



BNY MELLON  
ASSET MANAGEMENT



**Paul Brain**  
Investment Leader  
Fixed Income  
Newton

Newton Investment Management Limited is based in London, and recognised as a top-tier UK investment house, renowned for its distinctive, proven global thematic investment approach, consistently applied across all strategies.

**NEWTON**  
The Power of Ideas

## The year of the 'exit strategy'

Next year is likely to be the year of the 'exit strategy' for central banks. In a two-speed world economy, those economies with large debt burdens will exit through fiscal tightening, while others will rely on monetary tightening. This difference will have a profound effect on the bond and currency markets, and should lead to some significant investment opportunities.

A slow improvement in a variety of leading indicators and business confidence surveys across western economies is consistent with a return to positive economic growth across much of the globe. Unemployment, however, will remain high across the West, with job insecurity and the spectre of increasing fiscal austerity likely to ensure consumer confidence remains subdued. Monetary policy is already being tightened in those less indebted economies which are supported by high commodity prices.

### The West tightens its belt

One consequence of the growing deficit problem in western economies is the need for interest rates to stay lower for longer; another is the inevitable focus on higher taxes and lower government spending. Given its fragility, a tightening of fiscal policy in the West may have to wait for more convincing signs of economic recovery; indeed, some countries are still talking of further fiscal stimulus. The housing support scheme in the US has come to an end, but Congress is expected

to vote in another group of measures which could deliver another US\$90 billion of fiscal stimuli over the next 12 months. After that, a series of tax changes come into effect that should entail a tightening of fiscal policy and help rein in growth.

In the UK, there are already measures in place to increase the overall tax burden – in the form of value added tax, national insurance and income tax – in the first four months of 2010. However, these measures alone will not be enough to reverse the dramatic build-up in deficits or to stem the tide of government bond issuance. The next UK government will be obliged to put in place reduced spending plans and tax increases that start to fully address the problem.

For now, the view of the rating agencies is that sovereign debt servicing costs are moving closer to the edge of their 'comfort zone' but, providing that they can see a credible 'glide path' (through fiscal measures, asset sales and growth) back to a lower level of future debt costs, even a sharp rise can be tolerated in the interests of re-invigorating economic growth.

Meanwhile, a prolonged period of near-zero interest rates will push investors into bonds. Pension funds, insurance companies, endowments and retired individuals living on an income have already been steady buyers of government debt. These buyers,

together with bond-hungry banks, have taken up the extra new issuance comfortably and more than counteracted the small reduction in demand from foreign central banks. However, when the official quantitative easing measures stop, it will be up to the banks to take up the reins and buy government bonds in order to improve their liquidity 'buffers'.

### History lessons

We continue to refer to the early 1990s as a template for the current environment. Back then, there was a post-recession environment in which interest rates were kept low for a prolonged period and the emphasis was on fiscal tightening further down the road. The three years from 1990 to 1993 amounted to one of the best periods for bond investors as bond yields fell and investors made 36.5% by investing in the US government bond markets.

Unfortunately, in 1994 bond markets grew increasingly concerned that central banks were going to be too slow to raise rates and that inflation would rise substantially as a result. Bond markets bore the brunt of these worries.

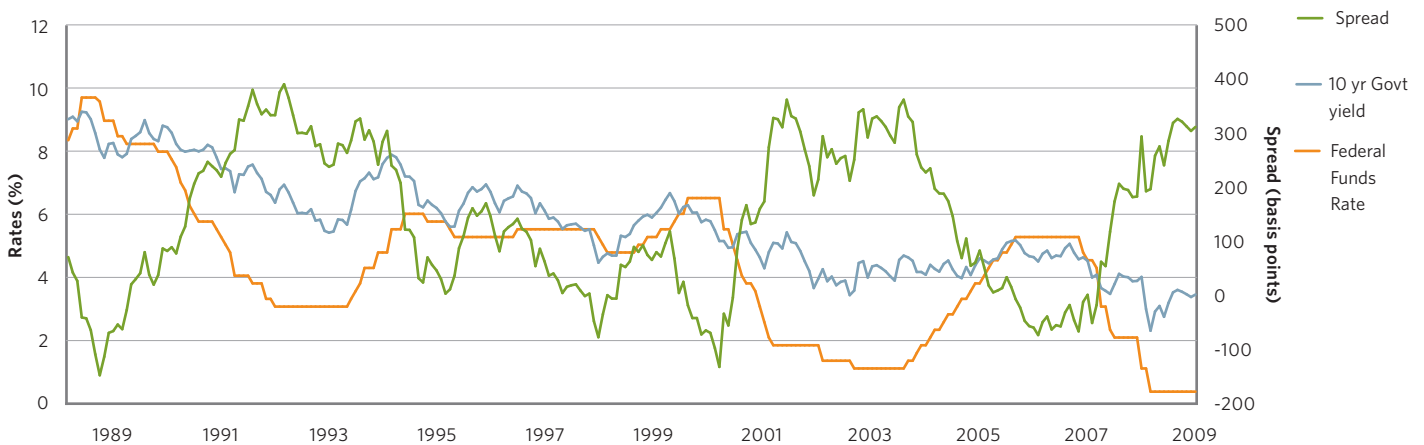
With interest rates in the West set to remain at their extreme lows for an extended period, their currencies will continue to be used as the funding currencies for 'carry trades'. This combined with the growth of the 'pro-risk trade' and general rise in interest rates in other countries is likely to lead to a global shift towards commodity-based and Asian-linked currencies.

Currency markets, therefore, should present significant opportunities over the coming months as diverging economic prospects and abundant liquidity drive

respective currency valuations apart. Over the medium term, currencies which are supported by sound economic fundamentals, and which are well placed to benefit from an Asia-led economic recovery and a rise in commodity prices (such as the Australian dollar and the Norwegian krone) look attractive. Selective Asian currencies themselves (the renminbi and the South Korean won included) can also be expected to appreciate as part of a continued global economic realignment over the medium term.

Bond yield volatility could be an increasing feature over the next 12 months as investors grapple with large amounts of supply and the possible exit strategies of authorities. Those bond markets that are supported by continued low interest rates and fiscal austerity should benefit from such an environment.

## US INTEREST RATES



Source: Datastream as at 30th Sept 2009

[www.bnymellonam.com](http://www.bnymellonam.com)

The statements and opinions expressed in this article are those of the author as of the date of the article, and do not necessarily represent the views of The Bank of New York Mellon Corporation, BNY Mellon Asset Management International or any of their respective affiliates. This article does not constitute investment advice, and should not be construed as an offer to sell or a solicitation to buy any security or make any offer where otherwise unlawful. BNY Asset Management International Limited and its affiliates are not responsible for any subsequent investment advice based on information supplied. Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investments you may get back less than you originally invested. Portfolio holdings are subject to change at any time without notice, are for information purposes only and should not be construed as investment recommendations. This is not intended as investment advice but may be deemed a financial promotion under non-US jurisdictions. The information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors. This document should not be published in hard copy, electronic form, via web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management International Limited. In Australia, this document is issued by BNY Mellon Asset Management Australia Limited (ABN 56 102 482 815, AFS License No. 227865) located at Level 6, 7 Macquarie Place, Sydney, NSW 2000. Authorized and regulated by the Australian Securities & Investments Commission. In Brazil, this document is issued by BNY Mellon Serviços Financeiros DTVM S.A., Av. Presidente Wilson, 231, 11th floor, Rio de Janeiro, RJ, Brazil, CEP 20030-905. BNY Mellon Serviços Financeiros DTVM S.A. is a Financial Institution, duly authorized by the Brazilian Central Bank to provide securities distribution and by the Brazilian Securities and Exchange Commission (CVM) to provide securities portfolio managing services under Declaratory Act No. 4.620, issued on December 19, 1997. In Canada, interests in any investment vehicles may be offered and sold through BNY Mellon Asset Management Canada, Ltd., an Ontario registered Investment Counsel Portfolio Manager and a Limited Market Dealer. In Dubai, United Arab Emirates, this document is issued by the Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. In Germany, this document is issued by WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH, which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. WestLB Mellon Asset Management Holdings Limited is a 50:50 joint venture between The Bank of New York Mellon Corporation and WestLB AG. WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH is a wholly owned subsidiary of this joint venture. If this document is used or distributed in Hong Kong, it is issued by BNY Mellon Asset Management Hong Kong Limited, whose business address is Unit 1501-1503, 15/F Vicwood Plaza, 199 Des Voeux Road, Central, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission and its registered office is at 6th floor, Alexandra House, 18 Chater Road, Central, Hong Kong. In Japan, this document is issued by BNY Mellon Asset Management Japan Limited, Meiji Seimei Kan 6F, 2-1-1 Marunouchi Chiyoda-ku, Tokyo 100-0005, Japan. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. In Singapore, this document is issued by The Bank of New York Mellon, Singapore Branch for presentation to professional investors. The Bank of New York Mellon, Singapore Branch, One Temasek Avenue, #02-01 Millenia Tower, Singapore 039192. Regulated by the Monetary Authority of Singapore. This document is issued in the UK and in mainland Europe (excluding Germany), Taiwan and Korea by BNY Mellon Asset Management International Limited. BNY Mellon Asset Management International Limited, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Services Authority. This document is issued in the United States by BNY Mellon Asset Management. BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by The Bank of New York Mellon Corporation. IC0078-07-12-09 (6M) 18157 12/09