Monthly Bond Letter

August 2013

Pictet Asset Management

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OVERVIEW

Recent developments

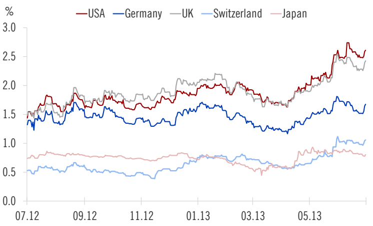
Ben Bernanke managed to soothe the markets by fleshing out some of the details

Minutes from the Federal Open Market Committee (FOMC) meeting revealing positions were less clear-cut and hard-line than expected, together with clarifying comments from Fed Chairman Bernanke, helped ease fears about a U-turn in US monetary policy. Ben Bernanke offered further elucidation on two occasions in July. The severe correction endured by all segments of the bond market, which was on the brink of degenerating into a full-blown crash, undoubtedly spurred the Fed Chairman into clarifying his message that was deemed to have been misconstrued by the markets.

The Fed has indicated it will keep those bonds acquired on its books

Ben Bernanke pointed out that the tempo for buying bonds under the Fed's programme was not following a pre-ordained trajectory. Moreover, he sought to provide reassurance about uncoupling any tapering of quantitative easing from the onset of a cycle of hikes in the Fed funds rate. The Fed also disclosed more detailed information about the fate of bonds that had been bought, confirming it would keep both mortgage-backed bonds and US Treasuries on its balance sheet.

10-YEAR BOND YIELDS



Source: Bloomberg, 10 Yr Govt yields

This clarification from the Fed, coupled with more mixed economic statistics for both the USA and China, restored a degree of calm to US Treasury bonds and risk asset classes. The yield on 10-year US T-bonds sank bank to 2.48% after climbing as high as 2.66%.

In Europe, the ECB is committed to keeping interest rates low, and economic numbers have been picking up

At the end of the ECB's July meeting, ECB President Mario Draghi reported the eurozone central bank's monetary policy would remain accommodating for as long as needed, pledging to keep interest rates low or even pushing them lower. In addition, the ECB offered a further boost for financing of companies and small businesses, by relaxing rules on eligible collateral in the shape of asset-backed securities. It would henceforward accept more securitised products as collateral.

Economic news made slightly more encouraging reading, sparking hopes of a recovery kicking in towards the end of the year. Although unemployment is still tracking a worrying course, Purchasing Managers' Indices posted better scores than expected, with the Manufacturing PMI up to 50.1 and the Services PMI at 49.6.

The long-running eurozone saga ensured volatility did not diminish on peripheral eurozone markets and helped Bund yields to settle, with the 10-year yield easing back to 1.50%.

Senate elections in Japan have opened the door to a period of political stability

As the Liberal Democrat Party (LDP) and its centre-ground allies managed to secure an outright majority in the Upper House of the Diet, Shinzo Abe now has free rein for the next three years. After the economic recovery phase, the Japanese will doubtless have to cope with a string of unpopular reforms, alluded to by the LDP, which had been sidelined in the run-up to the crucial elections. One of the first measures could well be a shake-up of employment rights.

Good month for risk assets in July as they recouped some of the ground they had lost

Reassuring noises being made by the global community of central bankers about ongoing accommodating policies helped calm to redescend on corporate bond and emerging-market debt markets. High-yield corporates and dollar-denominated emerging debt delivered the best gains. All high-yield segments posted positive returns, with the most cyclical issues enjoying the best gains.

OVERVIEW

Forecasts

The scenario envisaging a recovering economy in the USA remains a valid one

Upturns on the housing market, in unemployment and in lending to the private sector are ongoing whilst the budget deficit is being reduced faster than predicted, which prompted credit-rating agencies to put the USA's outlook label back to 'Stable'.

The option left open by the Fed about tailoring the amounts of bonds being repurchased depending on how the economy is faring will tend to see investors reacting rather jitterily to any positive statistics. Their eyes will be riveted on jobs data when released. If the upswing is confirmed, yields on 10-year US T-bonds might well rise to test out the 3% barrier in the second half of the year.

The long-running eurozone saga is fuelling volatility on peripheral markets

Business survey findings have confirmed the eurozone economy is stabilising, and an upturn might well materialise in the latter half of this year. Given the prospect of the economy exiting the recession and considering fears over QE tapering by the Fed, there is a risk 10-year Bund yields might well edge upwards although a rate cut by the ECB cannot be ruled out as a possibility. The yield curve could steepen if the economic upswing is confirmed, especially as Bund yields have become quite distinctly decoupled from US T-bond yields, with the spread widening to 94 basis points.

As the economic situation in many European countries is still delicately poised, spreads on peripheral markets are likely to remain prone to volatility. The possibility of some softening round the edges or even a U-turn on austerity policies would have a knock-on effect on rates.

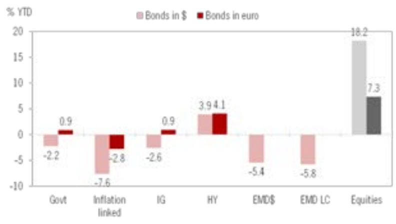
After the highs and lows during the spring, Japanese government bonds should be heading for a spell of stability

Yields on 10-year Japanese government bonds (JGBs), which had sunk back to their all-time lows of 0.3%, moved up to 1% in May as expectations over economic growth and inflation were adjusted in response to the Bank of Japan's move to adopt ultra-accommodating policies. Yields then levelled out. Over the next few months, we expect JGBs to continue being underpinned by the BoJ's wholesale purchases, with yields being fairly tightly range-bound in spite of the likelihood of more JGBs being issued. Confirmation that the Japanese economy is recovering might, however, bring about a change.

Corporates and emerging-debt markets remain exposed to the risk of the streams of liquidity drying up

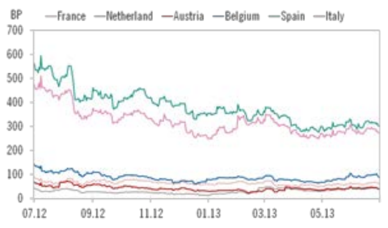
As trading activity looks more than likely to diminish over the next few weeks, any narrowing of spreads and returns from European corporates are likely to be limited. The main influences in the short and medium terms will remain developments on both the political and economic fronts in Europe. Expectations over the course of Fed monetary policy and any fresh bout of weakness on emerging markets might also enliven trading in the corporates segment. Prospects of the ECB persevering with its highly accommodating stance, moderate economic growth and subdued inflation in Europe are positives for the high-yield corporates segment.

PERFORMANCES 2013



Source: Bloomberg, Barclays, Citigroup, BoA Merrill Lynch, JP Morgan

10-YR GVT SPREADS VS GERMANY



Source: Bloomberg, gvt yield spreads

INFLATION-LINKED BONDS

Inflation-linked bonds bounce back

Ben Bernanke adjusting his sights

After alluding in his 22 May testimony to Congress to the possibility of the Fed's monthly bond-repurchasing programme being reined in, Fed Chairman Bernanke fine-tuned his public message twice during July. The severe correction endured by all segments of the bond market, which was on the brink of degenerating into a full-blown crash, undoubtedly spurred the Fed Chairman into clarifying his message that was deemed to have been misconstrued by the markets.

The notion of the initial tapering and subsequent halt to the purchasing programme being uncoupled from the onset of a fresh cycle of monetary retightening was conveyed on 10 July at a National Bureau of Economic Research (NBER) conference to mark the Fed's centenary. Then, on the occasion of Fed Chairman Bernanke's 16th Humphrey Hawkins testimony to the House of Representatives and the Senate (17/18 July), the message was sent out even louder and more clearly. Comments as regards the economy are still the same as those voiced by the FOMC after its 18 June meeting, embroidered with a few less upbeat nuances. The tempo of economic growth regarded as moderate is being matched by robust upturns in the housing and jobs markets. However, although almost 200,000 jobs have been created each month since the outset of the year, the state of affairs is, according to Ben Bernanke, far from satisfactory. He added that, even if the unemployment rate does drop to 6.5%, this will not necessarily be the trigger for monetary screws to start being retightened if expanding employment has come at the cost of further shrinkage in the workforce.

Rate at which bonds are being repurchased each month is not following a pre-ordained trajectory

The most insistent point being delivered lies in the variable way in which the asset-repurchasing programme underway is being managed. The markets had factored in an impending reining-in of purchases and a pre-programmed winding-up process, followed by QE being shifted into reverse and interest rates reverting more to normal. Any boosting, tapering or halting of quantitative easing is now firmly tied up with the ebb and flow of economic data releases. This meandering path means long-bond yields are likely to track a less linear course, which, during the initial phases of correction, might well pose a threat to the economic upswing in progress. The reverse side of the coin will, however, see a spike in volatility in response to any significant economic number that comes in either way above or well short of expectations.

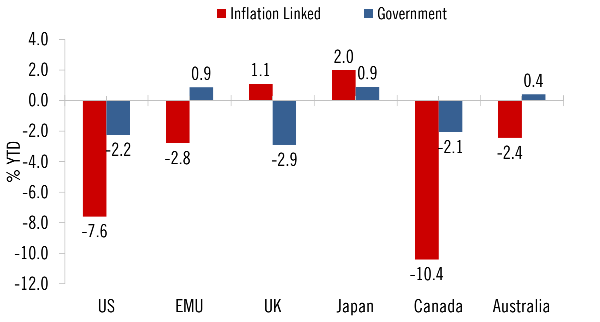
The Fed pledging to keep those bonds acquired on its books

Recently, the Fed had indicated mortgage-backed securities (MBSs) sitting on its balance sheet (USD1.235bn) would not be offloaded once the time did eventually come to exit from QE. The likely fate of US Treasury bonds (USD2,000bn on the Fed's books) remained unclear though. One of the key points clarified during the 17 July testimony was the commitment that US Treasury bonds would no longer be sold off and that proceeds of maturing bonds would be reinvested, even after the repurchase programme was halted.

The scenario of a QE exit by draining liquidity from the market (term deposits and reverse repos) rather than by selling assets has been reinforced, which will imply the Fed's balance sheet retaining a stable size after the purchases stop and even during the early onset of normalisation. Real rates, which had overshot, drifted back down by almost 50bp to level off at 0.25% on 10-year bonds. The squeeze on these rates to artificially low levels had been wrought by the Fed's wholesale buying of bonds. With no expectation of this flow of purchases being reversed, the process of real yields reverting to normal will now occur at a much more sedate tempo. At the same time, inflation break-even points edged upwards by 30bp on 10-year bonds to reach 2.20%. As expected, both components in inflation-linked bonds recovered. The long-dated end should continue to rally thanks to its attractive valuation, and the upturn could gain even more momentum if the US Treasury, as has been hinted at, were to decide replace some of its 30-year issues to come with 5-year maturities.

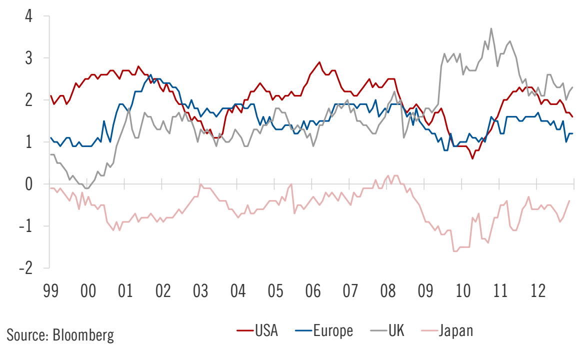
INFLATION-LINKED BONDS

PERFORMANCES 2013 (LOCAL CURRENCIES)



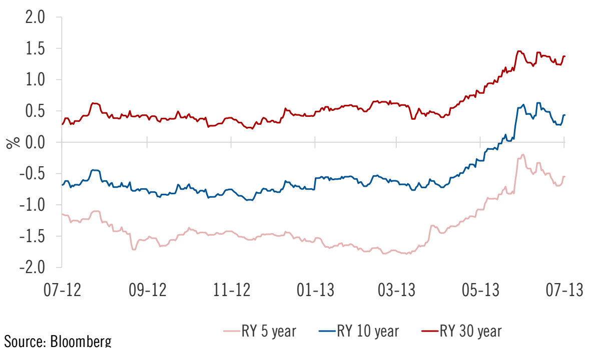
Source: Bloomberg, Citigroup, Barclays

CORE INFLATION



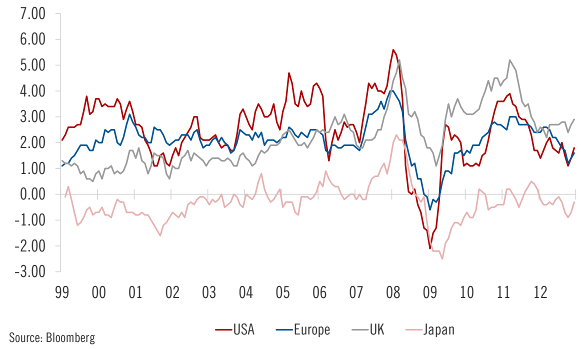
Source: Bloomberg

USA - REAL RATES



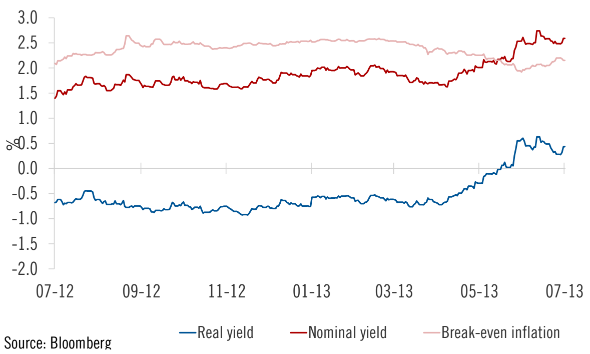
Source: Bloomberg

INFLATION



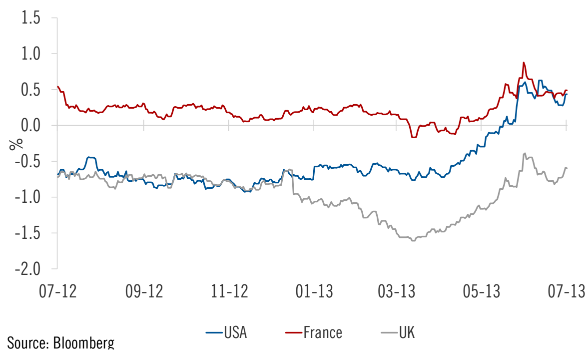
Source: Bloomberg

USA - 10-YEAR TREASURY YIELD COMPONENT



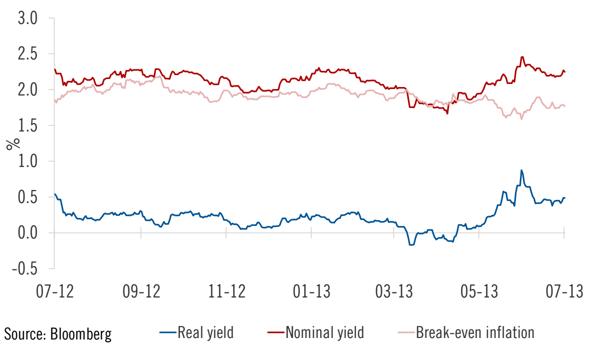
Source: Bloomberg

10-YEAR REAL YIELDS



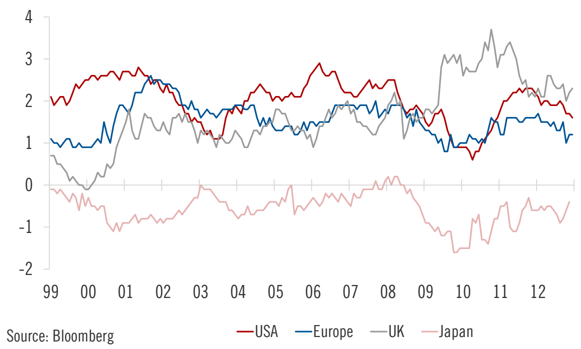
Source: Bloomberg

FRANCE - 10-YEAR YIELD COMPONENT



Source: Bloomberg

10-YEAR BREAKEVEN INFLATION POINTS



Source: Bloomberg

Good month of July for investment-grade corporates

Returns back in the black

Investment-grade corporate bonds, underpinned by the driftdown in government bond yields, performed well in July, with their returns for the year to date back into positive territory. The average level of credit spreads narrowed and corporate bonds moderately outperformed German Bunds although the pattern did not run evenly across the spectrum. Insurance, consumer, automotive and basic industrials sectors were the outperformers in July, chiefly by virtue of A-rated bonds and maturities between 7 and 10 years. As for subordinated debt, Tier 1 banking issues outperformed whereas hybrid instruments issued by utilities and energy companies delivered negative returns, partly on account of a risk of credit-rating downgrades and partly owing to still sizeable volumes of future bonds to be issued.

Spanish and Italian borrowers delivered mixed results, with financials in the black, but telecom and energy sectors in the red, as they responded to Italy's credit-rating downgrade, changes affecting the financing of power tariff deficits in Spain and uncertainties hanging over the future of Telecom Italia. In the UK, the segments of senior and Lower Tier 2 debt issued by banks were lifted by Nationwide's recapitalisation plans and the government's intention to reprivatise Lloyds.

Activity on the primary market

With interest rates below those on equivalent US corporate bonds and with euro/dollar swap costs holding steady, the euro-denominated corporates market proved an attractive forum for several non-European borrowers, such as Oracle, Toyota, Bank of America, Sumitomo Bank and General Electric, primarily opting for maturities from 7 to 10 years. In the emerging-economy sector, two companies, Gazprom and Banco do Brasil, launched 5-year euro-denominated bonds. After a period during which their appearances were quite scarce, the banks returned to the primary market, with Rabobank, Crédit Agricole, BFCM and Abbey launching senior debt, and the BPCE Group issuing subordinated debt. Italian issuers were also lively borrowers, with Eni, A2a and Ferrovie dello Stato among those to the fore.

Developments on the regulatory front

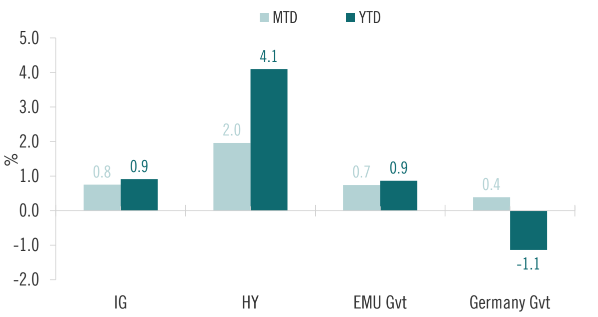
Performances by some categories of debt or specific bonds were influenced in July by what was happening on the regulations front. Tier 1 banking debt, for instance, enjoyed handsome gains thanks to clarification provided by the European Banking Authority (EBA) of their status under the terms of the Capital Requirements Directive IV (CRD IV). When they are no longer eligible as Tier 1 capital, they will no longer be as Tier 2 either. Very swiftly, the markets reacted in anticipation of banks being encouraged to redeem these debt instruments early. In contrast, the possibility of Standard & Poor's reducing the equity portion assigned to Lower Tier 2 debt issued in 2012 by Danske and Société Générale was an adverse development as a clause enables them to redeem the debt at a price lower than the going rate on the market. The latest EU proposals for the bank resolution mechanism, rejected by Germany, have postponed the prospect of an EU-wide banking union a little further into the future. On another front, the ECB did make a move to relax its collateral rules for asset-backed securities and is envisaging also accepting those backed by loans to small and mid-sized businesses.

Outlook

As trading activity looks more than likely to diminish over the next few weeks, any narrowing of spreads and returns from corporates are likely to be limited. The main influences in the short and medium terms will remain developments on both the political and economic fronts in Europe. Expectations over the course of Fed monetary policy and any fresh bout of weakness on emerging markets might also liven up trading in the corporates segment.

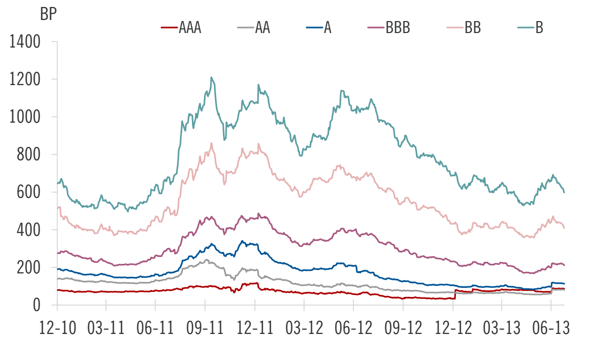
CREDIT RISK

RETURNS ON BONDS IN EURO



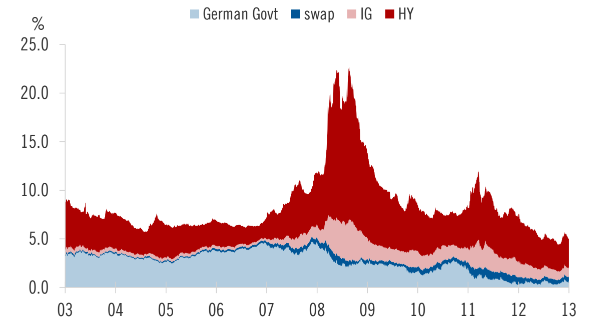
Source: Bloomberg, BoA Merill Lynch, Citigroup

CREDIT SPREADS (EURO)



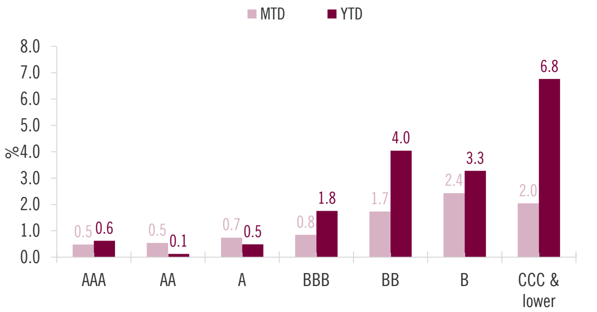
Source: Bloomberg, BoA Merill Lynch

YIELD COMPONENT (EURO)



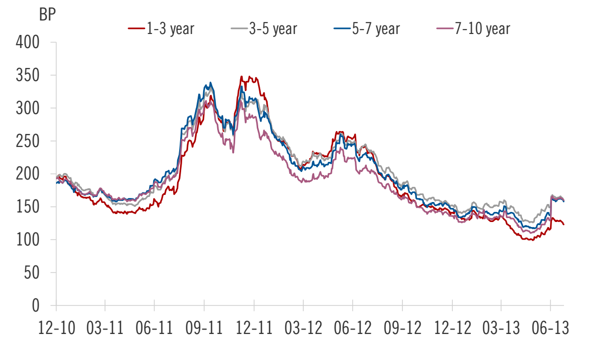
Source: Bloomberg, Barclays, Eur yields

RETURNS ON BONDS IN EURO



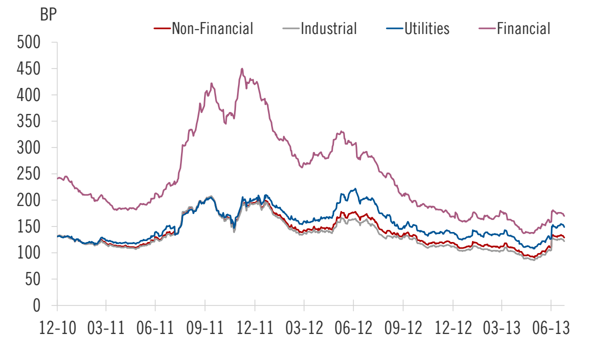
Source: Bloomberg, BoA Merill Lynch

INVESTMENT GRADE SPREADS BY MATURITY (EURO)



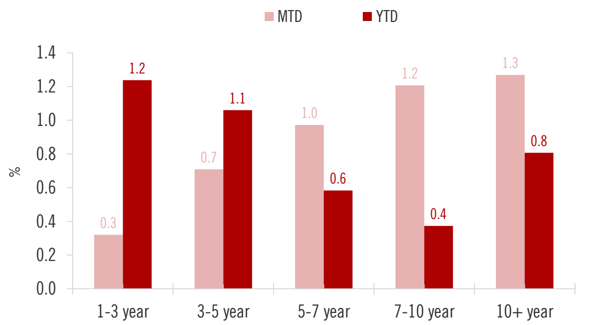
Source: Bloomberg - BoA Merrill Lynch

INVESTMENT GRADE SPREADS BY SECTOR (EURO)



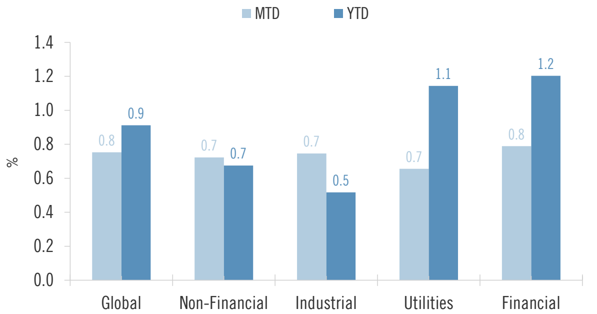
Source: Bloomberg - BoA Merrill Lynch

INVESTMENT GRADE RETURNS BY MATURITY (EURO)



Source: Bloomberg, BoA Merill Lynch

INVESTMENT GRADE RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merill Lynch

Energetic rebound by high-yield corporates

The market, heartened by the Fed's reassurance, delivered some handsome returns

The European high-yield corporates market staged an impressive rebound in July after losing ground in both May and June. Investors' attention remained focused on comments made by the Fed and its Chairman and on the latest set of FOMC meeting minutes. Ben Bernanke patently endeavoured to reassure the markets during his half-yearly testimony to Congress. Economic data released for Europe did not show much progress. S&P trimmed Italy's credit rating on 9 July. Likewise, France's rating was downgraded to AA+ by Fitch which cited the country's debt level and sluggish growth prospects. Fitch was the last of the credit-rating agencies still according France a triple-A status. As for the ECB, its President Mario Draghi took centre-stage, indicating, after the latest Governing Council meeting, that money-market rates would stay low for as long as necessary. In Japan, the ruling coalition, presided over by Shinzo Abe, emerged victorious from the elections to the Upper House. This win augurs promisingly for current policy to continue being pursued as the government now has free rein to implement even quite politically sensitive reforms, especially relating to deregulating the economy.

Against this overall background, European high-yield corporates benefited from the widespread rebound by risk-based assets although the rally that had begun in late June has gradually been running out of steam. All sectors posted positive returns, with the most cyclical issuers enjoying the best gains. Financials, telecoms and basic industrials performed in line with the European high-yield benchmark index. UK borrowers once again performed robustly. On Continental Europe, performances, barring from Portuguese companies struggling as a result of the government crisis, were also positive and fairly even across the board.

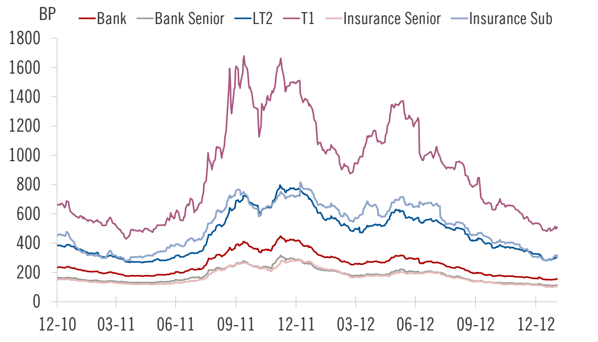
On the primary market, activity did pick up a little in July after being fairly lifeless amid the turbulence of the previous couple of months. The quarterly reporting season has kicked off. No surprises have been seen so far, with results matching expectations. In the aftermath of Italy's sovereign debt rating downgrade, Finmeccanica, the industrial and defence group, was relegated to high-yield status. This had no significant impact on the Italian issuer's spreads as the move had been broadly discounted by the markets. The Germany tyre manufacturer Continental saw its credit rating upgraded to investment-grade by Fitch who lifted it three notches from BB to BBB on 15 July. Fitch reassessed the ties between Continental and its parent group Schaeffler, a high-yield-status issuer for some time, and reaffirmed Continental's solid position in its industry. Lastly, Codere, the Spanish gambling company, at last paid its coupon due on 15 June before the one-month grace period ran out.

Outlook

Our macroeconomic outlook is basically unchanged, with the prospect of anaemic, but at least stable, growth in Europe, accompanied by mild inflation. The climate in Europe, compounded by the highly accommodating monetary policy, is conducive to high-yield corporate bonds. Moreover, with yields steadying in the USA, confidence has returned to the corporates market, especially high-yield segments. The quarterly reporting season should provide further insights into companies' well-being. In the circumstances, the selection of bonds looks of crucial importance to us both when it comes to restructuring portfolios to damp down their volatility, and for generating outperformance. The rebound in the primary market should provide some fresh investment openings. Some first-time issuers should prove of considerable interest, especially those with solid balance sheets and offering investors a handsome issuance premium.

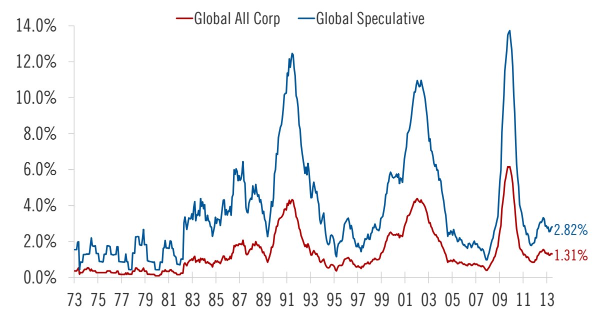
CREDIT RISK

FINANCIAL INVESTMENT-GRADE SPREADS (EURO)



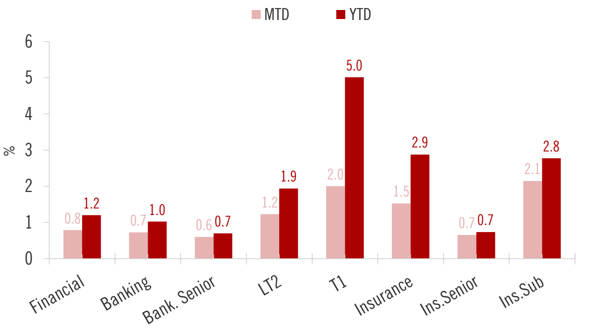
Source: Bloomberg - BoA Merrill Lynch

MOODY'S - DEFAULT RATES



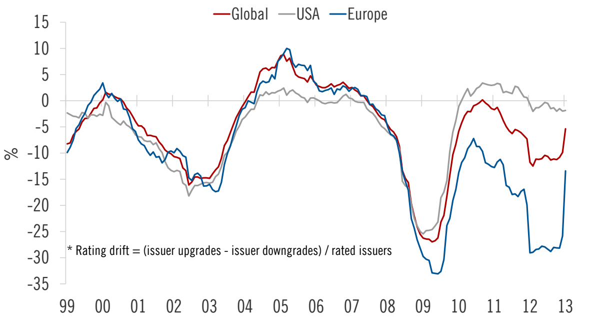
Source: Moody's

FINANCIAL INVESTMENT-GRADE RETURNS (EURO)



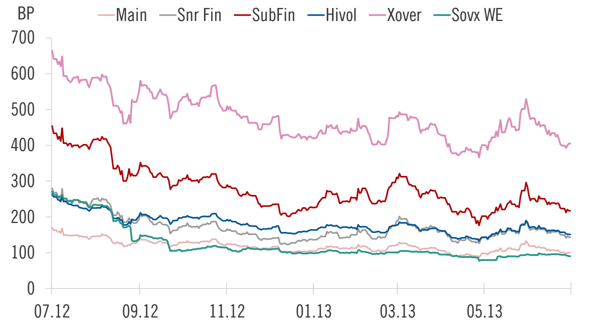
Source: Bloomberg, BoA Merill Lynch

MOODY'S - RATING DRIFT



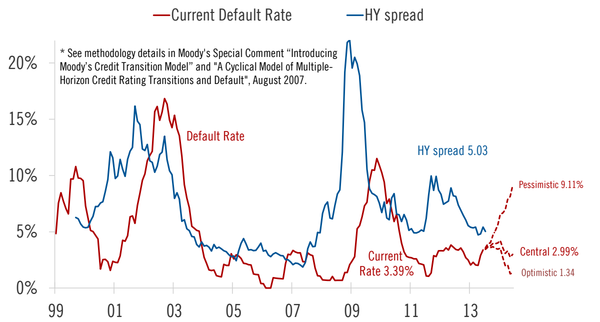
Source: Moody's

CDS - ITRAXX INDICES



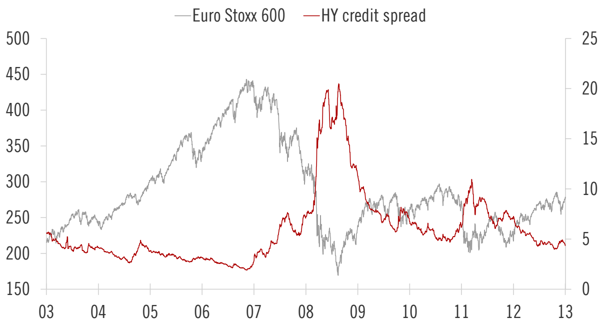
Source: Bloomberg, CDS Itraxx Europe

HIGH-YIELD SPREAD AND DEFAULT RATES (EURO)



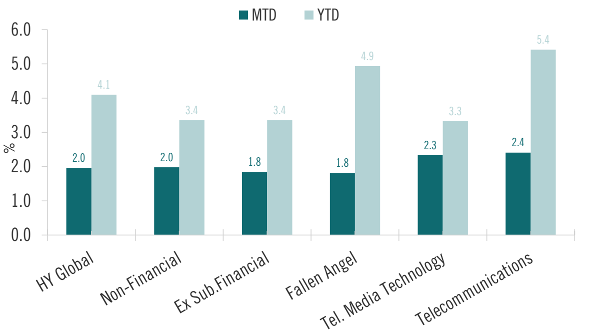
Source: Moody's and Merrill Lynch HY Index

STOCK MARKET & HIGH-YIELD SPREAD (EURO)



Source: Bloomberg, Barclays

HIGH-YIELD RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merill Lynch

Emerging-market debt benefiting from the Fed's clarifications

Local-currency debt – Recent developments

The sizeable swings in emerging-market asset prices we have experienced since late May have led to some clearing of positions and possible opportunities for the asset class. We have seen emerging countries acting to support their economies in ways that are idiosyncratic for them. The Reserve Bank of India acted decisively to stabilise the rupee, tightening domestic liquidity and hiking the upper end of the interest-rate corridor. Turkey has also intervened heavily in the currency market and now looks to be hawkish in hiking rates, whereas Hungary looks to be cutting rates. This once again highlights the diverse policies at play in emerging countries. Surprisingly, we have seen less intervention from Latin American countries than one might have expected given recent weakness. The Mexican peso was the most volatile currency, but we have seen some recovery in the region after Bernanke's public statements mid-month. Nigerian inflation slowed for a second month, reaching 8.4% in June, its lowest rate since April 2008.

Local-currency debt – Outlook

The outlook has seen some change in the short term, but the long-term case is intact. The themes of a firmer US dollar, soft commodity prices and mixed global growth, with continued hints quantitative easing will be phased out early, are pressurising emerging-market currencies and increasingly local rates. However, given the better growth potential in emerging countries and attractive yields with relatively good fundamentals, the potential for returns are still good, but possibly less than forecast at the start of the year. Many of the risks remain the same, such as possible protectionist measures to limit currency appreciation, macroeconomic risks and rising inflation. All these factors will see continued idiosyncrasies and market differentiation.

External debt – Recent developments

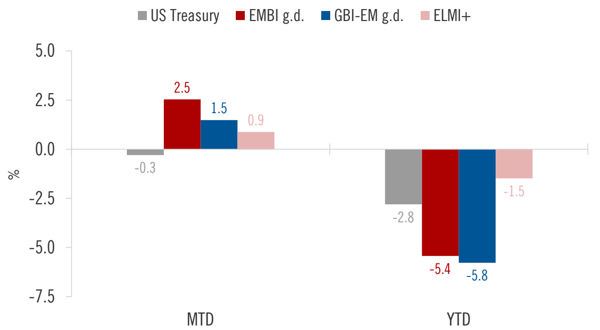
External/USD emerging-market debt saw a strong recovery in July, especially given US Treasury moves, but also some stabilisation in the market for risk assets. Spreads have tightened to around 310bp, which has led to positive returns for most of the countries in the benchmark. However, the asset class still remains vulnerable to external risks, such as US Treasuries and eurozone issues. For Mexico, despite disappointing GDP dynamics, improved fiscal accounts and solid economic policy directives continue to underscore a favourable outlook for external bonds. The widespread street protests that have engulfed Brazil in the last couple of months have the potential to accelerate the ongoing deterioration in Brazil's fiscal stance, which could eventually trigger a rating downgrade. Vietnam's one-party political system has been facing mounting pressure for change amid a groundswell of discontent towards the government in recent years.

External debt – Outlook

Lower-beta countries have an element of correlation with movements in US T-bonds while less correlated countries should continue to provide interesting opportunities. In addition, it is not a static opportunity-set as new bonds are issued along the curve, and new countries are potentially issuing for the first time, mostly sub-Saharan Africa. We see continued convergence of emerging-market credit ratings with developed markets as the latter continue to see downgrades versus upgrades in many emerging countries on the back of robust technical factors, such as debt/GDP levels a quarter that of developed countries, although we will see downgrades at the margins. The asset class is generally well supported by long-term strategic institutions and remains attractive given the low-rates environment, but the possibility of low or negative returns cannot be ruled out.

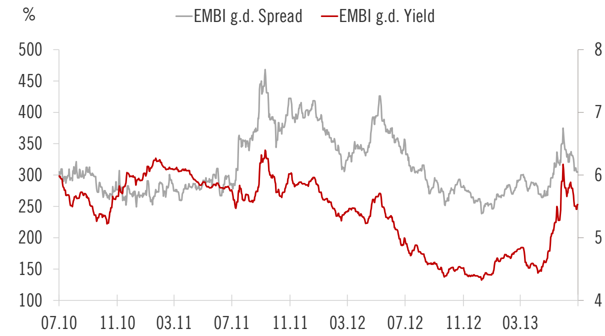
EMERGING DEBT

PERFORMANCES (USD)



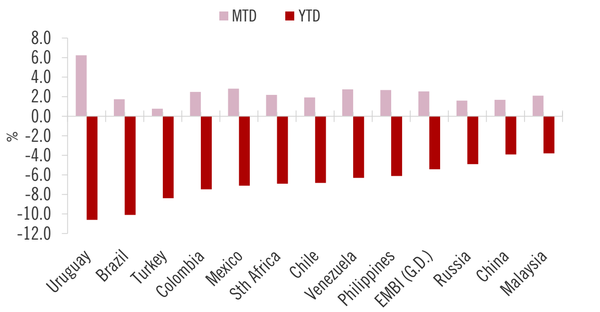
Source: Bloomberg, Index JP Morgan

US DOLLAR DEBT - YIELD & SPREAD



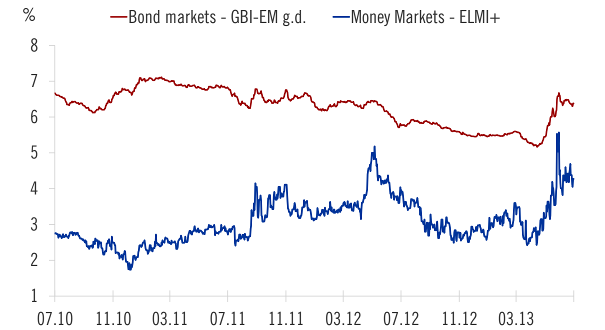
Source: Bloomberg, JP Morgan Indices

JP MORGAN EMBI GLOBAL DIVERSIFIED



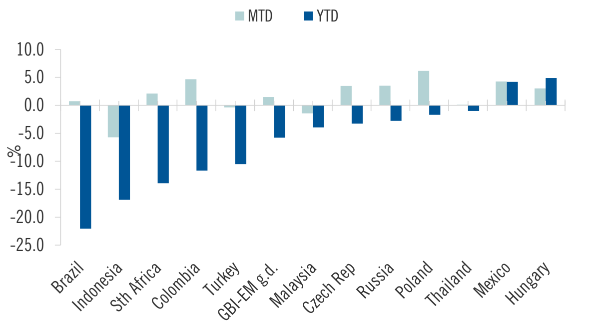
Source Bloomberg: Index JP Morgan

LOCAL CURRENCY DEBT - YIELDS



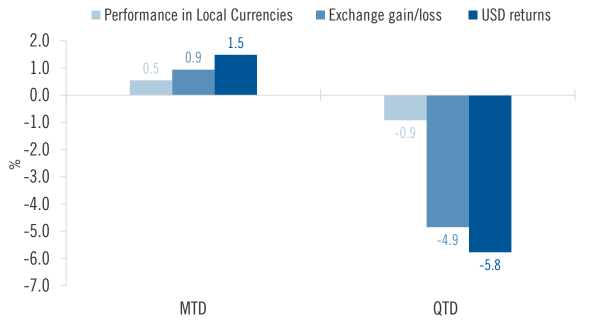
Source: Bloomberg, JP Morgan Indices

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



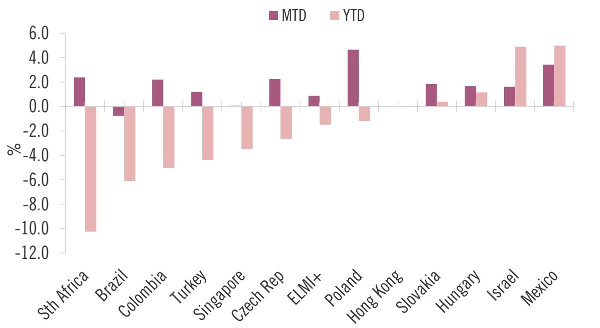
Source Bloomberg: Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



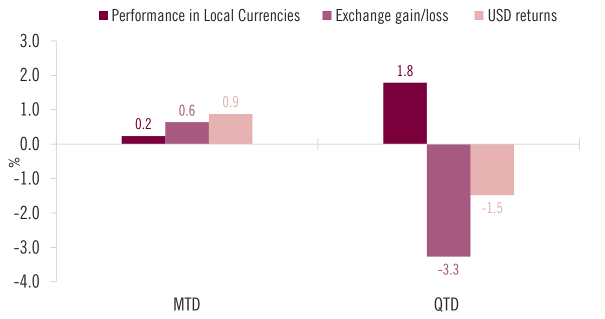
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg: Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

Fed offering reassurance on some aspects

More jobs being created than expected, but economic news flow has still been mixed

The Purchasing Managers' Index for Manufacturing bounced up in June, climbing from 49 to 50.9, whereas the Services PMI slipped lower from 53.7 to 52.2. Retail sales also registered growth (+0.4%), but not as much as had been expected (+0.8%), and, once car sales and energy are stripped out, they actually fell (-0.1%). Industrial output rose by 0.3%. The leading economic indicator was flat whereas economic commentators had been looking for a rise of 0.2.

Payroll numbers were better than had been expected: 195,000 net jobs were created whereas the market had been forecasting just 165,000. Moreover, figures for the previous month were also revised up. On the other hand, the jobless rate was unmoved at 7.6% owing to a rising labour participation rate.

Statistics released relating to the housing market were also a mixed bag. The National Association of Home Builders/Wells Fargo Housing Market Index progressed strongly, up from 52 to 57, and property prices continued to climb. In contrast, figures for sales of existing homes (-1.2%), housing starts (-9.9%) and building permits (-7.5%) proved disappointing. The declines can, however, be blamed on the multifamily housing component which is notoriously volatile. Towards the end of July, news that sales of new homes had risen by 8.3% provided some reassurance.

Rising oil prices fed through into inflation: the y-o-y rate quickened from 1.4% to 1.8% in June, but the core rate eased back a fraction from 1.7% to 1.6%.

The Moody's rating agency modified its outlook label on the USA's sovereign debt rating. As the budget deficit is being brought down, Moody's has moved its assessment back up to 'Stable' on the country's triple-A rating. Last month, S&P also upgraded its outlook to 'Stable', but left the actual rating one notch below Moody's at AA+.

Less hawkish FOMC minutes than expected and clarifying comments from Fed Chairman Bernanke helped to ease fears about a U-turn in US monetary policy

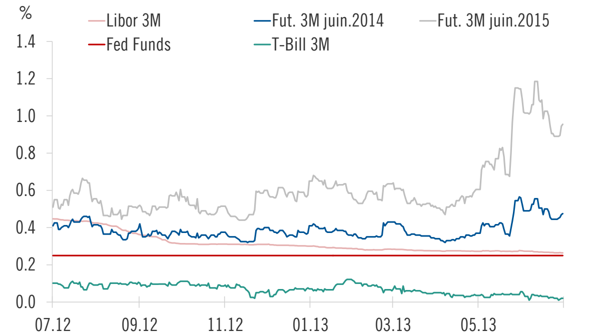
The Fed sought to provide reassurance about uncoupling any tapering of quantitative easing from the onset of a cycle of hikes in the Fed funds rate. It also disclosed more detailed information about the fate of bonds that it had bought, confirming it would keep both mortgage-backed bonds and US Treasuries on its balance sheet.

If economic figures are good, the bond market would be vulnerable

The Fed and, in particular, comments made by Chairman Bernanke, together with some rather more mixed economic news, restored some semblance of calm to the bond market. The yield on 10-year US T-bonds sank bank to 2.48% after climbing as high as 2.66%. The option left open by the Fed about tailoring the quantities of bonds being repurchased depending on how the economy is faring will tend to see investors reacting rather jitterily to any positive statistics. Their eyes will be riveted on jobs data when released. If the upswing is confirmed, yields on 10-year US T-bonds might well rise to test out the 3% barrier in the second half of the year.

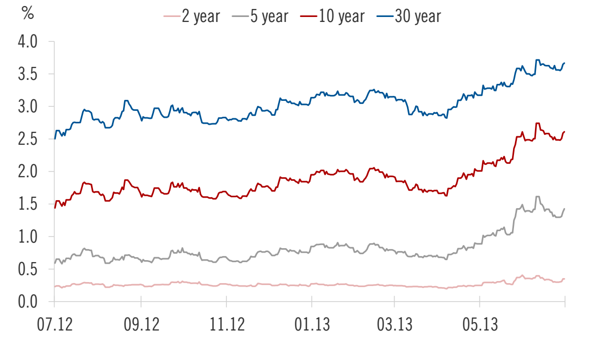
USA

SHORT-TERM RATES (USD)



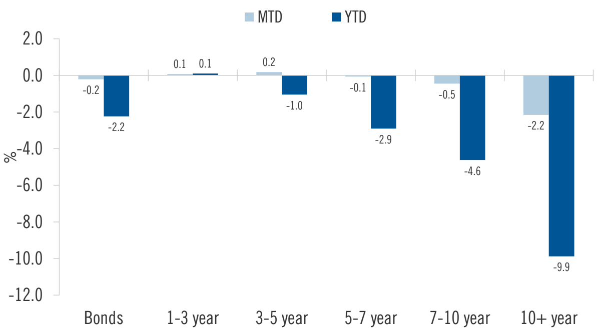
Source: Bloomberg, Money Market, USA

US TREASURY BOND YIELDS



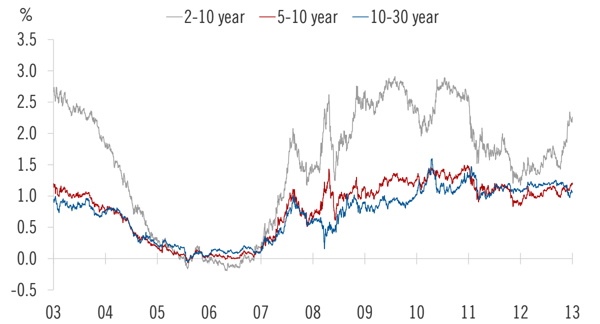
Source: Bloomberg, Us Treasury

RETURNS FROM GOVERNMENT BONDS BY MATURITY



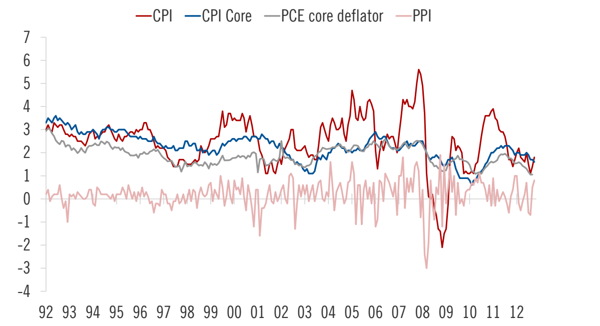
Source: Bloomberg, Citigroup, US Treasury

MOVEMENTS IN YIELD SPREADS



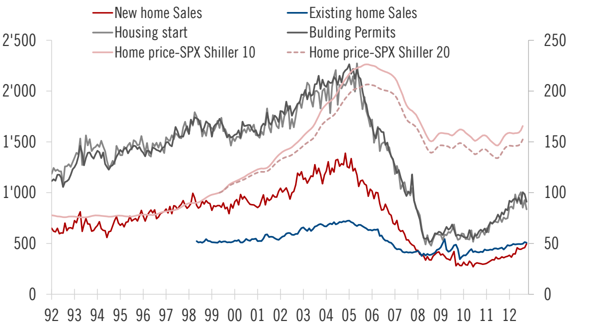
Source: Bloomberg, US Treasury

INFLATION



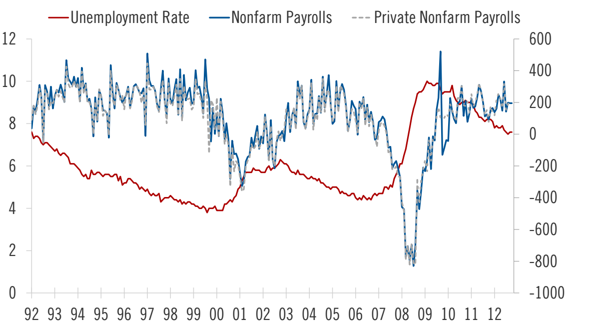
Source: Bloomberg, USA

HOUSING



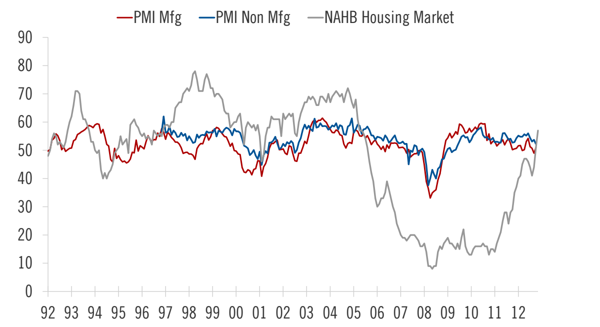
Source: Bloomberg, USA

LABOR MARKET



Source: Bloomberg, USA

PURCHASING MANAGER INDICES



Source: Bloomberg, USA

The ECB makes move to boost financing for businesses

The ECB is committed to keeping interest rates low

At the end of the ECB's July meeting, ECB President Mario Draghi reported the eurozone central bank's monetary policy would remain accommodating for as long as needed, pledging to keep interest rates low or even pushing them lower. In addition, the ECB offered further incentives for financing of companies and small businesses, by relaxing rules on eligible collateral in the shape of asset-backed securities. It would henceforward accept more securitised products as collateral.

The long-running eurozone saga has been fuelling volatility on peripheral markets

In Greece, the small DIMAR party withdrew from the ruling coalition, raising fears the government would lose its majority at a time when the country is still failing to hit its economic targets. Draft reforms to the tax regime and the civil service were at last approved, which should enable Greece to receive the payment of EUR4bn in aid, which had been objected to by Germany, at the end of the month. Cyprus restructured its debt (swapping EUR1bn worth of bonds for longer-dated instruments), which prompted credit-rating agencies to consider the island-state as being in 'selective default'.

A fortnight before the EU and IMF's joint inspection visit to Portugal, the resignations of the Finance Minister, Vitor Gaspar, a fervent proponent of austerity policies, and the Foreign Minister, Paulo Portas, unnerved investors. The yield on 10-year Portuguese sovereign debt shot up by 150bp to 8%. Eventually, a solution was cobbled together to keep the coalition in power.

In Spain where the unemployment rate is running at 27%, new revelations about bribery and corruption have further tarnished politicians' reputations. Prime Minister Mariano Rajoy is directly in the firing-line, with the opposition clamouring for him to resign.

The brittleness of the Letta government in Italy was cruelly exposed by a vote of no confidence and S&P's credit-rating downgrade from BBB+ to BBB with a 'Negative' outlook, the last notch before the slide into junk-bond status. This triggered a wave of readjustments to several Italian borrowers' credit ratings.

Economic news made slightly more encouraging reading, sparking hopes of a recovery kicking in towards the end of the year

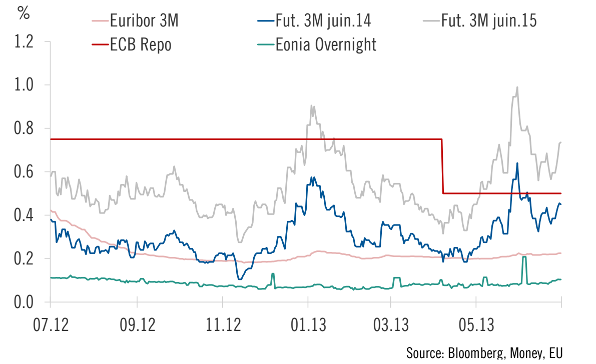
Although unemployment is still on a disturbing trajectory, some indicators have suggested the worst might now behind for the economy. PMI readings have continued to climb, with the Manufacturing PMI progressing from 48.3 to 48.8 and the Services PMI up from 47.2 to 48.3. Preliminary estimates suggest this movement extended into July too, with the twin PMIs climbing further than had been expected, to 50.1 and 49.6, respectively. Retail sales were up by 1% after falling by 0.2% in April; moreover, no country posted a decline in store sales in May. Headline inflation, fuelled by higher energy prices, quickened from 1.4% y-o-y to 1.6% in June, but the underlying rate was unchanged at 1.2%.

Peripheral markets have been volatile, especially Portugal, and the yield on 10-year Bunds inched back down a bit

Given the prospect of the eurozone economy exiting the recession in the second half of this year and considering fears over QE tapering by the Fed, there is a risk 10-year Bund yields might well edge upwards although a rate cut by the ECB cannot be ruled out as a possibility. The yield curve could steepen if the economic upswing is confirmed, especially as Bund yields have become quite distinctly decoupled from US T-bond yields, with the spread widening to 94 basis points.

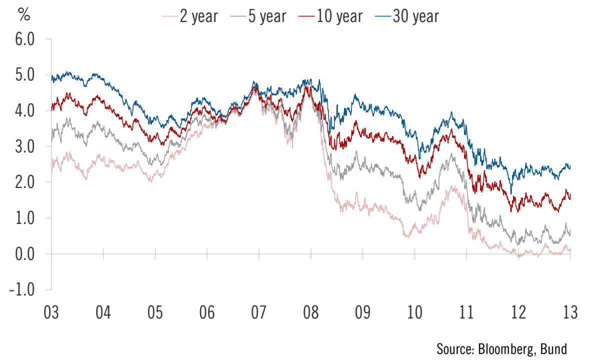
EUROZONE

SHORT-TERM RATES (EURO)



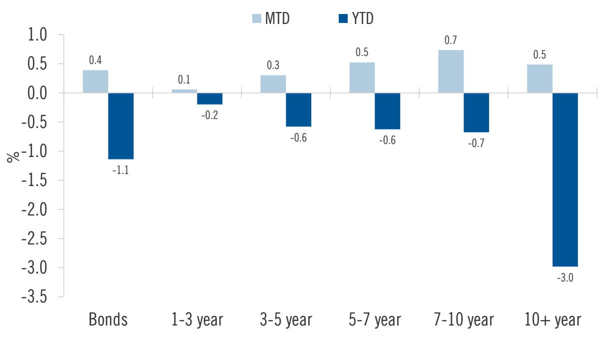
Source: Bloomberg, Money, EU

BUND YIELDS



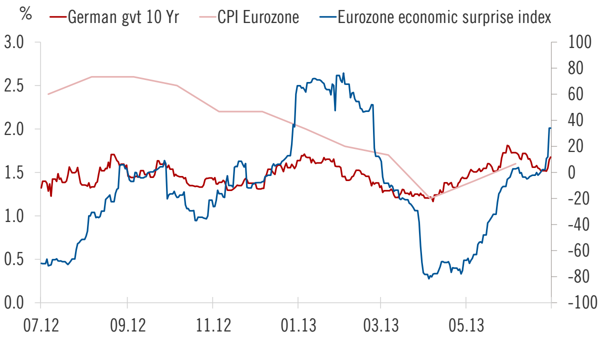
Source: Bloomberg, Bund

RETURNS BY MATURITY (BUND)



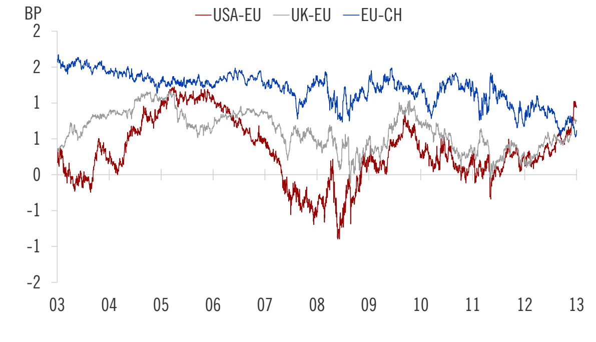
Source: Bloomberg, Citigroup, Germany Bund

EUROZONE ECONOMIC SURPRISE INDEX



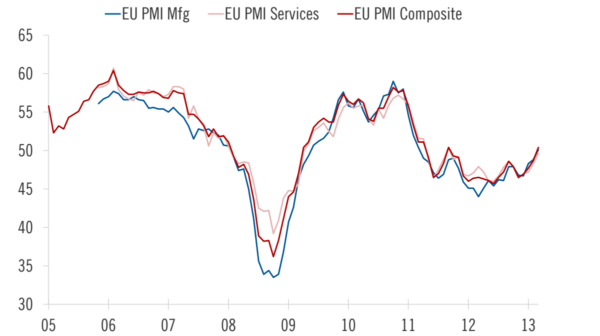
Source: Bloomberg, Citigroup, EU

YIELD SPREADS VS GERMANY



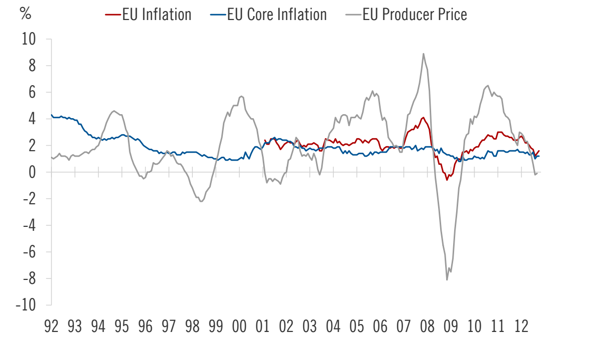
Source: Bloomberg, 10 yr Govt yield spreads

EUROZONE - PUCHASING MANAGER INDICES



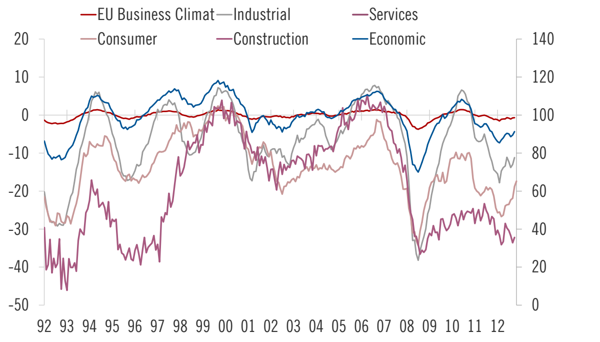
Source: Bloomberg, Eurozone PMI index

EUROZONE - INFLATION



Source: Bloomberg, Eurozone

ZONE EURO - ECONOMIC SURVEYS



Source: Bloomberg, Eurozone Economic Survey

Mark Carney innovates at his very first MPC meeting

UK economy starting to show more distinctive signs of recovering, and inflation on the rise again

UK Purchasing Managers' Indices (PMI) extended their uptrends, with the trio now above the key 50 threshold: in June, the Manufacturing PMI climbed from 51.3 to 52.5, the Construction PMI from 50.8 to 51 and the Services PMI from 54.9 to 56.9. House prices have continued to rise as well, and the index compiled by the Royal Institution of Chartered Surveyors, regarded as a leading indicator for the sector, advanced from 5 to 21 in June. The GfK's UK consumer confidence barometer posted a modest increase in June, edging higher from -22 to -21. Retail sales, which had already risen by 2.1% in May, notched up 0.2% growth in June. The 0.6% GDP growth reported for Q2 2013 confirmed the turnaround in the UK economy. Despite this, forecasters are still erring on the side of caution over the strength of the recovery as the government's perseverance with harsh austerity policies is likely to continue acting as a drag on growth.

In June, consumer prices in the UK fell by 0.2% m-o-m, but the headline y-o-y rate of inflation still advanced for the second month in a row, quickening from 2.4% to 2.9% and moving further away from the Bank of England's 2% target. The underlying rate of inflation has also risen in the last two months, from 2.2% y-o-y to 2.3%.

Monetary Policy Committee unanimously sticks with the status quo and seems to be on the way to being more communicative

As had been expected, the Bank of England (BoE) made no change to its monetary policy in early July. The base lending rate remained firm at 0.5% and the asset-repurchase programme was left at GBP375bn. The BoE did spring one surprise though by providing clarification about its decision straight after the first MPC meeting attended by the new Governor Mark Carney. In a departure from the BoE's usually terse press releases and communication style, the BoE indicated that, in spite of signs of the economy picking up, market expectations of monetary tightening ahead were not justifiably founded. The BoE is of the view that, since its May inflation report, there have been more widespread signs of a recovery, but that the upswing is still gentle. It also pointed out that it expected inflation to continue accelerating somewhat in the near term, but was still looking for the rate to revert to its 2% target in the medium term. These comments confirm the BoE is sticking with its accommodating monetary stance and remains prepared to turn even more expansionary if circumstances call for it.

This suggests several possibilities, in particular further expansion of the bond-repurchase programme and/or the adoption, as the Fed has done, of guidelines setting targets for one or more parameters such as the jobless rate, nominal GDP growth or spending on goods and services. The MPC's meeting in early August, to be followed a week later by publication of the BoE's quarterly inflation report, might well see such new guidelines for monetary-policy direction being implemented.

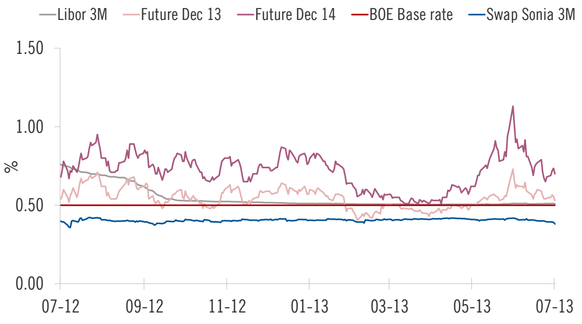
With the economy looking a little stronger, gilts yields may well remain under pressure

Even though signs of the economy turning upwards have been surfacing and inflation has been regaining speed, yields on UK gilts did drift down slightly in response to the BoE's public comments.

Although the performance of the UK economy has made the adoption of new quantitative-easing measures by the BoE somewhat less likely, it is still quite feasible the BoE might indicate that the base lending rate will stay low for some time to come. Given that prospect and the still fragile state of the economic recovery in the UK, the gilts market looks unlikely to suffer any serious correction.

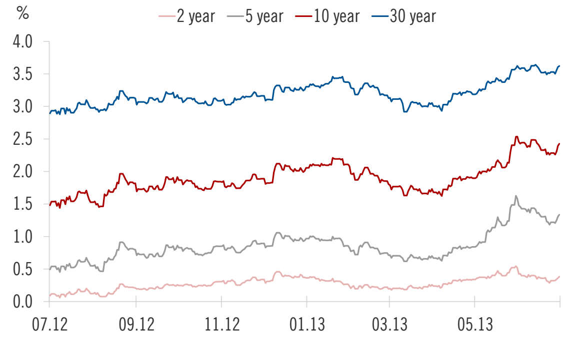
UK

SHORT-TERM RATES (GBP)



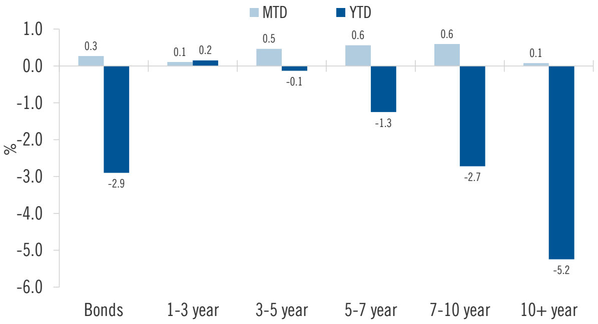
Source: Bloomberg

GILTS YIELDS



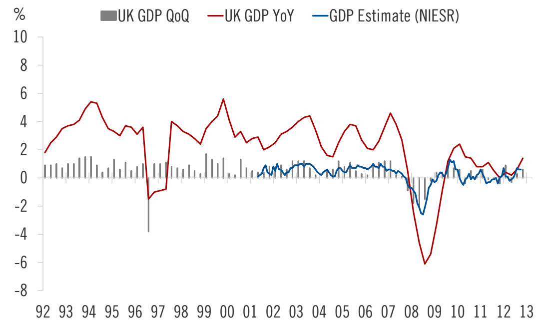
Source: Bloomberg, GILT

RETURNS FROM GOVERNMENT BONDS BY MATURITY



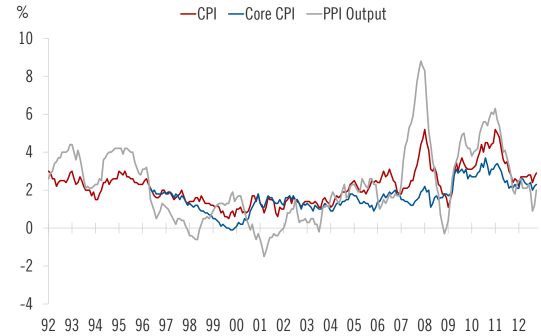
Source: Bloomberg, Citigroup, UK Treasury

GDP



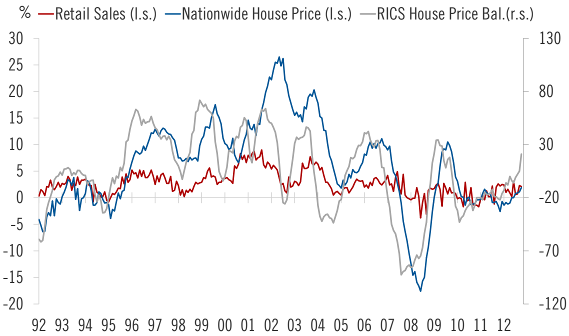
Source: Bloomberg, UK

INFLATION



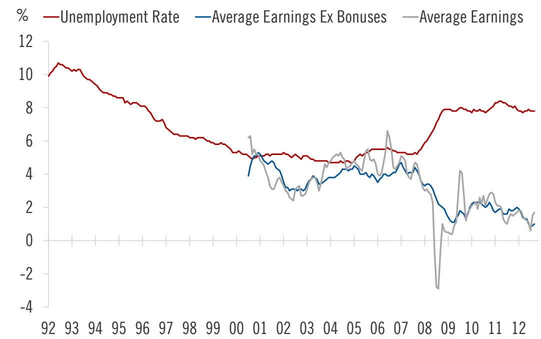
Source: Bloomberg, UK

HOUSING AND RETAIL SALES



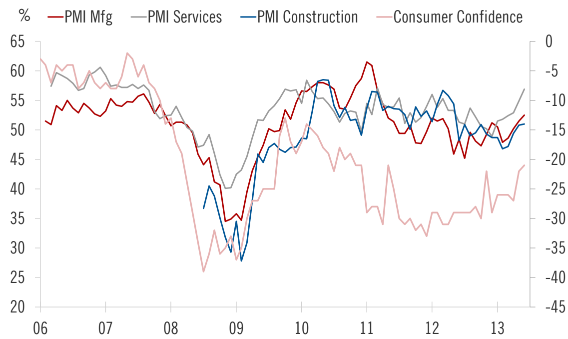
Source: Bloomberg, UK

UNEMPLOYMENT RATE AND AVERAGE EARNINGS



Source: Bloomberg, UK

ECONOMIC SURVEYS



Source: Bloomberg, UK

Interest rates and the franc levelling off

No change in the SNB's monetary policy on the cards

Although Switzerland's property market looks to be overheating, the macroeconomic situation argues against the likelihood of the SNB starting to raise interest rates again for quite some months. Recent statements from senior Swiss National Bank (SNB) officials, coupled with their projections for both inflation and growth, would appear to confirm the scenario envisaging a protracted status quo.

At the outcome of its June meeting, the SNB left its target range for its key interest rate, the 3-month LIBOR, unchanged at 0.0% to 0.25%. It also reiterated its determination to continue defending a ceiling level for its exchange rate at CHF1.20 to the euro. The SNB had instigated this upper limit for the Swiss franc's value in September 2011. It still regards the franc as being at a high level, considering any further appreciation would jeopardise both price stability and economic growth in Switzerland. The SNB's foreign-exchange reserves shrank a little in June to total CHF441bn, but the SNB remains quite ready to buy foreign currency in unlimited quantities to defend the level. If needed, it is also prepared to push through further measures.

After a buoyant opening quarter to 2013, the Swiss economy, which had proved stoutly resilient to the widespread recession in Europe, might lose a little momentum

The SNB believes risks confronting the Swiss economy are still quite considerable, associated in the main – as they have been for some time – with developments on the international scene. The Europe-wide recession and a faltering German economy could well have adverse knock-on effects on the Swiss economy. The SNB has not, however, made any change to its GDP growth forecast: it is still projecting a rate of between 1.0% and 1.5% this year. Although growth was a little more vigorous than expected in the opening quarter of 2013, the SNB believes it will slow down during the year. As for inflation, the SNB only fine-tuned its forecasts, projecting a rate of -0.3% for 2013, compared to its previous forecast of -0.2%. It made no change to its projections for 2014 (+0.2%) or 2015 (+0.7%).

Economic survey findings have been encouraging, but industry and exports are struggling to regain momentum

Switzerland's economy is likely to continue being underpinned by private consumer spending, but economists are guarded about prospects for investments and exports. The machinery industry is still bemoaning the problems being caused by the strong franc and the anaemic state of European economies. The Federal Statistical Office reported that industrial production had increased by 3%, but order books had contracted by 5.2%.

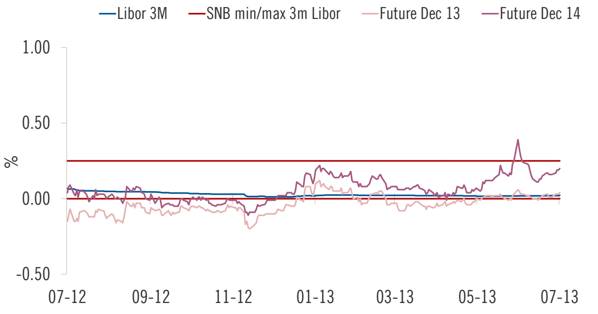
Consumer prices rose by 0.1% in June, but the grip of deflation on Switzerland has continued to ease, with the headline rate now back up to -0.1%. Lower prices for clothing and footwear, associated with stores' sales season, did not compensate for higher prices for oil & petroleum products and for fresh fruit and vegetables.

The Swiss bond market regained some stability in July after correcting in June

Even though Confederation bond yields have risen quite noticeably since the start of 2013, they are still really at pretty low levels. If investors' aversion to risk diminishes, then the corrective phase may extend for longer. Any rise in Swiss bond yields is likely to be limited, however, owing to the support from only subdued inflation, an anaemic economy, official interest rates close to zero and the fact uncertainties surrounding the global economy and future developments in the eurozone are unlikely to be dispelled altogether.

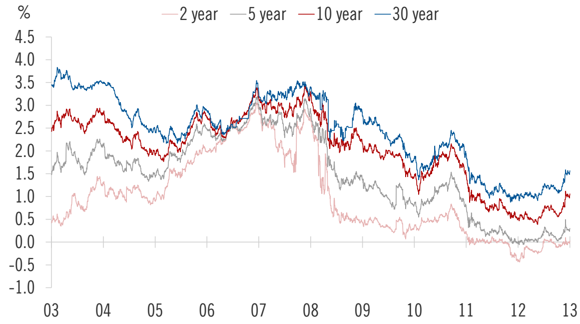
SWITZERLAND

SHORT-TERM RATES (CHF)



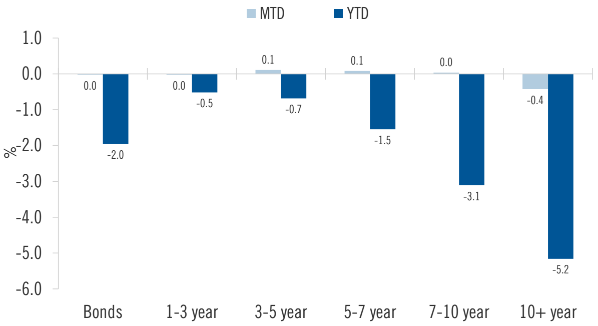
Source: Bloomberg

CONFEDERATION YIELDS



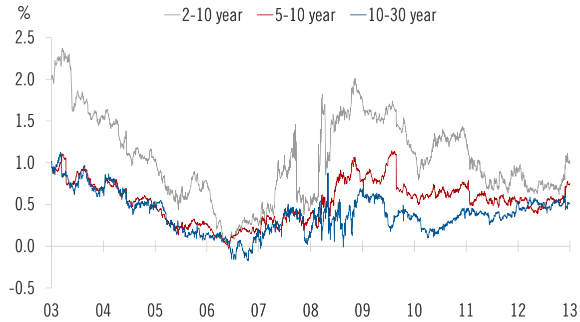
Source: Bloomberg, Confederation

RETURNS FROM GOVERNMENT BONDS BY MATURITY



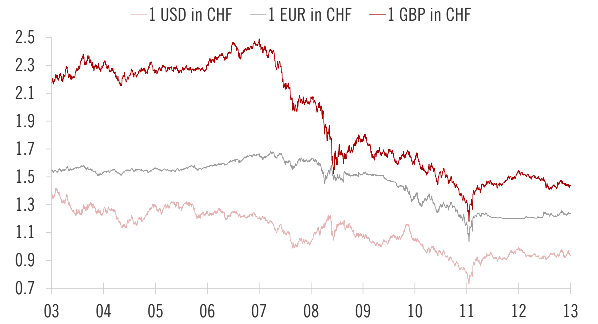
Source: Bloomberg, Citigroup, Switzerland Gvt Bonds

MOVEMENTS IN YIELDS SPREADS



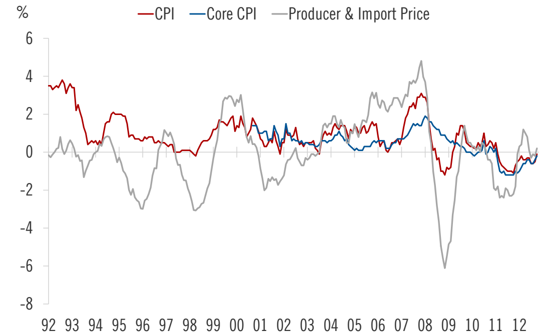
Source: Bloomberg, Confederation

SWISS FRANC EXCHANGE RATE



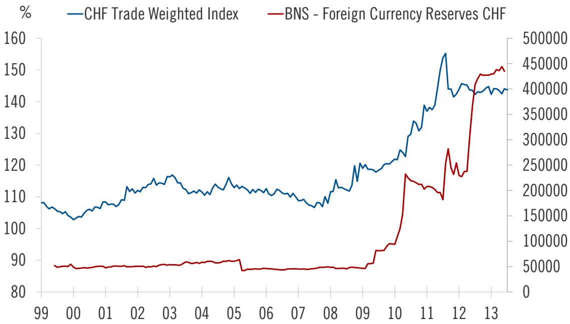
Source: Bloomberg, exchange rates

INFLATION



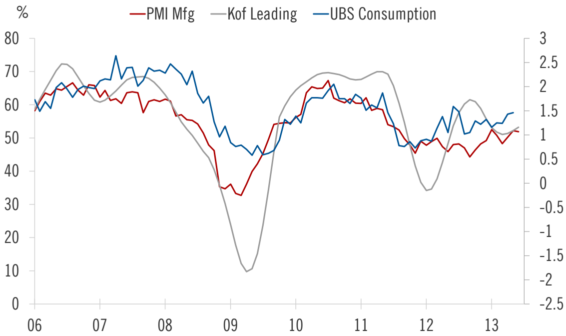
Source: Bloomberg, Switzerland

SNB - FOREIGN CURRENCY RESERVES



Source: Bloomberg, Switzerland

ECONOMIC SURVEYS



Source: Bloomberg, Switzerland

LDP's win should work in favour of reforms being pushed through

Business confidence picking up and deflation fading

Policies being implemented have helped to boost the Japanese economy's recovery. Exports have picked up, boosted by increased sales of cars to the USA, but the slowdown in China and the blurred outlook for the rest of Asia are casting a shadow over Japan's foreign-trade prospects. The grip of deflation has eased, but this can be put down primarily to the spike in energy prices. Industrial output rose by 2% in May, the Manufacturing PMI advanced to 52.3 in June whilst the Bank of Japan's quarterly *Tankan* survey confirmed that business confidence is being restored. The confidence index for major manufacturing companies rose from -8 to +4 points, moving into positive territory for the first time in two years. Big business in Japan also declared itself to be more prepared to invest, with the sub-index for capital spending progressing from -2 to +5.5. Lastly, bank lending has been picking up for several months now, suggesting the Bank of Japan's approach to monetary policy and the brightening economic outlook are underpinning demand for investment.

The BoJ extending its policies, indicating the recovery appears to be taking root

The Bank of Japan (BoJ) did not alter its monetary stance in July and, whilst still employing a more upbeat tone about the outlook for the economy, it did very marginally downgrade its economic forecasts. The BoJ is now projecting GDP growth of 2.8% for the 2013/14 fiscal year. It made no change, however, to its inflation forecast as it still expects the rate to move towards 2.0% by 2015. As expected, the BoJ's Policy Board voted unanimously to stick with its pledge to double the monetary base through buying assets, principally Japanese government bonds (JGBs). The BoJ did highlight the upturn in exports, the halt to the downturn in corporate investment, the rise in public-sector investment and the solidity of consumer spending.

The LDP's victory in the Upper House elections have strengthened the Prime Minister's power

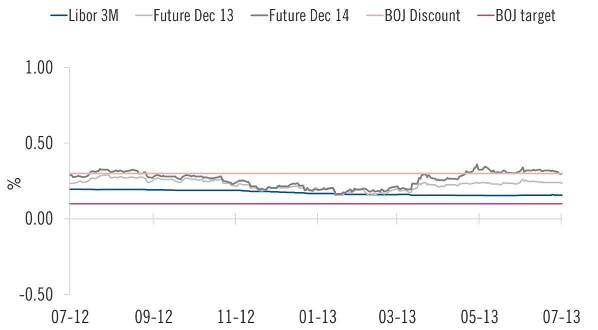
As the Liberal Democrat Party (LDP) and its centre-ground allies managed to secure an outright majority in the Upper House of the Diet, Shinzo Abe now has free rein for the next three years. It will benefit from much greater latitude to stimulate the economy and implement its nationalist ideas. For the first time in five years, Japan should enjoy the benefits of a period of government stability. After the economic recovery phase, the Japanese will doubtless have to cope with a string of unpopular reforms, alluded to by the LDP, which had been sidelined in the run-up to the crucial elections. One of the first measures could well be a shake-up of employment rights which are regarded by business as being overly protective. Prime Minister Abe is keen to liberalise whole swathes of Japan's economy in a drive to attract in foreign investment.

After the highs and lows during the spring, JGBs have enjoyed a spell of stability

Yields on 10-year JGBs, which had sunk back to their all-time lows of 0.3%, moved up to 1% in May as expectations over economic growth and inflation were adjusted. Yields then levelled out. Over the next few months, we expect JGBs to continue being underpinned by the BoJ's wholesale purchases, with yields being fairly tightly range-bound. Confirmation that the Japanese economy is recovering sustainably might, however, bring about a change.

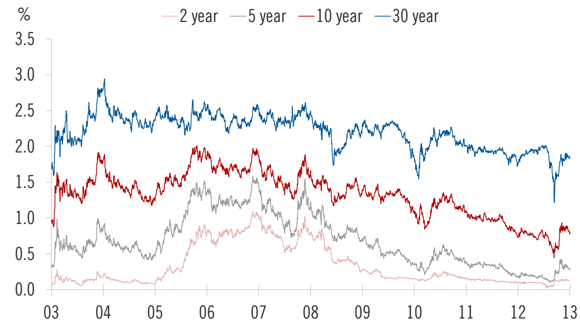
JAPAN

SHORT-TERM RATES (YEN)



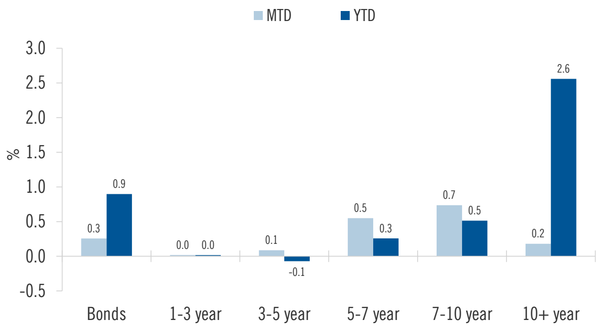
Source: Bloomberg

JAPANESE GOVERNMENT BOND YIELDS



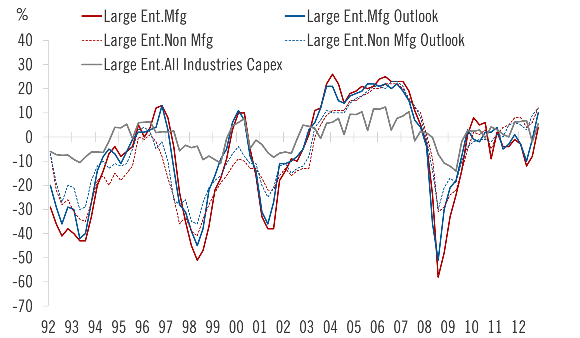
Source: Bloomberg, JGB

RETURNS FROM GOVERNMENT BONDS BY MATURITY



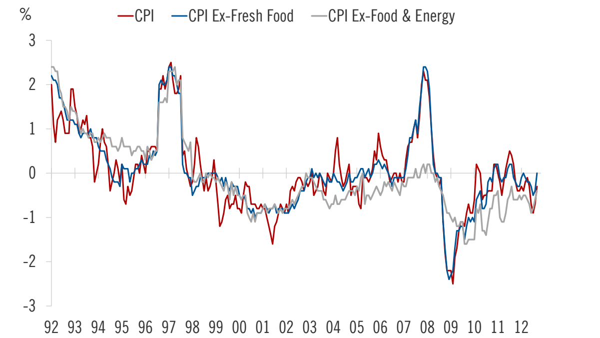
Source: Bloomberg, Citigroup, Japan Gvt Bonds

BOJ - TANKAN



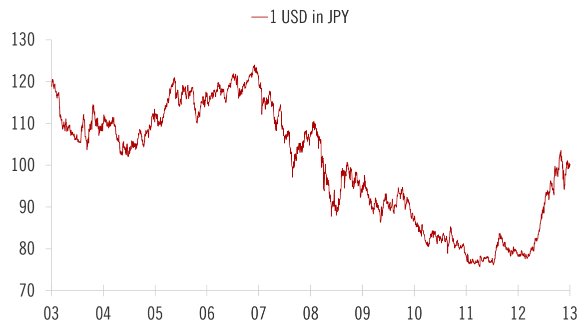
Source: Bloomberg, Japan

INFLATION



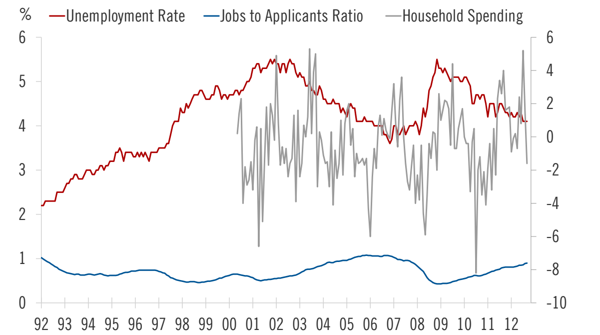
Source: Bloomberg, Japan

JAPANESE YEN VERSUS DOLLAR



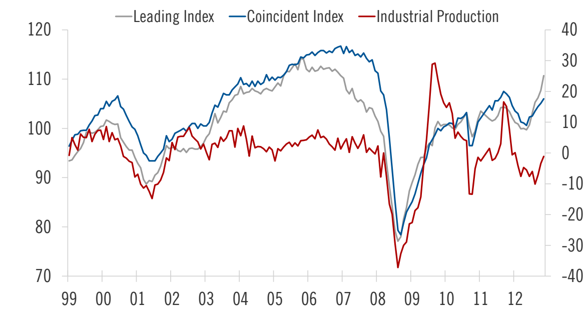
Source: Bloomberg, exchange rates

LABOR MARKET



Source: Bloomberg, Japan

LEADING INDICATOR AND INDUSTRIAL PRODUCTION



Source: Bloomberg

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