NARROW ROAD
CAPITAL

There's Always Something Interesting Happening in Debt Markets

When most people think about debt markets their first though is boring government bonds and investment grade bonds, which in the current environment will deliver a return less than inflation. However, for those venture off the well trodden pathways, there's a bunch of under-researched sectors that if managed well can deliver higher returns with far less volatility than vanilla equities. (More on that in another article soon) But as always, venturing off the usual routes can bring up some interesting situations. Here's some light hearted notes on a few of these unusual situations, of which I'm a mere spectator.

Green Bonds or Greenwashing?

It's debatable whether someone should be sceptical about evidence put forward arguing that climate change is or isn't a big deal, but investors should be sceptical about the claims put forward for green bonds. This week Spanish Bank BBVA sold €1 billion of hybrid securities that it is claiming are green bonds. First, these are technically a preference share not a bond, so there's a sleight of hand there. Second, the purpose of these securities is vague and is likely to at least partly be to redeem existing hybrids. BBVA has said it will try to use some of the proceeds to support green projects and in the normal course of business it would naturally make some of these loans anyway. There's nothing firm in all of this to say that buying these securities is going to change anything in financial markets that helps create a greener planet.

A likely outcome though is that the buyers of these bonds will receive a slightly lower yield than they otherwise would have, if not for the green label. Increasingly, super funds and other large investors are establishing dedicated ESG mandates within their portfolios. The problem is that there aren't a lot of dedicated ESG debt investments available, and what is available is either offering a lower yield or is stretching the definition of a green bond. Banks might be more than happy to offload wind farm or solar farm loans, but these loans are typically barely profitable for the banks and there are significant risks in the project revenue streams as more of these projects flood the grid with power generated in far flung locations. Whilst it might be heresy to some, buying lower risk/higher yielding non-ESG labelled debt and donating some of the profits to specific environmental projects would deliver a better outcome all round.

Chinese Local Governments Paper Over Local Bank Problems

In China there is a saying that "the mountains are high and the Emperor is a long way away." In Western countries we often say "all politics are local". Both are slightly different spins on the notion that governments care most about what happens directly around them, because their citizens care most about those things. The Chinese government is allowing its local governments to issue bonds and use the proceeds to prop-up local banks. This comes after a string of regional bank failures in the last year, these problems are only going to get worse with the Covid-19 economic impacts. This is another duct tape being used to cover the cracks in the plumbing situation.

Local banks typically make loans to the local entities, whereas the larger banks typically lend to the larger government and corporate entities. There is a bit of intermingling though as Chinese local banks are often themselves borrowing from the larger banks. Local banks tend to have both more geographic concentration and industry concentration. If the local factory, coal mine or steel mill is in trouble, it could be a substantial part of the bank's assets through direct loans and loans to the employees. As the economic pain in China isn't evenly spread, some local banks are being swamped with bad loans. Their local governments have every (short term) reason to issue debt and prop up their banks, who can then prop up the local businesses and citizens. Government officials that preside over regions with substantial economic problems are on a fast track to being out of work or worse. Issuing more debt and duct taping over the problems is much easier.

An Offer you can't Refuse

Fans of the Godfather movies will recognise the saying "an offer he can't refuse" which is soon followed by the infamous horse's head in the bed scene. The underlying theme is very much one of don't mess with these guys. Several European banks, pension funds and hedge funds might have to start brushing up on their dealing with the mob policies as they bought bonds issued by businesses owned and associated with the Calabrian mafia. Not only are they dealing with unsavoury counterparties, some of the "assets" that secured the debt are fraudulently inflated invoices making recovery even more treacherous. The kicker to this story is that EY was once again involved in facilitating the transactions, coming on the back of their failure as auditor to detect the years long fraud at Wirecard.

Written by Jonathan Rochford for Narrow Road Capital on 11 July 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

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