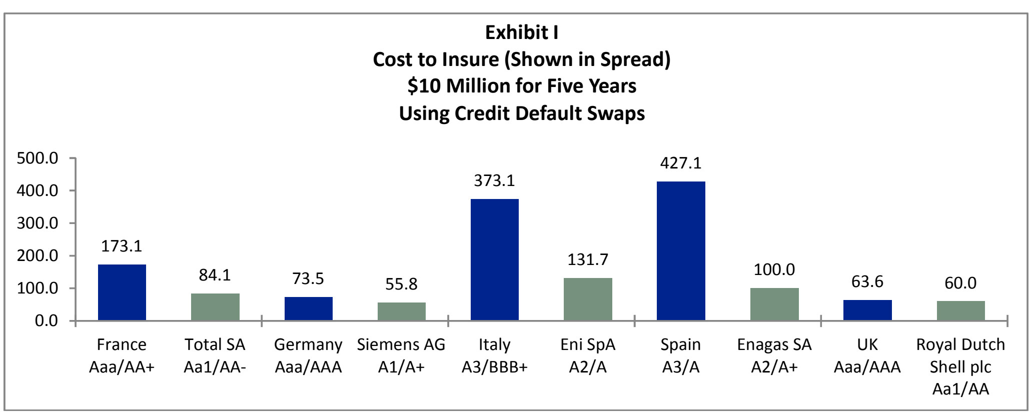
Sovereigns vs. Corporates

Five years have passed since the start of the most recent financial crisis in 2007. Compared to other downturns occurring after the Great Depression, this one has proven to be more acute and longer lasting. Increased market volatility also appears to be part of the “new normal” where risk on rotates into risk off. The quest for safety has led fixed income investors to developed country government bonds, or sovereigns, which have historically been considered low risk. Many entities such as banks are required to buy sovereign bonds or are encouraged to do so by existing laws and regulations in order to protect their deposits. For instance, European bank regulators set a zero-capital requirement on the debt of their governments. Ultimately, government debt investors have a very powerful claim on future tax revenue. Furthermore, according to Moody’s Investors Service, sovereign ratings have modestly lower default rates than corporate bonds, both overall and within similar rating categories. Lastly, sovereign ratings appear more stable. Over the 1983 to 2010 period, sovereign debt had an average 12 month migration rate of 3.92% from investment grade into non-investment grade status compared to 6.30% for corporate bonds.

But is it that simple? Are developed country bonds truly safer than corporate bonds? The recent euro-zone debt crisis (and the Greek debt restructuring in particular) has forced investors to reconsider what protection they have. For starters, corporate bonds have legally binding covenants whereas a government can change the terms of their bonds and do so retroactively. Some corporate debt provides collateral, in essence a call on the assets of the firm. Creditors can seize underlying assets such as plant and equipment in the event of default or debt restructuring. Corporate bond investors can go to court in order to liquidate the business or assume control of the company. With corporate bonds, in the event of a restructuring, creditors can convert the debt into equity and can use the equity ownership to replace the existing management. Governments do not have to post collateral and creditors have little recourse.

Corporate bonds almost always trade at a higher yield than developed country sovereign debt based on higher assumed risk. In spite of their higher bond yields, there are now some select companies whose credit default swaps (CDS) trade narrower than their sovereign counterparts. CDS is often used as a form of insurance against default. As shown in Exhibit I, the annual cost of insuring $10 million of government debt for five years using credit default swaps is currently higher than the cost to insure certain corporate debt issued by select companies in the same country, making corporate bonds appear safer in some situations than sovereign debt. Surprisingly, all of the companies shown have higher corporate debt yields than the comparable maturity sovereign debt, yet the cost to insure their corporate debt against default is less.



Source: Bloomberg

As part of our firm's due diligence, we systematically track and follow many corporate credits. What we notice is the amazing stability of most companies' corporate bond ratings. Many of these companies (Apache, Exxon Mobil, Coca-Cola, Becton Dickinson, Colgate-Palmolive, Johnson & Johnson, Procter & Gamble, Deere, Parker Hannifin, Northern Trust, Charles Schwab, and Alabama Power to name just a few) have maintained the same Moody's and S&P letter grade for over ten years. Other examples of this noteworthy ratings' stability, as demonstrated by credits in various market sectors over the past ten years, can be seen in Exhibit II below.

One of the main reasons for this remarkable stability is a corporation's ability to change and evolve. Corporations are dynamic entities that can introduce new products and services, expand into new markets as well as cut expenses, lay off employees, raise equity and/or debt, and even sell off assets as market conditions warrant. Sovereigns, by their very nature, are much less flexible. Sovereigns can raise taxes or cut expenses under the guise of an austerity program, the impacts of which could be extremely negative for both a country and its economy. As many European countries are discovering, it is very difficult to take away an entitlement program that has been in place for many years. Greece and Portugal were both downgraded to non-investment grade with Greece forced to restructure its debt. Other countries appear to be headed down that path whether they want to admit it or not. As laid out in Carmen Reinhart and Kenneth Rogoff's book, <u>This Time is Different: Eight Centuries of Folly</u>: "Throughout history, rich and poor countries alike have been lending, borrowing, crashing--and recovering--their way through an extraordinary range of financial crises. Each time, the experts have chimed, 'this time is different'--claiming that the old rules of valuation no longer apply and that the new situation bears little similarity to past disasters." This time may seem different but it almost never is.

Exhibit II
Barclays Corporate Ratings

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	12/31/2001	12/31/2011
Aerospace / Defense													
Honeywell	A	A	A	A	A	A	A	A	A	A	A	A2/A/A+	A2/A/A
Energy													
ConocoPhillips	A	A	A	A	A	A	A	A	A	A	A	A3/BBB+/A-	A1/A/A
Food and Beverage													
Coca-Cola	A	A	A	A	A	A	A	A	A	A	A	Aa3/A+/	Aa3/A+/A+
Industrial													
IBM	A	A	A	A	A	A	A	A	A	A	A	A1/A+/AA-	Aa3/A+/A+
Banking													
JPMorgan Chase	AA	A	A	A	A	A	AA	AA	AA	AA	AA	Aa3/AA-/AA-	Aa3/A/AA-
Finance													
American Express Company	A	A	A	A	A	A	A	A	A	A	A	A1/A+/A+	A3/BBB+/A+
Cable / Telephone													
Verizon Communications	A	A	A	A	A	A	A	A	A	A	A	A1/A+/A+	A3/A-/A

Source: Bloomberg

Fixed Income Data Bank

Index Returns

	Qtr.	1 Yr.	3 Yr.
Barclays Aggregate	0.30%	7.71%	6.83%
Barclays Int. Aggregate	0.66%	6.16%	6.10%
Barclays Govt/Credit	0.08%	8.53%	7.09%
Barclays Int. Govt/Credit	0.61%	6.09%	5.88%
Barclays 1-3 Year G/C	0.36%	1.78%	2.67%
Barclays 1-10 Year TIPS	1.44%	7.96%	7.14%

Source: Barclays Capital *As of March 31, 2012*

Treasury Market Yields

	3/31/12	12/31/11
3 Month	0.07%	0.01%
2 Year	0.33%	0.24%
5 Year	1.04%	0.83%
10 Year	2.21%	1.88%
30 Year	3.34%	2.89%

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