

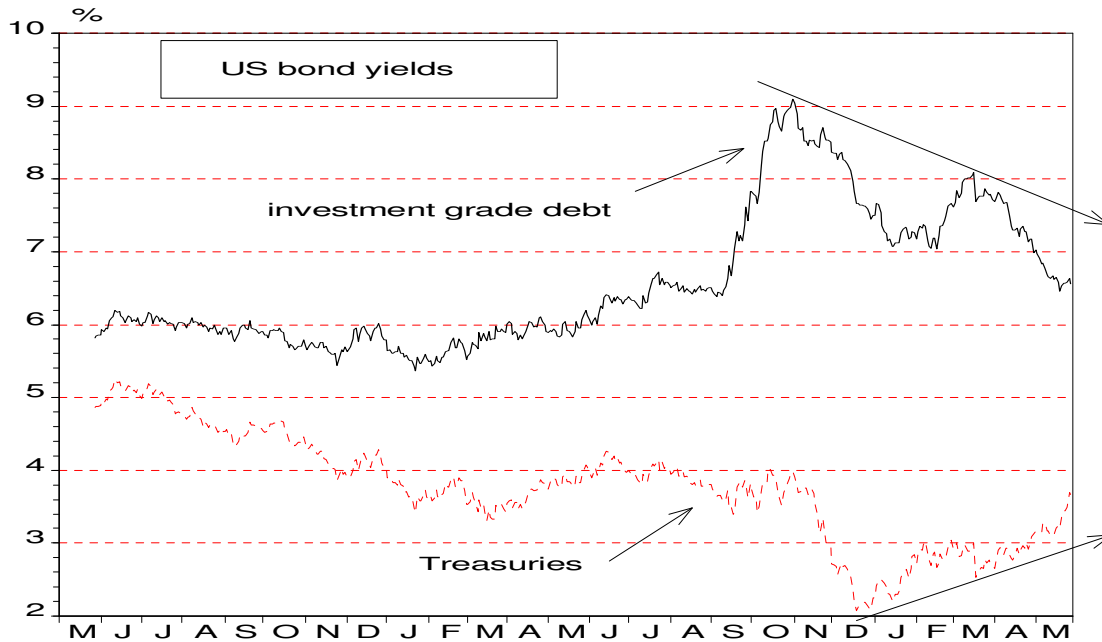
MARKET STRATEGY

INVESTMENT RESEARCH

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Bond market update



Source: DATASTREAM

Bond markets may be telling us to expect inflation but, more importantly, I think they are telling us that policy makers the world over will succeed with their efforts to reflate the global economy. One can quibble about what we mean by reflation but I would take it to mean the implementation of policies designed to support aggregate demand or money GDP in a way that is eventually consistent with sustaining non-inflationary growth - the Fed's coveted objective - or achieving central bank inflation targets - as in the UK and the eurozone. As the chart for the US bond markets shows, the trend of yields on corporate debt has been down and that on Treasuries up implying diminishing risk premiums - which is just what you would expect if markets are banking on recovery.

Because a narrowing of the yield premium in the markets for corporate debt has tended to precede recoveries, government bond markets may be telling us one other thing. This is that monetary policy is becoming too easy. This is not to say that policy should tighten. But as the next chart shows, the term spread in the US Treasury market has opened up to levels that have been not only associated with previous recessions but associated also with cyclical upturns.

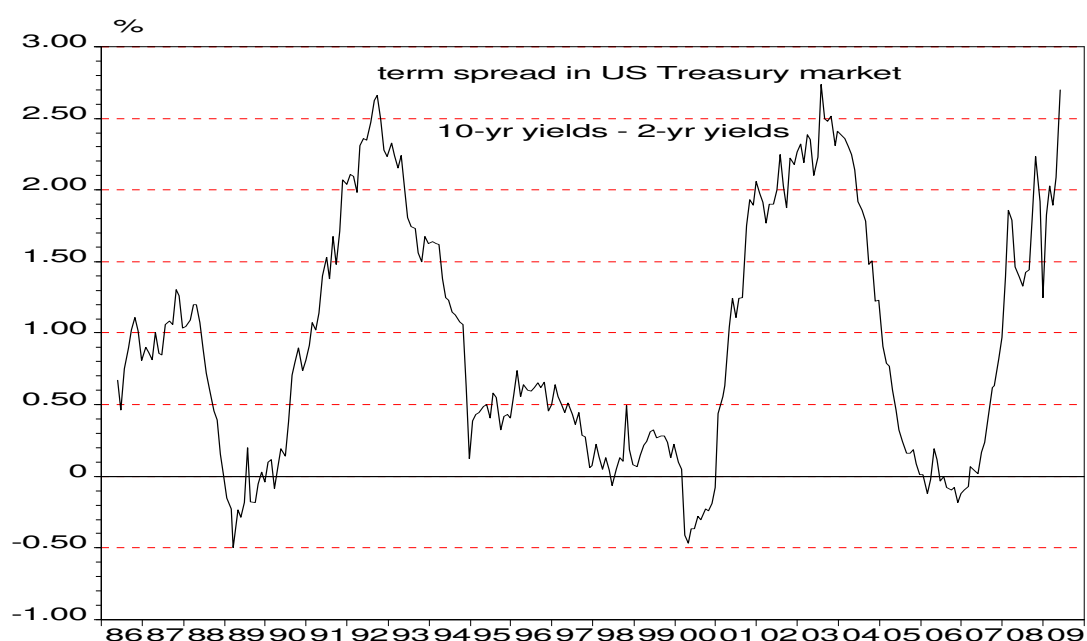
In another part of the world, consensus forecasts for GDP growth have just been upgraded for this year. We're talking about Asia and notably China but the forecasts for GDP growth in 2009 were revised upward too for South Korea, Indonesia and Malaysia as well as for Japan. Also, India saw no further downward revision in the consensus forecast for GDP growth for this year (see the *May 2009* issue of *Asia Pacific Consensus Forecasts* published by *Consensus Economics Inc*).

We don't know if these revisions mean the end to a long phase of downgrading in the outlook for economic activity but we do know that there is symmetry when it comes to revisions in forecasting. We see this with corporate earnings all the time; the downgrades, once they start, are followed by more of the same until the turn, and then the upgrades are followed by more of the same, until the next turn, and so the cycle goes. So what's this got to do with bond markets?

If government bond markets are reflecting on the beginning of the end for the wave of downgrading in the forecasts for GDP growth - starting with Asia - they will also be discounting the reflation that policy makers are hoping to achieve.

Government bond markets are being burdened by a huge amount of issuance. In the case of the US Treasury market, this is likely to be a multiple of six, seven or more times the quantity the Fed intends to buy through its QE programme. Also, bond markets may be worried about who the credit rating agencies might next have in their sights. If the dollar is heading for more weakness, that won't help the US Treasury market either. When expectations are being upgraded for a region of the world whose growth is bullish for commodity consumption, bond markets are likely to be watching. And so is the Saudi oil minister. When Ali Naimi says the global economy can support oil prices at \$75 to \$80 a barrel it's probably because he has got his eye on the improving prospects for the fastest growing regional consumer of oil and other commodities.

There are a host of reasons why yields are shooting up - actually the Treasury market looks oversold now - but the key is the likely success that policy makers will have with their attempts to reflate the global economy. That's the view that asset markets are backing. The re-pricing of risk including in this the change of sector leadership in equity markets is their way of saying a recovery is out there and that the time has come, as the Financial Times noted in one of today's leaders, for a return to 'normalization' in government bond markets.



Source: DATASTREAM

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