Sparinvest

Value Bonds

Headlines

- The Fed is behind the curve
- Financial stability risks in Euro area
- 'Bubble' in sovereigns, not corporates
- Sectors strongly represented in our funds

Our Value Bonds Funds

Fund	ISIN code
Corporate Value Bonds	LU0620744002
Emerging Markets Corporate Value Bonds	LU0519053697
Ethical High Yield Value Bonds	LU0473784196
High Yield Value Bonds	LU0232765429
Institutional Corporate Value Bonds	LU0760185370
Investment Grade Value Bonds	LU0264925727

Detailed information is available on sparinvest.eu

- sparinvest.eu

Dear investor,

The Fed is behind the curve

Rates in the US are too low. In particular 2, 5 and 10-year rates are too low when looking at the state of the underlying economy. The FED is playing an important role here, talking rate increases down with reference to 'slack' in the economy.

Unfortunately for the FED that slack, at least in terms of the labour market, might disappear sooner rather than later. Hence it will only take a couple of more solid job reports before it becomes clear that the FED is now behind the curve. So the realization of facts by the FED might create some short-term volatility – but not a major collapse – in financial markets. No collapse because central banks other than the US and perhaps UK are far from being done with monetary policy. The most notable here being the European Central Bank and Bank of Japan.

Financial stability risks in Euro area

Based on the inflation outlook, we expect the ECB to hike rates by next to nothing in early 2016, followed by a more real 25bp hike in the second half of 2016. But as the policy rate is kept low, the ECB will increasingly face a trade-off between supporting the economy (and fulfilling its growth and/or price stability mandate) and financial stability risks. Although that trade-off is less evident for the ECB at this point, given the cyclical position of the Euro area, concerns about financial stability risks are likely to grow over time.

To counter this risk, Europe's central bank has added macro-prudential policy measures to its toolbox. When asked about the risks to financial stability during a July press conference, Mr Draghi replied: “So we are addressing these risks as we see them, but the bottom line of this is that the first line of defence against financial stability risk should be the macro-prudential exercise, macro-prudential tools. I don't think that people would agree with the raising of interest rates now for the ECB. It would be quite an interesting proposition but is one that I wouldn't share."

Such considerations will, in the end, play second fiddle to the cyclical position and the inflation outlook when the ECB decides on the appropriate policy stance. But they may nonetheless push the Bank towards deciding on an earlier move. Hence, the first rate hike could very well be more motivated by financial stability concerns, while the rate hike forecast for the third quarter of 2016 will reflect the macro-economic outlook for the Euro area.

The ECB’s commitment to keep rates low ‘for an extended period of time’ is based on its forecast of a prolonged period of below-target inflation. The inflation outlook is, in turn, based on the view that growth will pick up momentum only very gradually as some countries in the Euro area will struggle with the rebalancing of public and private balance sheets.

Moreover, the adequacy of a given policy rate needs to be seen on the back of a broken transmission mechanism, which impedes the transmission of low policy rates to the private sector, at least in some parts of the Euro area. Finally, what other central banks are doing will also matter. The net impact on financial conditions in the Euro area of the normalisation process at the Fed and the BoE is difficult to gauge ex ante. On the one hand, higher rates in the US and the UK may also lead to higher yields in the Euro area, as seen during the second quarter of last year, when the Fed signalled its intention to reduce its purchases of financial assets. On the other hand, the relatively easier stance of the ECB could lead to a weakening of the exchange rate. The ECB’s exit could very well depend on which effect ultimately dominates.

Emerging Markets should be in a better position now to handle FED normalization than they were this time last year. Some of the bigger EM countries have adjusted policy so that current accounts are better balanced today. Also higher US and European growth is helping the still very export-dependent growth models of EM countries.

‘Bubble’ in sovereigns, not corporates

Lately there has been some talk of how expensive corporate bonds have become. Our comment is that the real ‘bubble’ lies in government bonds – in particular those of the US and Japan. We don’t believe the corporate bond markets are going to see a major sell-off without a major sell-off in government bonds and equities. We have seen a little scaling back lately of some very long risk positions, but that is only healthy we believe. We maintain our preference for European credit in our Developed Market funds. The European corporate bond markets enjoy a strong technical backdrop, a highly accommodative ECB and a lagging credit cycle relative to the US. We also still like the European banks and bonds from global small caps as we still see decent premiums there.

Related to the above, one very important reason why there is not a bubble in corporate bonds that people constantly seems to miss, is the fact the global default outlook is still good – i.e. defaults will probably stay around 2-3% p.a. for the next couple of years. Not until corporates have really started to become aggressive and use leverage to pump up their share prices should we become really nervous. We are not there yet - and in particular not with the banks.

Sectors strongly represented in funds

There have been no major changes to the sector allocations. Energy is still a solid performer with its high and sellable asset backing. Financials have been a bit more volatile lately after solid gains earlier this year. However, Financials are still undergoing tough regulatory reforms and making the right moves seen from the eyes of creditors, hence we still like them.

Materials have been a drag on performance both this year and last, following the Chinese downturn. However, we have not used the lower prices in this sector to increase exposure, as we remain wary of the possibility of a Chinese version of the US sub-prime crisis from 2007.

Sparinvest Value Bonds Team,
11 July 2014

Key Numbers Sparinvest Value Bond Funds

Key numbers for Sparinvest Value Bond funds	High Yield Value Bonds	Emerging Markets Value Bonds	Corporate Value Bonds	Investment Grade Value Bonds
Yield to Maturity	8.95%	7.19%	3.31%	3.95%
Duration	3.01	2.67	3.48	5.58
Average NDE	97.57%	78.27%	111.12%	53.00%
Avg. Interest Coverage	4.36x	6.29x	12.29x	11.58x
Average Price-to Book	1.02x	1.47x	2.04x	2.05x

Sparinvest is a signatory of UN PRI and member of Eurosif and Dansif.

UN PRI is an international investor initiative sponsored by the UN and based on six principles for responsible investments. The aim is to help investors actively to incorporate environmental, social and governance issues into their investments.

Signatory of:

PRI Principles for Responsible Investment