

Staring into the abyss and realising you don't want to go there

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Global dynamic bond strategy: Governments – neutral G10, underweight emerging markets Corporates – overweight investment grade, underweight high yield

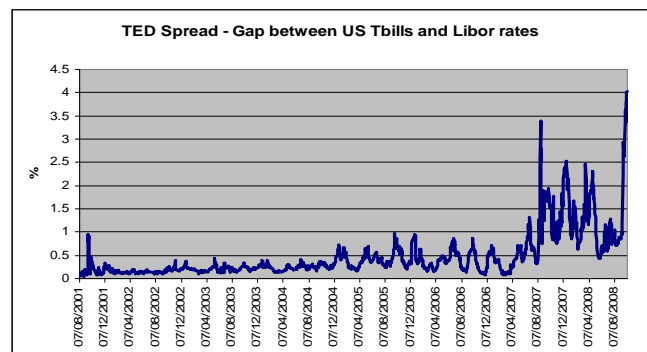
In other articles over the last year, we have made reference to previous US rescue packages (Savings and Loans and the Great Depression) and we have suggested that the current financial crisis would need another. The Troubled Asset Relief Plan (TARP) in its revised form is not the solution we were looking for, but it certainly helps. The new president is more likely to be able to put in place a better, more housing-focused solution once elected.

In Europe, the approach is more uncoordinated than that in the US, so far, and it is more concerning as a result. Previous bail-outs have been targeted at the underlying problem (housing in the case of the US) and have provided a clear mandate to act. This is what is required to stabilise the financial system and get private capital involved. Fiddling and writing off share-holder capital is not going to provide a long-term solution. The US authorities have the mechanisms under state control to be able to transmit the stimulus to homeowners. Refining mark-to-market rules seems appropriate given that banks don't have a proper market to mark to.

Meanwhile, the global economy continues to slip towards a recession. Some economies are already staring into the abyss (e.g. Iceland). The US is the only economy so far that has reacted aggressively to this economic worry by slashing interest rates (although these haven't fed through to the economy - see later). Others have been fighting inflation, which will be falling fast. Given this prospect, the hawkish stance of the European Central Bank seems totally wrong and could change soon. Emerging market central banks have, until recently, been raising rates to keep the inflation genie in the bottle. Their tight monetary policy stance is at odds with a rapidly declining

global trade outlook. These countries' 'hard' currency borrowings remain vulnerable as the lagged effects of monetary tightening undermine their perceived credit quality. Those countries with heavy reliance on overseas funding, such as the Baltic States, are especially vulnerable. Emerging market local currency bonds could outperform as domestic rates start to fall, but the currency risk needs to be hedged and, if currencies fall far enough, rate cuts might not come through.

The default of Lehman Brothers has triggered another round of concerns within the money markets and has hit money funds particularly hard. The Fed has had to support the money funds market directly. The collapse of a large counterparty has given the banks another excuse not to lend to each other. As a result, the gap between LIBOR rates and T-bills has widened to over 4% (see chart). What was seen as a symptom of the credit crisis has become one of its causes. With market rates so high, monetary easing has not been passed on and, in many cases, there has actually been a tightening of financial conditions.



Source: Bloomberg

Could the TARP (or Emergency Economic Stability Bill as it has become) come to the rescue? The plan

has been written in such a way as to give the US Treasury the mandate to spend money on whatever they deem fit to fix the financial system.

Suggestions that the Fed will resort to unsecured lending effectively to drive LIBOR rates down are only feasible if the US Treasury provides the funds. Even after it achieves what seems unachievable right now and gets LIBOR rates down towards historically low levels, the real economy will still be left damaged by this period of tight monetary conditions.

In the background, corporate attitudes to debt have been changing and there are merits in being overweight investment-grade corporate bonds in general and not focused just on financials. Growing respect for debt and lenders is making a comeback; see Xstrata's decision not to proceed with its bid for Lonmin. Leveraged buy-outs are history, share buy-backs are getting rarer and more companies are cutting dividends. This action to safeguard credit quality is good for bond holders.

September was one of the worst months for credit investing and October has started just as badly. The global high-yield market fell over 8% in September (and is down over 5% in October); the broad investment-grade index declined more than 5% in September. Emerging markets belatedly joined in this risk-aversion theme, but then caught up and fell 5.5%. The high-yield market is close to its highs, reached during the last significant sell-off following the technology, media and telecommunications bubble. With spreads on the European high-yield index at 1370 basis points

over governments (and therefore discounting 14% default rates), investors may be tempted, but they need to believe the European economy can climb away from the abyss before they take the plunge

Moves to stabilise the financial system as outlined above should help investment-grade financials directly and should provide some relief to the rest of the credit markets. But the fall-out from the freezing-up of finance has yet to be felt fully in the global economy. Further deterioration in economically sensitive credits (such as high-yield and emerging market debt) may still occur.

It is dangerous to draw conclusions in an environment in which governments are writing history, but:

- **Current investment-grade bond spreads are very attractive, especially if we are reaching a significant turning point in the authorities' efforts to solve the financial crisis.**
- **High-yield is also looking cheap, but the economic slowdown makes this market more specialised.**
- **Emerging market bonds are not cheap enough and should be avoided for now.**
- **A neutral position in government bonds, with a bias towards European short rates, completes the strategy.**

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