

Sending the right signal

Friday, 16 July, 2010

Designed with the power to bail out several countries simultaneously, Europe's €440bn rescue fund may end up never using that power and conducting few if any operations in the bond markets. The European Financial Stability Facility (EFSF), announced in early May at the height of the market panic over the Eurozone's debt crisis, is expected to become operational in the next couple of weeks, after the European Union finally overcame the reluctance of tiny Slovakia to sign up to the plan. The EFSF would extend emergency loans over a three-year period to Eurozone countries which had difficulty raising funds from the debt markets. It would obtain money for the loans by issuing bonds guaranteed by all Eurozone states. But the countries most likely to seek the money, weak states such as Spain and Portugal, appear determined to avoid applying for the loans, which could require them to introduce new austerity measures and would be more expensive than the borrowing costs they currently face in the markets. Madrid or Lisbon may still have to seek emergency aid next year if their austerity programmes run into trouble. However, the chances of them using the EFSF may recede further if their budget ratios start to improve as planned. Meanwhile, Greece is already supported by a separate, €110bn bailout. The bottom line is that European policymakers seem to be of the view that the very existence of the EFSF means that they will not have to use it, though a lot will depend on whether regional economic growth is strong enough to push countries through their debt problems.

In the absence of any immediate need for the EFSF to bail out governments, speculation has turned to the possibility of it being used to recapitalise some of Europe's banks. The results of bank stress tests across the European Union, to be released next Friday, may show a need for additional infusions of billions of euro into weak institutions to prevent them from destabilising the banking system. If banks are unable to raise the capital from the markets, national governments are supposed to provide the money. If governments exhaust their funds, they can turn to the EU's financial safety net, EU Economic and Monetary Affairs Commissioner Olli Rehn said last week. But national governments may well be able to deal with their banks without recourse to the EFSF. Germany's regional landesbanks are viewed as one potential danger spot, but the German bank rescue fund Soffin still has about €300bn, which is expected to be more than enough. Spain's cajas, or regional savings banks, are seen as the other main danger spot, but Madrid says it expects to need less than a third of its €99bn bank restructuring facility to clean up the banking system. About €1bn has already been provided and the Spanish government aims to raise the rest of the money it needs, which may total some €20bn, through bond issues. If demand for its debt remains solid, that should be possible without recourse to the EFSF.

So the EFSF may not be asked to extend emergency loans to any country for the foreseeable future. It may therefore not issue any bonds in the markets, or certainly far fewer than the hundreds of billions of euro worth which looked possible a couple of months ago. Some EU officials would like to see the EFSF borrow a small amount from the markets soon, perhaps €2bn or €3bn, simply to demonstrate that it is operational and convince doubters that it could respond quickly to an emergency. But proponents of this idea concede it may not be possible. Major operational decisions will ultimately be taken by Eurozone finance ministers, and countries such as Germany, which is sceptical about allowing the EFSF to play a major fiscal role in Europe, may not approve. The EFSF's Framework Agreement suggests it would only borrow in response to a specific need. IMF managing director Dominique Strauss-Kahn urged Europe last month to use the EFSF actively to help boost economic growth in the region, rather than merely leave it in place as a safety net. *"The real question is growth and if institutions are created they should serve a purpose and not just a form of security for times of need,"* he said. But there seems to be little appetite among EU policymakers for pursuing this idea at present. Creating the EFSF with its current, limited role was complex and politically difficult, and EU officials are now focused on sensitive talks to review the region's budget rules and increase economic policy coordination. The lack of urgent demand for EFSF money means the facility is likely to have little impact on the debt markets, contrary to initial concern of crowding out the bond market.

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International Bonds:

The big question for financial markets at the moment is whether the current economic slowdown will degenerate into a renewed business-cycle contraction. If the answer is yes, then the recent drop in global equity prices is just the beginning of a major cyclical breakdown. If the answer is no, then the recent shakeout has created another opportunity to buy equities on the cheap. The critical issue is whether the negative forces that are impacting on the markets at present will continue to gather momentum and culminate into a vicious dynamic that is strong enough to push the world economy into another period of renewed financial instability and economic contraction. Despite all the negative forces and key risks, our gut feeling is that the world economy in general and the US economy in particular will escape a double-dip recession. The G7 economy will most likely settle on to a path of soggy growth with periodic threats of deflation. The environment is "soft", but non-contractionary. Gibson's Paradox refers to the positive correlation between stock prices and government bond yields. In fact, Gibson's Paradox has prevailed after the Asian crisis, which in our view was the watershed event that marked the beginning of a new era characterised by increasing deflationary tendencies, over-competition, relative abundance and supply gluts. Obviously, in a world of deflation or very low inflation, bond yields tend to converge with real economic growth. As such, higher bond yields are usually consistent with higher economic growth and hence higher stock prices, and vice versa. ***This positive correlation between bond yields and stock prices is unlikely to change anytime soon, making switching between equities and bonds as part of asset allocation all the more important.***

For the government bond market the call is essentially whether the G7 economy looks decisively similar to that of post-crash Japan. If it is then bond prices have further to gain and equity prices have more to lose. But, we don't believe a Japanese-style liquidity trap will prevail in the United States, though the G7 bond market will face new equilibrium ranges in terms of bond yields. For the US Treasury market, the equilibrium of 10-year bond yields could range between 3-4%, with a central tendency of 3.5%: real growth at 2.5% plus steady-state inflation of 1.0%. For German Bunds, the range should be 2-3%, with a central tendency of 2.5%: real growth of 1.5% plus inflation at 1%. For Japan, JGBs should yield between 1% and 2%. Obviously, yields on 10-year Treasury bonds have breached below the lower band. Real 10-year yields, measured as nominal yields minus inflation swaps, have fallen to levels last seen at the end of 2008. Real yields in Euroland are at record lows, and the yield curve has also flattened across the G7. Clearly, the fixed-income market is behaving as if a double-dip is a foregone conclusion. ***Unless the world economy is indeed plunging into a new recession, the path of least resistance for bond yields should be up rather than down. However, in our view the G7 government bond market is overvalued. At any rate, it is a sensible strategy to cut duration to underweight.***

The only real bond market that is worth buying in the developed world is Australia. The Australian 10-year bond yield is currently yielding 5.20% while the Aussie dollar has weakened sharply over the last few months. Needless to say, the Reserve Bank of Australia's (RBA) hawkish move to tighten policy has been a key force holding up bond yields, but there are growing odds of a rally in the bond market for the following reasons: (1) Inflationary pressures in Australia are tame; (2) China is slowing down, which in turn, will cool off the Australian economy; (3) If the RBA continues hiking interest rates, the yield curve could flatten, i.e. the long-end of the yield curve should stay flat or even drop; (4) The Aussie dollar is starting to look attractive again. It is oversold, has a high carry and the Australian economy has no major imbalances. ***All in all, we think that even if long-term bond yields remain flat, investors will likely benefit from a strong Australian dollar, making the bond market look attractive.*** For the corporate bond market, we continue to recommend that investors buy quality spreads by going long junk or lower-quality bonds while shorting investment grade. Investment-grade bonds have no value left, and their spreads with Treasuries have shrunk to almost nothing. However, ***quality spreads remain higher than their historical range and could still compress further on stronger corporate balance sheets and continued improvement in default risk.***

Currencies/Commodities/Interest Rates

Hedge funds and private equity firms had an easier time raising capital in the last three months, but the market for asset-backed securities remains crippled, according to a new Federal Reserve survey. The Fed's first-ever *Senior Credit Officer Opinion Survey*, released this week, suggested financial markets are still fragile because banks are reluctant to lend. But it showed conditions are improving, if slowly. "Dealers provided somewhat more-favourable terms over the past three months" to hedge funds, private equity firms and other similar private pools of capital, the Fed said. The US banking sector is still recovering from its worst shock in modern history. Many avenues for corporate borrowing, including commercial paper and asset-backed bonds, were slammed shut for a long time. With the help of steep interest-rate cuts and an array of emergency programmes from the US central bank, markets have gradually begun functioning again. **But the Fed's survey, which also asked respondents to compare credit conditions to those in late 2006, indicated things are hardly back to normal.** "Responses to these special questions pointed to significantly tighter credit terms across counterparty and transaction types relative to the end of 2006," the report said. Each quarter, the Fed publishes a Senior Loan Officer Survey that focuses on bank lending. The new poll, which was based on responses from 20 financial institutions that account for nearly all dollar-based dealer financing, is meant to capture conditions at financial intermediaries.

Meanwhile, the latest consumer prices data in the UK have again raised questions about the timing of the first rate hike in a new tightening cycle. Falling petrol prices pushed British inflation down for a second month running in June, but underlying pressures rose and inflation over the quarter was higher than the Bank of England expected. Speaking shortly after the data came out, Bank of England policymaker Andrew Sentance repeated his call for interest rates to rise gradually but there are still few signs that other members of the Monetary Policy Committee back his view. "We need to start a process of moving interest rates up from what is an extremely low level and another reason for that is inflation hasn't turned out to be as low as expected," Sentance said. "Over a period of time we need to reassess the amount of support the recovery needs", he added. The obvious surprise in the June inflation data was the rise in the core rate to 3.1%, which serves to underline the theme of price stickiness. Clearly it is not falling as much as policymakers had hoped and as a result it is not making the Bank's job any easier. **While a rate hike in the third quarter remains unlikely, one cannot rule out a tightening of policy in the fourth quarter if the underlying inflation picture doesn't improve in the interim.**

Exchange Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
€/GBP	0.8390	0.8150	0.8000	0.7800	0.7500
€/\$	1.29	1.15	1.10	1.05	1.03
€/Yen	113	106	103	100	100
\$/Yen	87	92	94	95	97
GBP/\$	1.54	1.41	1.38	1.35	1.37

Official Interest Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US	0.25	0.25	0.25	0.50	0.75
Eurozone	1.00	1.00	1.00	1.00	1.00
Japan	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.75	1.00	1.25
Canada	0.50	1.00	1.00	1.25	1.50
Sweden	0.50	0.75	1.00	1.25	1.50
Norway	2.00	2.00	2.25	2.50	2.75
Switzerland	0.25	0.50	0.75	1.00	1.25
Australia	4.50	4.75	5.00	5.25	5.25
New Zealand	2.75	3.25	3.50	3.75	4.00
China	5.31	5.31	5.58	5.85	6.12

2010/2011 Native Global Bond Yield Forecasts %

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US					
2 Year Treasury	0.60	1.05	1.45	1.95	2.45
5 Year Treasury	1.74	2.15	2.45	2.85	3.25
10 Year Treasury	2.98	3.30	3.55	3.85	4.15
30 Year Treasury	3.98	4.25	4.45	4.70	5.00
Germany					
2 Year Bund	0.80	0.85	1.15	1.50	1.85
5 Year Bund	1.64	1.65	1.90	2.20	2.50
10 Year Bund	2.66	2.75	2.95	3.20	3.45
30 Year Bund	3.33	3.45	3.65	3.90	4.15
UK					
2 Year Gilt	0.78	1.10	1.45	1.85	2.25
5 Year Gilt	2.07	2.40	2.70	3.05	3.40
10 Year Gilt	3.37	3.60	3.85	4.15	4.45
30 Year Gilt	4.18	4.40	4.65	4.95	5.25

continued overleaf

Key International Economic Indicators/ Events of the Week

Canada: Bank of Canada Rate Decision (July) (Tuesday 20th, 14.00 BST)

The Bank of Canada will raise its key overnight interest rate next week, but the pace of subsequent hikes is less clear, according to Canadian primary dealers and global forecasters surveyed by Reuters. The Reuters poll, released on Wednesday, showed a 73% median probability that the Bank of Canada will raise the overnight rate by 25bps, to 0.75% from the current 0.50%, at its next policy announcement on July 20. More than half of 42 forecasters surveyed believe the central bank will not take every subsequent opportunity this year to raise rates by a quarter point, but will pause to gauge the pace of global economic recovery.

We think the Bank of Canada is certainly justified in raising rates at the next two announcement dates because of a strong economy. But by later this year it will want to sit back and assess the impact of earlier rate increases, as well as perhaps more importantly, the developments in Europe and the US. A rate increase on this occasion should boost the Canadian dollar and flatten the bond yield curve.

UK: MPC Minutes (July) (Wednesday 21st, 9.30 BST)

One Bank of England policymaker voted to raise UK interest rates from their record low last month in a surprise split with the majority for leaving policy unchanged, prompting speculation of a rate hike this year. But the general feeling among analysts is that it is unlikely that other members of the Monetary Policy Committee would support renowned 'hawk' Andrew Sentance quickly especially in light of the extremely tough emergency Budget introduced on June 22. Sentance voted for rates to rise to 0.75% from their record low of 0.50%, though he backed the MPC's unanimous vote to keep the stock of quantitative easing purchases steady at £200bn. Sentance is particularly worried about the higher than desired level of inflation at the moment. Given his comments in recent days it is quite clear that he again voted for a rate hike in July, putting him on a collision course with the Bank's Governor, Mervyn King, who has stressed recently that monetary policy had to take into account fiscal tightening and financial fragility.

We expect the minutes to show a 7-1 vote on interest rates for a second month running, and a 8-0 vote on unchanged quantitative easing. However, following this week's disappointing inflation data, the minutes are again likely to cast doubt on the market view of unchanged official interest rates over the remainder of 2010. On the whole, the minutes should be positive for sterling but negative for short-dated gilts.

EU: Bank Stress Test Results (Friday 23rd)

Last week Europe listed 91 banks taking part in financial stress tests, including many regional banks where markets suspect most of the sore spots are, as it seeks to restore confidence in the sector. Providing some, but not nearly all, details of so-called stress tests that markets have been clamouring for in recent weeks, a regulatory committee said it would test how banks held up if the economy and financial markets deteriorated. The exercise is being conducted on a bank-by-bank basis using commonly agreed macro-economic scenarios. It also envisages adverse conditions in financial markets and a shock on interest rates to capture an increase in risk premia. The scenarios are set to show a different impact on the various European Union member states. The banks, ranging from Germany's Deutsche Bank to Malta's Bank of Valletta, comprise 65% of the European banking sector. Most of Europe's large banks that operate in more than one country are on the list, as are many regional German and Spanish banks, the so-called landesbanks and cajas respectively, thought to be among the weakest. But there was less detail than many in the markets might have hoped for in the document, which listed two basic assumptions. One was that the adverse scenario would assume economic growth 3% below official Brussels forecasts. The shock to government bonds would assume a deterioration of market conditions similar to the situation observed in early May this year. The unusual move to disclose the design ahead of the results mimics the procedure of last year's US stress test, which was widely credited with reviving trust in banks. But many details, such as what markdowns regulators will assume on government bonds as a consequence of their "adverse scenarios" were not included in the document.

It is difficult to know exactly what the market reaction will be when the stress test results are released. However, given the speculation as regards "haircuts" for 'peripheral' bonds, one has to assume that these particular issues will under-perform benchmark Bunds in the immediate aftermath of the results release.

Main Debt Auctions/Announcements in the Coming Week:

Monday 19th	French Treasury sells BTFs.
	Germany sells €2bn of 9-month Bunds.
	Slovakia sells 182-day T-bills.
	Dutch State Treasury Agency sells up to €8.5bn in T-bills.
	Hungary sells 6-week T-bills.
	Lithuania sells 2012 government bonds.
	Romania sells 750m of 364-day T-bills.
Tuesday 20th	US Treasury sells 3-month and 6-month T-bills.
	Japan's Ministry of Finance sells 2-month T-bills.
	Ireland's NTMA sells up to €1.5bn of 4.60%, Treasury 2016 and 5.00%, Treasury 2020 government bonds.
	UK's DMO sells £3.75bn of 4.00%, Treasury 2016 Gilt.
	Spanish Treasury sells 12-month and 18-month T-bills.
	Switzerland sells 3-month T-bills.
	Hungary sells 2-week and 3-month T-bills.
	Poland holds bills buy-back auction.
	Malta sells 91-day T-bills.
	Canada sells C\$5.6bn of 98-day T-bills, C\$2.1bn of 168-day T-bills and C\$2.1bn of 350-day T-bills.
Wednesday 21st	US Treasury sells 4-week T-bills.
	Japan's Ministry of Finance sells 3-month T-bills.
	Germany auctions €4bn of July 2042 Bund.
	Czech Republic sells 7bn crowns of 5.00%, April 2019 bonds.
Thursday 22nd	Poland holds exchange offer auction
	Russia sells up to 15bn roubles of OFZ bonds; series 25072 and up to 30bn roubles of OFZ bonds; series 25075.
	Italian Treasury details amount of CTZs to be auctioned on July 27, BTPeI to be auctioned on July 28 and BTPs and CCTs to be auctioned on July 29.
	Hungary sells 12-month T-bills.
	Czech Republic sells 7bn crowns of 91-day T-bills.
Friday 23rd	Romania sells 400m lei of 6.75%, 2017 government bonds.
	US Treasury announces details of forthcoming 2-year, 5-year and 7-year note sales.
Friday 23rd	UK sells T-bills.

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