

Conference call highlights

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Absolute and Target Return Funds update

Distorted markets to continue

The outlook for world bond markets is confused. The supply and demand characteristics have been distorted by political intervention and we expect this trend to continue. The period that began with the credit crunch and continues with the euro sovereign debt crisis has been characterised by the strong influence of central banks and politicians – through governments' underwriting of banking systems and central banks' quantitative easing programmes. The result of this is investor uncertainty and opaque asset prices – markets do not properly reflect the risks and quality inherent in the underlying assets. Given the macro outlook, we expect this trend to persist through 2012. The good news is absolute and target return funds have flexible tools that allow us to cope with this.

Debt remains a key driver

Europe is the focal point of sovereign debt markets. The firewall that the troika of the EU, ECB and IMF has tried to build around Greece is fragile. And recently, Portugal has come under renewed pressure – its yields have spiked higher in spite of the ECB's three-year lending programme in December, such that the market now expects a second bailout. Were this to occur, Italy (with its enormous debt pile) and Spain (where unemployment is 22.5%) could be dragged back into the chaos, despite the ECB programme having relieved the pressure on its bond markets in recent weeks.

The macro outlook is unhelpful

Central banks in developed economies have turned the monetary taps fully open and are doing their best to maintain liquidity. However, it is clear that the monetary stimulus is not working as it should – the St Louis Federal Reserve Money Multiplier reveals that money is flowing round the US economy at less than half the rate prior to the collapse of Lehman Brothers. Central banks' stimulus is becoming clogged up in the commercial banks' balance sheets as they hold on to the capital and deleverage. The deleveraging theme will remain an important one, despite central banks' encouragement to lend more, and this will inhibit growth in the developed world.

Emerging economies to outperform the developed world

Given the deleveraging theme, we have low expectations for developed economies in 2012. We expect the eurozone to fall into recession – though Germany should grow a little if the US grows and China avoids a hard landing. The UK will teeter on the edge of contraction, though we expect inflation pressures to recede, as the base effects of lower energy prices should aid consumption at the margin. Therefore, we expect that the quantitative easing programme will be extended further – perhaps by £50bn – and this should support the gilt market. The US economy should do better than European economies and grow at a modest pace, though below the levels it enjoyed prior to the financial crisis. The main source of growth, meanwhile, will remain emerging economies such as China and Brazil.

“The taps are open but money is not flowing round the system as it should”

Unprecedented interest rate comments

Interest rates remain at historic lows. This has been the case for some time, and is likely to remain so for the foreseeable future. Indeed, the US Federal Reserve recently said it would keep US rates on hold at 0-0.25% until the end of 2014 – an unprecedented move both in terms of the Fed's openness in signalling its intentions and also in terms of the length of time that monetary policy will have been so accommodative. The huge quantitative easing programme – by which the Fed has bought government bonds by creating money – has also supported the loose monetary policy and boosted the treasury market.

Gold versus treasuries – distortion illustrated

The gold price has historically correlated well with treasury yields, as gold is seen as a hedge against inflation. However, this correlation has completely broken down over the past few years as extremely loose monetary policy has driven yields ever lower while the gold price has risen, partly as a result of global currency debasement and inflationary concerns. The breakdown in this relationship provides a good illustration of the distortions that political intervention has brought to financial markets.

The currency challenge

A further challenge comes in the shape of strong emerging economies, which are providing greater competition for the US dollar. Its status as the reserve currency of choice around the world is under threat. China has publicly stated that it now has too much invested in US dollar-denominated assets. The Hong Kong banking system, meanwhile, has seen a threefold increase in the number of commercial banks engaged in renminbi-denominated transactions.

Diversification the key to success

Our Absolute Return Bond Fund and Target Return Bond Fund offer valuable diversification benefits to investors. The funds are very lowly correlated with corporate bonds, and are negatively correlated with high yield, emerging market debt and UK equities. We believe this type of fund is a useful asset class for a diversified portfolio, particularly given the increased level of macro risks and bond market challenges we face now and are likely to face in the future.

Strategy favours non-European assets

Our favoured long positions are in US treasuries – the US is the most suitable market for liquidity and to increase the duration of the portfolio – and Australia, which is a true AAA sovereign issuer and offers a relatively high yield. In contrast, the funds are short in Italian bonds – a trading strategy that we are likely to add to as yields rally below 6%. We also have CDS positions opposing Bulgarian and Belgian sovereign debt – the former because of its close financial ties with Greece and the latter as a way of expressing a negative view on the eurozone as a whole. A short position in UK gilts is an opportunistic trade, and we are cautious that a dip in risk appetite might see gilt yields rally on 'safe haven' flows. Our short position in Japan, meanwhile, is predicated on the enormous level of debt – for perspective, around 50% of Japanese discretionary government spending goes on debt servicing.

“Australia is a true AAA issuer with an attractive yield”

Adding to financials

Within the portfolios, we had cut our weighting in financials last year. The ECB's actions in December – where they provided cheap three-year loans – have eased some of the risks, so we have recently increased our exposure to covered bonds. These super-senior assets pay a decent return above the interbank rate and give us a conservative way back into the banking sector.

Conclusion – market turmoil argues for diversification

Bond markets are somewhat schizophrenic, as investors push and pull on the back of good and bad news flow. On the one hand, ongoing concerns about the solvency of southern Europe have not gone away. On the other, extremely loose monetary policy and the 'politicisation' of markets are propping up core bond prices. This distortion is confusing investors and makes investing in government bonds a treacherous prospect. In this tough environment, absolute return investment strategies can improve the diversification of bond portfolios.

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