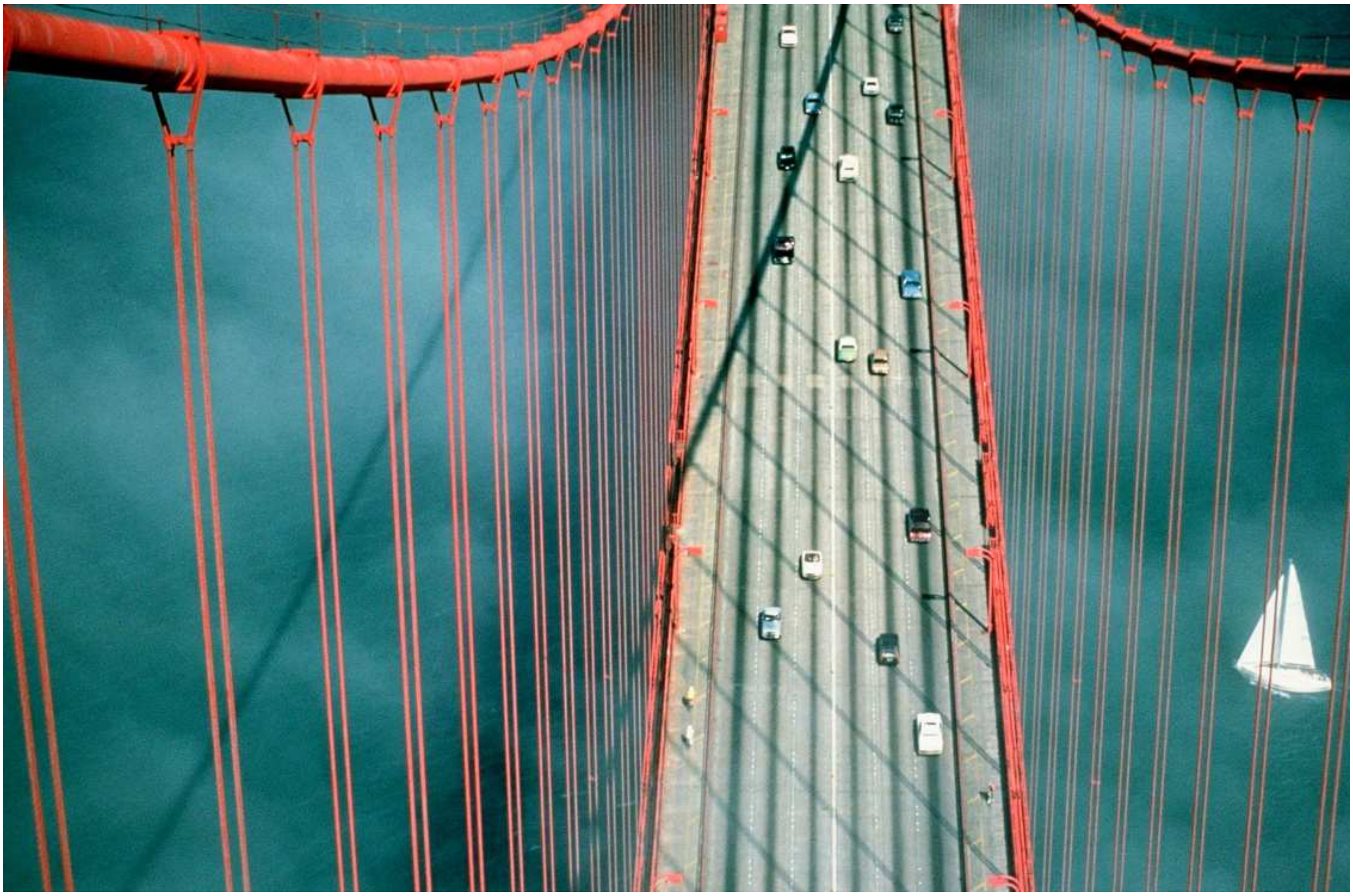
Monthly Bond Letter
September 2013

Pictet Asset Management



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OVERVIEW

Recent developments

Signs of economies recovering and the prospect of quantitative easing being tapered have continued to penalise bond markets

Economic data released recently in the USA, read overall, were better than expected, pointing towards the upswing being likely to extend for longer. On a less heartening note, statistics for the housing market were a mixed bag, fuelling fears the rebound in mortgage rates is already starting to bite, as exemplified by the 13.4% decline in sales of new homes and a 7.3% drop in consumer durables orders. On the inflation front, rising oil prices continued to feed through into price increases: the y-o-y rate quickened from 1.8% to 2.0%, with the core rate edging up a fraction from 1.6% to 1.7%.

The European economy appears to have levelled out, with findings from economic and business surveys heralding an upturn round the corner. The eurozone economy grew faster than expected in the second quarter as GDP growth worked out at +0.3%. Purchasing Managers' Indices (PMIs) delivered some pleasant surprises: the Manufacturing PMI progressed from 50.3 to 51.3 whilst the Services PMI rose from 49.8 to 51.0. The Ifo barometer of business sentiment registered an unexpectedly strong rise as well, up from 106.2 to 107.5.

Against this backdrop of improving economies and the prospect of cheap liquidity drying up, yields on government bonds extended their uptrend begun in May, with 10-year US Treasury bond yields rising to almost 3% and those on Bunds to close to 2%.

Geopolitical uncertainties, especially over reprisals against Syria and their potential fallout, caused aversion to risk to mount again

In late August, as a military response to the Syrian government regime's alleged use of chemical weapons was beginning to look increasingly likely, aversion to risk resurfaced noticeably on financial markets. Gold, oil and the Swiss franc all gained ground. Government bond yields eased back down, but the whole array of risk-based assets tumbled, especially those on emerging markets.

Debate in Japan over consumer sales tax and signs of the economy losing some steam dominated proceedings

After the Liberal Democratic Party's crushing victory in recent elections to the Upper House, the debate about the hike in the consumer sales tax hotted up among the party faithful. The increase in sales tax on consumer goods is one of Prime Minister Abe's flagship revenue-raising policies in his government's drive to reduce the budget deficit. Less than half of the country's deficit has been covered by tax receipts for many years now. A volatile yen and energy prices have further muddied the waters as far as the direction of inflation is concerned. Economic news made slightly less encouraging reading, sparking worries of the recovery losing momentum.

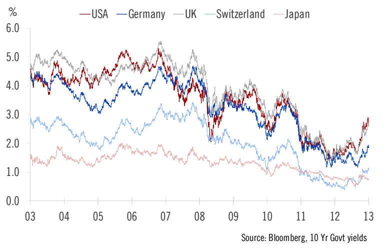
On the corporates market, investment-grade bonds were dented by the uptick in sovereign bond yields, but high-yield paper proved fairly resilient

High-yield corporates began August on an upbeat note before marking time in the last week of the month. Evidence of improving macroeconomics and the rise in PMIs in both the eurozone's core and periphery countries gave the high-yield segment a boost. The half-year reporting season provided reassurance about companies' fundamental health, with their balance sheets progressively looking sounder. Net debt has come down, and the generation of free cash flow picked up quite noticeably in Q2 2013.

Emerging-market debt down for the fourth month in a row

Returns were in negative territory as emerging-economy currencies have weakened further, down by over 10% against the US dollar in the year to date, and spreads stretched wider again.

10-YEAR GOVERNMENT YIELDS



OVERVIEW

Forecasts

The US Federal Reserve may well start to rein in its asset-purchasing programme from this autumn on

The minutes of the most recent Federal Open Market Committee (FOMC) meeting suggest the Fed, which is confident of the economy picking up in the second half of this year, may well make a start on scaling down its monthly buying of bonds from September. The ongoing stalemate in Congress still poses a threat to the US economic upswing. A series of key deadlines are fast approaching, but the political atmosphere is betraying no signs of becoming less fraught. The two opposing camps are going to have to cut a deal over a budget for the coming tax year as well as reach agreement about lifting the Federal debt ceiling.

With quantitative easing (QE) being tapered, the pattern of trading in bonds will be increasingly influenced by market forces. With the Fed gradually siphoning off liquidity, coupled with the improving state of the economy, pressure should, logically, be kept up on the bond market. Talks over the budget and the debt ceiling, not to mention the crucial appointment of the next Fed Chairman, will also keep markets on their toes. Over the last few months of the year, yields on 10-year T-bonds can be expected to climb further if the economic upswing is confirmed.

ECB to remain accommodating, but one final rate cut beginning to look less and less on the cards

The proliferation of less disheartening economic numbers and the willingness of several governments to water down their harsh austerity policies have nurtured hopes of Europe's economy staging a recovery whilst also diminishing the chances of one final cut in interest rates by the ECB. The good news should not, however, be allowed to mask the ongoing problems, most notably the still worryingly high levels of unemployment.

Given hopes of the eurozone economic recovery being confirmed for the final two quarters of this year and considering fears over QE tapering by the Fed, there is a risk yields on 10-year core eurozone sovereign bonds, which had dropped to rock-bottom levels, might well edge upwards before the year is out.

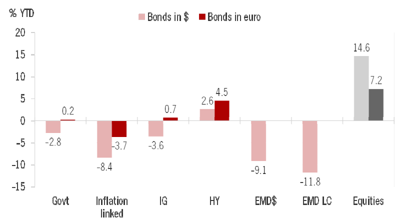
Slopes on yield curves in Europe could well steepen a little more, as has happened in the USA and the UK. Spreads on peripheral eurozone sovereign bonds might well narrow somewhat, but how they move will remain heavily influenced by the ebb and flow of political and economic developments. Political risks have already bubbled back to the surface in Italy.

Brightening economic outlook lending solid support to corporate bonds

Corporate bonds are likely to turn in a fairly lacklustre performance in the coming weeks owing, on the one side, to the political timetable and, on the other, to volatility stemming from uncertainties over US monetary policy. The worst-case scenario for corporate bonds would be a further turn for the worse in the emerging world.

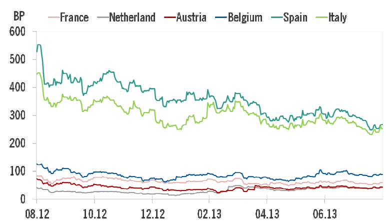
Penalised by an array of external factors, the short-term outlook for emerging-market debt is still quite bleak. Funds are continuing to haemorrhage away even though they have already weakened. There is an argument that value is being created by this, but most investors remain convinced it is too early to venture back to buy this asset on current weakness.

PERFORMANCES 2013



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

10-YR GVT SPREADS VS GERMANY



Source: Bloomberg, gvt yield spreads

Tension spiked again in August

A second, more orderly, corrective phase

After levelling off during July, yields on sovereign bonds were subjected to more tension again in August, forcing yields on 10-year US Treasuries and German Bunds up to almost 3% and 2%, respectively. Although the first wave of correction unleashed by Fed hints about a tapering of its QE bond-purchasing programme was wild and chaotic, the recent uptick in yields was more gradual and less traumatic for financial markets as a whole. Inflation-linked bonds had been laid low by a double whammy of a spike in real rates and a slump in break-even thresholds between mid-May and mid-June whereas they displayed greater resilience to this second barrage of pressure in August. Even though real rates have climbed to yet another high, break-even points, though they did edge down a touch, are still pitched well above the levels they were battered down to in late June.

Looked at another way, although the initial corrective spell involved a brutal readjustment of risk premiums along the interest-rate curve, the ongoing process of correction, with movements on a much less drastic scale of severity, is consistent with the corroborative evidence of macroeconomic data turning for the better and quite often comfortably beating expectations. With bond yields now well into this process of reverting more towards normal, questions about the tempo of the adjustment process and the scenario already factored into yield curves at present are all the more meaningful.

Process involving complete reversion to normal over the next five years priced in

As news of the Fed announcing its decision after the 18 September FOMC meeting that it intends to start tapering its QE programme has more or less been taken for granted and factored into market pricing for most bond segments, the time is right at this stage of the corrective process to pinpoint those individual valuation components likely to affect the dynamics of capital flows as the reallocation trend unfolds. The shape of forward interest-rate curves allows us to assess what future information is being priced into current levels and slopes.

In the cases of both the USA and the eurozone, 5-year forward yield curves are pricing in official interest rates at almost 3% for the Fed and of 2% for the ECB, with 10-year bond yields at almost 4% on US T-bonds and 3% on Bunds, with much of the correction already being factored for a three-year horizon. Paradoxically, no tightening of interest-rate screws by central banks has been priced in for at least the next couple of years.

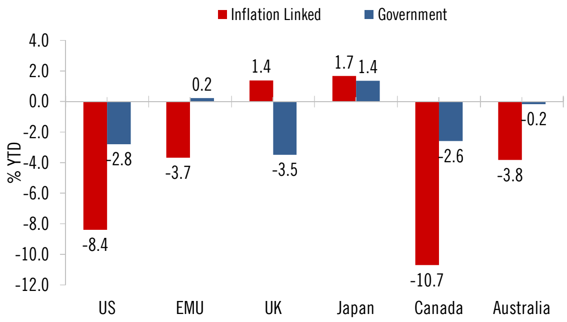
This suggests central banks' credibility as regards their ability gradually to steer interest rates back up to more normalised levels is being seriously called into question although no doubt is being cast over one of the cornerstones of their communications policy, their forward guidance, about keeping official rates very low for some time to come. Any further uptick in yields would have the knock-on effect of bringing forward in time a process involving the following sequence: tapering, then halting of QE; siphoning off of surplus liquidity; lastly, completion of the classic monetary-tightening cycle.

Dynamics of liquidity flows could drive a steeper increase in yields

Although bond yields are already moving up to levels consistent with a global economy returning to its trajectory of potential growth and the associated implication of interest rates reverting to normal in 3-5 years' time, the possibility of bond yields pushing on even higher now cannot be ruled out. Since the market-rocking tremors of 2008, the severe tightening-up of regulations and banks' ongoing downsizing of their balance sheets have radically reshaped the structure of intermediation in a market that is mostly conducted over the counter. Investment banks and other market makers no longer act as shock-absorbers to balance supply and demand as they no longer have the capacity to take such funds onto their own balance sheets as they had before. Reallocation of funds outside fixed-income instruments is fuelling big outflows that are liable to result in valuation pricing levels that might jeopardise the whole growth scenario.

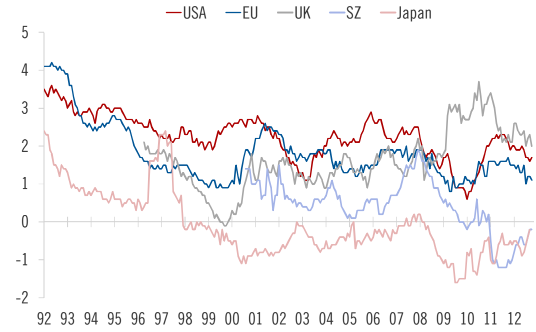
INFLATION-LINKED BONDS

PERFORMANCES 2013 (LOCAL CURRENCIES)



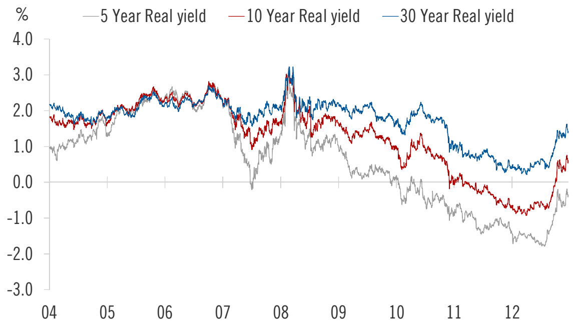
Source: Bloomberg, Citigroup, Barclays

CORE INFLATION



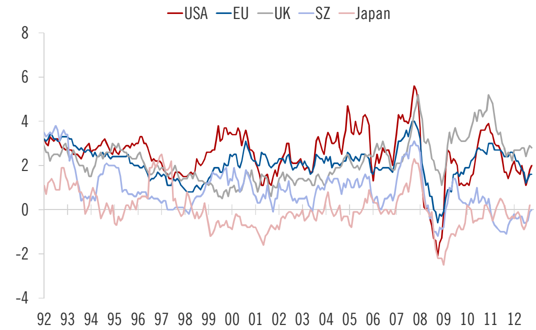
Source: Bloomberg, Core CPI

USA - REAL RATES



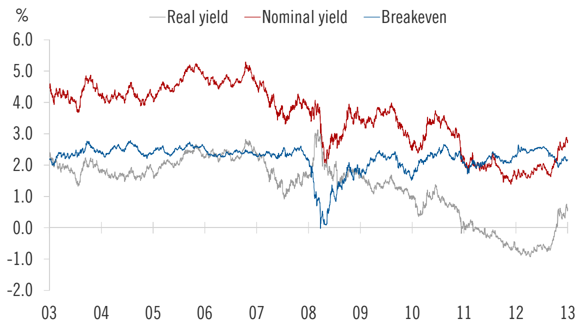
Source: Bloomberg, US Treasury

INFLATION



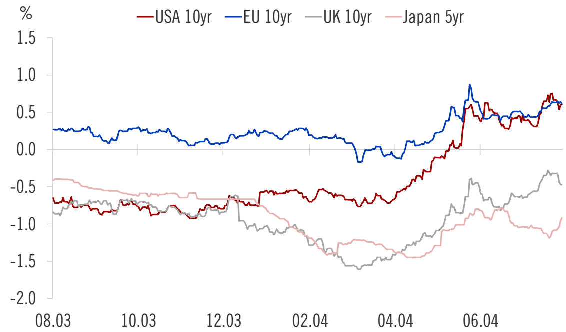
Source: Bloomberg, CPI

USA - 10-YEAR TREASURY YIELD COMPONENT



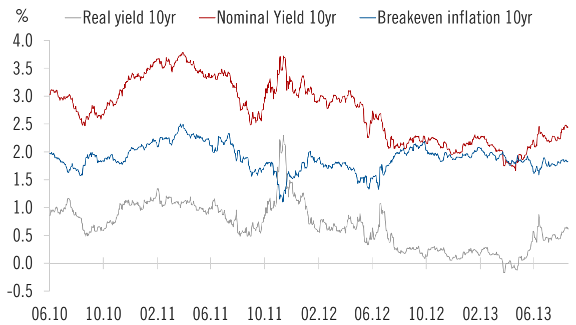
Source: Bloomberg, US Treasury 10 year

10-YEAR REAL YIELDS



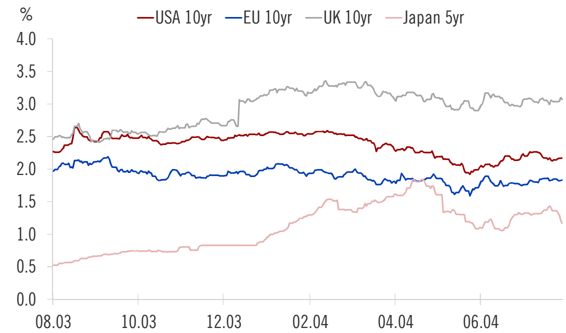
Source: Bloomberg, Real Yields

FRANCE - 10-YEAR YIELD COMPONENT



Source: Bloomberg, 10-yr French OAT

10-YEAR BREAKEVEN INFLATION POINTS



Source: Bloomberg, Break-even Inflation Rates

Investment-grade corporates hurt by government bond yields

Negative returns again in August

Spreads on corporate bonds continued to narrow in August, but rising yields on government bonds dented returns from corporate bonds in the latter half of the month. In the end, investment-grade corporate bonds delivered a negative return for August, but they still comfortably outperformed benchmark sovereign bonds for the month, and are still showing a gain for the year to date.

Most companies have already released their Q2 2013 results which, overall, have made for mixed reading. We have witnessed a positive trend in the consumer sector, founded on the slight upturn seen in Europe. Retailers and food & drinks manufacturers showed up positively. Slowdowns in emerging countries and volatility in commodity prices, however, dented results from basic materials and energy groups. Borrowers with links to emerging economies, like Vale, did deliver positive returns as spreads had been stretched too far in June. The pattern for results was also negative in the telecoms industry, but returns from sector bonds were more heavily influenced by M&A activity, such as the America Movil/KPN tie-up, or company-specific developments, such as Telecom Italia's rating being put on the 'Negative' watch-list by the rating agencies. Utilities, especially their hybrid debt and paper issued by Italian or Spanish groups, managed to outperform in August.

Interim results were also a mixed bag among financials, with profits showing falls, but capitalisation levels on the increase and asset quality levelling out. Banks' subordinated debt outperformed insurers' bonds in August. Returns from subordinated debt from reinsurers Swiss Re and Hannover Re, along with Allianz, dipped into the negative zone. Looking at geographical patterns, Spanish and Italian banks outperformed their counterparts in the eurozone's core countries.

Primary market should turn livelier in September

Issuance in August tended to be confined to the banking sector on account of the mid-year reporting season and traditional dip in activity over the summer holidays. The headline borrowers in the month were BNP, Goldman Sachs, Svenska Handelsbanken and Pohjola.

Banks' credit ratings downgraded a notch

With the new regime being put in place to cope with possible bank collapses, Moody's announced it was intending to lower ratings for the six biggest US banks to make allowance for the proposed toning-down of government bailout support. Moody's also highlighted the adverse implications for credit ratings stemming from adoption of the EU directive on bail-in procedures. Sweden's banks would be particularly affected by this as the rating agencies have always taken powerful support from the government into account since 2008, according them ratings generally above average for the European banking industry.

Credit default swaps (CDS) underperforming

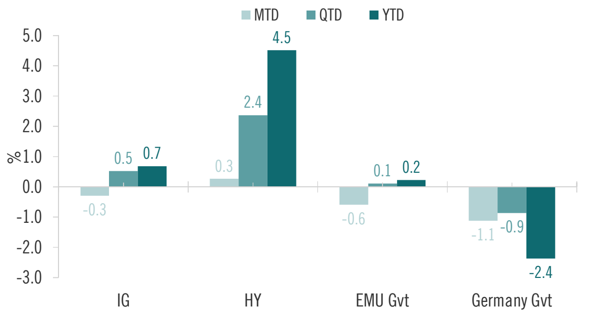
The Main iTraxx CDS index underperformed the bond market as such in August. Spreads widened on account of purchases made for protection purposes, amplified by the impact of low liquidity, to hedge against tension on emerging markets and fears of Fed tightening.

Outlook

The brightening economic outlook for Europe should provide a key factor of support to investment-grade corporates in the medium term. Corporate bonds are likely to turn in a fairly lacklustre performance in the coming weeks though owing, on the one side, to the political timetable and, on the other, to volatility stemming from uncertainties over US monetary policy. The worst-case scenario for corporate bonds would be a further turn for the worse in the emerging world.

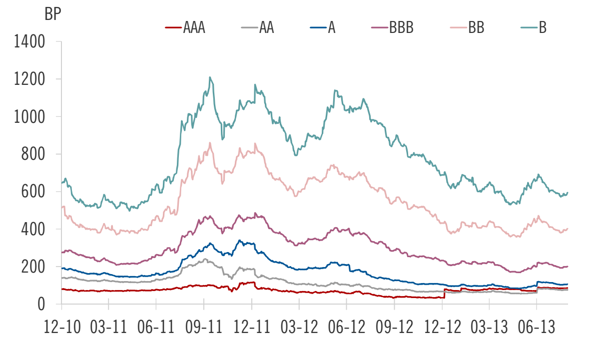
CREDIT RISK

RETURNS ON BONDS IN EURO



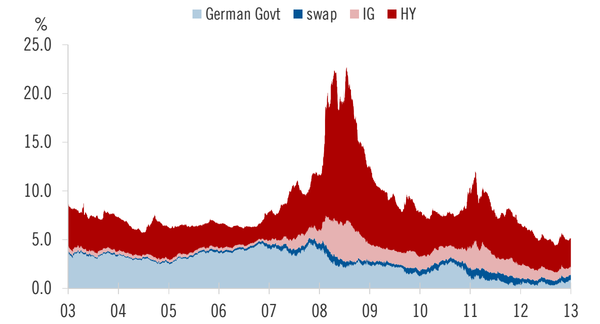
Source: Bloomberg, BoA Merill Lynch, Citigroup

CREDIT SPREADS (EURO)



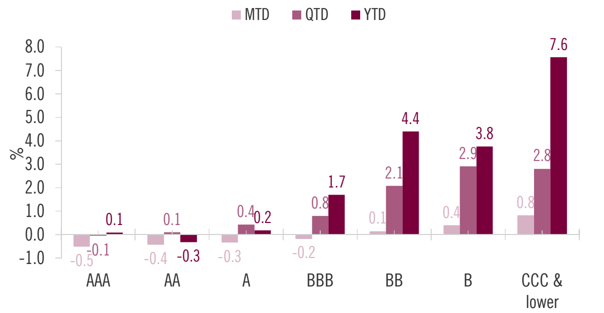
Source: Bloomberg, BoA Merill Lynch

YIELD COMPONENT (EURO)



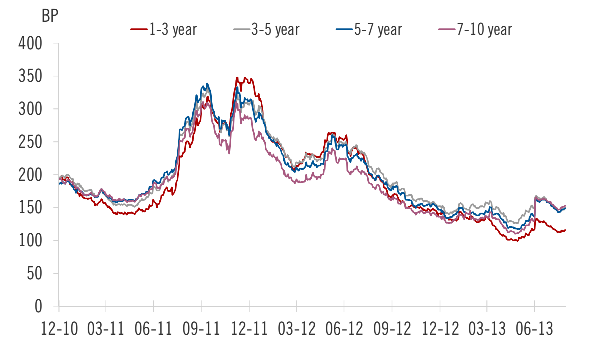
Source: Bloomberg, Barclays, Eur yields

RETURNS ON BONDS IN EURO



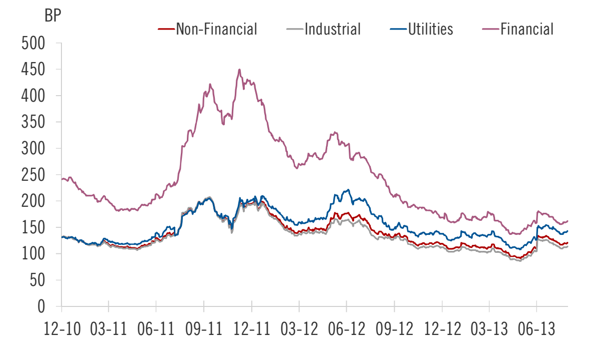
Source: Bloomberg, BoA Merill Lynch

INVESTMENT GRADE SPREADS BY MATURITY (EURO)



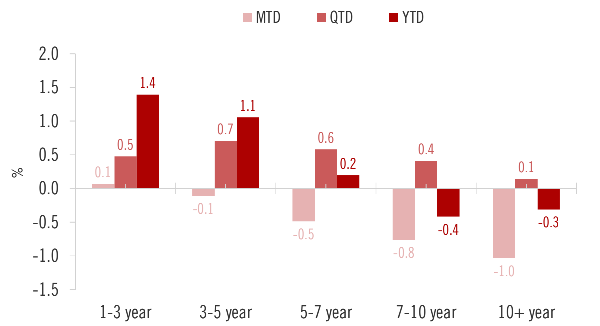
Source: Bloomberg - BoA Merrill Lynch

INVESTMENT GRADE SPREADS BY SECTOR (EURO)



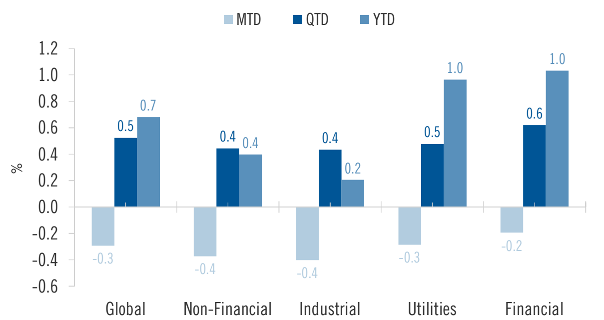
Source: Bloomberg - BoA Merrill Lynch

INVESTMENT GRADE RETURNS BY MATURITY (EURO)



Source: Bloomberg, BoA Merill Lynch

INVESTMENT GRADE RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merill Lynch

European high-yield bonds displaying commendable resilience

Positive performance in August

European high-yield bonds extended their gains in August. Sub-investment-grade corporates started the month on a bullish note before taking a breather in the last week of August. Signs of improving macroeconomics, with PMIs moving up in both core and peripheral countries, boosted positive momentum for the European high-yield segment. On the sovereign bond front, the rise in German Bund yields acted as a drag for all fixed-income markets as the 10-year Bund rate topped the highs in June and broke above the 1.9% level. Despite this headwind, European high-yield corporates advanced. This was not the case for US corporate bonds which, faced with rising US Treasury yields, lost ground in August. As a result, the European high-yield market and, primarily, the short-term segment attracted steady inflows, mostly coming from retail investors.

In this climate, most of the universe posted gains. The BB-rated non-financial segment was the clear loser though as it remained more exposed to rising interest rates. Ratings-wise, B-rated and CCC-grade companies advanced. In terms of sectors, banks – primarily subordinated debt – and insurers led the way, benefiting from not only a steeper curve, but also significant tightening of spreads between Germany and peripheral countries. With recovery taking hold in Europe, the automotive sector edged higher as some investors revised expectations upwards.

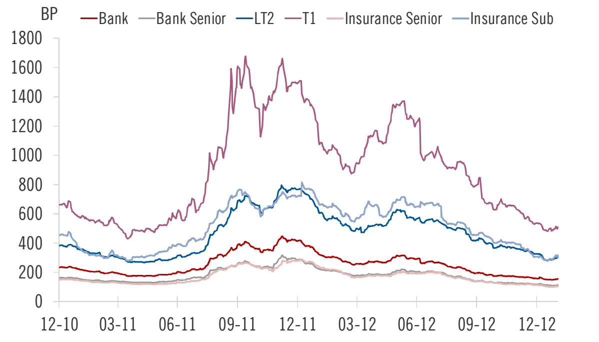
In this context, the primary market was reignited. A flurry of first-time issuers tapped the market in early August, the likes of Intralot, the Greek gaming company, making its debut with a 5-year bond yielding 9.75%, and B-rated Maison du Monde, the French furniture-store chain, with a 2020 bond. Two first-time issuers from Italy also took advantage of better conditions: Manutencoop, a facilities-management company, and Salini, a construction group who issued a 2018 senior secured bond. As for existing issuers, Picard, the French frozen-food specialist, issued a 2019 floating-rate bond at Euribor +450bp. On the issuers' side, the earnings season provided further comfort about fundamentals underpinning corporate bonds. Overall, companies continued to shore up their balance sheets. Net leverage went down and, above all, free cash flow generation markedly improved over the second quarter. Some companies, such as Takko, the German clothing retailer, released weak earnings although figures were broadly in line with expectations. Fundamentals from New World Resources still deteriorated as the Eastern European coal producer posted negative earnings. Codere, the Spanish gaming company, again ran into near-term restructuring risks as it did not pay the coupon on its USD-denominated 2019 bond.

Outlook

Our macroeconomic outlook has turned more constructive as PMIs have rebounded Europe-wide. Although such improvement remained modest and may be toned down later in the year as rises in government yields act as a drag, this should ease investors' concerns over Europe (primarily the international investor-base who had previously kept very light exposure to Europe) and provide support for companies' sales and production in the coming months. If confirmed, the economic recovery may also augur promisingly for potential upgrades, historically after a time-lag of 6-9 months. Combined with the better growth figures, the reporting season turned out fine, confirming that balance sheets are in decent shape on the back of conservative management. Against this background, any economic improvements, even modest ones, will be magnified and should percolate through to the bottom lines of high-yield issuers. However, in the near term, we cannot rule out an upsurge in volatility as investors absorb rate rises after the summer season. The short-term segment should exhibit, as usual, a less volatile pattern and even attract investors wary about duration risks. The longer part of the high-yield market should benefit from the appeal offered by first-time issuers, a recurring theme, as banks, large and mid-tier ones alike, are still halfway along their deleveraging road in Europe.

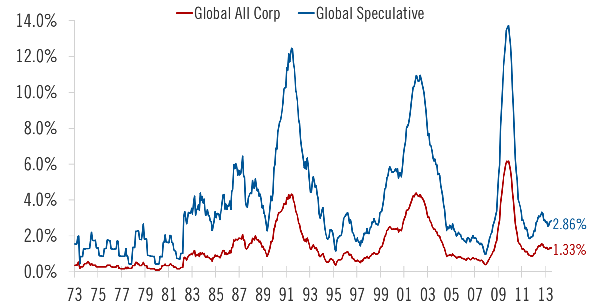
CREDIT RISK

FINANCIAL INVESTMENT-GRADE SPREADS (EURO)



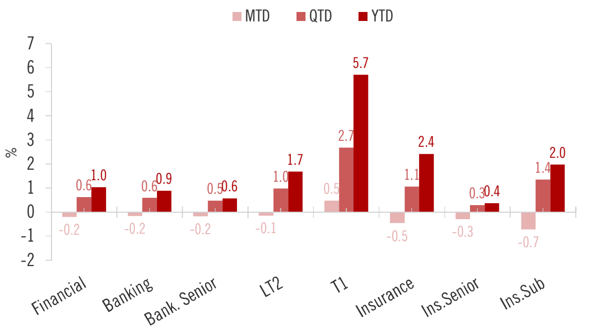
Source: Bloomberg - BoA Merill Lynch

MOODY'S - DEFAULT RATES



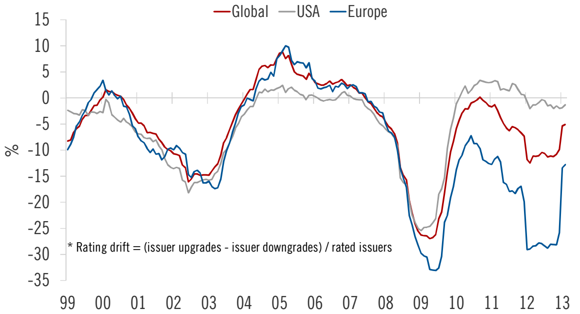
Source: Moody's

FINANCIAL INVESTMENT-GRADE RETURNS (EURO)



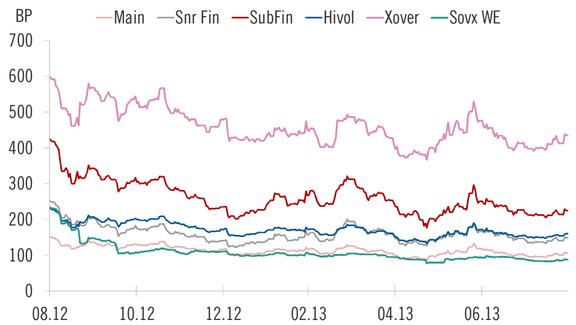
Source: Bloomberg, BoA Merill Lynch

MOODY'S - RATING DRIFT



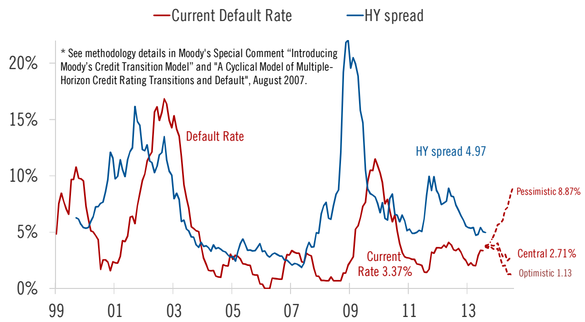
Source: Moody's

CDS - ITRAXX INDICES



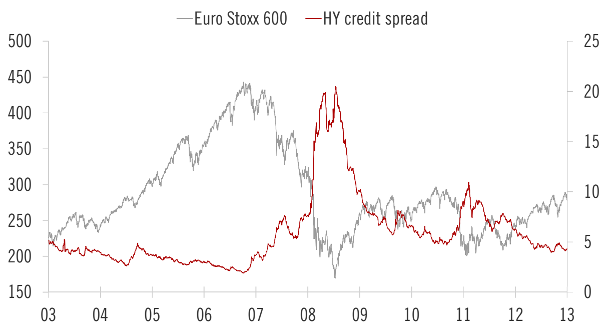
Source: Bloomberg, CDS Itraxx Europe

HIGH-YIELD SPREAD AND DEFAULT RATES (EURO)



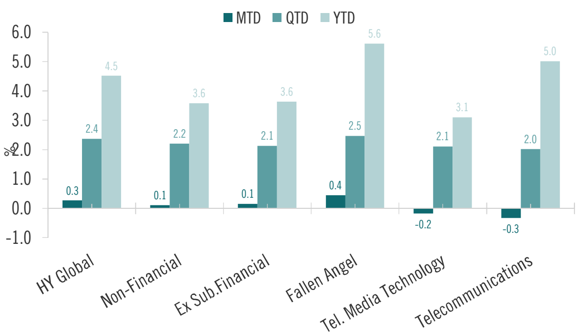
Source: Moody's and Merrill Lynch HY Index

STOCK MARKET & HIGH-YIELD SPREAD (EURO)



Source: Bloomberg, Barclays

HIGH-YIELD RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merill Lynch

Redemptions from EM bond funds continue as outflows intensify

Local-currency debt – Recent developments

August saw further negative returns, primarily from weaker currencies, for the fourth consecutive month, with a year-to-date return of over –10% in USD terms for the market. A stronger US dollar, founded on better US data, slower growth in emerging markets and generally weak commodity prices have all continued to weigh heavily on emerging currencies. Those with current-account deficits and lacklustre growth, such as Indonesia, India, Turkey and Brazil, had some of the worst hit currencies. Some bright spots were seen in Eastern Europe, with the zloty and forint marginally positive, partly benefiting from improving eurozone data, but local bonds came under further downward pressure. In local rates, increasing clarity about the timeline for the Fed's QE tapering continued to send bond yields up. Mexico moved closer to approving energy reforms whereas India imposed restrictions on money that Indians can send overseas, fuelling fears this might be extended to foreign investors. Russia, Peru, Chile, Turkey and Indonesia all left rates on hold whereas Romania, which cut rates by 50bp, was one of the few markets to see yields being compressed. Indonesia's disappointing current-account deficit and erosion of foreign-currency reserves sent the market down for its worst month in 4 years.

Local-currency debt – Outlook

The short-term outlook for the asset class remains challenging, with a number of outside factors working against it, but long-term fundamentals and the case for the asset class remain intact. The current themes of QE tapering, rising US Treasury yields, a stronger US dollar, soft commodity prices and slowing growth in emerging markets do not look likely to change in the coming weeks. Outflows from the asset class have slowed, but continue to be seen on a daily basis. One could argue that value is being created, but most investors believe it is too early to starting buying into weakness.

External debt – Recent developments

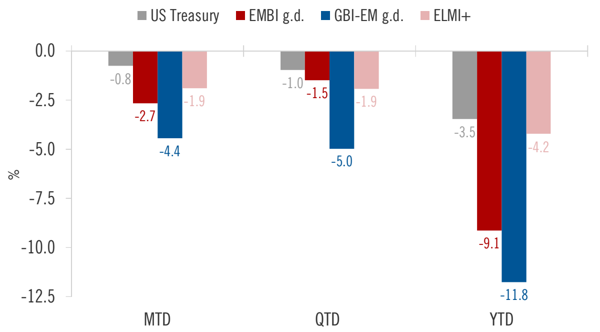
July's gentle rebound was short-lived as the market moved down by over 2% in August, driven largely by huge moves in US Treasuries. The yield on the asset class is back to the highs of early June at over 6% and a spread in excess of 300bp. Once again, highest-quality countries with the tightest spreads and correlations with US T-bonds were the hardest hit. Although the market moved mostly one way, fundamentals were being scrutinised. This resulted in investors punishing countries with economic woes, like India or Indonesia, both on account of recent disappointing current-account deficits and weak currencies, even though this has little direct impact on their USD-denominated sovereign bonds in the short term. Honduras was downgraded to B by Standard & Poor's who cited the country's deteriorating fiscal balance and rising level of public debt whilst El Salvador was downgraded one notch to BB-. Conversely, Peru was upgraded to BBB+, but this did not stop spreads widening. Fitch moved Malaysia's rating outlook to 'Negative', from 'Stable', citing an increasing public debt burden and poor reform outlook. Mexico moved closer to approving energy reforms which are expected to boost the economy if approved.

External debt – Outlook

As we are edging closer to seeing the Fed make a start on QE tapering, we view yields as likely to move higher. Most market participants still expect US Treasury yields to be range-bound in the medium term, but investors will need to feel more comfortable with the idea of a 'non-QE' world before we are likely to see stabilisation. In the short term, an actively managed underweight duration looks the prudent strategy to pursue whereas less correlated countries may continue to provide interesting opportunities. The asset class remains generally well supported by long-term institutional investors, and we could see further allocations by investors who might construe this as a buying opportunity once the market does start to stabilise.

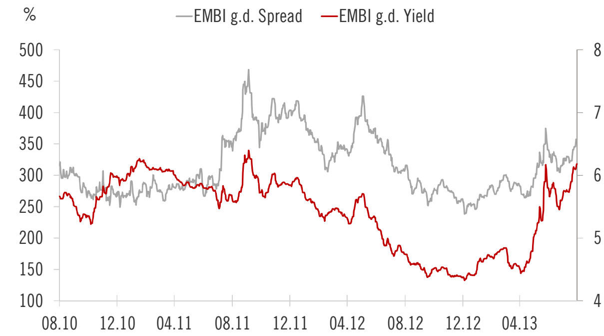
EMERGING DEBT

PERFORMANCES (USD)



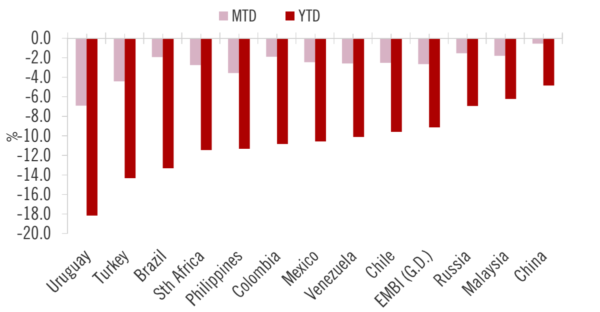
Source: Bloomberg, Index JP Morgan

US DOLLAR DEBT - YIELD & SPREAD



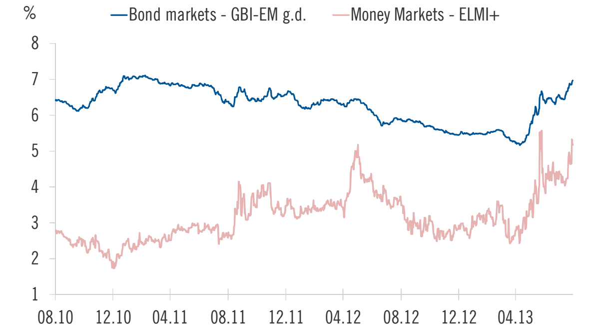
Source: Bloomberg, JP Morgan Indices

JP MORGAN EMBI GLOBAL DIVERSIFIED



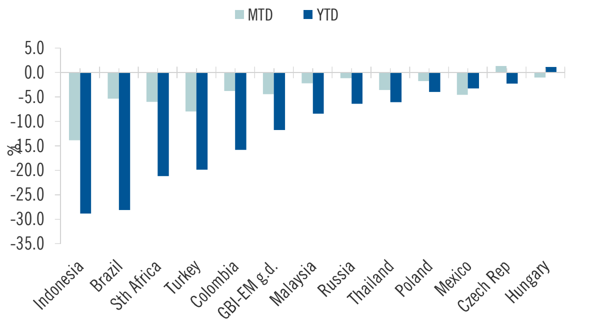
Source Bloomberg: Index JP Morgan

LOCAL CURRENCY DEBT - YIELDS



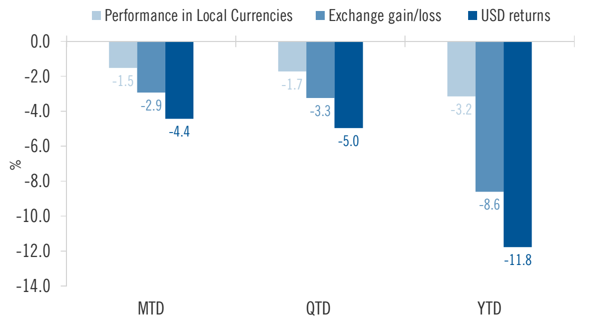
Source: Bloomberg, JP Morgan Indices

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



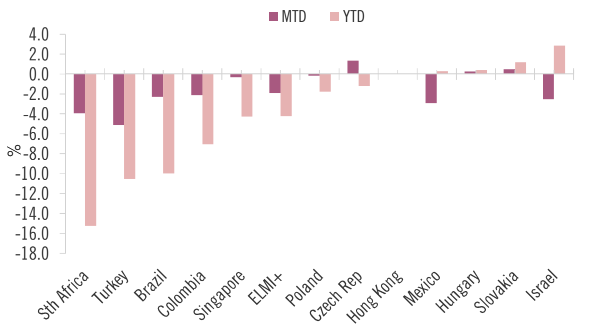
Source Bloomberg: Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



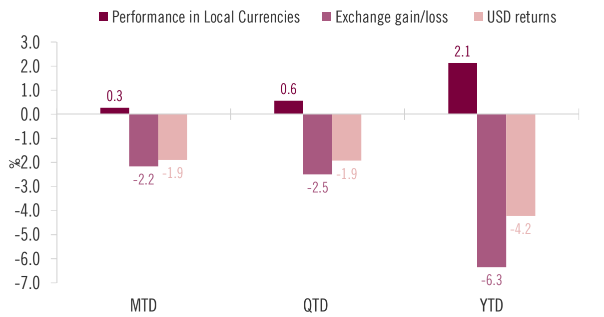
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg: Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

USA

Market braced for QE tapering

The Fed may well make a start on reining in its asset-purchasing programme in September even though economic stats have been mixed

The minutes of the most recent Federal Open Market Committee (FOMC) meeting suggest the Fed, which is confident of the economy picking up in the second half of this year, may well make a start on scaling back its monthly buying of bonds (USD85bn) from September.

President Obama is also due to nominate his proposed successor to Ben Bernanke as Fed Chairman this autumn. He confirmed the two market favourites and front-runners – Larry Summers and Janet Yellen – were highly qualified for the post, but he underlined there were other candidates. Janet Yellen is perceived as being more concerned about unemployment than inflation whereas Larry Summers is deemed to be less friendly for bond markets. This changing of the guard at the Fed, which will occur on 1st January 2014, will clearly be uppermost in markets' minds. Regardless of who takes over from Ben Bernanke, their public comments and statements will be scrutinised under the microscope and may perhaps not be interpreted in the way they were intended.

Figures still heartening, but the ongoing stalemate in Congress is looming like a threat over the recovery

The figure for new jobs created (+160k) was encouraging, if a little lower than expected, and the jobless rate extended its downtrend, from 7.6% to 7.4%. PMIs made good progress in July, with the Manufacturing PMI jumping from 50.9 to 55.4 and the Services PMI up from 52.2 to 56.0. The leading economic indicator advanced by 0.6%. On a less heartening note, statistics for the housing market were mixed, fuelling fears the rebound in mortgage rates is already starting to bite. The National Association of Home Builders/Wells Fargo Housing Market Index, regarded as a forward indicator for the market, rose yet again, up from 57 to 59, and property prices continued to climb. Moreover, housing starts (+5.9%), building permits (+2.7%) and sales of existing houses (+6.5%) were also up, but the 13.4% decline in sales of new homes and a 7.3% drop in consumer durables orders dampened the upbeat mood. On the inflation front, rising oil prices continued to feed through into price increases: the y-o-y rate quickened from 1.8% to 2.0%, with the core rate edging up a fraction from 1.6% to 1.7%.

Political atmosphere is still fraught, but the Federal debt is once again bumping up against its ceiling

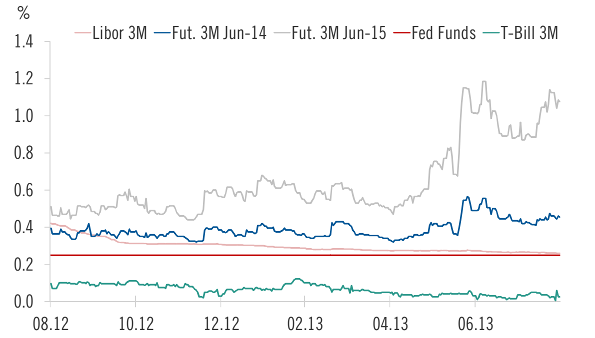
As no deal has been secured on Capitol Hill, automated spending cuts (the so-called 'sequester'), which came into force as from 1st March 2013, have curbed growth in the economy. A series of key deadlines are fast approaching this autumn, but the political atmosphere is betraying no signs of becoming less fraught. The two opposing camps are going to have to cut a deal over a budget for the coming tax year as well as reach agreement about lifting the Federal debt ceiling.

With QE being tapered, the pattern of trading for bonds will be increasingly influenced by market forces

With the Fed gradually siphoning off liquidity, coupled with the improving state of the economy, pressure should, logically, be kept up on the bond market. Talks over the budget and the debt ceiling, not to mention the crucial appointment of the next Fed Chairman, will also keep markets on their toes. Over the last few months of the year, yields on 10-year T-bonds can be expected to climb further if the economic upswing is confirmed.

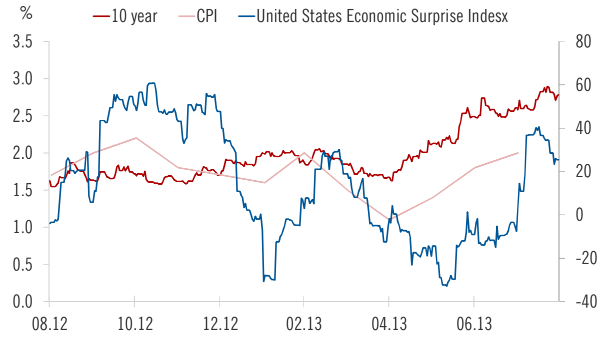
USA

SHORT-TERM RATES (USD)



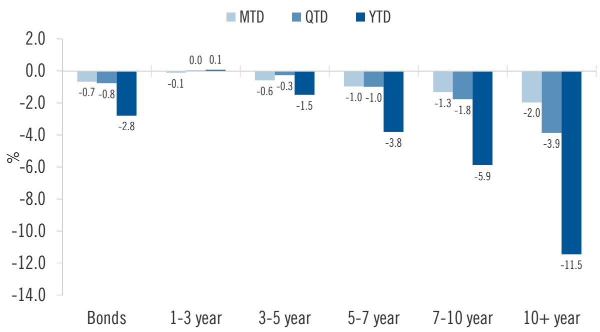
Source: Bloomberg, Money Market, USA

US TREASURY BOND YIELDS



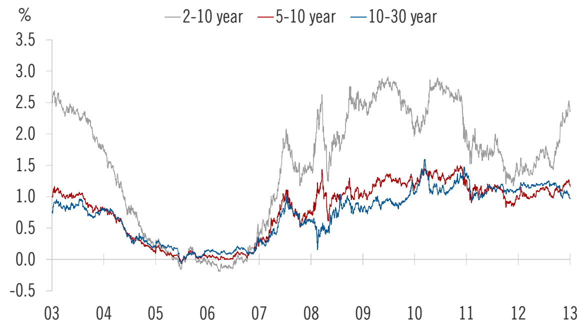
Source: Bloomberg, Citigroup, USA

RETURNS FROM GOVERNMENT BONDS BY MATURITY



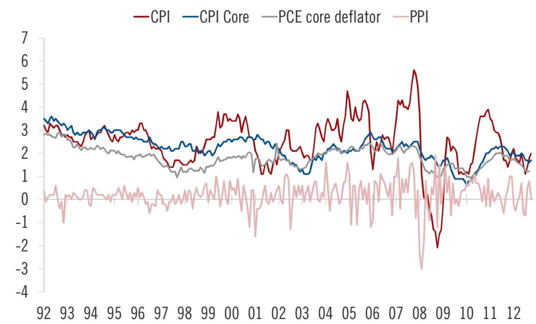
Source: Bloomberg, Citigroup, US Treasury

MOVEMENTS IN YIELD SPREADS



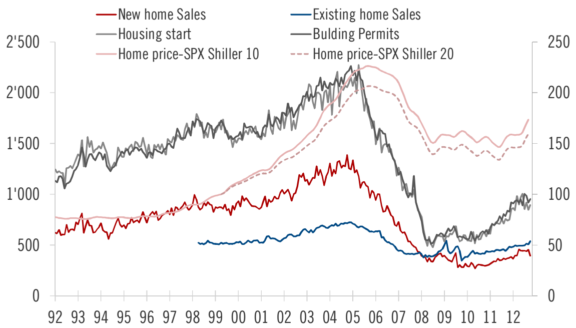
Source: Bloomberg, US Treasury

INFLATION



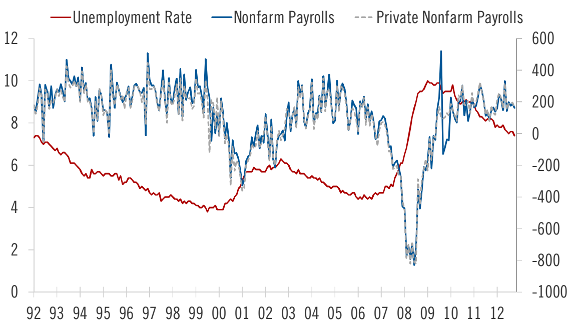
Source: Bloomberg, USA

HOUSING



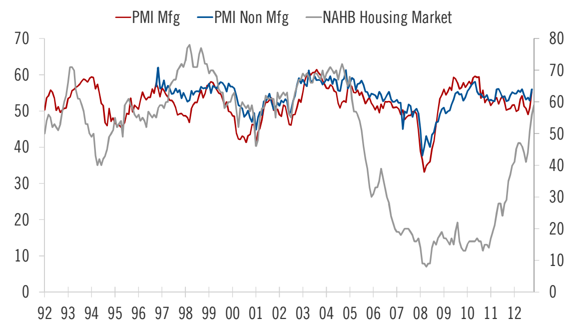
Source: Bloomberg, USA

LABOR MARKET



Source: Bloomberg, USA

PURCHASING MANAGER INDICES



Source: Bloomberg, USA

Economy in early stages of recovery

Europe's economy appears to have levelled out, with findings from economic surveys heralding an upturn ahead

The eurozone economy grew faster than expected in the second quarter as GDP growth worked out at +0.3%. PMIs also delivered some pleasant surprises in August: the Manufacturing PMI progressed from 50.3 to 51.3 whilst the Services PMI rose from 49.8 to 51.0. The Ifo barometer of business sentiment registered a bigger rise than expected as well, up from 106.2 to 107.5.

The proliferation of less disheartening economic numbers and the willingness of several governments to water down their harsh austerity policies have nurtured hopes of Europe's economy staging a recovery whilst also diminishing the chances of one final cut in interest rates by the ECB. The good news should not, however, be allowed to mask the ongoing problems, most notably the still worryingly high levels of unemployment. Investors will be keenly watching for confirmation of the eurozone's economic convalescence over the next two quarters.

Consumer prices edged down by 0.5% m-o-m in July, but the headline and core y-o-y rates of inflation were stable at 1.6% and 1.1%, respectively.

ECB to remain accommodating, but one final rate cut is beginning to look less and less on the cards

The ECB made no change to its monetary stance in early August, indicating the key refinancing rate would be left at its current level as long as price forecasts continued to point to inflation being mild and until the state of the economy improved noticeably. The ECB did acknowledge economic indicators were clearly pointing towards better times ahead, but the upswing is likely to remain pedestrian and the risks of a relapse are still quite significant. The ECB is, therefore, likely to stick with its accommodating tone in the months ahead. ECB President Mario Draghi's persuasiveness has allowed the ECB to avoid having to resort to overly risky strategies, but, if rates on either money or bond markets do spike too much, it might be forced to intervene and push through additional supportive measures. At his last press conference, the ECB President declared that expectations of interest-rate hikes were groundless, pointing out the ECB was not envisaging having to raise rates in the medium term. His comments had scarcely any impact on the market though as the December 2014 3-month LIBOR forward contract has risen by 25 basis points in recent weeks. To inject some calm into the market, the ECB might perhaps have to take action, such as launching a new 3-year long-term refinancing operation (LTRO).

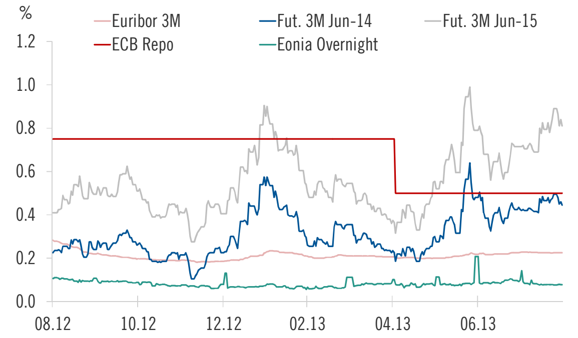
Yield on 10-year Bunds climbed to almost 2% and peripheral markets were a little less volatile

Given hopes of the eurozone economic recovery being confirmed for the final two quarters of this year and considering fears over QE tapering by the Fed, German Bunds might well be side-lined. A surprise outcome to the German Federal elections on 22 September could also unsettle the market.

Yields on core eurozone sovereign debt had sunk to rock-bottom levels, but they may well edge up a little further before the year is out if the scenario of a gradual upturn in eurozone economies were to materialise. Slopes on yield curves in Europe could well steepen a little more, as has happened in the USA and the UK. Spreads on peripheral eurozone sovereign bonds might well narrow a little, but how they move will remain heavily influenced by the ebb and flow of political and economic developments. Political risks have already bubbled back to the surface in Italy.

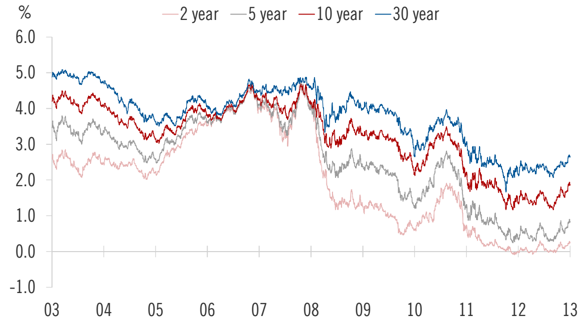
EUROZONE

SHORT-TERM RATES (EURO)



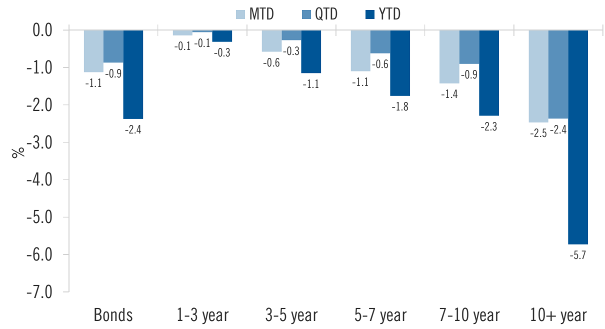
Source: Bloomberg, Money, EU

BUND YIELDS



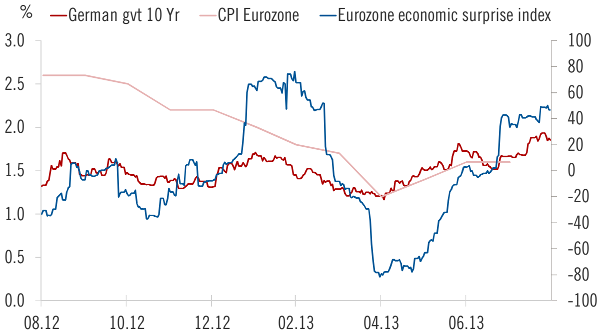
Source: Bloomberg, Bund

RETURNS BY MATURITY (BUND)



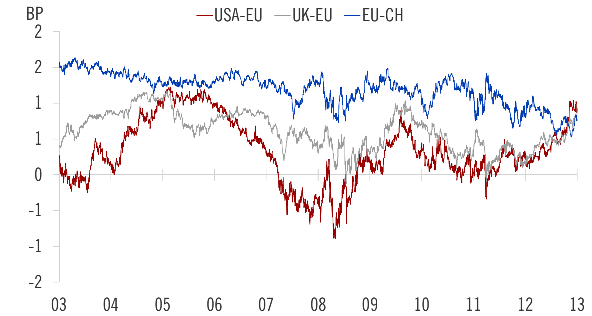
Source: Bloomberg, Citigroup, Germany Bund

EUROZONE ECONOMIC SURPRISE INDEX



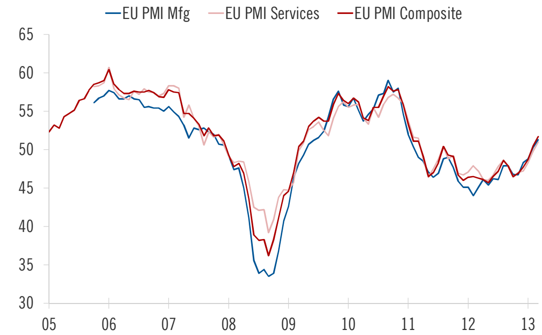
Source: Bloomberg, Citigroup, EU

YIELD SPREADS VS GERMANY



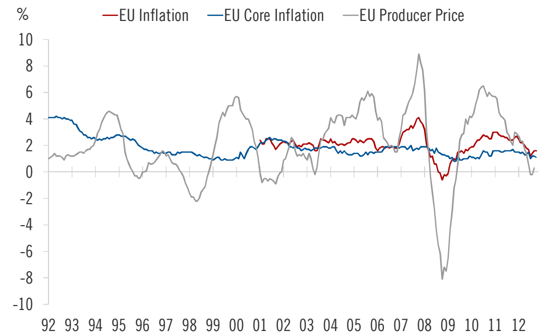
Source: Bloomberg, 10 yr Govt yield spreads

EUROZONE - PUCHASING MANAGER INDICES



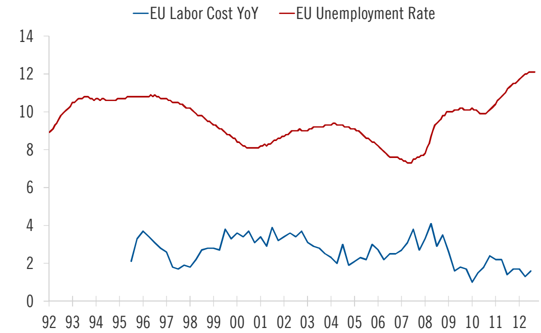
Source: Bloomberg, Eurozone PMI index

EUROZONE - INFLATION



Source: Bloomberg, Eurozone

GERMANY - UNEMPLOYMENT RATE



Source: Bloomberg, Eurozone

BoE's turn to link monetary policy to the jobless rate

Monetary policy for now will be influenced, in addition to ongoing inflation targeting, by movements in unemployment

One month after taking over the reins as Governor of the Bank of England (BoE), Mark Carney has adopted the principle of forward guidance, i.e. announcing detailed long-term prospects governing monetary policy. The BoE pledged neither to raise its base lending rate nor to reduce its GBP375bn asset-repurchase programme until the unemployment rate has dipped back below the 7%-barrier. The jobless rate has been stuck at 7.8% for several months now. This use of employment as a bellwether, emulating the Fed's approach, caught some commentators by surprise as they had been expecting monetary policy to be linked more to GDP growth or a combination of several economic indicators.

Nonetheless, even if unemployment does stay above the 7% threshold, the BoE has left open the door to raising interest rates if inflation quickens more than expected or if financial stability comes under threat. As for inflation itself, the BoE stated it expected inflation to stay close to 3% in the near term, but was still looking for the rate to retreat towards its 2% target in the second half of 2014. Mark Carney indicated that, although the UK economy had embarked along the road to recovery, GDP was unlikely to climb back up to its pre-crisis levels for at least a year. However, in response to a string of encouraging economic numbers, the BoE did upgrade its GDP growth forecast for 2015 from 2.2% to 2.6%.

According to many pundits, the BoE is likely to leave interest rates unchanged up to 2016. With evidence of the economy perking up, the BoE's decision has not really modified market expectations which are implying an initial move to raise the base lending rate in the second half of 2014. Some economists believe the unemployment rate set as a trigger-point by the BoE might well be reached earlier than expected.

GDP growth revised up to 0.7% and recent figures have offered more cheer than expected

The pace of the uptrend in UK PMIs quickened in July as the trio posted much bigger increases than the consensus had been projecting: the Manufacturing PMI climbed from 52.5 to 54.6, the Construction PMI from 51 to 57, and the Services PMI from 56.9 to 60.2. 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, which had already bounced up from 5 to 21 in June, rose further to 36, one of its highest levels over the last 10 years. The GfK's UK consumer confidence barometer also posted a strong increase in June, moving up from -21 to -16. Retail sales, up 1.1% in July, rose for their third month in a row. Economic forecasters have begun to upgrade their forecasts although they are still erring somewhat on the side of caution as the government's ongoing harsh austerity programme will continue to act as a damper on growth.

Consumer prices were unchanged m-o-m in July, which led to the headline y-o-y rate of inflation edging down from 2.9% to 2.8% and core inflation declining from 2.3% to 2.0%.

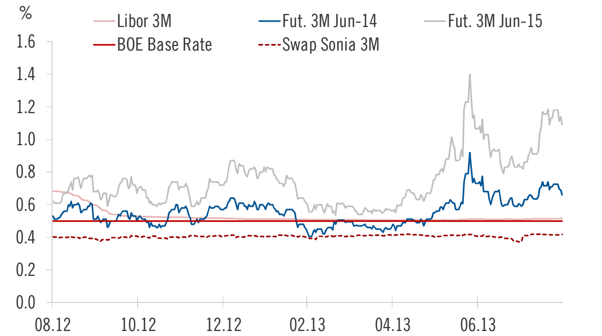
Economic rebound continuing to apply some pressure to gilts

As expected, confirmation of the recovery in the UK economy kept gilts yields moving upwards in spite of the BoE's forward guidance: the yield on 10-year UK Treasury gilts had moved up to 2.79% by end-August.

Although the base lending rate will remain glued to rock-bottom levels until employment has expanded enough, the gilts market might still correct further if the recovery continues. Yields on 10-year gilts might test out the 3% barrier in early autumn, with the yield curve possibly taking on an even steeper profile.

UK

SHORT-TERM RATES (GBP)

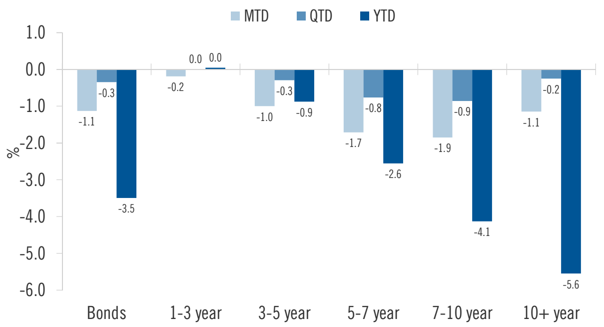


Source: Bloomberg, Money Market, UK

GILTS YIELDS

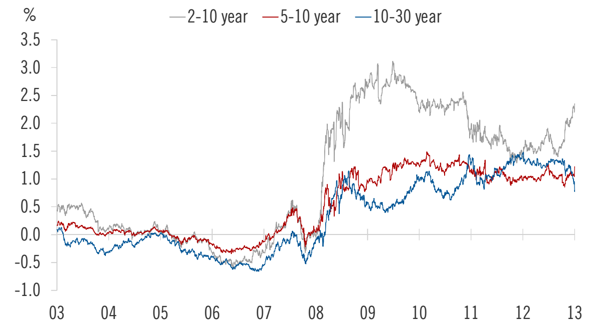
Source: Bloomberg, GILT

RETURNS FROM GOVERNMENT BONDS BY MATURITY



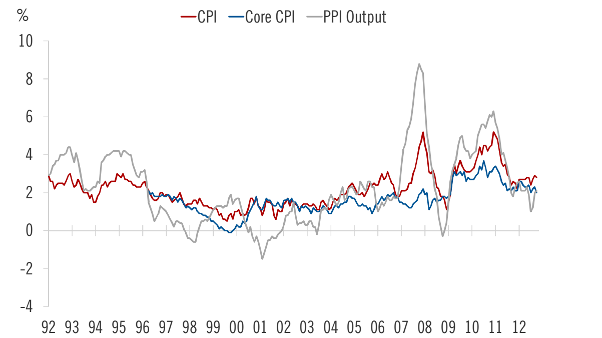
Source: Bloomberg, Citigroup, UK Treasury

MOVEMENTS IN YIELDS SPREADS



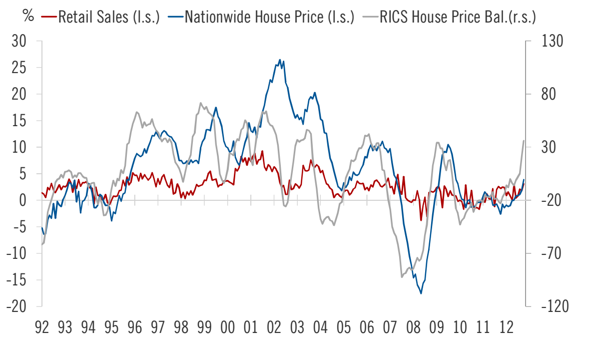
Source: Bloomberg, GILT

INFLATION



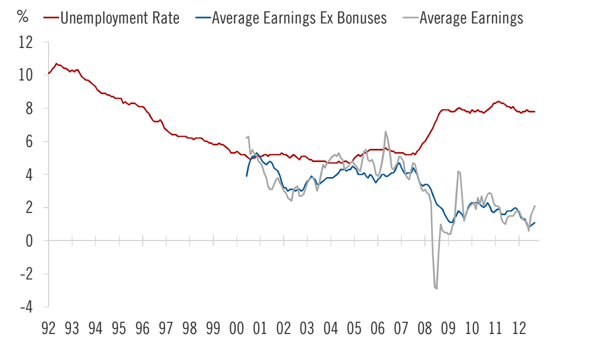
Source: Bloomberg, UK

HOUSING AND RETAIL SALES



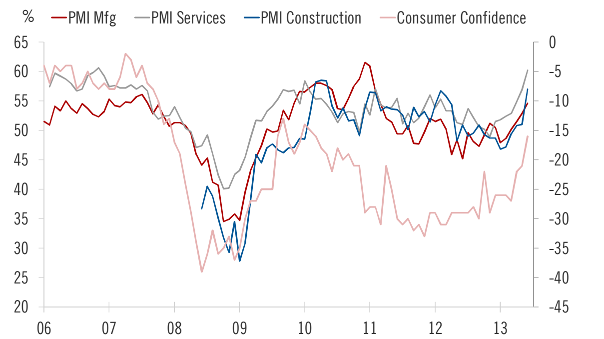
Source: Bloomberg, UK

UNEMPLOYMENT RATE AND AVERAGE EARNINGS



Source: Bloomberg, UK

ECONOMIC SURVEYS



Source: Bloomberg, UK

Interest rates and franc remain tightly range-bound

The SNB unlikely to alter its monetary stance while the franc remains so overvalued

Although deflation is seemingly fading away and the property market is still taut, the Swiss National Bank (SNB) looks unlikely to soften its monetary stance while the franc remains so overvalued. Some SNB members have reiterated the policy of sticking with the upper ceiling for the franc's value against the euro as price stability is not an issue. The SNB is still forecasting annual average inflation of -0.1% for 2013. At its most recent quarterly monetary-policy meeting in June, the SNB had estimated that, with the 3-month LIBOR close to 0%, consumer prices would rise by 0.2% in 2014 and by 0.7% in 2015. The SNB is still looking for GDP growth of between 1% and 1.5% for this year.

So, as the SNB's foreign-exchange reserves have remained pretty stable over the last few months (totalling CHF434.9bn in July, with almost half in euros), the SNB is still probably quite prepared to buy foreign currency in unlimited quantities to defend its target exchange-rate level. If needed, it is also prepared to push through further measures. The SNB booked a loss of CHF7.5bn for H1 2013, chiefly on account of the slump in the price of gold which generated a loss of CHF13.2bn. In contrast, foreign-exchange holdings delivered a gain of CHF5.8bn. The SNB is still trying to cool dynamics heating up the property market, continuing to brace banks for the inevitable prospect of hikes in interest rates and cautioning them against underestimating associated risks in their risk-assessment processes.

Businesses and consumers less confident in spite of Europe stabilising, but economic forecasters are still confident about the Swiss economic outlook for H2 2013

Although Switzerland's economy weathered the European recession fairly well, both business leaders and consumers are voicing a little less confidence about the future. KOF's Business Situation Indicator dipped yet again in July whilst the quarterly survey conducted by the State Secretariat for Economic Affairs (SECO) showed that consumer confidence has crumbled somewhat, sliding from -5 to -9. Unemployment has also edged up a little in recent months, climbing to 3.2% in July: the jobless total expanded m-o-m by 2,018. Although both industry and exports are finding it a struggle to rebound, KOF's economic barometer did move up slightly in July (from 1.16 to 1.23) and the Manufacturing PMI leaped from 51.9 to 57.4.

Consumer prices fell by 0.4% m-o-m in July on the back of discounted pricing in clothing and for holiday travel and transportation. Even though prices did fall, the grip of deflation is progressively easing, with inflation running at 0% y-o-y.

Swiss government now expecting to book a budget surplus for 2013

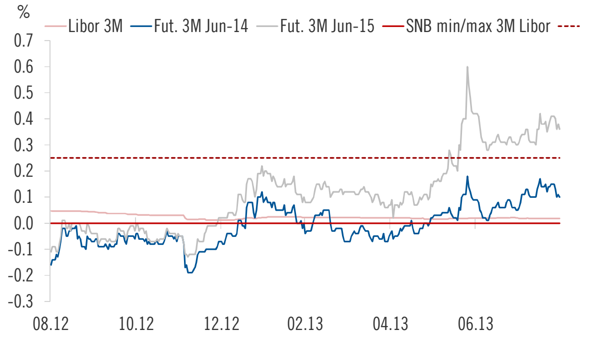
The Federal Council is now expecting to register a surplus on its budget of CHF600m for 2013, compared to the deficit of CHF400m previously pencilled in. Lower social-welfare spending, defence expenditure and operating costs were primarily the reasons for this upgrading of budget projections. Switzerland's public debt is running at around 40% of GDP.

Yields on 10-year Confederation bonds hovered around 1% in July and August

The Swiss bond market will look rather vulnerable if the economic recovery is confirmed and aversion to risk diminishes as Confederation bond yields are still at very low levels by past standards. Any rise in Swiss bond yields is likely to be limited, however, owing to non-existent inflation, 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.

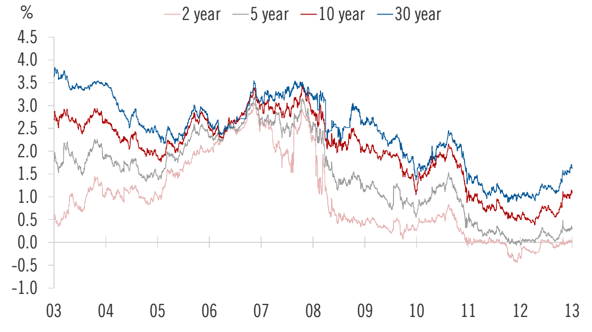
SWITZERLAND

SHORT-TERM RATES (CHF)



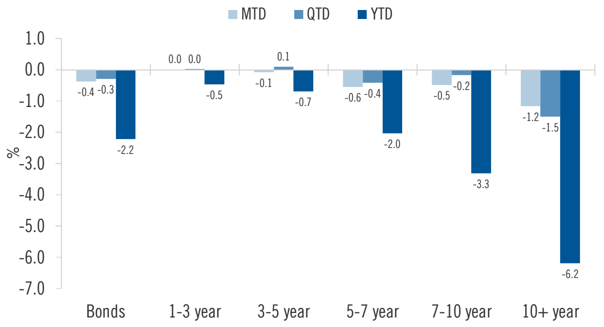
Source: Bloomberg, Money Market, CHF

CONFEDERATION YIELDS



Source: Bloomberg, Confederation

RETURNS FROM GOVERNMENT BONDS BY MATURITY

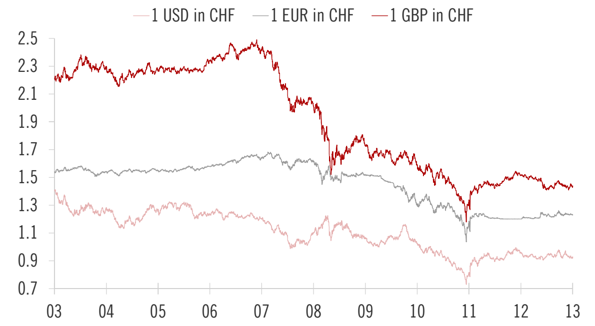


Source: Bloomberg, Citigroup, Switzerland Gvt Bonds

MOVEMENTS IN YIELDS SPREADS

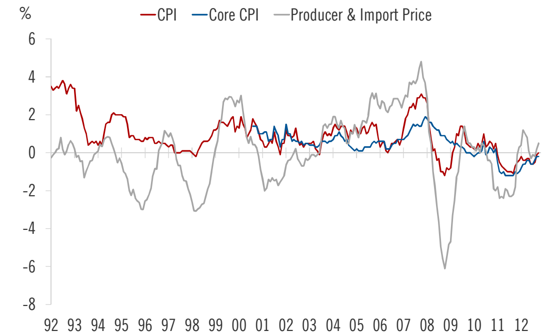
Source: Bloomberg, Confederation

SWISS FRANC EXCHANGE RATE



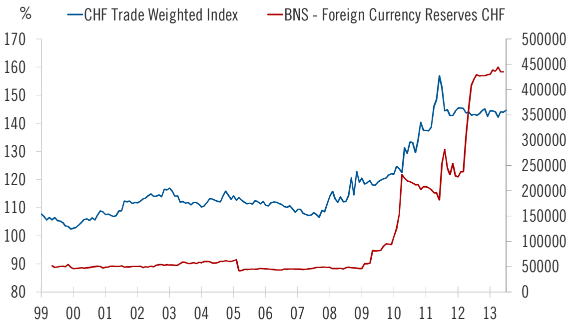
Source: Bloomberg, exchange rates

INFLATION



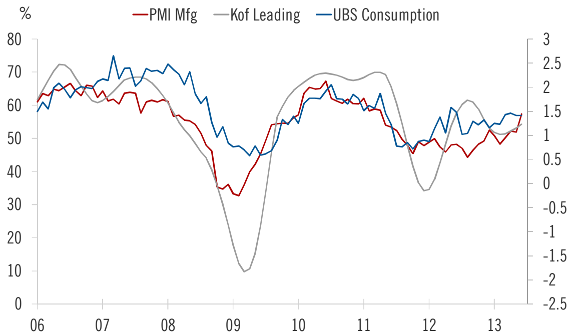
Source: Bloomberg, Switzerland

SNB - FOREIGN CURRENCY RESERVES



Source: Bloomberg, Switzerland

ECONOMIC SURVEYS



Source: Bloomberg, Switzerland

Consumer sales tax hike causing tension to mount

A volatile yen and energy prices have further muddied the waters as far as the direction of inflation is concerned

Consumer prices in Japan rose in May and June, pushing the y-o-y rate of inflation back into positive territory at 0.2%. This can, however, be put down principally to the surge in energy costs, especially the bill for imported hydrocarbons paid out in foreign currencies that rose in value against the yen over the summer. Nuclear reactors have been shut down since the Fukushima accident so the rising price of imported energy has pushed up bills for both business and consumers, making them likely to rein in their spending. If energy products are stripped out of the index, retail prices fell by 0.4% m-o-m in June. The drop was particularly steep on prices of electronic equipment and household appliances. For some 15 years, deflation has acted as a drag on growth as it deters manufacturing industries from investing and persuades consumers to delay their purchases.

Proposed hike in the consumer sales tax is not winning unanimous approval in the ruling LDP

After the Liberal Democratic Party's crushing victory in the recent elections to the Upper House, the debate about the hike in the consumer sales tax has hotted up among the party faithful. The increase in sales tax on consumer goods is one of Prime Minister Abe's flagship revenue-raising policies in his government's drive to reduce the budget deficit. Less than half of the country's deficit has been covered by tax receipts for many years now. With the purpose of redressing this state of affairs, the government is likely to announce this autumn a proposal to raise the consumer sales tax from 5% to 8% in 2014, then up to 10% 12 months later. Although Prime Minister Abe is pushing through this hike at a time when the Japanese economy is on an upswing, some of his advisers are critical of the timing out of fear the increase might curb growth.

The ruling coalition, which is fully signed up to driving the recovery forward, is still looking to make EUR62bn worth of savings in the next two years. It has tabled a plan to wield the axe to public spending to forestall the country's public debt, already up to 245% in GDP, from ballooning further.

Recent economic news has made slightly less encouraging reading, sparking worries of the recovery losing momentum in Q3

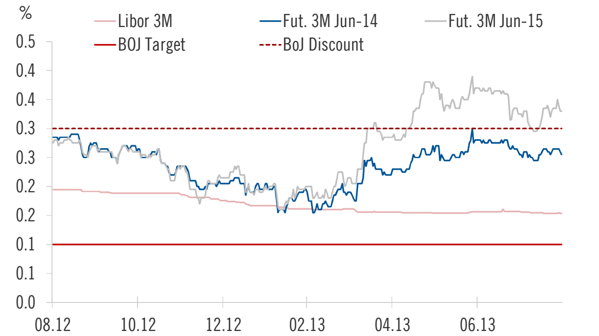
The Bank of Japan (BoJ) has left its monetary policy unchanged, making overt reference to the gentle upswing in the economy. It declined to upgrade its forecasts for growth again, preferring to wait for confirmation the upswing is encouraging business and industry to invest. Recent statistical evidence would appear to suggest the BoJ is right to err on the side of caution. The Manufacturing PMI inched back down in July, sliding from 52.3 to 50.7. Both coincident and leading economic indicators have also been stalling. The index for tertiary industry activity dropped by 0.3% whilst the all-industries index was down by 0.6%. Industrial output fell by 3.1%. Lastly, consumer confidence has been ebbing away over the last couple of months.

JGBs set to remain range-bound in next few months

Over the next few months, we expect Japanese government bonds (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, matched by deflation being genuinely vanquished, will be needed to bring about any significant shift.

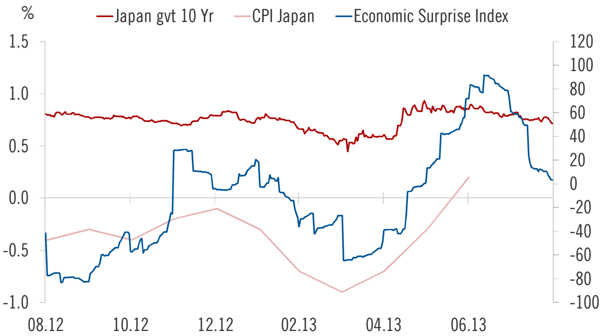
JAPAN

SHORT-TERM RATES (YEN)



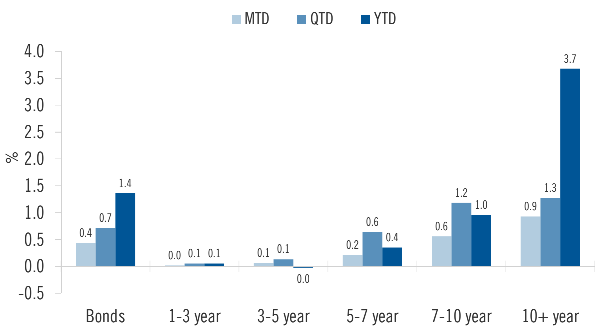
Source: Bloomberg, Money Market, Japan

JAPANESE GOVERNMENT BOND YIELDS



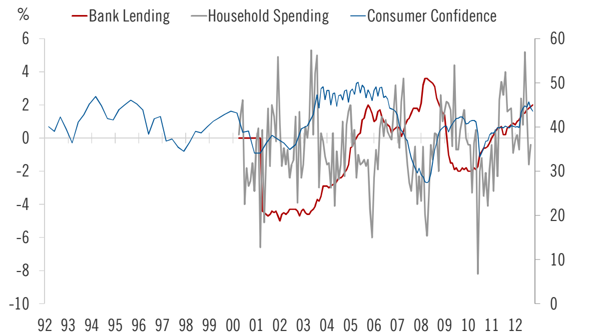
Source: Bloomberg, Citigroup, Japan

RETURNS FROM GOVERNMENT BONDS BY MATURITY



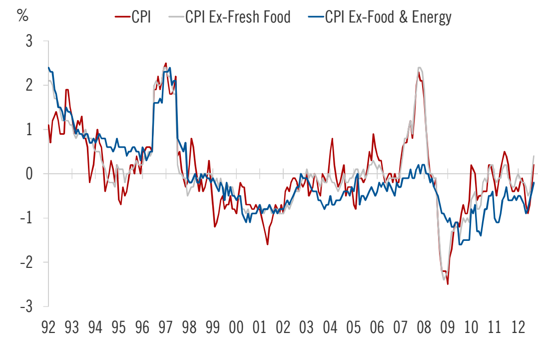
Source: Bloomberg, Citigroup, Japan Gvt Bonds

CONSUMPTION



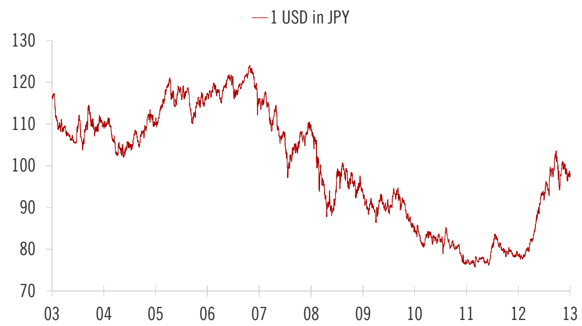
Source: Bloomberg, Japan

INFLATION



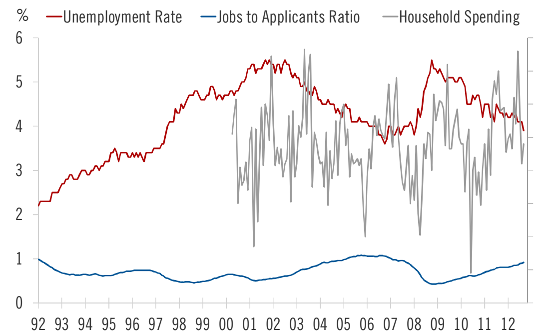
Source: Bloomberg, Japan

JAPANESE YEN VERSUS DOLLAR



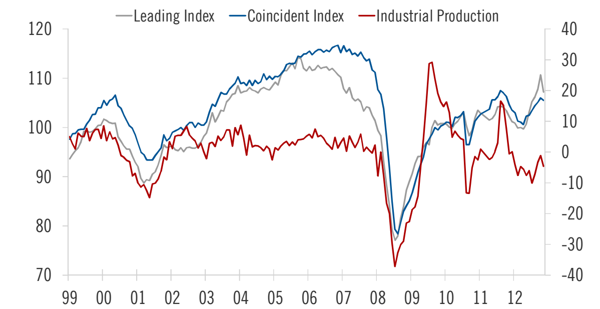
Source: Bloomberg, exchange rates

LABOR MARKET



Source: Bloomberg, Japan

LEADING INDICATOR AND INDUSTRIAL PRODUCTION



Source: Bloomberg

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