



• FLASH REPORT: GLOBAL FIXED INCOME •

The Federal Reserve increased the discount rate (to 75 basis points) for the first time since June 2006. The event was important, not for its inherent economic significance, but as a signal to the market. The Federal Reserve is moving toward a monetary policy that, while still accommodative, reverses the extreme measures taken in the fall of 2008. The Fed's action, combined with the Chinese Central Bank's policy changes to limit bank lending, puts us at an inflection point and presents a good opportunity to discuss our current views and positioning in the Newgate Global Fixed Income Portfolio.

Though the events of the past few years have been well documented, we believe it is helpful to describe what led to this point in order to better understand how we move forward. To be brief, what we saw in the latter half of 2007 and in 2008 was basically a collapse in the credit markets caused by two separate, though reinforcing mechanisms:

- 1) Credit defaults, especially in mortgage securities
- 2) Freezing of the markets, making prices unreliable and artificially low for many securities.

The winning investment in 2008 was US Treasury bonds, and the US dollar, which rallied sharply as a safe haven. However, outside of the mortgage market, the number and severity of defaults in the corporate debt market, though high by recent standards, was nowhere near the extent feared or predicted. As the level of defaults stabilizes, liquidity is returning to the market. While the markets have begun the process of healing and normalization, this process is likely to take several years.

The easing of the extreme distress in early 2009 caused a sharp rebound in Newgate's Portfolio. Defaults, predicted by some to be as high as 50%, have in fact been much lower. This, combined with (or caused by, depending on one's point of view) extreme policies from global central banks, has created stability in the corporate bond markets.

These same actions have created instability in the market for government securities. The sustainability of debt burdens is now being called into question openly, with more indebted countries seeing a decline in bond

prices and difficulty selling additional debt. This situation is most acute in what is referred to as "peripheral Europe," though Greece has gotten most of the attention.

NEWGATE'S ECONOMIC VIEW - WHAT ARE WE LIKELY TO SEE OVER THE NEXT FEW YEARS

- 1) Corporate bonds are likely to significantly outperform government bonds for several reasons.
 - a. The bond market is less optimistic on the recovery than the equity market. There is a greater chance of a better-than-expected recovery than of a weaker one. That is not because we think the global economy is strong, but merely that the forecasts implied by the bond market are too pessimistic.
 - b. The "safety premium" of global government bonds is proving illusory. Investors require a higher yield from corporate bonds due to chance of default. But if they fear government bonds may default as well, a scenario once considered highly unlikely, then the higher yields currently offered by corporate bonds become more attractive.
- 2) "Monetization of Debt" – Governments don't usually refuse to pay off debt in their own currency. In practice, they merely print money and/or devalue their currency. The European problem exists because Greece, Ireland and Spain have issued debt in Euros, a currency beyond their control. Depending on the circumstances, monetization can be seen as another form of default.
- 3) Inflation – Inflation is often the result of monetization. Governments define inflation differently and make adjustments¹ that limit inflation. Therefore, it is difficult to forecast inflation statistics such as the Consumer Price Index (CPI). Yet it is difficult to imagine that there will be no inflationary impact from all the money being created by central banks.
- 4) Rising interest rates – Interest rates have generally been on the decline since the early 1980s, with some notable reversals in the trend along the way. While it is almost certain that rates will

¹Two of the most controversial adjustments in the US are lowering the cost of newer goods due to higher quality (referred to as hedonic adjustments) and the impact of the housing market. These effects are quite large, generally over one-third of the CPI Index. We do not make any claim regarding the validity or application of these techniques, other than to point out that they have resulted in lower inflation statistics.

rise, it is unclear whether we will have many years of slowing rising rates or just a few years of rapidly rising ones. We are in *terra incognita*; no one knows how the markets will react to a rising interest rate environment given all the changes since the last sustained rate increase.

INVESTMENT OUTLOOK – KEY FACTORS INFORMING OUR CURRENT POSITIONING

- 1) Government bonds, especially US government bonds, are likely to be unattractive. Yields are very low; the dollar is supported in part by the Euro crisis and fear of another liquidity crisis. As the global economy recovers, however anemically, rates are almost certain to rise. Any renewal of dollar weakness will only compound the issue, as a weakening dollar discourages foreign purchases, further driving up rates.
- 2) Corporate bonds should be favored, but diversification is paramount. “Diversification” means not only by issuer, but also by place on the capital structure (secured and unsecured) and credit quality. Even though default rates are lower than anticipated, they are still high by recent historical standards and likely to remain so.
- 3) Maturity and duration should be kept relatively short, reducing losses from rising rates and allowing for more attractive reinvestment opportunities.
- 4) Tactical allocation matters. There is still a great deal of uncertainty, compounded by fragile market psychology. The traditional method of letting one’s fixed income allocation stay on autopilot is dangerous.
- 5) Watch the dollar. Newgate is currently bullish on the dollar as the best of the generally bad lot of major currencies. But the US structural deficits are likely to renew dollar weakness, depending to a great deal on how the current Euro crisis is resolved.
- 6) Find investments specifically targeted to rising rates and inflation. TIPS and floating rate debt are the traditional instruments for this, but REITs, mortgages and convertible bonds can also provide protection.

CURRENT PORTFOLIO

- 1) Consistent with our views on inflation, traditional US Treasuries represent under 10% of the Portfolio, with TIPS over 11%.
- 2) We have been actively rebalancing between investment and non-investment grade, currently at 20% of the Portfolio. This allocation has and is likely to change tactically as markets move.
- 3) The mortgage and agency markets, which are receiving support from the Fed, have greater yields and lower duration and represent nearly 15% of the Portfolio. These are now highly value-added allocations, but are being carefully monitored as Fed involvement lessens.
- 4) Non-dollar exposure is currently *de minimus*, but this is likely to change.
- 5) Opportunistic buying. Though most of the themes in the Portfolio are macroeconomic focused, there are select areas of closed-end funds that appear mispriced, specifically the multistrategy funds trading at double digit discounts and corresponding high yields.
- 6) Preferred stocks, an asset class hard to access with proper diversification outside of closed-end funds and ETFs, now represent over 15% of the Portfolio. As with agencies and mortgages, government involvement provides some credit support.
- 7) Floating rate debt has been recently reduced from 20% to 10% of the Portfolio. As with other sectors, we are actively managing the Portfolio given valuations and opportunities in the market. We think this sector is vital as rates begin to climb and we are seeking attractive points to increase exposure.

We see many opportunities, some tactical, some structural, as the fixed income markets recover. Our view on rising interest rates impacts how we will choose to allocate Newgate’s Global Income Portfolio, but we are confident we can find value in this environment. The increased issuance of ETFs has allowed us to address asset allocation with greater specificity than even three years ago. We look forward to the challenges ahead. As always, please feel free to contact us with your questions. ♦