Bonds bust a gut

ROBERT LEA LOOKS BACK AT THE YEAR'S GREAT BOND BULL RUN AND ASKS WHETHER THERE IS A GREAT INFLATION IN STORE THAT WILL BRING THE BOND BULLS TO THEIR KNEES.

It has been a year-long battle of the wounded balance sheet. In the corporate emergency room, there has been a seemingly unending supply of financial bandaging via support for blockbuster bond issues or equity raisings.

But while on Wall Street and in London the corporate bond market was ending 2009 as strong as it has been all year, and with a raft of high-yielding junk bonds too, the question is whether this robustness will last into the first year of the next decade.

Anthony Doyle of M&G Investments said at the end of the summer that the corporate bond market has been the stellar performer among all financial markets. "The rally is reminiscent of Usain Bolt in the 100m at the Beijing Olympics," he said. "Historic, unprecedented, fast." Perhaps then was the time to wonder whether the top of the market was fast approaching.

Even so, as the Wall Street Journal recently reported Philadelphia fund manager Stephen Maloney as saying, the bond market has been there to ride. "The corporate treasurers, I have to applaud them," said Maloney. "There's been a lot of cashflows into the bond market. People have to put their money to work."

It has been a simple fact: with low government bond yields and high investor demand, companies are locking in attractive rates for even long-term bonds. Yet while the window has been open and so many corporates still have so much work on – on the one hand to shore up balance sheets and on the other to take advantage of M&A deals as they become available – there has been a growing feeling that companies are getting issuances done while the market is still very much open for business.

Funds investing in corporate bonds have had a good run as investors sought their safer haven during market uncertainty. The average bond fund had fallen by 10% in 2008, but 2009 has seen a reversal of fortune. Those corporate bond fund averages are showing gains of around 14% and even after the rally in equity markets, the relative safety of corporate bonds – usually investment-grade with relatively low default rates – makes them highly attractive to investors.

The downside is that 2010 brings the spectre of inflation as government stimulus plans effectively devalue currencies. And inflation has historically been the enemy of the bond market. As companies focus on reducing their debt and interest rates hit historic lows, bonds seem the perfect place for investors' money.

What if interest rates have to start rising to fight inflation, which normally means bond prices fall? If the yield spread – the yield that corporate bond investors demand over the yield on government bonds – begins to narrow, to what extent will that dilute the attraction of the corporate bond?

But the corporate bond market has remained attractive on the fundamentals. Bonds are still less volatile than stocks. Corporate bonds have also been supported through asset purchase facilities, which have targeted corporate as well as government bonds. And bonds yielding high single digits have been attractive to investors otherwise looking at government debt yielding low single digits.

When the tipping point at the end of the corporate bond bull run comes it seems likely that it will be when interest rates start rising. That, however, may not be for a while yet. But has that bond bull run done its job?

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There is an argument that with the patching-up work of the wounded balance sheets comes a stability in company's finances even if for the most part the trading outlook remains uncertain.

If that is the case, while 2009 was the year of the bond and the year of the rights issue, then 2010 could easily be the year of the M&A deal, as the recovery from recession moves to a corporate growth-by-acquisition stage.

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