Stock Market Review

Investing in government bonds

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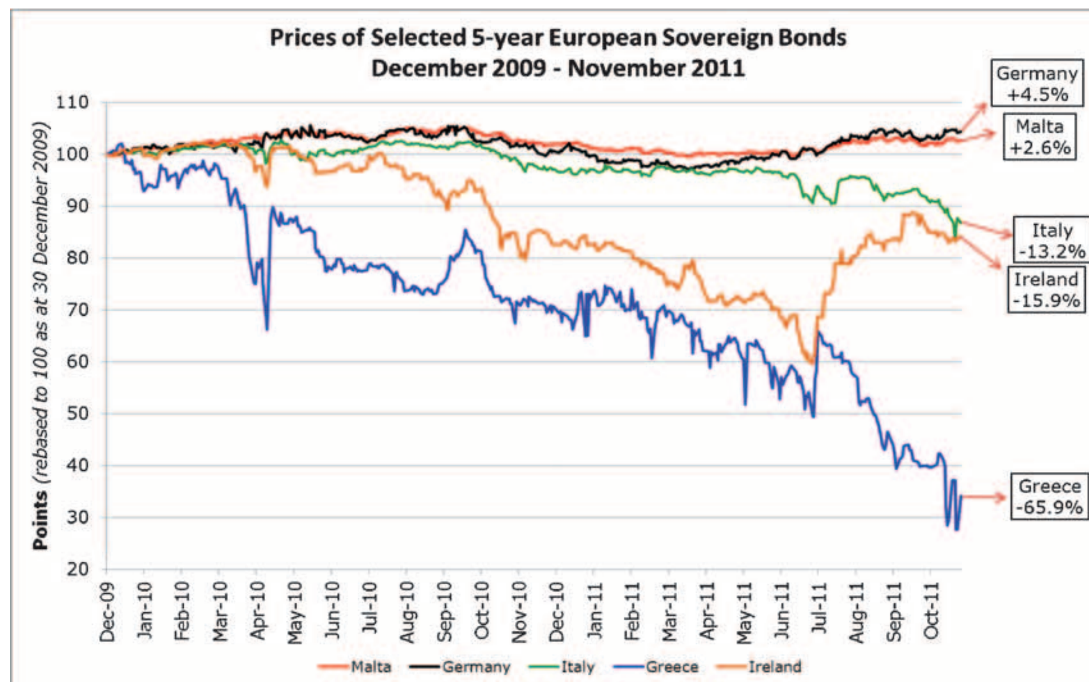

Investing in government bonds has always been popular with local investors especially for the more cautious individual wishing to take on low risk. This trend was again very evident over the past days as many retail investors scrambled to take a slice of the last offering by the Government of Malta for this year. Although the Treasury has not yet announced the amount of applicants and the overall level of demand by the retail investors (an announcement is expected tomorrow afternoon following the closure of tenders by institutional investors), this is expected to amount to several millions of euros once again. It may be worth recalling that in November of last year, the retail market crowded out institutional investors and applied for more than the total amount on offer by the Treasury, equivalent to €98.8 million.

While government bonds in Malta are referred to as "Malta Government Stocks" or "MGS", such terms vary in overseas markets. In the UK, government bonds are known as "Gilts" while in the US, government bonds are referred to as "Treasuries". In the eurozone, the German government bonds are called "Bunds" and in Italy they are referred to as "Buoni del Tesoro".

Apart from investing in Malta Government Stocks, local investors have also been able to invest in overseas government bonds through local financial intermediaries. Meanwhile, investors may also have been indirectly investing in foreign government securities through some local collective investment schemes.

However, the current crisis affecting the eurozone and the resulting soaring yields in some countries are grabbing the headlines almost on a daily basis and this may be difficult for some investors to understand.

As such, it may be worthwhile going back to the very basics of a bond or a fixed rate instrument to understand the dynamics of recent price movements. A bond is simply an obligation issued by governments or companies to investors, who in return receive a fixed rate of interest (the yield) over a pre-determined period of time. On maturity date, the original sum invested is returned to the investor and this is known as the face value or the par value. Since the interest is fixed over the duration of the bond, daily changes in the market price of bonds results in a higher or lower yield to investors.

There is an inverse relationship between the price and the yield. Therefore, a higher price gives a lower yield and vice versa. This explains last week's movements in Italian government bonds with bond prices falling dramatically and the yield surging past the seven per cent level for 10-year bonds! To put this into perspective, the yield on a 10-year German government bond is currently at 1.80 per cent per annum and that of a Malta Government Stock is 4.10 per cent per annum. The extra yield requested to invest in Italian bonds highlights the perceived risk and loss of confidence in Italy across the international financial markets.

Until a few years ago, the price movements of government bonds on the secondary market mainly reflected future interest rate movement expectations. However, price movements have been more pronounced and volatile in recent years in response to announcements by credit rating agencies reflecting underlying economic indicators and the overall strength of a government's finances.

The recent problems in Greece, Ireland and Portugal which came to the fore in 2010 have brought about increased focus on the ability of such countries to repay their obligations. In fact, as international investors deemed such countries to be too risky, they demanded higher returns (yields). This higher cost was perceived by investors to be unsustainable to finance on a yearly basis, and all three countries sought funding from the International Monetary Fund at lower rates. Although the countries borrowed huge sums of money from this institution to finance their ongoing commitments and also to honour their debt obligations, a number of conditions were imposed upon them in order to reduce their future government borrowings and achieve an improved budgetary position. These austerity measures brought about widespread criticism and protests in some countries which were widely televised.

> **Developments in recent months overseas confirm that an investment in government bonds is also not without risk**

Meanwhile, the Greek government's rapidly deteriorating financial situation and the offer from private investors to write-off 50 per cent of the value of their holdings in Greek government bonds worsened investor sentiment across international markets as market players digested the news that even governments within the eurozone may after all not be in a position to repay their obligations and "default".

The worsening situation in Greece also shifted the market's attention to other countries which have high levels of debt and other economic difficulties most notably Italy and Spain. The sheer size and importance of these two large economies to the overall eurozone also brought about debates on the future of the single currency. Furthermore, the fragile Berlusconi government and resulting political uncertainty in Italy had a strong negative impact on the market for Italian government bonds last week.

In fact, the price of Italian government bonds declined rapidly ahead of the debates in Parliament on the new austerity measures necessary to improve the debt situation in Italy and the confidence vote in the Italian Prime Minister Silvio Berlusconi. As prices declined, the yield on 10-year Italian bonds approached the seven per cent level last Tuesday.

Many international economists claim this level to be unsustainable and this lead to speculation that Italy will be the next country to require a bailout by the International Monetary Fund. The yield on Italy's 10 year bond rose swiftly past the seven level on Wednesday and touched a high of 7.5 per cent before dropping back towards 6.8 per cent by the end of the week as the Italian Prime Minister Silvio Berlusconi confirmed his intention to resign as soon as the austerity measures were approved by Parliament over the weekend.

It is also worth highlighting the situation in Cyprus which has also been affected by the Greek crisis. Only last week, the international credit rating agency Moody's downgraded Cyprus' bond rating by two notches to Baa3 (equivalent to BBB- by Fitch and S&P) on the likelihood that the Cypriot government will need to contribute heavily towards the recapitalisation of their banking system. Moody's also lowered the long-term deposit and debt ratings of three Cypriot banks to below investment grade.

Few investors may realise that while the prices of the government bonds of Greece, Italy, Spain, Ireland, Portugal and Cyprus have declined rapidly over recent months, the prices of bonds of those countries that are deemed to be safer rose leading to a sharp drop in their yields. The benchmark 10-year 2.25 per cent German bund saw its yield drop to a low of 1.68 per cent last week (equivalent to a price of circa 105 per cent) with the yields on UK Gilts dropping to their lowest levels in 50 years. In fact, the return on a 10-year UK Gilt was at a low of 2.10 per cent last week down from 3.88 per cent in February 2011. The sharp drop in yield (and resultant increase in the price of this bond) reflects positive sentiment among investors that the UK may be considered a safe haven amid fears surrounding the eurozone despite the rising government debt also in the UK.

So what is the situation with Malta's government bond prices? Market prices for MGS are very much influenced by the Central Bank of Malta as a buyer of last resort. The CBM issues daily indicative prices at which level it would be prepared to buy from an investor who wishes to dispose of reasonable amounts of stocks. MGS prices have tended to move in line with those of German bunds (as depicted in the graph) which have been very much in demand across the European markets with prices rising and lower yields on the back of this demand. Moreover, demand by institutional investors for MGS's has been very buoyant.

In essence, developments in recent months overseas confirm that an investment in government bonds is also not without risk as was evident in the cases of Greece, Ireland, Portugal, Cyprus and also Italy and Spain. Therefore, the research and analysis necessary before investing in individual company bonds should also be performed for sovereign states to identify the weaker and the stronger investment options available.

Although Malta's bonds have performed positively reflecting the stable performance of the Maltese economy and the much lower government debt levels compared to other countries, the government should not be complacent and further structural reforms need to be adopted as recommended by the IMF, the credit rating agencies as well as the ex-Governor of the Central Bank of Malta, Michael Bonello, over the years.

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