2017 Corporate Bond Report

COLLINS SARRI STATHAM
INVESTMENTS

Research Report

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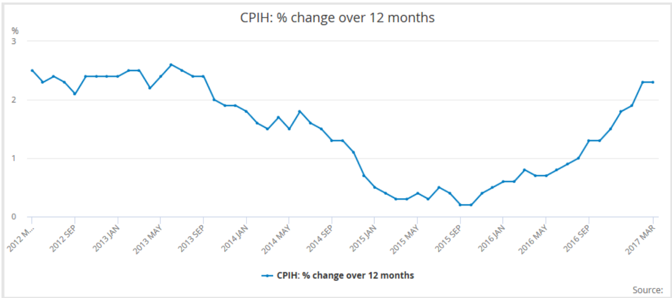
Fixed Income off to a strong 2017

2017 has started well for fixed income despite a very strong uptick in consumer price inflation. Pre 2008 rising inflation would have hurt bond investments.

Since 2008, distortions created by the zero interest rate policy (ZIRP) and quantitative easing programs introduced by many countries have meant short term inflation expectations are no longer the chief determinant of fixed income prices.

UK Consumer price inflation (March 2017: 2.3%) is rising due to strong consumer activity, higher import prices (caused by the weak pound) and inflationary pay settlements. This trend should continue over 2017.



source; ONS

Current inflation (2.3%) exceeds the yield to redemption all along the yield curve.

Gilt-edged stock	Price	Yield to Redemption	Real Return (-CPI)	COMMENT
Treasury 0.5% 2022	99.98	0.504%	-1.79%	5 year gilt has highest negative return
Treasury 4.25% 2027	131.60	1.085%	-1.21%	10 year yield suggests rates just over 1% for 10 years
Treasury 4.25% 2032	137.48	1.472%	-0.83%	15 year gilt yield also negative
Treasury 4.25% 2046	157.73	1.744%	-0.55%	30 year gilt yield also negative

One factor is intense competition in the £1.3trn UK mortgage market. A recent fixed rate offer from the Yorkshire Bank (2 year fix at 0.99%) undercut HSBC. Normal 2 year and 5 year fixed rates are in the 1.25% - 2.5% range. The 2 year mortgage pricing suggests lenders do not expect Base rates hikes until 2019.

Whilst daily fixed income price movements are muted, quarterly trend movements can be substantial. In the aftermath of the June 23rd 2016 EU Referendum there

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was a discernable up trend, which reversed in the run-up to the US Presidential election. Since February 2017, 10 year gilt prices have moved up cutting the yield to 1.02%

10 year gilt price has jumped c. 4 points from January 2017 lows

Is a 1% nominal yield enough return to compensate UK pension funds and other institutions for holding to maturity?

Barclays 5.75% 2026; (ISIN: XS0134886067) - BUY

Back in September 2001, Barclays, the UK High Street lender issued £350m 5.75% subordinated notes due in 2026. These bonds will mature on 14th September 2026 at which point, Barclays is obliged to repay £100 per £100 nominal of these bonds.

These bonds are dated tier 2 bonds and subordinated i.e. they rank low down in the capital structure, above equity and preference shares but below senior debt and debentures.

There are three note denominations, £1,000; £10,000 and £100,000.

The Barclays 5.75% 2026 bond is listed on the retail order book of the LSE with reasonable liquidity of around £100k per day.

Company	Barclays	Key Catalysts
Bond Price	£122	Last September Barclays launched an offer to buy back a portion of this bond at a small premium – it repurchased c. £144.6m of this issue reducing the o/s principal by 24%.
Target Price	£130	
52 Week Hi/Low	£122.90/ £79.60	

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5 Year Hi/ Low	£125/ £80	Barclays could undertake a similar buyback program in 2018. The 3% yield to redemption is attractive compared to similar corporate bond issues in the 9-10 year range.
Credit Rating	BBB-	
Amount o/s	£455.4m	
Avg. Daily Volume	c. £100k	
Yield to Redemption	3%	

Source: Bloomberg

Recent price movement has broadly mirrored the underlying 2026 gilt notwithstanding the jump in price during the tender offer.

Key Risks to Price Target

i) Bond liquidity might be adversely affected in the event of another tender offer
ii) Bond bid/ ask spread is variable – it can be up to 5 points
iii) Barclays restructuring steps in recent years has yet to deliver meaningful improvement in credit rating

If you are interested in investing in corporate bonds and would like to learn more then please complete the form below. You will receive a beginner's guide to Bonds and the opportunity to speak with one of our in-house experts

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