

## From the Editor....

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#### **Market Update**

Demand for the recent \$US118 billion US treasury auction resulted in the second sharp rise in US long yields this year. The benchmark 10-year bond yield spiked to a high of 3.93% (and more recently have gone above 4%), which represented a 0.26% rise from the yield of 3.67% set at the previous week's auction. The US government has scheduled \$US1.6 trillion in debt issuance in 2010 to fund both the forecast 10% budget deficit, and the interest on the US government's \$US12.1 trillion national debt. Our major concern is that either fixed interest investors will demand higher yields, or the appetite of foreign investors for US treasuries will diminish. We think the recent trend in US treasury auctions suggests that both issues appear likely.

Record supply of treasuries and fading demand will be the theme for the remainder of this year. This will inevitably push bond yields higher and we believe, contrary to consensus expectations, that the recent spike in US 10-year bond yields represents the first signs of a long term bear market for both US, and global government bond yields. Considering the huge weight of US public debt issuance over the next few years, we believe a solid break above a 4% yield for the US 10 year bond is inevitable, which would confirm further rises towards the 5% level.

There are two important global issues that are supporting a long term rise for US government bond yields. Firstly ris-

ing global sovereign debt levels, and secondly the massive pipeline of global government bond issuance. On the first issue of rising sovereign risk, the increase in world-wide government indebtedness simply represents the transfer of global bank debt to the public sector. Yet it appears that many people disagree and feel that the problems of Portugal, Ireland, Greece and Spain (the PIGS), have little relevance for the Australian and global equity markets. We would strongly disagree with this.

Why? Well, whilst a 100% national debt to GDP ratio for Greece is not a specific risk for domestic or global equities, it is symptomatic of a wider risk for global bond yields, currencies and world economic growth. The yield spread on Greek bonds recently expanded to a 3.7% premium over the benchmark German bund.

We feel Greece represents the tip of the global sovereign debt iceberg. Like an iceberg, the much larger problem remains unseen by the market. Consequently, we firmly believe that the recent rise in US bond yields, which represent the benchmark for global long bonds, reflects the early signs of a sovereign debt risk premium for government bonds. In late March this year, Portugal's credit rating was downgraded. Recently, ratings agency, Moody's warned the major economies, specifically the UK, US and Japan, that rising sovereign debt levels has negative implications for their AAA credit ratings. Whilst a downgrade is unlikely (with the exception of possibly the UK) this warning is now being manifested by a risk premium on government

debt issuance and a subsequent rise in US bond yields.

The second issue which we believe is supporting a rise in US bond yields is the massive pipeline of US debt issuance. The Congressional Budget Office (CBO) is forecasting US national debt to blow out to 85% of GDP by 2018. As a result, the CBO expects that interest payments on public debt alone, will rise from the current 6% of budget outlays to over 15%. Importantly, this figure is independent of any further government spending initiatives and the defence outlays in Iraq or Afghanistan. Clearly the current situation is unsustainable. Consequently, the Obama administration will be forced to either, cut government spending outlays significantly (unlikely), or raise income tax levels substantially (highly unlikely).

Importantly, the CBO recommends that the US government should aim to just stabilise (not reduce) sovereign debt levels by 2018. As a result, the Obama government is faced with massive budget shortfalls and US trillion dollar public debt issuance until 2020 at the earliest. The end result will inevitably be higher bond yields as both domestic and foreign buyers ultimately demand a US treasury risk premium for increased issuance and higher sovereign debt levels.

So where does this leave equity markets?

The rising US treasury yields continues to provide a conundrum for both equity and fixed interest investors. In a “normal” recovery cycle, rising bond yields are driven by an increase in short term interest rates which in turn is a clear signal of stronger economic growth for fixed interest investors. Similarly, for equity investors, rising 10-year bond yields are consistent with expected outperformance for high growth cyclical stocks leveraged to a recovery in economic activity. Yet, there is no pressure on short term interest rates in OECD countries. In fact, the reverse is true. The Fed has again reaffirmed its statement that short term rates will remain zero for an extended period. In addition, the Bank of England and the EU have confirmed a similar outlook. At the same time, the International Mone-

tary Fund (IMF) and the governments of all Western economies continue to reject the withdrawal of fiscal stimulus packages. The reality is that there is no pressure on short term rates due to the weak global economic recovery. As a result central banks are maintaining expansionist policy settings to stimulate economic growth. This is the main reason we remain cautious on bullish economic recovery projections that are in the media at present.

The actions of central banks and governments around the world do pose an important question though—is the nascent of economic recovery in OECD countries sustainable? Certainly the majority of economic strategists and economic forecasters believe this to be true. However, we remain unconvinced. If the recovery IS sustainable, then why do Western countries need zero interest rates, quantitative easing policies, and fiscal stimulus packages? The bottom line is the outlook remains totally unclear with the high sovereign debt levels, elevated household debt and rising bond yields.

In the meantime, rising government bond yields are primarily due to a re-pricing of sovereign debt risk which has direct implications for all asset classes, particularly equities. We believe strategists are wrongly associating the rise in long bond yields as indicative of a normal ‘V’ shaped recovery and a green light for cyclical, particularly resources, outperformance. The banking sector is also affected by rising bond yields with the Reserve Bank recently confirming that the level of official rates is providing less of an indication for the direction of variable mortgage rates due to the rise in wholesale funding costs. In this regard the Mortgage Backed Securities (MBS) market will be closely monitored after the cessation of the US\$1.25 trillion Fed buying program. In addition to this, the direction of US long yields has important implications for the US housing sector.

All the recent data on falling new home sales and rising foreclosures suggests that the US housing recovery is faltering.

A further rise in US mortgage rates, which are priced off long yields, would have very negative implications for the emerging housing recovery and Australian building stocks with US exposure. Make no mistake, Greece's sovereign debt concerns are very real, and are symptomatic of major global macro issues, which have genuine implications for all asset classes.

### **US Dollar, Commodities & China**

Not many people will have noticed that the US Dollar (USD) Index has risen +11% from its November 2009 lows. Most of these gains have been driven by a switch from the Euro (-11% from record highs against the USD) and Pound Sterling (-28% from record high and -11% from recent high against the USD).

The biggest downside risk we see from a continuation of the USD rally remains in commodities. US\$228 billion is now indexed to commodity indices and investment/speculation in commodities has never been higher. The vast bulk of this record level of investment is based around diversification away from USD's by US investors. But that game is now up as the rising USD erodes returns from commodities to US investors. It is worth remembering that investors/speculators don't consume commodities.

It is also worth noting that all investable commodities generated poor returns in USD's in the first quarter. What we also need to consider is that hedge funds not only have the carry trade on in scale but use leverage in those positions. Not only does the rising dollar erode carry trade returns, it also increases the cost of funding for using those positions. Financing costs rising and total returns going negative are not a combination that hedge funds will tolerate for long periods. Further USD strength will be driven as investors question the short-term sustainability of Chinese economic growth, or at least what really drove last year's rampant growth.

We also believe Chinese base metal imports will fall significantly from last year's levels. There are two important reasons supporting our view.

Firstly, the record Chinese base metal imports in 2009 represented massive restocking after a significant rundown in inventories over the

course of 2008. In the aftermath of the GFC, the unwinding of huge commodity carry trades and a 50%+ fall in base metal prices, provided an unprecedented opportunity for China to rebuild inventory levels. Incredibly, over the course of 2009, China imported over 3 million tonnes of copper, 1.5 million of aluminum, 0.65 million of zinc and nearly 0.30 million tonnes of nickel. Data shows that base metal inventories in China remain relatively high at between 2 to 2.5 months supply for most industrial metals. As a result we expect a slowdown in Chinese base metal imports this year.

Secondly, the Chinese government is committed to slowing lending and winding down the commodity-intensive Yuan 4 trillion economic stimulus. The February data revealed that bank lending declined nearly 50% from the January figures. In addition, commodity-intensive fixed asset growth has slowed from 30.1% growth last year to 20% for the first 3 months of this year. We believe slower growth will curb Chinese commodity demand and reduce base metal imports.

In the meantime, London Metals Exchange (LME) base metal inventories are rising. This is with little sign of a pick up in OECD demand, yet prices continue to hold. This is an unsustainable trend. Given our expectations of slower Chinese growth we think it is unwise to apply a Price Earnings Ratio to current iron ore and coal spot prices. Consequently, against a backdrop of further USD strength, carry trade unwinding and slowing Chinese imports, we remain cautious on resources.

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Information in this Newsletter is drawn from various sources, including extensive and comprehensive research by Southern Cross, Bloomberg and the local press.  
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