

Bond Markets in a Slow-Growth Scenario

September 2009

Government bonds are supported by a slow recovery

Hopes that the end of recession will almost immediately be followed by sustained growth seem overly optimistic if only because they are in sharp contrast to the pervasive gloom that existed about six months ago. However, financial markets tend to anticipate changes in the overall picture at the early stages and are especially volatile at supposed turning points.

In this regard the significant increase in government bond yields that occurred between March and June has gone hand in hand with the rally of both equity and corporate bond markets.

Besides losing their safe-haven attraction, government bonds have certainly suffered from one-sided policies aimed at stimulating the economy. Those who invest in government bonds are not reassured by the fact that inflation targeting or public finances stability are set aside.

While concerns over a long-term budget deficit in the United States persist, the inflation risk seems far-fetched with data showing year-on-year inflation near zero. Even the recent increase in gold prices above the threshold of US\$1000 per ounce suggests a demand for shelter against various risks (also geopolitical) other than inflation.

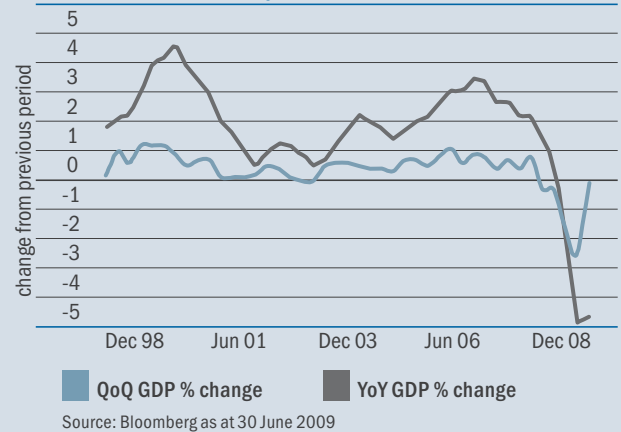
Recent market developments support this view. Government yields have settled and in the euro area they are halfway between the cycle lows and the levels reached in June when the post-recession relief was at its highest.

Admittedly our strategy has long retained an underweight in government bonds, more aggressively so in the US where the fiscal position looks set to deteriorate on a structural basis. This stance has not changed but it is being softened somewhat compared to early 2009 when it was also consistent with an aggressive overweight in corporate bonds amid record-high credit spreads, suggesting an unprecedented (and, in our view, overdone) rise in defaults.

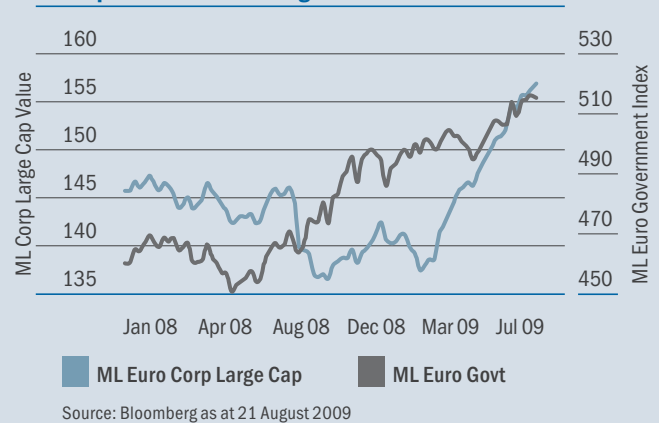
As we cut our corporate bond overweight, first in the High Yield segment of the market, we are slowly adding to our government exposure. Specialised portfolios have increased the duration, which is currently above the market benchmark.

This stance underscores a scenario of gradual (U-shaped) recovery as opposed to a quick and steep (V-shaped) upturn after

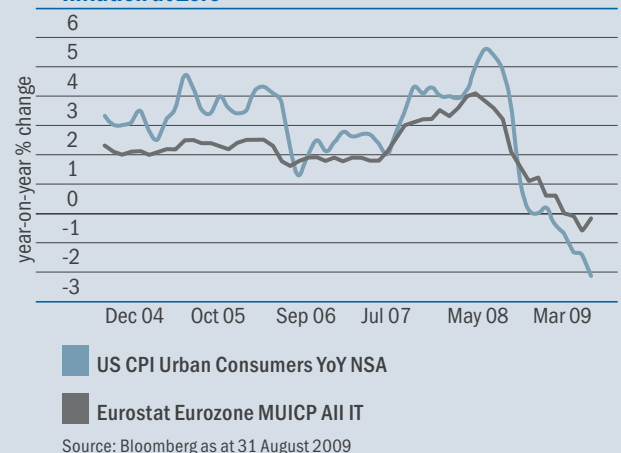
The Worst is Probably Over



Corporate Bonds' Revenge



Inflation at Zero



the recession is over (in late 2009 for the USA and next year in the euro area). In the early stages the rally in cyclical assets was mostly driven by a global relief, as the dreaded depression turned into a severe-but-manageable recession. The summer's leg of the rally, however, suggests that a V-shaped recovery is becoming the consensus scenario.

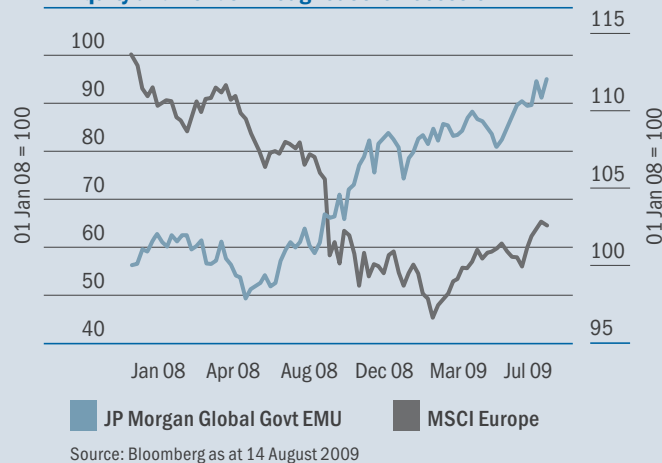
The main reason why the optimism may be overdone is that domestic consumption is unlikely to provide the same support to growth in industrialised countries as in previous upturns. Households, particularly in the United States, have been severely hit by the credit crunch and may not be back to past shopping habits any time soon. Unemployment rates are still rising and nearing 10%, while the housing market is recovering very slowly, with both data unlikely to lift spirits.

Without the help of policy measures such as the “cash-for-clunkers” scheme or other incentives (barely extendable over time) domestic demand cannot be expected to provide a strong contribution to overall growth.

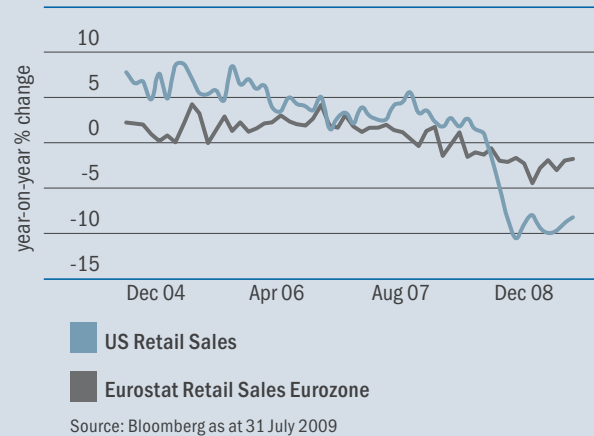
Remarkably, the European Central Bank has not taken the upbeat second-quarter data on GDP in the euro area as an excuse to send an inflation alert and mark the end of the zero-rate policy. However, it has renewed concerns about growth. The chairman of the US Federal Reserve is sounding more optimistic but he is careful to add that the economy is set to remain weak for some time yet, implying that there is no hurry to implement an exit strategy from current expansive policies. Keeping this policy stance should worry the bond market but it is unlikely to do so as long as consumption growth is muted.

With regards to our global strategy, government bonds will be favoured again when yields become attractive compared to dividend yields, which is not yet the case. This scenario seems appropriate to increase the risk of interest rates through an appropriate increase in the duration of the specialised portfolios.

Equity and Bonds Throughout the Recession



Retail Sales Remain Downbeat



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