Sparinvest

Letter to Shareholders | Q2 I 11

# Value Bonds

## Headlines

- The volatility continues
- Greek default risk is averted for now
- The Energy Sector is still attractive
- The Credit Markets
- The default rate holds its low level

### Our Value Bond Funds

| Fund | ISIN code |
|---|---|
| Emerging Markets Corporate Value Bonds | LU0519053697 |
| Ethical High Yield Value Bonds | LU0473784196 |
| High Yield Value Bonds | LU0232765429 |
| Investment Grade Value Bonds | LU0264925727 |

Detailed information is available in the relevant Fund Update.

- sparinvest.eu

First of all, we would like to wish all our investors a very pleasant summer.

## The volatility continues

The markets are still very volatile given the continuing uncertainty about the Eurozone debt problems and the level of activity in the global economy going forward. The significant risks for global financial markets range from Greek and other peripheral European sovereign credit concerns, to the extension of the US debt limit and the course of US fiscal consolidation generally. Further, there is also some doubt about the ability of policymakers to tackle rising inflation in the emerging economies and the associated risk to global growth.

Growth news has been decidedly weak over the past couple of months. Feeble Japanese growth was hit harder than expected by the earthquake and tsunami, which led to supply chain disruptions that caused US production of Japanese automobile makes to fall by half. At the same time, the jump in inflation sapped global purchasing power and consumer spending. However, inflation is expected to settle lower as the sharp rise in oil prices that was aggravated by the shutdown of Libyan production has settled, and the most recent data confirm that a rebound is under way in Japan. The outlook for the US economy is therefore brighter. However, the ongoing discussion about the US government's statutory debt limit is a deep political debate as to how to address the US deficit, which transforms legislative events, but neither party can afford to risk pushing the US government into default.

Europe has been less affected by the oil price increases and supply chain disruptions. Domestic demand, in particular, appears to have held up well and first-half growth showed a modest pickup from last year's levels. However, there will continue to be considerable disparity between economic performance in northern European countries – particularly Germany, which continues to experience relatively rapid growth – and the southern countries, where growth continues to be weighed down by fiscal austerity.

This time the emerging economies are also facing some challenges. Operating rates are high and inflationary pressures are considerable, particularly in Asia. Monetary tightening has proceeded cautiously, as had been expected, and the growth slowdown has been gradual. The IMF sees emerging country GDP growth slowing from the boom-like 7.8% of 2010 to a still very solid 6.3% next year, which is still impressive compared to developed markets. The continuous inflationary pressure is coming particularly from China, which has led international trade during the global recovery; this means that a Chinese tightening policy could slow global growth to a greater extent. However, the evident slower economic activity in Asia reflects not only slower growth in China, but also the plunge in trade from Japan, which could bounce back in the next quarter. In Latin America, inflation pressures have eased somewhat in key countries such as Brazil and Mexico, and the business and inflation cycles are not as advanced in other emerging regions such as the Middle Eastern and African nations, meaning that we have not experienced as high correlations between business volumes and inflation in these countries.

## Greek default risk is averted for now

Increased pressure on Greek policymakers by a very dissatisfied population has created significant risk to the proposed passage of further austerity and privatization measures. This situation has disturbed markets, causing a sell-off in equities, a widening in spreads and a rally in "safe" government bonds. However, towards the end of June, the Greek parliament approved the austerity package and privatizations, which were requirements of the EU and IMF before the next loan tranche of EUR 12 bn. under the original lending program could be advanced. It has for a long time been evident that Greece was in need of a second bailout to carry the country into next year, given the deterioration in national finances and economic activity since the initial assistance package was provided. Market attention is now on the voluntary roll-over of Greek government bonds by private sector investors, which would be part of a new lending package, the second bailout, covering funding needs in 2012-2014. The new bail-out package is not in place yet, but as it looks now it is not possible to stabilize the Greek debt-to-GDP level without a reduction of its debt, as the Greek economy's income cannot meet its current interest payments.

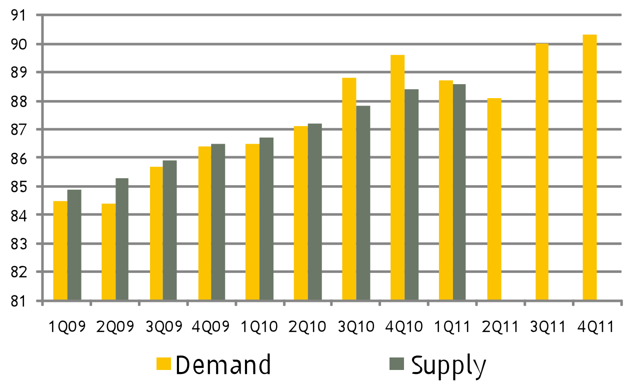
Unfortunately, Greece is not the only peripheral country causing stress to the markets, as the rating agency Moody's downgraded Portugal from Baa1 to Ba2 in early July. This means that Portugal has gone from investment grade to high yield in Moody's rating. Moody's is concerned about Portugal's ability to raise further liquidity in the market, but the cut in the country's rating has certainly not made it easier for Portugal.

Similarly, the financial markets have become more fearful about the Italian economy, which has until now had easier access to borrow at the financial markets than the rest of the so-called PIIGS (Portugal, Ireland, Italy, Greece and Spain). This fear regarding the Italian economy increased as the market became nervous about the country's banks and its great political instability; this time it is the Italian finance minister that is under suspicion for corruption. At the same time, we still experience large increases in the spread between Spanish and German bonds. Both the Italian and Spanish economies are far larger than those of the other PIIGS countries, and it would be very difficult for the EU to structure a bailout package for countries of such size. This is indeed a very interesting time for Europe.

## The Energy Sector is still attractive

Oil prices have seen a decrease during the last months, as the International Energy Agency (IEA) sent out 60 m barrels from its reserves to the market with the goal of taking the top off the large increase in the oil price experienced in early 2011, and as the Middle East crisis has attracted fewer headlines. We as long-term investors are though still bullish on the sector. Regional political issues remain at the top of the agenda in several OPEC countries and, as we wrote in our last letter, a consequence of these issues is higher oil prices as the oil-producing countries are boosting government spending to provide new social benefits for their people. Simultaneously, the high oil price is not only a result of unrest in the Middle East, but the price gain seen over the past year is also firmly backed by fundamentals. The last Oil Market Report by IEA reported the oil market to be on track to tighten significantly, with OPEC spare capacity approaching critically low levels by 2012-2013. This sets the stage for a solid increase in oil prices. Figure 1 shows the relationship between oil demand and supply and the forecasted demand for the rest of 2011.

### Figure 1: The demand and supply of oil




Source: IEA and Bloomberg

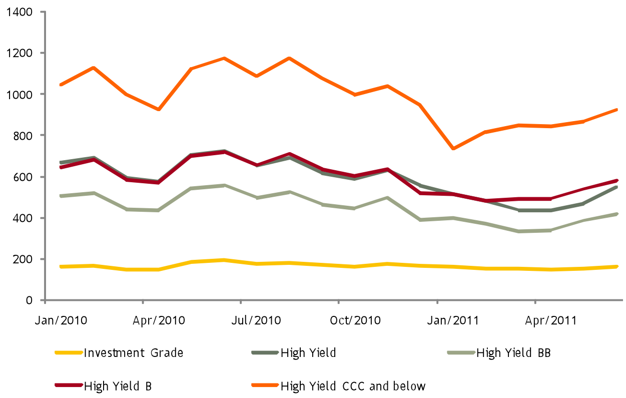
As the figure shows, IEA expects the demand for oil to reach new levels by the end of 2011. One of the main reasons for this rise is the high increase in the non-OECD countries' share of total demand, especially the uplifts from Brazil, India and China. These countries have subsidies and more energy-intensive growth. Furthermore, the gap between production and discoveries has been widening, oil production having exceeded discoveries since the 1980s. Therefore, we believe the risk/reward in fundamentals in this sector is highly attractive, as demand has much more capacity for rapid growth than supply.

## The Credit Markets

As figure 2 shows, credit spreads globally have widened during the last quarter compared to the first quarter of 2011 as a result of European sovereign volatility, signs of a slowdown in the US and renewed regulatory and legal considerations for banks. In some cases, supply pressures also played a role. For example, restrictions on domestic bank lending have forced many Chinese companies to raise money in the international bond markets, contributing to pressure on spreads, especially in emerging markets. In general, the US has had a strong positive net supply in the first half of 2011, whereas the European market has seen a negative supply in 2011. This is a result, in particular, of net negative supply in European financials, which have been shifting their funding to other markets, as the European banks prepare their capital requirements for the new legal regulations. While this also reflects better funding availability in other markets, it has helped buffer European credit spreads against some of the sovereign-led volatility this year.

The recent trend in spreads has created some buying opportunities in the markets, as the widening of spreads is not a result of increased leveraging by companies, and many companies' fundamentals are still strong.

### Figure 2: Credit Spreads




Source: Bloomberg and JP Morgan

The figure also shows that spreads have not widened to the levels we experienced in 2010 and, although spreads have widened during the last quarter, the total returns for the high yield sector for the year remain positive, driven in part by the large move in rates.

### Table 1: Returns across asset classes

| | Index | Year-to-date | 3-month | 1 year |
|---|---|---|---|---|
| USD | DXY | -4.6% | -0.5% | -12.1% |
| EM FX vs USD | BarCap Index | 4.6% | 3.1% | 11.8% |
| Cash | US Libor | 0.4% | 0.2% | 1.0% |
| Rates | BarCap Index | 6.5% | 3.1% | 11.9% |
| IG | BarCap Index | 6.5% | 2.7% | 13.3% |
| High Yield | BarCap Index | 10.8% | 2.0% | 17.8% |
| Em Sovereigns | EMBIGD | 4.2% | 3.7% | 11.7% |
| Equities (World) | MSCI | 0.9% | 1.2% | 18.3% |
| Equities (EM) | MSCI | -3.0% | 2.1% | 19.3% |
| Equities (DM) | MSCI | 1.5% | 1.1% | 18.1% |
| US | MSCI | 2.0% | 0.3% | 16.2% |
| Europe | MSCI | -0.8% | 1.8% | 8.0% |

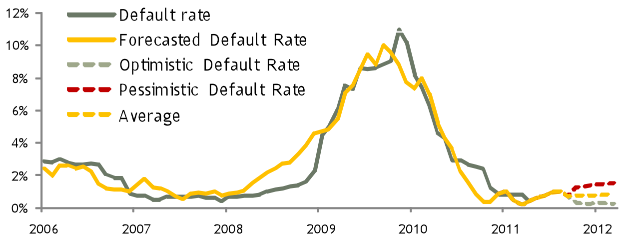
Source: Barclays and MSCI

Table 1 shows that the credit markets, especially the high yield market, have done very well compared to other asset classes in the first half of 2011. From an asset allocation perspective, we continue to find the credit markets an important asset class.

## The default rate holds its low level

A very useful indicator, which shows that the recent widening of spreads is not a consequence of companies' fundamental environment but of the financial markets in general, is our corporate default model, which has been presented in previous letters.

**Figure 3: The Sparinvest Value Bonds Default Rate Model**




Source: Sparinvest and JP Morgan

The model consistently forecasts a low future default rate, which is a result of the current positive environment for companies. They continue to have easy access to lending, more so in the US, and the financing gap shows good health from a cash flow perspective. This means that even though we see a lot of risk in the financial markets, we still see a benign outlook for default activity. Furthermore, focusing on companies with strong fundamentals is part of our investment process. We invest in companies with strong balance sheets.

For more specific performance and key figures (e.g. effective yield and duration) reporting, please refer to the individual fund updates issued by the portfolio managers for each of the funds in the Sparinvest Value Bonds range.

Have a very pleasant summer!

**Klaus Blaabjerg**
Lead Portfolio Manager
11 July 2011

## Sparinvest Value Bonds-Team

**Klaus Blaabjerg**
Lead Portfolio Manager

**Sune Højholt Jensen**
Senior Portfolio Manager

**Toke Hjortshøj**
Analyst

**Anne Margrethe Tingleff**
Analyst

.:PRI Eurosif DANSIF

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.