



Newton Fixed Income
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Exit strategy Global bonds and currencies



Newton global bonds and currencies strategy: market sentiment is shifting from perceptions of 'green shoots' to fears of Armageddon and back again. Conflicting data from a world economy finding a 'base'

is likely to keep bond markets range-bound during the summer. Currency diversification, however, will represent a significant opportunity.

Government bond yields had reached a 'top' in the middle of June, but the US treasury market came back from the brink and rallied (meaning that yields fell) on a realisation that higher government bond yields mean higher mortgage rates and that the US housing market is too fragile to cope with such higher rates. The rally then ran out of steam as 'risk trades' were re-applied and safe-haven government markets slipped once again. This kind of flip-flopping by the government bond markets is likely to continue for several months until a clear economic recovery path can be identified.

A typical recovery would involve big help from the consumer, but this seems unlikely this time. Saddled with high debt burdens and a need to rebuild their savings, it is doubtful that US consumers can come to the rescue as before. We continue to believe that monetary policy needs to be kept loose for much longer than in previous cycles. The healing process for the financial sector may be nearing completion, but consumers' balance sheets need more work.

Conflicting economic data, together with reduced liquidity during the summer months, should keep the core government markets (US Treasuries, German bunds and gilts) range-bound and allow the 'periphery' to catch up. Within the eurozone, increased exposure to peripheral markets such as Spain and Italy could prove more rewarding and, within the US dollar bloc, the yields of high-quality emerging market sovereigns and supranational bonds should converge towards those of the US Treasury market.

This approach does not rule out a relapse in growth expectations as inventory changes distort the forward-looking purchasing manager sentiment readings. This might result in a bond rally, which could be the last for the government markets for some while and would give conflicting messages. Any withering of the green shoots of recovery could prompt renewed calls for further fiscal stimulus which is unlikely to be received well by bond markets that are already worried about the supply of government debt.

Either way, the *all change* world means that economies require low interest rates for some time, prompting investors to seek higher yields 'up' the maturity curve and 'down' the credit curve.

While signs of economic recovery are intermittent and fragile, it still seems too early to apply exit strategies, but when large amounts of long-dated government debt are being issued, investors need to know what the risks are. Central bankers are talking as though their work is done and as though the emphasis of policymaking is now on fiscal measures. They have slashed interest rates to very low levels and have repeatedly said they will keep them there for as long as necessary.

This emphasis on fiscal policy is vital. Policymakers and investors are studying previous solutions to fiscal largesse such as Canada's in the 1980s and the UK's in the 1970s. A focus like the Canadians' on spending cuts might be more appropriate if economies remain fragile and require private sector growth; by contrast, increasing taxes would reduce the private sector's ability to invest and would be likely to stifle growth. We have pointed to the Clinton administration's attempts in the early 1990s to reduce the bloated budget of the Reagan-led government as an example of how the bond market can be supported by a credible debt reduction plan.

All of these scenarios required strong leadership and were not good for the popularity of respective governments. It does

help, however, if you can blame a previous administration; President Obama may still be able to get away with this approach, but others will not be so lucky.

Currencies should offer a significant opportunity to add value during the summer months as differing economic fortunes and abundant liquidity drive currencies apart. The long-term vulnerability of the US dollar as a reserve currency will remain and, the closer the world economy gets to a sustainable recovery path, the fewer safe-haven flows we will see going into the US dollar. The euro could be a beneficiary of this modest dollar negativity, but the yen is less likely to benefit as the Japanese economy seems the least able to 'self-start'. Other Asian currencies are much more interesting. In the current environment no one wants a strong currency, but some countries are more able than others to cope with one. Some currencies, like the Korean won, which was devalued last year, are perhaps able to absorb a bounce. The devaluation of the won last year against the dollar has given the Koreans a good platform to tap into the burgeoning Chinese domestic market.

The link between the level of sterling and the fortunes of the UK financial sector remains as strong as ever, but increasing attention on the exchange rate from the authorities may put a limit on the upside. Longer-term worries about UK finances could undermine sterling, especially as there is the prospect of an election and a possible change of government to unsettle investors.

Increasing political uncertainty suggests that the UK may be slower than its neighbours to grasp the fiscal problem. A clear electoral majority for the Conservative Party in a general election could be beneficial for the currency if it allows them to blame the previous government and cut spending to bring down the deficit, but a hung parliament with no clear

majority for those seeking to bring about change would be a disaster. It is at times like these that governments need to make a difference and show leadership. With the election not even called yet, talk about exit strategies in the UK is likely to remain just talk and is unlikely to be credible.

Many 'risk' currencies have bounced from oversold levels and await a new direction. It is difficult to see a longer-lasting economic recovery at the moment and we may have to experience another slip before a true recovery can begin. The currencies that will do better as we emerge the other side are those that can benefit from the Asian story and those that have a credible exit strategy for their fiscal policy. It is difficult to see the US authorities making any significant reductions in their fiscal borrowing for the time being, especially with the US needing to tap into the federal purse to keep going and given renewed talk of another fiscal stimulus package. Japan has run out of ideas and the election and subsequent new government will be unable to make any radical changes.

In Europe, the authorities will be in an earlier position than their counterparts elsewhere to reverse their fiscal stimulus while allowing 'automatic stabilisers' in the economy to provide a safety net.

Among the 'ugly three' currencies (US dollar, yen and euro), in the absence of any actual collapse in the Baltic region, the euro could be one of the near-term winners.

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

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