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WEEKLY COMMENT

Bond Outlook

When the world's two major currencies, the USD and the EUR, are both in trouble, investors are understandably running to gold, the CAD and the CHF. We see the USD difficulties as chronic, and the EUR's as mainly acute, but within a chronic framework. Let us consider each in turn.

Our view on the USA has consistently focused on the overspending / excessive debt issue as the main cause of the economic malaise. Only by addressing this can sustainable growth return. Monetary stimulus can be but palliative. At the time of the Lehman collapse, there was no alternative. Since then, however, deficit spending, QE2 and the likely QE3 (or something similar under a different name) can do nothing but create short-term gains, with no real turnaround in the economic situation.

This interpretation of the problem has found a new ally (thank you, John Mauldin) in the person of the economist Irving Fisher, who sang exactly the same song during the Great Recession as we do now – and was largely ignored. We can but rejoice if his views are being resurrected, and the USA finally begins to address its underlying problems. In a sense, that is what Congress is doing as it debates the raising of the debt ceiling. Too bad that Fisher did not spell out whether deficit reduction could be best achieved via spending cuts or tax increases (or what combination of the two).

In the euro zone, palliative remedies are being sought to prevent break-up and / or sovereign default. We suspect that a 'controlled' sovereign default may be allowed. As the FT points out, the default of US cities (like New York) did not wreck the dollar currency union, so why should default by a peripheral bring down the euro? It would not, but would cause a renewed banking crisis, as banks holding defaulted debt were forced to assume giant losses. That is the real reason why the ECB is out of step with German and other politicians. The risk of a banking crisis also explains the reluctance of institutional investors to buy any more bank debt in Europe.

The chronic dimension of the euro problem is that monetary union without at least a degree of fiscal union is (as Margaret Thatcher recalled) fundamentally unstable. The ECB knows this, which is why Trichet has been talking about a euro zone Ministry of Finance, and also why issuance of bonds by such a ministry will eventually come about, thereby creating a formal "transfer union". The EU already has elements of a transfer union -- think of the funds flow to Ireland, Italy's Mezzogiorno and new Eastern European members. Interregional fund transfers are common in individual countries and arouse only limited resentment in the richer regions. In due course, probably measured in decades, Europeans will espouse intra-European transfers as they now accept inter-regional transfers in, for example, Italy or the UK. The choice appears to be acceptance of a transfer union, despite current resentment, or break up.

Switzerland has an acute problem. A Franc heading towards EUR parity is intolerable for industry and retailing. The bounce back will be violent should the EU meeting this week provide not only a palliative, but a clear move to a long-term solution. If there is no bounce back, however, many Swiss companies will be facing lay-offs or lower wages. Maybe Switzerland needs a little QE of its own, but it seems scarcely likely.

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- USA: housing starts rose in June, by 15% from May. A 0.5% fall in the import-price index followed a revised 0.10% gain in May. Consumer confidence dropped in July to the lowest level in more than two years the (UoM index to 63.8). Standard & Poor's followed Moody's Investors Service in threatening to cut the AAA rating of the U.S. as Congress continues its stalemate on the debt ceiling

- Fed: Bernanke alluded to the possibility of QE3, telling Congress that the central bank is prepared to take additional action, including buying more government bonds, if the economy appears to be in danger of stalling

- Banking: as many as 24 European banks will be under pressure to show they can raise capital after failing, or just passing, a second round of stress tests by the European Banking Authority. An estimated €80 bln of capital may need to be raised by European banks. Now that the Financial Stability Board has excluded contingent convertible bonds ("CoCo's"), these funds will have to involve straight equity

- Germany: investor confidence, as measured by the ZEW index, fell from -9 in June to – 15. The Bundesbank stated that the economic outlook for Germany remains "favourable" as stronger domestic demand compensates for a slowdown in export growth

- Spain: the Treasury in Madrid sold EUR 4.45 billion Euros of treasury bills, just below its maximum target, and its financing costs surged as European leaders struggled to find a solution to the Greek crisis

- UK: home sellers lowered asking prices in July (by 1.60% from June). Public-sector pension liabilities reached £1.1 trillion last year, representing 80% of gross domestic product