

The race goes on – same horse, different jockey

The risk rally continued in May as fresh green shoots continued to sprout. Stocks extended their April gain, albeit at a slower pace. Year to date, the S&P and ASX 200 are slightly positive (1.75% and 2.91% respectively) after having spent the 1Q09 in deep negative territory.

The sharp sell off in government bonds over the past couple months is just the latest development in the global space involving growth prospects, inflation fears and interest rates. In the US and Australia, 10 year bonds have sold off a whopping 129 basis points since the beginning of the year as central banks continue to cut or maintain low policy rates. Year-to-date the UBS Composite Bond index has produced -0.46%, having fallen 0.74% in the month of May alone. Most asset classes have produced very little return for calendar year 2009.

Country	10YR Bond Yields			Cash Rates		
	Month end	MTD	YTD	Month end	YTD	Last 12 months
US	3.51	39	129	0.25%	Unchg	-1.75%
Japan	1.49	6	32	0.10%	Unchg	-0.40%
Eurozone	3.59	41	64	1.00%	-1.50%	-3.00%
UK	3.75	25	73	0.50%	-1.50%	-4.50%
Switzerland	2.43	29	34	0.25%	-0.25%	-2.50%
Norway	4.3	34	45	1.50%	-1.50%	-4.00%
Canada	3.43	33	75	0.25%	-1.25%	-2.75%
Sweden	3.77	52	135	0.50%	-1.50%	-3.75%
Australia	5.28	71	129	3.00%	-1.25%	-4.25%
New Zealand	5.74	44	112	2.50%	-2.50%	-5.75%

As we steer through this extended period of low rates, several twists and turns require close attention. The tradeoffs between economic growth (or lack there of) and interest rates has become important. The global data is becoming increasingly 'less bad', which has assisted in turning the bond market tide, pushing yields higher.

Government bonds are selling off for 3 main reasons:

1. Green shoots are starting to turn into trees and many believe that the worst of the crisis has been avoided and the system has been saved.
2. The central bankers can start to remove some of the excess liquidity provided at the height of the crisis.
3. The public sector is under massive stress due to bailing out the private sector. The risk has shifted to the public sector as the government balance sheets have ballooned. **The race to leverage and risk taking is merely being passed on to a new jockey.**

Rising yields were inevitable. At the peak of the crisis, US 10 year yields fell to nearly 2%, a level that was unsustainable for a long period of time. Once the market panic eased and the fall out from Lehman/banking crisis subsided, the safe haven of government bonds diminished. Since that point, the market has seen investors enter the market with a renewed sense of risk appetite. Equities have taken off and credit spreads have compressed significantly.

Contributing to the sell off in fixed income is the increased fears of central bank credibility, namely the Federal Reserve. The foray into quantitative easing started with a bang but has ended with a whimper. Many analysts suggest that the Fed could counteract the Treasury market weakness by stepping up its direct purchases (with the goal of bringing mortgage rates down), or cap yields by stepping up its printing press purchases (Morgan Stanley Research).

The recent sell off in government bonds hints at how much stress governments are under for taking on the troubled private sector. Investors recognise how impaired the US balance sheet is, and are unwilling to take on that debt at such low yields. Government (read taxpayer) money is pouring into the system, combined with the aggressive buying of Treasuries by the Fed. This has resulted in investors getting jittery about the supply-demand imbalance, future inflation, and a possible dollar crash.

What we know

While data has become increasingly 'less bad' the global economy is still in the infirmary.

In the US:

- The stress test results in the US were not as bad as originally feared. The additional capital now required by banks stood at a mere 75 billion USD (remember when that was a lot of money?).
- Real GDP in the US for Q109 was revised to -5.7% annualised from an initial estimate of -6.1%.
- April employment numbers showed some moderation (payroll jobs fell 539k) yet the unemployment rate rose to 8.9%.
- Retail sales were modestly worse in April falling 0.4% month-on-month, while housing starts fell 13% in April.

Similarly, in Europe/UK:

- Euro area GDP contracted 2.5% quarter over quarter in Q109.
- Industrial production fell 20.2% year over year in March (a record for Europe).
- S&P revised UK ratings to negative from stable.
- The German labour market and IFO were the only key green shoots of Europe. IFO increased to 85.9 from 83.9 in April and the number of jobless only rose by 1k compared to expectations of 64k loss.

Australia seems insulated from the rest of the world:

- The RBA maintains the highest cash rate of any developed country (with no immediate interest in cutting rates further).
- House and unit approvals have risen solidly for two straight months, with building approvals up 3.5%.
- Retail sales rose 2.2%.
- Employment rose an unexpected 27k and unemployment rate falling to 5.4%, which caught the market by surprise.
- The Government's annual budget showed a deficit of A\$57.1 billion. Expectations are that they will not return to a surplus until 2015-16.

Market at cross roads on both risks and opportunities

The market is trading as if the worst of the Armageddon scenario of the late 4th quarter has been avoided. It seems that the actions of the central banks (taking rates to zero combined with all the government initiatives – TARP, TALF, etc) are finally gaining some traction.



Equity markets have priced in an optimistic scenario – that the worst is behind us and hence earnings can only get better from here. Many of the bears have turned into bulls, as risk taking has come back with a vengeance. It seems that many are worried about missing out on the recovery. As a result, the bond markets continue to sell off. The massive liquidity tap that has been turned on has saved the world from collapsing for now. However, at some point, governments, particularly the US will have to let go. While it can be argued that that is a long way off, Stephen Stanley of RBS put it aptly, when it does happen, it could act like a stretched rubber band, and the market snapback could hurt. This could lead to higher inflation for the future as the cost of the bailout becomes a serious issue. Regardless, there are many paths investors can choose, and as we have learned, all paths are filled with danger. As Kapstream tries to navigate out of the woods, we see the caution sign that reads: Volatility and risk ahead.