PICTET
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Monthly Bond Letter

April 2014

Pictet Asset Management

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Recent developments

Economic uncertainties and low inflation have continued to underpin bonds despite the Fed's ongoing tapering. The latest Purchasing Managers' Indices (PMIs) for Manufacturing to be released have sent out some mixed signals about the upturn on the industry front.

The spate of cold snaps in the USA severely handicapped economic activity, but the impact appears to be fading

The harsh North American winter, not surprisingly, hit construction hard. The adverse effects do, however, seem to be gradually wearing off judging by the most recent numbers reported. Industrial output is being underpinned by manufacturing, and consumer spending has been holding up well.

Recovery in European economy on the right track

The economic upturn in Europe is seemingly progressing as borne out by not just the latest survey findings, but also hard macroeconomic data. The main thrust appears to be coming from industry, but there are tentative signs of domestic demand perking up too. The ECB left key rates unchanged (refinancing rate at 0.2% and deposit rate at zero), with Mario Draghi at great pains to reiterate the theme of forward guidance. The new Italian PM, Matteo Renzi, announced a raft of measures aimed at boosting domestic demand and designed to create jobs. Moreover, further steps were taken in the move to break ties between banks and government backing (agreement on bank resolution fund).

Improving retail sales and industrial production in Japan have given the recovery some support

Retail sales in Japan rose more steeply in January than expected. The rebound in domestic consumer spending has been driven by consumers' desire to spend ahead of the hike of 3 percentage points in the consumer sales tax in April.

The UK Chancellor of the Exchequer presented a neutral overall budget, but it should provide underpinning for the recovery in the run-up to elections

Britain's Chancellor of the Exchequer, George Osborne, presented a fiscally-neutral budget overall, projecting a budget deficit of 6% of GDP for the 2013/14 tax year, with it programmed to be reduced gradually to reach 3% by the 2016/17 tax year. Further tightening of the budget screws is unlikely to be on the cards with a general election looming in 2015.

US Federal Reserve modulating the tenor of its public statements and hinting the cycle of rate hikes may well kick off sooner

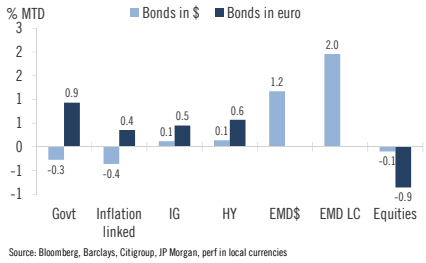
By clarifying that "*a considerable time*" equated to six months, the Fed has seemed to suggest the first hike in the Fed funds rate might well come in late April 2015, whilst emphasising, however, that the neutral equilibrium rate of 4% would not be reached for a few years. This shift in public statements triggered a severe correction on short-term interest rates, causing the yield curve to flatten quite unmistakably.

Stabilisation on risk assets: downward spiral on emerging debt halted and end of rush into high-yield segment

Although local-currency emerging-market debt was still coming under some pressure, pricing levels have started to look very appealing, which investors may well find hard to ignore at this stage.

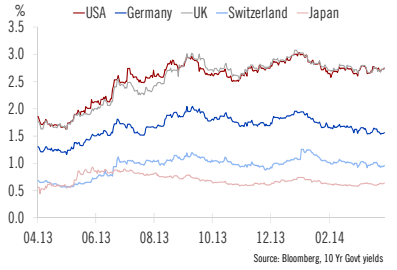
As for corporate bonds, although they are offering less attractive value, they are still being buoyed up by the eurozone's accommodating monetary stance.

PERFORMANCE – MARCH 2014



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

10-YR GOVERNMENT BOND YIELDS



Source: Bloomberg, 10 Yr Govt yields

Forecasts

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

The freezing cold winter weather obviously hurt the USA's GDP in the opening quarter. We believe the economy is likely to have grown at an annualised rate of just 2% q-o-q, compared to our previous projection of 3%. The annual rate of growth forecast is still pitched at 2.8% though.

At the last Federal Open Market Committee (FOMC) meeting, the Fed confirmed it would further rein in its purchases of assets by USD10bn a month, which was what the markets had been expecting. The Fed also decided to regear its monetary policy to qualitative forward guidance, emulating the approach of the Bank of England under Mark Carney. Once the process of tapering of quantitative easing is completed, projected to end in the final quarter this year, interest rates are likely to stay low for "*a considerable time*" after. Fed Chair Janet Yellen did, however, point out the first hike in the Fed funds rate might well happen sooner than the markets have been expecting, i.e. around 6 months after tapering has drawn to a close.

Eurozone economy likely to continue gradually picking up

Two factors likely to spur the ECB into monetary-policy action are pressure being felt on the money markets and more intense disinflation, but neither has materialised. Concerns with regard to deflation are visibly quite firmly anchored. There is little doubt that the decline in prices is not widespread, with pressure on the deflationary front coming chiefly from the steep drop in the volatile energy prices group. Pressures behind the disinflation are being stoked mainly by developments on the wages front as the necessary process of rebalancing domestic economies in Southern Europe runs its course. This is having a positive impact on supply as the competitiveness of peripheral eurozone states has undoubtedly been sharpened.

The ECB is expecting the economy to regain momentum steadily, and it has upgraded its growth forecast for 2014 to 1.2%, in line with our predictions.

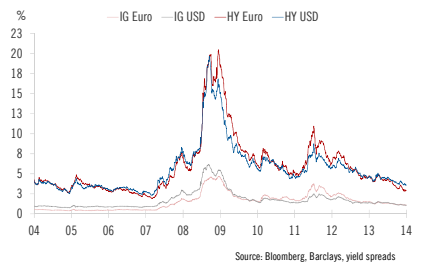
In light of strong growth in mortgage credit and rising property prices, the BoE may well follow the SNB's example and adopt countercyclical capital buffer measures

The upswing on the UK housing market is being driven by strong growth in mortgage lending and the government's *Help to Buy* incentive scheme. The rapid growth seen in the second half of 2013 has heightened risks of the property sector overheating and has already encouraged the Bank of England to suspend its programme of incentives for mortgage loans to households under the Funding for Lending scheme. As house prices are rising quite fast, the BoE may well go one step further to instigate a countercyclical capital buffer set at 2.5% for mortgage loans.

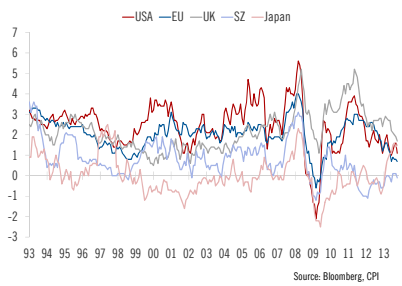
After two years of deflation in a row, inflation is unlikely to move back into positive territory again according to the SNB's latest forecasts

At its recent quarterly monetary-policy session, the Swiss National Bank (SNB) once again emphasised the increased deflationary risks, further downgrading its forecasts for inflation over the next three years. The SNB's mounting concerns are spurred by the deceleration in inflation worldwide and the rising value of the franc against a backdrop of mounting geopolitical.

CREDIT SPREADS



CORE INFLATION



US Federal Reserve changing its tune

USA: the difficulty of shifting from quantitative to qualitative

As the original target of a 6.5% unemployment rate is in sight of being reached, the Fed has decided no longer to make specific references to a quantity or number, preferring now to talk more generally about the state of the jobs market and employment. By taking this approach, the Fed is trying to shift its forward guidance on monetary policy from quantitative to qualitative mode.

This is no easy matter considering how loud the Fed hammered on about its actual target figure for joblessness. The task is made even more challenging when, in tandem and in keeping with an approach of crystal-clear transparency, each FOMC voting member's individual projections about how official interest rates will move over the next three years are made public. The qualitative guidance approach becomes well nigh impossible when such hard and fast quantitative information is being divulged to the markets.

Twin message from the Fed: very specific notions of 'time'

In effect, this is precisely what happened at the outcome of the last FOMC meeting. As the general statements had not altered much, the markets reacted sharply to changes in the unattributed individual projections, the famous 'dots', with the median forecasts climbing from 0.75% to 1% for end-2015 and 1.75% to 2.25% for end-2016, suggesting the Fed had brought forward in time the onset of future monetary tightening.

During the Q&A session, Janet Yellen fanned the flames of this perception. The Fed trotted out its usual line, describing the time-lag between the end of its balance-sheet expansion to the first hike in the Fed funds rates as "*a considerable time*". When quizzed more closely about what the lapse of time actually meant, she indicated, much to the surprise of market operators, that it could be around six months.

So, working on the basis of tapering unfolding steadily at a rate of USD10bn a month being pruned at each FOMC meeting, the process should end between October and December 2014. If we then factor in this 6-month time-lag, the first hike in the Fed funds rate could, therefore, come in late April 2015, well before the date currently being priced into the yield curve.

The second part of the Fed's message for public consumption was definitely less aggressive and hawkish. Although the Fed still regards the neutral interest rate for an economy that has recovered to a state of equilibrium as 4%, Janet Yellen pointed out that the policy rate would not reach that level "*for some time*" after the onset of renewed monetary tightening, with this vague notion of 'time' being subsequently qualified with a reference to "*some years*".

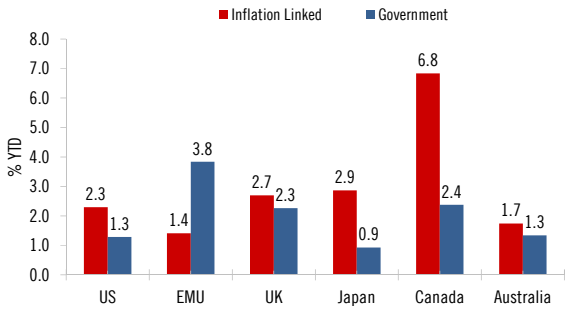
Flattening of curve and anaemic break-even points

With all this going on, the US yield curve, unsurprisingly, flattened quite noticeably, with the short-dated end now factoring in a rate-hike cycle kicking off sooner than predicted and the long-dated end pricing in an end rate well below the so-called neutral or equilibrium rate.

At the same time, inflation break-evens only edged down very gently, shedding a little of their future widening potential. The Fed's determination through its various recent communications is to convince the markets that it is not going to be running 'behind the curve' when it comes to inflation. There is now *de facto* little reason to reconstitute the risk premium that had been present in nominal long-term rates and in inflation break-evens if the Fed sticks to its new approach to monetary policy.

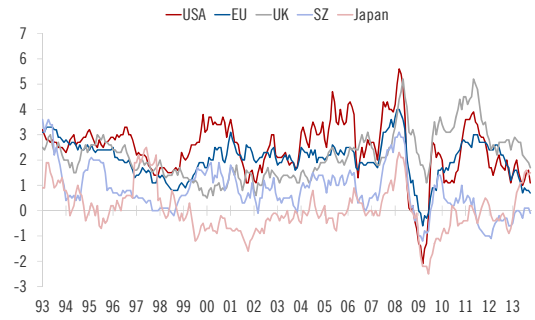
INFLATION-LINKED BONDS

PERFORMANCES 2013 (LOCAL CURRENCIES)



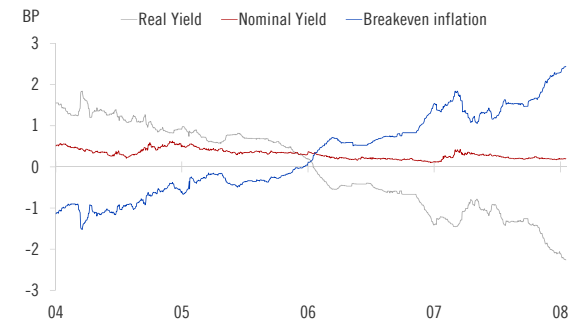
Source: Bloomberg, Citigroup, Barclays, Citigroup

INFLATION



Source: Bloomberg, CPI

JAPAN - TREASURY YIELD COMPONENT

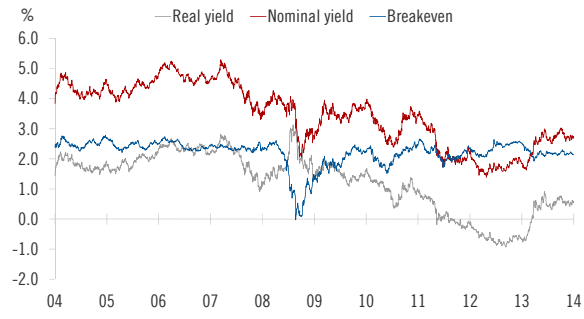


Source: Bloomberg, Japan

USA - REAL RATES

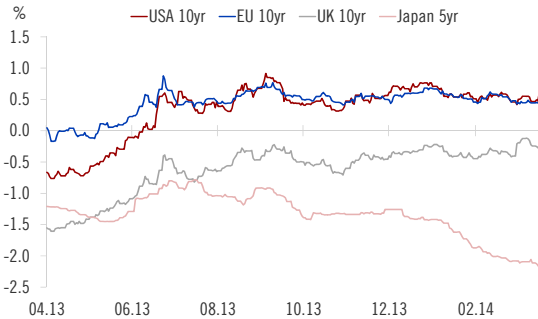
Source: Bloomberg, US Treasury

USA - 10-YEAR TREASURY YIELD COMPONENT



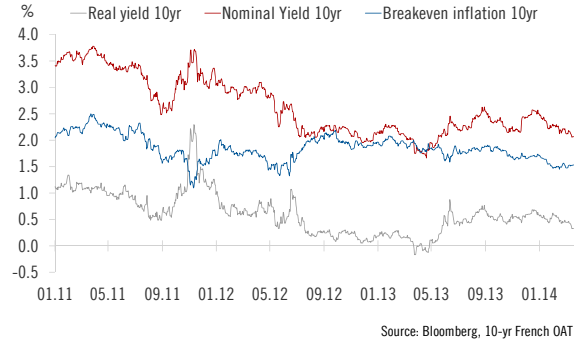
Source: Bloomberg, US Treasury 10 year

10-YEAR REAL YIELDS



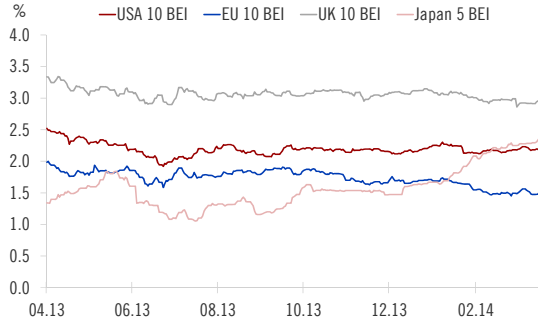
Source: Bloomberg, Real Yields

FRANCE - 10-YEAR YIELD COMPONENT



Source: Bloomberg, 10-yr French OAT

10-YEAR BREAKEVEN INFLATION POINTS



Source: Bloomberg, Break-even Inflation Rates

Credit spreads drifting lower

Mixed bag of returns

Investment-grade corporate bonds delivered positive returns for the third month in succession, mainly thanks to further spread tightening. In the senior debt segment, telecom and media bonds outperformed others in March, especially financials. Unlike the case in previous months, hybrid debt generally posted negative returns. One of the reasons for this was the flood of new issues that put pressure on pricing of already existing paper. Conversely, investment-grade subordinated debt from banks continued to offer positive returns as the risks involved are diminishing as banks strengthen their capital adequacy, especially through issuing the new-type contingent convertible ('CoCo') bonds which comply with the new regulatory requirements. Borrowers from peripheral eurozone countries outperformed among financials and utilities, albeit not quite so impressively as spreads have gradually been narrowing. Looking at geographical patterns, euro-denominated Russian bonds were the worst-performing segment.

Banking union

The third and final pillar to cement in place the Single Resolution Mechanism to deal with bank collapses is in the finishing straight now that various governments have agreed to set up a EUR55bn bail-out fund to be financed over 8 years by the banks themselves, but also through bonds raised on the markets. Structured at the outset on the basis of distinct national funds, the risks will quickly be mutualised between countries. As from 2015, the ECB, donning its mantle of future regulator, will be responsible for dealing with bank collapses and bankruptcies, being able to draw, if need be, on bail-in mechanisms as from 2016.

Primary market

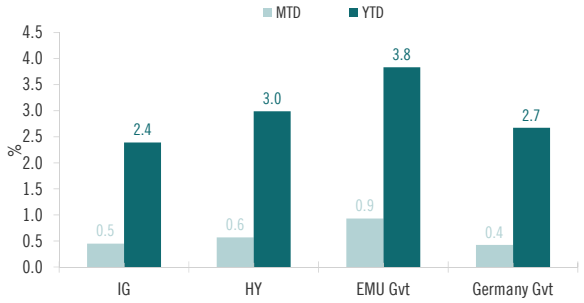
The primary market proved livelier in March, true to the tradition of borrowers flocking back to the markets once the year-end reporting season is done and dusted. Demand, as measured in terms of the size of order books, remains brisk, stemming to a large extent from a level of issuance volume not being big enough for coupon interest paid and proceeds from bond redemptions to be reinvested. In most cases, issuers can trim their issue premiums and/or expand the size of bonds being issued. Among non-financials, the country origin of borrowers was quite diversified in sector terms. Although bonds mostly had maturities from 5 to 10 years, less than a quarter of issues had longer maturity dates than 10 years. To meet demand from money-market funds, the number of variable-rate bonds being issued also rose in March. The hunt for yield is still favouring hybrid debt in the telecoms, energy and automotive sectors. As for senior debt, peripheral eurozone banks are still coming in numbers to the bond market to raise funds, the likes of Monte dei Paschi, Mediobanca or BPIM. The tempo of issuance has remained particularly brisk in subordinated debt, with new Additional Tier 1 (AT1) paper launched by Danske Bank, Santander, KBC and Unicredito. German banks will also shortly be able to issue the same instruments as the authorities are expected finally to accord them favourable tax status.

Outlook

The potential for returns from the corporates market looks fairly limited as average yields are at historically low levels. Nevertheless, spreads are likely to continue narrowing as monetary policy in Europe remains accommodating. The quest for yield is most likely to continue working to the advantage of subordinated bonds as well as corporate bonds with the lowest credit ratings

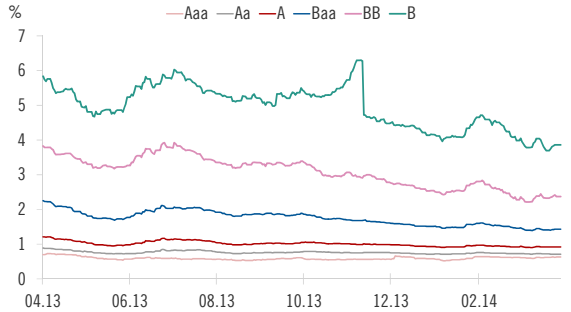
CREDIT RISK

RETURNS ON BONDS IN EURO



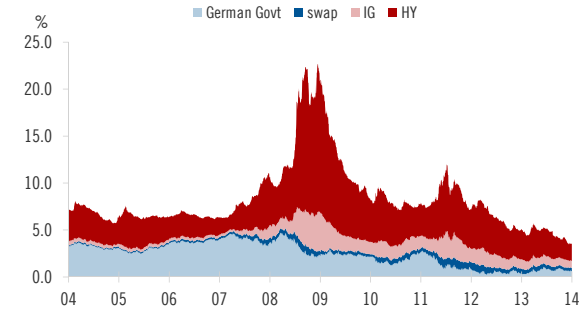
Source: Bloomberg, Barclays, Citigroup, Bonds in euro

CREDIT SPREADS (EURO)



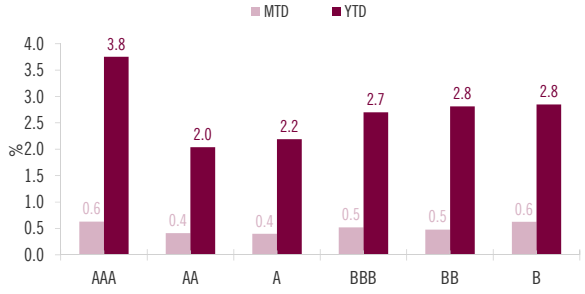
Source: Bloomberg, Barclays, EUR yield spreads

YIELD COMPONENT (EURO)



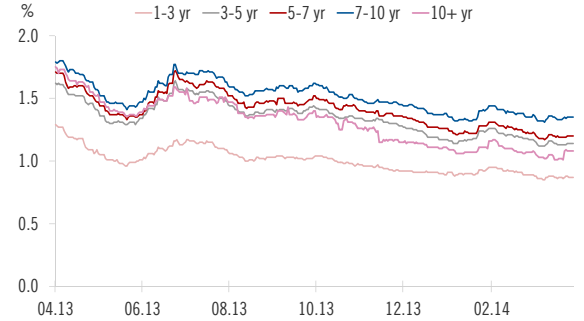
Source: Bloomberg, Barclays, Eur yields

RETURNS ON BONDS IN EURO



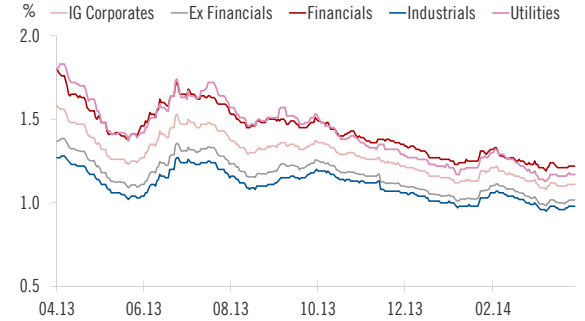
Source: Bloomberg, Barclays, Corporate Bonds in euro

INVESTMENT GRADE SPREADS BY MATURITY (EURO)



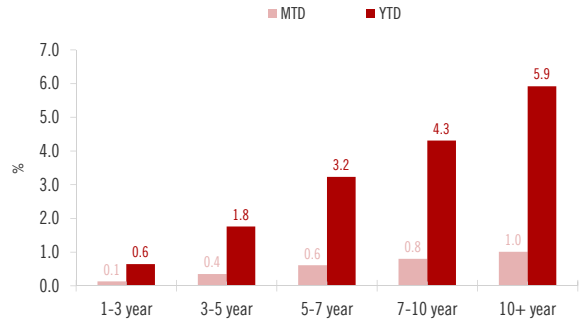
Source: Bloomberg, Barclays, EUR yield spreads

INVESTMENT GRADE SPREADS BY SECTOR (EURO)



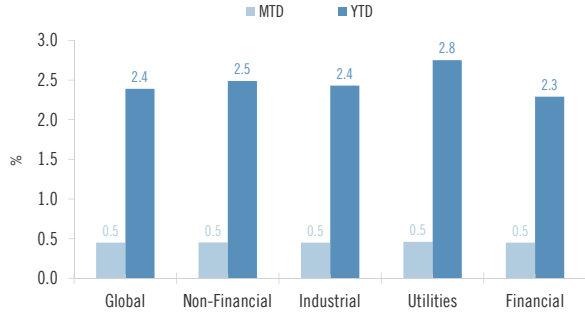
Source: Bloomberg, Barclays, EUR yield spreads

INVESTMENT GRADE RETURNS BY MATURITY (EURO)



Source: Bloomberg, Barclays, Corporate Bonds in Euro

INVESTMENT GRADE RETURNS BY SECTOR (EURO)



Source: Bloomberg, Barclays Corporates Bonds in Euro

Strong run by high-yield bonds grinds to a halt

Investors still searching eagerly for yields

The European high-yield corporates market remained range-bound after a strong start to March. All ratings were in positive territory, with Bs trading weaker as momentum lost steam. Sector-wise, banks' subordinated bonds primarily proved resilient, along with the health-care, services and telecoms sectors. In contrast, the auto sector was more sluggish. In terms of the geographical pattern, geopolitical risks primarily in the former USSR added to investors' disaffection for emerging-market issuers, primarily Russian and South African names. European borrowers with exposure to Russia, Ukraine and, generally speaking, developing economies navigated through the turbulence as improvements in eurozone economies have continued to set the tone. For instance, internal demand was a positive contributor to eurozone growth in the final quarter of 2013. Most recently, the confidence index in Italy reached a three-year peak, confirming positive momentum in the peninsula.

Primary market

As the reporting season drew to a close without noticeable surprises, the primary market proved more active in March, with established names like KBC (issuing subordinated debt), Obrascon (the Spanish construction and concessions group), Nationwide (the UK-based financial group), Lowell (a group providing credit management services) and Renault (the French car maker). Among the first-time issuers, Spanish corporates were well represented, with Antolin (a car-park operator), Isolux (an engineering and construction group) and Almirall (a pharmaceutical group).

Corporate fundamentals and news

Balance sheets remained in decent shape. The default rate is set to remain low throughout 2014, thanks to not only the ECB's accommodating policy, but also the improvement in the upgrade/downgrade ratio. On the corporate news front, the acquisition saga on SFR (the French mobile phone group) is still rumbling on. Numericable and Bouygues are engaged in a bidding war, with each contender counting its political allies. ONO eventually accepted Vodafone's offer which valued the No.2 Spanish cable operator at EUR7bn. Overall, the most significant news came for the derivatives market. BBVA, the Spanish financial institution, was included in the new iTraxx Main series, the leading investment-grade index. As a result, BBVA has become the first peripheral issuer included again after the eurozone sovereign-debt crisis. As for the iTraxx Crossover, the high-yield index was expanded to 60 names this month. In total, five were replaced, the latter trading very tight most of the time following M&A activities (such as ONO mentioned above), and ten new issuers were added. As a result, the iTraxx Crossover move sharply up as new names are traded more widely and the weight of Bs has increased. Overall, the index serves as a better reflection of the European high-yield market in the knowledge that the broadening may also enhance liquidity.

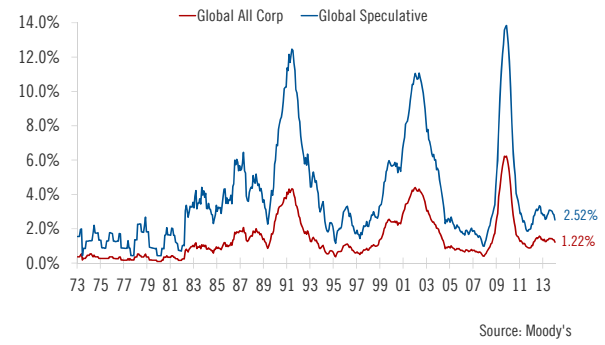
Outlook

We continue to be constructive on the high-yield asset class. Downside risks in the eurozone are receding. Fundamentals remain good and technically strong, with a widening client-base and benefits of negative net issuance in financial bonds. The market is well aware of this improvement. Current valuations better reflect macroeconomic conditions, along with the backstop provided by the ECB. At issuer level, idiosyncratic risks are set to remain high: on the positive side, with M&A and IPOs; on the negative side, with deteriorating credit metrics for a handful of issuers. All in all, the background remains favourable to high-yield corporates while bottom-up selection may gain in importance as the market takes a breather following the strong start to the year.

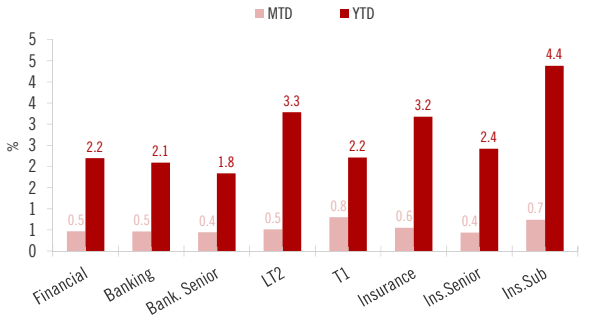
CREDIT RISK

EURO SWAP SPREADS

MOODY'S - DEFAULT RATES

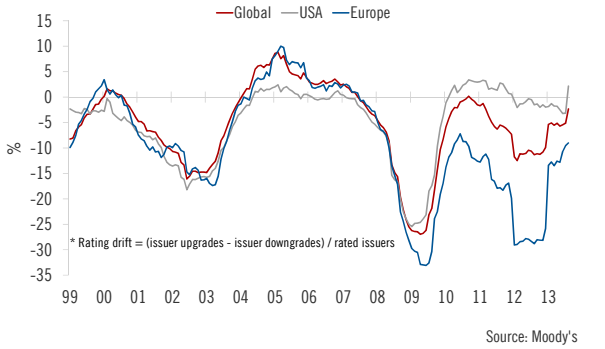


FINANCIAL INVESTMENT-GRADE RETURNS (EURO)

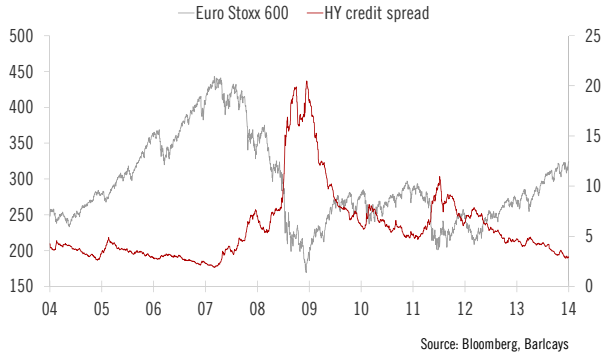


Source: Bloomberg, BoA Merill Lynch

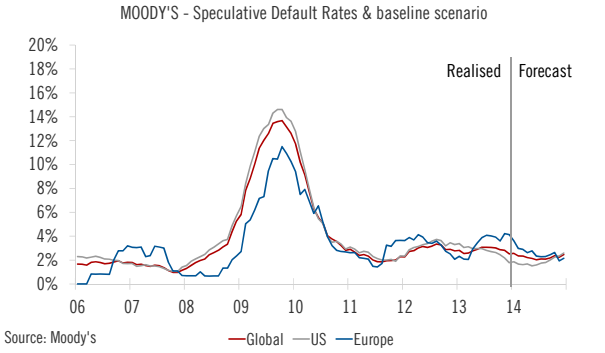
MOODY'S - RATING DRIFT



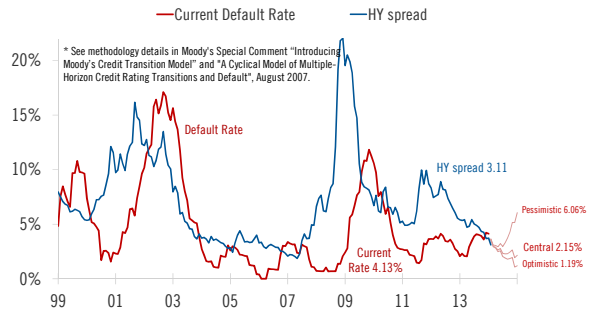
STOCK MARKET AND HY SPREAD



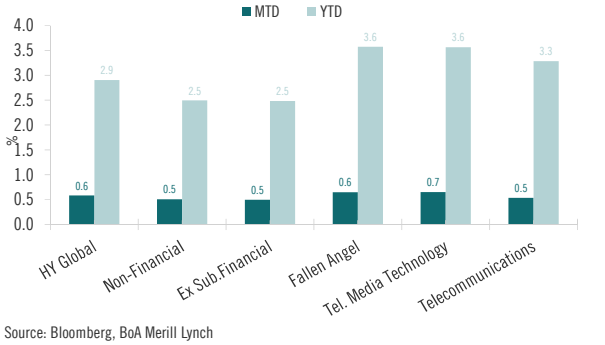
MOODY'S - DEFAULT RATES



HIGH-YIELD SPREAD AND DEFAULT RATES (EURO)



HIGH-YIELD RETURNS BY SECTOR (EURO)



Still no clear signs of a turnaround

Local-currency debt – Recent developments

March saw some volatility as tension in Ukraine escalated, China published disappointing export, retail sales and industrial production numbers while the Fed was considered to have adopted a more hawkish tone and forward guidance was modified to be less rigid. The market saw the local-currency emerging benchmark close to flat whereas some inflows were seen in the market for the first time in three months. This was not sustained though. Russia was the worst performer, down over 4%, almost all from weaker bond prices given some selling pressure in the face of sanctions and an emergency rate hike of 150bp to 7%. Turkey continued to see weakness as elections loom and corruption continues to dominate headlines. Indonesia held rates at 7.5% while the market enjoyed a good recovery, returning over 3% for the month. Thailand cut rates by 25bp to 2% given the negative impact of recent political turmoil. Chile eased rates by 25bp in the face of slower growth with ongoing weak demand for commodities not helping the world's largest copper exporter. Colombia surprised with a return of close to 5% as it saw its weight in a leading JP Morgan benchmark rise from 3.2% to 8% in response to a reduction in taxes on foreign investors. Poland left rates unchanged at 2.5% as it expects a modest economic recovery and manageable inflation.

Local-currency debt – Outlook

One underlying reason for emerging-market weakness has been the trend down in exports since 2010. Now, with expected more robust US and developed-market growth, emerging economies could strengthen as well. However, growth remains uneven, and the impact of Fed tapering will continue to affect countries with structural issues, in particular those with funding needs. Turkey is a key example, with significant political risks and a huge current-account deficit, whilst South Africa is seeing labour unrest, low growth, lack of reforms and upcoming elections – however, weaker currencies have been part of the solution. Despite some stabilisation, these markets could see continued pressure during this period of global transition to more normal monetary conditions. Countries like Mexico and the Philippines with political stability and positive structural reforms should fare better than others.

External debt – Recent developments

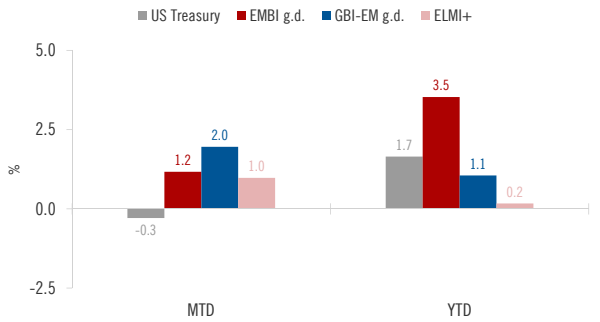
Returns from external emerging-market debt were close to flat even though US Treasuries had a negative impact on the index over the month. Spreads compressed marginally in the month. In March, high-yield countries, such as Argentina and Venezuela, fared well offsetting the negative performance of high-grade countries. Many eurozone countries suffered, not escaping the tension created in the region by Russia with Ukraine, and this risk was reflected in seeing Russia moving lower by more than 5% and Ukraine by over 2% where recent events have aggravated the country's economic challenges, even though public debt is not on an unsustainable path. Rating agencies have been busy, with downgrades on Nigeria, Croatia and Russia (both eurobonds and OFZs) as well as Brazil where they did not wait until the elections to downgrade paper to BBB- from BBB. The only exception was Uruguay where the agencies upgraded their ratings to BBB, from BBB-.

External debt – Outlook

We could see further pressure on the asset class with unwinding of risk by investors. However, at some point, attractive valuations will be hard for investors to ignore, and fundamentals will start to rebalance, leading to potential for a stronger recovery, but Fed tapering may continue to cause downward pressure while more focus will be put on the fundamentals of each country. The potential for range-bound US Treasury yields in the short term would be supportive and add weight to the argument that there is value given the spread level relative to other high-grade-spread asset classes and good support from longer-term investors. However, it remains subject to investor sentiment, and we have not yet seen a meaningful reversal of investor outflows.

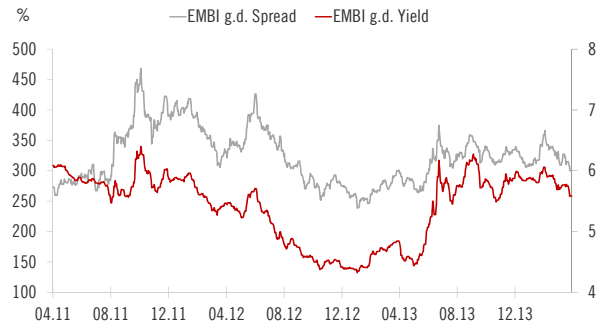
EMERGING DEBT

PERFORMANCES (USD)



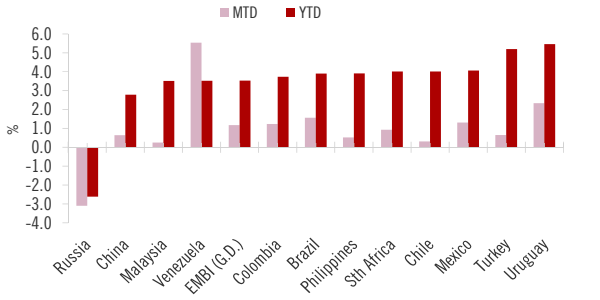
Source: Bloomberg, Index JP Morgan

US DOLLAR DEBT - YIELD & SPREAD



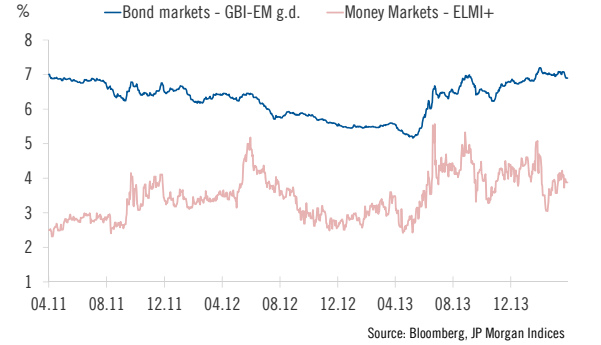
Source: Bloomberg, JP Morgan Indices

JP MORGAN EMBI GLOBAL DIVERSIFIED



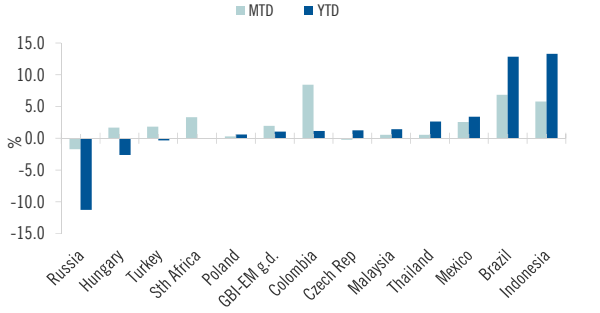
Source Bloomberg: Index JP Morgan

LOCAL CURRENCY DEBT - YIELD



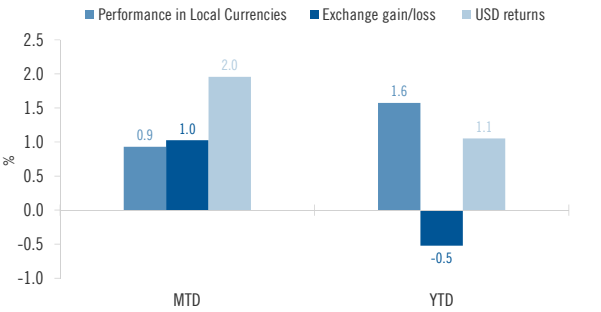
Source: Bloomberg, JP Morgan Indices

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



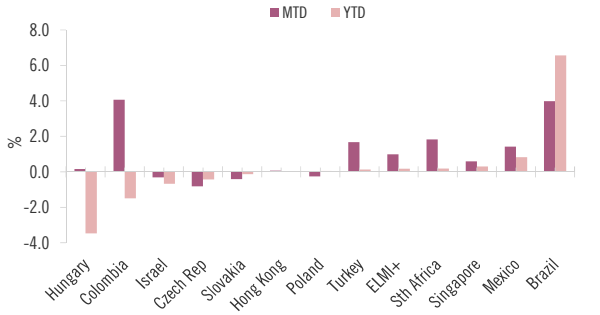
Source Bloomberg: Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



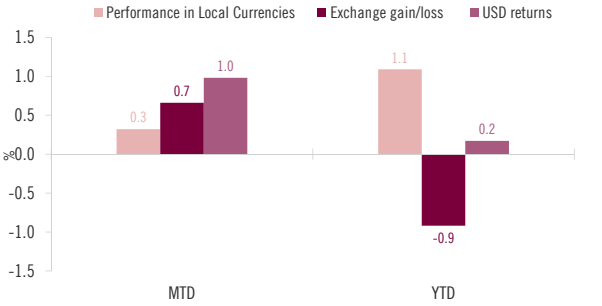
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg: Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

Economy set to regain momentum

The spate of cold snaps in the USA severely handicapped economic activity, but the impact appears to be fading

Figures released at the outset of this year have highlighted the slowdown caused by the unusually tough winter weather in North America this year. Construction, in particular, bore the brunt. The adverse effects do, however, seem to be gradually wearing off judging by the most recent numbers reported. Housing starts dropped by 4.5% at an annualised three-monthly rate in February, but building permits actually bounced up by 7.5%, making up for the December and January falls. The NAHB/Wells Fargo Housing Market Index, a reliable measure of confidence in the house-building sector, picked up to 47 in March (+2.2%) after its steep drop from 56 to 46 (-18%) in February. Turning to industry, production rose by 0.6% thanks to a 0.8% increase in manufacturing output. The underlying annualised rates of 3.6% and 1.5%, respectively, are travelling in the right direction and should, judging by recent survey findings, continue that way. The ISM for February registered a 1.9-point rise to 53.2. The PMI progressed too, up 3 to 56.7. On the household front, consumer spending proved a little disappointing. Retail sales rose by just 0.3% in February after falling in the two months before that. That is a fairly gentle uptrend, with spending on services (heating and health care) offsetting lacklustre spending on goods. Consumer spending remains, however, a key engine of growth in the US economy. Real consumer spending rose by 0.3%, given a lift by the Affordable Care Act. The increase was also mirrored in rising household incomes, helping to sustain a more than decent underlying rate of progress. Lastly, consumer credit is also clearly locked onto an uptrend.

The number of new jobs created in February was estimated at 175,000, picking up from 46,000, with the figures for the two previous months being revised up by 25,000. The unemployment rate itself worked out at 6.7% (slightly up from 6.6% for January).

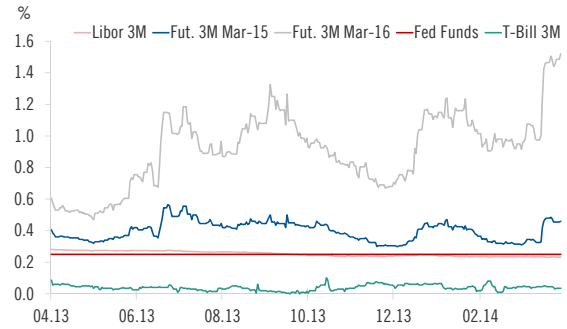
The freezing cold winter weather will obviously have hurt the USA's GDP in the opening quarter. We believe the economy is likely to have grown at an annualised rate of just 2% q-o-q, compared to our previous projection of 3%. The annual rate of growth forecast is still pitched at 2.8% though.

The Fed has relinquished its trigger target of a 6.5% unemployment rate, switching to an approach geared towards qualitative forward guidance

At the last FOMC meeting, the Fed confirmed it would further rein in its purchases of assets by USD10bn a month, which was what the markets had been expecting. The Fed also decided to regear its monetary policy to qualitative forward guidance, emulating the approach of the Bank of England under Mark Carney. This implies the Fed has relinquished its trigger target of a 6.5% jobless rate: below that point, the Fed would have thought about starting to tighten monetary conditions again. In future, the Fed will monitor a whole array of indicators before making the milestone step to lift the Fed funds rate. In particular, it will focus on assessing the degree of underutilised production capacity in the jobs market, inflationary expectations and the current rate of inflation. Once the process of tapering of quantitative easing is completed, projected to end in the final quarter this year, interest rates are likely to stay low for "*a considerable time*" after. Fed Chair Janet Yellen did, however, point out the first hike in the Fed funds rate might well happen sooner than the markets have been expecting, i.e. around 6 months after tapering has drawn to a close. The comments made referred to the first half of 2015 and pointed out the equilibrium level for the Fed funds rate is likely to be noticeably lower than the 'neutral' rate prevalent pre-crisis.

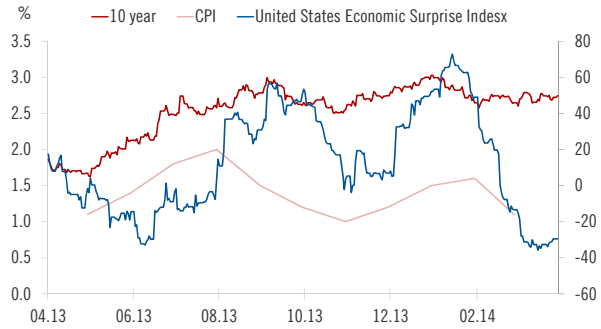
USA

SHORT-TERM RATES (USD)



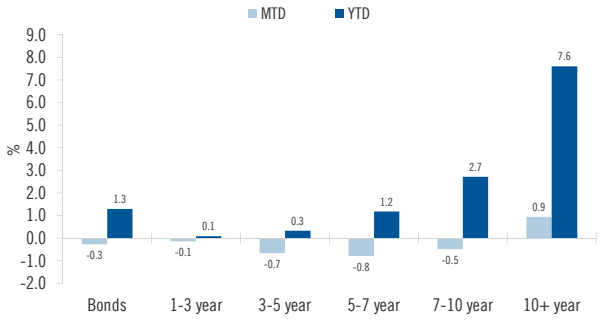
Source: Bloomberg, Money Market, USA

US TREASURY BOND YIELD



Source: Bloomberg, Citigroup, USA

RETURNS FROM GOVERNMENT BONDS BY MATURITY

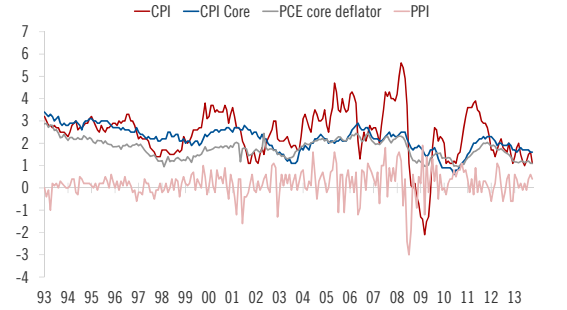


Source: Bloomberg, Citigroup, US Treasury

MOVEMENTS IN YIELD SPREADS

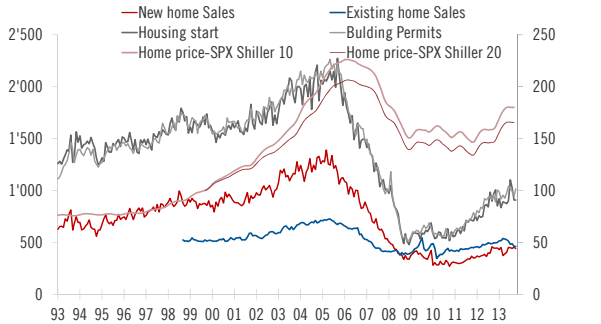
Source: Bloomberg, US Treasury

INFLATION



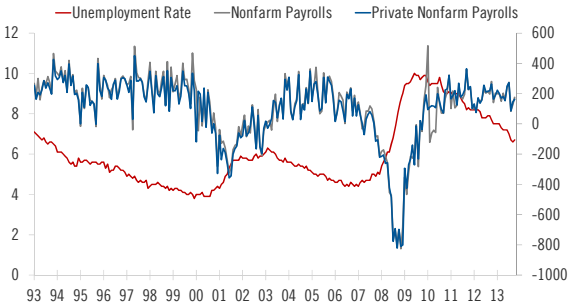
Source: Bloomberg, USA

HOUSING



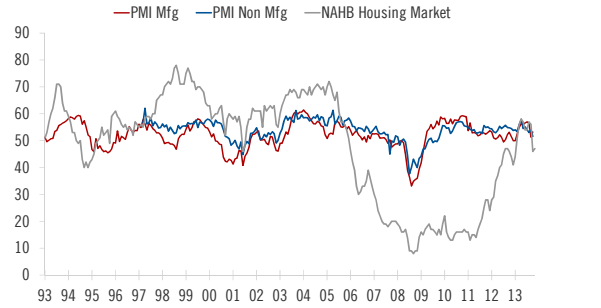
Source: Bloomberg, USA

LABOR MARKET



Source: Bloomberg, USA

PMI AND NAHB INDICES



Source: Bloomberg, USA

Recovery nicely on track

Industrial output underpinning the recovery – and not just that...

The economic upturn in Europe is seemingly progressing as borne out by not just the latest survey findings, but also hard macroeconomic data. The European Commission's Economic Sentiment Indicator has continued to climb, reaching in February its highest point since mid-2011. Likewise, the composite PMI has now been pitched in positive territory for 9 months. The main thrust appears to be coming from industry, but there are some tentative signs of domestic demand perking up as well. Findings from both consumer and business surveys are also pointing upwards, the unemployment rate has been hovering steadily at around 12% since October 2013, and lending to the private sector seems to have bottomed out. It has been shrinking, but the rate of contraction has encouragingly been slowing down. Detailed GDP figures for Q4 2013 have revealed that the economy was being underpinned by external demand, but domestic demand has begun to help too (primarily the investment component).

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

The ECB left key rates unchanged (refinancing rate at 0.2%; deposit rate at zero), with Mario Draghi at great pains to reiterate the theme of forward guidance. Interest rates look set to remain at their current or even lower levels for a lengthy period. There are two factors widely viewed as likely to trigger some sort of action from the ECB, but neither has materialised: pressure being felt on the money markets and more intense disinflation. Concerns with regard to deflation are visibly quite firmly anchored. There is little doubt that the decline in prices is not widespread, with pressure on the deflationary front coming chiefly from the steep drop in the volatile energy prices group. Pressures behind the disinflation are being stoked mainly by developments on the wages front as the necessary process of rebalancing domestic economies in Southern Europe runs its course. This is having a positive impact on supply as the competitiveness of peripheral eurozone states has undoubtedly been sharpened. On the households front, there is no compelling evidence yet to suggest consumers are deferring their purchases. The ECB is expecting the economy to regain momentum steadily, and it has upgraded its growth forecast for 2014 to 1.2%, in line with our predictions. Conversely, inflation rates are on a downward trend, with an increase of 1% y-o-y expected for 2014.

Welcome and necessary structural measures

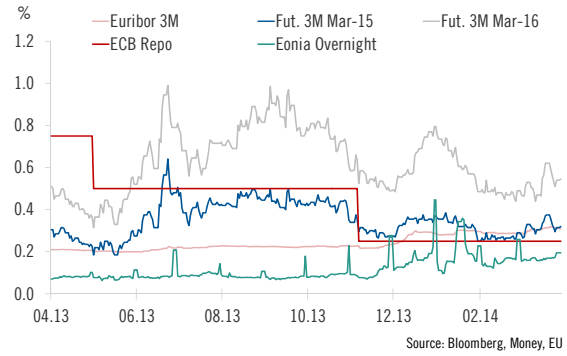
The new Italian PM, Matteo Renzi, announced a raft of measures aimed at boosting domestic demand and designed to create jobs. To do this, he has announced EUR10bn in tax cuts for low-income households. In addition, taxes on businesses have been reduced (10% cut in regional labour taxes and energy bills for small/mid-sized businesses). Moreover, the first step has been taken towards reforming the labour market with the introduction of a single contract, simplification of rules for recruiting trainees and harmonisation of the 24-month unemployment benefit programme. The announcement of these measures is encouraging and should have a favourable impact on consumer spending, youth unemployment and competitiveness which is a weak point of Italy's spluttering economy.

Further steps were taken in the move to break the ties between the banks and governmental backing. A deal has finally been secured on the Single Resolution Mechanism to be financed through contributions from the bank themselves built up over a period of eight years rather than the ten initially envisaged. The fund will gradually be topped up to reach EUR55bn.

The recovering economy and resolve to press ahead with requisite structural reforms are helping to strengthen the forward momentum in Europe.

EUROZONE

SHORT-TERM RATES (EURO)

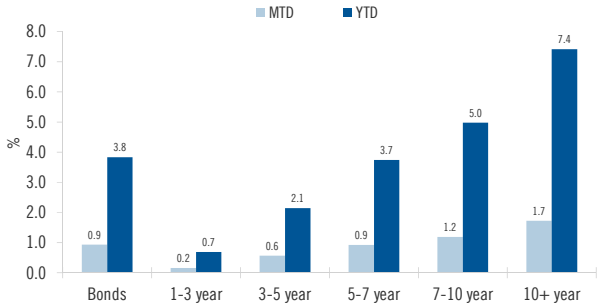


Source: Bloomberg, Money, EU

BUND YIELDS

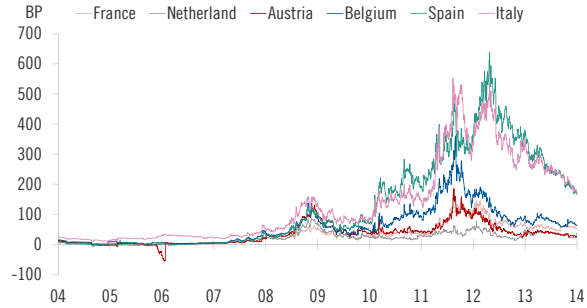
Source: Bloomberg, Bund

RETURNS BY MATURITY (EMU GVT)



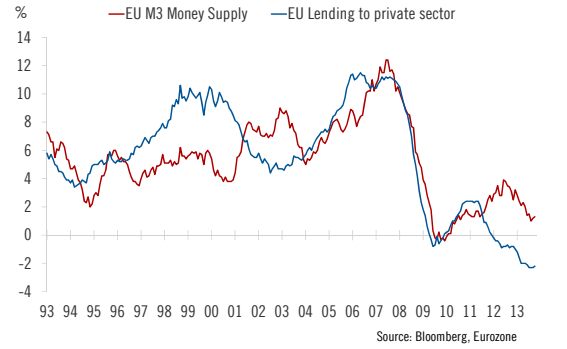
Source: Bloomberg, Citigroup, EMU Gvt Bonds

10-YR GVT SPREADS VS GERMANY



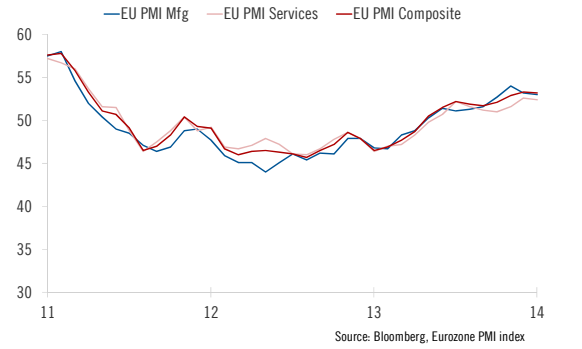
Source: Bloomberg, Govt yield spreads

M3 AND LENDING TO PRIVATE SECTOR



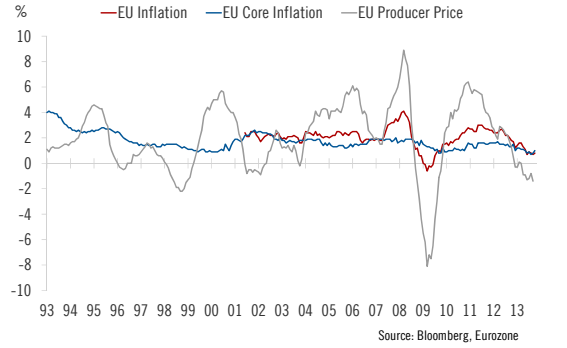
Source: Bloomberg, Eurozone

EUROZONE - PUCHASING MANAGER INDICES



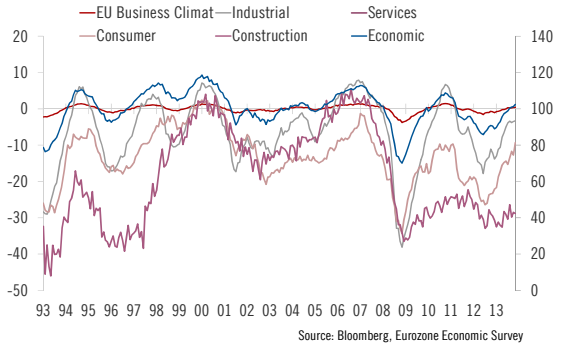
Source: Bloomberg, Eurozone PMI index

EUROZONE - INFLATION



Source: Bloomberg, Eurozone

EUROZONE - ECONOMIC SURVEYS



Source: Bloomberg, Eurozone Economic Survey

BoE could adopt prudential macro measures to cool down a fast-expanding housing market

In light of the strong growth in mortgage lending and rising property prices, the BoE may well follow the SNB's example and adopt the countercyclical capital buffer measure

Housing prices as reported by Nationwide rose more quickly than expected in February, registering an annual increase of 9.4%, compared to the 8.8% recorded for January. The rise in house prices was even more spectacular according to the Halifax's barometer which showed a 10% y-o-y rate of increase for February, a jump from 7.9% in January. The Office for National Statistics (ONS) also reported an annual increase in property prices for January at 6.8%, up from 5.5% in December 2013. The upswing on the housing market is being fuelled by the strong expansion in mortgage loans, with the number of home-loan approvals advancing by 42.4% y-o-y in January (compared to +29.6% in December). The rapid growth seen in the second half of 2013 has heightened the risks of the property sector overheating and has already encouraged the Bank of England to suspend its programme of incentives for mortgage loans to households under the Funding for Lending scheme. As house prices are rising quite fast, the BoE may well go one step further to instigate a countercyclical capital buffer set at 2.5% for mortgage loans. This mechanism should help to stabilise the UK's banking system, mirroring the prudential macroeconomic policy on this front being pursued by the Swiss National Bank. In terms of monetary policy itself, the BoE is likely to remain cautious by focusing on a whole array of indicators of underutilised production capacity, with the likelihood of the base lending rate staying unchanged for quite some time.

Jobs market has continued to rebound, but not quite as energetically as in late 2013

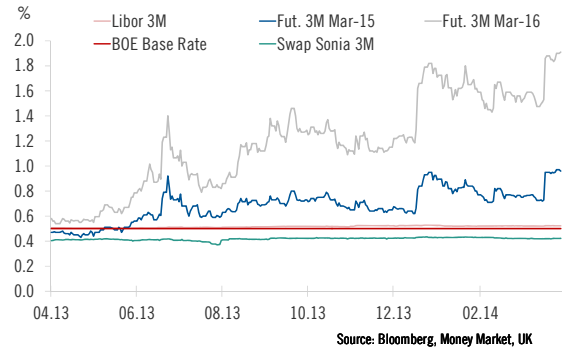
Employment data overall were better than expected for February, with the number of job-seekers claiming unemployment benefit falling by 34,600, compared to a drop of 33,900 in January, extending the run to 16 months of falls in a row. The unemployment rate held steady at 7.2% in February, masking an uptick on the jobs front. Over the last three months, employment has expanded by 105,000, with a noticeable rise in full-time workers. Moreover, with the y-o-y rate of inflation sliding to 1.7% in February, well below the BoE's official target, the BoE has greater room to manoeuvre before having to push interest rates back towards a more normal footing.

Chancellor of the Exchequer presented a neutral overall budget, but it should provide underpinning for the recovery in the run-up to elections

Public-finance data for February were in line with expectations and should enable the government to hit its budget target for the 2013/14 tax year. Britain's Chancellor of the Exchequer, George Osborne, presented a fiscally-neutral budget overall, projecting a budget deficit of 6% of GDP for the 2013/14 tax year, with the deficit programmed to be reduced gradually to reach 3% by the 2016/17 tax year. Moreover, the budget should lend some support to the recovery, with measures envisaged to give investment, housing construction and exports an extra boost. The independent Office for Budget Responsibility revised down its figure for the government's financing requirements for the 2013/14 tax year to GBP96bn, 3 billion lower than previously projected thanks, in the main, to higher tax receipts than expected.

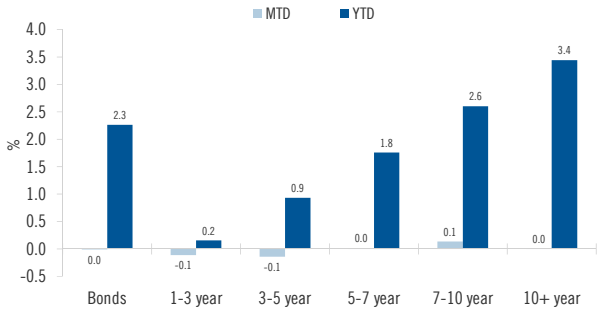
UK

SHORT-TERM RATES (GBP)



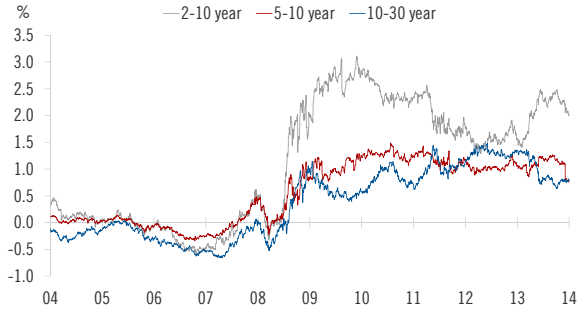
UK TREASURY YIELDS

RETURNS FROM GOVERNMENT BONDS BY MATURITY

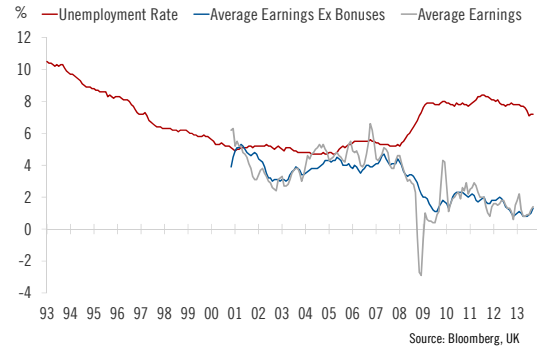


Source: Bloomberg, Citigroup, UK Treasury

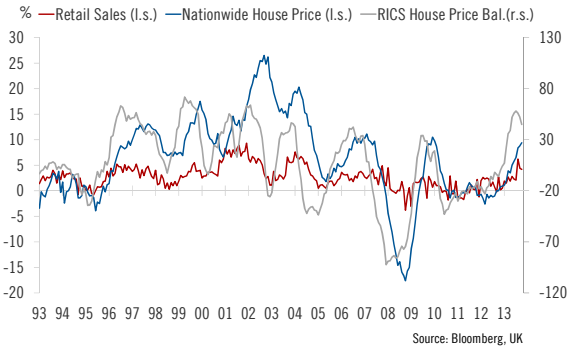
MOVEMENTS IN YIELD SPREADS



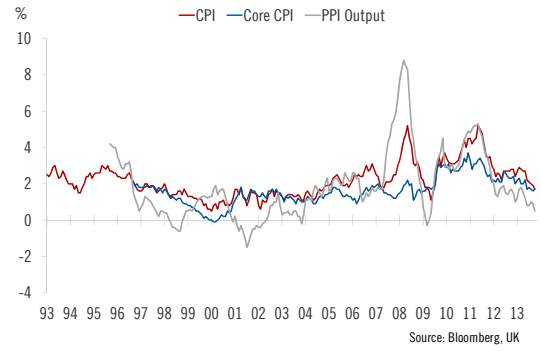
LABOR MARKET



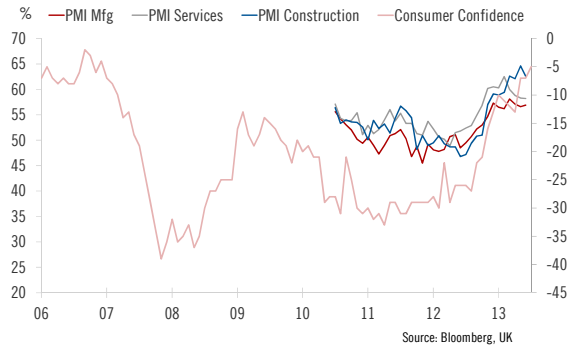
HOUSING AND RETAIL SALES



INFLATION



ECONOMIC SURVEYS



Comeback by deflation: looming risk for Switzerland's economy in 2014

The most recent survey findings suggest Switzerland's economy expanded at a less robust rate in Q1 2014

The most recent indications from surveys point towards a slowing of growth in the Swiss economy, with the UBS Consumption Indicator down from 1.81 in December to 1.44 in January before bouncing up a little to 1.57 in February. In much the same vein, the ZEW-CS Indicator measuring economic expectations for Switzerland also declined steeply for the third month in a row, down from 28.7 in February to 19 in March. Moreover, retail sales also slid in January (-1.9% m-o-m), owing to falling sales of non-food items, with this drop chiming with the signal coming from the Consumption Indicator. More reassuringly though, the Manufacturing PMI picked up again, advancing from 56.1 to 57.6 in February, signalling the likelihood of expected acceleration in industrial production. This rise in the PMI can be put down primarily to its Production sub-index as it progressed to 61.9 (up 5.8 points), followed by the New Orders component up to 61.4 (+1 point).

Pictet's leading indicator pointing towards the economy continuing on its growth path, but less robustly than forecast towards the end of last year

In February 2014, Pictet's leading indicator for Switzerland's economy climbed to 136 (+0.9 of a point), after falling by 1.3 in January. Its annual rate of progress is running at 1.9%, which suggests a sustained recovery in Switzerland's economy, albeit at a less robust tempo than had been thought in the latter half of 2013. The jobs market improved a fraction further in February, with the jobless total rising less fast than in January: 3,258 new job-seekers registered for unemployment benefit in February, taking the total to 149,259. The seasonally-adjusted unemployment rate was unchanged at 3.2%, masking this turn of events. Hearteningly, the number of young people unemployed fell by 1,114 to 19,419 (a 5.4% drop y-o-y). The number of job vacancies being advertised in regional labour exchanges rose by 1,746 in February to 14,042.

After two years of deflation in a row, inflation is unlikely to move back into positive territory again according to the SNB's latest forecasts

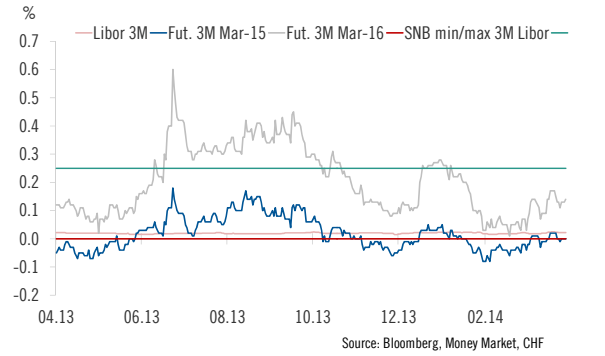
Consumer prices did edge up a touch in February (+0.1% m-o-m), but this still resulted in the headline rate declining to -0.1% y-o-y. At its recent quarterly monetary-policy session, the Swiss National Bank (SNB) once again emphasised the increased deflationary risks, further downgrading its forecasts for inflation over the next three years. The SNB's mounting concerns are spurred by the deceleration in inflation worldwide and the rising value of the franc against a backdrop of mounting geopolitical tension. Imported inflation was actually the biggest contributory factor to the drop in domestic inflation which is still being pushed upwards primarily by the services sector.

Low interest rates and the fixed ceiling rate for the euro/franc exchange rate set to remain in place for quite some time

In light of the increased deflationary risks and the slowdown in the rate of growth, the SNB looks set to keep its key interest rates and the ceiling exchange rate for the franc's value against the euro unchanged for some time to come. A worse than expected deterioration in the inflation outlook might well prompt the SNB to soften monetary policy by resorting to non-conventional measures.

SWITZERLAND

SHORT-TERM RATES (CHF)

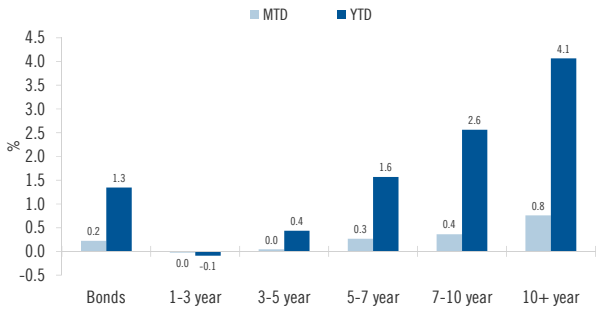


Source: Bloomberg, Money Market, CHF

CONFEDERATION BOND YIELDS

Source: Bloomberg, Confederation

RETURNS FROM GOVERNMENT BONDS BY MATURITY

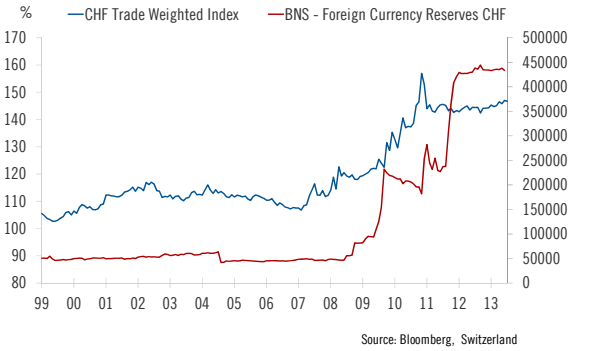


Source: Bloomberg, Citigroup, Switzerland Gvt Bonds

CONFEDERATION - MOVEMENTS IN YIELD SPREADS

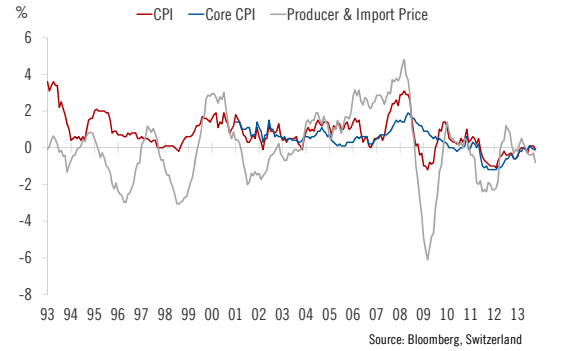
Source: Bloomberg, Confederation

SNB EXCHANGE RESERVES



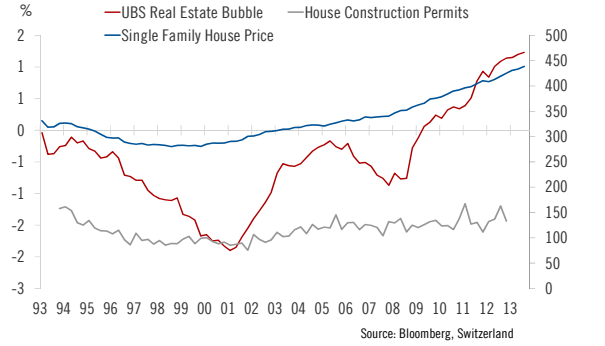
Source: Bloomberg, Switzerland

INFLATION



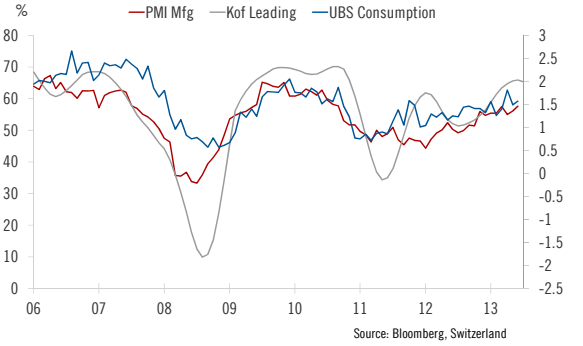
Source: Bloomberg, Switzerland

HOUSING MARKET



Source: Bloomberg, Switzerland

ECONOMIC SURVEYS



Source: Bloomberg, Switzerland

Low inflation still the biggest challenge facing the Bank of Japan

Improving retail sales and industrial production assisting the recovery

Retail sales rose more strongly than expected in January, posting 4.4% y-o-y growth, compared to the +2.5% recorded in December. The rebound in domestic consumer spending has been driven by consumers' desire to spend ahead of the hike of 3 percentage points in the consumer sales tax due in April. This jump should not be overplayed though considering the drop expected to come after April. For much the same reason, expansion in industrial output quickened as well to 10.3% y-o-y, up from 5.7% in December. The latest PMI findings for February though do point towards a slowdown in growth in the months ahead.

Lending to the private sector has continued to expand at a brisk pace

Lending to the private sector did lose a little of its impetus in February (+2.4% y-o-y, compared to +2.5% in January), but it has been expanding at its fastest since 2011 and should soon quicken to growth rates on a par with those seen in 2006/07. Overall, banks' intermediation operations have reflected the greater efficiency in transmission of the Bank of Japan's monetary policies.

Confidence barometers signalling a slowdown in the economy for Q2

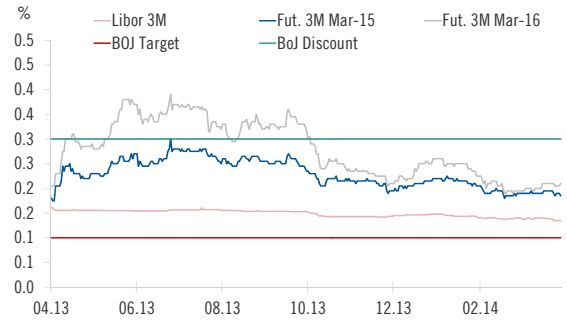
Consumer confidence fell quite steeply in February, sinking to 38.3, 2.2 points down on the January reading. That took the index to its lowest level since December 2012. The Economy Watchers' Sentiment Index also fell more steeply than expected in February, down to 46.5 on average for the Current and Outlook indices, compared to a score of 51.9 in January. This steep drop can be blamed primarily on the drop in the Outlook index which fell to 40 in February from 49 in January. That is the second biggest fall in the index since the devastating March 2011 earthquake/tsunami. On the plus side, the indicator from the latest survey of confidence at small/mid-sized businesses conducted by Shoko Chukin Bank climbed in March to its highest level since 1989, advancing to 53.5, up 2.9 points on its February reading. The indicator suggests businesses are still confident about the recovery and giving a high credibility rating to the BoJ's Governor Kuroda for the ambitious reflationary strategy that has been put in place. This index is, however, expected to drop in April as small local businesses will be the hardest hit in the immediate term by the hike in the consumer sales tax.

The BoJ may extend its programme of quantitative and qualitative easing so it can hit its target for an inflation rate of 2% by 2015

As expected, at the last meeting of its Monetary Policy Committee, the BoJ made no change to its quantitative and qualitative easing programme, highlighting the ongoing recovery in Japan's economy. The economy is likely to take a hit from the scheduled hike in the consumer sales tax in April. Inflation continued moving downwards for the second month in a row since the introduction of the new monetary-easing programme, working out at a rate of 1.4% y-o-y in January, down from 1.6% in December. With no significant rise in nominal pay and a subdued rate of imported inflation, inflationary pressures should ease further, posing a major challenge to the BoJ's current policy line. In such circumstances, the BoJ may extend its programme of asset purchases to confirm its anti-deflation credentials as it strives to hit its target for an inflation rate of 2% by 2015.

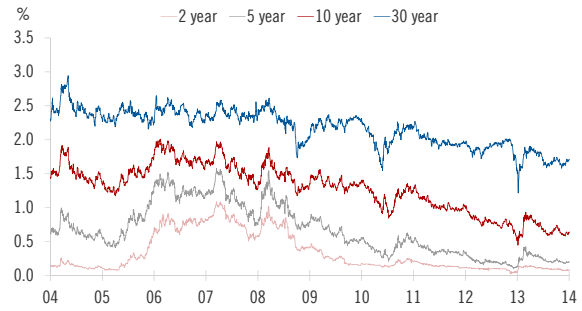
JAPAN

SHORT-TERM RATES (YEN)



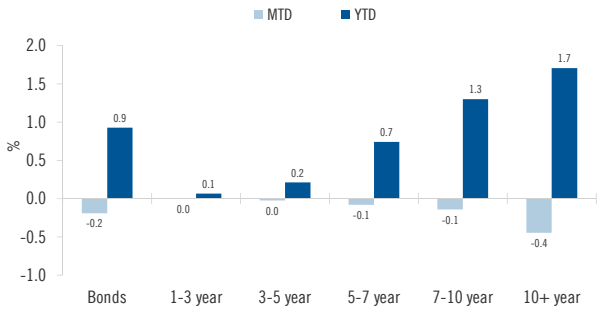
Source: Bloomberg, Money Market, Japan

JAPANESE GOVERNMENT BOND YIELDS



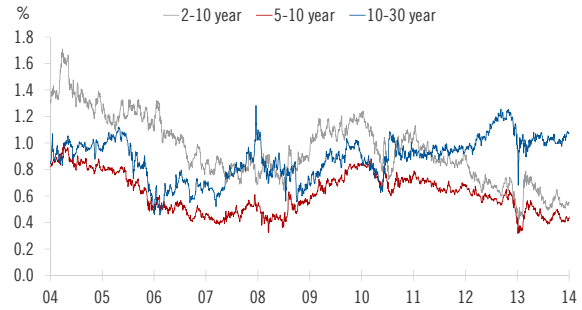
Source: Bloomberg, JGB

RETURNS FROM GOVERNMENT BONDS BY MATURITY



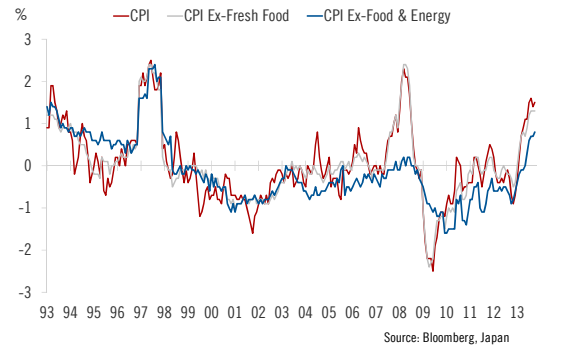
Source: Bloomberg, Citigroup, Japan Gvt Bonds

MOVEMENTS IN YIELD SPREADS



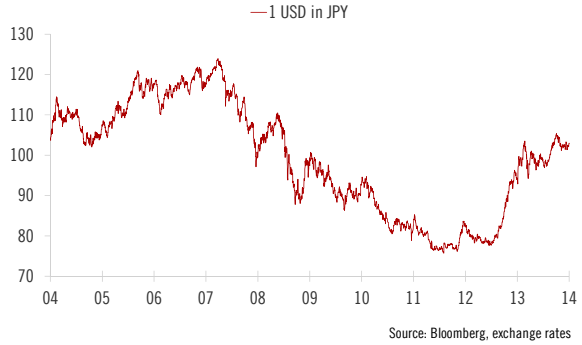
Source: Bloomberg, JGB

INFLATION



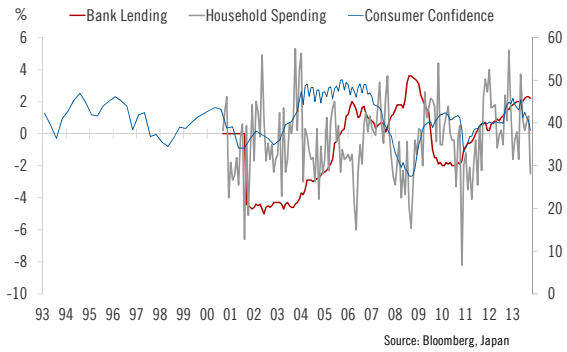
Source: Bloomberg, Japan

JAPANESE YEN VERSUS DOLLAR



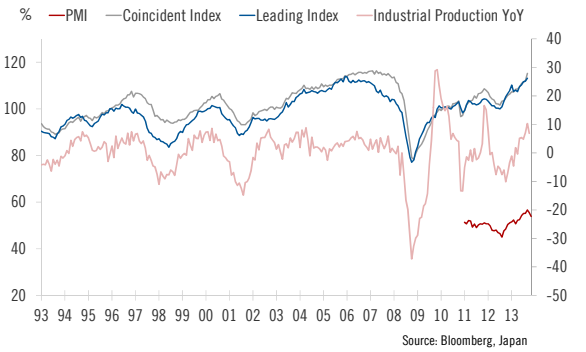
Source: Bloomberg, exchange rates

CONSUMPTION



Source: Bloomberg, Japan

LEADING INDICATOR AND INDUSTRIAL PRODUCTION



Source: Bloomberg, Japan

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