

 Threadneedle thinks  
Conference call highlights

Jim Cielinski  
Head of Fixed Income

## **FIXED INCOME UPDATE – SEPTEMBER 2011**

### **Policy risk looms large**

Markets are coming to realise that while leverage is fine in an environment of healthy growth, leverage without growth is a problem. Moreover, if you combine this with a lack of policy leadership, you have a crisis; and that is what we have today. Policy risk is worrying for investors because it is unpredictable. For example, it is hard to imagine that the authorities will get every decision right as they navigate through the problems facing the peripheral eurozone, but it is equally difficult to predict where mistakes will occur.

### **Growth fears exacerbate market risk aversion**

Meanwhile, economic growth is slowing significantly in the developed world, presenting a challenge to governments that are seeking to reduce their debt levels. Although this combination of slowing growth and policy risk means that volatility is likely to remain high, the good news is that we do believe there is a way through the crisis. At the same time, we have clear asset allocation preferences within fixed income.

### **Short-term fix**

It is becoming increasingly clear that Greece will default or restructure in some form, and the authorities are focusing on ensuring that this event happens in an orderly fashion and does not spark contagion to other markets. Greece is a true outlier in terms of debt to GDP and the proportion of debt held by external parties, so fundamentally markets such as Italy and Spain and even Portugal are much better-placed to survive. However, these markets require some support in the short term to maintain control.

### **ECB to play a key role**

The quickest way of providing this support may be for the European Central Bank to become a true “lender of last resort” and issue an open-ended commitment to buy the bonds of all peripheral issuers. Some recapitalisation will also be necessary in the European banking system. However, as long as the default is limited to Greece, the volume of this recapitalisation should be manageable. Finally, a greater degree of fiscal integration will be necessary over the medium term.

### **Break-up of the eurozone?**

The alternative to these measures would likely be the ultimate break-up of the eurozone. This outcome would be complex and expensive for all involved and, as such, we believe that it is highly unlikely. The actions of politicians and policy makers might appear chaotic, but in fact there is a huge will to keep the eurozone intact. Moreover, ring-fencing Greece and providing additional liquidity would be a cheaper alternative for Europe’s core nations compared with a break-up of the euro.

### **Limited value in government bonds**

The recent bout of risk aversion has driven treasury yields to historic lows, while spreads of peripheral government markets and corporate and emerging market bonds have widened substantially. This leaves bond investors with a dilemma: to be sure of getting paid back, it is necessary to accept a very paltry yield. Government bond yields below 2% are not going to drive an attractive total return, so we think these markets offer poor value.

### **Good value is available elsewhere**

Outside of the core government bond markets yields look much more attractive, but of course these yields come with additional risk. Assessing where spreads overstate the risks involved allows us to discern value. The key here is to focus on issuers whose destiny is in their own hands - any other strategy is speculation rather than investment. This approach leads us to favour high yield and emerging market bonds in particular.

### **High yield and emerging markets preferred**

High yield issuers have deleveraged and refinanced extensively in recent years and are now well positioned to deal with any policy errors that might occur. As a result, while default rates are likely to rise modestly over the next two years, we are not forecasting a significant increase and believe that yields and spreads more than compensate investors for the risks involved. Similarly, emerging markets have reduced their debt levels over the past decade (in sharp contrast to the trend seen in the developed world) and the average credit rating of emerging market issuers has risen steadily. This improvement has not been reflected in yields and, as such, we see good value in the asset class.

### **Scenario analysis**

The short-term direction of markets is always difficult to predict and current uncertainties only serve to increase this difficulty. However, focusing on the longer-term picture allows investors to take advantage of volatility. We have modelled the likely performance of various bond asset classes in a double-dip recession, a period of sub-trend growth and a sharp economic recovery. Government bonds do not provide significant returns in any of these outcomes, although they do outperform in the double-dip scenario. The yield cushion offered by high yield and emerging market bonds helps to protect total returns in the recessionary outcome and these assets significantly outperform in the low growth and recovery scenarios.

### **Summary**

Markets are facing significant challenges at the moment but we believe that the authorities will ultimately come up with a solution, even if current discussions appear chaotic. Greece is likely to default or restructure in some form but we believe that the eurozone will survive. Meanwhile, risk aversion has driven core government bond yields to historic lows and we see little value in these assets. In a world where policy risk is a dominant feature, we have a preference for issuers that are in control of their own destiny. High yield and emerging market bonds fit this description and we therefore remain overweight in these assets.

**For Investment Professionals use only, not to be relied upon by private investors.** Past performance is not a guide to the future. The value of investments and any income from them can go down as well as up. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. The mention of any specific shares or bonds should not be taken as a recommendation to deal. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Investment Services Limited. Registered in England and Wales, Registered No. 3701768, St Mary Axe, London EC3A 8JQ, United Kingdom. Authorised and regulated in the UK by the Financial Services Authority. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited ("TPSHKL"). Registered Office: 21F ICBC Tower, Citibank Plaza, Central, Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Please note that TPSHKL can only deal with professional investors in Hong Kong within the meaning of the Securities and Futures Ordinance. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. Issued in Singapore by Threadneedle Investments Singapore (Pte) Limited, 07-07 Winsland House 1, 3 Killiney Road, Singapore 239519. Any Fund mentioned in this document is a restricted scheme in Singapore, and is available only to residents of Singapore who are Institutional Investors under Section 304 of the SFA, relevant persons pursuant to Section 305(1), or any person pursuant to Section 305(2) in accordance with the conditions of, any other applicable provision of the SFA. Threadneedle funds are not authorised or recognised by the Monetary Authority of Singapore (the "MAS") and Shares are not allowed to be offered to the retail public. This document is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.