

## DWIGHT ASSET MANAGEMENT COMPANY LLC

# International Bond Market Update



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Is it always darkest before dawn? Economies around the globe continued their path of destruction during the first quarter and global policy makers responded by further loosening monetary policy, announcing new fiscal stimulus packages, and warming up the printing presses. Indeed, governments not only sold more family silver, but they also mortgaged the future of coming generations. Not surprisingly, bond prices were buffeted by the inflationary forces of government policy and the deflationary forces of economic deterioration.

Ireland and Spain, where public finances have deteriorated significantly, were penalized by rating agencies in the first quarter. Both lost their coveted AAA ratings when they were downgraded to AA+. Greece, meanwhile, was downgraded to A-. If additional downgrades materialize, the resulting detrimental impact on borrowing costs would put an even greater burden on already-stretched finances.

The Irish government, once touted for its ability to create jobs through the implementation of an investor-friendly tax code, was forced to unveil the harshest austerity measures in the history of the Irish Republic. Ironically, the same boom the government helped to create led to an enormous real estate bubble that has since forced it to throw a life line to the domestic banking system, now crippled by a crash in the property market. The government announced plans to set up a “bad bank” that will buy between €80 and €90 billion of bank loans. To counteract this massive assumption of new debt, the administration in Dublin announced an emergency budget that proposes a series of significant tax increases while slashing expenditures. There is little doubt that if Ireland still had its own currency, the Irish punt, it would devalue it, but that of course is a moot point, since it is part of an exclusive club, the euro!

In the meantime, U.K. Prime Minister Gordon Brown is fighting for his political survival as the deadline for setting an election date in 2010

fast approaches. Public dissatisfaction with the government and a very deep recession has led to an increase in populist proposals amidst unprecedented government spending. Indeed, the budget deficit in the United Kingdom could reach 12.5% this year! Not surprisingly, the tremendous amount of debt issuance necessary to fund the government’s programs is putting significant upward pressure on Gilt rates. On March 5, the Bank of England (BOE) was the first of the major central banks to announce plans for a quantitative easing policy via the purchase of government bonds. The announcement and initial success (which, subsequently, was largely neutralized by the ambitious spending budget and a failed bond auction) may have inspired the Federal Reserve to follow suit shortly thereafter and begin buying Treasuries in the open market.

It is without doubt that, in the United States, public policy has slowed the pace of deterioration. From the U.S. and U.K. perspectives, the problem child is the euro zone, where stubborn fiscal conservatives, particularly in France and Germany, continue to resist the implementation of additional stimulus packages despite struggling economies. The pressure within the euro zone is building. The rift between the presumed “haves” (Germany, France, and The Netherlands) and the “have-nots” (Ireland, Portugal, Spain, and Greece) is growing because forced adherence to fiscal discipline is weighing more heavily on the have-nots. Moreover, the ongoing deterioration of the economic and fiscal health of central-eastern European nations like Hungary and the Baltic states poses a new risk to the European financial system. This is evidenced by the dramatic widening in interest rate spreads between nations, such as Austria, which have strong ties to their eastern European neighbors, and Germany, the poster child for post-war European stability. Indeed, spreads between the haves and have-nots have also risen appreciably.

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Among the Asian nations, Japan is suffering from a catastrophic contraction of its export-driven economy. The Japanese government has counteracted with a third substantial stimulus package. Meanwhile, the largest creditor of the United States, China, is openly worried about its holdings of U.S. debt and is calling on our government to get its fiscal and economic affairs in order. Indeed, China has even suggested that a new reserve currency should be formed, which in our view is neither practical nor imminent at this point in time.

With respect to currencies, some fear that governments around the globe may use competitive devaluation and protectionist measures as weapons of last resort to stimulate their economies. We believe substantial foreign exchange intervention is unlikely at this time, but the Swiss National Bank successfully reduced the value of its currency in the first quarter by selling francs for euros. The risk is that other, larger central banks decide to follow the Swiss example if their economies remain weak for an extended period.

The dollar, meanwhile, should remain supported in the near term by strong relative improvement in U.S. growth versus the euro zone and Japan. Continued repatriation of overseas assets by U.S. investors led to further support for the U.S. dollar. Looking further ahead, we expect the dollar to weaken relative to the euro as foreigners seek to increase holdings in

currencies other than the dollar, particularly in light of the ballooning debt in the United States.

Global long-term interest rates have risen since the beginning of the year despite the deepening global recession because of increased issuance of public debt and concerns about future inflation. Central banks, however, have generally managed to cap the rise in interest rates. Among the major central banks, only the ECB still has room to reduce its official rate, and we believe the ECB will cut this rate by another 25 basis points at its May meeting. Unlike other major central banks, the ECB cannot easily engage in quantitative easing via the purchase of sovereign debt, but we would not be surprised to see the ECB take alternative measures to add liquidity to the market.

In summary, we continue to be constructive on euro-denominated debt and foreign fixed income in general. However, the prevalent thought within the ECB is that the loose monetary policy of the Greenspan Fed made significant contributions to various asset bubbles. For this reason, we caution that the ECB is likely to be the first central bank ready to drain excess liquidity, and it is likely to do so at any cost. Thus, while the European economies are likely to follow the United States out of the recession, they may well lead the next interest rate cycle by tightening monetary policy first. ■

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