

 Threadneedle thinks
Conference call highlights

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A meaningful growth slowdown

Markets had hoped that the slowdown in growth seen earlier in the year was due to one-off factors such as poor weather and the Japanese earthquake. However, leading indicators suggest that this is not the case and that, far from the recovery many had expected, the slowdown in developed markets is intensifying. For example, Purchasing Managers' Indices, which are typically a reliable predictor of economic activity, have fallen dangerously close to 50. Readings below this level are regarded as pointing to economic contraction.



Michael Poole
High Yield Fund Manager

Downgrades to our forecasts

We have been forecasting lacklustre growth in the developed world for some considerable time and we have revised our forecasts lower in light of recent data. We now expect the US economy to grow at 1.5% this year and next; the eurozone at 1.8% this year and 1.1% next and the UK at 1.25% this year and 1.5% next. Within these overall growth rates there is a good chance of negative quarters occurring.

Impact of lower growth

The slower growth backdrop outlined above is important given the over-leveraged position of the global economy. Economic growth is a key ingredient of governments' plans to deleverage and, if the cost of debt exceeds the rate of growth, debt levels could quickly reach unsustainable levels. This is at the root of the markets' concerns. The poor recent record of US and European politicians in acting swiftly to address economic problems has further undermined confidence.

Is there value in core government bonds?

Recent risk aversion has driven US, UK and core European government bond yields to historic lows and, at these levels, it is hard to discern value in these markets. This is not to say that yields are set to move higher in the short term – especially as interest rates are likely to be kept very low for a long time and inflation looks to be peaking over the next few months. However, yields cannot move much lower and, as such, the risks must be skewed towards yields moving higher over the longer term.

Eurozone crisis intensifies

Looking at various countries with regard to government debt and interest payments as a percentage of GDP, fiscal balance and the percentage of debt held externally helps to reveal where the stresses are in global government bond markets. Greece shows up as an outlier on these measures, combining high debt and interest payments as a proportion of GDP, a large fiscal deficit and wide international bond ownership. As such, Greece is a significantly higher risk than the other peripheral European issuers and is the market most desperately in need of growth as it seeks to address its structural problems.

Confidence is key for Italy and Spain

Markets have recently targeted Italy and Spain as potentially the next countries to require financial assistance. Our analysis suggests that these two countries are much better placed than Greece, Ireland and Portugal. However, confidence and the swift enactment of coherent policy are key for these issuers, and the outlook for Italy and Spain could change if the market drives their cost of debt above their growth rates for a significant period.

Best value still in higher yielding areas

The “risk-off” trade of recent weeks has seen spreads on high yield and emerging market bonds move out substantially to levels where they are discounting much higher default rates than we foresee. In high yield this has been exacerbated by liquidity, which is seasonally low over the summer. With the asset class seeing outflows during August and liquidity scarce, price moves have been exaggerated. This creates value opportunities for experienced, long-term investors and we have started to see some clients begin to take advantage of these opportunities.

Balance sheets in good shape

Corporate balance sheets globally are generally in much better shape than their government counterparts, with companies having cut costs aggressively during the financial crisis. High yield issuers are no different and leverage has fallen over the past few years while cash balances and interest cover have risen. The current yields and spreads do not reflect these trends.

Reduced risk in our HY portfolios

Over the past few months we have been steadily reducing risk in our high yield bond portfolios. We started by taking profits in recent new issues and subsequently trimmed exposure to cyclical areas such as chemicals and consumer discretionary issuers as well as food and beverage companies, where we were concerned about rising raw materials prices. We are overweight in more defensive areas such as cable providers and packaging companies.

EM issuers are in control

In contrast to the developed world, emerging economies continue to deliver robust levels of growth. Meanwhile, emerging countries such as Russia, China and Brazil have lower fiscal deficits and lower debt to GDP ratios than most of the developed world. This means that they are effectively in control of their own destinies, unlike the troubled issuers of the European periphery. The superior fundamentals that characterise emerging markets leave them better placed to deal with any policy errors that might occur and this, together with the healthy yields on offer, is one reason why we continue to prefer emerging market bonds to developed world government issues.

Conclusion

The global economic slowdown seen earlier in the year has intensified, with leading indicators now suggesting a heightened chance of recession. We have downgraded our forecasts but still expect the major economies to generate modest positive growth this year and next. Growth is a particular focus given the need for highly indebted countries in the European periphery to reduce leverage. Risk aversion has driven core government bond yields to historic lows and we see little value in this area. Meanwhile, high yield and emerging market spreads have moved out to attractive levels and both of these areas appear better placed to tolerate policy mistakes as we move through the critical phase in the European debt crisis. While we acknowledge that higher risk assets are likely to see further volatility in the short term, we continue to see the best long-term opportunities in higher yielding areas of fixed income.