

# M&G fixed interest funds

## Where do we go from here?

August 2009

There has been much comment on corporate bonds in the press recently, particularly on whether valuations have become stretched following the rally this year. In this article we explain why we believe investment grade corporate bonds still represent good value and why high yield is fair value whilst continuing to offer some attractive opportunities.

### Risk appetite returns

Corporate bonds have experienced a tremendous rally in the past few months as investor appetite for risky assets has escalated on growing optimism that recovery is in sight following some of the worst economic and market conditions on record. The high yield bond market has been particularly buoyant, returning a phenomenal 55% year to date, with the riskiest issues (rated CCC and below), rising nearly 100%. The investment grade corporate bond market, although more subdued, has also produced extremely strong returns: sterling investment grade corporate bonds have returned nearly 20% since the start of April, with the average spread on the Merrill Lynch Sterling Corporate and Collateralised Index tightening from 623 basis points (bps) over government bonds to 320 bps.

Investors returned to the credit markets after reports of better-than-expected corporate earnings from many companies and signs of improving business and consumer confidence. Firmer housing data have also reinforced a growing view that the residential property

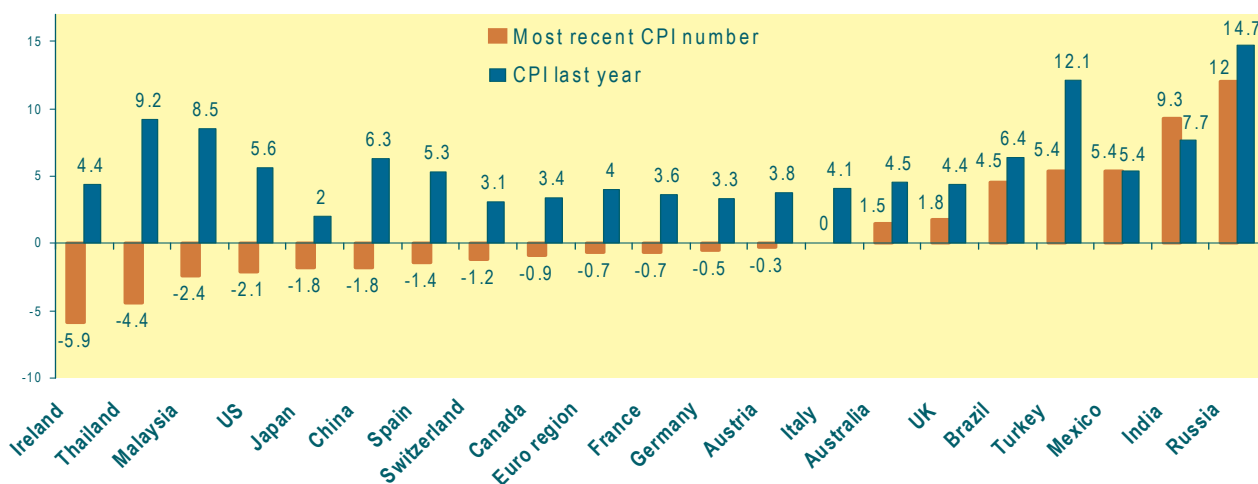
markets in the US and the UK may have bottomed. It appears that the huge monetary and fiscal stimuli are starting to take effect and that the unprecedented policy response has helped avoid another Great Depression. However, we believe it is still very unclear how sustainable growth will be when the recession finally ends.

### Low inflation outlook

The Fixed Interest team's view on inflation remains unchanged. It is likely that inflation will stay low for a long time due to the massive amount of slack in the global economy. Indeed, the spare capacity following huge falls in output as well as the decline in oil prices from last year's highs has meant that many countries are now in deflation. The chart below shows the latest CPI inflation rates in a number of countries, along with the rate for the same time last year. From this it is clear just how large some of the downward movements in CPI have been.

The Bank of England does not believe inflation is around the corner either. It recently stated that the recession is deeper than it previously thought, and that slack in the economy is likely to grow for some time yet. The bank decided to extend its asset purchase scheme in August to prevent inflation from undershooting its 2.0% target in the medium term. We believe that an increase was probably necessary given that the improvement in economic data is too recent and its sustainability too uncertain to be evidence of a true recovery.

### Consumer price inflation rates in selected economies (% YoY)



Source: Bloomberg (latest published inflation data as at 24 August 2009)

We remain cautious on the economic outlook for the UK and global economy, and expect inflation and, therefore, interest rates to stay low for the next one to two years. These are both factors that should be supportive of fixed income assets going forward since bonds tend to do well in a low inflationary/low interest rate environment.

### **Spreads still above historical averages**

Even though we have seen a significant rally in credit, particularly in higher-yielding bonds, corporate bond spreads remain well above historical averages. They have tightened to levels consistent with a 'typical' recession. Sterling BBB industrial spreads (ie, non-financials) are now at 278 bps over government bonds, compared with a peak of 275 bps in 2002, after the bursting of the technology bubble.

Although credit is not the 'once in a lifetime opportunity' it was earlier this year, Richard Woolnough, manager of the M&G Corporate Bond Fund, M&G Strategic Corporate Bond Fund and M&G Optimal Income Fund, believes credit spreads are likely to continue tightening. He thinks the asset class still looks historically cheap and, while the economic environment is still problematic, many issuers are responding in ways that are extremely positive for bondholders. Companies are cutting dividends, reducing capital expenditure and raising new capital via rights issues. Also, the technical picture looks very supportive. Demand for corporate bonds has been massive, and credit spreads have narrowed despite record issuance. Although government bond issuance is set to accelerate, activity within the corporate primary market is expected to gradually decline – all of which is supportive of further spread tightening.

### **High yield now fair value**

Spreads have narrowed significantly in high yield following the massive sell-off in the second half of 2008. The whole market has rallied, with the poorest quality bonds leading the way. But Jim Leaviss, manager of the M&G High Yield Corporate Bond Fund, believes that defaults in this part of the market could become more commonplace, as economic growth remains muted and highly leveraged companies suffer. He therefore remains focused on higher-quality companies.

Following the strong rally in high yield this year, we believe that the asset class is on average now around fair value. Returns for the remainder of the year are likely to be derived from coupon income rather than the strong capital gains we have seen in recent months. We believe that opportunities still exist for those investors

willing to take on a bit more risk, but investors should be pragmatic, however, as returns may be volatile in an economic environment that continues to be challenging.

### **Independent credit research**

Given the current economic climate, a full understanding of one's investments has never been so important. The in-depth research of M&G's specialist in-house 66-strong credit analyst team\*, one of the largest in Europe, helps our bond fund managers thoroughly understand each credit that they invest in. This research helps them to 'avoid the losers' – in our opinion, the key requirement in controlling the risks of corporate bond investment. Our internal valuation and rating system also makes M&G independent of the ratings agencies, enabling us to react quickly to any change in circumstances.

### **Gilts – QE: to exit or not to exit!**

While the improvement in risk appetite has dampened demand for government paper, the markets have also been caught between hefty debt sales on the one hand and buying from central banks on the other.

At some point the gilt market will be flooded when the UK government reverses its purchasing programme and needs to fund the huge budget deficit. If it does too much quantitative easing (QE), the result will be growth in the short to medium term, but accompanied with runaway inflation, which will be very bad for longer-term growth as rates are hiked and government bond yields soar. If it does too little QE, or implement the exit strategy too soon, the result would be an acceleration of the downturn and further pressure on the vulnerable banking sector.

Richard Woolnough has positioned the funds he manages short duration due to his fears over the looming huge supply of gilts rather than on 'traditional' gilt market concerns over strong growth and inflation. Jim Leaviss' view slightly differs in that on balance he feels weak growth and low inflation should help support government bond yields despite the surge in issuance.

### **Conclusion**

In conclusion, we believe that there is more credit spread tightening to come, particularly in those areas of the investment grade corporate bond market that are resilient to the downturn in the economic cycle. The asset class still looks historically cheap, demand for corporate bonds remains high and companies are carrying out bondholder-friendly actions.

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*Source for returns and spreads: Bloomberg, Merrill Lynch indices as at 24 August 2009.*

*\*Source: M&G Statistics as at 18 August 2009 for the employee figures.*

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