

DWIGHT ASSET MANAGEMENT COMPANY LLC

International Bond Market Update



Peter Vutz
Head of Corporates
International, Non-Dollar

The calendar for global bond issuance continued to be super-sized during the third quarter. New issues were received exceptionally well whether the borrowers were governments or corporations, despite fears to the contrary. Investment-grade and high-yield corporate bond spreads tightened to pre-Lehman Brothers bankruptcy levels both here and abroad, with high-beta names in particular finding a strong bid. The placement of new paper was undoubtedly helped by investors previously parked in money market funds as they returned to riskier assets in fear of being left behind.

Less than a decade after what former Fed Chairman Alan Greenspan once referred to as the “irrational exuberance” that preceded the dotcom bubble and just two years after the implosion of excessive housing speculation, the market appears to be on steroids, fuelled by historically low funding rates. Could we be witnessing the formation of the next bubble—this time in the bond markets—before our eyes? Over the past twelve months, governments around the world have launched record-setting stimulus programs, which were supplemented by major central banks providing unprecedented global liquidity, in an effort to unlock the credit markets and fight the recession. The initial scarcity of cash led to a massive and forced deleveraging of consumers and financial institutions alike, threatening global economic equilibrium at its core.

But times have since changed and, courtesy of the decisive actions from governments and central banks, global markets are now awash in cash. Not only have we witnessed a stunning turnaround in equity markets around the globe, but the feared flood of new issuance in the fixed income markets has been met by an insatiable appetite from investors. Could the same measures that were designed to unlock financial markets be contributing to the next bubble, with central banks serving as willing

accomplices in the next potential crisis?

For the first time since the early nineties, U.S. dollar-denominated LIBOR funding costs are lower than those denominated in Japanese yen. The U.S. dollar is suddenly among the favorite carry-trade currencies, which in return elevates its risk of spiraling lower. The traditional strong-dollar policy of the United States has long been abandoned—a trend that began well before the new administration took office. We cannot blame the current administration for trying to export its way out of this latest crisis, though. Our northern neighbors in Canada are increasingly concerned about their appreciating currency, as are the Europeans and the Japanese. While the weak U.S. dollar provides welcome relief to those U.S. companies that are dependent on exports, it also puts the rest of the world at a competitive disadvantage.

The weaker U.S. currency only adds fuel to the fire of a more broad-based discussion: the status of the U.S. dollar’s role as the number-one reserve currency in the world. As we have pointed out in the past, the replacement of the U.S. dollar as the world reserve currency, while neither likely nor practical in the short term, could have potentially catastrophic consequences for the United States’ ability to finance its mushrooming budget deficit.

There are many questions but few answers at this time. The fragile nature of the global economic recovery might give the investment community some reprieve, but eventually the exit strategy of leading central banks will become an unpleasant reality. During prior bubbles, the Federal Reserve and its peers have acted decisively in counteracting a potential crisis, but they have historically struggled when the time came to withdraw excess liquidity. Whether the global central banks will be able to effectively neutralize their massive liquidity injections without pricking another bubble in the

continued on the following page

bond markets remains to be seen.

We are increasingly concerned that the tremendous year-to-date performance of high-beta assets will motivate investors to take profits on their holdings ahead of year-end. Any pronounced setback in high-beta names could offer interesting opportunities to selectively increase our holdings. On a global basis, we continue to favor foreign-denominated debt relative to U.S. dollar-denominated debt. The

recent weakness of the greenback has become even more pronounced because of the aforementioned carry trades, with the dollar losing 16% of its value relative to the euro since March 2009. The dollar is likely to resume a more orderly downward trend, with neither the United States nor the rest of the G10 showing the willingness or the ability to reverse the depreciation of the U.S. currency. ■

For more information:

**Fixed Income, Stable Value
& Consultant Relations**

Lisa Trubiano, CFA
Senior Vice President
802.383.4066
ltrubiano@dwight.com

Anicia Mendez
Vice President
802.383.4067
amendez@dwight.com

Cash Management

John Donohue
Executive Vice President
617.391.0229
jdonohue@dwight.com

Kevin Zimmerman
Vice President
617.391.0269
kzimmerman@dwight.com

Insurance

Donald Hill
Senior Vice President
802.383.4062
dhill@dwight.com

John Loud
Vice President
802.383.4047
jloud@dwight.com

100 Bank Street
Suite 800
Burlington, VT 05401
802.383.4000

535 Boylston Street
Suite 4A
Boston, MA 02116
617.391.0043

One SW Columbia
Suite 1720
Portland, OR 97258
800.929.4427

www.dwight.com

This information reflects the viewpoint of Dwight Asset Management Company LLC as of Third Quarter 2009 and is subject to change. This article was prepared for general informational purposes only, without respect to the investment objectives, financial profile, or risk tolerance of any specific person or entity who may receive it. Investors should seek financial advice regarding the appropriateness of investing in any investment strategy or security discussed or recommended in this article and should understand that statements regarding future performance may not be realized. Investors should note that income, if any, from any investment strategy or security may fluctuate and that underlying principal values may rise or fall. Past performance is not necessarily a guide to future performance.