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Market Tactics

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INVESTMENT RESEARCH
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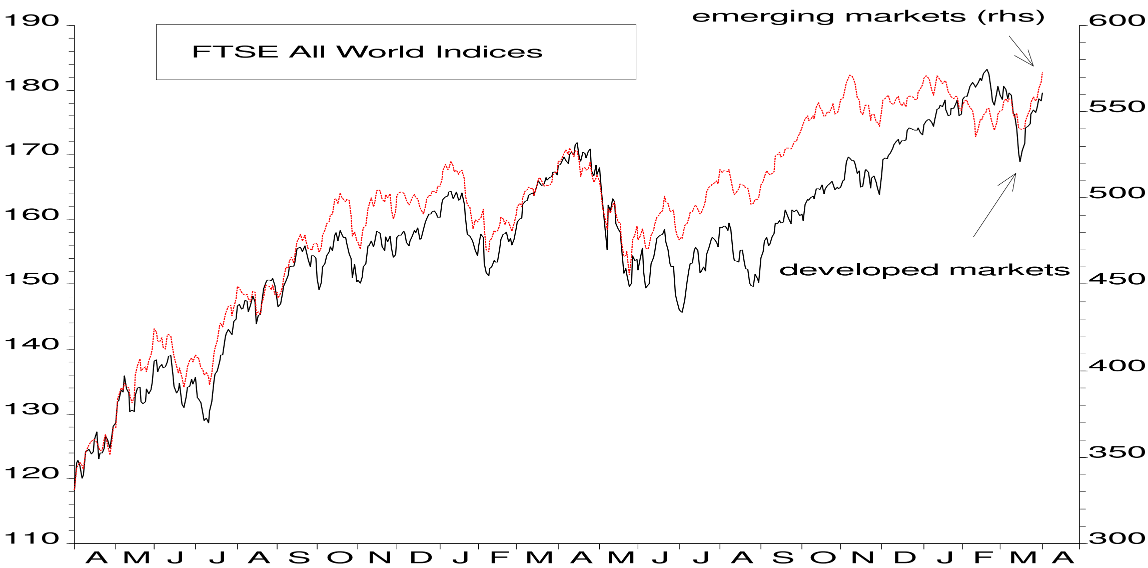
Bonds eye exit strategies as equities regain momentum.



Source: DATASTREAM

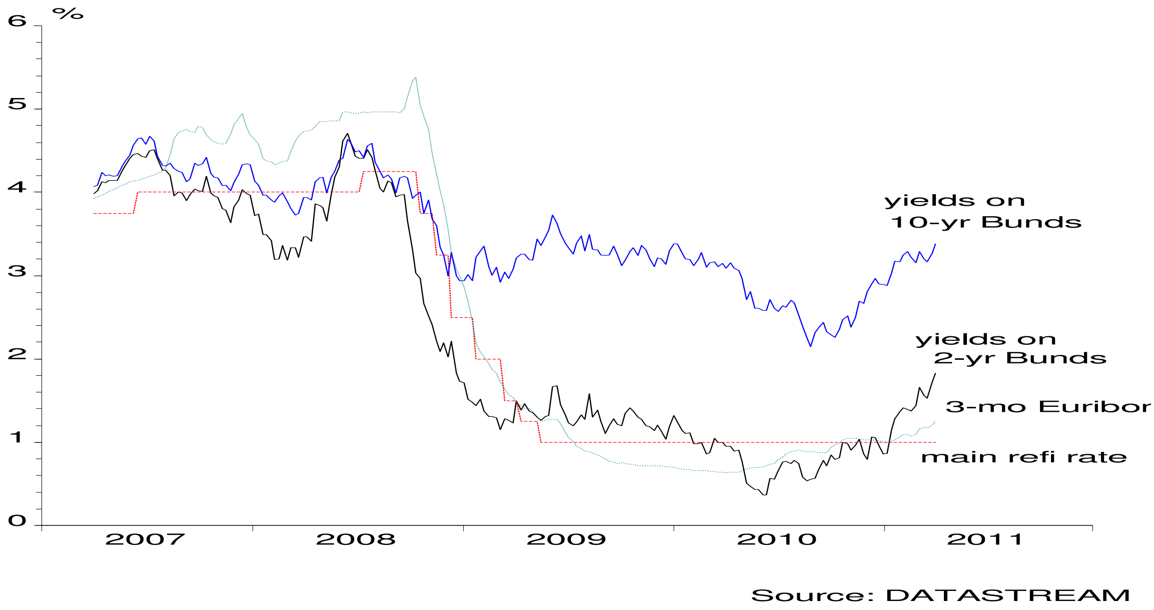
Equity markets, notably the developed markets, start the quarter having reclaimed most of what they lost in the sell-off from February's top. Developing markets, which haven't done much of anything over the past few months, that is, at least until recently, start the quarter at new highs for the year as the chart shows.

US Treasuries also start the quarter more convinced than before that the Fed will let QE2 run its course in June without rolling the programme over into QE3 or some other variant. Yields on 2-year Treasuries have climbed to within a whisker of their February high and tomorrow's Minutes for the March FOMC meeting, which noted the economy's firmer footing, could provide the wherewithal to drive them higher.

In part the move at the short end of the Treasury market has been prompted already by the assortment of opinion from the few Fed officials on how monetary policy might change. Included was a suggestion – not from the Fed Chairman – that interest rates could rise by year-end. For his part, the Fed Chairman sees a modest pick up in core inflation as something to be welcomed and more in keeping with the Fed's notion of price stability. But the Fed Chairman does not rule the roost and yields aren't likely to stop rising.

If anything, the latter applies with even more force to the Bund market. As the following chart shows, yields have shot to the highs last seen in 2008 when, unlike today, they were on the way down. Having been served notice by Mr Trichet after last month's council meeting that the time had come for the ECB to attend to its role as the guardian of price stability and also after several reminders to that effect by a few governing council members, the Bund market needs no convincing on what of the ECB's interest rate decision will bring on Thursday. A quarter point rise is more than discounted.

Is the ECB justified in no longer feeling policy needs to be so accommodating? For its part, current levels for interest rates were set in response to a financial system that lost its capacity to function. That was an emergency. Difficulties remain. The risk, potentially, is that there might still be a banking crisis but EU leaders are engaged in putting in place a framework for economic governance, crisis resolution procedures and stress tests for banks aimed at securing financial stability. For the ECB, the emergency is no more.



Meanwhile, inflation continues to run away from target thus putting at risk what the ECB sees as its notion of price stability. With the ECB now widely expected to push its refi rate up to the 2 percent level by year-end, yields in the Bund market will continue to head in one direction and one direction only.

Elsewhere, interest rates throughout the developing world are continuing to rise, as is inflation together with inflation expectations. This spells a loss of economic momentum ahead for the developing economies – a view acknowledged last week by the central bank of Brazil, which downgraded its forecast for growth and revised up its forecast for inflation. Considering the growing importance of the developing world to the outlook for global growth, this also spells some loss of momentum ahead for corporate earnings growth in the developed world.

While this is not expected to alter what is still a positive investment backdrop, it begs the question how equity markets will cope with rising bond yields and slowing, albeit modestly slowing, corporate earnings growth. The fact is that in the two largest and most powerful economies, namely the US and China, macro economic policies are running in parallel fashion in two important respects; their fiscal policy is geared towards expansion and their monetary policy is guided by similar dual mandates – implicit in China and explicit in the US. Both are pro-growth with price stability which, fundamentally and strategically, remains a big plus for equity markets.

Bond markets may be focusing on exit strategies of the major central banks but, as noted at the outset, equity markets start the quarter having re-gained momentum. Tactically, some consolidation of the recent gain is likely but there is nothing like a positive surprise from a big headliner like the US Non-farm Payrolls to give the markets confidence in the outlook for the global economy and encouragement to move on.

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IMPORTANT NOTES