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## This, too, shall pass

“Gentlemen prefer bonds.”

- Andrew Mellon.

All good things must come to an end. While many within the investment community have been wondering aloud whether stocks have entered a new **bull** market – unlikely, we feel, unless equities have now become inversely correlated to economic fundamentals – some of us have been increasingly wondering whether government bonds, most notably UK Gilts, but not ignoring the 1,000 lb gorilla that is US Treasuries, have entered a new **bear** market.

Even to suggest as much is to fly in the face of much economic theorizing – which is surely as good a reason for doing so as any. Conventional thinking has it that Gilts are the “go-to” asset in a supposedly deflationary recession, and a number of fund managers – most notably Eclectica’s Hugh Hendry – have gone on record with their fondness for owning government debt.

Put, just for one moment, the theorizing to one side, and simply look at the price action. Gilt yields, which move inversely to Gilt prices, have started rather ominously to rise. The last 12 months’ trend in 10 year Gilt yields is shown below:

### The only way is up ? 10 year Gilt yields, last 12 months



It made sense for benchmark Gilt yields to fall when the Bank of England was busily slashing at the base rate this past year – from 5% in October 2008 to just 0.5% in March 2009. But now that policy rates cannot go any lower, one has to ask whether Gilt yields can realistically go much lower either. Certainly that has not been their experience since March of this year; having cratered at just below 3%, Gilt yields have risen, in fits and starts, to around 3.75% currently.

Gilt bulls would point to quantitative easing in their defence – the process whereby the Bank of England purchases Gilts from banks and hopes that the money will somehow find its way into the real economy, as opposed to being hoarded by the selfish morons who brought us the banking crisis to begin with. But Gilt bears could easily point to the same trend – because the Bank of England is rapidly becoming the only buyer in town. Schroder Investment Management, the second largest holder of Gilts in the UK institutional market, revealed in an interview with Bloomberg this week that it had cut the holdings of Gilts in its global fund to “near zero” as Britain’s public finances are incinerated by the incumbent Labour administration.

“The UK clearly has a structural problem as it is spending more than it can justify,” Schroder fund manager David Scammell told Bloomberg; “Our international portfolio has effectively got rid of Gilts in the last month or two to near zero. The fiscal outlook just doesn’t work. There has to be a real chance that the UK will lose its top rating.”

Here Mr. Scammell was referring to the actions of Standard & Poor’s, which lowered its outlook for the UK’s AAA credit rating from “stable” to “negative” on May 21, citing the growing British burden of public debt. One can reasonably ask why anyone should trust the ratings agencies as the conflicted cheats that helped keep the securitized mortgage bubble aloft, and anyone who has worked in the bond market is well aware that the market is a lot more intelligent and fast-acting than the agencies – note, for example, the recent rise in yields that predated the S&P announcement. Nevertheless, the S&P warning served as a belated reminder that governments cannot borrow beyond their means indefinitely. The UK government is on course to sell a record £220 billion of Gilts in the fiscal year ending in March 2010. Provided it can find somebody, other than the Bank of England, to buy them. Following Chancellor Darling’s somewhat optimistic Budget, which incorporated some superheroic growth forecasts, Patrick Perret-Green of Citigroup suggested that

“If market participants want to believe in this ridiculous outlook then they should prepare to suffer significant losses. Buy Gilts at your peril.”

Not that a fragile economy assailed by mountains of government debt is a structural problem limited to the UK. Investment commentator John Mauldin points out that total US debt now stands at \$11.3 trillion and is rising fast. The Obama Administration forecasts that that figure will rise another \$1.85 trillion this year and \$1.4 trillion next. The Congressional Budget Office projects almost \$10 trillion in additional debt between 2010 and 2019.

“The world is going to have to fund multiple trillions in debt over the next several years. Pick a number. I think \$5 trillion sounds about right. \$3 trillion is on the cards for the US alone, if current projections are right.. Just exactly where is that money going to come from ? US savings are going to go up, but where is the incentive to buy 10 year debt at 3.5% ? Four year debt under 2% doesn’t do much for your savings growth. Even with monetization and the Chinese buying our debt with the dollars we send them, that still leaves the bond market about \$1.5 trillion short, give or take \$100 billion.”

That assumes, of course, that the likes of China and Brazil will be comfortable holding and using the US dollar as a reserve currency. They are already looking at replacing it as a means of exchange in trade transactions. As former Morgan Stanley economist Andy Xie wrote recently in the Financial Times, “If China loses faith, the dollar will collapse”. And Mauldin points out that a

fast deleveraging world, with debt being drawn down, securitization largely stopped, banks withdrawing from lending, home prices falling, and unemployment rising, these trends should all be massively deflationary. Interest rates should be falling. **But they are not.** US Treasury yields are also on the rise:

### 10 year US Treasury yields, last 12 months



There is a simple answer to why Anglo-Saxon government bond yields are rising when, given the economic bigger picture, they should otherwise be falling: **supply**. The US has committed something like \$15 trillion to “rescue” the economy from the credit crisis, housing crisis and recession. Barry Ritholtz in his new book ‘Bailout Nation’ indicates that \$15 trillion in inflation-adjusted terms is more than the cost of the Louisiana Purchase, the Marshall Plan, the moon landings, the S&L crisis and the Vietnam War all put together. Only World War II comes close to that overall cost. That money does not exist today. Almost all of it must be borrowed. In the form of government bonds. At a time when many other western governments are desperate to raise money. Hmm..

In our own Gilt funds, which never contained longer dated holdings to begin with, we have now liquidated all conventional Gilts longer than five years to maturity. Longer dated Gilts will exhibit more marked price volatility and stand to lose most in a bear market fuelled by concerns about future supply. They will also be more vulnerable to the inflation that we and others anticipate as a longer term result of the extraordinary coordinated international stimulus of the past 18 months. Shorter dated Gilts still have a place for those concerned about the ultimate safety of bank deposits, but the prospect of further capital gains from them is modest at best. Gilt investors may wish to consider reducing if not eliminating their holdings, in favour of building positions in the most creditworthy investment grade corporate and sovereign issues internationally, which thanks to global deleveraging are currently available at heavily discounted prices.

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