Security Selection Remains Key for Fixed Income: Standish Global Investment Outlook, 2014*

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"A ship is always safe at the shore – but that is not what it is built for."

— Albert Einstein

There is no reward without taking risk.

EXECUTIVE SUMMARY

- We expect government bond yields in core developed markets to gradually move higher as the global growth outlook improves and inflation begins to stabilize. Our outlook and valuation estimates support below benchmark duration positioning.
- Emerging market bonds look attractive in both spread and local rate markets. Certain emerging market currencies are below long-term fair value. Emerging markets present a key opportunity but idiosyncratic risks remain so country and security selection will be critical.
- Global investment grade and high yield corporate valuations appear fair to rich but fundamentals remain strong.
- Securitized assets, including commercial mortgage backed securities, should continue to benefit from a stronger U.S. economy and valuations are fair to attractive.
- Peripheral European debt markets continue to present opportunities given stronger economic fundamentals and structural improvements.

NO REWARD WITHOUT RISK

There is no reward without taking risk but it is the investment manager's job to know when the ship should be safely at shore or out looking for reward at sea. After an almost 30 year bull market in rates, investors are right to be concerned about the total return prospects for fixed income assets. While returns for many developed market government bonds may indeed be challenged, there remain fixed income assets in which we believe investors will still be able to earn positive total returns.

*Part I, our 2014 Global Economic Environment, was released in January.

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This outlook will highlight the total return expectations of the key sectors and risks based on our fundamental research and proprietary valuation model outputs. It is true that point estimates are rarely accurate but looking at a range of outcomes over a number of likely scenarios provides a necessary framework for thinking about risk and return of the many potential opportunities available.

During normal cyclical recoveries, Treasury yields typically increase and credit risk premiums typically decline.

Standish expects a resynchronization of global growth as the rebound in developed market (DM) economies filters through to a modest recovery in emerging market (EM) growth. We expect a slight increase in U.S. inflation, but overall we expect inflation in most areas of the global economy to remain relatively contained. We see a generally supportive macro outlook, stable or improving fundamentals across a number of sovereign and credit sectors, but fair to rich valuations in many of these areas.

A LOOK BACK AT 2013 PERFORMANCE

A few things stand out when we look back at 2013 fixed income markets. Most U.S. fixed income sectors had negative total returns with the exception of high yield, which benefited from the higher carry and strong performance amongst lower rated issuers. However, almost all credit sectors showed positive excess returns over Treasurys. By contrast, European bond markets posted positive total and relative returns. This was a result of lower yields across most peripheral government markets as many countries made strong progress on structural reforms that resulted in stabilization and, in some cases, improved credit metrics.

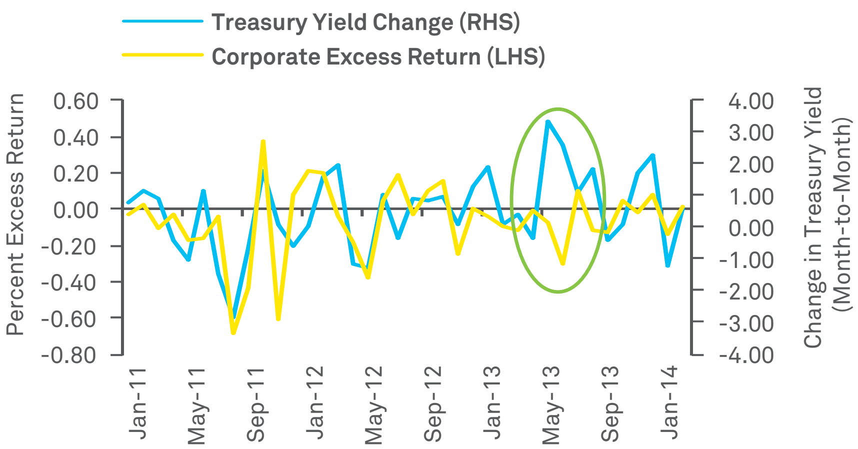
Developing markets did not fare as well. Volatility was a result of a number of factors including concerns about the Federal Reserve tapering quantitative easing (which hurt dollar assets), growth concerns particularly in China and a number of idiosyncratic stories, such as Turkey and Ukraine. Increased volatility of emerging markets assets, particularly local currency strategies, resulted in outflows particularly in U.S. retail funds, which exacerbated negative returns.

Fixed Income Returns	2013		Year-to-date 2014	
Sector	Excess Returns	Total Returns	Excess Returns	Total Returns
U.S. Treasury	NA	-2.8%	NA	1.6%
U.S. MBS	1.0%	-1.5%	-0.2%	1.9%
U.S. Corporate	2.9%	-1.5%	0.4%	2.9%
U.S. High Yield	9.5%	7.4%	1.4%	2.7%
ABS	0.2%	-0.3%	0.1%	0.7%
Euro Treasury	4.2%	2.2%	0.7%	2.9%
Euro Corporate	3.4%	2.4%	1.4%	1.9%
Euro High Yield	10.7%	10.1%	0.4%	2.3%
EM External	NA	-6.6%	NA	2.2%
EM Local	NA	-9.0%	NA	-0.8%
EM Corporate	NA	-1.7%	NA	2.5%

Source: Standish, BofA Merrill Lynch, Barclays and JP Morgan as of February 28, 2014.

Last year we noted that credit asset excess returns have generally been positively correlated with higher Treasury yields. During normal cyclical recoveries, Treasury yields typically increase and credit risk premiums typically decline as a stronger growth environment means tighter monetary policy and a more supportive environment for risky assets. However, when Treasury yields rise rapidly this correlation tends to break down. This happened in the early 1990s when the Fed unexpectedly tightened monetary policy and again last year when the Fed surprised markets with its intention to taper asset purchases. The chart below shows the divergence of Treasury yields and corporate excess returns. Normally, this divergence is short lived and indeed strong credit excess returns during the fourth quarter drove positive returns for the year. Yet, credit assets will remain vulnerable to this type of volatility as the Fed attempts to remove extraordinary monetary accommodation in the face of an improving economic environment.

We have used our proprietary valuation models to project year-end yield and spread values for various fixed income sectors.



Source: Barclays and Standish as of March 4, 2014.

2014 MODEL FORECASTS

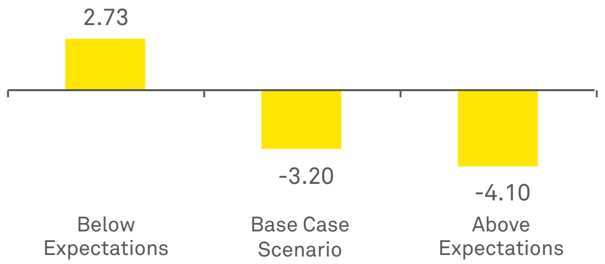
We have used our proprietary valuation models to project year-end yield and spread values for various fixed income sectors. The forecasts include three different economic scenarios; our base case forecast for 2014 (U.S. growth 2.7 percent and inflation 1.8 percent) and above trend and below trend forecasts. The forecast variables are populated based on the results of our global macro research as well as sector specific variables from sector research teams. The result is a presentation of our best expectations for 2014 and results around either side of that forecast.

SECTOR OUTLOOKS

U.S. Treasurys

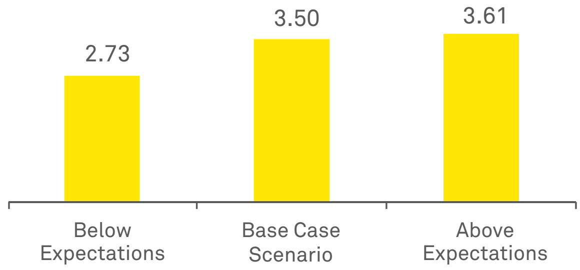
Treasury yields have been one of the most persistently overvalued sectors according to our valuation models due mostly to Fed intervention in the market. Treasury yields increased by more than 100 basis points in the past year and have now moved into the lower end of our fair value range as explained by our valuation models. Historical cyclical indicators, central bank policy, and to a lesser extent, safe haven demand for Treasury assets have been the key factors explaining Treasury yield valuations. Despite recent weak economic data, our view is that growth and labor markets will improve and the Fed will continue to reduce asset purchases. Therefore, we are calling for a modest increase in Treasury yields, which will make 2014 another year of negative total returns. The tables below show our expectations for 10-Year Treasury yields under various scenarios and the associated total returns. The 10-year was yielding approximately 2.73 percent at the time of this analysis.

10-Year Treasury Total Return (Percent Return)



Source: Barclays as of March 4, 2014.

10-Year Treasury Forecast (Percent Yield)

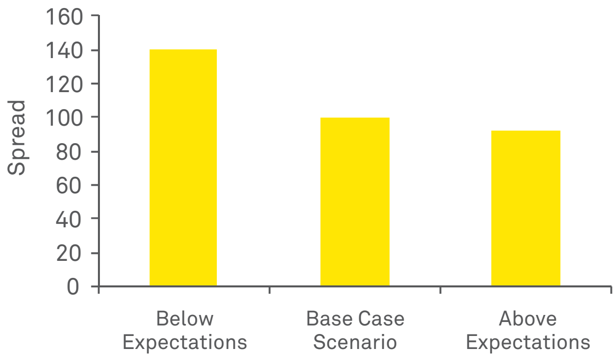


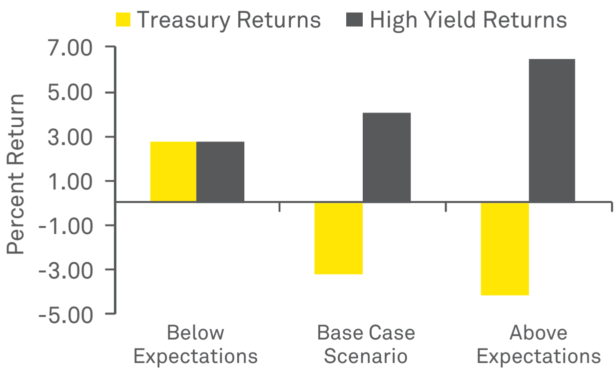
Source: Standish as of March 4, 2014.

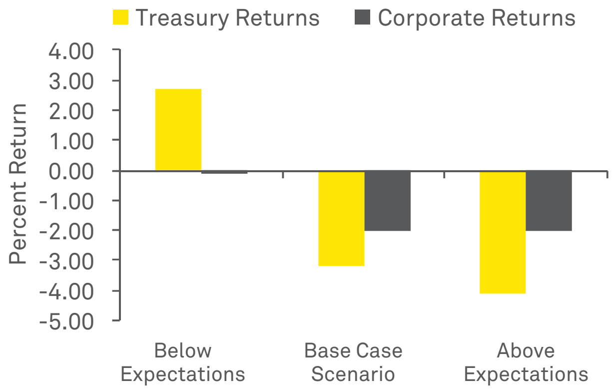
INVESTMENT GRADE CORPORATE CREDIT AND HIGH YIELD

Our global corporate and high yield teams see scope for additional spread tightening under our base case scenario. Corporate bond spreads have historically tightened in rising government yield environments. This cushions fixed income investors from some of the duration driven losses. Credit fundamentals for non-financial investment grade corporates have likely peaked in developed markets, but remain at historically strong levels. In our base case scenario, investment grade corporate bonds tighten about 10 basis points, outperforming similar duration Treasury bonds by more than 100 basis points.

Corporate Spreads





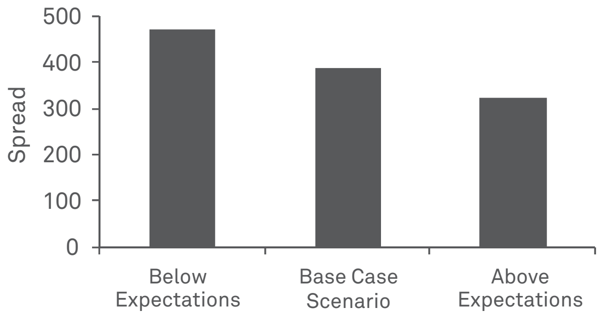


Source: Standish as of March 4, 2014.

High yield bonds are also expected to perform well during the rest of the year. Credit quality remains strong and default rates are expected to remain low. Issuers have been buoyed by the ability to refinance into lower cost debt in recent years, which has improved debt sustainability. We are forecasting a similar level of spread tightening in our base case scenario although our research team believes that spreads could tighten further in a stable market where investors continue the chase for yield. Notice that under all forecast scenarios we are projecting positive total returns for high yield assets. Our team also remains constructive on bank loans and floating rate assets that will, in our opinion, provide an additional cushion for investors in a rising rate environment.

The forecasts that come with the most uncertainty are the ones surrounding emerging market assets.

High Yield Spreads

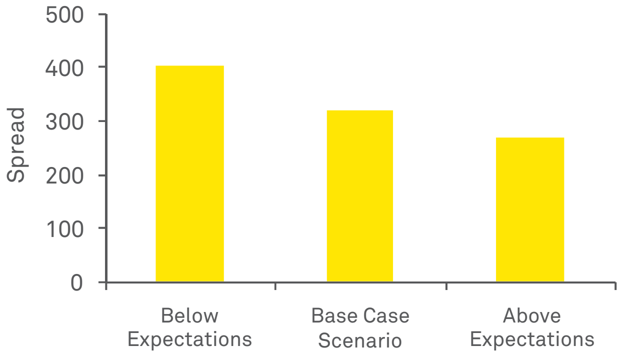


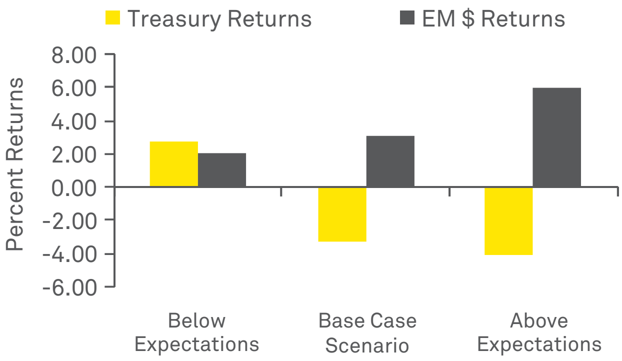
Source: Standish as of March 4, 2014.

EMERGING MARKETS

The forecasts that come with the most uncertainty are the ones surrounding emerging market (EM) assets. We have been highlighting the fact for some time that the asset class is heterogeneous. The EM label is applied to developing economies like Mexico with sound policies and current account surpluses, as well as to those like Turkey with current account deficits and policy/political risks. In addition, the outlook for emerging market returns is dependent on externalities, such as the developed market growth outlook and central bank policy changes. Despite these challenges, most emerging market countries retain considerable policy flexibility and valuations have become attractive as a result of recent underperformance. Returns for EM dollar debt are dependent on both our Treasury return forecasts as well as the outlook for emerging spreads. In our base case scenario, spread tightening and yield carry more than offset Treasury returns forecasts, resulting in a positive return of about 3%.

Emerging Market Dollar



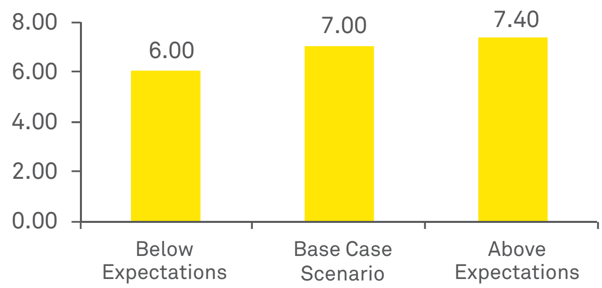


Source: Standish as of March 4, 2014.

EM local currency returns are also positive under most of our return scenarios.

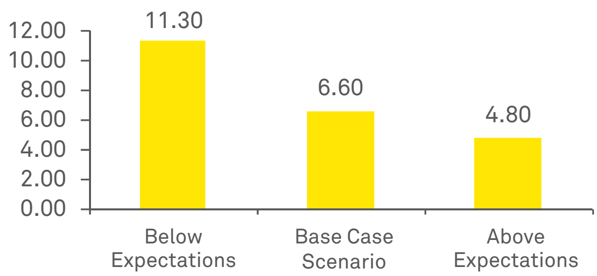
EM local currency returns are also positive under most of our return scenarios. With the development of deep and broad local currency debt markets, EM public sector finances are significantly less vulnerable to currency depreciation than in the past. In addition the movement toward more flexible exchange rates has lessened the risk that recent volatility will trigger a balance of payments crisis. We expect markets to continue to differentiate between countries, credits and currencies. One caveat is that the returns are based on our emerging market growth and inflation expectations and a continuation in emerging risk aversion from investors may continue to negatively impact near term return expectations.

Emerging Market Local Currency Yield Forecast (% Yield)



Source: Standish as of March 4, 2014.

Emerging Market Local Currency Total Return (% Return)



Source: Standish as of March 4, 2014.

WEATHERING THE STORM

Our journey through financial markets in 2014 seems destined to occur on some rough and choppy seas. Yet, forecasts are always subject to unforeseen storms. This year, we have to contend with concerns about growth, significant monetary policy changes and a number of idiosyncratic and political uncertainties. Nonetheless, our base case is for stronger growth in developed economies and stabilization in developing markets later this year.

Forecasts are always subject to unforeseen storms.

Our return forecasts show that despite the possibility of negative Treasury bond returns, there are a number of markets, including high yield and emerging markets, where we expect positive total returns in most scenarios. The recent improvement in peripheral European economies is evident in upgrades in Spain, Portugal and Italy. While peripheral sovereign debt returns were strong last year, we believe that there are more opportunities to capture value in European sovereigns in 2014. As was the case in 2013, we believe an important driver of excess returns will be security selection within sectors and countries, not just asset allocation decisions.

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