Investment Insight

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ARIA | CAPITAL

Incred(it)ible: *The flashing colours are not the only reason our Bloomberg screens seem a bit dazzling at present. At the time of writing, all the leading European five year government bond yields are flashing red (i.e. they are all negative). In other words, if investors choose to lend their hard-earned money to any of these countries for the next five years, they (investors, that is) will actually pay for the privilege in the form of a guaranteed negative return over five years. Indeed a similar situation in ten year bonds is getting ever closer. Quite incred(it)ible really.*

In light of the recently commenced European QE programme, government bond prices may rise still further in the short term, but it's very difficult to rationalise allocating to them at this stage. When the tide turns, it may not be pretty. In this week's ***Inside Track*** *we take a perspective from the highly regarded Bond Markets Research Team at Deutsche Bank who pose some arguments to counter their own bullish view.*

Saucy! *The merger of Heinz and Kraft is a saucy deal in more ways than one. It creates a company with total revenues of $28 billion and a portfolio of brands found in kitchens across the world – from ketchups to mayonnaise and much more besides.*

However, the deal is a saucy one from a financial perspective too, particularly for Heinz's shareholders Berkshire Hathaway and 3G Capital. In ***Pic of the Week*** *we take a look.*

The Inside Track

Jim Reid and his bond strategist colleagues in Deutsche Bank have been following bond markets for long enough to see several crises come and go. With many bond markets looking worryingly expensive today, they look at some parallels with the 2000 boom and bust in the context of counter arguments to their currently bullish view on credit spreads.

Although we still think credit spreads will tighten this year given the need for yield especially with QE likely to be a constant influence on markets for many quarters to come, we do acknowledge these are unprecedented times with little certainty about the medium to long-term impact of such a policy.

One thing resonates with us, and that's the slight parallels to where we were in the build up to the year 2000. In the mid-late 1990s, the first thing we used to look at as credit analysts was swap spreads. Indeed the all-time wides for swap spreads occurred in early 2000 when the market was pricing in a long period ahead of Government buy backs of debt. Indeed, the US CBO was predicting that the entire US debt could be eliminated by 2013!!

How times subsequently changed as a decade later Governments were issuing more debt that could ever have been imagined just a few years before. This period was characterized by record tight swap spreads so we went from the sublime to the ridiculous in a decade.

The experience is a reminder that credit spreads are simply the relative supply/demand balance between the benchmark and credit. At the moment the latter is seeing extreme demand relative to supply and the former has seen high demand but is perhaps currently digesting record supply.

While we think the extra yield story and decent fundamentals will be too compelling for investors to ignore given where Government bonds trade, it is a reminder of what spreads actually are. It not impossible to consider a scenario where credit remains well bid but that bunds see an even greater bid. If this is the case spreads will widen.

Pic of the Week

Just two years ago Warren Buffett joined forces with a Brazilian private equity firm to purchase Heinz for $28 billion. However, the deal was leveraged and Buffett's equity commitment was "just" $4.1 billion (with 3G contributing the same). Under the terms of the deal to acquire/merge with Kraft, Berkshire Hathaway and 3G between them will own 51% of the combined entity. Based on Kraft's recent valuation, this places an equity value on the combined entity of about $83 billion. Kraft shareholders also receive $10 billion in payout from the Heinz side of the deal, so the net residual value of Buffett's/3G's share is about $32 billion. That's a return of over 4x in just two years. Saucy!

Value of Berkshire Hathaway/3G Capital equity in Heinz

Market View

	Last 7 days	YTD	5Y Ann.
Global equities	-1.2%	+4.0%	+8.2%
US equities	-1.6%	-0.1%	+12.0%
European equities	-2.3%	+15.1%	+8.0%
Emerging market equities	-0.7%	+0.6%	-0.6%
Irish equities	-3.0%	+14.8%	+13.3%
Commodities	+0.8%	-3.8%	-5.0%
Hedge funds	-0.3%	+1.8%	+1.1%

Economic indicators	*Bond yields*	*Inflation*	*GDP YoY*
Ireland	+0.8%	-0.5%	+4.1%
Germany	+0.2%	+0.1%	+1.4%
USA	+2.0%	0.0%	+2.4%
China	+3.5%	+1.4%	+7.3%

Currencies	*Current*	*YTD Δ*
EUR:USD	1.08	-10.4%
EUR:GBP	0.73	-5.8%
EUR:CNY	6.73	-10.8%
GBP:USD	1.48	-4.9%
Bitcoin	248.73	-21.6%

Commodities	*Current*	*YTD Δ*
Gold	1,200.71	+1.3%
Copper	6,195.50	-2.7%
Oil	58.28	-3.2%
Wheat	501.50	-15.6%

Central Bank rates	*Current*
Eurozone	0.05%
USA	0.25%
UK	0.50%

Week ahead: Key events

30/03 UK Money Supply
30/03 EU Consumer Confidence & US Pending Home Sales
31/03 UK GDP & Retail Sales
31/03 EU Unemployment & US Consumer Confidence
01/04 China & Eurozone Manufacturing PMI
01/04 Ireland Live Register
01/04 US ISM Manufacturing & Employment
02/04 US Initial Jobless Claims
03/04 US Non-Farm Payrolls

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