

# The end of 'Top Gear' economics

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## Reducing duration in Western government bond markets; adding inflation-linked bonds in UK and US

The trouble with economic statistics is that they really don't discriminate between "good" and "bad" economic activity. For instance, the sale of drugs to combat lung cancer and the selling of cigarettes are both included in GDP statistics as if they were *both* equally positive for society and economic health. In the same vein, the last 18 months have given us a lesson in the difference between "good growth" and "bad growth" writ large. The implosion of our banking system has revealed the bad growth in our economies: the over-reliance on financial engineering to propel GDP. This, in turn, warped our value systems and created the illusion of economic wellbeing that saw us sitting in front of our television sets of a Sunday night casually nodding in agreement with the Top Gear presenters that "yes, £150,000 is actually quite a reasonable price to pay for a car; in fact it looks positively the best value – in the world", without any real sense of irony.

Clearly, the recalibration of values is going to take time, but time is what the markets do not want to take. They want a quick fix. There are signs of healing occurring within the money markets: the difference between market rates and 'riskless' rates has fallen substantially over recent weeks and the Federal Reserve has stepped in to recreate the commercial paper markets. This will begin the process of circulating money in the US economy once more. This is all good, but it amounts to just the first baby steps. In reality, the fixing of the financial system is a process rather than an event.

Government bonds have had a terrific run this year on the flight to quality and economics story but, with increased issuance now on the table, the tug between future interest rate reductions and supply will preoccupy bond holders. In the US, leaving aside florid electioneering, we really don't know what the policies of President-elect Obama will be. However, all the signs indicate that the \$700 billion that America has awarded itself of the world's money (the US has a zero or negative savings rate don't forget) won't be enough and we can only expect that the competition

between the public and private sector for capital will hot up in 2009 as the deficit increases yet further. The same is true in the UK; so, it remains to be seen whether 3% or 4% Western government bond yields will be sufficient to keep the attention of the nations who have money in their bank accounts, or whether they will direct it instead to their domestic economies (as the Chinese are doing). The danger is that government bond yields will have to rise to attract capital and that the great bull run in government bonds will be over. Of course we should be alive to the idea that the final desperate act of a series of increasingly desperate acts will be that the US engages in market manipulation and starts the process of quantitative easing (which would see US bond yields levels converge with Japanese bond yield levels). However, that scenario appears to be some time off right now. Before it gets to that point, the US Treasury will want to see if it can spend its way out of this mess without sending bond yields spinning higher (which would create the self-defeating situation of increasing mortgages rates which would choke off any nascent recovery inspired by government spending).



Let's assume that the fiscal packages work (and we all sincerely hope that they do). Two great opportunities have come to light in the bond markets. If there is a "killer graph" that will define our lives for the next couple of years, it's the one above, which illustrates the divergence of corporate

bond spreads from assumed inflation rates implied by Western inflation-linked bonds.

First, if you can get hold of them, investment-grade corporate bonds look good value: yield spreads are now generous by any measure. Availability is poor, but some perfectly sound companies now offer excellent investments for those who have the luxury to buy and hold to maturity over the next half decade or so. Also, Western inflation-linked bonds have discounted extremely low inflation for a considerable period of time; this is true in the US, UK and Europe. Given that we *still* live in open capitalist systems and that plenty of money will be sloshing around soon, it is difficult to

accept that inflation, *per se*, has been confined to history. The collapse of implied inflation rates to below or near zero makes inflation-linked bonds a good hedge against future economic recovery. This is especially true if we have secondary effects from currency movements, for example the rapid decline of UK sterling against the major currencies that has occurred in the last few days or a future decline in the US dollar as it loses its short-term, safe-haven status.

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