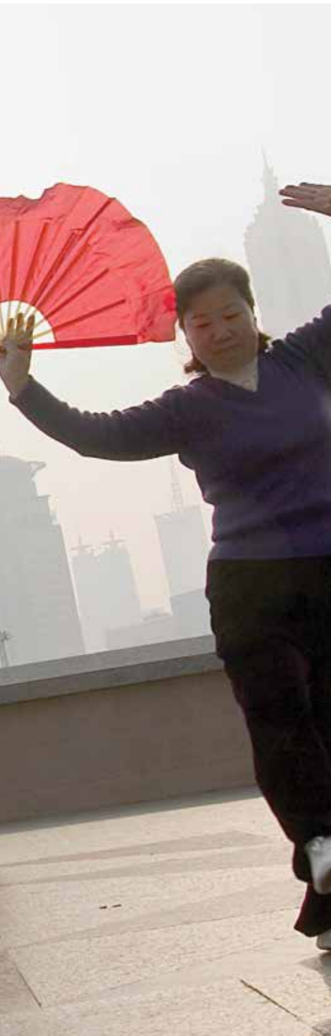

GLOBAL MARKET OUTLOOK 2014

AMID POLITICAL AND POLICY UNCERTAINTY LIES POTENTIAL OPPORTUNITY

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BNY MELLON

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MARKET OVERVIEW: DEVELOPED WORLD TO LEAD 2014 GLOBAL GROWTH

BNY Mellon chief economist Richard Hoey expects the lead engine for global growth in 2014 to be developed economies supported by aggressively easy monetary policy and continued post-financial crisis recovery. Hoey sees global GDP growth in 2014 accelerating by 0.5%-0.75% from the average pace near 3% in 2012 and 2013. The four main causes of that faster growth, he says, should be:

1. Past and ongoing monetary ease
2. Reduced fiscal drag
3. Moderation in the post-crisis deleveraging of the private sector
4. Moderate energy prices, given the expansion of new sources of energy supply, especially in the US.

CONTINUED RECOVERY

In the US he sees a 'three for three' pattern of roughly 3% real GDP growth for the next three years, as the US completes the second half of what he predicts will be a seven-year economic expansion. Hoey says monetary policy under new Federal Reserve chairman Janet Yellen will be "very supportive" of that expansion, as inflation remains below the Fed's target and the labour market is far from full employment. "Because the initial years of expansion were so slow," he says, "inflationary pressures have not built up." In his view, the implications of 'Yellenomics' is that US monetary policy could remain stimulative until after the next US presidential election in 2016, with meaningful tightening postponed until 2017 or 2018. He assesses that future budget battles will end in a low level status quo stalemate rather than repeating the recent pattern of disruptive major clashes over budget policy.

For the rest of the developed world, Hoey sees growth improvements in 2014. Stagnation in the UK, he says, has given way to a sustainable expansion. In mid-November, the Bank of England (BoE) under its new head, Mark Carney, indicated unemployment in the UK might be improving more quickly than expected and said there was a 50/50 chance that the jobless rate could fall to 7% by the end of 2014, sooner than its original projection of the summer of 2016.[1] Under its forward guidance policy, the BoE has cited 7% unemployment as the threshold for considering raising interest rates.

1 Chris Giles and Claire Jones, "Bank of England Accelerates Job Forecast" Financial Times, November 13, 2013.

While Hoey believes the eurozone will remain intact, he says the consequences of a continued 'one-size-fits none' monetary policy for disparate countries will contribute to a sluggish pace of expansion. He expects the eurozone to grow by only 1% to 1.5% in 2014 even after the ECB's surprise rate cut in November 2013. As for Japan, he expects moderate expansion under the triple-pronged policies of Abenomics to persist after a volatile pattern of pre-buying, then payback, due to the hike in the value-added tax scheduled for April 2014.

The picture for emerging countries in 2014, he says, is more challenging and differentiated, both by initial conditions (current account, interest rates, credit growth) and by questions about the credibility of some countries' economic policies over the medium term. Countries with large current account deficits, he says, will remain sensitive to swings in financial market sentiment. However, he believes Fed tapering of asset purchases in 2014 will be less disruptive for emerging markets than the talk of tapering in 2013, since the gap between the current QE-suppressed Treasury yields and free-market levels has already been reduced.

GOOD NEWS FOR MARKETS

On the whole, this macroeconomic backdrop is good news for the world's capital markets in general and risk assets in particular, says BNY Mellon chief global markets strategist Jack Malvey. While acknowledging that positive GDP growth does not necessarily correlate with strong market outperformance, he says there are a number of factors that will be supportive of global equity markets in 2014.

He believes the US equity market will continue to rise during 2014, as company earnings continue to advance, but at a slower pace than in 2013. "Some companies will be more sluggish than others," he says, "but overall the uplift will be constructive." In addition to earnings, he points out that dividend increases are running at a record rate and M&A activity continues to pick up. Equity buybacks also remain strong. Moreover, 2014 will continue to be challenging for fixed income as QE tapering could effectively lead to modest rate rises. All of those elements, he says, will likely drive investors toward equities.

"We've gone from a risk on/risk off environment to simply a static position of risk on." Citing the enormous gains in tech stocks in 2013, Malvey says it's understandable a debate has begun about whether we're seeing a return of the tech bubble of the 1990s, but he believes the run-up in tech stocks will persist for another few years. "You might get to bubble status, but I don't think we're there yet. I think we're seeing a shift in sentiment from old economy to new economy sectors. You see that reflected in the excitement over big data and social media and the new ways people are doing business."

Malvey expects the so-called 'Great Rotation' out of bonds into equities will continue this year. While institutional investors are several years into that switch, retail investors and European investors still have a way to go, he says. In Malvey's view, European investors have not been as bullish as US investors because of the scars they still carry from the financial crisis and the longer downturn they have had to endure. But Malvey believes that over the mid-teens, more European investors will return to equities.

RETURN OF ENTHUSIASM FOR EM

An important market theme for Malvey in 2014 will be a return of enthusiasm for emerging markets in both equities and bonds, after challenging performance in 2013. "The decoupling of emerging markets debt from high yield in 2013 was notable, as we hadn't seen that for a while. In 2014, I would submit that EM debt might rival or even surpass high-yield corporates. However, he points out the importance of analysing EM opportunities on a case-by-case basis.

"Global credit markets in both high yield and investment grade continue to enjoy a tremendous run," Malvey says. "We've seen record origination as treasurers correctly perceive that this is a good time to finance [their businesses] with low spreads and low rates, extinguishing some of the prefundings required over the middle part of the decade."

Malvey shares Hoey's view that potential QE tapering in 2014 will not be disruptive to the markets over the medium to long term, though he says there could be a "roller-coaster bump" that will cause valuation adjustments in the markets for approximately a week to a month. "In the big picture, the fact the Fed will be buying fewer debt securities on a monthly basis is almost irrelevant given the scale of the entire market. If the world capital market choice-set is at least US$383

trillion, it's statistically insignificant if in one month in 2014 the Fed buys US$10, $20 or even $40 billion less in securities." Even if tapering causes rates to rise somewhat, say 10-year Treasuries go from 2.70% to 2.95%, "those are still very low rates."

China remains a question, Malvey says. While he agrees with other observers that the pace of Chinese GDP growth will slow from over 7% to somewhere in the high to mid-6% range over the course of the next four to five years, there are still many unknowns around how the world's second largest economy will manage its shift to a new model of growth.

POTENTIAL RISKS

As for other potential sources of downside risk during 2014, Malvey sees them as possibilities rather than probabilities. "There is the gravitational pull of mean reversion and the extent to which the market feels heavy after such a big advance in risk assets over the past few years." Unexpected geopolitical events are always a possibility, he says, "but the current period feels relatively dormant compared with previous periods over the last 10 or 15 years." He says the 100th anniversary of the outbreak of World War I in August, however, will provide a potent reminder of the unpredictable events that can completely change the course of human history. High-frequency-trading technical glitches, he reminds us, remains another lurking source of potential market instability.

Beyond the short-term market influences in 2014, Malvey believes there are important secular shifts underway, whose contours are not completely known to us but whose influences are already being felt. These include everything from how new market regulations will ultimately be implemented to the global economic convergence of advanced and emerging economies; the normalisation of monetary policy around the world; a new major wave of technological changes in areas such as life sciences and big data; demographic shifts and intergenerational negotiations over entitlements and the funding of longer retirements; as well as the emergence of new investment opportunities and instruments as the financial landscape is re-sculpted.

"This is truly the best time in history," Malvey says. "Risks remain, but so far global capital markets have responded quite favorably to the unfurling of the 21st century global financial system banner."

BNY Mellon Investment Management's unique asset management model encompasses the investment skills of world class specialist asset managers, many of which are amongst the most advanced and highly regarded names in money management.

EQUITIES

ALL SHALE US ENERGY EVOLUTION

Robin Wehbé
Portfolio manager and head of the natural resources research team at The Boston Company

The Boston Company Asset Management, LLC (The Boston Company), is a global investment management firm providing a broad range of active, fundamental research driven equity strategies, including both traditional long-only portfolios and alternative investments.

THE BOSTON COMPANY
ASSET MANAGEMENT, LLC

The US 'shale revolution' has re-started talk of the US achieving energy self-sufficiency. While this may be a pipe-dream, Robin Wehbé, portfolio manager and head of the natural resources research team at TBCAM, explains how investors are likely to see further evolution in the oil and gas industry in 2014.

In the late 1970s, US President Jimmy Carter set the country's sights on energy self-sufficiency. In 2014, 33 years after Carter left office, the US has yet to reach this aspiration. Despite this, the 'shale revolution' looks to be the dominant US investment theme over the next decade.

The unconventional extraction boom in the US oil and gas sector, a result of technological improvements, has transformed the global energy picture. The days of peak oil are over. Global oil and gas supply has turned a corner and the US stands to enjoy this energy advantage over the rest of the world. From benefiting the consumer to driving infrastructure and transport spend, the benefits are likely to be felt across corporate America in the years to come.

SPEND, SPEND, SPEND

This virtuous cycle goes beyond cheaper fuel in the cars of the US consumer; it manifests itself in the form of huge direct investment within the oil and gas sector. America is trying to spend its way to global energy dominance and, in turn, self-sufficiency. Capital expenditures for oil and gas projects in the US are likely to come close to US$350bn in 2013, more than three times than spent in 2000. The US now makes up half of global upstream (operations stages that involve exploration and production) capital spend; world spend is predicted to have totalled US$700bn for 2013 (see chart).[1]

US infrastructure spend is being centred on three main areas: oil and natural gas in Texas and North Dakota and natural gas in the Mid-Atlantic area. Texas has already benefited from pre-existing oil infrastructure while the boom in unconventional natural gas extraction has opened up new areas such as North Dakota and the mid-Atlantic. These new methods are more complicated and expensive as they involve tapping non-traditional sources, such as shale rock, through horizontal drilling and hydraulic fracturing (fracking). Completely new manufacturing hubs are being created.

As far as transport spend is concerned, rail is the big winner so far. Once a victim of falling coal demand, the US rail system is being invigorated by the energy bounce. Oil and gas companies are taking control of train cars and sub-leasing to others. With pipelines

1 Barclays, October 2013.

a permanent, inflexible and expensive alternative, rail is no longer seen as the temporary solution. We are seeing the second coming of the US railways. According to the Association of American Railroads, trains transported a record 97,135 carloads of crude oil in the first quarter of 2013. That's 166% more than during the first quarter of 2012 and 922% more than trains hauled in all of 2008. This trend is set to continue through 2014.

GREASING THE WHEELS

How does the US monetise its position as one of the world's oil and gas 'big boys' and build for the long-term future? America's lawmakers have a role to play in changing the US export and cabotage (coastal shipping) laws that still reflect the country's historic energy scarcity and present stumbling blocks to monetisation. The Export Administration Act of 1979 prohibits the sale of US crude oil abroad, with the exception of Canada and Mexico, while the Merchant Marine Act of 1920 requires all goods transported by water between US ports to be carried by US ships, constructed in the US, owned by US citizens and crewed by US citizens and permanent US residents. With US energy law and regulation rooted in the protectionist era of the 1970s; the seismic shift in supply needs to be recognised on Capitol Hill.

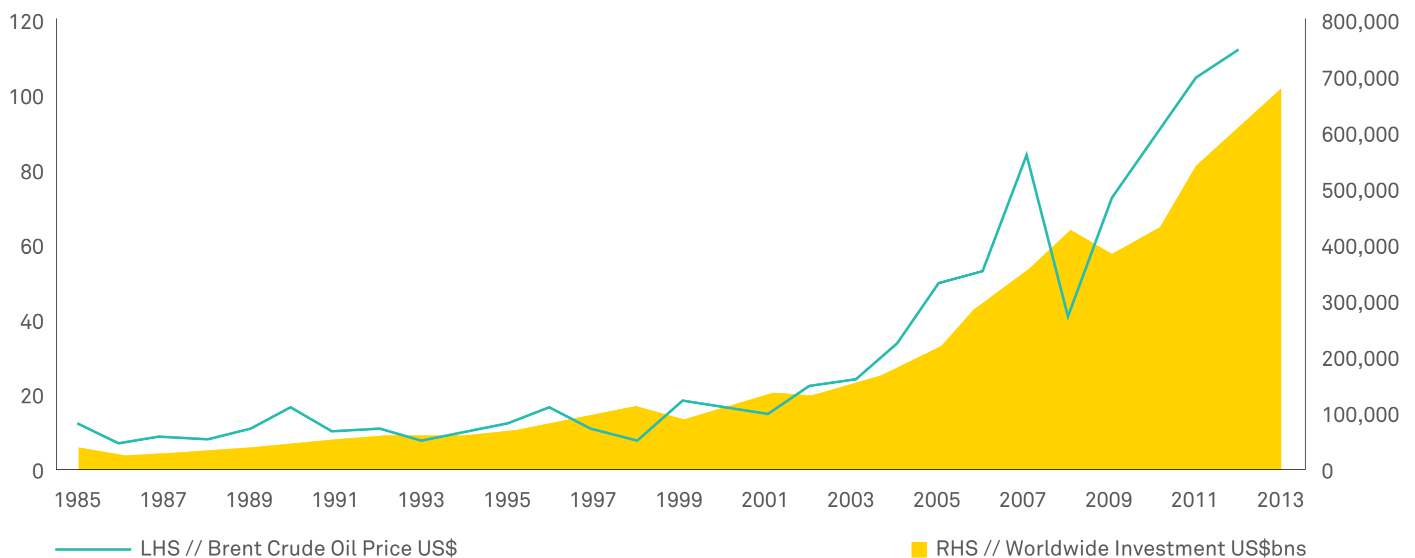
While the prospects for US shale gas, which is cheaper to extract than 'unconventional' crude, look positive, with Asian buyers willing to lock in for the long term at liquefied natural gas prices that far exceed the cost of extraction, the challenges in the 'unconventional' crude space are sizeable. The cost of 'unconventional' crude remains at the top of the cost curve; indeed, it can cost around US$90 to produce a US$100 barrel of oil. The US sector is achieving 10% efficiency gains on an annual basis but how much more efficiency can be achieved? This is no quick win.

MAKING PIPE-DREAMS REALITY

With its long history of conventional oil and gas production, the US is leading the 'unconventional revolution'. Benefiting from the existence of source rock in areas already producing conventional oil and gas, many of the exploration risks are reduced. However, at different points in this secular story, today's winners will be tomorrow's losers. This evolution will bring with it both opportunities and risks. Energy self-sufficiency it is not but the 'shale revolution' looks set to be a vital investment story not just in 2014 but over the coming decade.

> "Global oil and gas supply has turned a corner and the US stands to enjoy this energy advantage over the rest of the world"

Worldwide upstream capital spending (inflation adjusted)



Souce: Barclays, October 2013

ELECTIONS TAKE FRONT SEAT

Sophia Whitbread
Investment manager, Global and Emerging Markets at Newton

Caroline Keen
Investment manager, Asia-Pacific at Newton

Newton is renowned for its distinctive approach to global thematic investing. Based in London and with over 30 years' experience, Newton's thematic approach is applied consistently across all strategies.

NEWTON
The Power of Ideas

Emerging and Asian markets take centre stage in 2014 and not just because of the Winter Olympics and World Cup; a number of key elections are also likely to draw attention. BNY Mellon's Emerging Income and Asian Income Fund Managers, Sophia Whitbread and Caroline Keen, talk about what the year may hold.

What, outside of tapering announcements, will you watch closely in 2014?

Sophia Whitbread (SW): Elections. There are many key elections happening, most notably in Turkey, Brazil, India and South Africa. While shifts in power can largely be seen as a positive, it's important to remember reform in emerging markets can be a double-edged sword. There are also a number of events we will need to watch, like the Winter Olympics (February in Sochi, Russia) and World Cup (June, Brazil). Big events on the world stage can create a platform on which protesters or striking workers may try and garner attention.

Caroline Keen (CK): The situation in China will continue to be something we watch closely. Even though China proved fairly resilient in the second half of 2013, it remains a worry for us; its debt-to-GDP ratio of more than 200%[1] looms large. The government appears committed to the reform process, which will inevitably slow growth as areas of over-capacity are addressed. China's property market remains key. Much of the local government and corporate debt in the country is collateralised by property, so if property prices fall, debt-to-asset ratios rise significantly. Ultimately, we see the high level of leverage in China's system and the interconnectedness of its economy as a challenge for future growth.

Which election will you be watching with interest?

SW: Brazil (taking place in the second half of the year) stands out; the country has a sizeable civil service and the regulatory system is largely bureaucratic so a change of leadership could affect a number of sectors and the way Brazil does business. However, Brazil may not see any change at all. The incumbent Dilma Rousseff is expected to win but the race may be closer than previously expected after two opposition candidates joined forces in October 2013.

1 Source: CLSA October 2013.

CK: India has a spring 2014 election slated, although there is a question as to whether it will result in any meaningful change for economic growth in the near term. The current government has not been aggressive in passing or implementing necessary reforms to support growth. As a result, India is suffering from poor infrastructure, high inflation, slowing growth and a weak currency.

The push for change has become a familiar clamour across emerging markets; will this be a story affecting investments in 2014?

SW: Many regimes across the emerging markets perceived to be strong have been weakened by the internet allowing more of the popular voice to be heard. The long-term implication of this trend is that it should help encourage governments to behave more democratically. This ultimately may be good for investors but there is often an adjustment period before such change is embedded.

CK: Political unrest to varying degrees has always been a feature of Asian markets and one of the factors investors must consider. Thailand has had its fair share of political instability in recent history, notably the coup which ousted prime minister Thaksin in September 2006. However, since then the Thai stock market has outperformed world markets by several factors. We do feel the influence of politics on economic performance is growing in significance and could be a key risk, as governments worldwide experiment with unconventional policies.

Foreign investor flows have been a big reason for volatility in these markets, is that likely to continue?

SW: Yes, but on a country-by-country basis. Capital is a very fluid thing but some emerging markets have more shallow capital markets than others and as such flows in either direction can have a more marked effect. Economies with large current account deficits, such as Turkey and Indonesia, are more reliant on foreign investment flows than others.

What is the outlook for dividends for 2014?

SW: Dividend growth in emerging markets has come from earnings growth, not from stretching pay-out ratios. Like Asia, pay-out ratios across emerging markets have shown remarkable stability and proved commitment to dividends in the 2008-09 crisis period.

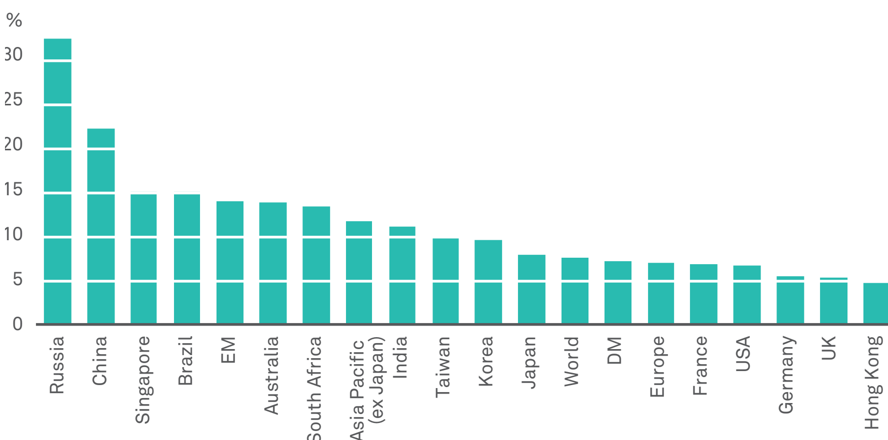
CK: We are confident in the stability of dividends in Asia Pacific, with many companies having maintained dividends even during the Asian and global financial crises. The average pay-out ratio for Asia Pacific ex Japan has been around 40% or above for more than a decade.[2]

Which economies are you most positive on for the year ahead?

SW: Mexico is one to keep an eye on. Mexican private debt as a percentage of GDP is around 20%; the country is in rude financial health and there are no state banks so state intervention in the financial sector is limited. In addition the country benefits from positive demographic trends and widespread reforms involving labour, tax, energy and education sectors. All of this serves to cast the Central American giant in a very favourable light.

CK: Australia continues to be one of our favoured countries and not just because of the high dividends available there. Yes, mining capex is slowing but Australia is more than just commodities and financials. It has a number of world-leading companies across a range of sectors, such as healthcare. We expect growth in the economy will remain reasonable; the level of unemployment is relatively benign; house prices have already risen around 9% since they bottomed-out in May 2012 which should spur confidence and encourage further construction, taking up some of the slack from slower mining investment.

MSCI regions and markets – dividend CAGR since 2000



Source: Factset, CLSA Asia-Pacific Markets as at end March 2013

> "While shifts in power can largely be seen as a positive, it's important to remember reform in emerging markets can be a double-edged sword."
> Sophia Whitbread

2 MSCI, CLSA and Newton, 30 June 2013.

A TIME TO BE FLEXIBLE

Exposure to alternative assets, unloved areas and short durations are all ways bond investors might achieve returns in 2014, according to fund managers from Meriten and Insight Investment.

Adam Mossakowski
Fixed income manager
at Insight Investment
Insight Investment Limited (Insight) is a London-based asset manager specialising in investment solutions across liability driven investment, absolute return, fixed income, cash management, multi-asset and specialist equity strategies.

Alexis Renault
Head of high yield at Meriten
Meriten Investment Management has an adaptable investment approach that combines fundamental and quantitative analysis. The firm is a specialist in European fixed income, equity and balanced mandates.

Meriten
INVESTMENT
MANAGEMENT

Adam Mossakowski, fixed income manager at Insight Investment, says despite market uncertainties dampening enthusiasm for bonds, 2014 could be a good year for fixed income. He believes bond markets are much more likely to be range bound over the year, which means it will be worth earning additional yield from being invested in the market, while at the same time flexible mandates will be able to exploit market volatility by timing their exposure.

Meriten's head of high yield, Alexis Renault echoes the sentiment there are many reasons to be positive about fixed interest for the year ahead and agrees the key to returns could be flexibility and risk management. To this end investors need to be acutely aware of how bond funds are being managed to ensure they are not overly vulnerable to liquidity shocks. Until 2007, high yield credit funds were predominantly driven by bottom-up, credit analysis, he notes, whereas in 2014 macroeconomic views in positioning portfolios will be invaluable.

"Today it is more difficult than it has been to be a credit manager. The new world we live in is one of low absolute yields." In this environment Renault contends duration exposure will be an important differentiator of risk and returns.

THE RISKS AHEAD

Renault notes one of the biggest unknowns for fixed interest investments in 2014 is the onset and potential impact of tapering in the US. How and when the US QE programme will be reversed remains an open question; in effect a ticking time bomb that could spark large outflows from the corporate credit markets, creating a funnel effect on liquidity, he says. Mossakowski agrees liquidity will remain a concern this year and could be a catalyst for underperformance in the asset class. "The exit doors for fixed income are very small these days."

As Mossakowski and Renault both point out, investors got a taste of this potential risk last summer when Ben Bernanke merely hinted at the possibility of tapering, leading to a sharp sell-off in emerging market debt and a wave of volatility through markets.

Although the tapering threat hangs over fixed income markets, it should not dampen the appeal of

bond investments, the managers say. First of all, exactly when tapering may begin is difficult to pin down. Renault notes: "It could be two weeks or three years from now; it's completely unpredictable. But when it does turn, it is important to be invested in liquid assets."

THE POSITIVE SIDE

In light of some of these risks, and the lack of visibility in the market, both managers favour the short end of the corporate bond market, particularly European high yield.

Short duration exposure not only helps to reduce volatility, it can ease liquidity concerns, Renault says. He favours issues that will mature in the next 15 months as they are easier to sell than longer dated bonds. In addition a holding cannot be sold, there is only a short time to maturity and redemption anyway.

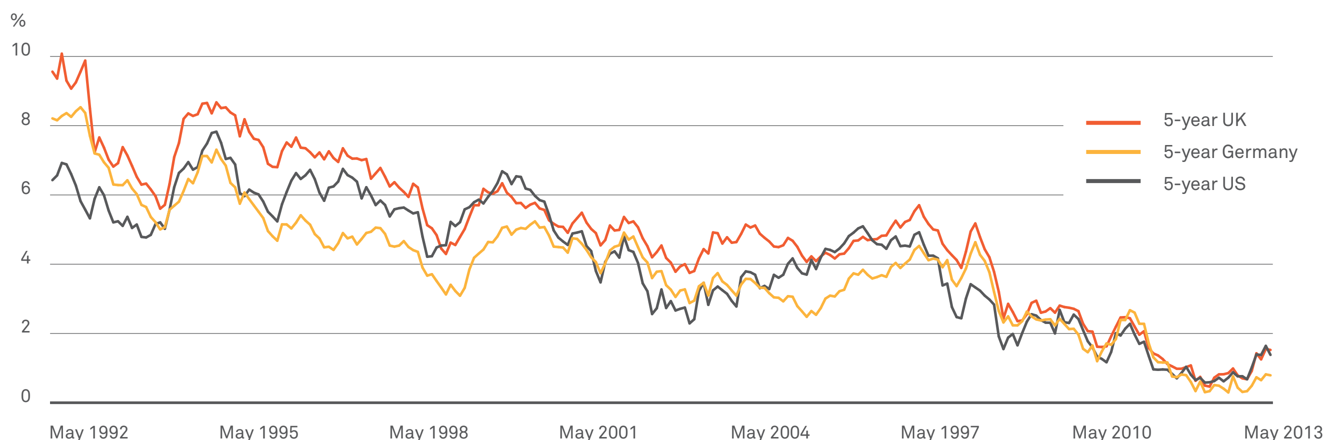
Although Mossakowski is less keen on sub-investment grade for 2014, believing it to look expensive, he does like very short dated high yield bonds, noting the yields on offer make it a good place to ride out any sudden economic dips. He also likes the short end of the asset backed securities (ABS) market. Mossakowski says European 12-18 month floating rate ABS's offer decent spreads and trade cheaply compared to a commensurate level of risk in investment grade corporate bonds. Issues in this space feature decent asset cover and so can absorb a huge amount of write downs before losses would be incurred, he notes.

Positive on select financials, Mossakowski is also exploring some newer bond alternatives, such as contingent capital (cocos), which are designed to convert into shares if or when a pre-set trigger is breached. Considering regulators' interest in shoring up bank capital, new hybrid assets like cocos could be increasingly important, he says.

At a macroeconomic level, Mossakowski points out interest rates across Western markets are unlikely to rise in 2014 while inflation looks to be largely under control. One risk Renault believes has lessened and will not pose quite so much difficulty for investors in 2014 is Europe. "Today we can see economic improvement in Europe so the chances of a big blow up in that region over the next 12 months are limited." He adds default rates for corporate credit in general are likely to remain low over the coming year.

"Investors need to be acutely aware of how bond funds are being managed to ensure they are not overly vulnerable to liquidity shocks."

Yields on 'safe haven' debt are still very low...



Source: Bloomberg as at 30 September 2013. Past performance is not a guide to future performance.

FIXED INCOME

STANDISH SEES REVIVAL IN DEMAND

Headquartered in Boston, Massachusetts, Standish Mellon Asset Management Company LLC (Standish) is a specialist investment manager dedicated exclusively to active fixed income and credit solutions, with a strong emphasis on fundamental credit research.

Standish sees increasing interest from investors in emerging markets debt (EMD). The sell-off in the summer of 2013 has helped to make EMD valuations more attractive, according to the fixed interest specialists.

Inflows into US high yield bonds and high yield loans demonstrate strong demand for credit. We think emerging markets credit (US dollar-denominated sovereign and corporate bonds) will be part of this trend in 2014, unless there are fundamental problems in emerging market countries. We continue to see increasing interest on the part of institutional investors in emerging markets debt (EMD), not least as EMD valuations have become more attractive as a result of the sell-off in the summer of 2013.

We acknowledge some foreign investors in emerging markets local currency denominated bonds have been finding the currency volatility too much to tolerate. Demand for such bonds from local financial institutions (pension plans, banks, mutual funds) has not been enough to mitigate the price effect of foreign sales, even though local institutions, on average, still own more than a half of the market. However, in our view, local demand will ensure a quick recovery to more fundamentally justified levels, once the dust settles from the foreign sell-off. This was the pattern seen in the immediate aftermath of the Lehman Brothers crisis.

DRIVING FORCE OF LIQUIDITY

The phrase EMD belies the diversity of the underlying risk exposures. We prefer to think instead in terms of bonds issued by entities located in 'non-rich' countries. Such non-rich countries may be on different economic trajectories, often pursue distinct monetary and fiscal policies, and possess unique strengths and vulnerabilities. Among non-rich countries, we can find very open economies (e.g., those of Poland and the Philippines) that are substantially affected by global trade flows, and fairly closed ones (e.g., India, and Brazil). There are plenty of commodity exporters but there are also commodity importers.

Among non-rich countries, some have poor creditworthiness but the majority of such countries are now of investment-grade quality. Similarly, their bonds come in different varieties. As such, formulating a single outlook for such a heterogeneous asset class as EMD is a difficult challenge.

The extent to which investors treat EMD as a single asset class has been affected by flows. For the past several years, flows have been very supportive

“stabilisation in US Treasury yields is a prerequisite for a rebound in EMD in 2014. The prospect of tapering is no longer a shocking surprise to market participants”

of EMD, with inflows encouraged by the aggressive loosening of monetary conditions and the debt overhang in developed countries, as well as by the promise of higher growth rates in emerging economies.

TURNING OFF THE TAP

In May 2013, inflows stopped abruptly (and, in fact, went into reverse) as the US Federal Reserve (Fed) signalled it would start tapering its asset-purchase programme. The surprise in May was not that the Fed would consider changing its course (hardly anyone expected the Fed to continue injecting liquidity indefinitely) but that it came so soon and in the absence of the more convincing signs of a US economic recovery. As a result of this major shift in expectations, US Treasury yields sold off aggressively.

EMD is certainly not the only asset class that previously benefited from a sea of liquidity. However, we believe it has suffered more than others in the latest sell-off due to its relatively high duration and the perception that the emerging markets growth story has recently lost some of its lustre. While non-rich countries will likely continue to grow at faster rates than that of their rich, developed counterparts, we believe slower growth in China and policy imbalances in Brazil, Turkey and elsewhere have unnerved some investors.

RE-EMERGENCE OF VALUE

While EMD has just gone through a testing period, value has re-emerged across its various segments, especially EM US dollar-sovereign debt, ‘cross-over’ corporates (previously widely owned and most recently heavily sold by global fixed-income managers), local currencies and rates. In risk-adjusted terms, EM US dollar-denominated debt (broadly defined) presents the most compelling value, in our opinion. However, EM local currency debt has more potential in the long run. It also offers value, with yields now higher than on US high yield debt when, historically, they have been lower.

While EM currencies have priced in higher US Treasury rates, they have not yet priced in the improved economic environment in the US that would allow the Fed to consider tapering. The rebound in the US economy is positive for emerging market exports and growth. We therefore expect some appreciation of emerging market currencies against the US dollar over the next 12 months. At the same time, we also expect volatility.

By and large, weakness in emerging market currencies is not producing detrimental effects. In the past, the depreciation of emerging market currencies would affect the debt-servicing capacity of emerging market sovereigns (and corporates), with heavy liabilities denominated in an external currency. The improvement (in most cases) of sovereign balance sheets over the past decade has greatly reduced this pernicious effect.

In our view, stabilisation in US Treasury yields is a prerequisite for a rebound in EMD in 2014. The prospect of tapering is no longer a shocking surprise to market participants. While we expect US Treasury bond yields to drift higher, the ripple effect on EMD is likely to be less pronounced than that experienced in more recent times.

OUTLOOK

Local demand should underpin local currency bonds

EMD should surmount the ripple effect of rising US Treasury yields

We remain wary of market sentiment and expect some volatility

LOCAL STORIES DOMINATE EMD OPPORTUNITIES

Colm McDonagh
Fixed income manager at Insight Investment

Insight Investment Limited (Insight) is a London-based asset manager specialising in investment solutions across liability driven investment, absolute return, fixed income, cash management, multi-asset and specialist equity strategies.

What does 2014 have in store for emerging market debt? From the chances of continued volatility to areas of potential downgrade, BNY Mellon Investment Management explores the appeal of the asset class with Insight Investment's Colm McDonagh.

Will emerging market debt (EMD) hold any appeal in 2014 considering the outflows seen in 2013?

People need income in their portfolio, and are looking to diversify away from the likes of the US, the UK, and Europe, so they can look towards emerging markets. These countries have a lot of appeal but people want to invest while also minimising risks.

In 2013 there was volatility and considering the potential impact fed tapering may gave, such concerns continue.

We think people are perhaps a little more worried than they need to be about emerging markets. We don't think there will be a rip-roaring recovery but likewise, looking at the data, it will not be too weak either. We expect there to be a slight upturn in economic growth over the next six months.

It's then a case of where to look for value. It could be a mixed bag through duration, rates and currency. Over the past few years, there were some pressures on emerging markets credit spreads, so people just bought debt.

It's important to remember that there are more than 70 countries which will have to deal with very different circumstances – we think it will come down to local stories. In Asia, for example, we think rates could pick up a little, while there could be improvements in Eastern European countries. Latin America, meanwhile, has a lot of different challenges.

What will drive EMD returns, aside from Fed policy?

Perhaps the biggest challenge for emerging markets is that this year is an enormous election cycle, with several important countries taking to the polls. Different governments respond to this in different ways – some, for example, tend to spend a lot before elections. We have to look at each different country and see how they deal with individual scenarios. Elections are the big issue, but also politics.

“Perhaps the biggest challenge for emerging markets is that this year is an enormous election cycle, with several important countries taking to the polls… We have to look at each country and see how they deal with individual scenarios.”

The global cost of money is another a factor to examine. There could be continued easy monetary policy throughout Europe and Asia, which is typically supportive of risk assets in general – including EMD.

Are you likely to avoid countries with elections coming up next year?

If we think the electoral processes in a country might cause difficulties then that is important to bear in mind. Typically, before elections people spend more money, which can lead to inflation and other negative side effects.

In Brazil, which is due to have its presidential elections in September 2014, there is an uneven distribution of wealth among its population. Its middle class has been rising but now it has become squeezed, which is why we see protests happening in the country. People see vast spending on things like the World Cup and the Olympics, but not enough is being done to help with the cost and quality of, for example, public transport – which can be a catalyst for protests.

For a long time Brazil was held up as a regional example of how public policy should be run, but lines seem to have blurred in recent times. There was muddled policy from the central bank, GDP figures which came as a negative shock and rising inflation with weaker growth caused dissatisfaction among squeezed workers. Meanwhile Mexico let its currency weaken and as a result is in a better position.

I think all of the BRICs (Brazil, Russia, India and China) have their challenges, but it’s actually in the next largest size segment of emerging market countries where we see better structural stories coming through.

What other political risks might appear?

I think we have got to keep an eye on the Middle East. It’s a positive that relations are improving between Iran and the US but there remains the potential for flare-ups. In China, the new political regime seems to be steady for the moment – and it’s interesting to see it has publicly fired and prosecuted members of the government in corruption cases. In Latin America, recent polling in Argentina points to a potentially positive transition. It will be interesting to see how many of the current president’s supporters change allegiance.

A big issue for bond markets is that some countries issued bonds very cheaply over the past year, but what happens if interest rates go up in 2014? It is also important to keep an eye on countries employing protectionist tactics, as that is when regional differences flare up.

There could be problems with some countries in ‘frontier’ markets which have borrowed a lot of money. There are certain countries in Central America, for example, which have borrowed in US dollars but have revenues in local currency. What if these local currencies suffer a sell-off? Also, if some of these countries were borrowing to support infrastructure projects, then it would be fine, but many are borrowing on financial markets simply because they can. Will they always be able to pay this money back?

What will likely be more attractive: EMD in US dollars, or local currency denominations?

In each country, we look at where is the best risk to reward – local or external? I think in dollar denominations there’s a lot of value in corporates. In local rates, currencies are far more mixed because some will be weaker than others.

Having said that, we don’t segregate – our portfolios take a blended approach, searching for whichever sub-asset class offers the best value.

SECTOR VIEW

JAB IN THE ARM FOR HEALTHCARE R&D

Stephen Rowntree
Global healthcare analyst,
Newton

Newton is renowned for its distinctive approach to global thematic investing. Based in London and with over 30 years' experience, Newton's thematic approach is applied consistently across all strategies.

NEWTON
The Power of Ideas

A shift towards more targeted health care treatments, the advent of new technologies, US reforms and Chinese developments make for attractive prospects in the global healthcare sector.

Increasing demand for effective treatments and an improving outlook for research and development support our positive view on the healthcare sector. We have witnessed many large pharmaceutical companies successfully navigate the 'patent cliff' of key drug sales losses and now see the first signs of how these companies can deliver future growth through successful design and development of new cost-effective treatments. Valuations have risen amid this strengthening sector confidence. The healthcare 'bears' would question the ability of company pipelines to deliver successful treatments, but we are confident we should be able to distinguish companies with true growth and innovation potential from those with less attractive prospects.

TARGETED TREATMENTS

An exciting emerging trend we are following with interest is the shift towards targeted treatments. Traditionally, drugs have often been developed to treat a broad patient population or condition. Increasingly, we see a move towards specialisation, whereby drugs are targeted at a defined group of patients, or a particular manifestation of a disease, for example a specific type of cancer. These targeted treatments should help companies to reduce their development times and testing costs as well as to improve the outcomes for patients. As long-term investors, the search for cost-effective treatments and signs of productive R&D form fundamental aspects of our analysis of growth potential.

As drugs become more specific, new types of data collection and analysis will become increasingly prevalent in the healthcare industry. The use and implementation of such techniques byregulators and payers could be a pivotal factor affecting the potential for future health care growth.

The development speed of hand-held devices and portable diagnostics equipment is one area of progress we are monitoring as investors. Development of new methods of drug administration is a further field of innovation potential, where it is no longer just the drug itself but the way in which it can be administered to (or by) the patient that may provide a company with a competitive advantage.

IN WITH THE NEW

It is not just technological innovation changing the health care industry: a perceptible shift in focus upon particular types of conditions is also underway around the world. Previously, more common conditions such as cardiovascular and gastrointestinal diseases were often the focus of treatments. Now, increasing attention is focused upon more difficult-to-treat conditions such as oncology (cancers), metabolic diseases (such as diabetes) and neurological disorders (such as Alzheimer's). We understand part of this transition is born of changes in people and society. As people live for longer and as lifestyles across both developed and emerging markets improve, it is those conditions associated with older age and a richer (yet ironically poorer) diet and sedentary lifestyles which are becoming greater concerns for society. Correspondingly, this means that more government attention and spending will be focused upon these new areas.

GOVERNMENTS AND GEOGRAPHIES

The spotlight upon the advent of Obamacare in the US has brought to the fore the influence of government spending on healthcare and the various ways different governments may choose to meet the increasing healthcare demand. While the effects of US healthcare reform will unfold over the next three to five years, positive changes in emerging markets, such as China, which start from a lower base of coverage and treatment access, will evolve over a much longer time horizon. As investors, we see the contrasts in healthcare provision between developed and emerging markets as offering a range of opportunities. What is evident, certainly across developed economies in Europe in the wake of the financial crisis, is that concern over cost savings dominates the healthcare debate. In emerging markets, on the other hand, healthcare spending on both an individual and national basis is likely to increase.

We believe global healthcare offers many exciting opportunities for long-term investment and we will be keeping our finger on the pulse of new emerging opportunities in innovative treatments and services.

OUTLOOK

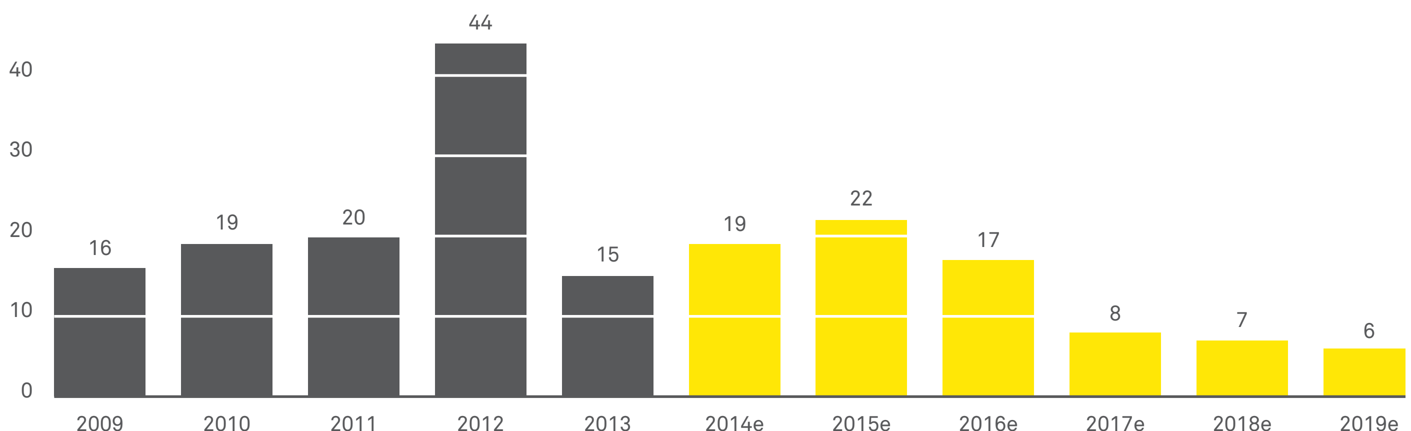
Watch out for the companies likely to be impacted, both positively and negatively, by the roll-out of Obamacare in the US

Expect to see the first signs of improving earnings prospects for a number of global pharmaceutical companies

Keep a close eye on pipeline developments and regulatory approvals for drugs and treatments; these are often considered key sources of competitiveness

> "As people live for longer and lifestyles across developed and emerging markets improve, it is those conditions associated with older age and a richer diet and lifestyles which are becoming greater concerns for society"

Annual sales of products losing exclusivity (US$ billion)



Source: Equity Research, Evaluate Pharma.

SECTOR VIEW

BUILDING SOLID FOUNDATIONS

Todd Briddell
Chief investment officer,
CenterSquare

Focusing exclusively on public, private, global and US real estate, CentreSquare's investment approach includes both a top-down market/country selection and a bottom-up underwriting of properties, companies and management teams.

Todd Briddell, chief investment officer at CenterSquare, looks at the opportunities within direct property and the historic performance of the real-estate securities in an environment of rising interest rates.

The out-of-fashion areas within the direct property market that bring value hold the most attractive and interesting opportunities for the year ahead, while the popular primary markets are poised to disappoint investors. Meanwhile listed real-estate securities, such as REITs, should continue to experience uplift in valuations. Although it may seem counterintuitive, rising interest rates could, in fact, be a boon for listed real-estate securities.

On the physical side of property investments, commercial real-estate investors have focused much attention on core assets in primary markets since the global financial crisis. They have sought those properties with the most secure cashflows and that offer a store of value during uncertain times. As a result, this wave of investment has driven up capital values. Although core real estate continues to produce stable yields, the cost basis required to be paid for that yield has grown significantly, relative to other real-estate asset classes.

As interest rates and/or inflation rise from current levels, these stable yields will become significantly less attractive and owners of core properties will have limited options to increase their yields through asset enhancements. This, in turn, creates a very real risk of substantial capital loss in core real-estate investments, which exceeds the perceived risk for the asset class.

Meanwhile, opportunities abound for the acquisition of fundamentally sound assets (so-called value-added properties) that have been overlooked. This may be because investors have limited appetite for properties they see a challenge or risk. Yet such properties can be bought for less and offer the ability to create or optimise their income streams, thereby providing greater margin and downside protection than purchasing existing current yield in today's unbalanced market.

For those with the capital and redevelopment expertise value-added assets can be transformed into core quality properties with a reduced risk profile, which a deep pool of investors will line up to buy. As such, we see an opportunity to arbitrage the mispriced perception of risk that currently exists between stabilised core assets and fundamental value-added investments. We believe a middle market, value-added strategy represents a sweet spot in the current market for value creation and risk reduction.

REITS AND RATES

The efforts of central banks around the world to boost economic activity have been making headlines and playing a large role in the global markets. Many investors are keenly aware that traditionally, a spike in government bond yields will put downward pressure on real-asset pricing as debt financing becomes more expensive.

However, although sovereign yields have and may continue to increase, it should not necessarily be a cause for concern for REIT shareholders. Between 2004 and 2007, when increases in the Fed funds rate in the US were driven primarily by economic growth, US REITs not only did well in absolute terms but they outperformed the broader equity market during a time when the Fed funds rate rose nearly 500 basis points.

The effect of an increasing Fed funds rate on REITs has everything to do with why rates are being moved, particularly at the short end of the curve.

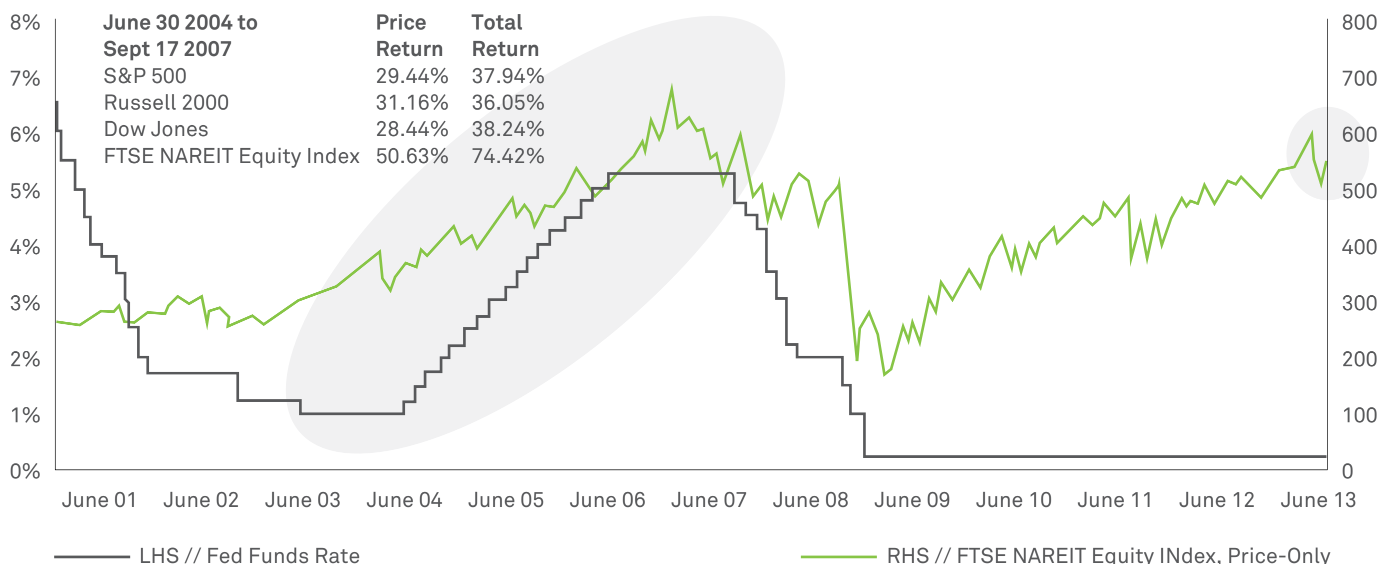
When rates are increased in response to economic growth, the positive effect on rental growth can offset, and sometimes outweigh, the negative effects of higher interest rates on real asset values. The economic recovery implicit in the contemplation of tapering by the Fed could push US REITs up in spite of the traditional relationship between interest rates and REIT performance.

In addition, while they have moved higher, interest rates remain low relative to historic levels and still provide accretive refinancing opportunities for REITs whose assets have seen income growth behind healthy fundamentals.

TOTAL RETURN FOCUS

As we look ahead, we expect monetary policy to continue to drive real-estate market returns around the globe. Despite delays in the tapering of US economic stimulus, there is reason to believe an inflection point is near and that tailwinds for global economic growth will provide modest upside. Going forward, we expect central banks will maintain easy monetary policy, keeping interest rates low, inflation down, and catastrophic crises at bay. We believe investors will come to accept a weak to modest growth, low yield environment as the 'new normal'. In this environment, we are optimistic for future growth but we caution investors to temper their return expectations. As a consequence, we believe the most successful investment strategies will be those with the ability to provide both yield and total return.

REIT price returns vs the federal funds rate



Source: Bloomberg, July 2013

THE EVOLUTION OF ABSOLUTE RETURN

Could a sustained economic recovery render absolute return funds redundant in 2014? Absolutely not, according to BNY Mellon Investment Management.

Matt Oomen
Head of distribution for EMEA at BNY Mellon
BNY Mellon Investment Management's unique asset management model encompasses the investment skills of world class specialist asset managers, many of which are amongst the most advanced and highly regarded names in money management.

David Chellew
Head of marketing at Insight Investment Management
Insight Investment Management Limited (Insight) is a London-based asset manager specialising in investment solutions across liability driven investment, absolute return, fixed income, cash management, multi-asset and specialist equity strategies.

BNY MELLON

Absolute return investing has attracted praise and censure in equal measure in recent times. Indeed, ever since this style of investing gained popularity in the wake of the financial crisis of 2008 it has been the subject of intense scrutiny. It is not surprising. Any investment manager that promises clients steady, growing returns that are less affected by wider market volatility is deserving of such scrutiny.

As with any nascent retail investment technique there has been a wide disparity between those funds that have delivered on their goal and those that have failed. But the wider question for 2014 is: do we really need absolute return funds at all?

It is not hard to justify investing in an absolute return fund at a time of profound economic uncertainty. The prospect of steady, lower risk returns at a time when economic growth is stagnant and markets are capricious is a tempting one. In particular if that fund aims to protect your capital on the downside.

But at a time when markets appear to be gaining consistent upward momentum, will there be a place for these kinds of funds in three, six or 12 months' time? Will investors simply move into funds that offer more exposure to rising markets?

Matt Oomen, head of distribution for EMEA at BNY Mellon Investment Management, does not believe interest in absolute return funds will wane in 2014. On the contrary, he thinks 2014 will be the year when absolute return funds truly come of age.

"Investors have a more developed understanding of how to use absolute return funds today," he says. "Whereas before the financial crisis people had looked upon these kinds of products as purely a proxy for hedge funds, today long/short style funds are used more holistically, for example, as a dampener of volatility, or as part of an investor's broader equity or fixed income exposure."

VOLATILITY FEARS

Oomen says there is a high chance markets will remain volatile this year. "Enough potential problems remain [in the global economic system] that need to be worked through to keep investors in fear of volatility rearing its ugly head again," he says. "There will be a lot of focus on flexible absolute return strategies and we will see that trend continue."

“Today there is more emphasis on the journey rather than the end game. There is a swathe of the investment community that doesn’t want too rocky a ride... absolute return investing is coming of age.”

Most commentators agree that the biggest threats to market stability next year will be the US Federal Reserve tapering its quantitative easing (QE) programme and the end of near zero interest rates across the developed world. It is these twin risks, says Ivo Batista, an investment strategist from the BNY Mellon Investment Strategy and Solutions Group, which could lead to further turbulence in financial markets.

“Demand will be driven primarily by investors’ risk appetites, but also by the characteristics and perceived risks of different asset classes,” he says. “For example, if US interest rates were to rise in 2014, investors may seek shelter from the duration risk inherent in fixed income assets. An absolute return approach employing an interest rate hedging strategy could help to mitigate this risk.”

According to Peter Bentley, head of UK and global credit at Insight Investment (Insight), taking on more risk is not the only way for absolute return investors to seek to generate the same level of gains achievable under previous, higher-return conditions. “Having a duration neutral, or an essentially interest rate risk-free stance as a portfolio’s starting point can serve investors well if their primary concern is capital preservation.

“This can entail buying offsetting pairs of markets and instruments: a benefit of such a long/short approach is that there is the potential to generate positive returns in both rising and falling markets,” he adds.

David Chellew, global head of marketing at Insight Investment, agrees volatility will continue to lurk in the shadows of growth. “Given the risk inherent in equities and where yields are, demand for absolute return investing is likely to remain strong in 2014,” he says.

With demand for absolute return funds set to continue, just what kinds of funds will make the grade? For Chellew absolute return funds will be judged on whether they offer their aims. It seems an obvious point to make, but these strategies are very prescriptive in what they offer investors and success can only be judged on the delivery of those objectives.

“The best absolute return funds are outcome orientated in their approach,” Chellew says. “It is not a horse race, you can’t choose the winner by looking at the peer group ranking over five years. Some funds aim for positive returns over both the short and long term, while others target higher positive returns in the longer term, with the potential for greater volatility on the way. The funds that will grow will be the ones that deliver on their promises year in year out – critically without any nasty surprises”.

As to whether there will be more ‘me-too’ launches of absolute return funds in 2014, Chellew thinks it is more a case of existing competitors proving they can stand the test of time. “Investors in the successful funds will be tempted to increase their exposure while new clients will be attracted by those with long-term records,” he says.

HELP THE AGED

One big opportunity for absolute return funds in the years ahead, according to Chellew, is the developed world’s ageing population. What he refers to as “clients on the glide path into retirement.”

“As people approach retirement they need steady, low volatile returns because their investment horizon is getting shorter and their tolerance for big drawdowns is reducing,” he says.

“Investments that aim to deliver on a short-term horizon with a high degree of capital preservation give the client more control over the timing of their investment and redemption dates. This is a growing need and it is currently under served by the investment industry.”

For Oomen absolute return funds will remain popular due to a change in attitudes among investors since the financial crisis. “Today there is more emphasis on the journey rather than the end game. There is a swathe of the investment community that doesn’t want too rocky a ride.”

UNCONVENTIONAL FIX

Iain Stewart
investment manager, Newton

Newton is renowned for its distinctive approach to global thematic investing. Based in London and with over 30 years' experience, Newton's thematic approach is applied consistently across all strategies.

NEWTON
The Power of Ideas

Iain Stewart, who heads Newton's Real Return team, expects policymakers will continue to walk a tightrope between generating economic growth at almost any cost, and maintaining real interest rates at low enough levels to service liabilities that are unprecedented in peacetime.

Through 2014, a key question will remain at the forefront: whether the authorities have really 'fixed' the financial system and created a self-sustaining recovery? While unconventional monetary policy initiatives, such as quantitative easing (QE), have bought time and benefited investors in risk assets, some investors have been inclined to interpret cyclical improvements in the developed economies as evidence the world has finally shrugged off the depressive grip of the financial crisis.

Should economic expansion undershoot, the offical response is likely to be more unconventional stimulus. If this stance proves correct, we would expect a continuation of ultra-loose monetary policy. Were the response of the authorities to succeed in delivering a more robust pick-up, the outlook for interest rates is likely to change radically and make it more difficult to hold down debt-servicing costs. Either scenario would seem to set the stage for continued volatility. A further complication is that policymakers are increasingly seeking to link their interventions to economic variables, such as employment, meaning short-term market movements will become increasingly dependent on data.

SHORT-LIVED SUPPORT ASSUMES PERMANENCY

The financial crisis merited a life-saving jolt in the form of previously unthinkable levels of state support and intervention on a global scale. The balance sheets of the world's central banks have ballooned to more than US$20 trillion since 2007 (roughly half of this in the developing world) through intervention in local bond and foreign exchange markets.

Emergency support for the global economy was intended to be temporary. Whatever the expectations for QE, the unprecedented monetary interventions were intended to give politicians time to put in place the necessary structural reforms and fiscal consolidation. However, painful adjustments hardly ever fit modern electoral processes or cycles.

1 Making the most of borrowed time, Jaime Caruana, General Manager, Bank for International Settlements, Basel, 23 June 2013.

Although the rhetoric of central bankers is aimed at instilling confidence (and market participants have taken policymakers at their word by building in expectations of more growth and higher bond yields), the authorities clearly harbour doubts about whether recovery is indeed self-sustaining. They remain deeply concerned that economies are still fragile and prone to deflation. Doubts we share.

DEBT BURDEN BORNE BY GOVERNMENTS

We have long argued the difficulties facing the developed economies (debt burdens, worsening demographic trends and increasing competitiveness in a globalised world) represent a challenge for politicians, largely because any action is likely to affect growth adversely in the short term. (The credit bubble has left many economies carrying levels of debt that materially impair their economic prospects. As debt is reduced to more manageable levels, an extended period of relatively low growth and higher economic volatility can be expected.)

In the recession that followed the boom, governments stepped in to fill the void left by a retreating private sector. If the crisis was caused by private-sector debt growing more rapidly than the ability to service it, the post-crisis era has been marked by public debt growing faster than GDP. In aggregate, the world has been deficit spending, adding some US$23 trillion to sovereign debt liabilities since 2007 (according to the Bank for International Settlements).[1] In total, liabilities have not been reduced but have actually grown by some 30%.

Demographic trends mean this increased debt load needs to be serviced by a shrinking working population, which, in turn, also faces ballooning costs related to ageing and healthcare expenses. Weak growth in productivity in the major economies, rigid product and labour markets, falling real incomes and historically low savings could translate into restrained growth in consumption.

Economies that pursue policies that cheapen money and use asset prices as a tool of policy become overly dependent and sensitive to those same asset prices. The financial system, which is supposed to serve the economy, begins to drive the economy; the 'cart' is put before the 'horse'. The danger with this is that the horse will stand still, munching grass, so moving the cart takes ever bigger efforts.

Against this backdrop, we maintain a focus on stable, sustainable and predictable companies, which should be well positioned to prosper when the day arrives that economic data releases disappoint, as we believe they will inevitably. We retain our emphasis on capital preservation, while accepting some risk and volatility in order to achieve a return.

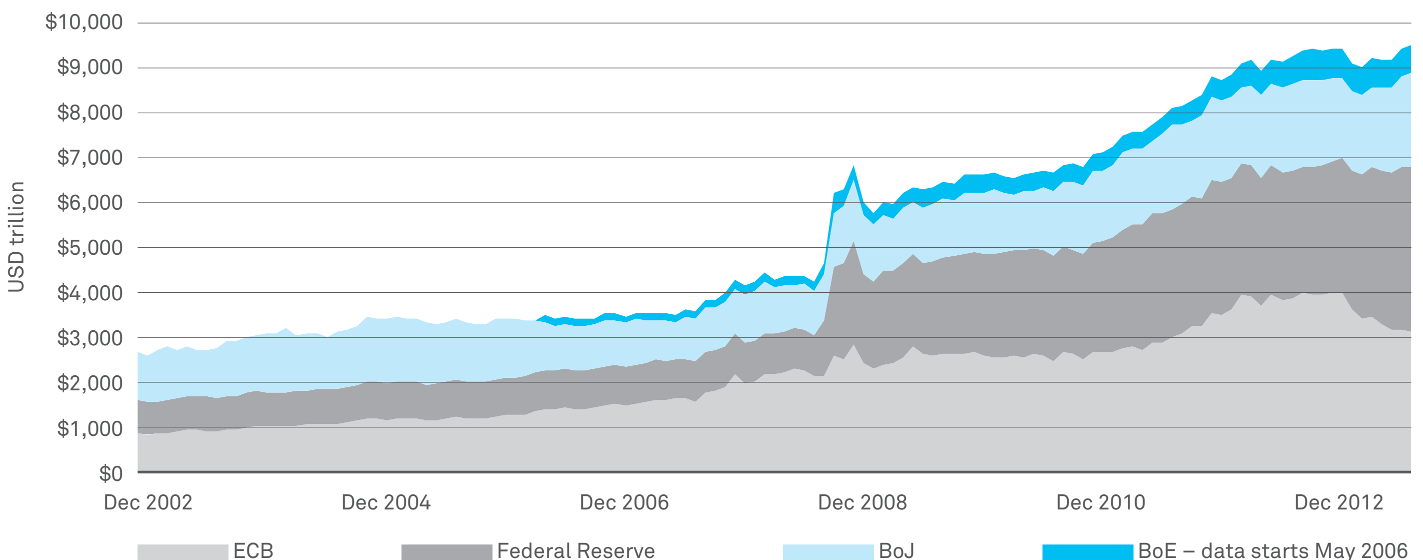
OUTLOOK

The world has shifted from 'taper' to 'no taper'

The next stage could be 'melt up'

Race to the bottom is the fashion for currencies

Central Bank Balance Sheets have ballooned



Source: Datastream, September 2013

ISSUANCE ON THE RISE

Paul Hatfield
Chief investment officer at Alcentra
Located in London, New York and Boston, Alcentra is a global asset management firm focussed on sub-investment grade debt capital markets in Europe and the US.

Paul Hatfield, chief investment officer at Alcentra believes 2014 is an attractive year for senior secured loans with a backdrop of high rates of recovery and low defaults in both the US and Europe.

I still take a very positive view on the loan asset class in both Europe and the US, although there is certainly capacity for more issuance, especially in the European market. However, I think the amount of dry powder private-equity has to its name, combined with the recent uptick in M&A activity, means 2014 will be a better year for new issuance. Economic recovery in both markets, though still in its early stages, will also help in this respect.

We've seen declining default rates and I expect 2014 will remain a year with few defaults. Outside of the loans we already know are headed that way, there should be no surprises in that area.

Inflation does not seem to be exactly racing ahead and with recent events in Washington pointing to continued low interest rates as tapering is delayed, the backdrop for borrowers remains favourable. I think interest rates will stay lower for longer in Europe until the problems with peripheral countries are sorted.

LOAN DEMAND SET TO CONTINUE

Through most of 2013 there was $481bn of issuance in the US market, compared to €61bn in Europe (a large jump from €23bn in 2012).[1] This disparity is reflected in the number of issues in each market: 1,450 in the US versus 517 in Europe.[2] It is worth bearing in mind the US loan market is much larger than its European counterpart with a total notional value outstanding of US $726bn, versus €144bn in Europe.

We (Alcentra) expect continued demand for loan assets in Europe. However, a number of factors, including a fledgling return of the European CLO market, limited scope for retail investors and the smaller size of the LBO market, is likely to contain any moves toward parity with the US in terms of size.

Liquidity is undoubtedly greater in the US than in Europe. In the US, on average more than US$400bn of principal value in loans has been traded each year since 2007,[3] clearly outstripping

1 Credit Suisse, Leveraged Finance Strategy Update, October 2013.
2 Credit Suisse, Leveraged Loan Index and Western European Leveraged Loan Index, Monthly Excel data, September 2013.
3 S&P/LSTA, 2013.

"We've seen declining default rates and I expect 2014 to remain a year with few defaults. Outside of the loans we already know are headed that way, there should be no surprises in that area."

the market size of European loans in total. In Europe the private nature of many financings – often numbering a handful of lenders in a 'club' deal – tends to limit the volumes traded, with many participants buying to hold until maturity. Though liquidity is lower in Europe, for institutional investors this may be seen as presenting less pressure on prices (both upward and downward), meaning greater price discipline can be maintained and volatility minimised.

Covenants are common in the European market but increasingly rare in the US. In the first three quarters of 2013 the US loan issuance was on average 52% 'covenant-lite' versus 21% 'cov-lite' in Europe, with the majority of the latter being in 'cross-border' deals.[4]

We believe covenants will remain an important part of the European market this year, with the greater discipline we see in evidence from the mainly institutional investor base important in maintaining lender-friendly terms and deal structures.

FALLING DEFAULT RATES

Default rates in the US and European loan markets have started to converge, after a long period of higher European numbers inflated by directories' businesses and Spanish issuers. In the US, the lagging 12-month default rate by volume increased to 2.41% at the end of September 2013 from 1.37% at the end of June 2013. In Europe this rate has fallen from 5.29% to 3.14% over the same period (starting at more than 6% at the beginning of 2013).[5]

We believe European default rates will be benign throughout 2014, with rates falling further than their current level. Should TXU, a US issuer, default on its US$20bn of outstanding debt, which we believe is likely; this would lift the default rate for the US to more than 6%. However, we expect by the end of 2014, rates will have normalised below the mean of 2.5%–3.0%. As a senior secured asset class, we continue to believe that high rates of recovery, and therefore low default loss rates, will continue throughout this year in both the US and Europe.

Average annual total returns for US loans have been 6.90% versus 5.49% in Europe[6] from 2003 to 2012. In 2013, Credit Suisse estimated a total return for US loans of 5.5% versus 7.5% for European loans. As such we would expect a total return for a diversified portfolio of US loans to achieve approximately 5%-6% in 2014, relatively unchanged on 2013. For European loans we expect returns of 6.5%-7.5%, slightly lower than last year.

OUTLOOK

Economic recovery in US and European markets will help to keep default rates low

Interest rates will stay lower for longer in Europe until the problems with peripheral countries are sorted out

Inflation doesn't seem to be exactly racing ahead and with recent events in Washington pointing to continued low interest rates, with the delay in the Fed's so-called tapering, the backdrop for borrowers is still very favorable

4 S&P LCD European Leveraged Lending Review, Q3 2013 & S&P LCD LoanStats Weekly, 10th October 2013. "Cov-lite" loans only have a financial incurrance covenant (akin to a bond), rather than the traditional maintenance covenants that are normally guaranteed by a loan agreement.

5 Standard and Poor's, Weekly Topicals, ELLI Default Rate, 10th October 2013.

6 Credit Suisse, Leveraged Loan Index and Western European Leveraged Loan Index, Monthly Excel data, September 2013.

LIGHT AT THE END OF THE REGULATORY TUNNEL

Gerald Rehn
Head of product development, BNY Mellon

BNY Mellon Investment Management's unique asset management model encompasses the investment skills of world class specialist asset managers, many of which are amongst the most advanced and highly regarded names in money management.

BNY MELLON

In May 2014, European parliamentary elections could change the focus of the regulatory agenda, offering a silver lining for intermediaries. BNY Mellon Investment Management's head of product development, Gerald Rehn, reports on the key opportunities and concerns facing the European investment and advice industry.

Overregulation has become a key worry for the European funds industry. From asset managers to distributors, few areas of investment management have been untouched by the plethora of regulation initiated or implemented since the financial crisis began. With around 30 initiatives since 2008, it has been an expansive, expensive exercise.

What has been the result of this increased regulation? Has the ultimate effect been to reduce risk for investors and increase protection, or has it eroded value and the availability of investment advice? In addition, what will the European Parliamentary elections in May mean for those directives already winding their way through the system?

Some believe the elections could present an opportunity to better engage with the incoming politicians, who may be fresh to the topics. Yet the outlook of the outgoing Parliamentarians is already somewhat more positive than we have seen in recent years. Several MEPs and regulators spoke at a recent asset management conference in Brussels and noticeable by its absence was their previous emphasis on needed change and reform; instead much was discussed about the new growth agenda and the need to assess those initiatives already implemented.

TOO MUCH REGULATION?

The majority of industry leaders speaking at the European Fund and Asset Management Association (EFAMA) conference in November all seemed to agree the regulatory agenda with regards to asset management has been overdone.

It is acknowledged the focus of policymakers on the asset management industry is a spill-over from the banking system. However, as the cost of compliance with the myriad of regulations being passed continues to rise, authorities now need to take a step back, prioritise, and think about what it is they are trying to achieve, presenters at the conference argued. There are too many overlapping, sometimes contradictory regulations in the pipeline and greater harmonisation is needed; not just within the EU but with other regions as well.

Many in the asset management industry feel EU policymakers, as well as individual national regulators, need to refocus attention on creative solutions instead of punitive actions. In fact, some fear regulators have already pushed past their original objectives. "There is talk in Europe of regulators' growth agenda but in fact the pendulum has swung from not enough regulation and too much growth to now too much regulation, which is stifling growth," one speaker noted.

Representatives of the European Securities and Markets Authority at the conference commented about the capacity of the EU financial services industry to digest the amount of regulation being introduced. "There is no point introducing new rules if we do not have the capacity to implement and supervise them," one said. "We are at risk in not having the right balance."

UNINTENDED CONSEQUENCES

In addition several initiatives designed to protect investors may end up doing the opposite. The EU's proposed Financial Transaction Tax (which many hope will disappear with the next Parliament) is considered to be a case in point. Speakers at the conference noted that in practice it could work more like a tax on savers and investors as opposed to financial institutions. This is because the tax as it is currently proposed affects individual investments through each link of the distribution chain, including advisers. Each then has the capacity to move the cost down the line until it rests with the investor.

The panacea of increased competition was brought up more than once at the conference. Regulators and politicians say their focus has been on increasing competition, to improve transparency and reduce fees. In fact, the opposite has been happening, speakers at the conference contended. The growing cost of regulations has made it more difficult for smaller investment houses to compete, while fund selection and proof of suitability in recommendations mean advisers are moving away from a broad range of providers towards a select few. Still others pointed out that as asset groups consolidate and/or rationalise and close funds as a cost-saving exercise, the end effect will be an increase in turnover and churning for investors.

LONG-TERM SAVINGS

Highlighted as an example of regulators' new growth agenda is a proposal for a long-term savings investment vehicle, designed to help promote economic growth. The proposed European Long-Term Investment Fund (ELTIF) would be a structure, much like UCITS, which asset managers could offer investors. It is so-called long-term because the intention such funds would invest in illiquid assets such as infrastructure, unlisted equities and private equity. ELTIFs could open the path for non-institutional investors, such as retail investment savers and defined contribution plan participants to be able to access these potential diversifying, long-term investments, a gap which has remained in such portfolios due to current regulations. Given the long lock up periods, however, redemptions from ELTIFs would have to be limited but just how restricted has yet to be decided.

The speed of decisions regarding the ELTIF is a problem in the face of the May elections. According to some it stands a good chance or at least a better chance than say, resolution on some of the issues contained in other financial proposals also being debated by Parliament (such as those concerning money market funds). Ultimately it will come down to the number of amendments EU member states attempt to attach to the proposals, as they will hamper progress.

> "Few areas of investment management have been untouched by the plethora of regulation initiated or implemented since the financial crisis began."

FUND OFFERINGS

The ELTIF is expected to be a popular choice for investors with many asset managers commenting that there has been an increase in demand for longer-term investments. European investors have also become more outcome orientated, looking for solutions and a broader array of assets, as opposed to plain vanilla equity or bond funds.

Asset managers at the conference noted there has been greater demand across Europe for absolute return products and more targeted, specific and alternative fixed interest funds, as opposed to broad-based bond portfolios. Infrastructure and real estate investors are also a draw at the moment.

Amid this increase in investment demand, regulators continue to focus attention on fees being charged. However, industry members said the headline figure of funds' fees is too difficult to compare across Europe. Instead more attention should be drawn to total expense ratios (TER), something the UK's local Financial Conduct Authority is already examining delegates said.

It was also argued, again several times, the asset management industry should not be alone in the fees debate with regulators, so too should insurance providers. Many expressed dismay that regulations (such as the Packaged Retail Investment Products (Prips) directive) that could establish a level playing field between investment funds and insurance products continue to be delayed.

This article continues overleaf >>

INDUCEMENTS

Although there were questions as to the supervision and enforcement of the existing Markets in Financial Instruments Directive (Mifid), the second version of this directive is winding its way through Europe. Controversially Mifid II is proposing a ban on inducements in much the way the UK's RDR has eliminated adviser commission. However, the UK has a long established independent advice channel, one not necessarily replicated through Europe.

As a result, conference speakers pointed out (several times) that this regulation has the potential to hurt the nascent independent advice market in some EU member states, pushing distribution back to banks. This, they noted, does not seem to be in keeping with regulators' stated desire to encourage competition.

There is also a cultural difference between countries relating to the payment of fees that the inducement ban does not take into consideration, speakers at the conference purported. Questions were asked as to why commission and fees cannot co-exist, with both models competing?
If not, the regulation could result in many investors going without advice at all.

One silver lining in this debate is that Mifid II is so mired in the process, it is unlikely to get finalised anytime soon. This may make it one less change that advisers need to be concerned about. However, it will be one with which the next European Parliament may have to quickly come to grip.

"One silver lining in this debate is that Mifid II is so mired in the process it is unlikely to get finalised anytime soon."

Regulatory Initiatives targeting specifically the European AM industry

Initiatives targeting specifically the European AM industry
- UCITS IV
- UCITS V
- UCITS VI
- ETFs
- Money Market Funds
- AIFMD
- Venture Capital Funds
- Social Entrepreneurship Funds
- Long-term investment funds

Initiatives targeting financial institutions, comprising the European AM industry
- PRIPs
- MiFID review
- ICSD
- Shadow banking
- EMIR
- EU Supervisory structure
- Short selling
- Financial Transaction Tax
- Corporate Governance

Initiatives not targeting the AM industry but having spill-over effects
- Banking Union
- Recovery and resolution
- Liikanen report
- Basel III
- Solvency II
- IMD review
- Revision of IORP
- White Paper on pensions
- Credit rating agencies
- SLD
- Audit review

FATCA (US)
Dodd Frank (US)
Volcker Rule (US)

European national initiatives to
- Ban inducements (e.g. UK, NL)
- Ban complex products (e.g. Belgium)

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