Market Insights

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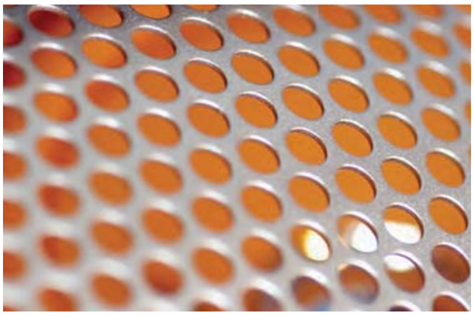

# CIO View: Global Uncertainty and Thirst for Yield to Dominate Markets for Rest of 2012

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Standish Chief Investment Officer David Leduc reflects on market developments in the first half of the year and argues that fiscal uncertainty in the U.S. and Europe as well as the slowdown in China will weigh on markets for the rest of the year.

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**Executive Summary**

Standish Chief Investment Officer David Leduc reflects on market developments in the first half of the year and argues that fiscal uncertainty in the U.S. and Europe as well as the slowdown in China will weigh on markets for the rest of the year. He describes the transformed notion of "safe-haven" government bonds as the debt crisis in Europe continues to challenge policymakers. Credit risk analysis, he argues, is now an enduring element of sovereign bond investing in developed markets while global financial markets reflect a tug of war between continued global economic and policy uncertainty versus a thirst for yield. That thirst for yield, he says, will likely continue to support rich valuations on "safe-haven" assets and select credit sectors with strong fundamentals. The global bond manager believes global growth will remain below trend reflecting ongoing deleveraging in developed economies. Credit markets, he says, remain fundamentally attractive but earnings momentum has peaked across a number of sectors, prompting caution on valuations. The crisis in Europe, the U.S. fiscal cliff and China's slowdown continue to be the key risks to Standish's global growth outlook.

*"Countries don't go bust." — Walter Wriston, Former Chairman Citicorp 1967-1984*

**"Safe-Haven" Bonds**

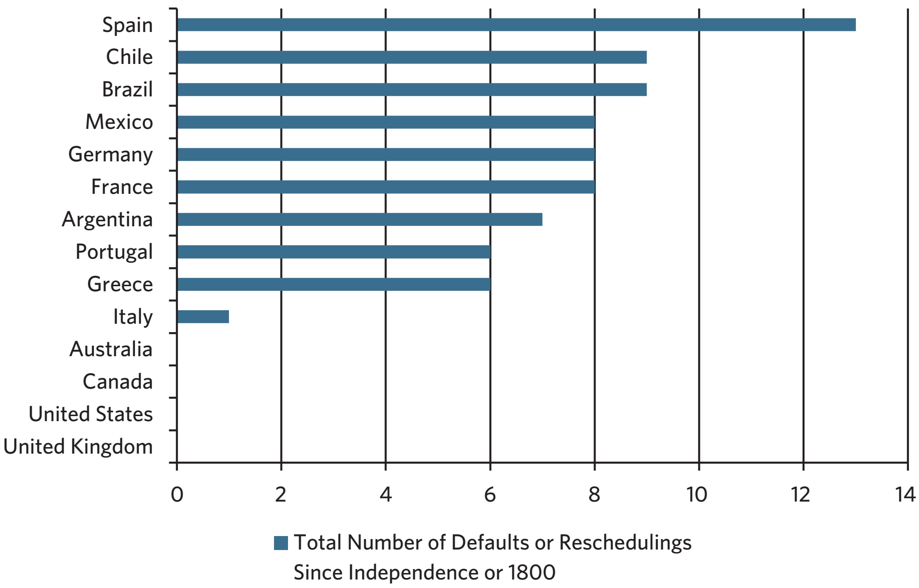
Fixed income is an asset class where the issuers of securities make a promise to repay the initial investment as well as a return on the investment in the form of interest. While there are many ways to stratify the risk associated with a bond investment, there have always been two principal risks: the risk that the promise is not kept (default risk) and the risk that the promised return does not keep up with changes in the price of goods and services over time (inflation risk). Investors should generally evaluate both risks when deciding whether to buy any type of bond.

As we know, countries do go bust. Indeed, Spain alone defaulted 13 times during the roughly two centuries from 1800 to 2008.

However, history is littered with periods when investors became complacent about default risk while investing in sovereign bonds. For example, at Standish we have a bond certificate issued by the Confederate States of America in 1864. Purchased by Dutch investors, the bond was issued to yield 6% annually and made only one coupon payment. Comparable maturity bonds issued by the United Kingdom, the dominant global power in the mid-1800s with equal if not greater safe-haven status than that of the United States today, were yielding 3.3% at the time. Thus, investors were willing to accept a yield premium of just 270 basis points to invest in an emerging country in the midst of a life or death struggle. At the time of issuance, the American Civil War was in its fourth year and the Confederate bid was already waning. Union forces had won the battle of Gettysburg the prior summer and were closing in on the Confederate capital in Richmond, Virginia.

Did the Dutch investors really believe that a premium that was roughly half the 500-600 basis point risk premium that Spain now pays versus Germany was enough to compensate them for the potential risk of default? Perhaps they believed, as Citicorp did at the height of the Latin American lending boom in 1970s, that sovereign nations generally do not have default risk. As we know, countries do go bust. Indeed, Spain alone defaulted 13 times during the roughly two centuries from 1800 to 2008. There were a total of 73 default and restructuring events in Europe during this same period. That number increases to 74 if we extend the analysis to 2012 to include the recent restructuring in Greece.[1]

**Exhibit 1 – Sovereign Defaults Happen**




Source: Reinhart and Rogoff 2009 and Standish 2012.

1 Carmen M. Reinhart and Kenneth S. Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (New Jersey: Princeton University Press) 2009, p. 99.

Despite this track record, developed country bond yields have primarily reflected expectations about economic activity and inflation over the past few decades. Sovereign default risk was a worry consigned mainly to emerging market countries. This has clearly changed as gross debt levels in the advanced economies now surpass 100% of GDP on average, which is roughly 25 percentage points higher than where they stood before the 2008 global financial crisis.[2] This has implications for fixed income returns, not only in Europe, but across all sovereign fixed income markets.

Increasing concerns about sovereign credit risk have diminished the number of markets that are considered "safe havens."

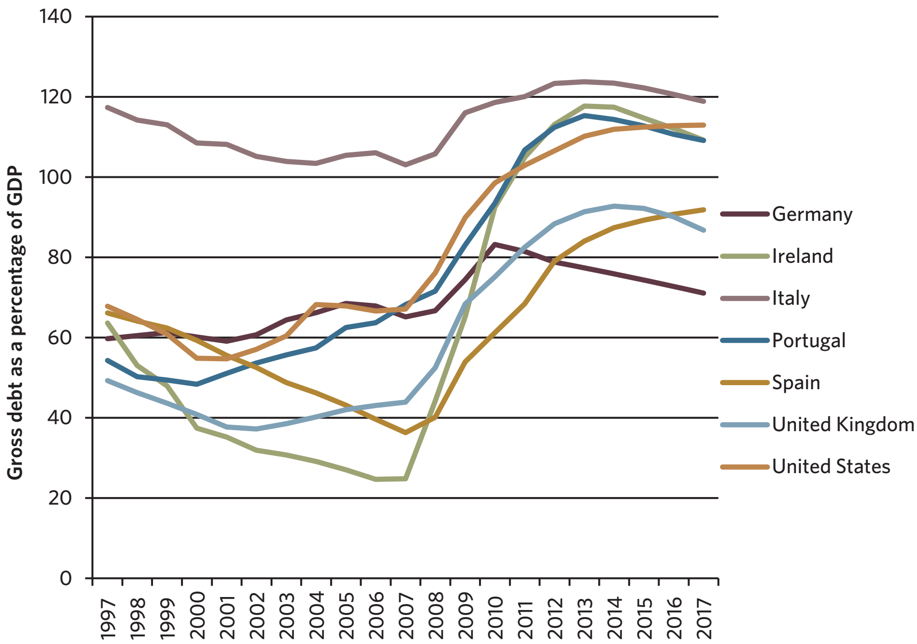
At Standish, we do our own homework when it comes to evaluating country risk. We use a combination of fundamental analysis and proprietary quantitative models to evaluate default and ratings migration risk in both developed and emerging markets. Increasing concerns about sovereign credit risk have diminished the number of markets that are considered "safe havens." This largely explains the continued investment in German bunds, British gilts and U.S. Treasury bonds even though yields in these markets are 150-200 basis points below fair value by our estimates.

We believe this dynamic is likely to persist until strains in Europe ease and investors begin to focus more on the debt dynamics in some of these safe-haven markets. Indeed, Germany is already seeing some pressure on government bond yields as investors speculate that the country will be forced to bear the brunt of the cost of preserving Europe's monetary union. At the same time, deteriorating fiscal positions in the U.K. and U.S. could affect safe-haven flows to these economies. In fact, gross debt/GDP for both economies is expected to remain above Spain's through 2014 according to the International Monetary Fund (Exhibit 1). This raises a number of troubling questions for investors looking for a store of value in global fixed income markets. Nonetheless, we continue to see pockets of value in other areas of the fixed income markets where the fundamentals remain supportive of higher valuations.

2 International Monetary Fund, "World Economic Outlook Database," April 2012.

Although no country has been immune to the European downturn, there has been a clear decoupling in global economic performance during the first half of 2012 as we expected.

**Exhibit 2 – Find the "Safe Haven"**




Source: International Monetary Fund as of July 2012.

**Review of Our First Half Economic Forecasts and What to Expect in the Second Half**

At Standish, our search for value in global fixed income markets begins with our top-down macro view of the world economy. Our projections for the first half of 2012 were fairly accurate. Global economic growth is roughly in line with our 3.3% forecast for 2012, with much of the weakness concentrated in Europe. Although no country has been immune to the European downturn, there has been a clear decoupling in global economic performance during the first half of 2012 as we expected. Moreover, our call that emerging market economies in Asia and Latin America would be the least tainted by Europe's woes proved to be on the mark. Finally, our expectation for further monetary easing was correct with the Federal Reserve, the European Central Bank (ECB), and People's Bank of China all taking action in the first half of the year.

We expect the focus to shift from Europe to the U.S. as we enter election season and rhetoric about the fiscal cliff heats up.

The biggest misses in our forecast related to global inflation, which was stickier than we had anticipated due to rising energy costs resulting from tensions between Iran and Israel in the Middle East. Looking ahead, we worry that headline inflation may remain elevated in the second half of 2012, given the impact of recent droughts in the U.S. on global food prices and on corn in particular. Yet core inflation rates excluding food and energy prices should remain benign given the slack in product and labor markets. Separately, we probably underestimated the severity of the slowdown in China in the first half of the year. Though we continue to believe the Chinese economy will avoid a hard landing, we have trimmed our forecast from 8% to 7.5% for the full year.

Many of the issues that made it difficult to forecast in the first half continue to cloud the outlook as we enter the second half of 2012. Specifically, we remain concerned about the situation in Europe, the U.S. fiscal cliff, and the risk of a slower growth in China. We view recent ECB proposals for purchasing the short-term debt of countries that request a bailout from the European Financial Stabilization Fund (and eventually the European Stabilization Mechanism) as potentially meaningful. However, such action is not a substitute for either structural reform or setting out a road map for the eventual formation of a banking and fiscal union with joint Eurobond issuance.

We expect the focus to shift from Europe to the U.S. as we enter election season and rhetoric about the fiscal cliff heats up. Our base line view is that Congress will take action to avoid the full implementation of the $450 billion in tax hikes and spending cuts. Unfortunately, we believe they will delay doing so until the eleventh hour when it has already taken a toll on consumer and business confidence and thus economic growth in the second half. Overall, since these are not new risks, we remain comfortable with our call for 3.3% world GDP growth for the full year. We expect a modest acceleration in global economic activity in 2013 to 3.5% as we bypass the fiscal cliff, the downturn in Europe begins to abate, and coordinated policy action by the major central banks begins to bolster global demand.

Given our expectation that growth in emerging markets will remain higher than that of the advanced economies, we continue to look for value in both local currency and external emerging market bonds.

**Opportunities for the Balance of 2012**

As with our economic forecast, our investment stance for the second half of the year has not changed materially since our January outlook. We continue to believe that with strong or stable fundamentals, such as U.S. corporate credit, securitized products, and some emerging market currencies are favorable. Yet, valuations are less attractive than they were at the beginning of the year given the market rally, and the risks to our macro view have not dissipated during the first half of 2012. Therefore, we are less favorable toward areas that have exhibited strong performance and support a preference toward areas such as shorter duration medium-quality credit and consumer asset-backed securities where expected returns remain attractive.

Given our expectation that growth in emerging markets will remain higher than that of the advanced economies, we continue to look for value in both local currency and external emerging market bonds. Certain currencies, such as the Mexican peso, remain undervalued in our view but we expect their performance will be highly correlated with global risk sentiment. We still believe investments in the securitized sector remain attractive and U.S. consumer structured assets and U.S. agency mortgage securities should provide a stable and highly liquid foundation for fixed income portfolios.

As we pointed out at the beginning of the year, agency mortgage securities should benefit from the low and stable interest rate environment that the Fed is trying to foster. We also expect the Fed to pursue another round of quantitative easing targeting mortgage-backed securities. Despite ongoing concerns about the policy choices in Europe with respect to austerity programs and peripheral funding needs, we do see areas of opportunity in economies that have stable economic outlooks, such as Slovakia, and those with improving fiscal dynamics, such as Ireland. Nonetheless, policy uncertainty remains extremely high and begets forecast uncertainty. Our view will be to avoid assets with deteriorating fundamentals such as the sovereign bonds and senior and subordinated bank bonds from certain peripheral European economies.

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