Corporate bond investors should be careful what they wish for

28th June 2020 **|** *Ardea Investment Management*

Corporate bonds are not a natural asset for central banks to own and investors need to be aware of the risk that central bank appetite for these assets diminishes rapidly.

Is central bank support for corporate bond markets truly unlimited? Our sense is decidedly not.

Unlike government bonds, where central bank appetite and capacity is truly unlimited, corporate bonds are not a natural asset for central banks to own. Corporate bonds are more likely a cause for future headaches and indigestion, with the risk that central bank appetite for these assets diminishes rapidly thereafter.

Central banks can quite rightly have full confidence in using terms like “unlimited” and “whatever it takes” when it comes to buying government bonds. But the situation when it comes to buying corporate bonds couldn’t be more different.

The reasoning lies in the fundamental difference between corporate bonds and government bonds.

With government bonds, central banks (and central bankers) can trust that their close colleagues in the government will not default on them. This confidence is not a reflection of the robust financial standing of the government of the day. Rather it reflects the practical reality that a government defaulting on bonds owned by its central bank would serve no practical purpose. A default would make it harder to solve the very problems that the government and the central bank are working hard to address, so there would be no appetite to do so.

Moreover, as central banks are government owned, the government would essentially be defaulting on itself, thus taking from one hand to give to the other.

A central bank that made a loss on owning government bonds that defaulted would also require a capital injection from its parent owner, the government. An unnecessary charade, and one to be avoided.

Central banks can quite rightly have full confidence in using terms like “unlimited” and “whatever it takes” when it comes to buying government bonds. This approach has brought much-needed confidence and stability to markets over recent months.

CONTACT VIEW PROFILE

But the situation when it comes to buying corporate bonds couldn't be more different. Ideally, the central bank would offer the same type of unlimited support for corporate bonds as has been extended for government bonds. This would provide a great boost to financial market confidence, and perhaps assist the real economy too.

Support for corporate bonds might lead to cheaper financing for investment undertaken in the real economy, that in turn increases the economy's productive capacity.

However, a crucial difference is that corporate bonds carry with them the very real prospect of loss of capital.

Corporations, unlike governments, have no qualms about defaulting on debt holders, and indeed have no discretion over doing so when faced with such circumstances.

Some analysts expect default rates to rise as a result of the COVID-19 crisis, so the risk of loss on corporate bonds purchased by the central bank is likely to be higher in future.

And while near-zero interest rates buy valuable breathing room and central bank purchases help ease refinancing pressures, companies must eventually produce earnings if they are to pay down debt.

Even investment grade bonds, which central banks have restricted themselves to, might see a small number of defaults as idiosyncratic risks from the virus come to the fore, not to mention more numerous credit rating downgrades.

In such circumstances, anyone holding the corporate bonds in question, including a central bank, incurs a capital loss. If recovery rates are zero, then so is the value of the asset held by the central bank.

Central banks must then record a loss on these investments, which, if large enough, may translate to weakened profitability for the central bank in that year. In extreme circumstances, the central bank may even face an outright loss. While this might seem remote at first glance, the complete loss of the capital value of a bond (ie, $100) is quite large relative to the very slim interest earnings on other bond holdings. So on even small allocations, this can become material.

The problems this creates, for the central bank and for the broader economy, are many.

Throwing good money after bad?

For the central bank, there is the uncomfortable position of having made a loss. Being public institutions, central banks are subject to scrutiny from the media and from the government itself. The loss would soon be politicised, and accusations levelled at whomever was held responsible for the outcome.

Firewalling important public institutions such as central banks is exactly why debt problems are often dealt with via separate, statutory, special-purpose vehicles created solely for the purpose of buying up excess debt. In any case, in circumstances where the central bank has lost money, public support for buying corporate bonds would likely evaporate quickly. Once a loss has occurred, who is to say that it wouldn't be throwing good money after bad?

Such an outcome also creates a loss of confidence in economic management.

It also raises questions around whether the unlimited support of the central bank is, in fact, limited. If an esteemed and respected central bank can lose money, what hope does that suggest for the rest of the economy?

So the avenue of buying corporate bonds, while increasingly a last resort that is being turned to by some central banks, carries with it certain risks that are not fully appreciated by markets. While we would hope for the very best outcomes of these programs, we are also mindful of a very bumpy ride ahead for markets, should programs not turn out as expected. The dislocation to markets from such outcomes would be severe, and perhaps worse than if they had not commenced in the first place.

Unlimited support, and unquestionably so, is the exact prescription needed for these challenging times. But if there are doubts about stomach, appetite, or capacity when buying corporate bonds, then the consequences could well prove more damaging than any lasting benefits from these programs.

Corporate bond markets are quick to call on central bank support, but we should be careful what we wish for.

The information in this publication is current as at the date of publication and is provided by Ardea Investment Management Pty Limited (Ardea) (ABN 50 132 902 722) (AFSL 329 828)

It is intended to be general information only and not financial product advice and has been prepared without taking into account your objectives, financial situation or needs. Past performance is not a reliable indicator of future performance.

Insights by Australian Fund Monitors Pty Ltd (AFM) provides investors and advisors with commentary and articles originated and provided by fund managers and other contributors. The views and opinions contained within each Insights article are those of the contributor and do not necessarily reflect those of AFM. www.fundmonitors.com.

Disclaimer: Australian Fund Monitors Pty Ltd, holds AFS Licence number 324476. The information contained herein is general in its nature only and does not and cannot take into account an investor's financial position or requirements. Investors should therefore seek appropriate advice prior to making any decisions to invest in any product contained herein. Australian Fund Monitors Pty Ltd is not, and will not be held responsible for investment decisions made by investors, and is not responsible for the performance of any investment made by any investor, notwithstanding that it may be providing information and or monitoring services to that investor. This information is collated from a variety of sources and we cannot be held responsible for any errors or omissions. Australian Fund Monitors Pty Ltd, A.C.N. 122 226 724

CONTACT

VIEW PROFILE