

**Bond Outlook**

Suddenly Web search pages are full of articles addressing “Financial Oppression”, most of them dated August 2010, although there are older pieces from as far back as 2007. Amongst them is a Morgan Stanley report in which they use the term to great effect. This week we build our comments around the MS paper, which has helped to clarify much of our recent thinking.

The starting point is one we have often mentioned: that the long-term liabilities of governments for pensions and medical care, which are not included in overall debt calculations, imply that most Western governments would be declared bankrupt under private sector accounting rules. Overall indebtedness means some form of default is inevitable, although not necessarily in the form of skipping coupons or failing to repay principal. That is where “Financial Oppression” comes in as the more likely result of excessive indebtedness.

We have often pointed out the attraction of inflation as a means for government to reduce its indebtedness, by repaying with a debased currency. That is part (possibly the major part), of financial oppression, but there are other aspects, e.g. tax on bond holdings or obligatory bond sales. Yet these measures (or “events” as inflation is scarcely a “measure”) address only bond holders, who have so far been protected against government irresponsibility. They are not, however, the only group which a government could attack with financial oppression. The other huge group are retirees. MS present the situation as a kind of war between bondholders and retirees as to who pays the higher price, and voting power may well give the advantage to retirees (although not enough of an advantage, however, to avoid an increase in retirement age).

Our view is still that inflation remains the most likely outcome, partly because the US (in particular) is creating so much money, but also because, despite Bernanke’s protestations, (“methinks he doth protest too much”) rising inflation is very attractive to indebted governments, it being the natural solution for governments faced with insufficient revenues to support debt repayments. All they have to do, assuming the debt is in their own currency, is print more money. And that is precisely what quantitative easing is!

MS also point out that debt to GDP ratios are less revealing of a government’s solvency than debt to government revenues. They list this ratio for several countries; the USA’s, at 3.5, is actually greater than Greece’s at 3.25, while most European countries are around 1.6. Add these data to the FT’s “Economic Weather Map” and we find substantial support for our view that the European scenario is less dire than the USA’s, and that Asia is the engine of growth.

Nevertheless, the great experiment as to whether confidence can be rebuilt through austerity (as in Europe) or enhanced stimulus (as in the USA) has yet to deliver a definitive result.

An interesting aspect of recent market activity, given the continuing ascent in most bond prices and corresponding tightening in yields, has been the relative dearth of new issues. This, as most of our clients have realised, has lead to a situation where (often significant) premiums above par must be paid for purchases of new holdings. We have recently completed a piece of research, which is attached to this weekly, which demonstrates the magnitude of the problem for those investors seeking to buy bonds below par, with only 2% of the USD and EUR investment grade market now trading at prices between 95 and 100. The implications of this for future capital performance, in a potentially inflationary environment, are yet unclear.

**Focus**

- 🔍 USA: second quarter growth was revised down from 2.4% to 1.6%. In July, household spending rose 0.4%, on revenues up 0.2%. Consumer confidence is recovering more strongly in August (53.5 against 51 in July)
  - 🟢 UK: for the first time since February, consumer confidence has improved in August based on the perception of an improved economic outlook. (-18 in August, against -22 in July)
  - 🔍 Euro area: economic sentiment improved in August (101.8 in August, against 101.1 in July). The annual inflation rate was 1.6% in August. The seasonally-adjusted unemployment rate was 10.0%, unchanged from June
  - 🟢 Germany: unemployment fell in August to its lowest level since November 2008
  - 🟢 Sweden: the unemployment rate fell sharply in July to 8.0% against 9.5% in June
  - 🔍 Japan: the CPI fell 0.5% last month compared to June, representing a decrease of 0.9% yoy
  - 🟢 Belgium: inflation slowed slightly in August for the first time this year, to 2.32% yoy
  - 🟢 Denmark: GDP grew by 2.8% compared to Q2 2009 and 1.0% over Q1 of this year. Unemployment fell slightly in July to 4.1% of the workforce, against 4.2% in June
  - 🟢 Poland: the economy grew at a 3.5% annual rate in the second quarter
  - 🟢 India: economic growth reached 8.8% during the April to June period, its highest level in almost three years
  - 🟢 Russia: GDP grew by 4% in the first half of 2010 compared to H1 2009
  - 🟢 Australia: the economy grew 1.2% in Q2 2010, or 3.3% over the last 12 months
- 🟢 *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