Fixed Income Focus.

Confidence Crisis.

August is often a quiet time for the market with little news to digest, low corporate bond supply to absorb, and liquidity restricted by the number of market participants on holiday.

Contribution by Ben Bennett – Credit Strategist

Ben focuses on allocation within the credit funds as well as providing the credit input to macro strategies.

He joined LGIM in May 2008, having spent the previous three years at Lehman as a Director within the bank's credit strategy function.

Ben has 11 years of experience within credit strategy. He holds an MA in Mathematics from Queens' College, Cambridge University, graduating in 1999.

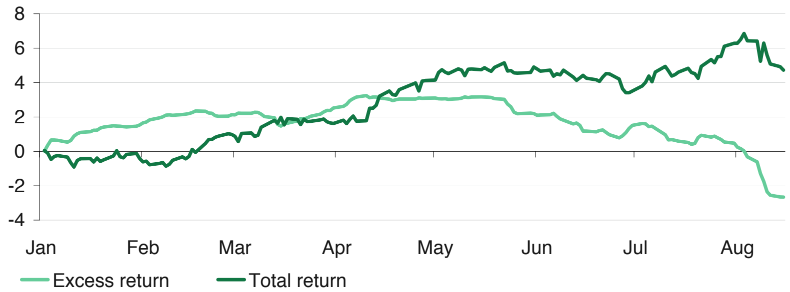
This year, the post-holiday shock of the first day back in the office will be magnified by some pretty extreme repricing of assets. The choice is to either panic and sell, or see the opportunity and add to risk. Confidence seems to have vanished during the last few weeks and needs to return quickly if we are to avoid further price falls.

Investor confidence is fragile at the best of times, and it certainly isn't helped by Governments squabbling over raising the US debt ceiling and how best to force bondholders to take losses after only a year of trying to get the Greek economy back on track. That said, investors can only blame themselves for failing to predict the dramatic slowdown in global growth that took place in the second quarter of this year. Portfolios had to be quickly repositioned to factor in US fiscal indiscipline, European government bond volatility and the chance of a global economic double-dip.

Summer illiquidity probably exaggerated market moves, with credit markets reversing all of the year's excess return over government bonds in a little over two weeks. On a more positive note, unlike the equity market, credit has benefitted from the strength of underlying government debt over the period, which means that total returns for 2011 remain strong **(Figure 1)**.

Figure 1: Total returns remain strong, but excess corporate bond returns have dipped below zero

GBP Corporate Bond Index 2011 Performance (%)



Source: BarCap

Investor confidence, while it can lead to some pretty wild swings in markets, ultimately tends to be mean reverting as the market sells off in a panic and then scrambles to cover short positions when composure is restored. Unfortunately, the current confidence crisis is starting to feed into the real economy which can become self fulfilling. US money market funds have been gradually reducing their exposure to European banks over the last few weeks in reaction to the latest Greek bailout negotiations. It wouldn't be unreasonable therefore for such European banks to reign in their lending or tighten conditions, which at the margin will negatively impact the real economy. If European businesses see wild market gyrations at the same time as lending conditions become more restrictive, they could delay some investment spending or hiring plans.

It is very difficult to quantify the impact of this, or even confirm that it is taking place, until lending surveys and activity data are produced weeks after the event. But, if 2008 is a reasonable guide, stresses in the bank financing markets should be taken as an indicator of a negative impact on the real economy. Global central banks should be taking this seriously and make sure that emergency lending facilities, developed during the post-Lehman crisis, are in place and allow banks to operate in a normal fashion. Unfortunately, base rates are already close to zero and cannot be cut much further, but further rounds of quantitative easing are an option, although difficult from a political point of view.

Of course, investors could return from their holidays, decide that the recent sell-off has resulted in cheap investment opportunities and start to plough money back in. Positive confidence could thereby feed on itself in the opposite way to the negative confidence feedback loop described above. Looser monetary policy would then be a mistake and central banks would be compelled to unwind their actions in short order. But it feels that protecting the downside right now is much more important than the embarrassment of having to unwind overly loose policy later this year. Given the fragile nature of the economic recovery, policy makers should be looking to instil confidence rather than playing safe.

Legal & General Investment Management Ltd,
One Coleman Street
London, EC2R 5AA

www.lgim.com

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