

# WEEKLY MACRO COMMENT

By Han de Jong  
Chief Economist  
ABN AMRO Bank NV  
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## THE END OF AN ERA FOR BONDS

**Abstract:** Optimism about the world economy, on the eve of a growth explosion, justifies higher bond yields, but last week's spike in US yields was premature, argues Han de Jong, chief economist at ABN AMRO Bank.

### Key points

- Higher bond yields justified, but the spike has come too early
- US data expected to soften in the near term
- Higher Chinese inflation not unwelcome

Last Thursday saw the US bond market melt down with yields on 10-year Treasuries rising by 17 bp, statistically a rare event. Many commentators have argued that the rise beyond 5.05% marks the end of an era. In 1981, US 10-year yields peaked at close to 16% as inflation was high and the Federal Reserve was pursuing a very tight monetary policy. It was successful: inflation fell and so did interest rates.

US 10yr Treasury yield



Source: Bloomberg

Now, we have come to the end of the road. A period of some 25 years of declining inflation and bond yields is over. This, of course, entirely ignores

the fact that bond yields were even a touch higher twelve months ago. In the second half of 2006, yields fell again as inflation worries receded.

OK, perhaps it is different now. Last year, the below-trend growth phase in the US had only just started and as it continued, earlier inflation worries seemed overdone. This time around, the rise in yields is not due to rising inflation fears, but to expectations of strong (global) growth. This is a theme we have a lot of sympathy with.

In our view, the world is at the early stage of a period of unprecedented growth. The drivers are obvious to us: the labour force available to the global market economy is growing rapidly and will continue to do so. In addition, developments in the financial system are leading to a better dispersion of risks through the system and are making credit much more widely available to companies and private households.

Furthermore, the IT revolution has caused the cost of information and knowledge to drop sharply. Finally, macro- and microeconomic policies are guided increasingly by faith in market capitalism, which is likely to increase overall economic efficiency. Combine these four drivers and the inevitable conclusion is that the world economy is headed for an explosion of growth never seen before.

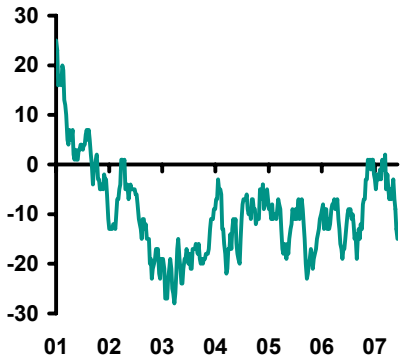
Naturally, this justifies higher borrowing costs, or higher real interest rates, if you wish. I am not saying that inflation

will rise. But the pace of trend growth of the global economy is rising and nobody really knows how fast. Central banks realise that there is no need anymore for extremely low rates and are adjusting their policies accordingly. This is bound to continue.

While we are optimistic about the medium-term outlook, there is one problem. The US housing market is clearly the weakest link. It will continue to be soft for some time yet. So far, the spill-over effects into the wider economy have been limited. The labour market has weakened somewhat this year, but much less so than one would have expected on the basis of historical evidence. The manufacturing sector got over its inventory correction in the first quarter and recent data has been quite robust. Nevertheless, in our view, the numbers have flattered the economy somewhat. Consumer spending is clearly flagging. Last week saw large US retailers warn on profits and the weekly retail sales indicators have weakened noticeably recently. US consumers also face higher borrowing costs due to the bond market rout and higher petrol prices as crude oil prices rise. Unsurprisingly, the weekly index of consumer confidence, the ABC index, has fallen in the last four weeks to a level last seen in September 2006. Accordingly, US economic data are bound to soften. If inflation continues to be benign, the bond market could easily see yields ease again or at least stabilise. There can be little doubt, however, that yields will rise once the US has overcome its short-term growth

issues, particularly in the housing market. That may still take a couple of quarters. Higher yields are justified, but perhaps not just yet in the US.

**US: ABC index consumer confidence**



Source: Bloomberg

The ECB raised its refi rate to 4% last week, as expected. The language used at the news conference on the rate hike supports our view that the ECB is not done yet. Expect another hike in the eurozone in September. The central bank may then want to take stock and review the situation before raising rates further in 2008. But there is also a chance that it will continue its steady pace of monetary tightening and hike again in December.

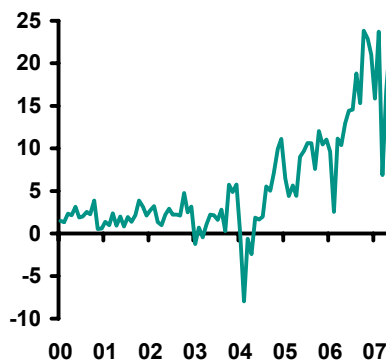
Eurozone economic data were mixed. The services PMI rose fractionally. The OECD leading indicator also rose a little, but the underlying trend appears to be weakening. Eurozone retail sales rose by 0.2% mom in April and by 1.6%

yoy, weaker than hoped for. Factory orders and industrial production in Germany were weak in April, but these series are relatively volatile and the underlying trend remains favourable.

Japan saw encouraging data on machine orders and machine tool orders, but several leading indicators were softer. There is still every reason for the BoJ to be cautious, although the natural inclination of the central bank is to continue raising rates. Since politicians will keep up the pressure on the BoJ, one should not expect any rash monetary policy decisions.

China reported another large trade surplus in May: USD 22.5 bln. At 28.7% yoy, export growth continues to outpace import growth of 19.1%.

**China: Trade balance USD bln**

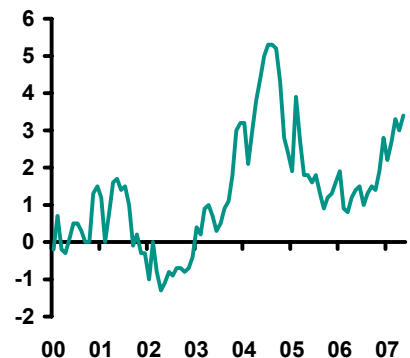


Source: Bloomberg

Inflation rose to 3.4% in May, the highest since early 2005 and just

ahead of April's 3.3%. As such, higher inflation boosts the chance of further monetary tightening, but one must take into consideration that the rise in inflation is largely due to agricultural prices. In itself, this is not unwelcome as the ratio between agricultural prices on the one hand and other prices on the other determines the terms of trade between the agricultural sector and the rest of the economy and some improvement in the living standards outside the cities is desirable.

**China: CPI % yoy**



Source: Bloomberg

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