



## Bond Alchemy: Conjuring Solutions to Sovereign Debt Problems

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### Executive Summary

Paul Brain, Newton's investment leader for fixed income, considers "creative" solutions policymakers might conjure up to address persistent investor concerns over Europe's sovereign debt problems. He points to the new instruments invented to deal with Latin America's debt problems in the 1980s. Meanwhile on the other side of the Atlantic, he argues that anxiety over U.S. credit risk will continue to rise until political leaders reach agreement on a credible debt management plan.

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Never underestimate the bond alchemists' (aka policymakers') ability to create something out of nothing. The coming months are once again full of difficult events and issues for the bond markets. These include the end of QE2 (the second round of quantitative easing in the U.S.), encroachment of the U.S. debt ceiling and the ongoing eurozone crisis. Not all of these issues will be resolved over the summer, but a clearer view may emerge towards the fourth quarter.

The news that Portugal has asked for funding from the European Commission raised the possibility that the three little periphery markets (the three little PIGs: Portugal, Ireland and Greece) could be funded using the existing structures and that the larger periphery markets (Spain and Italy) may be able to survive on their own. This prospect assumes that the property market problems in Spain are manageable and that the three little PIGs can achieve wage deflation and positive economic growth. However, we continue to believe that a restructuring of some peripheral debt is inevitable and, as yet, we do not have sufficient transparency regarding Spain to reach a conclusion.

In Europe, we believe the "bond alchemists" will work their magic to achieve lower borrowing costs and longer repayment schedules for the issuing countries. To do this, they must ensure three conditions: first, that the banks that hold the periphery bonds in the "hold to maturity" part of their books do not suffer a significant loss; secondly, that the issuing countries can return to the markets; and finally, that investors will be confident that these countries will not default. Lower borrowing costs and longer maturities may provide these countries with the time they need turn to their deficits around and put their debts on a sustainable path. The fact that the debt of Portugal, Ireland and Greece could be held increasingly by the authorities (European Central Bank) and European banks could make this alchemy easier. This form of "bond alchemy" was performed before during the 1980s, when Latin American debt was re-packaged

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\*See disclosure on page 3.

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and resold via the Brady bond plan.<sup>1</sup> We believe something similar needs to be considered for the three little PIGs. The exact mechanism is not yet visible, and unlike the Brady plan, the authorities do not have seven years to pull it together. Existing funding for Portugal, Ireland and Greece will start to run out next year, but the new European Stability Mechanism (ESM) funding facility will not kick in until mid-2013. A credible projection of better deficit management needs to be in place before investors are bound by the new "bail-in" clauses connected to the ESM.

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### **QE2 Sails into the Sunset**

Unlike some other bond commentators, we are not convinced that the conclusion of QE2 will be an instant negative event for the U.S. Treasury market. Much will depend on the underlying strength of the economy. It is true to say that some of the recent recovery in economic growth can be traced to official stimulus, either fiscal or monetary, but we believe not all. Will the removal of one element of monetary stimulus, i.e., QE2, as well as some fiscal stimulus, produce a sufficient slowdown to prompt fears of a "double dip," and give the bond market a reason to rally?

It is possible that the underlying economy in the U.S. may have moved to a more sustainable path, and does not need as much life support. We uphold the view that U.S. Treasury yields should continue to rise in line with the stronger economy, but we believe yields will not rise as high as some suggest. The other concern over which investors may pontificate is the credit quality of the U.S. government itself (particularly in light of the S&P downgrade of its U.S. ratings outlook). The U.S. is the only major country whose budget deficit is expected to continue to grow this year, yet no definitive plan to turn it around has been announced. Forthcoming debt ceiling limits have focused attention on this issue, and both sides of the political divide are putting forward their ideas as to how to address the situation.

As in the past when such issues have been debated, we believe these divisions are primarily ideological, and therefore it is difficult to see how a compromise will be reached, although in our view one will eventually materialize. The threat of default as the debt ceiling (U.S.\$ 14,294,000,000,000) is reached should ignite urgency to reach a compromise, but, in the meantime, anxiety over the credit risk of the U.S. will rise. So while the end of QE2 is not the only concern for U.S. Treasury investors, the fragility of the U.S. economic recovery suggests U.S. interest rates will not rise in the near term. We believe, therefore, that holding U.S. dollar-denominated bonds issued by other countries (with better credit stories) appears an attractive strategy to optimize returns, while we wait for the alchemic clouds to clear from global bond markets.

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<sup>1</sup> Brady bonds, named after former U.S. Treasury Secretary Nicholas Brady, were dollar-denominated bonds issued by Latin American countries that defaulted on their debts in the 1980s. They were created to allow commercial banks to exchange their claims on those countries into tradable instruments and to get the debt off their balance sheets.

## **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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