

Overview

European corporate bonds have witnessed an unprecedented rally as the global economy avoided a depression thanks to supportive fiscal and monetary policies.

Returns were boosted by strong investment inflows from market participants that have previously avoided corporate debt, such as retail investors and hedge funds.

While riding the market has proved beneficial in this momentum-driven rally, the investment landscape no longer favours index-trackers – credit selection will be the key to superior returns in this asset class for three reasons:

- Markets have yet to recognise that stronger companies are pulling away from their weaker counterparts in an uncertain business environment
- The favourable supply and demand imbalances at play in the corporate bond market are likely to shift, leading to increased volatility
- Due diligence and fundamental credit research has become more important than ever amid a decline in the accuracy of rating agencies' default predictions

Give credit where it's due: selection the key in European corporate bonds

Much like the 9,000 amateur cyclists who take part in France's gruelling *Étape du Tour* mountain race, risk premiums on European corporate bonds have in the last year both scaled dizzying heights and made swift descents.

The shifts reflect the remarkable swings in investor sentiment that have occurred during what has been one of the most challenging periods for the global economy.

In the six months to March 2009, non-government investment-grade bond markets were paralysed by the prospect of a collapse of the financial system. Since then, those worries have been decisively displaced by an unbridled confidence in the world's ability to bounce back from the turmoil caused by the credit crisis.

That a positive repricing of credit risk was warranted is something few would dispute. During the worst of the financial turmoil, corporate bonds' excess yield over government debt had soared to levels that were both unprecedented and incompatible with even the most pessimistic expectations for the creditworthiness of investment-grade borrowers. Valuations looked even more attractive once the effects of significant fiscal and monetary stimulus measures began to flow through to both the economy and credit markets.

Seven months into one of the strongest credit rallies on record, however, the investment landscape has changed yet again.

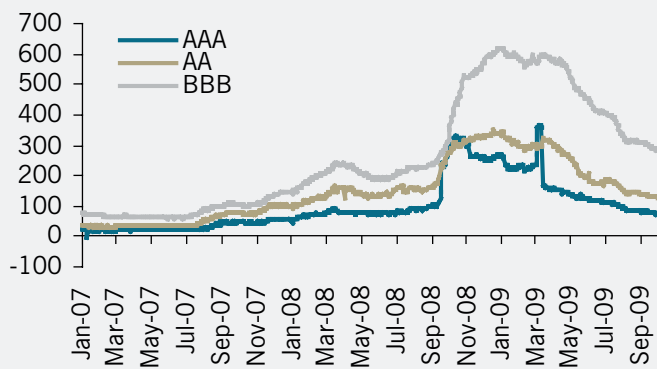
Corporate prospects are diverging in what promises to be a challenging economic climate, supply-demand dynamics in corporate debt appear poised to become less favourable and third-party credit opinions are more unreliable than ever. It is therefore clear that those looking to gain meaningful returns from corporate credit can no longer rely on riding the market. Credit selection will be the key to future investment success.

Quality takes a back seat in rally

The rally in investment-grade debt that began in March has much justification. It is in many ways a natural reaction to both the panic that ensued after the collapse of Lehman Brothers in September 2008 and the swift implementation of ultimately successful credit-boosting measures from governments and central banks worldwide.

What appears less justifiable, however, is that the market rebound has been kinder to lower quality credits than higher quality ones. Just as investors indiscriminately bailed out of corporate bonds during the bear market, they have also failed to distinguish between good and poor-quality credits in the rally. As Figure 1 shows, the yield differential between the highest and lowest quality bonds has fallen sharply since March: the lower the credit quality, the greater the return.

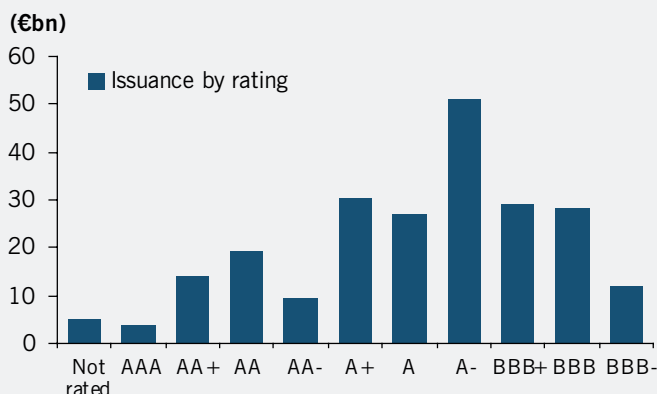
FIGURE 1: EURO CORPORATE YIELD SPREADS BREAKDOWN BY RATING



Source: Barclays Capital

The lack of rigorous credit scrutiny is also increasingly evident in the primary debt markets, where new corporate bond issues are priced and traded. Corporate bond issuance has reached record levels in Europe this year as a dramatic reduction in lending among the region's banks has forced companies from a broad range of industries to turn to the bond markets. While primary bond market activity was initially dominated by the highest quality credits, recent months have seen lower quality borrowers issue new deals in greater numbers. For the year to September, unrated issuers and those rated triple-B or lower account for almost a third of the €26 billion euro issued in the primary bond market, as Figure 2 shows.

FIGURE 2: EURO CORPORATE BOND ISSUANCE VOLUMES BY RATING — YEAR TO SEPTEMBER 2009



Source: SG Capital Research

The shift from higher to lower quality bond issuance has been accompanied by a sharp drop in the yield premium offered on new debt. Since January, the average excess yield on newly issued corporate bonds relative to outstanding corporate debt in the secondary market has fallen from 75 basis points to just 15 basis points by the end of September.

The ease with which riskier borrowers have raised funds and the narrowing of risk premiums between higher and lower quality debt point to a remarkably optimistic scenario: a swift return to pre-crisis economic growth rates that will benefit all credits in equal measure.

Strong companies pull away from the weak

However, in an economic environment characterised by sluggish consumer spending, rising unemployment, reduced availability of bank credit and increased government borrowing, there is evidence to suggest that the gap between the strongest and weakest companies has grown and will continue to do so.

An analysis of the key financial metrics of the largest companies in Western Europe, the US and developed countries in the Asia-Pacific region starkly illustrates how the strongest firms are pulling away from the weak. A recent report by Citigroup shows that while companies in aggregate have seen EBITDA (earnings before interest, taxes, depreciation and amortisation) margins fall some 22% since 2007, the drop has been twice as severe for the firms with the lowest margins. Specifically, the top 25% of companies in any one industry had on average become 3.3 times more profitable than the bottom 25% by the second quarter of 2009. This compares to a multiple of 2.4 in 2007.

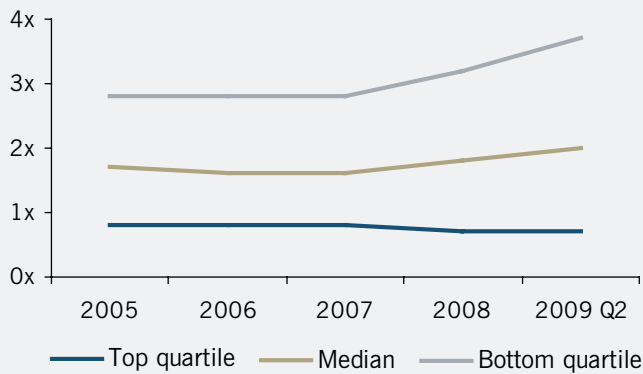
Of arguably greater significance for corporate bond investors is the fact that there is an even greater divergence in the credit metrics of the best and worst companies in any one industry.

Companies that maintained strong balance sheets prior to the credit crisis have emerged largely unscathed from the turmoil. The debt/EBITDA ratio — a measure of a company's ability to meet its debt obligations — for the top 25% of corporations has remained stable at around 0.8. For the most indebted firms, however, the bottom 25%, that ratio has soared from 2.8 to 3.7, as shown in Figure 3.

Nowhere will the gap between the weak and strong be wider than in financials, by far the largest sector in the European corporate bond market. It is here where refinancing risks are especially elevated.

In the euro zone alone, banks' reliance on short to medium-term debt during the credit boom means that some US\$3.1 trillion in bonds will come due by 2012, according to research by Moody's. UK banks meanwhile face redemptions totalling US\$650 billion by the end of the same year.

FIGURE 3: DEBT/EBITDA RATIOS OF MSCI WORLD CONSTITUENT COMPANIES BY QUARTILE



Source: Citigroup

With interest rates likely to rise from historically low levels, the rush to refinance debt in the next few years will likely widen the divide between winners and losers from the credit crisis.

Healthier banks will be able to secure far lower borrowing costs than their weaker rivals, Moody's concludes.

The divergence in the relative strength of companies has important ramifications for investors in corporate bonds. More than ever before, there is a need to distinguish between those companies that are able to maintain profitability, strong balance sheets and healthy cash flows and those that remain highly indebted and struggle to generate cash, and whose access to relatively cheap funding can be expected to quickly diminish.

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Favourable supply-demand dynamics could prove temporary

Aside from the growing divide in the credit metrics and financial performance of corporate borrowers, investors in credit markets will also need to be mindful of potentially adverse shifts in demand and supply.

Throughout the rally, the market has been supported by uniquely favourable supply and demand imbalances. Investor groups that have traditionally paid little heed to credit markets have this year poured record amounts into the asset class, attracted by the relatively high yields corporate bonds were offering at the beginning of the year. European Fund and Asset Management Association data shows that European collective investment vehicles have seen retail investors shift a record 45 billion euro net into bond funds so far this year. And in the UK, through

August corporate bond funds achieved the highest net retail sales of any sector for the tenth month running, according to the Investment Management Association.

Hedge funds and other speculative market participants traditionally invested in equities have also moved to take advantage of the relative value in corporate bonds, further boosting net inflows. Such record levels of demand have easily outstripped the unprecedented volumes of new corporate bond supply this year.

The problem is that this favourable demand backdrop is unlikely to endure. Inflows from momentum-driven market participants such as retail investors and hedge funds tend to evaporate as quickly as they appear.

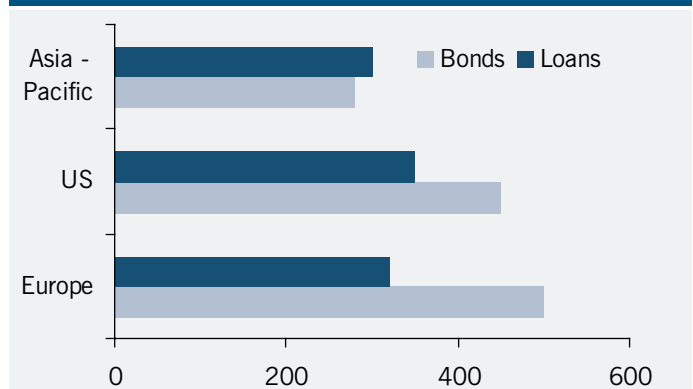
Thanks to the rally, particularly the sharp gains seen in lower-rated investment-grade debt, the high-single-digit yields such investors were targeting at the beginning of the year now look more difficult to achieve. In January, for example, the yield on high-grade European bonds was an attractive 200 basis points

above dividend yields. Now that this differential has virtually halved, the cash earmarked for bond investment may be reallocated into other assets.

Of equal significance for corporate bond markets is that a retrenchment among retail investors and hedge funds looks unlikely to be accompanied by a corresponding fall in the supply of new debt. The structural shifts that have driven the record levels of

corporate bond issuance this year could prove long-lasting. As Figure 4 shows, European corporations have borrowed more

FIGURE 4: BOND ISSUANCE VS LOAN VOLUMES IN US\$ – YEAR TO SEPTEMBER 2009



Source: Dealogic

from bond investors than from banks thus far in 2009, the first year they have done so. With banks likely to remain focused on balance sheet repair under what may well be a tougher regulatory regime, the debt issuance witnessed this year may mark the beginning of a permanent shift from loan to bond financing.

Any rebalancing of supply-demand dynamics raises risks for index-tracker funds as it could lead to heightened market volatility. Conversely, the greater the dispersion in the returns among individual credits, the more scope fundamentally oriented investors have to distinguish themselves from the benchmark.

Rating agencies' problems reinforce value of in-house credit research

While the suitability of credit ratings as the key risk assessment tool for bond investors has been questioned for many years, recent events have confirmed the very worst fears of the rating agencies' detractors.

The flaws of an assessment framework that failed to fully reflect companies' underlying operational risks were brutally exposed by the credit crisis. AIG, for example, was rated Aa3/A+ the day before it had to be bailed out by the US government.

Put simply, rating agencies are not as accurate in predicting defaults as they used to be. Data from Moody's shows that in 1998, the average rating of a company that went into default was Caa2; by 2008, the average rating of a defaulted credit had risen to Ba1 — just below investment grade.

With credit agencies' reputations tarnished, due diligence and in-house research have become of paramount importance if investors are to protect themselves against company-specific risks. Credit-pickers' skills are in more demand than ever.

Giving credit, but only where it's due

Corporate bonds remain attractive as valuations are some way below historical norms despite the recent rally. But given that corporate prospects are diverging, and the increased likelihood of a rebalancing of supply and demand in the bond market, there is a growing need to be more discerning. The strongest returns will come from an ever more select number of credits.

In order to unearth the companies best equipped to thrive under a changed business climate and identify those whose prospects will fall victim to the lasting effects of the credit

crisis, robust fundamental research and technical analysis is essential. The lack of reliable third-party opinion can only further enhance the role of research-driven investment in corporate bonds. As any cyclist brave enough to attempt the Étape du Tour will acknowledge, only the fittest and best prepared can prosper in challenging environments.

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