

## The Changing World of Fixed Income and Currency Safe Havens

What is a safe haven investment? For many investors it is something that goes up in value when stock markets are roiled by surprising events. Since news broke on March 11<sup>th</sup> that Japan had been struck by a series of tragic events, markets have moved in ways that are both traditional - stocks down, bonds up - and unexpected - the first major G-7 currency intervention since 2000.

The human tragedy unfolding in Japan is first and foremost in all investors minds. Yet at the same time investors are inevitably drawn to the volatility and price action in global markets, what it means to their portfolios, and to their future strategy. The dramatic swings in market relationships since March 11<sup>th</sup> have reinforced why certain investments, such as U.S. Treasuries, have traditionally been viewed as safe havens. The decisive role Treasuries have played in the past, however is being challenged by new competitors. Similarly, the preeminent role of the Japanese Yen and the Swiss Franc as currency safe havens may also be less clear.

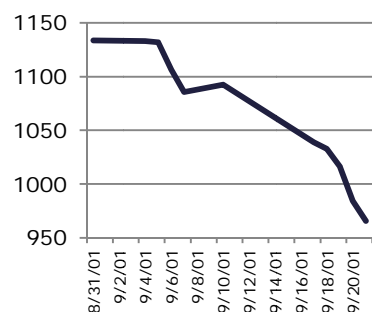
The changing relative performance of instruments traditionally viewed as safe havens, and those not usually considered may offer important insights into changing perceptions of risk. The discussion below will seek to evaluate these changes in relative performance in pursuit of a better understanding of what is likely to be viewed as safe in future times of trouble.

For purposes of discussion, we will consider three notable events that most investors will agree were times when safe haven considerations drove investor behavior: September 11<sup>th</sup>, the Financial Crisis of 2008, and the current crisis which we will simply call Japan 2011. Many investors think about safe havens as investments that will hedge their equity exposure. In this context, we will define the end of the safe haven period as the bottom of the decline in stocks. Two of these periods are brief, September 11<sup>th</sup> and Japan 2011, and of course Financial Crisis 2008, which was protracted and lasted into 2009.

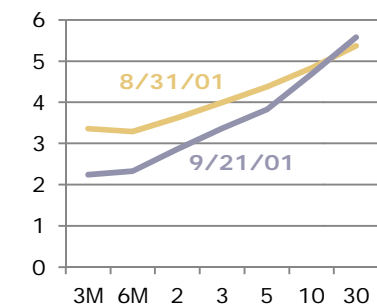
U.S. stocks, defined as the S&P 500, fell by varying amounts in each crisis, but regardless of the amplitude of the stock decline Treasury securities rallied in each scenario. Depending on the nature of the crisis the relative performance of the Treasury curve differed materially. September 11<sup>th</sup> witnessed a massive drop in short to intermediate Treasury yields, while ten and thirty year maturity bonds either rallied modestly, or actually fell in price further out the curve. From a total return perspective, the diversification benefit of being in intermediate maturity Treasuries was superior to being in longer maturity Treasuries.

### September 11<sup>th</sup> (8/31/01 - 9/21/01)

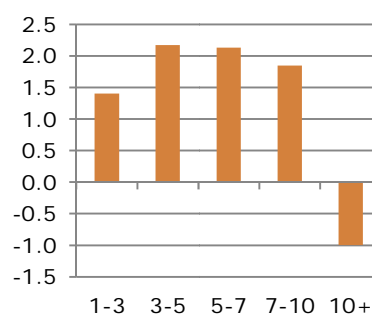
**S&P 500**



**Treasury Yield Curve**



**TSY Total Return by Maturity**

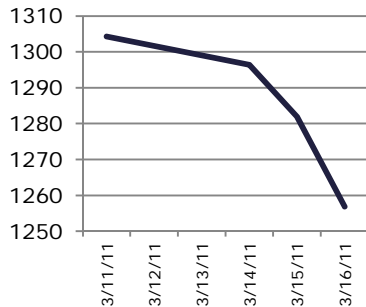


Source: Bloomberg®

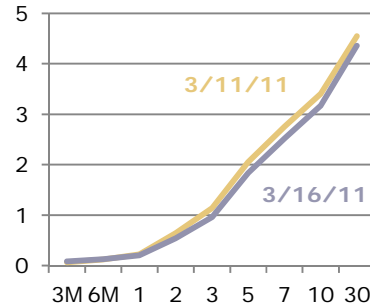
Japan 2011, also a short-term time series, was a different kind of Treasury rally: The usefulness of Treasuries as a safe haven instrument improved dramatically as one extended in maturity.

**Japan 2011 (3/11/11 – 3/16/11)**

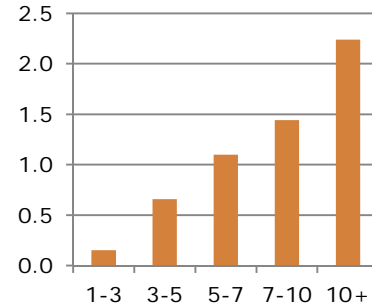
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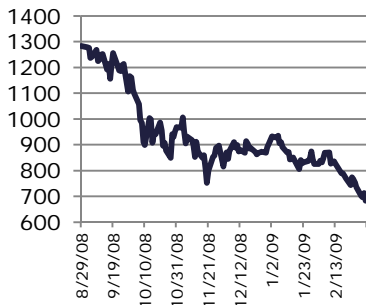


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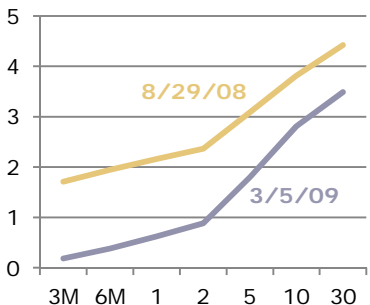
Financial Crisis 2008 provides perspective to help us appreciate the divergent performance of Treasuries during the September 11<sup>th</sup> safe haven move and Japan 2011. As readers are painfully aware, Financial Crisis 2008 led to the worst economic event since the Great Depression, a collapse in growth and inflation expectations, and, as a result, short rates fell to essentially zero and long rates fell precipitously.

**Financial Crisis 2008 (8/29/08 – 3/5/09)**

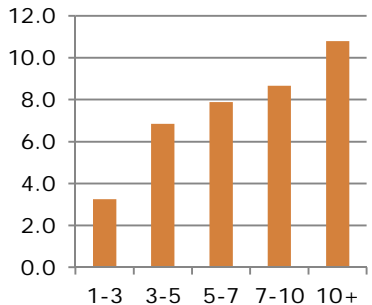
**S&P 500**



**Treasury Yield Curve**



**TSY Total Return by Maturity**



Source: Bloomberg®

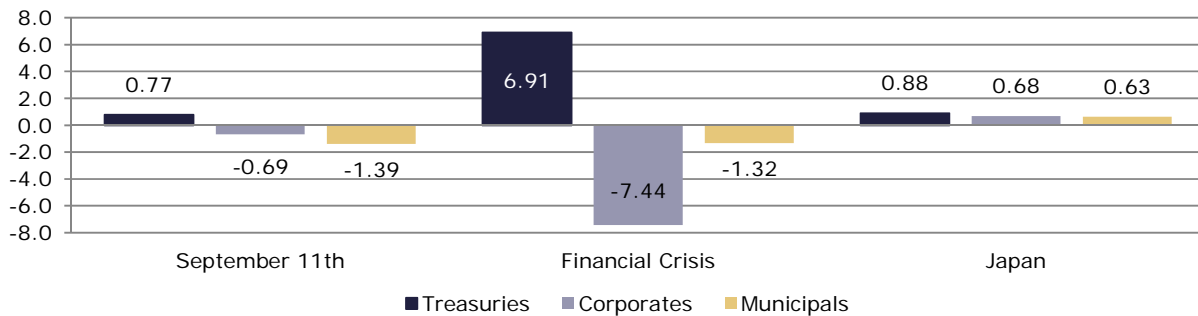
The above discussion, focused around three major events, underscores the role of Treasuries as a safe haven, but also highlights that yield curve positioning matters significantly if an investor is to maximize the benefit of a Treasury safe haven allocation. We believe there is no simple approach, even in a market as seemingly straight forward as Treasuries.

Yet, Treasuries are not the only bond an investor could choose for a safe haven instrument, though they may be the most consistent performer in that role. Given all of the concerns about the fiscal position of the United States, it is reasonable to ask if the term “safe haven” is an oxymoron when applied to bonds issued by the U.S. government. If we define safe havens as investments that go up in price when stocks go down, Treasuries still get to wear that title, but there are some surprising competitors in high grade fixed income. For purposes of illustration, we will compare the relative performance of Treasuries, corporates, and municipals during these three events. The results may provide us with insight into changing investor perceptions of risk and how markets may behave in the next crisis.

Despite the divergent relative performance in the treasury curve discussed above, September 11 and Financial Crisis 2008 bear a striking resemblance when it comes to corporate and municipal sector performance: both sectors generated negative returns providing no safe haven benefit. The drop in the value of these securities

during crisis is familiar and intuitive. Yet in Japan 2011, as the chart below shows, the pattern is broken. Both investment grade corporate bonds and municipals have generated healthy, positive returns. In fact, not only have corporates and municipals increased in value during this crisis, but they have been competitive with the total return of Treasuries. Technical factors such as the recent low supply of municipal new issues may be playing a contributing factor in this most recent time series, but when investors are worried market technicals only go so far. Considering the continuing uncertainty about the U.S. economy, and the parade of negative press about municipals, this positive shift in relative performance during crisis is indeed striking. It may be too early to say that corporates and municipals are the new safe havens, but perhaps it is not too early to say that the clear role Treasuries play in such an event is in doubt.

### Treasury, Municipal, and Corporate Performance



Source: Bloomberg®

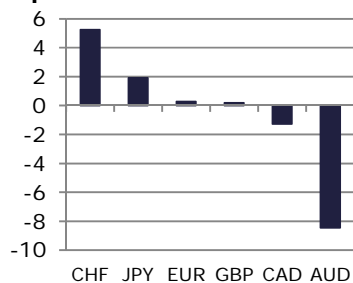
This shift in relative performance among fixed income sectors is matched by an equally revealing shift in the relative performance of major currencies during this crisis. Taking the same approach we applied to fixed income to reveal changing relationships we will evaluate how the major currencies performed during these events. Interestingly, in none of these events has the U.S. Dollar been the world's best performing currency – a great reminder of the benefits of currency diversification. Not surprisingly, the Swiss Franc and the Japanese Yen show up as stalwarts in the universe of currency safe havens, always ranking near the top. Yet in this crisis a shift has occurred that is notable for what it says about free market forces in currency markets, as well as how investors perceive the relative safety of the world's major currencies. The G-7 currency intervention on March 18th was the first major intervention by the group in nearly a decade and effectively ended the rally of the Yen.

The reasons for the intervention were laudable – a nation dealing with catastrophe should not be further hobbled by a strengthening currency that hurts its export engine and hopes of recovery. Noble as the G-7 intervention may be viewed, and it is a great example of Central Banks working together for the common good of human kind, it effectively ends the role of the Yen as a safe haven for the time being. If we keep in mind our definition of a safe haven, something that goes up when crisis hits and stocks go down, we believe that the Yen's days of going up are largely behind it for the foreseeable future.

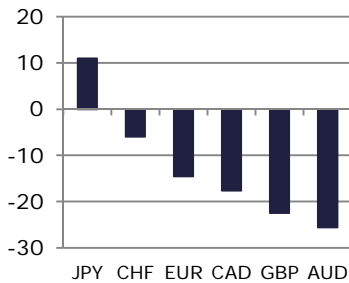
The surprise in this safe haven move is not that the Dollar lost value against almost every other major currency, but that the strongest currency after the Swiss Franc is the Euro. Its relative performance demonstrates that investors may be beginning to appreciate that European leaders, in their own distinctly European style of management, have pulled together a patchwork of policies to strengthen the currency zone, and provide support beneath the periphery nations with a stabilization fund.

## Currency Returns Versus the U.S. Dollar

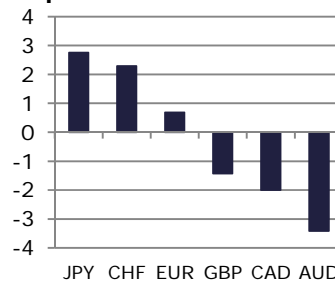
September 11<sup>th</sup>



Financial Crisis 2008



Japan 2011



Source: Bloomberg®

The strength of the Euro as a safe haven currency contender is matched by the equally impressive performance of the German Government Bonds (Bunds) in both the Financial Crisis of 2008 and Japan 2011. In both cases, German Bunds performed well. In Japan 2011, German Bunds generated a return comparable to Treasuries in local currency terms, while they generated significant outperformance in Financial Crisis 2008. We believe that investors seeking safe havens would be prudent to consider bunds as part of their solution set. To the extent they are uncomfortable with currency volatility, as the table to below suggests, a Bund portfolio hedged using liquid and transparent currency forwards may provide all the benefits of a safe haven allocation without the foreign exchange volatility.

	September 11 <sup>th</sup>	Japan 2011	Financial Crisis 2008
German Bund	0.14%	0.82%	9.52%
U.S. Treasury	0.77%	0.88%	6.91%

History shows that those countries who fail to deal with debt crisis diminish in importance, while those who effectively deal with debt crisis, enhance not only their economic development, but nationhood. The United States evolved into a stronger group of states with a sterling credit rating not after the revolution, but in the 1790's when Secretary of the Treasury Alexander Hamilton dealt with the debts of the weak states and consolidated them into the Federal debt. Perhaps the strong relative performance of the Euro during this crisis is telling us that Europeans are gaining the respect of investors and a brighter future for Europe is ahead.

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Principal

March 24, 2011

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