

JAN
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the View

A Thesis Asset Management view of the market



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Michael Lally

Quantum of solace - bond is back!

The New Year is traditionally the time for looking back at the previous year's highlights (of which there were precious few) and low points (of which there were far too many!). In reality the best time for such reminiscing and crystal ball gazing is at or close to the end of an economic cycle, not slap bang in the middle of one. Clearly, despite the best efforts of the world's central banks and governments, we are not yet out of the economic go slow caused by the credit crunch and irresponsible bank lending (and consumer borrowing!) practices.

Most comment has been focused on equity markets, as the key driver and barometer of economic health. However, the inception of nearly all previous bull and bear markets has been signalled first by bond markets. Unlike many experts I don't hold to the mantra that historical data, in itself, is an accurate source of predicting future behaviour. But in the case of bonds there are sound fundamental reasons why it would be foolhardy to overlook their importance.

Both governments and corporations raise a significant proportion of their finance from bond issuance. The interest rate they pay - relative to cash rates - is determined by the quality of the individual issuer, as evidenced by the ratings attributed to them by the main ratings agencies, such as Standard & Poors and Moodys. The highest quality is known as 'Investment grade' and ranges between AAA (eg gilts, quasi sovereign and top class blue chip companies) down to BBB (mainly large but highly geared companies in sectors such as financials and utilities). Below this is the quagmire of sub-investment grade (commonly, but not always accurately, referred to either as junk bonds or - in the case of US mortgage backed securities - toxic debt). A number of factors determine the grading, not least the issuer's (perceived) ability to service the debt, ie pay the interest and return the principal on maturity.

The grading has wider implications as it will also influence the rate of interest payable on shorter term finance (eg overdrafts and loans) as well as the rate and ease at which further bonds can be issued. Any movement in the rating (ie actual or expected) will have an immediate impact on the company's share price. Analysts - and more importantly banks - will look at interest cover as a useful tool in determining a company's ability to service its debt. Hence the reason why many companies' share prices have collapsed over fears that banking covenants have been (or may be) breached or that new loans cannot be issued to finance maturing bonds or loans.

As far as 2009 is concerned, the high yield sector is probably best avoided (even though interest yields have nearly tripled into the high 'teens' as defaults are expected to reach a record high. This leaves just two areas, ie government (and here I'm thinking of UK, ie gilts) and investment grade corporate bonds.

Gilts

These are by far the lowest risk means of investing in bonds; hence yields are usually much lower than those of corporate bonds. The two main factors influencing price movements are interest and inflation rates (ie actual or forecast). With the globalisation of markets one must now throw in to the equation the value of sterling, and relationship to other G7 sovereign debt. Other factors are new issuance (expect record levels this year but not a problem as there will be plenty of takers) and major political crises/conflicts.

Whilst prices can be distorted short term - as was seen last year - by either their 'safe haven' status or speculative inflationary pressures, there are fundamental reasons why we believe, even now, that prices are still far too low. Most economists are now forecasting a period of deflation this year, followed by an extended period (up to two years) of only nominal inflation rates (a similar pattern to that seen in Japan in the last decade). Interest rates will be cut further, probably well below 1%, which means you can still achieve a real return (ie interest yield less any capital loss to maturity and inflation) of probably around 3% pa. Just as markets were slow to discount the full impact of the credit crisis on corporate earnings, then so, we believe are they yet convinced as to the extent and duration of nominal interest and inflation rates. We expect them to catch up pretty smartly over the next few months with prices peaking possibly in the autumn. Just how far they can rise is limited only by the market's medium term inflation expectations.



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In other words be prepared to be nimble because, after that, upward pressures on commodity prices may start to resurface. Don't worry though, because there is an answer for that too, ie inflation sensitive index linked gilts.

Corporate bonds

Last year investment grade corporate bonds traded more like equities, with falls of 15%-30% commonplace. Credit spreads (ie the yield margin over gilts) rocketed from around 1% to 5% with prices discounting a 10% default rate in 2009. In the high yield sector the margin has risen to over 20% (80% if you're General Motors) with a 50% default rate implied.

The reality is that it is not so much market expectations of defaults which has driven prices down, but more a function of trading conditions. Lack of demand, distressed selling and a general flight to safety resulted in trading and new issuance (at non-distressed levels) drying up. History tells us little as developed bond markets are a fairly recent phenomenon (ie discounting the original loans and debentures) and this is really only the second time (the first being the technology, media and telecom crash in 2001/02) that this market has really been tested.

With hindsight, spreads were far too low back in 2007 (enhanced risk appetite and assumed infallibility of the biggest bond issuers, ie the banks) and until liquidity returns then investors will continue to demand a healthy yield premium. However, with blue chip AA bonds yielding nearly double that of gilts (which themselves we expect to fall significantly this year), and way above both cash and inflation, then at some stage, possibly later this year, prices should recoup at least a third of last year's losses, possibly more.

So, with downside risk on bonds less than on equities, and upside (one year) probably similar (but arguably more assured), then, as our American cousins would say, "We're in a whole new ball game." The amount of years when you can make serious money on bonds are few and far between, but this year (particularly for gilts) could well prove to be one of them. The motto of the London Stock Exchange is *Dictum meum pactum* (My word is my bond). How prophetic?



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Markets

Indices	Value as at 31/12/08	% change on month	% change 2008 year to date	% change on 12 months
FTSE 100 Share	4434.17	3.41%	-31.33%	-31.33%
FTSE All Share	2209.29	3.53%	-32.78%	-32.78%
Dow Jones	8776.39	-0.60%	-33.84%	-33.84%
DJ Euro Stoxx 50 E	2451.48	0.87%	-44.28%	-44.28%
Nikkei 225	8859.56	4.08%	-42.12%	-42.12%
FTSE A British Government All Stocks	160.83	5.14%	7.38%	7.38%

The saying 'as January goes, so goes the year', unfortunately proved to be correct last year, but what will this month or year hold for investors? Very early days, but the year has so far started quite well, despite a real lack of news and results, but lots of opinion! Next week sees the Bank of England meet to discuss interest rates again, which given the recent carnage in the retail sector and latest economic news should see a further reduction in the base rate. Likely newspaper headlines to follow will surely be 'More woe for savers', which wrongly assumes that all savers are sitting only on cash deposits - not shares, Gilts or other forms of investment (the choice of pension funds), where the comparable rates of return should become even fairer.

The Government looks set to punish the banking sector (or those banks within its control), by forcing more lending and debt on an already indebted nation. As Andy Brough, one of Schroders leading fund managers, recently commented "in the old days we used to be allowed to go into a recession" and this process helped sort the wheat from the chaff in true Darwinian fashion. Survival of the fittest is no longer allowed in the US either, with the car bail out scheme surely doomed to failure in the long term. Rumours of another banking bail out abound, but it is more likely we will see some form of guaranteed lending scheme, partly tax payer backed, rather than the huge capital injections we saw in October 2008.

The recent demise of **Woolworths** is a sad state of affairs and with others clearly 'on the ropes', forthcoming retail announcements in early 2009 look set to be bleak. The brokers' knives seem to out for both **Next** and **Debenhams** in particular. As an aside, isn't the failure of Woolies partly due to the upsurge of 'out of town'

shopping centres and the supermarkets - other than 'pick and mix' what else couldn't have been bought at Tesco? The other issue here is the retraction of global lending to those most indebted and it was ironically the retrenchment of primarily non-UK bank lending that put the final nail in Woolies' coffin. **MFI** is another story, but is anyone crying?! There has been some buoyant activity already this year as investors have been short covering the retail sector after heavy losses in 2008.

Speculation continues that **Marks & Spencer** is likely to cut its dividend and others will surely follow - maybe even as many as one in four companies. Taking the dividend yield paid out over the past year has been 4.7%, well above its 20 year average of 4.1%; this is certainly attractive in its own right and against other asset classes. We shouldn't also forget that three out of four companies will be maintaining or raising their dividend payouts in 2009. Compared to cash, just maybe investing in shares for income won't look a lousy decision by the end of 2009.

The outlook for oil and commodities looks set to be disappointing according to some commentators, yet the 'commodity supercycle' debate still continues! That said, the first few days of this year have seen a significant rally in all resource stocks, but this seems to be being driven by oversold technical factors rather than fundamentals. It is likely that cost cutting and retrenchments will dominate the newsflow for the mining sector in 2009.

Aberdeen Asset Management has snapped up **Credit Suisse's** fund management arm, as another bout of likely consolidation deals sweeps the sector. The group will now concentrate on its strengths, such as alternative assets, emerging markets and the

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Swiss domestic business, where it has a competitive edge and critical mass. Credit Suisse will not receive cash for its stake, but will obtain a 24.9% stake in Aberdeen, although this may be lower and will depend on the final valuation of the transaction.

Commercial property stocks and REITS are currently a very mixed bag. Lots of rumours are currently circulating in the sector. Dividends and rental yields certainly look quite attractive in some cases, so long as one steers clear of the most indebted, but with predicted falls of 30% from the IPD property benchmark being quoted, it is difficult for investors to get excited! That said, contrarian investor, Anthony Bolton's top sector picks for a stockmarket rally in 2009 are financials and... you guessed it... property.

Finally, the best piece of news for a very long while - you can now buy a pint of beer at **JD Wetherspoon** pubs for 99p! More news to follow when there is some... it should be an interesting month.



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