

Immediate Insight: bond market update

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Decisive action by the European Central Bank (ECB) over the weekend

Further to our note of last week, this weekend has seen more decisive action from the eurozone, with the announcement on Sunday night that the ECB would be stepping into the market “actively” to implement its bond purchase programme. Today, the ECB has bought around €800m of Spanish, Italian and Portuguese bonds. Mid-market spreads on ten-year government bonds in Spain and Italy are now in the region of 280-290bps over Germany, from last week’s highs of close to 400bps.

What caused this more decisive action?

Firstly, the downgrade of the US credit rating by Standard & Poor’s to AA+ may have made the ECB more concerned about possible further negative investor reaction. Secondly, Italy and Spain are now seen to be taking the right sort of action to strengthen their fiscal discipline. Indeed, Italy has brought forward its fiscal tightening with a view to achieving a balanced budget by 2013 and will also seek to enshrine a balanced budget in the constitution. Furthermore, a joint statement from France and Germany showed commitment to getting the new powers of the European Financial Stability Facility (EFSF) implemented by the end of September. Thirdly, a further effort to bolster markets has come from a G7 statement pledging to take “coordinated action where necessary” to prevent disruption and ensure liquidity in markets.

Does this change anything?

For now the risk of disorderly eurozone bond markets appears to have been averted. However, pitfalls remain on the horizon. With the ECB only intervening for an interim period, until the EFSF is up and running, there is a finite limit on purchases (that of the EFSF’s buying power). The next step will be further discussion of how to expand the EFSF. This is something that the French want but that the Germans oppose. Over time, the outcome is likely to be common debt issuance of ‘euro’ bonds combined with greater fiscal centralisation. This is unlikely to be done quickly or without further public wrangling.

Insight’s position

Insight remains committed to managing our client portfolios in a prudent manner. This weekend’s news does signal a near-term shift and we have taken action accordingly. In our bond portfolios, underweight positions in Italy and Spain have been reduced where appropriate. However, as things stand, we would be tempted to use a significant further tightening of spreads as a selling opportunity for both markets.

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