Investment update

19 January 2012

Christine Johnson, manager of the Old Mutual Corporate Bond Fund

Christine Johnson joined OMAM in September 2010 from Halbis Capital Management (formerly HSBC Asset Management), where she was a senior fixed income fund manager, initially focusing on sterling credit before also managing global portfolios. She moved to Halbis from Investec Asset Management, which she joined as a high yield credit analyst, becoming a high yield fixed income fund manager a year later. She began her asset management career as a credit analyst at Royal & Sun Alliance Investment Management, having previously been a relationship manager at NatWest Bank. Christine has a BA in Economics from Manchester University.

Managing for 'recession-lite'

Low growth and gradual disinflation will be good for fixed cash-flows – precisely what a well-run corporate bond fund can provide

I don't wish to make worse what has been a generally gloomy New Year, but it is our central scenario that either the UK goes into recession in 2012 or that we trundle along with a weak economy. If it is not technically recession, it may be the next worst thing, a negative quarter then a positive quarter then another negative quarter.

What will this mean for investors in sterling corporate bonds? At a policy level, the Bank of England has been very clear that it is happy with quantitative easing and if they see further weakness in the economy there will be more of it. That will impact corporate bonds in a number of ways. One is that longer duration biases are likely to outperform as QE helps to suppress government yields. It also means support for the real economy, which of course is ultimately good for corporates. As government yields are kept at very low levels, the excess return that you can earn from corporates – the spread over government bonds – becomes that bit more valuable.

Although we expect low growth in the UK, well-run companies will remain profitable. Unlike governments, financials and individuals, operational businesses have already deleveraged and now have strong balance sheets. Many are no longer directly dependent on the UK for the majority of their revenue, and among those that are there are still sectors with good, growing cash-flows, such as cable companies. This would seem to suggest an economy in which there is not enough spark to set riskier assets on fire, but sufficient to ensure that default rates remain low – which is what the rating agencies are telling us in their central forecasts.

Along with sluggish growth will probably come lower inflation, and the latest CPI figures may indicate the beginning of a period of mild disinflation. Given the low growth side of the equation, this is not going give investors much to hope for from low yielding government bonds – and public finances have other problems anyway, to put it mildly. But a degree of disinflation gradually improves the real value of fixed cash-flows, which is what you get from corporate bonds.

The extreme defensiveness of the past year has taken money from corporate bonds to governments, where investors have perceived greater safety. Whether they were running in the right direction is an argument for another day, but the effect has been a significant widening in spreads (that is, in the difference between corporate and government yields). This suggests that if growth recovers there is ample room for spreads to narrow – effectively an increase in the capital value of corporate bonds.

Corporate bonds give investors a degree of choice about where they sit in the capital structure, as well as the industry sector and geographic region. These decisions help manage risk. If you get them right, on the current 'recession-lite' outlook, corporate bonds appear to offer relatively secure, inflation-beating returns.

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