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Greek deal leaves investors fearful of two-tier bonds

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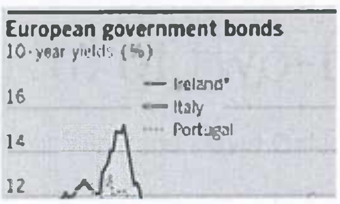
Analysts worry long-term damage is being done to bond markets

Bond markets reacted with remarkable equanimity to Greece's second bail-out.

Both in the aftermath of the deal announced early on Tuesday and in the long build-up to it, there have been few of the jitters that greeted the first three eurozone rescues of Greece, Ireland and Portugal.



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But investors and analysts worry that in the rush to patch up Athens and show that the crisis in Greece is being contained, longer-term damage is being done to Europe's bond markets.

"What has happened is not good for the market in the long term, but it is better than the alternative in the short term," says Gary Jenkins, head of Swordfish Research.

The concern over how the Greek deal has been concluded centres on the question of subordination. Traditionally only the International Monetary Fund has been seen as being "super senior".

But some investors are now worried that they may end up being junior bondholders to other entities.

The worries are twofold. The first is over the special treatment of the European Central Bank. The ECB owns about €40bn in Greek bonds, according to analyst estimates, bought in the market from private investors. But late last week it struck a deal that excludes its holding from the so-called private sector involvement (PSI) agreement, designed to cut €100bn from Greece's debt load.

Other investors are irked that the ECB ranks senior to them, not just in Greece but the other four eurozone countries – Portugal, Ireland, Italy and Spain – where it has intervened.

"The ECB has the gilt-edged Greek bonds and private investors now know where they rank in the pecking order.

“This decreases Greece’s ability to return to the capital markets,” says Paul Griffiths, global head of fixed income at Aberdeen Asset Managers. The problem for us with buying peripheral debt is that we don’t know what the future terms will be for issuing these bonds – that is, what will underwrite them.”

Andrew Balls, head of European portfolio management at Pimco, says he presumes that the ECB has decided that not taking a “haircut”, or a loss on its holdings, is the lesser of two evils compared with “the subordination of private sector bondholders”.

But he underlines how the ECB has defended its purchases as necessary purely for the transmission of monetary policy. “The assumed seniority suggests that they are doing something different,” he says.

Mr Jenkins argues that the deal does little for the ECB’s reputation and would cause investors to question whether the central bank is helping out sovereigns or not.

“In the future, we have to analyse these countries on their individual economic metrics and their own debt sustainability and without any support from the ECB,” he says.

The second concern surrounding the Greek deal centres on the new bonds created by the debt swap. A preliminary debt sustainability analysis presented to eurozone finance ministers, and obtained by the Financial Times, shows concern about Greece’s prospects for regaining market access any time soon.

“The PSI deal, in the process of being agreed with creditors, has worsened the outlook for new market access due to the proposed co-financing structure with the European Financial Stability Facility (which essentially implies that any new debt will be junior to all existing debt). It is now uncertain whether market access can be restored in the immediate post-programme years,” the document says.

Investors are divided over how damaging this will prove. One large French bondholder says that investors are already used to pricing different markets in bank bonds depending on whether they are secured on assets or not. If Greece returns to growth quicker than most in the market expect, investors are likely to buy its debt at a suitable price. “People have to take a view on the recovery of Greece,” he says.

Elisabeth Afseth, strategist at Investec Capital Markets, argues that Athens is likely to be locked out of the markets for a long time: “I can’t see Greece coming back to the market for years, not until 2030 at the earliest. PSI may prove a worrying precedent too for other peripheral markets. There is the danger that now we have a deal on Greece, the markets will turn their attention to the other peripherals.”

But Mr Balls is unconvinced that there would be a two-tier bond market because the complexities of the deal and argues that Greece is likely to have far bigger issues to worry about than this if it is to return to the markets.

Execution risk remains the biggest fear for investors. The PSI deal is far from certain to run smoothly, especially with such a tight deadline before a crucial Greek debt redemption on March 20.

Moreover, there are worries about Greece's domestic situation, from civil unrest to the passing of the necessary laws by parliament.

Mr Griffiths says: "It may well be that relative disaster has been avoided, but we are still on very, very tentative ground. Nothing in this package makes us want to rush out and buy Greek bonds, and the risks are there for Portugal and Ireland, and for the bigger peripherals of Spain and Italy too."