SOCIETY OF ACTUARIES

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TWO FOR THE PRICE OF ONE

By Brett Gallagher

Normally, the saying "two for the price of one" is associated with a good deal; something to be desired. Across the global financial markets, "two for the price of one" also nicely describes the price action in 2009—periods of both extreme distress and incredible euphoria. Whether it was something to be desired is another matter.

Through March 9th of this year, the poor returns of 2008 continued across a variety of asset classes. Equities were particularly distressed as fixed income markets had already begun to stabilize late in 2008. Since early March, however, we have seen strong rallies across typically "riskier" classes in what can only be described as a once-in-a-lifetime bull market rally for a number of them.

Return Performance December 31st – March 9th

ML US High Yield Master	-2.1%
ML US Corp BBB	+1.2%
ML Global High Yield Euro Issuer	+3.9%
ML Global EM Sovereign	+0.0%
MSCI World	-24.9%
MSCI Emerging Market Equity	-20.7%
MSCI All Country World Equity	-23.4%
Oil	+5.5%
Copper	+31.6%
Euro vs. US$	-9.7%

Combine the following table with the one above

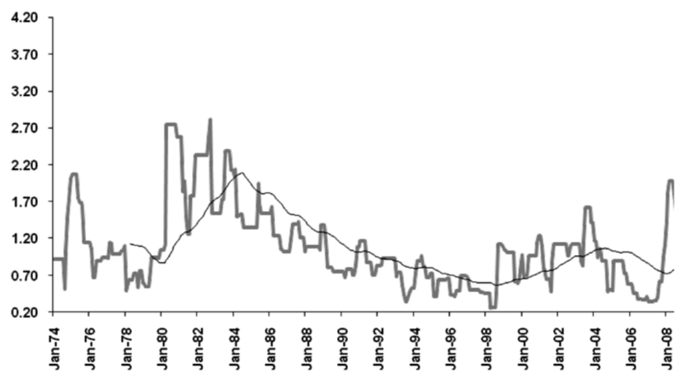
Return Performance March 9th – September 30th

ML US High Yield Master	+50.8%
ML US Corp BBB	+27.1%
ML Global High Yield Euro Issuer	+65.4%
ML Global EM Sovereign	+33.9%
MSCI World	+66.2%
MSCI Emerging Market Equity	+113.7%
MSCI All Country World Equity	+68.9%
Oil	+50.0%
Copper	+52.5%
Euro vs. US$	+16.1%

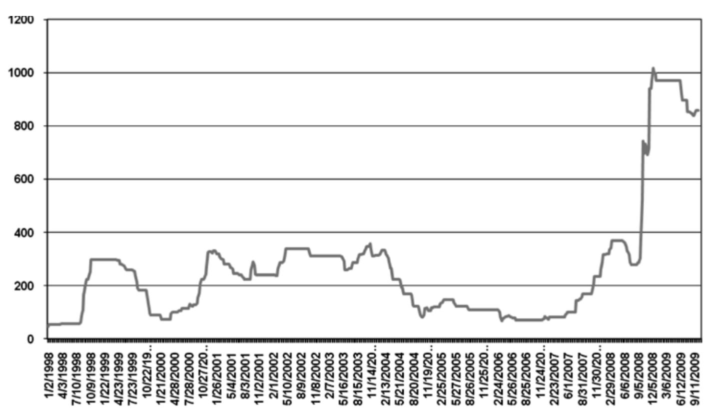
Source: Bank of America Merrill Lynch, MSCI Barra, Bloomberg, Artio Global Investors

The reversals we experienced from asset class lows, to their highs have not been seen in decades. In some cases (equities) we witnessed the biggest moves since the 1930s.

Credit Spreads (Baa-UST)
12 Month Difference between Maximun and Minimun



High Yield vs BBB Spreads
12 Month Difference between Maximun and Minimun



Source: Bank of America Merrill Lynch, Artio Global Investors

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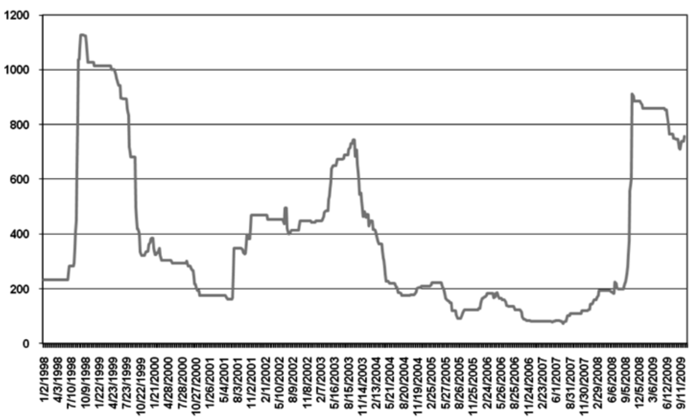
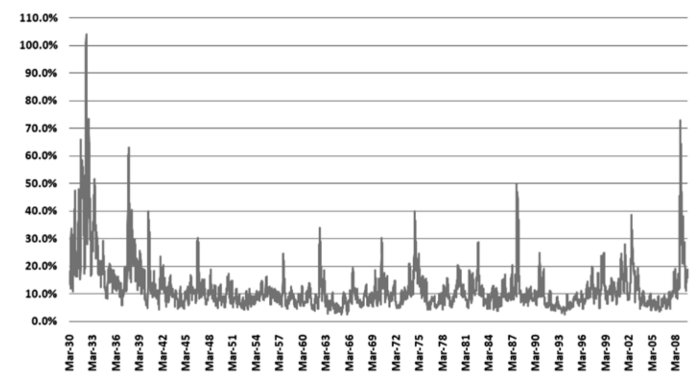
Emerging Sovereign Spreads
12 Month Difference between Maximum and Minimum



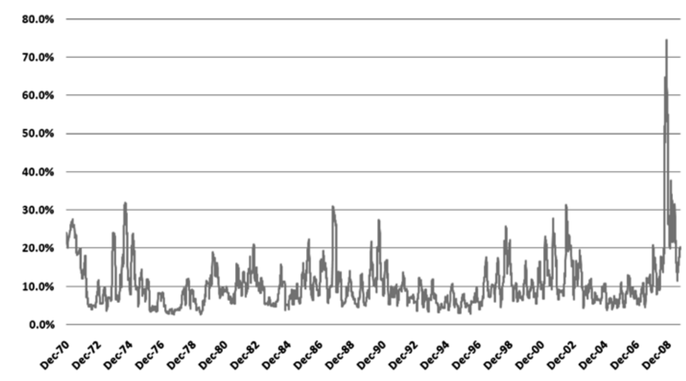
Source: Bank of America Merrill Lynch, Artio Global Investors

S&P 500 Index
% difference Between 12 Month Hi/Lo



Source: Standard and Poor's, Artio Global Investors

MSCI World Index
% Difference Between 12 Month Hi/Lo



Source: MSCI Barra, Artio Global Investors

Such rapid market turns would seem to reflect a belief that we have avoided the worst possible outcome of the economic/credit crisis (i.e., Armageddon) and that we are on our way to a more typical cyclical recovery. The real question is, "are we"?

BACKDROP

Most of the market's liquidity-related issues of Q4 2008 had been addressed through the massive and coordinated efforts of governments and central banks around the world. In total, fiscal "stimulus" packages aggregated to approximately 4 percent of Global GDP.

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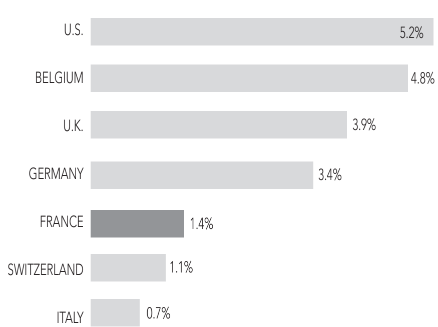
	US$ Bn	As a % of National GDP
China*	1171	27%
United States	787	6%
Europe	298	2%
Japan	154	3%
Latin America	149	4%
Emerging Asia	52	2%
Central/Eastern Europe	23	2%
Russia	20	1%
TOTAL		4% Global GDP

Source: Nomura Research. China number includes non-central Gov't spending

Monetary (including quantitative easing) and bailout programs (the banks, Fannie/Fredie, GM/Chrysler, AIG) provided further fuel to remedy the worst of the credit market woes.

Give and Take

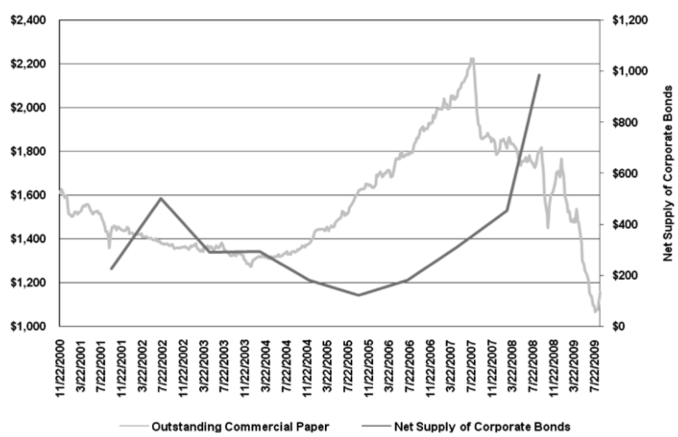
France, like many countries, is considering ways to recoup some of the money it has spent on bank bailouts.



PLEDGED GOVERNMENT RECAPITAL-IZATION OF BANKS AS A SHARE OF 2008 GDP

Source: International Monetary Fund

Corporate Funding Alternatives ($bn)



Source: Bloomberg

As a result, credit spreads collapsed and funding markets opened wide. Corporate issuers have taken advantage of the opportunity and, in our opinion, behaved wisely by extending borrowing maturities to take advantage of historically low interest rates while at the same time providing themselves with enhanced financial flexibility.

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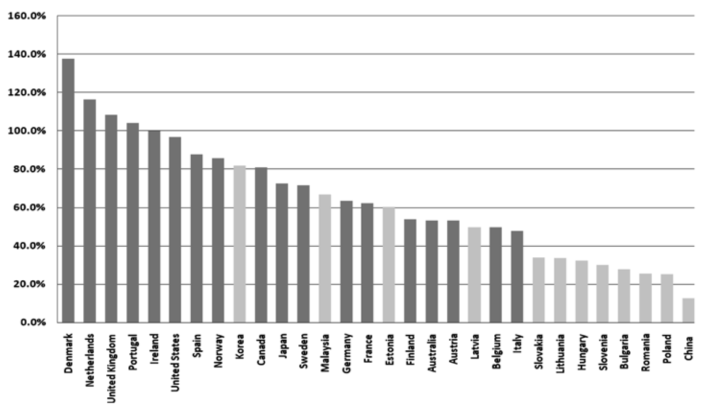
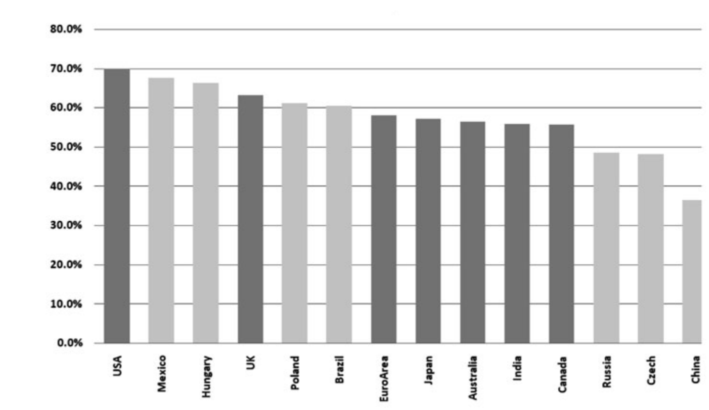
Household Liabilities as % GDP (2007)



Source: Eurostat, Federal Reserve, BIS Papers No. 46, Statistics Canada

What has been neglected throughout, however, and what we fear will guide the future, is massive leveraging—first of the consumer sector in a number of developed countries and now, as these same consumers pull back, their governments. Recent actions in both sectors are likely to result in lower secular growth rates and present the greatest risks to a return to sustainable global growth.

Personal Consumption as % GDP



Source: The Economist Intelligence Unit

Consumers across many developed countries had supported spending, not through incomes, but through borrowing. Household debt levels reached record highs in many countries, notably the United States and the United Kingdom amongst the larger economies.

Some may question our obsession with the consumer that we have voiced consistently throughout our previous commentaries. However, we do not think our concern is overdone given the houshold's importance to most economies, typically representing between 50 percent and 70 percent of their GDP. In other words, as goes the consumer, so goes the economy.
The mathematics of consumer deleveraging are clear. By way of example, if we assume the U.S. consumer needs to repair their balance sheets to pre-2000 levels, they will have to pay down roughly $5 trillion in debt (reducing household debt from 97 percent of GDP to 65 percent). If this is accomplished through increased savings, many years will be required to reach the point of stability. Should the U.S. savings rate rise to its long-term average of 8 percent of income (it is currently 5 percent), approximately $800 billion will be saved annually, implying a six-year debt paydown. Slower economic growth will be the side effect of this prudent activity, as savings become money no longer spent.

A corollary to the retreating consumer lies in the resurgent government sector. However, with the government generally 20 percent or less of GDP, its spending must grow by 3 percent to counter each 1 percent decline in consumer spending. While countries with excess savings, like China, are able to provide such a boost without borrowing, most developed countries have had to resort to the kindness of strangers and have stepped up their borrowing. The hope is that by the time the government needs to withdraw, spirits should be such that the consumer is ready to pick up the baton.

We tend to feel that the amount of stimulus in the pipe today, and what is likely to flow over the next six to nine months (U.S. stimulus spending is approximately 25 percent complete, China approximately 50 percent complete, at time of writing in Nov. 2009), will tend to lend a positive boost to the world

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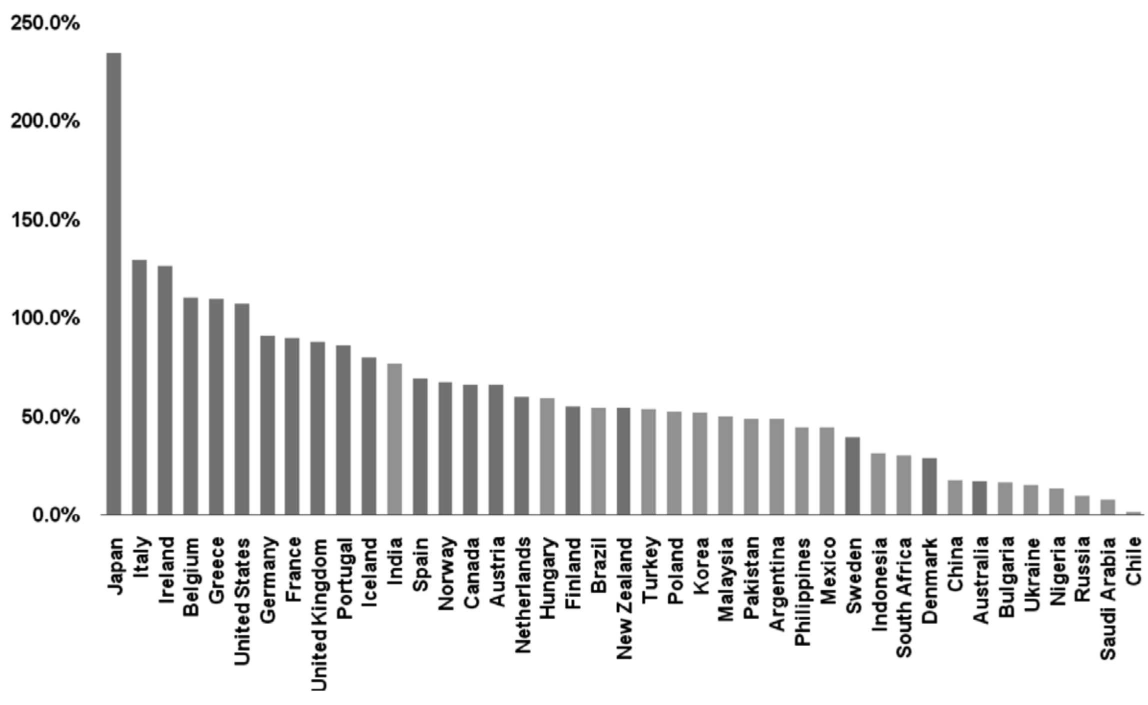
economy. We differ with the consensus in that we find government efforts unsustainable and doubt consumers will be in shape, or in the mood, to take over when the government steps back.

The chart that follows is from the IMF's June report, "Fiscal Implications of the Global Economic and Financial Crisis," *http://www.imf.org/external/pubs/ft/spn/2009/spn0913.pdf.* In it, the IMF calculates likely government sector debt/GDP ratios in five years time, based on current debt levels and forecast spending and growth plans. The reading is sobering.

Developed countries are shown in green, while emerging countries are shaded in grey. What jumps out at even the casual observer is the fact that it is the developed nations who have the most stretched balance sheets—the same observation we made about the consumer side of the ledger.

Government Debt/GDP Estimates in Year 2014



Source: The IMF

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"... WHILE THE CHINESE HAVE NOT YET LEFT THE PARTY, THEY HAVE CERTAINLY MOVED CLOSER TO THE DOOR."

Secondly, those countries where debt levels approach 100 percent of GDP have a dilemma. It becomes increasingly possible that any growth in wealth (GDP), may be absorbed simply to support the debt service on previously borrowed moneys. Japan's "lost decade" began around the time government debt exceeded 100 percent of GDP (though abnormally low interest rates kept the overall debt service ratios in check and a large current account surplus supported the currency).

This situation is especially worrying in the United States where not only is the debt level high, but also the average maturity of outstanding debt quite low. More than 40 percent of all U.S. Treasury obligations will need to be refinanced by the end of 2010 (and over 50 percent by the end of 2011), leaving America most vulnerable to rising interest rates. Other countries with high debt levels would seem to have a more prudent distribution of debt maturities, most notably the United Kingdom which, though it shares our debt dependence, sees less than 12 percent of their debt roll over before next year end.

	USA	Japan	UK	Germany	Aus	Can	France
2009-'10	42.4%	28.8%	11.6%	23.6%	15.2%	42.6%	26.1%
2011-'15	34.4%	39.6%	28.8%	46.4%	44.8%	30.1%	39.1%
2016-'20	15.1%	18.2%	16.9%	17.5%	21.4%	9.7%	20.1%
2021-'30	4.5%	11.0%	17.9%	5.3%	7.8%	7.5%	7.6%
2031+	3.6%	2.4%	24.9%	7.2%	10.8%	10.2%	7.2%

	USA	Japan	UK	Germany	Aus	Can	France
2009-'11	52.8%	40.1%	18.2%	35.6%	24.8%	52.2%	35.6%
2012-'15	24.0%	28.6%	22.1%	34.4%	35.2%	20.5%	29.6%
2016-'20	15.1%	18.2%	16.9%	17.5%	21.4%	9.7%	20.1%
2021-'30	4.5%	11.0%	17.9%	5.3%	7.8%	7.5%	7.6%
2031+	3.6%	2.4%	24.9%	7.2%	10.8%	10.2%	7.2%

France debt includes Social Security Debt Repayment Fund
Germany debt includes Federal Post, Deutsche Bundesbahn and Treuhand
Australia debt includes Queensland Treasury, South Australia GFA, Treasury Corp Western Aus, Tasmanian PFC, NT Treasury
Japan debt includes government bonds for individuals
Source: Bloomberg, Artio Global Investors (as of Oct. 20, 2009)

It is also worth noting that almost 25 percent of Chinese Treasury holdings have a maturity of under 12 months (up from less than 4 percent just over a year ago). So, while the Chinese have not yet left the party, they have certainly moved closer to the door. There are many who poo-poo the idea of China abandoning U.S. Treasuries. Their simple question is, "what else are they going to do with the money"? They then answer themselves by stating, "certainly they would not stop buying UST for that would damage the $800 billion worth of debt they already hold which is akin to shooting yourself in the foot." I would argue that **the maturity restructuring of their debt is just step one. Step two will be when the Chinese choose to issue sovereign debt denominated in the U.S. dollar, beginning to currency match their assets and liabilities.** Maybe it's the back door they're looking to sneak out of? The Russians announced their intentions to issue $18 billion in dollar debt in mid-October, while the Germans decided to do it a few weeks earlier. Can the Chinese be far behind?

While debt levels are certainly a signal, it all really comes down to a country's ability to service its debt. At year-end 2008, the U.S. debt service ratio was 3.1 percent of GDP. Assuming IMF projections are accurate and interest rates do not change (we think that is probably a generous assumption), American's debt service ratio will increase to 4.1 percent by 2014. Should rates also climb, the U.S. may quickly reach the point at which debt service consumes any increase in GDP.

Another way of looking at this is to consider that debt servicing currently has a claim on just less than 40 percent of all U.S. income taxes (which is also equal to just less than 20 percent of total government receipts). It is no longer inconceivable that it could reach a point where new investment or support of government programs is difficult.

The implications of the levered westerner (both at the consumer and government levels) could potentially lead to a scenario where consumers increase their raise savings rate which, while good for the balance sheet, is bad for economic growth. The government, which has already spent and borrowed as much as they can, must raise taxes while cutting spending, further retarding growth. In short, a number of Western economies, led by the United States and the United Kingdom, have likely gone ex-growth, joining Japan which did so more than a decade ago. Those investors looking for opportunity, are better off focused on companies which do business in the still viable emerging markets and those fewer developed markets where consumers and governments are not as stretched. Interestingly, as Angela Merkel wins another election in Germany, her focus is on cutting corporate tax rates. The balance sheet flexibility of the Germans allows this and is likely to widen the capital attractiveness gap versus the United States—just one of the reasons Continental Europe finds favor in our portfolios.

Our international and global equity teams also continue to have a pro-cyclical bias to sector allocation to take advantage of continued stimulus flows. We also have a bias toward commodity-exposed countries which stand to benefit not only from the increased demand of a rebounding economy, but also as a hedge against a weak U.S. dollar. While we have taken some profits from our recently increased Emerging Markets exposures given their dramatic runs, we still have a relatively positive view of them for the intermediate-term. Further out, we may have to revisit our China exposure as it is likely to have difficulty given its export dependency and our forecast for slower baseline global growth, but that time is not today.

High yield bonds have had a year for the ages. While spreads have compressed dramatically, we are still above longer-term spread norms and while we do suspect the future normal will be about wider than before* given the slower rate of global growth (and likely higher defaults), the reason for buying the asset class is still valid—you don't (or shouldn't) buy high yield for the compression (though it was a nice bonus). You buy it for the ongoing yield. We believe that from current levels, the asset class is still likely to outperform equities.

*The historic average default rate for high yield has been about 5 percent and the recovery rate about 40 percent. Given our view for slower global growth, we would expect both higher defaults and lower recoveries going forward (let's assume 6 percent and 20 percent, respectively). That would make the cost of default roughly 480 basis points (6 percent * (1 - .2)). If we further assume an additional 150 bps by way of liquidity premium, we could expect a future normal spread of approximately 630 bps (up from 450 bps today).

The views expressed are subject to change, based on market and other conditions and do not constitute investment advice. This article was previously published as part of the Artio Global Advisors CIO Letter sent in Q4 2009.

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