Could Austria's Century Bond End up like Argentina's?

In June 2017, Argentina sold US$2.75 billion of 100 year bonds at a yield of 7.92%. At the time I wrote that this was crazy and reflected a desperate chase for yield that had spilled over into emerging market debt. Now that Argentina has defaulted, for the fifth time in the last 40 years, its bonds are trading at around 40% of their face value. Just over a week ago, Austria sold €2 billion of 100 year bonds at a 0.88% yield. So what would it take for Austria's bonds to trade at the same price as Argentina's?

Those who are familiar with the credit profiles of the respective nations might think I'm crazy to make such a comparison. It's a fair point as Argentina had a B rating from S&P in 2017 and Austria currently has a AA+ rating. I'm not going to argue that Austria has meaningful default risk now, though over 100 years almost anything could happen. Rather, I'm thinking about what a change in interest rate expectations could do to the price of Austria's century bond.

We obviously live in a world where almost no one has any expectation of central banks lifting overnight rates soon. Low growth forecasts and low inflation expectations are widely assumed. However, the enormous quantity of quantitative easing, the structural weaknesses of the European Union and/or the expected surge in government debt to GDP ratios could change the outlook. Given we are talking about 100 years this doesn't need to happen in the short or medium term to have a substantial impact on long term bond yields and prices.

Another risk is that economists, politicians and central bankers start to acknowledge that low interest rates and quantitative easing are short term gain at the cost of substantial long term pain. Inflated asset prices, debt bubbles, zombie companies, depressed economic growth and greater boom/bust cycles are all associated with current central bank policy settings.

Just as many learnt about Minsky cycles after the credit crash in 2007-2009, so many are starting to learn about the long held positions of the Austrian economic school now. Keynesian and MMT economics are the establishment position currently. However, as major economies continue to be stuck in funks lasting decades (think Japan and Europe) the search for a better solution will grow.

The policy prescriptions of Austrian school economics have served Western economies well for hundreds of years and have created enormous growth in the living standards of their citizens. Those who care to look past the short term almost always become proponents of its key tenants of small government with limited interference in the economy, a strongly competitive private sector and a focus on freeing individuals to pursue their own prosperity. It would be supremely ironic if a return to the wisdom of Austrian school economics brought about a crash in the price of century bonds issued by Austria!

Having discussed some ways that markets could form a different view on future interest rate levels, it's time to conduct some simple modelling of what impact this would have on bond prices. First the small moves, where a 1 basis point change (i.e. from 0.88% to 0.89% yield) results in a 0.66% drop in the bond price. A strong day for equities accompanied by a 0.10% increase in the yield on this bond results in a 6.37% drop in the bond price.

If we start to consider substantial shifts in yields, which might occur after a build up of evidence of a V shaped recovery, then the bond falls by 27.1% and 45% for a 0.50%/1.00% increase in yield respectively. These would be enormous losses that many investors in government bond portfolios would be horrified to see.

Lastly, some interest rate regime change scenarios, which could occur as a result of inflation spiking or central banks normalising monetary policy. A 1.50% increase in yield, from 0.88% to 2.38%, sees a 57.1% drop in the bond price. That's the same ballpark as the fall in Argentina's bond price. A normalisation of rates to 4% or 5% would see the bond price fall by 76.5% and 81.8% respectively. Those outcomes would be slightly worse than an average corporate bond default with a recovery rate of around 35%.

Written by Jonathan Rochford for Narrow Road Capital on 4 July 2020. Comments and criticisms are welcomed and can be sent to info@narrowroadcapital.com

Disclosure