Monthly Bond Letter

February 2014

Pictet Asset Management

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OVERVIEW

Recent developments

Somewhat less encouraging numbers from the USA and China, compounded by upheavals in some emerging countries, rattled the markets

Recent US jobs statistics, above all, put a damper on the market mood. The number of jobs created turned out to be surprisingly weak – just 74k instead of the 197k that had been expected – and the fall in the unemployment rate from 7% to 6.7% was put down to the reduction in the labour participation rate to 62.8%, its lowest level since 1978. Other figures were mixed, with the markets tending to focus in on the less good news and the fact inflation is running below the US Federal Reserve's target. Against this backdrop, we witnessed some lively activity in US Treasury bonds from a good many investors covering their short exposures. The yield on 10-year T-bonds, which had climbed to 3.02% by end-2013, slipped back to 2.69% despite the prospect of the Fed pressing ahead with its tapering.

Europe's economy is on its recovery track, but low inflation is a cause for some concern

The ongoing uptrends on European economic and business surveys and Purchasing Managers' Indices sustained hopes of the economic recovery continuing, with the jobless rate stationary at 12.1% and inflation decelerating to 0.8%.

Comments from the ECB, the strong euro and tensions on Eonia prompted speculation about a cut in official interest rates. The yield on 10-year Bunds, which had advanced to almost 2% by end-2013, drifted back down to 1.65%. Peripheral eurozone markets have been in fine form since the turn of the year, buoyed by the economic upturn and a possible ECB rate cut. The trend was underpinned by Irish, Spanish and Italian sovereign bonds being issued without any hitch, with spreads narrowing noticeably.

Structural reforms have been slow in coming in Japan, and doubts remain about the ability of the economy to cope with the hike in the consumer sales tax

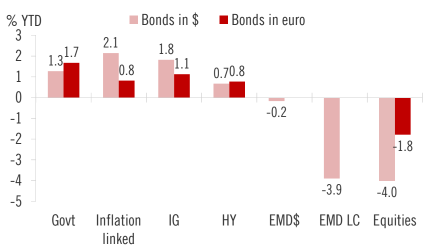
The Bank of Japan's activist stance supported the bond market, with the yield on 10-year Japanese government bonds receding to 0.61%, very close to their 2013 year-lows.

Risk assets experienced a bumpy ride in the latter half of January

The European corporate bond market made a good start to 2014, but the fizz went flat late on the month in response to worries about emerging countries. Investment-grade corporates still managed to deliver a positive return courtesy of the driftdown in government bond yields. High-yield corporates continued to be boosted by investors' hunt for yield, but were penalised by the correction on emerging markets in late January.

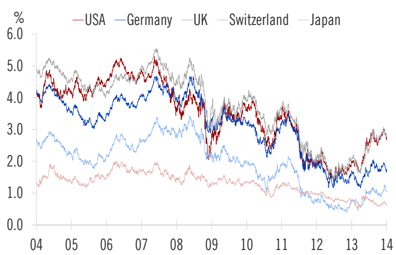
Emerging-market debt was unsettled by the prospect of the Fed reining in its quantitative easing and by the mounting political instability and questions over growth in some emerging economies. Local-currency emerging debt was hit hard by the slump in value of emerging currencies against the dollar and hikes in interest rates. Dollar-denominated emerging debt, however, was less affected on account of the driftdown in US T-bond yields.

PERFORMANCE 2013



Source: Bloomberg, Barclays, Citigroup, JP Morgan, perf in local currencies

10-YEAR GOVT BOND YIELDS



Source: Bloomberg, 10 Yr Govt yields

OVERVIEW

Forecasts

Central banks are set to remain highly accommodating despite the improving economic climate

Although demand in the USA is still rather flaky, growth was fuelled by companies rebuilding their inventories. There is still a question-mark hanging over the decline in the jobless rate owing to the slide in the labour participation rate. Against the backdrop of a sustained, but still rather brittle, economic recovery amid mild inflation, the Fed will pursue a softly-softly approach. It is likely to press ahead with reining in its asset purchases as the months go by, steering its public utterances more towards the question of inflation. This suggests the Fed funds rate is most unlikely to be moved before next year. In such circumstances, yields on 10-year US Treasuries can be expected to hover between 2.5% and 3.25% over the coming months.

Eurozone in rehab, but its recovery is still looking fragile

Questions are still being asked about the solidity of the economic recovery in the eurozone as unemployment is still above the 12% threshold, business investment is lacklustre and lending to the private sector is still shrinking, all this against a backdrop of ongoing trepidation about deflation. The ECB decided not to make any change in January although ECB President Mario Draghi did adopt a notably accommodating tone, insisting once again on his determination to deploy all weapons available to combat deflation. He remarked that the eurozone's recovery was moderate and fragile, and that inflation looked set to remain subdued for quite some time to come. He confirmed indications about the future direction of interest rates which should remain at current levels or even be pushed lower, if deemed necessary. In the next few weeks, Bund yields are likely to remain fairly tightly range-bound as the market will probably not receive the confirmation that the recovery is sustainable, which would damp down all the fears about deflation round the corner.

Corporates should go on benefiting from investors' search for yield, but will remain prone to volatility

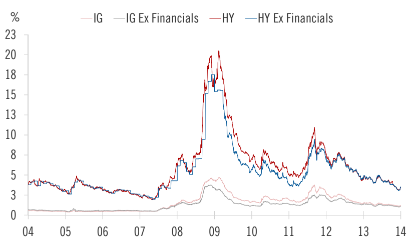
As issuance volume looks set to diminish over the next few weeks, this should provide some technical support for the European corporate bond market, with demand still favouring financials and borrowers from periphery countries.

However, although the reporting season will provide an opportunity for reviewing valuations and reassessing companies' credit ratings, market sentiment and appetite for risk will be influenced heavily by emerging markets, as can be seen from what happened in late January. High-yield corporates remain attractive-looking options even though spreads have narrowed.

Emerging-market debt may well stay under pressure

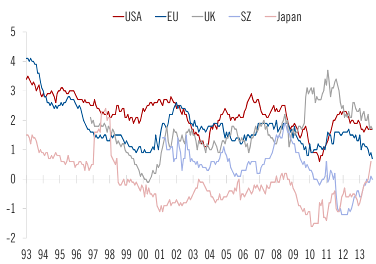
The Fed's move to turn off the liquidity taps and the deteriorating state of several emerging economies look likely to maintain pressure on this asset class which will be heavily reliant on investor confidence. Discriminating between the various countries may well become increasingly important.

CREDIT SPREADS



Source: Bloomberg, Barclays, EUR yield spreads

CORE INFLATION



Source: Bloomberg, Core CPI

Forward guidance: resembling a moving target

Bright and breezy start to 2014, but it soon ran out of puff

After a resoundingly good start to the New Year, US inflation-linked bonds lost ground due to their inflation component. The start to 2014 was marked by an atmosphere of almost surreal euphoria, nurtured by hopes of an even more vigorous economic recovery and repeat displays of strength by risk assets. As a result, break-even inflation points moved up by 10 basis points on average whereas real rates came down by 25bp on longer-dated bonds, these two drivers combining to propel the asset class up to new heights. As January unfolded though, the markets became spooked by the resurgent problems in the emerging world (Ukraine in a state of worsening disarray; devaluation in Argentina; slump in Turkish lira; unrest and mass protests in Thailand). This sent inflation break-evens back down to starting-year values, but cemented the gains on the real-rate component.

Forward guidance: a moving target

Why real rates reacted the way they did when the market went into reverse is perfectly understandable, but the remarkable behaviour at the start of the year has its roots in stances being adopted by central bankers in the developed world. These had begun to make widespread use of more finely tuned steering of expectations about monetary policy, which has popularly come to be known as 'forward guidance'. The Fed and the Bank of England had even cited a very specific target in association with their forward guidance: unemployment declining to 6.5% and 7%, respectively. The rapid pace at which US and UK jobless rates have been converging on those stated goals – December rates of 6.7% and 7.1%, respectively – had justifiably persuaded market operators that accommodating monetary policies would very soon be shifted into reverse. In reality though, the statements on forward guidance have merely turned out to be a form of words that could be modified at any stage to suit the circumstances. For example, the Fed had already pointed out the first hike in the Fed funds rate would only happen well after the target had been reached. The BoE, in somewhat vaguer terms, recently commented that the target was not the trigger factor, adding it would review the terms of its forward guidance when it published its next quarterly inflation report in February.

Barring the fact such guidance statements are often efficient and cheap ways of taking monetary-policy action, the twists and turns do, however, betray a much more telling dilemma facing central bankers in the developed world. The burning issue at the heart of all the debates about monetary policy is to ascertain the real quality of the improvement occurring on the jobs front.

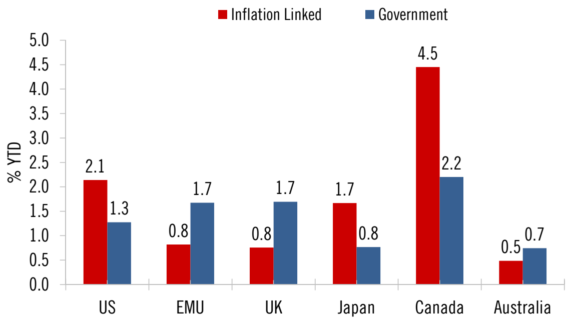
Structural or cyclical unemployment? No matter, it is really all about inflation

One school of thought believes there has been a structural shock on the labour market which has shaken up key much relied upon pre-crisis metrics, like the non-accelerating inflation rate of unemployment (NAIRU) that is higher today than it was five or ten years ago. Those holding with this theory consequently believe genuine inflation, pushed up by wages, is imminently about to make its comeback, a prospect that warrants already making a start on tightening monetary screws.

In contrast, others, in the majority and including most of the world's high-profile central bankers such as the Fed's Janet Yellen and the BoE's Mark Carney, err towards the view the main thrust of the downswing in employment during the crisis has been cyclical. That implies levels of full employment are still some way off in the future, a conviction bolstered in the USA by the labour participation rate which has been steadily falling as the months go by. On this basis, inflationary risks are hypothetical and more remote, which warrants leaving interest rates low for a lengthy period yet. Forward guidance is not, therefore, likely to disappear, but be qualified by considerations about the relative interplay of structural and cyclical influences.

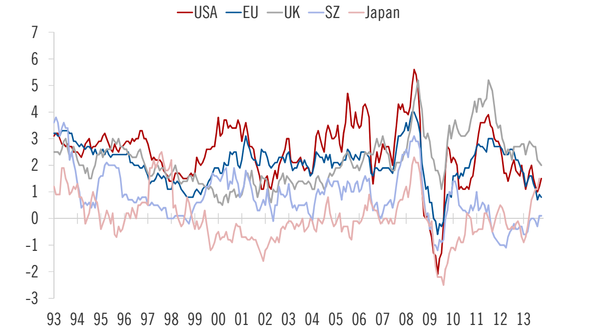
INFLATION-LINKED BONDS

PERFORMANCES 2013 (LOCAL CURRENCIES)



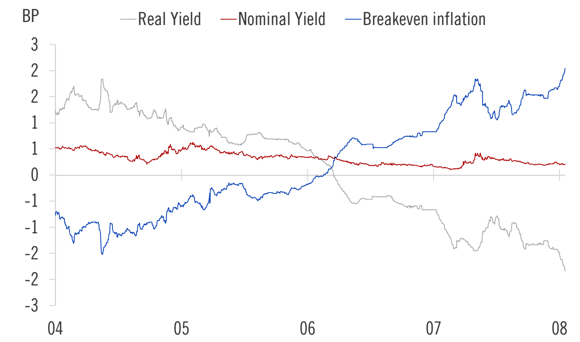
Source: Bloomberg, Citigroup, Barclays, Citigroup

INFLATION



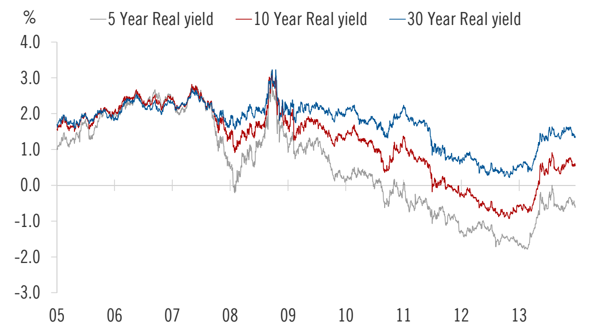
Source: Bloomberg, CPI

JAPAN - TREASURY YIELD COMPONENT



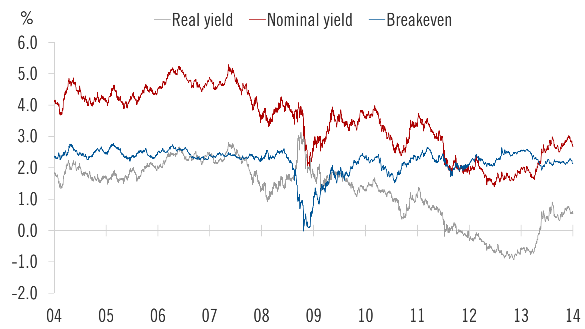
Source: Bloomberg, Japan

USA - REAL RATES



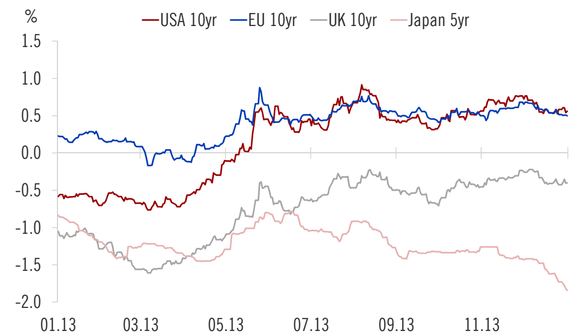
Source: Bloomberg, US Treasury

USA - 10-YEAR TREASURY YIELD COMPONENT



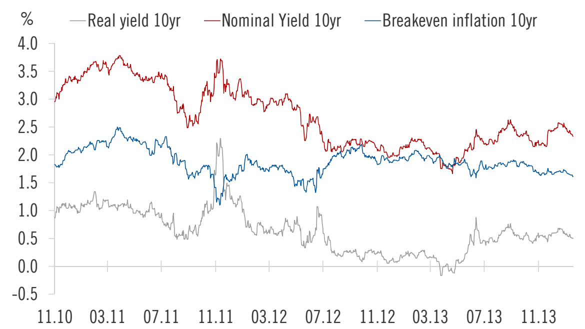
Source: Bloomberg, US Treasury 10 year

10-YEAR REAL YIELDS



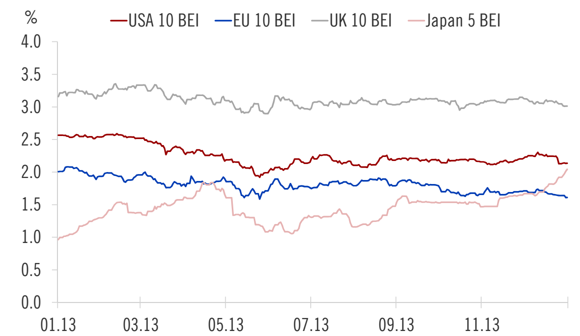
Source: Bloomberg, Real Yields

FRANCE - 10-YEAR YIELD COMPONENT



Source: Bloomberg, 10-yr French OAT

10-YEAR BREAKEVEN INFLATION POINTS



Source: Bloomberg, Break-even Inflation Rates

Returns given a boost by declining sovereign bond yields

Underpinned by movements in interest rates

Even though credit spreads had narrowed considerably in the final quarter of 2013, the European corporate bond market made a good start to 2014, but it lost steam late on the month in response to worries about emerging countries. Investment-grade corporates still managed to deliver a positive return for the month, primarily courtesy of the driftdown in government bond yields. Hybrid debt issued by utilities, telecom, energy, mining and metals companies posted negative returns for January though. Although issuance volume was partly to blame for this, risks related to regulatory developments played their part as well: for instance, ArcelorMittal was allowed to call debt at a much lower price than its market value. Conversely, subordinated debt issued by banks and insurers outperformed, underpinned by these financial groups' reassuring capital levels and the gradual reduction of this debt category's role under Basel III.

Looking at the geographical pattern, Spanish and Italian non-financial borrowers underperformed owing to the renewed upsurge in aversion to risk late in the month. In contrast, banks and insurers marginally outperformed. On a regional note as well, issuers from the emerging world, the likes of Petrobras, Bharti Telecom or Pemex, were also in the red for the month.

CDS contracts

The market for credit default swaps (CDSs) undeniably underperformed bonds in the month. For example, the Main iTraxx index retraced some of its recent spread narrowing, moving back to its early December 2013 levels. Investors preferred to use CDSs for tactical risk-hedging purposes rather than reduce their actual positioning in bonds in a market where dealing liquidity was thin.

Banking regulations

The Basel Committee has amended its definition of the leverage ratio. It has scaled down the impact of off-balance-sheet items, alleviating some of the pressure bearing down on banks like Deutsche Bank or Barclays.

Primary market

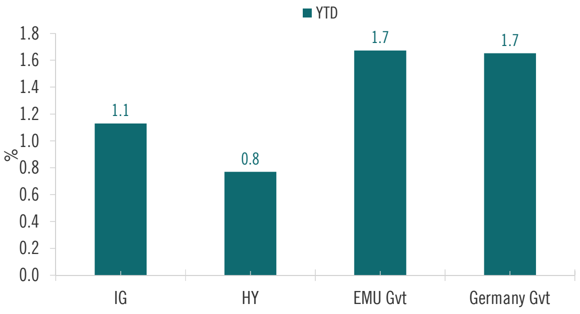
The volume and tempo of bonds being issued was lively for the first three weeks of 2014. Demand was generally pretty brisk, bearing testament to investors' ongoing quest to hunt out yields, with bonds offering high premiums, such as new issues from Eni and Telecom Italia or hybrid paper from EDF and Enel or the dollar-denominated Tier 1 deal from Credit Agricole being eagerly snapped up. A significant proportion of the bonds being issued came, above all, from vehicle manufacturers – BMW, Daimler, VW – and industrials – Holcim, Valéo, BASF. Among financials, the bond market was not the exclusive preserve of the major banks. Several second-tier banks from peripheral eurozone countries also raised funds, such as Bankia, Banco Popular Español, Banco Popolare di Milano or Bank of Ireland. Moving to non-European issues, Petrobras launched bonds while Bharti Telecom tapped the market further, re-opening its initial bond offering.

Outlook

As issuance volume looks set to diminish over the next few weeks, this should provide some technical support for the corporate bond market, with demand still favouring financials and borrowers from periphery countries. However, although the reporting season will provide an opportunity for reviewing valuations and reassessing companies' credit ratings, market sentiment and appetite for risk will be influenced heavily by emerging markets, as can be seen from what happened in late January.

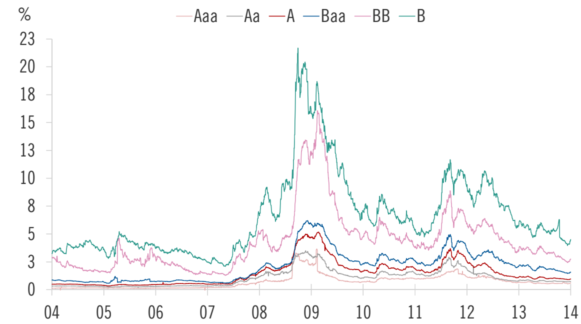
CREDIT RISK

RETURNS ON BONDS IN EURO



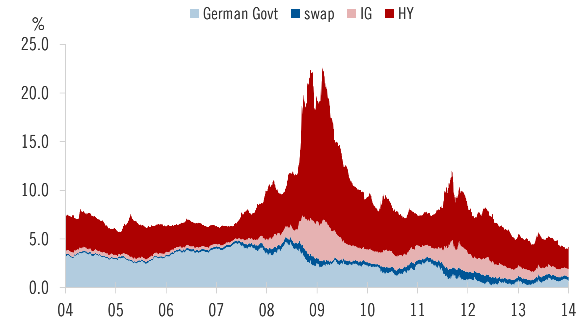
Source: Bloomberg, Barclays, Citigroup, Bonds in euro

CREDIT SPREADS (EURO)



Source: Bloomberg, Barclays, EUR yield spreads

YIELD COMPONENT (EURO)

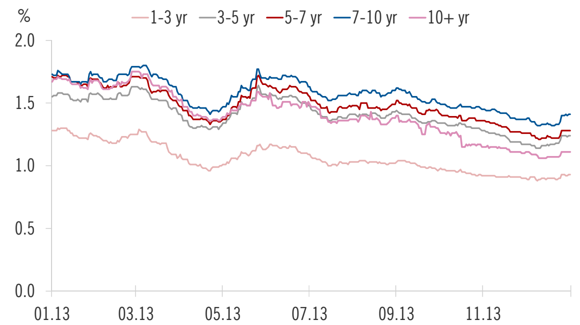


Source: Bloomberg, Barclays, Eur yields

RETURNS ON BONDS IN EURO

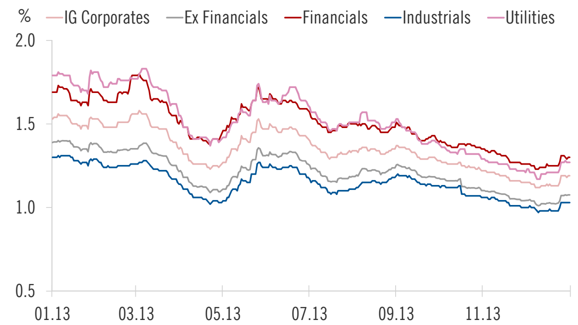
Source: Bloomberg, Barclays, Corporate Bonds in euro

INVESTMENT-GRADE SPREADS BY MATURITY (EURO)



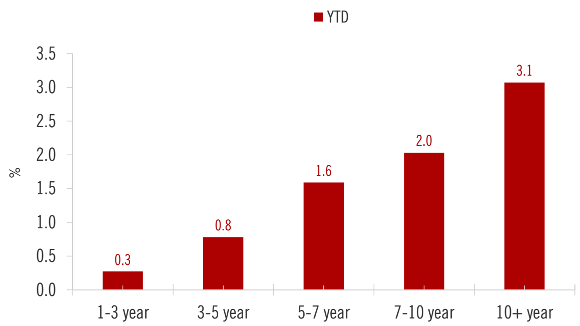
Source: Bloomberg, Barclays, EUR yield spreads

INVESTMENT-GRADE SPREADS BY SECTOR (EURO)



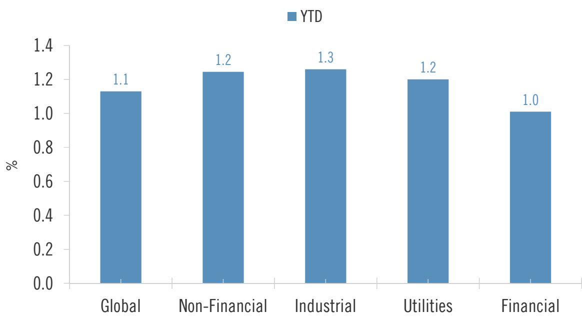
Source: Bloomberg, Barclays, EUR yield spreads

INVESTMENT-GRADE RETURNS BY MATURITY (EURO)



Source: Bloomberg, Barclays, Corporate Bonds in Euro

INVESTMENT-GRADE RETURNS BY SECTOR (EURO)



Source: Bloomberg, Barclays Corporates Bonds in Euro

High-yield bonds' strong run grinds to a halt

Investors still searching eagerly for yields

The European high-yield market started the year on a bullish note, with a solid performance and significant inflows primarily into the short-term segment. All sectors and ratings advanced, led by banks. However, towards the end of the month, the market was affected by a sell-off on emerging-market debt and stock markets.

High-yield borrowers benefited from investors' improved sentiment towards Europe. This has been encouraged by the turnaround in Spain in terms of growth, exports and competitiveness. Spain, for instance, has become the second biggest car maker in Europe. Ireland was also upgraded on 17 January by Moody's to Baa3, promoting it back up to the investment-grade category. As a result, peripheral issuers performed well, primarily thanks to spread contraction on their respective sovereign bonds. Portugal's solid performance, in particularly, deserves to highlighted. As for France, the government announced a series of measures in favour of the private sector, namely a reduction in labour costs. However, the IMF noted in its 2014 outlook that "*confidence is still low and weighing on growth*". In the UK, domestic consumption surprised on the upside and boosted UK retailers, such as Matalan, a CCC-rated clothing chain, who reported better than expected sales over its Q3 2013.

Corporate fundamentals remain sound

January vindicated data realised in 2013 on the corporate front. Interest coverage ratios and cash flow generation remained high despite leverage being on the increase. The default rate is set to remain low throughout 2014. Accommodating ECB monetary policies, along with cautious balance-sheet management, are the main factors behind this low default rate.

The primary market started the year with Bankia issuing 5-year senior debt at 3.5% yield and FGA Capital, the joint venture between Fiat and Crédit Agricole, launching a 4-year bond. As for corporate activity, ArcelorMittal unexpectedly decided to call its USD650m hybrid debt as Moody's erased last year the equity content of hybrids for all borrowers rated below investment grade. The ArcelorMittal bond tumbled close to the 101 call price. This decision sent tremors through the hybrid market, pinpointing the vulnerability of this nascent market. Peugeot is finalising a capital increase, negotiating with the French government and Dongfeng Motor, a Chinese conglomerate. Overall, as the equity market is gaining momentum, this should herald a comeback in initial public offerings and capital increases in Europe.

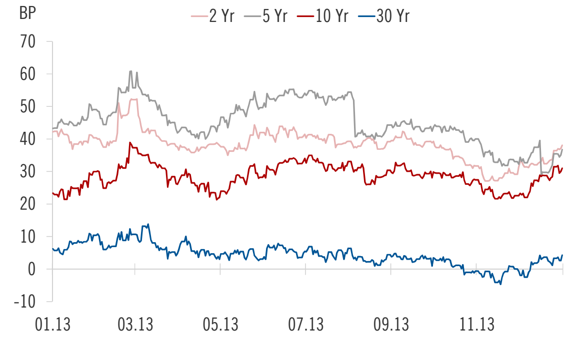
Outlook

We remain constructive on the high-yield corporate bond asset class. Downside risks for the European economy continue to recede, as ECB President Mario Draghi observed during his introductory statement to the monthly press conference in early January. Growth is gaining momentum in peripheral countries and continues to be robust in core countries, primarily Germany.

In this context, our main views are unchanged. Despite recent spread tightening, companies' balance sheets are in good shape, and investors remain well compensated for credit risks although other risks (political, peripheral, fiscal or a relapse in economic growth) are more thinly priced in. January, like December, tends to be traditionally favourable to risky assets, namely equities and high-yield bonds, which supports both the long- and short-dated segments of the sub-investment-grade market. In addition, European high-yield corporates benefit from the fact there are almost no alternatives for procuring yield in other fixed-income segments for the foreseeable future as rates look set to remain low over the next 12 to 18 months.

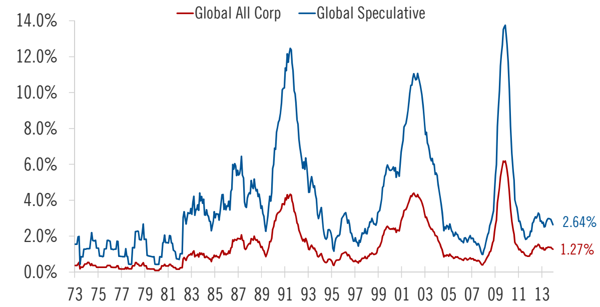
CREDIT RISK

EURO SWAP SPREADS



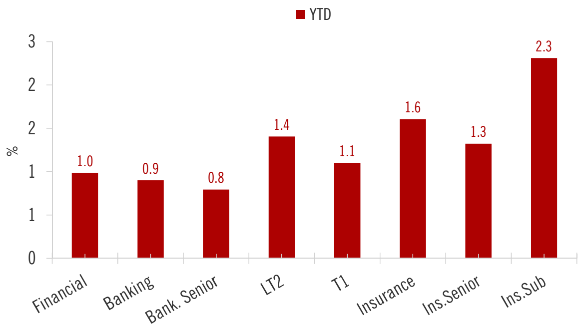
Source: Bloomberg, Swap spread EUR

MOODY'S - DEFAULT RATES



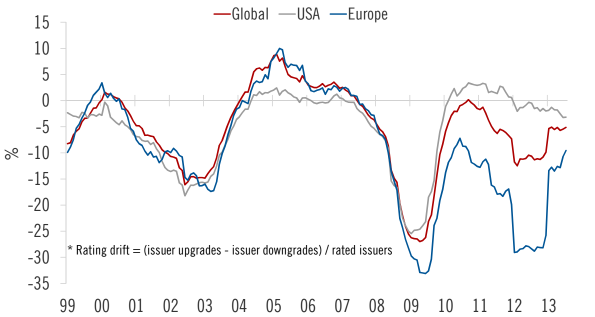
Source: Moody's

FINANCIAL INVESTMENT-GRADE RETURNS (EURO)



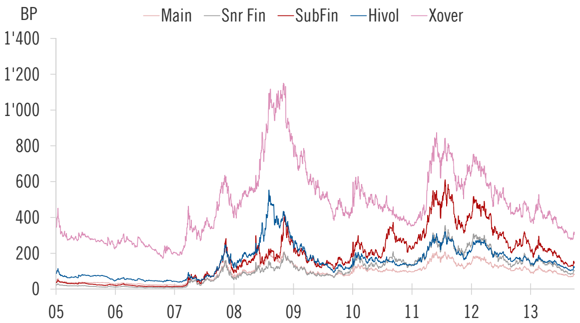
Source: Bloomberg, BoA Merill Lynch

MOODY'S - RATING DRIFT



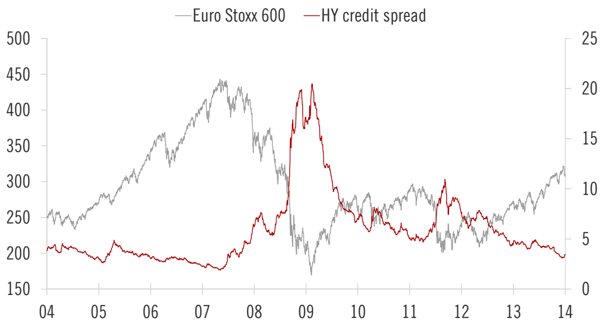
Source: Moody's

CDS - ITRAXX INDICES



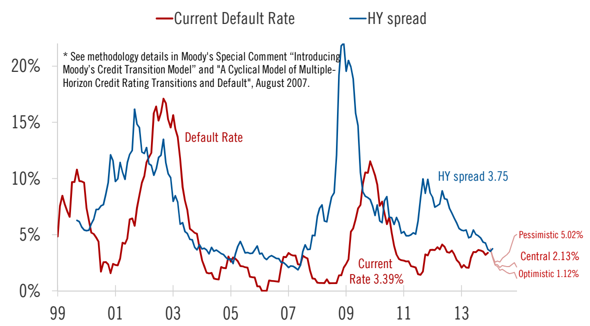
Source: Bloomberg, CDS Itraxx Europe

STOCK MARKET AND HY SPREAD



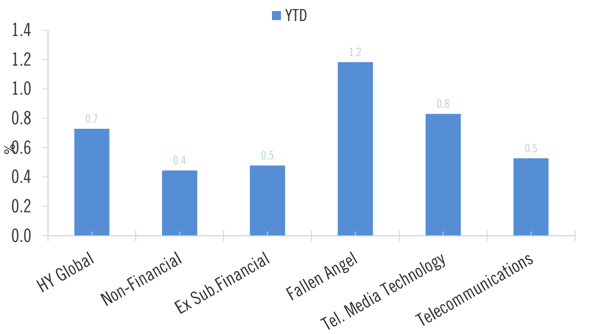
Source: Bloomberg, Barclays

HIGH-YIELD SPREAD AND DEFAULT RATES (EURO)



Source: Moody's and Merrill Lynch HY Index

HIGH-YIELD RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merill Lynch

Sell-off escalated towards the end of January

Local-currency debt – Recent developments

In January, the emerging-market local-currency debt benchmark index was down by almost 4% as yield crept up towards 7%. Most weakness was attributable to the worst sell-off in emerging currencies in years as markets revealed the impact of tightening financial conditions. This was compounded by mounting political and growth instability in many countries. One hopeful driver of global growth, China, stunned markets, reporting a fall in industrial production while the reality of defaults in the 'shadow banking' sector looms ever larger. The Turkish lira, also hit by a government corruption scandal, had plunged by nearly 9% at the time of writing, with Turkey's central bank burning through 10% of its reserves in a bid to stop the bleeding. As it has only USD33bn in foreign reserves, many market participants hoped for aggressive emergency rate hikes. South Africa's rand fell to its weakest level since 2008 while the Russian rouble fell 5% against a backdrop of growth barely above 1% and ongoing weak commodity demand. Brazil hiked rates by 50bp to 10.50%, more than expected to keep a lid on inflation, but this did not stop the real weakening almost 3%, though partly offset by bonds yielding well over 12%. Indonesia held up well given already weak levels while China saw a marginally positive return and the Thai baht also held up well.

Local-currency debt – Outlook

An underlying reason for emerging-market weakness has been the downtrend in exports since 2010. Now with expected stronger US and developed-market growth, emerging markets could strengthen too. However, growth remains uneven, and the impact of Fed tapering will continue to hit countries with structural issues, particularly those with funding needs. Key examples are Turkey, dogged by serious political risks and huge current-account deficit, or South Africa, unsettled by labour unrest, low growth, lack of reforms and upcoming elections. These markets are likely to see sustained pressure during this period of global transition to more normal monetary conditions. This could mean a scenario where the sell-off continues before investors identify value, resulting in a bounce-back. Countries, like Mexico and the Philippines, with solid growth, political stability and positive structural reforms should fare better than others.

External debt – Recent developments

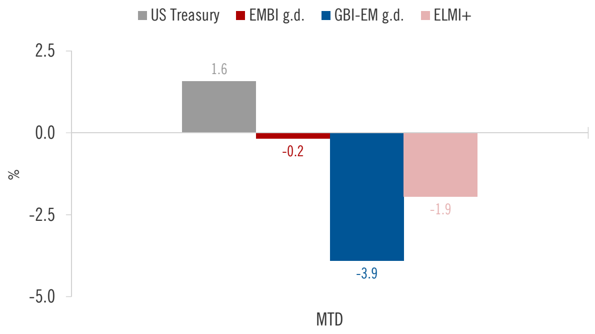
Emerging-market external debt was less affected. A primary driver was the driftdown in US Treasury yields on mixed US and Chinese data. High-grade countries with the tightest spreads were the best performers, the likes of Malaysia, Hungary and the Philippines. Underlying fundamentals for these markets came to the fore, with Brazilian spreads widening as the current-account deficit worsened amid other structural issues. Among higher-beta countries, Croatia was downgraded one notch to BB by S&P while Fitch downgraded Serbia to B+, citing concerns about weak fiscal dynamics and mounting public debt. Argentina was the worst-performing market, down over 10% and a spread approaching 1,000bp as forex reserves dwindled and the currency weakened the most in over 10 years, down close to 20% for the month. Ukraine's effective bail-out from Russia was a little short-lived as the bond declined as investors focused on deteriorating fundamentals and anti-government protests spreading across the country. Egypt was a strong performer as voters approved a new constitution providing support for the political transition with parliamentary elections in the months ahead.

External debt – Outlook

Long-term fundamentals of the asset class are largely intact, such as lower debt/GDP ratios than developed countries and attractive yields, but Fed tapering may continue to cause downward pressure while more focus will be placed on individual countries' fundamentals. At the same time, the potential for US Treasury yields to stay range-bound in the short term would be supportive and add to the argument there is value given spread levels relative to other high-grade-spread asset classes and good support from longer-term investors. However, it remains subject to investor sentiment, and we have seen no signs of investor outflows reversing.

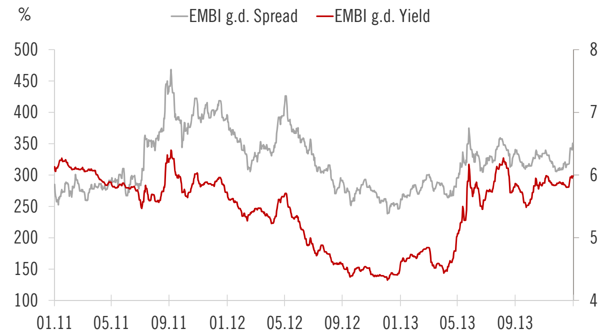
EMERGING DEBT

PERFORMANCES (USD)



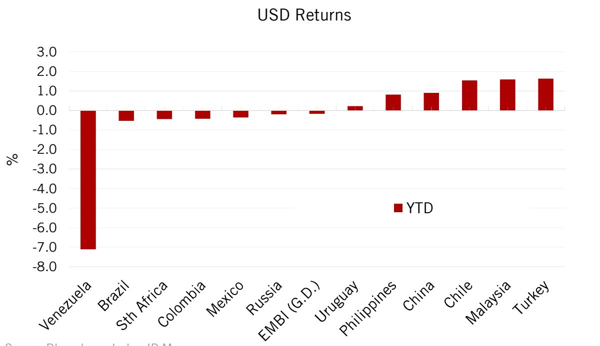
Source: Bloomberg, Index JP Morgan

US DOLLAR DEBT - YIELD & SPREAD



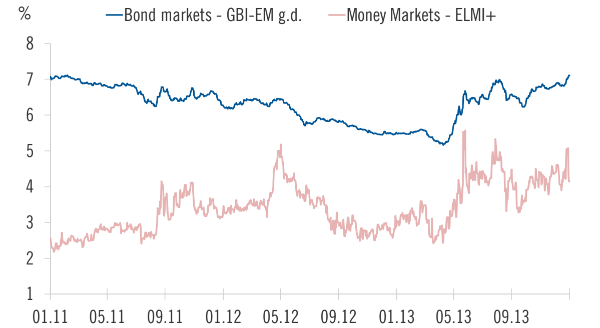
Source: Bloomberg, JP Morgan Indices

JP MORGAN EMBI GLOBAL DIVERSIFIED



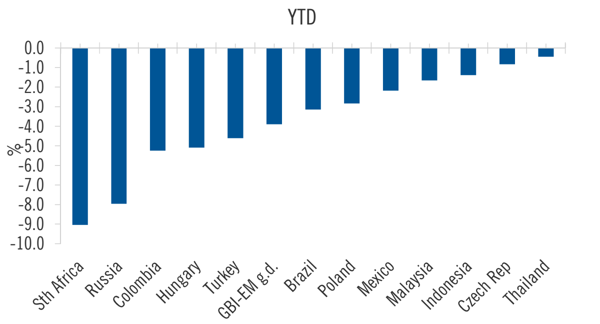
Source Bloomberg; Index JP Morgan

LOCAL CURRENCY DEBT - YIELD



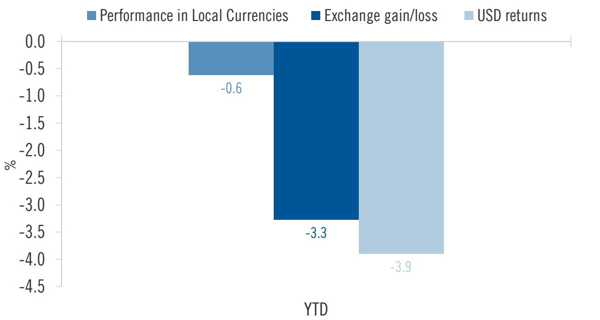
Source: Bloomberg, JP Morgan Indices

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



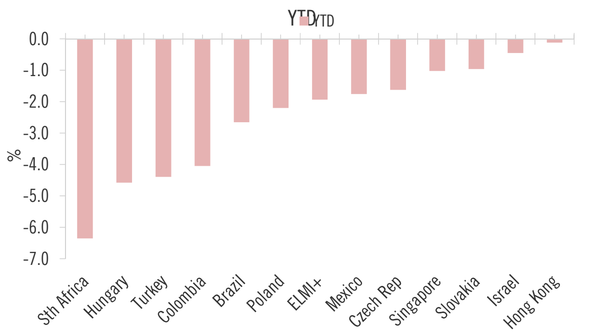
Source Bloomberg; Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



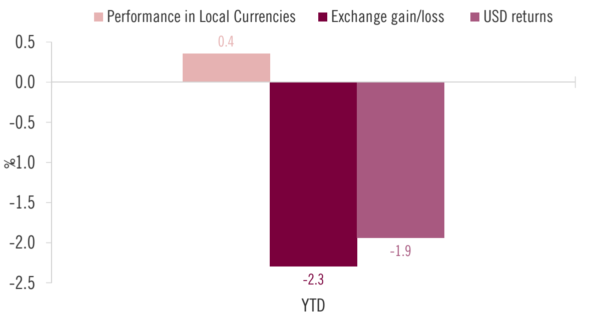
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg; Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

Wave of short covering on US Treasury bonds

Jobs numbers and the turn of events in emerging countries have been unsettling the markets

After a wave of upgrading of growth forecasts by many economic pundits in the last few weeks of 2013, the jobs data published in early January threw a dampener over all the enthusiasm that had taken hold of the markets. The mood was further soured by news from China heralding a slowdown in its economy. The US employment report was surprisingly weak: just 74k jobs created in December whereas 197k had been expected. Unemployment has, however, continued to come down, sliding from 7% to 6.7%, but, in mitigation, the labour participation rate, measuring those in employment as a percentage of the potential working-age population, sank to 62.8%, its lowest level since 1978. At a time when the Fed's *Beige Book* was further confirming the strengthening economic recovery, other statistics were delivering more mixed readings. Moreover, market operators have tended to focus and dwell more on the less encouraging news: small rise in the leading economic indicator (+0.1%); the 7.0% drop in sales of new homes; a 9.8% fall in housing starts; the decline in Markit's preliminary PMI for January to 53.7, vs. the expected 55; the slide in consumer confidence to 71.3; the 4.3% decline in durable goods orders.

Consumer prices rose by 0.3% m-o-m in December, pushing the headline y-o-y rate of inflation up from 1.2% to 1.5%, but core inflation was flat at 1.7%. The other key measure of inflation, the core personal consumption expenditure (PCE) price index – a bellwether very closely monitored by the Fed – pointed to a 1.1% increase in prices.

The budget problem may have been settled, but the issue of the Federal debt ceiling is still on the table

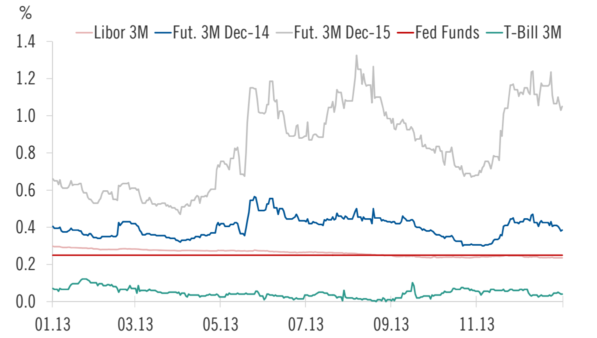
President Obama signed off the Federal budget for the coming two years, effectively translating into law the compromise deal thrashed out by the Democrats and Republicans and cancelling out the kicking-in of automatic spending cuts. The budget deficit, at 4.1% of GDP in 2013, should continue being reduced over the coming decade. According to the latest estimate from the Congressional Budget Office, it should be cut to 2.3% of GDP by 2016. Despite this, the US Treasury may soon find itself unable to pay its bills if a deal is not hammered out in Congress to lift the Federal debt ceiling in the not too distant future. With the country on course to have exhausted its borrowing capabilities in a month's time, the Republicans are insisting on receiving concessions in return for agreeing to lift the ceiling whilst also being mindful to promise the USA will not flirt with disaster as it had done during the fortnight shutdown of Federal government in October.

The Fed is pressing ahead with its tapering, but is likely to focus more on inflation

Disappointing numbers released in the USA and China, some mixed company results and the troubles engulfing several emerging nations prompted a wave of short covering of US Treasury bonds by a good many investors. The yield on 10-year T-bonds, which had climbed to 3.02% by end-2013, slipped back to 2.69% in spite of the prospect of the Fed pressing ahead with its tapering. The Fed is likely to press on with reining in its purchases of assets by USD10bn each month and may focus its statements for public consumption more on inflation, which is currently running below its targeted level, and less on the jobless rate which is nearing its target. This increases the likelihood of the Fed funds rate being left where it is for several more months to come.

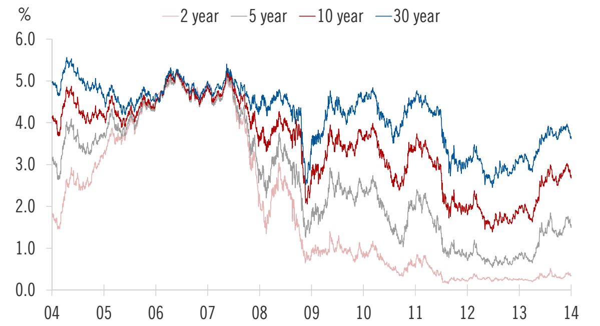
USA

SHORT-TERM RATES (USD)



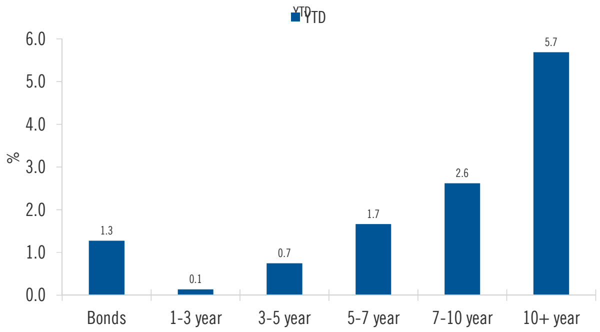
Source: Bloomberg, Money Market, USA

US TREASURY BOND YIELDS



Source: Bloomberg, Us Treasury

RETURNS FROM GOVERNMENT BONDS BY MATURITY

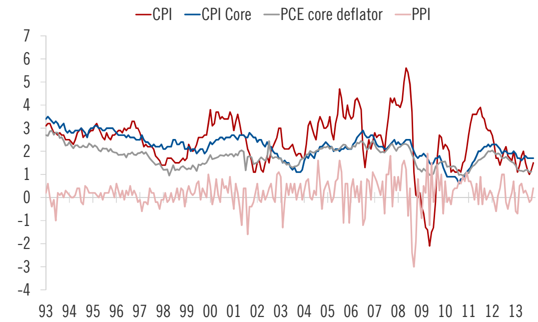


Source: Bloomberg, Citigroup, US Treasury

MOVEMENTS IN YIELD SPREADS

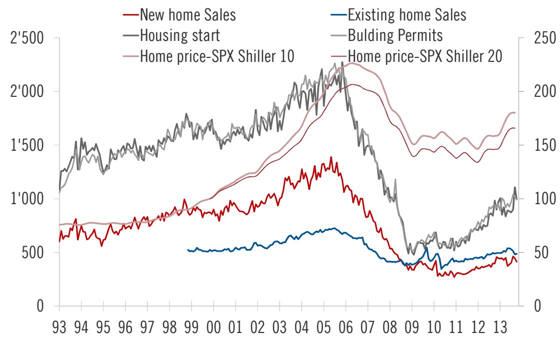
Source: Bloomberg, US Treasury

INFLATION



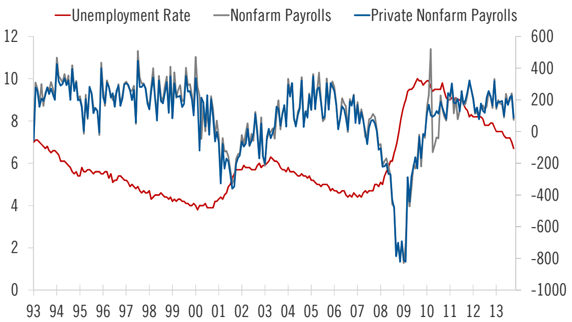
Source: Bloomberg, USA

HOUSING



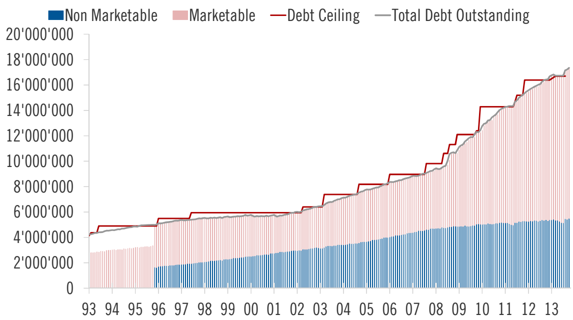
Source: Bloomberg, USA

LABOUR MARKET



Source: Bloomberg, USA

DEBT CEILING



Source: Bloomberg, USA

ECB envisaging a prolonged spell of mild inflation

Recent statistics have confirmed the eurozone economy has been picking up speed, but inflation is still in retreat

The ongoing uptrends on European economic and business surveys and PMIs sustained hopes of the economic recovery continuing, with the jobless rate stationary at a high level. The Manufacturing PMI for the eurozone advanced from 52.7 to 53.9 in January, with the Services PMI progressing from 51 to 51.9. The most heartening news was the upturn in French PMIs, which had been the cause for some concern in December, and the steeper than expected rise in the German Ifo Business Climate Index. On a less encouraging note, questions are still being asked about the solidity of the economic recovery in the eurozone as unemployment is still above 12%, business investment is lacklustre and lending to the private sector is still shrinking.

The headline rate of inflation edged down in December, fuelling further fears about the onset of deflation. The y-o-y rate receded from 0.9% to 0.8%, with the underlying rate declining from 0.9% to 0.7%. Decelerating inflation in October and November could be explained by falling energy prices whereas the driftdown in December appears to have been driven by a drop in the prices of other goods and services.

Spreads on 10-year sovereign bonds of peripheral countries narrowing and interest rates at very low levels

Peripheral eurozone markets have been in fine form since the turn of the year, buoyed by the economic upturn and a possible ECB rate cut. The markets have been underpinned by Ireland's successful return to the stage as it launched a 10-year bond with a 3.4% coupon. The order book swelled to EUR14bn for the EUR3.75bn being raised. Moody's upgraded its rating on Ireland to Baa3, which restored it to investment-grade status. Bonds from Portugal, Spain and Italy were also in keen demand. Portugal's 5-year EUR3.25bn 4.65% bond was 3.8X oversubscribed, with foreign investors making up 88.2% of the demand. The issue enabled Portugal to cover almost half of the funds it was planning to raise in 2014. Spain issued 5- and 15-year bonds, raising EUR5.3bn, at much reduced rates, and the country's nationalised banks also made their returns to the capital markets. Italy also raised some EUR8.2bn with bonds having very low rates and maturities ranging from 3 to 14 years. Lastly, Moody's gave France some breathing-space, leaving its rating at Aa1, but still voicing some doubts over the country's capacity to implement reforms.

Comments from the ECB, the strong euro and tensions on Eonia prompted speculation about a cut in official interest rates

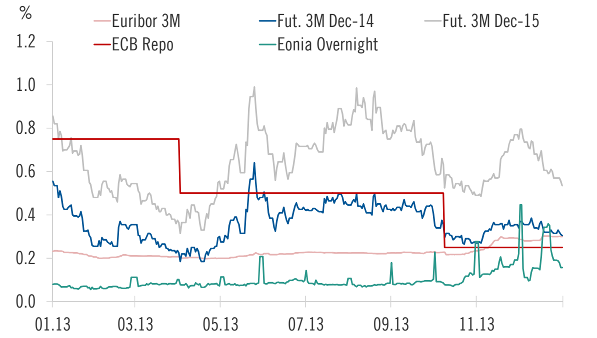
As expected, the SNB left its monetary policy unchanged following its first meeting in 2014. Nevertheless, ECB President Mario Draghi did adopt a notably accommodating tone, insisting once again on his determination to use all weapons available to combat deflation. He remarked that the eurozone's recovery was moderate and fragile, and that inflation looked set to remain subdued for quite some time to come. He confirmed indications about the future direction of interest rates which should remain at current levels or be pushed lower, if deemed necessary.

Turmoil rippling through the emerging world and speculation about an ECB rate cut pushed bond yields downwards

The yield on 10-year Bunds, which had advanced to almost 2% by end-2013, drifted back down to 1.65%. Over the next few weeks, yields are likely to remain fairly tightly range-bound as the market will probably not receive the confirmation that the recovery is sustainable, which would damp down fears about deflation round the corner.

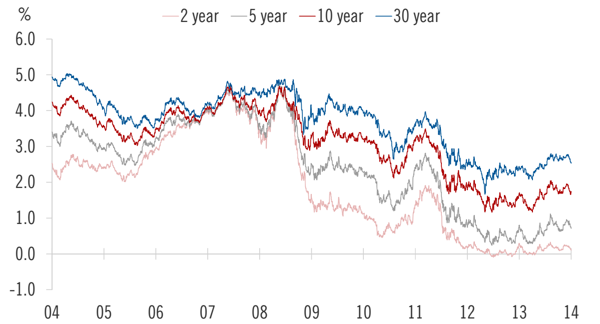
EUROZONE

SHORT-TERM RATES (EURO)



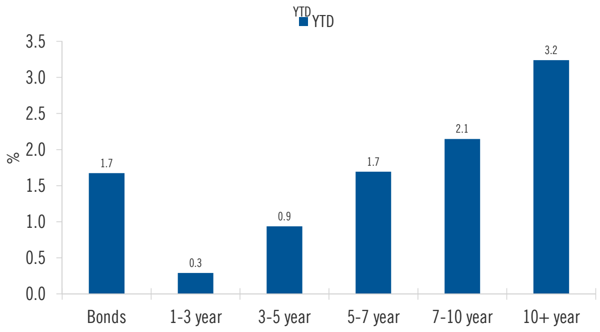
Source: Bloomberg, Money, EU

BUND YIELDS



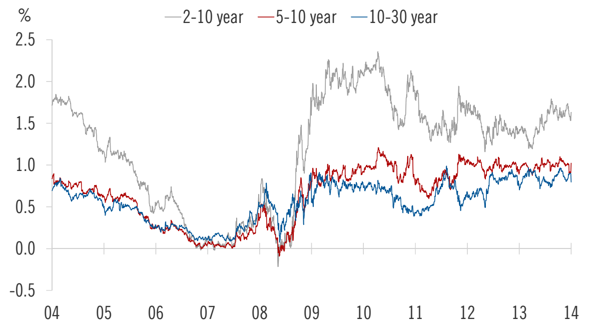
Source: Bloomberg, Bund

RETURNS BY MATURITY (EMU GVT)



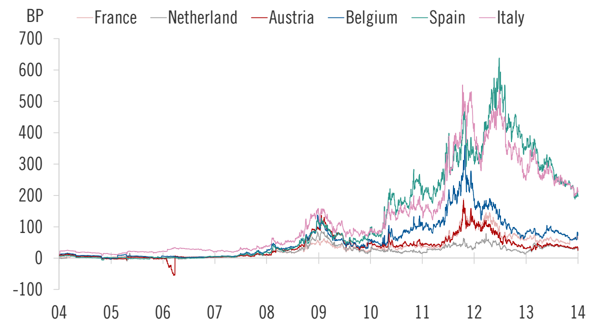
Source: Bloomberg, Citigroup, EMU Gvt Bonds

MOVEMENTS IN YIELD SPREADS



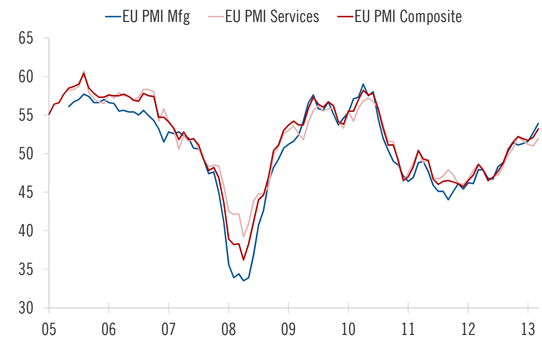
Source: Bloomberg, Bund

10-YR GVT SPREADS VS GERMANY



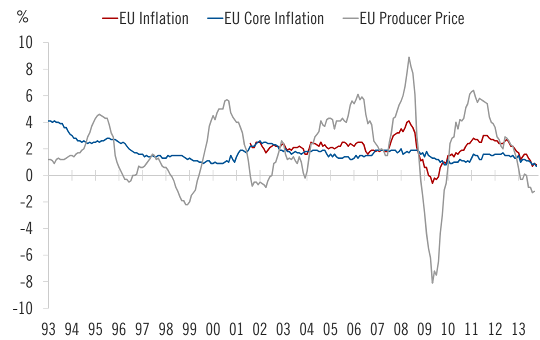
Source: Bloomberg, Govt yield spreads

EUROZONE - PUCHASING MANAGER INDICES



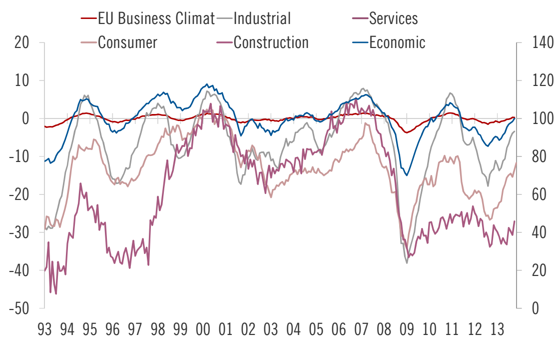
Source: Bloomberg, Eurozone PMI index

EUROZONE - INFLATION



Source: Bloomberg, Eurozone

EUROZONE - ECONOMIC SURVEYS



Source: Bloomberg, Eurozone Economic Survey

Speedier fall in inflation and unemployment than expected

The UK economy sustained a robust rate of growth in Q4 2013

The UK's GDP growth worked out at 0.8% for the final quarter of 2013. Although some economic numbers have dipped a little of late, many economists remain confident the British economy will extend its upswing this year. Overall, the consensus is projecting GDP growth of over 2% for 2014. The PMIs did edge down a fraction in January, but they had admittedly risen quite steeply in previous months: the Manufacturing PMI fell from 58.1 to 57.3 whilst the Services PMI, which had climbed to 62.5 in October, fell back down to 58.8. The car market has picked up impressively, expanding by 11% last year. Retail sales registered a record level in December, posting a 2.6% rise thanks to a buoyant Christmas shopping season.

Economic recovery is, however, coming hand in glove with some disconcerting imbalances

Although consumer spending has picked up, the recovery is primarily being fuelled by the housing and property markets. Demand for mortgage loans has jumped to its highest since 1997 and house prices rocketed by 8.4% in 2013. According to some forecasters, they could well rise by a further 10% this year, spawning fears of overheating and another housing bubble, especially as household debt in the UK has not come down, unlike what has been the case in the USA.

Rapidly falling unemployment has rekindled speculation about what the Bank of England might choose to do

The fall in unemployment has been picking up speed, with the jobless rate dropping from 7.4% to 7.1% in November. In the three months to November, the jobless total fell by 167,000 to 2.32m, its steepest drop since 1997. The headline rate of inflation fell again in December, with the y-o-y rate hitting the 2% target rate. With both unemployment and inflation falling faster than expected, the Bank of England (BoE), which has adopted the practice of providing forward guidance, finds itself in the spotlight.

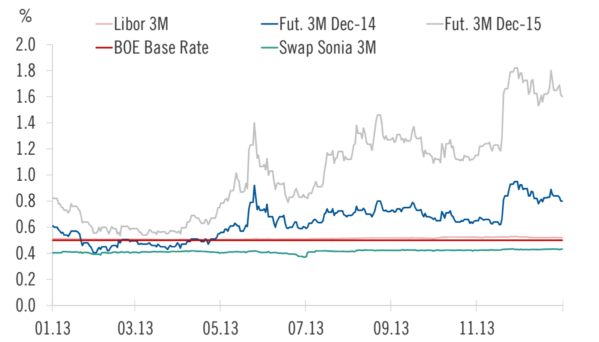
For the time being, the BoE sees no need to readjust its monetary stance

With the arrival of Mark Carney as the new Governor and the adoption of the policy of forward guidance, the BoE had clearly intimated it would not raise the base lending rate until the jobless rate had moved back below 7%, which it had expected to occur sometime in 2016. As things now stand, the rate is closing in very fast on that 7% threshold at a time when inflation has also dropped towards the BoE's 2% target level. The BoE has stated that it sees no pressing need to take any action now as productivity levels are still fairly disappointing. Mark Carney pointed out that the BoE's Monetary Policy Committee would review its guidance in February in light of the quarterly inflation report. Back in November, the BoE had taken an initial step towards tightening lending conditions, ending its 'Help to Buy' home-loan incentive programme. However, so as not to jeopardise the recovery, the possibility of the BoE choosing to lower its target threshold for the jobless rate or placing greater emphasis on various inflation measures, including wage levels, cannot be ruled out.

With the UK economy extending its recovery and both inflation and unemployment declining, market expectations for short-term rates have been significantly modified, with the market now pricing in an initial hike in the base lending rate for H2 2014. Despite that, yields on 10-year gilts moved down from 3.07% to 2.76%.

UK

SHORT-TERM RATES (GBP)

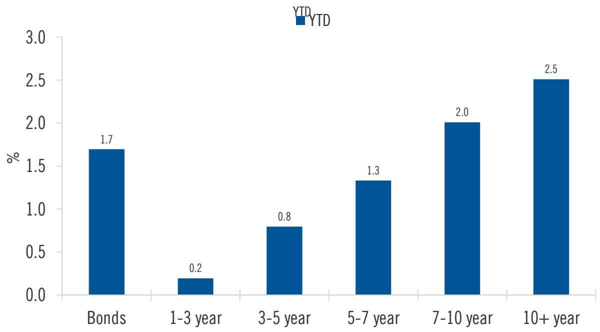


Source: Bloomberg, Money Market, UK

UK TREASURY YIELDS

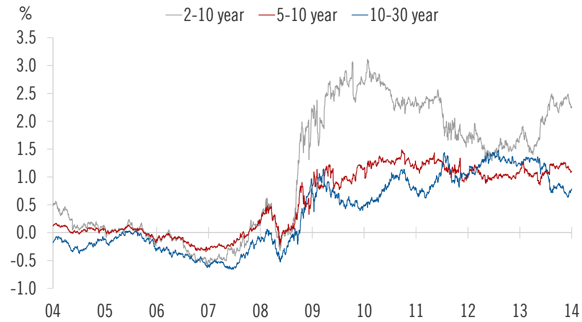
Source: Bloomberg, GILT

RETURNS FROM GOVERNMENT BONDS BY MATURITY



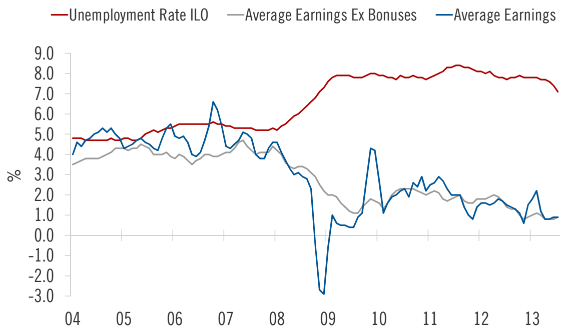
Source: Bloomberg, Citigroup, UK Treasury

MOVEMENTS IN YIELD SPREADS



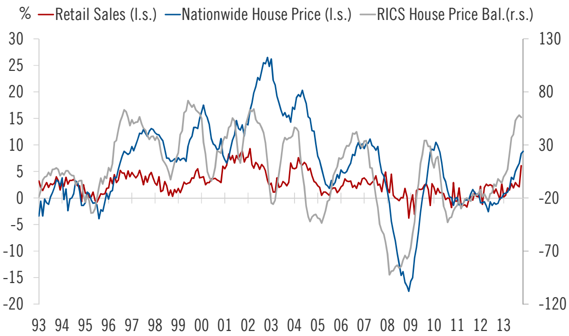
Source: Bloomberg, GILT

LABOUR MARKET



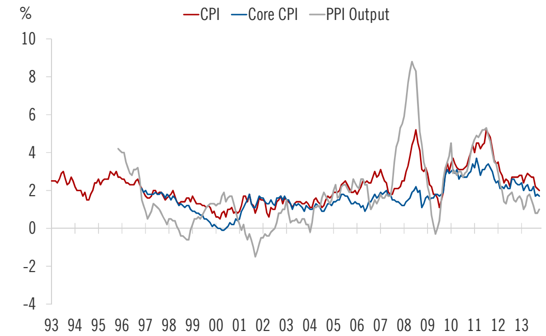
Source: Bloomberg

HOUSING AND RETAIL SALES



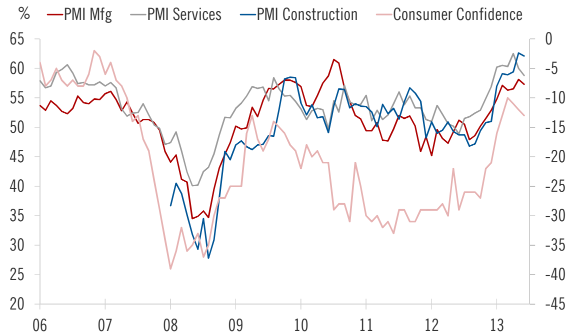
Source: Bloomberg, UK

INFLATION



Source: Bloomberg, UK

ECONOMIC SURVEYS



Source: Bloomberg, UK

Measures reinforced to cool down overheating property market

Recent economic data have been more mixed, but do not challenge the scenario for growth of around 2% in 2014

KOF's economic indicator extended its uptrend in December, climbing from 1.85 to 1.95, which points towards the Swiss economy performing solidly over the next few quarters The Manufacturing PMI, however, slipped from 56.5 to 53.9 whereas consensus expectations had been looking for it to hold steady. Despite the drop, it is still firmly in the 'growth' zone, making that the ninth month in a row. Moreover, the Order Books sub-index, running at 59, points to plenty of orders in the pipeline to be worked through. The unemployment rate advanced from 3.2% to 3.5% although the seasonally-adjusted jobless rate was stationary at 3.2%. According to the State Secretariat for Economic Affairs (SECO), 149,437 people were registered as unemployed with regional labour exchanges as of end-2013, 10,364 more than at the end of November. The ZEW-Credit Suisse Indicator measuring expectations about Switzerland's economic outlook declined from 39.4 to 36.4 in January.

Consumer prices fell by slightly more than had been expected in December (down 0.2%), pushed down by falls in the prices of medicines, hospital services, package holidays, clothing and footwear. In contrast, prices for heating oil and fresh fruit/vegetables rose. The headline rate of inflation was steady at -0.1% y-o-y, with underlying inflation inching down from 0.1% to 0%.

The SNB, whose profits were dented by the falling gold price, will not be paying out any proceeds to the Confederation or the cantons

The Swiss National Bank (SNB) reported a loss of CHF9bn for its 2013 financial year. The slump in the price of gold produced a loss of CHF15bn, which was partly offset by gains made on the bank's foreign-exchange reserves. This loss will mean both the Federal and cantonal government authorities will be deprived of a traditional source of income of some CHF1bn, which will leave a bit of a hole in public-sector finances. This will send the Confederation's accounts into deficit, estimated at -CHF212m, as opposed to an expected surplus of CHF121m. Cantonal authorities will also have to rejig their budgets to make allowance for this unexpected turn of events.

Neither the size nor the currency breakdown of the SNB's foreign-exchange reserves fluctuated much in 2013: they totalled some CHF435.2bn as of end-2013, with the euro accounting for 48% and the US dollar for 27%.

SNB still worried about the soaring property market and determined to stop the franc from climbing further in value

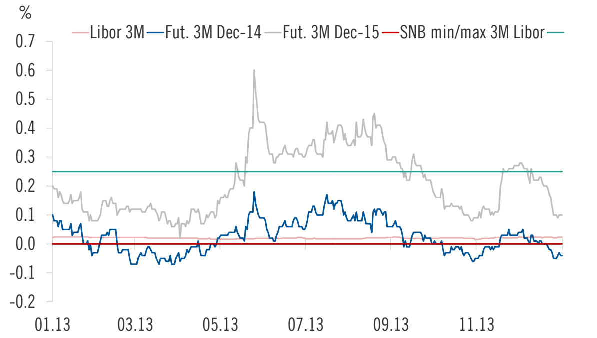
The ongoing rise in the index of house/flat prices in Switzerland and the trend on the Swiss mortgage market prompted the SNB to table a series of proposals to the Federal Council which decided to make adjustments to the countercyclical capital buffer banks are required to hold. As a result, banks will now have to set aside an increased 2% cushion (up from 1%) to cover mortgage lending as from 30 June.

The SNB is unlikely to push up interest rates this year as forecasts are for inflation to stay subdued, the franc is expected to remain firm and uncertainties persist over the well-being of the eurozone economy.

Yields on 10-year Confederation bonds did climb to a new year-high in late December, but receded again in January in the slipstream of declining yields on main international bond markets. The spread relative to German Bunds remained stuck in a narrow range. Swiss bond yields should not fluctuate dramatically during the course of the first quarter with the SNB's monetary policy set to be unchanged.

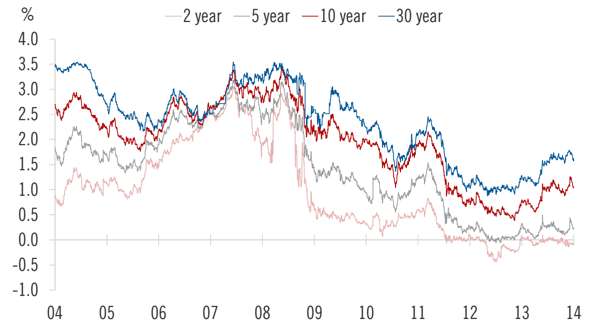
SWITZERLAND

SHORT-TERM RATES (CHF)



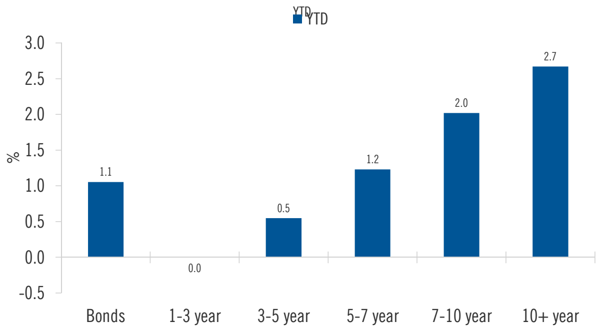
Source: Bloomberg, Money Market, CHF

CONFEDERATION BOND YIELDS



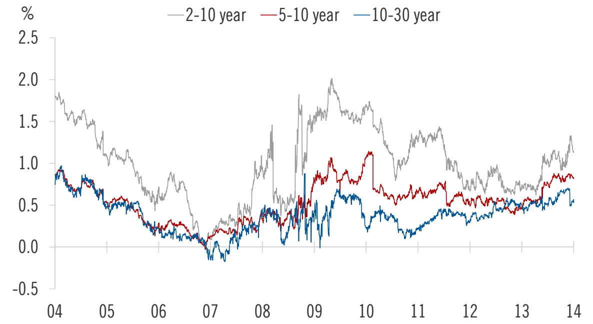
Source: Bloomberg, Confederation

RETURNS FROM GOVERNMENT BONDS BY MATURITY



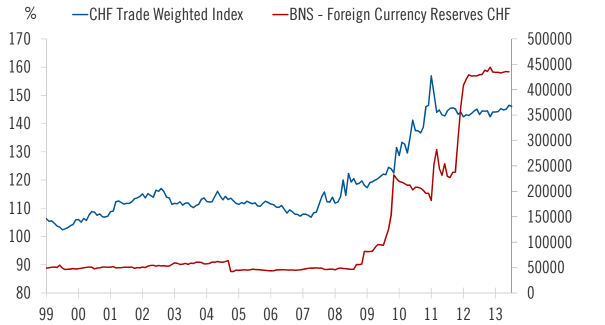
Source: Bloomberg, Citigroup, Switzerland Gvt Bonds

CONFEDERATION - MOVEMENTS IN YIELD SPREADS



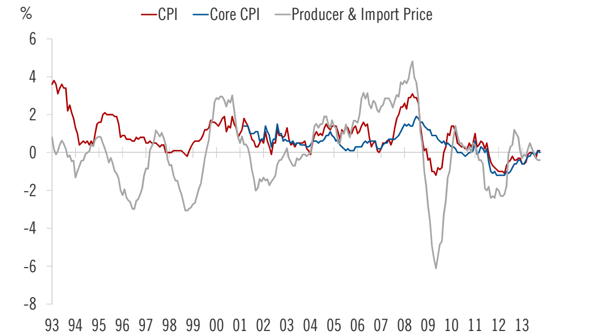
Source: Bloomberg, Confederation

SNB EXCHANGE RESERVES



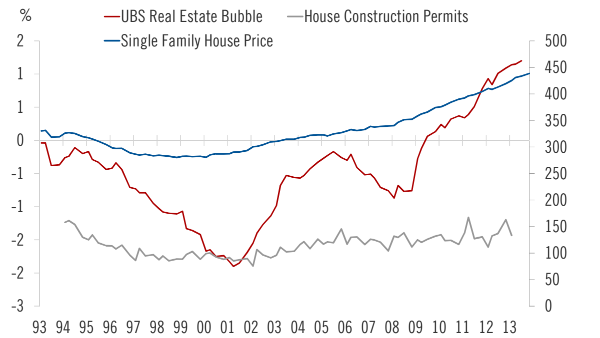
Source: Bloomberg, Switzerland

INFLATION



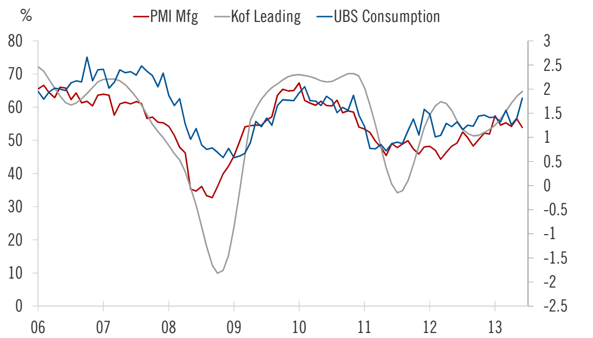
Source: Bloomberg, Switzerland

HOUSING MARKET



Source: Bloomberg, Switzerland

ECONOMIC SURVEYS



Source: Bloomberg, Switzerland

Plans to revitalise the economy still ongoing

Structural reforms have been slow in coming, and doubts persist about the ability of the economy to cope with the hike in the consumer sales tax

By fostering growth by spending public money and allowing the yen to fall in value, which pushes up the cost of imports, Prime Minister Shinzo Abe has managed to boost the Japanese economy and lift the rate of inflation. Despite this, many forecasters and commentators remain sceptical. They hold the view that the Bank of Japan's aggressive monetary easing and the government's array of reflationary plans are just not going to be enough to ensure Japan returns to the path of sustained and sustainable growth. Moreover, as things stand, the much vaunted structural reforms, which should help to make the recovery sustainable, are still running into opposition. Furthermore, consumer spending may well be dented by the forthcoming hike in the consumer sales tax, with the rate set to rise from 5% to 8% in April this year and perhaps to 10% by end-2014. The proceeds from this tax hike should give Japan's public-sector coffers a welcome boost, with the debt/GDP ratio pitched as high as 227% in 2013. Worryingly though, consumer confidence, with income levels flat, has dropped, with the index sliding from 42.5 to 41.3% in December. Pay-bargaining talks scheduled for this spring will be key in influencing what happens to household spending.

Japan's GDP growth had already betrayed signs of slackening in pace in late 2013 so the possibility of consumer spending contracting is giving rise to fears Japan will be unable to achieve its growth targets. Structural reforms and measures to deregulate the economy, being touted by Prime Minister Abe, are intended to open the country's doors to foreign investors, to attract in fresh investment and boost domestic demand.

Progress being made on the inflation front

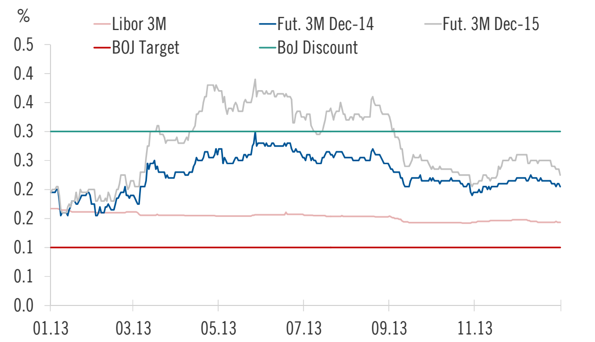
Prices of consumer goods like computers or mobile phones have risen for the first time since 1992, which suggests some progress is being made in the fight to conquer deflation. In recent months, increased electricity and oil prices, imported in huge quantities since the Fukushima disaster and the shutdown of the country's nuclear power plants, have, above all, been responsible for driving inflation upwards and causing a lasting trade deficit. The headline rate of inflation advanced from 1.1% to 1.5% y-o-y in November, with core inflation, i.e. excluding prices for energy and fresh food, edging higher from 0.3% to 0.6%.

The BoJ is still confident about the outlook for the recovery and remains braced to push through fresh measures if required

Not surprisingly, the Bank of Japan made no change to its ultra-accommodating monetary stance at its recent meeting, indicating that it was still aiming to double the size of the monetary base and to force inflation up to a rate of +2%. The BoJ believes the Japanese economy is still on a moderately-paced recovery course. As such, it has made no change to its forecasts for either growth or inflation. It is most likely to wait to see what impact the hike in the consumer sales tax has before making any significant decisions on whether any new measures are needed. Over the next few months, the BoJ's activist approach should continue to underpin the market for Japanese government bonds on which yields moved quite noticeably lower in January. The yield on 10-year JGBs receded to 0.61%, very close to their 2013 year-lows.

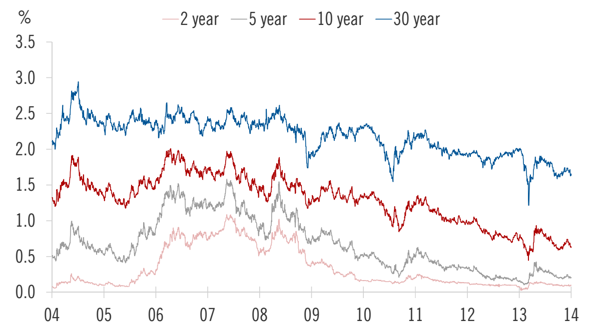
JAPAN

SHORT-TERM RATES (YEN)



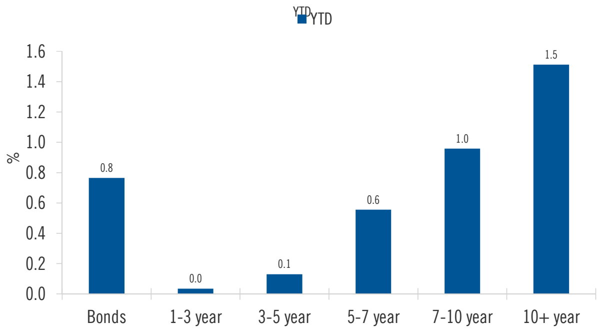
Source: Bloomberg, Money Market, Japan

JAPANESE GOVERNMENT BOND YIELDS



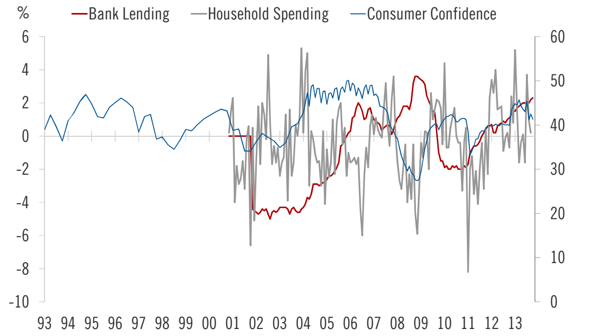
Source: Bloomberg, JGB

RETURNS FROM GOVERNMENT BONDS BY MATURITY



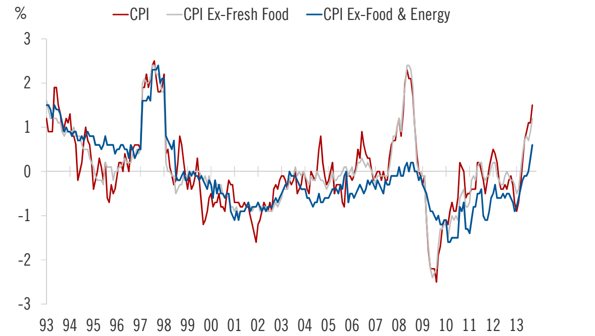
Source: Bloomberg, Citigroup, Japan Gvt Bonds

CONSUMPTION



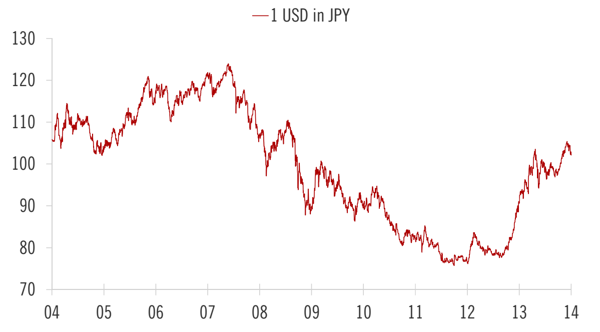
Source: Bloomberg, Japan

INFLATION



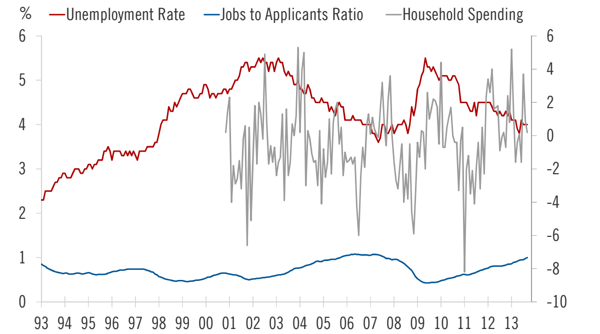
Source: Bloomberg, Japan

JAPANESE YEN VERSUS DOLLAR



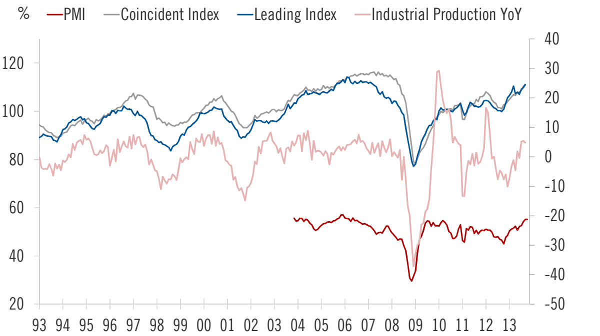
Source: Bloomberg, exchange rates

LABOUR MARKET



Source: Bloomberg, Japan

LEADING INDICATOR AND INDUSTRIAL PRODUCTION



Source: Bloomberg, Japan

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