Stock Market Review

Rizzo Farrugia MGS Index surpasses 1,000 points

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The Rizzo Farrugia MGS Index was launched in December 2010 to enable market practitioners and investors to follow price trends in Malta Government Stocks. This index tracks movements in the bid prices of the Central Bank for all Malta Government Stocks listed on the Stock Exchange.

MGS issues of a larger size have a larger weighting on movements in the index. Due to the inverse relationship between bond prices and yields, an increase in the index represents a decline in yields and vice versa. The Rizzo Farrugia MGS Index has so far advanced by 1.1 per cent this year and surpassed the level of 1,000 points at the start of this week. This is the best annual performance for the MGS Index since its launch two years ago.

The increase in the index over the past 11 months signals a decline in yields of Malta Government Stocks. MGS prices, especially those with longer terms to maturity, have increased considerably in recent months, reflecting the decline in benchmark eurozone yields. The German so-called 'bund' is the benchmark yield across the eurozone and MGS prices have generally tended to track the movement in German bund prices over recent years.

On the other hand, many investors may have noticed the recent headlines across main business reports often mentioning surging yields of some eurozone nations. As several eurozone periphery countries grappled with their sizeable debt levels and increasing unemployment, the market responded by demanding higher returns from these countries which were perceived to be more risky. The 10-year yields of Spain and Italy spiked earlier this year as prices declined reflecting the increasing concerns that both countries will not manage to continue borrowing from the market at acceptable interest rate levels and would be forced to seek aid similar to what happened in Greece, Portugal, Ireland and Cyprus.

Therefore, while interest rates for these countries have risen reflecting the worsening macroeconomic environment, German yields dropped as German bonds were increasingly being regarded as the 'safe haven' of the EU.

Movements in the yields on local sovereign bonds (i.e. MGS) moved in line with the general trend seen in German bunds. This is partly reflective of Malta's success in managing to reduce the budget deficit to below the three per cent level, and maintaining unemployment rates well below the EU average. Additionally, various sectors performed positively in the context of the international financial crisis.

However, the reduction in yields on Malta Government Stocks is also because almost all bonds are held exclusively by Maltese retail investors and local institutions and therefore the Government was not required to turn to the international financial markets to finance its deficit and maturing bonds. Additionally, the strong demand for such bonds by retail investors and the consistent support from the various local institutional investors which held on to very high levels of liquidity during the financial crisis played a pivotal role in maintaining local yields at relatively low levels. However, it is worth mentioning that the difference in the yield of MGS over those issued by the German Government widened considerably in 2011 and 2012 possibly in view of the two rating downgrades of Malta by the international credit rating agency Moody's.

The Rizzo Farrugia MGS Index is based on the daily indicative prices published by the Central Bank. While prices on the secondary market have generally moved in line with the prices quoted by the Central Bank, in recent weeks there have been many instances where trading on the secondary market has taken place at a premium to such CBM bid prices.

> **"Bond prices are likely to drop to reflect the higher yields in the market"**

This is not reflective in the MGS Index and had such movements also been factored in to the index, the performance this year would have been superior to that of 1.1 per cent.

Some Malta Government Stocks continue to trade at a premium to the indicative bid prices of the Central Bank as a result of the continued strong demand from investors for such securities. Sizeable demand from the investing public for MGS's was once again very evident a couple of weeks ago, when retail investors subscribed for over €120 million in the new MGS offerings by the Treasury.

The vast majority opted for the longest-dated offering given the higher rate of interest and this is also reflective on the secondary market. As an example, the price of the new offering of the 4.8 per cent MGS 2028 has so far rallied by 224 basis points in recent weeks from the initial offering price of 100.75 per cent to 102.99 per cent. This movement came about notwithstanding the indicative CBM bid price of this 16-year bond has not surpassed the level of 101.40 per cent.

Likewise, the longest-date stock (the 5.20 per cent MGS 2031) has been trading above the indicative CBM bid price for a couple of months. Although the Central Bank's recent bid price was established around 103 per cent, the price of this stock touched 104.50 per cent on two occasions over the past week. This represents a handsome capital gain compared to the last primary offering in February by the Treasury at 101.75 per cent apart from the interest that investors would have also earned from holding this security during this period.

While MGS prices have so far performed positively this year, it is worth mentioning the volatility that was evident especially between May and August. The index had declined when eurozone yields had risen in May and June on widespread concerns over Spain as the country continued to struggle to reduce its public deficit from 8.5 per cent of GDP in 2011 amid increasing levels of unemployment. Many international commentators were also arguing that the intervention by the European Central Bank in the form of its long-term refinancing operations which assisted in injecting liquidity into the market, did not provide any permanent solution to solvency woes of the various eurozone governments.

However, the MGS Index climbed steadily from the end of June onwards as a result of three key determining events. Initially, on July 11, the ECB's refinancing rate was lowered by 25 basis points to 0.75 per cent amid increasing signs of weaker growth prospects across the eurozone. Moreover, ECB President Mario Draghi heralded a significant shift in stance for the ECB in a speech in London on July 26 when he stated "the ECB is ready to do whatever it takes to preserve the euro".

This important statement was followed by another significant development when on August 2, the ECB unveiled a plan to counter the ongoing crisis. Eurozone markets rallied on the news of the ECB's Outright Monetary Transactions programme involving unlimited purchasing of sovereign debt maturing between one and three years. However, to secure help from the ECB, countries would have to apply in advance for assistance from the eurozone rescue funds and accept that a number of strict conditions would need to be complied with. Although no country formally requested this assistance so far, the reassuring comments from the ECB about the long-term viability of the eurozone culminated in a significant turnaround for bond and equity markets.

The Rizzo Farrugia MGS Index continued to edge higher in recent weeks although eurozone benchmark instruments remained broadly flat. The narrowing of the yield gap between Malta's yields and those of the eurozone benchmark was evident over recent months despite the fluctuations surrounding the recent downgrade of France from its 'AAA' credit rating.

The rise in the MGS Index and the subsequent narrowing of the yield differential could be attributed to the August announcement by Fitch ratings that it maintained Malta's A+ credit rating. The more recent statement by the European Commission that it recommended a lifting of the Excessive Deficit Procedure for Malta in view of the island's success in maintaining a relatively low budget deficit must have also impacted the reduction in yields compared to the rest of the eurozone.

Recent statements by the Monetary Policy committees of most of the major central banks around the world indicate that official interest rates will remain at exceptionally low levels for many more years. While bonds generally perform positively when interest rates are low, investors must not necessarily expect similar performances also in future years. Yields on government debt in the eurozone, the US, UK and other regions are hovering around their lowest levels on record.

Although yields can possibly trend further lower if the financial crisis continues to escalate, it is also highly likely that yields will start to return to normalised levels even before official interest rates will begin to edge higher in the coming years. Once this happens, bond prices are likely to drop to reflect the higher yields in the market. It is naturally very difficult to know when this correction will precisely take place. However, investors must start to realise that bond prices cannot continue to keep performing positively from one year to the next.