

Fixed Income Market Review and Outlook

July 2011

A safety-first quarter

Two issues dominated fixed income markets in the second quarter of 2011: a steady deterioration in global economic data; and the fall-out from renewed problems in the eurozone. These had two fundamental impacts on bond markets. The former meant that government bonds in the major markets performed very strongly, as investors started to worry that the slowdown was more than a mid-cycle slowdown, and shifted their expectations for interest rate rises in the US and UK further into 2011 or even 2012. The eurozone peripheral debt problems led to a flight to quality and general increase in risk aversion. The result was that benchmark 10-year yields in major markets fell between 25bps and 35bps, with short-dated bonds performing even better, leading to steeper yield curves. Increased risk aversion meant that credit markets lagged, with investment grade spreads around 30bps and 80bps wider in sterling and eurozone markets respectively.

Consensus changes on UK interest rates

UK economic data weakened during the quarter. First quarter GDP growth was confirmed as just 0.5%, not even offsetting the -0.6% equivalent for the last quarter of 2010. Inflation showed little sign of rolling over. CPI inflation increased to 4.5% – its highest level in the current cycle – although the Bank of England maintains that without VAT rises, a weaker pound and higher oil prices, CPI would be significantly lower.

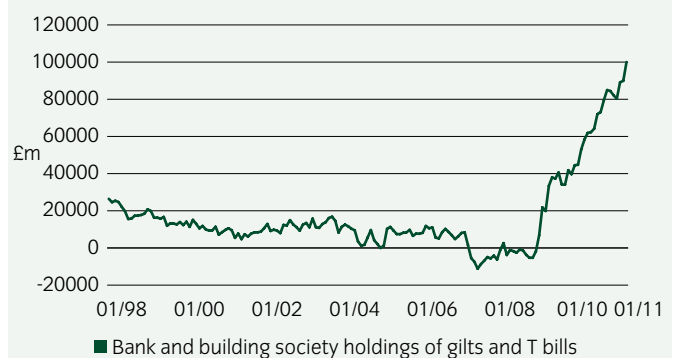
The consensus view on the future for UK interest rates changed significantly during the quarter. The market ignored inflation concerns, with the focus much more on weak growth, and the market consensus for the first rate increase is now May 2012.

Gilts had a positive quarter. Weaker global growth and dovish bias from the Bank of England was a positive backdrop for lower yields. Gilts benefited from a general preference for higher rated sovereign debt as risk aversion increased on the

back of renewed concerns about Greece. In addition, gilts benefited from a strong technical backdrop, as financial institutions increased gilt holdings to comply with new capital requirements (see chart 1). Yields were lower across the curve, but the short end was particularly strong, with the two-year yield falling from 1.36% to 0.83%. The ten-year yield fell from 3.69% to 3.38%.

The index-linked market lagged conventionals in April and May before performing strongly in June. Breakeven inflation (the difference between conventional and index-linked gilt yields) traded in the same broad range as seen in the first quarter. Real yields shrugged off lower commodity prices to end the quarter lower, particularly at the short end, with the five-year falling steadily from -0.06% at the start of the quarter to a low of -0.61% in mid June, before finishing at -0.38%.

Chart 1: Financial sector gilt holdings



Source: Bank of England.

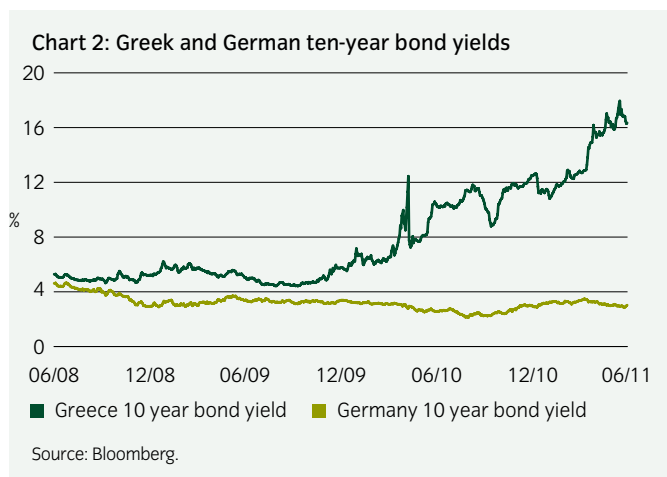
Eurozone peripheral woes continue

The eurozone saw two familiar themes in the second quarter: the re-emergence of peripheral debt problems and a vigilant European Central Bank (ECB). The ECB started the quarter with a widely predicted rise in interest rates from 1% to 1.25%. The decision came as a result of a continued rise in inflationary pressures in the region from rising commodity prices and despite growth rates in peripheral countries remaining subdued. As the quarter drew to a close, the ECB was

indicating that despite the greater uncertainty due to the Greek crisis, that it would likely increase rates again at its meeting in early July.

Despite the rate rise, the eurozone periphery again dominated headlines. Portugal finally admitted that it needed a bailout early in April after a long period of speculation. It then quickly became apparent that Greece was going to need further funds to avoid a default, as economic growth, and hence tax receipts, were much weaker than expected. Although agreement with the EU and IMF was finally reached in late June, there was a long period of nervousness.

Against this backdrop, core sovereign bonds performed strongly, with short maturities the main beneficiaries. Two-year Germany bond yields fell from 1.79% to 1.61%, while the 10-year ended 30bps lower at 3.03%. Peripheral yield spreads over Germany widened for most of the quarter, before regaining some of the lost ground in a small relief rally after Greece passed a new austerity budget. Greek 10-year bonds ended the quarter yielding nearly 14% more than their German equivalents.



US economy still weak

US economic data disappointed during the quarter. After an above-trend reading in the fourth quarter of 2010, first quarter growth was an anaemic 1.8%, thanks to the impact of the oil price shock, supply chain problems caused by the Japanese earthquake and larger inventories. The Federal Reserve's (Fed) second spell of quantitative easing came to an end in June, and Fed chairman Bernanke suggested that a third round was unlikely as the Fed believes that the slowdown is temporary and driven by external factors such as Japan. The US treasury market was also boosted by buying of short-dated treasuries by banks. US treasuries followed the same path as other major bond markets, with lower yields across the curve. Short-dated bonds saw the largest gains.

Emerging market debt – the new safe haven?

Emerging market debt (EMD) performed very strongly over the quarter relative to other risk assets. This was notable as there were numerous negative external factors, including the potential restructuring of Greek debt that might have previously led to EMD weakness. Investors took the view that these were external issues with no direct impact on emerging market economies, where growth is only moderating from very strong growth levels.

Interest rates were increased in a number of countries over the quarter, particularly in Latin America and Asia, as central banks looked to tackle inflation. These increases were generally signalled in advance and hence markets had already adjusted.

Risk assets weaker

Credit markets had performed well in the first few months of the year, and this continued into April. Issuance remained high but was generally well-received by the market. However, the weaker nature of economic data and uncertainty over Greece led to rising risk aversion, which resulted in wider credit spreads. Markets rallied after the successful outcome of the Greek austerity vote, but this was enough only to reduce the scale of credit market underperformance.

Financials were the most affected sector of the investment grade universe; ratings agencies expressed concerns over the strength of banks, while rumours that the forthcoming EU stress-tests would be stricter than initially expected did little to aid sentiment. The financial sector is also a "high beta" sector and therefore tends to move more (higher or lower) than the rest of the market. Insurance lagged on high issuance as well as potential losses for reinsurers due to the Japanese earthquake. Property outperformed, helped by lower leverage where companies have sold off assets and initiated fewer new projects, as well as inflation-linked rent reviews.

High yield markets followed a similar pattern, with a strong start and finish to the quarter sandwiching a period where spreads gradually widened. Companies have continued to swap inflexible bank loans for high yield bond issues. This attracted new issuers to the market, particularly UK retailers, but the market increasingly struggled to absorb the new bonds. High issuance was also a feature of the loans market.

Elsewhere in the credit universe, asset-backed securities continued to perform well. Issuance increased materially from the quiet levels seen early in the year with prime UK, Italian and Dutch residential mortgage-backed securities all well received. The asset class is still benefiting from attractive yields, and this attracted increasing interest from US buyers as well as European investors.

Fixed Income Outlook

Not a time for strategic positions

Peripheral eurozone debt issues and the strength of the global economy have dominated sentiment in recent months and we see no reason this should change in the immediate future. On the latter, we believe that while we are past the peak at the current growth cycle, the recent weakness is a pause rather than a full reversal, and that emerging market growth will help fuel positive growth in the G4 economies. Inflation will remain elevated but with the recovery still fragile, we do not expect substantial increases in interest rates. The European Central Bank (ECB) is the exception to this forecast, but even here we expect a slow, drawn-out tightening, rather than a swift return to 'normal' rates.

At the end of June, peripheral eurozone sovereign debt concerns lessened with the passing of the new Greek austerity measures. In our view, recent actions have simply postponed a meaningful resolution, while it is worth remembering that these problems are not restricted to Greece. As a result, we remain underweight in peripheral markets.

We are approaching duration positions tactically given the uncertain interest rate environment. In government bond portfolios, we have a bias towards flatter yield curves as we believe that the recent outperformance of short-dated bonds has gone too far. In credit markets, we see selective value across several sectors and individual issuers.

Gilts to remain strong – at least in the near term

Interest rate expectations have swung violently over the past quarter and the market now expects rates will remain unchanged until the second quarter of 2012. This seems unrealistic to us. We believe that rates need to be higher than they are now, but not significantly so. As such, we expect base rates to be 0.75% a year from now, with a first increase late this year.

Looking at conventional and index-linked gilt markets, the market is caught between the conflicting influences of less benign economic fundamentals and the European sovereign crisis. Our view is that yields will be slightly higher in twelve months time. However, in the near term, fundamentals are not going to be the only factor for markets as further disruption in the eurozone periphery could lead to further 'flight to quality' rallies. This problem requires a political solution, and experience suggests that taking strategic market positions based on faith in a political process is not attractive from a risk/reward perspective. We retain curve flattening positions in most UK portfolios – the UK five-year yield is not quite at the levels seen in 2010, but is still too low in our view.

In index-linked markets short-dated real yields are negative, which is not attractive in an absolute or fundamental sense.

In addition, we see the forthcoming index change as further catalyst for a move in the curve. Following the change, the duration of the index will increase by over a year, which should cause the real yield curve to flatten as investors look to add longer-dated index-linked bonds.

Europe – no solution in sight

All eyes were fixed on Greece in the latter part of the second quarter. With that problem now at least postponed, attention will revert to the wider issue of the rest of the periphery, as it seems apparent that further creditor support will be needed in a number of countries. With the EU in almost permanent crisis-management mode, we expect some sort of debt adjustment or orderly resolution mechanism to be agreed, while in the longer term, a greater degree of fiscal unity will be required. Domestic political pressures will limit leaders' flexibility to compromise and thus make this a drawn-out process which will periodically create market volatility. We expect to see short, sharp rallies of the peripheral markets followed by sell-offs, and hence will be taking a tactical approach in the lower rated European sovereigns.

We anticipate no difference in the ECB's strict attitude to inflation (and hence its interest rate policy) due to the appointment of Mario Draghi as the new head of the ECB. Consequently we expect the ECB to continue to carry out further rate increases over the next twelve months. However, the pace of rate rises may slow if we see further signs of fragility in the economies.

Given the economic background, we are expecting to see higher yields in the core European bond markets in 12 months time. The sell-off will be most pronounced in the shorter maturities given the ECB's decision to continue to normalise the level of interest rates.

US – brinkmanship within limits

US economic data deteriorated over the quarter. It is worrying however, that after holding rates at virtually zero for over two years and implementing two quantitative easing programmes totalling over \$2 trillion, the US economy is still producing sub-trend growth. We expect GDP growth to remain positive, without improving materially from current levels. As such, we expect the Federal Reserve to keep rates unchanged until well into 2012.

Markets have been concerned about the US deficit ceiling as total Federal debt approaches the \$14.3 trillion limit. Political grandstanding has created uncertainty, but neither the Democrats nor the Republicans will want to be blamed for a shutdown of government services and hence an eleventh-hour resolution should be agreed.

In the near term, we expect treasury yields to remain in current ranges due to weaker economic data and low interest rates, but for yields to increase in the longer term as the economic picture improves and the market starts to price in eventual interest rate rises. The end of the quantitative easing

program also removes a key support for treasuries and at the margin we believe that this must be negative for the market.

Emerging market debt still supported by fundamentals

In emerging markets, the 'Arab Spring' has receded from investor consciousness, but the situations in Libya, Syria and Egypt are not yet resolved. There is still potential for further unrest and a knock-on both in terms of oil prices and general risk appetite more widely. There are also risks from countries such as China. This represents a wider risk, as G4 growth will remain dependent on exports to buoyant emerging markets in the near term.

Developed markets may still be looking at the start of interest rate increases, but many emerging market economies have now completed their rate hike cycles. Inflation has been a concern in a number of areas, but central banks have generally already taken swift action to clamp down on this – unlike developed market counterparts, they do not need to worry too much about rate hikes strangling growth.

Risk appetite is obviously a key short-term influence on this market, as with a number of other risk assets. This appetite is largely driven by external factors such as the eurozone peripheral issue. However, we believe that the long-term structural positives of emerging market debt remain in place. Cumulatively, we are taking a less defensive stance, but differentiation remains a key factor in structuring exposure to this area.

Credit markets looking more attractive

Credit markets struggled for much of the last quarter but rallied late on following the Greek austerity vote. As the eurozone peripheral debt issue can only be said to be on hold rather than resolved, further worries will undoubtedly lead to increased risk aversion and create a headwind for credit markets.

That said, with fundamentals still supportive and following the sell-off over the past few months, valuations are now looking more interesting, which should present an opportunity to add to exposure selectively. The main risks to the market are volatility in government bond yields and profit warnings as a weaker economy starts to affect corporate earnings.

The bank sector came under pressure in May and June and we would expect this to continue through the summer. The forthcoming EU stress tests are probably going to be tougher

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than initially thought, while various ratings agencies have stated concerns over the strength of the banking system and its ability to weather any Greek default. Our own analysis of the sector suggests that in the main, the larger banks have sufficient capital to absorb any losses and that some of these now represent good value. Second and third tier banks are less well placed.

High yield and asset-backed securities (ABS) both enjoyed strong performance through the spring. We are now more cautious on the former: the sector is seeing increased outflows as investors look to take profits after a good run. We expect returns to be driven more by yield than capital gains over the second half of the year. ABS has a better technical backdrop: US investors have been increasingly active in European ABS as these are more attractive than US equivalents.

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