

Newton Fixed Income
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Sterling - the ugly duckling Global bonds and currencies

Newton global bonds and currencies strategy:
The beauty contest between currencies may have another 'ugly' contender. At the start of the year, we thought that the big three currencies (dollar, yen and euro) would not perform well compared with 'risk' currencies in more flexible economies. Sterling was included in this group mainly owing to its devaluation last year, but it is no longer inexpensive and the underlying challenges for the UK remain.

Currency beauty contest	Overall ranking
Australia	1
Norway	2
Switzerland	3
Sweden	4
Canada	5
New Zealand	6
USA	7
UK	8
Euro	9
Japan	10

Source: Newton rankings

Since the beginning of February, a diversified basket of currencies (equally weighted to the Australian dollar, Swedish krona, Canadian dollar, British pound, New Zealand dollar, Norwegian krona and Korean won), funded by a short position in the yen and U.S. dollar, would have produced a +20% return.

The switch away from 'safe-haven' to 'risk' currencies has coincided with a more optimistic appraisal of the global economy. As we have stated recently, we believe that this shift in sentiment may have gone too far too quickly (see our recent article entitled *Stocks and bonds*); the recovery from one of the worst recessions in 50 years should take longer than the

markets currently think. A more realistic assessment of the stop-start recovery could revive demand for those safe-haven currencies and lift the U.S. dollar and the yen once more.

Looking slightly longer term, we expect the dollar to resume its long-term downward trend against currencies that have better fundamental support (from current account or trade surpluses for example). The West could remain submersed in debt for several years, thereby reducing economic growth potential and favoring those countries that can respond to the liquidity from monetary stimulus that is still flowing well. This longer-term decline of the dollar will be gradual as there is unlikely to be a credible alternative reserve currency for some time. The dollar remains the only currency that can be used freely for trade and as a destination for reserves. The providers of dollar capital (chiefly the Middle East and Asia) have too much already invested to risk a wholesale dollar collapse and the consumers of their goods are still largely resident in the U.S. The U.S. dollar should gradually lose out to those Asian and emerging-market currencies that appreciate in value.

Our approach since the beginning of the year has been to maintain underweight exposure to the big three currencies (the 'ugly currencies') and to focus on currencies in countries with strong fiscal and monetary policy flexibility. This strategy has benefited from the shift into riskier currencies, but it would be vulnerable should the inventory-led rebound in economic activity fail to live up to expectations. We have reduced exposure to some of these 'strong' currencies and meanwhile we have increased core government bond duration. Central bankers seem more pessimistic than investors these days. Recent comments by Bank of England officials and European Central Bank members seem to be targeted at reducing growth expectations.

One of the main beneficiaries of the 'pro-risk' trade since March has been sterling. As sentiment changes, sterling could be one of the main losers. Its long-term credentials were never as robust as other currencies that have strengthened this year

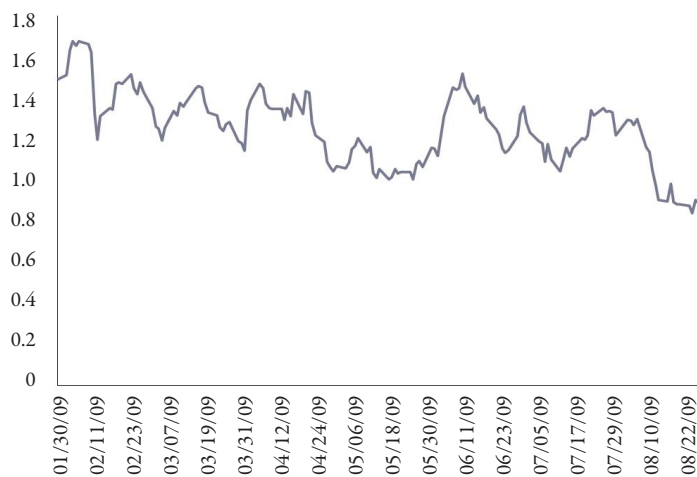
and its bounce is closely linked with the recovery in bank stock prices. This correlation is breaking down as the market focuses on the longer-term challenges facing the current government. Signs that attempts by the UK central bank to stimulate domestic lending via ‘quantitative easing’ are being thwarted by banks’ desire for safe-haven investments are especially worrying. It seems the UK banks are hoarding cash to improve their balance sheets owing to the delicate state of credit markets. This has led to a sizeable chunk of cash being placed with the Bank of England rather than being used in the real economy. The central bank could resort to negative interest rates on these reserves (which have risen from £45bn to £150bn in the last four months), a move that would force banks to buy gilts instead. This would be positive in helping to finance the ever-expanding government bond market, but it would not provide an immediate boost to the UK economy.

The relationship between the wellbeing of the banking sector and the fate of sterling started to break down just as the two-year gilt yield fell below its 1 to 1.5% trading range at the beginning of August. It seems that foreign-exchange markets are now more concerned with interest-rate differentials.

The fall in two-year yields could be replicated in the U.S. as economic growth disappoints over the next couple of months, but that scenario would favor the safe-haven currencies at the expense of the others. A simple ranking of the main supports for a currency (the ratio of debt to gross domestic product, economic growth, the current account position, interest rates and valuation) would put sterling down with the ‘ugly three’ currencies (yen, U.S. dollar and euro) – see the table of our rankings on the previous page. The euro may be better supported in the months ahead owing to the core governments’ (especially Germany’s) desire to confront budget challenges early. The delay in the calling of a general election will not allow such rigor in the UK.

Conclusion: the safe-haven currencies may bounce in the short term before fading again. The main loser during the next period of economic uncertainty could be sterling. We favor currencies with good long-term support from themes that capture Asian economic recovery prospects and a gradual rise in commodity prices.

TWO-YEAR GILT YIELD



Source: Bloomberg

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

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