

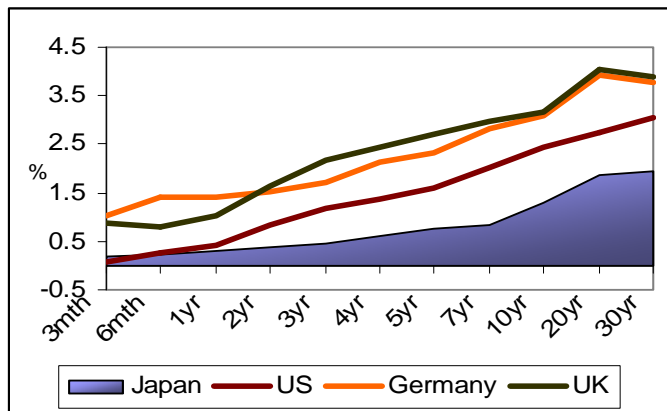


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## Welcome to the planet ZIRP

### Newton global fixed income strategy: overweight duration - for now

Since October, major Western government bond yields (in the US, the UK and Europe) have fallen to unprecedented lows. Global economic growth has fallen off a cliff and the authorities have moved beyond 'normal' monetary policy responses to adopt radical measures to combat the growing global slowdown. The expectation of a move to a zero-interest-rate policy (ZIRP) in the US (Fed Funds rate cut from 2% to 0.25% during the fourth quarter) has been enhanced by the Fed's expansion of its balance sheet and by talk of 'quantitative easing'. As we have highlighted in the past, there is a precedent for this kind of response in the form of Japan; using the Japanese yield curve as a template is a useful strategy. We have added longer-dated US and European government bonds to funds so that they can capture the convergence to the Japanese model.



Source: Bloomberg

Although some of this convergence has occurred already, we still have further to go, especially with maturities of more than five years and particularly in Europe and the UK. It is always better to travel than to arrive and the decline in long bond yields in the US in the last quarter has already led to a total return of 25.8% from US long bonds over that quarter. The outlook for the rest of the year is less certain. With mounting supply concerns and potential inflation problems, some investors argue that yields will have to shoot higher to attract demand. For the time being, we believe that we

are still travelling on the convergence path and that supply and inflation are worries for later in the year. Rising unemployment and increased domestic savings rates should keep demand for government bonds high.

Supply will not be an issue as long as investors believe there is no alternative to government bonds and as long as domestic savings rates continue to rise rapidly.

As we enter the New Year, there is usually an air of optimism which leads investors to look longer term and buy riskier assets. This particular phenomenon may have extra support from the inauguration of a new president on 20 January and from the announcement of another fiscal package. We have taken some of our government duration 'off the table' and increased our exposure to index-linked securities.

This early optimism could prove temporary as the economic slowdown continues and the full force of deleveraging (as anticipated in our *all change* theme) feeds through. Once the New Year shine fades, there will be renewed demand for safe-haven assets and US government bond yields should continue their convergence with lower Japanese levels. The best value appears to be in the ten-year area, which also has the attraction of being more liquid. The main support for US (and possibly UK) government bonds comes from the authorities' need to keep yields low. The land of ZIRP works only if it results in lower rates for the whole economy (including housing and consumer loans). Mortgage rates in the US are only just starting to come down and required the purchasing of mortgage bonds by the Fed to begin falling. Any significant back-up in government bond yields at this delicate stage for the economy would derail any nascent recovery in housing and would further enhance the damaging effects of the credit crunch on the consumer and corporates. We believe that long-bond yields approaching 3.5% could threaten planet ZIRP and may cause major seismic shocks. Money supply numbers are rising rapidly in the US and UK but the velocity of money remains very low. The authorities appear to have little control of velocity while the banks continue to rebuild their balance

sheets, meaning that they are likely to overdo it on the money supply. A pick up in velocity requires a working banking system and a willingness to lend. We are not there yet, so all the concerns about crowding out and inflation seem premature.

The high-grade corporate bond market has priced in the worst outcome and, with the greater prospect of bond buy backs, choosing the survivors in this difficult environment could be very rewarding.

Another asset class that has priced in a poor 2009 is the inflation-linked markets. Fear of deflation remains justifiably high but the market seems to believe that deflation will be with us for many years. If the US Treasury Inflation-Protected Securities market is right and we are looking at an average deflation rate of 0.5% for the next 5 years, there are other asset classes that should take note. The absence of monetary velocity means the authorities have to throw money into the pot. We believe this liquidity will ultimately prove too much for the economy and we will see it seep out in the form of inflation. For now, we are content to buy the inflation-linked markets when they have overpriced deflation expectations rather than anticipate when inflation will return. Finally, seeking higher yields from government-guaranteed paper seems a sensible thing to do during this phase of low absolute yields. Agency, supranational and government-guaranteed bank paper

can be utilised in this way. For now, the majority of duration risk should be focused on US, UK and German government issuers, but eventually other European issuers can be considered. This more diversified European government stance will probably have to wait until there is a much greater potential turnaround in the global economy but, with spreads as wide as 150bp between Germany and Italy, it is worth beginning to consider.

Currencies continue to develop along the 'which is the ugliest' theme. In a global recession, it is hard to find a currency that will outperform. There are two areas which we will look to explore. The first of these is the notion that commodity prices are too low; rising government infrastructure spending means that some of the commodity-based currencies are offering good value. The second is that the euro could be undermined by the fact that the European Central Bank might be 'behind the curve'. The US dollar (and later sterling) could benefit from a growing belief that the US could come out of this recession faster than the rest.

**We are reaching a significant turning point in the authorities' efforts to solve the financial crisis. Government bond markets should continue to benefit and a more diversified bond allocation should be planned for.**

#### **Important Information**

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