

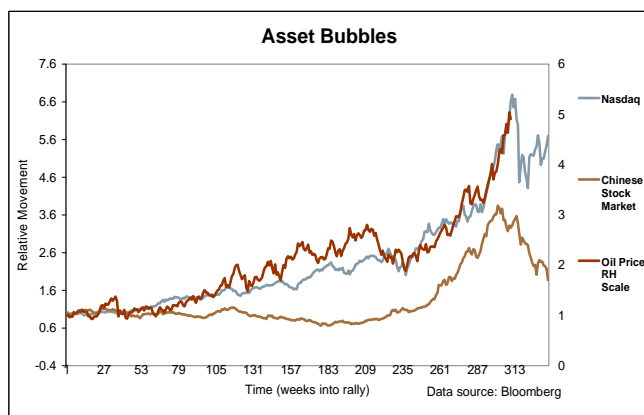
Parabolic, Exponential, Hyperbolic

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Global fixed income strategy: Overweight duration in Western bond markets

So we are progressing nicely now – Goldman Sachs has told us that we should expect a “Super Spike” in the oil price to \$200/barrel. This comes on top of warnings from Russia that we should expect oil to hit \$250/barrel. What was a parabolic trend for the oil price has gone exponential and now into hyperbole. If you’ve been around long enough, this sounds like an end game.

How many of these bubbles do we have to go through to recognise the pattern? You only have to look at a couple of examples in the recent past - the NASDAQ and Chinese stock market - to see what happens over and over again. A sensible idea is taken too far because of irrational exuberance, which is then perpetuated by a self-serving justification until the last sucker is drawn into the trade and the bubble bursts. If you take oil and lay it onto the patterns formed by the NASDAQ and the Chinese stock market as they went through the run up to their respective peaks, you see we are in the midst of the same process. Whether the recent moves represent the final throes of the rally is yet to be seen (as you could have made the same comparison when oil was at \$80 a barrel) but, by simply fitting curves to the oil price, it’s easy to show that the price departed from any kind of graphical “reality” at about \$100. The rest is just froth.



We shouldn't have any real argument with the idea that we have a supply/demand imbalance with respect to oil, but does it really justify such a dramatic price rise in such a short space of time? To be sure, there is plenty of the stuff around and it was heartening to see Saudi Arabia over the weekend doing its part to increase supply in an attempt to reduce the near-term speculation built into the price and with it the sense of an imminent shortage.

It could be argued that part of the reason that this situation has gotten out of hand is that:

1. We have dignified the idea of commodities as a legitimate “asset class” for pension funds. They are not, as they pay no dividends or interest and are about as relevant to the real needs of pensioners as a Picasso painting.
2. Access to the futures markets has been made easier by vehicles like Exchange Trade Funds (ETFs) which do not require individuals or institutions to open brokerage accounts (thereby circumventing scrutiny and regulation). Instead, a fund which must be fully invested at all times has to go and buy oil or commodity contracts regardless of the price and regardless of the day. It is the sheer weight of money that drives the market rather than the fundamentals of supply/demand, reserves, discovery rates or recovery rates in the oil industry. The financial engineers are in charge.
3. There isn't much else to go for: the credit markets have been destroyed, tech stocks have matured from the wild west days of the late-1990's, the Far Eastern stock markets have been shown not to be a one-way bet, and emerging markets have been driven (at least in the bond and currency space) to regions which discount a generation of value; whilst developed world government bond yields offer 3-5% tops. Frankly, the parasitical nature of the

modern investment environment has moved on to the only area left to it (commodities) and is in the process of taking a good and valid idea too far.

This is damaging on all kinds of levels and is merely rubbing salt into an already gaping wound. Fundamental numbers coming out of the US, UK and Europe show an increasingly desperate situation in the real economy, whilst stock markets have reacted to the gathering problem by falling by 10% in the US and UK and an astonishing 20% in Europe. Under normal circumstances the bond markets would have reacted violently, falling in yield so that at least a low discounting factor would help limit stock declines. However, this hasn't happened yet and the mixed message created by

the commodity markets has only served to set off a battle between central bankers as to who can appear to be the most vigilant on inflation which has actually sent bond yields higher. In some respects this tees things up very nicely. As soon as the froth comes out of the oil markets and we start hearing phrases like "inflation numbers are backward looking" then we may be in a position to realise the value built into the bond markets. For that reason alone, we are maintaining an overweight duration position in Western bond markets.

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