



**Jim Leaviss**, Head of M&G Retail Fixed Income, explains why he believes there are opportunities for strong returns in global fixed interest.

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# seizing opportunity

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Anyone hoping that the economic downturn would be short-lived has received a nasty awakening in the past couple of months. Here in the UK, the situation has deteriorated rapidly as shown by the dramatic fall in GDP, the sharp rise in unemployment and the country's broken housing market. A similar scenario has unfolded in the US, while Europe, by no means immune from this crisis, is quickly catching up.

Amid all the doom and gloom, there is some reason for optimism, namely the authorities' recognition of the extent of the crisis. Their efforts so far to avoid another great depression scenario have been astounding. From the US Federal Reserve's reduction in interest rates to near zero, to the Bank of England's equally aggressive loosening in monetary policy, and most recently the introduction of quantitative easing strategies on both sides of the Atlantic, no one can accuse the policymakers of resting on their laurels. They are also committed to propping up the banking system and unlike Japan in the 1990s governments have shown that they will not let banks fail. Admittedly, we should not expect decent growth for a few years, but at least we have a proportional response to the problems we have seen.

With the worry of deflation hanging over central banks, interest rates around the world will remain low for some time. Looking at history, banking crises have typically been strongly deflationary and there is no reason to believe that this one will be different. For example, in Japan, the bursting of a commercial property bubble led to a banking crisis and the government has battled to stave off deflation ever since. Even after cutting rates to zero and bailing out banks, the central bank failed to

generate inflation. On the other hand, the US and UK governments have done more in terms of stimulus in the past six months than the Japanese did in the first six years of the problem, so there is a chance that we will escape the deflation mindset. Nevertheless, the possibility of deflation will still cause a headache for the policymakers.

## excellent opportunities

In this environment of rapidly deteriorating growth, historically low interest rates and central banks' commitments to buying up government securities, we can expect government bonds to continue receiving support over the coming months.

For those willing to take on more risk, we believe that investment grade corporate bonds offer the opportunity for excellent returns with spreads hovering around record highs over government bonds. Focusing purely on the size of credit spreads, the risk premium on corporate bonds now implies that corporate bonds are the cheapest they have ever been. That is why the asset class has attracted so much attention in the past couple of months and will, in our opinion, continue to do so for some time. Given that we are in a deep recession, are the large yields available really that compelling though?

While we accept that there will be defaults over the next six to 12 months, we do not think that one in four of the UK's PLCs will go bust over the next five years, as current market pricing suggests. Of course, there will be failures as conditions weaken especially among highly geared companies. That is why careful credit selection, which enables us to focus on the better quality businesses, plays a pivotal role in our investment process.

## reflecting views in bond portfolios

I run an unconstrained bond fund, the M&G Global Macro Bond Fund, in which I'm able to invest anywhere across the fixed interest spectrum. This was mainly in government bonds about a year ago when we didn't want to take on much credit risk. But since Lehman defaulted, people have sold out of credit and we've started to see things we like. As a result I have begun to increase the Fund's exposure to corporate bonds, buying paper from the likes of E.ON, National Grid, and Vodafone. As these names suggest, our preference is for defensive businesses with relatively low leverage and strong and stable cashflows, such as telecoms. In contrast, we will avoid poor quality bonds and those in highly leveraged and the most vulnerable industries, such as car manufacturing, where we expect the majority of defaults to be concentrated.

For investors that want to diversify away from the UK but don't want to take on much credit risk, I also run the M&G International Sovereign Bond Fund. It invests in government bonds from the most politically stable economies, such as Germany, Japan and the US. It has managed to give exposure to foreign currencies and this has been a key driver of its strong returns over the past year or so as sterling has collapsed.

Looking ahead, while we face a dire market and economic backdrop, I believe that both the M&G Global Macro Bond Fund and M&G International Sovereign Bond Fund are well positioned to take full advantage of the best opportunities offered in the fixed interest market. ●

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