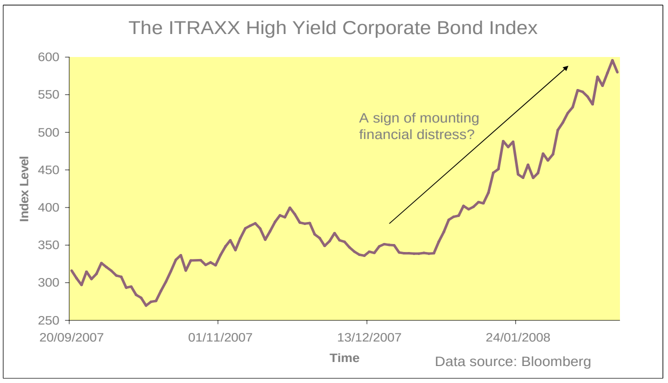
'Dancing on the motorway'
By Stewart Cowley

Newton Global Fixed Income Strategy
Overweight US duration; overweight long-dated bonds

There is no doubting that there is a serious problem in the credit markets which could have very real and very long-term effects on the financial system. You only have to look at how corporate bond spreads are behaving to see the truth of this. Indices like the ITRAXX Europe Crossover Index, which is a bundle of high-yield (sub-investment grade) bonds, have risen substantially (and especially since December 2007), indicating that yield spreads over government bonds are rising and the fear of default is increasingly stalking Europe (see chart below).



At this time nobody really knows the ultimate destination of credit but, as has been pointed out by our credit team here at Newton, when the turnaround comes there are going to be some real bargains out there for them to hunt down for our investors. Obviously, when the inflection point comes, government bonds are going to look pretty silly. For instance, who in their right mind REALLY thinks that a two-year-maturity US-government bond is anything but a guaranteed loss when it yields less than 2%, headline inflation is over 4% and the US stock market is down over 8% year to date (as I write).

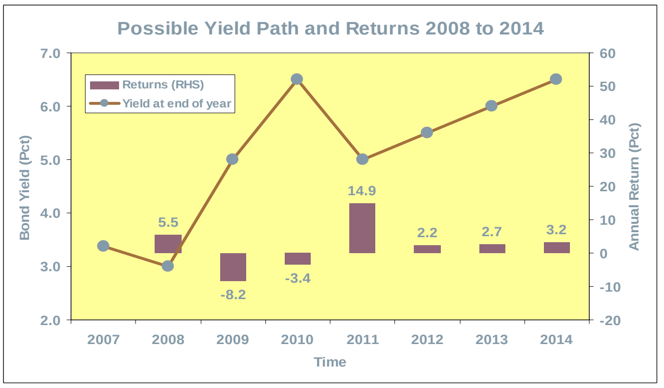
There is trouble brewing and although we acknowledge that for the duration of the reconstruction period, the US and other economies may well need a period of negative real interest rates to cope with the situation, from the point of view of a bond investor, when the turnaround comes we think it is going to be sudden and vicious. Having a long duration like ours, seeking the last part of the 'Great Bond Rally' that has been going on for the past 27 years really is like dancing on the motorway. You just know it's only a matter of time before you get hit by a truck, especially if any of you witnessed the dancing of the Newton fixed income team at the Christmas party last year.

To give you an idea of the financial dangers inherent in the bond markets in the coming years, we thought we'd have some fun and put together a yield path for a domestic government bond market (i.e. to currency or corporate bond returns) and then calculate the returns on an annual basis.

The scenario we used follows this scheme:

- Bond yields fall in 2008 as a response to the credit crunch.
- Some time in 2009 the market starts looking ahead to the next cycle and yields start to rise.
- Inflation becomes the world's major concern, together with the level of borrowing at a government level (particularly in the US), sending western-government bond yields higher.
- The yield and interest-rate increases in previous years causes a cyclical slowdown allowing yields to fall in 2010, instigating a recovery.
- The old problems resurface and there is a steady rise in bond yields in the subsequent years.

While performing the calculations there are a couple of assumptions (for example we are looking at market returns and not a managed portfolio), but the idea is to get a sense of things rather than over-complicate the situation. The results are shown in the chart below:



Source: Newton estimates.

As you can see in our scenario, bond returns aren't likely to be bad in 2008, but the rise in yields from a low base in subsequent years has some nasty consequences: back-to-back negative returns. Payback occurs in 2011 as yields fall but thereafter, with the best will in the world, domestic government bond returns just won't be competitive with cash returns or other asset classes if yields continue to rise.

This might all appear somewhat fanciful and it's certainly true that those low bond yields could extend into 2009. In that case we have nothing to fear from a turning point in the immediate future but at some point in the future we are going to have to cope with a cyclical, if not secular, turning point for yields and there just won't be enough coupon income on the table to compensate for the ensuing capital losses. There are various things we can do to protect client money from the ravages of the bond markets at this point of inflection. We could for instance:

- Hold a relatively high-duration strategy and try to call the turning point and recognise it for what it is when it shows up and reduce duration.
- Use call options on bond futures to implement our duration strategy.
- Systematically have a very low duration on our bond portfolios and give up on the idea of calling the turning point. We might miss the last part of the rally in favour of not being caught by a sudden rise in yields and, perhaps, experience a couple of years of underperformance in the process.

For the time being we don't have to make this call and, instead, we see the above as a road map for our behaviour rather than a discrete set of choices. So, as we move through the year, we will probably go from being long the markets to using options, and finally implementing a low duration and all the time acknowledge we are dancing baby, we are dancing.

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