

# BLACKROCK

## Week in View - 31 August 2010

We saw equity market weakness over the first four days of last week, which was largely reversed through a rebound on Friday. We know that the underlying trend since late July has been down - most of the major developed indices are by off by about 5% since that time - but in terms of the big picture, most of the major indices are still very much range bound and not particularly close to the bottom end or the top end of these various ranges.

Meanwhile, we saw the US dollar come under pressure again, before rebounding on Friday, and we saw some up ticks in the prices of oil, copper and gold, although these were relatively subdued movements.

### Market Movements\*

| Markets                                   | 30 Aug 2010 | % Change    |
|---|-------------|-------------|
| S&P 500                                   | 1048.92     | -1.73       |
| NASDAQ                                    | 2119.97     | -1.84       |
| TSE 1st Section                           | 829.21      | 0.54        |
| FTSE S&P World Europe                     | 298.75      | -1.03       |
| FTSE All-Share                            | 2684.41     | -0.61       |
| DAX                                       | 5912.41     | -1.64       |
| Hang Seng                                 | 20737.22    | -0.73       |
| Citi World Govt Bond Index All Maturities | 589.88      | 0.08        |
| Bonds**                                   | 30 Aug 2010 | 23 Aug 2010 |
| US  | 2.53        | 2.60        |
| Japan                                     | 1.00        | 0.94        |
| Germany                                   | 2.11        | 2.26        |
| UK  | 2.99        | 3.06        |
| Currencies                                | 30 Aug 2010 | 23 Aug 2010 |
| USD/Euro                                  | 1.27        | 1.27        |
| GBP/Euro                                  | 0.82        | 0.82        |
| JPY/USD                                   | 84.72       | 85.19       |
| USD/GBP                                   | 1.55        | 1.55        |
| JPY/GBP                                   | 131.10      | 132.09      |
| Commodities                               | 30 Aug 2010 | % Change    |
| Oil (Brent Crude)                         | 75.86       | 4.49        |
| Commodity Futures (CRB) Index             | 497.13      | 0.85        |
| Gold                                      | 1241.35     | 1.42        |

The big story recently has been the continued fall in government bond yields, not just over the past week, but since the start of the year. Since the end of 2009, looking at the ten-year bond yields in Germany and the US, both have declined by well over 100 basis points (bps), both were also, at one stage in the past few days, below 2.5%, with the German Bund closer to 2% and, in the latter case in particular, this was well below the levels reached even in the aftermath of the demise of Lehmans.

What's been going on in the short term to drive this? It is still very much the case that the concerns over global growth are close to the surface. We have discussed the nature of some recent Chinese data indicating the slow down there and, over the past few days, we have had more data indicating that the US economy is losing momentum, most notably the second-quarter GDP reading at 1.6%, revised down from an initial estimate of 2.4%.

In addition, when we look at recent data covering the third quarter, including weak housing data, typically weak labour market data, and some weakish capital goods orders data, it

looks like another quarter in which the US economy is going to be growing well below trend.

Not all macro news has been bad, however, and there is an interesting contrast between the US and Germany. Germany had a very strong second quarter and the latest numbers coming through from the Ifo survey, for example, suggest that it has remained robust and perhaps even stronger in the third quarter. However, given what has been happening elsewhere in Europe, and given Europe's tendency to follow any major move in the US cycle, markets are looking through these numbers at the moment.

The theme, as such, is very much around what the extent of the slow down will be and what happens next. An interesting speech by Ben Bernanke, on Friday, came in response to the slow down, with key themes including his view that the US Federal Reserve (Fed) has tools to deal with a more-sustained slow down, and whether or not it will be necessary to use them at the moment, especially given that the market had been pricing in some additional Fed bond buying. This was sufficient to push bond yields up somewhat towards the end of the week.

Has the decline in government bond yields been sufficient that we should be describing developed markets, sovereign bonds as now being in a bubble? We think it is helpful to decompose government bonds into two components: a real component, and inflation expectations. If we look in the US, the real yield for ten-year maturity is now 1% and inflation expectations for the next year are 1.6%, giving a ten-year bond yield of 2.6%.

What is the oddity here? Inflation expectations have been coming down quite materially over the past few months, but we would not say that 1.6% is materially out of line with what may happen over the next decade, and the real anomaly seems to be the level of real interest rates, which is very low in the context of the history (both for the US economy, and indeed for all of the major developed economies, real interest rates at this low a level are very unusual).

Now from one perspective you can rationalise these lower yields: let's not forget we are in an environment of low short-term interest rates and central banks are indicating that short-term rates will remain low, potentially for a very long period of time; inflation is low and declining, except in the UK, where given enough time it will begin to fall; economic growth globally is clearly losing momentum and it is not clear where this loss and growth momentum is going to leave the global economy in three-six months' time; and central banks are indicating that they are perfectly happy, if necessary, to step up their programme of quantitative easing.

So the issue is not that yields have fallen, rather the level at which they are now at, and particularly the real component within. Does this mean that it's a bubble? We would need to see not just extended valuations, but more genuine evidence of bubble-type conditions. So, for example, strong evidence of leverage, or huge flows into the asset class, or an expectation that returns from the asset class are going to be unsustainably high, and none of these factors really appear to be relevant for bond markets at the moment.

It is difficult to believe that investors who are buying ten-year US treasuries at around 2.5% are expecting to make a great deal of money, and we can identify some buyers of bonds who are

perfectly happy to do so for liability hedging reasons, in particular pension funds.

Another reason put forward to suggest that bonds are in a bubble is that fiscal positions are very extended and it seems odd to have a low level of real interest rates at a time where budget deficits are so high, and it is only a few months since Greece was being held out as the potential “canary in the mine” showing what would happen if other governments did not cut their deficit sharply.

This ignores two other developments, however, which have been going on. Firstly, the increase in budget deficits has been associated with a very large rise in private sector saving, so it is easier to finance them, and, within that, a very cautious investing community which has been prepared to reallocate away from risky assets towards the perceived less-risky assets, such as government bonds.

So when might government bond yields rise? The real wild card is when the fiscal risk premium could increase and it is difficult to give a strong idea of timing on that. But if we are looking at other potential drivers of high bond yields - re-acceleration of growth; high short-term interest rates; higher inflation; or higher private sector borrowing - these do not look likely to be factors certainly in the first half of this year, and maybe not for some time in 2011 as well.

Our feeling is that bonds have got to very low levels, but in a longer-term context return expectations have to be very low. The next big move in bond yields is likely to be up, but at the moment we are struggling for any catalyst that could lead to a correction in bond yields, which is more than a technical correction to the sharp decline in yields that we have had over the past week or two weeks.

In conclusion, government bonds are at expensive valuations and there are reasons as to how we got here. Therefore, we do not believe that this is a bond market bubble.

\*Equity, currency and bond markets measured over seven days, from previous Monday's close to Monday's close. All index returns in local currency terms. All equity index returns are price only.  
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