
THE GLOBAL SHUFFLE

With global economies becoming increasingly intertwined, shifts in long-term interest rates are changing the way investors are viewing money flows around the world.

After a period in which the United States and China served as the world's economic engines, the global economy is regaining its balance. Wayne G. Bowers, director of global fixed income for Northern Trust in London, says that all the major developed regions are participating in the recovery. "We now have Asia, including Japan, growing very nicely, and Europe is coming out of several years of sub 1% growth to grow at 1.5% to 2% for 2006 and 2007. We have less of a reliance on the U.S. and China — it's a healthier global growth scenario."

Prior to this recovery, interest rates had been held low across the major markets in response to the lower growth, inflation and confidence levels prevalent in the early 2000s. The 10-year rate for U.S. Treasuries and for euro government bonds was under 4% in mid-2003. The rate for 10-year Japanese government bonds was less than 1% at the same time.

The recent firming of economic conditions has resulted in central banks raising interest rates. As of May 2006, the yield on 10-year Treasuries was above 5% and approaching 2% on Japanese government bonds.

"Central banks are in the process of removing their accommodative monetary policies and normalizing interest rates," Bowers says.

Flatter Curves Around the Globe

Global rates did not increase lockstep across the maturities, however, as yield curves flattened in numerous markets. Although the U.S. market has received much of the attention, as noted in former U.S. Federal Reserve Chairman Alan Greenspan's comments on the long-term bond "conundrum," flat yield curves were observed in Australia and the U.K. six to nine months before the U.S. experience. In both cases, those countries' central banks made pre-emptive rate increases to correct perceived imbalances, such as rapidly rising home prices in their economies.



Other central bankers have more positive reactions to the flattening curves. Jean-Claude Trichet, president of the European Central Bank, has said he believes that the low level of long-term rates in Europe is an expression of confidence by international investors in Europe's economy and the European Central Bank's ability to control inflation going forward.

Consequently, says Bowers, in terms of setting monetary policy and the curve's expected slope, one could say that the European Central Bank is supportive of maintaining the low level of long-term rates.

Growth Scenarios

Bowers notes that while rates are rising globally, each market's circumstances influence the pace and quantity of forecasted increases. In Japan, the policy of quantitative monetary easing ended earlier this year. Japan's economy grew by 2.7% in 2005

and the outlook is for greater growth this year. The economy is showing the first signs of inflation, and the Bank of Japan aims to reduce the savings rate and encourage consumers to spend. If the bank succeeds, it will allow a domestically driven recovery to build on the previous export-driven recovery.

The Bank of Japan must be careful not to derail confidence in growth, however, Bowers says. “The last thing the Bank of Japan needs to do is start raising rates aggressively and encourage saving instead of spending. As a result, we expect rate increases of 5 to 10 basis points each through the third quarter of this year so the bank can determine how the increases affect consumers.”

The growth outlook for the European Union is also positive with strong economic data and positive sentiment. Bowers cautions that the forward-looking nature of sentiment data doesn't guarantee subsequent solid economic data, but he is optimistic about a better growth profile going forward. The European Central Bank has done a good job in terms of removing accommodative rates, Bowers says, and he expects the bank to increase rates in the next three to six months to the 3.25% level.



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—Wayne Bowers, director of global fixed income for Northern Trust in London

The Bank of England raised rates reasonably swiftly over a period of 18 months to a year ago. As a result, the housing market and overall growth have cooled, and the consensus forecast is for 2.5% economic growth in 2006 with low inflation.

The next move could be a fine adjustment up or down, Bowers says, as the risks are reasonably weighted to both sides. “In terms of our U.K. rate expectations, we're happy to own two- to three-year instruments. We don't think the central bank will be raising rates more quickly or significantly more than is currently priced into the market.”

Several unforeseen scenarios could influence these forecasts. In particular, avian flu could have a significant impact in terms of growth and confidence for many months because it could run through several cycles, not just one event.

The prospect of higher oil prices, however, is not a huge concern for Bowers. He notes that the experience of the last few years indicates that additional price increases shouldn't derail economic growth, which is forecast at a worldwide rate of 4.1% for 2006.

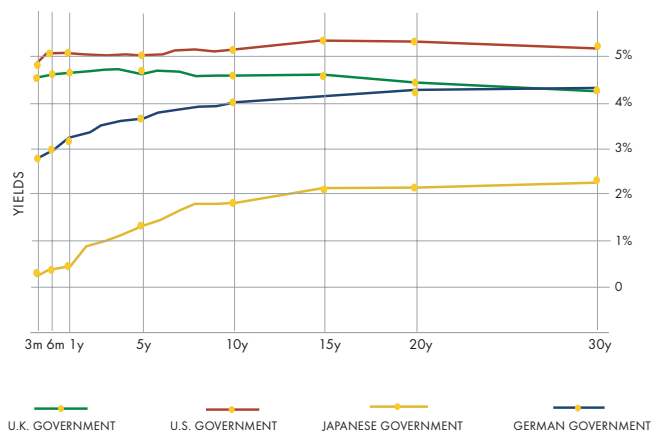
Distorted Global Flows?

Recent media reports have voiced some analysts' concerns that rising rates in Japan and other countries could lead foreign investors to sell long-term U.S. Treasuries and reinvest in their domestic markets. Although Bowers agrees that a market could experience short-term dislocations and significant yield moves because of capital flows, he believes the market would subsequently stabilize.

“Who buys and who owns an instrument is secondary in terms of the price and yield,” he says. “Not all global investors act in unison. For every Japanese life insurer selling U.S. Treasuries, you may find a European pension fund looking to buy. The major move of any yield curve is determined by economic fundamentals and monetary and fiscal policies. Prices will reach a point where they will become attractive again to either domestic investors or to overseas investors.” ❖

Global Yield Curves Have Flattened

The long bond conundrum: Despite interest rate hikes, bond yields have stayed flat in major markets. Investors shied away from locking into low rates as markets around the globe saw sluggish growth and economic uncertainty.



Note: Yields are as of May 31, 2006.
Source: Bloomberg