

Supply, Demand & Curve

6 Sep 2010

GLOBAL DEBT RESEARCH

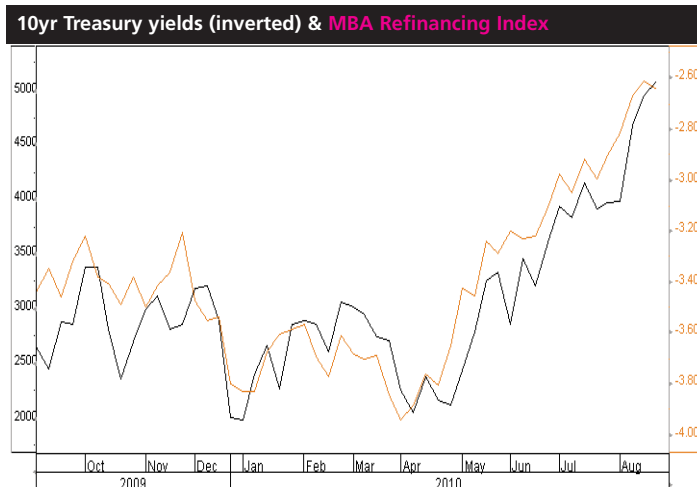
Conundrum Redux

- Self-feeding duration grab in major bond markets eliciting record low yields in both government and credit space
- Policy duration effect somewhat instrumental, as is QE-lite, but technical factors also to the fore in pivotal markets
- Policy settings/ commitments naysay "bubble" accusations, but relative valuation extremes incite asset reallocation trade

"Any further weakening of the economy that resulted in lower long-term interest rates and a still-faster pace of mortgage refinancing would likely lead in turn to an even more rapid run-off of MBS from the Fed's balance sheet" (Ben Bernanke, 27 August, 2010)

Double-dip doomsters ceded some air-time last week, amidst an array of better-than-expected economic data releases in the US, Europe and Asia. Some mean-reverting tendencies are doubtless at play here, with positive surprises apt to succeed a prolonged period of negative surprises as expectations adjust to a lower hurdle rate. This is perhaps especially so in relation to the US economy, the focal point of global growth angst in recent months. Last week witnessed topside surprises across the activity spectrum (manufacturing, housing, retail sales and labour market), with Fri's nonfarm payroll data providing the greatest fillip of all to fragile investor sensibilities. Taken together, recent US data flow (revisions included) points to an economy clearly buffeted by that abrupt second quarter tightening in financial conditions, but one for which the subsequent re-improvement in financial conditions heralds more a "soft patch" than "double-dip" evolution. Custodian in chief of US financial conditions is the Federal Reserve, whose recent policy-lite decision to re-invest maturing MBS proceeds into Treasury securities was not solely an attempt to dispel unwarranted tightening (via Fed balance-sheet contraction), but also a signal of "intent to maintain accommodative financial conditions as needed to support recovery". This combination of policy duration effects and renewed Treasury purchases has sparked a relentless and self-feeding duration grab across the major global bond markets, a consequence of which being record low yields across the government, mortgage and credit spectra. With US bank transmission channels for such debased bond yields progressively improving, Bernanke's optimism that the "critical handoff appears to be underway" for a sustained expansion does not appear misplaced.

In his recent address at Jackson Hole, Ben Bernanke affirmed the Fed's belief that the degree of monetary accommodation provided by QE is determined primarily by the "stock" of securities (Treasury, MBS and Agency) held on balance sheet rather than by the "flow" of any new purchases. Accordingly, unconventional policy settings can be faced with their own "negative convexity" problem, whereby "a weakening of the economy might act indirectly (via lower bond yields) to increase



the pace of passive policy tightening (via accelerated MBS repayments); a perverse outcome". Hence the FOMC's early-Aug decision to maintain its existing balance-sheet size of \$2.05trn through the recycling of all MBS/Agency run-offs into long-dated Treasuries. The Fed estimates that additional MBS/Agency repayments may total c \$400bn by end-2011. However, the final outcome could be substantially higher, given scope for a mini refinancing boom on foot of the Fed's own actions. Note that 30yr FRMs averaged 4.32% in the latest MBA survey, a record low and compared with year-ago levels of 5.08%. Admittedly, existing refi activity is running shy of expectations for the prevailing rates, testament perhaps to tighter lending standards than heretofore.

The conundrum of historically low benchmark bond yields has become even more acute in Euroland, wherein 30yr swap rates have nose-dived by over 90bps since the Fed's announcement to record lows at 2.52%. Clearly, the break of prior lows at 3.07% has triggered substantial and captive receiving interest from the ALM brigade, a more liquid (albeit expensive) swaps market the preferred location for a duration grab in the absence of any ultra-long dated issuance in Euroland cash markets. Of course, issuance activity by both sovereigns and corporates should step-up materially in the months ahead, and French tapping of ultra-long paper Thu last may prove the thin end of the wedge, given the prevailing yield levels. Meanwhile, the Dutch press is reporting pressure from some of the largest pension funds to find an alternative approach to discounting liabilities than the current distortion.

All told, US investors have poured \$480bn into bond mutual funds in the two years to end-Jun, while withdrawing \$215bn from stock funds over the same period. This reflects a post-Lehman mindset prepared to over-pay for fixed income security rather than under-pay for equity risk. As bond valuations scale absolute and relative extremes, and deflation policies gain slow but steady traction, a shift in mindsets is inevitable. Temporary hiatus forthcoming for SD&C, returning 20th Sep.

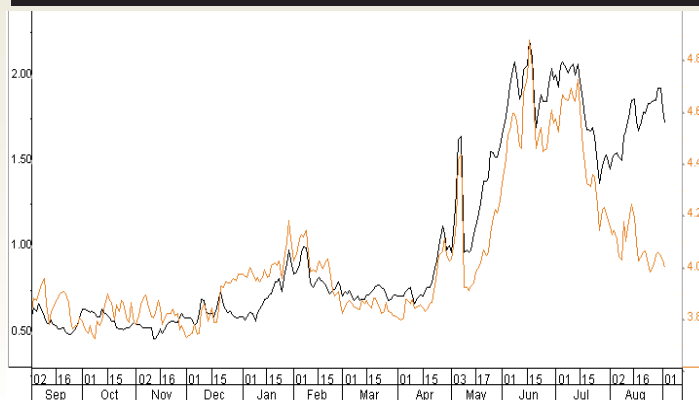
Duration Risk : Bund future (with trendline and retracements)



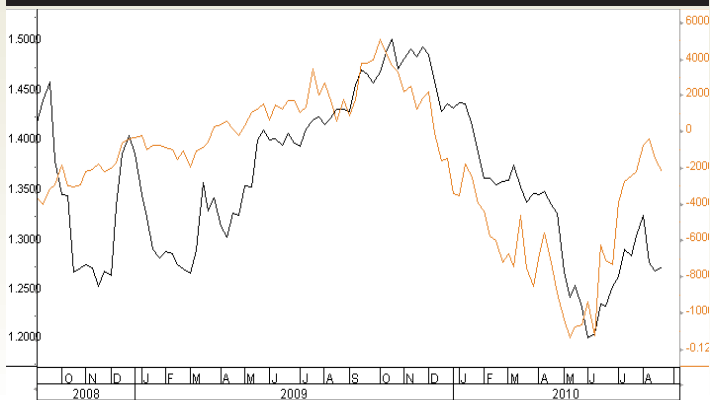
It is first notice day for the expiring Sep Bund future on Wed and, not for the first time, a contract roll-over phase may be presaging a change in trend. To be fair, it has been some trend, given the more than 7-point spurt from **127.37** lows on 27Jul, the contract thereby obliterating all prior records with its **134.77** twinned-peaks in late Aug. However, with *der* Bund bumping along a 5-mth channel top, daily RSIs rolling-over from their highest levels (81.84) since Dec/08, and daily sentiment indicators (DSIs) reading 98% bullish, corrective risks loomed large. Last week delivered the latter, with a double-top trigger *sub*-**133.25** followed by a Q3 trendline breach *sub*-**132.98**, and Fri's **132.00** close cementing a bearish weekly reversal off cycle highs. The contract bounced off **131.73** double-top target Fri, but odds favour a deeper retrace. Channel support is **129.46**, and rising.

A 5-yr auction of Spanish government paper drew an average yield of **2.96%** last week, substantially below the **3.66%** clearance for a previous 5-yr debt offering (in early Jul), and not a world removed from 2010 lows at **2.64%**. The fact that Bono/ Bund spreads have widened towards record peaks of late speaks for an altogether different dynamic to more recent core/ periphery moves compared with the "crisis" developments of May/Jun. Then, spread widening was driven by a surge in periphery yields, amidst fears of funding dislocations for Euroland's more vulnerable sovereigns. Now, the latest spread widening is wholly attributable to an across-the-curve plunge in benchmark Bund yields to record depths, the catalyst for which having been no longer endogenous (*viz* Euroland sovereign credit crisis) but rather exogenous (*viz* plummeting Trsy bond yields).

Yield Curve / Spread Risk : 10yr Bonos Spread (vs Bunds) & Yield



Foreign Exchange Risk : Eur/USD (with IMM non-comm positions)



The recent widening of Euroland core/peripheral spreads has had a relatively muted reaction in the foreign exchange market, given the "made in the USA" nature of recent investor preoccupations. To be sure, Eur/USD has retraced from **1.3335** peaks on 6Aug, but by no more than 50% of its rebound from **1.1875** troughs on 7Jun. This correction duly stalled at the **1.2605** Fibo, and last week's revival in "risk on" trades supported a rebound to **1.2890** peaks, the 55dma duly vaulted through **1.2765**. It is apparent that the Eur/USD cross has somewhat underachieved of late, at least relative to the steers from both fundamental (interest-rate differentials) and positioning (IMM) data. Headwinds were clearly gusting from prevailing "risk off" dispositions, but these winds are now a'changing, providing scope for a forex catch-up. The 200dma at **1.3335** is thus radared.

A fifth consecutive weekly advance for Gold prices, Wed's **\$1255** peak in sight of Jul's cycle high at **\$1265**. Investor interest in the yellow metal is undimmed, with physical ETF holdings marking fresh records at 2106 tonnes by end-Aug, a 17% advance on end-2009 levels. Speculative length (*per* Comex) is also on the rise, testament to Gold's time-honoured fruitfulness during these Autumnal mists (Sep gains in 9 of the past 11 years). A pick-up in Asian jewellery demand is part and parcel of this seasonal bias and, with mining output still flatlining and official sales readily offset by purchases, a tight physical market only serves to reinforce investor enthusiasm. Mind you, bullish sentiment threatens to spillover amongst analyst forecasts, recently upgraded to an average **\$1500** expectation for 2011. Still, this bull trend is very orderly, so **\$1340** stays targeted.

Fundamental Risk : Gold Price (with trendline & 55/200wmas)



Strategic

- * Global economies and markets exiting 2009 in much better shape than they were in entering it. The credit crisis is over, financial market conditions are progressively improving, and such improvement has provided the foundation for economic recovery now underway.
- * A combination of zero policy rates, private sector deleveraging and renewed foreign reserves accumulation has driven real interest rates sharply lower, thereby bestowing a reflationary underpinning to real economies and asset values.
- * Investor reaction function recalibrating from systemic to idiosyncratic risk; excess liquidity still ensuring tight cross-market correlations, but prior indiscriminate beta-chasing finally drawing to a close. Fair-value equity markets now in the vanguard of the global reflation trade.
- * Growing fixation with sovereign default risks as public debt/ deficits explode, with credible fiscal "exit" strategies not yet articulated. Such risks more apparent in synthetics than cash, but a rising bond yield trajectory hard to arrest as term premia (policy/ refinancing) rebuild.
- * Dollar now liberated from risk-market enslavement as risk appetites normalise. Outlook hinges on the greater sway of conflicting cyclical (rates) and structural (reserves) forces. Size RMB yuan revaluation a potential wild card for 2010.

Tactical

- * Bearish weekly reversals in short-dated Treasuries (off cycle highs) are now being replicated in benchmark Bunds, all strongly indicative of a directional shift. Sentiment and positioning metrics over-extended on the bull-tack, adding weight to reversal risks. Time to reinstate a short duration stance.
- * Curve flatteners exhausted for now, with bear steepening hoisting 2/10yr Treasuries +23bps to 219bps, and 2/10yr Euroland +18bps to 171bps. Sell wings against bellies, most notably in Euroland.
- * Trsy/Bund spreads consolidative within 20/40bps range in 10yr mats, but sights stay set on a downside breach. Remain long Aud vs Cad in the USD-bloc, and ditto periphery (esp Ireland) vs core in Euroland. Still short UK gilts amongst "opt-outs", neutral JGBs and long IL.
- * Credit markets back on the bridle after their Summer somnolence, given improving macro, risk appetites and an eroding VIX. Primary markets now reactivating with a vengeance, but supply creating its own demand amongst cash-laden investors. Overweight.
- * August's rebound in Dollar trade-weighted index neatly corraled by 55dma (83.20-83.65), with renewed slippage now targeting 81.50 (200dma) ahead of 80.10 revisit. Eur/USD a prime beneficiary (IMM specs still short Euro), with sights set on 1.3335.

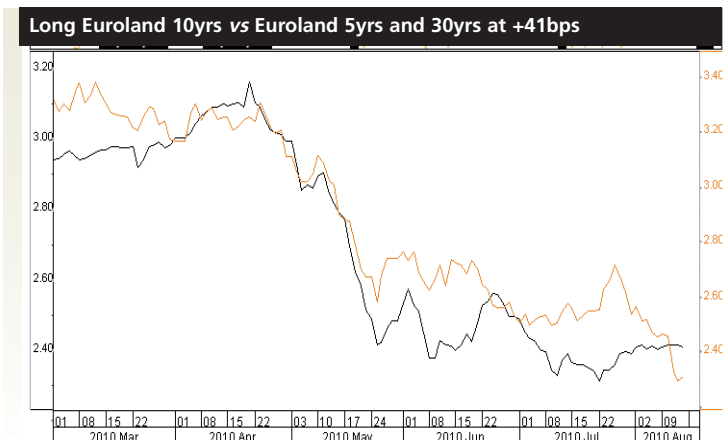
Model Portfolio

Country	Benchmark*		Market	Duration	Yield Curve			Issuer	ActiveFx**
	Weight	Duration			1 -5	5 -10	10+		
US	22.30%	5.61	-	-	+	N	-	HG	-
Canada	2.03%	7.05	-	-	+	N	-	HG	N
Australia	0.37%	4.70	+	-	+	N	-	HG	N
Germany	10.65%	5.87	-	-	+	N	-	HG	Base
France	9.24%	5.77	-	-	+	N	-	HG	Base
Holland	2.66%	5.22	N	-	+	N	-	HG	Base
Italy	9.71%	6.91	+	-	+	N	-	HG	Base
Spain	3.67%	5.97	+	-	+	N	-	HG	Base
Belgium	3.07%	5.72	N	-	+	N	-	HG	Base
UK	5.32%	8.04	-	-	+	N	-	HG	-
Sweden	1.00%	4.79	N	-	+	N	-	HG	N
Denmark	1.02%	44	N	-	+	N	-	HG	N
Japan	28.95%	5.61	N	-	+	N	-	HG	N
		6.00		-					

* JP Morgan

**Euro Base

Best Trade



The French Tresor reactivated its funding machine last Thu, issuing 5yr (1.78%), 10yr (2.55%), 15yr (3.00%) and 30yr (3.17%) paper at record low yields. The 30yr offering (1.94x covered) was the first in this space by a Euroland sovereign for some time, coming amidst a relentless squeeze into longer-end maturities, ostensibly on macro concerns but more acutely on ALM grounds. With the shorter dates bolstered by the policy duration effects of avuncular central banks, the 10yr maturity has found itself the poor relation of a 5/10/30yr Butterfly now rapidly spreading its wings. Wings can only stretch so far, however, and with macro concerns somewhat alleviated by last weeks US economic data (7 out of 10 positive surprises), the scope for a corrective bear steepener (and 10yr curve catch-up) presents itself. A "peripheral" belly vs "core" wings adds to the attractions.

Event Watch

	Monday 06 Sep	Tuesday 07 Sep	Wednesday 08 Sep	Thursday 09 Sep	Friday 10 Sep
UNITED STATES	Holiday	ICSC/ Redbook (6 Sep) 3 yr Treasuries 3 & 6 mth T-bills	ABC Cons Con (5 Sep) MBA Survey (2 Sep) EIA Stocks (5 Sep) Consumer Credit (Jul) 10 yr Treasuries Kocherlakota Speech Fed Beige Book	Initial Claims (4 Sep) Trade Balance (Jul) 30 yr Treasuries	Wholesale Invents (Jul)
CANADA	Holiday		Building Permits (Jul) IVEY PMI (Aug) BOC Policy Announce	Housing Starts (Aug) Trade Balance (Jul) New House Prices (Jul)	Employment (Aug)
JAPAN		Foreign Reserves (Aug) Leading Index (Jul) MPB Policy Announce	Current Acc (Jul) Machine Ords (Jul) M2+CDs (Aug) BOJ Mthly Report (Sep)	Consumer Conf (Aug)	GDP (Q2) Domestic CGPI (Aug) MPB Minutes (Aug)
AUSTRALIA	ANZ Job Ads (Aug)	RBA Policy Announce	Housing Finance (Jul) Consumer Sent (Sep)	Employment (Aug) DeBelle Speech	
EUROLAND	GER W/sale Prices (Aug) EUR Sentix Index (Sep)	GRE HICP (Aug) GER Manu Ords (Jul) AUT 9 & 17 yr RAGB	FIN GDP (Q2) GER Trade Balance (Jul) FRA Trade Balance (Jul) SPA Indust Prod (Jul) GER 2 yr Schatz POR 3 & 11 yr PGB	FRA INSEE Payrolls (Q2) ECB Bulletin (Sep)	EUR Current Acc (Q2) ITA GDP (Q2)
UNITED KINGDOM	Halifax Hse Prices (Aug) M0 Money Supply (Aug) Auto Regs (Aug)	N/wide Cons Conf (Aug) BRC Retail Survey (Aug) 37 yr IL	BRC Shop Prices (Aug) Industrial Prod (Jul) NIESR GDP est (Aug)	Trade Balance (Jul) MPC Policy Announce	Producer Prices (Aug) Leading Index (Jul)
SWEDEN			GDP (Q2)		
DENMARK	Consumer Prices (Aug) Industrial Prod (Jul) Trade Balance (Jul)				

Dublin Office, Davy House, 49 Dawson Street, Dublin 2, Ireland. T: +353 1 679 7788. F: +353 1 614 8727.

Southern Office, 89/90 South Mall, Cork, Ireland. T: +353 21 425 1420. F: +353 21 425 1410.

Western Office, 1 Dockgate, Dock Road, Galway, Ireland. T: +353 91 530 520. F: +353 91 530 710.

Northern Ireland Office, 2nd Floor, Donegall House, 7 Donegall Sq. North, Belfast BT1 5GB. T: +44 0 2890 310655. F: +44 0 2890 310656.

Website www.davy.ie

J&E Davy, trading as Davy, is regulated by the Financial Regulator. Davy is a member of the Irish Stock Exchange and the London Stock Exchange. Confidential © Davy 2009.

No part of this document is to be reproduced without our written permission. This document has been prepared and issued by Davy on the basis of publicly available information, internally developed data and other sources believed to be reliable. The information contained herein does not purport to be comprehensive and is strictly for information purposes only. It does not constitute an offer or an invitation to invest. No party should treat any of the contents herein as advice.