

Schroders Outlook



2012: A year in UK and European corporate bonds

Adam Cordery, Head of European & UK Credit Strategies and Sarang Kulkarni, European Credit Fund Manager, look ahead into 2012, a year of more questions than answers



- Risk assets are stuck in a doom-boom cycle
- There are clearly more uncertainties in the UK and eurozone today than there ever were in the past, and they are closer to home
- Sentiment will be the key short term driver, rather than fundamentals, and is likely to shift frequently
- Liquidity will be abnormally low and volatility will be abnormally high in 2012.

Risk assets are stuck in a doom-boom cycle at the moment. The natural dynamics of the political process drains market confidence and creates more fear and speculation than normal about the health of the real economy.

What can break the cycle?

- A co-ordinated sovereign bond buying programme could contain bond yields, but may or may not prevent weak growth. It would, however, give the market confidence that the weaker sovereigns will be supported as they work their way through their debt burdens
- The lack of liquidity may indeed force investors to take longer term views, and low yields in core government bonds and cash may eventually push them in to risk assets, including corporate bonds, or at least slow down the pace of selling
- If there is an acceleration of the sell off, prices may then better reflect what investors see as the possible worst case outcome, and risk assets may see greater demand.

It seems like investors are currently hoping for the first option, preparing for the third and resigning themselves to the second.

What does this tell us about credit in 2012?

- There are clearly more uncertainties in the UK and eurozone today than there ever were in the past, and they are closer to home
- Sentiment will be the key short term driver, rather than fundamentals, and is likely to shift frequently
- Liquidity will be abnormally low and volatility will be abnormally high in 2012, and as fund managers, we will need to make this work for us and not against us.

Our outlook for 2012 is characterised by more questions than there are answers.

We have laid out many of the relevant questions below. Many of these questions are highly political issues; the answers will be determined by politics, and the nature of politics means we have little chance of coming up with definitive answers in advance.

For us, the challenge for investment in 2012 will be to invest well in an environment in which the range of possible outcomes is far greater in number and far harder to identify and quantify than we have been used to in the past.

The UK and Europe of 2012 will probably not be the UK and Europe of the decades up to 2007, and in 2012 more than ever the ability to make decisions in the midst of genuine uncertainty is the skill that will be tested.



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Sovereigns

- 1 **Cycle of downgrades** – As yields rise, funding becomes more difficult and this leads to downgrades and higher yields. Could a credible bond buying programme address this?
- 2 **Austerity plans** – Austerity plans have been approved in most countries, and deleveraging is going to be a very slow process, particularly with low growth. Would the stronger economies force austerity at the expense of growth?
- 3 **ECB Buying** – The ECB’s buying programme always has a positive effect on the market, even though the ECB is a reluctant buyer. The ECB’s proposed limit of €20 billion a week is large enough to meet all of Italy and Spain’s refinancing needs for next year. Can the ECB be persuaded to do more?
- 4 **EFSF** – The EFSF is the closest we have come to a eurobond, however the market disagrees and the EFSF remains unfunded. Could this be the vehicle for greater international co-operation where the US, China and others buy EFSF bonds?
- 5 **Eurobonds** – The current willingness and ability to launch a eurobond are limited, even though this quasi transfer union is what may be needed. Would the treaty change proposed in the mini summit bring greater fiscal accountability, which may make Germany open to the idea of a eurobond?
- 6 **Greece** – Greece will impose losses on private sector bond holders and may continue to generate negative headlines. Is this yesterday’s story? Or is the issue of Greece’s exit from the EZ/EU going to rise up and create further chaos and disruption?
- 7 **Italy/Spain/France** – New governments in Italy and Spain have done little to contain yields yet. Domestic demand should be strong but there may be limited demand from the international community for these countries’ bonds. Would year end rebalancing and profit taking cause a rally, as these names are large parts of benchmarks?
- 8 **Ireland/Portugal** – Implementation of austerity plans seems to be on track, though they are not yet able to access markets independently. Would a successful resolution of Ireland / Portugal serve as a workable template for the larger countries?
- 9 **USA** – Another downgrade may be possible if the budget process drags on. The US does not seem to be actively addressing the extent of its sovereign debt, but there seems to be plenty of demand for it. Would the US launch the next round of quantitative easing (QE3) and possible QE4, QE5 etc if a recession threatened?
- 10 **UK** – Right place, right time! Deleveraging plans need speeding up, but opposition is growing. Current plans seem to be focused on using the balance sheet strength to promote growth. Can the UK decouple from Europe? Or is it just being given the benefit of the doubt for now?
- 11 **Euro breakup** – A breakup could mean default for some sovereigns and their banks, but could solve the over leveraging problem overnight. Hence, international support for individual sovereigns may be lacking until the issue of the euro is resolved. What would it cost a weaker sovereign to leave the euro?
- 12 **The new Deutsche Mark** – It would be the world’s safe haven currency, making German exports uncompetitive. Can Germany afford to leave the euro?

The Economy

- 1 **Growth** – Expectations of growth are being lowered to reflect the impact of the sovereign crisis. Does a protracted period of low or no growth necessarily lead to a deep recession?
- 2 **Inflation and base rates** – Output gaps remain large and commodity prices are coming off their highs. Base rates are to stay low over the medium term. As low inflation or even the risk of deflation arises, how long will the ECB remain a reluctant dove?
- 3 **Money supply** – The velocity of money will remain low until central banks find a way of bypassing the banks and getting cash directly to borrowers. Can more schemes like the UK’s Credit Easing improve the access for corporates?
- 4 **Employment** – Will remain under pressure, particularly with public sector retrenchment. Wage growth will be subdued as a result, making Europe more competitive. Can falling wages in G7/EU bring more production and services onshore?

Corporates

- 1 **Earnings** – Estimates for future earnings remain relatively optimistic, equities seem priced for a moderate recovery, so a profit recession would drive prices down. P/E ratios are approaching cyclical lows. Do corporates have the flexibility to cut costs, having done so aggressively in 2009?
- 2 **Balance sheets** – By and large balance sheets are pretty robust, with the ability to meet short term liabilities as they fall due. With large cash balances, would corporates see debt/stock buybacks as the most effective use of cash?
- 3 **Ratings** – Although most corporates have robust balance sheets, ratings may come under pressure if the sovereign gets downgraded. Most European corporates are geographically diversified. Can corporate ratings decouple from sovereign ratings?

Banks

- 1 **Funding/Liquidity** – Central banks, deposits and natural deleveraging are continuing sources of funding. Is the ECB likely to reduce liquidity to the banking sector when markets are impaired?
- 2 **Capital** – There are concerns about their ability to raise capital for the June 2012 deadline set by the European Banking Authority, but most banks have plans in place. With the equity markets weak, will banks have enough options to avoid sovereign bail-outs?
- 3 **Profitability** – With trading profits and commission income falling, and charge offs rising (but that may be mitigated by some sort of forbearance), bank profitability may be under pressure. Will any bank be able to survive if the EU stops supporting the sovereign bond market?
- 4 **Liability Management Exercises (LMEs)** – Spreads on subordinated bank bonds have reached a level where it's now attractive for banks to buy back their own debt and book a gain. Could LMEs take away the selling pressure on subordinated bank bonds?
- 5 **Ratings** – Ratings may come under pressure as the agencies modify their methodology to remove the ratings uplift from sovereign support. Would a wave of downgrades spur banks to do more LMEs?

Market Dynamics

- 1 **Demand for risk assets** – Uncertainty will reduce demand for risk assets up until the time when valuations reflect the worst case scenario, or until the need for returns start overriding fear. How wide do spreads have to go to push investors from government bonds into corporate bonds?
- 2 **Liquidity** – Highly institutionalised markets such as corporate bonds will suffer from a lack of liquidity as all counterparties work to a shorter investment horizon and intermediaries continue to reduce risk limits. Is 'buy and hold' the new style of active management?
- 3 **Valuations** – High yield is already pricing in three quarters of the credit losses suffered in the worst five year period in history (the second leg of the Great Depression). Investment grade credit spreads are consistent with a mild recession but are not yet pricing in a 2008 type scenario. However, the correlation between equities and credit makes credit vulnerable if earnings disappoint. Can investment grade, high yield and equities decouple?



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Sarang Kulkarni, European Credit Fund Manager, joined Schroders in March 2008, after spending almost six years at Aerion Fund Management, the principal investment manager of the £13 billion National Grid UK Pension Scheme. Before that, Sarang worked as a corporate financier for around eight years with Andersen Corporate Finance and Peregrine Capital, specialising in structured debt financing for utilities and infrastructure projects. He holds a Bachelors degree in Electrical Engineering from the University of Bombay and a Post Graduate Diploma in Management from the Indian Institute of Management, Calcutta.