When Risk is Sovereign

What is the best signal for investors worried about the risks posed by investing in sovereign bonds? Does one look at the relative size of countries' debt, the nature of their borrowings or their credit ratings? Or is the market itself the best guide?

With the strained balance sheets of governments in the Europe and US the focus of so much media and market attention in recent times, it is understandable that investors would fret about the risks of putting their money into sovereign bonds.

Alongside the sheer size of the liabilities being accumulated by many governments, the often reckless behaviour of politicians of all stripes on either side of the Atlantic in seeking to deal with these policy issues hardly inspires confidence.

For example, how does a country like France, with total government debt of nearly 70 per cent of its economic output, maintain a top tier 'AAA' bill of health from all the major credit rating agencies – Moody's, Standard & Poor's and Fitch?

Correspondingly, how does a country like Japan, with an even bigger proportionate debt load (184 per cent of GDP) than beleaguered Greece (148 per cent), maintain a superior credit rating (AA/AA–) to the junk paper of the Greeks (CCC/CC)?

And how does the United States – supposedly the safest of all safe havens—hold a AAA/AA+ credit rating when it has the biggest nominal debt load of any country at nearly $US15 trillion or just over 60 per cent of its economic output?

So what should we pay attention to: The nominal debt, the proportionate load, the interest bill or the credit rating? And if we decide the credit rating is the best guide, whom do we believe: Moody's, S&P or Fitch? For instance, while S&P recently downgraded the US to AA+ with a negative outlook, Fitch later confirmed the US as AAA. It's confusing, isn't it?

Listening to the Market

But there is an alternative marker. And that is the market price. Specifically, there is a very large market in a form of derivatives called 'credit default swaps' or CDS. These are a form of insurance policy that some investors take out against a loan default. There are CDS for corporate borrowers and for sovereign borrowers.

While our Portfolios do not invest in credit default swaps, this very liquid market does perform a useful guide to how the market views the relative risk of default among various sovereign borrowers. It is clear that risk as judged by the market and the risk as judged by credit rating agencies are not necessarily the same.

For example, seven months before it defaulted in 2008, Ecuador was rated 'BBB' by Standard & Poor's. Yet, its bonds were yielding around 9 percentage points above those of US Treasury bonds, which implied a risk associated with a 'CCC' rating, according to a report by the International Monetary Fund.

And this isn't a one-off quirk. Chart 1 below maps the prices of credit default swaps (the vertical axis) for 26 different sovereign borrowers (the horizontal axis). Marked against the individual chart points are the average credit ratings—based on the three major agencies—for the individual countries.

Broadly speaking, the higher the price of default insurance for each sovereign borrower, the greater the market sees as the risk of investors not getting their money back.

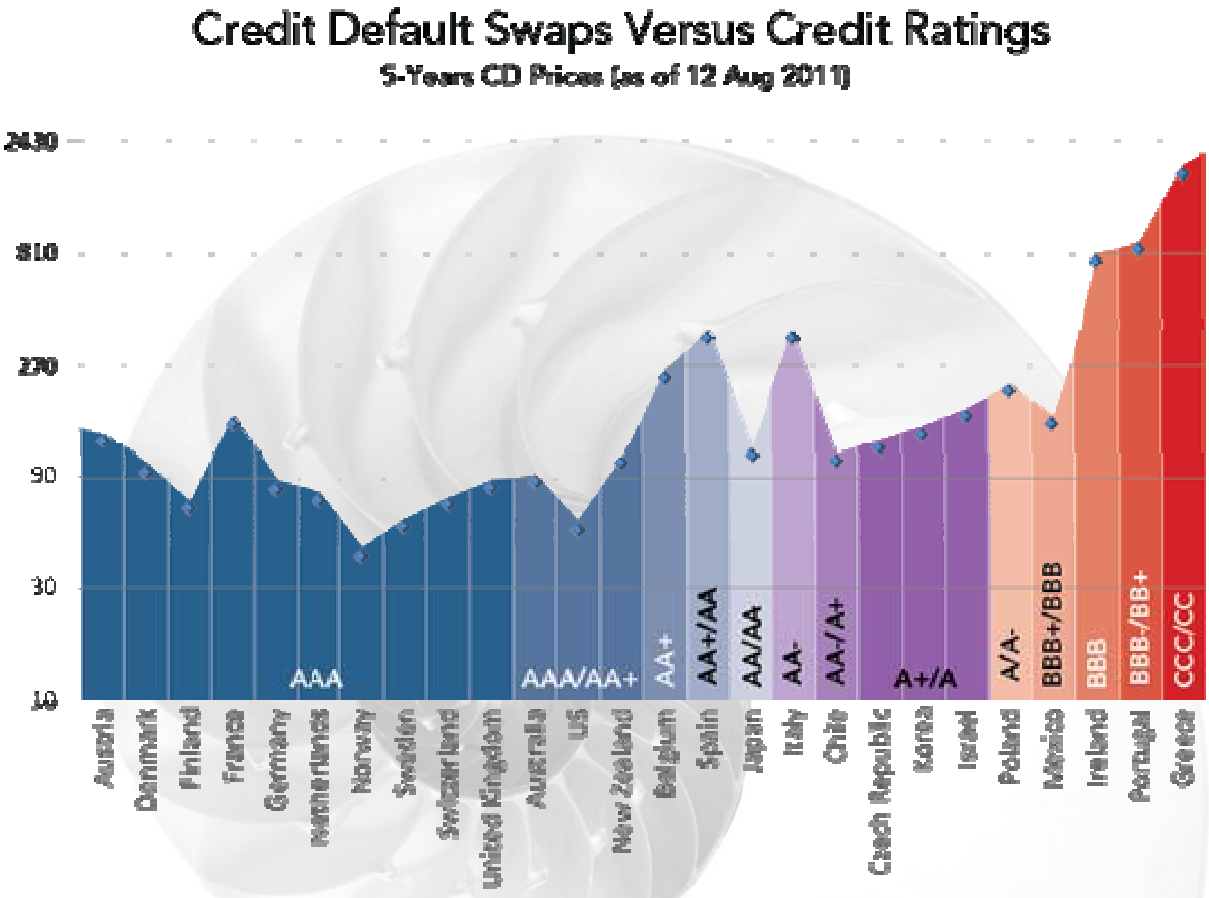

Chart 1

Not surprisingly, the most expensive CDS—as of August 2011—were those for Greece, which also happened to be the lowest rated country in this sample. The least expensive CDS were for Norway, a AAA-rated borrower with a low debt burden. So far so good.

But now look at the US, which was downgraded by S&P, but whose cost of default insurance was lower than that of France, which maintained a AAA rating at time of writing. Or compare Mexico, with the lowest investment grade rating of 'BBB', whose default insurance actually cost less than AA-rated Spain.

The point of this is that the market believes the US, while fiscally challenged, retains sufficient flexibility to raise funds if needed. On the other hand, the market saw some of the European borrowers—locked into the monetary settings and debt constraints of the European Union— as having less flexibility.

Now look at the second graphic, Chart 2, below. This charts the total debt-to-GDP ratios (vertical axis) of seven countries in our sample with the price of their individual credit default swaps (horizontal axis).

Again, Greece was the most expensive country to insure and Norway the cheapest when we took this snapshot. But then look at Japan, whose total debt in proportionate terms is the highest of them all, but whose CDS were only marginally more expensive than those of Chile (the least indebted of all the nations in our sample). Incidentally, the market judged Australia—also one of the least indebted sovereigns in the developed world— as actually a higher credit risk than the US.

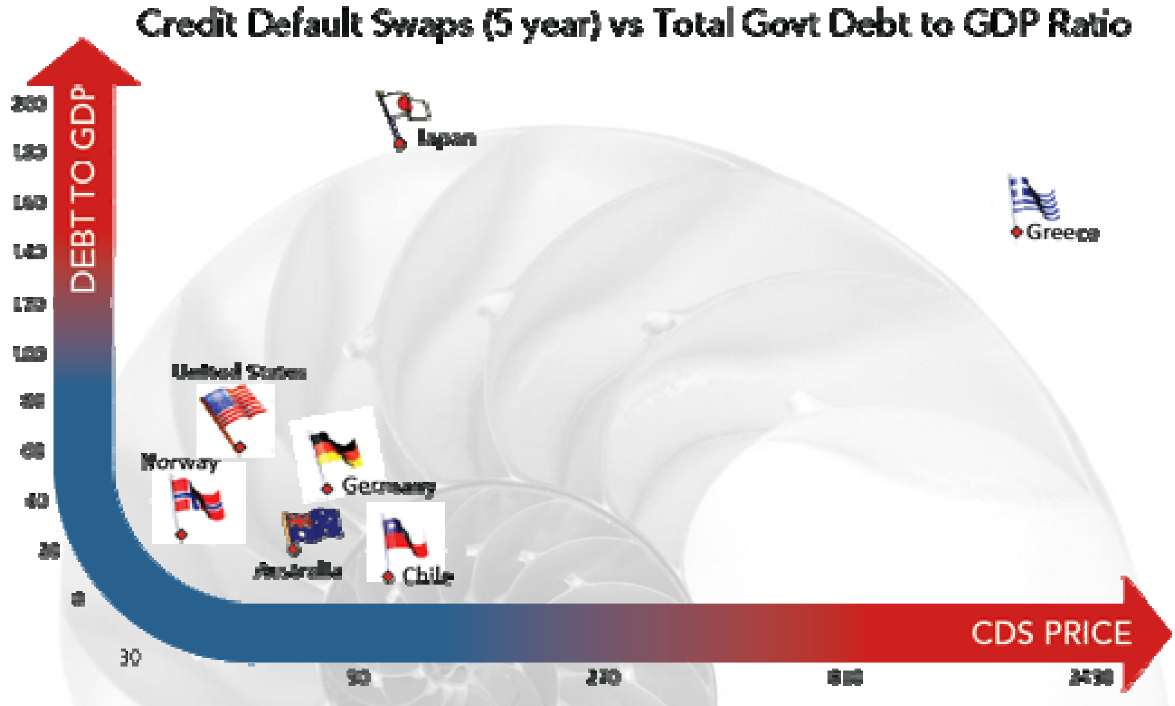

Chart 2

So which offers the best signal: the credit rating agencies, the economic fundamentals or the market? The answer to that question is that no one knows for sure, because no one has found a way of correctly and reliably forecasting the future.

But in pricing risk, it is usually better to give greater weight to market signals—if for no other reason than the price represents the combined wisdom of millions of market participants staking real money on the outcome.

While credit ratings and debt-to-GDP ratios are important, the market ultimately judges sovereign risk on both the perceived ability of sovereign borrowers to find new sources of revenue as needed and the perceived willingness of those borrowers to repay.

So while the US undoubtedly is stretched, it is perceived by the market as having the capacity to fund its liabilities relatively easily through tax increases and/or additional spending cuts. It also has the advantage of being able to borrow in its own currency in capital markets and is less reliant than the Europeans on bank funding.

Markets incorporate all these pieces of information—economic variables, credit ratings, risk perceptions, willingness to pay—and put a price on them.

And that is why, in our Portfolios, the first point of reference is always the market itself, not economic variables or the credit rating agencies.

Sovereign risk is called as such because it is a risk, like any other. Countries can and have defaulted. As recently as 2010, Jamaica defaulted on its debt. Others to default in the past decade have included Ecuador (2008), Belize (2006), Dominican Republic (2005), Uruguay and Nicaragua (2003), Moldova (2002) and Argentina (2001).

Summary

The way to deal with those risks are the tried and true methods of working with the market, diversifying broadly, taking risks only when there is a demonstrated reward for doing so and basing one's strategy on a long-term, scientifically proven research and a consistent philosophy.

The size of a country's debt—both in nominal and proportional terms—is one input to this process, as is its credit rating. But also important is the market's perception of a country's ability and willingness to raise new revenues, reduce outlays and pay back its debt. Ultimately, all this information is reflected in market pricing.

Do not act on this information alone!

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