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## Top of the range? Global bond and currencies

**Newton global bonds and currencies strategy: cautious approach to duration; government bonds are oversold but target levels have been revised**

### TOP OF THE RANGE FOR THE LONG BOND YIELD?



Source: Bloomberg, June 2009

A top-of-the-range car from GM or Chrysler may not be worth what it was and neither are those companies' bonds. GM has had to resort to drastic measures, including government ownership and debt destruction, to keep going. What GM couldn't do was print money to pay off its bond holders. So, once the equity holders' value was written off and the government was called in, the company had to write off a substantial part of bond holders' value too; bond holders were left with up to 25% of the new company. The new GM is going to be a leaner version of the old one. The most profitable parts are being kept alive, and a slimmed-down dealer network and reduced employee cost programme could mean that the company makes cars that people want to buy rather than cars that keep the production machines rolling, people in jobs and bad factories open.

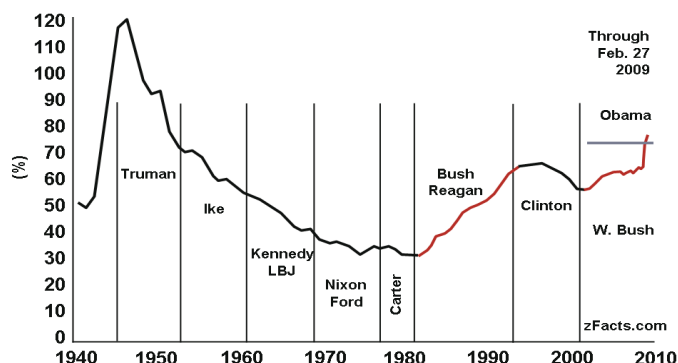
As the government becomes more involved in the economy, and as it takes on additional burdens (such as bankrolling key car companies), we are increasingly worried about the scale of supply of government bonds. Large budget deficits are a lesser

concern during a recession as the demand for safe-haven assets such as government bonds is likely to offset supply; but, if economic conditions improve, that demand should weaken.

Since the beginning of the year, there has been a mini crisis of confidence in relation to government debt and US long-bond yields have risen to levels that seem about to threaten the economic recovery; but there has also been a change in the outlook for the economy. Has the rise in yields been attributable to fears about supply, or is it a normal reaction to the improvement in economic growth prospects since those dark days of January when the world was heading for a depression? The relationship between government bond yields and economic growth is a strong one. The US ISM purchasing manager's index tends to be a good guide to the economic outlook and, as a result, to the level of bond yields. Since the ISM measure of economic activity reached its low point in December (with a reading of 32.9), it has bounced back to 42.8. This is still below the 50 level which represents the boundary between economic contraction and expansion, but at least the economy has come back from the brink of depression.

The rise in bond yields so far this year has been in line with similar moves in the ISM index from its lows in the past. The last time the budget deficit grew as fast as it is now growing was during the budget extravaganza of Ronald Reagan's presidency. Initially, the widening of the budget deficit was undertaken to counteract the 1980 recession, but we believe President Reagan widened the deficit further than was required to do so. His replacement, Bush senior, failed to address the issue and, by the time President Clinton came to power in 1993, the US debt-to-GDP ratio had doubled to more than 60%. However, government bond yields, rather than rising to take account of increased bond supply, actually fell dramatically during this period owing to the efforts of Paul Volker, chairman of the Federal Reserve, who was able to reduce inflation via tight monetary policy.

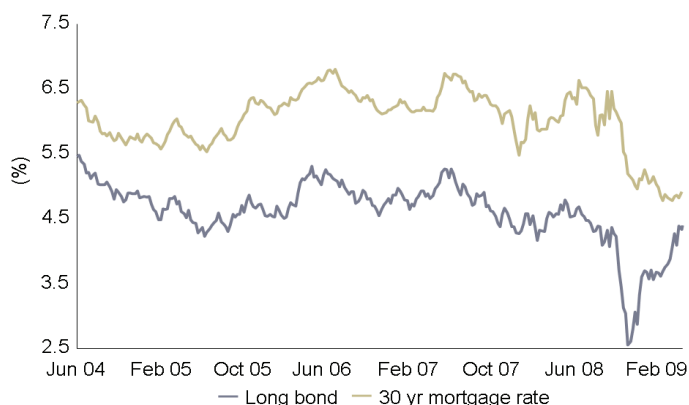
## US NATIONAL DEBT AS A PROPORTION OF GROSS DOMESTIC PRODUCT



Source: zFacts.com, (Data through 2007 is from Bush's whitehouse.gov)

Before we become too bearish about the outlook for government bonds, we should remind ourselves too that the link between US bond yields and fixed-rate mortgages is strong; and it is in relation to mortgage rates that the bond market may bite the proverbial heads off the green shoots of recovery. As can be seen from the next graph, normalising (narrowing) spreads on mortgage bonds offset until recently the rise in government bond yields, but now the increase in bond yields is threatening to push mortgage rates higher and choke off any prospect of a recovery in the key housing sector. The bond market can tighten monetary policy for the Federal Reserve if growth is picking up, but this recovery could be jeopardised by further shocks in the housing market.

## US LONG BOND YIELD AND MORTGAGE RATES



Source: Bloomberg, June 2009

With the large amount of stimulus being deployed in seeking to boost global economic activity, does the world economy need a US housing market recovery? Maybe not; but the delicate financial system does require such a recovery because it can't afford for problem housing loans to become any worse. Delinquencies already stand at a rate of 9% of all outstanding residential loans, and there appear to be mounting problems in the commercial real estate market too. These negative influences may be especially troublesome as savings rates and unemployment rates rise. Ensuring that the two US car manufacturers pass through Chapter 11 (and that they emerge the other side of that process) will necessitate debt write-downs and job losses. The implications for job losses could have been worse if the government had not been involved, but the hit to the economy will nonetheless be negative at a time when fiscal stimulus (totalling US\$1.3 trillion) and the benefits of lower energy costs (US\$1.6 trillion) are starting to wane. The next economic recovery may take longer to occur than previous recoveries have done, but meanwhile the liquidity being provided by authorities should be supportive of 'risk' assets. In this vein, commodities and commodity-based currencies remain attractive for now.

Since the dark days of Lehman Brothers' bankruptcy filing, some markets have 'normalised'. Long bond yields have risen to levels at which they stood before the filing and the relationship between yields and economic growth prospects has returned to 'normal'. The outlook for economic growth is likely to remain uncertain in the medium term and this suggests that yields are attractive for now; but there is little necessity for yields to return to the low levels we saw at the end of last year. Agency spreads have also normalised and we have taken profits on these holdings. We believe that other quasi-government bonds have further to rally, as do some of the more peripheral government markets, and we will continue to seek opportunities in those markets.

Like a brand new GM automobile, the US Treasury market isn't worth what it was, but there is still value in that market during these recessionary times.

Unless otherwise stated, all data is sourced from Bloomberg or Thomson Datastream.

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