

Bond Market Update

July 2009

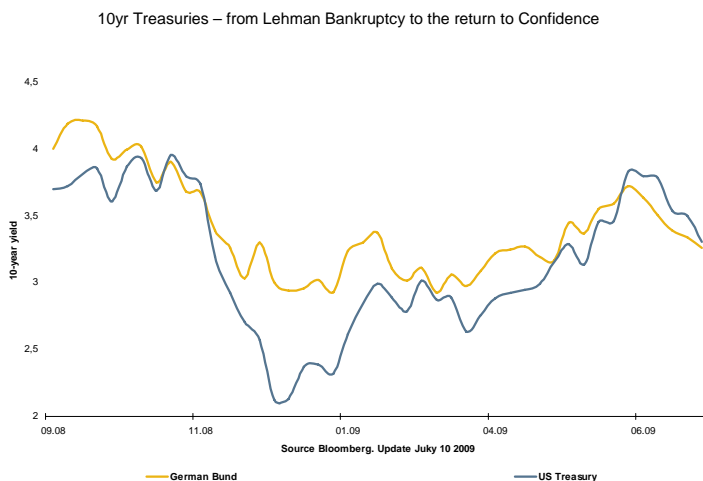
Bond

From Safe Haven to Risky Asset

The green shoots of recovery have sparked a global rally in both equity and credit markets during the first half of the year. As a consequence, government bonds, after enjoying a safe-haven status during the crisis, have progressively lost their appeal.

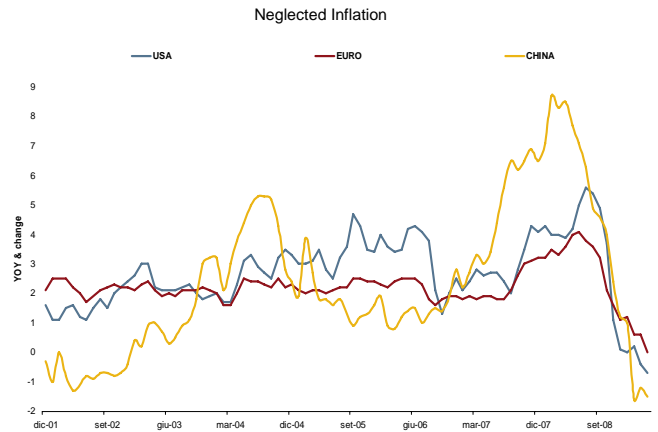
In this document we examine the factors driving the increase in government yields from their recent lows (2.90% for German Bunds in mid-January and 2.05% for US Treasuries at the end of last year).

The policies put in place by most governments to revive growth call for substantial financial backing. This is especially true for the US government. Unsurprisingly, US Treasury yields have almost doubled versus benchmark 10-year maturity in the last 6 months.



On the monetary side, a zero-rate policy is unlikely to reassure investors of the central bank's commitment to consumer price stability once the recession is over. Usually, the higher the expectations about economic growth, the sharper the rise in government bond yields.

In other words, the market has begun to price in an end to the recession and a return to inflation as a result of the government policies, particularly since autumn 2008. In reality, inflation remains well under control while deflation appears to be the main area of risk.



Source: Bloomberg 30.06.09

Inflation? Not quite yet

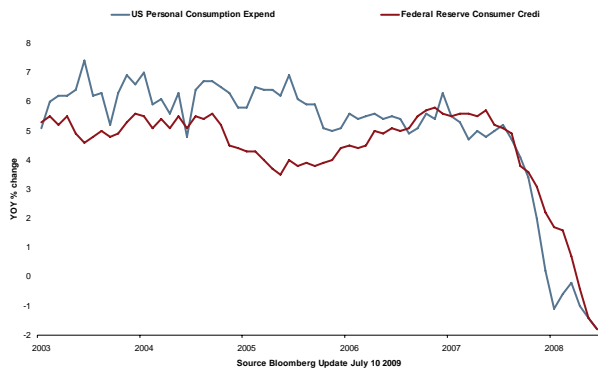
For the most part, it is not so much a case of returning optimism on the back of positive growth, as a decline in the extreme pessimism experienced after the collapse of Lehman Brothers. The possibility that the recession may end, as difficult as this may seem, has had a disproportionate effect on market optimism. Admittedly the green shoots of recovery are there. Developing countries with a strong potential for domestic growth are still in need of resources. Against this backdrop, their contribution to global GDP growth is bound to increase further.

The confidence-inspired rally seems to suggest that developed countries could also return to trend growth soon after emerging from recession. This level of confidence may prove excessive. The recession has been very hard on debt-laden US households. Their shopping habits, which strongly contributed to GDP growth before the crisis, are unlikely to return this year, or next and overall growth may remain below trend.

In our view, when the recession ends, it is likely that recovery will be gradual. In this scenario, nervousness concerning inflation appears premature. Central banks can afford to keep zero-rate policies for a relatively long time, without fuelling inflation concerns.

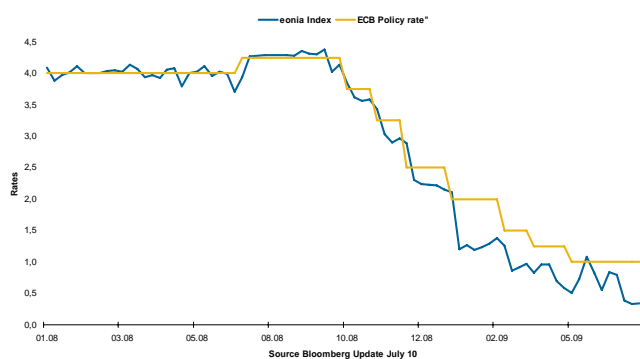
We hold a more positive view on the Euro area, where we believe that the economy may benefit, although with some delay, from a global recovery. The ECB, usually preoccupied with inflation control, seems to be uncharacteristically focused on concerns surrounding growth prospects and issues in the banking sector.

Consumer credit is key for US household spending



Key policy rates have probably bottomed out at 1%, but a zero-rate policy is being introduced “by stealth” as overnight rates fell as a result of substantial ECB refinancing operations.

Euro Overnight Rates close to zero



In this context we consider the market’s concerns surrounding inflation to be excessive, also taking into account that returns have increased to 3.70% since the beginning of June on 10-year German government bonds. Consequently we decided to increase duration on our government bond funds.

Medium to Long Term Risk

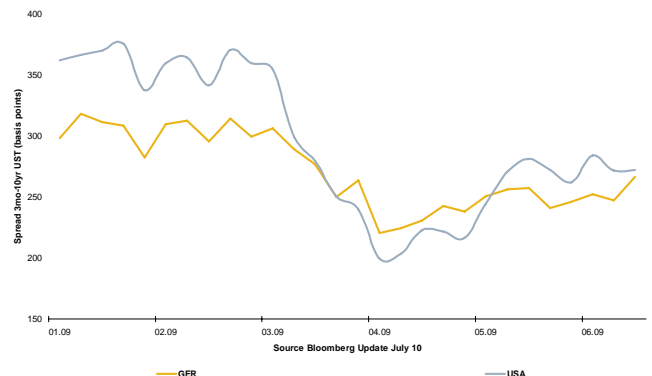
Looking forward, the central banks will have to start factoring in a return to normality, and must plan a careful “exit strategy” from current policies, which exist only to deal with unprecedented “emergency” conditions.

If they persist with current expansionary policies for too long, they risk incurring the wrath of the “bond market vigilantes”. In the past markets have often sold off bonds when inflation threatened to erode purchasing power, thereby driving yields up sharply.

A further rise in bond yields, of, for example, 2-3% from current levels, may have the same impact as a series of policy rate hikes. The real economy could suffer from a “market-driven” tightening (for instance borrowers would pay more to service debts such as mortgages).

The slope of the yield curve will be useful in order to assess this ‘intervention’ by the market rather than the authorities. Other things being equal, the larger the spread of short-term rates (3-month US T Bills in the graph) to long-maturity yields (the benchmark 10-year) the higher the perceived “inflation” risk premium.

Inflation Risk Premium



A structural increase in budget in budget deficits may also increase the expectation of inflation.

In the US, inflation risk premium rose to almost 4% for Treasuries in the six-month period to last June; it was not a coincidence that this occurred exactly when the stockmarket rally peaked in early June.

Investors have since caught up with reality and the slow-growth recovery scenario duly regained ground. The premium is now closer to 3%. Nevertheless, the Federal Reserve will have to pay close attention to the bond market “vigilantes”. In the past they were often a challenge for central banks and added to market volatility. This is likely to be repeated for US Treasuries, which is why we remain aggressively underweight in the sector.

We believe that the European bond markets may be less impacted by this; as a consequence both our strategic exposure to the asset class and the duration of our fixed income portfolios have been higher in Europe than in the US.

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