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STANDARD LIFE INVESTMENTS

Global Insight

August 2008

First light at the end of the tunnel

- Value in investment grade corporate bonds
- Elevated credit spreads drive sector allocation

Market view

- Growing signs of a global recession
- Commodity prices key factor for central banks

Elevated credit spreads, especially amongst financial companies, drive our sector allocation within corporate bonds. We see marginal incremental returns from investing in high yield bonds. Such bonds contain more implicit default risk than investment grade credit, which remains our preferred sector.

Focus On Change

Photograph
'Detail of water droplet on nasturtium leaf England' by Rosemary Calvert

First light at the end of the tunnel

Introduction

There have been a rolling series of bear markets across a range of financial assets during the course of 2007 and 2008. The initial pain was felt last summer in parts of the credit and wholesale money markets. Since then the strains and stresses in the global economy and the financial system have resulted in sizeable price declines across a range of government bond, equity and property markets.

In this edition of Global Insight, we return to the initial centre of the problem, the global credit crunch. We examine the latest drivers and the likely outturn into 2009, using our ***Focus on Change*** methodology. Our conclusion is that within credit portfolios we remain relatively bullish on global investment grade corporate bonds. We distinguish them from higher yield bonds, where we see less attractive risk adjusted returns. Within the House View, we remain Heavy in UK Corporate Bonds, a position we took in the spring at the expense of UK Gilts and US Treasuries which are both rated Neutral.

The drivers of corporate bond returns

The returns from owning corporate bonds are derived from two sources: the income from the bond coupon and a capacity to generate capital growth. In turn, these are determined by the overall level and structure of interest rates in an economy, as well as the credit worthiness of any issuer and the premia for owning a risk asset. Corporate bonds need a higher interest rate than government bonds to reflect the added risk of a possible default or credit rating downgrade. At present this additional interest rate or spread is historically very high, suggesting that corporate bonds could materially outperform government bonds over the medium term.

The outlook into 2009

Our House View concludes that global economic conditions will stay challenging in the medium term. Nevertheless, a key ***Focus on Change*** question is whether this has already been discounted adequately in the price of credit. Chart 1 illustrates the extra spread available today compared with the last two crises in 1998 (LTCM / Russia) and 2001/2 (the tech bubble implosion and the corporate problems engulfing, inter alia, Worldcom, Enron and Marconi).

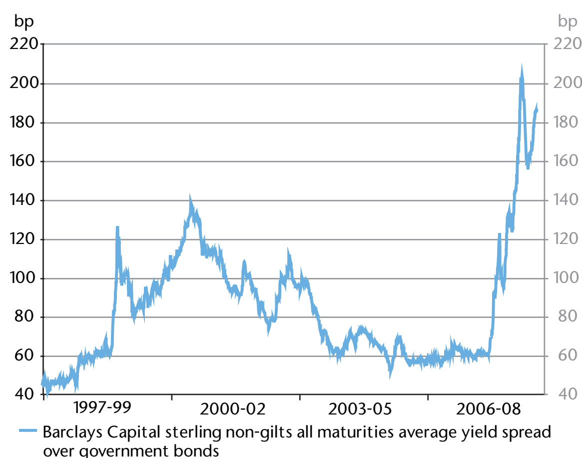
On this occasion, investor concerns are centred on the financial sector's problems. We are reassured by clear signals from policy makers that they will provide direct support to troubled financial entities, even if this erodes value for equity investors. A recent example would be the US government's support for Freddie Mac and Fannie Mae. We expect ongoing support for key banks and other financial institutions, helping them to rebuild balance sheets.

Whilst ordinarily such measures would provide comfort to investors, central bankers are also grappling with a combination of weak economic growth yet elevated consumer inflation, complicating the monetary backdrop. This situation has created further risks for credit markets, for example whether policy errors will appear. Headline inflation has reached worrying levels for many central banks, in some cases causing a tightening of monetary policy. However, we view the surge in commodity prices as a temporary, late cycle phenomenon, not a harbinger of a lengthy period of elevated global inflation. The recent drop in oil prices is beneficial for credit pricing. We expect central bankers will 'talk tough' in order to calm down inflation expectations, ruling out interest rate hikes as long as commodity prices do not surge once again. In due course, we foresee lower government and corporate bond yields as economies slow and investors see the chances of higher interest rates in the US, UK and Europe receding.

Another key driver is confidence in the financial system. The banking system is experiencing a major de-leveraging process as new lending is restrained. Ultimately this will allow bank margins to be rebuilt and

Chart 1

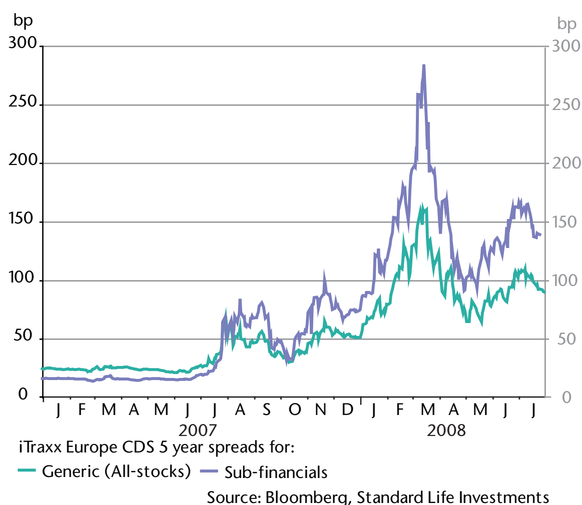
UK credit spreads offer more value



Source: Bloomberg, Standard Life Investments

Chart 2

Financials offer extreme value



Source: Bloomberg, Standard Life Investments

capital to be deployed in a more rational manner. The necessary counterpart is the re-capitalisation of the banking system, a lengthy and painful process. So far banks have raised about $350bn of new capital, about half the amount required on some estimates.

Investor confidence in credit ratings also needs to revive. Structured credit was an important financial innovation, allowing investors to take on different slices of credit risk and creating a much larger group of buyers for higher rated assets despite their risky underlying collateral. Not only has confidence in these asset pools deteriorated, for example as mortgage defaults rise, but clearly the credit rating agencies have struggled to measure risks adequately. By end May, Standard and Poor's had been forced to downgrade $350bn of mortgaged backed assets. Stabilisation in the housing markets will be required before we see a material appreciation in the pricing of many asset backed securities (ABS). Nevertheless, we do see value in certain sectors of the ABS market, such as bonds secured on social housing and some leisure stocks.

What is priced into credit spreads?

Tradable derivative instruments give insights about what is priced into markets. The current Itraxx investment grade credit default swap index, a measure of the credit risk of the average single A-rated name, has a spread of about 100bp over government bonds (see chart 2). This implies default rates over a one year period of 1.7%, compared with historical default rates of only 0.04% in the period 1985-2006 and 0.4% in the 2001-02 recession. Such a wide spread indicates that investment grade credit is historically cheap, with investors pricing four times as many defaults as in the worst recent period.

Investment grade credit appears to be pricing in a relatively worse default outlook than its high yield counterparts. When we look at BB rated high yield credit the implied default rate is around 9% which compares to historical default rates from 1985-2006 of 1.7% but 6.6% in 2001-2002. Thus spreads in high yield imply defaults only 1.4 times worse than the 2001-02 period.

Another way of examining the current situation is a comparison with the depression era of the 1930's, when Moody's investment grade default rates peaked just below 2%. Current corporate bond spreads over government bonds approximately equate to a 3% default rate, again somewhat in excess of historical norms.

Investors should recognise that credit spreads also include uncertainty risk premia, over and above default risk, hence the previous analysis is intentionally simplistic. Nonetheless, it does illustrate the extremes of valuation markets have currently reached.

Why will the market change its mind about credit ?

In general terms, the market will reprice credit positively when some element of stability returns to the macro-economic and corporate environments, allowing the large risk premium in credit to fall back. Our economic forecasts suggest a period of sub-trend growth, which will be beneficial both in terms of reducing inflationary tendencies within the major economies as well as a more rational allocation of capital through purging the leverage excesses of recent years.

Specific triggers, which credit investors should pay attention to when timing their decisions, include the following:

- Greater confidence in the financial, rating and regulatory environment and a reduction in fears of systemic risk.
- Signs of the economic policy stimulus working.
- More stability in asset prices; for example even if house prices stop falling, rather than actually appreciate, this would help sentiment and put a floor under capital market pricing.
- Stability or a decline in commodity prices and therefore forecasts of headline inflation.
- Recognition that corporate profitability is on a less severe trajectory than the consensus expects, even if it remains on a downward trend.

Conclusion

The House View does not expect a rapid recovery for the global economy, and warns that a variety of risks lie ahead. There is scope for credit spreads to fall although we continue to warn that volatility will continue. The likelihood of weak economic data or further surprises from individual companies, either positive or negative, is high. Nevertheless, the credit markets appear to have already priced in a large amount of the bad news. Although commercial and investment banks may be recapitalising, they will be unable to embark on major lending programmes for some time. Although overall credit spreads may remain at elevated levels for some time, there is value in the financials sector in particular. Conversely, our analysis concludes that the incremental return from investing in high yield bonds is marginal. They contain more implicit default risk than investment grade debt, due to the more leveraged nature of the companies involved thereby making this asset class particularly sensitive to ongoing economic stress.

House View

Aug 08

Within a UK based balanced fund, the House View shows the following preferences between the major asset classes: firstly, corporate and government bonds, secondly cash, thirdly global equities and fourthly global property.

	Positive	Negative	Our View
US Equities	• Continued support from policy makers to offset credit market problems • Valuations have improved, especially for financials and some cyclicals	• Squeeze on corporate margins could force employment and investment cuts • Considerable uncertainty about extent of negative news from the housing sector	Market supported by improving valuations and easy monetary policy despite credit concerns STAY HEAVY
European Ex-UK Equities	• Management still focused on restructuring and M&A opportunities • Companies benefiting from emerging economy orders for capital spending	• Exports coming under pressure as US and other major trading partners slow • Higher commodity prices and euro appreciation squeeze corporate margins	The region is vulnerable to weaker earnings and continued credit market problems STAY LIGHT
UK Equities	• Positive earnings and dividend growth as companies continue to control costs • Investors reassured by strong cash flow, dividend yield and share buy backs	• Oil and resource companies vulnerable to sharp falls in commodity prices • Concerns remain about the housing market and prospects for bad debts	Although financials and retailers are under pressure, the market is supported by favourable valuations STAY HEAVY
Japanese Equities	• Companies are still benefiting from strong regional demand • Increasing dividends plus share buy backs are helpful for investors	• Companies increasingly face weakening exports to the US and Europe • Domestic economic data suggests lacklustre activity ahead	Valuations of many stocks already reflect a regional slowdown STAY HEAVY
Pacific Basin Ex-Japan Equities	• Infrastructure spending remains a primary driver of many economies • Strong retail inflows into stock markets in many countries	• Policy makers are taking more steps to restrain high rates of inflation • Equities at risk from any marked slowdown in OECD or Chinese demand	The region is vulnerable to significant domestic tightening as well as weaker exports STAY VERY LIGHT
Global Emerging Market Equities	• Current account surpluses protect some countries from credit concerns • Some central banks able to ease monetary policy as inflation remains under control	• Valuations still remain rich in many markets • Higher food prices are squeezing consumers and worrying central banks	Valuations are stretched while earnings growth is slowing STAY VERY LIGHT
International Bonds			STAY HEAVY
US	• Growing signs of recession open the way for easier monetary policy	• Vulnerable to higher commodity prices feeding through into wage expectations	**STAY NEUTRAL** within International bonds
Euro-zone	• Markets slow to price in weaker economic activity in response to credit tightening	• Risk of rising inflation due to tight labour markets in some countries	**STAY HEAVY** within International bonds
Japan	• Solid demand from domestic investors plus limited correlation with other global bond markets	• Bank of Japan has been warning about the need to tighten monetary policy	**STAY NEUTRAL** within International bonds
UK Bonds			STAY NEUTRAL
Gilts	• Previous rate rises and credit market turmoil should restrain economic activity • Defensive characteristics of longer dated debt increasingly recognised	• After a flight to quality, gilts are vulnerable if investor confidence revives quickly • Longer end of gilt curve vulnerable if interest rates are cut significantly	Within UK bonds, we are **Heavy** corporate bonds, **Neutral** conventional gilts, and **Very Light** index-linked debt
Corporate	• Strong retail and institutional investor demand for extra yield amidst relatively limited issuance	• Downturn in earnings growth would lead to higher corporate bond defaults	Corporate bond valuations are generally attractive although individual issues still require careful examination
Property			
UK	• Sustained employment and economic growth continues to support UK occupier and rental markets	• Keen valuations and slower consumer spending in the UK are depressing the outlook for returns	We retain our preference for offices over retail property in the UK given stronger rental prospects STAY LIGHT
Global	• Strong occupier demand and limited supply in US and Asian office markets • New vehicles appearing for diversification into global property	• Valuations have become stretched in some markets • Sector is vulnerable to withdrawal of global liquidity and higher credit costs	Funds are Heavy in global property. Strong demand and tight supply underpin office markets. Employment trends support Asian retail prospects
Cash	• Cash is an attractive alternative when corporate earnings and dividends are under considerable pressure	• Pressures are growing on many central banks to relax monetary policy aggressively as economic activity slows	A higher weighting of cash in a portfolio is beneficial in volatile market conditions STAY HEAVY

This page sets out our House View as it applies to a UK based balanced fund. Details of how the House View applies to other UK based funds and funds based in other parts of the world can be obtained from your Standard Life Investments representative.

The terms, Very Heavy, Heavy, Light, Very Light and Neutral express Standard Life Investments' view of a balanced portfolio against a given benchmark.

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