

Fixed Income Perspectives

Fantastic Bonds and Where to Find Them

Regular readers of our Fixed Income Perspectives would know that we take a mid to long term view, evaluating investments on such a horizon. To recap, at this point in time we generally prefer:

- taking capital structure risk and duration risk over credit risk, opting for subordinated bonds of investment grade companies over high yield companies; and
- synthetic credit opportunities trading wider than cash bonds of the investee companies which have the added flexibility of being floating rate in nature.

However, with the new issue market for bonds opening with a bang in 2023, investors may seek to understand pricing dynamics a bit better. For example, what caused the newly issued Hong Kong government 30-year bond ("HKINTL") to trade at a whopping 106% one day after issuance? Are bonds that in demand?

Back to Basics

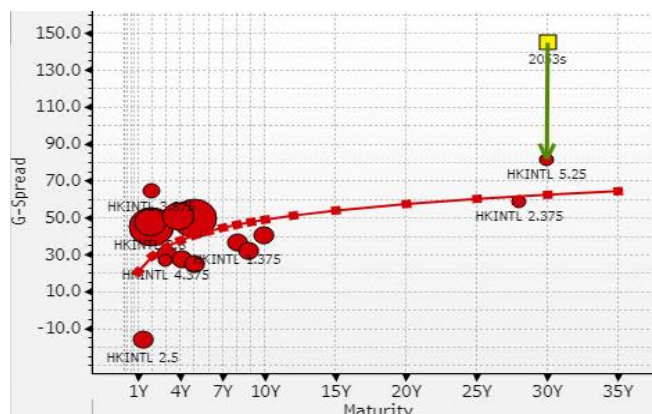
A bond generally provides a stream of income over its tenor. Investors look at the yield, which roughly¹ represents the annual average expected income taking into account the effects of buying the bond above or below par value.

However, yield does not exist in a vacuum. No matter how attractive a US bank bond with 7% yield might sound, an investor needs to compare it to a benchmark interest rate in the same currency, which is usually the government bond rate. For example, if Treasuries of the same tenor yielded 8%, a rational investor would simply buy the risk free government bond and be better off. The additional

amount a corporate bond yields above the Treasury rate is referred to as the credit spread.

Going back to the HKINTL example, despite the fact that existing bonds of similar tenor were valued at a spread of about 0.88%, HKINTL had to pay a spread of 1.45%, or a new issue concession of about 0.57% per annum. Multiplied by 30 years, the immediate price appreciation potential was significant enough to draw investors despite the long duration. As of 3rd February 2023 these bonds were trading at about 114%.

TABLE 1. SPREAD X MATURITY OF HKINTL BONDS



Source: BNP Paribas (WM), Bloomberg Finance LP as at 7 February 2023

"While whether a bond does well in the secondary market primarily depends on the issue spread against the alternatives available, TINA² is still alive and well in certain bond markets."

TINA² markets are generally trading markets. Investors would be well served to identify their expected primary source of returns – either from income carry or bond trading.

1. The exact methodology of various yield calculations is fairly technical in nature
2. TINA: There is no alternative

The Secondary Market

In the secondary market, pressures for liquidity raising are less evident. While we continue to see some opportunities in cross currency bond opportunities, investors need to be comfortable in hedging longer dated foreign exchange exposures in order to fully capitalise on them.

Additionally, with investment grade bond yields looking attractive, we understand many investors have been taking the opportunity to build resilient income generating portfolios to the extent that supply and sourcing of such bonds is getting increasingly difficult. This is especially true in less liquid markets such as the Australian dollar and the Singapore dollar bond markets.

"TINA lives on in the SGD Bond Market"

With a lack of compelling alternatives to SGD treasury bills, any issuance from a known issuer with a yield above 5% attracts a large amount of interest. In January 2023, Commerzbank (NEGATIVE credit opinion) priced a 10 year Tier 2 subordinated bond at 5.70% (with a reset and call option after 5 years), representing a negative new issue concession of about 15-25bps per annum vs. its own bonds in EUR. Simply put, after adjusting for currency and foreign exchange differentials the new bonds were more expensive than the existing bonds available in the market. Despite that the bonds rallied immediately, trading above 101% the next day.

The Importance of a Personality Test

"知己知彼，百战不殆" - 《孙子兵法》

As Sun Tzu, one of the most brilliant military strategists in history once alluded, it is important to know yourself as well as your enemies in order to win every battle.

And so here we make a distinction between investment intent.

- Investors with a trading mindset should closely follow developments in the new issue market. Most of the bonds issued in 2023 year-to-date are trading above 100%³ due to the initial premium paid to raise liquidity as well as a rate peaking environment.
- However, investors (especially outside of USD and EUR) who are looking to simply build out income portfolios would be well served to explore synthetic credit given ample liquidity and ease of execution.

CONCLUSION

The new issue markets and synthetic credit remain to be good investment opportunities in 2023. Investors looking to build out income portfolios in order to lock in historically high yields should look to the new issue markets for liquidity and execution, while investors looking to trade should be more selective in relative value as well as choice of currency markets.

3. Source: BNP Paribas Wealth Management, 7 February 2023



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