

## Credit strategy: overweight investment grade; underweight high yield



Source: www.uol.com

It's funny how we seem to be obsessed with history these days. Although there is a tendency to believe that 'this time will be different', we constantly look at occasions in the past to see if there are similarities with today's markets. It was only six months ago that the markets were looking at the deleveraging story and the credit crunch and trying to draw parallels with the Great Depression. Now, inflation has become the dominant theme and comparisons are being drawn with the 1970s, which was the last period in which we saw significant inflation problems.

History can help, but there are always differences. Inflation in the '70s was at a high level before the first oil shock and unions were able to dominate wage negotiations. This is only partly true today and applies mainly in the public sector which has been relatively immune from both the 'hollowing out' process that has decimated the private sector and the 'credit crisis' that is decimating the banking sector. There are some interesting similarities with the '70s, however, which have implications for the credit markets.

In the UK, a number of UK manufacturers were merged in 1968 to create British Leyland. The company brought together a mixture of brands but, instead of achieving economies of scale, it suffered

from collective wage-bargaining and bad management.

The US-owned car industry is experiencing similar problems today, made worse by a large legacy workforce. The US has too many brands and the wrong product mix, just like British Leyland through the '70s. Management is constrained by the legacy contracts that encouraged high volumes and also, to a lesser extent, by the inflexibility of existing workers. Although some progress has been made on reducing the workforce, the combination of many headwinds has dealt a serious blow to these efforts.

Just when the 'big three' seemed to be moving forward, and benefiting from overseas demand, higher oil and energy costs have dealt them another blow. Lower US spending on autos is obvious now and will continue to slip as US consumers switch from trucks and have less money to spend. Their finance arms used to be a source of cash flow, but they are now a big drain. The competition has better products and the cost of borrowing has risen. Of the big three manufacturers, it is Chrysler that looks the most vulnerable owing to its relatively small overseas market exposure and also its reliance on Trucks.

The private equity owners of Chrysler, Cerberus, will have less interest in keeping the company together and it wouldn't be surprising to see it broken up. After all, unlike British Leyland, Chrysler does have some assets to sell: Jeep is a highly sought-after brand and there should be plenty of demand from those emerging market producers looking for product. We have seen this already with the Tata purchases of Jaguar and Land Rover from Ford.

British Leyland was rocked by strikes and poor quality products that failed to excite the consumer. The picture above is of an Austin Allegro, which is best remembered for its square steering wheel, but also for its nickname, 'All Agro'.

British Leyland cars weren't as good as their American 'transplant' rivals, especially those built by Ford. The Ford Cortina was the best selling car for most of the '70s. Now it is Ford's turn to be overtaken by a foreign competitor, as the F150 truck has lost its crown as the best selling vehicle to a Japanese car.

British Leyland was nationalised in 1975, which saved it from bankruptcy. This couldn't happen in Europe today (unless it was a French company), but it could still happen in the US. The US doesn't have a history of nationalising failed national champions (just look at the airline industry), but it does have Chapter 11 and there are ways of tipping the playing field in companies' favour. The ethanol subsidies are a good example of this. In response to high oil costs, there are a number of different ways for car companies to go from here. For example they could go for hybrid, or plug-in or hydrogen fuel cell cars. With US Government support for ethanol production and the limits of current battery technology, a hybrid that can be plugged in seems to be the path being chosen by the US manufacturers. The current Toyota Prius (best selling hybrid in the US) can't be plugged in, but the new Chevy Volt is being designed that way. Toyota has responded by recently showing a plug-in version of the Prius.

Chrysler is far behind in investing in these new technologies, partly because the skills of its private

equity management are in cost control and turnaround rather than in investing in future products. Its solution is joint ventures, but it seems unlikely that they will catch up. British Leyland went through many guises, including de-privatisation and sale to both Japanese and the German car companies, before it was closed down and its remaining assets sold to a couple of Chinese manufacturers.

These Chinese companies are now one; and not only do they own the designs, but they also own some of the UK factories. One thing that the high oil price has done is question the merits of producing bulky, but low margin, goods (like cars) on one side of the world and then shipping them to the consumer on the other side. The Chinese (and Indians through Tata) have manufacturing capabilities on the door step of Europe. If the current Chrysler owners could engineer a sale of some of the US manufacturing capability (without the legacy staff costs), then they could see a return on their investments. This 'de-globalisation' story is a consequence of the high oil price, but it may result in a way out for Cerberus.

**Difficult outlook for corporate profits requires careful credit selection. There will be winners and losers from these trends.**

#### **Important Information**

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