

Market Insight

Bond yields are indicating a disorderly recovery

Government bond yields in developed countries such as the US, Euro-zone, UK and Japan have been steadily falling over the course of 2010 alongside a broad retrenching of risk preferences. A sway of fiscal austerity has begun across Europe following the emergence of plausible default risk. The sudden, far-reaching spending cuts planned for most EU countries is being supplemented by concerns that the Chinese economy will tighten monetary policy in the near future as a result of a frothy housing market and rising inflation expectations. The mixture of mushrooming debt in the developed world, draconian spending cuts and the emerging markets gradually moving towards policy tightening is having an adverse affect on global equities, commodities and cyclical currencies. The most recent retracement from the highs in risk assets is the most significant yet – since March 2009 all asset classes exposed to the global recovery have seen significant appreciation but with several risks to the recovery having emerged, global investors are retrenching back into cash, safe-havens and security with eye-watering declines of 2008 still fresh in the memory. The sovereign debt crisis in Europe has been the most high-impact factor that has dented recovery expectations.

Bond yields and bond spreads can be an excellent indicator of market stress and where the fault lines lie. For example, market participants are keenly watching spreads between peripheral European countries and Germany to see which nation is at most risk of default. Yields on long-term debt in the developed world are falling because investors are insecure about exposing themselves to equities, commodities and risk-FX given the latest doubts about the global recovery. The yield on the US 2yr government bond has broken below its 2009 lows while US Treasuries have fallen by over 100bp since April. A rising yield spread between German and Spanish debt for example, is a sign that investors perceive Germany to be a safer investment than Spain. Taking this into account, the important question is whether investors doubt the solvency of the EU as a whole or simply making a statement that they don't believe Germany will act as a lender of last resort to its neighbours?

In Europe, the ECB's surrender to engaging in bond purchases and placing a €750bn safety net underneath fiscally challenged nations has not calmed the bond markets which are continuing to price in significant default risk. Yields on Greek, Portuguese, Spanish and Irish debt remain close to their peaks; so too are CDS prices. In the meantime, German, Japanese, US and UK bond yields have been declining as demand for the best AAA securities continues to rise.

The implications of this phenomenon are varied. Lower yields would help governments reduce their debt burdens in real terms but in order to attract investors, austerity measures must be credible and the scale of the debt burden cannot be too high to



Market Research

George Tchetvertakov

Head of Market Research
gtchetvertakov@alpari.co.uk

start with. Unfortunately, in the Euro-zone austerity measures are seemingly not credible according to market prices and the debt burden (including bank exposure) is considered extremely high at its peak. From one perspective, the EU is taking the necessary steps towards fiscal balance but from another, it's not doing enough because a sole, co-ordinated fiscal policy for the entire region is lacking.

In the US, the debt burden is much larger than in Europe but market stress is lower, and for the time being at least, investor confidence is higher. The US state of California must cut \$20bn of expenditure by the end of 2010 - the same as Greece, Portugal and Ireland combined but market participants have yet to question the US budget deficit to the same degree as Europe's. The coming months are likely to be erratic and volatile while there's a lack of certainty about how government debt around the globe will affect the global recovery longer-term.

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