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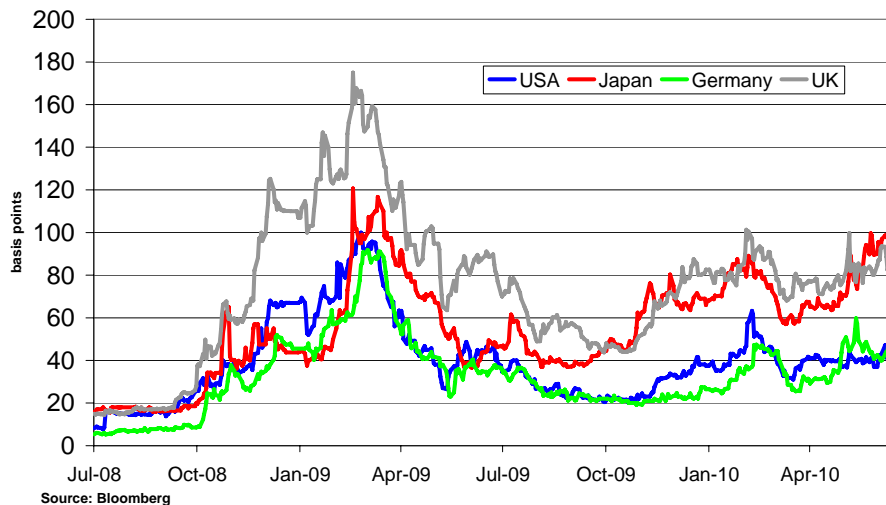
Navigating Fears of the Bond Market

June 21, 2010

As we take stock of the global landscape at mid-year it is immediately apparent that international risk appetite remains very fragile, with bond market investors in particular nervous about the massive amounts of debt being issued by many countries. Fear of sovereign default (historically a pretty rare occurrence) has surged. For many countries credit default swaps (CDS), the main point of reference for indicators of sovereign default risk, remain sharply higher than two years ago (Chart 1). The synchronized nature of the global financial crisis and recession led to a massive increase in government borrowing that has yet to abate. Most investors are reluctant to take big positions given the level of uncertainty about the global outlook and even emerging market debt issuance has been drying up in recent weeks as spreads have ballooned. After last year's recession-induced fiscal blowouts, many sovereign debt issuers are now discovering that demand at auctions is hinging on domestic policy news, particularly on progress in implementing fiscal tightening or even outright austerity. The need to keep the bond market happy while implementing often far-reaching fiscal reforms is most acute across Europe, where the outlook is for weak real GDP growth into 2011 – albeit with significant variations between countries. Conversely, the recoveries in Asia and in the Americas have effectively eliminated fears of sovereign defaults but now concerns over economic overheating will dominate. Finally, the U.S will eventually have to address its own public debt overhang, but for now is enjoying a temporary safe haven status.

Chart 1

Selected Credit Default Swaps - Major Economies



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Europe: Higher Funding Costs and Painful Reforms

The trigger for Europe's current difficulties came late last year with revelations that Greece's budget deficit and public sector debt levels were far higher than previously admitted. As a result Greece, with junk-level sovereign debt ratings and punishingly-high CDS rates (Chart 2), is now shut out of the markets and dependent on IMF and EU aid. However, the roots of Europe's woes can be traced to last year's recession. The economic contraction hit some public budgets harder than others, depending on the underlying flexibility of labor markets, the fiscal stimulus measures enacted, and the level of spending on banking sector bailouts. In the wake of a number of Euro-zone sovereign debt rating downgrades earlier this year, the markets are now hyper-sensitive to the longer-term fiscal outlook across the region. Euro-zone sovereigns face additional pressure because they are unable to print money to repay their outstanding debts. Non-Euro-zone Sweden, which has recovered smartly from the recession, looks set to return to a public sector surplus by 2012 without having to implement any major spending cuts or reforms. The rest of the region is not in such a happy place. Countries such as Finland and Germany should be able to get their government accounts back onto a sustainable path by clawing back stimulus measures and continuing with existing plans to maintain competitiveness and productivity – although the political fallout of spending cuts will mean headaches for the incumbent governments. However, countries such as Spain and Portugal will need more deep-seated structural reforms of their labor markets and public spending. So, too, will France and Italy, although they are not yet as afraid of the bond markets, being much bigger economies and able to carry a higher debt load.

Governments across the EU are unveiling austerity plans that will kick in later this year and into 2011, but the stress of navigating between fear of the bond market and the need for fiscal tightening is exemplified most clearly in Spain and the UK. Spain, the Euro-zone's fourth-largest economy, suffered a particularly nasty recession. Real GDP only just edged upward again in Q1 2010 after seven consecutive quarters of decline. The unemployment rate stands at 20%, the highest in the Euro-zone. The impact of the global recession was exacerbated in Spain by the collapse of a housing and construction market bubble. As a result, the budget deficit soared to 11.4% of GDP last year, while public sector debt jumped from just 39.8% of GDP at end-2008 to 54.3% at end-2009 – a deterioration magnified by the fact that the level of GDP itself is shrinking. The sovereign has been able to access the markets, but at a higher cost, and while nowhere near Greek levels Spanish CDS rates remain elevated. Investors are paying close attention to Spain's costs of funding as the government struggles to bring the budget deficit below 3.0% of GDP by 2013. The markets are also wary of the contingent liabilities represented by a long-delayed consolidation that is finally underway among the smaller regional banks or *cajas*. The government wants to see borrowing costs come down before it has to fund a €16.2 billion debt redemption due at end-July (although the good news is that this should be the last such big redemption this year).

The Spanish parliament passed a €15 billion fiscal austerity package by just one vote in May and now the rigidity of the Spanish labor market has come under the spotlight. Labor reform is seen as crucial to easing the high unemployment rate and helping get the economy back on its feet. If PM Zapatero can't get the reform legislation passed by parliament, subsequent market pressure could

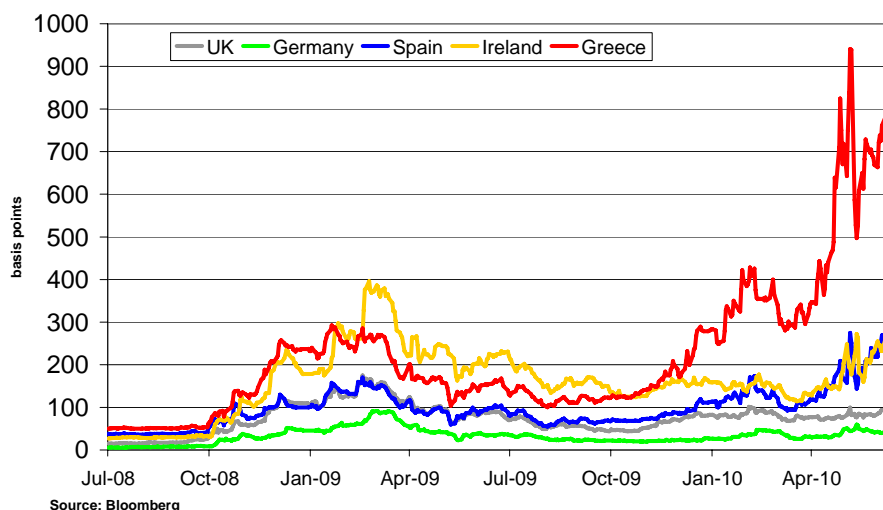
force him to call an early election, and would certainly sharply increase the sovereign's funding costs. Meanwhile, having contracted by 3.6% last year, real GDP may well stay in negative territory again this year.

Fear of the bond market is less acute in the UK, which has enjoyed a triple-A sovereign rating for over 30 years and which can issue debt at longer maturities and for lower costs than most of its European peers. Nevertheless, S&P sent a warning shot across London's bow last summer when it lowered the outlook on its AAA rating to negative, in light of the country's rising debt burden. Real GDP fell 4.9% last year, with the recession exacerbated by the bursting of a domestic real estate bubble and by the impact of the global financial crisis on London, a center of international finance. Thanks to the huge bank bailout package, and to the impact of the recession on spending and on revenues (much of which had come from the financial and real estate sectors in recent years), the general budget deficit (calendar year, EU accounting basis) soared to 11.5% of GDP in 2009. Total public sector debt stood at 68% at end-2009 up sharply from just 44% at end-2007. Although UK CDS rates do not yet reflect any fear of the sovereign losing its coveted AAA-rating, such a development would be a huge blow to the UK, sharply increasing its borrowing costs. The coalition government elected in early May is thus under enormous pressure to come up with a credible long-term fiscal plan.

The previous Labour administration had avoided any real structural reforms, content to ride the wave of prosperity from the financial boom years and to benefit from the labor market and privatization reforms implemented by PM Thatcher back in the 1980s. Now, however, the severity of the contraction in the real estate and financial sectors has sharply reduced revenues. It appears that the UK is headed for a round of spending cuts that will be more severe than anything yet seen in the post-war period (even PM Thatcher's famed "austerity" in the early 1980s did not cut spending in real terms). History says that economies hit by banking crises and/or the collapse of housing bubbles tend to suffer deep recessions and slow recoveries – and the UK has been hit by both. A prolonged period of private sector balance sheet adjustment is underway, which will weigh on private consumption and capital spending, and which will be exacerbated by the impact of fiscal austerity. This leaves exports as the mainstay of the recovery, but with many European trade partners also about to unleash a round of fiscal austerity on their economies, export demand may slip again heading into 2011. All told, real GDP growth is likely to hover around the 1.0% level this year and next.

Chart 2

Selected Credit Default Swaps - Europe



Across the 16-member Euro-zone governments are busy rolling out reforms and spending cuts in a bid to rein in their deficits. The German government has unveiled a four-year €80 billion package, mostly made up of spending cuts. Although the package is a relatively-modest affair that will be unrolled gradually over the next few years, the inclusion of some tax hikes has rattled Chancellor Merkel’s junior coalition partner, the Free Democrats, and could yet undermine the government’s cohesion. In the Netherlands, post-election coalition negotiations are underway, built around pledges of renewed fiscal discipline that could end up yielding some significant spending restraint. Italian PM Berlusconi has unveiled a €24 billion package of spending cuts, despite having spent the past two years insisting that Italy was in better economic and fiscal shape than the rest of the Euro-zone. Even French President Sarkozy, while studiously avoiding any mention of “austerity”, has ramped up plans for pension system reform, and proposed a constitutional amendment to limit budget deficits. Yet all these plans add uncertainty to the growth outlook as austerity measures will constrain demand. The ECB’s latest projection shows 2010 real GDP growth across the ‘zone at just 0.7% to 1.3%, with the 2011 outlook ranging from just 0.2% to 2.2%. The economic and financial crisis of the past two years may have lowered many Euro-zone economies’ long-term growth potential – an argument made recently by Bundesbank chief Axel Weber regarding his own country, Germany. If so, it will be even harder for governments to meet their debt-cutting goals.

The outlook for some of the newer EU members in central/eastern Europe is also uncertain. Poland was the only member of the EU to avoid outright recession last year and, along with the Czech Republic and Slovakia, its public finances are in better shape thanks in part to past reforms – a fact reflected in its still relatively-low CDS rates (Chart 3). Far more vulnerable, however, are

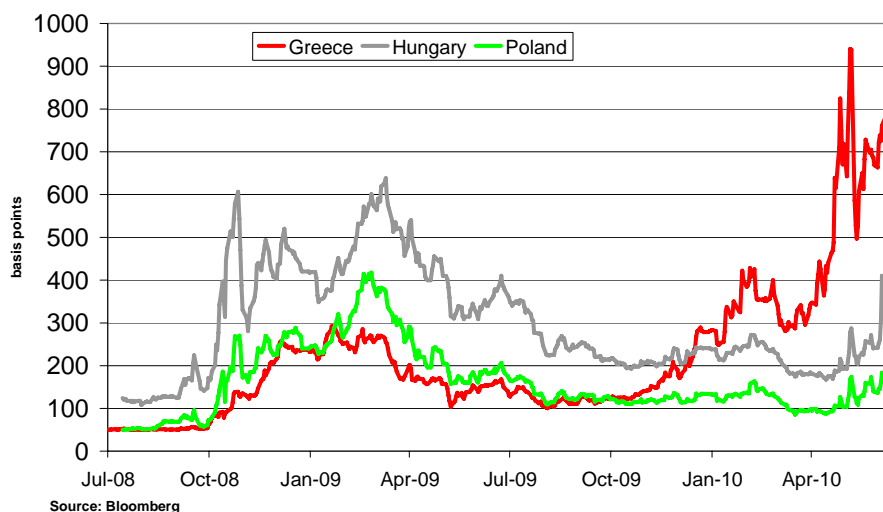
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the likes of Hungary, Bulgaria, and Romania. Hungary has had an IMF Standby Agreement in place since late 2008, which should assuage investor concerns. Nevertheless, its new government has spooked the markets anew by saying it has found the public finances to be in much worse shape than expected. It claims the 2010 budget is likely to overshoot the IMF-negotiated 3.8% of GDP target and come in as high as 7.0% thanks to the previous government's "hidden" measures. While assertions from PM Orban that there is only a slim chance of avoiding a Greek-style debt crisis were likely aimed at preparing the public for structural reforms, the effect has been to sow confusion and panic in the markets, which will exacerbate the government's problems. Hungary cut its June 10 bond auction offer and sold bills at higher yields than in late May, as the markets await proof that the government's economic plans can be implemented.

The European Commission is demanding an explanation for why the Bulgarian government has abruptly revised its 2010 budget forecast from balance to a deficit of 3.8% of GDP. Questions about the reliability of the country's statistics have helped to push five-year credit default swaps to eleven-month highs. In neighboring Romania the next disbursement of IMF and EU aid is contingent on the government passing spending cuts. However, there have already been massive anti-austerity protests across the country and although the government has survived the first no-confidence test of its fiscal austerity plan, it is still vulnerable. Both Bulgaria and Romania remain in the grip of recession. There are also concerns in both countries about the potential impact on their banking sectors of financial woes at Greek banks, which account for 25% of banking assets in Bulgaria and about 15% in Romania.

Chart 3

Selected Credit Default Swaps - Eastern Europe



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Asia: A Quick Recovery Creates Its Own Problems

A number of factors played into Asia's generally rapid rebound from the financial credit squeeze that started in 2008, but possibly the most overlooked of these is the prior decade of reform that most of these countries initiated in the wake of the 1997 currency crisis. The "Asian flu" triggered massive region-wide loan defaults, corporate failures and wealth destruction, but these developing economies emerged from unprecedented recessions with broad reform agendas and long-term strategies to stabilize the financial sector. It is just this kind of restructuring that built up Asia's immunity and helped it weather the contagion that spread so rapidly from Wall Street in September 2008. More conservative lending and financing practices, avoidance of excessive exposure to derivatives and collateralized debt obligations, and more open forex systems all weeded out dramatic external imbalances and allowed most of the Asian Tigers to avoid prolonged, damaging recessions.

Not to say that the region did not feel its share of pain. With exports and transshipments still a significant part of Asia's economy, the decline in global trade activity quickly put the lash to the larger economies. In Q4 2008, most of developing Asia witnessed annualized quarterly declines between 9% and 19%, with figures generally still negative in Q1 2009. However, the previous two years of strong global consumption and a sharp rise in total trade volumes gave these trading hubs a substantial financial cushion, and it was this windfall that the governments put to use to pay for their fiscal stimulus programs. These countercyclical spending packages were not intensive long-term development programs (although China's \$529 billion in stimulus was a large exception to this), but rather the funding and enhancement of economic stabilizers during the drought in trade. With far lower public debt ratios than most of their peers, a year of fiscal laxity could be managed easily by the markets, and indeed Asia's rapid recovery made this even more palatable.

By avoiding technical recession, Australia came to be considered one of the few developed economies to emerge unscathed by the financial recession. This view was reinforced in the fall of 2009 when the Reserve Bank of Australia began to normalize monetary policy, months before the next G20 country would do the same. The country's comfortable debt position allowed for considerable fiscal stimulus, including many measures that shifted private consumption forward into 2009. The stimulus program, also heavy on public investment, drove the government finances into deficit, but with public debt consistently below 20% of GDP there are no fears over the country's debt (Chart 4). Despite this enviable position, it should be noted that Australian growth remains buoyed by public sector spending that will begin to dry up in coming quarters. The budget is expected to return to surplus in FY 2012/13 without the need for sharp reductions in spending, thanks in part to an ambitious tax increase on the mining sector.

Most of Asia's developing economies have since weaned off the stimulus measures and are treating the slow recovery in global trade as a manageable economic deceleration. Government debt strains are no longer the prime market concern – in fact, such quick recoveries have raised worries about nascent asset bubbles and the possible inflationary impacts of all that extra cash flooding the economies. Deflation had been an issue throughout most of Asia in 2009, but the

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subsequent rebound in the CPI made investors consider the rising likelihood of a boom-bust scenario. If this were to occur, most analysts said it would be in places that had the largest stimulus packages relative to their economies. At this point, everyone turned eyes toward China.

The structure of China's national statistics makes it difficult to study the magnitude of the country's economic slowdown, but a stimulus package worth well over 13% of GDP suggested the government expected a deep recession and acted aggressively to shorten its duration. The recession never showed (at least according to official data), the economy appeared to bottom out in Q1 2009, and by the end of 2009 year-on-year growth was faster than at the end of 2007. This recovery was also marked by rapid growth in credit generation, ultra-low interest rates and sharp increases in real estate development and prices. Furthermore, during this period of easy money, the government's concerns remained firmly seated in broad-based economic stability, which included a secure export-manufacturing sector – the largest employer along the east coast provinces. To achieve this end, the People's Bank of China restricted its policy-tightening decisions to raising reserve ratios for the major banks, while holding benchmark interest rates at low crisis levels. Fears of a bubble seemed justified heading into 2010.

Only as of June 2010 did the government concede problems with asset prices, when the China Banking Regulatory Commission stated the real estate market bubble was particularly concerning, adding to this that bad loans based on speculative purchases are likely to rise over the next twelve months, bank losses will mount, and credit growth is at risk of being negatively impacted by imprudent behavior. These buzzwords all but state that in the government's opinion, the economy is vulnerable to the bursting of a market bubble. Undoubtedly, the government knows that a managed deflation of an asset bubble is a tricky operation that rarely succeeds. But now that it has created that very thing, it will have to find a way to ease back prices and not frighten off foreign investors.

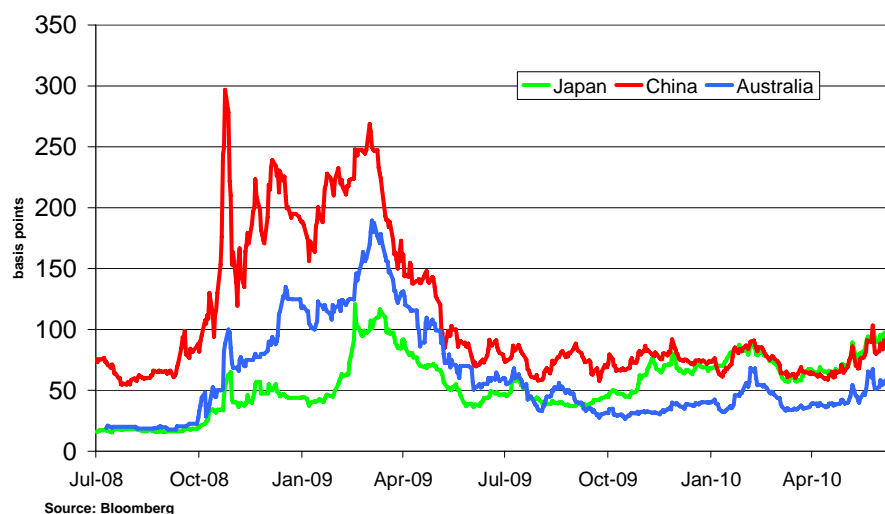
Conversely, Japan is not suffering from its own excesses but rather from the frank realization that its domestic economy is singularly incapable of carrying growth when the export sector slows, and that without deep and painful reform the country is destined to fall into a debt spiral (if it is not already in the first stages). The Bank of Japan (BoJ) has few conventional tools at its disposal to stimulate the economy – the main policy rate is at 0.10% and has been below 1.00% for over 15 years – and its quantitative easing programs have proven unsuccessful in stimulating self-sustaining growth. The fiscal picture is just as bleak, with public debt ending 2009 at \$9.7 trillion, or 191% of GDP. While most of this is very low-interest debt, the sheer volume means that even a slight increase in interest rates will put dramatic pressures on servicing and rollover costs, all while Tokyo runs further annual deficits in an effort to kick-start the moribund economy. With export demand only recovering at a slow, gradual pace, the Japanese government will not see its trade sector produce the robust numbers necessary to raise revenues, bring new money into the economy and perhaps pay for what would be an expensive program of reform and restructuring. Rather, the financial crisis has temporarily taken away the economy's one source of growth, leaving the country vulnerable to the ebb and flow of global demand and in desperate need of reform that Tokyo may not have the will or ability to implement. At some point, the local bond market will no longer have the capacity or will to absorb all this debt without a higher yield. If

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that day comes before public-sector finances and the economy are healthy, it will set off the final stage of a spiraling debt trap.

Chart 4

Selected Credit Default Swaps - Asia



Americas: Lower Public Debt Levels offer Calm, Pro-Cyclical Spending Must be Addressed

Canada faces little pressure from market participants to address the country's rare string of fiscal deficits, but cutting back expenditures in 2011 is on the agenda regardless. The market's positive view of Canadian finances is primarily due to the country's low level of public debt, along with the fact that its politicians have a strong recent track record when it comes to fiscal consolidation. The government is attempting to trim the budget shortfall sooner rather than later, motivated not by bond yields but by a desire to avoid future tax hikes. The economy benefited from the large two-year stimulus package in January 2009 and if recent monetary tightening is an indication, self-sustaining growth is in hand and the economy will be able to handle the withdrawal of counter-cyclical government spending next year.

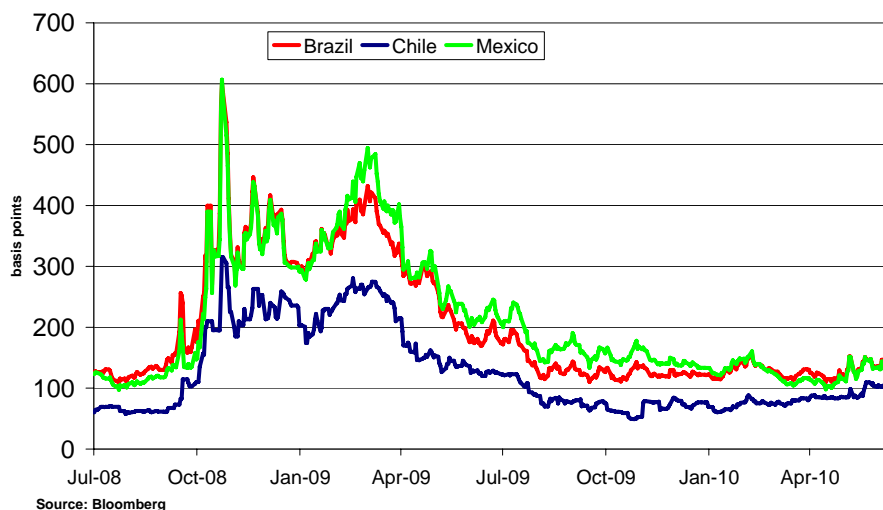
The Latin American region is home to countries with lower levels of public debt, healthy commodity endowment, as well as elevated growth potential. As a result, the large economies currently face little pressure from the bond market (Chart 5), with the exceptions of Venezuela and Argentina which have unique bond market challenges of their own. Mexico has a need for significant fiscal reform leading to less reliance on PEMEX revenue, but due to lower debt/GDP levels (under 40%), Mexican sovereign debt has yet to be punished.

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The more typical fiscal challenge in the region is the one currently faced by Brazil, and to a lesser extent Peru. As the throes of the financial crisis spread in 2008, many predicted that Latin American economies would be acutely affected and among the last to recover. We now know that to have been an incorrect prophecy, but that mindset resulted in quite ambitious fiscal packages to head off the crisis. In many places, those packages have now become decidedly pro-cyclical and risk doing much more long-term harm than good. In Brazil, central government expenditures and transfers as a percent of GDP have increased from 19% in March 2008 to over 24% in March of this year (despite GDP growth) and new infrastructure spending programs are still coming down the pike. This year and next are filled with big elections on the South American continent and cutting back on spending will be difficult, especially when capital is still affordable. But, if the Latin American economies are to weather the next storm as well as they did the past one, fiscal consolidation must begin by next year, or in Brazil's case, the day following the October presidential election.

Chart 5


Selected Credit Default Swaps - Latin America



United States: Pressing Fiscal Problems Need to be Addressed Despite Safe Haven Status

Which brings us, finally, to the U.S. The rally in the bond market since the European crisis unfolded is a reflection of the safe haven status of the U.S. economy, and there still is no threatening message about U.S. sovereign debt from credit default swaps. However, even the U.S. economy cannot continue to function without paying heed to its looming federal deficit and debt

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problems. The Congressional Budget Office (CBO) baseline estimates of March 2010 point to a lower federal deficit as a percent of GDP in 2010 from the historical high mark of 9.9% in 2009. CBO projections into 2020 indicate that the federal deficit will drop to about 3.0% by 2013 but persist in that neighborhood until 2020. The nation's federal debt is projected to climb to nearly 68% of GDP by 2020 from 53.0% in 2009. The implications of growing deficits are three fold: (1) it crowds out private sector investment and erodes the future standard living of the nation; (2) it reduces budget flexibility; and (3) it raises the risk of high interest rates.

U.S. fiscal policy is on an unsustainable path and minor meddling of budgetary options is unlikely to solve the problem. In order to avert a major crisis over the medium-term and not jeopardize the well being of the nation, policymakers will have to make stark choices in the quarters ahead. However, it will be politically impossible to implement new policies until the recovery, which is only four quarters old, is fully entrenched. As the economy grows, expenditures due to automatic stabilizers will fade away and the focus on discretionary aspects of spending will be possible. At the same time, the projected costs of entitlements -- Medicare, Medicaid, and Social Security -- will have to be addressed in the medium term. A key ingredient to change the outlook for the federal deficit is the political will to engage in addressing the causes of the fiscal challenges ahead. The CBO estimates that by 2020, Medicare, Medicaid, and Social Security will make up 47% of total outlays (33% in 2009) and net interest costs will amount to 14% of expenditures (5.4% in 2009). CBO's computations indicate that Medicare and Social Security are the fastest growing components of federal outlays. The key to the fiscal future is designing ways to cut the rapid escalation of these costs. Forecasts of budgets and embedded economic assumptions are highly uncertain. But the important fact remains that the nation will have to employ a combination of higher taxes and reductions in expenditures to bring back deficit and debt ratios to prudent levels -- or risk experiencing the kinds of bond market pressures now afflicting much of Europe.