

Investment View January 2010

Over the festive break one would have expected a good deal of 'sober' reflection on the remarkable upturn in investment markets since March 2009. I was half expecting a modest correction at the start of the New Year. But what is becoming evident is that the markets are pricing in an even stronger global recovery than most analysts would have predicted just a few months before the year end.

The Vix index – Wall Street's so-called 'fear gauge' – has fallen to levels last seen in May 2008 fuelled by rising hopes that the global recovery can be maintained with expectations that fourth-quarter GDP in the US, UK and Eurozone will show healthy rises. Meanwhile cash is still piling into emerging markets and high-yield bonds. In some cases these asset classes are actually trading at pre-financial crisis levels!

Confidence is also high on the corporate front, with fourth quarter earnings expected to come in strongly. The credit markets are expecting that the recovery will be maintained over the next few months, with new issues of high yield (lower grade) bond surging and yields falling. The surge in prices is amply illustrated in the graph below.

This dramatic rise in values has been most spectacular in the higher yield category, but the 'blue chips' of the corporate bond market – so called 'investment grade' bonds – have also enjoyed a remarkable period as fears of a global economic recession have receded.

Bonds are valued in terms of yield – the lower the price, the higher the yield. For corporate bonds the key figure is the 'spread', which is the difference between the yield on 'corporate' and 'government' bonds.

Cumulative performance			
	1m	3m	6m
Sterling High Yield	2.3	4.4	20.3



Following the collapse of Lehman Brothers in September 2008 yield spreads widened to almost unprecedented levels as markets feared massive defaults. Prices were further pushed down as banks were forced to sell corporate bonds to shore up their balance sheets creating more fear and panic as liquidity all but dried up completely. The combined effect was to create a 'cliff edge' that is now so clearly illustrated in the graph. Unfortunately anyone who joined in the panic selling in the aftermath of the credit crisis will now have lost out, while those who followed the 'buy' opportunities presented to them are now reaping rich rewards.

This remarkable rally in corporate bonds shows no sign of stopping in the short term - yields that topped 20% at the height of the financial crisis just over a year ago have dropped below 9% but still with further room to fall. Future returns will of course be less dramatic but nevertheless demand remains strong with a return to more normal market conditions after credit markets around the world stopped functioning. Investors are still buying creating a rush by companies and governments to sell new debt to the market still attracted by the yields on offer. Although many companies have focused on reducing debt this option was not available to all, and many paid off bank loans by raising replacement funding money through issuing new bonds. The activity has risen to a level bordering on the frenetic and now encompasses high yield issues too (perhaps foreshadowing the new emergence of 'junk bonds').

At some point the credit rally will inevitably falter and may even go into reverse, as bonds prices tend to fall when interest rates rise. In the medium term that is surely inevitable on the back of a widely anticipated rise in inflationary pressures caused by the massive injections of liquidity into the world economy. The big question question is - when?

In the meantime the demand for corporate bonds has allowed the Bank of to begin its 'exit strategy' from quantitative easing – the £200bn of emergency funding manufactured to preserve the UK economy. It has now sold £80m of the £2bn of corporate bonds that was included in this financial rescue package, a mere sliver of the total that was injected but an indication of the changing tide. The Bank is expected to put QE on hold next month, once it has reached its buy-back target of £200bn.

The iTraxx Crossover index (which reflects the cost to insure junk-rated bonds against default) is trading at its lowest level since May. However market indicators such as these are only useful as a short term indicator and although most investment analysts are confident of a strong economic recovery until the middle of the year it becomes harder to see further ahead. The predictions I have read range widely from "moderate economic growth on the back of low interest rates", to "strong economic growth with higher interest rates caused by rising inflation", to the 'uber-pessimists' who declare a world of "deflation and economic stagnation".

The jury is therefore well and truly out on the 'medium term' view and unlikely to return for several months!

Perhaps the single biggest single risk is a major government defaulting on its bonds which could bring the markets crashing back down. Although this is highly unlikely there are rumblings about possible 'rating' downgrades which have increased sensitivity in government bond markets. Sovereign credit default swaps (which measure the risk of a government default) have been rising since September, especially for Greece but also Spain and (rather depressingly) the UK.

The UK government will of course hope that the economic outlook will have improved by the time of the election. Data from the British Retail Consortium survey showed a strong improvement in sales. The Office for National Statistics said consumer prices rose 0.6% last month, taking the annual rate up to 2.9% from 1.9% in November. That was the biggest monthly rise in the annual index since records began and exceeded the City's expectations for an increase to 2.6%. Retail Price Index inflation rose to 2.4%, its highest level since November 2008. A further 'spike up' in inflation is expected over the next few months, partly reflecting the rise in oil prices during the past year.

Uniquely in living memory the focus for those looking for encouragement for the medium term has been not so much the health of the US economy but that of China. The Chinese authorities have recently taken some steps to tighten monetary policy. GDP in the final quarter of last year returned to double-digit growth however consumer price inflation is forecast to have jumped to 1.4% in December. The central bank is concerned about excessive liquidity and inflation pressures, and taking steps to ensure bank lending does not exceed official targets. The market reaction was noticeable, showing the sensitivity of investors. Our analysis suggests that a managed expansion with tightly controlled monetary policy will continue in 2010.

Equity markets elsewhere are reaching something approaching 'fair value' and we expect only gradual gains in the year ahead with mixed fortunes at both sector and regional levels. Volatility will remain an issue and the emphasis on stock selection through active funds will remain a feature. The increased weighting towards Emerging Markets is likely to become a permanent element in most portfolios as is the risk diversification out of the UK into Europe, but with investment exposure now spreading into smaller companies rather than solely the larger capitalization holdings already included in the majority of client portfolios.

Finally, we are at long last starting to see an improvement in property values in the institutional market. The IPD UK Pooled Property Index showed a rise of 1.7% in the final quarter of 2009, a trend we expect to continue as investment funding becomes more readily available and the fears of default levels gradually recede. The current rental yield levels remain attractive and values should be helped by falling bond yields. The recovery in market values will be nothing like as dramatic as we have witnessed in bond markets but nevertheless on a 'risk adjusted' basis high grade commercial property as an asset class is looking very attractive on a medium term viewpoint. We will therefore continue the current programme of gradually rebalancing into property thereby taking advantage of the low unit prices currently available.

Steve Patterson
Investment and Managing Director