

## Global Investing

A view from the top: go global in fixed income and currencies

The rationale for investing in global fixed-income securities used to be founded upon the existence of a weak local currency. There are now many more reasons to invest in overseas fixed-income markets. Diversifying away from a domestic market in which the central bank is running the risk of inflation and in which the government is not addressing debt challenges adequately seems a sensible idea. Investing in the bond markets of fiscally responsible countries in which inflation is poised to stay low gives investors a potentially attractive alternative. Global currency investing can potentially benefit investors with better economic growth and higher interest rates around the world.

Following more than 25 years of declines in U.S. government bond yields, the beginnings of a reversal may well be imminent. The trough in government bond yields occurred at the end of 2008 and, after a brief climb, they have remained relatively stable at historically low levels since.

Over the last quarter of a century, a large part of the world's manufacturing base has shifted to China, where the comparative advantage afforded by low wages provided a steady global disinflationary impulse. The U.S. dollar revenues China has earned have been recycled into U.S. government bonds, thereby keeping U.S. interest rates low and creating a symbiotic relationship between the Chinese producer and the U.S. consumer. Low rates created the backdrop for a vast accumulation of debt, which supported growth but also fuelled a debt bubble which has now landed most notably in the lap of the U.S. government.

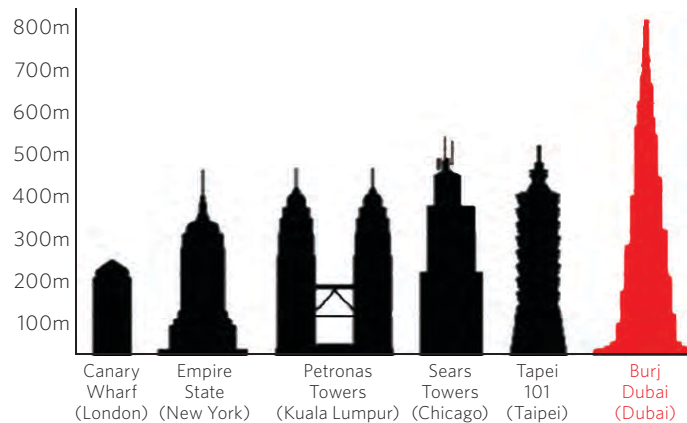
Low U.S. interest rates were also "exported" to places like the Middle East via exchange-rate links and by virtue of the fact that major revenue earners set prices in dollars. The culmination of this low-rate-fuelled debt explosion is symbolized by the newly opened Burj Khalifa building in Dubai, the world's tallest by some margin. The building was renamed in honor of the ruler of Abu Dhabi, in recognition of the financial support that Abu Dhabi has provided to Dubai.

## World's Tall Buildings

There seems to be a positive correlation between tall buildings and periods of excess. A previous record-holder, the Petronas Towers in Kuala Lumpur, was finished just after the Asian crisis, and the Empire State Building in New York was finished two years after the 1929 stock market crash. As with the Canary Wharf in Canary Wharf, London, such buildings usually depress surrounding property prices for many years to come.

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### World's Tall Buildings



Source: Wikipedia

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As the world adjusts to the fallout from the recent debt crisis, there may be significant opportunities for U.S. and U.K.-based fixed-income investors, but such opportunities are likely to lie overseas. After many years of coordinated monetary and fiscal policies, the likelihood in the period ahead is that different countries will adopt different approaches to tackling the government debt crisis. There is a clear divergence, for example, between the indebted Western economies' approach and those in the "East" (excluding Japan) and emerging markets. Even within Western economies, there are differences in approach.

As the world economy seeks to move out of recession, some significant headwinds still need to be faced. Large government budget deficits must be reined in and ultra-loose monetary policies will have to be reversed. We believe the pace and extent of these events will be the driving factor for asset-market returns for the rest of 2010.

The authorities in the U.S. seem reluctant to turn their attention to reducing the size of their fiscal deficit. The Federal Reserve will not want to repeat its own mistakes of the 1930s or those of Japan in the 1990s by raising rates prematurely. Economic growth could surprise positively as the combination of a depressed currency and very loose policy brings investment forward. Stronger growth and a lack of fiscal discipline, together with a politically influenced central bank, could create a dangerous cocktail for the U.S. bond market and U.S. investors might be better served by investing overseas.

The U.K. is in a similar position, but with a looming general election appearing to stand in the way of an imminent plan. The possibility of a new government lacking the majority required to force through the necessary changes should not be ignored.

Policymakers' bias remains to err on the side of allowing excess inflation pressure, rather than risking tightening policy too soon. In Europe, the full extent of the recession has yet to be felt, but government debt overhangs in Greece, Ireland and Spain are forcing significant public spending cuts. The negative effects on growth are likely to be felt over the next two years in Europe, and inflation should remain low. Lower inflation, stable short rates and fiscal austerity are a good combination for the European government bond markets.

Currency management needs to be kept separate from bond allocation decisions. What is good for a bond market is not so good for a currency (and vice versa). Currencies in Asia and emerging markets may offer good opportunities as they are supported by rising interest rates, sounder fiscal positions and stronger economic growth. Using that simple basis for valuing currencies, there are other more "mainstream" currencies such as the Australian dollar and Norwegian kroner that could be of interest to the U.S. or U.K.-based investor. The euro could also strengthen once the benefits of fiscal austerity start to come through.

Another way to take advantage of diverse global monetary and fiscal policies is to buy the debt of an issuer with an improving credit backdrop (such as Brazil), but in a currency in relation to which rates are staying low (such as the U.S. dollar), and to hedge the U.S. dollar back into the Brazilian real in the "forward" market. Investing directly in the Brazilian local market exposes the investor to the negative effects of rising Brazilian rates, but owning Brazilian debt should be preferable to owning U.S. Treasuries as Brazil's budget deficit is likely to fall faster than that of the U.S.

With the increasing globalization of asset markets, there are more reasons than ever before to broaden the opportunity set for bond and currency investing. As mentioned, investors can potentially benefit from the diversity of monetary and fiscal policies around the world. We believe investing in the bond markets of more fiscally responsible countries with low inflation can provide an attractive alternative to domestic markets for some investors. Given recent developments in European sovereign debt, it is especially important for managers to monitor carefully the credit risks associated with any issuer. Taking a global approach to currency management also allows investors to take advantage of better growth prospects and higher interest rates across world markets. We believe a global bond and currency approach is now more important than ever.

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### **Paul Brain**

Paul is Investment Leader of Newton's Fixed Income Team and Chairman of Newton's bond and currency strategy group. Paul has 25 years' experience managing complex fixed income portfolios. He joined Newton in 2004, having held a number of senior fixed income positions within the industry. He is a Stage II Candidate with the Chartered Institute of Bankers.



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