




Quentin Fitzsimmons
Head of Government Bonds

ABSOLUTE RETURN FIXED INCOME – JUNE 2011

Tough times for government bonds

Investors in government bonds have historically been attracted by the asset class's key characteristics of low volatility and minimal default risk. However, both of these features are more questionable today than they have been in the past. The high and unsustainable level of government debt in a number of countries, combined with low growth and large fiscal deficits, has led to an increase in default risk among sovereign issuers.

Safe havens crumbling

There is a widespread expectation of default or "restructuring" in Greece, but sovereign risk is not confined to peripheral European issuers. The UK government has embarked on an austerity programme but the success of this plan depends on the UK economy generating reasonable growth and, if growth disappoints, gilt issuance will need to rise. Meanwhile even the US – for decades seen as the ultimate safe haven – has been placed on negative rating watch by Standard & Poor's as its politicians struggle to reach agreement on how to service the growing debt mountain. Uncertainties about the risk-free status of government bonds have understandably led to increased volatility and we expect this volatility to persist.

Inflationary pressures mounting

Inflation was one of the expected consequences of quantitative easing and there is evidence that this outcome is now being seen in a number of areas. Significant increases in commodity prices over the past year have driven an increase in inflation readings in several economies. Meanwhile, China's industrialisation has been a deflationary force over the past decade but, with wage pressures now on the increase, export prices may have to rise. This could exacerbate the inflationary backdrop. Adjusted for inflation, many government bonds are offering negative real yields at current levels. This is likely to prove unsustainable over the medium-term.

Interest rates to rise?

Base rates remain at all-time lows in the US and UK and just 25 basis points above their nadir in Europe. However, with stubbornly high inflation in the UK and CPI starting to move higher in the US, some commentators have started to call for a normalisation in rates. Meanwhile, the European Central Bank has already begun the process of normalising monetary policy and, despite the difficulties facing many eurozone economies, the ECB's keen focus on inflation means that a further rate hike before the year-end cannot be ruled out.

Asymmetric risks

The low current level of government bond yields in many markets means that capital risk is skewed to the downside. Using the UK gilt market as an example, from a starting point of 3.5%, a 100 basis point increase in yields would lead to a capital loss in excess of 8% on a 10-year bond. We believe that government bond yields in the US, UK and Japan do not adequately reflect the risks involved. As such, we are expecting yields to move higher and are reflecting this view via a negative effective duration position. This positioning was unhelpful for performance in May but we believe that it will be proved correct in the coming months.

Pockets of value

Our overall negative effective duration position is partially offset by long exposure to Australian bonds and to short-dated European issues. In the former case, the government has low levels of debt and benefits from superior fundamentals given

the country's significant commodity exports. Meanwhile in Europe, we acknowledge the possibility of a further rate hike this year but believe that the market is currently pricing in more tightening than we expect to see.

US dollar to remain weak

On a trade-weighted basis the US dollar has been persistently weakening over the last phase of the cycle. This suits the Federal Reserve, as a low dollar boosts exports, which in turn should help to improve growth and create employment. We expect the dollar to remain weak over the medium term, especially as the US's traditional safe haven status is eroded. This may support growth, but the corollary of a weak dollar is heightened inflation risk. We are reflecting our view on the US dollar by being short against a basket of Asian currencies, specifically the Korean won, the Singapore dollar and the Chinese renminbi. Superior growth is attracting significant capital inflows to these economies and interest rates in Asia have been on a rising trend. Moreover, authorities in Asia are likely to have to let their currencies appreciate against the US dollar over the long term.

Absolute return – an attractive option in uncertain times

The uncertain conditions outlined above – and in particular the bearish outlook for government bonds – represent a challenge for traditional bond investors. However, the flexibility inherent in an absolute return portfolio means that it can turn volatility and uncertainty to its advantage. Furthermore, absolute return products have demonstrated limited correlation with other asset classes over time and this affords them useful diversification qualities. Since launching our first absolute return fixed income product in 2005, Threadneedle has built a good track record in this arena. As such, we believe that we are well-placed to meet investors' needs in a challenging period for fixed income markets.

For Investment Professionals use only, not to be relied upon by private investors. Past performance is not a guide to the future. The value of investments and any income from them can go down as well as up. Threadneedle's absolute return funds may hold up to 100% in cash or money market securities. Therefore, investors should be aware that these funds may not participate fully in a market rise. The funds' exposure involves short sales of securities and leverage which increases the risk of the funds. Short selling is designed to make a profit from falling prices. However, if the value of the underlying investment increases, the short position will negatively affect the funds' value. Leverage amplifies the effect of changes in the price of an investment on the funds' value. As such, leverage can enhance returns to shareholders but can also increase losses. For the avoidance of doubt, these funds do not offer any form of guarantee with respect to investment performance, and no form of capital protection will apply. This material is for information only and does not constitute an offer or solicitation of an order to buy or sell any securities or other financial instruments, or to provide investment advice or services. The mention of any specific shares or bonds should not be taken as a recommendation to deal. The research and analysis included in this document has been produced by Threadneedle Investments for its own investment management activities, may have been acted upon prior to publication and is made available here incidentally. Any opinions expressed are made as at the date of publication but are subject to change without notice. Information obtained from external sources is believed to be reliable but its accuracy or completeness cannot be guaranteed. Issued by Threadneedle Investment Services Limited. Registered in England and Wales, Registered No. 3701768, St Mary Axe, London EC3A 8JQ, United Kingdom. Authorised and regulated in the UK by the Financial Services Authority. Issued in Hong Kong by Threadneedle Portfolio Services Hong Kong Limited ("TPSHKL"). Registered Office: 21F ICBC Tower, Citibank Plaza, Central, Hong Kong. Registered in Hong Kong under the Companies Ordinance (Chapter 32), No. 173058. Authorised and regulated in Hong Kong by the Securities and Futures Commission. Please note that TPSHKL can only deal with professional investors in Hong Kong within the meaning of the Securities and Futures Ordinance. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document you should obtain independent professional advice. Issued in Singapore by Threadneedle Investments Singapore (Pte) Limited, 07-07 Winsland House 1, 3 Killiney Road, Singapore 239519. Any Fund mentioned in this document is a restricted scheme in Singapore, and is available only to residents of Singapore who are Institutional Investors under Section 304 of the SFA, relevant persons pursuant to Section 305(1), or any person pursuant to Section 305(2) in accordance with the conditions of, any other applicable provision of the SFA. Threadneedle funds are not authorised or recognised by the Monetary Authority of Singapore (the "MAS") and Shares are not allowed to be offered to the retail public. This document is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses would not apply. Threadneedle Investments is a brand name and both the Threadneedle Investments name and logo are trademarks or registered trademarks of the Threadneedle group of companies.