



## **Bond Outlook** [by bridport & cie, August 26<sup>th</sup> 2009]

After our muted rejoicing last week that the world is undergoing its needed rebalancing, the time has come to look at what is still, for the West at least, the most important single economy: the USA. The more we look, the greater the discouragement we feel, along with a sense of wonder at whether financial markets are looking at the same data as we are. Again we see a divergence between market sentiment and economic fundamentals.

The fall in GDP may have been stopped by the various stimulus programmes including “cash for clunkers” and the USD 8,000 subsidy for first-time house buyers. The former is a victim of its own success and has been discontinued ahead of schedule, and the latter is to end on 30 November. The stimuli have supported household spending but the overwhelming pressure on households is to reduce debt, i.e. cut back on spending. What we called many months ago an “L-shaped recession” is not just a widely held view but is now “official” in the sense that Government and Fed data are saying the same thing. (The term “U”-shaped is sometimes used, but with the base so long that it might as well be an “L”.)

Why then are financial markets, both for equities and bonds, so positive? Part of the answer is to be found in the traditional dominance of hope over reality, but that explanation is insufficient. Another key reason must be that there is so much liquidity among investors that there are few opportunities to achieve returns:

- Money markets offer negligible net returns
- Government bonds, so remunerative in 2008, offer low yields and high probability of falling prices
- The panoply of derivative products has disappeared

So where do investors place their money? In stock markets in accordance with “momentum investing” and in corporate and emerging-market bonds, even though the yields are now very low (they are better than the zero on the money markets).

As fixed-income advisers we have a problem. Our basic counsel now is to lean towards selling and taking profits. Normally, we could then suggest redirecting the cash thus generated to other parts of the fixed-income world. Now, however, there are few good opportunities left; corporate spreads are so low that, faced with what is likely to be an environment of rising yields from their low base, there is every risk of declining prices. Likewise for emerging-markets.

We therefore fall back on suggestions we have already made, while recognising that holding cash may be the best option for the bulk of many portfolios:

- Floating rate notes (necessarily from the banking sector) to provide some return with little danger of capital loss, since we see the short end of the yield curve remaining low even if the curve steepens

- Inflation-linked bonds as long-term protection against the inflation risk being developed by government borrowing and rising commodity prices

Reappointing Bernanke may be the least bad option, but let his contribution to the crisis not be forgotten: as “Greenscam II” he acted too late and denied that there was a problem with sub-prime or CDOs (which we saw in January 2007 thanks to HSBC admitting to major sub-prime losses). The idea of putting the Fed in charge of systemic risks is bizarre bearing in mind that the Fed is a major, probably the biggest, cause of systemic risk!

## **Focus**

(+) Europe: industrial orders increased by 3.1% in the Euro zone in June, a better performance than expected

(+) USA: consumer confidence improved sharply in August with the Conference Board index at 54.1, versus 47.4 in July

(–) Spain: compared with June, industrial prices fell 0.2% in July and by 6.7% on the year

(+) Germany: Q2 GDP growth confirmed at 0.3%, against a yearly decline of 7.1%

(+) China: the annual growth rate of GDP reached 7.9% in Q2, versus 6.1% in Q1 (which was the lowest in ten years)

(–) Venezuela: GDP fell 2.4% in Q2, after 22 quarters of uninterrupted growth. Inflation last year reached 30.9% while prices have again increased, by 13.1% from January to July

(?) South Africa: after a fall of 1.8% at the end of 2008, GDP declined by 6,4% in Q1 and 3% in Q2

(!) Russia: GDP, down 9.3% over a year, picked up by 0.5% in July over June. Faced with a budget deficit of 9% of GDP, the Government plans to issue some USD 60 billion Treasury bonds over three years

*(+) positive for bonds (–) negative for bonds (!) watch out (?) begs the question*

## **Recommended average maturity for bonds.**

Stay relatively short across the board.

<b>Currency:</b>	<b>USD</b>	<b>GBP</b>	<b>EUR</b>	<b>CHF</b>
<b>As of 17.06.09</b>	2012	2012	2012	2012
<b>As of 21.01.09</b>	Max. 2013	Max. 2013	Max. 2013	Max. 2013

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