

Market views



Eric Holt, Fund Manager

- Sterling Extra Yield Bond Fund

It's now just over a year since the low point in corporate bond markets. In the 12 months to end March 2010, Sterling investment grade corporate bonds returned 21.7%, the BBB rated segment delivered a staggering 42.6%, while Gilts achieved just 0.8%. These exceptional returns from corporate bonds reflect the extreme stress in markets at this low point: the global financial system was fragile and still reeling from the demise of giant US investment bank Lehman Brothers; the economic outlook worldwide was poor, with western industrialised countries still in the throes of recession; conditions in bond markets were dire as capital had been withdrawn from market making activities, and some leveraged investors were forced to sell into unreceptive markets as their bank financing was withdrawn.

Investors who braved the market volatility, embracing risk to take advantage of fundamental long term value have been well rewarded. But does this mean that the opportunity in corporate bonds has now passed for another decade?

We think not. Undoubtedly such returns are not forecast for the coming 12 months, but the current pricing of underlying credit risk in corporate bonds is still attractive for investors – being as it is, well above the level necessary to compensate for default risk on any historic data, even encompassing the harshest of economic circumstances. The backdrop of a huge UK government financing (some £200bn for the current fiscal year) looks daunting and would appear to threaten a rise in gilt yields, undermining corporate bond prices. But the gilt yield curve is extremely steep; 30 year gilts now yield 4½% compared to 2 year gilts at just 1¼%, which helps mitigate this risk. Conditions in bond markets continue to improve, and this itself reinforces companies' access to capital markets and thus enhances investor confidence. The financial sector, a major part of the UK economy and of the corporate bond market, continues to benefit from debt restructurings – RBS's repurchase tender offer for Tier 1 bonds and exchange proposals for subordinated into senior bonds being just the latest example. While the corporate bond market continues to improve generally, we still see pockets of exceptional value.

Overall we expect to see attractive returns in corporate bonds in 2010, especially in the context of interest rates in the UK remaining very low. Portfolio diversification is particularly important to reduce the size of individual exposures and therefore risk, especially as the economic outlook remains challenging. Similarly, mitigating risk by investment in bonds which benefit from a claim on assets or from structural credit enhancements is appealing, especially as such fundamentally attractive attributes appear undervalued in current market prices.

Bull:

- Pricing remains attractive
- Pockets of exceptional value

Bear

- Fragility of the economic recovery
- Stock specific risk remains, so diversification is key

Source: rlam as at 20th April 2010 unless otherwise stated.

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