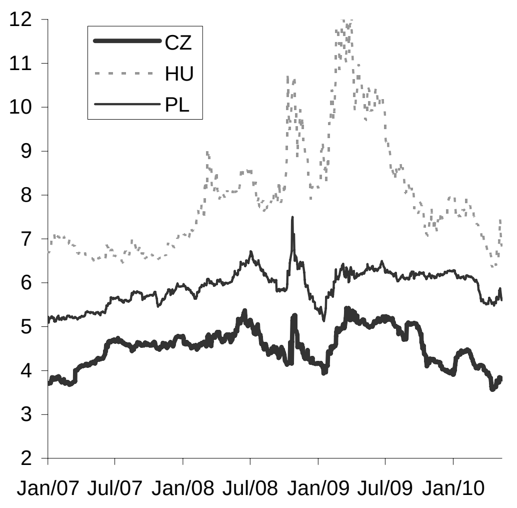
Monthly analysis – May

Regional bond markets: how big is the liquidity premium?

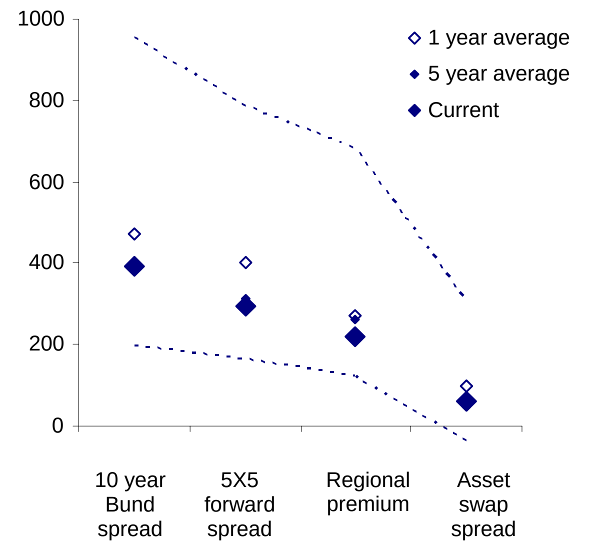
An important element of the investment process is deciding whether what we're buying or selling is cheap or expensive. Determining "valuation levels" in the case of bonds usually entails examining a certain premium or other, which means that we attempt to assess prices and yields in the light of the fundamentals, and assume that the fundamentals will change at a slower pace than the prices themselves. For this reason, we usually compare the yield on bonds with swap yields of the same currency and yields on bonds in other similar countries, as well as those of risk-free countries such as Germany. Often the deviation of the yield curve from normal is indicative of a degree of misvaluation, and consequently it is worth paying attention to how spreads between the various maturities, and forwards, develop. The most common cause of misvaluation is a very rapid change in market sentiment or the appearance of significant liquidity premiums, which may come about when substantial lots exchange hands relative to the depth of the market. These anomalies present opportunities particularly for long-term investors.

The ten-year bonds and premiums that we most frequently monitor developed as seen in the graphs below on three Central and East European markets in mid-May:

Change in yields on regional 10-year bonds issued in local currencies



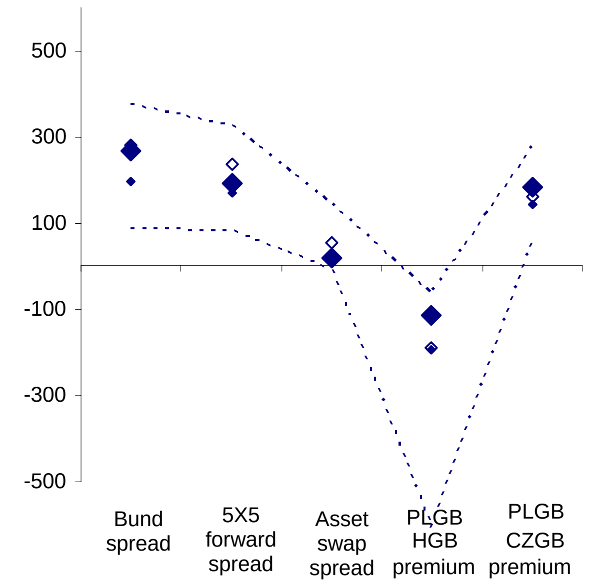
Valuation of Hungarian 10-year government bonds



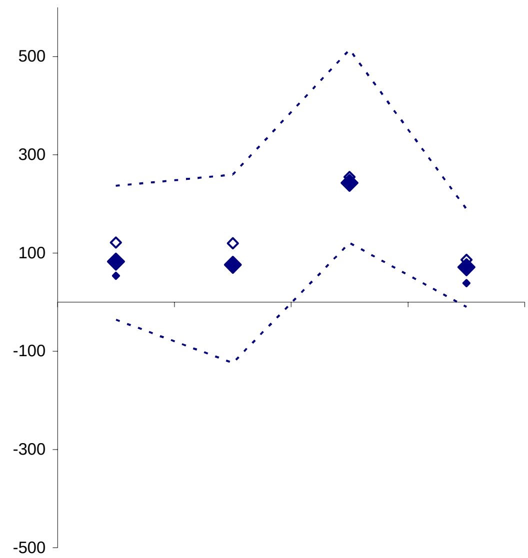
Sources: Bloomberg, AEGON Global Asset Management / AAM CEE

With respect to three indicators, the Hungarian market is at the five-year average, and it is overvalued relative to the one-year averages. In addition, the Hungarian ten-year yield is low compared to Czech and Polish average yields, and in relation to both annual and five-year historical averages. The change is due to the significant narrowing in the difference between Polish and Hungarian ten-year yields, as well as to the considerably less significant narrowing of the difference between Czech and Hungarian yields. From this perspective, Polish yields may appear cheap, an observation supported by the relatively high margin over German yields. The reason for the shift in regional premiums, meanwhile, may be sought in the divergence of interest rate cycles in the region: in Poland, the tightening phase in the cycle is expected by most investors to occur sooner than in the other two economies. The valuation of the Czech ten-year yield appears average, although its premium over the German Bund is greater than the five-year average.

Valuation of Polish 10-year government bonds



Valuation of Czech 10-year government bonds

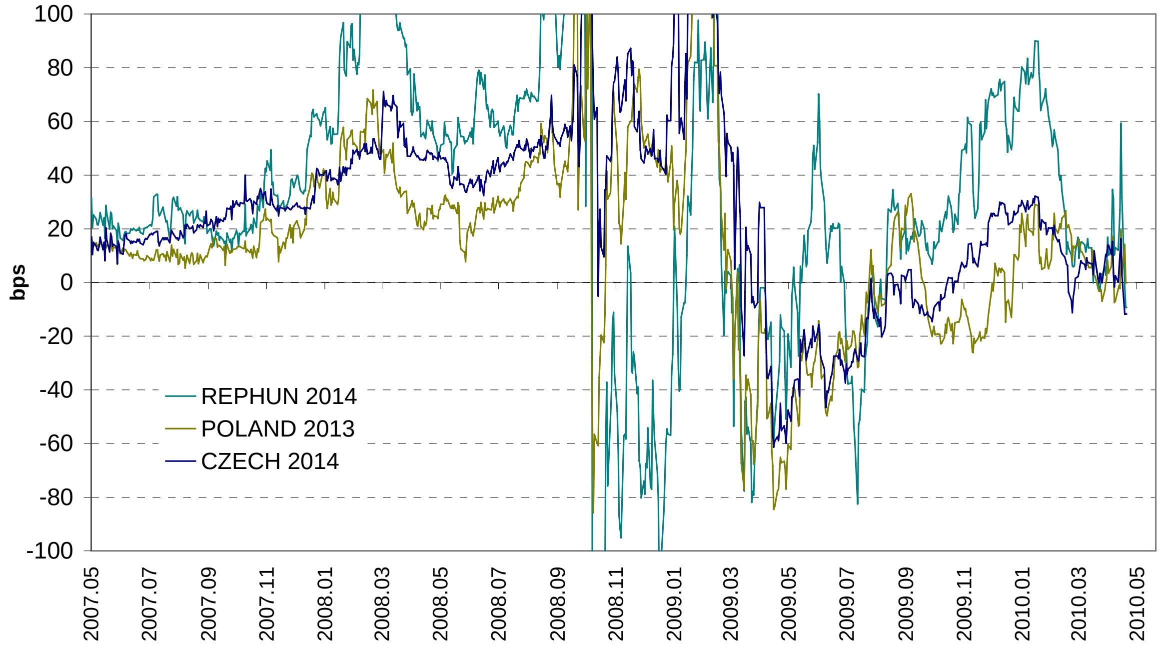


Sources: Bloomberg, AEGON Global Asset Management / AAM CEE

Based on these factors, the Hungarian market seems expensive, the Czech neutral, and the Polish perhaps cheap. In this analysis we add two new indicators to those mentioned above: first, we examine the liquidity premium on euro bonds via the so-called CDS basis, and then we compare the pricing of government bonds issued in local currency with the pricing of euro bonds.

The CDS basis compares the CDS premium of the issuer with the swap premium of the bond issued in foreign currency. The negative value here means that the bonds are traded at a higher premium compared to the price of the CDS of a matching maturity, and so on the cash product market investors may gain a liquidity premium and surplus yield. This is typical in periods when liquidity is limited, since considerably more investment capital (liquidity) is required for trading on the bond market than for CDS trading on the derivatives market. At times when there is a lot of liquidity in the system, there will also be more buyers on the market for cash products, while the CDS basis will widen, even venturing into positive territory. After 2009 and the turbulence that accompanied the crisis, the negative CDS basis, indicative also of disappearing liquidity, continuously rose and is now once more in positive territory, so that the cash premium has again disappeared from the system; moreover, in the Czech and Hungarian cases, the yield that can be gained is 15 basis points lower than on CDS that embody a similar risk. There is no CDS basis on the Polish market, which is probably due to the supply pressure caused by major euro bond issues carried out recently.

CDS basis

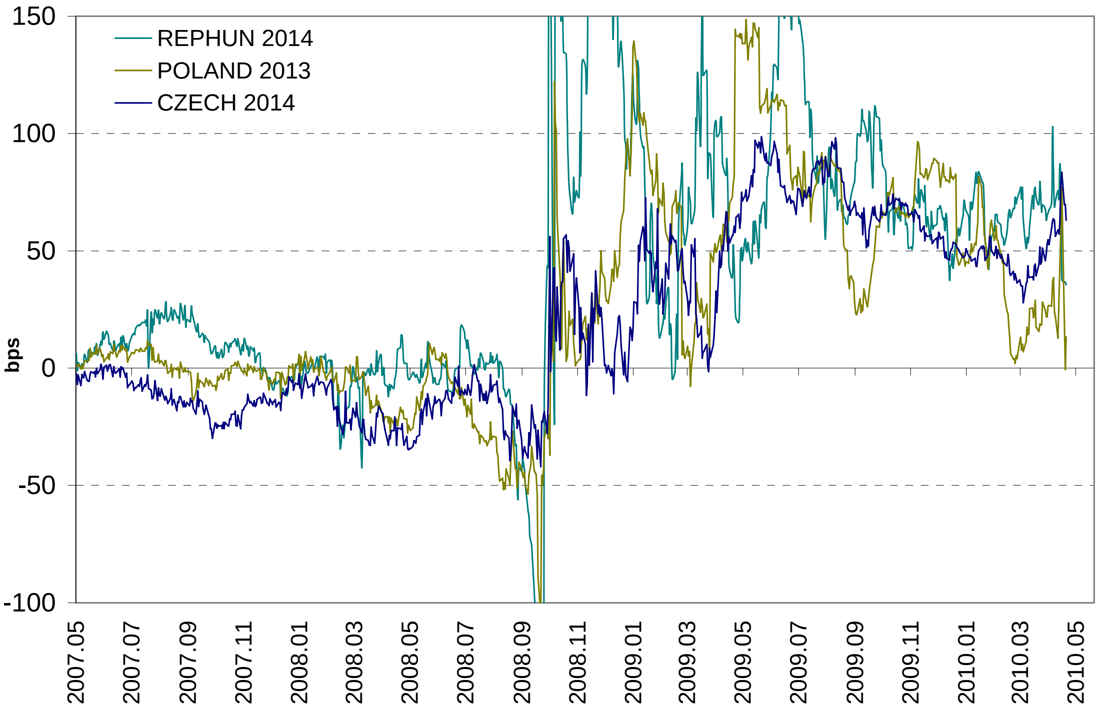


Sources: Bloomberg, AEGON Global Asset Management / AAM CEE

Based on the above reasoning, we might also conclude that regional euro bonds are actually expensive. What, then, might we say about bonds issued in the local currency? In theory the two types of instrument differ only in the currencies in which they are denominated, and can be exchanged for each other at almost any maturity on the basis swap market. In making such deals, we gain the difference between the euro and local currency swap interest in exchange for the exchange rate risk, and we must also pay any "basis" that may change over time. This creates a passage between the two markets, thus allowing the yield on bonds in local currency to be reconciled with the yield on euro bonds. Given that these markets exist quite separately (with differing circles of investors, regularity of issues and price quotations), the liquidity premium may also differ significantly.

In the graph below we can see that prior to the crisis there was only a minimal discrepancy, of a mere 20-30 basis points and primarily in favour of domestic issues, between the premiums (above swap yields) on regional government bonds issued in euro and converted into the local currency and the premiums on bonds issued in the local currency, and this was the extent of the margin on liquidity premiums. The crisis also generated significant movements on these markets and the difference between premiums became enormous, the reason for which was that the swap spread on euro bond markets expanded far more than on the local market: the proportion of major global investors is higher on euro bond markets, and thus the effects of the globally generated selling wave (following the drying up of global liquidity) were more significant there. It seems that the greatest differences evolved on the Hungarian market, where the yield margin remained high (at 70 basis points) in favour of euro-denominated securities, even when the local bond market had completely disintegrated. It is no wonder that the recovery has occurred most slowly in this country, and that foreign currency-denominated securities have had an over 50 basis-point "advantage" over forint securities even in recent weeks, although the basis swap expansion has led to this decreasing somewhat in recent days. The Polish market has now returned almost entirely to normal, with a margin of close to zero, while on the Czech market we see a discrepancy similar to that in Hungary in favour of euro bonds.

Yield on euro bonds converted to local currency vs. yield on local bonds of similar maturity



Sources: Bloomberg, AEGON Global Asset Management / AAM CEE

It appears, therefore, that liquidity works better on local markets, that swap spreads have narrowed more rapidly here, and that investors are returning to the euro bond market more slowly than to local markets. The reasons for the outperformance of forint, zloty and koruna-denominated securities may include the following:

- Investors have sought long positions in the currencies of developing markets in recent times as a consequence of the policy of quantitative easing seen on developed markets;
- Investors place the cycle of interest rate increases by the region's central banks at a point in the distant future, and thus seek duration exposure in local currency, which they do not receive with euro bonds.

Furthermore, it is also conceivable that in reality it is not local securities that are outperforming, but local swap curves that have stayed up due to:

- the relatively high level of local interbank rate fixing, and
- the comparatively low level of activity of leveraged players and hedge funds.

All things considered, euro bonds on the Czech and Hungarian markets – though 15 basis points more expensive than CDS – are still 70 basis points "cheaper" than forint or koruna-denominated securities. In contrast, the high price of zloty-denominated securities compared to Polish euro bonds is not so striking. The question of which instrument's price will eventually fall into line is difficult to predict: one possible outcome is the convergence of Hungarian and Polish basis swaps or the sagging of the forint and koruna swap curve, just as forint-denominated government bond yields may rise or euro bond yields may fall. However, the comparison with foreign currency-denominated securities certainly serves to confirm that the Czech and Hungarian domestic bond markets can no longer be regarded as cheap.

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