PICTET 1805

Monthly Bond Letter
March 2014

Pictet Asset Management

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Recent developments

Economic uncertainties and low inflation rates have been underpinning bond markets even though the Fed has been pressing ahead with its tapering. The widespread drop in Purchasing Managers' Indices (PMI) for manufacturing cast doubts over the economic upswing.

The spate of cold snaps in the USA has severely handicapped economic activity

Recent economic numbers have made pretty poor reading, and inflation is still pitched below the Fed's target rate. Restrictions imposed by the Federal debt ceiling have been lifted till 2015, and worries over the deficit have been pushed into the shade. According to the Congressional Budget Office, the deficit is likely to total around 3% of GDP in 2014 and 2.6% in 2015, pointing towards debt stabilising at around 74% of GDP for this year.

Europe's exit from recession confirmed

Eurozone GDP expanded by 0.3% q-o-q in Q4 2013, quickening in pace from +0.1% in Q3. The European Central Bank (ECB), which is still not seeing deflation taking a grip yet, did not alter its monetary stance in early February. Against the backdrop of subdued inflation, yields on 10-year Bunds slipped to 1.63% and peripheral bond markets benefited from better news at home and diminishing confidence being shown in some emerging markets. Yield spreads continued to narrow. Eurozone periphery countries have been regaining access to capital markets, aided by upgrades to credit ratings from both Standard & Poor's and Moody's.

More pedestrian growth in Japan than expected fuelled ongoing doubts about the ability of the economy to cope with the hike in the consumer sales tax

Although the Bank of Japan remains particularly watchful, further mini-budget packages and wage increases could give growth a lift. The yield on 10-year Japanese government bonds drifted even lower, nearing all-time lows.

Corporate bond markets in good shape, with credit spreads narrowing further

Investment-grade bonds notched gains for February. Unlike January, the return was driven this time by the credit-risk component and narrowing credit spreads. Worries about some emerging markets persisted in early February, but credit-risk instruments soon rallied as appetite for risk increased once again.

European high-yield corporates continued to be boosted by investors' hunt for yield and improving sentiment about the state of the eurozone economy. They were also boosted by rating upgrades for Italy and Spain by credit-rating agencies.

Emerging-market debt bounced back in February, but was still being unsettled by the prospect of the Fed reining in its quantitative easing and by mounting political instability and questions over growth in some emerging economies. Investors exhibited a greater degree of discrimination, placing a priority on each country's fundamentals..

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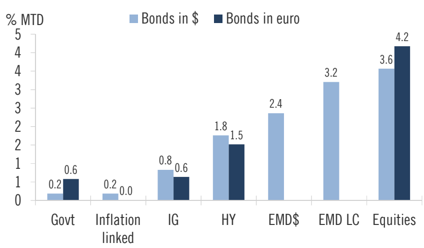
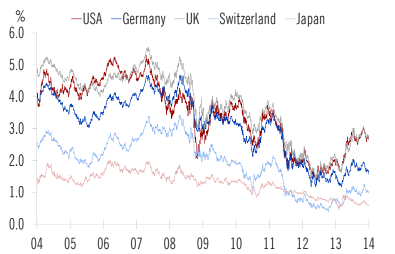
PERFORMANCE - FEBRUARY



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

10-YEAR GOVT BOND YIELDS



Source: Bloomberg, 10 Yr Govt yields

OVERVIEW

Forecasts

A brake has been applied to US economic growth, but this should turn out to be temporary and not call into question the Fed's tapering

A string of disheartening economic figures prompted economists to downgrade their growth forecasts. Preliminary estimates of US GDP growth for Q4 2013 had given a reading of 3.2%, but this is likely to be scaled down to just 2.5%. Moreover, the rate for Q1 2014 may well even come in below that.

Even though recent economic numbers have engendered considerable uncertainty, the Fed looks likely to press ahead with reining in its purchases of assets, as reasserted by the Fed's new Chair, Janet Yellen. She reconfirmed that only a significant turn for the worse on the jobs front would call into doubt continuation of QE tapering.

Until such time as economic data do perk up, the US bond market looks set to stay stuck in a fairly tight trading range. If the economy does bounce back this spring, 10-year US T-bond yields might well edge up towards the 3%-mark.

The worst looks over for Europe's economy, but the spectre of deflation is still haunting the eurozone

As lending to the private sector is still shrinking and unemployment is still pitched at high levels, doubts over the sustainability of the recovery have not gone away. The ECB, which has declared its readiness to take action if needed, is waiting for greater clarity about consumer prices, bank lending and GDP so it can assess the inflation outlook better. In early March once revised forecasts from its economists are revealed, the ECB might well step in unless economic prospects and credit trends have shown signs of improving. It might contemplate halting sterilisation of its Securities Markets Programme (SMP), lower its key refinancing rate, impose a negative rate of interest on banks' statutory reserves, or even buy up private-sector assets.

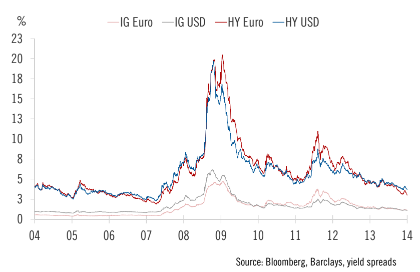
Bank of England wary of jeopardising the UK economic rebound

The BoE's precautionary stance is justified by the widespread floods that have hit the UK so far this year, which might well seriously curb growth in the early part of 2014. The fall in the y-o-y rate of inflation to 1.9% in January, plus the uptick in the jobless rate to 7.2%, provided some reassurance for the BoE in its strategy of wanting to ensure the recovery really is solidly anchored before tightening monetary screws again.

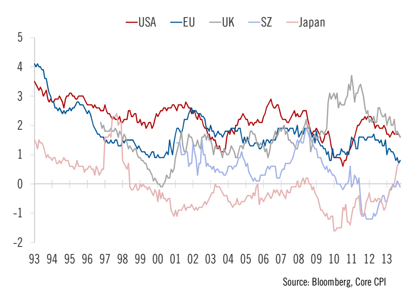
Corporate bonds should retain their good form

The main factor buoying the corporates segment is the ongoing squeezing of spreads on subordinated and hybrid debt and on bonds issued by borrowers from the eurozone's periphery. Yields themselves remain unappealingly small though as interest rates are low, which limits the attractions of investment-grade corporates. Volatility will tend to be influenced by risks associated with emerging countries and any signs of economies worsening again. We remain upbeat about prospects for high-yield bonds as risks relating to the eurozone economy have subsided and corporate balance sheets are still fairly sturdy.

CREDIT SPREADS



CORE INFLATION



Eurozone sliding into a state of permanently low inflation

Eurozone: anchored firmly in low-inflation waters

January's y-o-y rate of headline inflation in the eurozone was revised to 0.8%, up from a preliminary estimate of 0.7%. That upwards revision does not, by any means, signal a turning-point and even masks the still worrying underlying trend in inflation in Europe. If we look at the rate of inflation on the basis of constant tax rates, its tempo slowed once again at the outset of 2014, easing from 0.7% in November and December to 0.6% in January.

At the ECB's last press conference, ECB President Mario Draghi insisted this disinflationary tend was chiefly being driven by the so-called 'programme countries', i.e. Spain, Ireland, Portugal and Greece, pointing out this was the knock-on effect of adjustments being engineered through prices rather than any creeping deflationary phenomenon. He also conducted a compare-and-contrast exercise between the situation prevalent in the eurozone and Japan's two decades of deflation, maintaining that, in Japan's case, prices for 60% of product groups in the inflation basket fell whereas that percentage is much, much lower at present in the eurozone.

The two arguments put forward by Mario Draghi, whilst pertinent, do need to be seen in perspective. If we look closely at the trend for inflation at constant tax rates, the most marked deceleration in January actually happened in the Netherlands and France, with the French rate sinking to just 0.2% y-o-y, below even rates in Italy and Spain. That rather knocks on the head the argument of disinflationary trends being confined to convalescent economies of Southern Europe.

Secondly, although the percentage of product groups in the eurozone inflation basket registering falling prices may be considerably beneath Japanese levels, the trend is hardly inspiring much confidence. Of the 94 product groups in the headline rate and the 73 included to calculate core inflation, the percentages climbed from 20% to 24% and from 17% to 22%, respectively, between December and January.

Will the ECB be able to turn back the disinflationary tide?

The upturn in the eurozone economy – admittedly from its low-water mark – coupled with recent comments from ECB spokespersons suggest that, although the arsenal of monetary-policy weapons might have to be wheeled out in the medium term, there is no urgency in the short term to do anything. The next Governing Council meeting on 6 March could provide answers as the ECB is due to disclose its latest growth and inflation forecasts for the next three years. On this score, the inflation number for 2016 will be the one to watch: any figure above 1.5% will see the current inertia holding sway whereas any figure below 1% might well set in train measures involving even more monetary accommodation.

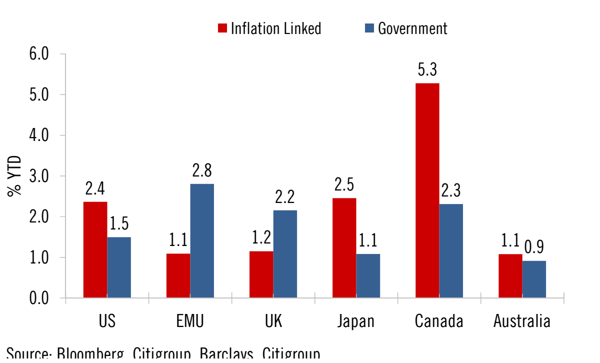
If the latter were to be the case, the ECB could well take the following steps, listed in order of priority: calling a halt to sterilising its SMP; cutting its refinancing rate; lowering the deposit rate; buying private-sector assets or government debt.

Still feasible the ECB might resort to more quantitative easing

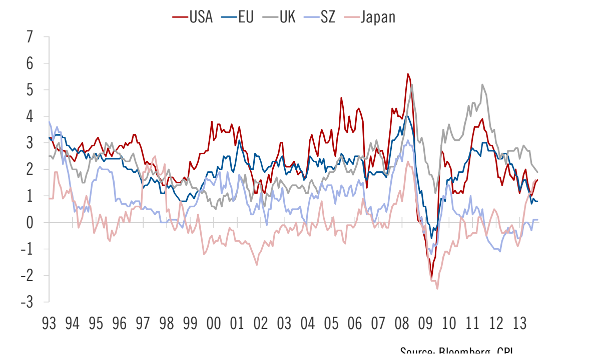
For there to be genuinely full-blown QE in the eurozone, inflation – both current and future – would have, however, to stick close to its current level, economic agents' long-term inflationary expectations would have to be toned down noticeably below the 2%-threshold and the above-listed measures would have to be put in place and subsequently turn out to be ineffectual. That string of criteria might seem implausible, but the possibility they might materialise in the second half of this year cannot be ruled out.

INFLATION-LINKED BONDS

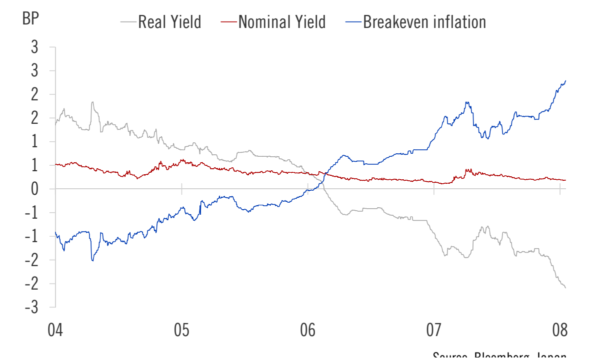
PERFORMANCES 2013 (LOCAL CURRENCIES)



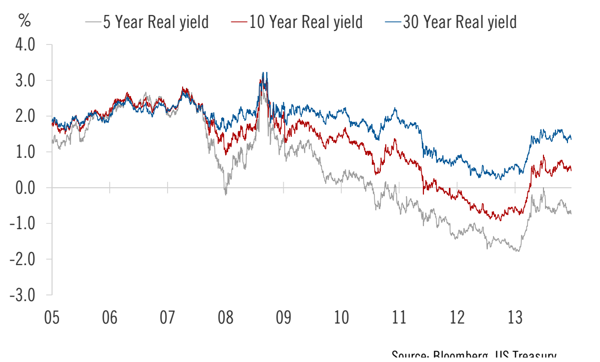
INFLATION



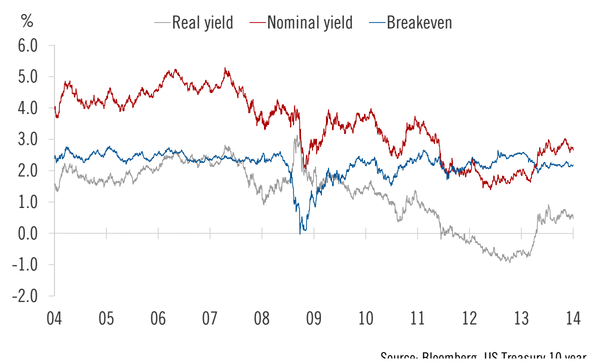
JAPAN - TREASURY YIELD COMPONENT



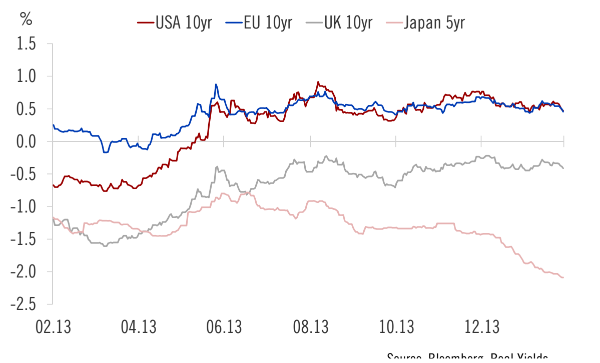
USA - REAL RATES



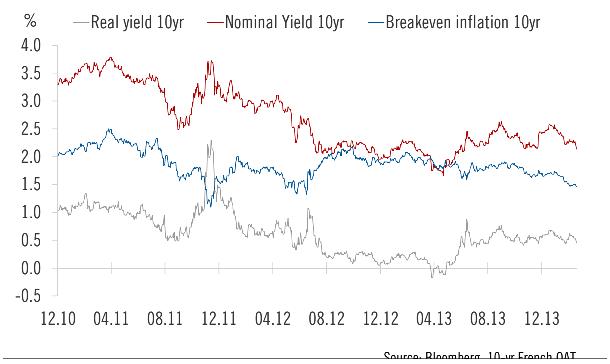
USA - 10-YEAR TREASURY YIELD COMPONENT



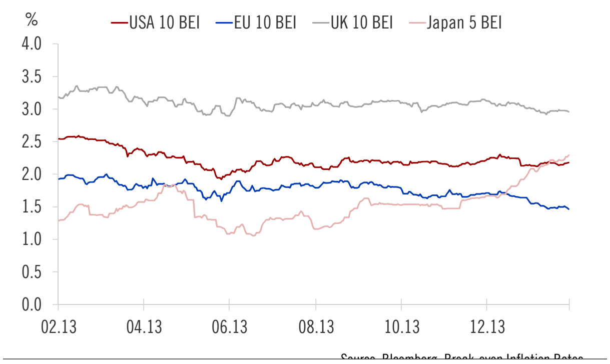
10-YEAR REAL YIELDS



FRANCE - 10-YEAR YIELD COMPONENT



10-YEAR BREAKEVEN INFLATION POINTS



Returns in the positive zone

Credit spreads have been narrowing

Investment-grade bonds notched up gains in February. Unlike January, the return was driven this time by the credit-risk component and narrowing credit spreads. Worries about some emerging markets persisted in early February, but credit-risk instruments soon rallied as appetite for risk increased once again. The level of spreads, for instance on the Main iTraxx index, has still not, however, drifted back down to lows seen at the outset of 2014.

Investors' hunt for yield, understandably, worked to the advantage of subordinated hybrid debt which delivered some impressive returns, followed by insurance companies' subordinated debt boosted by insurers' sound results. Spanish and Italian borrowers in banking and, to a lesser extent, in the utilities, telecoms and energy sectors continued to outperform. In contrast, consumer and pharmaceuticals sectors saw little change in their spreads. Borrowers from emerging countries generally did quite well, recouping some of their losses made in January.

Banking sector

The Moody's rating agency confirmed its 'Negative' outlook label for Dutch banks. Although it did acknowledge they were generally solidly capitalised and profitable, it highlighted the fact that economic woes were likely to result in increased non-performing loans and, by extension, a squeeze on profits. Conversely, confirmation of Italy's sovereign debt rating and removal of its 'Negative' outlook tag imply that ratings for Italy's banks should be confirmed with a 'Stable' outlook label. The threat of downgrades looks to have been dispelled for the medium term. European banks active on the US market will be required to set up holding companies that will be Fed-regulated, endowed with adequate capital of their own and have to comply with a leverage ratio of 4%, to be lowered to 3% in 2018. These regulations have ultimately turned out less harsh than had been feared, and will have to be complied with by the 17 largest non-American banks, including Deutsche Bank, Barclays, BNP, UBS and Credit Suisse.

Primary market

Although the reporting season did curb the number of new issues, volumes were still higher than in February 2013. Issuers came from a broad array of both sectors and countries. We saw plenty of borrowers from the American side of the Atlantic, the likes of Ford, Cargill or Verizon with its EUR3bn bond, whereas peripheral eurozone borrowers have been conspicuous by their virtual absence from the primary market in the early part of this year.

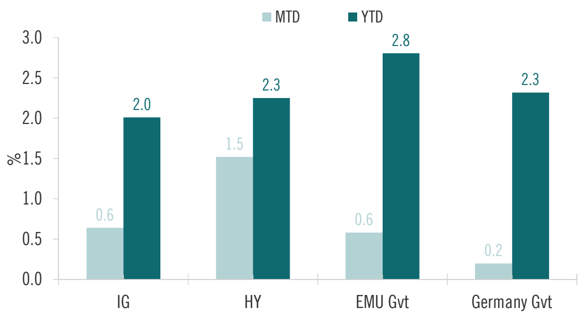
Among financials, the heaviest volumes were seen in senior debt, with US banks, such as JP Morgan and Goldman Sachs, particularly active. The rest came from Scandinavian banks Nordea and SEB, one Italian bank, UBI Banca, and Barclays. As for subordinated debt, there were just two Lower Tier 2 issues, from Raiffeisen and ING, as well as a new Tier 1 CoCo from BBVA.

Outlook

Corporate bonds should continue to do well, the main factor buoying the segment being the ongoing squeezing of spreads on subordinated and hybrid debt and on bonds issued by borrowers from the eurozone's periphery. Yields themselves remain unappealingly small though as interest rates are low, tarnishing the attractions of this asset class. Volatility will tend to be influenced by risks associated with emerging countries and economies turning for the worse again.

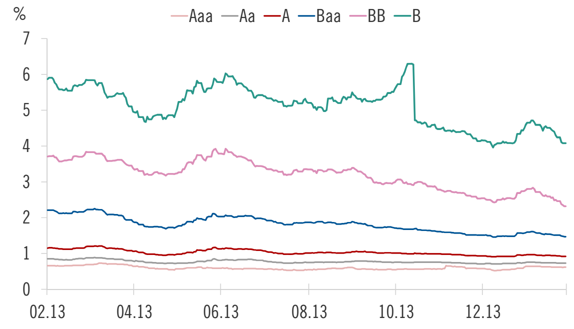
CREDIT RISK

RETURNS ON BONDS IN EURO



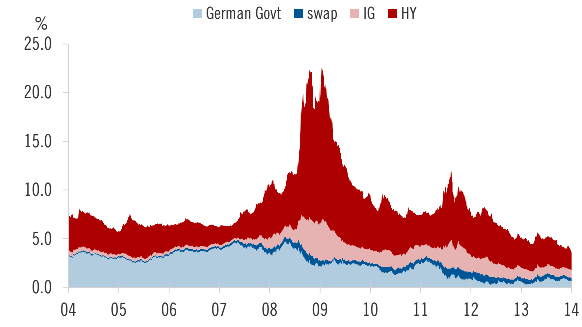
Source: Bloomberg, Barclays, Citigroup. Bonds in euro

CREDIT SPREADS (EURO)



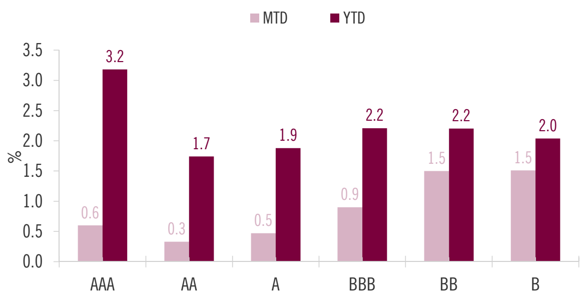
Source: Bloomberg, Barclays, EUR yield spreads

YIELD COMPONENT (EURO)



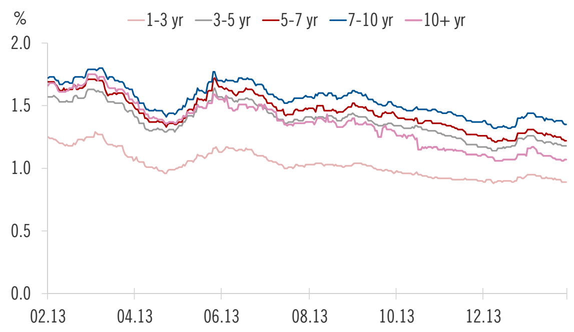
Source: Bloomberg, Barclays, Eur yields

RETURNS ON BONDS IN EURO



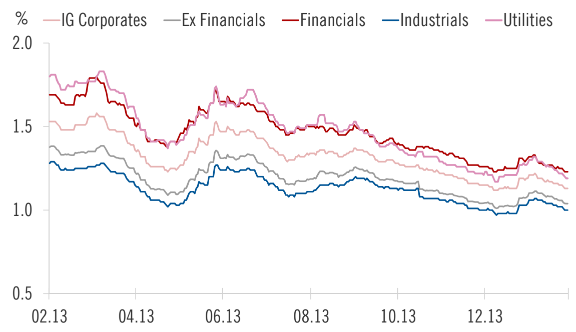
Source: Bloomberg, Barclays, Corporate Bonds in euro

INVESTMENT GRADE SPREADS BY MATURITY



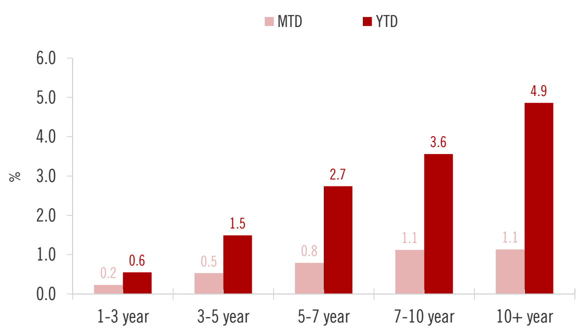
Source: Bloomberg, Barclays, EUR yield spreads

INVESTMENT GRADE SPREADS BY SECTOR



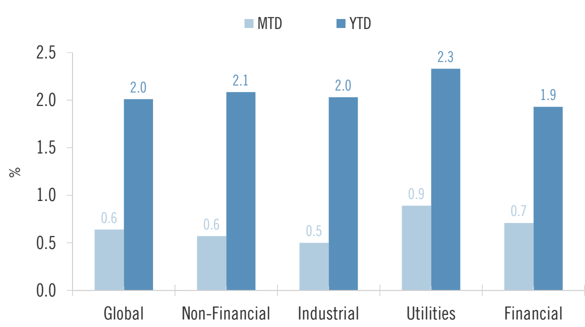
Source: Bloomberg, Barclays, EUR yield spreads

INVESTMENT GRADE RETURNS BY MATURITY



Source: Bloomberg, Barclays, Corporate Bonds in Euro

INVESTMENT GRADE RETURNS BY SECTOR



Source: Bloomberg, Barclays Corporates Bonds in Euro

Fundamentals have remained supportive for high-yield bonds

February was another good month for corporate bonds

The European high-yield market advanced in February following its pause at the end of January in the wake of the turmoil on emerging markets. Inflows, primarily into the short-term segment, remained well oriented. All sectors and ratings were in positive territory. Ratings-wise, BBs outperformed the rest of the market in the first half of the month before being outpaced by Bs as risk appetite gained momentum. High-yield borrowers still benefited from investors' improved sentiment towards Europe and primarily the periphery. Spain was upgraded to Baa2 with a 'Positive' outlook, Moody's citing progress in rebalancing the economy and implementing structural reforms. In Italy, the appointment of a new government was well received by equity and bond investors alike. Moody's confirmed Italy's sovereign rating and removed the 'Negative' outlook tag attached to it. As a result, bonds from the periphery led the pack in February. In contrast, the handful of issuers headquartered in emerging countries – mostly South African and Eastern European borrowers – underperformed.

Primary market

The primary market proved quite sluggish this month with names such as Löwen Play, operating gaming arcades in Germany, and the B-rated packaging borrower Innovia that issued a floating rate bond in mid-February. BBVA, a Spanish financial group, issued €1.5bn of perpetual bonds rated BB-. Overall, the primary market is slightly less active than 12 months ago, with total issuance marginally exceeding €10bn. On a year-to-date basis, the primary market has been dominated by BB-rated companies, a stark difference with 2013 when issuance had been evenly shared between BBs and Bs at the same date.

Corporate fundamentals and news

Balance sheets remain in decent shape. Interest coverage ratio and cash flow generation remain at high levels despite leverage being on the rise. The default rate is set to stay low throughout 2014. The ECB's accommodating policies, along with cautious balance-sheet management, are the main factors explaining this low default rate. On the corporate news front, most of the noise was still coming from the cable/telecom sector, with Numericable keen to buy SFR after its successful IPO last November. ONO, wooed by various contenders, has appointed banks to prepare for an IPO, too. Consolidation may also extend to the paper and pulp industry to cope with declining paper consumption with the advent of electronic media. In the auto sector, the latest figures proved encouraging, with Jaguar posting upbeat results and Renault releasing good figures and higher than expected margins.

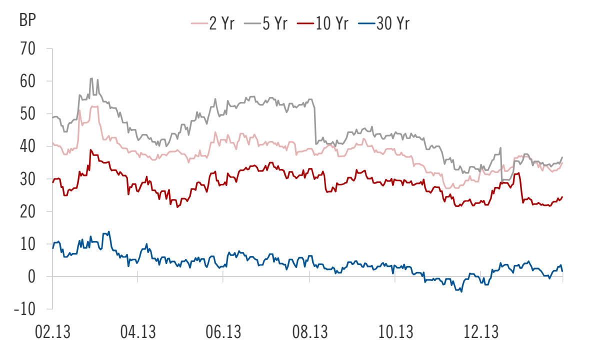
Perspectives

We remain constructive on the high-yield asset class. Downside risks on the European economy continue to recede. 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. 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. Momentum, while still positive, remains weaker than three months ago. Developments on emerging markets are set to be a driver for the months to come and may penalise companies with operations in developing countries. Mergers and acquisitions will be the second dominant theme, mostly arising from telecommunication and cable companies.

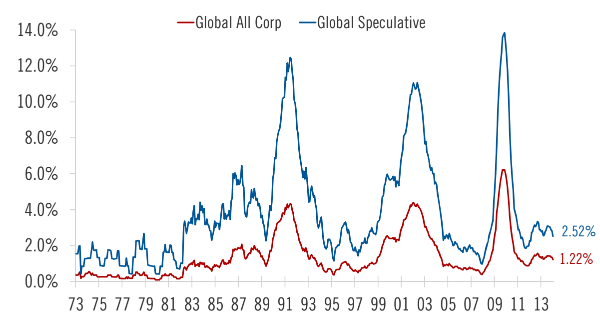
CREDIT RISK

EURO SWAP SPREADS



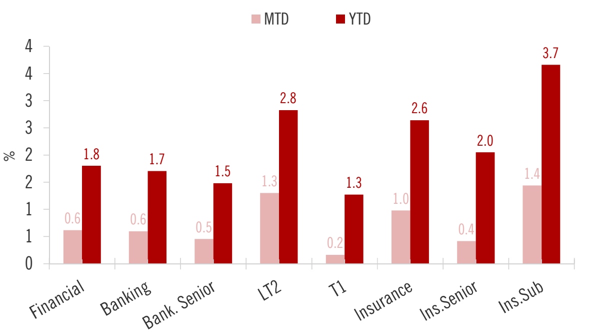
Source: Bloomberg, Swap spread EUR

MOODY'S - DEFAULT RATES



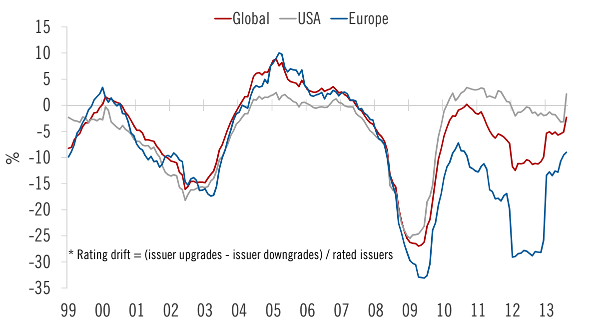
Source: Moody's

FINANCIAL INVESTMENT-GRADE RETURNS



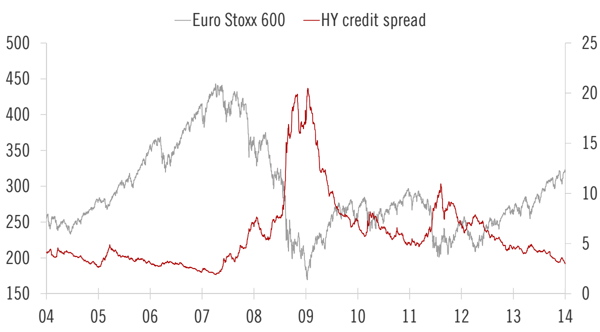
Source: Bloomberg, BoA Merill Lynch

MOODY'S - RATING DRIFT



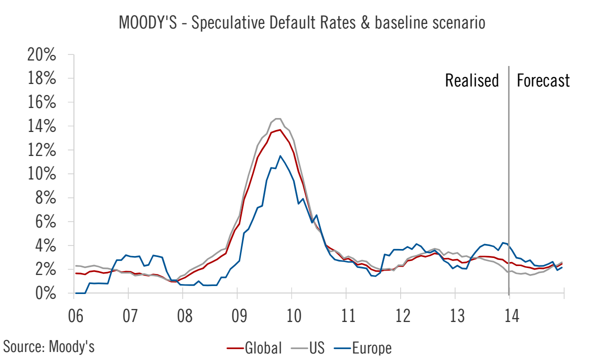
Source: Moody's

STOCK MARKET AND HY SPREAD



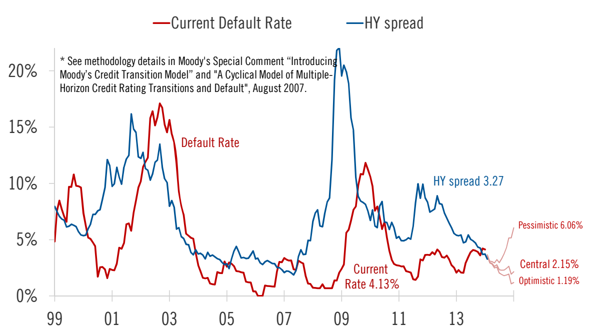
Source: Bloomberg, Barclays

MOODY'S – TAUX DE DÉFAUT



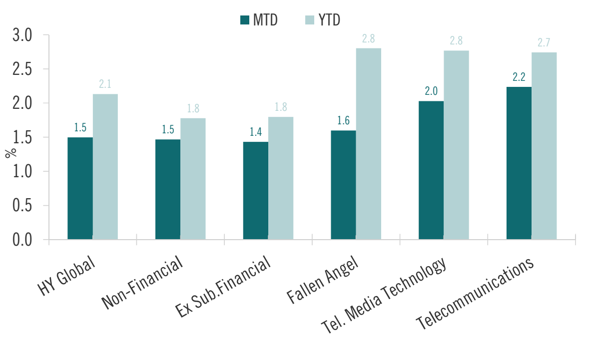
Source: Moody's

HIGH-YIELD SPREAD AND DEFAULT RATES



Source: Moody's and Merrill Lynch HY Index

HIGH-YIELD RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merill Lynch

Gentle recovery, but risks persist

Local-currency debt – Recent developments

February saw the local-currency emerging debt benchmark up by more than 3% in US dollars, but the partial recovery for the year has been nervous and uneven. Some investors have looked at the asset class as a buying opportunity, but this was somewhat offset by lacklustre Chinese PMIs and softer US data, apparently weather-related. Events in Ukraine and Venezuela also cast a cloud over investor sentiment for emerging markets. Brazil was one of the best-performing markets as it reacted positively to budget targets. Poland, Indonesia and South Africa were also good performers. Hungary cut rates by 15bp to 2.7%, with both GDP growth and industrial production showing strong improvement. Romania was positive, but underperformed the market on the back of industrial production trending weaker and interest rates being cut by 25bp to 3.5%. The Russian rouble declined over 1% as economic data from manufacturing to retail sales continued to disappoint and some analysts see the country at risk of recession. Nigeria fell by over 2% where the central bank Governor was ousted by the President, though the acting Governor confirmed there would be no change in policy direction.

Local-currency debt – Outlook

One 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 as well. However, growth remains uneven, and the impact of Fed tapering will continue to affect countries with structural issues, particularly those with funding needs. Turkey is a key example, with major political risks and a huge current-account deficit, while South Africa is seeing labour unrest, low growth, lack of reforms and upcoming elections. Despite a recovery in February, these markets could see continued pressure during a period of global transition to more normal monetary conditions. Countries like the Philippines and Mexico, with political stability and positive structural reforms, should fare better than others.

External debt – Recent developments

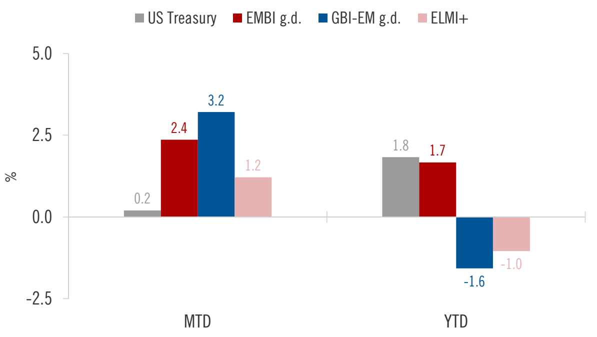
The external emerging debt segment performed well in correlation with US Treasuries, the spread on the asset class tightening to 330bp. High-grade countries outperformed high-yield countries as news surrounding Ukraine and Venezuela created nervous market sentiment. Ukraine escalated into violence and more downgrades to CCC while President Yanukovych's impeachment and planned Presidential elections in May resulted in a rally based on market expectations of a financial aid package, but this is still not close to being finalised. Venezuela saw violent protests threatening to destabilise the government as high crime, high inflation and goods shortages put the economy in decline. The bonds were relatively flat towards the end of the month as the yield of over 12% makes it expensive to be underweight. Argentina was driven 10% higher by speculative investors as there has been no fundamental improvement even with a more realistic inflation index and new Economy Minister. Paraguay returned close to 3% as Moody's upgraded it to Ba2. Brazil slightly outperformed the market given budget targets. Mexico also outperformed where it was upgraded to A3 by Moody's.

External debt – Outlook

We could see further pressure on the asset class with the unwinding of risk by investors. However, at some point, attractive valuations will be hard for investors to ignore, and fundamentals will start to rebalance, leading to potential for a stronger recovery, but Fed tapering may continue to cause downward pressure while more focus will be put on the fundamentals of each country. 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 and good support from longer-term investors. However, it remains subject to investor sentiment, and we have not yet seen a meaningful reversal of investor outflows.

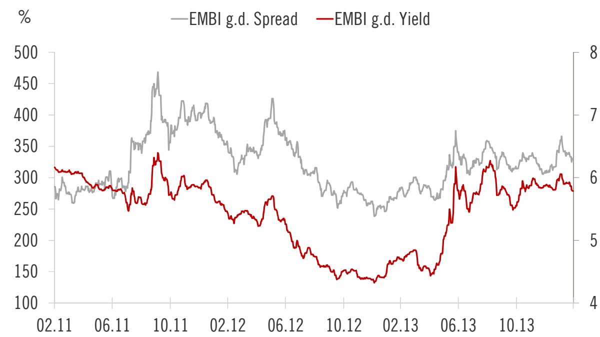
EMERGING DEBT

PERFORMANCES (USD)



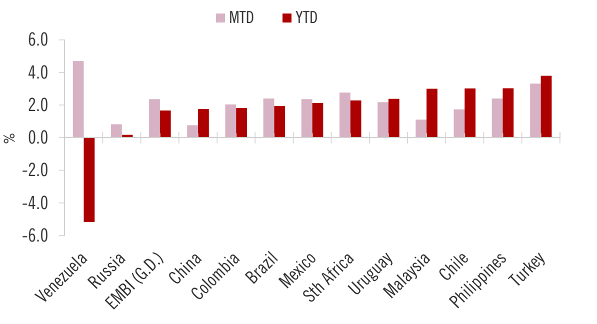
Source: Bloomberg, Index JP Morgan

US DOLLAR DEBT - YIELD & SPREAD



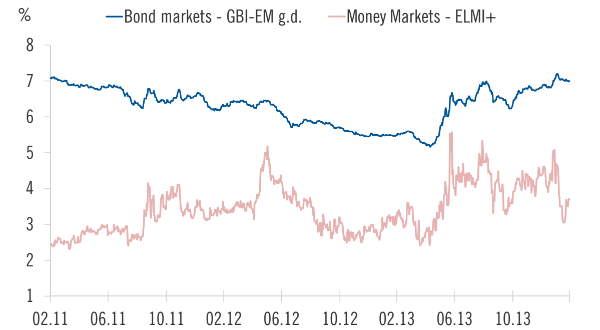
Source: Bloomberg, JP Morgan Indices

JP MORGAN EMBI GLOBAL DIVERSIFIED



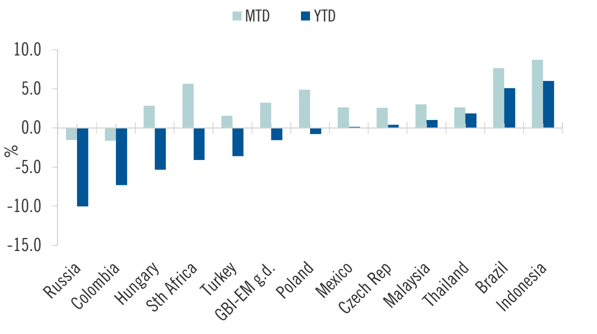
Source Bloomberg; Index JP Morgan

LOCAL CURRENCY DEBT - YIELD



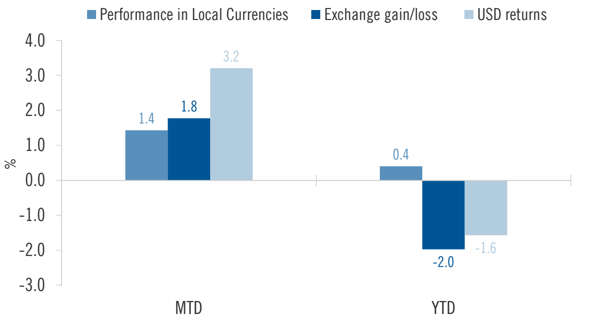
Source: Bloomberg, JP Morgan Indices

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



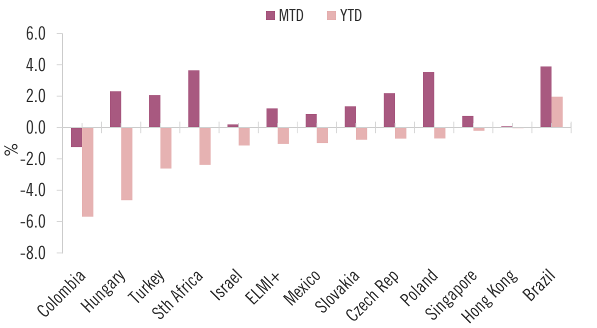
Source Bloomberg; Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



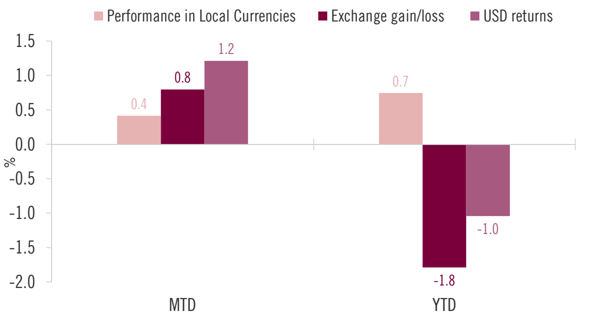
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg; Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

The economy chilled by a cold snap

The spate of cold snaps in the USA has severely handicapped economic activity, with recent data making very dispiriting reading

A string of disheartening economic figures prompted economists to downgrade their growth forecasts. Preliminary estimates of GDP growth for the US economy in Q4 2013 had given a reading of 3.2%, but this is likely to be scaled down to just 2.5%. Moreover, the rate for Q1 2014 may well even come in below that. The Manufacturing PMI plummeted from 57 to 51.3 for January. Industrial production fell by 0.3% and manufacturing output was down by 0.8%. Durable goods orders declined by 4.3%, industrial orders dropped by 1.5% and retail sales were down by 0.4%. The number of new jobs being created was lacklustre for the second month in a row: just 113k jobs were created in January whereas 180k had been expected. On a plus note though, the unemployment rate continued to recede, declining from 6.7% to 6.6%. Housing-market data have been dented too. The NAHB/Wells Fargo Housing Market Index, purported to be a reliable barometer for the sector, sank from 56 to 46; housing starts plunged by 16%; building permits fell by 5.4%; sales of existing homes dropped by 5.1%. This string of discouraging figures prompted the most pessimistic to jump to the conclusion that the US economy may perhaps not have been solely damaged by harsh winter weather. On that score, the rebound in the preliminary Markit PMI for February from 53.7 to 56.7 did provide some crumbs of comfort.

Consumer prices rose by 0.1% m-o-m in January, pushing the headline y-o-y rate of inflation up from 1.5% to 1.6%, but core inflation retreated from 1.7% to 1.6%. That means inflation is still running below the Fed's target, with its key measure of inflation, the core personal consumption expenditure (PCE) price index – a bellwether very closely monitored by the Fed – pointing to just a 1.1% increase in prices.

Restrictions imposed by the Federal debt ceiling lifted till 2015, and worries over the deficit pushed into the shade

President Obama's Republican opponents ceded ground, allowing a bill to be approved authorising the Administration to borrow up to 15 March 2015 without a ceiling being enforced on Federal debt. The Congressional Budget Office indicated that Federal spending would exceed Federal income by the lowest level since 2007. The budget deficit is expected this year to reach 3% of GDP and work out at 2.6% in 2015. That should help to stabilise the country's national debt which is likely to total 74% of GDP this year.

Economic slowdown likely to be temporary and not call into question the Fed's tapering

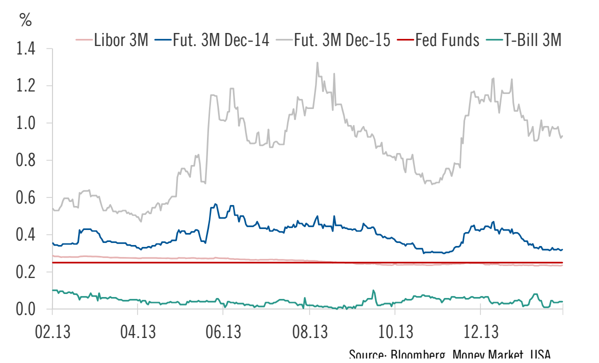
Even though recent economic numbers have engendered considerable uncertainty, the Fed looks likely to press ahead with reining in its purchases of assets, as reasserted by the Fed's new Chair, Janet Yellen.

She reconfirmed that only a significant turn for the worse on the jobs front would call into question any continuation of QE tapering. The tapering process should run on at the same tempo over the next few months before coming to an end in October. The Fed can be expected to focus its public utterances more on inflation considerations, with the rate pitched below its target level, reinforcing the prospect of the Fed funds rate being left unchanged for many months to come.

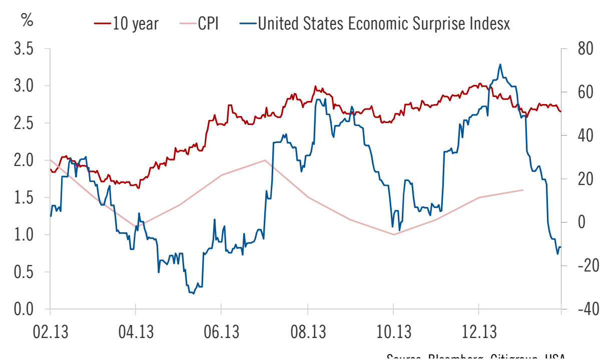
Until such time as economic data do perk up, the US bond market looks set to stay stuck in a fairly tight trading range. If the economy does bounce back this spring, 10-year US T-bond yields might well edge back up towards the 3%-mark, with the slope of the yield curve steepening.

USA

SHORT-TERM RATES (USD)



US TREASURY BOND YIELDS



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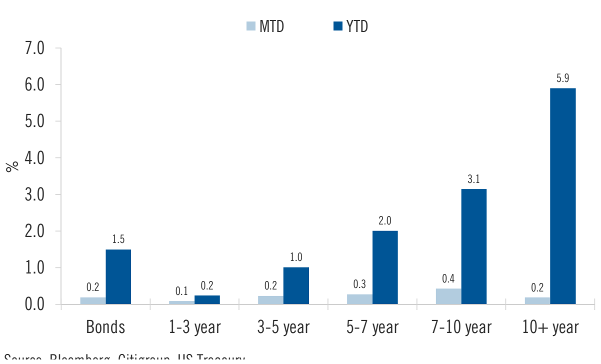
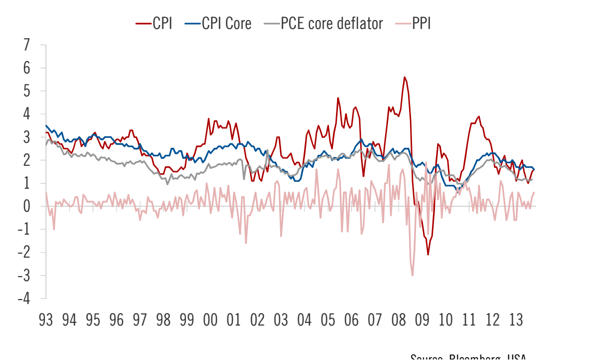
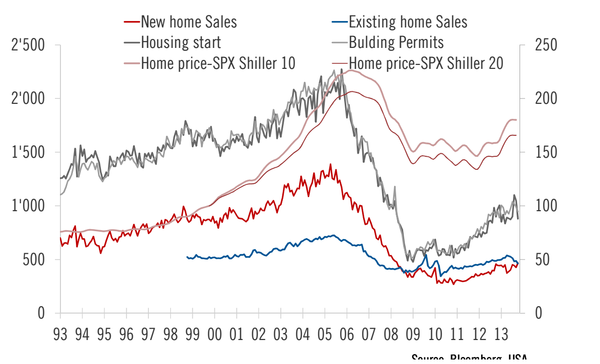


MOVEMENTS IN YIELD SPREADS

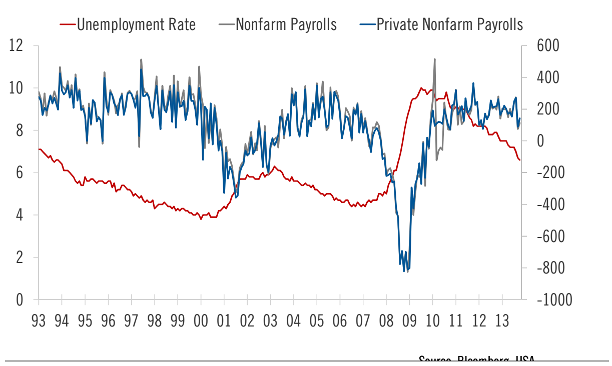
INFLATION



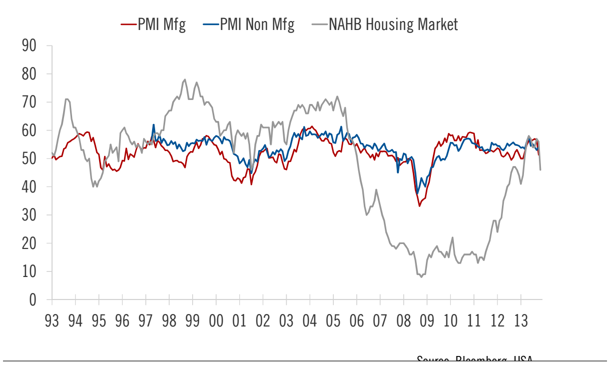
HOUSING



LABOR MARKET



PMI AND NAHB



Exit from recession confirmed

Germany, France and Italy all notched up faster growth than forecast in Q4 2013

Eurozone GDP expanded by 0.3% q-o-q in Q4 2013, quickening in pace from 0.1% in Q3. Business investment made its contribution to the upturn. The OECD has estimated that eurozone economies, including those of France and Italy, were experiencing an uplift. The Manufacturing PMI declined from 54 to 53 in February, but the Services PMI was practically unchanged, inching up from 51.6 to 51.7. The German Ifo Business Climate Index again registered a stronger rise than expected, climbing from 110.6 to 111.3. Despite this, lending to the private sector is still shrinking and unemployment is still pitched at high levels, feeding doubts over the sustainability of the recovery.

The ECB, which is still not seeing deflation taking a grip yet, opted not to alter its monetary stance in early February

ECB President Mario Draghi justified the 'no change' decision on the grounds he did not consider deflation had taken a hold in Europe, but the ECB would keep a very close eye on price trends and, especially, the still brittle economic recovery. The Governing Council indicated it needed to assess the complex state of affairs in eurozone carefully before, if appropriate, sanctioning implementation of fresh measures. The disinflationary trend can be attributed primarily to four countries: Spain, Ireland, Portugal and Greece where domestic demand is shrinking. The ECB, which has declared its readiness to take action if needed, is waiting for more clarity about consumer prices, bank lending and GDP so it can assess the inflation outlook better. In early March once revised forecasts from its economists are revealed, the ECB might well step in unless macroeconomic prospects and credit trends have shown signs of improving. It might contemplate halting sterilisation of its SMP, lowering its key refinancing rate, imposing a negative rate of interest on banks' statutory reserves, or even buying private-sector assets. Criticism levelled by Germany's Constitutional Court against the ECB's Outright Market Transactions programme to purchase sovereign bonds, which allegedly breaches the ban on monetary financing of government budgets, suggests implementation is unlikely at this juncture.

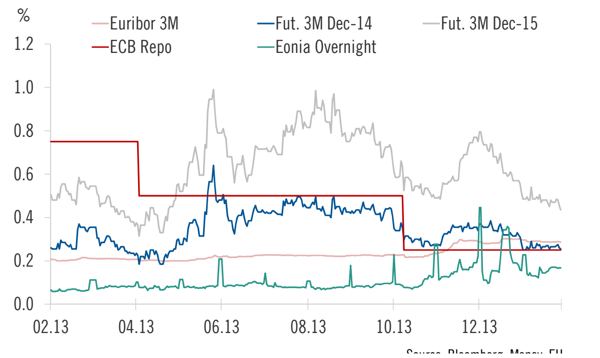
Hopes of a cut in ECB interest rates, together with disheartening stats from the USA and China, kept bond yields moving downwards

Against the backdrop of subdued inflation, 10-year Bund yields slipped to 1.63% and peripheral bond markets benefited from better news at home and diminishing confidence shown in some emerging markets. Yield spreads continued to narrow. Eurozone periphery countries have been regaining access to capital markets and seen credit ratings being upgraded by the agencies. The change in government in Italy had no real impact on the market trend, with the Italian economy pulling out of the recessionary doldrums and Moody's revising its outlook appraisal from 'Negative' to 'Stable'. The agency also welcomed the progress being made in Spain, lifting its credit rating from Baa3 to Baa2 and even giving the outlook a 'Positive' assessment. Moody's highlighted the reforms pushed through by the Madrid government and the fact Spain can now benefit from a lower rate for borrowing. Portugal reported a budget surplus for January, with spending reduced by 4.4% and revenue flowing into State coffers up 6.2%.

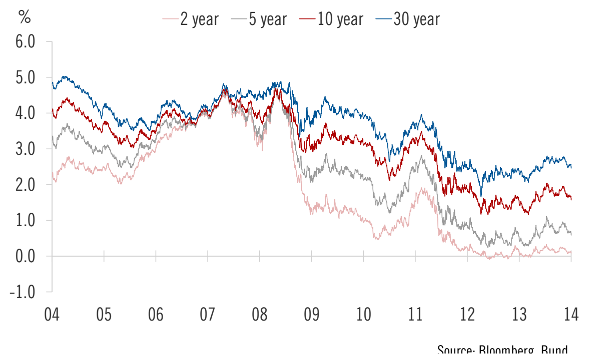
In the next few weeks, Bund yields are set to stay fairly range-bound as markets are unlikely to be gratified by assurance the recovery is shifting into sustainable mode or that deflationary risks are evaporating. On the plus side though, it will underpinned by the certainty official rates will stay low for quite some time. Peripheral eurozone markets should retain their decent form. The eurozone will, of course, also remain heavily influenced by what happens on the US Treasuries market.

EUROZONE

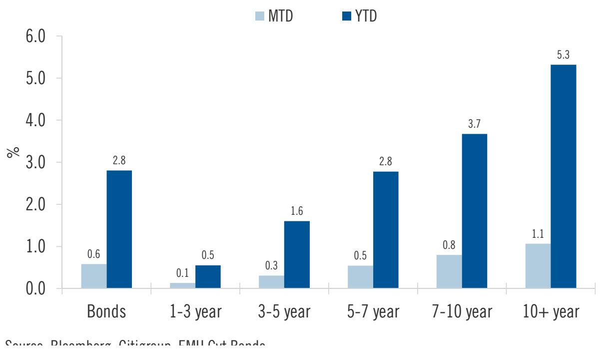
SHORT-TERM RATES (EURO)



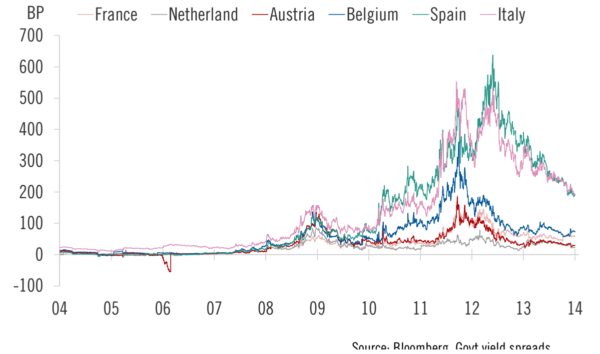
BUND YIELDS



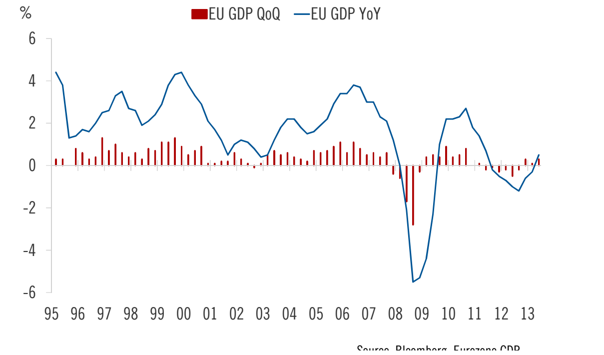
RETURNS BY MATURITY (EMU GVT)



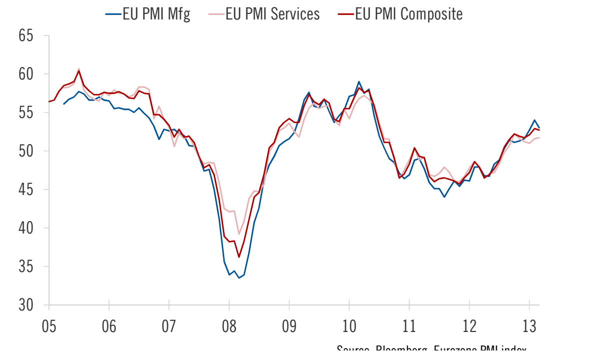
10-YR GVT SPREADS VS GERMANY



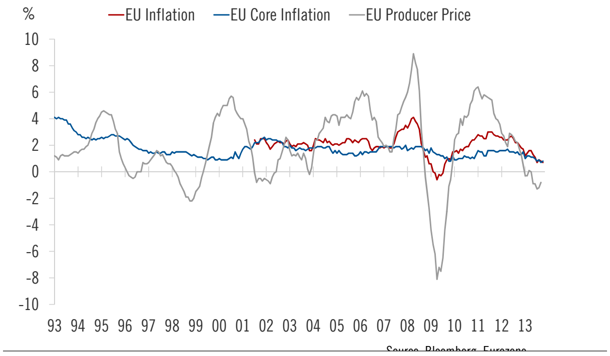
GDP



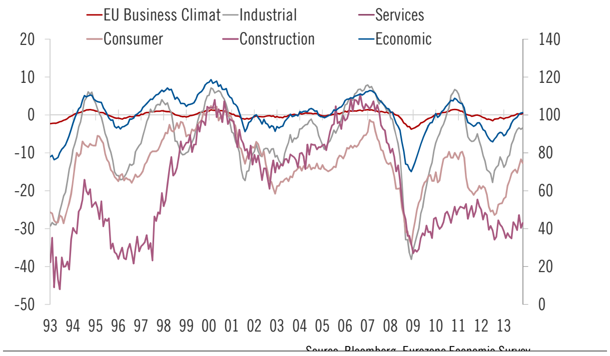
EUROZONE - PUCHASING MANAGER INDICES



EUROZONE - INFLATION



EUROZONE - ECONOMIC SURVEYS



BoE waiting for solid recovery to be confirmed before hiking the base rate

The BoE is determined to err on the side of caution and, even though it has upgraded its growth forecasts, it is unlikely to lift the base rate before 2015

The Bank of England (BoE) stated that, despite unemployment falling faster than predicted, the base lending rate is unlikely to be hiked before next year. It also stressed that the increase, when it does come, will be gradual and probably be halted before reaching the average pre-crisis rate of 5%. BoE Governor Mark Carney pointed out that a base rate at 3% looked a more suitable level, indicating that too much production capacity was still lying idle and that the BoE would be monitoring an entire dashboard of indicators, including unemployment, PMIs and working hours, to assess the appropriateness of raising interest rates. The BoE is projecting that inflation will decline to 1.7% in March before edging back up towards its 2% target. The BoE has also revised its GDP growth forecast for this year, upgrading it to 3.4% from the 2.8% projected in November, and is looking for growth of 2.7% in 2015.

The BoE is erring very much on the side of caution as it wants to avoid running the risk of endangering the recovery at a time when widespread floods that have hit the UK so far this year might seriously curb growth in the early part of 2014. The fall in the y-o-y rate of inflation to 1.9% in January, plus the uptick in the jobless rate to 7.2%, provided some reassurance for the BoE in its strategy of wanting to make sure the recovery really is solidly anchored before tightening monetary screws again.

On the budget front, the gradual mopping-up of the deficit is ongoing, with the progress being driven primarily by the boost from a strengthening UK economy. In the run-up to the elections, the government is likely to toe a less austere line and pursue a comparatively neutral fiscal policy. Moreover, the Conservatives have already signalled the possibility of tax cuts.

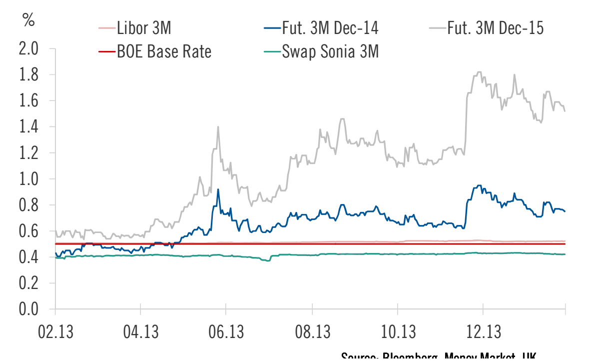
Economic recovery has been confirmed, but still looks quite fragile, and the bad weather may well curb growth in Q1 2014

With the backing of the BoE's highly accommodating monetary policies, the UK economy notched up growth of 1.9% in 2013, with consensus expectations forecasting further growth of 2.4% for this year. Findings from economic and business surveys, while still encouraging, did dip a little in December and January. The serious flooding in many parts of the country will have adverse implications for the economy. The floods caused major disruption to the transport network and hit farmers as well as sectors like retailing and tourism hard. Some experts are putting the cost of a month of paralysis caused by flooding in the Thames valley area at around one whole GDP percentage point, expressing some concern the negative knock-on effects might well stretch into May. However, the slowdown might well be offset at a later stage by a rebound in construction as major repair work gets under way. The upheavals caused by the floods come on top of concerns the upswing in the economy is founded on imbalances. The recovery is chiefly being fuelled by steep rises in housing prices which is driving spending by consumers who still have sizeable debt overhangs, but, on the downside, both business investment and exports are lagging behind.

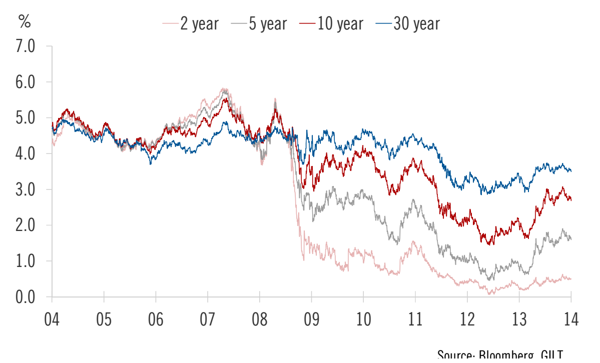
In view of the probable repercussions from bad weather on growth, the ongoing deceleration in inflation and the likelihood of the base rate staying where it is throughout this year, the gilts market looks set to remain in a tight range over the next three months of so.

UK

SHORT-TERM RATES (GBP)



UK TREASURY YIELDS



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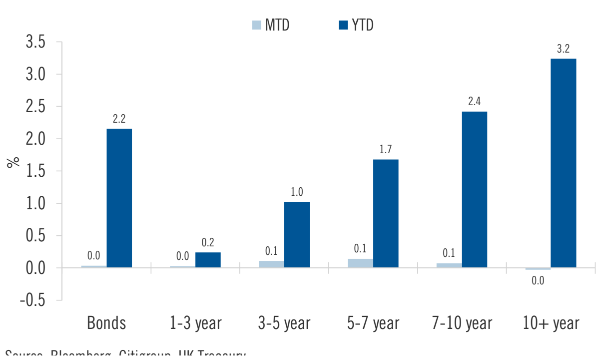
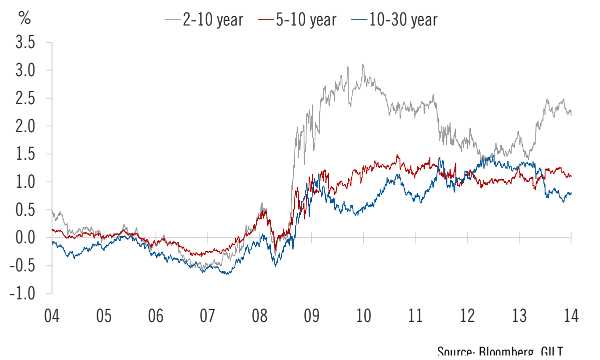


MOVEMENTS IN YIELD SPREADS



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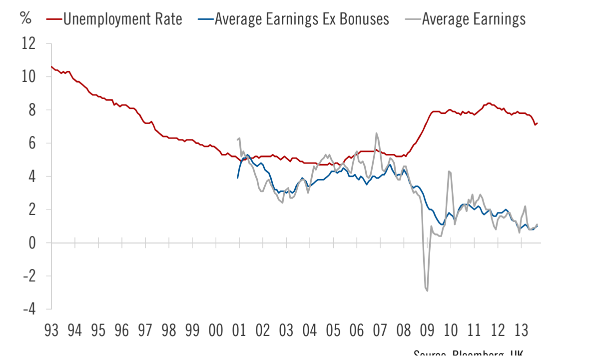
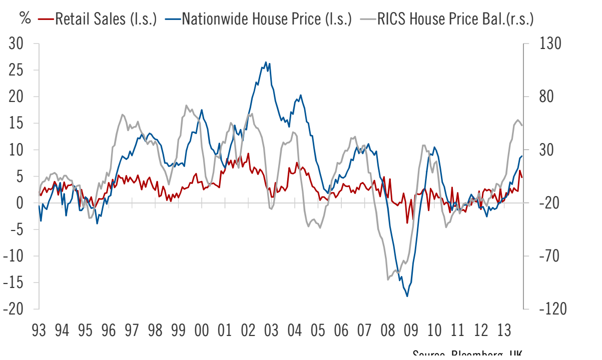
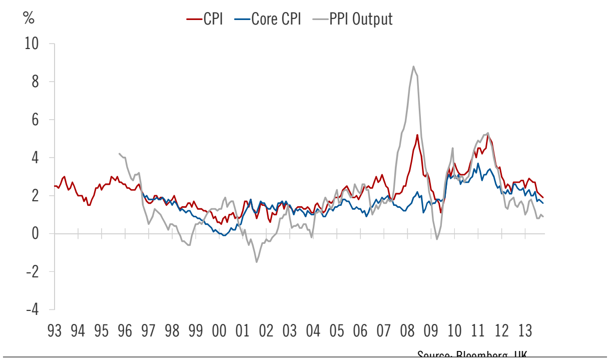


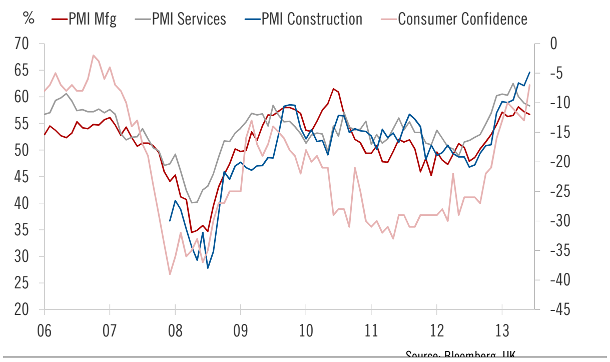
HOUSING AND RETAIL SALES



INFLATION



ECONOMIC SURVEYS



Vote against immigration has opened the door to uncertainty

GDP growth this year is unlikely to be really affected by the outcome of the vote, and, for now, forecasters have barely changed their projections

Recent statistics released have confirmed the bright outlook. The KOF Economic Barometer extended its uptrend in January, advancing from 1.95 to 1.98, the Manufacturing PMI rebounded from 55 to 56.1, and the quarterly survey conducted by the State Secretariat for Economic Affairs (SECO) revealed consumer confidence remains on an upward trajectory. The Swiss are upbeat about how Switzerland's economy is performing. The 1,200 householders polled voiced greater optimism about overall economic prospects as well as their assessment of their personal financial circumstances for the next 12 months. In contrast, UBS's Consumption Indicator fell from 1.81 to 1.44 in January. The ZEW-CS Indicator measuring economic expectations for Switzerland also declined for the second month in a row, down from 39.4 to December to 28.7 in February. The unemployed total rose by 3,823 in January to reach 153,260. That rise can once again be blamed on seasonal swings, with the seasonally-adjusted jobless rate still steady at 3.2%. Economic growth was weaker than expected in the final quarter of 2013 due to the 1.7% drop in exports. GDP advanced by just 0.2%, instead of the 0.4% expected and a rate slower than that registered in the eurozone.

Still no inflation on the radar

Consumer prices fell 0.3% m-o-m in January, mainly as a result of the sales of clothing in stores. Prices on domestic items edged up by 0.1% m-o-m whereas imported product prices fell quite steeply by 1.3%. The headline rate of inflation was flat at -0.1% y-o-y, but the underlying rate sank back into the negative zone as well, to -0.1%.

Although reactions to the referendum outcome on immigration have been minimal, both Fitch and Moody's have sounded a warning bell

Although UBS remains very upbeat about growth in Switzerland for this year in spite of the approval of the Swiss People's Party anti-mass-immigration initiative, the other Big Two bank, Credit Suisse, is less so. UBS is looking for GDP growth to quicken to 2.4% for this year from 2.1% in 2013, but it is now expecting the Swiss franc to weaken on account of the increasingly unsettled atmosphere. Credit Suisse has voiced concerns the uncertainties might well cause a slowdown in business investment and less job creation over the coming years. A scaling-back of immigration could hurt the property market which is already being curbed by changes to the countercyclical capital buffer involving a more stringent capital requirement being imposed on banks, raised from 1% to 2%, to cover lending on their mortgage books as from 30 June.

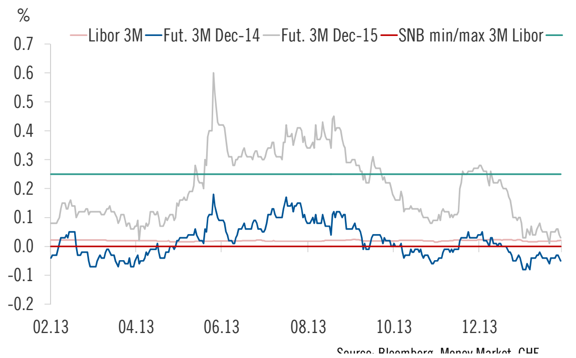
The agencies have already commented on possible negative effects from the vote on Switzerland's economy, citing, in particular, access to EU markets, availability of skilled labour and the impact on the property market. Moody's pointed out that curbing immigration could well dent the country's growth potential, wealth and overall economic solidity. In the long run, this could even have an adverse effect on Switzerland's triple-A rating.

Interest rates set to stay low in the months ahead

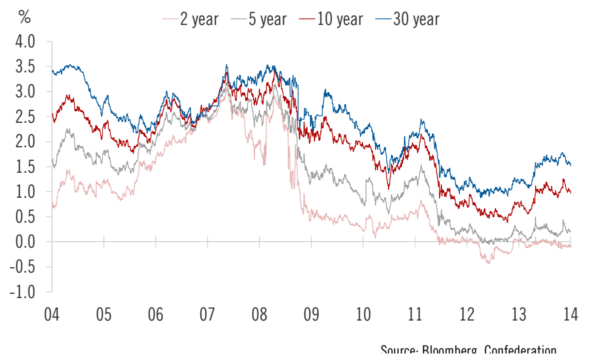
The SNB is unlikely to push up interest rates before next year as forecasts are for inflation to stay subdued, the franc is expected to remain firm and uncertainties persist over the well-being of the economy. In light of that outlook, we expect yields on 10-year Swiss Confederation bonds to hover in a narrowish trading range over the coming three months.

SWITZERLAND

SHORT-TERM RATES (CHF)



CONFEDERATION BOND YIELDS



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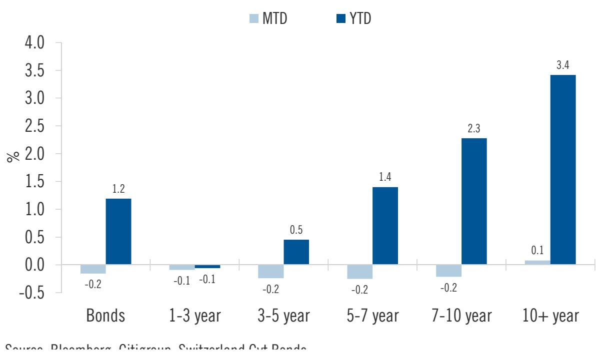
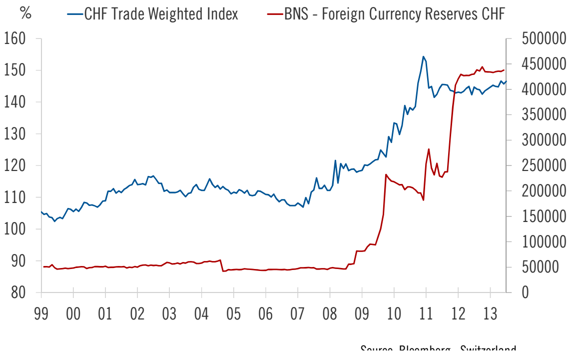
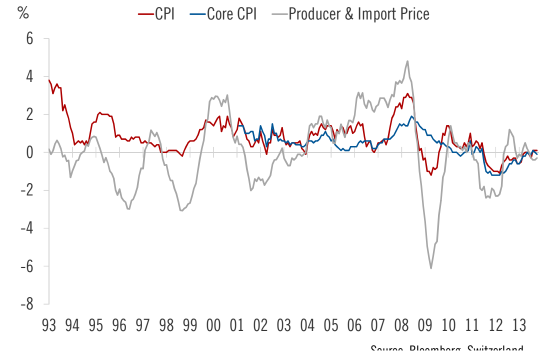


CONFEDERATION - MOVEMENTS IN YIELD

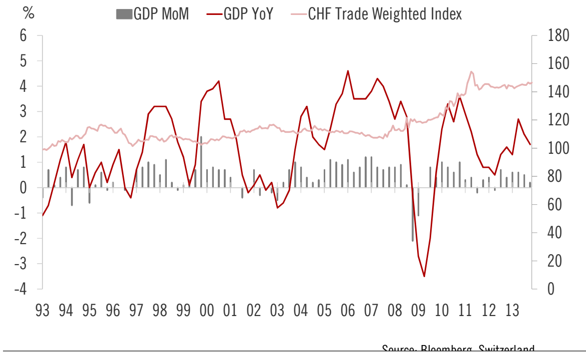
SNB EXCHANGE RESERVES



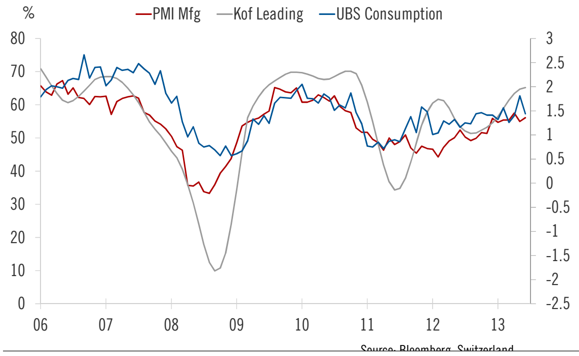
INFLATION



GDP



ECONOMIC SURVEYS



Growth slowing down towards the end of 2013

Consumer confidence declining further ahead of the move to raise the consumer sales tax rate in April

Although consumer spending held up more or less, underpinned by some buying to pre-empt the hike in the consumer sales tax, the barometer of consumer confidence fell by 0.8% in January. Confidence is being knocked as households' income is flat and their purchasing power is being eroded by the return of inflation and, soon, by the increased sales tax rate. This demoralisation is giving rise to concerns consumer spending will slump this spring.

Quickening pace of inflation due to a combination of rising energy prices and a falling yen

The headline rate of inflation was reported at 1.6% y-o-y for December, with the underlying rate, excluding fresh food and energy, at 0.7%. Reflationary measures being pursued by Japan's authorities have helped to push prices upwards. For the time being though, inflation is being fuelled principally by rising import prices, pushed up by the slide in the yen's value. Declining domestic demand, squeezed by the prospect of the higher sales tax, may well exert some downward pressure on prices. Increased prices for electricity and oil, which have been imported in huge quantities since the Fukushima disaster and the shutdown of the country's nuclear power plants, have caused Japan's trade deficit to balloon (up 83% in 2013) whereas the country has, traditionally, been an exporting nation.

Japan's economy slowed noticeably in the latter stages of 2013

GDP increased by 0.3% q-o-q in the final quarter, half the rate that had been expected. This more pedestrian growth, which can be blamed on disappointing consumer spending, export and investment trends, has fuelled doubts about the ability of Japan's economy to cope with the hike in the consumer sales tax.

The fears are being compounded by the fact that structural reforms promised by Prime Minister Abe, which have been running into fierce opposition, have been slow in materialising. Although the yen is cheap, exports are flat, penalised by anaemic demand from emerging economies and Europe. It cannot be taken for granted that the Bank of Japan's aggressive monetary easing and the government's array of reflationary plans are going to be enough to ensure Japan returns to the path of sustained and sustainable growth.

Although the BoJ remains watchful, further mini-budget packages and wage increases might have to give growth a lift

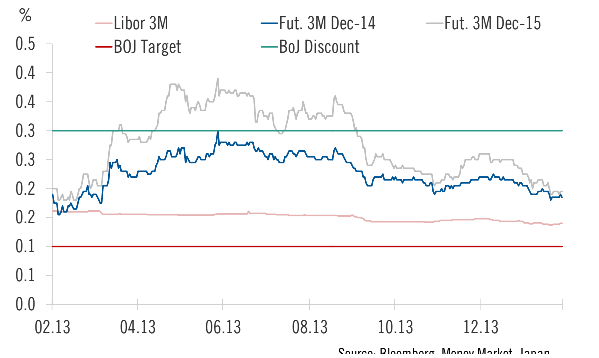
In a bid to boost domestic demand, the government has called on State agencies and local authorities to spend the budget package of EUR40bn made available as quickly as possible. It is also urging companies to raise wages when the traditional pay-bargaining round occurs in the spring.

At its February meeting, the Bank of Japan (BoJ) decided to extend by a year the trio of loan facilities intended to encourage banks to lend. Even though there have been signs recently of the economy slowing and as the sales tax hike is looming, the BoJ remains confident the economic recovery will continue, but it is still prepared to push through further measures if required.

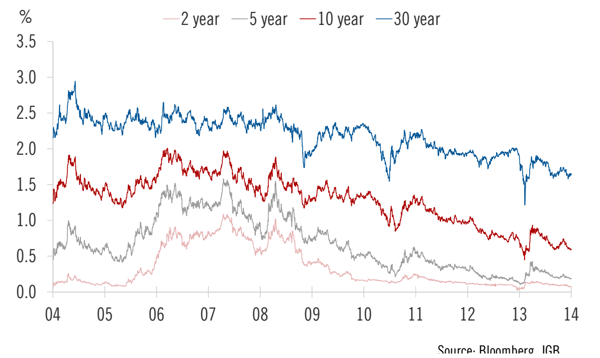
Over the next few months, the BoJ's activist approach should continue to underpin the market for Japanese government bonds, but it cannot be ruled out that yields might move even lower, tumbling to their all-time lows of 2003, especially if the sales tax hike dents consumer spending.

JAPAN

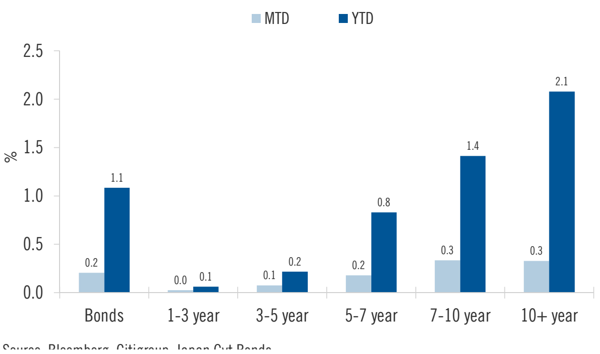
SHORT-TERM RATES (YEN)



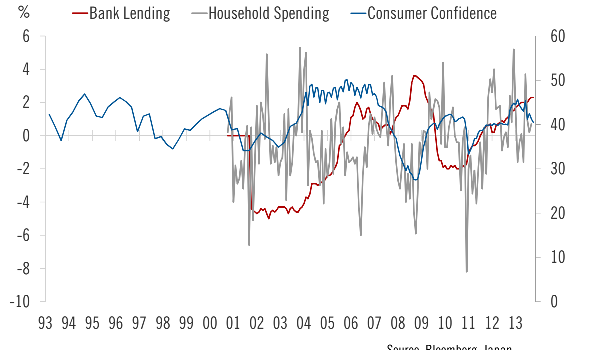
JAPANESE GOVERNMENT BOND YIELDS



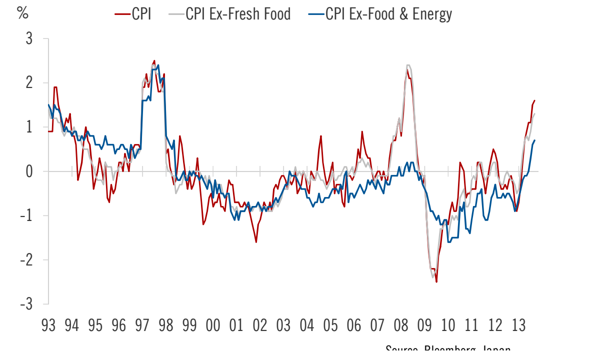
RETURNS FROM GOVERNMENT BONDS BY



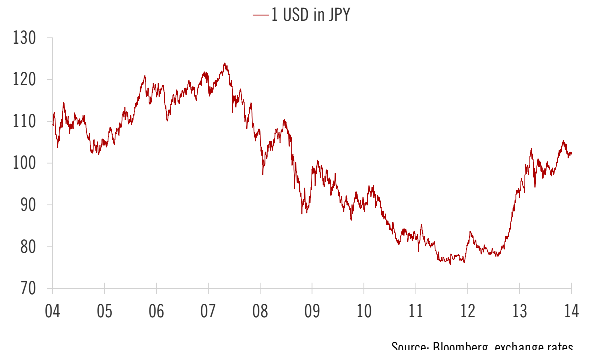
CONSUMPTION



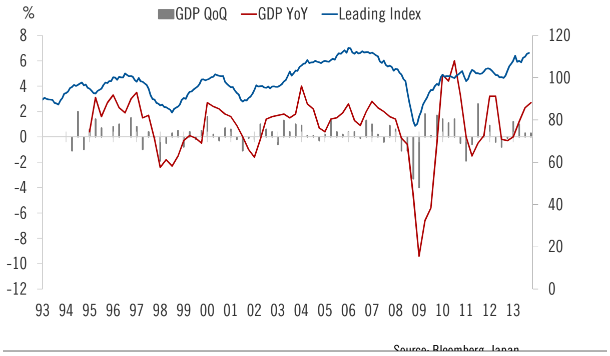
INFLATION



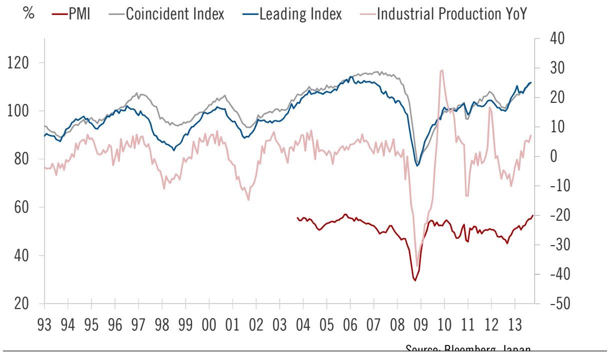
JAPANESE YEN VERSUS DOLLAR



GDP



LEADING INDICATOR AND INDUSTRIAL



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