

## Fixed income: global bonds and currencies

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# If it were done... 'twere well it were done quickly

### Newton global bonds and currencies strategy: underweight gilt exposure in the near term

In a week in which our Scottish leader was almost politically 'knifed' by members of his own party, it seems appropriate to summarise the state of the gilt market with a quotation from Macbeth, the Shakespeare play in which another Scottish ruler, King Duncan, is murdered by one of his supposed supporters, the eponymous "villain". The full quotation, as Macbeth steals himself for the bloody task (in Act 1, scene vii), is:

*"If it were done, when 'tis done, then 'twere well  
It were done quickly: if the assassination  
Could trammel up the consequence, and catch,  
With his surcease, success; that but this blow  
Might be the be-all and the end-all..."*

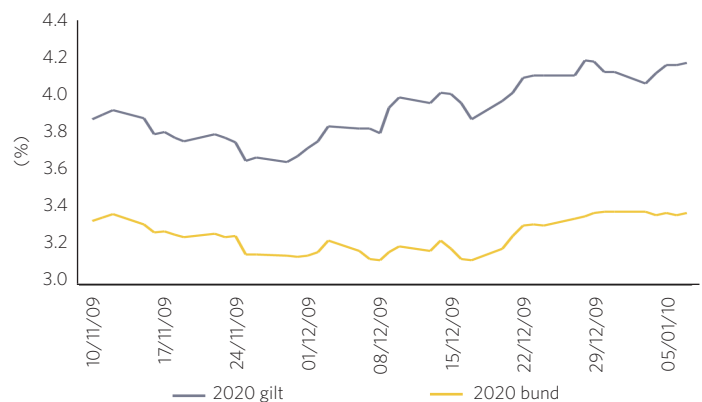
The same sentiment could be applied to the urgent need in the UK for action to cut the budget deficit, for greater political certainty, and for clarity on the future extent of quantitative easing ("QE"). Given the rapid deterioration in the UK's public finances, it is universally agreed that action is necessary. Unfortunately, there is less consensus about the timing and nature of such action. Furthermore, the imminent General Election (which must take place by early June) complicates matters; massive spending cuts tend to be unpopular, so the political rhetoric is likely to be more upbeat, or at least evasive.

Fortunately for UK plc, both the rating agencies and financial-market participants have (so far) been prepared to give the authorities time to formulate and implement a deficit-reduction plan. Standard & Poor's, the rating agency, revised the outlook associated with the UK's 'AAA' rating to 'negative' last Summer, signalling its view that the rate of deterioration in the public finances was unsustainable, but S&P also acknowledged, given the UK's "comfortable" starting point, that its fiscal position was recoverable provided that a coherent plan was put in place following the General Election.

At the same time, the markets were happy to buy gilts at historically low yields, despite the fact that the UK's deficit for the current fiscal year is not dissimilar to that of Greece. In large part this was because the Bank of England, through its (QE) Asset Purchase Facility was absorbing most of the record net new supply of gilts.

However, the rate of expansion of the QE programme has already slowed, and it may well cease at February's meeting of the UK's Monetary Policy Committee. Time is running out. The Pre-Budget Report ("PBR") of 9 December set out the problem amply, but was unconvincing as to how that problem would be resolved. Since then, gilt yields have been on the rise, and gilts have underperformed other major markets.

#### RECENT GOVERNMENT BOND YIELD CHANGES



Source: Bloomberg

The chart above shows the yield on the 10-year gilt versus the yield on the 10-year German bund; while the bund yield has remained in its recent 3.2 - 3.4% range, the gilt yield has broken decisively above 4%, rising nearly 0.4% since the PBR.

We concur with the view that, if public finances were to follow the path set out in the PBR, there would be a strong likelihood of a rating downgrade from at least one of the major agencies this year. After all, the UK's debt-to-GDP (public sector net borrowing or "PSNB") ratio will still be rising in 2015 on the projections set out in the PBR.

	Per cent of GDP						
	Outturn	Estimate	Projections				
	2008-09	2009-10	2010-2011	2011-12	2012-13	2013-14	2014-15
Public sector net borrowing (PSNB)	6.6	12.6	12.0	9.1	7.1	5.5	4.4
<i>Total change since budget 2009</i>	<i>0.4</i>	<i>0.2</i>	<i>0.1</i>	<i>0.0</i>	<i>-0.1</i>	<i>0.0</i>	
<i>Impact of discretionary measures on PSNB<sup>1</sup></i>	<i>0.0</i>	<i>0.0</i>	<i>0.3</i>	<i>0.3</i>	<i>0.1</i>	<i>0.0</i>	<i>-0.2</i>
Cyclically-adjusted PSNB	5.7	9.0	8.0	5.8	4.5	3.6	3.1
Surplus on current budget	-3.5	-9.1	-9.3	-7.2	-5.6	-4.3	-3.2
Public sector net investment	3.2	3.5	2.7	1.9	1.6	1.3	1.3
Public sector net debt <sup>2</sup>	44.0	55.6	65.4	71.7	75.4	77.1	77.7

Note: All measures are presented on a basis which excludes the temporary effect of financial interventions

<sup>1</sup>Including changes in forecasting assumptions on spending growth in 2011-12, 2012-13, 2013-14 and 2014-15

<sup>2</sup>Debt at end March; GDP centered on end March

Source: HM Treasury – pre-budget report

Clearly Pre-Budget Reports are not ‘gospel’; according to the 2007 PBR, the PSNB (“deficit”) should have been 2% this financial year (2009-10), rather than 12.6%, and the debt-to-GDP ratio should have been little more than half of the now-projected level for 2012-13 (38.6% versus 75.4%). For the same year, under the ‘Maastricht criteria’, which set out the conditions that must be met by European countries if they wish to adopt the Euro as their currency, the ratio will be over 90% (Greece’s ratio was at 99.2% when last measured at the end of 2008, and is also on an upward trend).

However, we believe that, whichever party wins the General Election, much tougher fiscal measures will be implemented to address the deficit (through both higher taxation and spending cuts). For the second half of this year, then, we are inclined to be positive on gilts; lower disposable incomes are likely to crimp consumer spending, escalating job losses in the public sector should curtail wage pressures in the public and private sectors, and deflationary pressures are likely to re-emerge. A very tight fiscal stance should warrant very loose monetary policy (low interest rates).

However, for the markets, there is one outcome likely to be worse than a victory for either main party in the UK General Election – a ‘hung parliament’ (in which no single party has an overall majority); such an outcome would be likely to lead to delay or a watering down of any decisive action on the deficit. This remains a possibility rather than a probability.

What the markets need is “the be-all and the end-all” of a decisive victory for one party or the other. Therefore, for the next few months, the risk is skewed towards still-higher yields. When QE

was introduced in early March 2009, ten-year yields fell by 0.5%, even though the introduction of QE had been much speculated about. If QE were to be withdrawn, it would not be a ‘shock’, but yields would probably move correspondingly higher if that were to happen. Politicians’ talk of ‘growing our way out of debt’ or of unfunded spending increases or tax cuts are unlikely to wash with the markets, but they will not be aimed at appeasing markets (but rather voters). Any increase in the likelihood of a hung parliament is also likely to see further selling of gilts.

Our near-term concerns about the credit quality and attractiveness of ‘UK plc’ are driving our underweight gilts recommendation, and those concerns apply equally to index-linked gilts; while index-linked gilt investors do not have to deal directly with the potential effects of an end to QE (the Bank of England has not bought any index-linked issues), they are likely to suffer collateral damage from political uncertainty and rising nominal yields, even if ‘break-even’ rates (which reflect the difference between the nominal yields on conventional bonds and the inflation-adjusted yields on inflation-indexed bonds of the same maturity) on index-linked gilts rise. In the longer term, the ‘drag’ of fiscal policy is likely to lower inflation expectations, leading to lower break-even rates.

## Conclusion

In the medium term, we believe that gilt yields will stay low, as unavoidable fiscal tightening will engender low growth, low inflation and low interest rates. However, for the next few months we advocate underweight exposure to gilts, as electoral uncertainty, the risk of sovereign rating downgrades, and the likely cessation of QE are all likely to continue to push yields higher.

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