Global bond markets: Opportunity taken in much calmer debt markets

SABMiller and the SA government have in recent days been able to take advantage of the appetite for fixed interest lending by borrowers with favourable credit ratings. The government was able to raise US$1.5bn of 12 year money at 4.665%. SABMiller plc was almost simultaneously able to raise over US$7bn in a variety of maturities at significantly better terms: $1bn maturing in 2015 at 1.85%; $2bn at 2.45% maturing in 2017; $2.5bn of 10 year money at 3.75% (compared with the 4.665% the government paid for 12 year money); and an additional $1.5bn of 2042 notes with a yield of 4.95%.

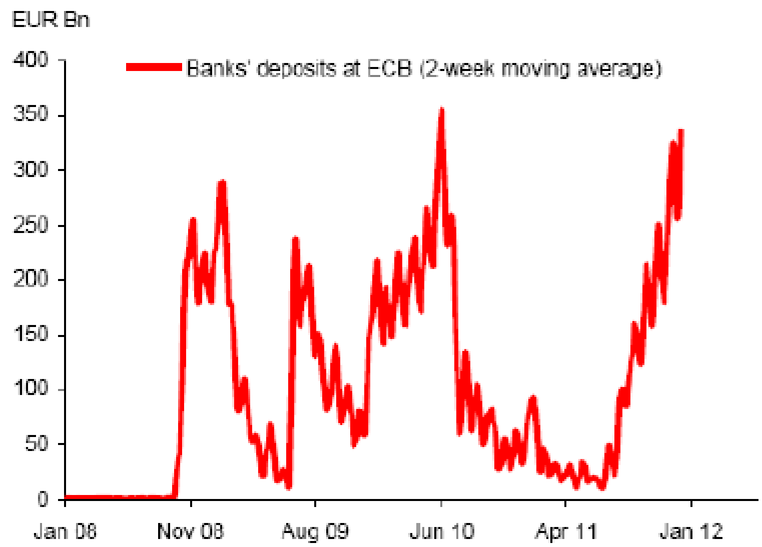
SABMiller thus enjoys a superior credit rating than the SA government, surprisingly perhaps to those who might regard the tax base of SA as more predictable and reliable than the revenue and profits from global beer sales. However the credit status of SA, while inferior to SABMiller, is now far superior to those of the governments of Italy and Spain. Even so, their credit status in the market place has been improving dramatically in recent days. The yield on 10 year Italian government debt in euros was 6.65% yesterday, 33bps lower than the day before. However of greater significance for financial markets generally, was that troubled Italy was able to sell €12bn of Treasury bills with maturities up to 12 months at an average yield of 2.735%. This average yield was less than half the yields on similarly dated paper auctioned a month ago. Spanish 10 year euro bonds are now yielding 5.19% and Spain at its auction yesterday was able to issue nearly €10bn of three year money at about 3.384%, about 12bps lower than the prevailing yield on such paper in the secondary market.

The ECB’s recently willingness to act as a lender of last resort to European banks, without inhibition or effective limits, and offer loans to banks for at 1% for up to three years against paper (including Italian and Spanish debt offered to it as collateral) has clearly improved conditions in the euro debt markets. About an extra €500bn of three year ECB cash has been taken up by European banks under this newly arranged facility.

According to a report in the online Wall Street Journal filed by Emese Bartha yesterday, ECB president Mario Draghi commented that the three-year loans provided for banks have been particularly effective at improving conditions in financial markets. Somewhat unusually Draghi referred to Thursday's decline in Eurozone bond yields as highly encouraging: central bankers do not typically comment on day-to-day market movements.

The ECB refinancing rate was left unchanged at 1% though the possibility of a further decline in this rate is open. Draghi also, according to the WSJ, took the opportunity to dismiss speculation that banks are simply depositing the money they borrowed from the ECB back at the central bank, commenting that the banks that are borrowing from the ECB are generally not the same as those depositing funds with the central bank. Cash reserves held by banks with the ECB have increased significantly in recent weeks. The ECB has announced its intention to a further tranche of three year money in February 2012 when it expects further demand from banks to be substantial.

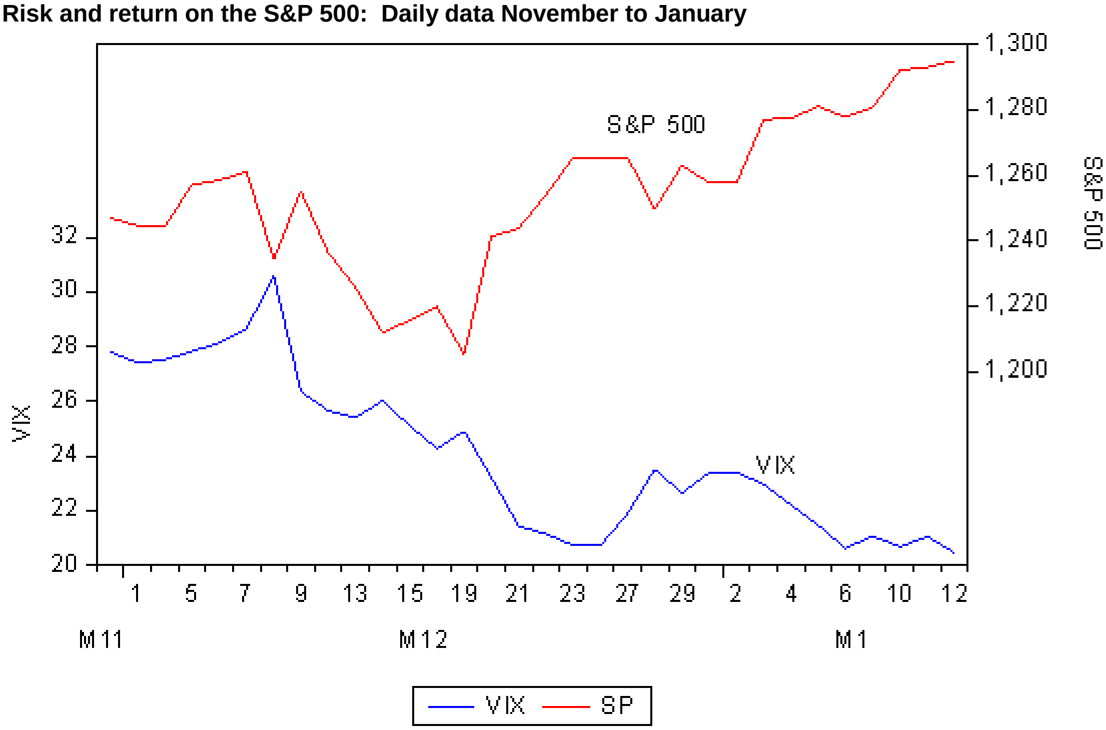
Fig 8 Recent pick-up in bank's deposits at the ECB highlights a lack of willingness to lend



Source: ECB, Macquarie Research, January 2012

We would suggest this strong and overdue ECB action is proving enough to have resolved the liquidity crisis of the European banks. The risks of a financial and banking implosion have surely declined significantly. The measures of risk in the form of volatility priced into equity options have declined in recent weeks with associated improvements in equity as well as in Euro bond values. We are hoping for more of the same. ***Brian Kantor***

Risk and return on the S&P 500: Daily data November to January



Source: I-Net Bridge, Investec Wealth & Investment