Report UST, Bund &BTP

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"Quantitative approach for asymmetric results"

The good, the bad and the ugly, or.. the ugly, the ugly and the ugly?

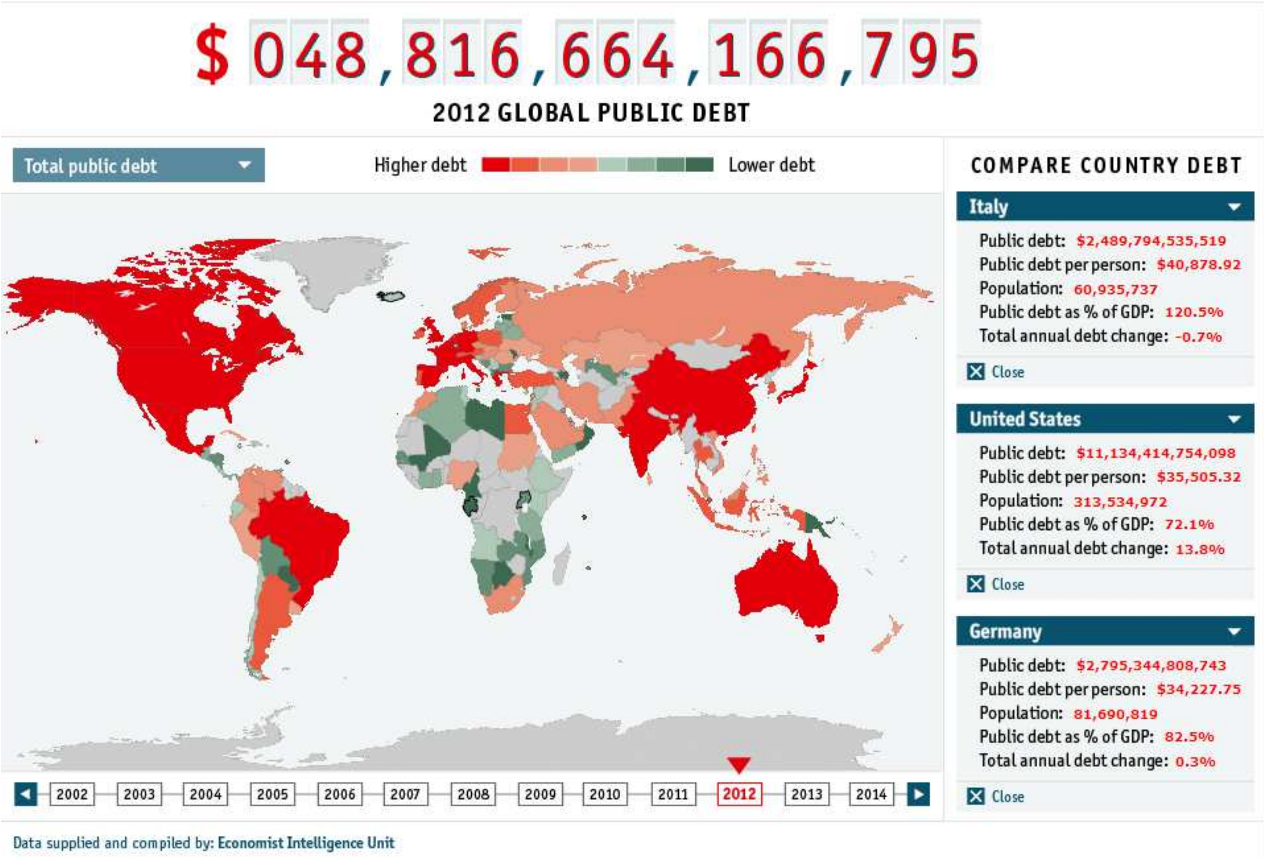


Figure 1: World Debt Map from the Economist website

The above "heat map" (never this term had a more perfect meaning like this time) is provided by the Economist website and shows the level of debt in 2012 divided by Countries, and for each Countries the level of debt (the heat).

It is no surprise that the Western world is the patient here with more or less developed countries being just behind them. Africa for once, is the best in class with almost no debt.

The reason why I am preparing this study is to try to analyze the situation and come up with some possible forecasts for the future of equities and government bonds from now on.

Next to the map there are pieces of data concerning three countries: Italy, United States and Germany.

Unfortunately those data, to me, are not correct (or at least it will be beneficial to know how they are computed) since they seems to imply few things:

- **Public debt**: this number is a well kept secret. Nobody really knows what is the debt level for the US or Germany. The former has unfunded liabilities which are not taken into account for sure (someone say its debt is in the 100 tril. USD range) and the latter's one display only the debt at central government level, not taking into account the regional level (Laender) which if summed up, it reaches Italy's level. The same can be said for Italy, but in order to have it looking worse, I would guess accountants and journalists added already everything now and for the future (I am not pro-Italy here).

- **Debt per person**: even though it is a correct result of the division between debt and population, this data implies that each citizen is able to pay the debt. It doesn't take into account the level of unemployment, which if it would be accounted, it would make the debt per person much higher due to a less (working) population and the increased level of debt. And even if it takes into account the unemployment level, it is still a non complete information as for instance, unemployment rate in the US in the media is always trumpeted without mentioning the partecipation rate, which is the percentage of active people who are looking for jobs on the total population. The current partecipation rate is t 63%, at 1970s level.

Lets' however take these figures as correct, this in fact it is not my main point here.

In the last few months we are witnessing a widespread timid increase in interest rates. Why is this happening? One reason is that since the US economy but in general overall western economies are giving timid signs of recovery, money is shifting from safer assets into riskier assets, namely stocks. Another reason is that because of signs of recovery, investors are predicting an increase of GDP which means higher spending for individuals in consumer discretionary goods or simply a higher turnaround of goods. That has the effect of an increase in revenues for companies, and that is the bottom line for switching from bonds to equities.

But is it really so? Even data on consumptions are difficult to be interpreted making it almost impossible to really understand the current situation.

However what could bring more clarity on the situation is the Consumer Confidence where its reading is at very low level compared to previous recoveries.

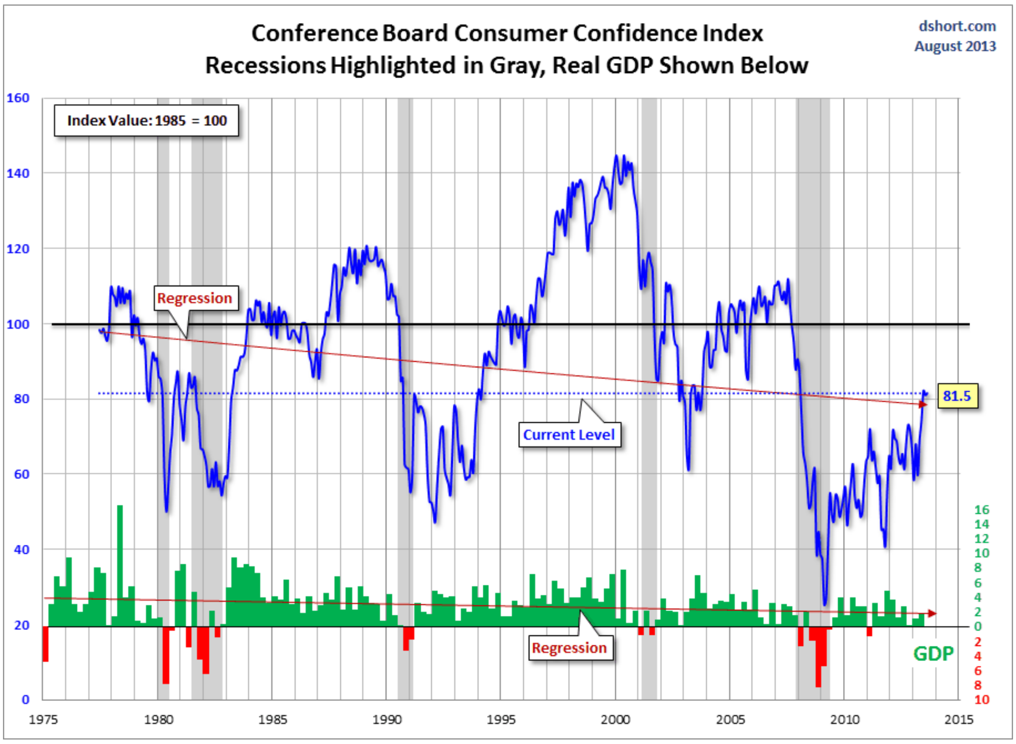


Figure 2: Consumer confidence from 1975 to 2013

2000 – 2013: Investing in the era of caos

Looking simply at a buy and hold strategy for the last 13 years the highest returns would have been the bond investment, while the equity investment would be still negative (only the US and Germany in the western world would have a with a fractional positive return). Average return of a bond investment is around 3-4%.

This chart can give an idea of what I am referring to:

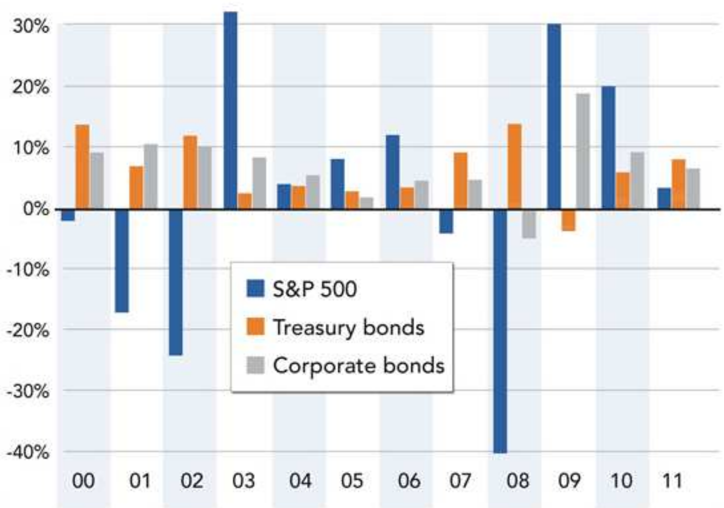


Figure 3: Tables fo returns for three different asset classes 2000-2011

For a number of reasons, the evidence is that interest rates are rising despite the effort of any Central Bank to stop it and keep interest rates at historical low for a prolonged historical period of time.

The Quantitative Easing in the US, Switzerland, Japan and the United Kingdom which were in part responsible for this low interest rate environment had also another consequences, driving the stock markets at a historical high.

Do you realize how many times the word historical is used above in the space of only 4 lines?

These are not emphasis added, these are facts. At some point markets will leave this stretched situation of multi historical levels, it cannot last forever.

QEs and rates cuts forced investors to put their money in the only space left with positive nominal and real yield, the stock market. That is true for the average Joe as for the Chief Investment Officers of pension funds alike who are managing pensions money within their mandate, probably overweighting (correctly) equities and underweighting bonds.

Let's look at smart money then, big institutions like Pension Funds of Sovreign Wealth Funds.

With US Treasuries arriving at a 3% yield what will they do their allocation? They will probably start moving part of their equity (riskier) allocation back to where it should have been in normal condition namely in the bond space causing a redemptions from US equity funds to bond funds.

Not surprisngly in the last 3 weeks US equity funds had a massive outflows of 22 billion dollars (source: Market Movers on Bloomberg TV).

The same is happening and will happen in Europe, but in a slightly different fashion.

Currently the 10yr German Treasury, the "Bund" has a yield of 1.99%, with the Italian counterpart BTP at 4.55% (see table at the of the report with a complete list of yields).

If the rise in interest rate will materialize in Europe too, what will happen?

Well the yield chasing made investors in the recent past buy every sort of lower grade bond, from Italy to Spain, Portgual alike. This year is also a historical year for junk bonds emissions, no wonder.

But when the Bund will go back to a quasi average yield of 3%, what should be the yield level of peripheral Europe to lure investors to stay with them? Even if the spread between the German Bund and the Italian BTP stays at current level (255 bpts) it would mean a higher interest expense at 5.55% which is too close to the 6-7% level that is the default area.

If that scenario will unfold, it will become a potential self fulfilling prophecy of higher interest rates in peripheral Europe, and still a considerable low interest rate enviroment for the Northern Europe countries, but why is that?

For the same reason of the US instituational investors effect moving from equity to bonds.

Institutional investors in Europe too (or generally institutional investors who invest in Europe) will move their allocation from overweighting peripheral Europe to underweighting it, and increase allocation to safer assets at a decent return, namely German Bunds.

Today the higher cost of funding for Italy in comparison to Germany is around 20 billion Euros (source:http://www.ilsole24ore.com/art/finanza-e-mercati/2013-09-10/vero-spread-miliardi-anno-081314.shtml?uuid=Ab0Ue7UI) per year, which can only go up if interest rates will move upwards.

Let's assume that the interest rate rising enviroment is correctly forecasted because a true recovery is materializing, which is not by the way. Governments will see their cost of funding increase but at the same time their receipts from taxes will also increase. It will be to be seen the net effect and hope that the taxes are higher then the increased cost of funding.

But what if something goes wrong, and tax receipts do not increase? In Italy they know exactly what will happen, a spiral effect where at the same time lower tax receipts come with higher cost of funding, jeopardizing every effort that the government and the citizens have made so far.

Italy is not alone with this problem, in fact all Western Countries face the same fate if interest rates start to go up, United States, Japan, France, Spain, Portugal all these countries will have to refinance their debt at a higher price and in order to be left alone (from IMF intervention for example, they will have to continue with the austerity measures or increase taxes: what they will not be able to afford is reducing taxes at the very best).

That is why personally I am very skeptical on greeting the arrival of a new rates rising environment, it will have mixed effect, and we do not know how good or bad the net effect will be.

This historical (!) moment is one of the most complicated time for forecasting markets and their directions because too many variables are there, not even considering external potential factors or geopoitical events.

I often like to quote Donald Rumsfield, a former Secretary of Defense in the Geroge W. Bush administation when he said:

"There are known knowns; there are things we know that we know.
There are known unknowns; that is to say, there are things that we now know we don't know.
But there are also unknown unknowns – there are things we do not know we don't know."
Source: http://en.wikipedia.org/wiki/There_are_known_knowns

Which for our purpose can be read this way:

"There are known knowns; there are things we know that we know.
Economic and financial theories.

There are known unknowns; that is to say, there are things that we now know we don't know.
Directions of equity and bond markets in the near future.

But there are also unknown unknowns – there are things we do not know we don't know."
Events that will interfere with theories and forecasts that could not possibly be foreseen.

10-Year Government Bond Yields

AMERICAS		Yield	1 Day	1 Month	1 Year	Time
United States	**More US Treasuries**	2.95%	+4	+36	+128	09:05:15
Canada		2.81%	+7	+33	+99	07:29:41
Mexico (USD)		3.91%	0	+8	+129	09:01:38
Brazil (USD)		4.63%	+2	+30	+200	09:00:01

Change shown in basis points

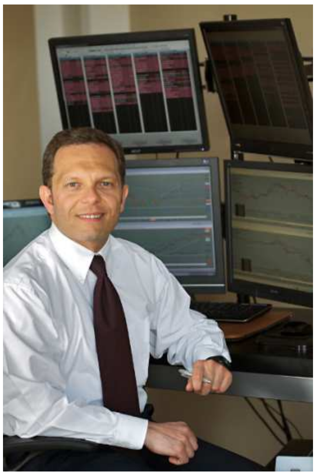
EUROPE		Yield	1 Day	1 Month	1 Year	Time
Germany		1.99%	+3	+31	+44	02:30:03
Britain	**More UK Gilts**	3.02%	+7	+56	+129	09:02:50
France		2.59%	+3	+36	+35	02:32:59
Italy		4.55%	+3	+37	-63	02:30:25
Spain		4.55%	+2	+7	-114	02:30:06
Netherlands		2.41%	+2	+35	+52	02:31:30
Portugal		6.90%	+1	+43	-135	02:30:19
Greece		10.23%	0	+74	-1136	02:30:23
Switzerland		1.13%	+4	+17	+55	02:31:15

Change shown in basis points

ASIA		Yield	1 Day	1 Month	1 Year	Time
Japan	**More Japanese Bonds**	0.72%	-2	-2	-7	01:32:59
Australia	**More Australian Bonds**	4.10%	+3	+39	+98	09/09/2013
New Zealand		4.69%	+1	+39	+112	00:01:38
Hong Kong		2.41%	-2	+23	+182	05:07:48
Singapore		2.66%	0	+34	+133	00:38:39
South Korea		3.55%	-3	-2	+51	00:05:33
India		8.52%	0	+34	+31	06:25:19

Change shown in basis points

Figure 4: Tables of real time worldwide yields as of Sept.10, 2013. Source: Bloomberg



Mr. Maggioni has been working in the financial markets for the last 11 years covering different roles and working in tier 1 consulting companies and banks worldwide.

In recent years his studies have been focused on the psycho-emotional aspects of trading and how those aspects have an impact on traders' behavior.
Before starting this venture, he was head of a hedge fund desk at HSBC Private Bank in Monaco and before that he was employed at Credit Suisse Asset Management (CSAM) in Zurich covering the in-house single manager hedge funds.

Most of his experience in hedge funds was gained while working in a Swiss family office where he was in charge of the research and analysis as well as due diligence for US and European hedge funds. He also performed quantitative analysis and portfolio construction for several funds advised by the family office.

Prior to that he worked as an external consultant for KPMG Financial Services in the Milan office. In 2002 he has been hired by Ernst & Young LLP, San Francisco as auditor for hedge funds, auditing large single funds and fund of funds. In 2000 he joined Ernst & Young in Milan as an auditor for mid-sized companies.

Mr. Maggioni holds an MBA from IUM and a Portfolio Management degree from the University of Chicago GSB.

Useful Links:

European Central Bank:	www.ecb.int
Bank for International Settlements:	www.bis.org
International Monetary Fund:	www.imf.org
Federal Reserve:	www.federalreserve.gov
US CFTC	www.cftc.gov