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Credit, Currency and Curve

They're Not Just for Bond Investors to Worry about Anymore

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By Gene . Needles | Posted: 03-08-12 | 12:10 PM | Email Article

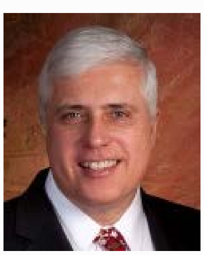
Equity investors, who experienced one of the most volatile global stock markets on record last year, may finally be breathing a cautious sigh of relief. During the first two months of the year, the major U.S. stock indexes have shown a steady, if not dramatic, incline, continuing the momentum that began late in 2011. Though trading volumes are low, investors seem eager to embrace cautious signs that the economy, housing and labor markets are slowly improving.

Unfortunately, this may be the calm before the storm brewing over the horizon, whipped up by an all-too-familiar four-letter word: debt.

Credit, currency and curve – long the watchwords of bond traders – are now the principal risk factors for all investors and will remain so over the next three to seven years because of the massive debt overhang casting its shadow across the globe.

How big a shadow? According to the Bank for International Settlements, the amount of global debt securities stood at approximately $100 trillion dollars as of June 30, 2011. That is up from $95 trillion at the end of 2010 and does not include another $500 trillion in derivatives that are either credit default swaps or interest-rate swaps.

By comparison, global equity market capitalization at the end of 2011 was $47.4 trillion, down about $7.5 trillion from a



About the Author

Gene L. Needles, Jr. serves as President and CEO of American Beacon and as President of the American Beacon Funds. Mr. Needles most recently served as President of Touchstone Investments, part of the Western & Southern Financial Group. He was with AIM Investments from 1993 through 2007, progressing from Regional Vice President to President and CEO of AIM Distributors in 2004. In this role, he was responsible for distributing products that included mutual funds, exchange traded funds, separate accounts, variable annuities, sub-advised portfolios, collective trusts, offshore funds, retirement plans and college savings plans. In addition, he worked as a Vice President at Putnam Investments and MetLife State

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Street before moving to AIM. Mr. Needles received his Bachelor of Arts in English from Iowa State University in 1978.

year earlier, according to figures published by the World Federation of Exchanges, the trade association of 54 publicly regulated stock, futures and options exchanges.

Add to the mix approximately $9 trillion of government debt coming due this year in the developed world alone, according to research by Pyramis Global Advisors, and it is clear that while near-term volatility may have abated, it is likely to be a driving force in the world economic order over the next several years.

What isn't clear is who will pay the tab. Ultimately, some portion of the burden is likely to fall on taxpayers in the U.S., the U.K., the European Union and a host of other countries. Perhaps central banks will just print money to pay back bondholders, essentially devaluing their currencies and repaying creditors with pennies on the dollar.

We're seeing evidence of that right now in the global currency maneuvers already underway. Japan and the European Central bank have flooded their markets with yen and euro, respectively. That, in turn, has caused the dollar to strengthen, which may lead the Federal Reserve to unleash another round of quantitative easing to ensure the dollar does not get too strong relative to other currencies. In a fragile economic recovery – and a presidential election year – the U.S. cannot afford a strong dollar, which raises the price of American goods, making them non-competitive overseas and stifling domestic growth.

However, as many economists have warned, that is a tried and true recipe for inflation. Though the Fed is doing what it believes it must to keep short-term borrowing costs low and fuel the economy with liquidity, it is also setting the stage for much higher inflation and interest rates down the road. That day of reckoning may come sooner than expected as oil and gasoline prices continue to creep up and drive the price of everything else higher.

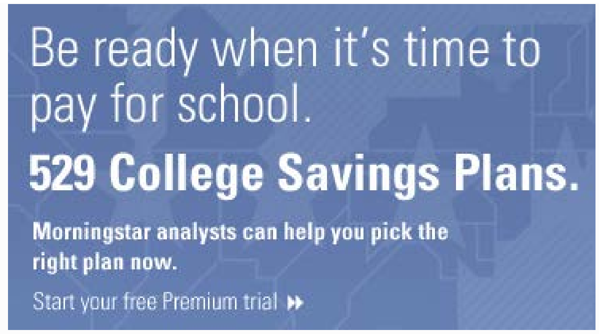
The Challenge for Investors

Investors wondering how to protect their portfolios should start by seeking out investment managers who have demonstrated expertise in the credit, currency and interest-rate markets. The simple truth is that developments in each of these critical segments are much more likely to have a profound impact on their portfolios going forward than the recent rally in stocks.

The most important strategy is to avoid investments denominated in a single currency. We're likely to see the currency-market equivalent of a game of musical chairs over the next three to five years as nations devalue and inflate their currencies, depending on the state of their economies. This is one scenario where an investor definitely does not want to be the last one standing.

Among the holdings careful investors may want to consider are global bond funds, flexible bond funds, high-yield bonds, equity income funds and emerging-market funds denominated in local currencies. Investors must also be wary of taking on too much interest-rate risk. To that end, lower or medium-duration fixed-income instruments or alternative sources of income such as dividend-paying stocks, which have been out-performing the overall market dramatically over the last six to 12 months, offer the best options.

Given the heavy debt burden weighing down world markets and economies, something will have to give somewhere. The responses may be currency



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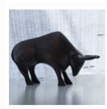

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MORNINGSTAR INVESTOR TRAINING THE FUND PROGRAM FREE CONSULTATION devaluations, higher inflation, rising interest rates – or some combination of all three, none of which bode well for unprotected investors. Back in 2008-2009, the collapse of the sub-prime mortgage-backed bond market caused banks to write off more than $1 trillion in assets in the U.S. alone. A similar situation may be in the offing but on an even larger scale and across multiple industries and nations.

Although economic conditions appear somewhat more encouraging now than they have in recent months, investors should remain wary of and position their portfolios to protect against the credit, currency and curve-related volatility that may still lie ahead.

Gene L. Needles, Jr., is President and CEO of American Beacon Advisors and President of American Beacon Funds in Fort Worth, Texas. The firm managed approximately $46.6 billion in assets as of January 31, 2012.

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