Is now the time for long-term finance?

Thirty-year UK interest rates are much lower than in the rest of Europe. But will this change if sterling joins euro? Paul Stanworth of RBS looks at the facts.

The sterling bond market is currently experiencing a strange distortion. The UK gilt curve has a baffling shape when compared to other more conventional-looking global bond curves and is mystifying economists and investors worldwide. The rate at which the UK government is able to borrow over 30 years is cheaper than it can borrow over three months – unlike any other developed government worldwide. Moreover, 30-year interest rates are just over 4%, whereas other Western governments have to pay over 6%.

Much is referenced from these low-yielding 30-year UK bonds, in particular annuity rates for retirees. The current annuity rates are creating an outcry as pensioners are faced with poor annuity pensions. They will have to retire with income retirement products yielding 4–5% pa for the rest of their lives – with no inflation protection if we return to the days of higher inflation.

There is much speculation as to why this position exists. But whatever the reason, if it is expensive to buy annuities (and therefore yields are excessively low) it follows that it should be cheap to borrow long-term funds. This article considers this opportunity to borrow cheaply and focuses on the potential effects of sterling joining the euro.

Should corporates borrow long?

Since the Bank of England was granted independence and given an explicit RPI target of 2.5%, the target has become a reasonable basis to calculate inflation-adjusted or 'real' interest rates. Simply deducting this from the sterling swap curve gives expected real interest rates at various maturities (see *Table 1*).

The table shows the attractive real interest rates available with 30-year finance. The reason for this pattern is the downward or 'inverted' shape of the UK's gilt yield curve. This leads to the conclusion that the longer the maturity of the borrowing the lower the real cost of capital. This is obvious, if you believe that sterling will join the euro and that UK interest rates will need to converge with those of Europe. The prevailing view is that this would cause falling rates in the UK. It is therefore cheapest to issue longest with no need to wait to join the euro since it seems to be priced into the interest rate. But is the gilt curve reflecting that sterling may join the euro, or something else altogether?

Market discounting euro/sterling?

The sterling Libor and European Euribor yield curves converge some time over the next five years, implying that the market is correctly assuming sterling interest rates will lower to join the euro. However, there is a strange distortion over longer terms suggesting that sterling will not be in the euro at all.

The past experience of the 'first wave' of euro members demonstrated how the member government yields did converge and that the individual swap curves collapsed into the Euribor curve. It is reasonable to suggest that sterling's entry would be exactly the same. This would be clearly observable through the 'forward swap curves'. For example, Italian interest rates were higher than Germany's one year ahead of entry, giving the swap curves shown in *Figure 1.1*. However on a forward one-year (to entry date) the curves were as shown in *Figure 1.2*.


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TABLE 1 Expected real interest rates (var. maturities)

	5-yr	10-yr	20-yr	30-yr
Real interest rate (%)	3.40	2.70	2.03	1.85

The predicted collapse of the two swap curves exactly into Euribor can be seen in the market levels on a one-year forward basis. In contrast, the 'inverted' sterling Libor curves and more conventional upward sloping Euribor are currently as shown in *Figure 2.1*. This figure shows that at any future forward date they do not converge at all (see *Figures 2.2–2.4*).

What the market is saying is that far from converging to Euribor, sterling will be on a downward interest rate trend soon and will have long interest rates substantially below those of Europe by about 1.5%. This is despite the Bank of England having a 2.5% inflation target and the ECB having a lower 'soft' target of 0–2%. Hence, the UK's long-term real interest rates are set to be much lower than those of Europe.

There is no good reason why this should occur. The UK (in line with global economies) is on a monetary tightening trend following an acceleration of economic growth. This is causing nervousness in equity markets – particularly in the US. The perplexing question is: why will the UK – on its own – develop real interest rates so much lower than in Europe? The prevailing view is that the yields have become detached from the consensus economic 'scenario'.

This point is crucial, ie, that the yield levels of longer maturity swaps – particularly at 30 years – has been driven artificially low due to excessive demand for gilts. The gilt yield curve is causing the distortion. One of the main reasons is the government's minimum funding requirement (MFR), which is forcing pension schemes to buy gilts. Others include poor solvency in UK life office companies inclining them to de-risk balance sheets by purchasing gilts. Finally, the lagged effect of hedge fund activity of some years ago may also be contributing to the distortion.

The current position of very low long-term real interest rates is adrift of any euro convergence scenario or any other particular economic trend. It can perhaps best be described as a technical 'squeeze' in the market. This raises two further questions. First, are companies taking advantage of these rates?, and second, how long will they last?

FIGURES 1–2

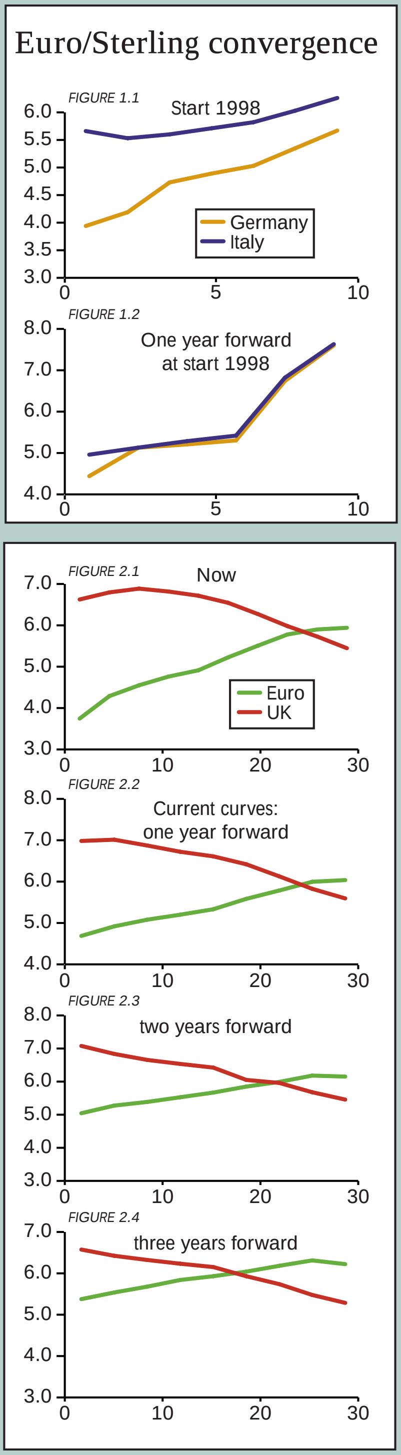
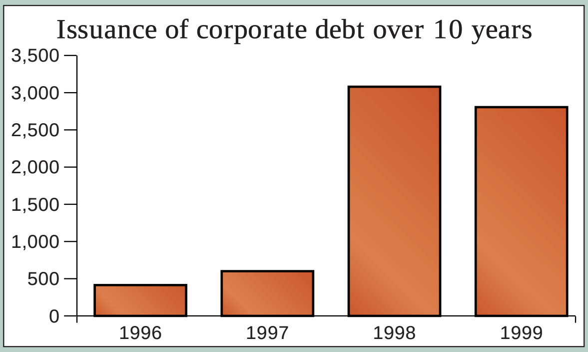


FIGURE 3



Long-dated bonds

Are companies rushing to issue long-dated bonds? The short answer is no. Given the backdrop of a downward sloping yield curve, most institutional fund managers are expecting a flood of issues at long-dated maturities since shorter dates give higher coupons. However long-dated corporate bond issuance has not exceeded that of 1998, when long-term interest rates were at similar levels, but short-term rates were lower. It seems that despite base rates of 5.5% with three-month Libor at 5.95%, versus the long gilt of 4.45% with 30-year Libor of 5.6%, long-dated finance fails to attract UK corporates (*Figure 3*).

Reasons put forward for this include:

1. Sterling joining the euro will result in lower interest rates – if this were the case our forward curves would converge and the Euribor curve would be downward sloping. The outcome of such a borrower strategy on this premise would mean higher rates since 1) the borrower would pay high rates until the UK joined, with 2) the prospect of higher long-term interest rates once sterling becomes the euro. In this scenario, UK and European corporates should issue long-dated sterling bonds.

2. The sterling market has less depth than the dollar or euro markets – liquidity exists either for buyers or sellers. However, the reason for the extraordinary yield levels of long-dated gilts and corporate bonds is that institutional funds are desperate to buy long-dated assets – there is certainly 'super-liquidity' for sterling issuers.

3. That rates will fall lower in the UK, whether sterling joins euro or not, as priced into the yield curve – that's not what the equity market or economists feel. The general consensus is that global interest rates are on the way up and the Bank of England is responding to a very buoyant economy.

In summary, these arguments against long finance at least may be a myth. The next question is: how long will this opportunity exist? The answer is: not long if the government can help it. The low annuities British pensioners endure are a poor reward for their working life, and the UK government is reviewing the legislation that contributed to this anomaly.

The government has requested a review of the MFR by the actuarial profession. There is growing support for the relaxation of the rules so funds avoid buying long-dated gilts at these very low-yielding levels. When this happens, demand for long-dated gilts will fall. Also, the lagged effect of hedge fund activity will fall in time, further reducing demand for gilts. Even if sterling doesn't join the euro we may still see a change to regulation in the UK to 'allow' the UK gilt and Libor curves to adopt a more conventional 'upward' sloping shape. If the UK government adopts a euro-friendly policy, the long-dated sterling and euro interest rates will converge, causing a rise in long-dated yields.

The timeframe in which these yields will prevail may not be that long. When the market corrects itself, this phase will be seen as a window of opportunity. It could be one of the most opportune moments to issue long-dated debt for a while and companies should consider the long end seriously. ■

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