

Ask Legg Mason

Government Bonds

This is the third in a series of educational guides that seeks to explain some of the concepts widely used in fixed income investing. In this guide we will take a look at one of the major asset classes in fixed income, government and government-related bonds (including supranationals and local authorities).

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Introduction to Government Bonds

Sovereign bonds

To finance their activities, governments raise funding in capital markets through the issuance of bonds. Bonds can be issued by various levels of government, from the central government to local authorities. The bonds usually referred to as government or sovereign bonds are those issued by a central or federal government of a country. Those issued by advanced economies, such as US Treasuries, UK Gilts and German Bunds, are considered relatively secure, as the payment of interest and principal at maturity is backed by government guarantees and there is a relatively low risk of default. Bonds issued by emerging countries, however, are considered higher risk and of lower credit quality than those issued by advanced economies and are usually grouped under the bond market sector 'emerging market debt'. Over the long term, investors should expect higher returns from the latter asset class. We will examine emerging market debt in more detail in a later guide.

Governments issue conventional (or nominal) bonds, which have a fixed coupon, and inflation-linked bonds, where the coupon and/or the face value of the bond is adjusted to reflect a measured rate of inflation. As the value of fixed cash flows is eroded over time due to inflation, inflation-linked bonds are aimed at preserving an investors' purchasing power in the future. We will examine inflation-linked bonds in more detail in the next guide.

Other government-related bonds

Supranationals

Supranationals are entities that are formed by a number of central governments through international treaties, usually with the aim of promoting economic development. As these entities are jointly guaranteed by several central governments, bonds issued by supranationals are generally considered as safe as those issued by central governments. This sector includes bonds issued by the following:

- International Bank for Reconstruction and Development (World Bank)
- European Investment Bank
- Asian Development Bank

Local governments

Lower levels of government, such as provincial, state or local authorities, also issue bonds. In the US, these bonds are known as municipal bonds and enjoy certain tax advantages.

Agencies

Agencies are government-sponsored entities created by central governments to support specific public goals, such as the provision of housing and small business loans. Agencies issue various types of bonds: agency debt, which are direct debt obligations used to fund the agencies' activities, and agency asset-backed securities (ABS), which are bonds that are guaranteed by agencies and use pools of loans, often mortgages, issued by the agency as collateral for the bond. We will go into more detail on asset- and mortgage-backed securities in a separate guide.

Debt issued by certain agencies is explicitly guaranteed by the central government and therefore generally considered as safe as bonds issued by the government. These include the Government National Mortgage Association (GNMA/Ginnie Mae) in the US or the German state development bank (Kreditanstalt für Wiederaufbau – KfW). Other agencies have an implicit guarantee, with market participants widely assuming that the government would provide financial support to an agency if the need arose and are therefore also rated highly by investors. In the US, these include the Federal Home Loan Mortgage Corporation, known as Freddie Mac, and the Federal National Mortgage Association, known as Fannie Mae. Indeed, as these institutions ran into financial difficulties during the credit crisis of 2008, the US government was forced to step in and take them into conservatorship.

A low risk asset class

Government bonds issued by developed countries are considered the highest quality and therefore lowest risk asset class within bond markets. The various bonds issued by other government-related entities discussed above are also at the low end of the risk spectrum within bond markets, as these are considered (almost) as safe as government bonds.

As a low risk investment, government and government-related bonds tend to perform well in a weakening economic environment when inflation slows, corporate earnings moderate and central banks cut interest rates. Indeed, government bond prices are largely driven by investors' outlook for growth, inflation and interest rates. The asset class also benefits from investors' generally lower appetite for risk during periods of broad financial or equity market turmoil. For example, during the credit crisis of 2007-2008, investors shifted exposure out of riskier asset classes, such as corporate bonds, into the relative safety of government bonds, pushing up the prices of government bonds and reducing their yield.

Supply and demand

Supply and demand dynamics also play a significant role in government bond pricing. The UK gilt market, for instance, has been significantly affected in recent years by increased demand from pension funds for longer-dated government bonds, which has helped to reduce bond yields in longer-dated bonds compared to shorter-dated issues.

On the supply side, increasing budget deficits are forcing governments to issue larger amounts of bonds to finance their funding shortfall. As supply increases, the price of government bonds will generally decline, leading to a rise in government bond yields.

Significance of government bonds for other bond sectors

Developments in government bond markets are relevant to all other bond market sectors, as investors value all non-government bonds relative to government bond prices. Indeed, the yield on a non-government bond consists of the government bond yield plus an additional bit of return (the so-called 'spread'), which compensates investors for the additional risk they take compared to bonds issued by governments from advanced economies. We will look into this relationship between government and non-government bond prices and the resulting yield spread in more detail in a later guide.

Summary

In this guide we have looked at one of the major bond sectors, government bonds, which is considered to be the lowest risk asset class within bond markets. What happens in government bond markets is relevant for all other bond market sectors, because of the price relationship between government and non-government bonds. In the next guide, we will look in more detail at inflation-linked bonds, before we move on to the various types of non-government bond sectors.



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