INVESTMENT NOTE

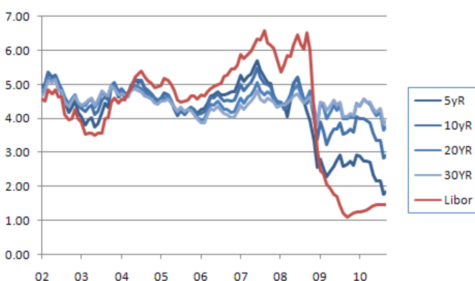
September 2010

Hubble Bubble Toil and Trouble

As Gilt Yields Fall to Historic Lows we ask "has a bubble is formed in the Sovereign Debt Markets?"

Each piece of positive economic data released seems to be followed by two negative ones leaving financial analysts and investors scratching their heads as to the underlying health of any economic recovery and thus the direction of financial markets. As a consequence equity market volatility has risen even though markets remain range-bound, moving higher or lower depending upon last news or data release. Indeed having scaled recent heights of 5,800 and plumbed the depths of 4,900, the FTSE 100 index is now only just above where it started for the year. One asset class that has benefitted from this uncertainty however has been the Government Bond Markets, both in the UK and overseas. Herein, we discuss why, and should, investors now be wary of that market.

Typically longer term Government Bond prices move inversely to changes in interest rates. In late 2008 and early 2009 UK Government Securities (or Gilts) prices rose in value as UK interest rates were cut to historic lows. Since then interest rates have remained constant and yet Government Bond have continued to rise. This unexpected strength has been driven by a sense that the UK (and Global) economic recovery is not progressing as smoothly as one would have hoped. Indeed the broad expectation is that interest rates will be kept at their current low levels for far longer than anyone initially expected. Certainly, in the US, Federal Reserve Chairman Bernanke coined the slightly ambiguous phrase "unusually uncertain" as a description of the economic outlook and announced a "light" version of their quantitative easing programme. More importantly in times of uncertainty investors seek sanctuary in perceived "safe haven" investments such as Government Debt and hard assets, such as gold, which has also performed well in the last 12 months.



With uncertainty to the economic recovery and the spectre of a "double dip" still present, it would seem possible that bond yields will remain low or even fall a little further. However we believe strongly that this is a short-sighted view and one that ignores many of the issues which the gilt market faces (a number of which we highlighted earlier in the year). The economic recovery though fragile is continuing and growth will rise this year, albeit at a more moderate pace than some of the over-optimistic estimates made earlier in the year. Indeed, second quarter growth in the UK was higher than expected and rose at the fastest pace since 2006. Inflation remains stubbornly above target and as Sterling weakens and food and energy prices increase this is likely to continue. Inflation fears alone have led some to forecast aggressive interest rate rises next year (and thereafter). Even now one, of the nine person Bank of England committee, is voting for an immediate rate rises to combat any inflation impacts!

Reviewing the arguments, **we believe that the capital risk of investing in Government Bonds at this juncture (other than very short term) far outweighs any yield return** (less than 3% per annum for a 10-yr gilt) and we fear that this Debt rally could dissolve even more quickly than it appeared. **We will therefore remain underweight the UK Gilt Market and accept any short-term underperformance against benchmark this may produce rather than potentially be crushed in the rush for the exit when, and if Gilt prices retreat.**

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