

Henderson's John Pattullo believes credit markets have finally hit the bottom

By John Pattullo, Director of Fixed Income,

In my last note I mentioned the three factors that shape my view on bond markets; **valuations**, **technicals** and **momentum**. Last month valuations looked compelling, with a recession being well and truly priced in and bond investors being offered equity-like returns for bond type risks. However technicals (i.e. too many sellers and not enough buyers) and momentum (the direction of the market) were both lousy. Now the picture is changing.

Have credit markets finally hit the bottom? I think so, and there are a number of reasons why.

Sentiment looks to be on the way back up. There has been a rally in synthetic credit indices such as the iTraxx Crossover Index. The forced sellers (private equity and hedge funds) that were putting such a damper on sentiment appear to have now been flushed out of the system, and new bonds that have recently come to the market are performing reasonably well.

Bear Stearns – if ever an economics undergraduate wanted an example of how the capitalist structure worked in practice, this is it. The US Federal Reserve is prepared to cushion the blow of market excess by underwriting the big brokers as well as the big banks, because they are simply too large to fail. But what does this mean for investors?

Bear Stearns will be part of JP Morgan, which offers some degree of comfort for the bondholders. However, those left holding equity in the company will not enjoy the same security and despite an improved buyout offer from JPM will see the value of their investment severely discounted - a painful but timely reminder that the value of shares "can go down as well as up".

UBS rights issue – the announcement from UBS of further credit write-downs and a new rights issue was met favourably by markets, but I still think this announcement is much more positive for creditors rather than shareholders. I'm still backing Banking sector debt in my portfolios, as the valuations still look cheap on any risk-adjusted basis.

Loan market movement - at last the indigestion in the loans market is easing. In Wednesday's *Financial Times* Citigroup announced it was working out the details of a deal to offload \$12bn in leveraged loans to private equity, albeit at a discount. This appears to demonstrate that the market is starting to stabilise and appetite is slowly returning, further proof that the economic cycle cannot remain static for too long before the wheels start to turn again.

We expect earnings newsflow will continue to deteriorate (we remain short of the heavy cyclical industrial names), and although the LIBOR rate is still elevated, today's rate cut from the Bank of England should ease some of the pressure.



The valuations in some bonds have been compelling for some time, but with technicals approaching equilibrium and momentum levelling off, now would be a prudent time for investors to get back into bonds.

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