



Diversifying Into Global Bonds and Currencies Amid Uncertainty

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Executive Summary

Paul Brain, Newton's investment leader for fixed income, offers a new look at what to do when domestic safe haven markets no longer seem to provide comfort. He discusses how to diversify currency, credit and interest rate risk by adopting a global approach to fixed income and currencies.

Global investors, particularly those in the US, have expressed increasing concern about the stability of their own domestic markets. Over the last two years, investors have worried about the de-basing of their domestic currency, the credit quality of their "risk-free" bond market and what will happen when their central bank starts to tighten monetary policy. We respond to these fears by arguing that interest rates are unlikely to rise too soon, that other currencies are undermined by similar problems and also that there is still time to address the concerns over sovereign debt. All of these answers, however, have a limited shelf life, and will be tested over the next 12 months.

As a result, we believe investors can diversify their currency and interest rate risk by "going global," and expanding the horizons of their investment universe. From our perspective, the concerns of US investors can also be applied to Europe, the UK and Japan; we strongly believe, therefore, that when adopting a global approach to fixed income, investors probably should not follow bond indices. Bond indices are based on market capitalization; so the greater the volume of issuance, the heavier the index weighting. The bond index investor is therefore forced to buy increasing amounts of the bonds of those countries that are issuing large volumes of debt, and is thereby locked into those countries' declining credit story. Is there a better way?

Since the announcement by certain key investors of their dislike of the US Treasury market, the 10-year Treasury market has rallied, and yields have declined from their February peaks. Softer economic growth numbers and reiteration of a "lower for longer" mantra by the US Federal Reserve on interest rates have made this supposedly expensive market even more so. In measuring bond value, we believe investors ignore the power of the yield curve at their peril: compared to cash rates, longer-dated bonds are, historically, cheap. Absolute yield levels are low, but this a reflection of the current low cash rates. Inflation and other assets (equities) may provide a useful measure when global concerns begin to subside.

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*See disclosure on page 3.

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Commodity price inflation has been a further concern for investors during the early part of the year. Moving into the second half of 2011, however, it appears increasingly likely that these inflation expectations will subside. The year-on-year effects are such that yearly headline inflation statistics will likely be in decline. In the absence of a collapse in the European periphery, lower inflation expectations, together with Japan's return to normal, should, in our view, allow economic growth forecasts to rise once more.

Eventually current concerns might subside, which would lead to rising expectations of tighter monetary policy, and in turn raise questions about how best to diversify current "safe haven" assets. From our perspective, worries about declining credit quality and the potential for higher cash rates (eventually) could be applied to most developed markets, and each country would love to see its currency decline in value. The traditional global government bond indices are dominated by such markets; the US dollar, euro and yen make up just under 90% of global government bond indices.

When seeking to diversify away from these markets, we believe one must look for better credit quality, where higher official rates are already priced in, and a currency that has potential to rally. Many developing markets fit this description, but their local markets are, generally, small, and subject to manipulation. There are also a number of developed markets (Australia, Sweden, Norway, Canada, Switzerland and Denmark) that could also be placed within this category. The weightings of these markets in bond indices are small or non-existent, but their liquidity is more than sufficient for inclusion, and their share of world GDP or currency trade puts them in the top 30 countries. If the net is widened to include investment-grade developing markets such as the BRICs (excluding India), South Korea, Mexico, Poland, Malaysia, Singapore and the Czech Republic, the pool expands to encompass a truly global universe, which provides investors greater opportunity to diversify interest rate, credit and currency risk.

In putting this note together, we started to enter the debate about what is a developing and a developed market in this "all change" and global realignment phase. This is most likely to be the subject of a separate discussion, but at the end of the day, for a "safe haven"-oriented strategy, a stable investment-grade rating and good liquidity are the key characteristics.

Newton's fixed income team has followed this global approach to bond investing for many years, and both the opportunities and need to diversify have never been greater. Bonds and currencies are driven by monetary and fiscal policies which, since the credit crisis, have diverged greatly. Those countries that are not encumbered by legacy debt issues have raised interest rates and kept their government balance sheets clean. The resultant tightening of monetary policy in such countries (Australia, for example) leaves them with attractive bond yields and greater fiscal credibility. Those countries that must work through their debt problems will likely continue to finance their rebuilding through ultra-low rates and steep yield curves. We believe a diversified exposure to these different themes is an exciting way to reduce domestic risk.

Paul Brain

Paul is investment leader of the fixed income team. He joined Newton in 2004, and manages a range of global bond portfolios. He is also the lead manager of Newton's global dynamic bond strategy. Paul is chairman of the bond/ FX strategy group, and a member of the macro strategy group and the investment committee.

Paul has held a number of senior fixed income positions within the industry, and has acquired a wide breadth of knowledge and experience in managing fixed income portfolios. As head of retail fixed income at Investec (formerly Guinness Flight), Paul led the team that won the International Money Marketing "Fixed Interest Manager of the Year" in 2000.

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