challenging conditions

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Quentin Fitzsimmons, Threadneedle's Head of Government Bonds and Co-Manager of the Threadneedle Absolute Return Bond Fund, assesses the current economic environment.

The past year has been quite a volatile one for global equity and bond markets amid a persistent credit crunch. The situation notably worsened in September in the wake of the failure of Lehman Brothers in the US, which set in motion a stream of corporate failures in the financial sectors of both America and Europe.

The resulting panic also saw liquidity in the credit, cash and money markets freeze again. Even lending between banks almost completely dried up. Once again, central banks moved quickly to try and shore up financial markets. In the US, the government put together a $700 billion bailout package and in Europe governments injected equity and took holdings in major banks to keep them solvent. Central banks have also recently moved aggressively to cut interest rates in Europe and the US. Although this has gone some way to calming market fears, the impact of these repeated interventions by governments has, at least so far, been of limited utility in resolving the crisis. Banks are still not passing on the significant cuts in base rates to their customers. In the US, mortgage rates are actually higher now than they were a year ago!

low consumer confidence

The consequence of the prolonged financial crisis on economies is becoming clear. The sharp contraction in the ability of firms and individuals to borrow is having an enormous impact on growth. In the US, consumer confidence has fallen on some measures to the lowest level in 40 years. Consumer spending accounts for two-thirds of US growth, so this is very worrying for recovery prospects

Consumer sentiment has been hit by a rapid deterioration in the labour market. In addition, the ongoing falls in the housing market are another area undercutting spending power, particularly in the US and UK, where consumers have tapped into home equity to finance higher spending. Indications point to further declines before there is a recovery. As a result, consumers, like companies, have been sharply curtailing cash outflows and trying to increase saving in the harsh economic environment. While this will be a healthy development in the long term, it will add to the slowing momentum in the near term.

Recent data shows that both the Eurozone and Japan have moved into recession. Indeed all the major economies now seem set to enter recession if they have not already done so. And as regional economies have deteriorated, global trade has dropped precipitately. This has proven particularly worrisome for export-oriented countries such as Japan.

gilt-edged?

Government bonds have been one of the strongest asset classes amid the gloom, as risk-averse investors have sought to put their money into securities that look relatively safe. As a result there has been a long downtrend in government bond yields, despite strong inflationary pressures earlier in the year. Indeed, some countries now have negative real yields. There are no signs yet of a reversal in the trend despite prospects for greatly increased supply, as governments look to finance their moves to support the financial system.

Meanwhile, the recent grave concerns earlier in the year over inflation have evaporated, as inflationary pressures have fallen amid a slump in global commodity prices. In fact, worries have veered from the possibility of resurgent inflation to the potential for deflation.

irrational pricing

The panic in financial markets has resulted in yield spreads on corporate bonds widening to levels not seen since the Great Depression – they are pricing in an assumed degree of corporate failures that looks very unlikely.

Elsewhere, in foreign exchange markets, carry trades seem to have gone out of fashion, as the US dollar and Japanese yen have benefited from the general flight to quality, while emerging market currencies especially have fallen out of favour.

The factors influencing the market, eg market illiquidity and weaker economic growth, are likely to continue to affect the investment environment for some months to come.

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managing the Threadneedle Absolute Return Bond Fund

There has been a great deal of variation in performance among the different absolute return fund offerings on the market. The approach taken at Threadneedle is to start with a low-risk short-dated bond portfolio and construct a derivatives-based overlay to aim for cash-plus type returns over the medium term. The derivatives and underlying assets are based on fixed income and currency instruments. A benefit of using derivatives is that one can obtain a positive return when the price of the underlying asset falls in value. By combining derivatives designed to make money when markets fall as well as when markets rise, it is possible to generate an absolute return in all market conditions.

In the current very volatile conditions, we have aimed to have no holdings in assets that have little transparency or liquidity. This approach helped prevent investing in securities with components of sub-prime debt. The diversification benefit of strategies employing all types of instruments and markets where we seek returns has also helped performance. We have minimised negative market impacts by keeping our short-dated bond portfolio very defensive, sacrificing yield in return for security.

The Fund has achieved a return of 8.2% over the last 12 months. As the market environment continues to be challenging, we have looked to make further use of shorting strategies to cope with the volatile movements that are likely in the months ahead.

The Threadneedle Absolute Return Bond Fund is available through Skandia's Life and Pensions fund ranges and the Selestia Investment Solutions investment platform.

Cumulative Performance	1 year	2 years	3 years
Threadneedle Absolute Return Bond Fund	**8.2%**	**14.1%**	**17.2%**
Sector average	-2.9%	6.0%	14.9%
Ranking	1st	1st	1st
Quartile	1st	1st	1st

Data source: Morningstar 31 October 2008, bid-bid basis with net income re-invested at bid.

Past performance is not a guide to future returns. The Threadneedle Absolute Return Bond Fund may invest in derivatives and may hold up to 100% in cash or money market securities. Therefore, there are additional risks associated with this Fund.

The Skandia fund will not mirror the performance of the underlying fund because of Skandia fund charges, taxation adjustments (if appropriate) and the Skandia investment process.

The opinions expressed here represent the views of the author at the time of preparation, which may change and should not be interpreted as investment advice.