

# Global market outlook 2012: Time of reckoning

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# Global Market Outlook 2012: Time of reckoning

2012 looks set to be another year of volatility and uncertainty for investors, as the developed world continues to deal with deleveraging and spluttering growth. Although the Eurozone's debt crisis seemed to reach new heights of urgency in 2011, political leaders are still struggling to find a definitive solution that will preserve the European monetary union's stability and credibility, all while the region slides closer to recession. In the US, the run-up to the presidential election will place debt reduction, job creation and revenue increases front and centre in 2012, though it seems likely that campaigning will crowd out any significant action, even as increased austerity measures bite at the state and municipal levels.

Meanwhile, emerging markets continue to be a beacon of light for global growth, though their growth rates are slowing, and leaders face the delicate task of diversifying their economies away from a heavy reliance on exports to more domestic consumption. Many of these issues could come to a head in 2012, with markets hyper-reactive to new information, both good and bad.

Against this backdrop, BNY Mellon's specialist managers from across our global asset management boutiques reflect on how these forces might affect their specific asset classes and regions in our 2012 Global Market Outlook. We include their views on equity, fixed income, currency, and commodity and real estate markets around the world as well as how investors might think of positioning their portfolios in this environment.

While all acknowledge the bumpy road ahead during this multi-year period of global deleveraging and rebalancing, they point to the opportunities such volatility and uncertainty can create for skilled global investors. We hope you find this collection of perspectives thought-provoking and informative.

**You can also find this collection at  
<http://outlook.bnymellonam.com>**



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## The Great Transition to a new conservative financial era



**Jack Malvey, CFA**  
Chief Global  
Market Strategist,  
BNY Mellon Asset  
Management

*"The economic process (progress) of capitalist society is identical with the sequence of events that gives rise to the business cycle."*

Joseph Schumpeter,  
Business Cycles, 1939

As we head into 2012, the Great Recession and its aftermath linger. Initiated in 2007 and perhaps enduring until 2014-2015 in some form, this early 21st century upgrade of the capitalist model, while painful, is essential to long-term economic progress.

Economic and market outlook caution prevailed at the end of 2011, with good reason. Greece tottered on the brink of default. The fate of the Eurozone and the euro remain unclear. Europe is likely to have drifted back into recession. World economic growth expectations have downshifted. Momentous 2012 elections loom for the US.

And the third millennium has been unkind to global financial asset returns. As shown in the chart, combined world equity and debt average annual returns registered a loss of 0.16% in the nearly dozen years from 2000 through November 2011.

We see 2012 unfolding in the context of the longer-term "Great Transition to a new conservative financial era," which will not be a frictionless epoch. Given the build-up in financial leverage over the last 30 years, a myriad of adjustment-risks needs to be surmounted. But numerous constructive offsets will eventually help push the valuation pendulum into mid-range equilibrium and maybe even

overshoot on the upside for a period. In less than a year, the medium-term economic fate of Europe should be defined, and the 2012 US election outcome will be known.

### **A disappointing 2011 for most financial asset classes**

The Japanese economy was afflicted by a tragic tsunami. In addition, the quadruple combination of the Washington "debt ceiling elevation debate" across a vast ideological divide, the climaxing of the multi-year European debt contagion, the related global economic growth deceleration, and the uncertainties aroused from the application of still to be fully defined regulations, resulted in a generally disappointing 2011 for most risky asset classes. For instance, the performance of the quasi-equity asset class high yield corporates was more in line with equities than bonds, with a scanty 2.26%<sup>1</sup> return in the US and -5.58%<sup>2</sup> in Europe for the 11 months ending 30 November.

The US barely sidestepped a perilous excursion into unprecedented default on 2 August, 2011. Opposite to initial consensus, S&P's downgrade of the US sovereign debt, from AAA to AA+, coincided with a risk-off rally that drove the US yield curve sharply lower and, in conjunction with the Fed's "Operation

1. Source: Barclays Capital Indices (US High Yield), Total Return, in US\$ as at 30/11/11  
2. Source: Barclays Capital Indices (Pan Europe High Yield), Total Return, in € as at 30/11/11.  
3. Source: Merrill Lynch Indices, Total Return, In US\$ as at 30/11/11  
4. Source: OECD

Twist 2.0" announced on 21 September, helped power the 30-year US Treasury to a 30.7%<sup>3</sup> return.

The protracted and incomplete efforts to fully address the European sovereign and banking crisis led to five European government changes, numerous rating downgrades, apprehensions of additional defaults, and contemplation of the once unthinkable, an unravelling of the Eurozone and an end to the euro.

Real estate has not yet bottomed in parts of the world. There seems to be no easy resolution to high structural unemployment in the US and Europe. Directly and indirectly attributable to the Great Recession, a congregation of political and economic anxieties spawned social unrest from Tunisia to Wall Street.

#### **A binary 2012: Onset of healing or Great Recession pinnacle**

A European solution of any substance and familiarity with the outcome of the 2012 US elections could inspire a risky-asset 'boomlet' worthy of 2009. Alternatively, Eurozone upheaval and subsequent economic downturn for the rest of the world could lead to another difficult year ahead.

Europe most likely slipped into recession during the fourth quarter of 2011. The

magnitude and duration of this continental economic plunge are difficult to gauge until the sovereign and financial institution debt crises have been resolved.

The spectre of a European contagion prompted the downward revisions of global economic forecasts. For example, the OECD now sees only 1.6% growth in 2012, compared to a growth expectation of 2.8% in May 2011<sup>4</sup>. After a second half rebound in 2011, the US economy may decelerate again in 2012. And although sporting consensus growth outlooks in the mid-8% area for 2012, the familiar China hard landing conjecture (5% or less growth) by the mid-teens has re-emerged.

In our view, European policymakers ultimately will solve their debt problem. The solution will involve some combination of a fast-track fiscal union pact, vast ECB intervention, further IMF assistance, implementation of backed funding from the European Financial Stability Facility, and the introduction of Eurozone-wide government bonds. This resolution may not be quick enough to forestall further rating downgrades. And to ensure funding access, the ownership of some European financial institutions may require some reconfiguration.

This deceleration of global economic growth, coupled with a re-appraisal

of the growing gap between pension fund assets and liabilities in a low interest rate environment, will likely pinch corporate profits. To demonstrate their conservative acumen and responding again in pro-cyclical fashion, the number of rating agency downgrades is likely to increase.

Despite these fundamental headwinds, equity valuations may generally rise in 2012 on the prospect of a European resolution, a favourable and rare dividend yield advantage to meagre bond yield coupons, dividend growth, equity buy-back demand, merger and acquisition increase due to cheap funding and a strategic desire by many firms to reconfigure and, most importantly, an allocation shift away from bonds to equities, given the anaemic return prospects for high-quality bonds.

Central banks again may hit the monetary policy accelerator in 2012. The welcome peaking of inflation, partially thanks to lower commodity prices, already has prompted many developing nations to revert to an easing mode.

I believe markets will remain tactically unpredictable, highly volatile, and highly correlated in 2012, especially with unprecedented government stimulus largesse.

# The Great Transition to a new conservative financial era **continued**

## **The Great Transition to a new conservative financial era**

Systemic uncertainties, especially in financial services, have bred a well-intentioned and partially errant quest by regulators to attempt to suppress instabilities through additional oversight. Policymakers have switched from a minimalist, “do not tamper with legal market activities” approach to a cautious, prophylactic philosophy focused on sound banking rules, high capital requirements, liquidity fortification, and malfeasance identification. “Expected risk” and “tail-risk investigations” now take precedence over “expected gain.” The first question has often become “what can go wrong?” rather than “what’s the upside?” The maintenance of liquidity and the minimisation of valuation volatility have risen in the financial decision-making checklist. The application has entailed the pursuit of prosperity through fiscal austerity which is consistent with a de facto repudiation of Keynesian economics.

Government deficits may retreat in the face of higher taxes (in some nations), lower entitlements, and a reappraisal of many governments’ international and domestic obligations. Both financial and non-financial firms should be better capitalised, more liquid, and reticent about capital spending and hiring.

Assigned more responsibility for financing their retirement and health care costs, individuals will be forced to save more. The slow revival of residential real estate will hinge on real cash down payments, verified proof of income, and rational loan-to-value ratios.

Except for ETFs, next-generation contingent bank capital structures and Islamic finance, new financial product innovation has largely stalled since 2007. Securitisation and derivitisation have

regressed into the plain-vanilla methods of the 1990s. The inevitable resurrection of innovation will likely be accompanied by more stringent pre-testing.

A multiple-generation escalation of financial leverage in all forms has crested and begun to recede. While undeniably a benefit in our view, globalisation acceleration comes with a price. Emerging economies are rapidly converging to advanced economy status through their ascent up the production value chain.

Outlook horizons rarely have been longer, and, for all financial institutions, risk culture seldom has been more wary. Risk vigilance has been possibly permanently enhanced.

In our view, this Great Transition will revamp the global financial system. Virtually all financial institutions will be inclined to modify their methods to varying degrees. Regulators will be keen to enhance their risk detection capabilities, mitigate the risk of sudden liquidity evaporation and valuation plunges as in “flash crashes,” and identify and address malfeasance.

This multi-year transition will exert a powerful influence on the trajectory of global capital market parameters and the evolution of asset management methodology. Ironically with the arrival of a new financial conservatism, well-below average interest rates and the accompanying prospect of low absolute returns for high-quality government bonds may stimulate risky-asset demand for all grades of corporate, securitised, and especially emerging market debt. In anticipation of an eventual escalation of interest rates, perhaps most prematurely in light of the long Japanese experience, generic asset allocation is likely to favour equities over bonds. In

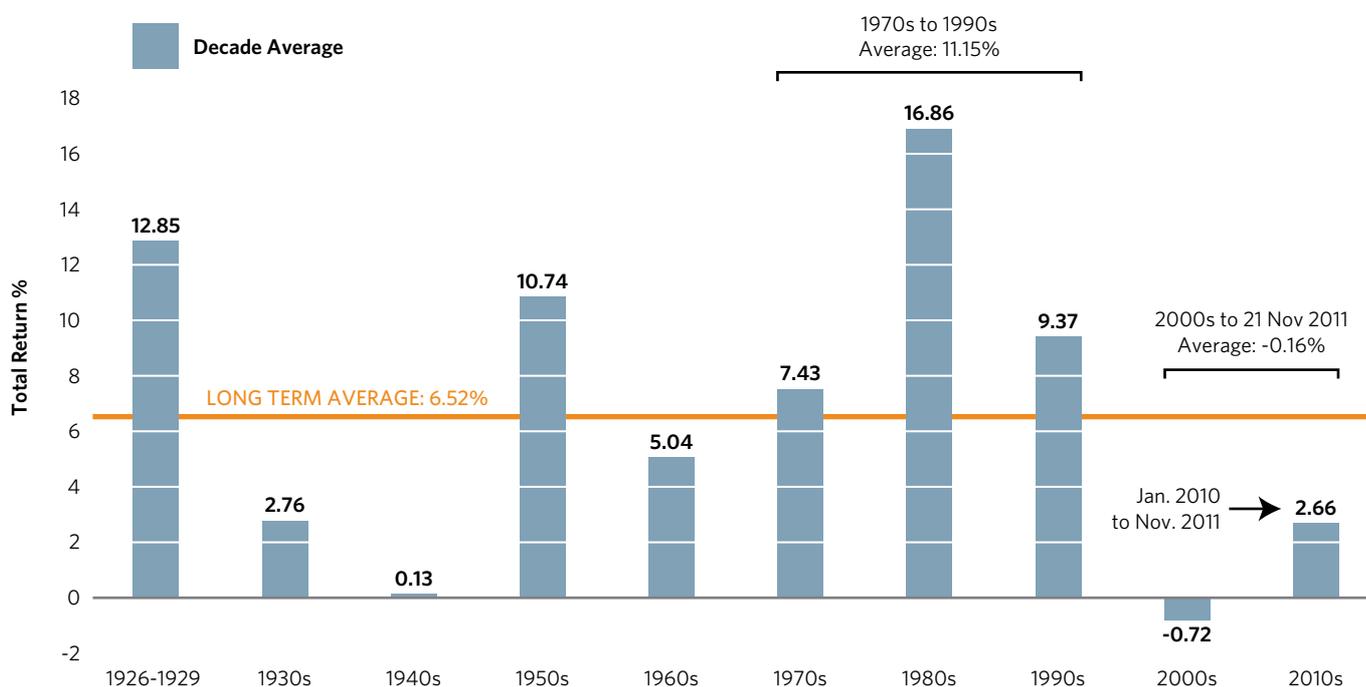
search of higher returns, sophisticated investors may pursue all segments of the alternatives universe. Plan sponsors, central banks, sovereign wealth funds and endowments will continue to strive for higher risk-adjusted returns as evidenced by the gradual globalisation and asset class range extensions of the portfolio management menu.

## **Toward a sturdier global financial system**

Conservatism alone will not immunise the global financial system from future setbacks. Structural adjustment frictions will not dissipate. Geopolitical risks never vanish. Business cycles persist and will possibly feature shorter-duration amplitudes and high volatility. Complete global financial, accounting, environmental, tax, and regulatory harmonisation remains a distant goal. The eventual abatement of massive monetary and fiscal stimulus by the mid-to-late teens may spur a minor, temporary growth retreat and cut systemic liquidity. Some risk complacency will cyclically reoccur when markets enjoy a long spell of relative calm.

This re-sculpting of the global financial system into a sturdier, conservative edifice is intended to reduce the chances of mishaps, especially along the instigating vectors of the late 2000s and early 2010s. Future economic historians may well cite the evolutionary-stimulative consequences of the Great Recession as a more important legacy than the containment of its numerous catalysts. A robust, generally stable, efficient global financial system underpins world economic progress. In our view, this early 21st century upgrade will reinvigorate strategic confidence, augment capital-raising, sharpen capital allocation, spur innovation, unleash new asset management methods, and help speed global economic growth.

## GLOBAL FINANCIAL ASSET RETURNS BY DECADE



## PERIODIC COMPOUND AVERAGE ANNUAL GROWTH RATES (%)

	1926-1999	1946-1999	1970-1999	1990s	2000s	2010-Nov. 2011
Global Equity	9.64	11.19	12.11	9.09	-2.60	-0.53
Global Bond	4.84	5.56	9.22	8.08	5.86	4.52
Global Financial Asset	7.64	8.75	11.15	9.37	-0.72	2.66

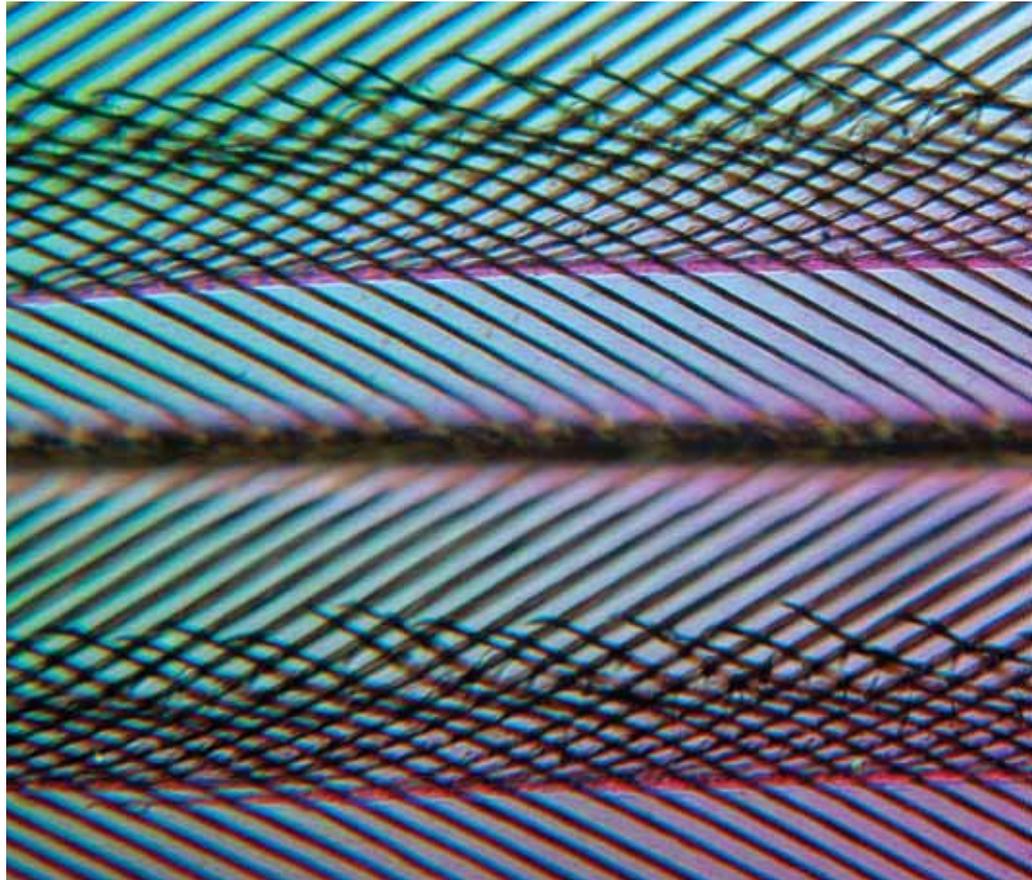
  

	1950-1999	1980-2011
Global Equity	12.45	8.07
Global Bond	6.39	8.50
Global Financial Asset	9.82	7.90

**Global Equity:** Data provided by Global Financial Data, a provider of historical market datasets and indices as described at [www.globalfinancialdata.com](http://www.globalfinancialdata.com), from 1926 to 1987; MSCI Hedged-World U.S. Dollar Index from 1988 to 2011. **Global Bond:** Data provided by Global Financial Data from 1926 to 1989; Lehman Global Aggregate Index from 1990 to 1998; Lehman Multiverse Index from 1999 to 2003; Lehman Multiverse Plus Index from 2004 to 2008; Barclays Capital Multiverse Index from 2008 to 2011. **Global Financial Asset:** Equally weighted average return of Global Equity and Global Bond from 1926 to 1989; market-value weighted average return from 1990 to 2011. U.S. Dollar hedged after 1990. Financial asset total return series begins in 1926. Please see appendix for index definitions. Source: BNY Mellon Asset Management using data from Lehman, Barclays Capital, Bloomberg, Global Financial Data, OECD, and MSCI.

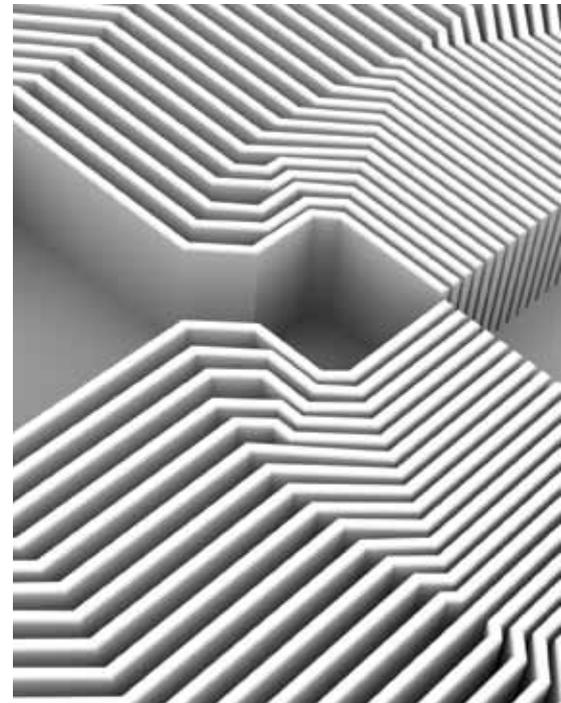
"...it is important to remember in our view that markets are not the same thing as economies. A large number of European companies currently enjoy rates of borrowing below that of their domestic banks, and, in some case, even their sovereigns."

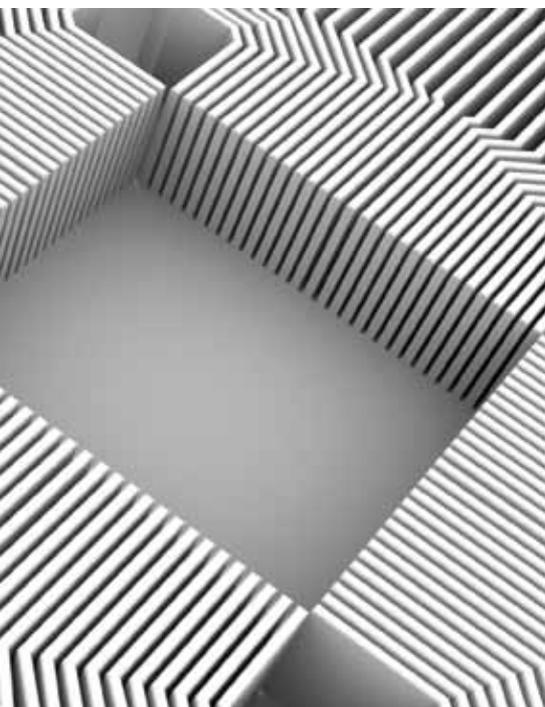
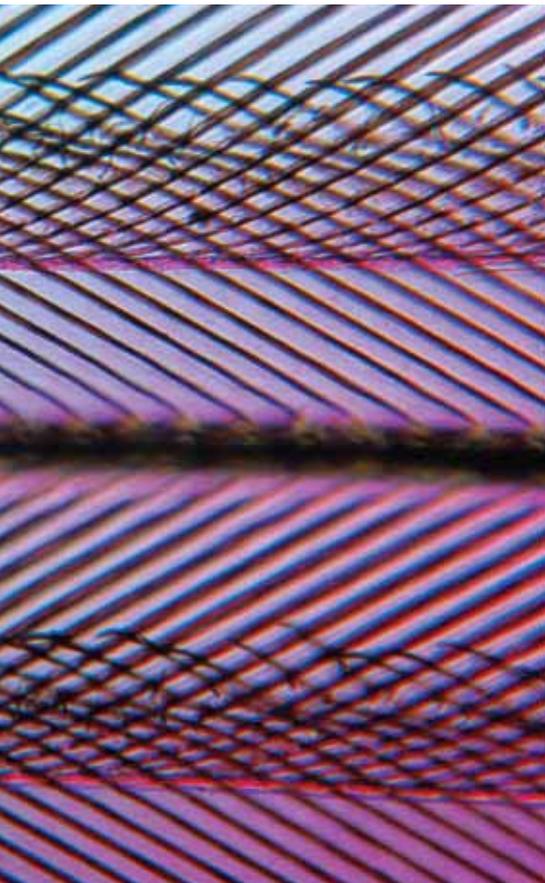
Raj Shant, Newton



"We think parallels to 2008 and fears of a double-dip recession in the US have been grossly exaggerated. Simply put, the US does not have the excesses (e.g., inventory, capital spending and hiring) now that existed four years ago."

Brian Ferguson, The Boston Company





# Equities

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## Navigating choppy waters



**James Harries**  
Head of Global Equity  
Income Strategy,  
Newton

Newton Investment Management Limited (Newton) is based in London, and recognised as a top-tier UK investment house, renowned for its distinctive, proven global thematic investment approach, consistently applied across all strategies.

**NEWTON**  
The Power of Ideas

We have emphasised that, in a world in which deleveraging has become so prevalent, investors should prepare for an extended period of slow economic growth, low investment returns and elevated volatility in financial markets. Within this context, we have expected that, as policymakers sought to counteract the effects of deleveraging with highly accommodative policies, investor sentiment could oscillate wildly, creating “mini-cycle” environments, which we anticipate could last for many years.

Since the first stages of the global credit crisis in 2007, our expectations have broadly come to fruition: “risk-on” phases of cyclical enthusiasm have tended to be followed by “risk-off” periods in which intractable structural challenges, caused by the surfeit of debt in many major developed economies, have reasserted their influence. 2011 was no exception: data indicate generally that economic growth is anaemic in the West and moderating in higher-growth, emerging economies.

There is significant risk that ultra-low rates serve simply to confirm to wary consumers and investors that the outlook is poor. Moreover, banks make a significant proportion of their profits by lending ‘out’ along the yield curve;

flattening that curve with tactics like Operation Twist, in the US, is likely to reduce these profits and make the industry less willing to lend to the real economy. In Europe, investors are increasingly aware of the huge gulf in expectations between what the markets, media and even the US administration believe can be achieved in order to solve the debt crisis, and what is practically possible within the strictures of the 17-state single-currency union.

### Eastern promise?

Asian and other developing world economies have for many years been viewed as the world’s growth engines. The longer-term case for rising living standards in relation to the developed Western economies is well-established. However, this trend of global realignment is likely to be highly volatile. Rebalancing domestic economies is difficult; much of the adjustment is likely to occur through changes in the value of currencies, either externally (via the exchange rate) or internally (by differences in inflation rates). Moreover, much of the developing world’s industrial base still depends on demand in the “rich” West; we do not believe that either developing-world economies or their capital markets can “decouple” from the developed world’s trends for any extended period.

1. Thomson Reuters Datastream, 30 September 2011

After the first stage of the global credit crisis, China responded with a large forced injection of capital, raising investment to over 50% of GDP.<sup>1</sup> China now has the world's second largest economy, and manipulation on this scale is not without significant risks. It could have dangerous inflationary implications, and entail capital misallocation, potential asset-price bubbles and significant levels of bad debts in the banking system: this is the basis of Newton's 'Chinese influence' theme. Concerns about China's economy appear to have moved from a "tail risk" to a major market preoccupation. While China's policymakers attempt to tackle the inflationary implications of the last credit expansion, their ability to stimulate the economy further may be curtailed.

**Thematic thinking**

The sheer scale of indebtedness has rendered many economies unusually vulnerable, ensuring that 'State intervention', with all its distortions,

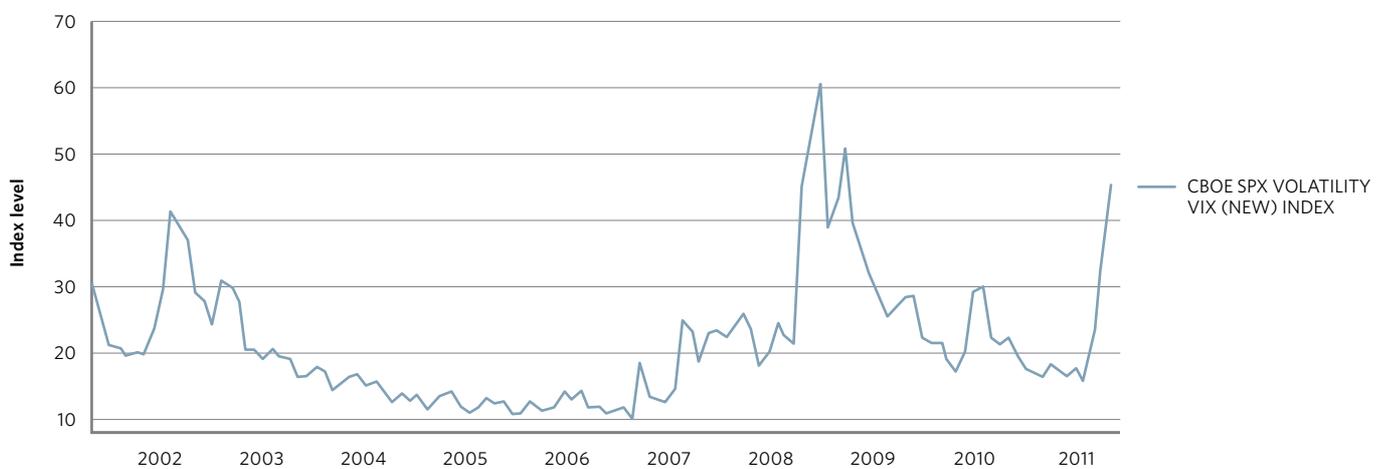
remains a key theme at Newton as countries, institutions and individuals struggle to deleverage. "Risk-free" interest rates need to be maintained at extremely low levels if current debts are to be sustainable. This kind of manipulation, combined with safe-haven flows out of large bond markets, has forced yields still lower in the higher-quality markets; in the majority of leading economies, real (inflation-adjusted) government bond yields are now miniscule or even negative at most maturities.

We continue to believe that the best "each-way" opportunities are still to be found in high quality dividend-paying equities that have growth potential, and in corporate debt markets. Among equities, we continue to favour strong business franchises in classically defensive sectors such as healthcare, telecoms and non-cyclical consumer areas such as food producers. We are also identifying strong franchises with attractive characteristics

in areas such as the technology sector (as depicted by Newton's 'Networked world' and 'Smart' themes), and among agriculture-related stocks (in the context of our 'Earth matters' theme). In relation to commodities and energy, there are strong supply-driven reasons to have exposure to these areas, but violent swings in sentiment will render them highly volatile. We expect that policy is likely to default to money printing if recession looms. This suggests strongly that gold may provide a hedge against monetary debasement.

An important message being sent by ultra-low interest rates is that, to achieve an acceptable real return, investors must assume more risk; we must, however, distinguish mark-to-market volatility from the genuine risk of suffering a permanent diminution of value. We continue to believe that the perspective provided by our thematic approach and investment process will help us navigate these risks.

**US EQUITY MARKET VOLATILITY (VIX)**



Source: Thomson Reuters Datastream, Chicago Board Options Exchange SPX500 Volatility Index, September 30, 2011.



EQUITIES GLOBAL



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## Focusing on strong companies in challenging times



**Francis Sempill**  
Investment Manager,  
Walter Scott

Walter Scott & Partners Limited (Walter Scott) is a global equity investment manager serving institutional investors worldwide, including pension plans, foundations, public funds and financial organizations. It sub-advises a number of mutual funds and equivalent vehicles in the USA, Canada, the UK, Europe and Australia. This manager is based in Edinburgh, where it was established in 1983.

**Walter Scott**  
Global Investment Management

We expect 2012 to be another eventful and challenging year for many financial markets, as the deep-rooted political and economic problems of 2011 will likely require years to resolve. Continued uncertainty in the Middle East and Northern Africa following the regime changes witnessed in 2011 is to be expected and the crippling political stalemate in the US is likely to continue through next year's election cycle, with the absence of any credible plan to deal with the serious and growing debt situation. Meanwhile, an ongoing state of crisis across the Eurozone continues to be exacerbated by the EU's apparent structural inability to make difficult decisions within a reasonable timeframe.

With a 24-hour news cycle repeatedly telling us all how bad things are, it is not surprising if some investors become rather morose. However, because we, at Walter Scott, are dedicated to identifying and staying with strong companies around the world, we feel rather more optimistic, especially from a long-term perspective. While the macroeconomic challenges and uncertainties cannot be ignored, we believe that leading companies with dominant market positions, robust balance sheets and strong cash generation to fund growth should have the potential to not

simply survive, but thrive in such an environment.

Our day-to-day conversations with the management of companies across all regions and most sectors continue in the main to be positive about the long-term prospects. In tough market conditions, our view is that market-leading companies with strong fundamentals can not only potentially take share from weaker competitors but also invest for future growth. In our view, limited debt and strong cash generation are among the most important criteria to look for in any investment. We believe it is those characteristics that allow companies to act from a position of strength to adapt to changing circumstances.

In terms of sectors, pressures upon the consumer are mounting. It may take years for many consumers in the developed world to free themselves from accumulated debt, particularly without any meaningful recovery in real estate prices. But that is not to say consumer spending will cease altogether. We believe discount retailers and other retailers at the value end of the market should benefit, as consumers trade down and limit discretionary spending. Our view is that this limited discretionary spending is more

likely to target products with strong brand identity and trust. For product purchases reserved for more special occasions, we believe the growth of the smart phone and tablet markets show very simply that with the correct product, there will be demand despite low consumer confidence and challenging economic conditions.

While Walter Scott's focus has always been and continues to be directed at the long-term investment outlook for each individual company, short-term pressures cannot be dismissed. Very few companies can remain immune to the broader macroeconomic environment. Even for an industry-leading, cash-generating company, we believe concerns about

the economy will creep into strategic and business decisions. In that regard, our belief is that consensus earnings estimates for 2012 seem high and could lead to disappointment if missed.

Moreover, continued marked swings in markets, which caused periods of consternation in 2011, are likely to have a negative impact on corporate confidence. With market uncertainty added to uncertainty about financing and end demand in slowing economies, CEOs might begin to delay investment decisions and feel the need to conserve cash. In 2011 we saw a number of high-profile corporate takeovers and a step up in share buyback activity and dividend

payments. But, not surprisingly, many companies have already begun to apply a higher hurdle rate to investment decisions. With a doubtful outlook for 2012 and the liquidity crisis of 2008 still entrenched in the minds of corporate management teams, cash continues to be regarded as a strategic asset.

As a result, we see little reason to expect confidence in markets to be fully restored during 2012. Against this background, we believe investors may benefit by being focused on seeking companies with the financial strength and strategic advantages that will allow them to create wealth over the long term in up and down markets.

## 2011: A VOLATILE YEAR FOR GLOBAL EQUITY MARKETS



Source: Thomson Reuters Datastream, 31/12/2010 to 23/11/2011, total returns, US dollar terms.



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## Brightening prospects for US equities



**Brian Ferguson**  
Director U.S. Large  
Value and Senior  
Portfolio Manager,  
The Boston Company

The Boston Company Asset Management, LLC (The Boston Company), based in Boston, uses a bottom-up approach to stock selection, blending quantitative screening with fundamental research. The manager covers value, growth, core and market neutral strategies.

THE BOSTON COMPANY

ASSET MANAGEMENT, LLC

We embrace an optimistic and perhaps contrarian view of the US equity markets heading into 2012, while being mindful of the risks. Amid the decidedly negative global headlines that defined 2011 including the European sovereign crisis, US credit downgrade, China slowing, Japan's natural disaster and Middle East/Northern Africa unrest, who would have guessed that the S&P 500 Index would be in positive territory for the year? In our view, what is lost among those sensationalised headlines and sharply negative investor sentiment are an increasing amount of US macro- and micro- economic data points and leading indicators that are increasingly positive.

### Fears of US recession yield to growth indicators

We think parallels to 2008 and fears of a double-dip recession in the US have been grossly exaggerated. Simply put, the US does not have the excesses (e.g., inventory, capital spending and hiring) now that existed four years ago. Business fundamentals are solid, company balance sheets are healthy, banks are well capitalised, and consumer spending remains on trend.

Moreover, leading economic indicators for US GDP growth are increasingly positive, including, for example, the Empire State Manufacturing Survey, the Philadelphia Fed Survey, PMIs, the Citigroup Economic

Surprise Index, ISM, bank loan activity surveys, and investor sentiment surveys as well as stock market performance itself. The major driver behind these economic green shoots is a reversal in global inflation expectations. In addition, easing efforts have only just begun in most parts of the world, and in our opinion, the related economic benefits should prove to be substantial and sustainable.

Of course, Europe remains a wild card, and US investors must continue to monitor developments there closely. Resolving the Eurozone's fundamental contradiction of imposing a single currency upon countries with vastly different fiscal and structural conditions is proving to be extremely challenging. In what is to us the unlikely event that there is a total collapse of the Eurozone, and global financial markets seize up as a result, the US wouldn't be immune and could be dragged into a recession. However, we believe such a US recession would likely be short and shallow.

Our view is that such an outcome, while possible, is not probable. We are optimistic that Eurozone crisis levels have intensified to the point where a comprehensive solution will soon be unveiled, greatly reducing that source of tail risk. It is also important to point out that trade with Europe constitutes a relatively small share of the US economy.

1. Bloomberg as at 12 November 2011  
2. TBCAM, Bloomberg data as at 1 December 2011  
3. National Association of Home Builders, 16 November 2011  
4. Thomas J Lee, North American Equity Research, JP Morgan, 17 November 2011  
5. Bloomberg, 23 November 2011  
6. Strategas Research Partners, LLC, 31 October 2011  
7. Ned Davis Research, 30 September 2011

### Strengthening US consumer

In 2011, consumer survey data remained weak for much of the year, while actual behaviour and consumer spending were remarkably strong. As of early December 2011, signals from holiday shopping activity suggested potential further improvements in consumer spending for 2012. Here, too, leading indicators are encouraging. Consumer survey data have been improving, and while the unemployment rate remains stubbornly high, weekly unemployment claims have been trending lower. By the end of 2011 they were nearing the critical four-week average of 400,000 per week (claims below 400,000 generally suggest an improving employment picture)<sup>1</sup>. Moreover, fuel prices fell by 15% in 2011 from a peak of US\$4/gallon<sup>2</sup>. While the end of 2011 saw an uptick in oil prices, we believe we will see lower fuel prices for longer, given a continued increase in refining capacity worldwide along with the improved ability of US refineries to access cheaper US and Canadian crude oil supplies. This fuel price relief has real and immediate benefits to consumers and is often likened to the effect of tax cuts.

### Signs of stabilising for US housing

US housing is also showing positive signs, with sales volumes increasing, inventories and vacancies decreasing, and building permits on the rise. As of the end of 2011, builder sentiment was at the highest level in almost four years<sup>3</sup>. In addition, non-distressed home prices have recently diverged from distressed

ones and are trending higher, a necessary development for unleashing pent-up demand and spurring a strong spring 2012 selling season. Given the close connection between housing, jobs and GDP growth, these positive signs in housing are important. According to one estimate, for every 250,000 homes built, one million jobs are created and GDP growth improves by 0.75%<sup>4</sup>. As of the end of 2011, annual housing starts in the US were still 500,000 below normal. Thus, a reversion to the mean in housing starts would have a profoundly positive impact on the US economy. We believe the likelihood of that will increase during 2012.

### Attractive fundamentals and valuations

Our bullish view on US equities in 2012 is also informed by extremely attractive valuations as of the end of 2011 and strong fundamentals among many S&P 500 companies. As of late November 2011, the S&P 500 Index was trading at 11 times operating earnings with a dividend yield greater than the 10-year US Treasury<sup>5</sup>. That yield premium over US Treasuries has not occurred since the 1960s<sup>6</sup>. Moreover, interest rates are at very low levels and inflation is controlled and moderating. This confluence of conditions is very favourable for US equities. Of course, not all US stocks are cheap, and it could be argued that high-yielding, economically insensitive securities are trading at bubble-like, record-high valuations. However, considering the decreasing correlations and single-digit valuations with other stocks, we believe

skilled stock pickers can find attractive opportunities.

As we head into 2012, we recall that company earnings reports from the third quarter of 2011 were generally very encouraging, with many upside surprises in terms of earnings and revenue growth. S&P 500-listed companies in general reported record levels of earnings, free cash flow, and cash levels in 2011. As a result, many US blue chips are now rivalling or exceeding the capital strength of many governments.

US companies are also sending a very bullish signal in terms of increased insider buying and dividend increases. We regard the latter as particularly significant, because if managements thought earnings were peaking and the future uncertain, they would likely distribute excess capital via one-time events such as buy-backs or special distributions. However, in the last year, more than half of the S&P 500 companies have raised their dividends, signalling a high degree of visibility and conviction in their outlook.<sup>7</sup>

We believe the risk to reward profile for US equities in 2012 is markedly skewed to the upside as valuations and sentiment provide a floor, while absolute and relative business momentum offer meaningful potential. Markets love to climb a wall of worry. And it is from these very same worries and risks we believe some of the biggest opportunities might ultimately emerge.

**S&P 500 INDEX DIVIDEND YIELD MINUS 10-YEAR US TREASURY YIELD (BASIS POINTS)**



Source: Strategas Research Partners, LLC.



BNY MELLON  
ASSET MANAGEMENT

## Opportunities abound despite economic headwinds



**Ben Russon**  
Investment Manager  
- UK Equities, Newton

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**NEWTON**  
The Power of Ideas

As the sovereign debt crisis continues to alter the political landscape of Europe, it serves as a timely reminder of the position the UK finds itself in as we enter the New Year. As Continental European leaders battle to save the single currency project, it could be argued that the UK is further along the path of adjustment that is necessary to reflect the new economic reality.

We have had our change in political leadership, austerity measures have been announced, and their painful implementation has begun. This is most starkly evidenced by the pick-up in public sector unemployment and the increased prevalence of public protest, both trends that are likely to continue as we move forward from here. It is worth remembering that there are structural factors that separate the UK from the greatest challenges facing the Eurozone economies. Most importantly, the UK has an independent floating currency that can depreciate (and has depreciated) to improve international trade competitiveness, boosting the potential for export-assisted growth. The Bank of England has both the autonomy and the mandate to provide ultra-loose monetary policy in the form of exceptionally low interest rates and is also influencing the supply of money through quantitative easing.

The UK also has a relatively flexible labour market, which facilitates more rapid, although still painful, economic adjustment. These factors, alongside a perception of the UK as a relative safe haven, has seen UK Gilt yields reach their lowest levels in several decades. This situation has profound consequences for investors, the government, and the corporate sector. However, if the UK were to lose the faith of the global bond markets then the outlook could deteriorate markedly from here.

### **Dangers persist**

Of course, despite the relative advantages outlined above, it is hard to argue that all is well in the UK economy. For one thing, Europe is by far its most important trading partner. Globalisation and banking contagion ensures that their problems are also our problems. Meanwhile, regardless of the situation in Europe, deleveraging suggests that the trend growth rate for the economy will be structurally lower than that enjoyed in the years prior to the 2008 credit crisis. This is illustrated in the chart by the shallow trajectory of GDP growth as we have emerged from the recession, as compared with previous recovery phases.

If the new trend GDP growth rate is not that far above zero, any weak quarter of activity will produce a flat or negative

data point, fuelling fears of a renewed economic downturn, which in turn impacts volatility in financial markets, consumer confidence and corporate investment decisions. There has been much talk of a “double-dip” recession and it is unlikely these fears will dissipate for some time to come.

Meanwhile, commodity price pressures were the main driver of the heightened inflation in recent times and this burden should ease as we look ahead. Given the downside risks to growth and the ongoing absence of wage inflation, it is likely that UK interest rates will remain unchanged as we move through 2012. With this in mind, we believe that negative real interest rates will continue to be an issue for UK-based investors.

**A focus on income**

Despite these macroeconomic challenges there are factors that are supportive of UK equities. As investors seek to protect the real value of their wealth, the dividend yield available on many high quality companies with undemanding valuations offers a compelling alternative to the

returns available on “risk-free” assets. These cash returns are supported by the fact that, on the whole, corporate balance sheets are in much improved positions as management teams have learnt the lessons of excessive borrowing, cut costs and focused on debt reduction. Not only does this diminish the downside risk to share prices in the event of an earnings shortfall, it also increases the availability of capital to be returned to shareholders. This can occur either directly through increased dividend payments and share buybacks or, as has been witnessed more recently, a pick up in merger and acquisition activity.

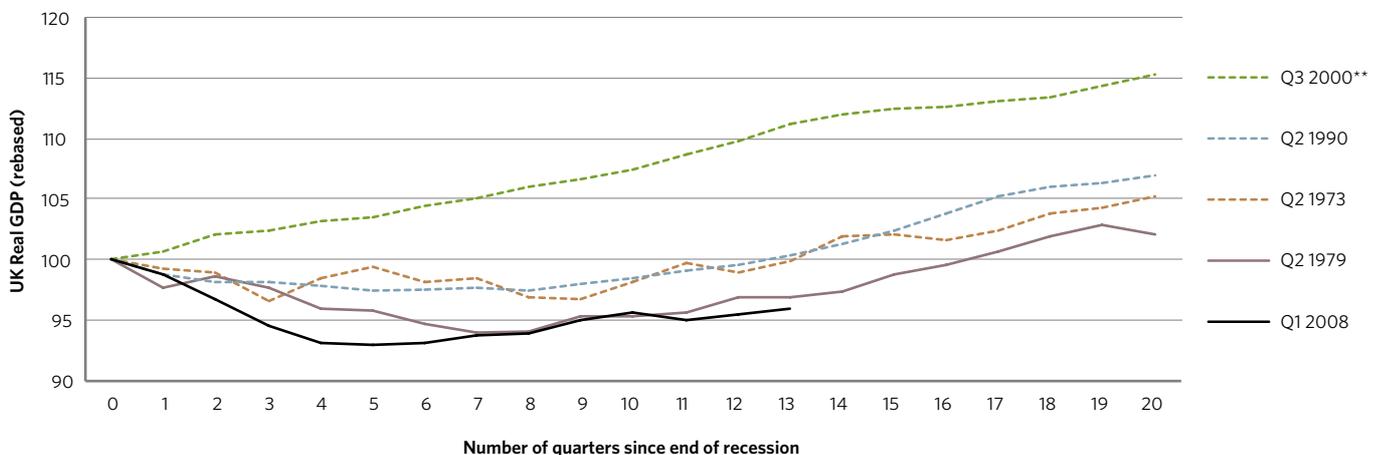
Even as the headline rate moderates, the continued inflationary backdrop can be beneficial for equity markets. There are companies and industries that have the ability to pass through input cost pressures and as such can be viewed as being able to offer investors inflation protection. Elsewhere, as is often observed, the UK equity markets offer global investment opportunities and the benefits of geographical diversification

are magnified as economic fortunes diverge. Active portfolio management becomes increasingly important in an era of anaemic growth in the Western world and heightened volatility in financial markets.

Having devalued significantly during 2008, sterling-denominated assets may look increasingly attractive to international investors, particularly when set against the travails impacting Europe. Although a strengthening pound produces a headwind to those companies with overseas earnings, asset allocation towards sterling assets underpins the demand profile for UK equities.

Bringing all of this together, we take the view that UK equities do offer the potential for further returns from here, but the road may well be bumpy and there are several risk factors that must be kept in the forefront of investors’ minds. Nonetheless, there remain attractive investment opportunities in good quality companies with business models well placed to navigate the current environment.

**UK ECONOMIC RECOVERIES FROM RECESSION: LOW GROWTH ENVIRONMENT IS HERE TO STAY?**



Source: Bloomberg, Newton, November 2011 \*\*2001 was not officially a UK recession



BNY MELLON  
ASSET MANAGEMENT

## Dangers and opportunities in a highly correlated world



**Andy Cawker**  
Head of Specialist  
Equities, Insight  
Investment

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



The past few years have borne witness to some of the most volatile market conditions in a generation. What started out as a credit crisis has now become a sovereign debt crisis. This is because governments which supported failing institutions have themselves become overly indebted as a result. Furthermore, the need to reduce government debt through austerity budgets is now hampering economic output in Western economies and reducing their ability to grow out of the problem. Markets continue to lurch from extreme pessimism around the resulting outlook for global demand to naïve hope of a political resolution. A defining feature of these volatile market conditions has been extremely high correlations within and across investment markets. High correlations are the product of extreme uncertainty, which in itself has real world and financial implications and presents both opportunities and dangers for investors.

### Implications for the real world

One of the key consequences of today's economic uncertainty is that companies are inevitably strengthening their balance sheets relative to history. This is not only to help insulate businesses from any future economic shocks, but is also a direct consequence of their

own uncertainty about the outlook and consequent reluctance to invest for future growth. This in itself then is unhelpful for the economy as it further subdues corporate expansion and employment. From a more positive standpoint, however, their low levels of debt mean that companies will have plenty of firepower to invest once the economy improves. What we also see is that economic uncertainty impacts consumers. The relentless stream of worrying headlines, news stories and resulting job uncertainty leads to belt-tightening and consumers trying to pay down debt, fearing worse times ahead.

### Implications for stock markets

From a stock market perspective, the main consequence of extreme investor uncertainty is that correlations rise within equity markets. This comes about as all stocks and sectors are sold down together, regardless of their underlying fundamental strength. Investors wanting to reduce or hedge exposure to a deteriorating market outlook look for liquidity as fear increases. This process has occurred in sharp sell-offs in each of 2008, 2009, 2010 and 2011 as liquidity in markets fell and investors redeemed stocks indiscriminately. The chart shows how correlations have risen at the same time as sharp market falls over the past five years.

The benefits of diversification from different stocks and sectors are therefore dramatically lower during these episodes. However, periods of indiscriminate selling can provide significant opportunities for active long/short equity managers to benefit from subsequent differentiation between winners and losers. Ultimately, these periods of highly correlated stock performance are short-lived, as fundamental company results and performance play out.

**Implication for asset classes**

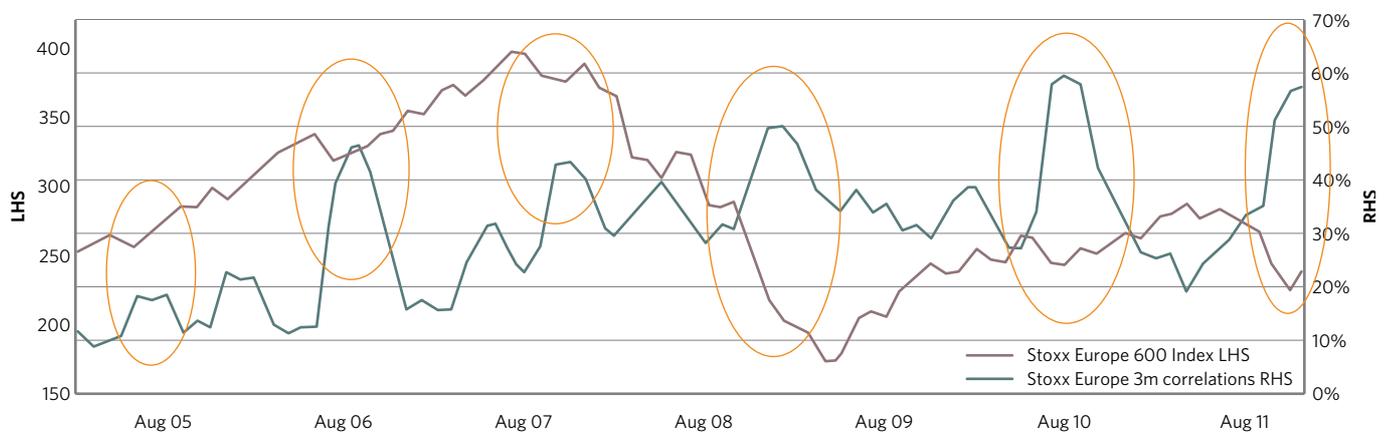
What we have seen more recently is that correlations also rise across different asset markets, with asset performance

being driven by the risk-on / risk-off trade. Investors have had very few options as they look for uncorrelated performance to help genuinely diversify and improve the efficiency of their portfolios. Only cash, gold, selective government bonds and safe-haven currencies such as the yen have proved to offer such attributes. This in itself represent a paradox: one could argue that none of these assets look fundamentally attractive from a valuation or yield perspective. As a result, the benefits of a traditional diversified portfolio have been dramatically reduced and investors are faced with an unenviable choice: opt for a traditional spread of assets and accept that the resulting

portfolio will not be as diversified as one might like, or choose to have a high weighting in true safe-haven assets and sacrifice the potential for decent long-term capital growth.

The uncertain economic and market environment highlights the importance of having a significant part of a portfolio dedicated to uncorrelated investments. Genuine absolute return funds should be able to fulfil this role. These funds have the potential to provide investors with the best of both worlds, as they can help protect capital as markets fall and also be well-placed to benefit from the resulting fundamental opportunities that exist between stocks and sectors.

**EUROPEAN MARKETS VS STOCK CORRELATIONS**



Source: Credit Suisse Holt, 31 October 2011.



EQUITIES EUROPE



BNY MELLON  
ASSET MANAGEMENT

## Eurozone crisis brings opportunity



**Raj Shant**  
Investment Leader  
European Equities,  
Newton

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We start 2012 almost two years into a mounting European sovereign debt crisis. During this time, we have seen contagion pass from Greece to Ireland, on to Portugal, and back to Greece. While each in turn was forced to accept a loss of market access and resulting help from external authorities, for the fourth country, Italy, it's different. The magnitudes are much higher, the potential disruption to wider global economies much greater - only Italy can save itself. The market has now become focused on this next game-changing domino as Italian 10-year sovereign bond yields flirt with record highs. However, change is afoot. Political change has arrived and the crisis in Europe has reached a new phase.

It is important to be clear that Europe is not Japan. It does not have the luxury of 20 years of gentle decline; the outcome can only be binary. For our part, we continue to believe that the European currency project has brought benefits to all involved. There remains huge political will behind the single currency which remains, after all, the world's second reserve currency.

### **A new dawn?**

The agenda of European policymakers has at last undergone a fundamental change; sticking plaster solutions are no longer enough, debtor countries

must be forced into radical reforms. This new hard-line approach was never more evident than in the move to suspend further monies from the European Financial Stability Facility (EFSF) to Greece in response to its shock call for a referendum on the essential bailout.

Germany is now accepted as the European Monetary Union (EMU) leader and fiscal consolidation and reform will move further. Even France has let go of any pretence of a Franco-German rule and is taking action, with President Sarkozy introducing a new, tougher austerity package just months before the next presidential election. The EMU is not one of equals. After a decade during which the Eurozone took advantage of Germany's low interest rates, now high interest rates are pushing the peripheral countries to restructure and restore competitiveness.

Accordingly, economic growth, which is expected to remain fragile across the region, will bifurcate, reversing the pattern of the 2000s when the periphery outgrew the core. However, for those countries doing the "right thing" the European Central Bank (ECB) and the creditor countries will be willing to offer full support. For the moment, the ECB and the euro are acting as external forces of discipline, keeping the heat on long

1. Bloomberg, 7 November 2011

enough to prompt the essential changes. The relief which will then follow is likely to result in a sharp correction in yields, which on such large debt to GDP ratios would have a material impact on interest payments and expedite a recovery in sentiment.

**Investment implications**

Politics and economics are more closely intertwined than ever. It is significant that, as we enter 2012, there has been a change of leadership in every single one of the troubled - Portugal, Ireland, Italy, Greece and Spain - countries. The ECB has also had a change of the guard; Mario Draghi surprised markets by cutting interest rates by 25 basis points to 1.25% at his first meeting as president, and with no inflation restricting policymakers, we foresee an environment where monetary policy stays loose and fiscal policy tight. "State intervention" is a core theme in our investment outlook. A key risk outside the control of the authorities is for how long electorates can maintain patience, and

2012 is likely to have many scares on this front as austerity and reforms begin in earnest.

At current levels European equities are pricing in a high level of risk premia and no growth. As the chart below shows, the Europe ex UK Shiller price/earnings (P/E) ratio - calculated using the average inflation-adjusted earnings from the previous 10 years - is back to levels approaching those of the early 1980s, suggesting an excellent buying opportunity. Believing that there will be a dissipation of this risk premium is not the same as saying deleveraging has ended; indeed, this remains a continued theme for Western countries and banking systems. However, with European equity valuations more than two standard deviations away from long-term averages, scope for some mean reversion as fiscal corrections begin seems entirely reasonable.

While further European equity market volatility seems inevitable, we believe

that it is important to remember that buying a share in a large, well-managed blue chip European company is buying truly global exposure at a European discount. Furthermore, it is important to remember in our view that markets are not the same thing as economies. A large number of European companies currently enjoy rates of borrowing below that of their domestic banks, and, in some case, even their sovereigns.

While the many bears on the region still shout the loudest, the ECB's (outgoing) Juergen Stark has stated his assumption that "in one to two years at the latest the crisis will be under control, if not overcome. Overcome in the sense that acute political actions are no longer necessary"<sup>1</sup>. We have watched this European crisis rumble on for nearly two years now, and should Stark be correct in his thinking, 2012 looks set to be a year dominated by significant shifts. This European crisis can also be a European opportunity.

**EUROPE EX UK SHILLER P/E RATIOS (INDEX) ARE APPROACHING THEIR EARLY 1980S LEVELS**



Source: Societe Generale, November 2011.



BNY MELLON  
ASSET MANAGEMENT

## Chinese slowdown casts a shadow over Asia



**Jason Pidcock**  
Investment Leader -  
Asian Equities,  
Newton

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We believe that the market has underestimated the extent to which Chinese GDP growth will slow next year, and are therefore more cautious in our outlook for the Asia Pacific ex Japan region for 2012. This slowdown in economic activity is likely to have implications not only for Chinese companies, but also for those operating in other countries in the region, as the intra-regional correlation is fairly high. The Chinese government made clear in its 12th five-year plan the intention to rebalance the economy from an investment-led to a consumption-led growth model in order to achieve a more sustainable long-term growth trajectory. This transition is unlikely to be smooth, and many structural issues that were previously masked by high economic growth could emerge when this growth disappears.

Despite China's likely deceleration, many of the country's corporates still have very aggressive growth targets and expansion plans. The likelihood is that these will not be met, for a couple of reasons. First, we believe there is a lack of experienced staff able to execute such ambitions. Despite some reports of unemployment tracking at levels higher than the official estimate in China, we have heard from company management that the labour market is becoming increasingly tight,

and that retaining quality staff is a top priority. Second, liquidity is tight, caused by the government hiking banks' reserve requirement ratios. This is putting pressure on the funding of working capital, especially for small and medium enterprises (SMEs), to whom Chinese banks are reluctant to lend. Such companies are forced to turn to informal lending, often having to borrow at excruciatingly high interest rates. This increases the likelihood of bankruptcies as SMEs fail to meet interest payments.

### Shaky foundations

The Chinese property sector has been burdened with regulation for some time now as the government moves to stamp out any sign of a bubble in prices. This has been well understood by the market, and equities have reacted accordingly. However, we find it concerning that housing developers are continuing to build in the face of slower demand. We also find that many locals are reluctant to accept the possibility of a property price drop. If prices did fall, this would have a widespread impact, notwithstanding the negative wealth effect it would have on consumption. The first signs of property developers struggling are evident as many housing construction projects have been left abandoned, mid-completion. This all highlights the unsustainable Chinese

1. "Global Steel Use to Hit Record in 2012", Reuters, 18 April 2011

infrastructure binge that has been ongoing since its massive stimulus package of 2009. We now fear that its subsequent hangover will reveal more problems than it originally aimed to solve.

Whether China has 'overbuilt' itself is a key debate. Even if it has, it doesn't necessarily mean infrastructure spending will stop immediately, but it will have to slow eventually, especially as local governments are burdened with current projects that are not generating sufficient returns to pay down debt. Looking at levels of commodity intensity in China does give weight to the overbuild case. For example, research from Credit Suisse suggests that cumulative per-capita cement consumption has reached levels close to those where Taiwan, Korea and Japan were just before the peak in their infrastructure build. Furthermore, the chart below highlights the acceleration

of Chinese per-capita demand for steel since 2000 compared to America's consistent growth over 75 years.

Any slowdown in activity will have a wider implication for the region, as China is a key market for commodities such as iron ore and coal - China now consumes 45% of world steel output - and this is likely to affect exporting nations such as Australia and Indonesia.<sup>1</sup> This is something we need to watch carefully, and is another reason for our caution on the region as a whole.

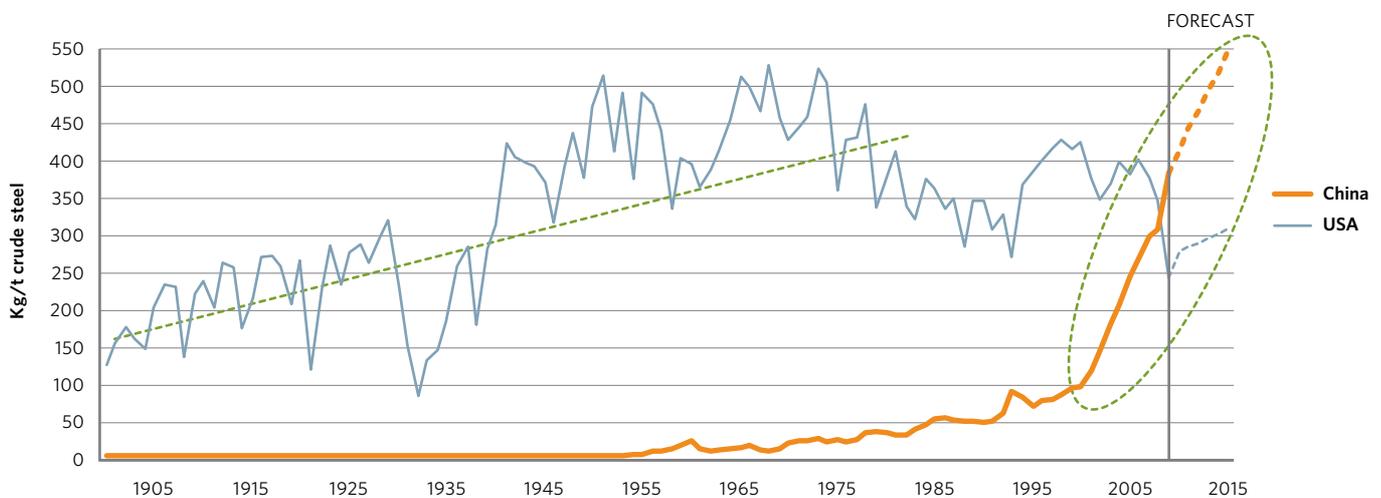
**Challenging times ahead**

We believe that as Chinese economic growth slows, cracks such as non-performing loans, corruption and social tensions that had previously been plastered over, are likely to emerge. We believe, therefore, that the market will focus more closely on some of these issues, resulting in further downgrades

for China's growth in 2012. Given the highly correlated nature of Asian economies, we believe slower Chinese growth could have negative implications for the region as a whole.

Regardless of the headwinds, investment opportunities can be found. Newton's investment themes have particular relevance in this environment. For example, "Smart" represents the idea that innovative companies can, via human ingenuity, create their own market for new products even in a low growth world, while "Healthy demand", reminds us that the need for increased healthcare services in Asia is a multi-decade story driven by ageing populations and increased affordability. Overall, we remain positive on the long-term prospects for the Asia Pacific ex Japan markets, but feel that 2012 could present challenges which cannot be ignored.

**US AND CHINESE PER CAPITA CONSUMPTION OF STEEL FROM 1900 - FINISHED STEEL BASIS**



Source, Macquarie, January 2011.



## EQUITIES EMERGING MARKETS



BNY MELLON  
ASSET MANAGEMENT

# A better 12 months ahead?



**Kirk Henry**  
Senior Managing  
Director and Senior  
Portfolio Manager,  
The Boston Company

The Boston Company Asset Management, LLC (The Boston Company), based in Boston, uses a bottom-up approach to stock selection, blending quantitative screening with fundamental research. The manager covers value, growth, core and market neutral strategies.

THE BOSTON COMPANY

ASSET MANAGEMENT, LLC

After posting strong performance during 2010, emerging market equities corrected sharply in 2011, particularly from July 2011 forward, underperforming US and developed market equities.<sup>1</sup> A combination of several macroeconomic issues: the European sovereign credit crisis; tighter monetary policy in many emerging market countries due to rising inflationary pressures and related fears of a hard landing in China; the stalled, jobless recovery in the US; and devastating natural disasters in Japan and Thailand. These all contributed to the global sell-off in equities during 2011.

Despite this, the market continued to reward emerging market stocks with higher valuations, better near-term earnings momentum and perceived stability at the expense of lowly valued companies with better recovery prospects, even in the steep pull-back during the third quarter of 2011. Normally, we would expect to see relative value characteristics begin to provide more downside protection in such an environment. The global 'risk-off' mentality also translated itself into volatile currency movements in emerging markets during 2011, with the Brazilian real depreciating by nearly 16% in a short period of time in September.<sup>2</sup>

We believe this correction has created a far more compelling valuation opportunity within the asset class than we had observed heading into 2011. As of 24 September 2011, the MSCI EM Index was trading at a 20% discount to historic average forward price-to-earnings ratio (P/E), a 30% discount to average trailing P/E and a 25% discount on price-to-book ratio (P/B).<sup>3</sup> Over the course of 2011, we found interesting relative value opportunities in the large country markets such as China, Brazil and India.

### Asian opportunities

We still believe there are attractive opportunities in the BRIC countries, with many companies showing single-digit price-to-earnings ratios and therefore having the potential for significant earnings recovery. While we recognise investor pessimism surrounding the Chinese market, specifically around inflationary pressures, potential misallocation of capital and rising risk associated with non-performing loans, we believe the market has already priced in a great deal of bad news over the past 12 months. In addition, in our view, China's sizeable reserves and savings base should allow it to navigate these obstacles and remain on track to becoming a more domestic-demand-driven economy.

1. As measured by the MSCI Emerging Markets Index.  
2. Bloomberg, 30 September 2011.  
3. MSCI, Morgan Stanley, 24 October 2011.  
4. The Wall Street Journal, 18 October 2011.

We believe there will continue to be attractive emerging market equity opportunities in 2012 in the information technology, energy and financials sectors, with energy being the least expensive sector in the market.

The smaller, peripheral Asian markets held up relatively well during 2011, and valuations expanded in countries such as Thailand, Malaysia and Indonesia. Rising interest rates and tighter lending conditions in China and India drove underperformance in those markets, though we see signs that we could be approaching a peak in the emerging markets interest rate cycle. Indonesia cut interest rates during Q4 2011, as did Brazil, despite lingering concerns over domestic inflation.

In our opinion, their view was to move ahead of the economic slowdown in Europe and the US, which should alleviate inflationary pressures. We believe the tighter conditions have been prudent and show that emerging central banks and the Chinese government are serious about containing inflation. China's recent GDP report revealed that while growth moderated during 2011, 9.1% growth does not indicate an imminent hard landing.<sup>4</sup>

As emerging markets are far more integrated with the global economy today, developments in Europe have had a profound impact on investment conditions. The EU's summit at the end of October yielded more aggressive agreements on how to handle their ongoing sovereign debt crisis: a voluntary 50% haircut on Greek debt by bondholders (mostly European banks), the scaling up of the European Financial Stability Facility to US\$1.4 trillion to provide a backstop to remaining sovereign credit issues in the union, as well as a targeted US\$170 billion European bank recapitalisation. While it is anyone's guess whether this will ultimately be enough to contain Europe's problems, we believe these support measures could well serve as a catalyst for global equities.

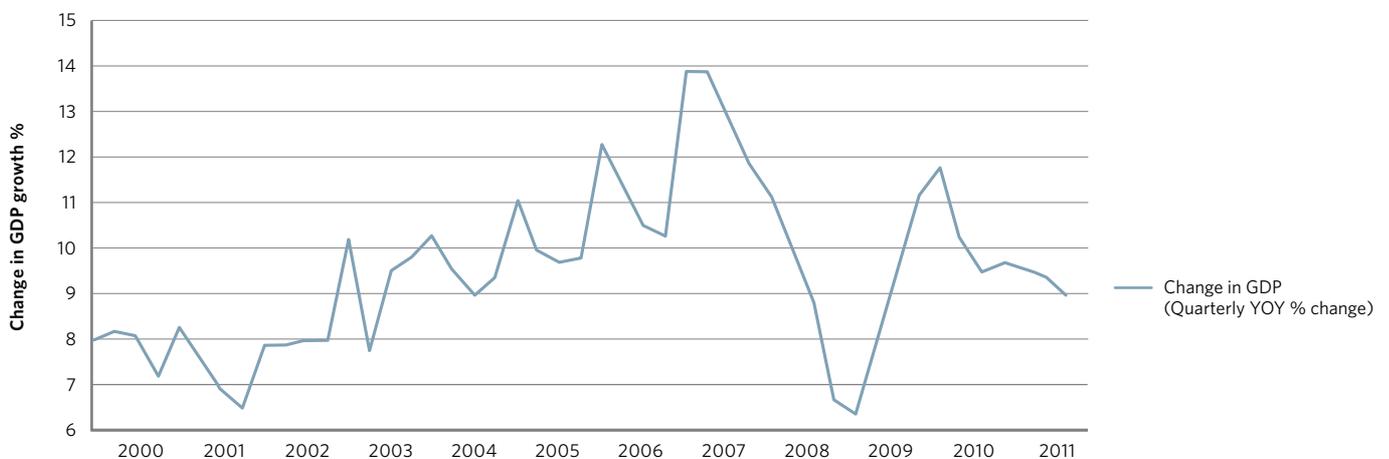
**The future is bright...**

Given relatively low valuation levels, oversold market conditions and pessimistic expectations, we would not be surprised to see emerging market equities rise during the course of 2012. In fact, whether the result is a mid-cycle recovery or a more pronounced bear market driven by a global double-dip recession, we could foresee a market rotation back to value stocks, as valuations have become more dispersed.

In a recovery scenario, we expect investors would extend their time horizons and be more willing to invest in the inexpensive recovery stock. In a more prolonged downturn, investors would, in our view, eventually sell the expensive "safety" stocks, as they would face their own earnings downgrade cycle. Instead, we believe they would seek protection in undervalued stocks with good capital structures and less potential for earnings declines. We would place higher odds on the former outcome.

Our long-term view of emerging markets remains positive. With a growing middle class, pent-up consumer demand and young populations, emerging markets appear to us to be unmatched in their prospective return on investment. We believe the staggering growth of emerging market economies will lead to a new dynamic in global consumerism. For us, the recent wage growth trends in China alone are a terrific reminder that tomorrow's most important consumer base will likely be in emerging markets. We continue to find more intriguing opportunities in smaller, domestically focused businesses that can tap into this potential compared to the larger resource-oriented exporters.

**CHINESE HARD LANDING YET TO MATERIALISE**



Source: National Bureau of Statistics, China, Thomson Reuters Datastream as at 15/08/2011.



"We believe the only place to hide during these periods is in US Treasuries and gold. Yet, we see limited value in these asset classes on a long-term basis. Instead, we remain focused on long-term fundamentals that favour US non-financial corporate credit as well as emerging market local currency debt."

Tom Higgins, Standish





# Fixed Income

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## FIXED INCOME GLOBAL GOVERNMENT BONDS



BNY MELLON  
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# Turn on the printers or restore default settings?



**Paul Brain**  
Investment Leader -  
Fixed Income,  
Newton

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**NEWTON**  
The Power of Ideas

Since the financial crisis broke in 2008, global economics has been dominated by one major theme, that of deleveraging. From the US, the UK and the Eurozone to the emerging economies, the whole world has been affected by this historical, multi-year deleveraging process. 2012 will no doubt continue to be dominated by the spectre of debt, with policymakers tackling their own debt challenges in very different ways according to the tools available at their disposal. A backdrop of low and volatile economic growth, along with the combination of loose monetary and tight fiscal policy poses tough questions of economies set on debt reduction, but historically, such conditions can also provide strong support for global government bond markets.

### Stick or twist...

Deleveraging in such an environment is an unenviable task, given the ease with which an economy can flit between positive and negative growth numbers. For developed economies, the policy responses available are limited. For those countries that don't have control over their monetary policy or bond markets, the response is to pay less back, whether it be through haircuts on their bonds or even through defaults, approaches that are ultimately deflationary in nature. Meanwhile, in an effort to ensure that economic growth remains positive, others could go down

the path of printing money and effectively devaluing their debt, especially if there is no scope to cut interest rates.

Historically, the countries that default tend to be those that are beholden to foreign demand for their sovereign debt, hence why it has traditionally been emerging economies that have defaulted in the past. Indeed, one of the problems with the structure of the Eurozone is that individual states do not have control of their monetary policy. A sovereign default can lead to a period of negative economic growth, destruction of capital, and less investment, although we believe that the sooner it happens, the sooner the rapid and enforced debt reduction, and subsequent rebuilding, can take place.

Meanwhile, if through the period of economic weakness there has been a devaluation of wages, the economy is likely to return more quickly to a state of competitiveness and begin attracting foreign investment once again. We need only look to the example of Argentina in the early 2000s to see that economies can emerge from sovereign defaults in a stronger position, despite the initial shocks to the system (see table).

In contrast with the deflationary nature of sovereign defaults, those economies in control of their monetary policy and with

their “money printers” switched on, face creating a legacy inflation problem. However, in the short term at least, this approach is likely to mean less deflation. While the banking sector is deleveraging, the velocity of money – the rate at which money is exchanged from one transaction to another – remains low and the printed money isn’t levered up into the real economy. The focus of these countries is to maintain economic growth at all costs, but there will be downward pressure on their currencies as the printing of money effectively means the debasement of that currency. Regardless, given that economic growth is likely to be positive and debt levels more stable, these sovereigns are likely to receive safe-haven flows. Furthermore, the stability of their currencies relative to others could come at a premium in the near term, although currency weakness is likely in the long term due to the effects of quantitative easing.

### Policy flexibility

In terms of government bond markets, the UK, US and some of the ‘core’ European countries are, perversely, likely to be supported by their quantitative easing programmes. They should be able to maintain positive economic growth, regardless of concerns about their burgeoning fiscal deficits. There is also likely to be appetite for sovereign debt issued by those countries that still have monetary policy flexibility, such as Norway and New Zealand.

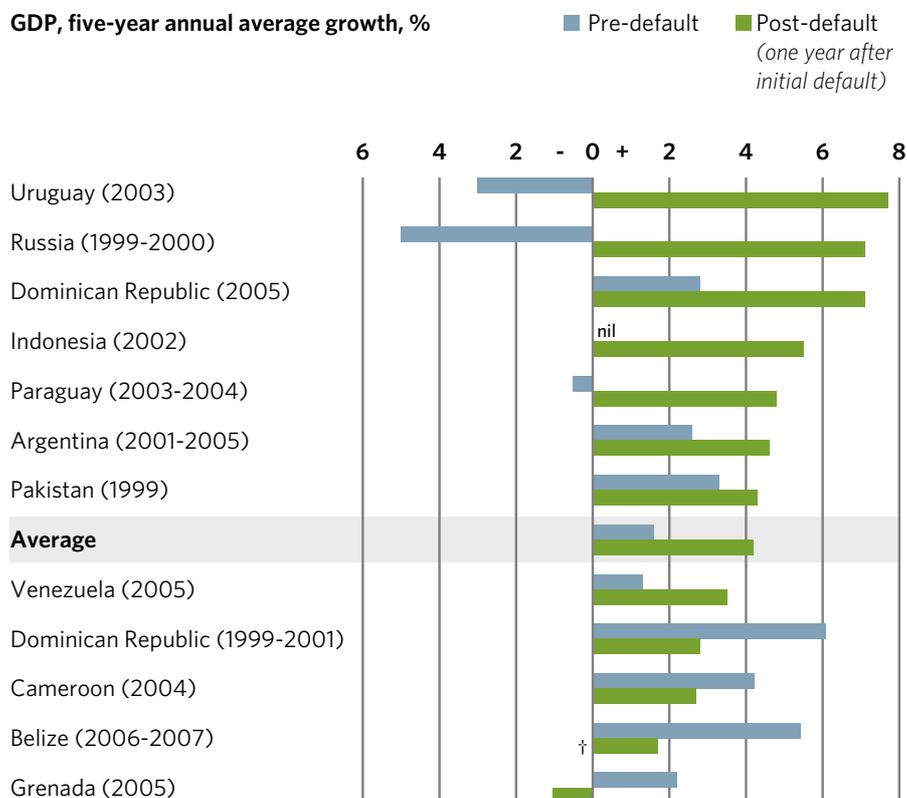
Meanwhile, bond investors are likely to remain wary of those countries lacking the ability to maintain economic growth, and without monetary policy control. This includes a number of the economies on the ‘periphery’ of the Eurozone, as

well as some of the ‘core’ nations such as France, Austria and Belgium. Further afield, there are likely to be investment opportunities in those emerging economies which have the scope to reverse monetary policy, which has been tightened in recent years, in order to maintain and boost economic growth. This is the case across a number of Asian and Latin American countries.

The deleveraging story seems set to heavily influence investment thinking over the coming year. In such an environment, the means by which countries attempt to maintain growth is likely to prompt a fragmentation of markets. However, for global bond investors, this allows plenty of scope for diversification across a number of investment opportunities.

## ECONOMIC RECOVERY FOLLOWING SOVEREIGN DEFAULTS: SELECTED DEFAULTS SINCE 1999

GDP, five-year annual average growth, %



Sources: IMF; Standard & Poor's; The Economist †Four year average



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## Diverging paths for global credit markets



**Thomas D. Higgins**  
PhD  
Global Macro  
Strategist, Standish

Headquartered in Boston, Massachusetts, Standish Mellon Asset Management Company LLC (Standish) is a specialist active fixed income manager investing in global fixed income markets and across the full credit spectrum. The company is regarded as one of the world's premier fixed income managers.



Investor anxiety was high for most of 2011 due to concerns about global contagion from the European sovereign debt crisis as well as the possibility of a double-dip recession in the US or a hard landing in China. Yet, as of the last quarter of 2011, economic indicators suggested that the probability of a renewed US recession remained low and that China was successfully engineering a soft landing for its economy. By contrast, the Eurozone is probably heading for a recession in 2012.

However, we believe the global economy can weather a Eurozone recession. With the exception of Central and Eastern Europe, there are few direct linkages between the problems in Europe's peripheral debt markets and the rest of the world. Moreover, Europe has not been a major contributor to global economic growth in recent years. Nevertheless, our view is that global economic recovery is still too fragile to absorb a severe financial shock, such as a break-up of the Eurozone.

Our base case is that European leaders will react in time to avoid a break-up of the Eurozone, but not a Eurozone recession. Therefore, we expect a greater degree of economic divergence between Europe and the rest of the global economy in the year ahead, with emerging market economies

in Asia and Latin America performing best. Looking beyond the current market volatility, we see long-term opportunities in US non-financial corporate credit as well as emerging market local currency debt, given better economic fundamentals. However, we anticipate further weakness in European sovereign debt markets, the euro currency, and European financials.

### European recession taking hold

The Eurozone economy appears to have stalled in the third quarter of 2011. Region-wide economic growth rose at an annual rate of just 0.6% with most of this growth coming from the core economies, especially France and Germany<sup>1</sup>. Deep recessions are apparent in most of the peripheral economies and forward-looking indicators, such as purchasing managers' surveys, indicate that manufacturing activity has begun to contract in the core economies as well.

We anticipate further economic deterioration in the region as credit conditions tighten and financial contagion spreads to some of the higher-rated sovereigns. European banks are heavily exposed to peripheral European debt, their average capitalization rates are low, and many are dependent on wholesale funding markets where liquidity can dry up quickly. Indeed, roughly three quarters of the US\$3

1. "Eurostatistics Data for Short-term Economic Analysis," Eurostat, Issue number 11/2011.

trillion in public and private sector debt of Greece, Portugal, Ireland, Spain and Italy is held by the European banking system at book value.<sup>2</sup> Yet, the market value of these holdings is considerably lower, which will eventually force a write-down of these assets and a contraction in credit.<sup>3</sup>

At the same time, government borrowing costs have begun to rise for European sovereigns with top credit ratings including Austria, Finland, France and the Netherlands, as the crisis in the peripheral economies spreads. In late November, French 10-year government bonds were trading more than 200 basis points above comparable German Bunds, a level unseen since the early 1990s<sup>4</sup>. This contagion effect has increased the urgency of finding a comprehensive solution to Europe's sovereign debt crisis.

We believe that such a solution will, by necessity, entail some socialisation of the debts of the peripheral economies to the entire Eurozone. While more fiscally responsible core countries, especially Germany, resist this idea, we believe an agreement will be reached whereby the core economies accept joint-liability for peripheral debts in exchange for more stringent fiscal oversight and commitments to deficit reduction by peripheral governments. That is the basis for the proposed European Redemption Fund, which the German Council of Economic Experts, the so-called Five Wise Men, put forward in mid-November.

Unfortunately, more pain may be necessary before European leaders and their constituents agree that it is in their common interest to preserve the currency union. Even with the necessary political will, structurally the Eurozone lacks the ability to act quickly, given the need for national parliamentary approvals by the

17 member governments to adopt new measures. Consequently, we expect a Eurozone recession in 2012 accompanied by periodic bouts of financial market volatility.

### **Implications for the global economy**

There are at least four channels through which a European recession might impact the global economy: direct holdings of peripheral European debt; exposure to European banks; a dependence on European export markets; and via global capital markets due to increased correlations between risky assets during periods of stress.

As mentioned, holdings of peripheral European debt outside of Europe are relatively small. For instance, American and Japanese holdings of peripheral European debt amount to less than 2% of their respective GDPs<sup>5</sup>. However, the US is indirectly exposed to peripheral Europe through the wholesale funding markets. According to Fitch, European bank debt represented 37.7% of total holdings of US\$654 billion of the 10 largest US prime money market funds as of the end of September 2011. While this is down from 47.2% at the end of July 2011, it remains sizeable.<sup>6</sup>

As wholesale funding from the US dries up, European banks have been forced to reduce their loan books. This threatens to undermine economies in Central and Eastern Europe<sup>7</sup> where borrowing from European banks accounts for one-third of regional GDP<sup>8</sup>. Central and Eastern Europe also have strong trade ties with the European Union where more than two-thirds of the region's exports are headed. By contrast, less than 17% of Asian exports and 13% of Latin American exports are destined for the European Union<sup>9</sup>.

2. "Preliminary International Banking Statistics," Bank of International Settlements, Second Quarter 2011.

3. "Grappling with Crisis Legacies," Global Financial Stability Report, International Monetary Fund, September 2011.

4. Bloomberg

5. International Monetary Fund and Bank of International Settlements

6. "U.S. Money Funds and European Banks: French Exposure Down," Fitch Credit Ratings, October 2011.

7. The IMF defines Central and Eastern Europe as including developing countries only: Albania, Bosnia, Bulgaria, Croatia, Hungary, Kosovo, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia and Turkey.

8. Op. cit., Bank of International Settlements.

9. International Monetary Fund Direction of Trade Statistics June 2011

## Diverging paths for global credit markets **continued**

Overall, we expect a Eurozone recession would be a drag on global growth but would not cause a worldwide recession. The region has not been an important contributor to global economic growth since the recovery began in mid-2009. In fact, the Eurozone only accounted for about 7% of global GDP growth in 2010 compared to 13% for the US and 65% for emerging markets<sup>10</sup>.

After Central and Eastern Europe and the UK, we think the country most at risk from a Eurozone recession would likely be the US due to its exposure to European banks. There are further lingering vulnerabilities in advanced economies because household and government balance sheets have not recovered from the global financial crisis of 2007-2009 and policy makers are running out of ammunition to stimulate economic activity. In our view, the least vulnerable regions to a Eurozone recession would be Asia and Latin America. Both regions have ample room for countercyclical policies,

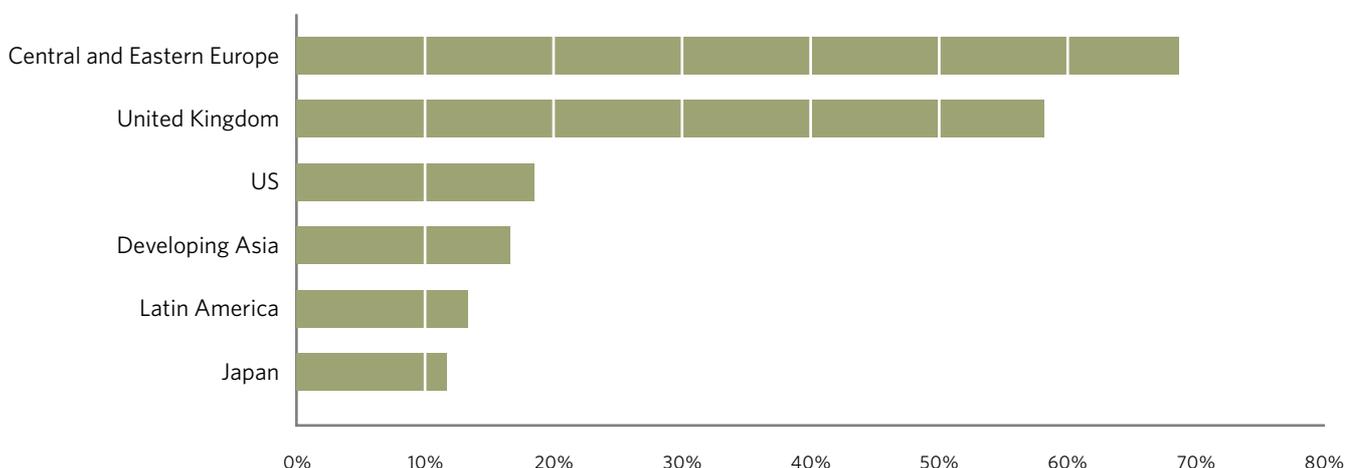
given their better fiscal positions and higher interest rates.

For us, the most worrisome source of contagion from the Eurozone would be through the global capital markets from which no region is immune. The good news is that we think a repeat of the 2008 global liquidity crisis is less likely today given the reduced amount of leverage in the financial system and the fact that global policy makers have put tools in place to mitigate this risk. However, recent experience suggests that correlations among risk assets tend to increase in periods of market stress, no matter how robust the economic fundamentals.

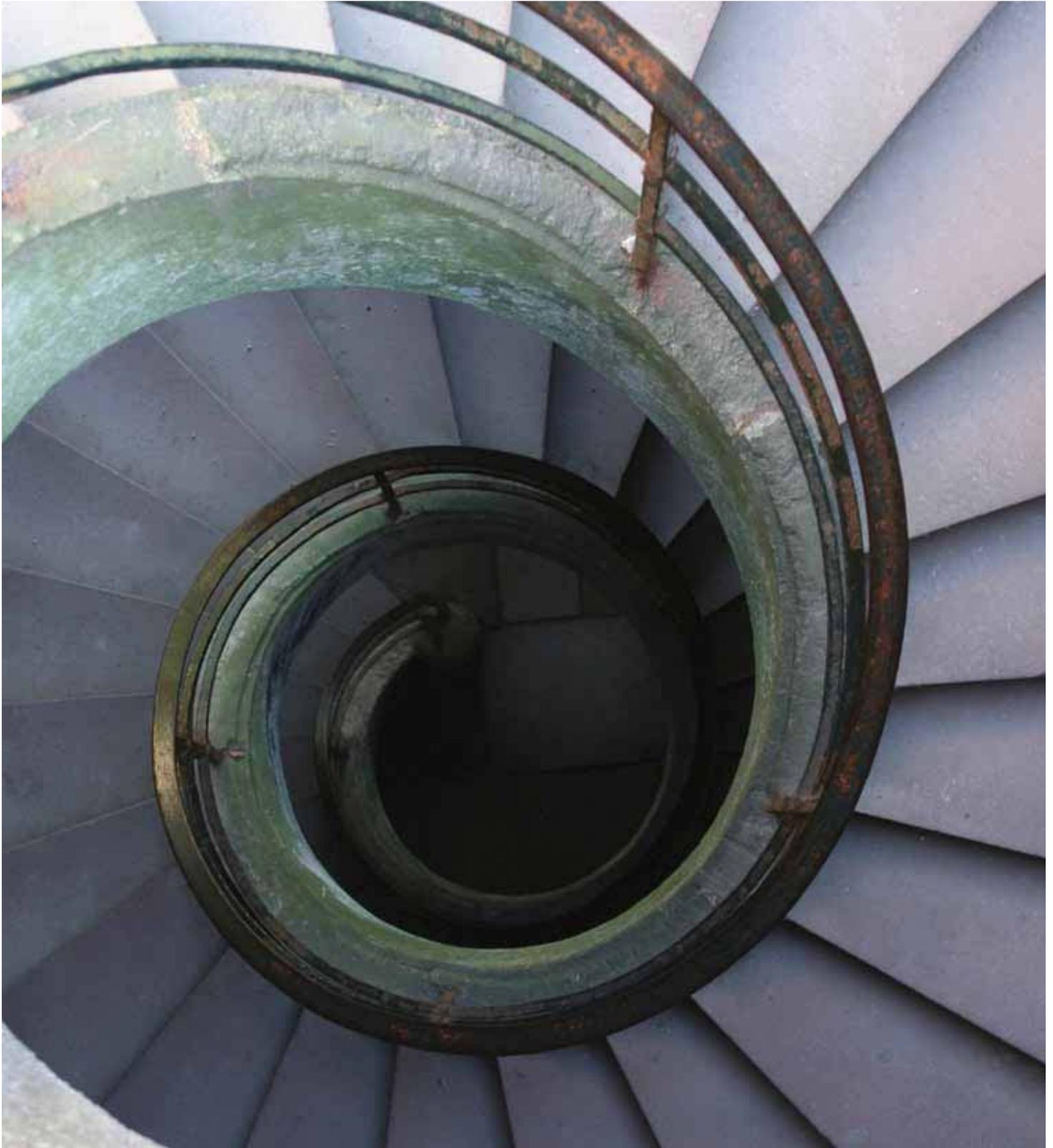
We believe the only place to hide during these periods is in US Treasuries and gold. Yet, we see limited value in these asset classes on a long-term basis. Instead, we remain focused on long-term fundamentals that favour US non-financial corporate credit as well as emerging market local currency debt.

10. International Monetary Fund and Standish

### EXPORTS TO THE EUROPEAN UNION AS A PERCENTAGE OF TOTAL EXPORTS



Source: International Monetary Fund Direction of Trade Statistics, June 2011





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## A silver lining for risk



**Gunther Westen**  
Head of Asset  
Allocation,  
WestLB Mellon  
Asset Management

WestLB Mellon Asset Management (WMAM) is a 50:50 joint venture between WestLB and The Bank of New York Mellon Corporation. Headquartered in Duesseldorf, WMAM offers clients both core and specialist products with the focus on European bonds and equities. It does not offer services in the US.



Investors had a great deal to worry about in 2011. The Eurozone funding crisis escalated. The global economy lost considerable momentum and fears of a double-dip recession spread. Banks stocks fell and financial institutions were able to tap capital markets only sporadically. All of this raised ominous memories of 2008. It was little wonder then that investors reacted to the uncertainty by selling anything remotely risky and flocked to the perceived safety of German Bunds and US Treasuries.

### **Credit premium for bunds to increase**

However rational it might seem for investors to search for pockets of safety during uncertain times, we believe this zero-diversification strategy of shifting into Bunds and equivalents might not be such a good idea going into 2012 and over the medium term. The German sovereign five-year credit default swap (CDS) hit 120 basis points (bps) at its peak in early October, clearly reflecting the increased likelihood of further fiscal integration within the Eurozone. Germany already guarantees nearly one third of the European Financial Stability Facility (EFSF), and we think the general burden may rise. Even if the idea to leverage the EFSF through a special purpose vehicle or via a banking license may go nowhere, other attempts are afoot to contain

systemic risks whether through capital injections into banks, turning the EFSF into a bond insurer as proposed by the latest summit or extending the European Central Bank's Securities Markets Programme. We believe the latter option is likely to be the smoothest way to hold the Eurozone together, without requiring the time-consuming and complicated approval of European parliaments. The bottom line for the Eurozone in 2012 and beyond, however, is that the German taxpayers will likely be the ones shouldering the largest tax burden, thus precipitating a higher credit premium and headwinds for Bund yields.

### **ECB follows Fed's lead on reflation**

Moreover, central banks in advanced economies have embarked on a route towards reflation their economies by flooding the markets with unprecedented amounts of liquidity. The ECB is following in the path of the US Federal Reserve by injecting further long-term money, cutting rates and launching a second covered bond buying programme. Add to that near-term inflation stickiness driven mainly by resilient commodity prices and we believe this policy may sow the seeds for higher inflation rates in the medium term - not ideal conditions for extremely low core rates.

1. Bloomberg as of October 21, 2011.  
2. Moody's Default Report, October 2011.  
3. Bloomberg database.  
4. Bloomberg as at 21 October 2011.

### Economic backdrop more resilient than expected

August saw leading indicators plummet, raising fears of a return to 2008. However, economic indicators since then have pointed to a broad pause in economic growth rather than to an outright recession. While fiscal consolidation will continue to be a drag on economic activity in 2012, we believe a double-dip scenario is not as likely as many pundits suggested. Against the backdrop of the unprecedented sharp yield declines in the Eurozone's core bond markets and high levels of volatility in the summer of 2011, we believe a repricing of recession probabilities may send Eurozone bond yields markedly higher in 2012 without altering the general low yield environment.

### The hunt for yield

In our opinion, risk-averse investors in Europe are caught between a rock and a hard place. While anxiously avoiding European peripheral bonds and reducing exposure to credit, the risk in their portfolios has - contrary to their intention - increased, with pure interest rate risk replacing diversified credit risk. In addition to this, record-low yields in core markets are nowhere near sufficient to ensure reaching nominal return targets envisaged by many investors in Germany. In order to close that gap, we believe investors will have to reverse course and creep back into more risk-prone asset classes and segments. And indeed, the recent market rout has created value opportunities, as we think that the risk-selling has been indiscriminate.

### Euro credit offers attractive valuations

Euro high yield bonds spreads nearly tripled from their lows in May, soaring to a cyclical high in early October.<sup>1</sup> Given a recovery rate of 40%, the spread level suggests an implicit default rate of roughly 9% compared to a bit more than 2% currently expected in one year's time by Moody's.<sup>2</sup> A 9% to 11% default rate is generally assumed to be the average yardstick for a normal recession. Although default rates were much higher in the immediate post-Lehman Brothers period, high yield bond prices are now historically low and would represent a significant value opportunity, should a recession in the Eurozone be averted or turn out to be very shallow.

The same holds true for euro-denominated investment grade bonds. The spreads of bank seniors (senior unsecured bank bonds) and peripheral companies have exploded, leading to the overall index spread exceeding what was observed during the 2001-2003 recession.<sup>3</sup> Senior bank spreads are even well above the levels seen in the post-Lehman Brothers period, owing to lingering fears of bank defaults. With some progress in view on the Eurozone funding crisis and the underfunding issues of some European banks, we believe good senior financials may offer attractive value in the medium term.

### Crisis of confidence, not fundamentals

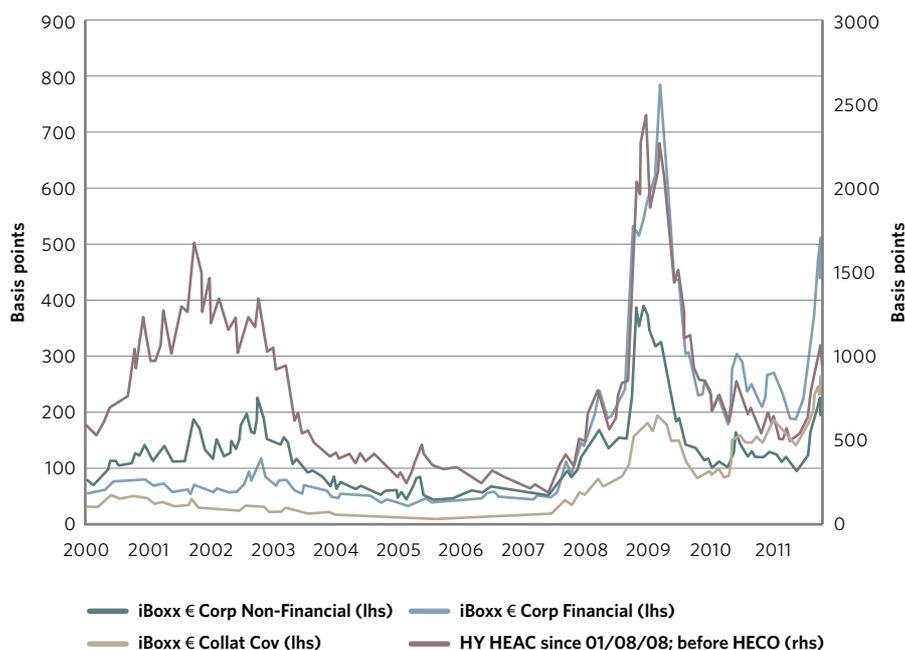
Even peripheral sovereign bonds may offer value. As evidenced by the persistent spread tightening of Irish government paper since July,<sup>4</sup> we believe the market may not be completely blind to progress in fiscal consolidation. Moreover, in our view, the combination of slow fiscal healing in some peripheral countries and increased awareness by policy makers to find meaningful solutions to the Eurozone debt problems may turn around the anxious sentiment of hyper-nervous

investors. Based on that, we believe Spanish and Italian bonds might offer an attractive carry and diversification opportunity as well as a chance to address potential yield convergence, should the market regain confidence.

### Bumpy road ahead

Having said that, we think volatility is most certainly here to stay during 2012, as the road to fiscal integration within the Eurozone may continue to be very bumpy and clarity about the economic development is low. Hence, risk premiums are likely to stay at high levels for longer, as the market prices tail risks for a systemic meltdown and a higher probability of recession. In our view, any moderate outcome of Europe's debt problems in 2012 makes the current valuations of European credit, peripheral sovereign and many covered bonds looking incredibly underpriced. Therefore, we believe a strategy that also takes account of opportunities and selectively increases exposure to good credits and peripherals by buying into weakness should be able to offer excess returns over a pure core market-centric portfolio in 2012.

SPREADS OVER BUNDS FROM JANUARY 2000 TO OCTOBER 2011



Source: DBIQ and Bloomberg as of 21 October 2011.



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## Positive prospects for emerging market debt in 2012



**Alexander Kozhemiakin**  
Head of Emerging Markets Strategy and Senior Portfolio Manager, Standish

Headquartered in Boston, Massachusetts, Standish Mellon Asset Management Company LLC (Standish) is a specialist active fixed-income manager investing in global fixed-income markets and across the full credit spectrum. The company is regarded as one of the world's premier fixed income managers.



We continue to have a favourable outlook on emerging markets and emerging market debt in particular for 2012. Our preferred way of looking at emerging markets is by thinking of them as "assets tied to economies of risky countries" (ASTERISCS). In most cases, the country risks - the characteristic distinguishing emerging markets from other asset classes - reflect the reasons why the vast majority of emerging market countries are not yet rich. So when we say we like emerging markets, we mean, in practical terms, that we like assets tied to economies of non-rich countries - countries whose gross national income, GNI, per capita falls below the upper quartile, as estimated by the World Bank.

### **Promise of higher growth rates**

What is the continuing appeal of non-rich countries? First, their economies carry the promise of growth at higher rates. This makes intuitive sense as non-rich countries are starting at a lower base. In addition, structural reforms, widespread improvements in creditworthiness, and more prudent macroeconomic policies in many (though not all) cases have created favourable conditions for the potential outperformance of emerging market economies. In 2012, in particular, we agree with the consensus view that emerging

market economies will likely expand faster than those of developed countries, in line with the trend observed over the past decade. While we always treat consensus views with healthy scepticism, we find no reason to disagree with this one.

Second, non-rich countries have managed to avoid debt excesses currently plaguing the developed economies. With sovereign balance sheets of developed, rich countries burdened by the costs of rescuing their private sectors, the balance sheets of non-rich countries compare favourably. While non-rich countries definitely have challenges of their own, they do look better than many of their developed counterparts.

Third, investors in the developed world are actively searching for ways to diversify their portfolios to mitigate a pronounced home bias (i.e., an investment concentration in domestic assets). We believe a careful, selective exposure to the assets of non-rich countries can be a prudent choice to increase international diversification. We also think it is important to emphasise that country diversification does not necessarily protect investors against sharp global crises. Unfortunately, there is little evidence in our view to dispute

1. Based on the JP Morgan GBI-EM Global Diversified Index as of November, 2011. The index is a global local emerging markets index, consisting of regularly traded, liquid, fixed rate, domestic currency government bonds.

the old adage that “diversification works least when you need it most”. However, over long periods, we believe globally diversified portfolios can meaningfully outperform portfolios with a home bias.

In our opinion, asset classes of non-rich countries are not decoupled from the asset classes of their rich counterparts. The global market falls in September 2008 were a reminder of that, just as the market challenges in September 2011 were. As such, we believe the biggest potential threat to emerging markets in 2012 would be an unexpected slowdown in global economic activity. The slowdown could result from an escalation of the sovereign debt problems in the developed world or it might occur if the economy of a major non-rich country such as China would begin to sputter. While we do not expect to see a global double-dip recession, we are mindful of this risk and monitor it closely.

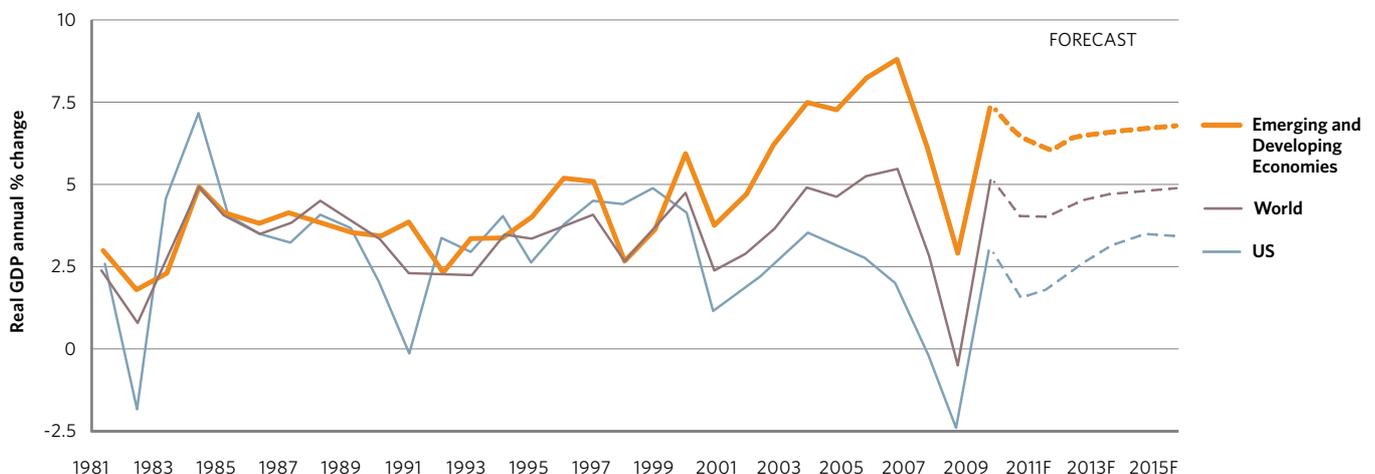
**Positive growth and currency appreciation**

Investing in emerging market fixed income in 2012 will continue to provide investors with two distinct options to capitalise on the expected positive growth differentials between rich and non-rich countries: US dollar-denominated and local currency bonds. Spreads of US dollar-denominated emerging market bonds are generally correlated with spreads of similarly rated corporate bonds in the US. Still, an exposure to US dollar-denominated bonds offers investors valuable issuer and country diversification.

In our view, local currency emerging market debt is poised to continue to attract investor interest in 2012 as well. The reason for this burgeoning interest is not just the potential for high single-digit/ low double-digit returns, based on a yield of 6-7%<sup>1</sup>, but also the potential for local

currency spot rate appreciation against the currencies of developed countries, the US dollar in particular. Just as important is the fact that the types of risks to which local currency bonds are exposing their foreign investors – emerging market currency and local duration – are distinct from the types of risks (e.g., spread, equity) that these investors already have in their portfolios. Local currency bonds issued by emerging market sovereigns are a relatively liquid asset class. As a result, its performance is affected by developments in other liquid asset classes in emerging markets and elsewhere. However, over longer periods of time, the distinct nature of risks associated with local bonds creates sizeable gaps between their performance and that of other asset classes. This is why we think local currency bonds can be an attractive addition to a well-diversified portfolio for 2012 and beyond.

**STRONG GROWTH EXPECTATION IN THE EMERGING AND DEVELOPING ECONOMIES**

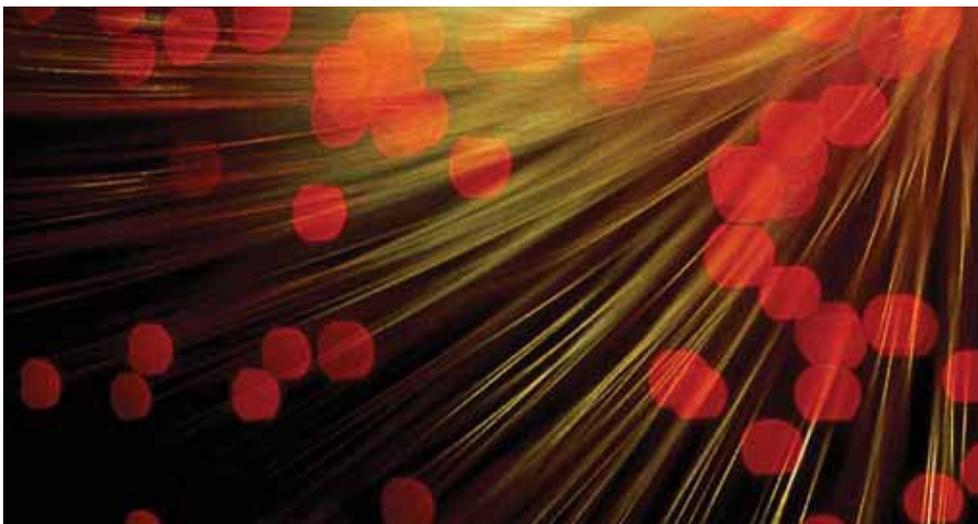
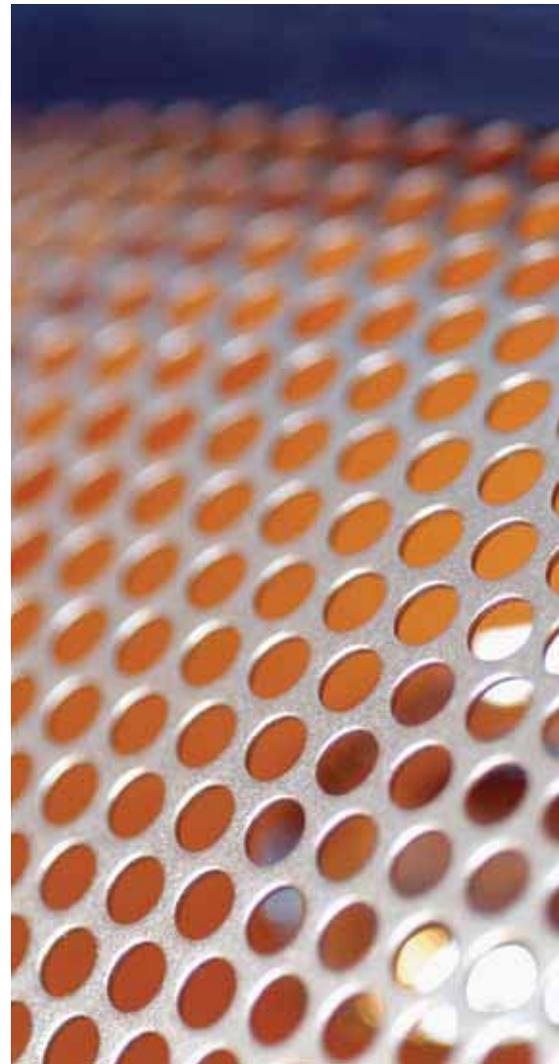


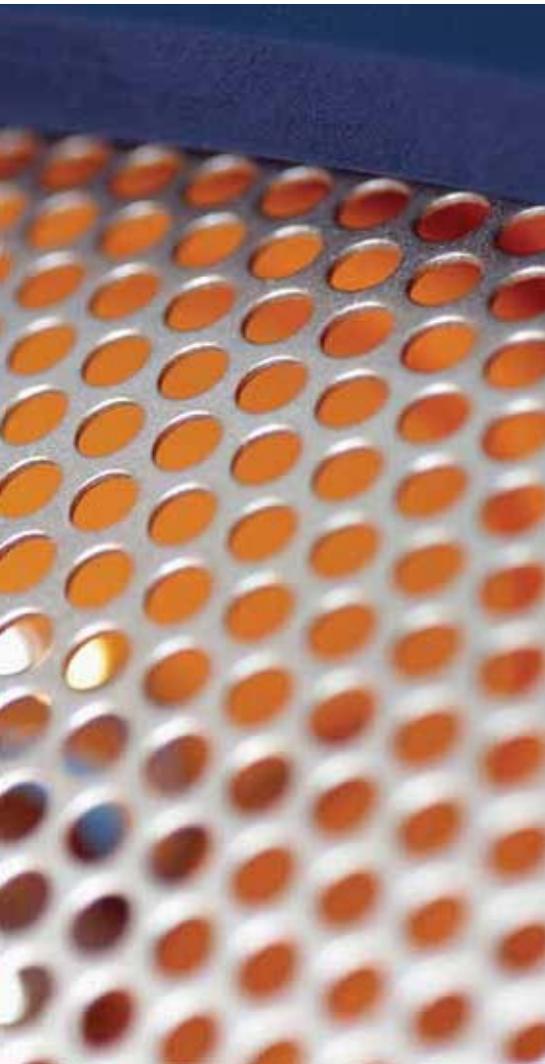
Source: Standish and IMF data, September 2011.



"...despite the weight of probability falling behind a weaker euro (and indeed a weaker Europe), the impact of bank deleveraging could paradoxically lead to a scenario that is positive for the euro (from repatriation, deleverage and easier capital flows) and the US dollar at the same time..."

Constantine Ponticos, Pareto





# Currencies

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**GLOBAL**

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Fragile growth in an uncertain world - currency implications

Constantine Ponticos, Managing Director, Investment Management Research

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# Fragile growth in an uncertain world: Currency implications



**Constantine Ponticos**  
Managing Director,  
Investment  
Management  
Research, Pareto

Pareto Investment Management is one of the world's foremost currency managers offering both overlay and absolute return strategies. Pareto does not attempt to forecast future currency returns. Instead, the focus is on utilising Pareto's proprietary models to systematically search for stretched market conditions. These opportunities are then implemented within the portfolio through the application of statistical techniques and pattern recognition models.



It appears that the principal considerations influencing investors' decisions in 2012 will be the prospects for global economic growth and a resolution to the Eurozone crisis. Unfortunately, the spectrum of possible outcomes to the European crisis remains very broad and the investment implications at each point may be very different. Until this source of uncertainty is resolved, banks, corporations and portfolio managers will hesitate to make firm investment decisions and risk-taking will remain moribund.

Beyond the Eurozone, we can take a guess that if a currency is to outperform in 2012 it will need to be aligned with an economy that has the following attributes:

- It must be capable of generating growth through domestic demand or it must be a satellite of an economic block capable of doing so.
- It must have relatively secure financing (i.e. has a competitive advantage in attracting savings or does not have any need to compete for global savings).

In addition, we can also safely expect that:

- Volatility will remain very high due to the combined effects of macroeconomic uncertainty and the sheer volume of cash looking for any 'hint' of real returns.

- If something does "snap" in the Eurozone, there will be an almighty scramble for US dollars.

## Endogenous growth matters

The first point addresses the lack of demand in an environment where advanced economies are repairing their balance sheets through fiscal tightening and bank recapitalisation, while emerging economies are fighting inflation via tight monetary policy. The Swiss experience of 2011, where the government authorities intervened in the summer to mitigate the appreciation of the Swiss franc, demonstrated that "safe haven" status will not be tolerated by an economy with a dominant export sector. Similarly, in Japan the authorities have intervened three times already this year as yen strength prompted multinationals to shift production abroad.

This suggests that endogenous growth (economic growth from within as opposed to trade) or resilient export demand and/or pricing will be key ingredients for currency strength in the near future. These characteristics can most readily be found in selected large/closed emerging economies and/or commodity exporting nations. Emerging markets offer other positive attributes; inflation appears to have been brought under control and this

1. Eurostat, 30 September 2011.  
2. European Central Bank, December 2011.

summer saw a great deal of capital flight already due to heightened investor risk aversion. Brazil springs to mind, although it does have a large current account deficit. However, as the opening salvos of the "currency wars" have shown, this does not mean that these currencies will be permitted to appreciate.

In the developed economy space, one can look to the US for a track record of internal regeneration and security of financing by virtue of the US dollar's dominance as a reserve currency. The economy is largely closed and does not rely on its external sector, although exporters have been performing well for a number of years now. This global locomotive can always produce upside surprises, especially when expectations are so low. So 2012 could well be the year of the buck. However, although surprises from the real economy are probable, the size of the US public and private debt burden and policy paralysis (due to upcoming elections) mean that risk aversion remains the most likely prospective cause of US dollar outperformance.

#### **Beware Eurozone bank deleveraging**

This brings us back to the Eurozone. This is the second largest economic block in the world, in nominal terms, lagging the US by a small margin. When viewed in aggregate, the region's level of indebtedness, private and public, is low while its current account is broadly balanced, its public deficits are manageable, its inflation is contained and

it was still growing at an unspectacular rate of 1.4% year-on-year at the end of September 2011.<sup>1</sup> In other words, the Eurozone has the prerequisites to make a significant contribution to global growth.

However, in terms of imbalances it is a microcosm of the global system of creditors and debtors with the added impediments, to name but a few, of zero (as opposed to some) currency flexibility, weak collective governance and, apparently, no buyer of last resort. In such a system where the creditors are calling the shots, it is no surprise that the flow of funds has effectively ceased. Indeed, the only viable conduit for cross-border capital market clearance seems to be through the European Central Bank (ECB). Furthermore, the absence of a buyer of last resort makes German Bunds the only safe euro-denominated asset.

The restructuring task for the Eurozone's institutional and governance architecture is so immense and the progress so slow that a positive outcome on these fronts seems very distant at this point in time. Unless there is a breakthrough (and I, for one, would not rule one out) a sustained euro appreciation is unlikely. However, it does not preclude sharp euro rallies as and when meaningful progress is announced on the political fronts.

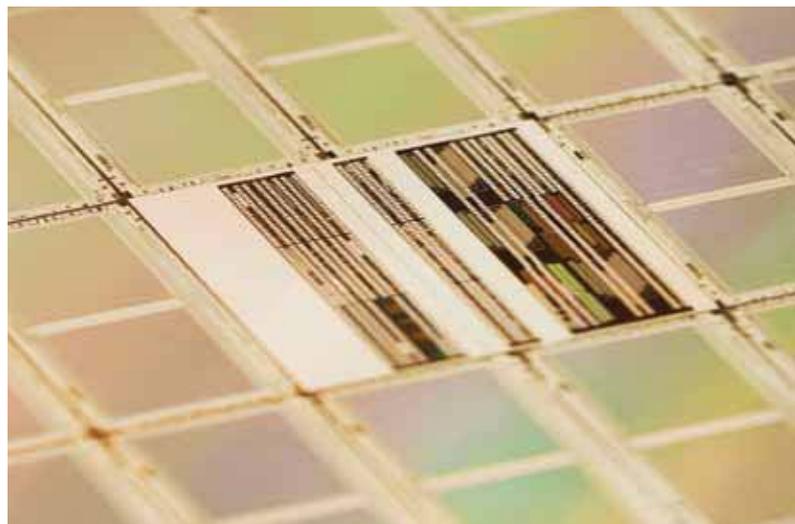
The 27 October 2011 Ecofin agreement contains some elements that are meaningful for currency markets. Principal among these is the decision to force banks to hold 9% tier one capital.

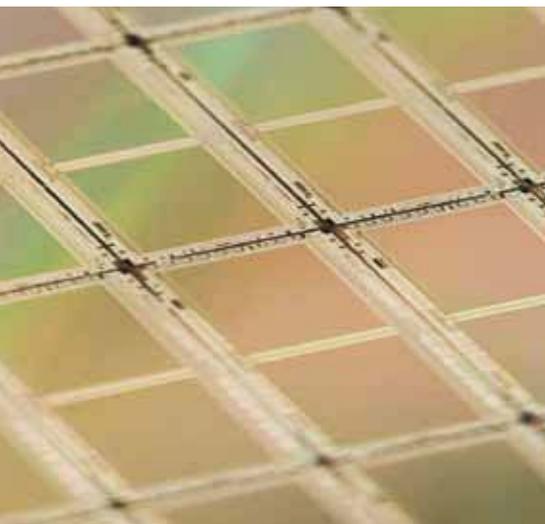
If this is carried out, it would present much of the European banking sector with the choice of issuing expensive equity or shedding assets. The latter (and probably the more palatable) choice for banks would strengthen the sector for the future and unblock the arteries of intra-Eurozone capital flows. This is a prerequisite for a successful resolution to the crisis, but it may come at a heavy cost on economic activity in the near term. Effects might not be limited to the Eurozone: the Eurozone banking sector has lent some €4.5 trillion to non-residents, which represents some 13% of its aggregated balance sheet.<sup>2</sup> The recent falls in the value of Eastern European currencies relative to the euro has been at least partially attributed to the start of the deleveraging process, and may continue into 2012. But the effect of such deleverage may be felt far beyond the immediate vicinity of Europe: the exposure of Iberian banks to South America has been well documented but, surprisingly, it turns out that European banks also have a great deal of exposure to Asia ex Japan.

In other words, the 27 October decision may make the Eurozone safer but could be a significant drag on global growth. Therefore, despite the weight of probability falling behind a weaker euro (and indeed a weaker Europe), the impact of bank deleveraging could paradoxically lead to a scenario that is positive for the euro (from repatriation, deleverage and easier capital flows) and the US dollar at the same time (increased risk aversion) but bad for everyone else.

"...we expect commodities will continue to attract investor interest in the coming year, in part because of their historically low correlation to equities as well as their diversification benefits."

Kenton Yee, Mellon Capital





# Commodities

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**GLOBAL**

Back to the futures: Commodities set to deliver diversification

By Kenton K. Yee, PhD, CAIA, Senior Research Analyst, Mellon Capital

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## Back to the futures: Commodities set to deliver diversification



By **Kenton K. Yee, PhD, CAIA**  
Senior Research Analyst, Mellon Capital

Mellon Capital Management Corporation (Mellon Capital) is an innovative leader in the development of global investment solutions. It is known for its unique approach to asset allocation and robust, structural models based on financial economics. Mellon Capital is intellectual capital – applied.



1. <http://www.cftc.gov/MarketReports/FinancialData/forFCMs/index.htm>, as of September 2011.
2. For example, see J. Zweig, "Why Your Stock Portfolio Is Acting Like a Commodity Basket," *The Wall Street Journal*, November 20, 2010; B. Solnik and F. Longin, "Extreme Correlation of International Equity Markets," *Journal of Finance*, 56.2 (2001), pp. 649-676; and B. Buyuksahin, M. Haigh, and M. Robe, "Commodities and Equities: Ever a 'Market of One'?", *The Journal of Alternative Investments*, 12.3 (2010), pp. 76-95.
3. "Shared macro factors" are macroeconomic measures (such as GDP, interest rates or inflation rates) that jointly affect the returns of stocks and energy or industrial metals.
4. The discussion about limited shelf life does not apply to gold. Given gold's role as a safe haven asset, there is less concern that gold would move in lockstep with stocks.

Between the US presidential election, budget deficit battles, uncertain economic growth, the potential for inflation in some countries, and heightened market volatility, the investment climate is likely to remain challenging in 2012. As a result, we believe 2012 may be a year when portfolio diversification is more important than ever. To this end, we expect commodities will continue to attract investor interest in the coming year, in part because of their historically low correlation to equities as well as their diversification benefits.

According to the US Commodity Futures Trading Commission, open interest in exchange-traded futures contracts increased significantly from December 1999 to August 2011<sup>1</sup>. For example, open interest in the West Texas Intermediate Crude Oil futures contracts traded in New York doubled. At the same time, this growing popularity of commodity-related investments has raised concerns that commodities markets may start to move in lockstep with financial markets in a globalised "market of one."<sup>2</sup> Are commodities losing their ability to provide diversification? Absolutely not, in our view. We believe commodities, including gold, will continue to be a source of diversification and help buffer portfolios during periods of stock market volatility.

### Commodities compared to commodity-related stocks

In our view, the distinction between commodities and commodity-related stocks is crucial to investors seeking diversification. As indicated in the chart, real estate investment trusts (REITs) and global natural resource stocks are, and have been, highly correlated to global stocks (as represented by the MSCI All Country World Index). In the last decade, REITs and natural resource stocks have consistently indicated correlations to the MSCI All Country World Index WI in excess of 50%. This is not surprising, since "stocks are stocks." In other words, commodity-related stocks, like other stocks, are financial instruments that have a long duration and whose returns are tied to profitability expectations and other equity factors.

The chart shows that so-called bread and butter commodities (agricultural, soft commodities and livestock) and precious metals, along with US Treasuries, have retained their low (or sometimes negative in the case of US Treasuries) correlation to global stocks. Although the correlations of these commodities have varied from year to year, they remain low and range-bound. Therefore, we believe the ability of these commodities to add diversification to traditional stock and bond portfolios will remain as effective as ever in 2012.

Perhaps surprising in this chart is the fact that energy and industrial metal commodities have exhibited a sharp rise in correlation to global stocks starting in late 2008, making these commodities less effective diversifiers. We believe that a plausible explanation for this uptick might be that the expansion of Chinese industry and construction has strengthened the correlation between corporate profits and energy and industrial metals prices. In other words, emerging market demand for energy and industrial metals may have caused these commodities to behave in a pro-cyclical manner like growth stocks. In addition, the global recession and financial deleveraging could have caused higher correlations between energy and industrial metals by virtue of increasing the volatility of their shared macro factors<sup>3</sup>, therefore obscuring the idiosyncratic volatility of these commodities. If so, we expect the high correlation of energy and industrial metals to stocks to persist for some time, until common macro influences stabilise. While we cannot forecast when these correlations will subside, we believe it is premature to accept them as permanent or even long term. A possibility is that the

correlations between stocks and energy and industrial metals might return to normal when the volatility of their shared macro factors eventually returns to normal levels.

#### Maintaining independence from stock prices

Taking a step back, we believe that at least two distinguishing characteristics of commodities should prevent them from permanently joining a “market of one” with global stocks. The first is their limited shelf-life<sup>4</sup>. (In contrast, stocks can be “stored” indefinitely, while bonds can be “stored” until maturity.) We emphasise that this attribute does not refer to storage costs, although costs are also a factor. Rather, limited shelf life refers to the fact that (most) commodities degrade in quality or perish in storage. Furthermore, limited storage capacity limits how much of some commodities, like above-ground crude oil, can be stored for investment purposes without constructing costly new facilities, which takes time. Consequently, bullish speculators cannot withhold as much supply from the market as might be optimal to await a demand rebound. Likewise, commodity consumers cannot

rely on stored inventory to meet all demand during production shortfalls.

The second distinguishing feature of commodities is that a physical unit not yet harvested or mined cannot be consumed. A consumer cannot make bread in May with September wheat. Therefore, commodity prices fluctuate based on “buy-as-you-go” supply and demand. Compared to stock and bond prices, commodity prices are not as influenced by speculative expectations about distant future events. This “instantaneous” (or “contemporaneous”) feature of commodity prices is another reason to believe that commodities, especially foodstuffs, will retain their independence from stock prices and continue to serve as reliable diversifiers in 2012.

In conclusion, we believe that commodities prices will continue to be set on the ‘Main Street and the Silk Road’. In contrast, stock and bond prices are set on Wall Street and The City. We believe remembering this distinction will serve investors well, as they strive to build diversified portfolios for weathering 2012 and beyond.

### HISTORICAL ROLLING 1-YEAR CORRELATIONS OF ASSET CLASSES TO MSCI ALL COUNTRY WORLD INDEX FEBRUARY 2002 TO SEPTEMBER 2011



**REITS** refer to FTSE EPRA/NAREIT United States Index. **Global natural resource stocks** refer to AMEX Composite Natural Resource Price Index. **Precious Metals** refer to the S&P GSCI Precious Metals Total Return Index. **U.S. Treasuries** refer to the 10-Year U.S. Government Bond Index. **Energy and Industrial Metals** are represented by an equal-weighted portfolio of the S&P GSCI Energy Total Return Index and the S&P GSCI Industrial Metals Total Return Index. **Agriculture, Softs, and Livestock** are represented by an equal-weighted portfolio of the S&P GSCI Agriculture Total Return Index, the S&P GSCI Softs Total Return Index, and the S&P GSCI Livestock Total Return Index. **Source:** Thomson Reuters Datastream and Mellon Capital Management, as of November 2011.



“We believe that investors concerned with generating income and protecting themselves from unexpected inflation risk in this tough economy should consider commercial real estate. Property fundamentals in certain markets are solid: rents and occupancy levels are rising, and the supply of competitive properties is low.”

Todd Briddell, Urdang





# Property

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**GLOBAL****48**

Property offers shelter from the storm

E. Todd Briddell, Chief Investment Officer, Urdang Securities Management, Inc.

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PROPERTY GLOBAL



BNY MELLON  
ASSET MANAGEMENT

## Property offers shelter from the storm



**E. Todd Briddell**  
Chief Investment  
Officer,  
Urdang Securities  
Management, Inc.<sup>1</sup>

Urdang focuses solely on real estate, managing private equity investments, real estate debt investments and portfolios of real estate securities.



In light of the uncertainties in the marketplace today, we believe that investors are looking at the future economy in one of two ways: either that the market will revert to the mean, with a return to growth and potential for higher inflation; or, instead, the market will enter into a new paradigm: a period of sustained low growth and continued deleveraging. Either outlook will largely shape investment decisions for the foreseeable future. We believe that locking in yields now with the expectation of sustained low growth may be the correct course, and that real estate investments are a compelling vehicle for doing so.

### **Downward pressures on property markets**

As we assess the recent downward pressure on the globally listed property markets, we find that they were driven by three main forces: market fundamentals, the capital markets and government policy.

From a fundamentals perspective, GDP growth worldwide is slowing, and the outlook for a recovery has dimmed. Unemployment remains a persistent issue in the US and Europe. Both investors and governments seem to be relying somewhat on future growth to solve their problems, which we believe will be very difficult to achieve.

In the capital markets of the developed world, underwriting standards and credit availability are tightening once again. European banks are being closely examined as they face both the unresolved debt crisis in Europe, and the capital adequacy and liquidity requirements of Basel III. Meanwhile, rating agencies are redefining how they look at credit.

On the policy side, the situation is equally challenging. In China, the government has enacted tightening measures to temper an overheated market, but many investors continue to worry about a debt bubble and a hard landing. In Europe, the European Union sought unanimous consent for a plan to bail out governments on the brink of default, but continues to have difficulty working out the details and acting in a concerted and consistent way. The US continues to face its own challenges with indebtedness and political impasse, prompting the historic credit downgrade in 2011 and continuing to unsettle markets.

### **Standing prepared**

With so much volatility in today's global market, we believe in making more preparations than predictions. Amid expectations for low growth in the near to mid term, we are focused on companies which have the highest quality assets in what we regard as the best markets and with the best management teams.

1. Urdang Securities Management, Inc., is a wholly-owned subsidiary of Urdang Capital Management, Inc., collectively referred to as "Urdang."

2. SNL Financial, September 30, 2011. SNL Financial is a provider of global real estate data.

We seek companies with low leverage and appropriate liquidity. We find companies that are focused on long-term leases, and/or solid credit tenants to be attractive. We are also willing to bide our time with new investments, as we believe ongoing market volatility in 2012 will provide multiple entry points and opportunities.

In our view, attractive valuations argue a strong case for global real estate. We are finding significant discounts to net asset value (NAV) available in REITs (Real Estate Investment Trusts) around the world. The global median in NAV discounts was near -28% as of September 30, 2011.<sup>2</sup> From a spread perspective, dividend yields on REITs relative to local treasury yields are significantly above the long-term averages across regions. These valuation factors suggest to us extremely attractive entry points for REITs in 2012.

We believe REITs own some of the best assets in large business centres such as in New York City, serving as a hedge in the event of a pick-up in inflation. In addition, they offer strong historical liquidity, and currently trade at attractive valuations as described above. However, investors, in our view, will need to have strong stomachs to withstand the market volatility we expect to see during the next 12 months.

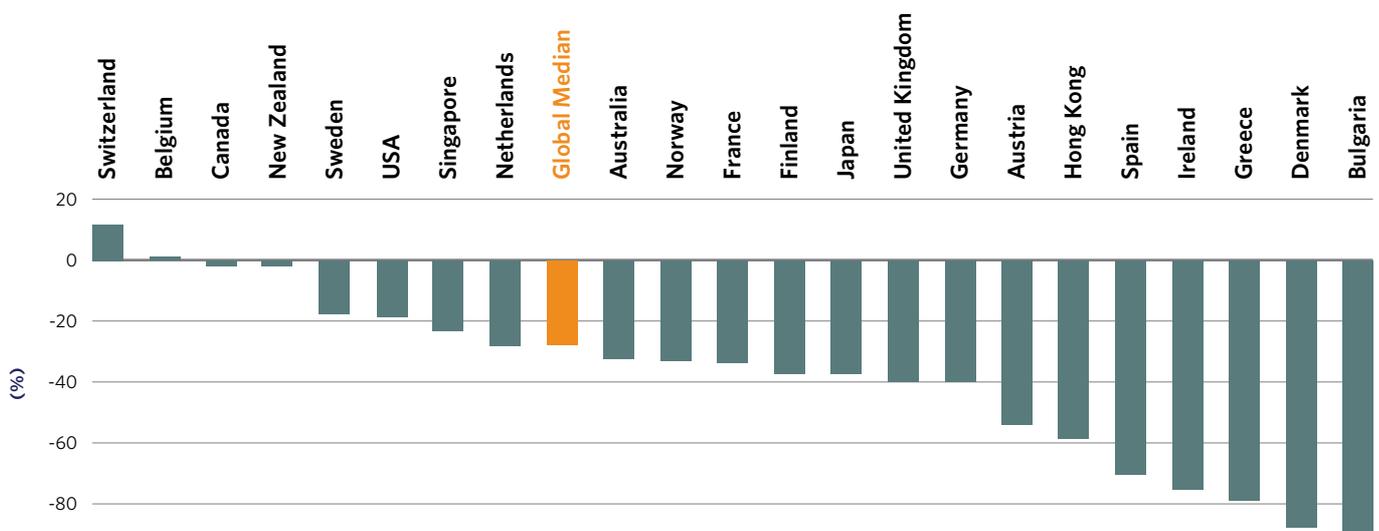
**Real estate in 2012**

We believe that investors concerned with generating income and protecting themselves from unexpected inflation risk in this tough economy should consider commercial real estate. Property fundamentals in certain markets are solid: rents and occupancy levels are rising, and the supply of competitive properties is low. At current yields, the spread relative to US Treasuries is historically high. There

is a growing supply of attractive distressed opportunities available for acquisition due to the number of underwater assets that need to be marketed for sale. And, real estate offers inflation protection; unlike bonds and other fixed US dollar investments, real estate has demonstrated a long-term ability to hold its real value during inflationary cycles.

While we do not expect a double-dip recession, we have adjusted our market outlook to account for lower growth in what looks to be a cloudy economic future. Still, we believe the case for REITs remains compelling. Increasingly we see a bifurcation in the market between regions with strong growth prospects for real estate and other areas that continue to struggle. We believe investors who are prepared to withstand market volatility have the potential to experience strong upside in their real estate investments.

**DISCOUNTS TO NET ASSET VALUE WORLDWIDE**



Source: SNL Financial, Urdang, as of 30 September 2011.



“With developed market growth oscillating between slow and slower, and markets remaining skittish, we believe investors need to be smart about positioning themselves for both good and bad news in a valuation-conscious and opportunistic way.”

Robert Jaeger and  
Stephen Kolano,  
BNY Mellon





# Asset allocation

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**GLOBAL**

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Balancing portfolio risks in a square root recovery  
Robert A. Jaeger, PhD, Senior Investment Strategist,  
BNY Mellon Investment Strategy and Solutions Group (ISSG),  
Stephen Kolano, CFA, Investment Analyst, ISSG

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BNY MELLON  
ASSET MANAGEMENT

## Balancing portfolio risks in a square root recovery



**Robert A. Jaeger, PhD**  
Senior Investment  
Strategist, BNY Mellon  
Investment Strategy  
and Solutions Group  
(ISSG)<sup>1</sup>



**Stephen Kolano, CFA**  
Investment Analyst,  
ISSG

As our asset class specialists have described in this year's Global Market Outlook, investors are increasingly concerned about the possibility of a square root recovery in developed markets: a sharp bounce off the lows of the global financial crisis, followed by a prolonged flat-line recovery featuring stubbornly slow growth and high unemployment (that is, a growth line shaped like a square root symbol). Investors who believe in the square root scenario are very focused on protecting their portfolios against left tail risk, and have therefore become interested in high quality, financially strong assets that are oriented towards income rather than growth.

Although the square root scenario is entirely plausible, we think it might be a mistake for investors to make radical changes in their asset allocation in order to take advantage of that scenario, presuming that investors already have reasonably well-diversified portfolios. Investors are now so thoroughly focused on the square root scenario that market prices already reflect very low expectations. Setting out to build a "square root portfolio" now runs the risk of selling undervalued assets in order to buy expensive assets as well as missing healthy returns if the fundamental economic news turns out to be better than expected. In an

environment of diminished expectations and markets reacting disproportionately to good and bad news, we believe the right tail of the return distribution becomes at least as important as the left.

### **The big question...**

Even with a strong conviction about the macroeconomic backdrop, the key investment question for 2012 will continue to be how investors should position their portfolios. To answer that intelligently, investors need to be mindful of valuations. Seeking left-tail protection now is likely to involve selling assets saddled with low expectations and buying assets that are regarded as reliable sources of modest return. We believe this is a classic recipe for selling low and buying high, even before tallying up transaction costs. Moreover, constructing a square root portfolio addresses the downside risks, but provides no exposure to upside surprises. Investors might address this problem by buying options on equities (perhaps even options on more aggressive, growth-oriented equities), but options are notoriously expensive in the current environment of heightened uncertainty and volatility.

Indeed, given current valuations, we believe the most radical option for investors with well-diversified portfolios might be to do nothing. Current asset prices already reflect downbeat

1. Investment Strategy and Solutions Group ("ISSG") is part of The Bank of New York Mellon ("Bank"). ISSG offers products and services through the Bank, including investment strategies that are developed by affiliated BNY Mellon Asset Management investment advisory firms and managed by officers of such affiliated firms acting in their capacities as dual officers of the Bank.

expectations. Those prices could certainly move down further, but low expectations create enormous amounts of upside risk, especially in highly reactive markets. Our view is very simple: investors should be wary of allowing a widespread preoccupation with downside risks tempt them into some very expensive moves that might leave them without enough exposure to the potential for significant rises in undervalued asset classes and markets.

### Which tail should wag the dog?

Given that no one can predict the future, we think investors should be mindful of both tails of the return distribution. To protect against left tail risks, investors would focus on capital preservation. Right tail risk protection would revolve around capital appreciation and income in the face of large capital market gains. Similar to option strategies, we believe investors in the current environment should maintain a constant straddle on tail risk where volatility is high and direction is uncertain in order to limit downside risk, while maintaining upside potential.

We believe that dividend-yielding equity strategies fit this bill. While they continue to provide income in down markets,

they also allow for capital appreciation should equity markets begin to move higher. In addition, using dividend yield to fund the purchase of out-of-the-money call options on an equity index provides investors with the potential to defend both right and left tail risk. Similar to equity income strategies, other investments that provide similar defence to both tails would include higher-yielding investment grade non-callable bonds, mezzanine debt, bank loans, and leveraged loans. All of these debt instruments provide yield, while also maintaining a focus on capital preservation through the return of principal. In particular, the security component of both bank loans and leveraged loans offers an attractive feature by combining higher, and sometimes variable, yields with the collateral of the business assets to support recovery in the event of default.

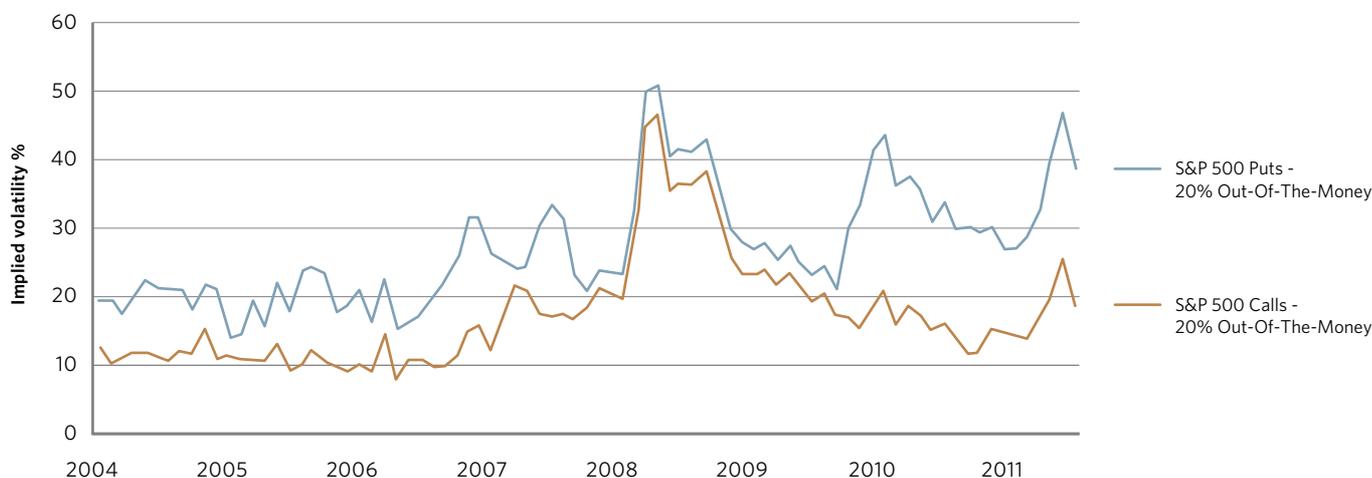
Protecting intelligently against tail risk requires balancing the cost of hedging that risk. As more investors have focused on downside risk following the financial crisis, the cost of doing so has risen considerably. Looking at the dispersion of cost between puts and calls, it is clear that the market is skewed towards left tail risk in the current environment and the cost of left tail

protection has been bid up (see the chart below). We believe investors must weigh the value of that protection with its cost and the effect on total portfolio returns. Similar to the price of hedges being bid up, the valuations of high-yielding dividend stocks have also risen to historically high levels in response to growing demand.

### A radical alternative: do nothing

We believe investors need to avoid knee-jerk defensive measures and consider potential changes in the context of their overall portfolio, along with valuations and transaction costs. The best option for well-diversified investors might be to do nothing. The risk we see is that investors might buy left tail risk insurance by selling undervalued right tail opportunities, incurring transaction costs, and ending up with no better return in their overall portfolio. Instead, it might be more prudent for investors to maintain some dry powder in the form of cash to have available for opportunities as they arise. With developed market growth oscillating between slow and slower, and markets remaining skittish, we believe investors need to be smart about positioning themselves for both good and bad news in a valuation-conscious and opportunistic way.

## MONTHLY S&P 500 OPTION IMPLIED VOLATILITY



"Out of the money" is used to describe an option whose strike price is either higher than the current market value, in the case of a call, or lower, in the case of a put. Source: ISSG using Bloomberg data as of 31 October 2011.

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