REUTERS

Wed Jun 18, 2014 4:31 am EDT

Bond market to feed yield-hungry investors

By John Geddie

LONDON, June 18 (Reuters) - Cyprus is on the verge of making the fastest comeback to markets of any bailed-out euro zone country when it sells a new five-year bond later on Wednesday.

The Mediterranean island is offering higher returns than any other sovereign issuer in the single-currency bloc, hoping that yield-starved investors will be coaxed back to a country that was hitting bank depositors and imposing capital controls just over a year ago.

"It's not a domestic issue, it's a European issue. People are searching for yield," said of Martin Wilhelm, founder of IfK, a German Kiel-based bond boutique, which runs a bond fund with Acatis.

Cyprus is taking orders for its new bonds, which mature in June 2019, with an indicative yield of around 4.90 percent. It has already received over 1.5 billion euros of interest and will price the bonds later on Wednesday, reports IfK.

Wilhelm said he has placed orders in the sale and believes it will price at an yield between 4.75 and 4.90 percent.

The sale comes just two months after Greece sold a new five-year bond at a yield of 4.95 percent which was one of the fastest return to markets of a defaulted country. Those bonds have since rallied to 4.25 percent, according to Tradeweb data.

Returns on all euro zone sovereign bonds have been squeezed, to record lows in many cases, as the European Central Bank has pumped the market with liquidity and cut interest rates so far they have turned negative.

As a direct result of the ECB charging banks to keep their money in overnight deposits, Germany and the Netherlands sold treasury bills at a negative yield on Monday.

This dynamic will further fuel investor appetite to take higher risks to maximize profits, exacerbating fears that some bonds have become over valued.

"The risk that valuations and primary market dynamics aren't related to fundamentals anymore," said Michael Leister, senior strategist at Commerzbank.

Cyprus' credit ratings remain deep in junk territory following a debt exchange in March last year that ratings agencies classed as a default.

There have been glimmers of a recovery since it signed a 10 billion euro aid, however.

Its economy is expected to contract by 4.2 percent this year, less than the 4.8 percent initially expected, and some, such as local consultancy Sapienta, see the decline in output at closer to 3 percent.

Like Greece's deal in April, the buyers are expected to largely British- and U.S.-based hedge funds. Following the success of its deal, Greece is seeking to raise around 2-3 billion euros via the sale of a new seven-year bond in the next months. (Additional reporting by Marius Zaharia Editing by Jeremy Gaunt)

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