



Bond market update

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Continuing what has become a rather familiar theme, markets remained volatile in November, with ten year yields declining to almost 2% in the UK. This move was attributed to investors seeking safety from the turmoil that affected the euro, although an alternative view was proposed by American Professor of Economics and New York Times columnist Paul Krugman. Krugman commented: "It's sad, actually: the wolf is at the door, and Osborne thinks it's the confidence fairy". In effect there is a clear division of view: either that current yields reflect the austerity programme that will bring the UK deficit juggernaut under control, or that the economy is headed for depression, with the only credible asset being government debt.

Despite the universal gloom I remain a bit more upbeat. The US economy has shown some signs of improvement in recent months and although the lack of leadership is a concern, I feel that the US will again demonstrate its resilience. In Europe the lack of clear leadership is also evident and, for the first time in this crisis, concerns have been expressed about the relative standing of German debt – hence ten year UK government bond yields briefly falling below the levels of their German counterparts. Panic was also evident in the hitherto unaffected supranational sector, where the debt of the European Investment Bank came under heavy selling pressure. Over the last year the yield premium of 20 year EIB debt over UK government bonds has widened by around 1%. This may not seem much, but in market terms the return has lagged gilts by over 10% - for a supposedly low risk asset.

Our emphasis on secured and asset backed bonds within credit portfolios remains a key element of our approach. We believe that the medium term economic outlook is for subdued growth and I would re-iterate the importance of having strong covenants and security backing credit bonds where possible.

Source: rlam as at 5 December 2011 unless otherwise stated.

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