



**Newton Fixed Income
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Get real! (or perhaps not?) Global bonds and currencies

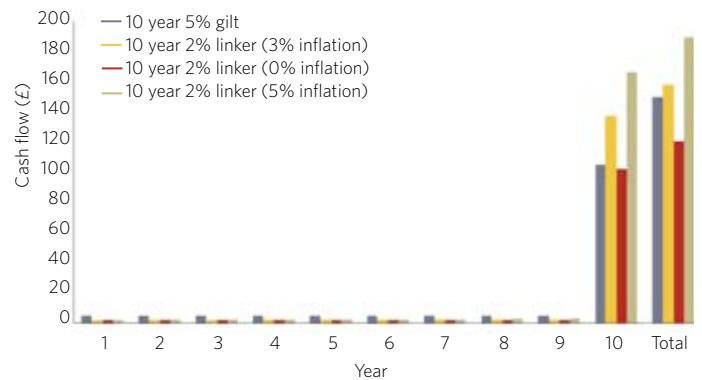
Index-linked gilts (UK government bonds) are receiving a lot of attention currently. In this article, we ask whether they are worth the paper they are written on.

Given the adoption of quantitative easing (QE) measures by leading central banks, and given that an 'ugly contest' is underway between the world's major currencies, it is natural for investors to look at index-linked gilts ('linkers') as an insurance policy against rising inflation. But how good is the cover - fully comprehensive or 'third party, fire and theft'? And might investors find themselves underinsured?

An index-linked gilt is not a gilt with a proverbial 'cherry on the top'. Instead of receiving a regular fixed coupon (designed to give one a return after inflation) and the principal (par value) at maturity, index-linked-gilt investors receive a lower coupon, which is indexed (positively or negatively) by inflation, as well as an indexed capital sum at maturity.

If we look solely at their price history, index-linked gilts can be beguiling; their prices tend to rise (because the principal is indexed). What investors really hold is a long-duration, low-coupon bond. Below we show the respective annual cash flows from a £100 investment in a theoretical new 5% 10-year gilt (which pays £5 interest per year and £100 principal at maturity), and from a 2% index-linked gilt under different scenarios. If inflation is 3%, the total cash return from a 5% conventional gilt and a 2% index-linked gilt is, as you would expect, very similar (£150), but more of the index-linked gilt's return comes at maturity in the form of an indexed principal amount. If inflation is more than 3%, the index-linked gilt will return more; if it is less, it will return less.

STYLISTED CASH FLOWS UNDER A RANGE OF INFLATION SCENARIOS



Source: Newton, December 2009

Many investors fear that 'easy' money is storing up inflation and new asset 'bubbles'; but what about Japan's experience? Japan 'invented' QE in 2001, and yet has still been mired in deflation for the past eight years. If investors want simply to protect themselves against inflation, but instead find that deflation takes hold, they ought to be indifferent as to what their coupon or principal is in nominal terms (even if the principal is less than they paid) because the real value (purchasing power) of their capital is maintained. But who really thinks like that?

There is more potential bad news from history in relation to the correlation between gilts and linkers. A review of the period from 1993 to 1994 is particularly informative; 1993 was a good year for bonds (including gilts), but 1994 was very bad (against a backdrop of rising inflation and interest rates). But, in which period did linkers do best?

GILTS IN 1993 AND 1994

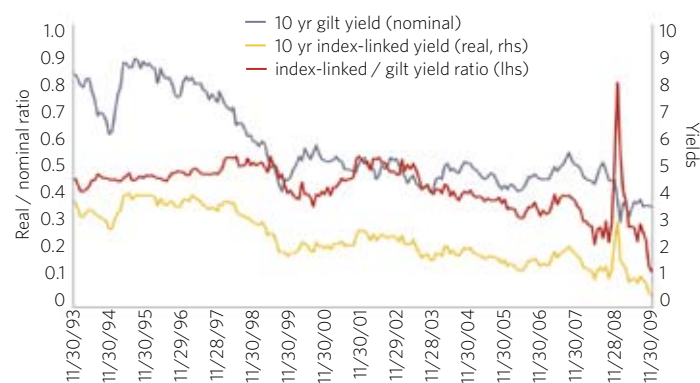


Source: Bloomberg, December 2009

In the chart above, the green line is the cash price of the 4.375% 2004 index-linked gilt (the then 10-year index-linked bond). The two white lines are the yield on the 10-year conventional gilt (top) and index-linked gilt (bottom). It is even more salutary to look at absolute levels of yields then and now. In the 1993-94 period, the conventional gilt yielded around 8% and the real yield on the index-linked gilt was around 4%. Today they are 3.6% and 0.6% respectively.

With good reason, gilt investors worry about the enormous supply of gilts and the deterioration in UK creditworthiness; but buying linkers is not an antidote to those worries. A promise to 'pay' retail price inflation is as strong as a promise to pay a fixed cash amount or a promise to pay in chocolate buttons (if it comes from the same person). If investors are really concerned about the creditworthiness of 'UK plc', buying linkers is like getting cover from a low-grade insurance company. If nominal yields of 3.6% do not stack up, why should investors accept real yields of 0.6%? Surely, if gilt yields need to rise to reflect increasing 'sovereign' risk, real (inflation-adjusted) yields must also rise. Could rational investors expect 8% nominal (non-inflation-adjusted) gilt yields to exist in tandem with 0.6% real yields this time around? We doubt it.

UK REAL AND NOMINAL YIELDS



Source: Bloomberg, December 2009

The chart above shows real and nominal yields (and the ratio of the two) in the UK over the past 17 years. On neither an outright, nor a relative, basis do index-linked gilts look cheap.

People living near a river may find that insurers refuse to provide cover against flooding. Those people might rationally decide to buy cover at any cost, or to obtain it from a low-quality insurance company. Similarly, because governments are opening the floodgates to inject liquidity into financial markets, there is a risk of catastrophe in the form of higher inflation and asset bubbles. In seeking insurance, investors will be aware that linkers constitute a small market, which could easily become 'squeezed'. Indeed, even as many investors are fretting about the huge supply of gilts over recent and coming months, the National Association of Pension Funds (representing UK pension funds) is clamoring for more long-dated linkers. Pension fund actuaries, anxious to hedge against index-linked liabilities, may continue to buy index-linked gilts, even at 'silly' prices.

Additionally, perhaps even those who have worked in the finance industry for 20 years lack experience of high inflation, having lived through three recessions which have been punctuated by the 'NICE' decade (of non-inflationary continuous expansion) and structural falls in inflation as a result of globalization. So we should not dismiss the risk of materially higher inflation but, before buying the 'insurance', we should check the policy (as to how index-linked bonds might behave under different scenarios).

What is covered?

- Somewhat higher-than-expected inflation: nominal yields should rise, and 'break-even' rates should rise too, but real yields should stay low
- Low rates and moderate inflation: nominal and real yields will stay low

What is not covered?

- Deflation: not impossible; investors should not forget Japan's 'zombie banks' and 'lost decade' (even after several years of QE and fiscal stimulus, Japan is still suffering from deflation). Remember, the value of coupons and the principal on a linker can go down as well as up!
- 'Fire risks' - a big leap in inflation: without doubt, index-linked bonds will outperform gilts substantially in this scenario, but it is by no means certain they will make investors money; risk premia are likely to be much higher, and real yields will have to rise to reflect this
- 'Insurer default' – the United Kingdom still enjoys 'AAA' ratings, and a default is virtually unthinkable, but we believe sovereign defaults are more likely to coincide with very high inflation
- Small print exclusions: the failure of Office for National Statistics data to reflect the 'true' nature of inflation
- 'Flood risk': buckets full of new supply to plug the gap in the public finances are as much an issue for linker investors as for conventional gilt investors.

Newton's strategy response:

To be clear, we expect gilt yields and inflation to stay low in light of fragile growth and impending fiscal 'drag'; whoever wins the next

general election in the UK will have to increase taxes and cut public spending materially to restore order to public finances.

Cautiously neutral gilts – accepting that 'tail' risks in relation to inflation are high.

Underweight index-linked gilts, with a preference for TIPS (the U.S. government equivalent of linkers) as real yields on these are higher; if there is a re-awakening of inflation, it is likely to be a global, not UK-specific, phenomenon, given the coordinated nature of monetary easing so far around the globe.

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