THE US ECONOMY – MISSION ACCOMPLISHED?

I always like to start with a positive, and there’s little doubt that most of the positives in our macroeconomic view are currently coming from the US. Recent housing market developments are particularly encouraging as we move into 2013.

HOUSING MARKET

Back in 2007, we used US housing inventory as a leading indicator for the US economy. Speculative overbuilding in US residential property meant that housing inventory moved from about four months’ supply in 2004 to over seven months in 2006. Such an increase had historically signalled an imminent recession, and it made us extremely cautious on the prospects for the US and global economies. We all know what happened next: US GDP growth turned negative in 2008, fell by more than 3% year on year in 2009 and the collapse of the US housing market was one of the root causes of the global financial crisis.

Today, the housing inventory indicator paints a very different picture. Available housing stock decreased significantly in 2012 and is now back around 4 months of supply (see figure 1). Major equity markets also look likely to end the year in the black.

These broad-based gains on global stock and bond markets have occurred against a still challenging macroeconomic backdrop. In fact, looking back at our last annual outlook, many of the things we were worried about then – “double dips” and rising indebtedness in developed countries and the risk of a significant policy error worldwide – have not only remained unresolved but have become, in some cases, more of a concern. But it’s not all bad news and we’re pleased to note pockets of progress in some parts of the world.

So, what do we expect from bonds in the year to come? Well, as ever, it depends on where you invest and what you invest in.
EUROZONE – MOVING IN THE RIGHT DIRECTION?

With the world’s bond markets breathing down its neck, the eurozone lacks the luxury of time that the US seems to have in dealing with its debt problems. Add to this the region’s withering economies, massive trade imbalances and growing social strains and it’s hard to see how things could get much worse, or better, for Europe in 2013.

POLICY DEVELOPMENTS

The key area to watch in the new year will be policy. On the plus side, the European Central Bank (ECB) has recently adopted a more aggressive approach and appears to enter 2013 with a stronger armoury with which to tackle the region’s difficulties. In our last outlook we argued that, after two disastrous attempts to raise interest rates, the ECB’s refinancing rate needed to fall by 50 basis points in 2012. We also suggested that the bank would need to consider less conventional policies and carry out wide scale recapitalisations of the continent’s banking sector.

The ECB has followed through on each of these. Alongside a cut in the refinancing rate to a record low of 0.75 %, the institution has shown a greater willingness to consider non-standard rescue measures, ranging from Long-Term Refinancing Operations to bank recapitalisations and most recently, Outright Monetary Transactions. Mario Draghi has vowed to do ‘whatever it takes’.

FISCAL CLIFF

Part of our positive view on the US is based on the belief that the country won’t go “over the cliff” – allow automatic spending cuts and tax rises equivalent to 4% of GDP to come into effect – in 2013. We don’t discount politicians allowing us to start the new year without an agreement on the deficit. However, neither of the nation’s two main political parties can afford to let the country slip into recession and this would be the inevitable result of the aforementioned fiscal tightening. Instead, we expect that they will eventually agree on a near-term compromise, pushing out by a few years the date on which they have to agree a credible long-term solution to their debts.

Such a response brings its own issues. It seems that the US debt problem is already too big for any one politician to deal with. And putting off a solution will only make it worse. US public debt recently shot through the $16tn level, making further repairs to the nation’s debt ceiling increasingly likely. And although current debt to GDP of around 90% might not appear too troubling in the context of the eurozone debt crisis, it’s already at the threshold above which – as Reinhart and Rogoff remind us – economic growth really begins to suffer.

There are other reasons to worry. Government debt per capita is higher in the US than in any major European country and fiscal austerity, already underway in Europe, is anathema to most American politicians – policy scenarios from the Congressional Budget Office (CBO), White House, and House Budget Committee project the budget to stay in deficit over the next 10 years. Net interest on public debt is already one of the US’s largest budget items; debt service costs were equivalent to 1.5% of GDP in 2011 and are projected to climb to 2.3% of GDP by 2020, according to the CBO.

Of course, such projections rely heavily on the assumption that funding costs for the US will stay low. But will they? The US was downgraded by S&P in 2011, and on Moody’s “distance to downgrade” metrics they have come worryingly close to another demotion. Moreover, the ultra-short maturity profile of US public debt makes the country particularly vulnerable to any fluctuation in its interest rate. In our view, the US has been slowly going broke for years and if its borrowing costs were to rise, this could be the catalyst for a default – either against the population’s pension and healthcare expectations, or directly or indirectly (through dollar devaluation or inflation), against bondholders.

Looking at these debt dynamics and composition, we are reminded of a quote from Ernest Hemingway in “The Sun Also Rises”: “How did you go bankrupt?” “Two ways. Gradually, then suddenly.”

But, this is supposed to be a 2013 outlook, so let’s shelve this longer-term worry and turn to more pressing issues.

continued on next page
Peripheral countries’ government bonds should still be handled with kid gloves. The recent rally in these bonds makes valuations less attractive than a year ago and any bad news – of which there is likely to be plenty – will be felt in higher yields.

Despite some exceptions, our preference for core over periphery is echoed in the corporate sector. 2012 was another year of credit downgrades for Spanish, Italian and other peripheral bond issuers, particularly in the banking sector, and we remain wary of further cuts that could weigh on returns. Bonds in more defensive sectors are also broadly more appealing.

Although many eurozone companies are well placed to ride out further economic weakness, investors in European credit – both investment grade and high yield – may need to recalibrate their return expectations in 2013. Given the impressive capital gains seen in 2012, and the lower starting point for spreads, future results are likely to come increasingly from yield and careful security selection.

UK – A LONG WAY TO GO

UK investors have had plenty to distract them from the country’s continuing economic travails in 2012. However, after a year punctuated by the Diamond Jubilee, the Olympics and our first ever victory in the Tour de France, the British public is likely to have rather less to cheer about in 2013 – even if Bradley Wiggins wins the Giro d’Italia, as planned!

Though the economy returned to growth in the third quarter of 2012, official figures show the current recovery to be even worse than that during the Great Depression – a worrying sign for policymakers. Annual UK consumer price rises may have fallen from the 5.2% high reached in late 2011, but they have now remained above the bank’s 2% target for three consecutive years.

CENTRAL BANK REGIME CHANGE: AN UPDATE

We expect the Bank of England, with its new Canadian governor, will continue to steal the headlines in 2013. 2012 provided further evidence of what we have termed “Central Bank Regime Change” – the unspoken shift in major central banks’ priorities away from targeting inflation towards boosting economic growth. Annual UK consumer price rises may have fallen from the 5.2% high reached in late 2011, but they have now remained above the bank’s 2% target for three consecutive years.

Mervyn King came closest yet to acknowledging this shift in 2012, stating that “there may be circumstances in which it is justified to aim off the inflation target for a while in order to moderate the risk of financial crises.” Late in the year, he also agreed to use the interest earned on the bank’s £375 billion of gilt purchases also agreed to use the interest earned on the bank’s £375 billion of gilt purchases to reduce the UK’s deficit (by £11 billion in this financial year and more than £30 billion next year). You know we hate to say we told you so, but, well, we did, in April.

With inflation likely to remain above target, UK index-linked bonds continue to offer attractively priced protection against an inflation overshoot in the medium term.
look attractively valued. However, we are closely monitoring proposed changes to the calculation of the Retail Prices Index, due to come into effect in 2013, that could affect these securities.

Whilst we believe that any changes to the UK’s inflation statistics are being done with the best intentions, for many international investors it feels all too much of a coincidence that these changes could reduce the UK’s bond interest bill just as its budget problems cause its AAA status to come under threat.

STILL FAVOUR NON-FINANCIAL CORPORATES

We’ve been saying for a while now that the historically low yields on conventional UK government bonds limit their long-term attractiveness. We maintain this view, but would not rule out a continuation of the current low-rate environment in the short term. AAA rated or not, the UK government is likely to be seen as a shelter from the eurozone crisis and the still precarious macroeconomic backdrop.

On a longer-term basis, bonds issued by UK companies look much better value. Although bank bonds led the market higher in 2012, we continue to believe that the sector has major structural challenges to face. Where we do own financials, we prefer to buy US banks as well as covered bonds and residential mortgage-backed securities, which offer a greater degree of downside protection because they are secured on housing stock. Nonetheless, we still favour conservatively managed non-financial firms with healthy balance sheets. Despite yield compression this year, we can still buy bonds in these companies at an attractive spread over gilts and expect new issuance to remain solid in 2013, increasing our investable universe.

EMERGING MARKETS – STILL NOT ‘COOL’

Almost everybody we speak to continues to be bullish on emerging markets. But as we wrote about at length in July’s Panoramic Outlook, we do not buy into the “EM” story to the same degree.

That’s not to say that we don’t invest in emerging markets – we tend to both emerging market governments and companies — but we do so very selectively. Yes, many developing countries have superior growth prospects, better demographics and lower debt/GDP ratios than their developed peers. But emerging market local currency debt returns are highly correlated with equity markets, which indicates that returns have often been driven by investor risk appetite rather than their superior fundamentals. Any large-scale wobble in global investor sentiment could see the massive inflows of recent years reverse, with considerable consequences for investors.

We’re also concerned about valuations. The rally in emerging markets debt over the past few years has left some markets very expensive. In several cases, spreads over US Treasuries have reached record lows, and many emerging issuers are trading inside developed countries that we consider to pose less credit risk.

THE YEAR AHEAD

Since we started sharing our thoughts on the bond markets and the world in general in our blog, Bond Vigilantes, six years ago, the economic environment has been one of almost unrelenting doom and gloom.

Looking ahead, we’re beginning to see signs that a more positive outlook is developing. In the US, in particular, the recovery we see in the housing market could have a meaningful impact on growth prospects.

Does this mean that the 30-year bull market in bonds is coming to an end? And should we be braced for an imminent increase in interest rates, reminiscent of the US Federal Reserve’s 2.5% worth of hikes that clobbered bond markets in 1994?

We don’t think so. The Fed has said that it won’t raise rates until 2015 and while it could do so earlier, we think that next year would almost certainly be far too soon. Japan – a country that I recently visited – is an interesting example of how long a recovery can take after a financial crisis and how low bond yields can go in such an environment.

Returning to the point we made at the start of this piece, the outlook for returns in 2013 will depend on where you invest. While we don’t expect a repeat of the very strong gains seen in the past year, we are confident that there are still attractive investment opportunities in several areas of the fixed income universe. In these conditions, a flexible approach and experienced active management can really prove their worth.

LIQUIDITY

Bond market liquidity is a subject that’s cropped up time and again this year, both in the press and in meetings with clients. The cause for concern stems from the fact that dealer inventories have shrunk considerably post credit crisis as losses on securities, more conservative management and reduced yet more expensive capital, have resulted in a shrinking of their market-making balance sheets. This is true, but it’s only one side of the story. US investment grade data shows that whilst inventory is much lower than in 2007, the volume going through dealing desks is actually higher. In addition, the primary markets have been very healthy in 2012 as companies have taken advantage of historically low bond yields to term out their debt profiles. That being said, liquidity in the bond markets does fluctuate depending on sentiment, so it’s important to integrate liquidity management into the investment process.

To hear more from the M&G Retail Fixed Interest team, visit their blog www.bondvigilantes.com