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Whose default is it, anyway ?

“Government bonds are now an extremely poor investment.”

- Société Générale Global Strategy Outlook, 1 December 2009.

As Detective ‘Dirty’ Harry Callahan once said, a good man always knows his limitations. The employees of investment banks are not always the first to concede to any kind of limits with regard to human intelligence, insight or fortune-telling. Bloomberg reported on Friday the opinion of [name withheld to avoid embarrassment], an interest rate strategist at [name of bank withheld to avoid embarrassment]. [Name withheld to avoid embarrassment] has just joined [name of bank withheld to avoid embarrassment] having previously worked at another bankrupt investment bank, namely [name of Wall Street bank withheld to avoid embarrassment]. His opinion is that US Treasury bonds are outrageously cheap and that next year will be the year of the bond. He may be right.

On the other hand, he may be catastrophically wrong. His employer, for example, which is effectively in government ownership having wrecked its own balance sheet and impoverished most of its shareholders, is also the UK bank with the single biggest exposure to the troubled holding company Dubai World. (As Shakespeare once said, when sorrows come, they come not single spies, but in battalions.) Never mind. His previous employer, a US investment bank that wrecked its own balance sheet and impoverished most of its shareholders, is now a unit of a commercial bank that itself required emergency government support. Never mind. You can’t necessarily be right all of the time. Or indeed any of the time.

Other than taking seriously advice on debt management from a representative of two separate organisations that have spectacularly failed to conduct that activity sensibly, what else might make us sceptical of the supposed merits of US Treasury bonds in the year, and years, to come ? Here is Edmund Andrews of the New York Times:

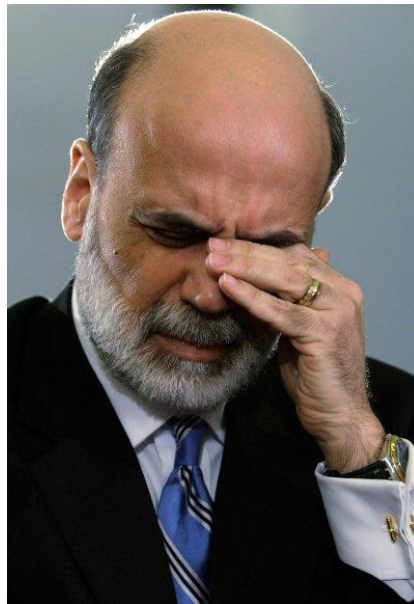
“The US government is financing its more than trillion dollar a year borrowing with IOU’s on terms that seem too good to be true. But that happy situation, aided by ultra-low interest rates, may not last much longer. Treasury officials now face a trifecta of headaches: a mountain of new debt, a balloon of short-term borrowings that come due in the months ahead, and interest rates that are sure to climb back to normal as soon as the Federal Reserve decides that the emergency has passed. Even as Treasury officials are racing to lock in today’s low rates by exchanging short-term borrowings for long-term bonds, the government faces a payment shock similar to those that sent legions of overstretched homeowners into default on their mortgages. With the national debt

now topping \$12 trillion.. an additional \$500 billion a year in interest expense would total more than the combined federal budgets this year for education, energy, homeland security and the wars in Iraq and Afghanistan. “The government is on teaser rates,” said Robert Bixby, executive director of the Concord Coalition, a non-partisan group.. “We’re taking out a huge mortgage right now, but we won’t feel the pain until later.”

Traditional responses to G7 government bond markets – viewing them as essentially riskless – are no longer appropriate. Ratings agency Moody’s warned two years ago that the US risked losing its triple A credit rating if it did not start putting its finances in order. Its finances have deteriorated markedly since then. As David Walker, former Comptroller General of the US, points out,

“How can one justify bestowing a triple A rating on an entity with an accumulated negative net worth of more than \$11 trillion and additional off-balance sheet obligations of \$45 trillion ? An entity that is set to run a \$1,800 billion-plus deficit for the current year and trillion dollar-plus deficits for years to come ?”

Well, do you feel lucky ?



Things are no better closer to home. Morgan Stanley, an investment bank that also knows a little about coming close to financial failure, warned last week that

“..in an extreme situation a fiscal crisis could lead to some domestic capital flight, severe pound weakness and a sell-off in UK government bonds. The Bank of England may feel forced to hike rates to shore up confidence in monetary policy and stabilize the currency, threatening the fragile economic recovery.”

That UK Chancellor Alistair Darling has apparently chosen to defer any form of fiscal austerity and instead has elected to soak the rich is not necessarily a move that will improve the national finances, rather pander populistically to New Labour’s shrinking socialist support base. But why change the habit of an entire administration ?

2010 will only turn out to be the Year of the Bond – in a good way for government bond-holders – if the Anglo-Saxon economies roll over and investors are once again gripped by deflationary

angst. In almost all other scenarios it is very difficult to get excited by the investment prospects of five year Gilts, for example, yielding just 2.5%.

2010 could, on the other hand, be the Year of the Bond in a peculiarly bad way for government bond-holders. Kenneth Rogoff, former chief economist for the IMF, told Jeff Randall last week that so many countries are vulnerable that it is difficult to know where a debt crisis could next pop up. Perhaps [name withheld to avoid embarrassment] might care to respond to that.

Our take is that the deterioration in the outlook for mainstream government debt is also consistent with a deterioration in the outlook for the currencies in which that debt is denominated (and the accelerating deterioration in local currency terms would mark something approximating to implicit default). That said, bearishness with regard to the US dollar is now so widespread that the prospect of a counter-trend rally – particularly if accompanied by a correction in financial asset prices, notably equities – should not be overlooked. On the back of such a dollar rally, and the weakness in the gold price that would be logically consistent with it, we would be buying precious metals with renewed conviction. The macro uncertainties are huge – as evinced by the hugely divergent views of government bonds cited here by different investment banks. The world is becoming a more, not less, dangerous place, and truly safe assets are becoming increasingly difficult to find.

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