

**Robert Talbut**, RLAM's Chief Investment Officer, discusses the need for policy makers to face up to reality in a bid to lift the world's economy out of its torpor.

**Ian Kernohan**, Economist, looks at the ever worsening economic and market sentiment in the UK and explains why we need to look beyond the double-dip or no double-dip question.

**Paola Binns**, Sterling Credit Fund Manager, looks at why corporate bonds are an attractive option for investors in the current climate.



**Robert Talbut**

**CIO**

At present, the essential quality for market participants is the ability to believe in the impossible, much like the queen in Alice in Wonderland. However, policymakers need to appreciate that finding a way through the current crisis requires them to suspend their belief in the world as they would like it to be and instead implement new credible policies in the world as it actually is. In reality the longer we delay then I believe the larger will be the required policy response.

The belief that we can all contract our way to prosperity should be recognised as fundamentally wrong in a western world which is clearly suffering from a lack of aggregate demand. However, we remain trapped in the pre-credit crisis conventional wisdom of adherence to inflation control as the source of stability, whilst failing to acknowledge the role that the extension of credit to those unable to repay it played in creating respectable levels of economic growth. With the elimination of this excess credit growth and the gradual payback of debt we are inevitably faced with continual crises, given the ongoing fragility of the financial system exacerbated by the current policy paralysis.

There are a number of inevitable realities that need to be addressed, as follows:

- the significant undercapitalisation of the European banking system
- the inability of certain sovereigns and other private sector borrowers to repay all their outstanding debts
- the significant underfunding of future pension and healthcare liabilities
- the absence of a credible policy response, which is undermining confidence and increasing the chances of a renewed recession
- that the received wisdom that underpinned policy prior to 2007 will not create the conditions for a return to durable growth.

Therefore, while we need individual countries to change tack, we also require a return to the greater policy coordination that briefly existed in 2008/09. Perhaps we need a new crisis to bring this about, and if so, I believe we are increasingly close to this as investors appreciate that the current prescription will not cure the patient.

Rather than pumping further money that cannot be repaid into the Greek economy, we should be significantly recapitalising the European banks, allowing much of the non-repayable debt to be written off. Similarly in the US, if the banks were further recapitalised then some of the housing debt could be written down to realistic levels. Repaired balance sheets would enable the financial system itself to be better placed to function and those currently over-indebted could again participate in the economy. While this requires further transfers from the government to other parts of the economy, this could be accommodated by central banks. Although implementing such a policy would be far from painless, I fundamentally believe that it stands a far better chance of helping lift the western world out of the current torpor. It would also create the conditions in which aggregate demand could recover, allowing economic growth to return to a far healthier level. Clearly this would go against the grain of conventional wisdom, but as has been said before, when you're in a hole you should stop digging. Furthermore, by facing up to reality in the west, we have a far better prospect of securing participation in the greater coordinated approach from those with considerable amounts of available money in the developing world, as they see us tackling our problems that it would be in their interests to support.



**Ian Kernohan**  
*Economist*

I return from two weeks holiday to find that if economic and market sentiment was poor when I left, it is even worse now. Two examples illustrate this: QE2 in the UK has now become highly likely, rather than just possible, and there is open debate about a double-dip recession in Europe, following another poor set of PMIs. It's hard to recall that at the start of 2011, commentators were actively discussing whether the US economy was growing too fast and what would happen when the Fed and the BOE raised rates.

For us, unless the next recession is of 2008/9 proportions, the "double-dip or no double-dip" question is an oversimplification of the main issue: at best, we are looking at a protracted period of modest growth in the developed world. The 2008/9 recession in advanced economies was not a quick 1980s or 1990s type downturn, which could easily be cured with policy easing, creating a new and vigorous cycle. The build-up of debt had gone on for some decades and each US expansion over the past 30 years has appeared weaker than the last, such that if the US does indeed enter recession within the next year, the latest expansion will have been so shallow to have scarcely been noticed.

The major caveat to all this gloom is found in the emerging market space, which now accounts for the bulk of global growth. These economies have their own problems, but are dancing to a very different tune with respect to growth, inflation and policy options. In short, their inflationary problems look more like those faced by advanced economies in the 80s and 90s, and hence their policy options are less constrained.



**Paola Binns**  
*Sterling Credit  
Fund Manager*

September saw the third anniversary of the Royal London Sterling Credit Fund. Structured as an OIEC, the fund was set up to take advantage of the extraordinary value in the corporate bond markets after the collapse of Lehman Brothers. Corporate debt prices fell to levels not seen since the Great Depression of the 1930s as banks and leveraged investment companies rushed to sell assets and liquidity seemed to dry up overnight. Even the most robust companies either had no access to bank lending or had to pay a high cost of funding to diversify their sources of liquidity. The

premium of corporate debt to gilt yields was so high that with a 20% default rate over 5 years (levels never experienced in recent history), a diversified corporate bond portfolio could still achieve the same return as a gilt portfolio. Our assessment of value has been validated by the performance of the fund, which has returned close to 9% per annum since inception.

The current European crisis that we have witnessed over the last few months has provided investors with similar opportunities to those we had two years ago. Valuations on corporate bonds are again looking very attractive. The average yield premium of investment grade corporate bonds over government bonds is approaching 3%, levels not seen since the Lehman crisis. The value in corporate bonds is even more striking when you look at gilt yields which are at historic lows; the 10 year gilt currently yields only 2.5%. Meanwhile in recent years corporate borrowers have deleveraged their balance sheets and increased their cash balances in order to be less dependent on bank lending. While the volatility caused by the current crisis may continue in the near term, it has given investors another chance to buy very attractively priced corporate bonds offering the prospect of appealing returns over the medium term.

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Source: rlam as at 28 September 2011 unless otherwise stated.

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