

## Sovereign Bond Investment Strategy

### Executive Summary

- The world economy faces a period of heightened uncertainty and volatility, with developed and developing countries facing different challenges.
- Traditional sovereign bond benchmarks are no longer satisfying every requirement.
- The distinction between developing and developed markets has narrowed, as the former benefit from structural tailwinds and the latter suffer structural headwinds.
- There is a need for a sovereign bond investment strategy that is based on sovereign credit fundamentals.

### Background

The world economy faces a period of heightened uncertainty and volatility that offers experienced active investors enhanced opportunities to generate return and manage risk.

Developed countries and developing countries have different challenges. In the former, weak growth, sovereign balance sheet pressures and disinflationary economic forces are pulling government bond yields to extremes and in opposite directions. In the latter, commodity-driven inflationary pressures, mercantilist trade policies and institutionally-challenged currency pegs are pushing government bond and currency markets in similarly conflicting directions.

At the same time, the demand for 'safe' liquid government debt from sovereign wealth funds has risen, especially from commodity exporting countries in which foreign currency reserves have risen sharply in recent years. Supply and demand dynamics juxtaposed with historically steep yield curves, decade-high sovereign spreads of peripheral European government bond markets and misaligned currencies bring investment opportunities with them.

### Not All Investors' Needs Will Be Met by Traditional Sovereign Bond Benchmarks

Bob Hope once joked that "a bank is a place that will lend you money only if you can prove that you don't need it." It is true for investors—certainly for those who prize capital preservation above returns—that, rates of interest aside, they would rather lend to borrowers who don't need to borrow than to those who do. This points to a fundamental problem with traditional bond indices: those issuers who comprise the largest proportion of them are, in all likelihood, those issuers to whom traditional bond investors will have the greatest exposure as a potentially unintended consequence of their benchmark choice.

It therefore seems questionable whether traditional sovereign bond benchmarks meet our requirements at all. If they are to serve to define a permitted investment universe, it may be time for that universe to change. Alternatively, it may be time for investors to drop their allegiance to benchmarks altogether and to embrace a total return—non-benchmark-constrained—approach that allows them to maximize opportunities available to them from both traditional developed and developing government markets and currencies.

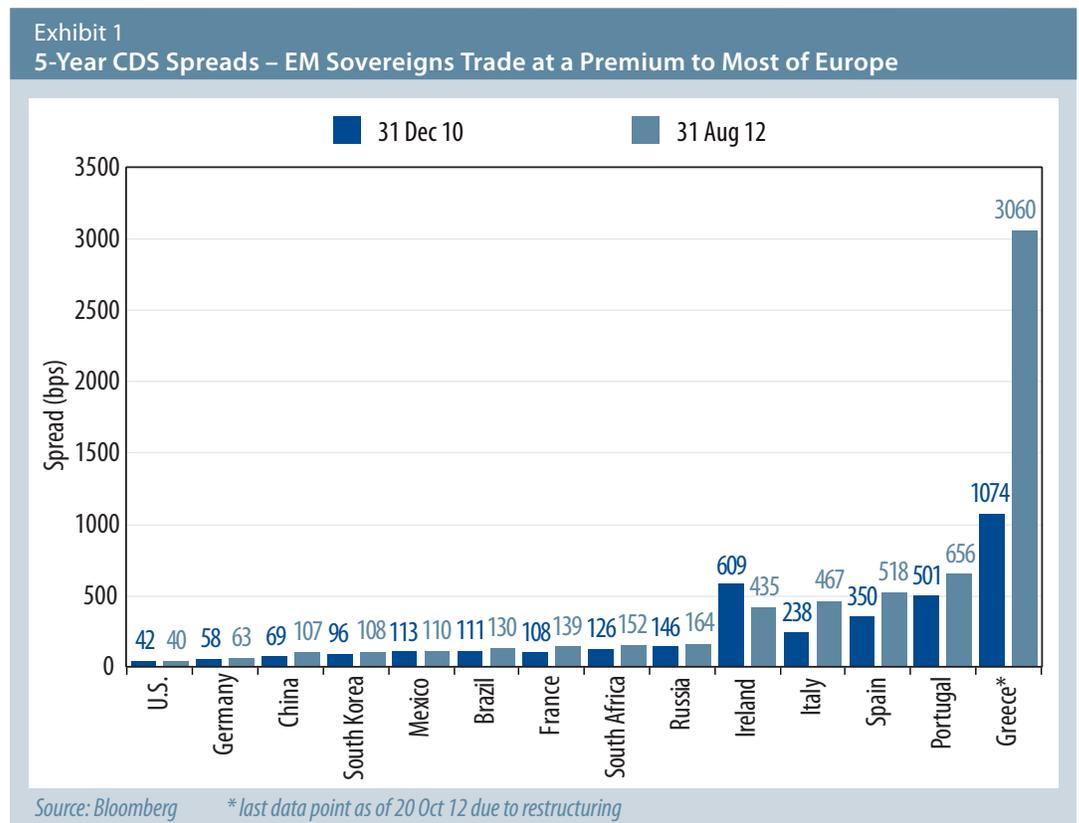
### The Distinction Between Developing and Developed Markets Has Lessened

Developing countries have demonstrated continued resilience in the face of the deepening eurozone sovereign crisis that has neither resulted in a deterioration of their credit fundamentals nor reversed their strong fiscal and debt metrics.

In addition to accounting for the majority of the contribution to global growth this year, the average debt-to-GDP ratio for developing countries has remained steady, at around 34% compared with nearly 114% for developed countries. Similarly, fiscal deficits among developing countries average around 2.2% compared with 6.2% for developed countries.

The factors behind the downward re-rating of developed countries (low/negative growth rates, declining working age populations and increased longevity, to name a few) are well documented elsewhere, so we consider it more instructive to focus on the other side of the global re-rating trend, namely, the upward re-rating of developing countries, and to explore how the positive fundamentals of these countries can be exploited in fixed-income investment strategies.

The pool of 'safe' AAA rated assets has fallen in recent years. The share of the global economy by countries that are rated AAA by the two largest rating agencies has fallen from around 50% in 2007 to around 20% today. In the last two years, there have been approximately 100 developed market downgrades and five developed market countries have lost their AAA rating. The lowest rung of the investment-grade ladder is no longer the sole preserve of developing countries and embraces a wide range of countries including Indonesia, Brazil, Peru, Russia, Italy, Spain and Iceland, with Ireland, Portugal and Greece now below investment-grade. Over the same period, there have been approximately 100 credit rating upgrades in developing countries and the average rating of these countries has risen to BBB- from BB+. As Exhibit 1 illustrates, developing countries now trade at tighter sovereign credit default spreads than many developed countries.

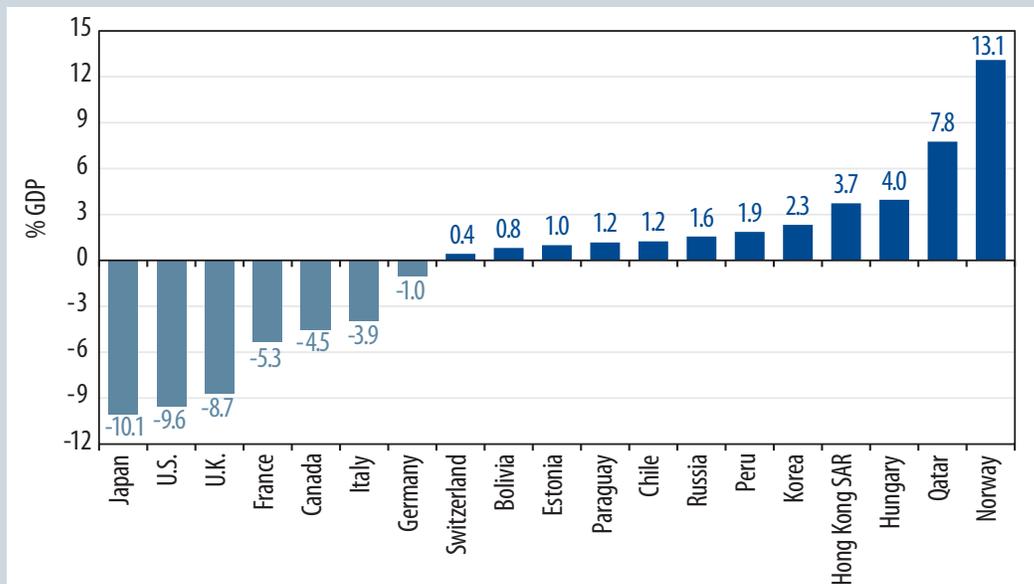


A structural factor that supports the view that the challenges facing many mature developed economies are likely to increase is the unfunded rising cost of medical treatment and of public sector pensions that is excluded from official debt statistics. The authors of BIS Working Papers 300, "The Future of Public Debt: Prospects and Implications", factored these unfunded liabilities stemming from age-related expenditure in their calculations of public debt trajectories in March 2010. Their baseline scenario using growth, government revenue and age-related spending (assumptions that, in retrospect, can be seen to have been optimistic), is that debt-to-GDP ratios will rise to untenable levels that will require the countries in the study to achieve impossible primary balances as they pay double-digit interest payments on their debt as a percentage of their GDP.

Today's high credit ratings, then, provide no certainty of 'safe havens' for wealth, so investors are advised to

look beyond credit ratings to identify those sovereign issuers that most promise to repay. Under S&P's no-policy-change scenario, S&P estimates having no AAA-rated sovereigns and only seven AA-rated sovereigns by 2035. This suggests investors will need more guidance than credit ratings alone as a means of defining an investment universe and leads us to revisit Bob Hope's dictum on the advisability of lending to those who don't need to borrow (if return of capital trumps return on capital as a priority). Exhibits 2 and 3 hold clues as to who the world's better creditors may be.

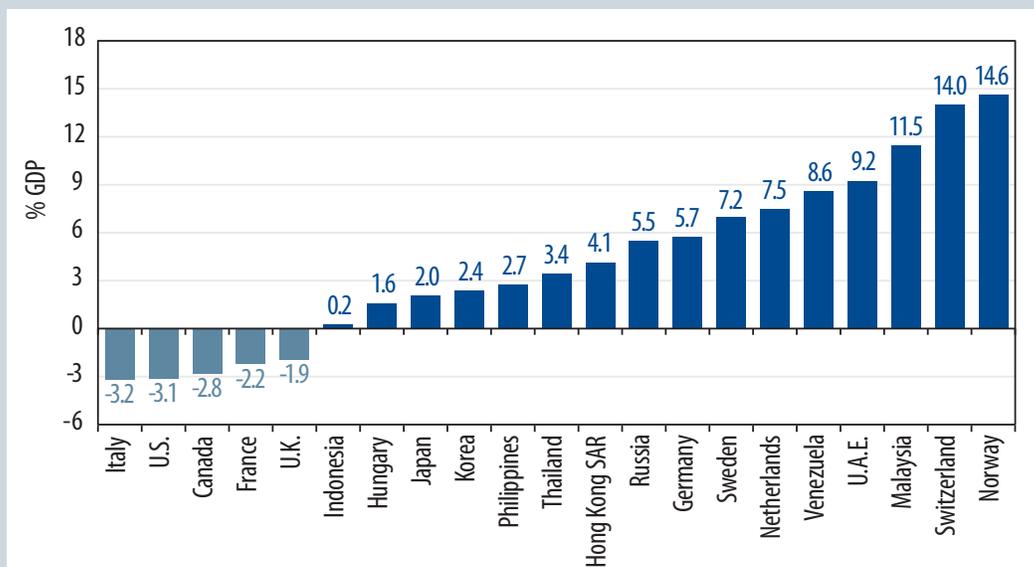
Exhibit 2  
Net Lending/Borrowing 2011



Source: International Monetary Fund, World Economic Outlook Database, April 2012

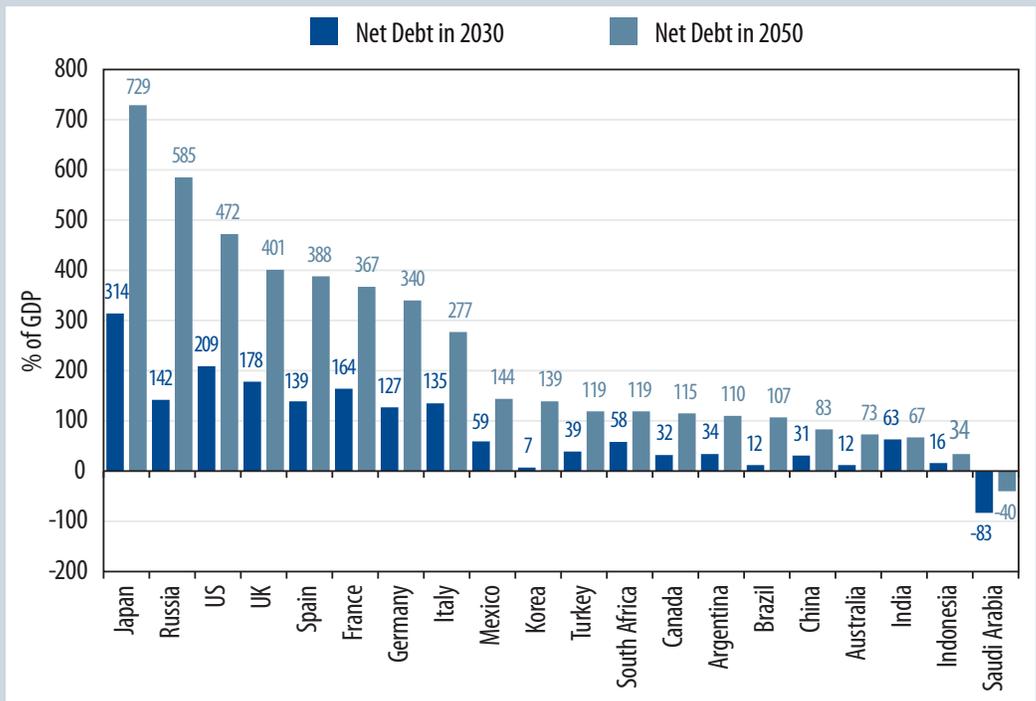
The debt dynamics in the largest developed countries have, generally, been negatively impacted by a painful mix of low growth and government revenue and of increased government spending. With the exception of Canada (Exhibit 4), this is unsustainable given today's government debt levels.

Exhibit 3  
Current Account Balance 2011



Source: International Monetary Fund, World Economic Outlook Database, April 2012

Exhibit 4  
Forecast Debt/GDP Ratio (No Policy Change Scenario)



Source: S&P

Exhibit 4 points to the way ahead, namely, to the discarding of the increasingly tired distinction between high wealth but high debt developed markets and low wealth but low debt developing markets, in other words, the idea that developed markets are more likely than developing markets to meet their obligations is much less tenable now than it was twenty years ago. Part of the reason lies not just in nominal debt terms but also—in not especially—in real debt terms, which is to assume that investors wish to see not just the return of their capital in nominal terms but also, if not particularly, the preservation of their spending power.

Broader sovereign solvency measures and indications of ability to pay, such as broad basic balance of payments (BBoP)<sup>1</sup> and current accounts and public and private sector balances, serve to give a more accurate picture of indebtedness than debt-to-GDP ratios alone and support our conclusions.

Faced with potentially unsustainable debt levels, governments may shun politically painful fiscal policy tightening and embark on a policy of debt monetization—the purchase of new debt issuance to finance government spending—to one of debt inflation, whereby the stock of money supply is increased such that inflation rises and debt levels become more manageable in real terms. While this reduction in real debt values may be the only alternative to default, it constitutes a partial default insofar as a rise in inflation reduces savers' purchasing power. To the extent such monetization leads to currency depreciation, it also erodes foreign investors' returns.

### Differentiating Credit Fundamentals Re-assert Their Importance

To be fair, not all developed economies need suffer this fate. A number of countries including Norway, Sweden, Australia, Canada and Singapore have successful economies that, in recent years, have not relied on excessive debt accumulation or external borrowing. These countries' sound fiscal management has allowed them to

<sup>1</sup> BBoP= current account + net foreign direct investment flows + portfolio flows of bonds and equities.

avoid the corrosive fiscal tightening that is crippling many European economies and may soon spread to the US and Japan. Investors have rewarded these superior fundamentals with currency appreciation that may have further to go—a factor that in turn may lead to competitiveness issues.

After decades of political and economic instability and excessive reliance on short-term foreign debt, many developing economies have succeeded in putting their houses in order. A focus on inflation targeting by largely independent central banks has reduced the scourge of hyperinflation and necessitated that governments pursue sound fiscal policies focusing on targeting largely balanced budgets. Moreover, the accumulation of very large foreign currency reserves and the active replacement of external debt with domestic sovereign debt held increasingly by domestic savers have reduced these countries' vulnerabilities to a reversal in foreign investor flows.

These policies, combined with positive supply-side trends such as urbanization and infrastructure investment, have boosted growth and productivity above that seen in more mature economies. If sustained, these trends could help currencies in many developing economies to appreciate as exchange rate regimes are liberalized with a rebalancing of growth towards domestic demand. Such countries' fundamentals are not without challenge: a heavy weighting to food and energy in their inflation baskets makes them particularly vulnerable to spikes in commodity prices. At the same time, the mercantilist trade policies (in part manifested by managed currency policies) pursued at the expense of domestic demand have raised the risks to growth from a slowing in demand from developed economies.

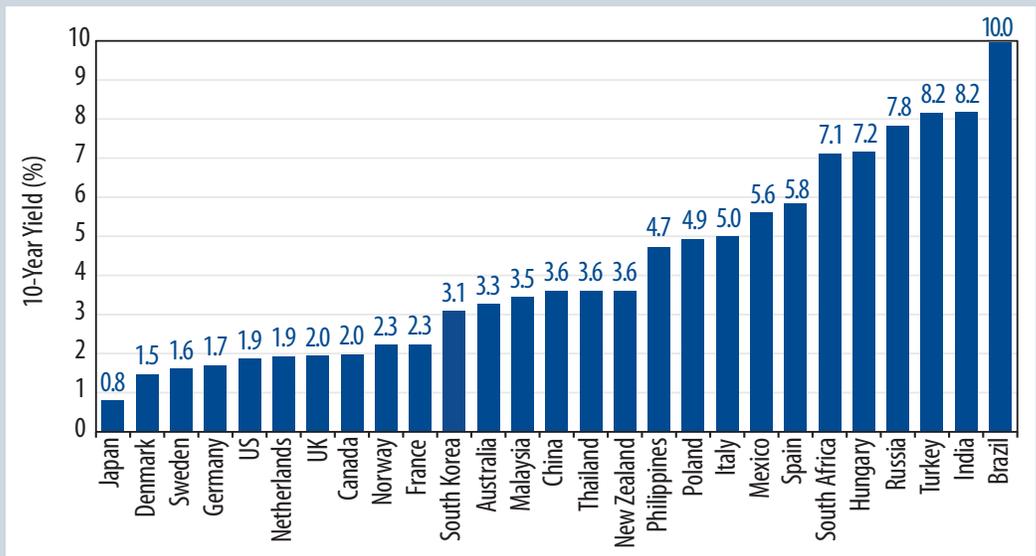
The trends documented in this paper argue for an investment strategy that focuses on countries with strong credit fundamentals and which seeks to maximize total return by identifying investment opportunities in sovereign bond markets and currencies spanning both developed and developing markets. Given the benefits inherent in a value-oriented diversified investment approach, this strategy will seek to allocate risk across three distinct sovereign debt sectors:

1. Highly rated, net saver, core countries with scope for currency appreciation. These countries' debt and currencies should show less susceptibility to market weakness during periods of financial market instability and/or concerns over global economic weakness.
2. Countries with positive long-term macroeconomic fundamentals that offer a moderate yield advantage to core countries with a potential for yield convergence and with currencies that have the scope to strengthen over time.
3. Countries with fundamentals that are showing signs of improving and where we believe the yield spread to core countries and currency valuations excessively compensate us for taking sovereign risk. These countries' debt and currencies could be volatile during periods of market instability but are likely to offer very attractive returns over a market cycle.

Portfolio construction will weigh market valuations (Exhibit 5) and liquidity against issuers' fundamentals and use derivatives for efficient portfolio management and yield enhancement while controlling counterparty risk.

No longer referencing traditional bond indices (which can result in exposure to a market primarily due to its inclusion in an index on one hand and, on the other, restrict the size of an allocation because of its small weighting or absence from an index) may facilitate the attainment of improved risk-adjusted returns for investors. The greater level of flexibility inherent in this approach encourages managers to allocate to and switch between markets based purely on an assessment of their valuations relative to their fundamentals.

Exhibit 5  
Government Bond Yields (Local Currency)



Source: Bloomberg. As of 14 Sep 12

## Conclusion

This paper advocates a move away from benchmark-oriented sovereign bond investing to an approach focused on the prospects for total return based on sovereign credit fundamentals. Potentially unsustainable debt levels have become an increasingly important investment consideration as these head for unprecedented levels in developed markets and the prospect for governments' primary fiscal deficits or surpluses accrue in importance too. These have implications not just for the fundamental question of whether investors will be repaid at par—at all, even—but also—and, perhaps, most importantly in the case of those governments that have retained control of their money printing presses—whether they will be repaid in a currency that has retained its value and that has enabled investors to grow their purchasing power.

A sovereign bond mandate managed along the above lines would not favour the biggest issuers of debt but the exporters of capital and the net savers. A diversified sovereign portfolio fitting this bill might be comprised of allocations to those countries that maintain high credit ratings by virtue of their positive credit fundamentals, to those that have improving, converging credit fundamentals and to those benefiting from relatively high yields and compensating investors for risk. It would allow allocations to inflation index-linked government bonds and significant non-domestic currency exposure, with the expectation that currency returns would feature more prominently as a source of added value than in a more traditional sovereign bond mandate.

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