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ARTEMIS
The PROFIT Hunter

Profiting from panic:

Bond market commentary for the Daily Telegraph, by James Foster, Artemis.

The past few months have been as exciting as I can remember in the bond markets. Excitement is not always good in investment of course and the news has certainly not always been positive. But from where we stand now I am extremely optimistic for the coming year.

The so-called credit crunch has set the current agenda and the loss of confidence and the new-found aversion to risk swept in so quickly that it was close to panic at times. This caused irrational decisions and market volatility: conditions which produce buying opportunities for the considered investor. It is still not too late to take advantage of them.

The first obvious example of this is the drop in price and therefore increase in yield of investment grade bonds. These are the large companies that we really cannot see defaulting on loans, but companies such as Eon, the German utility and Imperial Tobacco are both currently looking very cheap. These companies have been affected by the fall from favour of the financial sector, which make up a large part of the index. Although they have little in common with financials, they have been lumped together and dragged down with them in the near-panic. We see no reason for this and have certainly been returning to this part of the market.

More specifically, the rush away from banks has also caused some irrational effects in the financials sector, as many other businesses have been contaminated by their dramatic fall from favour. Insurance companies for instance have fallen alongside the banks for no logical reason and again we have been buying bonds from companies such as Royal & Sun Alliance and Legal and General in this sector.

Government bonds, or gilts, are certainly a safe haven, but that has already been widely recognised, so they are priced accordingly. Safe they may be, but we do not see many bargains there.

Our one area of concern is the high yield market. These offer higher returns for higher risk, an equation that until recently the market seemed happy to ignore. We now believe that it is likely that defaults in this sector will start to increase as the economy slows. This reinforces the need for careful stock selection and we are focusing on shorter dated higher yielding bonds, with a bias towards the better quality names rather than the most risky lower rated ones.

In particular, we have retained a good weighting to oil related high yield stocks. These have proven to be quite resilient, as sustained high oil prices is maintaining good demand for new oil rigs and we are helping to fund some of these projects. The yields remain attractive and demand for the assets when constructed is looking exceptional.

Generally, the prospects for bond markets over the coming months look attractive. This may seem surprising when interest rates are seen as high, but we believe that they will now come down, particularly in the US. The poor US housing market will undermine confidence and keep inflation under control, so further rate tightening should not be necessary.

In the UK, interest rates will also start to fall throughout next year. The repercussions from tighter lending standards by banks will affect the consumer, and slow their expenditure. Furthermore, the higher rates we have seen in the last 12 months are starting to severely impact on the consumer's pocket, so again the Bank of England will not have to go further.

In summary, falling rates provides a generally good backdrop for bonds. However, more important, the extra yield you earn for owning investment grade bonds is now very attractive. The credit crunch has provided many good opportunities especially amongst some bonds issued by banks where the greatest panic was demonstrated.

The markets will take some time to right themselves properly and to borrow from Kipling, if you can keep a cool head while those around you are losing theirs, there is still money to be made in these bond markets.

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