

View from the

trading floor

Our Fixed Income team set out their latest views on the issues that are driving markets

US downgrade

- The cut in the US credit rating to AA+ has not had a significant impact on US Treasuries. The risk of a downgrade had already been flagged (as the US rating had been put on “negative watch” by S&P) and the deterioration in the US finances as well as rising political risks has not gone unnoticed by markets. In addition, the action taken by S&P may well act to strengthen the resolve of US policymakers to do what is necessary. However, the concern is that ratings sensitive investors may be forced to reduce their holdings. Given that both Fitch and Moody’s retain a AAA rating for the US at the current time should limit forced selling pressures based on rating. Note that US two year yields have hit new lows (0.25% on the two-year note) Monday morning as investors continue to see the US dollar as a safe haven.
- Longer term we expect to see stronger demand for AAA-rated government bonds as an alternative which should be supportive for yields on UK gilts, Australian government bonds, German bunds and AAA-rated covered bonds as a means of diversifying exposure away from a further deterioration in the US position.
- On the credit side, the downgrade of the US government has led to similar downgrades for agency mortgage backed securities issued by Freddie Mac and Fannie Mae due to their direct reliance on US government support (confirmed Monday afternoon). Bank credit ratings have been enhanced (uplifted) in the past for “systemic government support”, but in our view the risk of ratings downgrades for the large US banks is low as the legislation changes (e.g. Dodd-Frank) have weakened the link between the government and the bank ratings. Of more concern is the risk that this downgrade will push up the cost of funding for banks – particularly in repo markets where US Treasuries and Agency bonds accounts are the majority of collateral posted on repo transactions. We continue to monitor the situation closely.

Global growth

- The weakness of recent macroeconomic data (despite a slightly better-than-expected payroll report in the US on Friday) has increased demand for safe haven government bonds. One example of this is in the Australian government bond market where markets have gone from pricing no rate hikes over the next year to 1% of cuts in the space of a month.
- In general, the growth slowdown will require short-term interest rates to remain lower for longer in both developed and emerging markets. Our expectation is that a second global recession will be avoided (although, certain countries will struggle to avoid recession e.g. peripheral Europe) and the current weak patch will prove to be temporary, with a return to a sub-trend pace of recovery. With government bond yields hitting new lows over the last month, we are increasingly minded to establish a short position, but we need to see more stability in markets and the underlying economic data before we take a material negative view.

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Euro sovereign debt crisis

- The decision of the European Central Bank (ECB) to use their securities purchase programme (SMP) to buy Spanish and Italian government bonds is an important step to reduce/stem contagion in the eurozone and keep cost of funding for these larger economies at affordable levels. Using the bond purchases to appease market concern over Italy and Spain is an understandable and necessary move given the ineffectiveness of actions and rhetoric last week.
- This buyer of last resort action should help to stabilise the market in the shorter term, but we do not expect the ECB to continue to do this indefinitely. The immediate impact has been to reduce bond yields considerably (see chart of ten-year Italian government bond yields below), but questions remain about the sustainability and firepower of the ECB to continue buying, given the amount of Spanish and Italian bonds outstanding.
- The political ramifications of these moves are high. Bailing out of profligate nations runs counter to the basic Euro treaty principles. Ultimately, the ECB wants European governments to instead use the European Financial Stability Facility (EFSF) to “rescue” highly indebted countries; German and other ECB members reportedly disagreed with the Portuguese and Irish open market bond purchases last week. If the ECB purchases are used as a bridge to greater EFSF funding, the EFSF is too small as it currently stands and ratification of broadening its funding capability would not be straight forward. The US downgrade suggests that other core European countries such as France may see their rating come under pressure, and therefore be less willing to commit more guarantees to the EFSF as this could accelerate such ratings pressure.
- In the medium-term the challenges are two-fold: firstly, the need to run balanced budgets (Italy has little room for slippage given its high debt to GDP) and secondly, deliver meaningful growth to erode the burden of debt over time. Whilst ECB actions attempt again to address the current concerns with solvent Euro nations being dragged into a liquidity crisis, there remains the major issue of the outlook for growth in these countries going forward given the need for fiscal austerity and no control over monetary policy.
- To date, the political inertia and abject lack of expediency is troubling and reveals a fundamental lack of understanding of how quickly uncertainty can impact a capital market. This again leaves little in the way of confidence in how a future crisis will be handled and heightens the likelihood of policy error.

Portfolio activity

Rates strategy

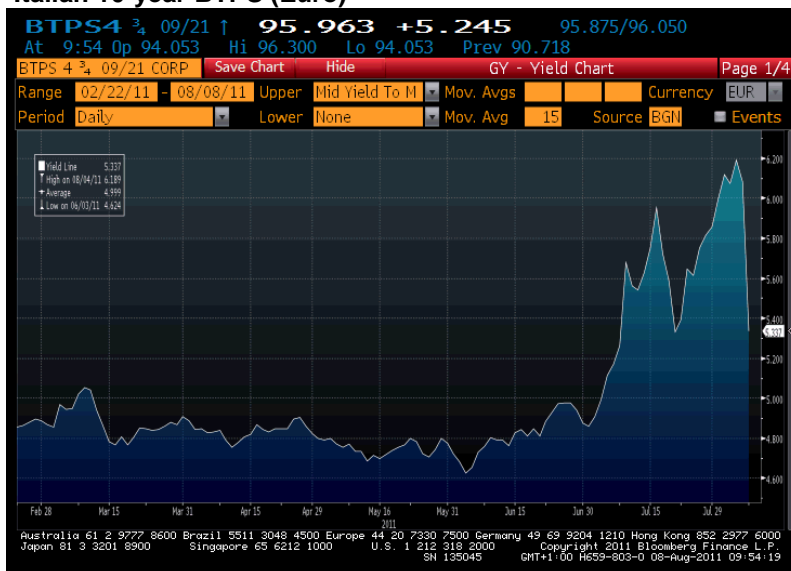
- We have closed our short position in Australian government bonds as the US downgrade has increased demand for higher-yielding AAA-rated government debt. This was paired with a long position to the US market which has also been closed.
- We have reduced/hedged our position expecting UK RPI inflation to rise as strong demand for UK gilts and increased risk aversion will push breakeven-inflation levels lower

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Credit strategy

- Post Lehman, credit markets in particular have no appetite to understate “tail” risk. In this environment, we have remained active, maintained an underweight to corporates in peripheral eurozone countries in credit benchmark funds and moved towards a more neutral stance.
- There is a risk that the recent market volatility may cause a broader drop off in demand as business and household confidence falls. This transmission mechanism would lead to downward pressure on the broader credit market, rather than just be confined to more peripheral names. In an environment where the credit market is still markedly more expensive than the distressed price levels of the 2008/9 (and where the downside could be greater), we are watching very carefully for cheaper moments to establish both positive and negative positions.

Italian 10-year BTPS (Euro)



Source: Bloomberg, at 08 August 2011

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