



Newton Fixed Income
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A view from the top - go global Global bonds and currencies

The rationale for going into global fixed-income securities used to be founded upon the existence of a weak base currency. There are now many more reasons to invest in overseas fixed-income markets.



Source: burjdubaiskyscraper.com

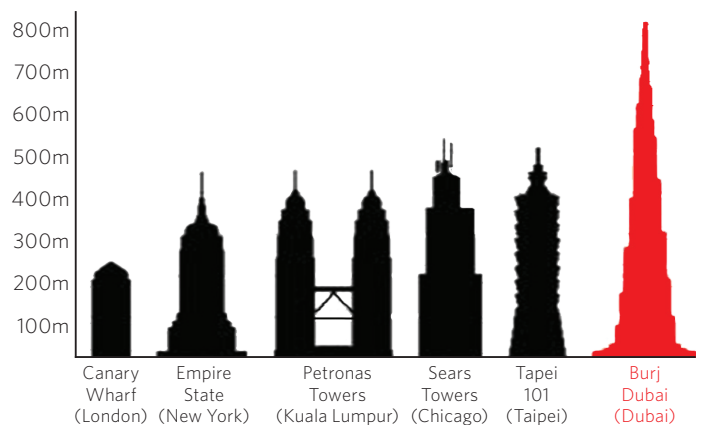
Following more than 25 years of declines in US government bond yields, the beginnings of a reversal may well be imminent. The trough in government bond yields occurred at the end of 2008 and, after a brief climb, they have remained relatively stable at historically low levels since.

Over the last quarter of a century a large part of the world's manufacturing base has shifted to China, where the comparative advantage afforded by low wages provided a steady global disinflationary impulse. The US dollar revenues China has earned have been recycled into US government bonds, thereby keeping US interest rates low and creating a symbiotic relationship between the Chinese producer and the US consumer. Low rates created the backdrop for a vast accumulation of debt, which supported growth but also fuelled a debt bubble which has now landed most notably in the lap of the US government.

Low US interest rates were also 'exported' to places like the Middle East via exchange-rate links and by virtue of the fact that major revenue earners set prices in dollars. The culmination of this

low-rate-fuelled debt explosion is symbolised by the Burj Khalifa building in Dubai, which has just opened and is the world's tallest by some margin. The building was renamed in honour of the ruler of Abu Dhabi, in recognition of the financial support that Abu Dhabi has provided to Dubai. The picture to the left was taken at the top of the Burj Khalifa and seems an appropriate point from which to start viewing the new global landscape.

WORLD'S TALL BUILDINGS



Source: Wikipedia

There is a good link between tall buildings and periods of excess. A previous record-holder, the Petronas Towers in Kuala Lumpur, was finished just after the Asian crisis, and the Empire State Building in New York was finished two years after the 1929 stock market crash. As with the Canada Tower in Canary Wharf, London, such buildings usually depress surrounding property prices for many years to come.

As the world adjusts to the fallout from the recent debt crisis, there will be significant opportunities for US and UK-based fixed-income investors, but such opportunities are likely to lie overseas. After many years of coordinated monetary and fiscal policies, the likelihood in the period ahead is that different countries will adopt different approaches to tackling the government debt crisis. There

is a clear divergence, for example, between the indebted Western economies' approach and those in the 'east' (excluding Japan) and emerging markets. Even within Western economies there are differences in approach.

As the world economy moves out of recession, some significant headwinds still need to be faced. Large government budget deficits must be reined in and ultra-loose monetary policies will have to be reversed. The pace and extent of these events will determine asset-market returns during 2010.

The authorities in the US seem reluctant to turn their attention to reducing the size of their fiscal deficit. The Federal Reserve will not want to repeat its own mistakes of the 1930s or those of Japan in the 1990s by raising rates prematurely. Economic growth could surprise positively as the combination of a depressed currency and very loose policy brings investment forward. Stronger growth and a lack of fiscal discipline, together with a politically influenced central bank, amounts to a dangerous cocktail for the US bond market and US investors may be better served by investing overseas.

The UK is in a similar position, but with a looming general election appearing to stand in the way of an imminent plan. The possibility of a new government which lacks the majority required to force through the necessary changes should not be ignored.

Policymakers' bias remains to err on the side of creating excess inflation pressure, rather than risking tightening policy too soon. This is evident in the latest minutes of the Bank of England's Monetary Policy Committee. Like all (chastened) forecasters, the Bank believes that there remain "exceptional uncertainties over the outlook for inflation and activity growth, which [will] only be resolved over time".

In Europe, the full extent of the recession has yet to be felt, but government debt overhangs are likely to be addressed sooner. The Irish have taken draconian measures in cutting public spending to reduce their deficit, and they could soon be followed by Greece and Spain. The negative effects on growth will be felt over the next two

years in Europe and inflation should remain low. Lower inflation, stable short rates and fiscal austerity are a good combination for the European government bond markets.

Currency management needs to be kept separate from bond allocation decisions. What is good for a bond market is not so good for a currency (and vice versa). Currencies in Asia and emerging markets will offer good opportunities as they are supported by rising interest rates, sounder fiscal positions and stronger economic growth. Using that simple basis for valuing currencies, there are other more 'mainstream' currencies such as the Australian dollar and Norwegian kroner) that could be of interest to the US or UK-based investor. The euro could also strengthen once the benefits of fiscal austerity start to come through.

Another way to take advantage of diverse global monetary and fiscal policies is to buy the debt of an issuer with an improving credit backdrop (such as Brazil), but in a currency in relation to which rates are staying low (such as the US dollar), and to hedge the US dollar back into the Brazilian real in the 'forward' market. Investing directly in the Brazilian local market exposes the investor to the negative effects of rising Brazilian rates, but owning Brazilian debt should be preferable to owning US Treasuries as Brazil's budget deficit is likely to fall faster than that of the US.

Conclusion

Diversifying away from a domestic market in which the central bank is running the risk of inflation and in which the government is not addressing debt challenges adequately seems a sensible idea. Investing in the bond markets of more fiscally responsible countries in which inflation is likely to stay low gives the investor an attractive alternative. Currencies can play their part too, by allowing investors to benefit from better economic growth prospects and higher interest rates.

A global bond and currency approach is now more important than ever.

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