



Newton Fixed Income
November 2009
Paul Brain
No. 296

Be careful what you wish for Global bonds and currencies



The scale of government debt issuance is beginning to attract attention from the ‘scribblers’. Should we worry about it? In some cases, yes; and in most cases we should be careful what we wish for.

The fact that we have a growing deficit problem in the Western economies is well-known and the burden of this extra debt will be with us for many years to come. As the central banks have confirmed this week, the consequence of this high debt level is that we need lower interest rates for longer as well as a focus on higher taxes and lower government spending.

Given the fragility of the Western economies and their banking systems, a tightening of fiscal policy may have to wait (at least six months) for more convincing signs of economic recovery; indeed, some countries are still talking of further fiscal stimulus. The housing support scheme in the U.S. has come to an end, but Congress is about to vote in another tranche of measures which, together with some tax concessions for businesses, could result in another \$90 billion of fiscal stimuli over the next 12 months. After that, a series of tax changes comes into effect that should entail a tightening of fiscal policy and reign in growth.

Here in the UK, there are already measures in place that will increase the overall tax burden (in the form of value added tax, national insurance and income tax) when they come into effect during the first four months of next year. These measures alone will not be enough to reverse the dramatic build-up in deficits or to stem the tide of government bond issuance. The next UK government (following the general election that must be called by the middle of 2010) will be obliged to put in place reduced spending plans and tax increases that start to address the problem.

As to the U.S., we remain concerned that the authorities are not even talking about how they will overcome their deficit mountain

and we suggest that the bond vigilantes’ patience may run out if the authorities do not focus on the problem in the New Year.

For now, the view of the rating agencies is that sovereign debt servicing costs are moving closer to the edge of their ‘comfort zone’ but, providing that they can see a credible ‘glide path’ (through fiscal measures, asset sales and growth) back to a lower level of debt costs in future, even a sharp rise can be tolerated in the interests of re-invigorating economic growth.

Record government bond supply has been absorbed this year through a variety of means. Increased supply is not initially an issue as it comes at a time of increased economic weakness, low interest rates and a lack of inflation. Zero interest rates have pushed many investors, who cannot stay in cash and earn a zero return for long, into bonds this year; pension funds, insurance companies, endowments and retired individuals living on an income have been steady buyers of government debt. These buyers, together with bond-hungry banks, have taken up the extra new issuance comfortably and more than counteracted the small reduction in demand from foreign central banks. The Federal Reserve’s U.S.\$300bn purchases of U.S. Treasury paper have now ended, although the U.S. central bank is only two-thirds (U.S.\$918bn vs. U.S.\$1,425bn proposed) of the way through its credit (mortgage-related) purchases. When the official quantitative-easing (QE) measures stop, it will be up to the banks to take up the reins and buy government bonds to improve their liquidity ‘buffers’.

In the UK, the Bank of England has just announced a further boost to its gilt-purchase scheme, which now amounts to £200bn (or 14% of GDP). These purchases are more than enough to soak up the net gilt issuance of £175bn this year.

In Europe, the situation is not much clearer as the newly elected German government has bowed to electoral pressure and announced a series of tax cuts that seem at odds with its deficit-fighting credentials.

What about next year? A post-recession economy that is saddled with huge deficit problems would appear to require an exit from

loose policies via fiscal tightening rather than by the raising of interest rates. While attacking the debt problem, monetary authorities need to keep policy loose in order not to endanger slowly recovering economies.

A tighter fiscal stance and low official interest rates provide a positive backdrop for government bonds and, over the last month, we have increased our exposure to the long end of the UK and U.S. markets to benefit from steep yield curves in those countries. At the same time, we have added some protection in case the authorities do not do the right thing and squander an opportunity to reduce the fiscal burden. We have bought options on U.S. 10-year Treasuries that effectively limit a large part of the downside if the bond vigilantes pounce.

We continue to refer to the early 1990s as a template for the current environment. Then, we had a post-recession environment in which interest rates were kept low for a prolonged period and when the emphasis was on fiscal tightening further down the road. The three years from 1990 to 1993 amounted to one of the best periods for bond investors as bond yields fell and investors made 36.5% by investing in the U.S. government bond markets (source: JPM U.S. Treasury index). Unfortunately, in 1994 the bond markets grew increasingly concerned that the central banks were going to be too slow to raise rates and that inflation would rise substantially as a result, which led to a negative return during that year.

Although there have been some stronger signs of growth recently, a broad-based recovery in the economy is still some way off. Indeed the evidence suggests that the U.S. economy remains addicted to stimulus and that, without another package of support, the U.S. housing market may take another lurch downwards. A broad recovery in investment is possible, but an imminent recovery in consumer spending is unlikely.

The situation in Japan is similar, but much worse. The country's budget deficit has been growing for 15 years and the economy has been addicted to fiscal stimulus and zero interest rates for just as long; and yet yields are still much lower than in the West. Given a strong yen and a collapse in global trade, the export sector looks especially vulnerable at present. The deficit problem has been getting worse for too long and has been masked by the high level of domestic savings. The numbers are reaching a 'tipping point', particularly now that the savings rate has declined to below U.S.

levels. The ageing population 'time bomb' has been ticking away in the background and eroding the savings rate. The decline in the Japanese economy has reduced tax revenues to such a low level that, even though interest rates are very low, the interest costs of the outstanding government debt are now 27% of the tax take (assuming an average 1% interest rate).

If interest rates were to rise or if the economy were to weaken further, the Japanese government would find it increasingly difficult to pay its bills. The debt-to-GDP ratio could easily top 200% next year and, although the market is 95% owned by domestic savers, the government is rapidly running out of fresh buyers of its debt and may have to resort to overseas buyers therefore to fill the gap. Unfortunately, Japanese bond yields are too low to attract foreigners, especially as the country's credit rating is inferior to that of other major bond markets and may well deteriorate further.

Before we write Japan off, there is one other factor to consider. The country has also been running a large current account surplus and, as a result, it has built up reserves. The Japanese central bank currently owns U.S.\$ 791bn of U.S. Treasury debt, which could be sold to fund the Japanese government's interest payments. This would be yen-currency-positive, as it would involve a repatriation of Japanese yen but, in the long term, the decline in the credit quality of the country and its weak economic profile would be likely to weigh heavily on its bond market. Japanese selling of U.S. Treasuries will naturally be a burden on the U.S. Treasury market, but the rise in the domestic savings rate could be enough to offset this, especially if the banks continue their recent 'love fest' with U.S. Treasury debt.

As public-sector deficits grow, the possibility of a policy error increases. The current focus on government supply and the conclusion that bond yields have to rise ignores the demand for government debt but, more importantly, it overlooks the consequences of much higher bond yields. After all, 1994 was not a good year for equities or even for the economy.

Conclusion

Bond-yield volatility could be an increasing feature over the next 12 months as investors grapple with large amounts of supply and the possible exit strategies of authorities. We believe that buying some protection against higher yields is a good idea, and so is shunning the Japanese government bond market.

Past performance is not a guide to future returns. The information contained within this document should not be construed as a recommendation to buy or sell a security. It should not be assumed that a security has been - or will be - profitable. There is no assurance that a security will remain in the portfolio. The opinions expressed in this presentation are those of Newton Capital Management Limited and should not be construed as investment advice.

'Newton' refers to the following group of affiliated companies: Newton Investment Management Limited, Newton Capital Management Limited, Newton International Investment Management Limited, Newton Capital Management LLC and Newton Fund Managers (CI) Limited. Assets under management include assets managed by all of these companies except Newton Capital Management LLC, which provides marketing services in the U.S. for Newton Capital Management Limited. Except for Newton Capital Management LLC and Newton Capital Management Limited, none of the other Newton companies offer services in the U.S. Newton Capital Management Limited is an investment management firm authorized and regulated in the United Kingdom by the Financial Services Authority in the conduct of investment business and is a wholly owned subsidiary of The Bank of New York Mellon Corporation. Registered in England no: 2675952. Newton Capital Management Limited is registered in the United States as an investment adviser under the Investment Advisers Act of 1940.

Tel: (516) 338 3521

www.newtoncapitalmanagement.com