

CIO PERSPECTIVE: FIXED INCOME

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2012: Threats and opportunities



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AT A GLANCE

- The sovereign debt crisis is playing out at alarming speed and we may now see significant weakness in the euro.
- The crisis is entering into a final phase, which should see us move inexorably towards a policy of quantitative easing by the ECB despite German objections.
- The fixed income asset class still offers attractive investments despite the focus on sovereign risk. Cases can be made for allocations to corporate, high yield and particularly inflation-linked bonds.
- Periods of market stress present opportunities for investors prepared to take a longer-term view than myopic markets; nimble fund managers can take advantage of these periods.

2012 will be a challenging year for bond investors as they are forced to adapt to a changing fixed income environment by recasting their established ideas about the nature of risk. The realisation that some of the largest risks in the bond universe reside in what was seen as the lowest-risk end of the spectrum is a watershed moment. Sovereign defaults will remain the major concern for markets in 2012. However, investors should be wary of tarring all bonds with the same sovereign brush. 2012 will be a year of threats and opportunities in bond markets and nimble fund managers can take advantage of situations where investor sentiment becomes detached from the fundamentals.

The eurozone sovereign bond crisis is playing out at an alarming pace as markets attempt to periodically force the hand of policymakers. This is a pattern that is likely to remain in force for the early part of 2012 as markets continue to test any perceived weakness in the authorities' preparedness to act.

The idea of a member state leaving the eurozone has been transformed from unthinkable at the outset of 2011 to something that is being openly discussed in 2012. We first saw this possibility take shape with Greece, which was initially described as a 'unique situation'. While it is not our base case that we will see multiple departures, investors should prepare themselves for a number of potential break-up scenarios.

I think we are now entering into a final phase of the sovereign debt crisis. A policy of quantitative easing that increases the money supply would begin to erode the value of eurozone debts and provide respite for the eurozone region to recover and reach agreements on fiscal integration. The alternatives have now been exhausted and I believe the act of persuading German policymakers to consider some form of QE has already begun.

Given the events that we have seen in Europe, the euro has actually held up unexpectedly well. It is debatable how much longer this can continue. The weight of negativity against the euro is beginning to build towards a tipping point that introduces the prospect of significant weakness. We are already seeing Asian investors lose confidence in the eurozone and in the euro currency itself.

We are now in a reflationary phase of the global economic cycle in developed economies that has, in fact, traditionally been associated with relatively strong bond performance. Economic growth is slowing and inflation is coming down, quite markedly in certain areas. The challenge for investors is to understand that bonds can be a good place to be if your bond manager is exposed to the right risks. A strategic approach is obviously paramount, particularly with regard to sovereign bonds.

Aggregate bond indices and funds which are benchmarked against them now include significant concentration risks within sovereign bonds. Around half of the risk in the Bank of America Euro Aggregate Bond Index comes from sovereign bonds. More worryingly, the nature of that risk is highly correlated since if one peripheral nation leaves the eurozone, it increases the likelihood that others will follow.

While aggregate benchmarks still make up the bulk of the bond market, I think we will see increasing consideration given to more equally weighted, high quality benchmarks, going forward. I think we will see greater interest in 'strategic' bond funds that balance risk and return, as investors move away from products that expose them to increasingly indebted governments and institutions.

Portfolios based on "best issuers" can differentiate between government bonds, investing in the most fiscally sound sovereigns, such as Canada and Australia, as well as the highest quality investment grade corporate bonds of multi-nationals, such as Procter & Gamble and Johnson & Johnson. Such companies benefit from multi-national reach in relation to national regulatory risks, as well as strong cashflows and healthy balance sheets. They offer better credit risk characteristics than many sovereigns and allow investors to mitigate their overall sovereign concentration risk.

Turning to the individual bond classes, there are threats and opportunities. In **government bonds**, we are seeing a reappraisal of what constitutes a 'safe haven'. Investor demand for the

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government debt of countries deemed to be ultra-safe such as the US, the UK, Canada and Australia has risen. With the ability to print money in their own national currencies, these bonds are considered to have low default risks by investors. However, the low yields on offer make them less attractive for investors searching for yield.

Fortunately, the fixed income asset class is both wide and deep, so there are still very good opportunities for investors to achieve an attractive income, while avoiding threatened sovereigns. Higher-yielding parts of the bond market will retain support from investors searching for yield in an extended period of low nominal rates and negative real rates in Western economies. Coupled with aging demographics, the search for yield is a powerful force supporting the demand for high income generating assets.

High-quality **investment grade corporate bonds** can offer many of the characteristics once associated with sovereigns. Generalised macro concerns have served to push up yields in corporate bonds across the whole credit spectrum, but crucially this has occurred while company fundamentals have remained basically sound. In reality, many companies are now in a better position than their governments.

While they entail more risk, a case can also be made for **high yield corporate bonds** for investors prepared to take a longer-term view than myopic markets. Credit spreads now imply a significant rise in default rates, but as most seasoned bond investors know, the market rarely offers a pure assessment of fundamentals. Dislocation in financial markets periodically pushes the prices of high yield bonds to 'distressed levels', which do not reflect company fundamentals. Bank deleveraging will impact the high yield market as it is a recessionary influence on the economy that squeezes the availability of credit for firms. On the other hand, this bank deleveraging phenomenon virtually assures a strong pipeline of new issuers for some time.

In reality, most companies enter 2012 in much better shape than they did 2008/9. They have kept their cost bases under control; they continue to have access to bank lending, even if terms have become tighter, and they have actively managed their own refinancing needs in the past two years to protect themselves from this kind of volatility. These factors should contain default rates at lower levels than the market appears to be discounting. The total return of the high yield asset class is now supported by a very strong income stream - this income goes a long way to protecting total returns from this point. However, stock selection is critical to avoid the worst issues in the high yield space - these can have a disproportionate impact on returns.

Given that quantitative easing and an increase in the money supply are possible policy outcomes in the continuation of this crisis, then inflation must be considered a significant tail risk. **Inflation-linked bonds** look cheap; inflation is not on investors' radars as we have not yet turned the corner on QE. The problem is if investors wait for the corner to be turned, they will be too late as inflation will be the word on everyone lips and the markets will react quickly to build in those new expectations. I would certainly encourage investors to think about introducing inflation protection to their portfolios at the start of 2012, while it is still attractively priced.

2012 will also see bond investors give much more weight to the idea of **emerging market bonds** being a structural, rather than a tactical, allocation in their portfolios. These economies are forecast to deliver the strongest growth rates, which gives sound underpinnings to their sovereign credentials. Indeed, the debt and budgetary positions of many emerging market countries is now far superior than many developed countries. Sharp drops in risk sentiment that lead to rises in the government bond yields of well managed, fiscally responsible emerging market countries could present opportunities for income-seeking investors. Similarly, emerging market inflation-linked bonds offer attractive real yields; inflation is higher than in the West but this likely to be more than compensated by robust growth.

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