

Europe: Bond buyers brace for eurozone debt restructuring

by Mark Johnson

Not if, but when; Debt burden numbers don't lie

A full-scale European sovereign debt restructuring is nigh-on inevitable, say leading bond buyers. Speaking at Euromoney's annual Bond Investors Congress in London, a series of international investors argued that it was now not a question of "if" but "when" and "how".

"It's coming," said Louis Gargour, chief investment officer at London-based hedge fund LNG Capital. Speaking before a late-March meeting of eurozone leaders tasked with finding a permanent solution to the crisis, Gargour said that policymakers "will come up with too little, too late".

The numbers on the European debt burden don't lie, said Sanjeev Handa, senior managing director and head of global public markets at TIAA-CREF, a New York-based pension fund. "The first problem is the amount of debt, the second the interest burden. If this were a corporate balance sheet the question would be 'can you grow into it?'" he said. "The answer is no: the primary deficits are just too big."

As evidence: Greece's debt-to-GDP ratio is set to climb to 150%, while its equivalent tax take is just 50% of Germany's.

Majority expect rescheduling

Asked if some form of rescheduling was inevitable, just two members of a 400-strong audience of fixed-income specialists voted "no". When quizzed as to his reasons, one of that pair said his views were based on hope rather than belief.

Bond buyers are certainly readying themselves for pain. TIAA-CREF's Handa estimated the likely size of the haircut on outstanding holdings of debt in countries such as Greece at around 50%. Andrew Milligan, head of global strategy at Edinburgh-based Standard Life Investments, pointed out that markets were already pricing in a 45% discount on peripheral country bonds. History might have some lessons to offer; the average haircut in sovereign debt restructurings over the past 150 years was 35%, said George Magnus, senior adviser to investment bank UBS, and author of a book that long ago predicted a debt crash in developed economies. He argued for a long view of the looming negotiations: "All restructurings begin as liquidity crises. Everyone thinks that if you can finance and hang on long enough, everything will be fine. It just doesn't happen that way; sovereigns invariably capitulate."

Others caution that no two debt crises are alike. "We have not seen a whole lot of sovereign restructurings in the west," said TIAA-CREF's Handa. Karthik Ramanathan, senior vice-president at Washington-based Pyramis Global Advisors, argued that the scale of the crisis might mean that key European institutions summon up the will to surprise doomsayers. "People such as the ECB may not disappoint," he said. (Ramanathan may be excused his unnatural optimism; until recently he managed the national debt of the US.)

However the eurozone crisis pans out, two things are certain: the solution will be messy and it will take time. "Liquidity disappears, then there is a negotiation and a haircut," said LNG Capital's Gargour. That slicing will not be enough, he said: "The first cut is not the deepest."

Debt forgiveness, amend-and-extend, and some form of Brady bond will be the endgame, argued Gargour.

Investors running for yield in wounded eurozone credits are playing a dangerous game of chicken, panellists agreed.

Crucial to any solution will be the unwinding of the tangled and noxious relationship between sovereign debt and European bank balance sheets. "If you reschedule the debt, you have to recapitalize the banking system," said Pyramis's Ramanathan. "I haven't seen any evidence that [European policymakers] are sorting it out."

UBS's Magnus agreed. "This is a crisis in a parallel universe which does not bear much relation to the world I see today," he said. "The most important thing they have to do is to recapitalize European banks and they don't seem to want to even talk about it."

Transformed landscape

Even if successful in averting the bloodbath that investors now fear, the proposed solutions to the eurozone crisis will alter utterly the landscape for fixed-income investors. The introduction of collective action clauses in eurozone government bonds issued after 2013 – a keystone of the architecture surrounding the introduction of the new European Stability Mechanism – is a particular bugbear. "If I am offered a bond with that kind of uncertainty, I am going to demand a lot more risk premium," said Standard Life's Milligan. (Collective action clauses allow a qualified majority of bondholders, typically 75%, to enforce a renegotiation of terms against standout investors.)

It gets worse. Investors at the Euromoney Bond Congress said that, faced with sluggish economies, demographic headwinds and restive voters, policymakers might find it hard to resist the temptation to seek other ways of slimming their debt, fundamentally altering the nature of a bond-buyer's claim on a state. "Inflation, restructuring, monetization of the debt: in all sorts of ways governments will alter the nominal value of the bonds we hold today," says Standard Life's Milligan. "And there is nothing we can do about it."