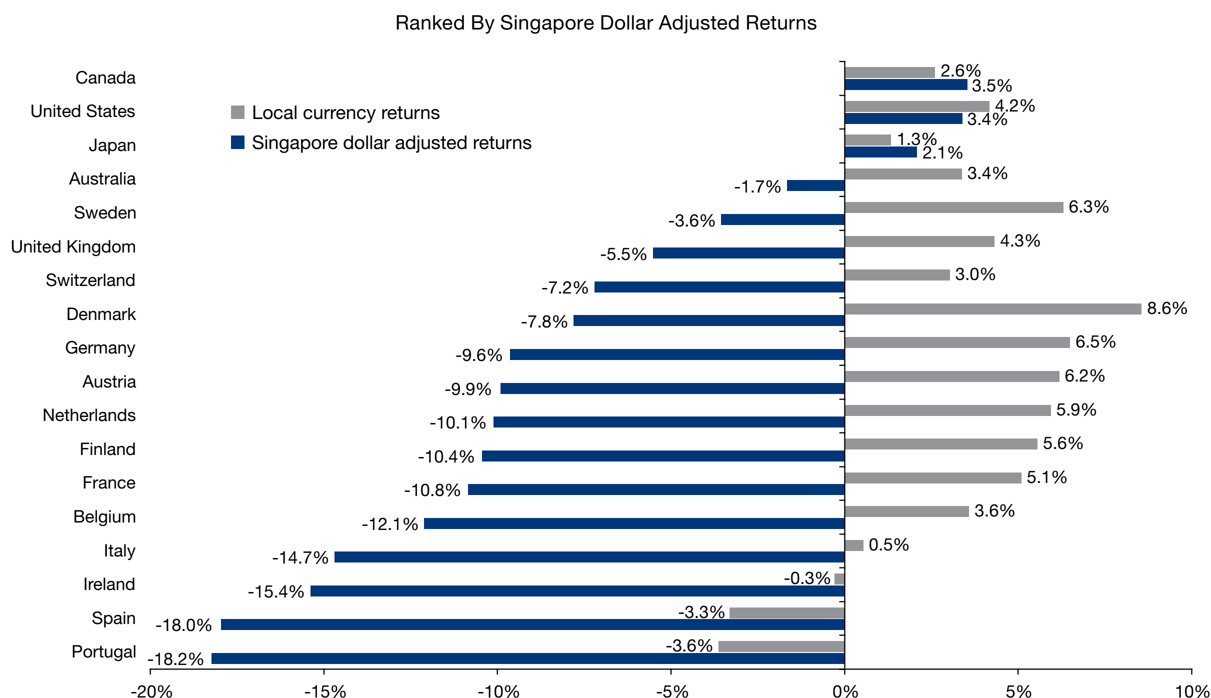
Bond Market Returns



Source: Bloomberg, 15 June 2010

G-10 FIXED INCOME

Outlook And Strategy

The focus on sovereign debt continued into the second quarter of 2010 and reminded the countries with large and growing fiscal deficits of the low tolerance the bond markets have for burgeoning public debt. Although the spreads of Greek government debt to German government bonds have declined from their worst levels after the announcement of the €750 billion rescue package, they have remained highly elevated. A recent Bloomberg investor poll showed that a large majority of investors are of the opinion that a debt restructuring is inevitable for Greece despite the huge financial aid packages.

The €750 billion aid package is large enough to cover the financing needs of Greece, Spain, Portugal, Italy and Ireland for more or less the next two years but the credit spreads not just of Greece but all of these peripheral countries have continued to stay high as the financial market remains sceptical on the ability of the respective governments' commitment to follow through with their announced budget targets.

Concern on the level of sovereign debt has spread into the European banking sector. This is manifested in the widening borrowing spreads in the money markets. As most of the peripheral European countries' sovereign debt are held by overseas investors (mostly banks), further concerns have been raised on the possibility of worsening sovereign

fiscal positions if the domestic banking sector should need government assistance as losses on those holdings accelerate. Despite the various liquidity enhancing operations by the European Central Bank (ECB) (repo operations, US dollar swap lines with US Federal Reserve) deposits with the central banks have continued to increase to record highs. The current level of deposits with the ECB exceeds the levels experienced during the Lehman Brothers bankruptcy in September 2008. The reluctance of European banks to lend to each other despite all these liquidity enhancing measures is reflective of fear that parts of the European banking sector may be insolvent.

The commitment to consolidate budgets in the coming years is likely to add downward pressure to an already anaemic recovery in the Eurozone, where the economic outlook has become more uncertain with the tightening of credit conditions. Coupled with low inflation and a desire to keep liquidity abundant in the money markets, it is unlikely that the ECB, or any other major central banks for the matter, will raise official interest rates anytime this year. The only caveat is how the bond market will react to increased sovereign debt supply. As European countries struggle with the tighter fiscal situation, the risk of excessively tight fiscal policy increases the probability of choking growth; which could result in larger government expenditure to rescue key institutions. Also, weaker economic growth would lead to weaker tax collection and this could lead to a temporary increase in government debt to supplement the lower revenues as spending tends to be sticky in the short term.

We have an overweight exposure to the core European government bonds in light of the weakened economic prospects and improved outlook on the fiscal stance. The UK's fiscal situation is just as challenging as the peripheral Eurozone economies, and the new UK government's commitment to narrow the fiscal deficit remains to be seen. The UK's core inflation had also been rising more than the other regions and we take a short duration profile in gilts relative to the benchmark. US government debt remains the first choice for investors in this uncertain environment. As long as the US dollar remains a key reserve currency, the dire US fiscal situation remains a worry for another day. For the moment, we have a neutral exposure to US government debt but remain vigilant for a change in sentiment.