rlam®
royal london asset management

30 January 2012

European bond market update

George Henderson
Manager of the Royal London Global Index Linked Fund

Following recent downgrades by Standard & Poor's and Fitch, European government bond markets have been stable, with risk assets rallying. Spreads on Italian 10 year bonds (over German bunds) have tightened 80 basis points and are now trading at 410bps over. The current absolute 10 year yield has breached the psychologically important 6% level to the downside.

In my view, positioning is having a larger effect on markets than fundamentals and we can see this through the reaction to auctions. Firstly, Spain auctioned 10% of its annual funding requirement earlier this month, meeting solid demand for its debt, while the following day an Italian auction was met with poor demand. Ratings downgrades by Standard & Poor's then followed, and both government debt markets began rallying.

For now, there is some stability, although markets continue to feel fickle. I suspect the 'pain trade' is for risk assets to continue rallying, either as investors have positioned themselves for a fall in risk markets, or remorse as they have missed the 'buy' opportunity of their careers. However, conviction levels remain low and the environment is extremely volatile. In the near term, political developments and headlines will drive volatility and with fiscal pacts requiring ratification, politicians angling for re-election and disputes between lender and creditor countries, there is a wealth of material to trigger sharp moves.

I believe this requires a contrarian strategy, given the volatility of markets and their tendency to over-react. As yield levels are at multi-year (even generational) lows, I have been managing this approach from the short duration side.

Over the longer term I don't expect a European break-up. Too much political capital has been invested in the project and it is in very few people's interests for it to disintegrate. As Europe stumbles towards a higher level of fiscal integration and creates or reorganises the accompanying institutions, I expect markets to remain extremely volatile.