



Weather Eye for Opportunities in All Seasons

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Executive Summary

Newton's head of fixed income, Paul Brain, provides his latest market overview, warning that the eurozone remains stormy and unpredictable despite intermittent rays of light for the global economy overall. In such an uncertain climate, he argues that flexible and unconstrained investment approaches are likely to find pockets of opportunity across global bond and currency markets.

As we look into 2012, we continue to see significant risks in the global economy, as a result of the continued effects of deleveraging (debt repayment) by overindebted countries. We believe many of the risks are associated with the predicament of authorities in most developed economies, who are being compelled to keep monetary policy extremely loose in order to offset the dramatic fiscal austerity that is being applied simultaneously.

In our opinion, these extreme monetary and fiscal policy stances form a dangerous cocktail, more Molotov than martini, which is likely to have significant and unpredictable side effects. As we navigate this volatile environment, we believe that a flexible approach to investment without the constraints of being pinned to a benchmark should be considered. While we think it is important to be aware of benchmark composition and movements, we prefer the approach of maintaining freedom to select investments on the basis of their return and risk characteristics rather than their inclusion in a benchmark index.

We believe this double-edged environment of high risk and loose monetary policy might encourage riskier markets, in the absence of any key event, to rise in value. Just like commuters who have heard a bad weather forecast, the markets will walk around wearing an extra layer to protect against inclement conditions. This combination of extra protection and cheap funding rates could, in our opinion, lead to modest risk-taking and more attractive returns, especially if the "Armageddon" forecasters turn out to be incorrect.

*Please see page 3 for disclosure.

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We anticipate that another consequence of these extreme policy initiatives and increasing political risk is that markets could become less correlated with one another. Those markets more vulnerable to liquidity squeezes and government policy changes (for example, Hungary) could suffer, while the search for yield could push up markets that are not afflicted, to the same degree at least, by these issues (such as Poland). Although it is far from perfect, we expect that this improved investment environment will be severely challenged where growth fails to live up to expectations; for now, the sun may not be shining, but at least we do not think that we are in the midst of a tornado.

We have identified **money printing**, **rate cutting** and the **eurozone** as three major trends, or the wind, the rain and the fog, affecting global bond markets.

The potential for the **eurozone** to fall apart remains, for us, a pertinent concern. We have observed that fiscal austerity is in full swing in already weak economies, threatening to bring about recessions and to push government finances further into the red, while additionally compounding banking sector concerns. For the European Central Bank (ECB), we believe that the need to offset this fiscal drag is a gathering storm cloud. In our view, this offsetting could be accomplished through aggressively loose monetary policy, but the ECB will only be able to implement this via the banking system. We think that its three-year Long-Term Refinancing Operations should help, but their effectiveness for the peripheral government bond markets may have been overestimated. We anticipate that peripheral government bond supply during the first half of 2012 may create a challenging smog, requiring sustained demand from banks in order to be cleared. If the prospects for economic growth and politics were brighter, we would, in turn, be more sanguine about the prospects for peripheral European government bonds, but Greece's Private Sector Initiative (requiring private holders of Greek debt to take a 50% reduction or haircut) and its S&P downgrade hang over the market, creating a fog of uncertainty.

In our view, the **money printing** cohort (U.S., U.K. and Japan) is stuck within the eye of the storm: these markets are supported by both their "safe-haven" status and their central banks' buying activity, which may offset a potential ignition of risk appetite. We will continue to evaluate duration (interest rate risk) in these markets according to overall risk appetite and economic growth expectations.

We remain cautious regarding the outlook for the global economy. Although there may be glimmers of light between the clouds, we believe the conditions, particularly within the eurozone, remain stormy and unpredictable.

The countries that form the group of **rate cutters** could, we believe, also offer potential to trim duration, as some of these markets, such as Australia, appear to have started to price in negative effects of a possible Chinese “hard landing.” In our opinion, however, the anticipated bump following the country’s rapid growth may not come about.

Some of the cash from these sales may, we believe, find a home through reinvestment in emerging markets, where spreads (the difference in yield compared to “risk-free” markets, such as the U.S.) have widened. We anticipate that cash may also be reinvested if markets start to rise on the wings of future economic growth expectations.

We believe that the U.S. economy appears to be the brightest, relative to global expectations. Normally, a revival in growth expectations would be negative for the U.S. dollar and supportive of Asian and commodity-based currencies, but the lingering concerns about China and the eurozone have, we believe, altered this dynamic. For us, it is important to keep a “weather eye” on opportunities in other currencies that perform well during steady economic recoveries. We remain wary, however, of the risks that we anticipate will continue to lurk in the background.

We remain cautious regarding the outlook for the global economy. Although there may be glimmers of light between the clouds, we believe the conditions, particularly within the eurozone, remain stormy and unpredictable. We support a flexible approach to investment in global bonds and in currencies, which we believe would minimize the impact of these volatile conditions, while seeking to take advantage of opportunities that may come to light.

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