

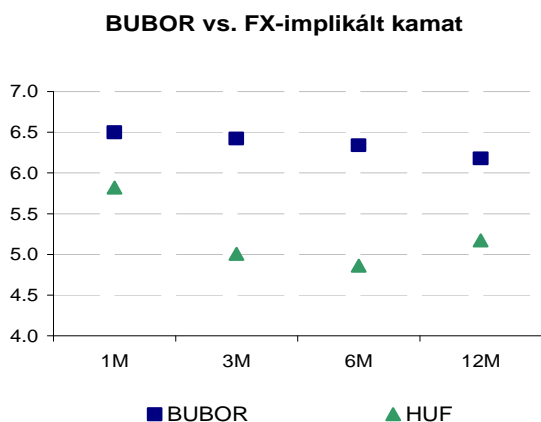
Monthly analysis – November-December

Judit Hevér – Gábor Orbán: What are the swap points telling us?

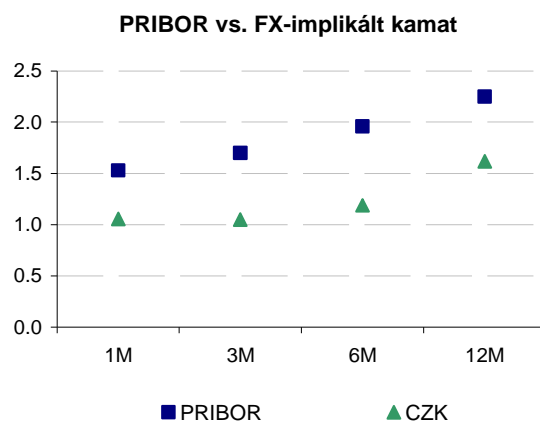
Money-market opportunities in the immediate region

Since we entered the latest, current stage of the global financial crisis, in spring 2009, the money markets of the “Visegrád” group of nations (Czech Republic, Hungary, Poland, Slovakia) have taken on a distinct, shared feature. The whole “Central and Eastern European banking system”, partly due to the fact that banks in the individual countries tend to have the same owners, is working to reduce the ratio of loans to deposits, with the result that funds for short-term placement are constantly being generated. Governments – despite a marked increase in their financing requirements – are neither able nor willing to tie up these funds by issuing a higher volume of discount T-bills. This is because, firstly, they are attempting to limit issuances as best they can under the present circumstances, since they would prefer to delay any rise in ratio of state debt to GDP until next year; and secondly they are intent on seizing every opportunity to raise the average maturity of state debt. And as if all this weren’t enough, the central banks are implementing (or simply threatening) extraordinary intervention in order to increase the supply of liquidity and push down the money-market (less-than-one-year, interbank) interest rates. The most aggressive was the Polish central bank, which pushed the maturity of active repos to 12 months, and bought securities issued by commercial banks at public auction.

All of this inevitably led to exceptionally low interbank rates in these markets. The interbank fixing rates (BUBOR, PRIBOR, WIBOR), however, present us with a slightly different picture. Since the interest-cutting cycle can be regarded as over in the Czech Republic and Poland, the curve of the interbank fixing rates starts out from the central-bank base rate, displaying an upward tendency at expiry. A downward trend is only observable in Hungary, a fact which is attributable to expectations of a continuation of the interest-cutting cycle. But the interbank fixing rates are the result of an interbank tender, a form of questionnaire, and no actual trading takes place at these levels. Since the banks could have a vested interest in maintaining higher fixing values, these rates typically do not reflect the actual interest levels in the money market, which is why they also show no trace of the abundant liquidity.



Source: Bloomberg, AEGON Fund Management

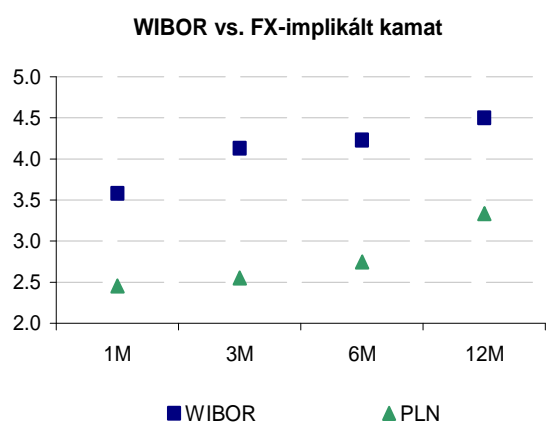


Source: Bloomberg, AEGON Fund Management

A more accurate picture of the actual money-market interest rates can be obtained by examining the implied interest rates calculated from forward currency transactions. This is simply the difference between the forward and the spot price (the “swap point”), divided by the spot exchange rate. The levels thus calculated are largely undistorted by partner risk, and this makes them suitable for the monitoring of actual interest levels. (The partner risk can be ignored here because the notional value of the deal doesn't change hands, and settlement usually takes place retrospectively.) We have calculated the interest levels below from the USDHUF quotes published on Bloomberg, and for the USD interest levels we have applied the USD LIBOR fixing rates. It is clear to see that the “base” appears even within the less-than-one-year segment; in other words the BUBOR-LIBOR difference is greater than the interest differential received upon the conclusion of forward rate agreements. Put another way, the “carry” is lower than the difference between the fixing rates.

What has widened the gap between the fixing rates and the implied interest rates to such an extent, after it had remained consistently at around zero for so many years? Glancing at the timeline for the annual base, it is clear that the difference has been even greater than it is now. One reason for the increase in the base is that Hungarian operators are seeing a rise in the cost of foreign-currency funds, and therefore the foreign-currency interest charged to them is also very high, which in turn lowers the “carry”. We could also refer to this as a partner risk, although it is more akin to a form of credit rationing, a situation in which the supply of credit is scarce and inflexible. This effect was typical of the market turbulence in the wake of the Lehman bankruptcy of October 2008, or the regional upset of spring 2009. The scarcity of foreign-currency funding sources has eased considerably since then, as foreign parent banks have reinforced their commitments to the financing of their subsidiaries, and the local bank system has also received foreign-currency funds from the state, in the form of central-bank intervention in the currency market, as well as a variety of loans. All this led to a decline in the base, right up until autumn of this year.

Since the middle of September the implied interest on the Czech koruna has slid down by 30 basis points, and the Polish zloty by 60 basis points relative to the fixing, while in the forint money market an opposing trend could be observed. The foreign-currency funding problem could not have worsened significantly since the summer, as the behaviour of the forint base suggests precisely the opposite despite the fact that that in the past the Hungarian market has always been far more sensitive to glitches in the supply of FCY funds. In other words, it is likely that in the background it is the abundance of liquidity (mentioned in the introduction) that is having the greatest impact in the zloty money-market interest rates.



Source: Bloomberg, AEGON Fund Management



Source: Bloomberg, AEGON Fund Management

In order to identify the market opportunities arising from the anomalies in implied interest rates, we need to find tradable interest rates in place of the fixing rates. The one-year discount T-bill market is the obvious choice in all three countries. The levels are shown in the first three rows of the table below. When buying discount T-bills, you assume the default risk of the given state, as the issuer, which is reflected in the CDS premium. (Second row, expressed in basis points. To keep things simple, we are treating America's as 0.) The third row summarises the cost of hedging and the CDS premium. The difference between discount T-bills from the region and the US are indicated in the fourth row. In an efficient market the difference in discount T-bill yields should precisely offset the cost of foreign-currency hedging and the CDS. (The fixing rates have now been left out of all this!) Thus, for example, the difference between the yield on Hungarian and US 1-year discount T-bills corresponds to the sum of the percentage cost of forint-dollar hedging and the CDS premium between the two countries. If, instead of one-year US government securities, we invest in Hungarian government securities with a similar maturity, hedging our currency exposure in the forward market and taking out insurance (CDS) against bankruptcy, then the result is the same (according to the last row of the table a very low 12 points, which is within the error margin for the calculation, but would be lost in the course of the transaction anyway). The situation is also similar in the Czech discount T-bills market, where no major anomalies can be found.

	HUF	CZK	PLN
T-bill yields	6.1	1.2	4.0
CDS	151	41	61
Swappoints+CDS	5.59	0.96	3.05
T-bill spread	5.71	0.86	3.66
T-bill relative value	0.12	-0.10	0.60

Poland, on the other hand, is more interesting. While the annual discount T-bill spread is 3.66%, the sum of the annual CDS premium and the implied interest is only 3.05%. This means that either the annual discount level is not justified by Polish sovereign risk, or the implied interest rates are too low. Whichever is the case, assuming that the securities are held until maturity it is worth buying one-year Polish discount T-bills at 4%, with currency hedging, rather than either the Hungarian or the Czech papers. This way, in contrast to the 1.1% Czech discount T-bills you get 2% with no currency risk, whereas the difference in default risk would only justify a 1.4% yield.

Prepared by AEGON Magyarország Befektetési Alapkezelő Zrt. (1091 Budapest, Üllői út 1.)

Judit Hevér – junior analyst

Gábor Orbán - macroeconomic analyst and bond portfolio manager

Supervisory authority: Hungarian Financial Supervisory Authority

All information contained in this document is intended for information purposes only. AEGON Magyarország Befektetési Alapkezelő Zrt. accepts no responsibility for any investment decisions made on the basis of this publication and for the consequences of such decisions, nor for any possible shortcomings or inaccuracies in the data in this document.