



20th February 2014

the technical analyst

AWARDS 2011

F I N A L I S T

Market Update:

Are UK bonds are looking vulnerable? Charting v the Fundamentals....

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Are UK bonds are looking vulnerable? Charting v the Fundamentals....



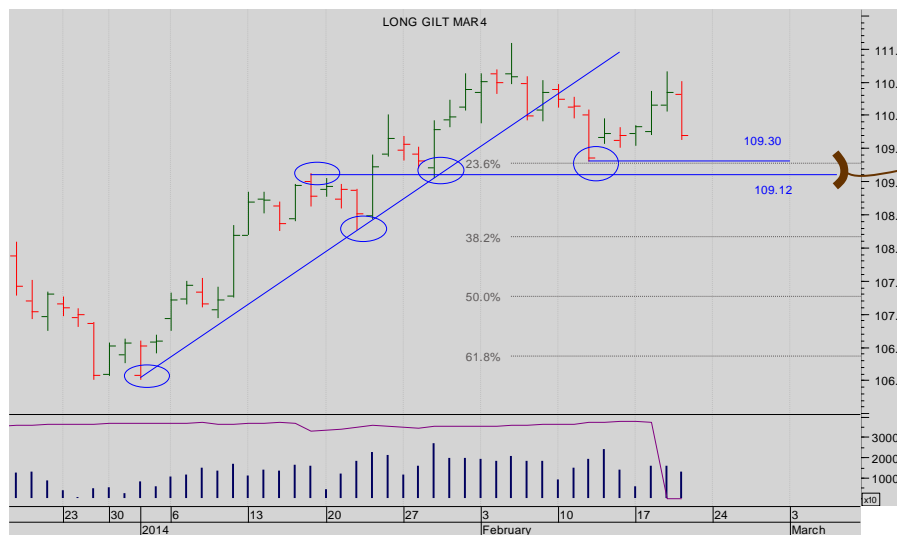
Monthly chart

The long-term chart remains very bearish:

Note well the large H&S Reversal that suggests a move down to 97 or so.

Note too that the completion of the H&S pattern coincided with the break of a long-term trendline support that adds credence to the pressure on the market.

Now look closer.



Daily Gilt chart

The short-term price action is not yet compelling for the bears.

But note the importance of the band 109.12/30 formed from the Prior High support and the recent low pivot.

Note too that there is a Fibonacci support within that band.

Were those supports – quite close – to be broken **the bears would be tempted to sell in line with the long-term charts.**

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FUNDAMENTALS:

The UK economy's recovery throughout last year surprised almost everyone from the IMF to the Bank of England. Early last year the IMF warned the UK Chancellor that he should consider plan B or risk disaster, but he stuck to his plan and the economy roared back.

Now only today (20th Feb) Martin Weil of the Bank of England Monetary Policy Committee was dropping heavy hints that borrowers should prepare them selves for a first rate hike early in 2015, but apart from a small correction today, the Gilt remains close to all time highs.

Usually when the economic cycle is perceived to have turned and the monetary policy cycle is expected to follow suit, Bonds are usually a sell. But at the moment the rules appear to have changed; why?

Looking at the fundamentals we can see clues as to why. The recovery has certainly moved up through the gears, but inflation is falling and this month came in below target for the first time in years. This helps the Bank delay a rate hike. But why would inflation fall when economic activity has strengthened?

The answer is two fold:

- When the financial crisis/recession first hit, Sterling sold off heavily against the other major currencies because UK debt to GDP levels and the budget deficit were too high and unsustainable in the medium long/term. Fearing a crisis similar to that of Greece, Ireland, Portugal, Italy and Spain and too a degree France, investors sold Sterling because they thought the UK government would be unable to sustain, let alone implement, an austerity policy.
- At the same time world commodity prices were rallying hard.



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FUNDAMENTALS: CONTINUED

So these two together ratcheted up UK inflation.

But now that commodity prices have stabilised and even eased lower, and the Pound has begun to strengthen as the economy strengthens, inflationary pressures have eased to the extent that CPI has fallen from a peak of around 5% to the current level of 1.9%.

This is bullish for bonds, so the strength of recovery is to an extent offset by the decline in inflation.

But add in the continuing austerity drive under the current Government which seeks to reduce the debt to GDP ratio further and return the budget to surplus by around 2018 and this too is another bullish influence for the gilt.

However, today's announcement that interest rates could begin to rise early next year has the Gilt bears twitching to sell, but how can they? **There currently is no clear cut fundamental case for a bear market in government bonds.**

Elsewhere, the Bund remains supported by slow growth, weak inflation and an ECB that has not yet ruled out further rate cuts. And in the US the Fed may be tapering its QE3 policy, but that is a reduction of new stimulus, not a withdrawal of existing stimulus and interest rates in the US probably still won't rise until 2016.

So the fundamentalist argument in favour of a bear market in bonds especially the gilt is not sound - yet.

Not until the Bank sees the recovery so solid that policy can be returned to at least neutral with inflation forecast to rise above target once more, is the gilt likely to prove a strong sell.

But neither are we keen to buy. In the current economic climate the gilt is supported, but it is equities where the hot action is expected.



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