

Bigger, not better

Friday, 3 September, 2010

Bigger, as the Federal Reserve may soon discover, is not always better. The prospect of a renewed effort by the US central bank to drive down already super-low borrowing costs raises the issue of whether such measures can help stimulate a recovery that is faltering due to a lack of consumer demand. The sorry state of the US economy, despite all the monetary and fiscal firepower the Fed and the US Treasury have deployed, already befuddles the experts. Worries about a double-dip recession are rampant, and were the main topic of conversation at the Fed's annual Jackson Hole conference last weekend. Speaking at the event last Friday, Fed Chairman Ben Bernanke signalled he would be willing to embark on yet another round of asset purchases should the economy weaken further, even if he currently believes that will not happen. But there is a growing fear within and outside the central bank about whether the risks of such purchases outweigh the benefits. One concern is that it may take an ever larger amount of bond buying to get the same effect. *"If it's buying Treasuries, which is what the Fed is talking about lately, I think it has low returns period, and maybe diminishing returns to scale,"* said Alan Blinder, Princeton economist and former Fed vice chair, on the sidelines of the Fed symposium. That's partly because of the impact of Fed easing, especially that which is accomplished through unorthodox means, comes from the *"announcement effect"* on market expectations, rather than the purchase of securities themselves. In an example of just how meek the effects of unconventional policy might be, Larry Meyer, a former Fed governor now with Macroeconomic Advisers, once estimated that \$100bn in Treasury buys might only lead to a 0.10 point drop in long-term rates.

So just how much bond buying would the US central bank have to do to get reticent consumers spending again? The figures bandied about are eye-popping. When the Fed first embarked on its policy of asset purchases, known as quantitative easing, Goldman Sachs economists estimated Fed credit to the banking system might have to expand to as much as \$4 trillion to \$5 trillion in order to grapple with the scope of the financial crisis. According to Meyer, the Goldman estimates were in line with those of Fed staffers. However, the central bank's policy committee saw this as complicating an eventual exit strategy, and stopped well short. Instead, the Fed, in addition to slashing official borrowing costs to effectively zero, bought over \$1.5 trillion in Treasury and mortgage bonds, bringing its balance sheet to a still-lofty \$2.3 trillion from pre-crisis levels around \$850bn. Back then, this tack was widely seen by investors as the Fed pulling out the big guns. But the policy, coupled with the government's \$800bn stimulus, has not exactly gone as planned. While the measures likely prevented an even worse outcome, the US economy, after rebounding initially from its worst recession since the Great Depression, seems to be slipping again. After all that amount of stimulus, meagre growth is the best the US can do. Unemployment, currently at 9.5%, shows no sign of coming down and manufacturing, which had led the recovery, now appears to be running out of steam. Quite simply, the US authorities have got to do something different because what they did before hasn't worked.

The problem is that conventional policy tools look to have had their day. Politicians in Washington, having spent billions of dollars rescuing the banking system and the economy from the brink, are now bickering over large budget deficits, so another major fiscal stimulus package looks unlikely. The Fed, in the meantime, says there is plenty it can do to ease monetary conditions further. At its August 10 FOMC policy meeting, central bank officials announced they would use the proceeds from maturing mortgage bonds to buy more Treasuries, thereby preventing bank reserve credit from slowly shrinking. The central bank has also argued it could bolster its commitment to keep interest rates low for an extended period, or lower the rate it pays on bank reserves, but those approaches appear on the backburner for now. Bernanke made it clear that buying Treasuries is the most likely and palatable course of action if the economy goes off track. In our view, the Fed cannot do much more to affect economic activity right now, which is slow because of the devastating hit to wealth suffered by consumers in 2008 and 2009. The central bank's latest actions are therefore unlikely to have a positive impact. They simply keep a large volume of excess reserves at banks, threatening higher future inflation.

2/3 Exchange Place, IFSC
Dublin 1, Ireland
DX no: 64
Tel: +353 (0)1 611 9200
Fax: +353 (0)1 829 1877

86 South Mall
Cork, Ireland
DX no: 2008
Tel: +353 (0)21 490 6500
Fax: +353 (0)21 427 6036

100 O'Connell Street
Limerick, Ireland
DX no: 3046
Tel: +353 (0)61 414 065
Fax: +353 (0)61 419 750

info@bloxham.ie
www.bloxham.ie

International Bonds: Bond Market Vigilantes

The so-called bond market vigilantes who in the past drove up US bond yields and forced the government into more conservative budget policies are holding fire this time around. **For now these influential, and at times feared, investors seem to have concluded the American economy is still too weak and deflation too much of a danger to tackle the huge and soaring US budget deficit right away.** Prominent US economist Ed Yardeni coined the term "bond vigilantes" back in 1984 to describe why major investors were demanding higher yields to compensate for perceived risks of rising inflation as a result of large deficits. But in recent times, some major bond managers say huge deficits are less of a worry in the short-term than maintaining spending to keep the world's largest economy from falling back into recession. The general feeling is that something needs to be done eventually but not just now. Such sentiments are a change from past US economic debates when bond managers played the part of deficit hawks, selling bonds and sending interest rates higher while urging Washington to cut back on spending or risk sparking dangerously high inflation. Washington financial blogger Stan Collender described the shift last month, titling a post that "*Bond Vigilantes Are Now Deficit Cheerleaders,*" and noting plunging interest rates. A number of major US bond markets say they are comfortable with congressional votes to continue spending on programmes such as extended unemployment benefits. Conversely, most see the need for long-term cuts to government spending or fixes to make programmes like Social Security and Defence spending more sustainable going forward.

If not cheerleaders, some managers at least are sceptical of quick deficit fixes. It is not clear just what steps the federal government should take soon to curb spending without undermining the anaemic recovery. One can understand the seeming consensus that its too early to draw the stimulus back. But the situation leaves the US with the conundrum of when, and how, to cut. There is no doubt that many economists and officials are feeling confused as regards seeking a balance between encouraging growth and controlling deficits, following the most severe economic downturn in a generation. Broadly, Democrats in Washington have cited arguments for keeping money flowing to various aid programmes as a way of boosting demand lacking from the private sector. Republicans, on the other hand, have been vehement in their criticism of rising federal deficits, recently forecast to reach over \$1.3 trillion for 2010 by the Congressional Budget Office, or 9.1% of GDP, and how investors may react to the numbers. Collectively, however, the bond managers seem to be content to wait and see how the economy develops. **Right now the bond vigilantes have given carte blanche to the US government to keep on spending, with the only evidence of "vigilantism" coming in Europe, where the bond yields of some countries have risen sharply in recent months on the back of rising budget deficits and fiscal austerity measures being implemented to correct the imbalances.**

But, in the United States, interest rates in the main fallen of late, with benchmark 10-year Treasuries currently yielding just over 2.60%, down from a peak of 4.00% in the Spring and not far from the lows near 2.00% at the depths of the financial crisis in 2008. The low rates have prompted some fund managers to sell, and leading to calls for the Obama administration to consider new tools to promote employment growth, such as tax breaks for new hiring. There is also a feeling, though, that the US may have to embrace bigger changes like adopting a value-added tax, as in Europe. Others remain concerned about long-term issues, and believe new revenue sources ought to be considered, like new taxes such as on gas or carbon emissions. What the market wants is clarity on tax policy, uncertainty reduction, and a plan to shrink the US budget deficit over time and in the future. However, **even if internal demand for government bonds in the United States starts to flag in the next two to three months, there still appears to be a huge desire among Asian investors to hold Treasuries.** Many players, particularly in Japan, are still betting that the rally in US government bonds on the back of double-dip recession fears has not yet run its course, and continue to look for a higher yield, especially as the yield on JGBs is not exactly overly attractive. There may also be a lesson for Europe from the movement in US bond yields, that forcing countries to implement tough fiscal austerity measures when the global economic situation remains fragile is a recipe for disaster.

Currencies/Commodities/Interest Rates

The Bank of Japan boosted its cheap loan scheme on Monday, bowing to government pressure for action to protect a fragile recovery by curbing the yen's rise, while cabinet ministers signalled they may intervene to weaken the currency. In the immediate aftermath of the Bank of Japan decision, the yen surged more than 1% against the dollar after the central bank beefed up the supply of fixed-rate loans to banks, a move investors saw as a symbolic gesture that will do little to halt a climb in the currency that hurts exports and may prolong deflation. Government officials, increasingly alarmed by the yen's rise that took it to a 15-year high against the dollar last week, have tried to talk down the currency while leaning on the central bank to help by further relaxing its policy. Now, the Bank of Japan's cautious move at an emergency meeting held a week ahead of a scheduled review has put the ball back in the government's court and market players may test its resolve to back its words with yen-selling intervention. Market players were disappointed that the Bank failed to act more aggressively and, for example, increase Japanese government bond purchases or cut its benchmark interest rate from 0.10% to zero. **Japan would probably have to intervene alone if it were to step in to curb yen gains, as its Group of Seven counterparts, happy with the benefits to exports from their own weak currencies, are in no mood for co-ordinated intervention.** At the same time, the world does not look favourably upon China's currency "manipulations". Currency intervention is most effective when it occurs with a change in monetary policy. The Fed may be about to launch further quantitative easing on the market. The Bank of Japan must introduce operations that are larger than the Fed's. **For now this seems unlikely, and the yen may continue on its merry way towards 80 versus the dollar.**

Closer to home, we are still bullish on sterling. Recent dovish comments from the newest member of the Monetary Policy Committee, Martin Weale, have had little negative impact on the British pound, highlighting that trade-weighted sterling is already in deeply undervalued territory. The UK economy continues to show some bright spots, even though the recovery has become choppy. The latest CBI retail sales survey rose to a three-year high in August, and orders placed with suppliers rose to their highest level since May 2004. Meanwhile, there was some good news on the fiscal front as government net borrowing came in at £3.2bn in July, less than the £4.8bn expected. Furthermore, inflation remains quite sticky. Indeed, the CBI retail sales survey saw the prices component rising to an 18-year high. **We still think a level of 0.80 to the euro is achievable by year-end, and a 0.75-0.80 trading range in the first half of 2011.**

Exchange Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
€/GBP	0.8330	0.8150	0.8000	0.7800	0.7500
€/\$	1.28	1.24	1.18	1.16	1.15
€/Yen	108	106	103	100	100
\$/Yen	84	85	87	86	87
GBP/\$	1.54	1.52	1.48	1.49	1.53

Official Interest Rates 2010/2011

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US	0.25	0.25	0.25	0.25	0.50
Eurozone	1.00	1.00	1.00	1.00	1.00
Japan	0.10	0.10	0.10	0.10	0.10
UK	0.50	0.50	0.50	0.75	1.00
Canada	0.75	1.00	1.00	1.25	1.50
Sweden	0.75	0.75	1.00	1.25	1.50
Norway	2.00	2.00	2.25	2.50	2.75
Switzerland	0.25	0.25	0.25	0.50	0.75
Australia	4.50	4.50	4.75	5.00	5.00
New Zealand	3.00	3.25	3.50	3.75	4.00
China	5.31	5.31	5.58	5.85	6.12

2010/2011 Native Global Bond Yield Forecasts %

	Current	End Sept (f)	End Dec (f)	End Mar (f)	End June (f)
US					
2 Year Treasury	0.51	0.65	1.05	1.55	2.05
5 Year Treasury	1.43	1.55	1.85	2.25	2.65
10 Year Treasury	2.62	2.70	2.95	3.25	3.55
30 Year Treasury	3.71	3.75	3.95	4.20	4.50
Germany					
2 Year Bund	0.63	0.80	1.10	1.45	1.80
5 Year Bund	1.32	1.45	1.70	2.00	2.30
10 Year Bund	2.29	2.40	2.60	2.85	3.10
30 Year Bund	2.91	3.05	3.25	3.50	3.75
UK					
2 Year Gilt	0.70	0.85	1.20	1.60	2.00
5 Year Gilt	1.70	1.90	2.20	2.55	2.90
10 Year Gilt	2.95	3.15	3.40	3.70	4.00
30 Year Gilt	3.99	4.20	4.45	4.75	5.05

continued overleaf

Key International Economic Indicators/ Events of the Week

Australia: RBA Rate Decision (September) (Tuesday 7th, 5.30 BST)

Figures released in the past week showed that retail sales were surprisingly strong in July while Q2 saw the highest GDP growth in three years, suggesting the economy was not nearly as subdued as feared and the next move in official interest rates is still upward. Investors have been fretting that a slowdown in the United States and Japan could spill over into Australia, where a series of rate hikes earlier in the year had hit demand and housing. As a result, the market had priced in a real chance that the Reserve Bank of Australia (RBA) would have to cut its 4.50% cash rate by year-end, even though the central bank itself has remained resolutely upbeat on the economic outlook. The latest sales/GDP data are a real positive and support the RBA's confidence. The economy is clearly doing well and any talk of a rate cut is nonsense right now.

No change in rates is anticipated at this latest meeting and a lot will depend on the underlying tone of the RBA's comments accompanying the decision. On balance we still believe the central bank will be erring on the side of further monetary tightening, which should boost the Aussie dollar and further flatten the bond yield curve in the short-term.

US: Fed 'Beige Book' (Wednesday 8th, 19.00 BST)

Quite clearly the US economic data have weakened in recent weeks, increasing concerns that the world's largest economy is headed for a 'double-dip' recession. Some Fed officials question whether recent weakness in the US economy is not merely a soft patch in a recovery that will eventually gather momentum rather than an early warning sign that growth will be too sluggish to support new job creation. Either way, we are not expecting too much good news in this latest 'Beige Book' anecdotal survey of economic conditions in the Fed's 12 regional districts. The results of this latest survey will form the basis for discussion at the central bank's next policy meeting, later this month.

A 'soft' 'Beige Book' on this occasion is likely to boost the allure of Treasuries further.

UK: MPC Decision (September) (Thursday 9th, 12.00 BST)

Bank of England rate-setters mulled the case for both easing and tightening policy at their August meeting before voting eight to one to keep interest rates at a record low of 0.50%. Monetary Policy Committee member Andrew Sentance called for a 25bps hike for the third month running while new MPC recruit Martin Weale did not rock the boat, joining the majority of the Committee who thought it best to keep rates on hold and maintain a £200bn asset purchase scheme because of big risks on both sides of the inflation outlook.

We expect the exact same discussion and outcome at the September policy meeting, with Sentance again out on his own in calling for an increase in rates. All in all, we feel the latest MPC decision will be fairly 'neutral' as regards Gilts and sterling.

US: Trade Balance (July) (Thursday 9th, 13.30 BST)

\$bn	Goods & Services
2009 July	-33.1
2010 May	-42.0
2010 June	-49.9
2010 July (f)	-46.0

June's international trade figures suggest that the US cannot rely on a boost from overseas demand to offset the current weakness of the domestic economy. In fact, the rebounding trade deficit is exacerbating the downturn. Annual import growth in June was an incredible 29.2%, while export growth ran at 17.7%. Both will slow from here. In recent months, import growth has been boosted by strong gains in both capital and consumer goods. The former is likely to fade once the projects that were postponed during the recession are completed, while the latter looks very strange given that consumption growth has remained lacklustre.

We don't trust the import figures and are looking for a lower trade deficit, of \$46bn, in July. This should be seen as a positive for the economy and equities and a negative for government bonds.

Main Debt Auctions/Announcements in the Coming Week:

Monday 6th	Japan's Ministry of Finance sells 6-month T-bills.
	Italian Treasury details amount of BTPs to be auctioned on September 13.
	French Treasury sells BTFs.
	Norway sells 3bn krone of 4.50%, 2019 government bonds.
	Dutch State Treasury Agency sells T-bills.
	Poland sells T-bills.
	Hungary sells 6-week T-bills.
	Lithuania sells 2015 government bonds.
	Romania sells T-bills
Tuesday 7th	Turkey sells 182-day T-bills.
	Austria sells €1.925bn of 4.35%, 2019 and 4.85, 2026 RAGBs.
	Denmark sells government bonds.
	UK's DMO sells £800m of 0.75%, index-linked Treasury 2047 Gilt.
	Switzerland sells 3-month T-bills.
	Hungary sells 2-week and 3-month T-bills.
	Turkey sells 2012 zero coupon government bonds.
	Federal Reserve purchases notes/bonds.
	Canada to repurchase C\$500m of cash management bills.
Wednesday 8th	US Treasury sells 3-month and 6-month T-bills.
	US Treasury sells 3-year notes.
	Japan's Ministry of Finance sells 3-month T-bills.
	Japan's Ministry of Finance sells 30-year JGBs.
	Germany sells €6bn of September 2012 Schatz.
	Italian Treasury details amount of BTPs to be auctioned on September 13.
	Sweden's Debt Office sells T-bills.
	Switzerland sells government bonds.
	Poland sells fixed-rate government bonds.
Thursday 9th	Czech Republic sells 7bn crowns of 2.80%, September 2013 government bonds.
	Hungary buys back government bonds.
	Russia sells up to 25bn roubles of OFZ bonds; series #25072 and up to 40bn roubles of OFZ bonds; series #26203.
	US Treasury sells 4-week T-bills.
	US Treasury sells 10-year notes.
	Sweden's Debt Office sells index-linked bonds.
	NTMA sells T-bills.
	Hungary sells government bonds.
	Czech Republic sells 8bn crowns of 273-day bills.
Friday 10th	Federal Reserve purchases notes/bonds.
	US Treasury sells 30-year bonds.
	UK sells T-bills.

Written by Alan McQuaid.
Direct Tel: +353 (0)1 611 9226
E-Mail: mcquaida@bloxham.ie

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