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Investor Services

Weekly Comment

Bond Outlook [by bridport & cie, January 6th 2010]

In these opening days of 2010, there is positive prevailing sentiment in the financial markets, based apparently on optimism that a normal recovery is underway. That would imply expanding demand, increasing output and decreasing unemployment. For the world as a whole, this optimistic mood appears justified, not so however for the USA, UK and Japan, where government indebtedness is a millstone around the neck of the economy.

Unlike many commentators, we cannot see Japan as a "model" for what is to happen in the USA and UK. The continued trade surplus of Japan and massive domestic savings, which fund the government deficit, are key differences. The USA and UK still need funding from foreigners to sustain their internal and external deficits. To return to an old theme of ours, China still holds the strings for the exchange rate of the USD and, by extension, US interest rates.

The only comment we would make on the UK at present is the development of the strange situation of having a government which is almost certain to lose power by June 2010, but which cannot resist the temptation to be irresponsible in these last months of its life in the hope of reversing the tide of political sentiment.

The reason that a "normal recovery" cannot be expected in the USA lies in the continued unemployment rate of 10% plus, with no sign of a decrease, and also in the stagnation of household incomes. The way out of the current economic impasse is to be found not in the usual priming of consumer spending, but in the much slower process of household debt reduction until expenditures more closely match earnings. The return of modest increases in house prices might suggest that the corner has already been turned, However, data on mortgage arrears suggest that, while the subprime crisis might be over, foreclosures on prime mortgage holders can but increase, even at these historically low interest rates.

Our year-old description of the recession as "L-shaped" remains accurate. We must however admit that the fall in US GDP before it levelled off was smaller than we thought, coming in at 3.8%, whereas we envisaged a fall twice as large. If the USA can move forward with such a small adjustment, we can but congratulate the Administration, even though we suspect a lot of the cushioning is due to Keynesian policies of government spending running wild.

The biggest single worry for 2010, and the key supposition for our own economic outlook, is that the withdrawal of stimuli and reversal of quantitative easing will increase long-term yields. Indeed, this has become the general view of most major bond commentators, with just a few mavericks who still suppose a second downward leg of the recession. Timing? Consensus is centring on the second half of 2010.

The overnight rate is a more difficult call, partly because it is a function of political choice rather than market forces. We suspect that neither the Fed nor the BoE will "dare" raise their target rates, because the recovery is so precarious. The ECB may act a little more aggressively, and sooner.

Until the yield curves really do steepen, there is little opportunity in government bonds, a view strongly supported by bond funds almost unanimously announcing that they are reducing government debt holdings, particularly in the USA and UK. The suggestions we were making in the last months of 2009 are still valid: careful selection of corporate and emerging market bonds, some participation in emerging market bonds in local currencies, and a further move into the sovereign bonds of “commodity” currencies/countries. In addition, some investors may now find the risk/reward profiles of selected new members of the EU acceptable.

We are not yet ready to lengthen our recommended average maturities, not even to recognise the year end rollover.

Focus

(?) USA: as a reflection of the stimulus programmes, the market performance of US Treasuries was the worst of most major sovereign bonds. Most observers expect the 10-year yield to exceed 4% by the end of the year. The 2-year yield should rise from 1.16% to at least 2%. The national debt moved up from USD 5.80 trillion to USD 7.17 trillion

(!) Germany: strong correction of the Bund over the holidays; it dropped out of its band from 123.5 on 18 December to 121.50 on 29 December

(?) China: rumours from Asia concern a 10% revaluation of the RMB

(–) Spain: 20% unemployment rate

(?) Greece: a simple rescue of Greece by the EU is looking unlikely according to the ECB

(–) Iceland: the President’s veto and the holding of a referendum on debt repayment to the Netherlands and the UK could isolate this country

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

Recommended average maturity for bonds.

Stay short across the board.

Currency:	**USD**	**GBP**	**EUR**	**CHF**
As of 17.06.09	2012	2012	2012	2012
As of 21.01.09	Max. 2013	Max. 2013	Max. 2013	Max. 2013

Dr. Roy Damary