a coupon miss is extraordinarily low."

"It's worth pausing for one moment," Lorenz adds, "to review just how deep Spain's depression was. In the five years ending 2013, Spain's output declined by a real 8.6%. For comparison, U.S. real GDP declined by less than half that amount—4.2%—from the fourth quarter 2007 through the second quarter 2009. While Spain's economy grew at the rates of 1.4% and 3.2% in 2014 and 2015, the unemployment rate sits at a still uncomfortably high 19.8%."

Italian bank sampler

	market cap (€ mns)	equity/ assets(%)	price to book (%)	y-t-d chg. (%)
UniCredit	€12,990	5.7	25	-59
Intesa Sanpaolo	32,106	7.1	65	-38
Banca Monte dei Paschi di Siena	909	5.6	9	-75
Banco Popolare	1,970	7.0	14	-75
Unione di Banche Italiane	2,541	8.5	26	-55
Mediobanca	4,965	12.3	56	-36
Banca Popolare dell'Emilia Romagna	1,635	8.3	32	-52

source: The Bloomberg

BBVA, with March 31 assets of €740.9 billion, was profitable on a full-year basis throughout the crisis and its aftermath. We judge that today's credit metrics pass the mother-in-law test (i.e., sound enough to admit the relevant securities for consideration as an intra-family investment): slow loans to overall loans, 5.8%; reserve coverage of slow loans, 73%; equity to assets, 7.4%; senior debt ratings, triple-B-plus. The ratio of loans to deposits, at 110.5%, gives pause, though it is on an improving track.

By one criterion, the market rates BBVA as far safer than Deutsche Bank AG, which the IMF recently fingered as the top "net contributor to systemic risks in the global banking system." Thus, BBVA changes hands at 72% of book value, Deutsche Bank at 28% of book.

By another criterion, the market tells a very different story. BBVA's 8⅞s, as noted, are quoted at an 8.84% yield. Deutsche's euro-denominated 6% perpetuals, which came to in 2014 (and which will undergo a coupon reset in 2022 to the five-year euro swap rate plus 4.698%), are quoted at 6.86%, almost two percentage points richer than the BBVAs. As usual, Mr. Market was unavailable to explain his reasoning.

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Collapsing bond yields throw a flattering light on Continental equities, of course. On June 27, Brexit opened the gap between the STOXX 600 dividend yield and the 10-year bund to a record-high 419 basis points, eclipsing the 393-basis-point mark set in the panicky month of March 2009. The gap has subsequently narrowed, but it remains distended, thanks mainly to the almost 6% yield on the bank segment of the STOXX index. To earn 4% on a non-bank equity, therefore, takes some doing.

Which brings us to Gecina SA (GFC on Paris), a 3.9%-yielding real-estate investment trust. Ninety percent of Gecina's properties are situated in Paris, the would-be new, post-Brexit financial capital of Europe. Sources of Gecina's rental income as of March 31 were as follows: offices, 65%; apartments, 19%; medical facilities, 13%; student housing, 3%.

We don't mind saying that Gecina is not our idea of a great investment. For any in need of euro-denominated income, it may prove a serviceable investment. Bullish arguments include the legendary French hostility to Anglo-Saxon notions of getting ahead in life. "Due to construction restrictions," a June 14 bulletin from Ned Davis Securities relates, "there is almost no competition for prime commercial locations, and vacancy rates have remained very low (2.5%) throughout the recession" (at that, Paris does sound a little like San Francisco). Then, too, since 2009, according to a Feb. 25 presentation by Gecina, central Paris office rents have stagnated while central London rents have risen by half (both expressed in euros per square meter). It would be no bad thing for a Paris-centric REIT if even a fraction of the bruited exodus from London did, indeed, take place.

"While Gecina's dividend yield may pale next to the BBVA 8⅞s," Lorenz observes, "it beats the 2.9% on offer from American office REITs, not to mention the 0.19% yield attached to the 10-year French government bond or, as far as that goes, the 0.75% yield on Gecina's own triple-B-plus-rated senior unsecured 1½s of 2025."

SL Green Realty Corp., the Manhattan-centered office REIT on which this publication staked out a bearish position on May 6, provides another point of comparison. We had complained that Green needs toppy capital markets to implement its business plan. So does Gecina, which intends to shift more to office buildings by disposing of non-office assets. We had objected, too, to SL Green's rising indebtedness. Let the record show that Gecina shows a ratio of net debt to EBITDA of 11.4 times; in the first quarter, EBITDA covered interest expense by 4.9:1. Green is not so leveraged, showing a ratio of net debt to EBITDA of 9.2:1 and an EBITDA coverage ratio of 3:1.

Will interest rates ever rise again? If they did rise by, say, 100 basis points, how would the Gecina share price respond? "Other things being the same," Lorenz points out, "the common would have to fall by 21% (which would deliver a 4.9% dividend yield). Compare and contrast the BBVA 8⅞s. A rise in rates might prompt a 2021 call, meaning that the CoCos would, eventually, trade to 100."

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Speaking of tail events, what about the risk of something—anything—in the eurozone going right? For instance, that last year's authorized €86 billion in Greek bailout funds actually winds up covering the maturing Greek 3⅜s of July 2017? The notes, which change hands at 96.64 to yield 6.94%, are priced for the speculation that they are. Not so, Italian 10-year notes. At a yield to maturity of 1.2%, they are priced for the investment that they are not.

It's nobody's state secret that Italy has a debt problem (its ratio of debt to GDP stands at 132.6%, second highest in the eurozone after Greece) or that that problem debt clogs the balance sheets of Italian banks. What might as well be secret are the (fully disclosed) risks embedded in the depths of Italian government bond indentures.

Europe's fractious politics are what confer investment relevance on the fine print of Italian bond documents. There is, after all, the possibility that Matteo Renzi, losing the referendum he called for October, may resign. There is a chance that the successor government, perhaps the Five Star Movement of Beppe Grillo, would call for a national vote on the euro. And, as David Cameron might attest, there is a chance that the plebiscite delivers the destabilizing, i.e., anti-euro, outcome. In such a case, how would the debt be redenominated? Who would decide? How would claims be repriced?

"Italy, of course, isn't the only eurozone nation to see a rise in populism and growing EU resentment," Lorenz notes. "According to a June 7 report by the Pew Research Center, France holds a more negative view of the European Union (61% unfavorable vs. 38% favorable) than even the UK (48% unfavorable vs. 44% favorable). The Paris newspaper *Libération* reports that 68% of French people believe the EU is heading in the wrong direction. According to a June 29 poll conducted by TNS Sofres for *Figaro* magazine, French president François Hollande's approval rating has fallen to 12%. Similar sentiments are bubbling to the surface in Germany."

"To be sure," Lorenz goes on, "Italy is a special case. Its banks and its government are almost financially indistinguishable. Bank holdings of Italian sovereign debt amount to 166% of Italian bank capital and reserves. Out of €2.2 trillion in overall government debt, the banks hold €734.7 billion."

Which facts cast in a problematical light the European Union's new Bank Recovery and Resolution Directive. It's the ruling that prohibits a government from bailing out a bank unless the senior debt holders of the failing institution bear a loss. The awkward fact in Italy is that, according to Fitch Ratings, Italian depositors hold one-third of the bank debt.

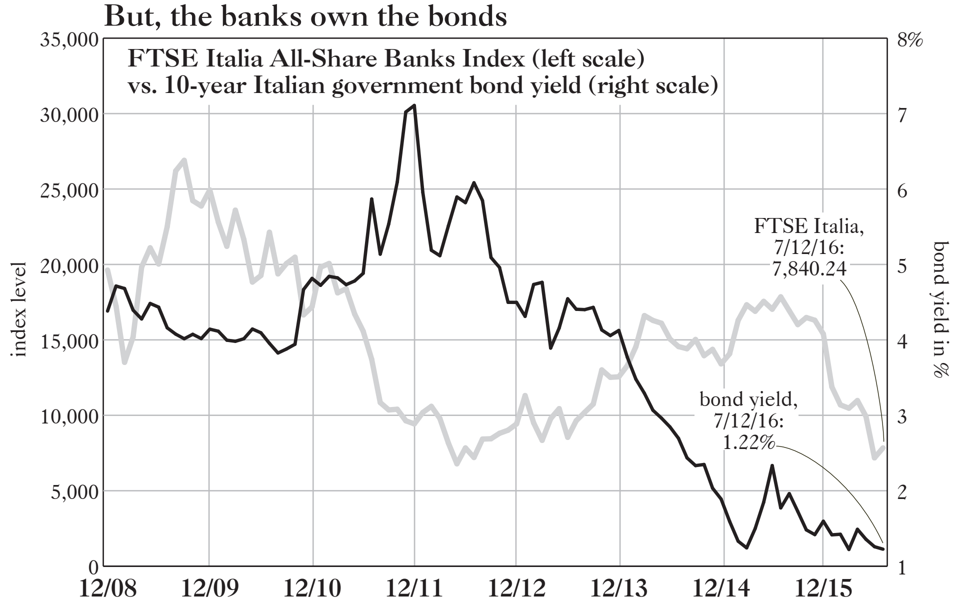
"From which it follows," Lorenz observes, "that a well-intentioned policy of imposing losses on seemingly sophisticated creditors could cause a stampede of all the creditors, including the depositors. Which could, in turn, poison the political atmosphere in the runup to the October referendum. It may just be that Renzi's Democratic Party is fully enmeshed in Italy's bank-sovereign-bond doom loop."

Certainly, Renzi is applying his powers of persuasion to winning an anti-bailout waiver. Next to nobody seems to expect the weakest Italian banks to pass the latest ECB stress tests (results are slated for release at the end of this month). Conspicuous among these underachievers is Banca Monte dei Paschi di Siena SpA, the third-largest bank in Italy by assets. It must say something about the present era in finance that Banca Monte, founded 20 years before Columbus discovered America, is on the rocks now. After raising capital of almost €15 billion since 2008, the bank today commands a market cap of just €909 million (the share price is down by 75% in the year to date). Price to so-called book stands at 9%.

It's hardly inconceivable, then, that an Italian banking crisis could spill over into an Italian sovereign-debt crisis. Yields on the Italian 10-year note topped 7% as recently as 2011. There is another risk, too, apart from banking contagion.

We now come to the explosive open

But, the banks own the bonds



source: The Bloomberg

secret that Italy has it within its power the right to impose new terms on its creditors—to extend contracted repayment dates, for instance, or otherwise to order what is called a "reprofiling."

You will find the facts laid out in a May 9, 2012 essay entitled "A Mature Approach: Using a Unilateral or Voluntary Extension of Maturities to Restructure Italian Debt," which is archived on the Social Science Research Network. The authors are four members of the Class of 2013 of the Duke University School of Law: Andrew Edelen, Paige Gentry, Jessalee Landfried and Theresa Monteleone. Ugo Panizza, professor of international finance at The Graduate Institute in Geneva, corroborated their work in a 2014 paper called "Public Debt Risks in Italy: Myths, Facts, and Policies."

"Italy's debt stock is ideal for a reprofiling—a majority of its bonds have low coupon rates, are governed by Italian law, and have no contract terms," the Duke alumni observe. The fact is that only around 3% of Italian government bonds are subject to foreign law. Of the local law bonds, €840 billion have collective action clauses, which allow the state to restructure terms if two-thirds of bond holders agree. Another €1.3 trillion of debt is subject to a 2003 decree by the president of the republic (currently, on form temporarily, he is Sergio Mattarella). Article 8 of that decree stipulates, "The payments of public debt are not reduced, paid late or subject to any special levy, not even in case of public necessity." However, the four authors note, Article 3 likewise bears on the situation. It says: "In each financial year, the Ministry [of Economy and Finances] has the authority, within the annual limits established by the budgetary law, to issue framework decrees that allow the Treasury to . . . proceed, in order to restructure the national and external public debt, to the reimbursement before maturity of bonds, to the transformation of maturities."

"When read together," Edelen et al. conclude, "these provisions seem to allow Italy to extend the decree bonds' maturities without passing new legislation or regulations that would apply to the bonds retroactively." As of June 30, Italian government bonds had an average weighted maturity of 6.52 years. Should he choose, Pier Carlo Padoan, the current Italian Minister of Economy and Finances, could reset the maturity on €1.3 trillion of Italian bonds to 15 years, 30 years, or 100 years. He could negotiate terms with the holders of an additional €840 billion's worth of debt.

The legal structure around Italian sovereign bonds indeed appears unique, our man X comments. "But," he adds, "the point is, the power of the treasury can be given to any other treasury in Europe to alter local law bonds after the process of legislative update [i.e., passing laws that retroactively change the terms of local law bonds]. It happened in Greece, and it can happen elsewhere. It doesn't give additional power, but it gives the government earlier power."

It will be said that Italy would take no such high-handed action lest the government bankrupt its bondholding banks. Not necessarily, as the Duke essayists point out. Bank accounting conventions in the EU hold that securities designated "available-for-sale" must be marked to market, while securities tagged "hold-to-maturity" need not be so marked. "Therefore," according to Edelen et al., "while extending maturities would cause a drop in the bonds' market value, that reduction would not necessarily be reflected on banks' hold-to-maturity books."

We here venture the guess that a central-bank holder of Italian debt would prove a compliant counterparty in a negotiation over a proposed reprofiling. Since March 2015, Mario Draghi's ECB has purchased €884.5 billion's worth of euro-area government securities, including €144 billion of Italian sovereigns. Gross holdings of the Bank of Italy are, as far as we can tell, undisclosed. Conveniently, however, the Italian central bank does list the CUSIPs of the Italian government bonds it holds (see Bloomberg, page GPGX256 70). Of the 87 CUSIPs so named, we note, 38 have collective action clauses. It seems to us that, if one were of a mind to short Italian sovereign debt, those would be the bonds to sell.

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"Of course," Lorenz concludes, "tail risk extends in both directions. By March 5, 2009, the bank component of the S&P 500 had dropped 88% from its Feb. 20, 2007 top. At their peak, U.S. banks traded hands at 197% of book; at trough, 47%.

"Yet, on 5:00 p.m. Eastern Time on May 7, the Fed announced the results of its inaugural bank stress test and credibly drew a line under problem assets in the U.S. financial system. Banks were then required to recapitalize along that line. With confidence restored, investors rushed bank stocks. Over the next 12 months, the bank component of the S&P rallied by 184% and by March 5, 2010, banks traded up to 127% of book.

"Europe's bank stress tests today bear the whiff of past failures, but that can change. Few probably forget that Dexia S.A., the Franco-Belgian bank, not only passed the ECB's stress test on July 15, 2011, but was actually deemed one of the safest banks on the continent. On Oct. 10—87 days later—the fortress-like bank applied for aid from its home state, Belgium.

"What if the ECB's upcoming stress test accomplishes what the Fed achieved in 2009? Or, what if Chancellor Angela Merkel and the other stewards of tight money in the eurozone finance rules blink? A sudden relaxation of budget deficit rules along with a fresh round of quantitative easing could send risk-markets ablaze. 'Time is ticking away and a decision will have to be made within weeks if a European recession,' Russell Napier warns in a July 7 note on the Electronic Research Interchange, 'which will raise severe questions about the survivability of the European political union, is to be averted.'"

If there were a central-bank-led melt-up in the markets, it will be the most-hated stocks, i.e., the banks—at that, we judge, the Italian banks—that would likely rally the hardest.

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