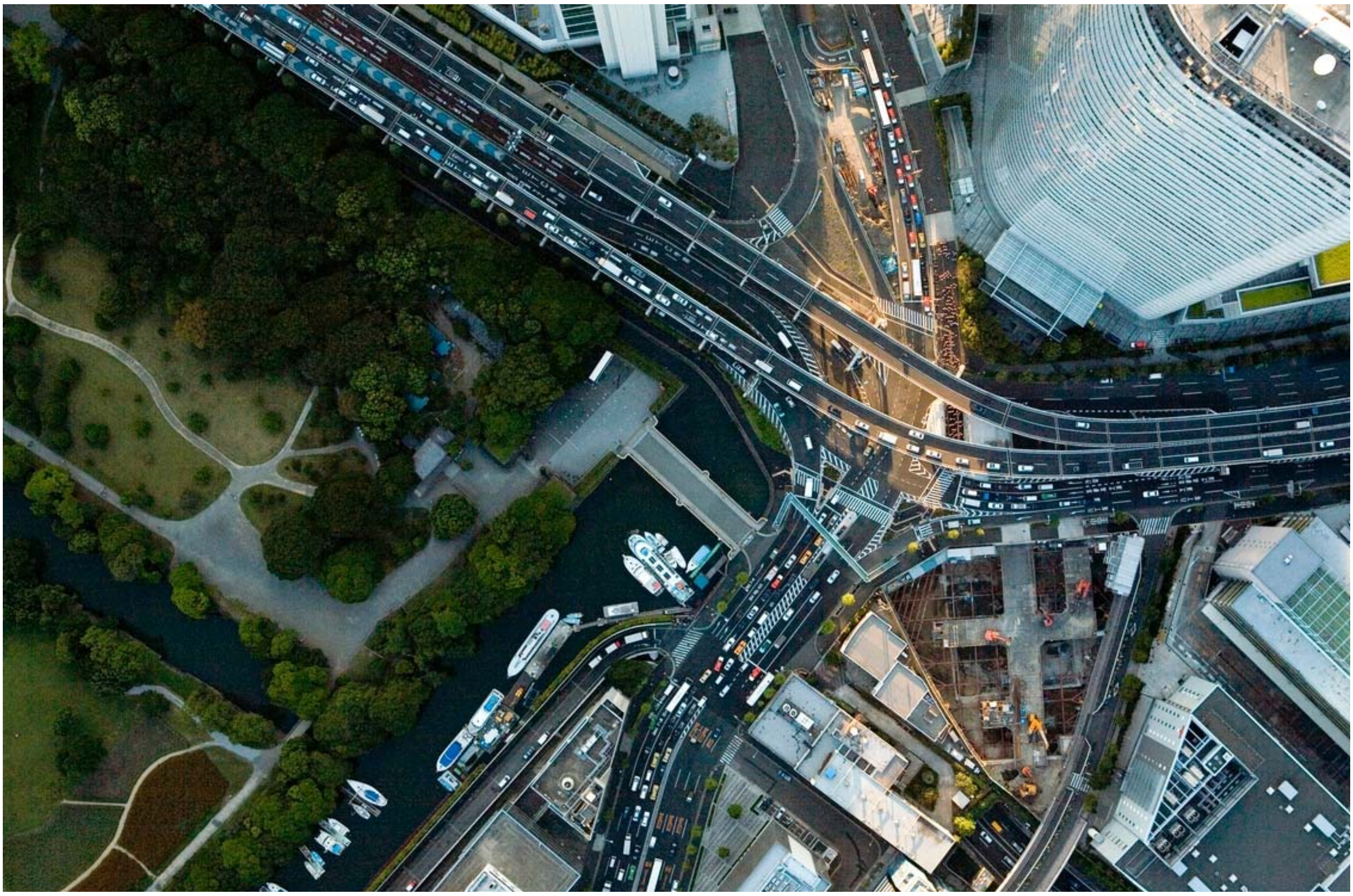
Monthly Bond Letter
June 2014

Pictet Asset Management



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OVERVIEW

Recent developments

Even though economic news was a little brighter and inflation regained some speed, bond yields still drifted downwards in May

After GDP growth for Q1 2014 in the US was initially published as being practically zero, statistics have been released confirming the rebound during the spring months. In April, the ISM Purchasing Managers' Indices (PMI) extended their uptrend, 288,000 jobs were created and the housing market picked up. Economists are looking for GDP growth in the region of 3% for Q2. Inflation moved within touching distance of the US Federal Reserve's target as the y-o-y headline rate quickened from 1.5% to 2%. In spite of all this, yields on 10-year US Treasury bonds extended their decline in May, dipping as low as 2.5% in mid-month.

Pedestrian recovery in Europe still vulnerable-looking

Eurozone GDP only expanded by 0.2% in Q1 2014, falling short of expectations which had been looking for 0.4% growth. This sluggishness tempered the optimistic view the eurozone had at long last shrugged off its troubles, delivering a reminder the recovery remains both brittle and fragmented. Moreover, the slowdown in Russia's economy might well have knock-on effects throughout Europe, with some countries already feeling the pinch.

Even though eurozone inflation did climb from 0.5% y-o-y to 0.7%, anxiety that disinflation might degenerate into deflation has not yet been dispelled. In early May, the ECB stuck with the status quo, but did hint fresh measures might well be adopted in the not too distant future.

Against this backdrop of economic uncertainty, low inflation and mounting likelihood of fresh steps being taken by the ECB, European bond yields receded further

After their spell of euphoria, peripheral eurozone markets were flat in late May as they were hit by a flurry of profit-taking in response to the disappointing eurozone GDP numbers as well as rumours foreign holders of Greek bonds might be liable for capital gains tax. Right at the end of May, Matteo Renzi's impressive showing in European Parliament elections in Italy helped the market to rebound.

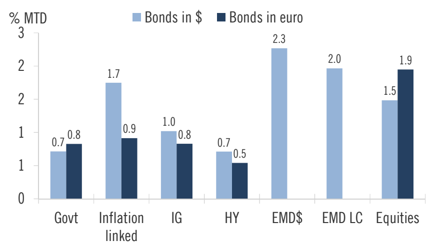
Japan's GDP boosted by buying brought forward to beat the hike in consumer sales tax

The hike in the rate of consumer sales tax from 5% to 8% as of 1st April this year prompted consumers to bring forward purchases of goods to beat the deadline. Japan's GDP duly jumped by 1.5% q-o-q in Q1, corresponding to an annualised rate of 5.9%. Consumer spending notched up its biggest rise since 1997, the year when the consumer sales tax rate had been hiked with all the, by now, familiar disastrous after-effects.

European corporates still in fine shape

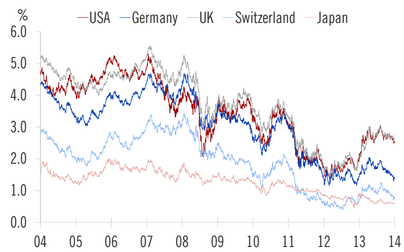
In early May, corporate bonds continued to behave as they had in April, with the market still dominated by investors' quest for yield. Credit spreads unsurprisingly continued to narrow, with, in time-honoured fashion, subordinated financials debt, hybrid paper and bonds issued by Spanish and Italian borrowers outperforming. The market, however, underwent a bout of correction in mid-May.

RETURNS – MAY 2014



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

10-YEAR GOVT. BOND YIELDS



Source: Bloomberg, 10 Yr Govt yields

OVERVIEW

Forecasts

With the US economic rebound confirmed in Q2, the Fed will press on with scaling back liquidity injections

The Fed considers recent indicators have been pointing to a rebound in the economy, suggesting it is now embarked on a trajectory of moderate growth. However, the Fed has, commented that it is still too early to judge for certain whether this upswing will enable the economy to grow faster than its trend-rate. At the most recent Federal Open Market Committee meeting, FOMC members looked into potential options for putting monetary policy onto a normal footing, assessing permutations of the various tools available for use. This debate is set to continue in forthcoming FOMC meetings, implying the first hike in the Fed funds rate is still some way off in the future. Nevertheless, if it is confirmed the US economy has indeed bounced back strongly this spring and if inflation picks up more pace, yields on 10-year US T-bonds might well edge back up in the summer.

As inflation in Europe is so low, the ECB does appear determined to act

Sluggish monetary and lending growth, coupled with considerable slack in terms of capacity in the economy, still pose a serious risk to the eurozone recovery. The ECB is biding its time, waiting to be in full possession of growth forecasts from its economists. Once it has those, it may well make a move to stave off the threat from deflation. Several Governing Council members have confirmed the ECB might well push through a cocktail of traditional and non-conventional measures as early as its June meeting. It might contemplate halting sterilisation of its Securities Markets Programme (SMP), lower one of its benchmark interest rates (the deposit rate could become negative), or even make an announcement about buying private-sector assets. How effective such measures will be may, however, turn out to be fairly limited. Given this prospect, the yield on 10-year German Bunds, which has already slipped close to all-time lows, looks likely to remain tightly range-bound as long as eurozone inflation stays low and US Treasury yields do not climb back up steeply.

Bank of Japan will want to assess what impact the consumer sales tax hike has before implementing new measures

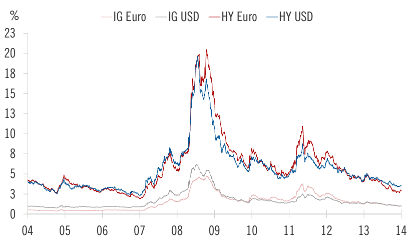
The BoJ is confident knock-on effects from the sales tax increase are likely to diminish from summer on. It remains quite ready to make any adjustments if it becomes likely its inflation target is not going to be hit. Japanese government bonds will continue to be underpinned by the BoJ's activist approach.

European corporates should retain reasonably good form

Near-term, the investment-grade corporate bond segment will be waiting for news on what the ECB intends to do. In any event, the market is likely to remain fairly range-bound. Although rapid deployment of non-conventional policies would be likely to be good for credit spreads, the expected low level of yields would dampen investors' interest. If the ECB were to postpone action till later, we would expect corporates to underperform slightly.

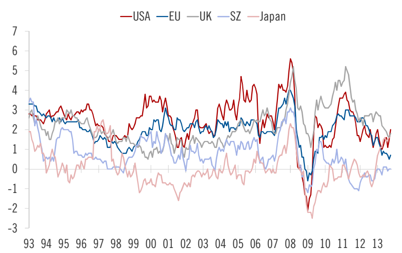
High-yield corporates look set to continue being buoyed by advantageous fundamentals, with company balance sheets still in pretty healthy shape.

CREDIT SPREADS



Source: Bloomberg, Barclays, yield spreads

INFLATION



Source: Bloomberg, CPI

ECB on the verge of pushing through some non-standard measures

Eurozone inflation: Mario Draghi sounding the alarm-bell

The ECB decided to keep its benchmark rates unchanged at its 8 May meeting. Although the eurozone economy does seem to be fulfilling expectations and steadily turning upwards, the ECB's analysis of the monetary state of affairs does seem to be pointing towards a spell of low inflation. Moreover, sluggish monetary and lending growth, coupled with considerable slack in terms of capacity in the economy, still pose a serious risk to the eurozone recovery. As a corollary, the ECB has stuck with its accommodating stance, commenting that it was expecting to leave interest rates unchanged or maybe even lower them in future. ECB President Mario Draghi did, however, spring one surprise on investors and the markets when he categorically stated that the Governing Council was not prepared to tolerate for long a low rate of inflation, even if it was pitched above zero.

Apparently, ECB policymakers are keen to ascertain whether other factors, apart from the decline in energy prices, might be responsible for the sluggish rate of inflation in the eurozone. If this supposition were to be corroborated in early June when the latest set of inflation projections are produced by the ECB's economic forecasting unit, the Governing Council would have more ammunition to warrant pushing through at its 5 June meeting fresh measures to make monetary policy even more accommodating, which could include some unconventional policy measures. The publication of economic forecasts for Q2 2014, completed in May by economists charged to do so by the ECB, would seem to have confirmed this likelihood as their projections clearly point towards a softening of inflationary expectations for the eurozone over the next three years.

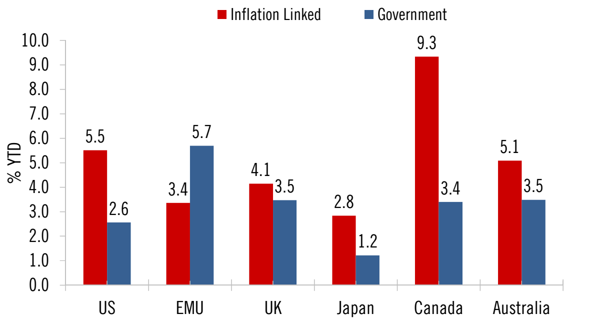
UK: persistent slack in capacity in the British economy allowing the Bank of England to delay its first hike in the base lending rate

In its most recent quarterly report on inflation, the Bank of England (BoE) noted the UK economy was picking up strongly. Growth is estimated to have worked out at around 3.1% y-o-y in Q1 2014 thanks, particularly, to diminishing uncertainty over the economic outlook and improved lending conditions. The BoE was also at pains to point that, for the recovery to turn self-sustaining, the UK economy would need to see increased productivity in British businesses and a rise in real pay. Although the unemployment rate has been coming down, the BoE still believes it is well above its long-term level, primarily on account of slackness in production capacity, estimated at between 1% and 1.5% of GDP, concentrated chiefly in the jobs market.

After the decline in inflation during the first quarter of the year, the BoE is expecting inflation to quicken again in Q2 2014 towards the target rate of 2% on account of a diminishing base effect on oil prices and a slowdown in the rise of sterling's value. All in all, the BoE does not appear to be on the brink of embarking on a new cycle of rate hikes in the near future. Moreover, it had mentioned in its previous report that its intention was to move ahead very gradually with raising its base lending rate and, once the rate hike cycle was over, that benchmark interest rate would be likely to be pitched well below its average long-term level.

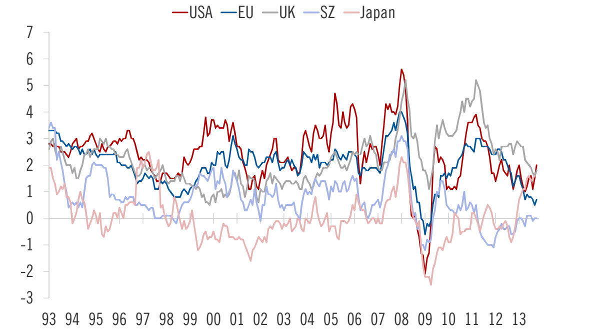
INFLATION-LINKED BONDS

PERFORMANCES 2014 (LOCAL CURRENCIES)



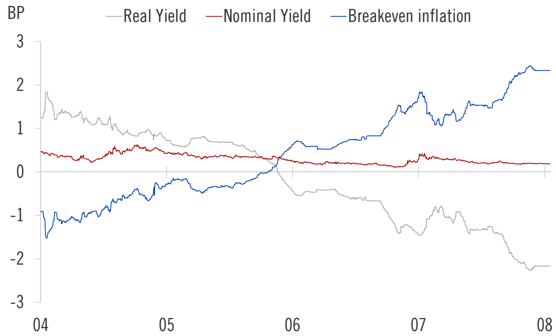
Source: Bloomberg, Citigroup, Barclays, Citigroup

INFLATION



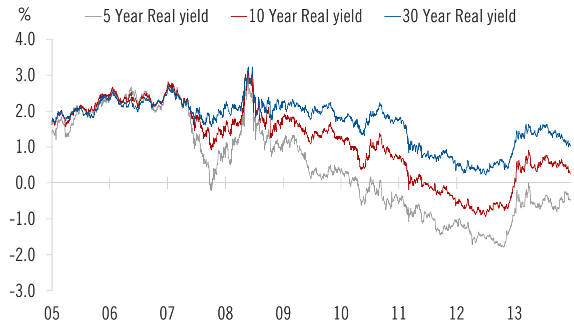
Source: Bloomberg, CPI

JAPAN - TREASURY YIELD COMPONENT



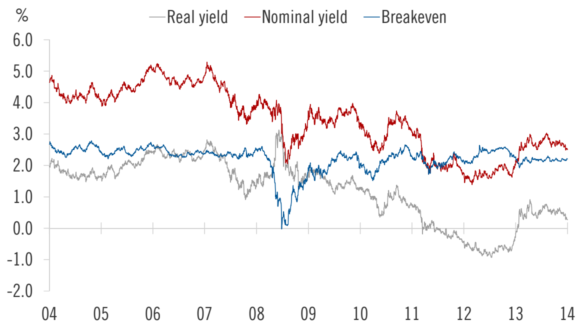
Source: Bloomberg, Japan

USA - REAL RATES



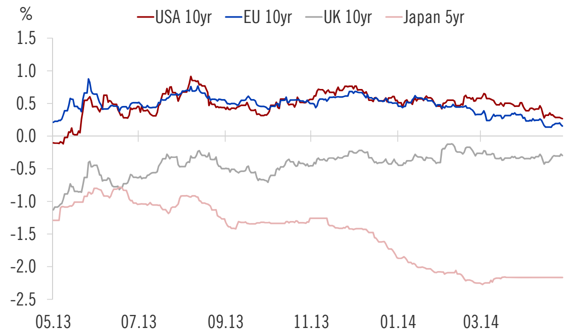
Source: Bloomberg, US Treasury

USA - 10-YEAR TREASURY YIELD COMPONENT



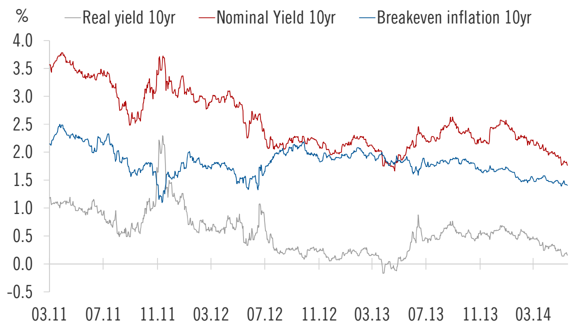
Source: Bloomberg, US Treasury 10 year

10-YEAR REAL YIELDS



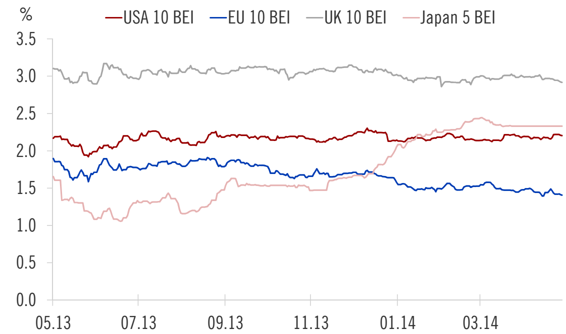
Source: Bloomberg, Real Yields

FRANCE - 10-YEAR YIELD COMPONENT



Source: Bloomberg, 10-yr French OAT

10-YEAR BREAKEVEN INFLATION POINTS



Source: Bloomberg, Break-even Inflation Rates

Profit-taking

Peripheral assets underperformed

In early May, investment-grade corporate bonds continued to behave much as they had in April as the market remained dominated by the quest to find yield. Credit spreads unsurprisingly continued to narrow, with, in time-honoured fashion, subordinated financials debt, hybrid paper and bonds issued by Spanish and Italian borrowers outperforming the rest. Later in the month, the market underwent a corrective spell, wiping out some of the gains made in the opening fortnight. Credit spreads initially stretched wider again in response to the torrent of bonds being launched on the primary market, with reduced issuance premiums that have probably reached their limit in the short term. The second phase of spread widening was prompted by the abrupt jump up in yields of peripheral eurozone government bonds, triggered, it would seem, by some disappointing economic numbers and mounting aversion to risk among investors ahead of the European elections. One explanation for the underperformance by corporate bonds is most likely to have been a flurry of profit-taking at a time when doubts were growing about the chances of any major intervention by the ECB and about the potential impact this could have for credit-risk instruments.

Mixed bag of returns

In the end, investment-grade corporates still managed to deliver a positive return for May, primarily courtesy of the driftdown in government bond yields. The extra return achieved on corporate bonds was, however, pretty small, with performances varying considerably from one sector to another. Financials delivered a rather mixed showing, with subordinated banking debt just in the black, but insurers' subordinated paper quite deep in the red. To a lesser extent, hybrid debt issued by utilities and energy companies also produced negative returns. As for issuers from the eurozone's periphery, non-financials underperformed, but banks proved a little more resilient. Looking at individual securities, bonds from Direct TV outperformed on the back of the bid from AT&T. Moving elsewhere, bonds issued by Russian borrowers, especially from the energy sector, posted gains.

Primary market

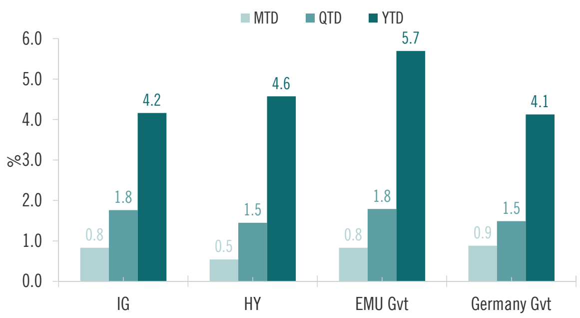
The primary market was lively, registering record volumes in the opening fortnight of May although activity subsided later in the month as investors' appetite faded somewhat. Banks were very much to the fore, with senior debt being issued having maturities ranging from 5 to 10 years. The key issuers were the big banks like BNP Paribas or Rabobank, but smaller banks and especially those from the periphery were active too, the likes of Banco Espírito Santo, La Caixa and Veneto Banca. US companies, such as Illinois Works, Kellogg's, PepsiCo, Philip Morris and banks like Citigroup and JP Morgan, rediscovered the appeal of issuing bonds in euros, going for medium-to-long-dated maturities. In the subordinated debt segment, several new Additional Tier 1 (AT1) issues were forthcoming from Santander, Nykredit and Deutsche Bank whereas the Scandinavian banks SEB and Danske stuck with the more conventional Lower Tier 2 format. The insurers Axa, Generali and Groupama also launched new subordinated paper. As for hybrid debt, GDF Suez was the sole issuer, offering two tranches of 5 and 10 years.

Outlook

In the near term, the investment-grade corporate bond segment will be waiting for news on what the ECB intends to do. In any event, the market is likely to remain fairly range-bound. Although rapid deployment of non-conventional policies, such as quantitative-easing programmes, would be likely to be good for credit spreads, the low level of expected returns would dampen investors' interest. If the ECB were to postpone action till later, we would expect corporates to underperform slightly.

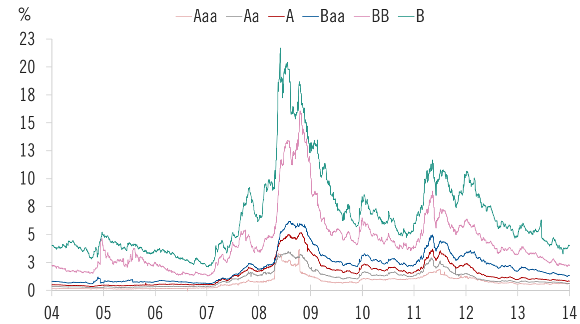
CREDIT RISK

RETURNS ON BONDS IN EURO



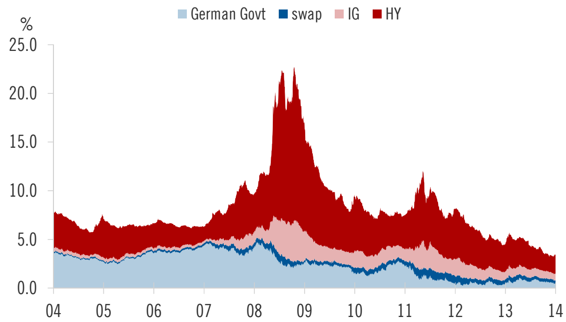
Source: Bloomberg, Barclays, Citigroup, Bonds in euro

CREDIT SPREADS (EURO)



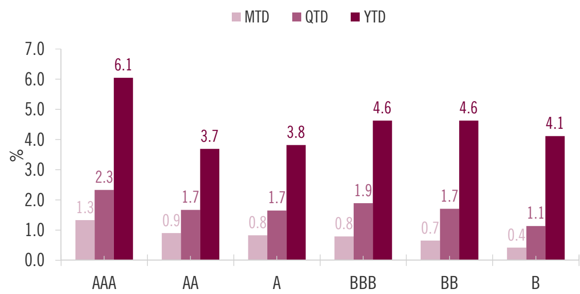
Source: Bloomberg, Barclays, EUR yield spreads

YIELD COMPONENT (EURO)



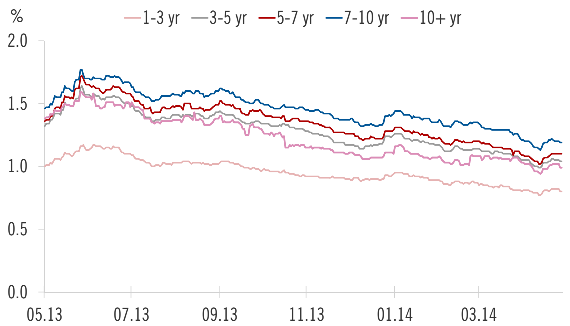
Source: Bloomberg, Barclays, Eur yields

RETURNS ON BONDS IN EURO



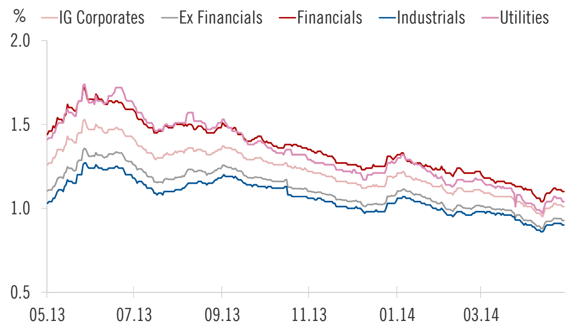
Source: Bloomberg, Barclays, Corporate Bonds in euro

INVESTMENT GRADE SPREADS BY MATURITY (EURO)



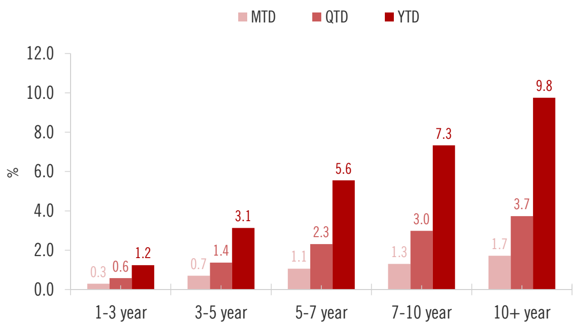
Source: Bloomberg, Barclays, EUR yield spreads

INVESTMENT GRADE SPREADS BY SECTOR (EURO)



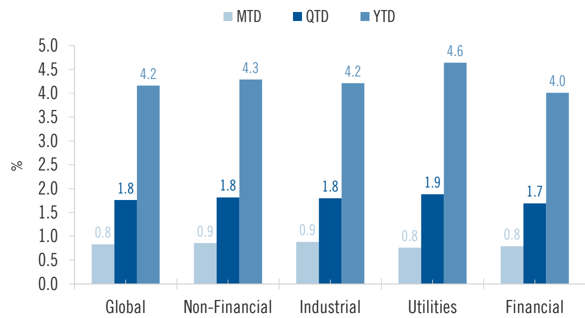
Source: Bloomberg, Barclays, EUR yield spreads

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

Fundamentals remain favourable for high-yield corporates

Favourable environment for credit

May was a positive month for European high-yield corporates as they extended their positive run since the outset of the year. Their ongoing strength got a boost from the ECB which, at its monthly meeting, gave the strongest indication yet that further support from monetary policy is to be expected in the coming months either via rate cuts or additional tools. Consequently, all rating categories advanced. CCCs led the charge as momentum continues to be positive overall, with BBs performing well, mainly helped by a good performance by government bonds. Lastly, Bs did well, too, but suffered somewhat during the second half of May as investors generally became more cautious about riskier asset classes. Part of the reason for the weaker second half was European GDP figures. Sovereign spreads in peripheral countries widened before calming down at the end of the month. This also proved true in the financial sector where some bank debt followed the sovereign lead. Beyond this, geopolitical news, such as Ukraine/Russia, simmered along, keeping investors on their toes, as did elections in India and for the European Parliament.

Corporate fundamentals and news

Companies continued the reporting season throughout the month. Numbers have been generally been fine, with few surprises. There have been signs of moderate cyclical improvements in developed markets, while some companies with exposure to the commodity cycle saw some moderating impact from exposure to emerging economies. In telecoms, competitive pressure remains stiff after the end of MTR cuts, but companies are managing this actively, often by launching new, successful product offerings. In gaming, results generally looked slightly better, possibly reflecting brighter consumer confidence. Industrials and business-related services also did well overall, showing little growth, but good margins. Earnings released were broadly in line, following existing trends without significant surprises. M&A stories and capital market activity continue to be important themes. Several companies have been aiming for an IPO over the next few months as valuations are appealing, and demand for attractive equity stories remains brisk. This month, Com Hem, a Swedish cable operator, has started to prepare a listing, helped by ongoing M&A activity in this sector. Eircom, an Irish telephone company, is also looking at an equity offering or sale over the coming months – all of these should have a positive impact for the credit quality of the companies concerned.

Primary market

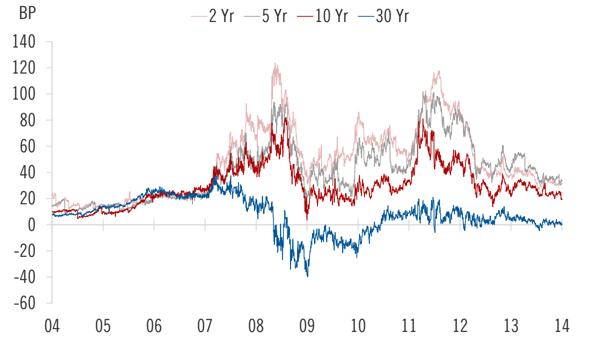
New issues have continued with a series of deals. Among these, Matalan, the UK retailer, refinanced its existing bonds, Motor Oil, a Greek refinery, came with a bank-to-bond issue, and Constellium, a French industrial company placed its initial bond offering, just like Heat-Exchange, a German-based industrial producer. Overall, the issues did well, even if some of the recent technical pressure, which had pushed issues up in previous months, has abated.

Outlook

The overall climate has changed very little in the last few months: economic activity has slightly improved, but continues to be only moderate rather than buoyant. There is only little sign of inflation and rates are set to remain low for some time. This is a positive backdrop for credit in general and for high-yield corporates specifically. Moderate tailwinds and relative stability are positive factors for companies. The reporting season has been fine, and overall key figures such as leverage and interest-rate coverage have moderately improved. Ratings momentum continues to be positive as the balance between upgrades and downgrades has extended its favourable trend. We expect refinancing activity to remain steady and allow companies to bring their funding costs down further. Lastly, companies continue to show positive cash flow on an aggregated basis. Overall, defaults should remain low. Risks persist in the form of geopolitical tension, mainly from emerging countries, but also some uncertainty surrounding the situation in Europe where ongoing fiscal consolidation is needed, even if the sovereign crisis is less prominent for now.

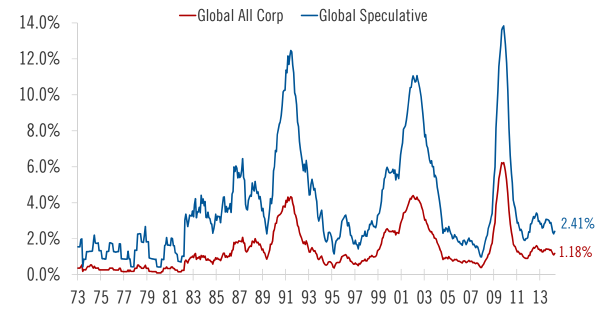
CREDIT RISK

EURO SWAP SPREADS



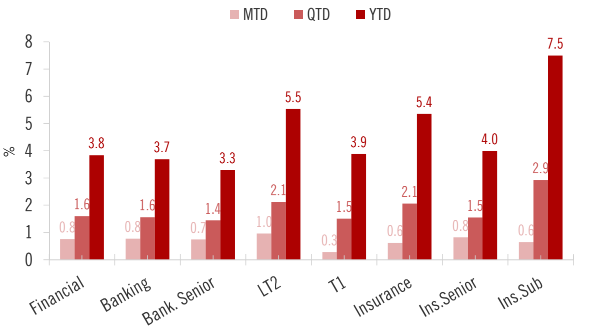
Source: Bloomberg, Swap spread EUR

MOODY'S - DEFAULT RATES



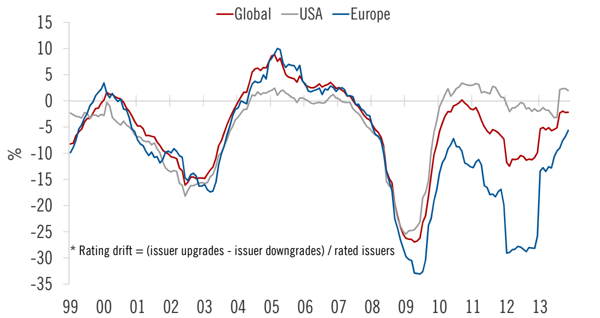
Source: Moody's

FINANCIAL INVESTMENT-GRADE RETURNS (EURO)



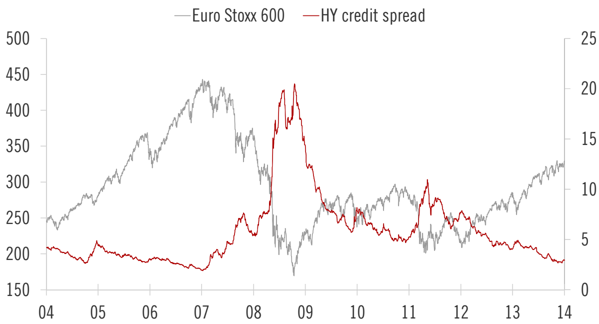
Source: Bloomberg, BoA Merill Lynch

MOODY'S - RATING DRIFT



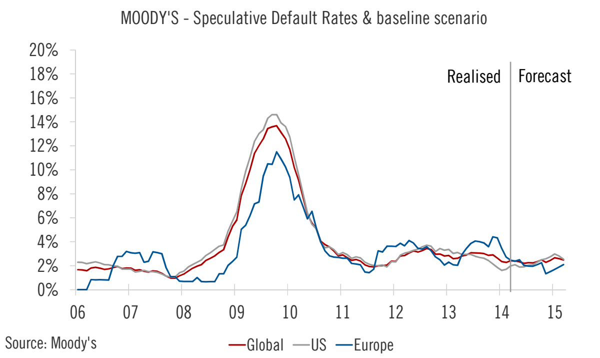
Source: Moody's

STOCK MARKET AND HY SPREAD



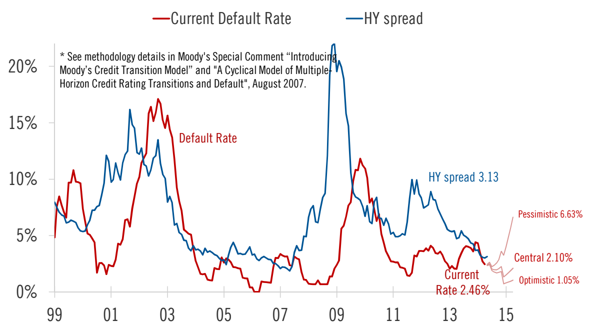
Source: Bloomberg, Barclays

MOODY'S – TAUX DE DÉFAUT



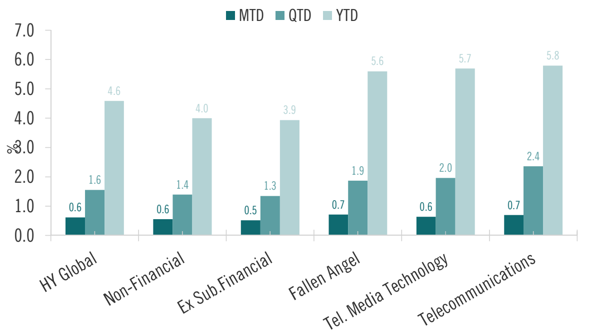
Source: Moody's

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

A technical recovery, but fundamentals need to improve more

Local-currency debt – Recent developments

May saw the market-leading benchmark return 2.0% in USD terms, with half from yield and currencies and capital appreciation in bonds contributing equally to the other half. Lower US Treasuries and the potential for QE in the eurozone all contributed to a more supportive macroeconomic backdrop. In addition, several key elections in emerging countries have now passed, with a positive win for the market-friendly BJP in India. However, export and growth numbers saw little improvement over the month. Russian local bonds returned over 6%, with the rouble up 3.5%, as the situation has stabilised with the government announcing a pullback of troops from the Ukrainian border. The Philippines performed well, up over 5%, with a nearly 2% return in the peso as rates were kept on hold by the central bank, annual growth is forecast to be 6.5% this year and S&P upgraded its rating one notch to BBB. Despite Romania being upgraded to investment-grade status at BBB- by S&P, making it eligible for JP Morgan's investment-grade benchmark, the market was slightly negative, with the central bank ending an easing cycle, holding rates at 3.5% as inflation quickens. Despite a military coup in Thailand, local bonds were largely flat.

Local-currency debt – Outlook

Yields look attractive and fundamentals will start to rebalance, leading to increased potential for a strong recovery. However, valuations may need to reach better levels before we see a more meaningful trend of inflows. With expected stronger developed-market growth, emerging markets should move stronger as well, though not in a straight line as growth remains uneven, while Fed tapering could continue to have an impact although this has been broadly priced in now. More vulnerable markets like Turkey and South Africa may see sustained pressure during the period of transition to more normal global monetary conditions, but this could also prove an interesting entry-point. Countries such as Mexico and the Philippines with better growth, political stability and positive structural reforms continue to look attractive.

External debt – Recent developments

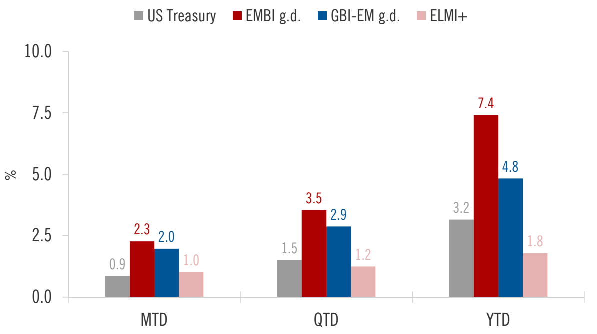
Emerging-market external debt saw spreads tighten by more than 10bp to 280bp, posting a total return of 2.3% for May. Once again, high-grade countries were the outperformers overall, with Russia notching up a return of nearly 5% as there looked to be some de-escalation of events with Ukraine which itself returned over 8% as the IMF approved a USD17bn bailout package. Elsewhere in high-grade countries, returns were largely driven by the technical factor of lower US Treasury yields, with emerging-market sovereign bonds playing catch-up. China, Mexico and Poland all returned around 1.5% despite little change in fundamentals. Panama held elections where policy continuity is expected under the centre-right regime of winner Juan Carlos Varela: the bonds posted a return of 2.4%. Higher-yielding markets saw some retracement, such as Argentina down 1% given the bond supply overhang related to Repsol's compensation and rising inflation eroding recent gains in competitiveness as a result of recent currency weakness. Venezuelan bonds were also down about 1% where President Madura has seen his popularity rating slide to 37%.

External debt – Outlook

We believe the global economy is recovering, but remains fragile, as evidenced by the IMF's recent downgrade to growth for 2014 owing to a number of ongoing risks. The potential for range-bound US Treasury yields in the short term would be supportive and add to the argument that there is value given the spread level relative to other high-grade-spread asset classes. However, it remains subject to investor sentiment, and we have not yet seen a meaningful enough comeback of investor inflows. If US Treasury yields start moving higher again, we could expect to see pressure return to the asset class. Investors are being more discriminating as credit ratings have probably passed their peak for now, and we are seeing the risk in some higher-beta countries, like Ukraine, increase more rapidly. However, at some point, attractive valuations will be hard for investors to ignore.

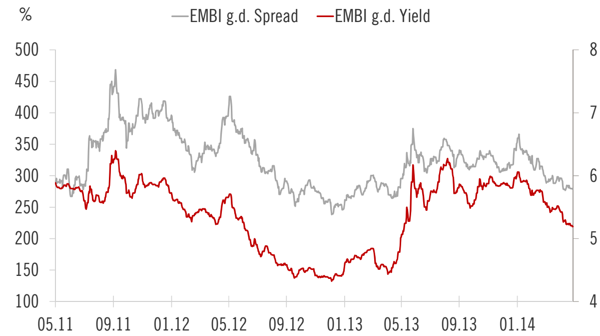
EMERGING DEBT

PERFORMANCES (USD)



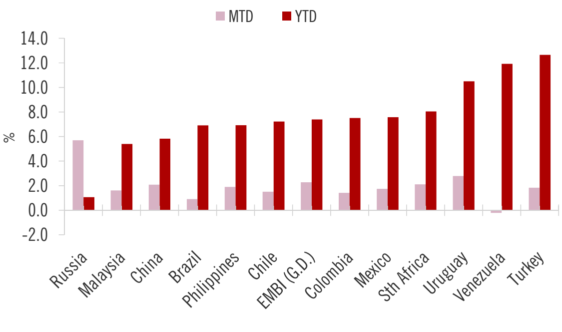
Source: Bloomberg, Index JP Morgan

US DOLLAR DEBT - YIELD & SPREAD



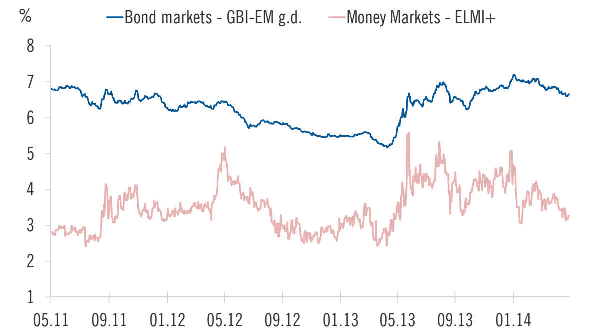
Source: Bloomberg, JP Morgan Indices

JP MORGAN EMBI GLOBAL DIVERSIFIED



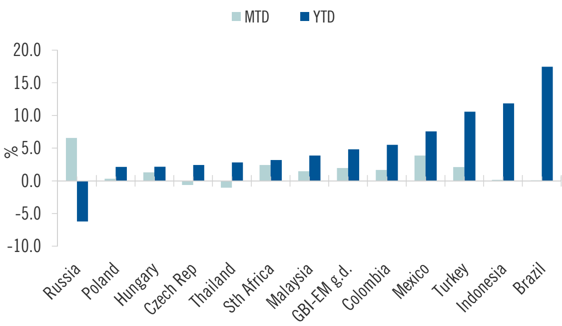
Source Bloomberg: Index JP Morgan

LOCAL CURRENCY DEBT - YIELD



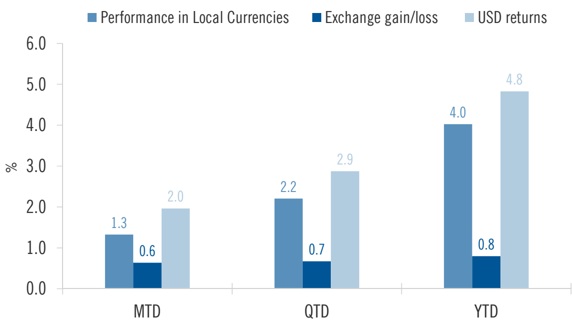
Source: Bloomberg, JP Morgan Indices

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



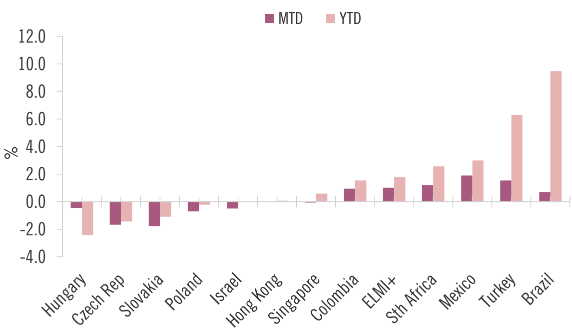
Source Bloomberg: Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



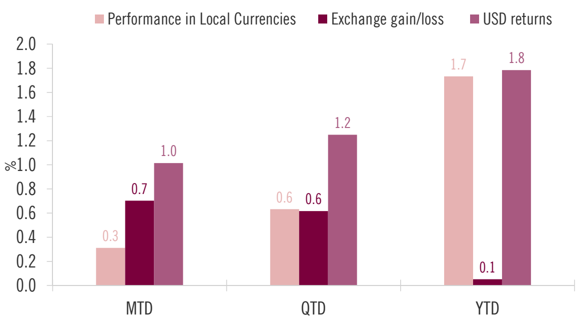
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg: Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

The Fed to continue scaling back its liquidity injections

Recent economic data have confirmed the rebound in Q2 2014

After GDP growth for Q1 2014 in the US was initially published as being practically zero, statistics have been released confirming the rebound during the spring months. The ISM PMIs extended their uptrend in April, with the Manufacturing PMI picking up from 53.7 to 53.9 and the Services PMI up from 53.1 to 55.2. Payroll numbers delivered some pleasant surprises: some 288k new jobs were created in April, with figures for the previous month being revised up as well. The unemployment rate has continued to recede, declining from 6.7% to 6.3%. The leading economic indicator advanced again in April, by 0.4%. Figures for the housing market were also more encouraging, providing some welcome reassurance about the state of the property sector. In April, housing starts rose by 13.2%, building permits were up by 8.0%, sales of existing houses edged up by 1.3% whilst sales of new homes climbed by 6.4%. The NAHB/Wells Fargo Housing Market Index, regarded as a bellwether for the housing sector, has been comparatively steady over the last few months. On the grounds of the latest data, economists are looking for GDP growth in the region of 3% for Q2 2014.

Inflation has been quickening again, with the y-o-y rate moving within touching distance of the Fed's target

Consumer prices rose by 0.3% m-o-m in April, pushing the y-o-y rate of headline inflation up from 1.5% to 2.0%, with core inflation inching up from 1.7% to 1.8%, moving ever nearer to the Fed's official 2% target. This acceleration in inflation was due, to a large extent, to rising food and petrol prices.

The Fed set to continue scaling back its pumping-in of liquidity and starting to look at strategies to engineer a normalisation of rates

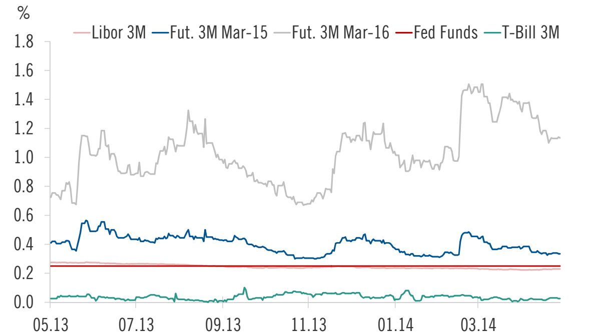
Confirmation the US economy has been staging a recovery in Q2 2014, allied with the rebound in inflation as the y-o-y headline rate has jumped from 1.1% to 2% in the last couple of months, encouraged the Fed to take yet another step to rein in its injections of liquidity at the end-April FOMC meeting.

The minutes for that meeting reveal that the Fed considers recent indicators have been pointing to a rebound in the economy, suggesting it is now embarked on a trajectory of moderate growth. The Fed has, however, commented that it is still too early to judge for certain whether this upswing will enable the economy to grow faster than its trend-rate. At the meeting, FOMC members also looked into potential options for pushing monetary policy onto a normal footing, assessing permutations of the various tools available for use. This debate is set to continue in forthcoming FOMC meetings, implying that the first hike in the Fed funds rate is still some way off in the future, something which the Fed itself affirmed. The Fed's monetary policymakers have thus been assessing how long the Fed should retain on its books the Treasury notes and mortgage-backed securities that it has been purchasing. The FOMC is worried about possible fallout for the US economy from the mounting geopolitical tension between Ukraine and Russia, not to mention the slowing Chinese economy.

Despite the more heartening economic numbers and the quickening rate of inflation, the yield on 10-year US Treasury bonds managed to drift even lower towards 2.5%. Nevertheless, if the US economy's spring recovery is indeed confirmed, yields on 10-year US T-bonds will, in all probability, edge back upwards over the summer.

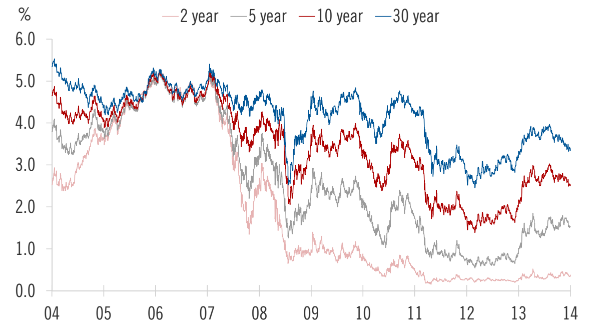
USA

SHORT-TERM RATES (USD)



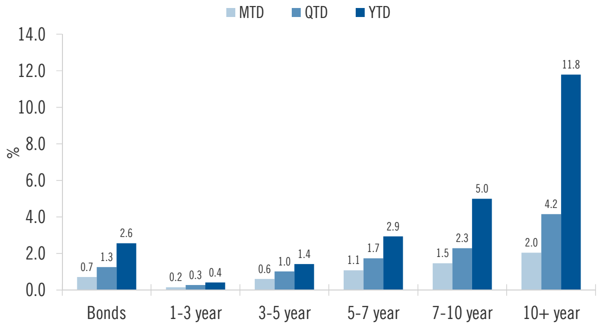
Source: Bloomberg, Money Market, USA

US TREASURY BOND YIELDS



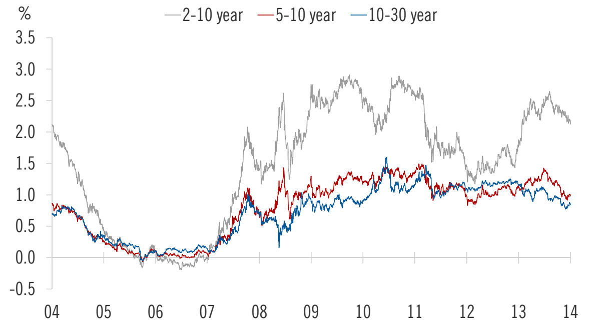
Source: Bloomberg, Us Treasury

RETURNS FROM GOVERNMENT BONDS BY MATURITY



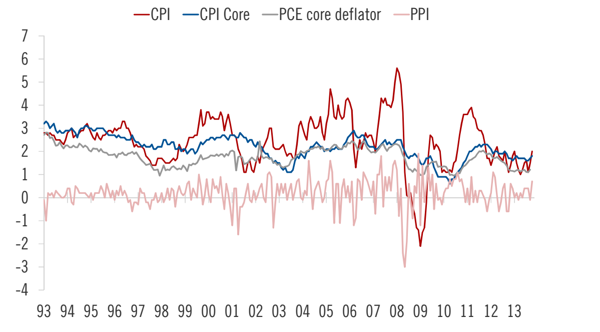
Source: Bloomberg, Citigroup, US Treasury

MOVEMENTS IN YIELD SPREADS



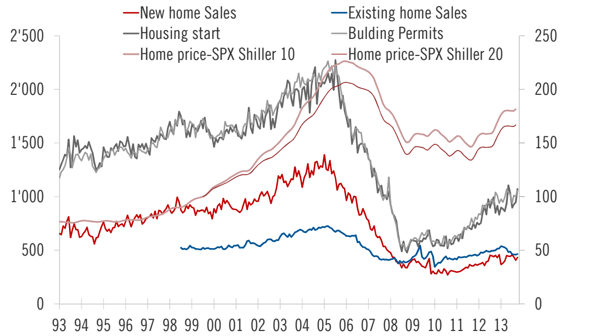
Source: Bloomberg, US Treasury

INFLATION



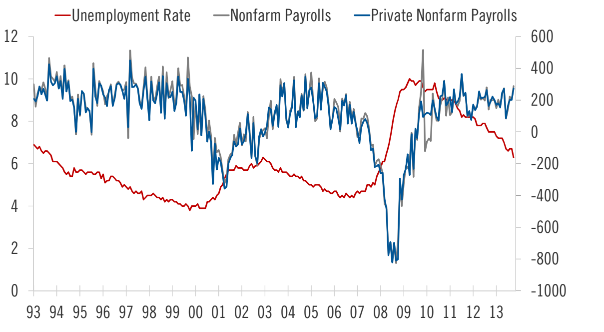
Source: Bloomberg, USA

HOUSING



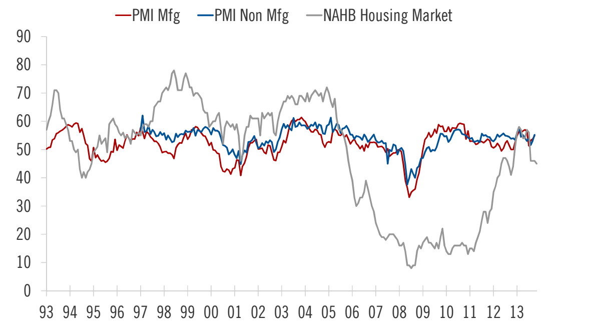
Source: Bloomberg, USA

LABOR MARKET



Source: Bloomberg, USA

PMI AND NAHB



Source: Bloomberg, USA

Mounting likelihood that the ECB will take action

Pedestrian recovery in Europe still vulnerable-looking

GDP only expanded by 0.2% in Q1 2014, falling short of expectations which had been looking for 0.4% growth. This sluggishness tempered the optimistic view the eurozone had at long last shrugged off its troubles, delivering a reminder that the recovery remains both brittle and fragmented. A number of factors would appear to explain this mini-setback, and the economy is expected to bounce back from this in Q2. Nevertheless, consumer spending, most strikingly in France (-0.5%) which has already published detailed national accounts for Q1 2014, and exports from some countries are fuelling much of the uncertainty about the eurozone recovery. The Composite PMI for the eurozone advanced from 53.1 to 54.0 in April, signifying that it has been running above the key 50 threshold, indicating growth ahead, for ten months now. According to Markit, the PMI score points towards estimated GDP growth in the region of 0.5% for Q2 2014. However, the slowdown in global trade, the Ukraine crisis and Russia's slowing economy might well have knock-on effects throughout Europe, with some countries already feeling the pinch.

Fears that disinflation might degenerate into deflation have not been dispelled

Consumer prices rose by 0.2% m-o-m in April, pushing the headline y-o-y rate of inflation up from 0.5% to 0.7%, but core inflation was flat at 1.0%. These inflation numbers proved disappointing as the markets had been expecting a headline rate of 0.8%. Moreover, the quickening in April appears to be due to a seasonal influence as the Easter bank holiday weekend fell in April this year. The European Commission is still convinced the risk of deflation is low: it is projecting inflation of 0.8% for 2014 and 1.2% for 2015.

ECB opting for the status quo and still contemplating some form of QE

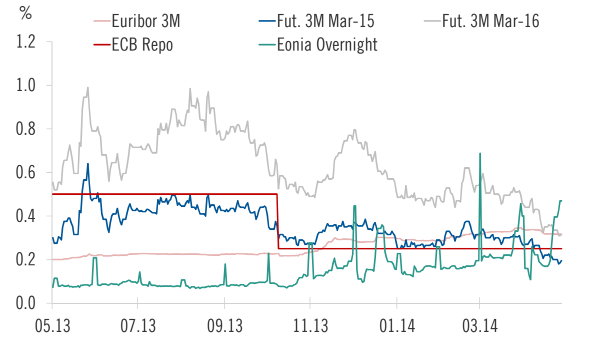
At its latest meeting, as expected, the ECB left official interest rates unchanged. However, during the press conference, Mario Draghi did point out that the strength of the euro, flirting with a rate of USD1.40, was regarded as a major cause for concern. He indicated there had been serious discussions about the euro's exchange rate which is a vital factor influencing price stability and growth. He also stated the ECB was ready to take action from as early as next month to provide support to the eurozone economy and curb the risk posed by inflation staying too low, but the ECB was keen to have the most recent sets of economic forecasts available before taking any new steps. Since that meeting, other Governing Council members have confirmed the ECB might well push through a cocktail of traditional and non-conventional measures as early as that June meeting. The ECB might contemplate halting sterilisation of its Securities Markets Programme (SMP), lower one of its benchmark interest rates (the deposit rate could become negative), or even make an announcement about buying private-sector assets. How effective such measures will be may, however, turn out to be fairly limited.

Yields on 10-year Bunds drifting back towards their all-time lows

Against this backdrop of economic uncertainty, subdued inflation and mounting likelihood of fresh steps being taken by the ECB, European bond yields receded further After their spell of euphoria, peripheral eurozone markets were flat in late May as they were hit by a flurry of profit-taking in response to the disappointing eurozone GDP numbers as well as rumours foreign holders of Greek bonds might be liable for capital gains tax. Yields on 10-year German Bunds look likely to remain low as long as eurozone inflation remains subdued and US Treasury yields do not climb back up steeply.

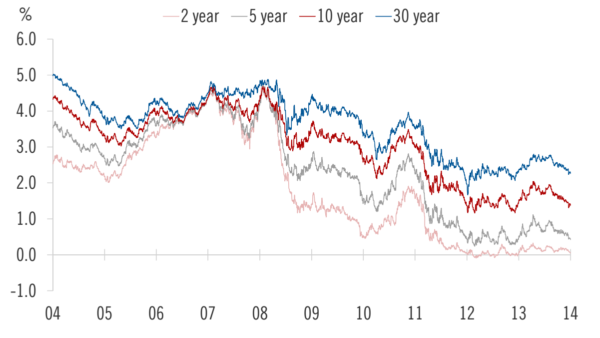
EUROZONE

SHORT-TERM RATES (EURO)



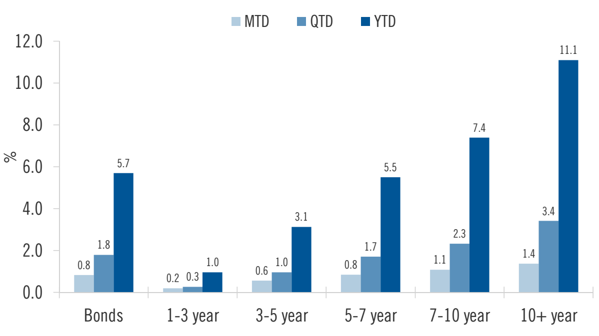
Source: Bloomberg, Money, EU

BUND YIELDS



Source: Bloomberg, Bund

RETURNS BY MATURITY (EMU GVT)

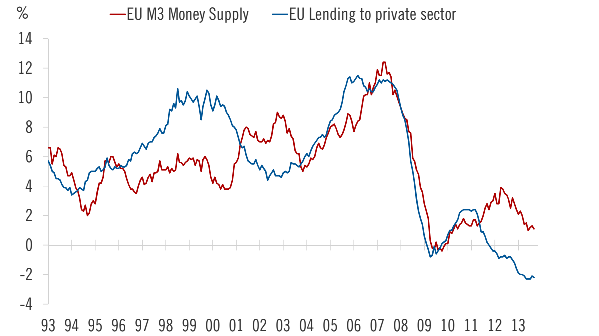


Source: Bloomberg, Citigroup, EMU Gvt Bonds

10-YR GVT SPREADS VS GERMANY

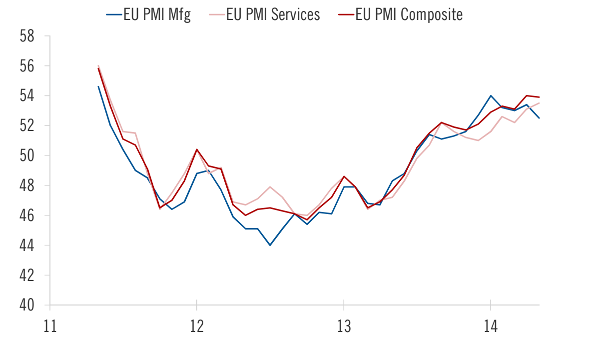
Source: Bloomberg, Bund

EUROZONE - M3 AND LENDING TO PRIVATE SECTOR



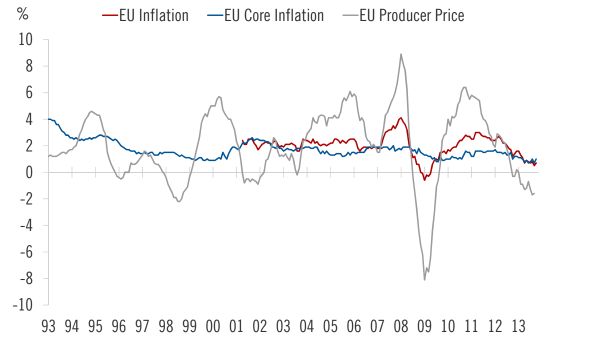
Source: Bloomberg, Eurozone

EUROZONE - PUCHASING MANAGER INDICES



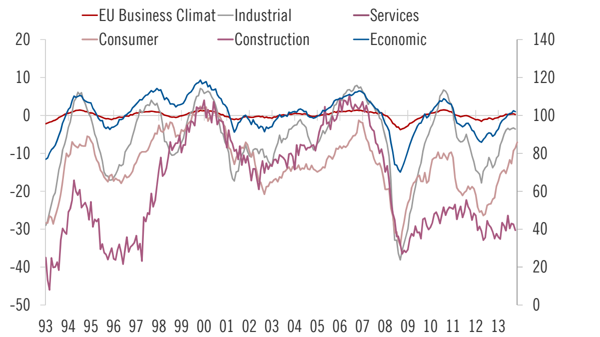
Source: Bloomberg, Eurozone PMI index

EUROZONE - INFLATION



Source: Bloomberg, Eurozone

EUROZONE - ECONOMIC SURVEYS



Source: Bloomberg, Eurozone Economic Survey

Growth becoming a little more balanced and inflation moving up

The UK's GDP expanded by 0.8% q-o-q in Q1 2014, with inflation quickening to 1.8% y-o-y

Growth in Britain's economy was a little stronger in the opening quarter and has become rather more balanced. According to the Office for National Statistics, growth was driven by services (+0.9%), industrial production (+0.8%) and, to a lesser degree, construction output (+0.3%), which had been hit by the terrible weather earlier this year, as was farming where production shrank by 0.7%. The y-o-y rate of growth in the UK economy worked out at 3.1% for Q1. After expansion of 1.7% in 2013, the UK's GDP is forecast to grow by 2.7% this year according to the noticeably upgraded projections made when the Chancellor presented the budget to parliament in March. Increased manufacturing output and higher exports have been viewed as encouraging signs of the improving health of the UK economy which is looking a little less reliant on consumer spending fuelled by a spike in house prices and falling unemployment. Retail sales leaped by 1.8% in April. The jobless rate, which, once again, fell in March from 6.9% to 6.8%, should continue sliding in the months ahead. These positive developments are good news for the government with a general election on the horizon in 2015 as it remains determined to persevere with its austerity budget programme geared towards lowering the public-sector deficit which is still pitched at around 6%.

Inflation quickened rather more than expected in April (+0.4% m-o-m), pushing the y-o-y rate up from 1.6% to 1.8%, whilst the core rate rose from 1.6% to 2%. The surge can be blamed on rising housing costs, but the moveable Easter holiday weekend, which fell in April this year as opposed to March in 2013, served to push up transport costs.

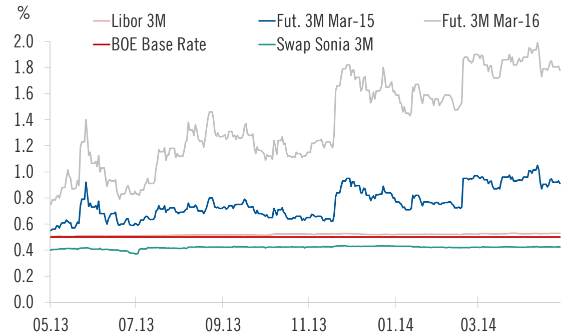
The Bank of England opting for no change, but key policymakers appear less unanimous in their assessments

In early May, the BoE's Monetary Policy Committee (MPC) once again opted to stick with the status quo in spite of signs of the economy gaining momentum and worries about the housing market overheating. In delivering the quarterly report on inflation, BoE Governor Mark Carney acknowledged the economy was indeed getting stronger, but he did not particularly criticise the recovering housing market or signal any likelihood of measures being implemented to take heat out of the sector. In fact, he did indicate there was still considerable slack in the economy which was curtailing the inflationary risks. The BoE raised its economic forecasts for 2015 and is now looking for GDP growth of 2.9%, compared to its previous 2.7% prediction, but made no change to estimates for 2014 or 2016. The BoE expects inflation to stay close to its 2% target rate in the next two years. Mark Carney indicated interest rates would probably stay where they were until the second half of 2015, then there would most likely be a limited and progressive increase.

Minutes of the MPC meeting, released since, have revealed some MPC members have been beginning to err increasingly towards hiking interest rates even though the vote to leave the base lending rate was unanimous. As inflation is still pitched below-target, the BoE, whose MPC members do not hold the same views about the extent of the slackness in the economy, will probably wait for a few more months before tightening monetary screws again. However, any spike in property prices might prompt the BoE to step in earlier than it has suggested so far if the health of the UK economy is further confirmed. In this climate, gilts yields can be expected to move a little higher over the coming months.

UK

SHORT-TERM RATES (GBP)

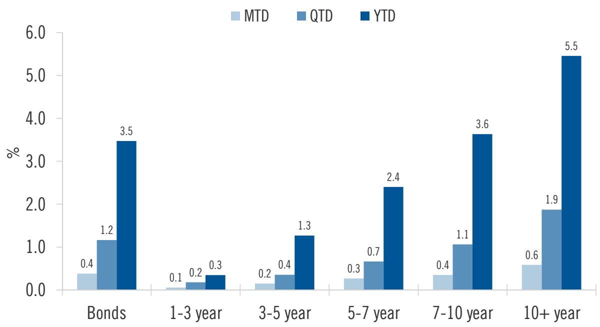


Source: Bloomberg, Money Market, UK

UK TREASURY YIELDS

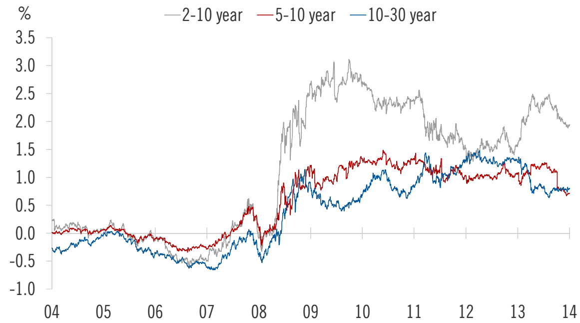
Source: Bloomberg, GILT

RETURNS FROM GOVERNMENT BONDS BY MATURITY



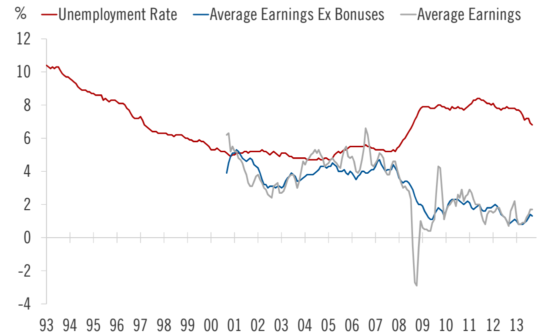
Source: Bloomberg, Citigroup, UK Treasury

MOVEMENTS IN YIELD SPREADS



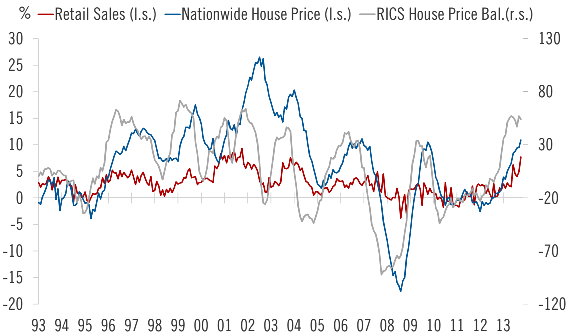
Source: Bloomberg, GILT

LABOR MARKET



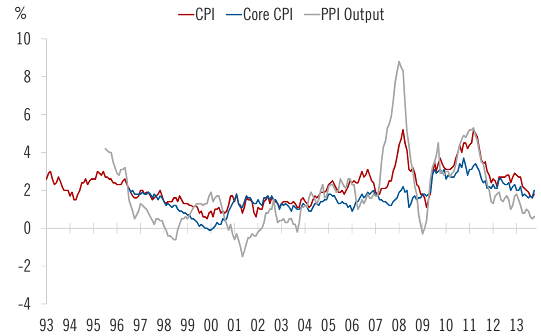
Source: Bloomberg, UK

HOUSING AND RETAIL SALES



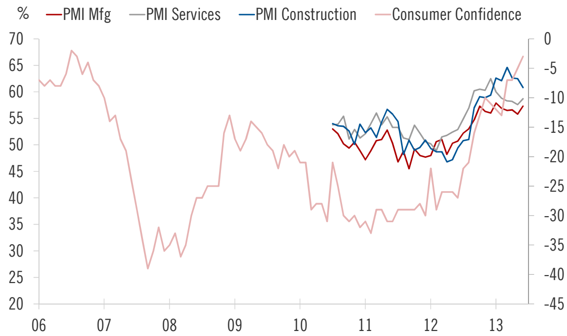
Source: Bloomberg, UK

INFLATION



Source: Bloomberg, UK

ECONOMIC SURVEYS



Source: Bloomberg, UK

Room for the SNB to manoeuvre somewhat cramped

Growth regained some momentum at the outset of 2014 and survey findings are still making encouraging reading

Switzerland recorded GDP growth of 0.5% q-o-q in Q1 2014, a distinct improvement on the previous quarter. The KOF economic barometer fell for the second month in a row in April, but its score of 102.04 remains high. According to KOF, industry's expectations as regards exports are a little less upbeat, and, although Switzerland's economy is still on an encouraging trajectory, growth may well turn out to be less robust in the near future. Despite these provisos, the Manufacturing PMI advanced from 54.4 to 55.8 for April, the increase driven, primarily, by a rebound in the 'Order Books' component. The property market at last seems to be calming down somewhat, with the latest adjustment to the countercyclical capital buffer, under which banks are required to set aside greater capital cover for lending on their mortgage loan books, should curtail activity. On the whole, forecasters are reasonably confident about prospects for Switzerland's economy, projecting GDP growth of around 2.0% for this year. Consumer prices rose by 0.1% m-o-m in April, but the headline y-o-y rate was flat at zero, as was the core inflation rate, indicating that deflationary risks have not gone away.

SNB's room to manoeuvre being cramped by the possibility of a cut in ECB interest rates

The Swiss National Bank (SNB) will have precious little latitude for action should the ECB decide to intervene by opting to cut key interest rates in order to forestall the danger of disinflation eventually degenerating into full-blown deflation in the eurozone. For now though, it is by no means certain the ECB will take that step even though Mario Draghi has been hinting it will. The ECB has already used words and statements to instil some calm in the markets and might well seek to gain some breathing-space for itself so as to avoid firing its last-resort weapons with the economy showing some vital signs of improving. It might also opt for other measures such as imposing a negative interest rate to stave off the threat from deflation.

If the ECB were to lower its official interest rates, the SNB might have to follow suit and readjust its own rates so as counter any rise in the Swiss franc's value relative to the euro. Indeed, judging by recent movements on three-month money-market futures on which rates are now showing negative up to the March 2016 deadline, the markets already seem to have started assuming this will happen. As the threat of deflation has not been dispelled, the SNB may well be forced into action. It did recently hint that it would prefer to step in on the forex markets, but nothing can be taken for granted. Some commentators who had begun to forecast a surprise raising of the SNB's floor exchange rate had had to rewrite their scenarios in response to the crisis in Ukraine and the possibility of eurozone interest rates being lowered.

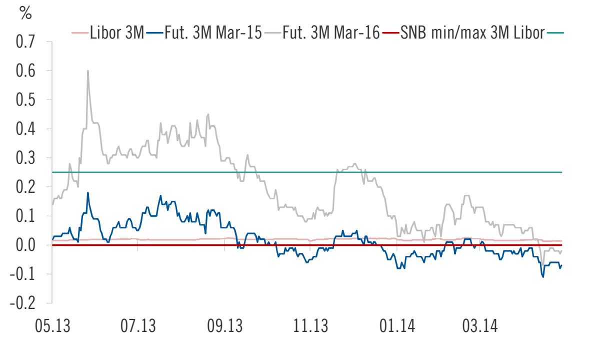
After posting of a loss of CHF9bn in 2013, which meant the SNB for the first time did not pay a dividend to the Confederation or the cantons, the SNB reported a profit of CHF4.4bn for Q1 2014. That profit comprised a CHF1.7bn gain on its currency positions and a CHF2.6bn profit made on its gold reserves.

Confederation bond yields set to stay low in the months ahead

The risk of deflation, the strong franc and uncertainties over prospects for the global economy will keep up the pressure on the SNB. Considering the possibility of official rates turning negative, the Swiss bond market looks set to remain fairly tightly range-bound over the next three months.

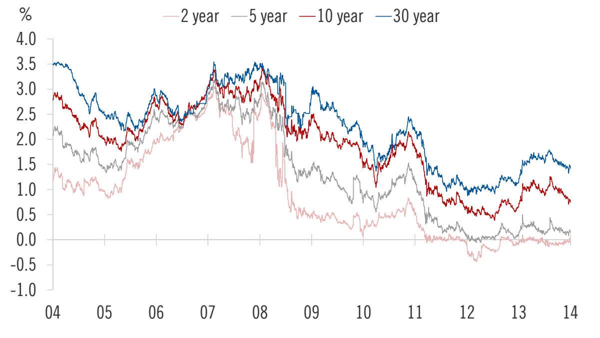
SWITZERLAND

SHORT-TERM RATES (CHF)



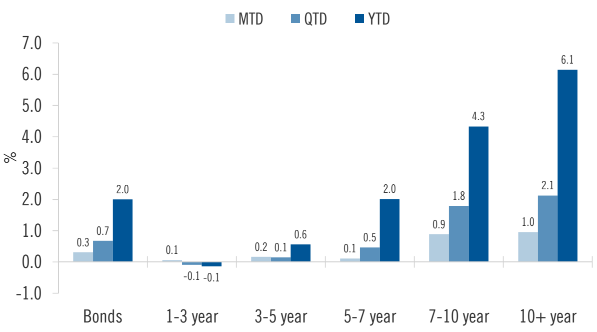
Source: Bloomberg, Money Market, CHF

CONFEDERATION BOND YIELDS



Source: Bloomberg, Confederation

RETURNS FROM GOVERNMENT BONDS BY MATURITY

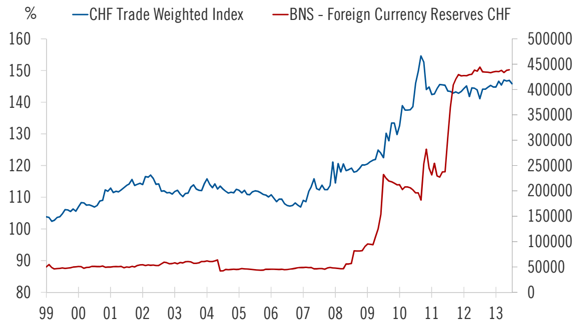


Source: Bloomberg, Citigroup, Switzerland Gvt Bonds

CONFEDERATION - MOVEMENTS IN YIELD SPREADS

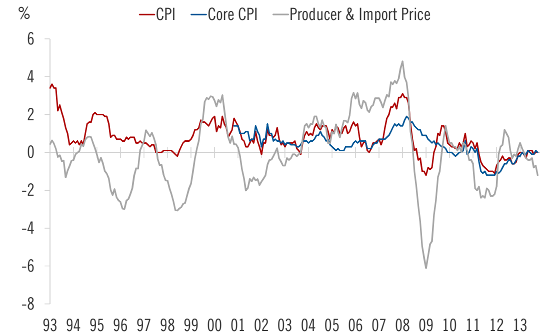
Source: Bloomberg, Confederation

SNB EXCHANGE RESERVES



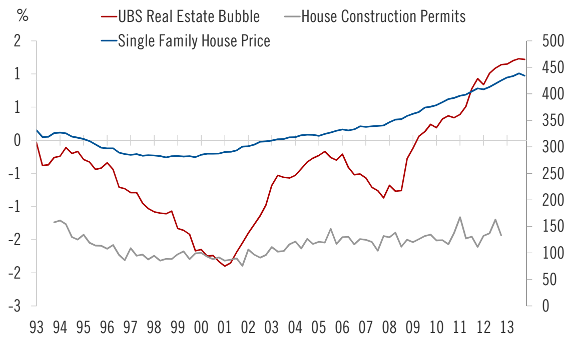
Source: Bloomberg, Switzerland

INFLATION



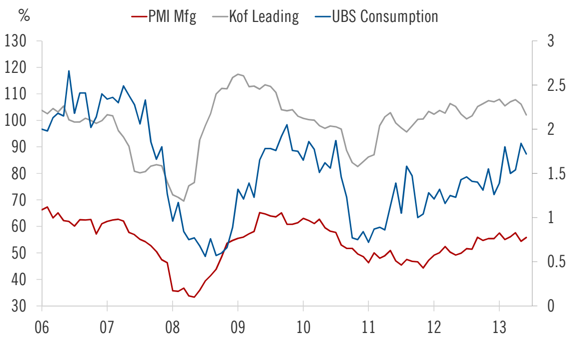
Source: Bloomberg, Switzerland

HOUSING



Source: Bloomberg, Switzerland

ECONOMIC SURVEYS



Source: Bloomberg, Switzerland

JAPAN

BoJ lowers its forecasts for economic growth

GDP expanded faster than expected in Q1 2014, boosted by consumers bringing forward purchases to beat the hike in consumer sales tax

The hike in the rate of consumer sales tax from 5% to 8% as of 1st April this year prompted consumers to bring forward their purchases of goods to beat the deadline. GDP growth worked out at 1.5% for the opening quarter, translating into an annualised q-o-q rate of 5.9%, compared to an expectation for +4.2%. Consumer spending notched up its biggest rise since 1997, the year when the consumer sales tax rate had been hiked with all the, by now, familiar disastrous after-effects. Business investment also notched up a robust increase. Even though consumer spending was buoyant in Q1 2014, consumer confidence is still pretty subdued as rising inflation, chiefly driven by the hike in the sales tax, has further eroded households' purchasing power, which wage increases have failed to offset in full. Analysts are worried the downturn on the consumer spending front might well undermine the overall recovery, but the Abe government, struggling to cope with debt at an astronomical 240% of GDP and a chronic budget deficit, exacerbated by the costs of the ageing population, had very little choice. In light of sluggish exports, together with shrinking domestic demand, forecasters are expecting GDP to shrink by 1% in Q2 2014.

Inflation has climbed back up to its fastest rate for twenty years, with the prices index for Tokyo posting a 2.9% y-o-y rise, but, with the sales tax impact stripped out, prices would only have increased by 1% in Japan's capital city. Unless there is a significant rise in nominal pay, inflation will remain a daunting challenge for the Bank of Japan (BoJ) which has been urging the government to push ahead at long last with its structural reforms.

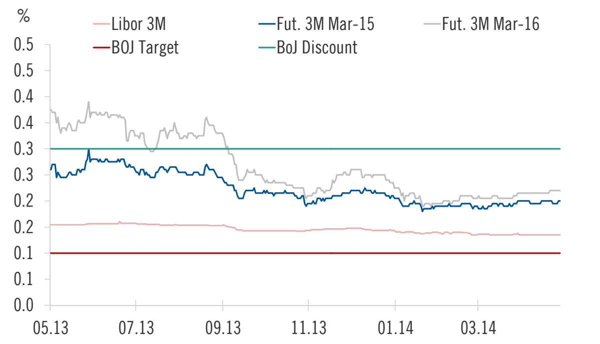
BoJ will want to assess what impact the hike in the sales tax has on consumer spending before implementing any new measures

The BoJ downgraded in April its forecasts for Japan's economic growth, but it remains confident that inflation will reach its target. According to its latest forecasts, GDP is expected to expand by 1.1% for the year to end-March 2015, down from the previous forecast for 1.4% growth. This revision to the downside can be blamed on the more pedestrian recovery in exports than expected. Moreover, exports could be further unsettled by the turn of events in Thailand. The Japanese government has already voiced its concerns about recent developments in Thailand where Japan is one of the major investors. According to the BoJ, Japan's economy is suffering at present from the feed-through impact of the 3-point hike in the consumer sales tax, but it is confident the effects will start to wear off from summer onwards. As expected, the BoJ made no change to its monetary policy at its recent meeting, preferring to wait for clearer details about the impact of the hike in the consumer sales tax rate. The BoJ announced it would continue to expand the monetary base by JPY60-70bn a year to double its size, but it gave no more detailed information than that. Though still comparatively optimistic, the BoJ remains ready to make any adjustments if it becomes likely its inflation target is not going to be hit. Its aim is to encourage individuals and businesses to spend and invest to stimulate growth so Japan can pull out of the deflationary spiral in which it has been stuck for several years now.

The BoJ's activist line on monetary policy is likely to continue underpinning the market for Japanese government bonds (JGBs). Yields on 10-year JGBs are unlikely to experience any significant fluctuations in the next three months.

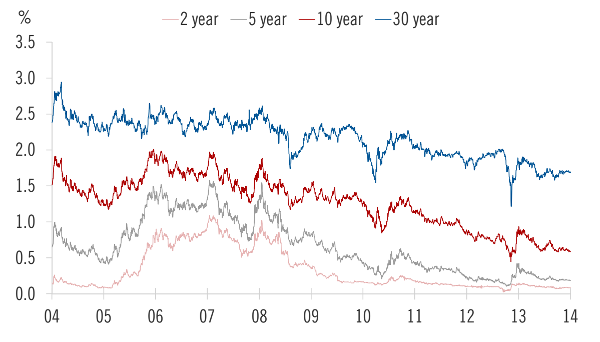
JAPAN

SHORT-TERM RATES (YEN)



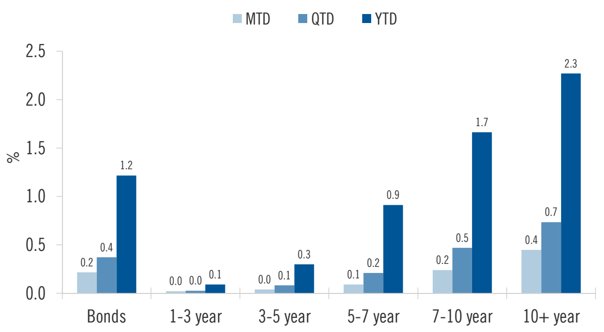
Source: Bloomberg, Money Market, Japan

JAPANESE GOVERNMENT BOND YIELDS



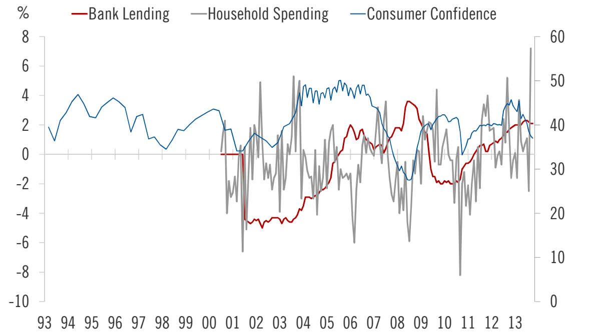
Source: Bloomberg, JGB

RETURNS FROM GOVERNMENT BONDS BY MATURITY



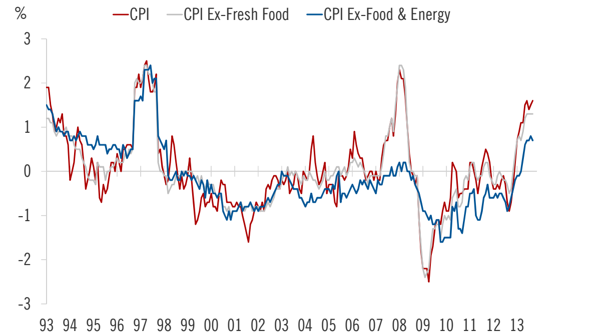
Source: Bloomberg, Citigroup, Japan Gvt Bonds

CONSUMPTION



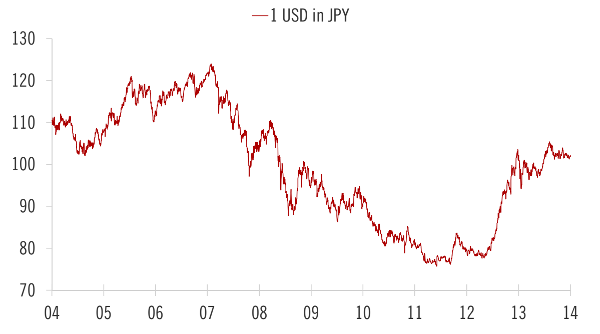
Source: Bloomberg, Japan

INFLATION



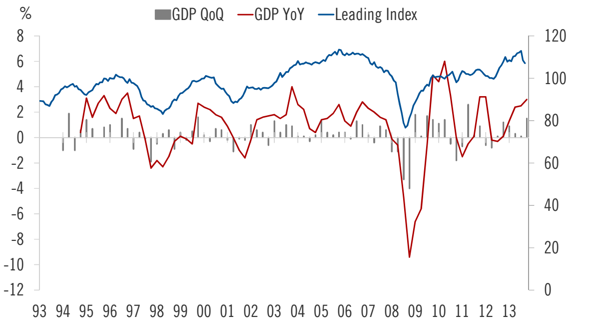
Source: Bloomberg, Japan

JAPANESE YEN VERSUS DOLLAR



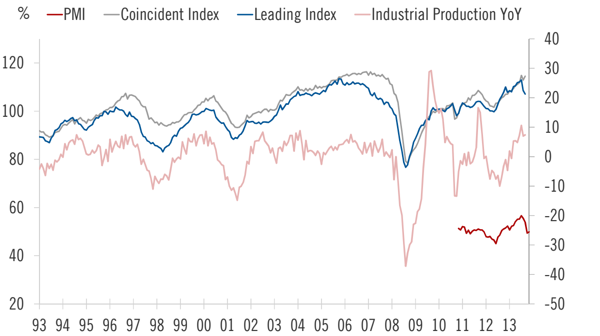
Source: Bloomberg, exchange rates

GDP



Source: Bloomberg, Japan

LEADING INDICATOR AND INDUSTRIAL PRODUCTION



Source: Bloomberg, Japan

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