



Value Bonds

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Our Value Bond 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
Investment Grade Value Bonds	LU0264925727

Detailed information is available in the relevant Fund Update.

- sparinvest.eu

Dear Investor

After a relatively benign first half, risk premia ballooned over the second half of 2011. Credit spreads now stand dislocated from current corporate fundamentals, default rates and growth expectations. With liquidity poor and volatility high, risk aversion prevails and credit markets are in a state of limbo. Evidence is mounting of a more general, global risk aversion towards euro-denominated assets. Consequently, now more than ever, the overall future direction of credit markets is beyond the influence of corporate fundamentals and returns next year will be driven, to a large degree, by political will.

Aggregate credit spreads, in our view, represent the weighted average of a few key scenarios, each revolving around the survival – or not – of the euro in its current form. In essence, either:

- The euro survives and the euro area perseveres with low growth, some form of Quantitative Easing (QE) including LTRO 2 and steps towards fiscal integration; or
- Certain member states abandon the single currency. For example, Germany could leave with the remainder intact or some non-core countries could depart, in the worst case leading to a severe recession and a significant increase in default rates.

Our core view is the former. However, we stress that the risk of the latter is higher than ever. Even if the resolve exists to preserve the single currency, expediency is of the essence. Containing the cost of funding for Eurozone member states must be a top priority if investor confidence is to be restored. Failure to address this promptly will worsen an already poor economic outlook. A successful

lowering of the sovereign risk premium will not stall the deleveraging and recapitalization processes underway by banks, which bear enormous funding and regulatory challenges. These processes themselves generate a negative feedback loop, posing a risk to economic recovery, to credit supply and to sovereign funding levels.

European Economics

In late 2011, the combination of the additional austerity measures taken in France, Italy and Spain (to mention only the larger member states), tighter financing conditions as government bond spreads widened and commercial banks tightened credit conditions, and falling private sector confidence, pushed euro area growth into negative territory. This contraction in overall economic activity will likely continue in early 2012. The weakness should mostly show in domestic demand, reflecting the tightening in financial conditions, falling equity markets and, in some countries, house prices. Consumer spending will have to bear the brunt of the additional fiscal austerity, of the deterioration in labor-market conditions, and of the ongoing need to reduce household debt. Investment spending, notably on machinery and equipment, will likely be hit by the slowdown in demand for final products, the tightening in credit conditions and the increase in uncertainty about euro area politics. Construction investment will likely shrink as well, due to falling corporate investment, government cut-backs on infrastructure spending and sluggish residential activity as consumers struggle with their mortgages and house prices soften. Government spending will weaken meaningfully on the back of the fresh round of fiscal consolidation across the euro area.

But 2012 should also be the year in which the economy turns around. *This turning point in the business cycle will be an important catalyst for financial markets, which usually anticipate such a turnaround with a lead-time of up to six months. In our view, there are several reasons to expect a tentative turnaround in the euro economy in H2 2012.*

First, we still see decent global growth momentum outside Europe in 2012. Despite the fact that the euro area is not forecasted to contribute to growth at all, the global economy is still expected to expand by something close to the trend rate of around 3.5%. Second, the EUR ought to weaken further in 2012 – to a EUR/USD exchange rate of 1.2 – if standard models of purchasing-power parity hold. The ECB itself estimates that a weakening in the EUR in trade-weighted terms by 10% adds 0.7% to GDP in the first year and 1.2% in the second. Together these two factors should help to support a recovery in extra-euro area export demand. Third, it seems likely to us that bank deleveraging will be concentrated in H1 2012, i.e. ahead of the June deadline set by the EBA for banks to reach their 9% CT1 targets

in its latest stress test. Hence, **we would not expect a further marked tightening in credit conditions beyond that point in time.** Four, fiscal tightening is going to bite at the start of 2012 when most of the new measures are brought in. In our view, the 2013 budgets (on which we will gain some visibility after the parliamentary summer recess) are unlikely to see the same amount of additional tightening again and are hence at the margin supportive for growth. Finally, we expect the ECB to further ease its policy stance – first by cutting the refi rate to a new historical low of 50 bp (implying another 50 bp of rate reductions) and eventually by also engaging in further Quantitative Easing (QE) including LTRO 2 at the end of February 2012. Historically 100 bp of ECB rate cuts have boosted GDP by 0.2% in the first year and 0.4% in the second. However, **risks to the outlook are currently skewed to the downside.** The downside risks include a full-blown credit crunch across the euro area, a further spreading of the sovereign debt crisis into the core and additional fiscal tightening becoming necessary.

US Economics

The US economy has surprised on the upside during H2 2011 and seems to carry momentum into 2012. Recently released employment numbers have been better than expected. Perhaps this is why the appetite for borrowing has increased. Consumer credit increased by \$20.4bn (seasonally adjusted) in November, driven higher by a \$5.6bn (sa) increase in revolving credit and a \$14.8bn (sa) increase in the non-revolving component. The increase was a sharp rise compared with the \$6bn increase in October, and well above consensus expectations of \$7bn. The rise in revolving credit, which consists primarily of credit cards, was the largest monthly gain since the spring of 2008 and probably reflects strengthening consumer spending and modestly easier credit standards (the opposite of what has happened in Europe). For example, in the most recent Federal Reserve Senior Loan Officer Opinion Survey, some banks have reported modestly easing credit standards on credit cards, *while no banks reported tightening standards.* Hopefully the US household sector will keep or even increase spending, given the availability of credit and better sentiment following good news from the labor market.

Small businesses are also quite important for job creation in the US. Recently published numbers from the National Federation of Independent Businesses saw the index of small business confidence rising for the fourth consecutive month, moving higher by 1.8 points to 93.8. The rise was driven by improvements in respondents' earnings trends and expected real sales.

Should the US economy lose momentum, the FED will be ready to launch their version of QE3 – which will probably include purchases of mortgage bonds to drive down further the cost of buying a house.

“Rest of the world” Economics

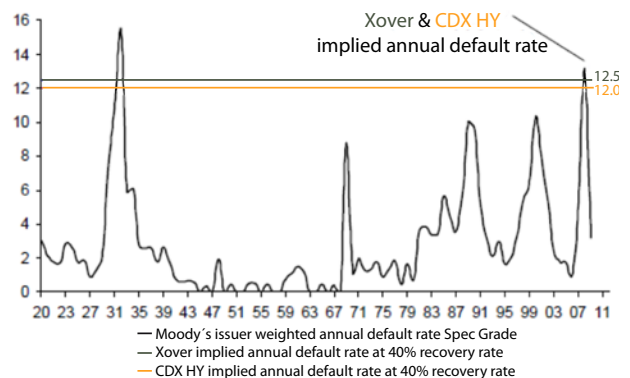
For 2012 the global economy is expected to grow “on-trend”, meaning around 3.5%. China has cooled down during 2011, following domestic tightening of monetary policy. Recently released import numbers from China have shown the weakest increase that we have seen for a while. We expect China to ease monetary policy during H1 2012, alongside other economies in Emerging Markets, adding to the likelihood of a liquidity-driven rally in risk assets during 2012.

Valuations

We believe credit is significantly undervalued currently – Emerging Market Corporate credit included: European credit got significantly cheaper in 2011. Although Europe faces material risks to both growth and financial stability, we think that credit discounts these risks. We also believe that markets are assigning far too low a probability to a ‘Japanification’ of Europe, where a secular shift towards deleveraging (rather than low yields) drives spreads tighter.

Regulators and rating agencies represent one of the main risks in financial markets today. Both professions are trying to compensate for their failure to act prior to the crisis of 2008. Moody’s and S&P for example have expressed concerns that, to the extent that the ECB does not provide an explicit backstop to government funding, this might justify a reassessment of their ratings for the euro area sovereigns, including AAA countries. Should the agencies follow through, it might well have a short-term impact on the banking sector and, perhaps, also on multilateral institutions whose AAA rating has typically been justified by the support they enjoy from AAA-rated countries. We believe rating agencies are failing to take into account the steps taken to contain the European sovereign debt crisis.

Currently, HY spreads in Europe as well as in the US (iTraxx Xover and CDX HY being the most obvious examples) are implying very high default rates. At 750 bp the Xover index implies a default rate comparable to that in 2009 post Lehman, or the 1930’s depression.



Source: Moody's

The majority of corporates are well positioned to withstand even a prolonged downturn in activity, and hence a decline in earnings, at least in 2012. While we expect an increase from the current low default rate, we do not expect it to be substantial. Our model for predicting the global default rate predicts that approximately 2% of the global high-yield market will default during 2012. This is only marginally higher than the 1.8% registered for 2011. A key reason to expect a continuing low default rate for 2012 is that many companies have refinanced during the last couple of years. To be conservative one could use a base case of 4% for the global default rate (the long-term average) and a 40% recovery rate (also the long-term average). This would imply an expected 2.4% loss from holding global high yield. Hence investors in global high yield today receive 5.25% in excess compensation for taking high yield credit risk.

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

Yours faithfully,

Klaus Blaabjerg
Lead Portfolio Manager
11 January 2012

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