

Where next for bond funds?

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Commentators often seem keen to dismiss the summer months as a period of low liquidity and reduced investor participation. However, economic releases show no respect for such arguments and it has certainly been worth following this data closely over recent months. What has emerged is a picture of clear deceleration in US economic growth. The long predicted US housing market correction is under way and in dramatic style. Existing home sales are falling at a rate of 11% year on year according to the most recent data whilst new home sales are down 21%. In turn this has fed through to other areas of the economy, with residential investment falling 10% year on year in the second quarter, the impact of which was to knock 0.6% off real GDP. The repercussions of a deflating US housing market are significant & likely to reverberate further than just the domestic economy. As I write, Tomkins, a UK engineering company has issued a profit warning citing a weaker US housing market, a tough automotive market in North America & a decline in US consumer confidence. These problems highlight that interest rate sensitive sectors are slowing in response to two years of interest rate hikes from the Federal Reserve.

It seems clear that a transition is under way and it's one that sovereign bond markets have responded positively to. After six months of steadily rising yields and falling prices, US Treasury bonds have reversed course, falling from a high of 5.25% in yield to a low of 4.70%. UK Gilt yields followed, falling from 4.78% to 4.50% despite a surprise rate hike from the Bank of England in August. Ben Bernanke is beginning to look prescient in his predictions of slowing economic growth, and after a lag, slowing inflation. To be clear, inflation has yet to slow significantly but it is worth noting that of the last four rate hiking cycles in the US inflation has, on average, peaked 3 to 12 months after the last rate hike; inflation is a lagging economic indicator. As a result it is likely that the Federal Reserve has completed its rate hiking cycle. This makes bonds a more attractive asset class than they were earlier in the year when preserving capital was a difficult prospect.

The returns from investment grade bonds are, on average, about 90% correlated to the returns on the underlying government bonds. The key driver of a standard corporate bond fund's return is therefore the interest rate sensitivity (duration) of the fund. We have discussed the outlook for the US economy and government bonds above. The secondary driver of returns are investment grade spreads themselves which offer little upside and where we are finding it increasingly difficult to find highly rated credits which offer a positive catalyst for debtholders. Spreads of high yield companies are also looking relatively expensive. However, it is easier to find credits with positive stories within high yield e.g. being acquired by a better rated company or a refinancing of (now expensive) bonds. An example of the former are rumours that Orange are looking to acquire a Greek high yield mobile telephone business, TIM Hellas. In general, it seems sensible to have a selective approach to high yield bonds at current valuation levels and the latest vintage of new deals is looking particularly unappealing due to very high debt levels at issue. Seasoned or proven high yield bonds which have historically operated well with debt are more appealing options.

In addition, 'alternative' parts of the fixed income universe also offer attractive options, for example asset backed securities and senior secured bank loans, both of which have a higher priority claim on a company's assets than standard bonds in the instance of a company failure.

Having the flexibility to diversify across the fixed income spectrum, from corporate bonds, gilts and high yield to alternative fixed income classes, is vital when faced with a slowing US economy. Indeed, it is vital for maximising total return from bonds in all economic environments. Asset allocation within fixed income remains as vital as ever.

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