Investment update

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Low growth environment beneficial for credit

Stephen Snowden, manager of the Old Mutual Corporate Bond Fund, outlines his view on markets

Stephen Snowden, manager of the Old Mutual Corporate Bond Fund

Stephen Snowden is a highly experienced fund manager who has specialised in corporate bonds for the last ten years. Earlier in his career he focused on equities, which gave him a strong grounding in company analysis, which is at the cornerstone of his investment process. Stephen combines top down analysis with bottom up stock selection, believing that selecting good bonds, rather than good companies, is the key to delivering returns for investors.

Stephen Snowden joined OMAM in 2004 and is the manager of the Old Mutual Corporate Bond Fund, as well as the bond element of the Old Mutual Extra Income Fund. He was previously Head of Retail Fixed Income at Aegon Asset Management where he managed the Aegon Extra Income Fund.

Six months ago there was greater certainty around global economic prospects than is currently the case, with the recent softening of key leading indicators being viewed by some as pointing towards a 'double dip' scenario, and by others of a less pessimistic disposition as being symptomatic of the current stage in the recovery cycle. We view the latter as the more likely outcome and we foresee a low growth, low interest rate environment for some time to come. Of the three broad economic environments - recession, low growth and robust growth - it can be argued that current conditions are perfect for corporate bonds.

Of these scenarios, clearly the worst for credit is recession, as defaults rise, causing realised losses, and heightened risk aversion pushes markets lower. In contrast, robust economic growth has many positives. Clearly defaults are low and risk appetite among investors keeps markets buoyant, although it is not the best environment for credit. As confidence is high, company management teams concede to investor demands and deliver increasing returns to equity holders in the form of increased dividend payments and abundant share buy-backs, frequently funded by increasing companies' debt burdens. In this scenario, danger lies ahead for those companies that choose to plough a more conservative furrow as private equity firms may pounce to materially increase leverage, with negative consequences for bond holders. All told, despite bumper profits, credit quality declines and credit markets slowly grind lower.

The middle ground is therefore best for credit. The dire consequences of recession are avoided so most companies muddle along, and with the lack of confidence, boardroom strategy is one of stability and caution. Investors still bruised from the last market collapse are mindful of the risk of too much leverage and therefore shareholder demands are moderated and investors see balance sheet strength as a quality and not a barrier to superior returns.

The current low growth environment looks likely to persist for a while, perhaps even for a considerable length of time. In a paper published at the start of this year entitled 'Growth in a Time of Debt', Reinhard & Rogoff demonstrate that historically growth is lower in nations with high debt burdens. To us this makes complete sense. As debt is high, interest payments are high, consuming a large part of the tax take. Taxes have to rise to pay the higher interest charge and pay down the debt. State spending also comes under pressure. This adds up to a material fiscal squeeze through a combination of tax hikes and public sector spending cuts, exactly what is happening in the UK at the moment. The current fiscal squeeze will keep economic growth low, not just in the UK but in most of the Western world as we all tackle our large budget deficits and high debt burdens.

In order to keep the blood pumping around the economy, monetary policy has to be loose to counterbalance tight fiscal policy, meaning that interest rates will have to stay low for a protracted period of time. In the UK, as in other Western countries, the deflationary forces of tight fiscal policies, coupled with high unemployment will keep price rises in check, as wage inflation - the largest component of overall inflation- remains constrained.

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Articles written by fund managers in support of their own asset classes are often viewed with a degree of healthy scepticism, and rightly so. After all, it is only natural for fund managers to want their own asset classes to perform well. But don't get me wrong – I would rather that we were headed for a return to higher rates of growth, as from a purely personal perspective I am a taxpayer who would prefer to pay less tax. However, from a professional standpoint I acknowledge that the most likely economic outcome is a protracted period of low growth. In other words, an environment which should be beneficial for corporate bonds.

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