

**Quo Vadis Bond Yields:  
Tactical Pullback or Strategic Retreat**

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## Quo Vadis Bond Yields: Tactical Pullback or Strategic Retreat?

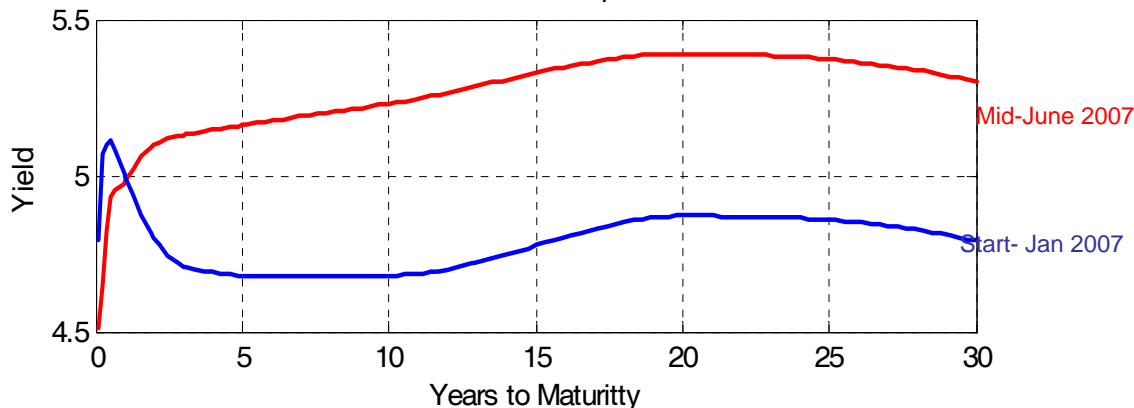
1. The findings: The rise of USD, GBP, EUR yields
2. The current paradigm: Re-visiting the „Greenspan“ factors
3. The search for the weakest link
4. Expectations for a new “trading range”
5. Investment strategies

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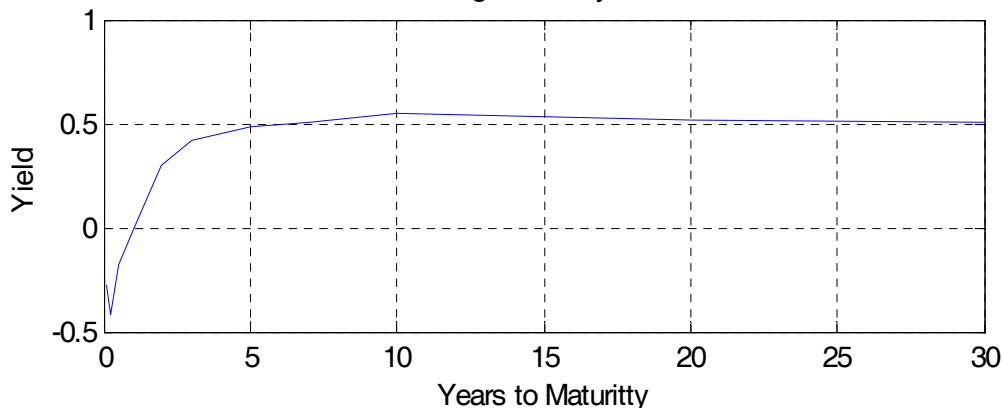
## The Findings: The steepening of the USD yield curve

USD Yield on-the-run par curves

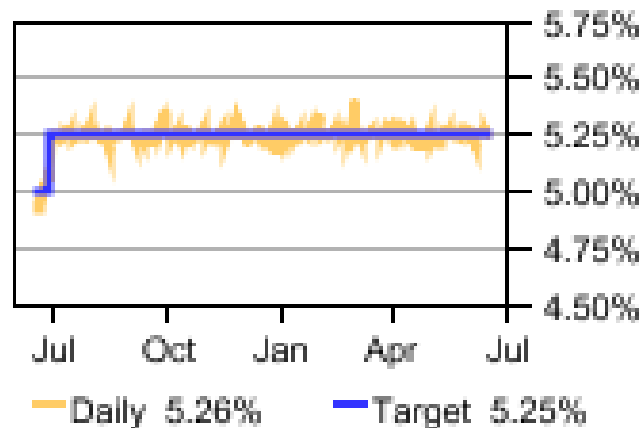


From the beginning of 2007 until mid-June, the USD yield curve steepened. Thus bonds with maturities above 4Y have increased their yield by 50 bps.

YTD Changes in the yield curves

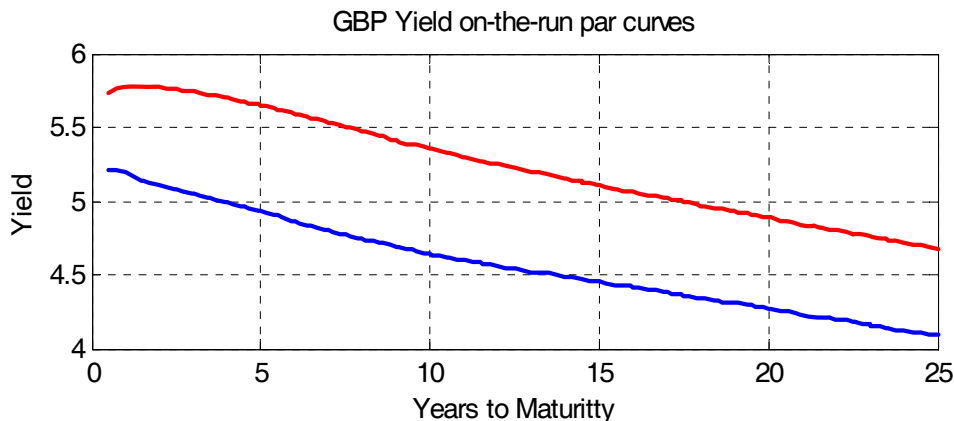


Over this period, the FED has kept its target rate (Fed Funds) stable at 5.25%



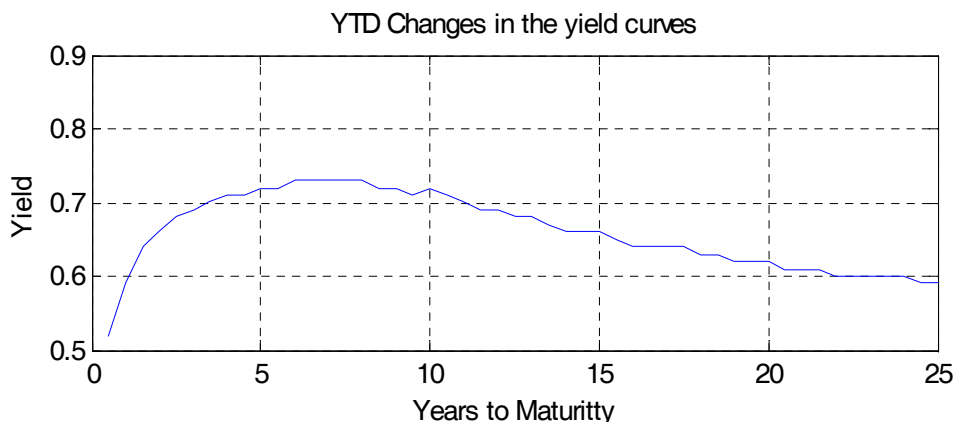
Source: US Treasury Department

## The Findings: The parallel shift of the inverted GBP yield curve



Mid-June 2007

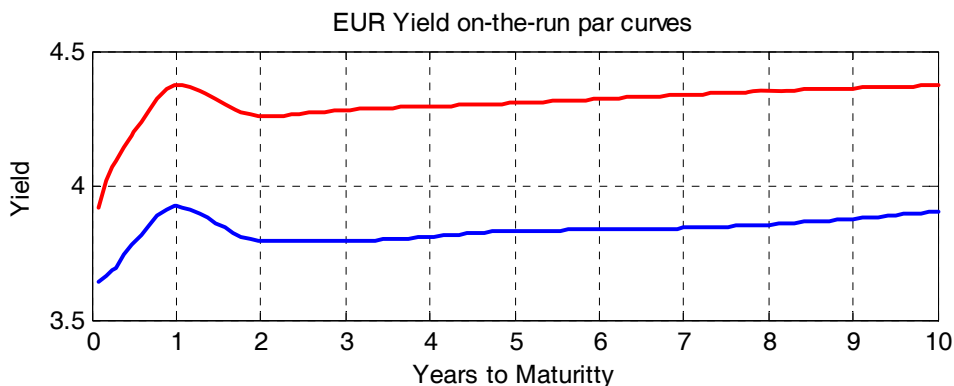
Start- Jan 2007



GBP bonds have increased their yields across the board. The 7-8 year segment recorded the highest increase with about 75bps from early Jan to mid-June. The long-term segment reported increases between 70bps and 60 bps.

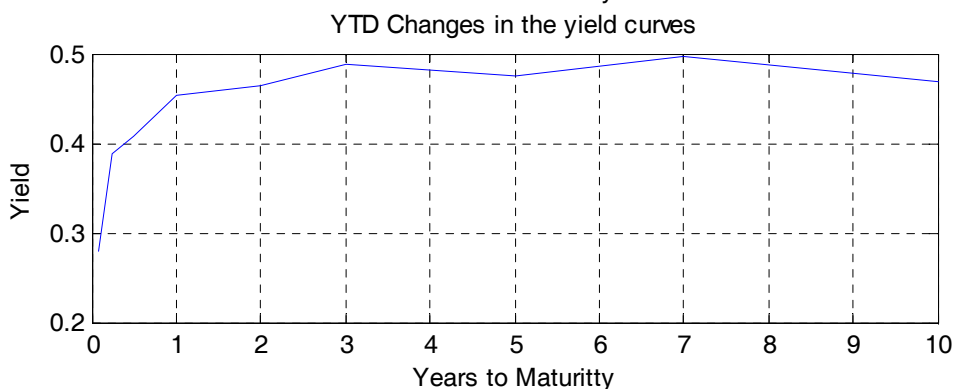
Over the reporting period, the BoE was seen twice in the market changing its key rates to 5.25% on Jan 11 and to 5.5% on May 10.

## The Findings: The parallel shift of an already flat EUR yield curve



Mid-June 2007 EUR denominated government bonds with maturities above 5Y lost about 50 bps from start Jan 07 to mid-Jun 07.

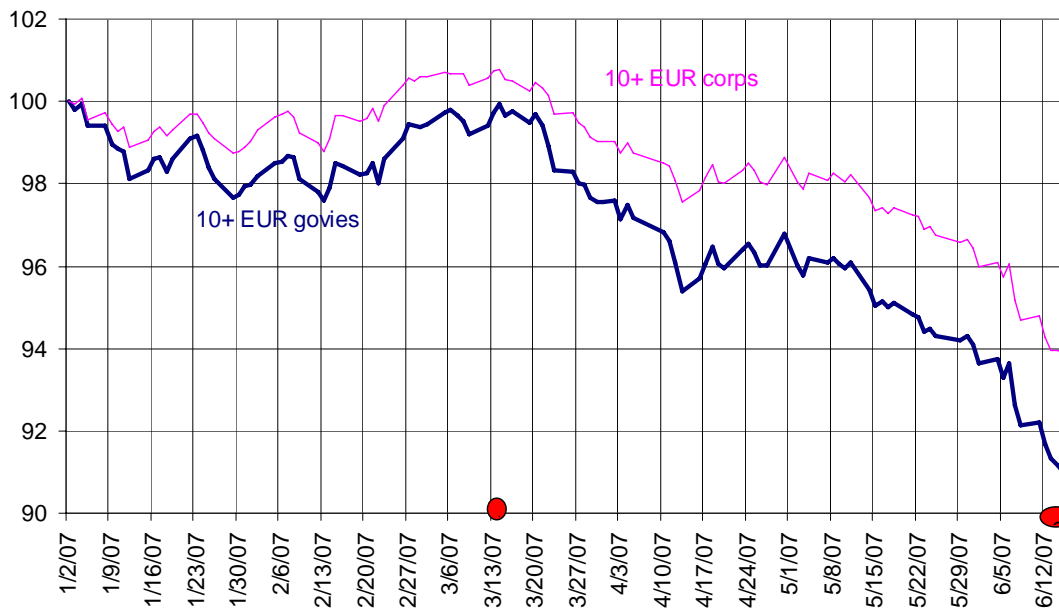
Start- Jan 2007



Over the reporting period, the ECB was seen twice in the market rising its key money market rates by a cumulative total of 50 bps to 3.5% on March 14, and to 3.75% on Jun 13.

## The consequences: Clean prices of EUR long-term govies declined 9% YTD

10+ EUR bonds clean price cum changes since Jan 07



Source: iBoxx

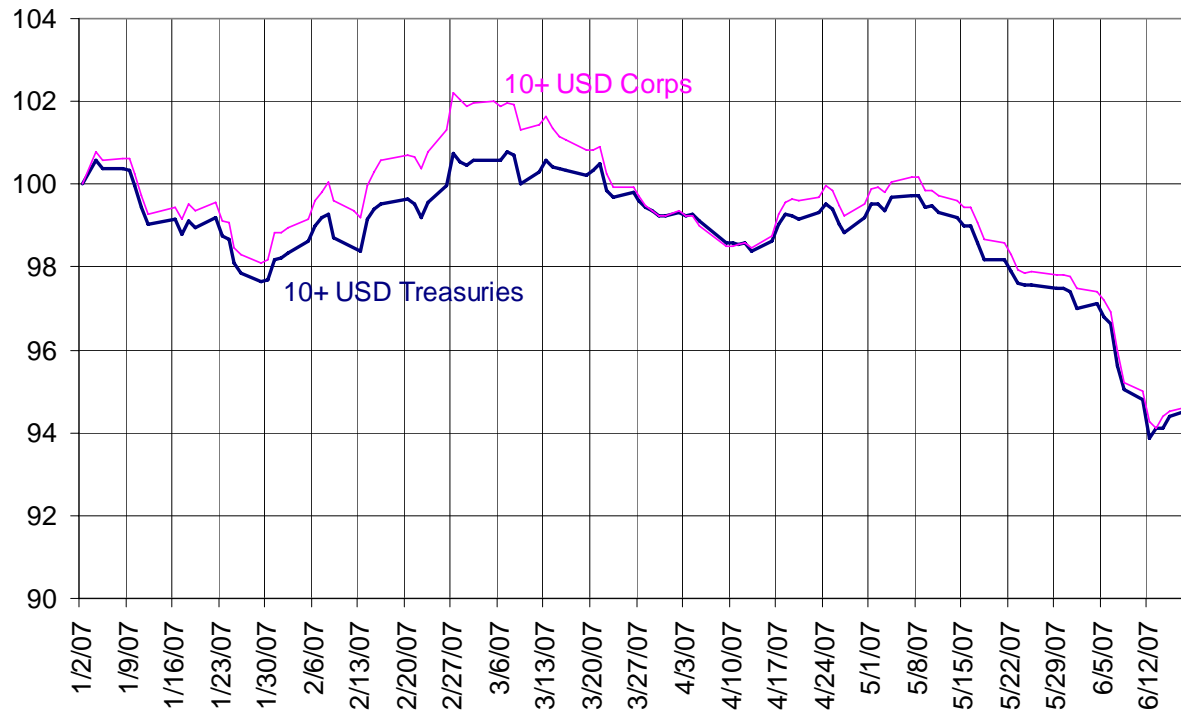
Red spot: Monetray tightening points

Since mid March 2007, the long-term government bond prices (clean) are in a free fall. The first devaluation last 4 weeks until (March 14 – April 14) and has cut 5% of the clean prices.

The second wave started May 11 and has taken an additional 5% from the clean price index.

## The consequences: Clean prices of USD long-term govies declined 6% YTD

10+ USD bonds clean price cum changes since Jan 2007



Source: iBoxx

On a year to date basis, the USD 10+ government bonds lost 5% of their clean price index values.

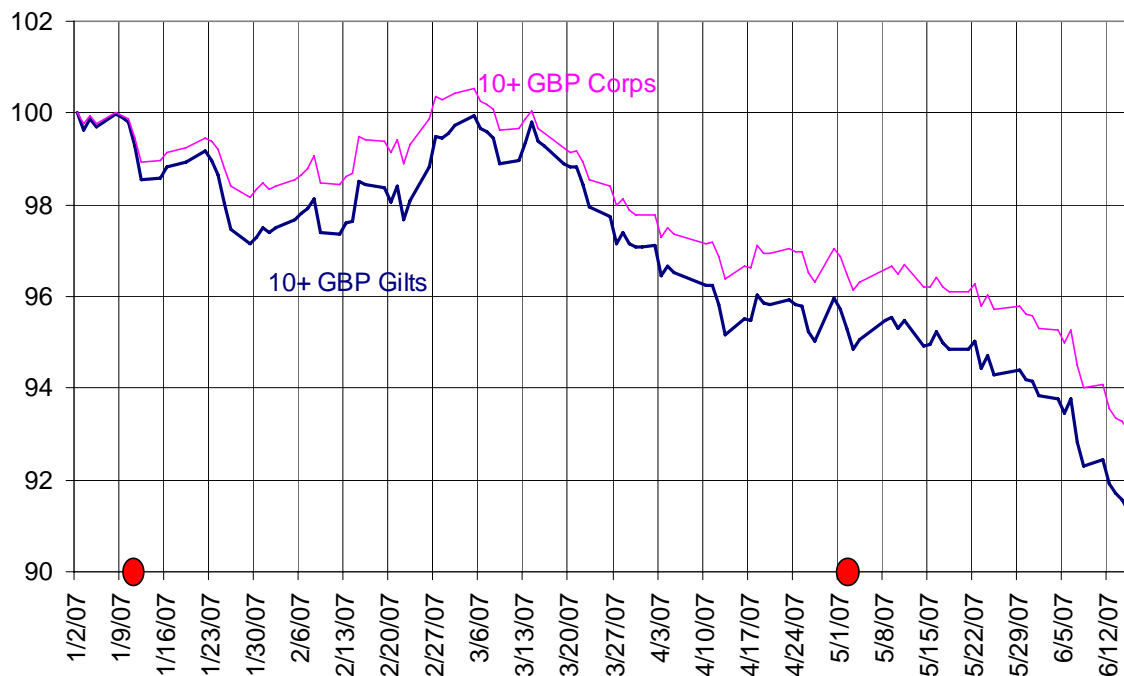
The first wave started March 8 to April 13 and has cut 2.5% of the index value. The second wave started May 8 and ended Jun 12 taking a toll of 6%.

Between mid-April and early May, the price index recovered partially from its earlier weakness.

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The consequences: Clean prices of GBP long-term govies declined 8.5% YTD

10+ GBP bonds clean price cum changes since Jan 2007



The 10+ Gilt price index declined by 8.5% YTD.

The decline period started March 13th, decelerated somewhat between mid-March and April 30, before continuing until June 15.

## Summary: The 2007 meltdown on bond prices

The meltdown in Y10+ bond prices since March 13



Correlation Matrix: 10Y+ Bond prices  
March 13 – June 15

	<i>GBP</i>	<i>USD</i>	<i>EUR</i>
<i>GBP</i>	1		
<i>USD</i>	0.859515	1	
<i>EUR</i>	0.989295	0.893803	1

Factors affecting all three bond markets have driven price down with remarkable correlation.

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## Revisiting the „Greenspan“ Factors

1. Ample liquidity is keeping long-term rates below historical trading levels
2. Stable - less volatile - economic growth is supplying a lower risk premium for long-term debt
3. The “Asian Saving Glut” is increasing the demand for high-quality government debt.
4. All major CBs succeed in building credibility in their ability and willingness to fight inflation (Credible inflation targeting).

**GLOBALIZATION is the ascendance and dominance of capital vs. labor.**

*“Add a billion or so potential workers to the global labor force, blend in a technology S curve acceleration, combine these with deregulation, lower taxes, and free trade, and you have a recipe for accelerating returns to capital and diminishing returns to labor.*

*Higher stock prices, lower inflation, declining interest rates and importantly a rather low volatility environment for both economic growth and asset prices have resulted. “ (PIMCO, Investment Outlook, May/June 2007)*

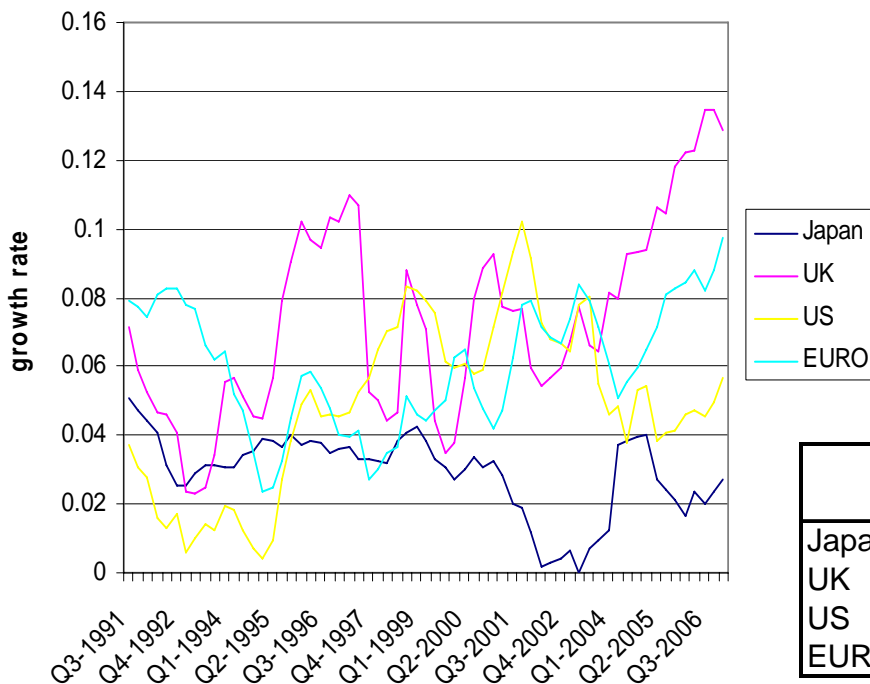
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## 1. Ample liquidity: Strong M3 growth in Europe

M3 growth rates  
annual q/q

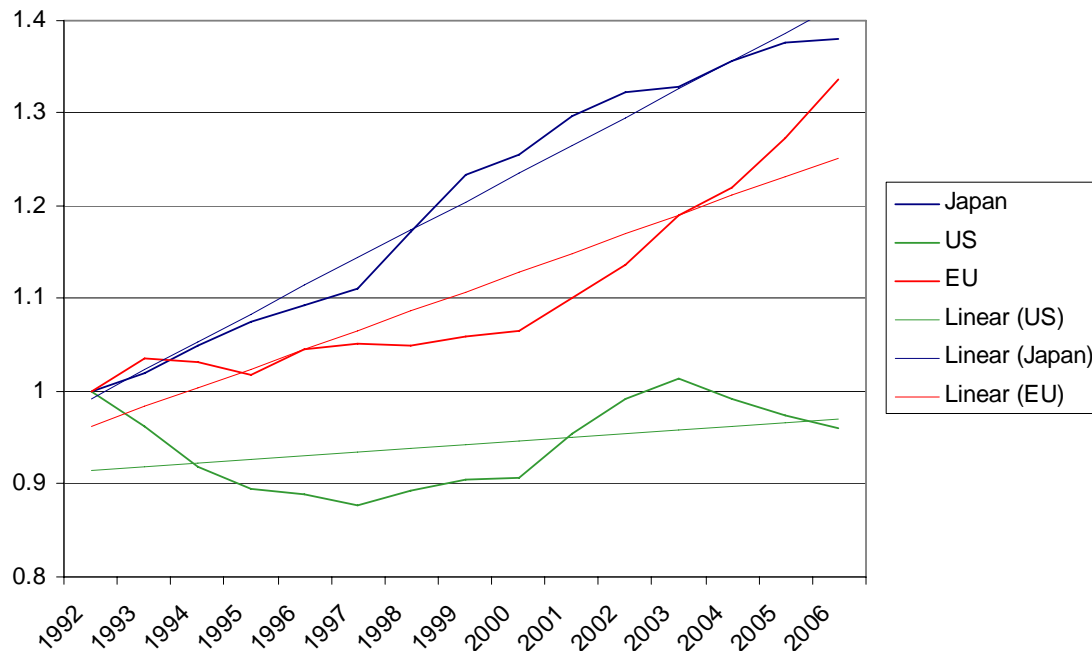


M3 annual growth rates are still at all time highs in the UK and Eurozone. In the US, there are about their long-term historical average. But even in the US, the M3 growth is accelerating.

	Long-Term average	Standard Deviation	Q1-2007	N-Dist Prob (pdf)
Japan	2.91%	1.17%	2.70%	33.68
UK	7.35%	2.86%	12.85%	2.20
US	4.87%	2.45%	5.69%	15.41
EURO	6.04%	1.84%	9.75%	2.82

## 1. Ample liquidity: Holds for Europe, poor with regard to US

Development of the Marhallian k index  
(1992=1)

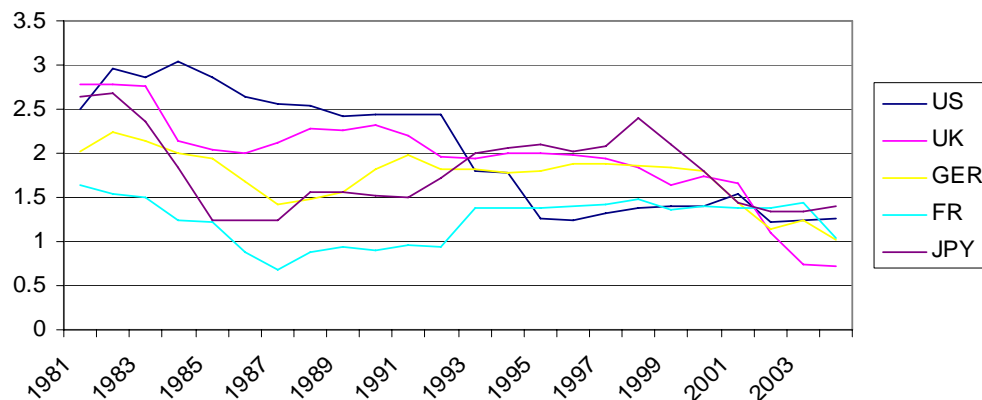


Liquidity over-hang in Japan is about to decelerate somewhat., while in the EU area, the liquidity overhang is growing rapidly. The ECB is forced to continue tightening.

In the US, the picture is mixed. Liquidity overhang produced in the Greenspan period is melting significantly. This gives the FED all options in its monetary policy.

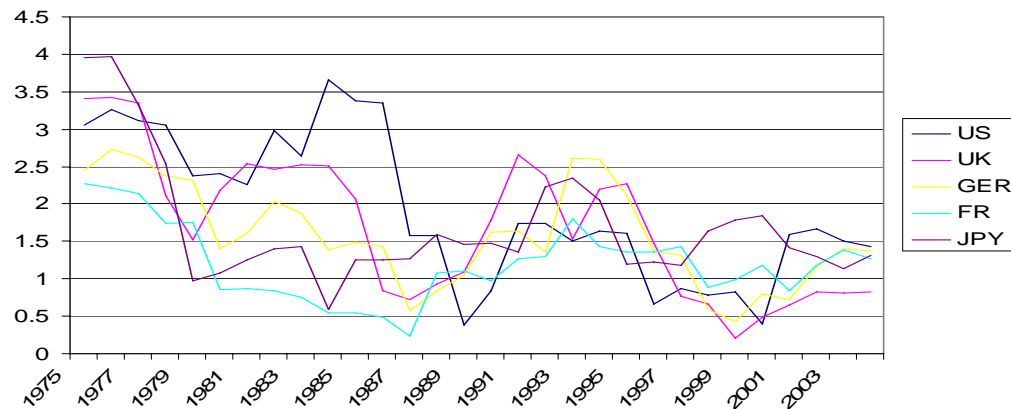
## 2. Stability in economic growth pattern holds

10 stdev on real gdp growth



The overall trend of reduced volatility in GDP growth holds on a long-term perspective (10Y) all major economies.

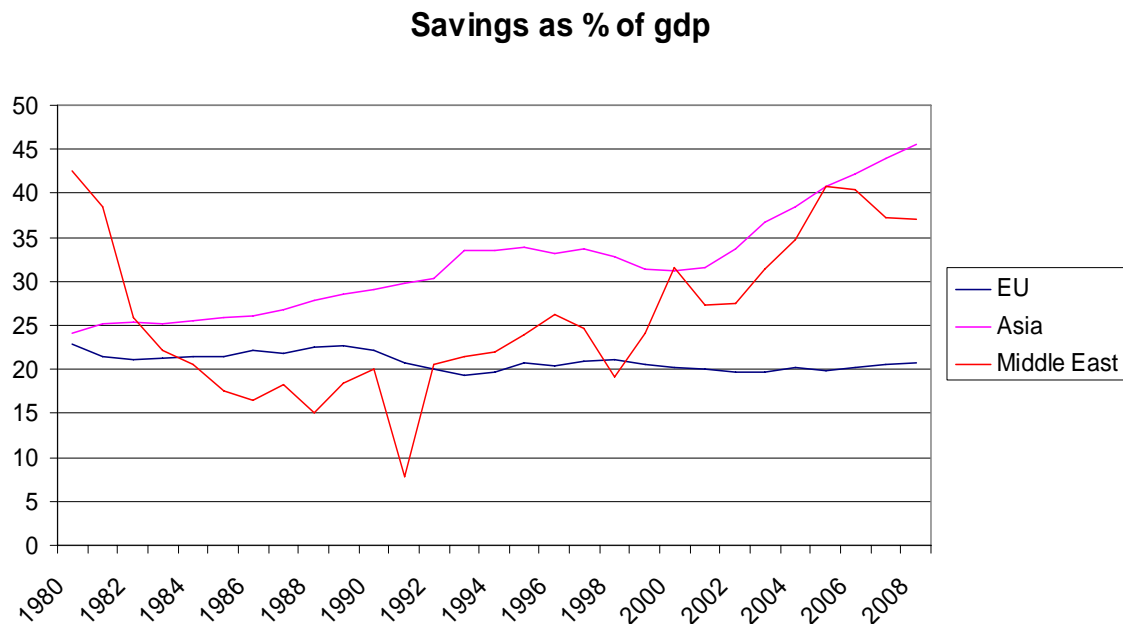
5Y stdev on real gdp growth



While in the medium term view (5 year) , Germany and France show slightly increasing volatilities.

However, the overall picture of a more robust and stable economic growth pattern holds.

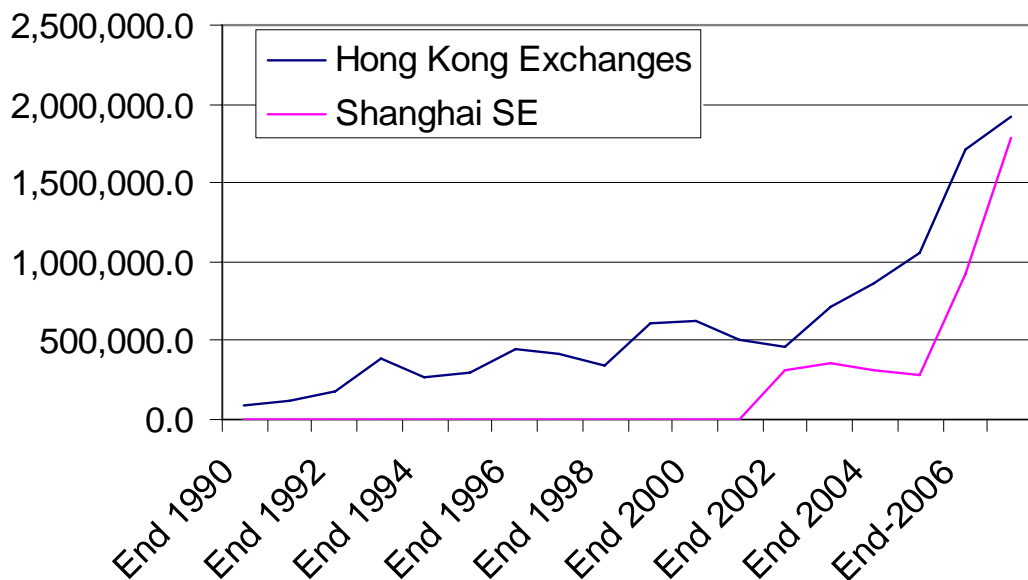
## 3. Persistency of Bernanke's „Asian saving glut“ ...



Asia is still exhibiting extra-ordinary high savings as percentage of gdp. They have a current saving ratio of 45%. Also the money accumulated in the “Middle East” (oil exporting countries) has reached significant levels after the oil price has started to climb to new record levels in 2006.

... savings may have found investment alternatives

## Chinese Stock Exchanges Market cap in USD million



Day to Day, May 21, 2007 .  
China's new state investment fund is taking a \$3 billion stake in Blackstone Group, the massive U.S. buyout fund that plans to go public later this year.

*The attributes of the new player "People's Republic of China" are not yet fully understood, albeit impacting significantly global financial markets.*

## 4. Observed and anticipated success of central banks in inflation targeting

The success of CBs to combat inflation over the last 10 years is remarkable. And the IMF is forecasting inflation at around 2% for 2007 and 2008 in all major economies except Japan.

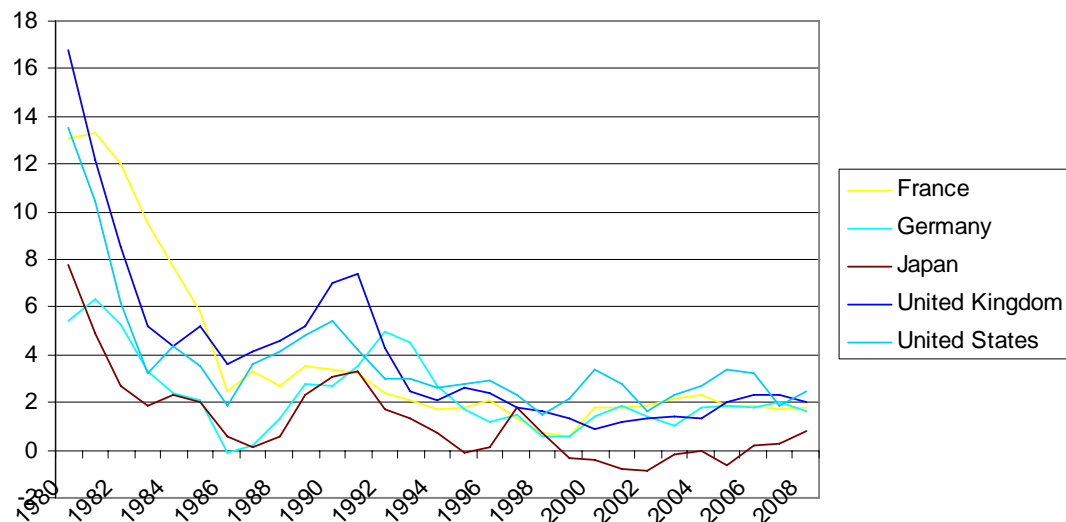
However, the last battle against inflation was fought 1992/1993.

Bernanke: Feb 2006

Trichet : Nov 2003

King: Jun 2003

Developments in CPI



Source:IMF

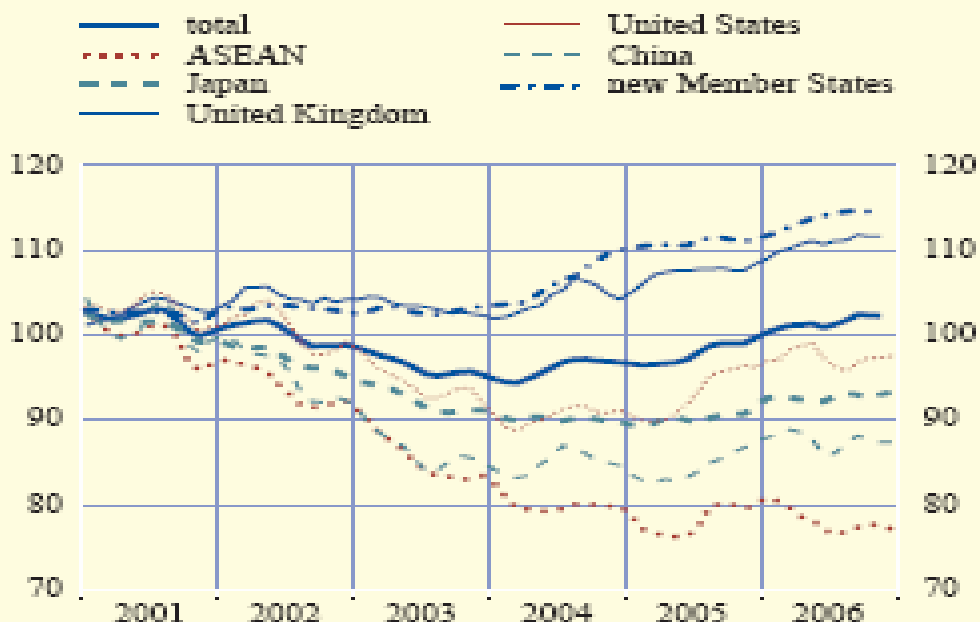
## The weak link: Inflation

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## The weak link: Import prices from China on the rise: Maybe not in Europe

**Chart B Prices of euro area manufacturing imports from selected countries and regions**

(unit value indices in euro; 2001 Q1=100)



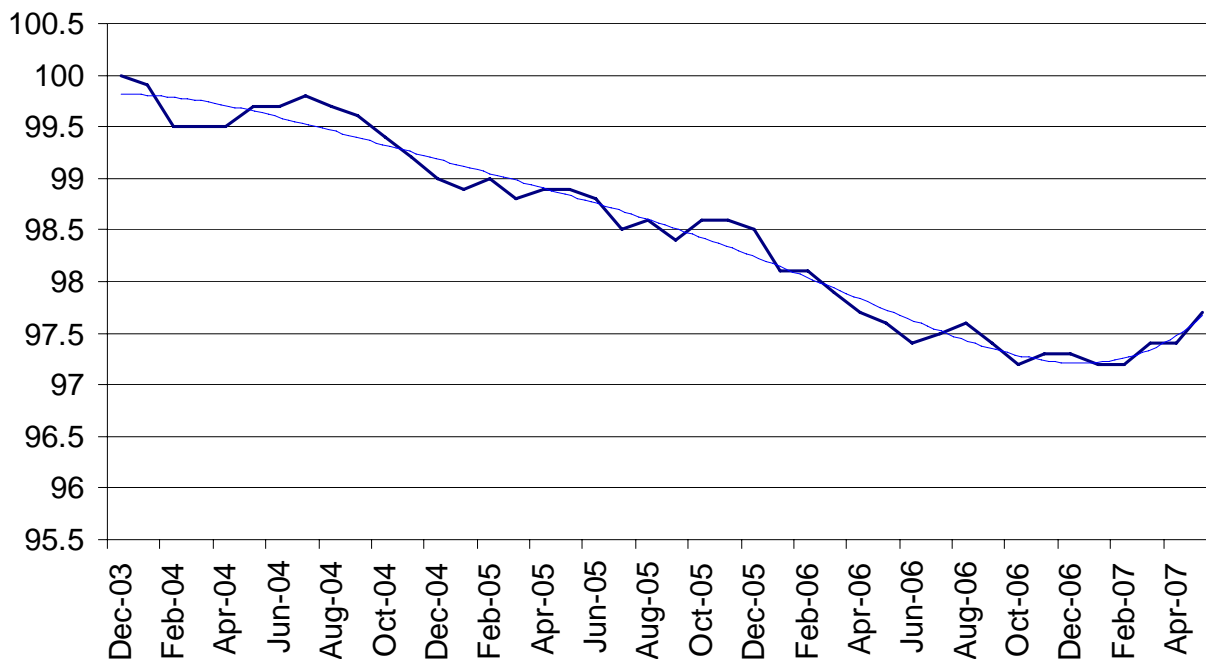
Sources: Eurostat and ECB calculations.

Notes: The latest observation refers to December 2006, except in the case of the euro area and the United Kingdom (November) and the new EU Member States (October). The chart shows the total import prices for the new Member States, due to the non-availability of manufacturing import prices. The new Member States refer to the eastern European countries that joined the EU on 1 May 2004.

Albeit the ECB concluded in June 2007 that “the downward pressures of globalization on euro area import prices are not yet petering out”, I would like to highlight that since mid-2005, import prices from China stopped declining. And are set to rise significantly in the first quarter of 1Q2007. However, increase is damped by EUR strength.

## The weak link: ...but certainly in the US

USD Import Prices from China (all commodities)  
Dec 2003 = 100

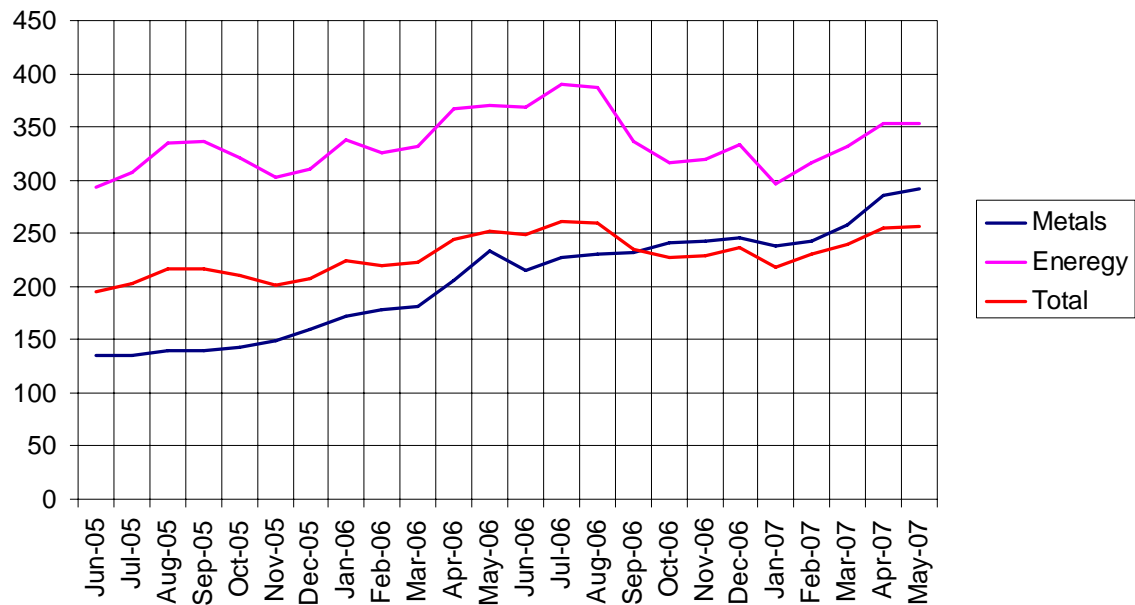


“The price index for imports from China rose 0.3 percent in May, the largest monthly increase since the index was first published in January 2004. Over the past year, import prices from China ticked up 0.1 percent, the first time the index increased over a 12-month period”. DOL

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## The weak link: Increased global demand for commodities will drive prices higher

IMF index of Primary Commodity prices in USD



The theory of comparative cost advantages does not superseded the overall demand /supply function.

Increased industrial demand for a product (i.e. metals) will not change its price given stable supply.

Please note the strong upward momentum in metal prices since the start of 2007. The PPI in China has increased 4.85% in the 1Q07 over the same quarter pervious year.

## The weak link: Price pressure from China

Region	Labor Rewards (1000 yuan)				Increase rate over the same period of last year (%)			
	Total	State- owned Units	Collective- owned Units	Others	Total	State- owned Units	Collective- owned Units	Others
National Total	637456637	372924138	24207540	240324959	21	18.2	10.2	27.1

National Bureau of Statistics of China , 1Q2007

Chinese labor revenues increased by 21% yoy in February 2007. In the same time, the overall labor force has increased by 2.5% yoy.

Region	Number of employed persons in urban units				Increase over the same period of last year			
	Total	State- owned Units	Collective- owned Units	Others	Total	State- owned Units	Collective- owned Units	Others
National Total	115803	64240	7391	44172	2749	-436	-448	3632

National Bureau of Statistics of China , 1Q2007

Results: The current low inflationary environment seem to be no longer sustainable.

In a 12 month horizon, inflation can be expected to increase to between 2.5% and 3% in the Eurozone.

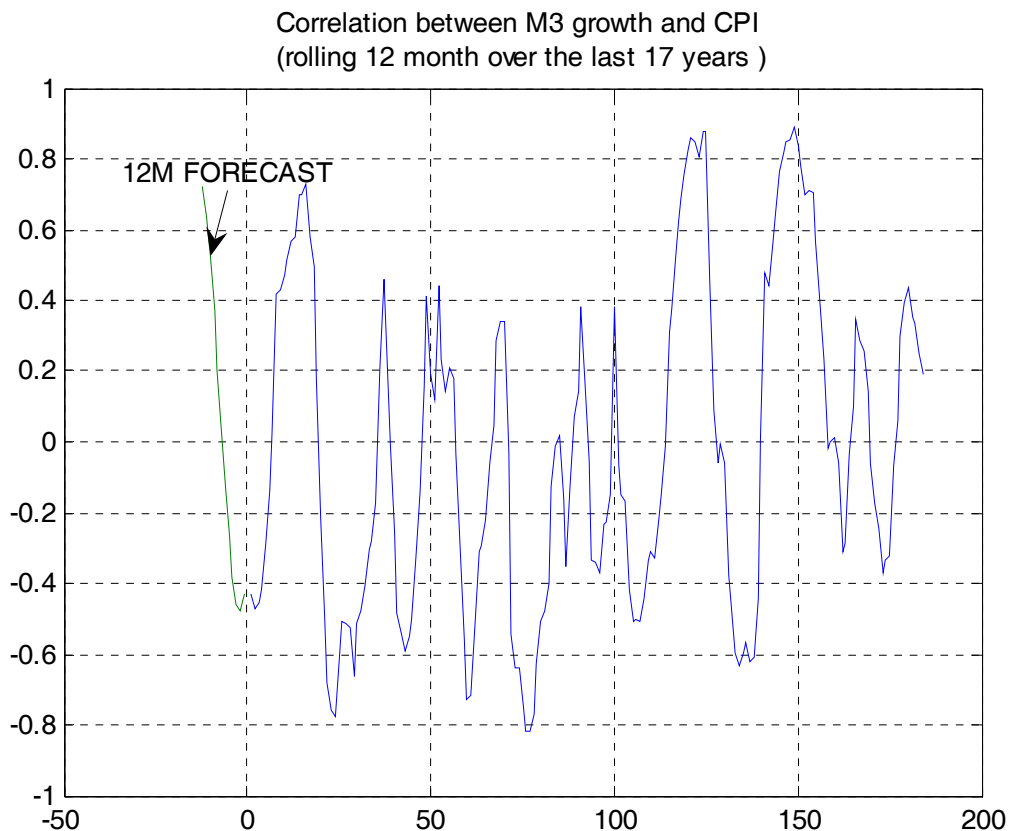
## **FINDING**

**Bond markets are experiencing a strategic retreat!!!**

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## Expectations for a new trading

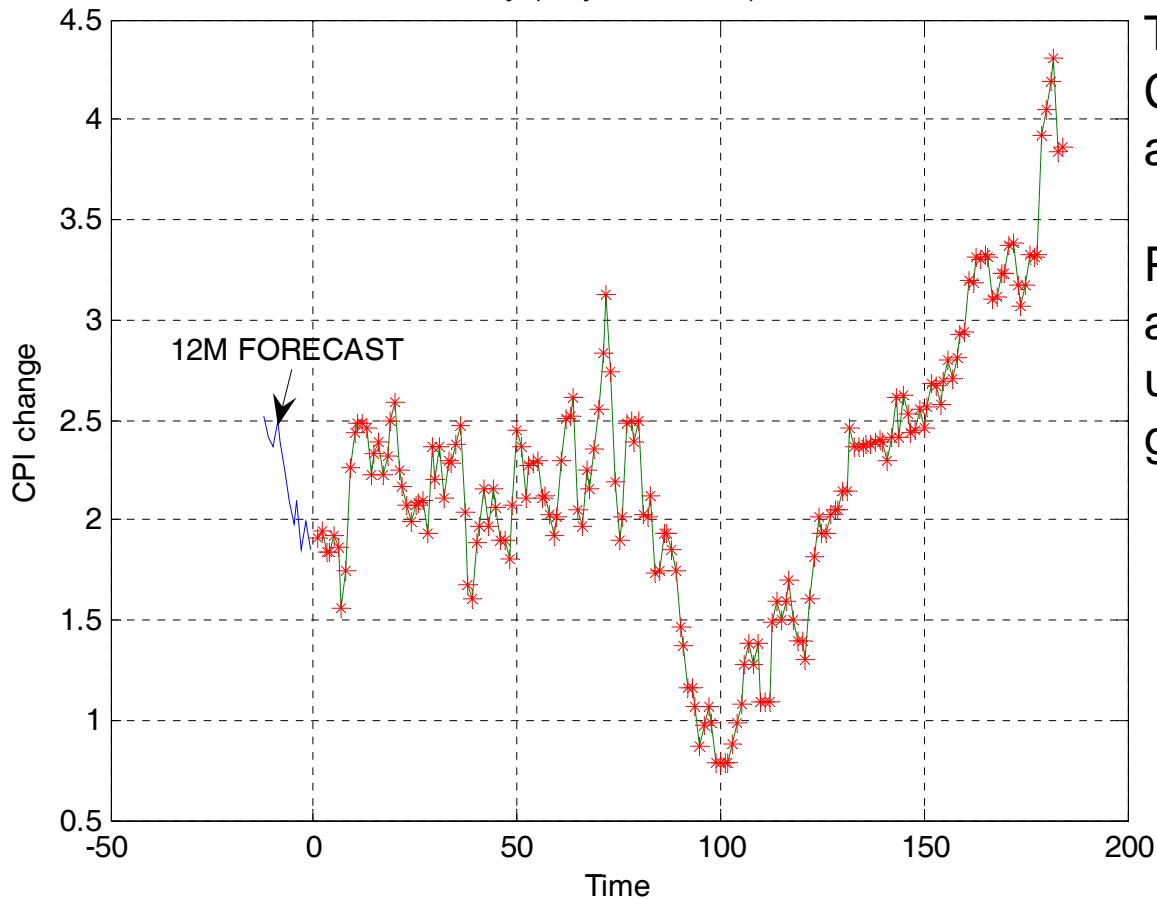


On a 12 month rolling basis, the relationship between M3 growth and CPI changes follows an interesting pattern. Periods of increasing correlation switch with periods of decreasing correlations.

The current pattern hints at an increase in the correlation between M3 growth and CPI changes.

## Expectations for a new trading

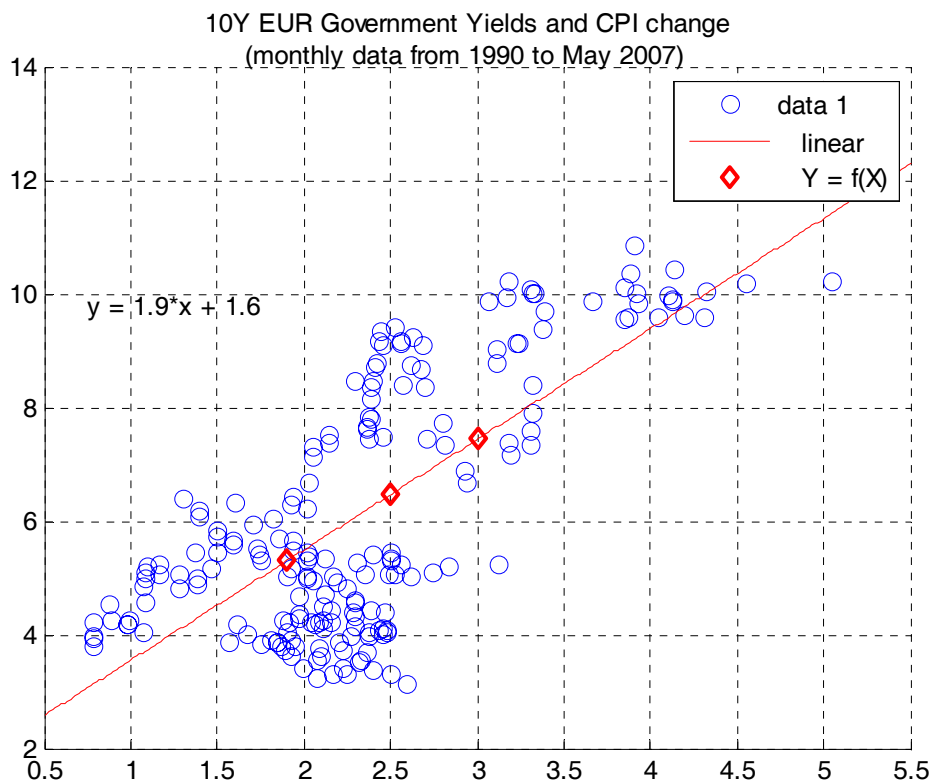
Eurozone CPI history (May 2007-1990) and 12m forecast



The simple model forecasts a CPI of 2.25% by end 2007 and of 2.6% by mid 2008.

Please note, historically this are not dramatic levels. But it underlines the weakening of globalization benefits.

## Expectations for a new trading



The long term relationship between 10Y EUR gov yields and CPI change is described by a growth factor of 1.9.

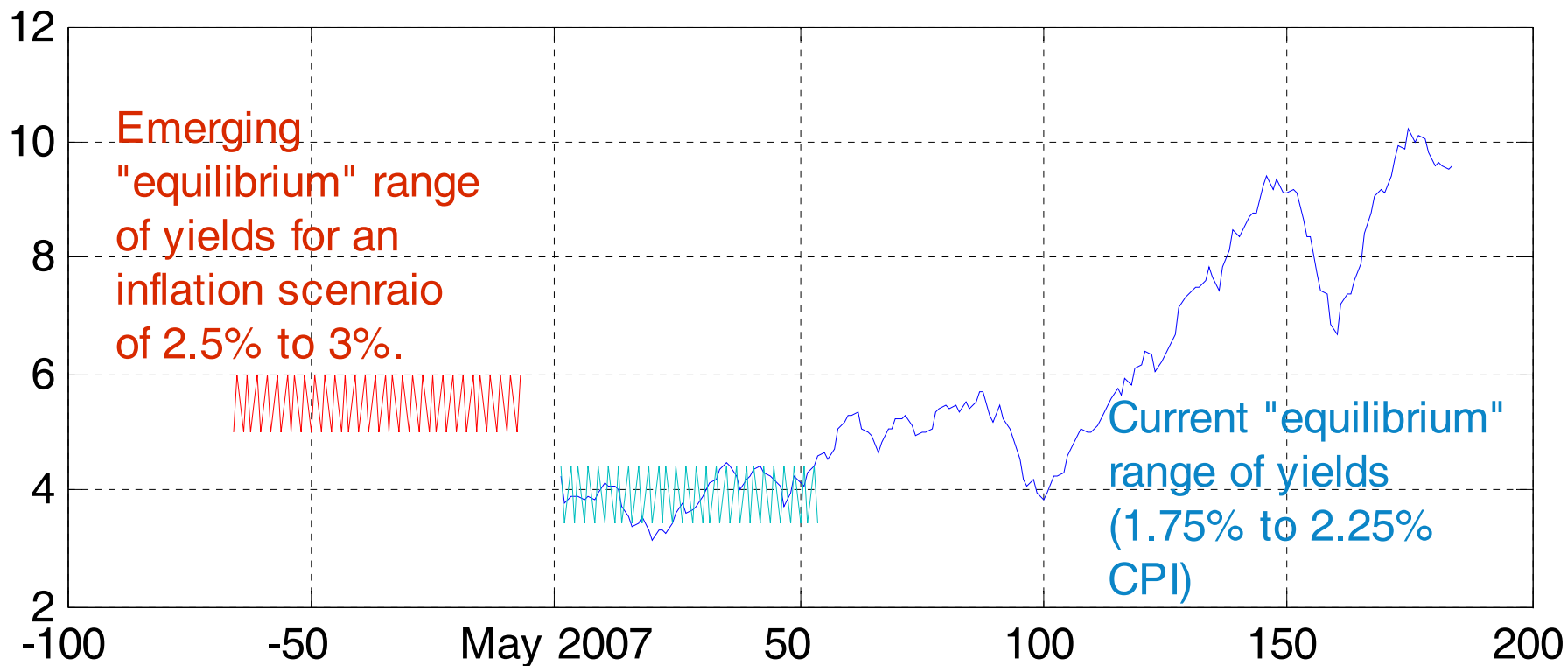
Using this factor will result the following predictions:

Time	CPI	Modeled 10Y Yield*
Jan 07	1.92	3.90
Dec 07	2.25	4.60/5.00
May 08	2.60	5.20

The new trading range for 10Y bond yields for an inflation environment of 2.5% to 3% is estimated at 5% to 6%. Hence, the downward pressure on bond prices is not yet over. We may yet have gone half the way.

## Expectations for a new trading

EUR 10Y Gov Yields (monthly data May 2007-1990)



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## Investment Strategies for an Fixed Income Manager

1. Go domestic (BRIC + followers) PIMCO
2. Go exotic in currencies PIMCO
3. Seek alpha in fixed income market neutral strategies

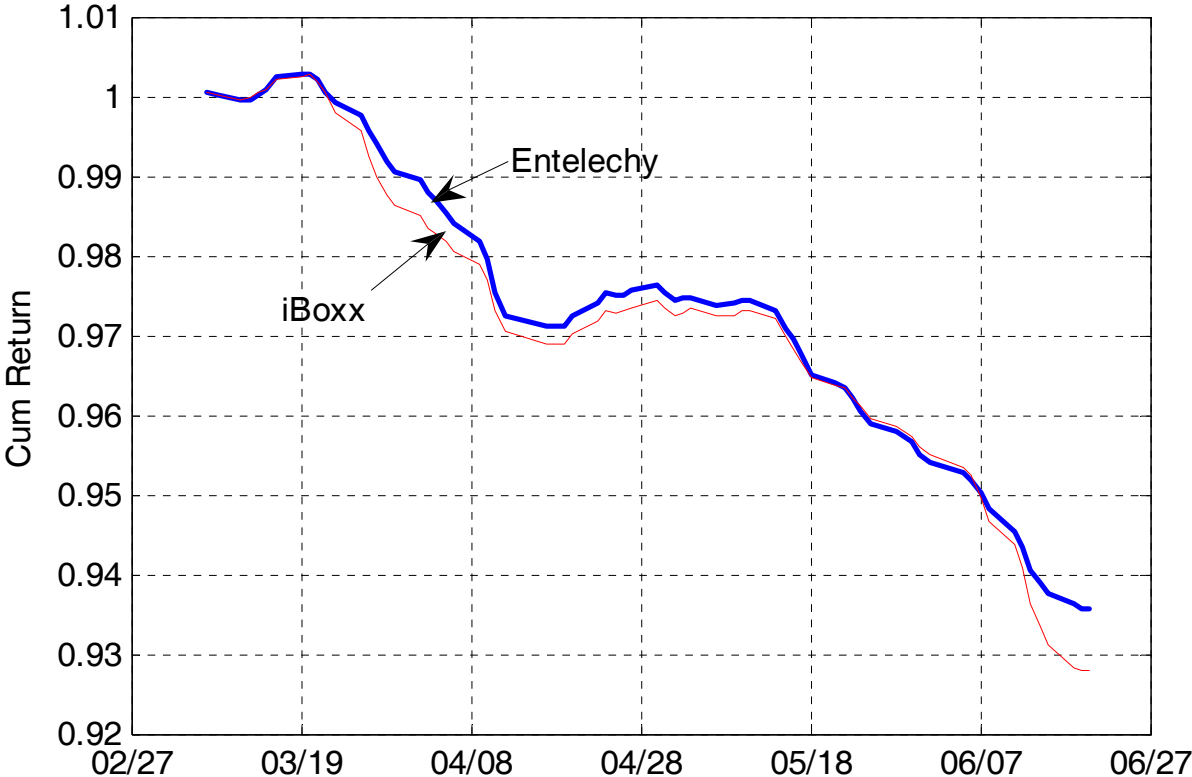
Example: Seeking Alpha via Entelechy (10Y+ EUR GOV Market Neutral)

Return Decomposition:  
*(March 1 to June 20)*

	in%:	No leverage	Fully invested
Long selected EUR 10+ GOV bonds:		- 6.43	-42.28
Short iBoxx EUR 10+TR GOV index:		+7.22	+47.48
<b>ALPHA:</b>			
Money Market (EONIA):		+0.63	0
<b>Total Return</b>		<b>+1.42</b>	<b>+5.20</b>

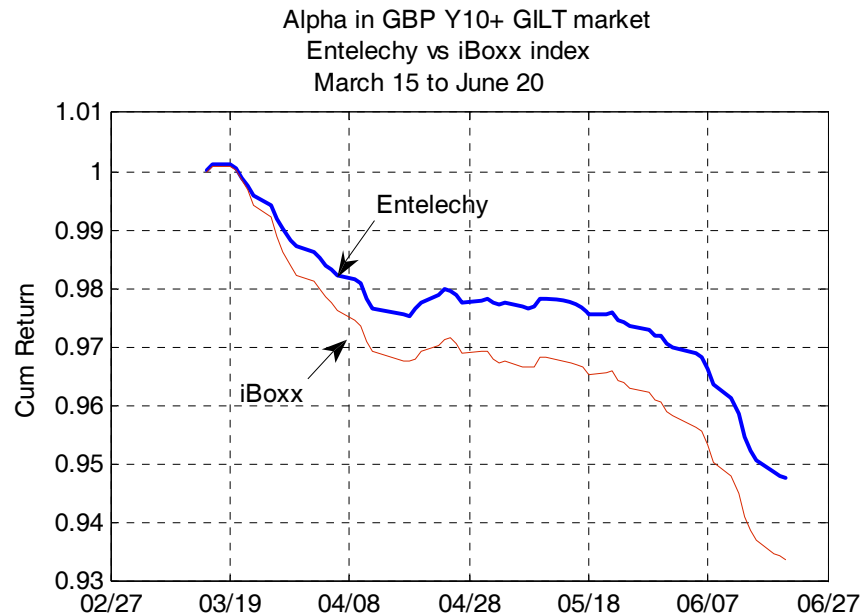
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Alpha generation in EUR 10+Y GOV Bonds  
Entelechy vs iBoxx TR index  
March 1 - June 20



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## Example: Seeking Alpha via Entelechy (10Y+ GBP GOV Market Neutral)



### Return Decomposition: (March 15 to June 20)

	in%:	No leverage	Fully invested
Long selected GBP 10+ GILTS:		- 5.23	-45.95
Short iBoxx GBP 10+TR GOV index:		+6.62	+58.16
<b>ALPHA:</b>			
Money Market (Libor ON):		+1.23	0
<b>Total Return</b>		<b>+2.62</b>	<b>+12.21</b>

## Summary

- The bear market in bonds is expected to continue over the remainder of the year
- Inflationary pressure is building up
- Market neutral strategies are able to produce required investment returns