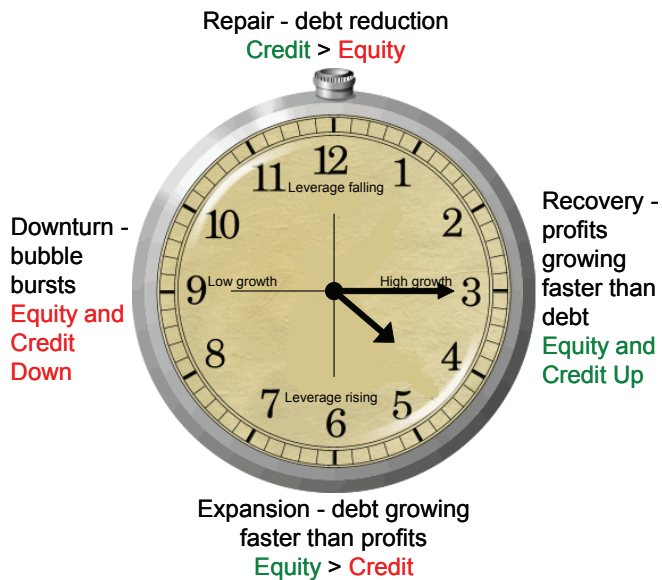




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Credit - ticking along . . .



Corporate bond spreads have tightened significantly from the 'wides' of early 2009, as companies have deleveraged during the 'repair' phase of the debt cycle, and yields are nearing historic lows, as government bonds rally. We believe credit still offers value, as spreads remain above the levels seen in 2001-02, following the bursting of the 'dotcom' bubble. Government bond yields are likely to remain low for longer in this low growth, low inflation, tight fiscal policy and loose monetary policy environment. This is a supportive backdrop for credit, and while we are mindful of the cycle entering the 'expansion' phase, which is negative for credit, we believe this could be some time away. We continue, therefore, to watch for signs of increasing shareholder-friendly activity.

The debt-equity clock (pictured above) illustrates the performance of corporate debt and equity across different stages of the business cycle. This clock does not necessarily move at a uniform speed, but is dependent on circumstances particular to each cycle.

The cycle entered the 'downturn' phase (9-12 o'clock) during late 2007 and early 2008, following an increase in leverage to boost future earnings potential during the previous 'expansion' phase. This high leverage became unsustainable, and so the bubble burst, resulting in a mass sale of both equity and credit, and the worst global recession since the Great Depression.

In late 2008 to early 2009, companies entered the 'repair' phase of the debt-equity cycle (12-3 o'clock), which is characterised by balance sheet repair, rights issues to raise funds to repay debt, and a focus on cash generation and company survival. Through 2009, this drove record high returns from credit as a result of broad-based spread tightening, as companies cut leverage, and demonstrated their resilience.

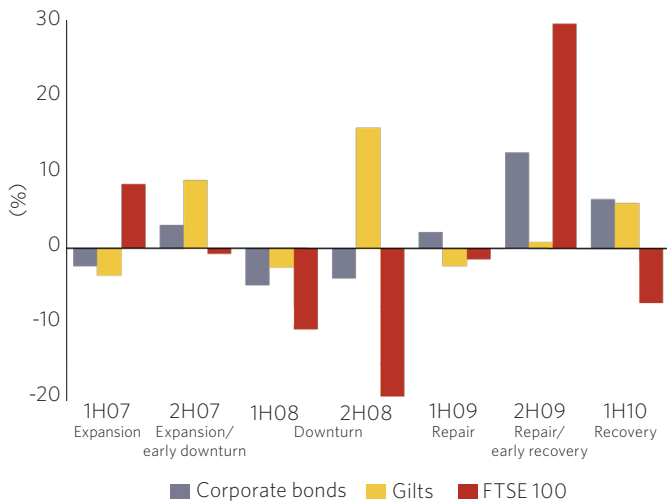
In late 2009, companies entered the 'recovery' phase of the cycle (3-6 o'clock). Credit rallied on the back of increased corporate profitability, which was achieved mainly through significant cost-cutting programmes and a return to growth in the global economy. These circumstances enabled companies to grow into their capital structures. In recognition of this, credit rating changes became more positive. The market has also reacted positively both to the most recent earnings season, and to the results of the European bank stress tests, which have improved transparency on banks' exposures to peripheral Europe.

Periods of volatility such as that experienced in the second quarter of 2010, driven by sovereign debt concerns, weakening macroeconomic data and the initiation of fiscal austerity measures, are likely to recur. This will have an adverse effect upon investor risk appetite, which is the equivalent of the clock going backwards. Perversely, at this stage of the cycle, this is a positive environment for credit. The current uncertainty over the economic outlook will likely dampen corporate confidence, thereby prolonging the period of deleveraging, and reducing the possibility of shareholder-friendly actions, such as mergers and acquisitions ("M&A") and share buybacks. Other existing headwinds include deteriorating macroeconomic data in Europe as the euro strengthens, and

further budgetary measures, which will act as a reminder of a tightening fiscal environment and challenging outlook. However, we do not envisage a double-dip recession as a likely scenario.

Leveraged buy-outs (“LBOs”) with large debt-funded elements have yet to return; a few opportunistic companies have tried and discovered that although yields are historically low, banks and investors do not have the appetite to provide funding. There have been some M&A rumblings, particularly within the commodities sector, but, again, the availability of funding remains limited for all but the most creditworthy companies.

Returns (GBP)



Source: Bloomberg

The next phase of the debt-equity clock is ‘expansion’, which is characterised by increasing leverage through LBOs, share buybacks and declining free cash flow amid increases in capital expenditure. Equity holders benefit from this higher gearing (leverage), but credit spreads ultimately widen in such circumstances, reflecting balance sheet deterioration. While this point has not yet been reached, we are concerned companies will become more shareholder-friendly following periods of extended market stability. Watching for signs of greater appetite for leverage is a fundamental part of our credit analysis.

Spreads remain elevated and are currently above the 2001-2002 levels, providing some buffer against the (relatively low) risk of rising government bond yields. The fiscal austerity path will be very challenging without the support of low interest rates and with the burden of a weakening macroeconomic backdrop, hence the need for governments to maintain loose monetary policy. Investors will continue to search for yield, thereby boosting demand for corporate bonds.

In a low, but positive growth environment, with limited shareholder-friendly activity, conditions should continue to be favorable for credit. On this basis, we believe that credit is ticking along slowly through the cycle, and that we will remain in the ‘recovery’ phase for some time yet.

Although we believe there is some value in the secondary market in the current environment, there is likely to be more value in the primary market. New issue premiums have shrunk considerably over the last year, but we continue to look for value. We therefore move into September with slightly higher levels of cash than our sanguine view on corporate bonds would otherwise dictate.

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