Market Update Note - Target Return Team

Credit Suisse Bond Fund (Lux) Target Return (Euro)

Overview

- Further easing in interest rates expected
- US economy unlikely to slip into a sustained recession
- We have been reducing exposure to riskier asset classes, with a view to go back in when market conditions stabilise
- Portfolio duration increased to 3 years

Target Return Team

- Dilip Rasgotra: Fixed Income Strategy
- John de Garis: European Fixed Income
- Andrew Dickinson: Short Duration
- Bryan Wallace: European Fixed Income
- Stephen Hargreaves: European High Yield
- Pierre Henri de Monts de Savasse: Convertible/Risk Analyst
- Himanshu Lukha: Client Portfolio Manager

Given continued volatility in financial markets, the Target Return team would like to take this opportunity to communicate their reading of recent market events and how they expect to position the Fund for the weeks ahead.

The 75bps cut in US interest rates earlier this week came against a backdrop of sharp falls in global equity markets. The equity declines stemmed from continued concerns about the state of the US economy, which many predict is already in or heading for a recession. While the fears about the US economy have been prevalent for many months, there were false expectations that a stimulus package announced by President Bush last Friday would be positive for markets, but the reaction proved to be disappointing.

While this latest cut in rates may have caused some surprise among investors, it was a necessary action and markets are now pricing in a further 50bps of cuts at next week's FOMC. We believe that other central banks, such as the Bank of England and the European Central Bank are also likely to loosen monetary policy in due course.

Although money market rates have normalized and liquidity conditions have improved slightly, risk aversion has hit credit markets hard and the spread on the iTraxx Crossover index has widened from around 350 in December to over 500 now. However, government bonds have once again benefited from the sell off in equity markets and we have seen sharp falls in the yields on both 2 year and 10 year US Treasuries.

How has the Fund been affected?

Recent weakness in the Fund can be attributed to the poor performance of the high yield and convertible segments of the portfolio. Within high yield, liquidity conditions remain poor and we have seen a further widening of the cash bond spreads as a result of the weak US economic data, while convertible bonds have been hit by the general weakness in equity markets.

Our current positioning

While the fears about a US recession and the impact this would have on the global economy have intensified in recent weeks and while we fully expect a marked slow down in US growth, we continue to believe that the economy will experience a soft landing and not slip into a recession.

In our last update note, we had highlighted the fact that while the outlook was encouraging for later in the year, the first quarter was likely to be a difficult period – and this is proving to be the case. We had already been selectively reducing exposure to some of the more riskier areas of the market such as convertibles, high yield and investment grade, and increasing duration. Over the last few days, we have continued to implement these changes. The Fund is currently around 3 years long duration – 2.5 years long relative to our 6 month benchmark.

However, while we are currently taking a conservative approach, we will look for opportunities in the coming months to move back into the more risk orientated assets and to cut duration. We expect that come the end of the first quarter, with the major US, European and Asian banks having reported and with greater clarity regarding write downs, the worst of the problems in the financial sector are likely to be behind us.

Looking ahead

The current events have shown that, under chairman Ben Bernanke, the behaviour of the Fed has changed to the extent that they are more proactive in terms of monetary policy. This week's interest rate cut, which was the first outside a scheduled meeting since September 2001 and the biggest single cut since 1982, means that rates have come down by 175bps in just over four months. If next week's FOMC meeting does result in another 50bps cut, this will make it 225bps of easing in under five months – an unprecedented rate of cuts.

However, just as the Fed have shown their willingness to cut aggressively, we believe that they will be equally quick to act when it comes to raising rates. If, as we expect, market conditions improve later in the year and economic growth recovers, we could see the Fed move to tighten.

The biggest risk to our strategy is that the US economy does indeed enter a recession. If this were to occur, the recovery in asset prices would be delayed even longer and we would see a further correction in equity markets. However, as we have already mentioned we don't believe this will be the case and are optimistic that returns for investors in the Fund will improve in the months ahead. We believe we have in place the tools necessary to generate alpha for clients as we have done in the past.