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A perfect storm...for bond markets, at least



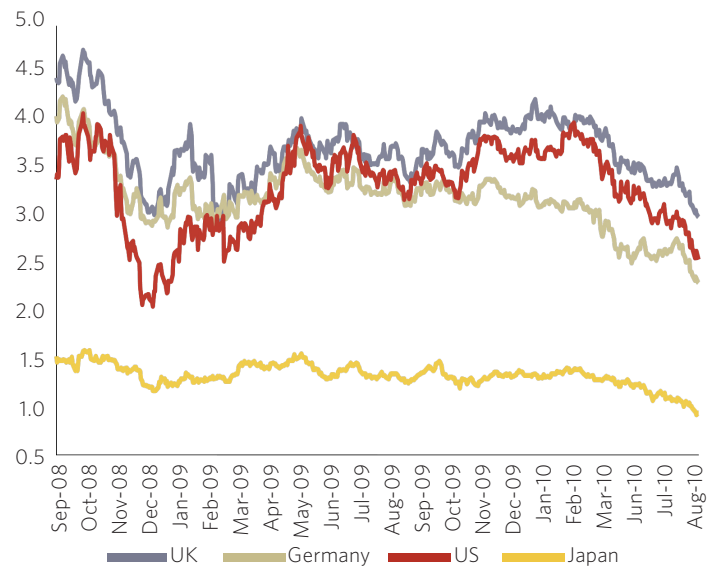
It is a strange feature of the core sovereign bond markets that the more a country borrows, the lower the yield it must pay on its debt. One of the main reasons for this is that at the same

time as supply peaks, demand for a country's bonds grows rapidly. This demand is fuelled by a *perfect storm* of supporting factors.

It seems increasingly likely that, amid stalling growth in the U.S. and fiscal austerity in Europe and the UK, short-term interest rates will not move higher any time soon. The current benign conditions for bond markets are therefore set to continue. As growth slips once again, the authorities have little choice but to resort, once more, to quantitative easing ("QE"). QE, which involves buying government bonds, does not, on its own, push money supply into the economy, but does serve to support bond markets.

The bond markets' reaction to bleak outlooks has been falling yields across the curve, reaching historic lows. As shown in the chart below, we have been here before. A key difference this time, however, is that a dramatic slowdown in growth, similar to that which was expected in the first quarter of 2009, has not been widely forecast. Another contrast is that the number of policy options available to the authorities in the event that the economy does falter is, currently, severely limited. The fiscal stimulus option is no longer available, and, furthermore, actually appears to be going into reverse. European economies are in full fiscal austerity mode, and the U.S. has its own version in the form of state balanced budget controls that will enforce fiscal tightening this year. The U.S. mid-term elections in November may reveal how much appetite remains for federal fiscal austerity measures in 2011.

**10 YEAR GOVERNMENT BOND YIELDS**



Source: Bloomberg

Other differences in today's markets, as compared to those of late 2008, are equally interesting. Breakeven spreads (a measure of inflation) are still above the low levels seen in December 2008. At that time, the global banking system was imploding, and support plans had not yet been fully implemented by the authorities. Fears of depression and deflation were at their highest. Current low breakeven levels, by contrast, suggest disinflation rather than deflation. Most of the economic statistics coming out of the U.S. show a roll-over from high levels which is not, however, ostensibly recessionary. There are, nevertheless, two underlying problems. Firstly, the recovery in employment (commonly a lagging indicator) was very modest last year and there is, consequently, limited scope for decline.

The second principal area of concern for the U.S. is the housing market, which stabilised at low levels during the recovery, but is heavily dependent upon support from fiscal stimulus. The housing market is crucial not only because of its direct impact on GDP, but

also because of its effect on consumer wealth. Although fixed rate mortgage interest rates have fallen to below 4% for the first time, this is not yet stimulating the housing market. It is hard to envisage private lenders rushing to lend at 4% for 30 years to borrowers who could default without fear of repercussions, or who could refinance at a lower rate if one becomes available. It is no wonder that there is only one mortgage lender in town, and that is the U.S. government, through its federal mortgage institutions known as Fannie Mae and Freddie Mac. This lack of competition will likely hinder the housing recovery.

With mortgage arrears running at close to double digits and unemployment stubbornly high, a modest economic slowdown could easily become more serious, especially if fiscal austerity is an additional factor. The burden then falls on central banks to put in place a proper resumption of QE. Cutting already near zero short-term interest rates is not an option, therefore printing money whilst governments tighten fiscal policy is likely. The resultant expansion of banks' balance sheets would flow directly into the government bond markets. This extra demand plus the existing increase in domestic savings, at a time when governments are planning to reduce their deficits, amid low and declining core inflation levels is a *perfect storm* for government bonds.

So, this is how we have ended up with bond yields on their way to previous troughs despite growth slowing only marginally, and breakeven rates nowhere near their former nadirs.

What could go wrong? Another difference from 2008 is that it is now the German and Japanese bond markets that are reaching new yield lows, and not the U.S. Both of the former are able to attract significant domestic (or, in the case of Germany, regional) flows and are less reliant on continuous foreign demand. They do, however, face greater deflationary pressures. The U.S., on the other hand, is more reliant upon foreign (particularly Asian) buyers of their bonds. Chinese demand for U.S. Treasuries may be on the decline as diversification of reserves is sought. This would remove one area of demand for Treasuries which, for the time being, would be offset by government, bank and retail domestic demand.

Outside of a recession, it is hard to comprehend U.S. yields falling to their 2008 lows, but equally, with a lack of fiscal stimulus and the burden falling on monetary policy, it is also difficult to understand why they should rise. Amid below-trend growth and short term interest rates stuck at zero, the pull up the yield curve becomes automatic, and low short-term rates are transmitted along the curve.

With a bedrock of lower rates across the curve and central banks ready to act if growth falters, fixed income markets that are spread off governments bonds look attractive. Until the increased money supply from QE can be used by the real economy (through an effective banking system), we believe the *perfect storm* for bonds will rage on.

All data is sourced from Bloomberg unless otherwise stated.

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