

Henderson's views from the trading floor

John Pattullo and Bill McQuaker give their views on the UK economy and provide an outlook for investors

Bonds view

It's been a bruising few months for investors. The good news is that it appears the current round of panic and capitulation in the market is now behind us.

Valuations within the investment grade corporate bond sector look compelling. The market is now pricing-in a default rate of 35% over the next five years. While we may be at the beginning of a far more ruthless default cycle, we don't subscribe to the view that nearly one in three investment grade companies won't emerge from this current crisis.

However, two major threats still exist. We expect there is more to come in the current de-leveraging cycle, given the recent falls in high yield and emerging market credit. The hedge fund industry is diminishing, and each fund closure brings with it another fire sale of assets. New issuance is also putting pressure on existing bond prices. Diageo, IBM and PepsiCo have recently issued new bonds at very wide levels to existing secondary bonds.

The outlook for financial bonds has improved considerably of late. Take Royal Bank of Scotland as an example. Although we currently own some RBS preference shares, we don't mind an extra £5 billion coming into the market at the same level as us in the capital structure, given that there's a £15 billion equity injection from the Government underneath us. The recent announcement by Barclays of a proposed £6 billion cash injection from the Middle East is another big positive for bond investors. Barclays can keep their balance sheet secure, fulfilling their capital raising obligation to the UK Government, while keeping them out of the Barclays boardroom. In addition it stops Barclays issuing more bonds into the European corporate bond market.

In order to take advantage of opportunities when they arise, we have a 20% cash holding in the Henderson Strategic Bond Fund. We will be looking to invest some of that cash between now and Christmas. Just before the end of October, the US reduced interest rates. It wouldn't be surprising that in a year the UK base rate could be half its current level.

Markets are forward-looking, so with the recession already priced-in, investors are already starting to think about the recovery, and where they want to be in twelve months' time. In an environment of falling interest rates, do you want to be stuck in floating rate, low-return cash instruments, or would you rather take the fixed yield available through bonds? When interest rates are on a downward path, fixed income is the place to be.

Given all of this, it's the ideal time for investors to increase their allocation to fixed income assets.

John Pattullo, fund manager of the Henderson Strategic Bond and Preference and Bond funds.

Multi-Manager view

October was punctuated by a series of bank bailouts in a number of different countries. All featured substantial equity injections to keep corporate balance sheets stable, as well as guarantees designed to help free up lending and restore consumer confidence. It appears that the medicine is working, and the numerous government bailouts from all over the globe are now gaining some traction in equity and bond markets.

The interbank lending freeze seems to be thawing, albeit slowly. The first-ever global unified rate cut has undoubtedly helped ease the situation, the Sterling three month LIBOR rate has continued to fall and inflation

pressures are abating. Now that the US has lowered interest rates to 1%, the possibility of seeing an interest rate of 3% in the UK and 2% in Europe is increasingly likely.

The de-leveraging cycle has showed no signs of waning. When this concerted effort to reduce borrowings and drag back debt will come to a halt is impossible to predict, but when it does, equity markets will start to move upwards from the current 'fire sale' levels, and closer to their underlying fundamental value.

The real positive however, is that the world is getting real about recession, and the first step to getting out of a bad situation is to accept you are in one. The economic theories of Keynes are now coming back into fashion. With private spending slowing down dramatically, the Government has announced 'big project' public spending to ease the effects of the recession. However painful, governments across the world must act decisively in the short-term to protect everyone's interests, because as Keynes said: "In the long run, we are all dead".

It is clear that the problems in the real economy are just beginning. From today's pessimistic levels there will be some upside surprises. However, there will also be bankruptcies – possibly within private equity, but also from some unexpected quarters. For the first time in a very long time, politics really affects markets. Those left-leaning and right-leaning state interventionists in Europe may soon be joined by a tax and spend Democrat in the White House. We think that markets are likely to take comfort from such an outcome.

Bill McQuaker, Head of Equities and Director of Multi-Manager Funds

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