

Market Insight

The bond market is calling the shots, as usual

The bond markets are often underestimated and overlooked by investors because they are usually very stable; almost too stable for some traders to take notice. However, over the past 18 months they have not only been volatile but also pivotal in influencing banks, governments, central banks and of course traders. The primary reason for this is that the financial crisis is intrinsically linked to debt; it occurred because of excessive personal debt and is now being resolved via surging government debt.

Bonds are simply long-term debt agreements which bear a level of interest for the buyer in exchange for a lump sum investment paid to the issuer. During the financial crisis, governments across the globe have been forced to increase borrowing in order to spend more on their respective economies by issuing government debt and selling it to long-term investors. Demand for this type of investment has risen sharply because fear-driven investors tend to congregate in the same places, specifically US, UK, German and Japanese bonds. The rationale is that these governments will not default on their obligations regardless of how badly the situation deteriorates. Over the course of 2008, higher demand for government bonds has meant lower yields because yields and prices are inversely correlated. This allows governments to borrow increasing amounts of capital at decreasing levels of interest based on confidence that the borrowed capital will be paid back. Lower yields are not good for investors who would like higher returns but are excellent for governments because they reduce the burden of debt payable to bond holders. The difficult part is when both government bond issuance and yields rise in unison as investors become anxious about their capital being repaid and the government witnesses a mushrooming debt burden. This scenario is beginning to appear in the United States and, to a lesser extent, in the UK, Europe and Japan.

Inflation expectations in the US have so far been anchored although, due to a far-reaching quantitative easing policy, market participants are now wary of inflation that could lead to spikes in inflation expectations in the future. The initial fear resulting from the credit crisis was that of deflation but \$1.3 Trillion of stimulus by US authorities alone have put medium-long term inflation on the horizon pushing yields higher as investors demand a higher return for trusting state creditworthiness. The US Treasury yield is almost 4% for the first time since October 2008 and within striking distance of pre-crisis levels. Conversely, higher yields (lower bond prices) could also indicate ongoing redirection of capital away from low fixed incomes into higher yielding investments such as equities, commodities and currencies which would be plausible given recently improving conditions. Taking yields into consideration, the consolidation in risk assets over the past few weeks may be a signal that the communal optimism-led recovery is beginning to diminish, reigniting fears that improving



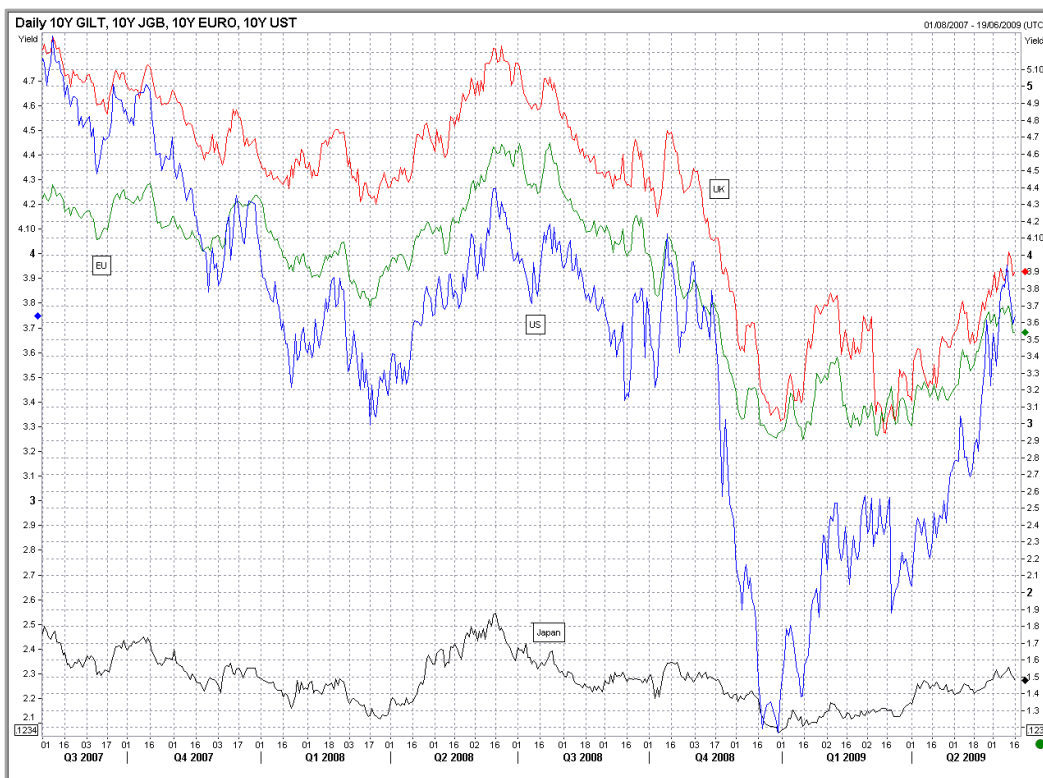
Market Research

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conditions are more illusory than real.

Recent macro data has shown US mortgage rates rising and demand falling because mortgage rates are inter-linked with long-term yields. The property market in the US is crucial because the current crisis began with falling property values leading to losses on securitised investment products linked to property. Market participants continue to hold large amounts of these investments. This means that lower mortgage rates are a blessing because they will entice buyers into the property market and support property demand over time. This in turn will help securitised products to stabilise and buyers to emerge. A recovery in the US is reliant on confidence in US assets and the property market; rising yields are threatening to sink both.

Ten year government bond yields in UK, US, Europe and Japan



Source: Reuters

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