1 AUGUST 2011

Royal London

Asset Management

US default risk exaggerated

Jonathan Platt, Head of Fixed Interest

Fixed interest markets are being buffeted by three main economic and political factors. However, they have a common cause in the disruption caused by the financial crisis of 2008/9. The first is the Greek sovereign debt crisis and its potential to spread to Italy and Spain. The second is the US budget deficit and the inability of politicians to agree on what needs to be done. The "solution" reached at the end of July is merely a sticking plaster and does not address the issue that governments in the US spend too much in relation to tax receipts. The political system in the US, which in the past has shown flexibility, is creaking and is finding it difficult to come to terms with two fundamentally opposing economic philosophies: small government against big government. The third issue is the clear loss of economic momentum in recent months and fears that slower than anticipated economic activity will lead to higher budget deficits and rising unemployment.

Despite the US debt default risk (those fears were greatly exaggerated) government bond prices, for those countries deemed "safe", moved significantly higher in July; ten year UK yields hit 2.85% at month end. Credit bonds, although generally up in price, saw higher risk premiums. This was marked in the case of subordinated financial bonds where the returns, in the case of sterling indices, were negative. Bonds tainted by association with peripheral Europe (governments, bank, utility, telecoms) were harshly treated as seen by Spanish and Italian ten year government debt ending the month at 6.1% and 5.9% respectively.

We remain of the view that credit bonds are attractive relative to government debt. The safe haven trade may push gilt yields lower in the next few weeks but gilts are overvalued on a medium term perspective.