

## Corporate bonds: Beware the tail-risks

In 2009 corporate bonds delivered remarkable gains. With double-digit returns typically reserved for the likes of equities rather than (normally tranquil) bonds, credit markets have attracted a steady flow of investors. Following such a stellar performance, however, what can investors expect in 2010? In this month's edition of Fundamentals, LGIM credit strategist Ben Bennett examines three broad risks facing credit markets in the year ahead and how investors may be able to navigate through them successfully.

Corporate bonds produced an exceptional index return of 14.7% (BarCap Sterling Aggregate Corporate index) during 2009. Such a performance was only made possible by the panic that transpired during 2008, which pushed corporate bond prices to extreme lows as investors fled to the safety of government bonds. Importantly, this panic affected a broad spectrum of corporate bonds, not only those at risk of downgrade or default (notably within the banking sector). Even bonds issued by highly-rated, non-cyclical global corporates with strong revenue

generation and ample liquidity (i.e. as bullet-proof as corporate bonds get) suffered significant weakness.

During this extraordinary period, the most successful active fund managers dipped in and out of the risky bonds, grabbing the exceptionally high yield when they could, while avoiding the inevitable blow-ups. However, as we argued one year ago in our February edition of Fundamentals entitled "Opportunity of a lifetime?", investors could generate significant returns over the course of 2009 by employing a

relatively cautious investment strategy. This could be achieved by sticking with the safer names and avoiding the risky ones altogether. As Figure 1 highlights, while investing in the lowest-rated investment grade corporate bonds (BBB) generated a huge 27.3% total return, the relative safety of AA corporate bonds still posted a 10.9% return.

Unfortunately, as Figure 2 shows, we cannot expect this phenomenon to reoccur in 2010. While a number of corporate bonds had very low prices at the start of 2009,



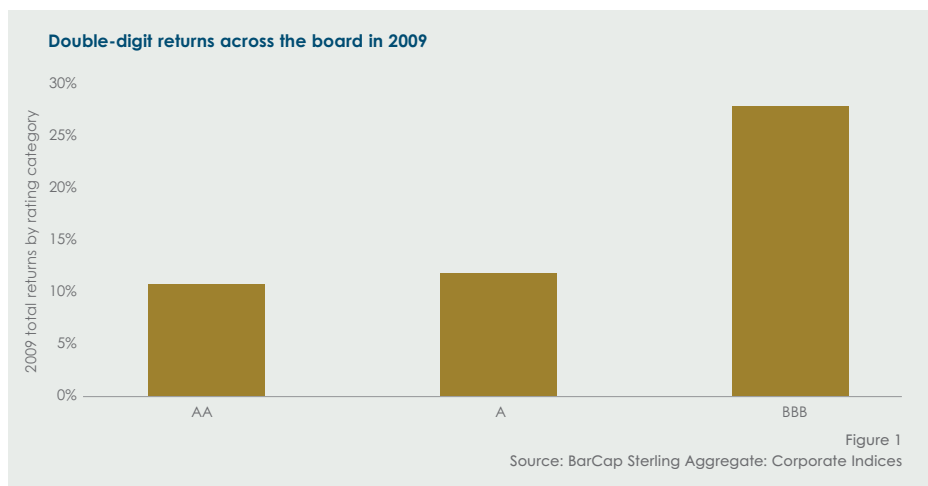
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bond prices are currently clustered around 100 (the price they are expected to eventually mature at), suggesting price appreciation is likely to be less of a factor in 2010. Bond prices are likely to fluctuate as the year progresses, but barring an economic relapse, gyrations should be small compared to 2008 and 2009.

### Total returns in 2010

As a quick reminder, the total return from any bond investment hinges on both price movements and the income the bond pays (its “yield”). Therefore, if price appreciation takes a back seat in 2010, investors will have to fall back on the yield component of the bond to generate performance. The yield of a corporate bond is made up of the risk-free government bond yield together with the excess yield which a corporate issuer must pay to compensate investors for potential default risk, downgrade risk, volatility etc.

Let’s ignore the government bond part of the yield for now (more on that later), and concentrate on the excess credit yield available to corporate bond investors at the start of 2010. Figure 3 plots this credit yield by sector and rating and it is immediately clear that the yields on offer at the safer end of the corporate bond universe are no longer particularly attractive. If we drill down further, some non-cyclical industries provide less than 1% of credit yield, while in contrast subordinated financial bonds can offer more than 5%.

### Riskier corporate bonds should not put investors off

The market backdrop is supportive for credit. Companies have cut costs and shored up finances, the economy has probably troughed and governments seem keen to keep stimulus in place until we are on a much firmer footing. In addition, the financials sector is now generally profitable and there is also far greater transparency surrounding potential for defaults (consumer delinquencies). Given all this, corporate bond investors would be giving up a lot of potential yield by playing it safe.

However, there are risks to our positive outlook. The volatility of the past couple of years has left the market in a vulnerable position and it would not take much to knock it from its current recovery. We have drawn up a list of the major risks in the coming months, and

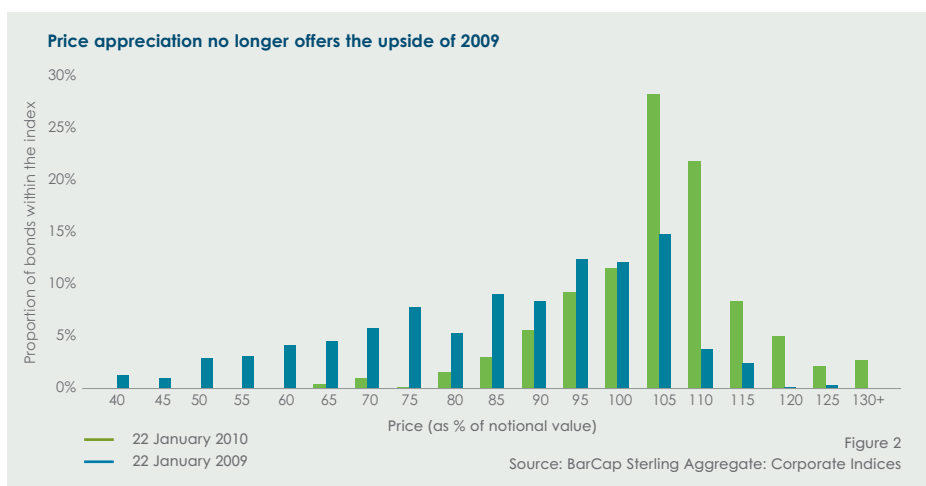
determined a system of hedges that may protect corporate bond investors if they should transpire. While hedges do tend to cost money, by being aggressive with the underlying portfolio (i.e. not shunning the riskier parts), the aim of such a strategy is to extract the greatest potential returns while protecting against major tail-risks, thereby generating a strong performance overall.

### The risks

#### Risk 1 - Economic boom

A strong economy may seem a strange risk scenario. However, here we are considering the impact on inflation and interest rates of growth moving too fast, too soon. In this case, it is the non-credit element of a corporate bond that could fluctuate with inflation expectations. Policy makers are likely to keep interest rates low for an extended period of time, until the recovery is staring us in the face. Such a tactic could ultimately lead to an aggressive recovery, asset price appreciation, a commodity bull market and ultimately stoke inflation. All this would probably take longer than one year to play out, but as always the market will price in the conclusion at an early stage, leading to higher interest rates and steeper yield curves.

A strong economic recovery would initially be seen as supportive for corporate bonds (given the reduced risk of default), leading to lower credit yields, but this would be counterbalanced by



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bond supply. A company’s access to funding is always important, but this is heightened during periods of investor nervousness, potentially resulting in the market demanding much higher yields from companies that are desperate to fund. We would therefore look to avoid sectors and names that have a large amount of refinancing to be done in the coming months (Figure 4). In this category, we can place senior debt from a number of banks which find traditional sources of funding (such as securitised markets) more difficult to access.

pressure from the risk-free (government bond) portion of the yield. So the hedging technique here would be to buy corporate bonds where the credit portion is large and where the benefit from an economic recovery is maximised. Obvious examples include cyclical sectors such as car manufacturers or mining companies. In addition, subordinated financial bonds also fit the bill given the sensitivity of banks to an economic recovery (and subordinated bank bonds provide some of the highest credit yields currently on offer). The bonds to avoid are those issued by safe, non-cyclical companies with a low credit yield, such as from the healthcare or utility sectors.

### Risk 2 - Economic double dip

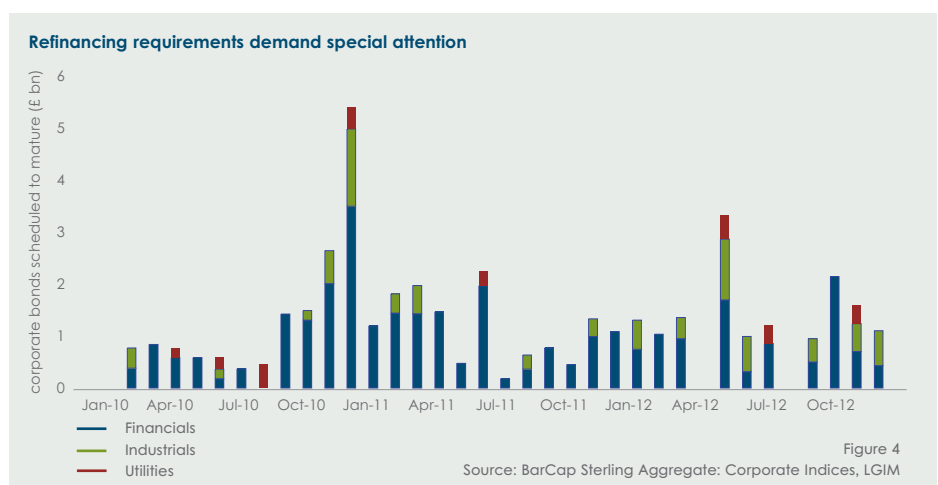
Research from our economics team indicates that the most likely set back to growth would be consumer related. As we discussed, companies are currently in reasonable health, having cut costs and controlled leverage throughout the recession. Indeed, they were not the problem in the first place; it was the consumer that took on too much debt via credit cards, auto loans, mortgages etc. It therefore stands to reason that an economic set-back would disproportionately impact the consumer once again. Therefore, while the market’s knee-jerk reaction following Lehman’s demise in 2008 was to flee from all risky asset classes, the education of the last year will hopefully result in a more discriminating response to a further

economic malaise. Out of the sectors suggested in the previous section, therefore, car manufacturers are probably an unwise choice, while mining companies should still be supported by emerging market demand. Retailers, particularly of luxury goods would be another sector to potentially avoid, despite relatively high credit yields. In regards to the financial sector, companies must be selected with a view to limiting consumer exposure where possible (auto loans, credit card receivables etc), while geographical activity is also a major factor. Exposure to consumers from rapidly growing developing countries, for example, looks far more attractive than exposure to the over-leveraged consumer from parts of the developed world.

The final consideration for hedging against a double-dip relates to corporate

### Risk 3 - Sovereign credit risk

Sovereign credit risk is not something that corporate bond investors usually follow carefully (the government yield portion of a corporate bond has already been described as “risk free”). However, the extraordinary measures undertaken by governments through the credit crisis has resulted in this risk coming to the fore. By cutting interest rates, nationalising banks, guaranteeing retail deposits and subsidising consumer spending, a significant amount of debt has been transferred from private institutions to government balance sheets. This debt nationalisation can be seen in official figures with the latest US flow of funds data demonstrating that private sector debt has recently ticked down, but Government debt has spiked higher (Figure 5). This trend is being replicated across the globe, and it is unlikely to end any time soon.

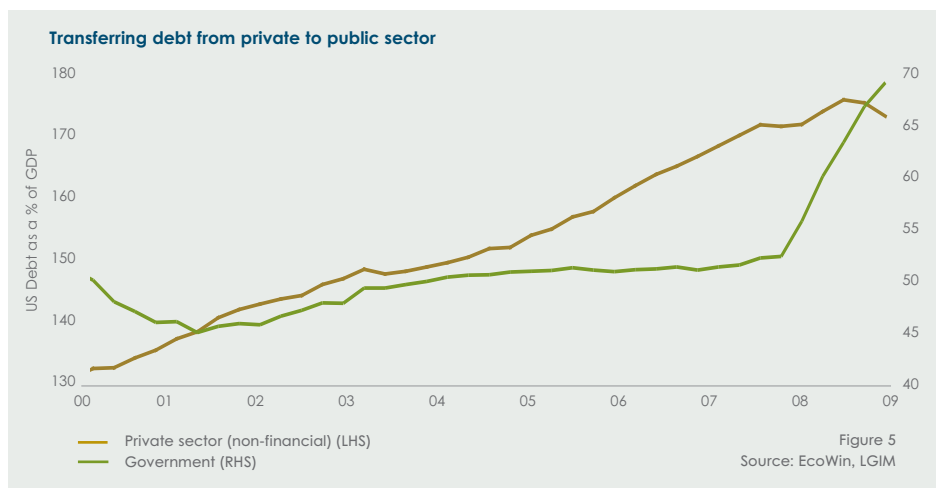


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The risk here is that the market may become uncomfortable with the amount of debt governments have taken on and the sharp increase in government bond auctions may result in temporary weakness. Even more concerning would be if the sustainability of government finances comes under the spotlight. Weak auctions are one thing, failed auctions are a different matter altogether.

The simplest way for a corporate bond fund to protect against such a risk is to buy insurance against the possibility of a country defaulting on its debt (via the credit default swap market). This has been a very popular hedge so far in 2010, particularly referencing peripheral Euro-zone countries such as Greece. Unfortunately, this popularity has made it a rather expensive strategy. In any case, buying insurance against the possibility of a sovereign default is not the normal activity of a corporate bond manager. So we have to think laterally. An alternative hedge could be to simply take a view on interest rates. Under a sovereign debt crisis or indeed even if heavy issuance leads to market indigestion, it is possible that interest rates would rise as buyers become scarce. As mentioned earlier, this also would suggest buying bonds with a high credit yield to counterbalance the rising government yield.

Corporate bond investors need to be careful about their exposure to names inextricably linked to susceptible sovereigns (such as Greek infrastructure companies), or benefit from an implicit guarantee (such as banks). However, avoiding all names tainted in this manner is unrealistic given the widespread problem of government debt. An alternative strategy would again be to use the credit default swap market and buy insurance against the possibility of a portfolio of banks defaulting. Figure 6 shows the annual cost of buying protection (for a 5 year period), referencing a portfolio of 25

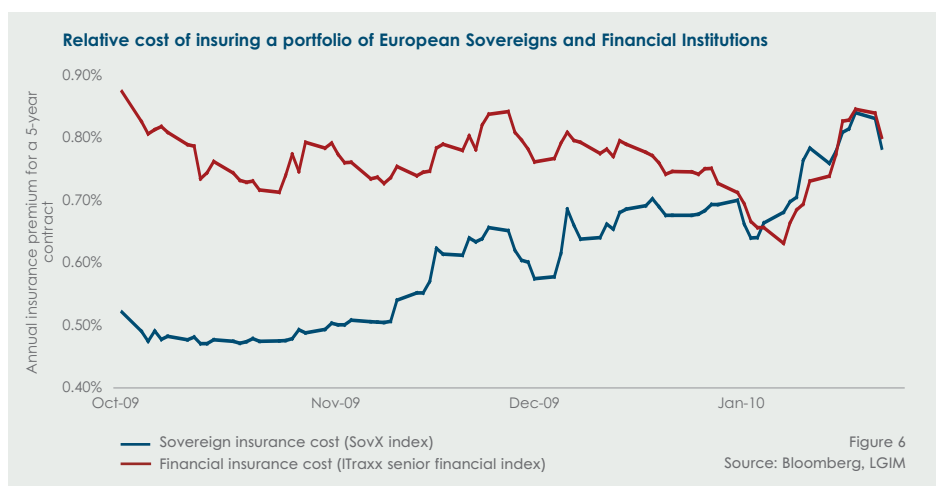


European financial institutions. For comparison purposes, this is plotted against the cost of buying protection, referencing a portfolio of 15 Western European sovereigns. While there are differences in the underlying nationalities of the indices, it is still surprising that sovereign credit risk is being priced higher than financial risk, given the dependence of one on the other. Again, this demonstrates how expensive explicit sovereign protection is.

This strategy complements our previous comments regarding subordinated financial debt. We can buy subordinated bonds to pick up the extra credit yield, thus protecting us from higher yields should the economy boom, but we also have senior financial insurance in case sovereign credit risk materialises.

### Bottom Line

In contrast to 2009, playing it safe will no longer provide exceptional corporate bond returns in the coming months. Portfolio managers will have to take some higher beta positions in order to generate yield. Some of this excess yield can then be used to hedge against the main risks to the market. We believe corporate bond investors can continue to benefit from good returns through buying non-consumer related cyclical names and subordinated financials, hedged by reducing exposure to low-yielding, non-cyclical and consumer-related cyclical sectors. We would also look to buy default protection referencing senior financial risk, particularly in relation to mounting sovereign credit risk.



# Market Overview

Helped by the tailwinds of the ongoing economic recovery, global equities made further progress in early January, with strong trading updates from heavyweights such as McDonalds and JP MorganChase raising hopes of a robust corporate earnings season. However, the rally faltered towards the end of the month as surprise US bank reform proposals and slightly softer economic data in the US and some parts of Europe took much of the wind out of the markets' sails.

Despite an upbeat assessment of the global economic outlook from the International Monetary Fund – predicting 2010 economic growth of 3.9% compared to the 3.1% forecast of last October - US and European equities drifted lower into month-end. Disappointing US retail sales and growing investor unease over the finances of some southern European countries prompted concerns over the sustainability of the recovery in developed markets as the stimulus taps are gradually shut off. Meanwhile President Obama's Glass-Steagall-style proposals to segregate Main Street and Wall Street banking added a further note of uncertainty, with bank shares in the US and the UK giving up much of their earlier advance. Even China and Brazil lost their upward momentum towards the end of January. Japanese equities performed relatively well, with returns for UK-based investors enhanced by the yen's strength against sterling.

## Equity Overview

### UK

#### Recession finally ends

Following six successive quarters of economic contraction, the UK finally emerged from recession during the last quarter of 2009. Helped by official interest rates remaining close to zero, £200bn of quantitative easing, the temporary VAT cut and resilient levels of government spending, the UK economy limped out of recession. The economy grew at an estimated 0.1% during the final quarter of 2009.

On the corporate front the long-running Cadbury takeover saga appeared close to its conclusion after the UK confectionary maker accepted an improved share offer of around 850p from Kraft. Meanwhile initial gains in the banking sector as RBS and Barclays won positive broker comment were subsequently reversed as investors reacted to the US bank breakup proposals, despite mixed reactions from UK political parties.

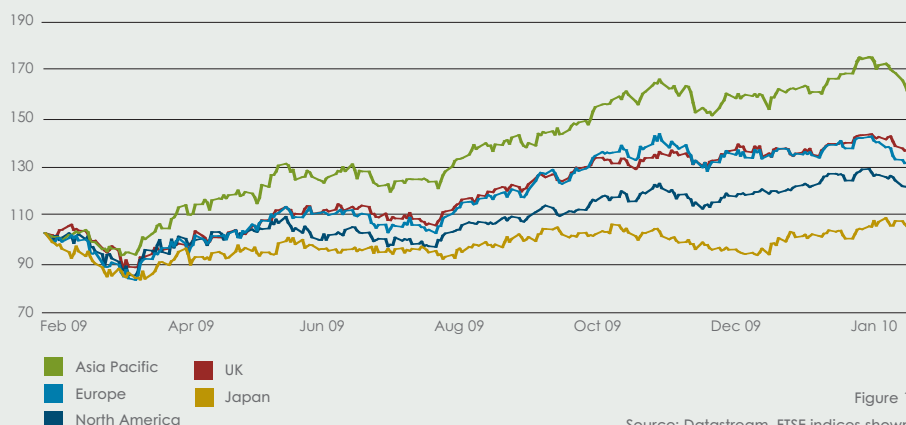
On the economic newsfront a better-than-expected unemployment report was followed by news that the economy returned to growth in the final quarter of 2009. News that consumer price inflation jumped to 2.9% in December from 1.9% in November sparked some concerns that the

### EQUITY OVERVIEW

Total return (denominated in £)	January (monthly) return %	Rolling 12 month % return (as at 31 January)
UK	-3.6	33.2
US	-3.0	21.5
Europe	-5.7	31.3
Japan	2.7	4.3
Asia	5.5	58.6

Source: Datastream, FTSE indices shown

Major Equity Markets – Total Returns £ 2009/2010



medium-term picture is less benign than many had predicted, even raising the prospect of an interest rate hike. Meanwhile disappointing retail sales figures served as a reminder that consumers shouldn't be relied on to drive the economic recovery.

### US

#### An unsteady recovery

January's batch of economic data painted a picture of a hesitant recovery in the world's biggest economy. December's jobs report was particularly disappointing, showing that 85,000 jobs were shed during the month, dashing hopes that November's encouraging report heralded the turning point for the jobs market. Despite the fledgling US economic recovery, unemployment levels in the US are hovering around 20-year highs, posing a major challenge for the Obama administration.

Meanwhile, US retailers had a relatively tough festive season as December retail sales unexpectedly dropped by 0.3% from November's level, taking the total fall in 2009 retail sales to 6.2% compared to 2008. Data also showed that wholesale inventories climbed by a stronger-than-expected 1.5%,

suggesting that the anticipated pickup in final demand is still lagging behind material supply, despite some more encouraging recent suggestions that inventories had been overly run down. However, the sixth consecutive monthly gain in the Standard & Poor's Case-Shiller house price index and a rise in consumer confidence suggested that the improving mood is gradually feeding through to support asset prices.

### EUROPE

#### It's a recovery Jean (Claude), but not as we know it

While economic data broadly confirmed that the recovery in the 'core' eurozone is continuing, notably in export-dominated Germany, fresh signs of strain emerged in the 16-nation bloc. Amid on-going concerns over the finances of some Eurozone countries, such as Greece and Portugal, European Central Bank (ECB) President Jean-Claude Trichet warned that rising debt is a major problem for European governments, and that the Eurozone recovery could be "chaotic" and inconsistent. President Trichet also appeared to distance the ECB from Greece's troubles, reminding markets that

## Equity Overview Contd.

Greece needs to “do its own work” and called for further reforms in the Irish economy to reinforce competitiveness.

These stresses seemed a world away from the improving trading environment noted by German companies, with the closely-watched economic indicator – the Ifo Business Climate Index – climbing for the 10th successive month in January, hitting its highest level for 18 months. Sentiment was particularly strong among manufacturers as companies anticipated a pronounced recovery in exports.

### JAPAN

#### Economy grows but deflation worries persist

A January report from the Bank of Japan observed that economic conditions are improving, yet the recovery remains dependent on ongoing government support measures. The central bank's board kept interest rates on hold at 0.1%, noting that while the outlook for exports is improving, domestic demand remains muted, with a heavy reliance on support from the debt-laden government.

Though the bank revised its Gross Domestic Product forecast for the present financial year from -3.2% to a -2.5%, the board expressed a very pessimistic note on deflation, warning that Japan faces three years of falling prices. Meanwhile, the yen recovered some of the ground lost against the dollar. A stronger yen versus the dollar is bad for Japanese exporters as it can erode overseas earnings.

### ASIA / EMERGING MARKETS

#### China begins to apply the brakes?

Data released in January provided further confirmation that China is firmly in the driving seat of the global economic recovery. The Chinese economy grew by a breakneck 10.7% in the fourth quarter of 2009, lifting growth for the full calendar year to 8.7%.

According to most estimates, China is now on the cusp of overtaking Japan as the world's second-largest economy. Buoyed by massive state infrastructure spending, the country's domestic economy continued to fizz amid fresh signs of soaring consumer activity, with the latest sales data

suggesting that China accounted for an amazing 25% of global car sales in November. However, following recent calls by the Chinese Prime Minister for banks to adopt a “more balanced” approach to cool the danger of asset bubbles in areas such as property, the central bank imposed new reserve requirements on banks with a view to curbing soaring lending activity.

Though intended to help achieve a more sustainable medium-term rate of economic growth, these measures, amounting to an effective tightening, had a knock-on impact on sentiment across other emerging economies. The commodity-rich Brazilian market pulled back from its strong start to the month, weighed down by the prospect that slower growth in China and elsewhere could cap global demand for Brazilian exports.

Though inflation remained relatively subdued by historical standards, firmer-than-expected food and beverages prices raised the prospect that interest rates could rise earlier than the market's present Q3 consensus. Nevertheless, Brazil's central bank is forecasting economic growth of 5.8% this year, while China has targeted growth of 8.3%.

## Fixed Income

Having risen sharply towards the end of December amid growing concerns over some countries' deficit woes, government bond yields eased back in January on fresh signs that the pace of the global economic recovery, particularly in the developed markets, is likely to be relatively mild.

A second downgrade to US third quarter GDP, taking growth down from the original 3.5% estimate to just 2.2% on an annualised basis, subdued retail sales and a setback for the jobs market combined to support sentiment to US government debt. News that President Obama is targeting a three-year public sector pay freeze to help tackle the US deficit also supported confidence in US Treasuries. Yields were also broadly lower in the ‘core’ European economies, such as Germany, though yields climbed in Greece, Spain and Portugal, reflecting the market's ongoing unease over these countries' efforts to tackle their deficits. Though economic data in the UK struck a more encouraging note, signs of a growing political consensus over the need to address the budget deficit helped to support the gilt market following its poor end to 2009. However, Japanese government bonds remained under pressure on lingering concerns over the levels of state spending as the government grapples to sustain the recovery.

Corporate bond markets gave back some of their recent gains towards the end of the month as investors reassessed risk on concerns that Greece's debt woes could be contagious and the surprise banking reforms lined up by President Obama. The softer trend was most apparent in the new issues market, with a number of new issues from lower-quality borrowers slipping noticeably in the secondary market.

Major Bond Markets – Total Returns £ 2009/2010



Figure 2  
Source: Datastream

## Snapshot

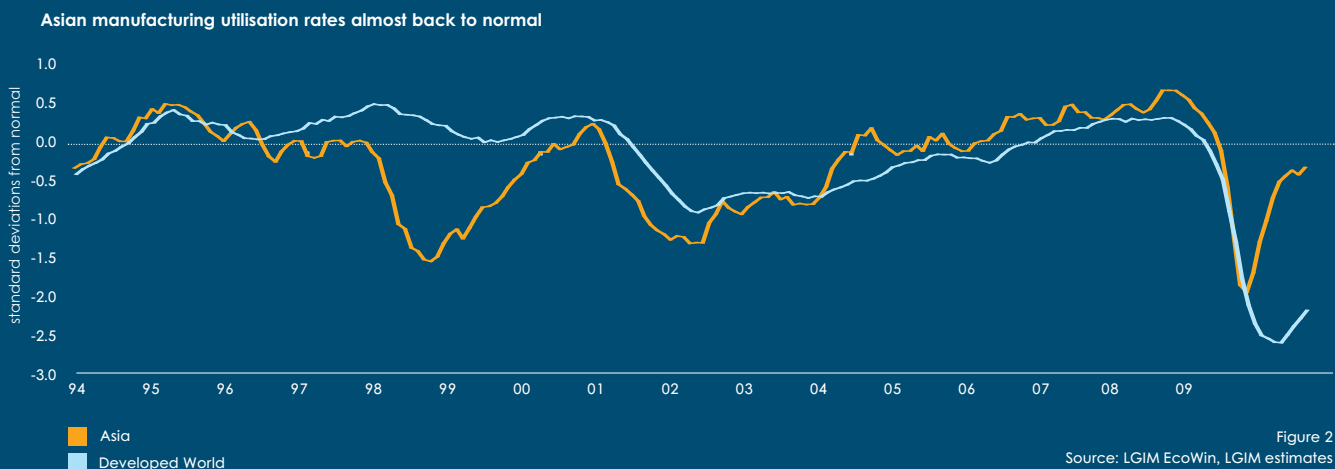
# Overheating?

The start of 2009 was marked by a synchronised global economic downturn as world trade slumped. The recovery in the second half of the year was more mixed, particularly for consumer spending. Car sales hit record highs in China, India and Brazil for example, but remained depressed in the US.

World trade is now recovering as companies have trimmed inventories to more desirable levels. A combination of stronger exports and buoyant domestic demand caused China to try and cool its economy in January by formally raising reserve requirements to restrict bank lending. This, together with concerns regarding Greek public finances and US bank regulation, knocked financial markets downwards. We believe the financial market uncertainty is likely to remain elevated for some time due to fears of further policy tightening in China. In particular, we believe Chinese inflation is likely to rise to an uncomfortably high level of 6% by end 2010 (Figure 1).



Some investors are downplaying the rise in inflation as they believe it is just caused by rising vegetable prices as a result of colder-than-normal weather. However, it's not just vegetable prices that have risen. A broad measure of industrial commodity prices has recovered back towards 2007 peak levels. Of more concern, we believe Asian factories are operating at normal capacity utilisation levels. Capacity utilisation rates are used as an indicator of how efficiently inputs to production are being used and are commonly watched as indicators of potential inflation pressures. With utilization rates at normal levels, growing demand is likely to result in Asian producers passing on price increases. This is in contrast to the developed world where utilisation rates are well below average, suggesting higher demand can be absorbed through higher productivity before prices need to rise, or "margin squeeze" (Figure 2).



Chinese money supply growth has also been running at close to 30% year-over-year in recent months. A model of Chinese inflation based on these factors suggests inflation will continue to rise throughout 2010. This is likely to constrain financial markets as investors could fear further policy tightening. In 2004 the Chinese stock market fell sharply as tighter monetary policy depressed construction activity and car sales. The impact of a slowdown in activity in China on Western financial markets is likely to be greater now than in the past given firms are more reliant on emerging economies for sales growth.

## UK Forecast

## A slow return to growth

UK Economy		Price Inflation (HICP)		GDP (Growth)		10 Yr Gilt Yields		Base Rates		\$/£		£/Euro	
		2010	2011	2010	2011	End 2010	End 2011	End 2010	End 2011	End 2010	End 2011	End 2009	End 2010
Market participants forecasts		%	%	%	%	%	%	%	%				
	High	3.40	2.50	2.20	3.05	5.13	5.00	2.00	3.00	1.79	1.75	1.00	0.95
	Low	1.50	0.10	0.40	0.80	3.40	4.40	0.50	0.50	1.31	1.55	0.80	0.79
	Median	2.40	1.78	1.20	2.10	4.50	4.80	1.00	1.75	1.65	1.65	0.85	0.84
	Last month median	2.10	n/a	1.30	n/a	4.43	n/a	1.25	n/a	1.68	n/a	0.85	n/a
<b>Legal &amp; General Investment Management</b>		<b>2.60</b>	<b>1.40</b>	<b>1.70</b>	<b>2.70</b>	<b>4.50</b>	<b>5.00</b>	<b>0.50</b>	<b>1.50</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>	<b>n/a</b>

Source: Bloomberg and LGIM estimates

The forecasts above are taken from Bloomberg and represent the views of between 20-40 different market participants (depending on the economic variable). The 'high' and 'low' figures shown above represent the highest/lowest single forecast from the sample. The median number takes the middle estimate from the entire sample.

The UK finally emerged from recession during the fourth quarter of 2009. However the magnitude of growth (a 0.1% expansion in GDP during the quarter) was lower than most market participants anticipated.

We have revised our growth (GDP) forecast for 2010 lower this month, from 2% to 1.7%. This reflects the weakness in the fourth quarter of 2009, rather than any change to our quarterly growth profile through 2010. While a full expenditure breakdown is not yet available, it appears as if the UK has yet to receive the boost to growth from a turn in the inventory cycle that we have seen in many other parts of the world. Manufacturing activity should improve over the next few months, but final demand is likely to remain subdued. We remain slightly more optimistic on UK growth in 2010 than the median market participant's forecast of 1.2%.

Despite the spike in the most recent reading on the Consumer Price Index (CPI) to 2.9%, we believe inflation pressures will ultimately subside through the coming year. Recent price pressures have resulted from exceptional events which took place at the end of 2008 that are now affecting the yearly calculation - including the reduction in the standard rate of Value Added Tax (VAT) from 17.5% to 15% and sharp falls in the price of oil.

Given our anaemic outlook for economic growth and ongoing weakness in the labour market we believe inflationary pressures will not build during 2010. Therefore, we retain our view that while we have likely seen the last extensions in the Bank of England's quantitative easing programme, official interest rates will remain on hold at 0.5% through 2010.

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