



Credit expected to outperform despite Greek crisis

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Credit markets have been buffeted recently by the prospect of Greek sovereign default. Whilst the exposure of sterling issuers to Greek government debt is limited, investors have focused on the knock on consequences. Concern can be broken down into three areas:

1. Contagion fears as government finances in Ireland, Portugal, Spain and Italy are thrust further under the spotlight.
2. The exposure of European Banks – this itself can be divided into two parts i.e. the extent of banks' holding Greek government debt (especially French and German) and fears of a general liquidity squeeze.
3. Impact on global economic growth as heightened risk aversion and banking problems push the western economies back into recession.

These concerns have been reflected in the widening of credit spreads in recent months, particularly in financial bonds. Indeed, since the start of 2010 credit spreads, as measured by iBoxx, have shown little change. So whilst credit bonds have significantly outperformed government securities over this 18 month period this reflects the extra yield rather than any change in relative value.

We continue to believe that current credit spreads are too wide and that investors will achieve much better returns from credit bonds than gilts over the next three years. We favour a strategy of biasing holdings towards strongly covenanted bonds – hence the high weighting in asset backed securities within our credit portfolios. Indeed we have been able to add to positions at attractive levels as investors again worry about liquidity without focusing on security or, indeed, underlying value. As the credit crisis amply demonstrated – in a distressed situation all credit bonds experience illiquidity.

Whilst a restructuring of Greek government debt now seems inevitable we believe that this is still compatible with strong relative returns from credit bonds.

Source: rlam as at 4th July 2011 unless otherwise stated.

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