



## Bond market outlook - 2012

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On a purchasing power parity basis, the Eurozone accounts for just 15% of global economic activity. However, on the basis of column inches in the press it accounts for close to 100%. Given that our economic base case is modest global economic growth, continued deleveraging and conservative corporate behaviour, we see scope for credit spreads to narrow significantly from current levels and to move towards a level which better reflects underlying corporate fundamentals. Corporate earnings have been strong and have been used to cut leverage, with the appetite for expansionary capex being relatively low. Indeed weak capital expenditure remains one of the main constraints to economic growth in the developed world.

The key downside risk remains a disorderly outcome to the Euro crisis, leading to corporate defaults and a freezing of credit markets, although other risk assets may perform even worse in this scenario. It is already clear that everything must be done to prevent a disorderly break-up of the Euro, since the complexity of interbank relationships would lead to legal and banking chaos. The intensification of the crisis has already pushed the Eurozone back into recession. At some point, we believe ECB action on a much larger scale, either unilaterally or as part of an IMF plan, is more likely than not. The aim would be to reduce the risk of liquidity crises for potentially illiquid but nevertheless solvent states. In short, we are heading in the direction of reflation via QE, with the risk of severe debt deflation in Europe the only other alternative. The rollover of Italian sovereign debt early in 2012 will be a key crunch moment and markets look set to remain volatile until this risk is better quantified.

From a bond market perspective, an outlook of sluggish growth, ultra low interest rates and falling inflation in 2012 favours fixed income assets in general. While AAA-rated government debt markets are more than discounting this scenario, corporate credit has much less of a valuation issue, remains less volatile than equities and, in recent months, has actually been less volatile than so called 'risk-free' sovereign debt. We question whether the existence of genuinely risk-free assets; it is a more at matter of relativities and what is already priced into different asset classes. On this basis, we believe credit looks attractive.

Source: rlam as at 21 December 2011 unless otherwise stated.

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