

Bond Outlook

It is hard to maintain a position of moderate optimism when almost everyone is forecasting a double dip. In addition to Ireland's downgrade yesterday by S&P, Moody's is threatening to downgrade several other European countries, which is clearly a case of "damned if you do and damned if you don't". The whole idea of austerity programmes is to re-establish confidence in government financing after a period of deficit spending. It is therefore a bit rich to threaten downgrading precisely because of a move to reduce deficits. Many professional economic commentators cannot resist adding a caveat to the announcement of good data to the effect that "it cannot last".

We are not so pessimistic, especially over Europe. The contrast with the USA is striking:

- a recovery in the USA has to be via a stable housing market. The tax incentives which recently ended helped to lift housing demand, but only at the expense of the severe drop in house sales that has now occurred. While housing bubbles also grew and burst in Europe, notably in Spain, Ireland and, to a lesser extent, the UK, on this side of the Atlantic there is little sense that housing is the barrier to renewed growth
- the American leadership is still convinced that recovery depends on greater household consumption, regardless of the continued current account deficit that implies. In Europe, a controlled reduction in standard of living is implicitly recognised by governments, who have been relatively successful in "selling" this concept
- given the state of the US economy there seems to be no choice but to expand quantitative easing. In Europe the practice of central banks buying government bonds has slowed or ceased, except in the UK, which in many respects follows the USA

Nevertheless, when doubts about the US recovery are raised, it is assumed by markets that the rest of the world will also go down, (a supposition deserving of growing scepticism). The result is a rush into T-bonds so great that it not only flattens the USD yield curve, but pushes up the USD against most currencies (except JPY). It is indeed strange that the currencies of the two countries most at risk of a double dip recession (USA and Japan) are seeing their currencies rise.

The observation that QE leads eventually to inflation is always in our mind. The reversal of QE leads to higher yields for longer maturities as the market becomes inundated with government and agency bonds. Yield curves can of course steepen without inflation, but inflation remains likely (witness the UK) and will be further stoked by the rising prices of agricultural products after the Russian fires and Asian flooding.

Make no mistake, the current environment is deflationary. Even the renewed expansion of M&A activity reinforces deflation: merged companies always cut costs through shedding personnel. It is very much as if corporations, cash rich from both cost savings and successful bond issues, have little real investment opportunities, and turn instead to seeking acquisition targets. In the meantime, small enterprises cannot raise bank loans.

What does this mean for fixed-income investors? Firstly, returns for the year to date have been very good as yields have fallen. Secondly, however, there are few opportunities left for this trend to continue. As we pointed out last week, yield can be sought either by lengthening maturities, or by seeking higher-yielding corporate (with all that implies for credit analysis). For the long run, protection against incipient inflation should be sought via index-linked bonds which are probably underpriced at present.

Focus

- 🔴 USA: jobless claims have again exceeded 500,000. Sales of existing homes fell 27.1% last month to an annualised 3.83 million units, the lowest level reached since these statistics began in 1999
 - 🔵 GB: the BoE kept its benchmark rate to 0.5%, a historical low, and the level of its programme of asset purchases at GBP 200 billion. Retail sales rose at an annual rate of 1.3% in July 2010
 - 🟢 Germany: employment increased by 72,000 (+0.2%) to 40.3 million, approaching the record 40.7 million in Q4 2008. Producer prices in July rose 0.5% from June, or 3.7% yoy. The government deficit reached 3.5% of GDP in the first half of 2010, against 1.5% for the same period in 2009
 - 🟢 Iceland: the Central Bank cut its key interest rate by one percentage point to 7% after a strengthening of the Krona and a slowdown in inflation
 - 🟢 Greece: the public deficit reached EUR 12.1 billion during the first seven months of 2010, down 39.7% in a year
 - 🟢 Mexico: GDP in the second largest economy in Latin America (after Brazil) increased 7.6% during the second quarter of 2010 yoy
 - 🔴 South Africa: economic growth slowed in Q2 to 3.2% annual rate, despite the World Cup
- 🟢 positive for bonds 🔴 negative for bonds 🟡 watch out 🔵 begs the question

Recommended average maturity for bonds (corporate/government)

Continue fairly long across the board, so long as the deflationary atmosphere pertains.

	GOVERNMENT				CORPORATE			
Currency	USD	GBP	EUR	CHF	USD	GBP	EUR	CHF
09.06.2010	2017	2017	2017	2017	2017	2017	2017	2017
19.05.2010	2015	2017	2017	2017	2015	2017	2017	2017