the technical analyst AWARDS 2011 FINALIST

20th April 2011

Market Update:

The vulnerability of bonds

UPDATE
Technical
Fundamental

SEVEN DAYS AHEAD

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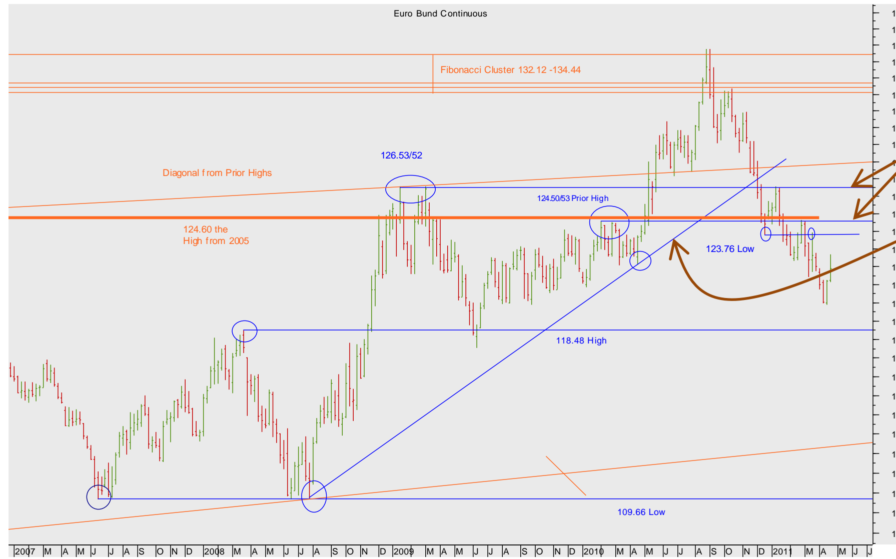

WEEKLY BUND CHART

The market's fall through the Prior High supports from 124.60 and 126.53,

and through the rising diagonal support from 2008, taken together

are very grave for the market long and medium-term.

WEEKLY US TNOTE CHART

The first critical breakdown of the market was the pull-back through the support from the Prior Highs 121-21.5 /14.5.

The market has consolidated beneath that band now. The cause of hesitation is surely the rising diagonal support from 2007.

A break of the successive lows around 118 will be grave for the market.

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WEEKLY YEN BOND CHART

The price action breaking down through the support from the Prior Highs and the rising diagonal from 2008 is a compelling bear breakdown.

The rallies from the 138.16 low have not been sustained.

A break of that level would leave the market very vulnerable.

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FUNDAMENTALS:

The trend in Bonds, both in Europe and the US had until recently been quite unmistakably bearish. A plan to reduce the US budget deficit over the longer term still proves illusive and in the Euro zone the Sovereign debt crisis continues to drag on.

However, over recent days government bond markets including the Euro Bund and US Treasuries, found a new lease of life as yet another wave of risk aversion swept through markets, driving equities lower.

The main reasons for this most recent flight from risk were:

1. Growing fears about global inflation,
2. Anxiety about government debt levels in the developed economies, and
3. The nuclear crisis in Japan which drags on, with officials there estimating it could take 9 months to bring the crisis to a conclusion.

Clearly for government Bond markets, inflation is a major negative, but are inflationary fears over done?

In the US the Fed recently noted an upward creep in inflation, but the view of Fed policy makers is inflation remains largely well contained. In the Euro zone CPI is above target. The latest level is 2.7% which is higher than the ECB's 2.0% target, but the ECB has already started to raise interest rates and judging from recent rhetoric they are set to rise further, at least to a level consistent with neutrality.

So why are traders so spooked by inflation?

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FUNDAMENTALS: CONTINUED

In China, the worlds fastest growing economy and now 2nd largest in the world, inflation is a problem and the Central Bank has recently raised rates for a 4th time to try and tame it.

Why is Chinese inflation so important at a global level? The answer is China is now the “work shop” of the world, almost everything the western developed economies consume is made in China, so rising prices there have a direct impact on inflation in other countries.

The driving force of inflation in China and globally is currently rising energy, commodity and food prices, but oil price inflation stands out as the most significant of these.

So where does the disaster in Japan fit in?

Clearly Japan is a major producer and exporter of high tech components used by other global companies in their own manufacturing processes. The earthquake/nuclear crisis in Japan has severely interrupted these supplies causing shortages. But of greater significance is the impact on global energy policy the nuclear crisis has had.

Around the World governments are seriously rethinking their energy policies and questioning whether nuclear energy is safe enough to continue with. If the conclusion is it isn’t, the only alternative is Oil/Gas.

Demand for oil is already elevated due to demand from China, India and other large emerging economies, if nuclear energy generation is replaced by Oil/Gas the price of oil will hit new all time highs sending inflation through the roof and potentially crippling the developed economies.

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FUNDAMENTALS: CONTINUED

This is important because the Euro zone and US are already trying to come to terms withexcessive government debt. Slower growth caused by rising energy inflation would make it harder to not only service that debt, but to implement a credible debt reduction plan that didn't further cripple growth.

So when the rating agency S&P announced this week they had placed US Sovereign debt on negative watch, Greece moved closer to restructuring its debts despite receiving a EU/EZ/IMF bailout and Finland openly questioned whether they would be able to support any future bailouts, the future doesn't look to bright for bond markets on either side of the Atlantic.

Moreover the latest wave of risk aversion seems to have passed; stocks are recovering and Bonds are weakening. Traders will refocus onto the issues outlined that negatively impact Bonds over the longer term and, in our opinion, send them lower.

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Authorised and Regulated by the FSA
124 REGENTS PARK ROAD LONDON NW18XL
TEL +44 (0) 7849 922573 E-MAIL msturdy@sevendaysahead.com, pallwright@sevendaysahead.com
WEB SITE SEVENDAYSAHEAD.COM

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