Schroders

A year of opportunity

January 2009

As we enter 2009, our bond fund managers reveal why they think this year may present investors with some extraordinary opportunities.

Fixed Income

“Clearly we enter this year in an environment that is fraught with risk but also offers high levels of compensation to investors given the dislocation of 2008 and the spread levels prevalent in the market"
Karl Dasher, Global Head of Fixed Income

Whilst we feel confident that the worst may now be behind us in terms of large scale systemic failures, we are poised to see unprecedented numbers of companies defaulting on their bond payments in 2009. These challenging conditions should, however, provide a rich hunting ground for the astute investor – as such, we believe that we are now faced with a significant opportunity.

Our strategy this year – as with last – will be to continue to keep a close eye on the economic environment and to identify those companies that are best positioned to weather the storm ahead. For us this means looking for companies with strong management teams with a focus on core operating principles and simple and transparent accounting policies.

Government bonds

“This is an environment in which the European Central Bank and the Bank of England will adopt zero (or near zero) interest rate policies in 2009 and maintain these low levels for the remainder of the year. This would suggest a supportive environment for government bonds, at least during the period of monetary easing or until economic conditions stabilise.”
David Scammell, Head of European and UK Interest Rate Strategies

Last year’s breakdown of confidence in financial markets saw many investors retreat from risk assets (such as equities or credit) and head for the safe haven of government bonds, which generated impressive returns over 2008. Indeed, we believe that economic conditions should continue to prove supportive of the government bond market in 2009.

There are concerns about how far both governments and central banks will be prepared to go in order to stabilise economic conditions; there is speculation that quantitative easing (printing more money) could later accompany further interest rate cuts. While the Federal Reserve has already formally moved to a zero interest rate policy, the Bank of England and European Central Bank still have some way to go in easing monetary policy. This could mean a return to higher levels of inflation – good for index-linked bonds, but bad news for bond prices more generally.

We are also likely to see unprecedented levels of issuance of government bonds in 2009. Whilst there has been some concern that an over-crowded market could spell lower prices, we believe that demand for government bonds should hold firm – particularly since new regulatory changes will mean banks are forced to seek a higher level of funding from government sources in the future.

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Credit

"Credit in 2009 should experience an inflection; the time will likely arrive when, having discounted more pain than is likely to occur, credit spreads will begin to improve. Starting from historically wide levels, these will prove to be extraordinary return opportunities."
Adam Cordery, Head of Pan-European Credit

Conditions for credit markets remain extremely volatile. We believe, however, that 2008 was the "Year of the Rat" for credit and that the market has had its most severe 'cheapening' for 70 years. As a result, we are now being presented with some extremely attractive buying opportunities.

Corporate bond yields are now trading at compelling levels and are, today, offering many percentage points above cash. However, this year is expected to prove to be another rough ride for the market as companies continue to default and gloomy economic news dents investor confidence. Nevertheless, we believe that the asset class will yield strong returns both this year (and next) as investors are attracted by the yields offered on corporate bonds relative to returns on cash, and as it becomes easier to identify those companies that will survive the economic downturn, and those that won't.

Important information: