



## Investing in a world of government debt

Governments around the world are driving recovery with aggressive economic policies, creating both opportunities and threats for investment markets. For this Point of View, AXA's National Development Manager – Investments Carmel McKenzie put some of the key questions raised by advisers to AXA's Chief Investment Officer Mark Dutton.

### **Carmel: In your view, are the looming government debt levels problematic?**

**Mark:** Policy makers around the world have intervened harder and faster than at any other time in history to stabilise the financial system and attack the forces of global recession.

As a result, global government actions will lead to a substantial increase in the level of public debt. For example, Australia's net public debt is set to increase from a modest 4 per cent of Gross Domestic Product (GDP) to almost 14 per cent of GDP by 2014. However, this pales into insignificance when looking at the world's largest economies. Net public debt is set to reach 80 per cent of GDP in the US and UK, while Japan is already there, with its net debt likely to exceed 130 per cent of GDP in five years time.

Yes, this level of borrowing is a problem. Government debt levels for some countries, including the US, UK and Japan are unprecedented, and most governments have not outlined credible exit strategies. And this is what's worrying credit agencies and the market.

### **Carmel: What does this mean for the outlook?**

**Mark:** Credit agencies have already begun to issue warnings about the sustainability of public debt levels. These warnings hit home in May, when Standard and Poor's (S&P) issued a negative outlook for the UK's prized AAA credit rating.

While there is no doubt that radical strategies were required to address the Global Financial Crisis, the price to pay will be an increased drag on economic performance of major debtor nations. In the long run, the risk of higher inflation will also re-emerge.

Despite the magnitude of the funding requirements, the US AAA rating is not under immediate threat, and will remain the global benchmark for the foreseeable future.

### **Carmel: What is the likely impact on investment markets? And what are the opportunities?**

**Mark:** Clearly, we will see a major increase in the volume of government bonds on issue. OECD countries are set to issue about \$US2.5 trillion of government bonds by the end of 2010 – the equivalent of 4 per cent of global GDP.

This issuance will change the structure of fixed income markets. As issuers compete for capital, we can expect to see markets differentiate further between issuers, creating new opportunities to improve yields and add value through active management of bond portfolios.

The key is to not chase higher yields without understanding the associated risks. For bonds, the risks are more volatility as the market wrestles with a surge in supply, credit rating dangers, and the re-emergence of inflation.

### **Carmel: What other risks do investors need to be aware of?**

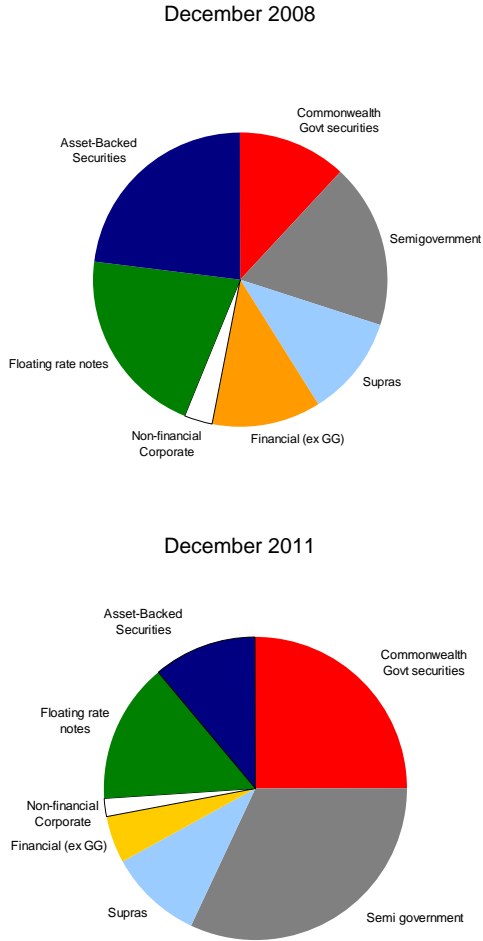
**Mark:** Investors need to be aware that large increases in government issuance will change the composition and duration of bond market indices, and that this has significant implications for investment strategies.

For example, figure 1 reveals that by 2011 government bonds are set to comprise almost two thirds of the UBS Australian Bond Index and the corporate bond sector will shrink to about one third of this index.

This index is commonly used as a proxy for fixed interest investment strategies in Australia, meaning that issuers are effectively deciding the investment strategy. The duration of the index will increase right at the time when investors should be concerned about increasing duration.



**Figure 1**



Source: UBS Reserve Bank of Australia and AllianceBernstein estimates. GG: Government Guaranteed Debt.

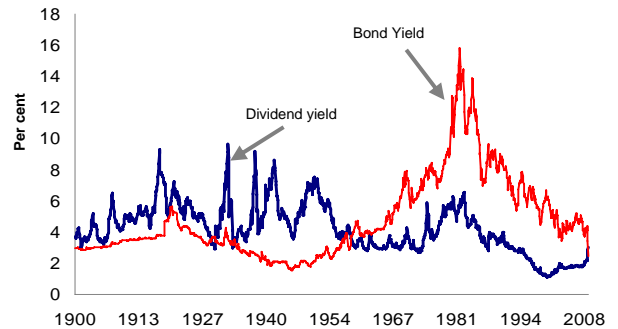
**Carmel: What about sharemarkets?**

**Mark:** Increased bond issuance should not be an immediate concern for sharemarkets, as this is the flip side of economic stimulus policies. Some good news for equity investors is that they are now effectively being ‘paid’ to be patient, as dividend yields (based on last reported dividends) are higher than interest rate yields, as shown by figure 2.

Cash rates have fallen a long way over the past year. Sharemarkets are better placed to generate real income growth over the longer term. For example, even if it takes five years for the Australian sharemarket to return to its previous high, this equates to an average annual return of 11 per cent (plus dividends). This is far higher than the current return from cash.

Global diversification will become increasingly important as countries and regions will emerge from recession at different times, with varying levels of debt to manage. As growth re-emerges, the beneficiaries will be unevenly spread and this will generate greater opportunities for ‘active’ managers than in recent years.

**Figure 2**



S&P 500 versus 10 Yr Treasuries. Source: AllianceBernstein, Federal Reserve, Schiller, S&P.

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