Global Market Outlook 2013

Experimental policy transforms the investment landscape

Prepared for professional investors only

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Experimental policy transforms the investment landscape

Unconventional monetary policy characterised 2012 as the European Central Bank initiated its Outright Monetary Transactions (OMT) programme and the US Federal Reserve embarked on a third round of quantitative easing (QE3), while the Bank of England continued to expand its asset purchases. Indeed, monetary easing, alongside regulatory reform and government intervention, has emerged as the policy of choice for addressing a multitude of problems facing the global economy. Whether these actions combined will assure stable growth for the global economy remains to be seen. Market participants may well be, if not entirely convinced, more hopeful.

As the intended and, possibly, unintended consequences of this great policy experiment play out in 2013, asset managers across BNY Mellon's global boutiques will continue to pursue investment opportunities in their specific asset classes. In fact, some of the broader regulatory and policy trends may provide new opportunities, or make existing ones more attractive.

For example, while more stringent capital requirements have impeded banks' capacity to lend, a space has also opened up in the market which is increasingly being filled by private investors lending directly to corporations. Similarly, low yields and sluggish growth in much of the developed world are turning greater attention to the emerging world, where a growing dividend culture and differentiated opportunities across asset classes are broadening the opportunity set for investors.

At the same time, investors are increasingly focused on managing risk, ranging from counterparty and liquidity risk to systemic risks such as inflation and interest rate fluctuations. In the relatively low-return environment that is likely to characterise the coming year, minimising losses through effective downside protection will be an important consideration.

It is against this backdrop that we present this collection of our managers' asset-class specific outlooks for the coming year. We hope that you find these views, spanning equities, fixed income, alternatives and asset allocation, both informative and thought-provoking.

Introduction – setting the scene

For much of 2012, markets were buffeted by investor risk aversion as a result of political and economic uncertainty and central bank liquidity injections aimed at stabilising the financial system. Weak economies in the developed world and signs of a slowdown in the major emerging regions weighed on markets. Frictions that had left the Eurozone teetering on the brink of disintegration at the end of 2011 continued to make headlines. Meanwhile, a close-run US Presidential election race culminated in a second term for President Barack Obama, and China underwent a once-in-a-decade change of leadership.

Equity markets made gains during the second half of the year as decisive policy action from central banks boosted sentiment. With the US Presidential election out of the way, however, the US 'fiscal cliff' was the subject of renewed focus, taking the shine off performance. Heightened tensions in the Middle East and continued wrangling in the Eurozone added to the uncertain investment backdrop. "A symptom of this increase in systemic risk has been a 'risk-off, risk-on' environment," explains Insight Investment's Andy Cawker.

By the end of November, the FTSE All-World Index was up by 14.4% year-to-date and the US equity market had returned 14.9% , both in US dollar terms. The sovereign debt market weakened, with the JP Morgan Global Government Bond Index falling by 2.4% in the year to the end of November[1], although continued investment flows into perceived 'safe-haven' markets boosted US Treasuries and UK Gilts. Commodity-related currencies, including the Australian dollar and the Canadian dollar, proved strongest in 2012.

Can 'impatient policy choices' deliver stability and growth?

As we move into 2013, the challenge facing policymakers is how to maintain stability and, at the same time, try to stimulate economic recovery. US economic indicators are improving, with the housing market a particular bright spot. However, the UK and Eurozone economies continue to struggle to generate growth, while there are concerns about the severity of the economic slowdown in China.

Masaaki Shirakawa, Governor of the Bank of Japan, warned in October that the path for the global economy was not an easy one and that it was important "... to avoid inflicting collateral damage from impatient policy choices". Ben Bernanke, Chairman of the US Federal Reserve (Fed), acknowledged that the Fed "... carefully weighs the costs and benefits of any proposed policy action". The latest, and third, round of quantitative easing (QE) in the US has committed the Fed to intervening for as long as it takes for labour market conditions to improve.

In September, the European Central Bank (ECB) announced its Outright Monetary Transactions programme, for potential purchases of Eurozone countries' short-term debt. This programme is also uncapped, reflecting a comment by the ECB President Mario Draghi that he would do 'whatever it takes' to save the euro. The Bank of England is committed to its own programme of QE.

A year of challenges and opportunities

For investors, 2013 is likely to bring with it a strong sense of deja vu. Newton's James Harries explains, "We believe that the investment backdrop remains structurally difficult... many of the same problems are re-emerging". While the efforts of central banks appear to have provided a degree of stability, the seemingly endless supply of liquidity is affecting the prices of financial assets and this may prove problematic over the longer term. In the short term, some valuations are being pushed well above levels that can be justified by fundamentals alone, providing investors

with challenges and opportunities in equal measure. A long-term view is essential, believes Newton's Nick Clay, "… it is important for investors to retain perspective on the investment backdrop that will continue to shape their approaches".

As far as fixed income returns are concerned, Standish's Tom Higgins believes that "The actions of global central bankers and legislators may trump the importance of economic fundamentals in 2013". Research into the Fed's first two rounds of QE suggests that there has been a material effect on fixed income markets, driving yields lower on US Treasuries.

Amid investors' search for higher returns, emerging market debt (EMD) has been a relatively strong performer. US dollar-denominated EMD, an asset class largely driven by spreads over US Treasuries, has been a notable beneficiary. Standish's Alexander Kozhemiakin believes that there are plenty of opportunities in the asset class, "We look at the most attractive issues from a risk-adjusted perspective, regardless of whether they are sovereign or corporate, B- or BBB-rated". Similarly, in the EM corporate debt space, Insight's Colm McDonagh expects the asset class to benefit from increasing institutional interest and a broadening in the composition of the market, saying that "As the economies of emerging market countries develop further, sector diversity will also increase".

The real economy in focus

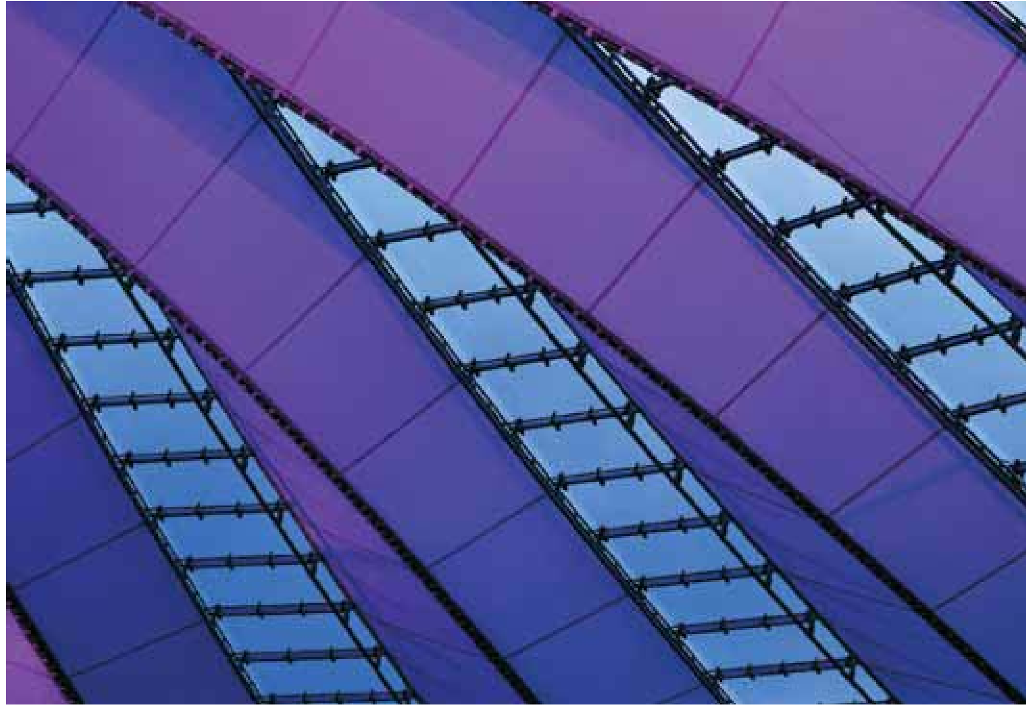
Long-term deleveraging will remain a significant theme for developed economies. While global economic growth remains fragile, the actions of politicians will continue to play a key role in investor confidence. Mellon Capital's Vassilis Dagioglu expects to see growth across the global economy, but "… at slow and geographically uneven tempos". There may be cause for a degree of optimism as far as the US is concerned. Newton's Paul Brain says, "In our view, the US could start to see an end to its private sector debt deleveraging and even see the banking system begin to work normally". Before that can happen, however, the US authorities need to address the 'fiscal cliff', which has the potential to de-rail both economic recovery and financial markets. European leaders also face difficult choices in reaching a consensus on the best way forward for the Eurozone.

The rate of Chinese economic growth will be closely followed in 2013. Of particular importance will be how the new leadership manages the shift from an export-led economy towards one more dependent on domestic consumption. Although, as Newton's Caroline Keen explains, "Even a 7.5% growth rate in China would mean the economy doubling in size every 10 years". A vibrant Chinese economy will undoubtedly be a significant factor in ensuring that global growth remains on track.

1. Lipper Hindsight, 30 November 2012

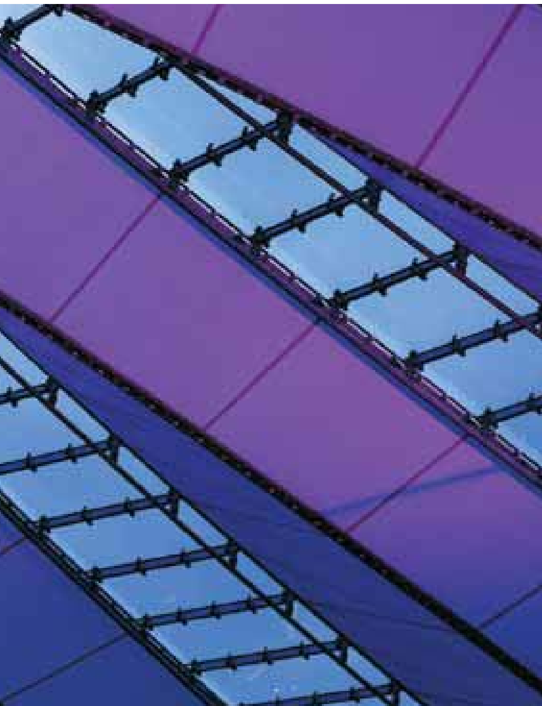
"As concerns about economic tail risks have started to fade, correlations between stocks have fallen back to more normal levels. Investors have refocused on company fundamentals, considering once again which stocks are best to own, as opposed to whether to own stocks at all."

Andy Cawker,
Insight Investment



"Following the global financial crisis, and for the first time since the Asia crisis of 1997, economies such as Malaysia, Thailand, the Philippines and Indonesia have been driven by increased fixed-investment spending."

Caroline Keen, Newton



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Identifying stable businesses in a distorted world

James Harries
Investment Manager, Global Funds, Newton

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

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We believe that the investment backdrop remains structurally difficult, and this leads us to emphasise the importance of the quality and sustainability of income streams. There have been some positives, we acknowledge, such as the stabilisation in the US housing market, but many of the same old problems are re-emerging. These include the twists and turns of the Greek crisis, the possibility of a Spanish bail-out, the approaching 'fiscal cliff' in the US and the ramifications of the Chinese leadership change, all of which present significant uncertainties in the months ahead.

The clear difficulty is that policymakers seem to want to force their efforts to work through a 'portfolio balance effect': pushing the return available on safe assets ever lower and, in so doing, cajoling those investors who wish to achieve higher target returns into buying riskier assets. The authorities continue to hold a strong conviction that unconventional monetary policies will result in a positive wealth effect, i.e., rising wealth will lead to rising consumption and, therefore, economic growth. Not only do we question the efficacy of this policy, we believe that it also creates difficulties for long-term investors by distorting prices.

The announcement of further unconventional monetary policy in the form of asset purchases by the European Central Bank (Outright Monetary Transactions) and the US Federal Reserve (Quantitative Easing, or QE) represents a major escalation of policies that have been in place since the global financial crisis broke. Though less trumpeted, the actions of the Bank of England and Bank of Japan are equally significant.

What motivates central bankers to act in this way? We believe there are clearly some well-intended motivations. Ben Bernanke, the US Federal Reserve chairman, is correct in his assertion that individuals lose out, and that the long-term productive potential of a society declines, when there is a high level of long-term unemployment. It is equally true that, without generating growth in excess of interest costs, debt burdens continue to rise. In addition, treating the symptoms of too much debt by lowering interest costs does buy time for politicians to make necessary structural changes.

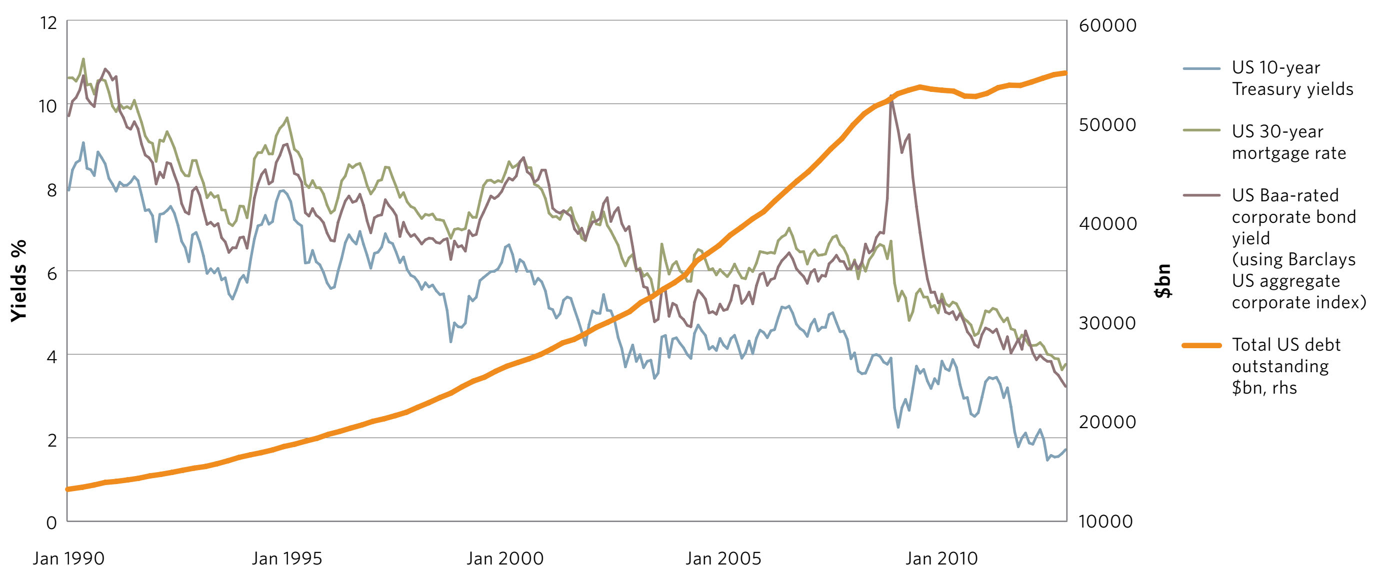
In our view, central bankers are equally likely to be proven incorrect in dismissing the costs of persistent low yields as manageable. We have consistently stressed that there is no such thing as free money, and that QE-type policies are not

without cost. For us, undesirable medium-term effects of the prevailing monetary approach range from the potential for ill-advised investments in the economy (capital projects that would not go ahead without distorted price signals and credit availability), the threat to the health of financial institutions, and the regressive effects on wealth and income distribution inherent in a policy that targets asset price inflation.

Growing pains

In a world facing the challenges of deleveraging (debt reduction) and the headwinds of demographic trends, we believe real growth will prove difficult to generate. The interplay between the challenging structural backdrop and the responses from monetary and political authorities is likely to maintain a high level of economic and financial volatility. All the historic evidence suggests that the best returns are made when investors are able to buy high-quality assets in well-managed businesses at attractive valuations. When policy is deliberately designed to prevent asset valuations from declining, it may be more challenging to identify such attractive valuations and, in our view, it is right, therefore, to remain cautiously positioned. Furthermore, continued economic and financial volatility is likely to increase the appeal of stable businesses and returns. As we have seen with the launch of QE1 and QE2, however, significant injections of liquidity by central banks can cause valuations of more operationally and financially leveraged businesses, which incorporate the risk of imminent failure, to rise sharply as they receive a stay of execution. Given that liquidity injections are likely to prove little more than short-term palliatives, and could ultimately end up facilitating greater economic damage, we still believe it is correct for investors to consider investing in businesses that have the high-quality cash flows and strong dividends we have long favoured.

US CREDIT COSTS AND STOCK OF DEBT - THE US DEBT BURDEN IS CONTINUING TO RISE AS GROWTH STRUGGLES TO OUTPACE INTEREST COSTS



Source: Thomson Reuters Datastream, monthly data from 01/01/90 to 01/11/12

Pursuing opportunities provided by falling correlations

Andy Cawker
Head of Specialist Equities, Insight Investment

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

Insight does not currently offer services in the U.S.

Over the past few years markets have been working through the aftermath of the 2008 financial crisis. This has morphed into a sovereign debt crisis, particularly in Europe, as the governments that looked to protect the financial system have consequently become overly indebted themselves. A symptom of this increase in systemic risk has been a 'risk-off, risk-on' environment. Financial markets have followed a wave-like pattern, taking two steps forwards as central banks announce policy action in response to a crisis, only to then take one step back as the next apparent crisis occurs.

Many asset classes have shown an increased correlation to the 'risk-off, risk-on' trend, making real diversification more difficult to achieve. Furthermore, correlations between stocks have intermittently spiked to multi-decade highs. As macroeconomic risks dominated investors' minds, there was less differentiation between relative winners and losers at the company level, with investors focusing on whether they wanted to own equities at all, rather than which equities might be best to own in such an environment. This may have served to reduce the returns from good stock selection. Recent policy announcements by the European Central Bank appear to have convinced market participants that there is now an effective backstop to prevent conditions from deteriorating in Europe. As concerns about economic tail risks have started to fade, correlations between stocks have fallen back to more normal levels. Investors have refocused on company fundamentals, considering once again which stocks are best to own, as opposed to whether to own stocks at all. This should present a more rewarding environment for active equity strategies as we move into 2013.

However, an environment in which tail risk is contained does not automatically translate into stable economic growth and trending markets. As we look forward, it seems likely that the combination of high government debt levels and financial deleveraging means that a low-growth environment is likely to persist. With growth levels close to what we regard as a 'stall rate', developed Western economies may be more vulnerable to recurring recessions.

Free from the constraints of the market cycle

Investors therefore have the challenge of adapting their strategies to a changeable and low-growth market environment. One way investors could tackle this is

to look to those strategies that have the ability to invest across a broad range of asset classes, yet have the flexibility to manage asset allocation dynamically in response to changes in economic and market conditions. Investors could also consider absolute return-style strategies, which can generate returns through investment selection strategies and are not hostage to the market cycle.

Equity market neutral approaches are a clear example of this, as they attempt to generate returns solely from stock picking, by employing a pair-trade approach, which involves matching each long or short idea with a hedging position of equal size. By carefully selecting the hedge, managers can isolate the specific risk they wish to target in the lead stock idea, while helping to minimise unwanted market, sector or other factor risks.

As a result, this approach may deliver returns that are uncorrelated with other assets and help improve overall portfolio diversification. These strategies can also be designed to deliver returns with low volatility and, as such, could represent an attractive option for investors looking to diversify their exposure to government bonds within the low-risk part of their portfolio.

Long/short equity approaches can take this one step further. While these approaches may generate returns from stock selection alone, they also have the potential to vary exposure to market direction. This means that net long exposure can be increased in periods when markets are expected to rise, but reduced when markets are expected to fall.

These types of approaches have the potential to deliver returns from stock selection, while also harnessing tactical returns from market direction exposure. As such, they are designed to provide medium-term returns similar to those typically associated with traditional long-only equity strategies, but with lower volatility and less downside risk.

Opportunities for stock pickers

While the economic environment looks set to remain tough, we see a number of opportunities in 2013. For instance, companies for which specific product and market dynamics offer higher growth levels in the technology sector may be attractive for some investors. In our view, investors may also be attracted to holding long positions in 'self-help' companies (those capable of internally-driven growth), particularly those that appear to be improving operating efficiencies and realising synergies from acquisitions.

Investors may find companies relying on their balance sheets to improve shareholder returns, by issuing low-interest rate bonds and using the capital to buy back their higher-yielding equity, attractive. On the short side, we see opportunities in the industrial sector, where our analysis suggests that earnings expectations rely on too-great-a-degree of operational gearing, which may not come to fruition, should revenue growth disappoint.

In an environment of more frequent economic and market cycles, timing the entry and exit of investments will be more important. We think this applies to asset allocation, but also to investments within markets. Stock prices tend to overshoot fundamentals during different phases of the investment cycle and long/short or equity market neutral strategies have the potential to profit from this and potentially generate a positive return throughout the market cycle. It is the potential for a smoother return profile that we believe will continue to offer significant value to investors in a world set for more volatile economic growth.

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Multiple challenges set to characterise markets

Nick Clay
Investment Manager,
Global Equities,
Newton

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We continue to believe that world equity markets will be volatile in 2013, with any number of hurdles to overcome. However, a consequence of volatility is that it could create opportunities to invest in companies at attractive valuations. We note that in many instances, stock valuations are currently not as attractive as two years ago but have still performed well.

Where valuations have risen too far, investors have the option to sell and move into areas that offer better value. At Newton, we use a collection of themes that stimulate debate and highlight opportunities to pursue. In an increasingly interconnected world, we believe that is important for investors to retain perspective on the true investment backdrop that will continue to shape their investment approaches.

Challenges ahead

Hurdles that may present themselves in 2013 could include a slowdown in the Chinese economy, plus the challenge of shifting from an export-led to a consumer-driven economy as well as the 'once-in-a-decade' leadership transformation. The Greek crisis continues to rumble on, with many possible outcomes, including default. Moreover, 2013 is a year of elections, including in Italy and Germany.

In our view, the 'fiscal cliff' in the US, the pending combination of spending cuts and higher taxes that, if mishandled or subject to political paralysis, could cost 4-5% of GDP and tip the US into recession. All this would, in turn, ensure central banks across the globe remain ultra-loose in monetary policy as the once unconventional policies become more conventional. We are now entering our fifth year of 'zero interest-rate policies' and our fourth year of quantitative easing.

The world is now markedly one of 'haves' and 'have-nots'. The US, UK, Germany, Switzerland, and Norway feature among the 'haves.' as they are able to access debt at record low rates; whereas the likes of Greece and Spain are dependent on some form of bail-outs. This pattern is also found at the corporate level with durable, well-financed, highly visible and stable businesses among the 'haves'; while small and medium-sized enterprises (SMEs) number among the 'have-nots' facing difficulty in finding finance. This distinction is also reflected among individuals. We believe investing in the 'haves' brings significant competitive advantages for an investor. Investing in companies able to establish meaningful and lasting competitive advantages in their cost of funding could serve the investor well over the medium term.

1. Bloomberg, 30 November 2012.

We continue to believe that avoiding companies that are exposed to excessive debt levels is desirable. The process of 'deleveraging' (debt reduction), particularly in the West, is expected to take a long time and is unpleasant for all concerned. A failure to generate growth in excess of interest costs at the country level will mean that debt burdens will continue to rise in those countries. Treating the symptoms of too much debt – by lowering interest costs – does buy time for politicians to begin to make the necessary structural changes, but the debt problem itself remains unsolved.

In the US, there has been some evidence of the beginnings of this rebalancing, with a return of investment in capital equipment[1]. The banking system in the US is nowhere near as concentrated or as large a proportion of the economy as in Europe and the UK. The US has moved further than Europe to repair its banking system and, fragile though the backdrop remains, the US is looking relatively more attractive as an investment opportunity.

Returning capital to shareholders

In our view, a focus on companies that pay regular cash dividends generally leads investors to hold a portfolio of companies that are reasonably valued and able to generate sustainable cash flows. Such companies, in our experience, tend to be sensibly managed and financed and allocate shareholders' funds with a view to long-term returns on capital. We think dividend yields can be a useful tool for identifying quality companies that are disciplined and efficient in their capital allocation and cash flow management, at attractive valuations.

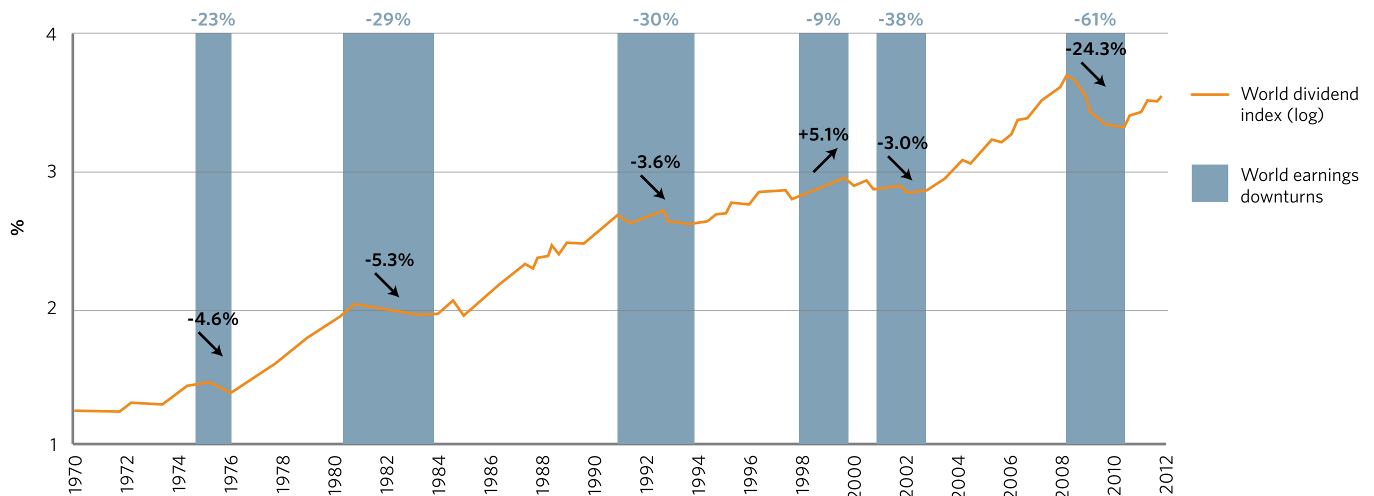
With the difficult economic conditions of recent years and prolonged record low interest rates, investors are coming to appreciate the power of regular dividend payments.

Historically, dividend payments tend to remain relatively stable, even when company earnings decline. This may provide investors with a cushion for those times of market volatility.

In a world of 'financial repression' and ageing populations, we think the 'search for yield' from investments will continue to be an important requirement for investors. Despite pending tax rises on dividends in the US, we believe companies will continue to appreciate the benefits a sustainable and growing dividend pay-out can bring to its investors and stock price.

For the long-term investor, attractive equity returns are derived not simply from the receipt of dividends but from the accumulation of shares as a result of the reinvestment of those dividends. The compounding of investment returns by way of income reinvestment can be a powerful driver of equity returns over the long run, particularly so in a volatile world.

HISTORICALLY, DIVIDENDS TEND TO BE RELATIVELY STABLE EVEN DURING PERIODS WHEN CORPORATE EARNINGS ARE DECLINING; REGULAR DIVIDEND PAYMENTS CAN HELP TO CUSHION INVESTORS FROM MARKET VOLATILITY



Source: Thomson Reuters Datastream, Newton analysis, 31 March 2012. All yield figures that are used are calculated on the basis of dividing the last 12 months dividends by the current price. Current yields are not indicative of future yields. Past performance is not a guide to the future performance

BNY MELLON

Active managers add value through trend-spotting in the US equity market

George C. Saffaye
Director and Portfolio Strategist, The Boston Company

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

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Despite the occasional stumble, the US equity market has remained relatively resilient in the face of high unemployment, a weak housing market and a series of financial crises. As the world's economies have struggled to bring about a sustainable recovery, the US equity market has boasted gains over the past four years that are among the best in the developed world. Comparable in length to what have now come to be known as historic 'bull runs', the rise in the S&P 500 Index has exceeded 100% since March 2009[1].

Against this backdrop, passive indexing vehicles, such as exchange-traded funds (ETF), have gained significant traction in the marketplace. Total assets in US domestic equity ETFs amounted to US$757.9 billion in September 2012, having increased by around 38% on an annual basis, according to data compiled by the Investment Company Institute[2].

Although ETFs have the appeal of generally lower fees, we believe that active equity management offers investors a crucial advantage: the ability to identify and respond quickly to innovation and exploit the insights that passive vehicles fail to recognise. Harnessing the knowledge of industry analysts who specialise in their respective fields to drive stock selection has the potential to serve as an important source of alpha generation.

In our view, US equity investors stand to benefit more from expert insight shaping portfolio construction; for example, healthcare analysts who understand the intricacies of their respective therapeutic categories guiding stock selection among biotechnology companies. We believe that there is clear added value in dedicated analysts reviewing company-specific information, seeking to identify potential catalysts for share-price movements and assessing the effects of industry trends. This expertise is likely to become increasingly important as innovation quickly transforms sectors such as technology and healthcare. Deep understanding will be required to identify the potential winners and losers and to position equity portfolios accordingly.

Riding the wave of innovation

We think the technology industry faces significant disruption, with focus shifting from desktops and servers to more mobile applications and 'cloud-computing'. We believe that the companies with the most promising prospects will be those with the strongest record for innovation.

1. Bloomberg, November, 2012.
2. Exchange-Traded Fund Data for September 2012, Investment Company Institute, October 31, 2012 http://www.ici.org/etf_resources/research/etfs_09_12

There are three important trends underway: the unprecedented growth in smart phones and tablets; the advent of 'cloud-computing', which has resulted in increased momentum for new, specialised businesses; and the proliferation of corporate data (breeding novel opportunities for infrastructure and data analytics providers). We expect to see continued and significant return dispersion in the US technology sector, which is likely to provide attractive investment opportunities, particularly for active managers able to keep abreast of, and be guided by, industry trends.

We also expect healthcare to offer compelling investment opportunities in 2013, as transformative secular change unfolds. Different segments of the sector are gearing up for change driven by healthcare reform, which will potentially see coverage extended to millions of currently uninsured Americans. Perhaps the most important factor underpinning the case for investing in healthcare is the force of innovation. Despite cost pressures, clear 'winners' are likely to emerge that can develop products addressing unmet medical needs. We believe that the bar for innovation has been raised.

Indeed, we expect innovation to be a key determinant of companies' performance across a wide swath of sectors, and share prices are likely to move in response to these forces. By relying on the expertise of specialised investment professionals, investors can capitalise on the trends that come to shape the US equity market in 2013.

Despite the US Federal Reserve's accommodative actions, the US economy continues to face persistent headwinds, including labour market weakness, below-trend GDP growth, and uncertainty about politics and the future direction of fiscal policy. However, positive sentiment seems to be building, with housing a bright spot amid rising housing starts and improving pricing data. Against this backdrop, we expect US stocks to outperform the global average in 2013.

SINCE THE FINANCIAL CRISIS, THE US EQUITY MARKET HAS REMAINED RESILIENT, THE S&P 500 INDEX RISING BY OVER 100% SINCE MARCH 2009

Source: Bloomberg, 20/03/2009 - 12/11/2012. Past performance is not a guide to future performance.

BNY MELLON

Chinese economic headwinds remain but Asian promise shines bright

Caroline Keen
Investment Manager,
Asian Equities,
Newton

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As the world's fastest-growing economy over the last decade, China has rightly been seen as the engine of the Asian growth story. Over the past 12 months, there has been increasing understanding of the economic headwinds facing China as it transitions from an investment -led growth economy to one driven by consumption. This transition has coincided with a period of weak economic global growth, meaning that demand from traditional markets for China's exports – the US and Europe – has suffered dramatically.

These factors combined have prompted the Chinese authorities to lower their growth target for the economy to 7.5% from 8% and, indeed, indicators including corporate profitability, manufacturing indices, and import and export data have weakened.

Age concerns

We think one of the most important global investment themes to help investors narrow down opportunities in the region is 'population dynamics'. This helps to identify patterns of consumption and savings that will ultimately determine the kind of companies and countries in which we want to invest. It may not be immediately apparent, but there is big diversity in the population dynamics of the Asia Pacific ex-Japan region. China has the largest population, of 1.3 billion, followed by India at 1.2 billion. Although of similar magnitudes, China faces the headwinds of an ageing population, where the number of 15-24 year olds is predicted to fall by 12.2% over the next five years. In addition, the proportion of the population of working age is expected to peak in the next year or so. By contrast, the working age population in India will still be growing beyond 2025, with rapid growth in the high spenders' age bracket of 25-44 in the next five years.

The economies of the Association of Southeast Asian Nations (ASEAN) make up the world's third most populous region, with a combined population of around 600 million. We see very bright prospects for countries in ASEAN because of the population dynamics and the domestic demand story playing out there. Following the global financial crisis, and for the first time since the Asia crisis of 1997, economies such as Malaysia, Thailand, the Philippines and Indonesia have been driven by increased fixed-investment spending. This has been facilitated by well-functioning banking systems and is reflected in the credit growth numbers, which have risen strongly. This is significant as these countries,

Source: all data sourced from IMF and OECD as at 21/11/2012

scarred by events of the Asia crisis, had been suffering from under-investment and a lack of infrastructure to support their growing populations. We are, therefore, just at the start of an investment cycle that could last for many years.

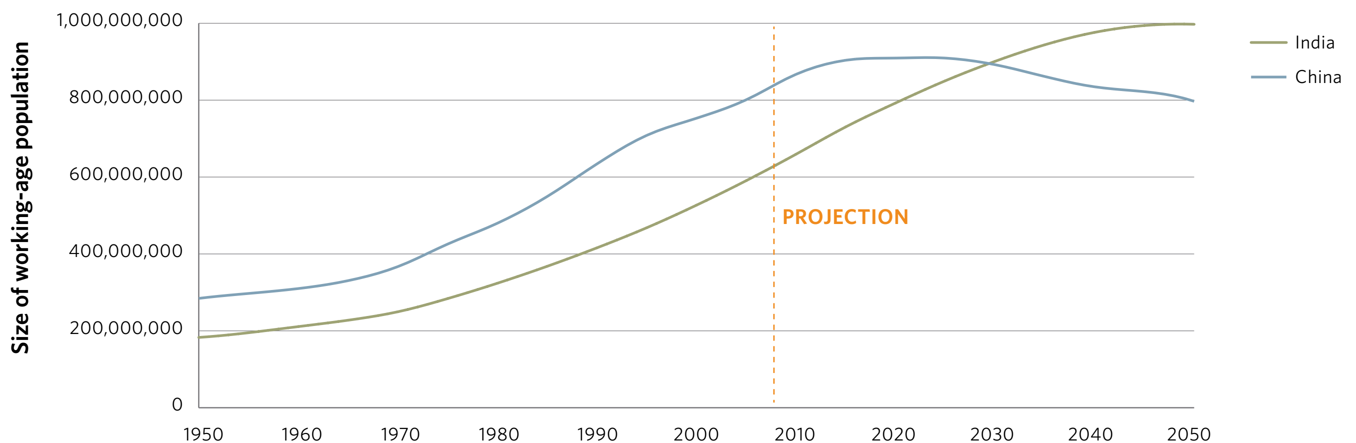
Growing opportunities

There are other reasons to be optimistic about the future of these economies. Indeed, the International Monetary Fund (IMF) predicts that the ASEAN 5 (Philippines, Indonesia, Malaysia, Thailand and Vietnam) will grow by 5.8% in 2013. Consumption trends are also very strong. As people leave the country in search of higher-paid employment opportunities, the consumption habits of their families back home are supported by remittances. ASEAN countries' unemployment rates remain below 10-year averages, supporting consumer sentiment and hence retail spending. In Thailand, Prime Minister Yingluck Shinawatra has introduced a number of populist policies to support consumption, such as minimum wage increases and guaranteed rice purchases for farmers. Thailand's corporate income tax rate has also been cut this year, with a further decrease expected in 2013.

Elsewhere in the region, Australia is attractive to us as an investment destination. In our view, many of the companies based there have a good understanding of capital management (and hence above-average payout ratios), and we are attracted by the low government debt-to-GDP ratio, the country's AAA sovereign credit rating and the abundance of commodities that are likely to support exports – especially when the liquefied natural gas industry commences production from 2014 onwards. In terms of the currency, we note that despite the Australian dollar's recent strength, we should not look to parity with the US dollar as a ceiling. For reasons outlined, we believe the Australian dollar has achieved 'safe-haven status' and in this global inflationary environment, we think it can be beneficial to own a currency that is backed by physical resources such as gold.

The challenges facing China in the medium term are well known, and we have therefore not dwelled on them here. Instead, we want to emphasise that opportunities for investment are still alive in the Asia Pacific ex Japan region. Furthermore, it is worth highlighting that a 7.5% growth rate in China would mean the economy doubling in size every 10 years. Even at a 5% compound growth rate, the economy would still double in 15 years. Despite slightly lower economic growth, there remain many attractive investment opportunities in China, and we remain particularly focused on the consumption story.

CHINA FACES AN AGEING POPULATION AND IS REACHING A PEAK IN THE WORKING AGE POPULATION; BY CONTRAST, THE WORKING POPULATION IN INDIA IS SET TO CONTINUE GROWING



Source: OECD/UN World Population Prospects 2008 revisions

BNY MELLON

Emerging opportunities for equity income investing

Sophia Whitbread
Investment Manager, Global and Emerging Market Equities, Newton

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

NEWTON
The Power of Ideas

While investors have traditionally looked to the emerging markets for growth, there is an increasing awareness that many of the countries of the developing world boast an established dividend culture. Of the FTSE World Index stocks that yield over 3%, the share attributable to emerging market companies has grown from 9.9% in 1995 to 23.4% in 2011[1]. We expect this trend, illustrated in the chart overleaf, to continue.

Emerging markets offer a wide range of investment opportunities, with investors focused on equity income attracted to companies showing an increasing commitment to dividends. The search for equity income in emerging markets differs little from that in the developed world. Indeed, a focus on those companies boasting strong cashflows, stable balance sheets and the ability to sustain dividend payments goes beyond the developing/developed world divide. However, there are marked differences in the composition of the domestic markets of different economies and as a result, their attractiveness to equity income investors.

Mutual appreciation

The size of a country's pensions industry is a useful yardstick when judging its suitability for equity income investors, and tends to have real significance for domestic equity markets. Where there is a strong and significant base of institutional investors, company management teams can be more heavily scrutinised, with greater focus on their capital allocation activity. This has positive implications for standards of management and governance in general. From an equity income perspective, when companies have committed to a dividend policy, cash is more likely to be returned to shareholders rather than remaining idle on the balance sheet or being used for activities such as mergers and acquisitions, which may prove destructive of value. For example, one of the reasons we remain cautious about investing in Russian equities is the small size of the assets under management (AUM) of the country's pensions industry. At around US$55 billion, the industry's total AUM amounts to less than 5% of GDP. Contrastingly, the equivalent AUM for Brazil is US$308 billion, which represents a contribution of nearly 15% to the country's GDP[2].

In South America, Brazil is well positioned to benefit from a youthful population and a growing middle class with increasing disposable incomes. We are especially interested in the development of infrastructure across the country, in particular with regard to transportation ahead of the World Cup in 2014 and the Rio Olympics in 2016. Furthermore, Brazilian companies listed on the local

1. FactSet, Thomson Reuters Datastream, 30 June 2012.
2. OECD 2012, 'Pension Markets in Focus', Issue 9, September 2012.
3. L'Oreal Mexico, June 2011.

exchange, BM&FBovespa, are required to maintain a minimum 25% dividend pay-out ratio, leading to an established dividend culture among domestic corporates.

However, in emerging markets, state intervention remains a concern for company management teams. Brazil's President Dilma Rousseff recently announced cuts to electricity tariffs in an effort to reduce energy costs and the adverse effects of inflation on households, causing real damage to valuations and having possible negative implications in terms of dividend sustainability. Indeed, the Brazilian utilities sector suffered a significant decline in market capitalisation following the announcement of tariff cuts, which are expected to markedly reduce the sector's revenues. Brazil, along with much of South America, is an area where we see plenty of investment opportunities, but risks remain.

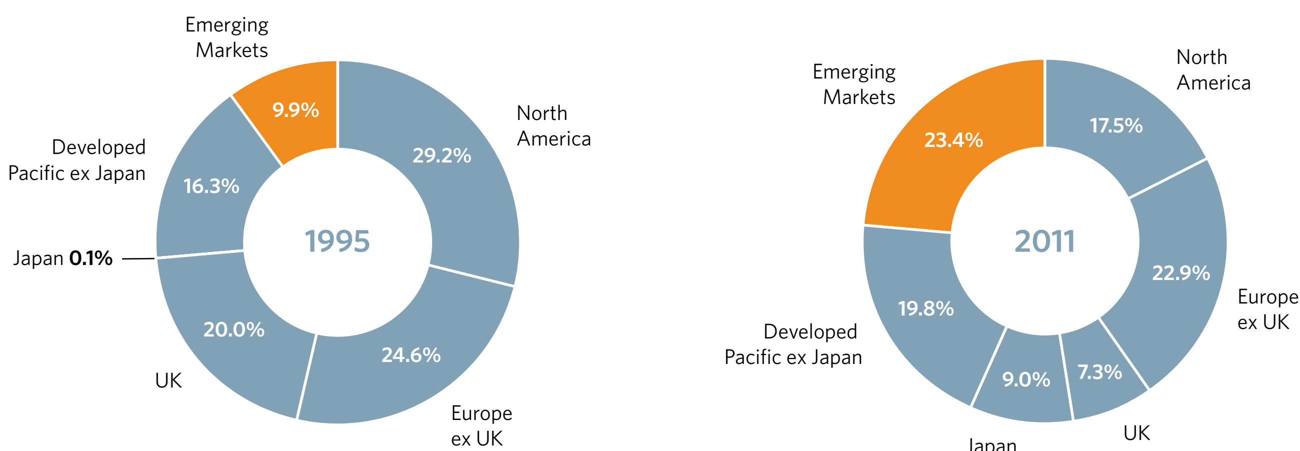
BRICs and mortar

Beyond the economies of Brazil, Russia, India and China, there are many investment opportunities for equity income investors in the regions and countries of Latin America, South East Asia and the African continent. For emerging market securities, it is important to compare and contrast not only between companies from the same country or region but also to compare between countries and regions. Mexico is an interesting case in point: it is primarily a manufacturing and export-driven economy, unlike much of Latin America, which is heavily reliant on commodities. Mexican wage inflation has been subdued, setting the country apart from many of its emerging market peers, particularly China, where wage inflation has become a serious concern. This has resulted in Mexico becoming a competitive and popular outsourcing location for global manufacturers, aided by its strong transport links with the US. Indeed, in 2011, L'Oreal announced plans to invest US$50 million in a new 30,000m^2 hair colour facility, its largest facility of this kind, in Mexico[3]. Global brands such as Unilever, Nissan and Honda have also made similar moves.

For many investors with a long-term horizon, equity income ticks plenty of boxes, especially against the backdrop of low interest rates and weak global economic growth. Dividends alone do not constitute the basis for an investment case. However, given the growth momentum relative to developed economies enjoyed by emerging markets, and the potential for rising dividend payments, we believe the outlook for 2013 is encouraging. While risks remain, the dividend culture in emerging markets continues to expand, and the opportunities for growth and income should increase.

While Newton may not own or invest in securities of these companies on behalf of clients, the references to these companies or strategies should not be considered a recommendation to purchase or sell any particular security. It should not be assumed that any of the securities discussed herein represent investment advice, that the securities will continue to perform as they have in the past, or that any investment recommendations or decisions we make in the future will be profitable or reflective of the investment performance of the securities discussed herein.

EMERGING MARKET COMPANIES ARE ACCOUNTING FOR AN INCREASING PROPORTION OF STOCKS THAT YIELD MORE THAN 3%



Source: FactSet, Thomson Reuters Datastream, 30 June 2012.

BNY MELLON

The Brazilian government steps in

Solange Srour
Chief Economist,
BNY Mellon ARX

Rio de Janeiro-based BNY Mellon ARX Investimentos (BNY Mellon ARX) is a specialist in Brazilian equity (long only and long/short), fixed income and macro investment strategies. The firm's approach combines fundamental bottom-up analysis with a detailed, top-down macroeconomic overview, while applying rigid risk controls.

BNY MELLON ARX

All figures sourced from Bloomberg, 16 November 2012.

The past 12 months have seen the Brazilian government increasingly step in to support domestic economic growth, while seeking to ensure that the outcomes of its efforts do not translate into inflationary pressures. Indeed, consumer price pressures have eased, while economic activity in several sectors suggests that a tentative domestic recovery is underway. Our outlook for Brazil in 2013 is positive, and we expect domestic activity, supported by the government's measures, to drive economic expansion.

Recovery in domestic activity has gradually been taking place across several areas of the Brazilian economy, having started in the automobile sector, for which tax exemptions on vehicle production were extended until October of 2012. Domestic demand is supported by a historically low, 5.4% unemployment rate. We do not expect the Brazilian unemployment rate to decline further, given that the domestic economy appears to be at close to full employment.

In 2012, industrial production suffered a sustained contraction, falling by 3.8% in the year to the end of September.

We are nevertheless encouraged by the fact that the Brazilian government has announced the addition of 25 sectors to its 'Brasil Maior Plan'; unveiled in August 2011, the plan specifies the government's industrial policy efforts until 2014.

We think this expansion should go some way towards relieving high labour costs and strengthening productivity in, and the competitiveness of, Brazilian industry. We expect the measures undertaken by the government to support domestic manufacturers over the longer term and subsequent capital investment, in turn, to boost GDP growth.

In the utilities sector, the government has implemented a broad strategy aimed at lowering energy costs for domestic consumers and industry, as well as subjecting state-owned companies to greater competition.

President Dilma Rousseff announced in September that utility companies would be required to reduce by up to 28% the rates they charge for energy. Although the measures have potentially adverse short-term effects on the utilities sector, they may provide a boost to energy-intensive metals and mining companies.

The end of an easing cycle?

Among financials, too, the effects of government intervention have been felt. Banks have been adjusting downwards the rates at which they lend, against the backdrop of a falling benchmark interest rate (Selic). The Monetary Policy Committee of the Central Bank of Brazil, known as Copom, has reduced the Selic by 3.25% during the course of 2012 alone. It stood at 7.25% in October. In its third-quarter inflation report, Copom said that the 'cumulative and lagged effects of policy action to date are already supporting the ongoing domestic recovery', and 'additional monetary easing is contingent on the prospective outlook'.

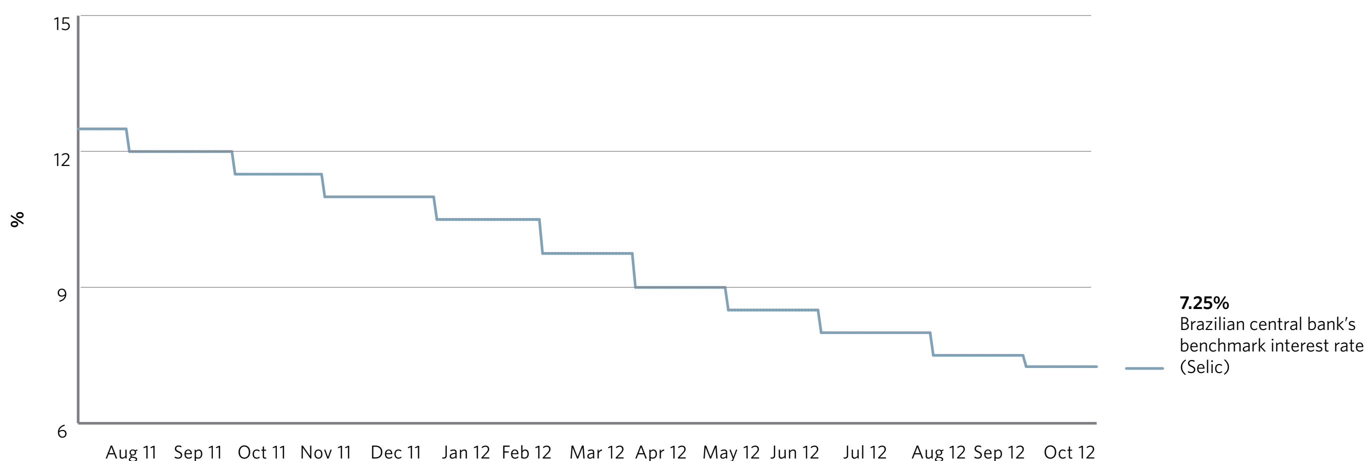
We do not expect the central bank to reduce materially the rate in 2013, given the significant degree to which it has already eased monetary policy. In our view, the Selic is likely to remain at its current level until at least the second half of 2013.

After edging towards the 6.5% upper limit of the authorities' inflation target in late 2011, consumer price inflation in Brazil, as measured by the IPCA consumer price index, had fallen by more than 1% in October, to an annualised 5.5%. We attribute much of this decrease to falling commodity prices, the restructuring of the weightings within the IPCA index itself, as well as the tax exemptions that the government has deployed to stimulate economic activity.

The Brazilian economic growth rate for the 12 months to the end of June marked a fall in the annual rate to its lowest level in nearly three years. Against this backdrop, we have revised downwards our economic growth expectations for 2012, to 1.6% from 2.0%.

For 2013, however, we expect economic growth to gather pace, and the Brazilian economy to expand by 4.2%, buoyed by the monetary and fiscal easing measures currently in place.

THE BRAZILIAN CENTRAL BANK HAS UNDERTAKEN A SIGNIFICANT PROGRAMME OF MONETARY EASING, CUTTING ITS BENCHMARK SELIC INTEREST RATE 10 TIMES SINCE AUGUST 2011



Source: Bloomberg, 14 November 2012

"The attractive fundamental backdrop is continuing to support inflows into emerging market corporate debt, both from the developed world and also from local institutional investors. These inflows are, in our view, justified..."

Colm McDonagh, Insight Investment

"Looking forward to 2013, we expect the returns available on cash, government bonds and sub-investment grade corporate bonds to remain roughly at current levels. Similarly, the main macroeconomic risks are likely to remain broadly unchanged."

Paul Brain, Newton

Fixed Income

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BNY MELLON

Central banks continue to call the shots in fixed income markets

Thomas D. Higgins, PhD
Global Macroeconomic Strategist, Standish

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

Policy intervention has been, and will continue to be, an important driver of investor sentiment and market performance in the year ahead. In fact, from our perspective, the actions of global central bankers and legislators may even trump the importance of economic fundamentals when it comes to fixed income returns in 2013.

This pattern is already evident in Europe where economies at the periphery of the region, such as Spain, have experienced sharp declines in government bond yields as a consequence of policy intervention by the European Central Bank (ECB), despite continuing to miss their debt and deficit reduction targets due to deep recessions in their domestic economies.

Under its Outright Monetary Transactions (OMT) programme, the ECB has committed to buying unlimited amounts of one- to three-year government debt of countries that request bailouts from the European Stability Mechanism (ESM) and submit to the conditionality of these loans. In the case of Spain, although no actual bond purchases would occur until a formal request for a bailout from the ESM, Spanish three-year government bond yields have tumbled from more than 7% in late July to less than 4% in November[1]. Unfortunately, policy intervention also poses risks. Assessing the consequences of the financial crisis, the Bank of Japan Governor Masaaki Shirakawa expressed his concern that 'a recovery could be endangered by the adoption of inopportune and inappropriate policies' that could 'destabilise the global economy'[2]. Although the Chairman of the US Federal Reserve (Fed), Ben Bernanke, has acknowledged these risks, it is his opinion that the benefits still outweigh the costs. Below we will explore in greater detail central bank policy intervention and its potential implications for fixed income markets in 2013.

The effects of unconventional policy

Most major central banks in the developed markets are engaged in some form of unconventional monetary policy. The boldest of these measures fall under the category of quantitative easing (QE), which involves expanding the central bank's balance sheet in order to increase the quantity of money in circulation through large-scale asset purchases.

Ironically, the Bank of Japan (BoJ) has been pursuing QE for some time, despite the reservations of Governor Shirakawa; the BoJ is poised to embark on its ninth round of asset purchases since October 2010. The ECB's OMT programme can also be considered a form of QE, although purchases will be sterilised – every euro the ECB puts into the system buying government bonds will be offset by the ECB taking money out elsewhere –

1. Bloomberg, 5 November, 2012.
2. Masaaki Shirakawa, 'The consequences of the great financial crisis: Five years on', 12 October, 2012, Bank of Japan.
3. US Federal Reserve, Federal Open Market Committee statement on the stance of monetary policy, 13 September, 2012.
4. Canlin Li and Min Wei. 'Term structure modeling with supply factors and the Federal Reserve's Large Scale Asset Purchase Programs.' Finance and Economics Discussion Series 2012-37. Board of Governors of the Federal Reserve System, Washington.
5. Arvind Krishnamurthy and Annette Vissing-Jorgensen. 'The effects of Quantitative Easing on interest rates: Channels and implications for policy'. National Bureau of Economic Research Working Paper 17555. October 2011.
6. Ben Bernanke. 'Monetary policy since the onset of the crisis.' Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyoming. 31 August, 2012.
7. Op. cit. Masaaki Shirakawa, Bank of Japan.

and thus are expected to have a limited effect on the money supply.

The Fed, which launched its third round of quantitative easing (QE3) in September, has arguably been the most aggressive with its use of unconventional measures. It unveiled an open-ended asset purchase plan entailing the purchase US$40 billion per month in agency mortgage-backed securities (MBS) and a promise to undertake additional asset purchases 'if the outlook for the labour market does not improve substantially'[3].

Research into the Fed's first two rounds of QE indicates that there has been a material effect on fixed income markets. For example, studies suggest yields on 10-year US Treasuries are between 0.8% and 1.2% lower than would otherwise be the case[4]. Moreover, the Fed's asset purchases have also corresponded with significant declines in the yields on both mortgages and highly rated corporate bonds[5]. Ben Bernanke has attributed the benefits of QE on the corporate bond market to the 'portfolio balance' effect[6]. According to this theory, investors will rebalance their portfolios by replacing the US Treasuries or MBS they sold to the Fed with other high-quality assets such as investment-grade corporate bonds, the prices of which should rise and their yields decline as well.

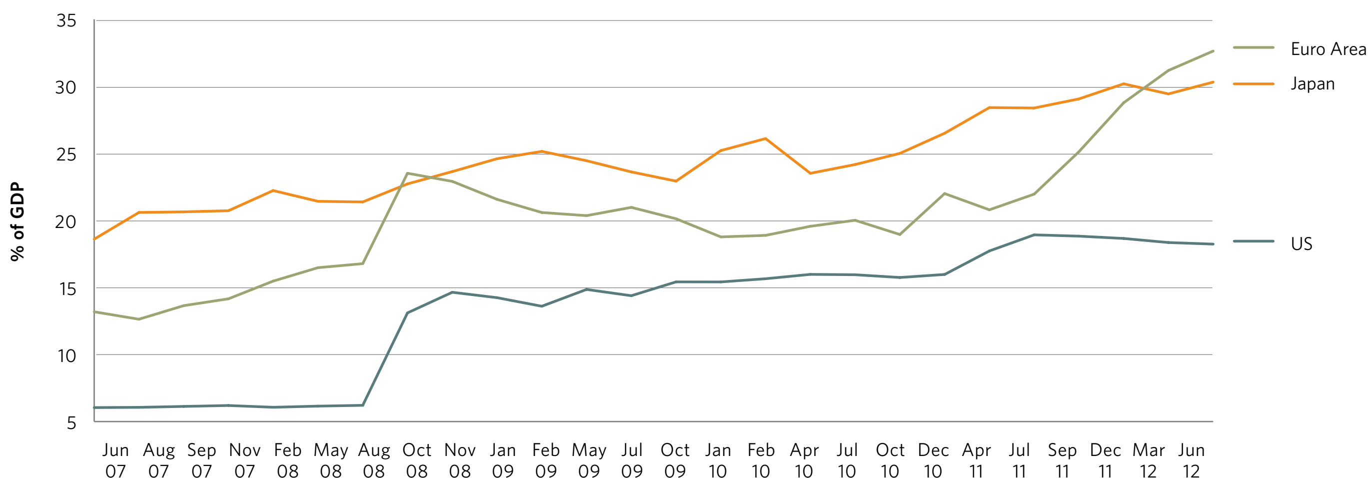
Clearly, the lower bond yields fall, the less room there is for further spread compression. Nevertheless, the longer the Fed and other central banks continue to be players in the fixed income market, the less likely it is that yield spreads on MBS and high-quality corporate bonds will widen on a meaningful and sustained basis (barring a recession). That said, we continue to expect periodic bouts of market volatility as fiscal policy makers struggle to rein in ballooning fiscal deficits in the US, Europe and Japan. We are also concerned, like Governor Shirakawa of Japan, that 'impatient' policy choices, driven primarily by discontent among the general public, could erode efficiency and inflict 'collateral damage' on the global economy[7].

DEBUNKING THE MYTH ABOUT THE NOVELTY OF QUANTITATIVE EASING

The unconventional monetary policy measures adopted by several of the world's major central banks may, at first glance, appear unprecedented. Most of them have, however, been tried in one way or another by the Bank of Japan (BoJ) during previous financial crises.

In March 2001, following the global economy's sharp downturn, the BoJ undertook what it described as 'drastic' monetary easing measures. These included a ¥1 trillion increase in the size of its current account balance sheet and the provision of ample liquidity until deflation ended (marked by the annualised consumer price index registering zero percent or an increase). Paving the way for the major central banks' more recent actions, as early as 2001, the BoJ was committed to the outright purchase of Japanese government bonds as it pursued the path towards sustainable economic growth.

THE INCREASING SIZE OF THE BALANCE SHEETS OF MAJOR CENTRAL BANKS IS A MEASURE OF THE EXTENT OF THE CENTRAL BANKS' RELIANCE ON UNCONVENTIONAL MONETARY POLICY MEASURES



Source: Thomson Reuters Datastream/Fathom Consulting, 29 June, 2012

BNY MELLON

Flexibility the key for bond investors as uncertainty abounds

Paul Brain
Investment Leader,
Fixed Income, Newton

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

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The Power of Ideas

2012 has been a year of limited choices and much anxiety for investors. With the potential for a collapse of the euro and sluggish global economic growth, along with large debts to service, investors have faced many challenges.

To smooth the deleveraging transition, the world's major central banks have put the monetary system on life support by keeping official rates at close to zero and experimenting with balance sheet expansion through unconventional monetary policy measures. This has meant that bond investors have had to choose between returns of near zero percent on cash, around 2% on 'safe-haven' government bonds, or more than 6% on riskier assets like sub-investment grade corporate bonds[1].

In fact, as we enter what many observers expect will be a prolonged period of financial repression, the real rate of return on cash and government bonds when inflation is taken into account is negative. However, we have been here before; the debt overhang from World War II and the Great Depression led to a highly regulated global financial system with capital controls and yield caps and ceilings (see chart). Savers were subjected to negative real (inflation-adjusted) returns as debts were repaid. The deleveraging of the developed world's debt mountain over the next few years is a similar task and, once again, savers will be expected to take a hit, potentially through negative real yields.

Tough choices ahead

Looking forward to 2013, we expect the returns available on cash, government bonds and sub-investment grade corporate bonds to remain roughly at current levels. Similarly, the main macroeconomic risks are likely to remain broadly unchanged.

We believe that uncertainty about the Chinese economy will continue as investors grapple with opaque data and leadership change. Perhaps equally important is how the US economy tackles its very large fiscal deficit and slower economic growth. Our biggest worry is the unpredictable fortunes of the Eurozone, which are likely to weigh heavily on the minds of investors.

It may be possible for the US to manage its fiscal contraction without derailing the economic recovery, especially if the central bank keeps the liquidity machine running. China appears to have significant resources that it can apply to help its

1. Bank of America Merrill Lynch Global Bond and Global High Yield Indices, Bloomberg, November 2012.
2. Bank of America Merrill Lynch Global Bond Index, Bloomberg, November 2012.

economy rebalance towards a mixture of export-led and domestic consumer demand-based growth. The Eurozone problem is a valid concern for investors because the fiscal austerity applied to the Southern European economies does not appear to be working (deficits are getting bigger as revenues collapse under the weight of the economic recessions). We believe that this is having an increasingly negative effect on the Northern European economies as well.

The longer-term deleveraging theme that has dominated markets since 2008 will, in our view, remain the most significant influence on world economic growth. However, as we move through 2013, it may be possible that some economies start to see an end to their deleveraging process, and even find that their banking systems begin to work normally.

In our view, the US could fit into this category of starting the process of ending its private sector debt deleveraging, although how fast the authorities tackle the fiscal deficit will be key. It is likely that bond markets are going to be a hostage to this debate; if deleveraging is coming to an end, then ultra-loose monetary policy is inappropriate and inflation concerns will rise rapidly, as will bond yields.

Investors heavily invested in indexed-bond products face a tough journey ahead, while those who manage portfolios close to their benchmarks may struggle to produce a positive return for their clients. Alternatively, if some of the tail risks mentioned actually materialise, then default risk is likely to rise once more and parts of the bond indices will produce significant capital losses.

Flexibility pays

So, how does an investor stay involved in markets that offer decent return potential but also come with significant volatility?

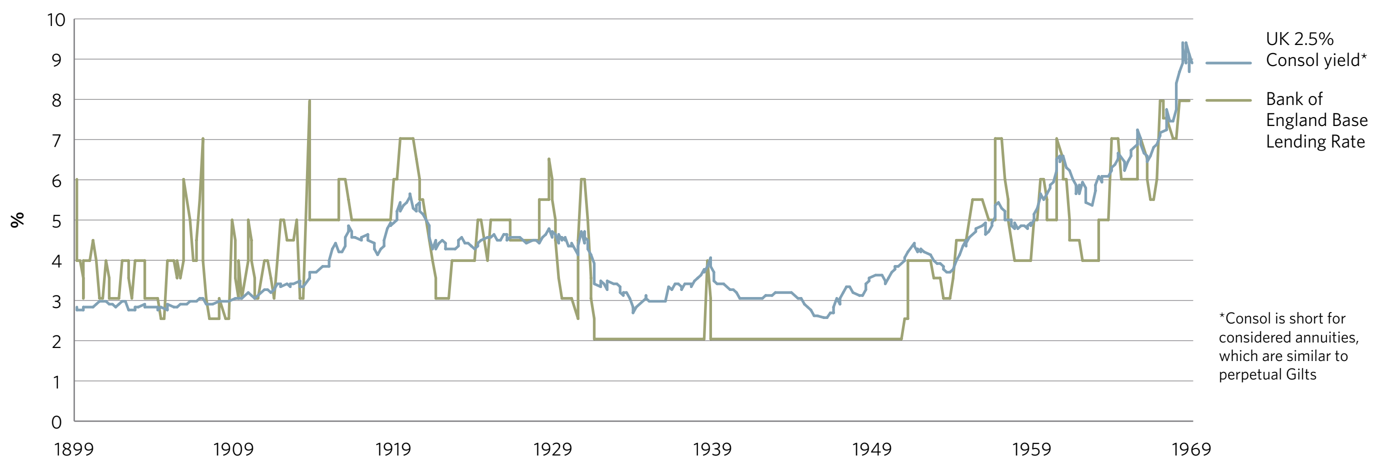
We believe that avoiding a slavish adherence to an index that is weighted according to market capitalisation would be a good start. For bond investors, one of the most dangerous places to be is wedded to an issuer that has to borrow more. Generally speaking, the more a country or company borrows, the lower its credit quality and the weaker the performance of its bonds; however, the higher their weighting in issuance-based indices. Furthermore, the rally in bond markets since 2008 has led to lower yields and a higher duration risk[2]. In other words, investors end up being more exposed to interest rate risk when interest rates are about to change.

Unconstrained by an index, investors can allocate globally and across different segments of the fixed income universe, and therefore gain exposure to markets with less credit risk. There will be countries that are at a different phase of their economic cycle and where inflation is declining, leading to interest rate cuts. Countries that have relied on Chinese economic growth over the last four years may see demand for their exports decline, and domestic consumption may not be sufficient to offset the effects of this.

Furthermore, we believe that investors should take the opportunity to invest in the different instruments of a company's capital structure. For example, in some sectors of the corporate bond market that are still vulnerable to the deleveraging process, such as banks, there may be opportunities to buy senior paper (with better default protection and a higher potential pay out), possibly with a floating rate coupon.

These simple measures, together with derivative hedging, can help an investor retain the potential to achieve a return higher than inflation in a near zero-interest rate environment, while avoiding some of the fall-out when interest rates look set to rise.

WE BELIEVE THAT THERE IS THE POTENTIAL FOR A PROLONGED PERIOD OF FINANCIAL REPRESSION, AKIN TO THE HIGHLY REGULATED GLOBAL FINANCIAL SYSTEM WITH YIELD CAPS AND CEILINGS WHICH EMERGED IN THE AFTERMATH OF WORLD WAR II



Source: Global Financial Data, November 2012

BNY MELLON

Reasonable returns expected from European fixed income

Gunther Westen
Head of Asset Allocation,
Meriten Investment Management

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

Meriten
INVESTMENT
MANAGEMENT

Meriten Investment Management does not currently offer services in the U.S.

As 2012 approached its end, it appeared to be one of the best 'worst' years for Eurozone bonds. Neither market fears of a Eurozone collapse, nor growth dwindling from already anaemic levels, deterred markets.

As of the end of October, performance for Eurozone government bonds ranged from 27% for Irish government bonds to 8% for French government securities. Investment-grade corporate bonds scored 11%, while high-yield investors fared even better at more than 18%. German 10-year Bunds, the default 'flight to quality' investment, languished with a 3% return[1].

While this might seem at odds with the newsflow, we think that some investors had positioned themselves for a market fall that simply did not occur. Instead, the European Central Bank (ECB) flooded the markets with liquidity and stabilised confidence.

Performance masked both volatility and strong spread dispersion across sectors, issuers and countries. Spanish utilities, for instance, ended October with lower spreads against Bunds compared with the start of the year. At the end of June, spread levels were trading at nearly double those seen in January.

More of the same

Although the spectacular performance of many fixed income Eurozone assets is unlikely to be repeated in 2013, corporate bonds and some segments of the government, as well as the covered, bond markets still appear attractive.

We expect the ECB to keep interest rates low for the time being. As a result, liquidity should remain ample at almost zero cost, creating a positive backdrop for bond investments that offer some yield advantage over cash. Research has consistently flagged demand from cash-rich investors. In particular, any new supply from corporate issuers perceived as relatively safe has been oversubscribed. Although new issuance picked up in 2012 compared to 2011, we believe this supply-demand imbalance will provide a tailwind for corporate bond prices.

Draghi's 'put' removes euro break-up premium

Since July, when the ECB president Mario Draghi announced plans to buy bonds from troubled Eurozone countries, spreads for peripheral markets have rallied substantially, without the ECB actually having to act. Moreover, countries like Spain and Italy have agreed to various fiscal consolidation measures to manage their debt. We believe this may yet be rewarded by the markets.

1. Source: DBIQ Bloomberg, IBOXX Index, in € as at 30/10/12
2. Source iBoxx as at 30/10/2012

Today's relative stability in spread levels might be tested in the coming year by frictions among Eurozone members, a lack of further integration, Spanish reluctance to join the rescue scheme or simply the poor economic backdrop in the periphery. However, with the Draghi 'put' or guarantee in place, potential spread widening should be limited and this could lure investors back into the market.

Economic weakness should not threaten corporate spreads

Even the weak economic environment is unlikely to spoil the party. As fiscal consolidation in peripheral countries takes hold and dampens GDP growth, it is likely to hover around the zero mark for some time. However, barring shocks, we do not expect a severe recession. Risk premia have room to fall from still-elevated levels as long as GDP remains low, since investors demand less compensation for holding risky securities. In addition, corporate bonds tend to fare well even in a moderately negative growth environment, because cash flow, not earnings momentum, is the crucial factor.

With yields of core investments (like Bunds) at record lows and negative in real terms, we think that even very risk-averse investors will have to creep back into riskier asset classes and segments to achieve nominal return requirements.

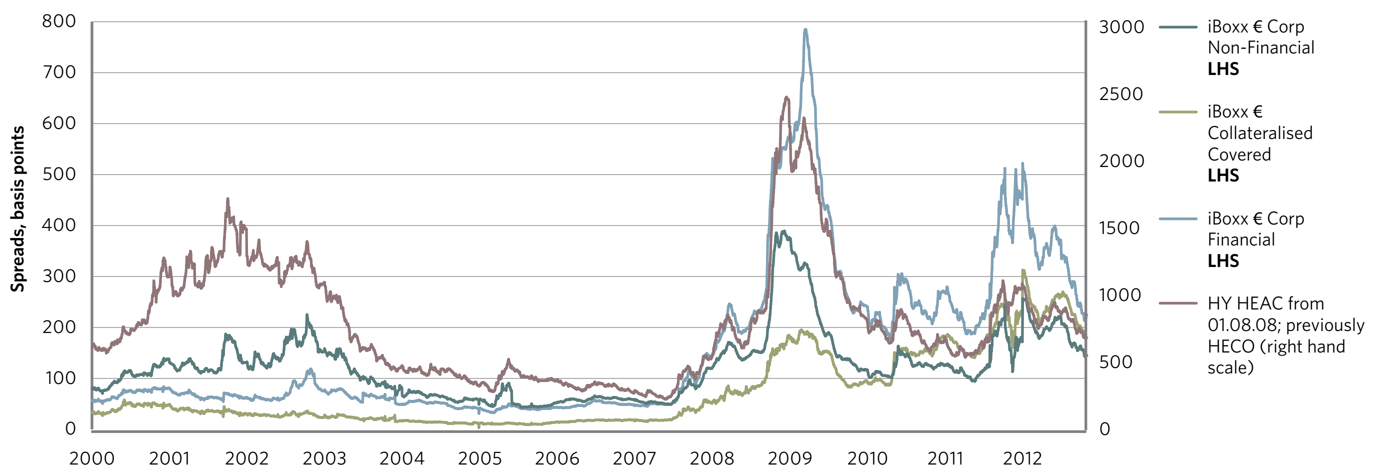
Corporate bonds in particular should benefit, even though valuations for some well-known issuers from core countries are stretched. We think that other parts of the credit spectrum still offer very attractive spreads - for example, peripheral utilities, telecommunication companies or some senior financial bonds that are still trading at a high premium to industrial bonds, despite various government-driven banking backstops. While risk aversion during the first half of 2012 affected all issuers indiscriminately, the market is now focusing on fundamental strength. Thorough credit analysis and selectivity should, therefore, be back on the agenda.

We think that European high-yield bonds may be more vulnerable to recession risks than investment grade bonds, but still offer a generous 550-650 basis point spread over Bunds[2]. Given a recovery rate of 40%, the spread level suggests an implicit default rate of roughly 7%. This compares with a rate slightly above 3% as at the end of October 2012, anticipated by Moody's on a one-year forward basis. We believe that high-yield bond spreads could tighten by 100-150 basis points, which continues to make them an attractive investment and a cushion against any unexpected deterioration in the economic backdrop.

Most peripheral sovereign bonds offer value relative to their corporate or covered bond peers. In our view, they should be considered as part of a well-diversified Eurozone portfolio. If progress on fiscal consolidation becomes visible, the Eurozone economy bottoms out and the ECB is ready to act, we could see yield convergence across the Eurozone. In this scenario, peripheral bonds should rally significantly, while the flight-to-quality bid for Bunds and core markets may reverse quickly.

Having said that, volatility is most certainly here to stay for some time as the road to fiscal integration in the Eurozone continues to be bumpy, economic visibility is low and the investor base for peripheral bonds has declined sharply. Risk premia have room to fall, however, as the market completely prices out the tail risks of a systemic meltdown and euro break-up. Current valuations of credit, peripheral sovereign and many covered bonds are looking fair to cheap against a backdrop of abundant liquidity and investors' search for yield. We think this combination bodes well for returns in 2013.

EUROPEAN HIGH-YIELD BONDS STILL LOOK ATTRACTIVE WITH THE SPREAD OVER BUNDS PROVIDING A CUSHION AGAINST ANY UNEXPECTED DOWNTURN IN ECONOMIC FORTUNES



Source: DBIQ, Bloomberg, 30 November 2012

BNY MELLON

Exploring the entire emerging market debt opportunity set

Alexander Kozhemiakin
Managing Director and Emerging Markets Debt Team Leader, Standish

Cathy Elmore
Portfolio Manager and Senior Sovereign Analyst, Standish

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

Emerging market US dollar-denominated debt ($EMD) is a credit asset class driven by the spreads over US Treasuries and the underlying US Treasury yields. These risk factors determine the performance of other US dollar-denominated credit asset classes, such as investment-grade or high-yield corporate bonds. In contrast to most other credit asset classes, $EMD is not necessarily defined by a credit rating. Its defining characteristic is the fact that the $EMD universe spans issuers (sovereign, quasi-sovereign, corporate, supranational) located in emerging market countries.

While definitions of emerging market countries vary, most of them share a unifying thread: they are not yet rich in GDP per capita terms. This characteristic, in turn, creates expectations of faster economic growth (as non-rich countries are starting from a lower base) and also highlights the risks inherent in emerging markets (there are reasons why these countries are not yet rich).

The opportunity set in $EMD now encompasses over US$1 trillion of bonds issued across Asia, Latin America, and EEMEA (Emerging Europe, Middle East and Africa). These are roughly half sovereign and half corporate obligations of varying liquidity, with approximately two-thirds rated investment grade and one-third rated sub-investment grade[1]. While some investors partition the asset class according to ratings, separating investment grade from sub-investment grade-rated emerging market bonds, other investors separate corporates from other types of issuers.

One way of doing it

From this broad range of opportunities available in $EMD, we think it makes sense to look at the most attractive, from a risk-adjusted perspective, regardless of whether they are sovereign or corporate, B-rated or BBB-rated. The opportunity set forms a deep reservoir of relative value choices available to an active manager. In some countries, such as Russia, we would consider investment-grade quasi-sovereign bonds. Yet in Indonesia, for example, we would consider investing in speculative grade-rated corporates. In sub-Saharan Africa, we prefer the approach of diversifying by having exposure across a number of countries, from Angola to Zambia.

Throughout the emerging world, we also find attractively priced supranational securities. As a result, this approach appeals to investors who are looking

1. JP Morgan EMBI Global and CEMBI Indices, JP Morgan Securities Ltd, July 2012.
2. Emergingportfolio.com, 30 September 2012.

to diversify their existing US dollar-denominated credit portfolios beyond developed, rich countries, without sacrificing liquidity.

In our view, it is important to actively manage the US Treasury duration risk embedded in $EMD. As a rule, the higher the credit rating, the stronger the empirical pass-through of fluctuations in the underlying US Treasuries to the overall bond yields. The weighted-average rating quality of $EMD, as measured by the JP Morgan Emerging Market Bond indices, is already investment grade, and has been for some years. As such, the rally in US Treasuries at least partially explains the strong performance of the asset class. We believe that future returns are unlikely to benefit to a significant extent from this tailwind. In fact, we believe that the potential headwind from rising US Treasury yields poses a serious risk.

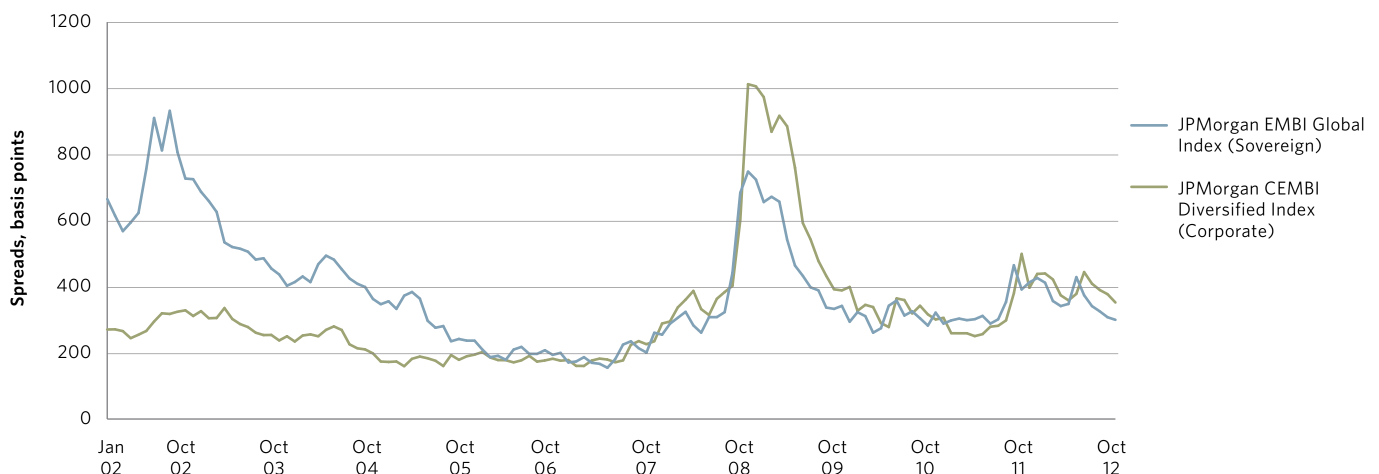
Positive asset flow dynamics ahead

Asset flows have a tendency to follow performance. In the first three quarters of 2012, nearly 80% (of a total of around US$50 billion) of flows into emerging market fixed income went into to $EMD assets[2]. In 2013, barring a significant increase in US Treasury yields, we are expecting flows into $EMD to remain strong. In our opinion, current spreads of around 300 basis points (see Chart 1) for the weighted-average investment-grade credit quality of the benchmark are likely to continue attracting investors looking for yield and country diversification benefits.

However, weighted averages can be misleading, as the $EMD universe is a distribution of different ratings and spreads, from A-rated Chile and China, with spreads below 160 basis points, to Belize, which is currently in default, offering spreads of around 2,300 basis points. As a result, the median BBB-rated bond in $EMD is currently trading at a spread of below 300 basis points. Even so, spreads on most emerging market bonds more than compensate for the expected probability of default, in our opinion.

We expect that inflows will be met by healthy issuance, especially in the corporate sector. Governments are likely to continue to be in a net redemption mode, repaying more via maturing bonds and coupons rather than issuing new bonds. Against this backdrop, we believe that managers who can be flexible in their approach, who are not burdened by large $EMD assets under management, and who are willing to explore the entire set of opportunities in US-dollar-denominated emerging market bonds (while remaining cognisant of US Treasury duration risk), will be well positioned for meeting their clients' needs in 2013.

GIVEN THE IMPROVEMENT IN THE WEIGHTED-AVERAGE CREDIT QUALITY OF THE $EMD ASSET CLASS, CURRENT SPREADS OVER US TREASURIES, IN OUR VIEW, OFFER MORE THAN ADEQUATE COMPENSATION FOR POTENTIAL CREDIT LOSSES



Source: JP Morgan, 30 September 2012

BNY MELLON

The outlook for liquidity in emerging market corporate debt

Colm McDonagh
Head of Emerging Market Fixed Income, Insight Investment

Insight Investment Management Limited (Insight) is a London-based asset manager specialising in investment solutions across liability-driven investment, absolute return, fixed income, cash management, multi-asset and specialist equity strategies. Insight has proven excellence in managing credit strategies across multiple jurisdictions, including emerging market corporates.

Insight does not currently offer services in the U.S.

The shift in the balance of global economic power from the developed to the developing world has not gone unnoticed by investors. They have markedly increased both the amount invested in emerging markets and the range of those investments.

However, the underlying liquidity of these markets continues to be a concern. It has made many investors hesitant about investing in securities perceived to be illiquid. This has been the case in bond markets. As a consequence, emerging market debt funds have historically been largely focused on investments in government-backed sovereign bonds rather than corporate debt. While it is undeniable that liquidity has been a challenge in emerging markets, in our view, this environment has changed rapidly in recent years.

Liquidity conditions in emerging market corporate debt have already improved as the pool of assets and investors has deepened. The outlook is even brighter as the asset class develops and plays a bigger role in institutional portfolios. One factor supporting this positive outlook is the increasing size of the emerging market corporate debt universe. At US$1.3 trillion, it is now larger than the emerging market government bond universe of US$680 billion and the US$300 billion European high-yield market combined[1]. More recently, with emerging market corporate debt issuance growing at between US$200 billion and US$300 billion a year, the total size of the asset class has overtaken that of the entire US high yield market[1].

Tapping the capital markets for finance

Another factor contributing to increased liquidity in emerging market corporate debt has been larger issuance size. As an emerging market country grows, the funding needs of its corporate sector will also increase. Bond issuance will be one of the financing tools used to fund that expansion. In addition, bank balance sheets are shrinking globally, meaning that companies are looking to tap capital markets for finance rather than relying on bank lending.

This trend has been particularly apparent since the beginning of 2009. The size of debt issues by emerging market companies has been steadily rising, with a significant increase in the number of individual issues of over US$500 million and US$1 billion (see chart overleaf). There has been a deepening of market liquidity, as an increasing number of counterparties have been able to enter the market. This has given some emerging market funds the confidence to offer investors access to daily liquidity.

1. Bank of America Merrill Lynch US High Yield Index, September 2012.

One of the main rationales for investing in emerging market government bonds over the past 20 years has been that improving credit quality would lead to yield compression in relation to developed markets. We believe that this structural shift will be replicated in corporate bond markets. There are many investment opportunities in emerging market companies that offer a higher yield than their developed market peers, and are underpinned by good credit fundamentals and strong growth prospects. This is, of course, still a maturing asset class, and there are issues with liquidity in certain parts of the market. Generally speaking, the smaller the issue size, the greater the illiquidity. This is particularly the case for infrequent issuers and bonds nearing maturity. While accessible local currency corporate debt is still a very small part of the universe, we expect this to change in a similar fashion to what has occurred in emerging market government bond markets. The rationale is that it is better for a company to issue in a currency that matches its revenue stream, rather than run the currency mismatch of borrowing in US dollars.

A strong investment case

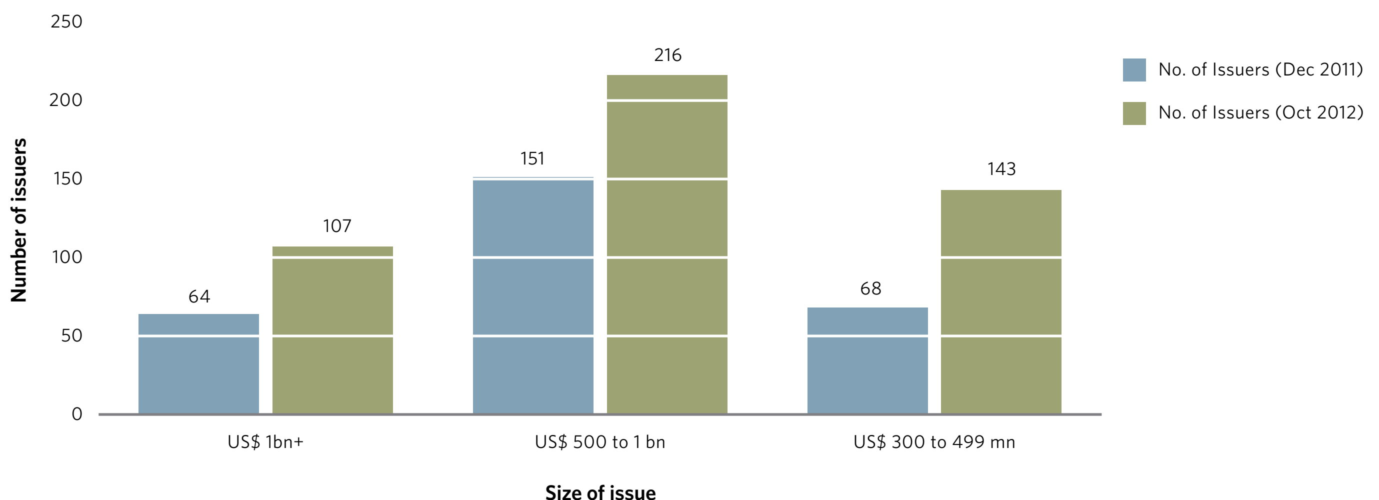
The attractive fundamental backdrop is continuing to support inflows into emerging market corporate debt, both from the developed world and also from local institutional investors. These inflows are, in our view, justified, given the strong investment case, and should continue to be meaningful as many pension funds and other investors still have low exposure to emerging markets. This should also support liquidity.

The increasing diversification opportunities available within the emerging market corporate debt universe offer further support for the investment case. The composition of the market continues to broaden, with Asia, Latin America, Africa and Europe all represented. Diversification opportunities are also increasing at the country level, with issuers from countries such as Mongolia and Zambia entering the market. As the economies of emerging market countries develop further, sector diversity will also increase. The current high weighting of financials in indices of corporate debt is likely to fall relative to other industries such as telecoms and consumer discretionary.

The indefinite extension of quantitative easing in the US means that investors' search for yield is likely to continue. In addition, the European Central Bank has limited the tail risk in markets, and added further to liquidity levels. These factors, combined with strong fundamentals and attractive valuations relative to other asset classes, lead us to remain positive on the outlook for emerging market corporate debt.

From a liquidity standpoint, it is a maturing asset class, and the continued replacement of bank lending by bond issuance is likely to support a further deepening of the market. Because the degree of liquidity can vary materially between individual bond issues, we believe this is an asset class that requires specialised investment expertise. Nevertheless, in our view, a strong fundamental case for investment remains; and as more money flows into the market, the outlook for liquidity should continue to improve.

THE INCREASING VOLUME OF INDIVIDUAL EMERGING MARKET CORPORATE BOND ISSUANCE IS POSITIVE FOR LIQUIDITY CONDITIONS



Source: JP Morgan, Bank of America Merrill Lynch, October 2012

Opportunities in European sub-investment grade credit

Paul Hatfield
Chief Investment Officer, Alcentra

Simon Perry
Managing Director, Business Development, Alcentra

BNY Alcentra Group Holdings Inc ("Alcentra") is an asset management group focused on sub-investment grade corporate debt markets in Europe and the US, with offices in London, New York and Singapore. Alcentra has a track record dating back to 2002, and is one of the largest institutional participants in these markets.

Equity markets seem unlikely to offer significant growth in 2013 but are very likely to be characterised by greater volatility as political factors continue to drive sentiment. This is causing investors to search for more predictable ways of generating returns. The fixed income markets have been the major beneficiaries of this demand, but currently, investment-grade corporate debt and 'safer' sovereign bonds are delivering ever-lower returns. Meanwhile, sub-investment grade corporate credit offers the promise of higher returns, but what is the outlook for this market and are defaults likely to be rising in 2013?

The answer to this question lies in an analysis of the 'maturity wall' depicted in the accompanying chart. Credit was easily available to finance leveraged buyouts during the boom years between 2004 and 2007. Issuance of loans exploded during that period, driven by high demand for the asset class from banks and collateralised loan obligations (CLOs). By 2007, issuance had peaked at around €111 billion[1], before the credit crisis caused this run to come to an abrupt end, preventing companies from accessing the capital markets for some time. This resulted in a significant concentration in refinancing requirements in 2014 and 2015.

Initially, market participants were concerned that this would herald a large increase in defaults as loans issued in the boom years came to maturity with no source of refinancing. In fact, significant progress was made in addressing the maturity wall problem. Companies were able to refinance through the loan market, through the issuance of senior-secured high yield bonds, and through the amendment of outstanding loan documentation to extend the maturity of their facilities, often in return for increasing the margin on their outstanding debt.

Consequently, the refinancing burden for 2014 and 2015 has been substantially reduced and extended across a broader range of maturities between 2014 and 2019.

Restricted access to financing for weaker businesses

The new financing available since 2009 has been characterised by wider spreads, less leverage and stronger security terms for the borrowers. As a result, this vintage of financing is better protected from the risk of default that resulted from stagnating economic growth, since new deals have higher equity contributions from equity sponsors, and less leverage as a function of annual earnings.

1. Credit Suisse Fixed Income Research, 2012 Leveraged Finance Outlook and 2011 Annual Review, 'Exhibit 194: Western European Institutional Leveraged Loan Market Size', 26 January 2012. Includes non-investment grade fully-drawn institutional term loans (TLb's, TLc's, TLd's, delayed-draw, and other tranches held by institutional investors) of issuers with assets located in or revenues derived from Western Europe, or the loan is denominated in a Western European currency.

However, access to the capital markets since 2009 has been restricted to those companies with sustainable business plans in defensive industry sectors, which have been able to demonstrate an ability to continue to service debt in a more modest growth environment. Those companies that have been slower to recover, those with challenged business models or those too small to access the more liquid parts of the capital markets are struggling to refinance ahead of imminent maturities.

While the volume of refinancing required in 2014 and 2015 has certainly fallen, the average credit quality of those businesses that still need to access the capital markets during those years has decreased. We believe that it is within this identifiable universe that we are likely to see an increase in business failures and defaults.

Changing investor type

In parallel with the flattening out of the maturity wall, the market has seen a change in investor composition. CLOs have become less significant players in the market as many have reached the end of their investment periods and turned into static pools of collateral. There has been no significant new issue in the European CLO market since the crisis, so the capacity lost as older transactions mature has not been replaced by new issuance. At the same time, the banks have become less willing long-term holders of corporate credit, driven by increasing capital requirements. In place of the banks and the CLOs, institutional investors have been the main providers of refinancing, either through participation in the loan market or by increasing their allocation to European high yield bonds.

The bond market has also benefited from an influx of retail money into specialist bond funds in UCITS format, for which assets under management have swelled over the last three years. As a result, the European high yield bond market is now of a similar size to the institutional loan market, whereas in 2008, outstanding debt in loans dwarfed that of the bond market.

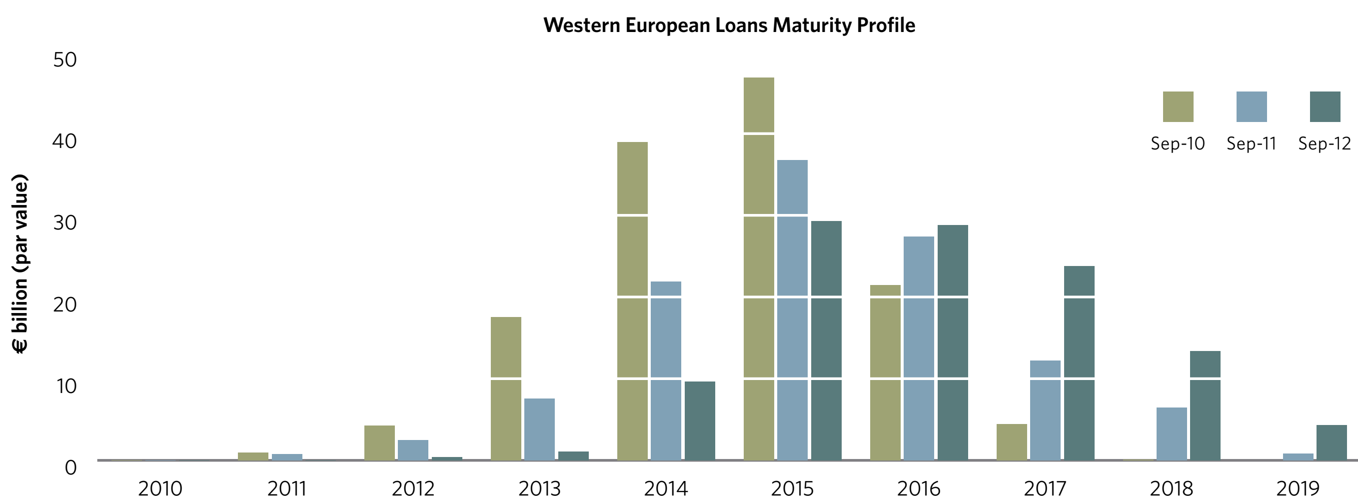
The opportunity set

This situation presents investors with a variety of opportunities in sub-investment grade corporate credit for 2013. We believe that for those seeking more secure, stable returns in a liquid format, the loans and bonds issued since the crisis to refinance those businesses that have proven resilient in the face of modest global growth can offer yields of between 6% and 9%, with only a modest risk of default-related loss.

For those seeking higher returns, an opportunity exists in stressed and distressed credit. We anticipate that some holders of debt in those companies that have not yet been able to refinance forthcoming maturities in 2014 and 2015 will start to sell positions, with a view to cleaning up their balance sheets. This is creating an opportunity for informed asset managers specialising in stressed and distressed investment to source assets at below fair value from forced sellers.

Finally, the increasing burden of regulation on the banking sector is making banks less efficient holders of long-term debt, causing them to scale back their corporate lending activities. This has left those companies unable to access the more liquid capital markets starved of a reliable source of financing. We therefore believe there is a new opportunity for investors with a tolerance for a less liquid investment to fill this gap in the coming years by providing private debt, directly originated to middle market corporates across Europe.

THE 'MATURITY WALL' CREATING INVESTMENT OPPORTUNITIES IN THE STRESSED/DISTRESSED MARKETS



Source: Standard & Poor's Global Leveraged Loan Review – US/Europe, Q3 2010, Q3 2011 and Q3 2012, P53.

"The relatively attractive yield spread that quality real estate offers over prevailing low interest rates has driven global investor demand in markets such as London and New York City. Additionally, with many rents index-linked, real estate can act as a potential hedge against inflation."

Todd Briddell, Urdang

Alternatives

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Real estate stands firm on robust supply and demand foundations
Todd Briddell, Chief Executive Officer and Chief Investment Officer, Urdang

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Currency management opportunities in an uncertain world
Arnaud Gerard, Senior Vice President, Pareto

Real estate stands firm on robust supply and demand foundations

Todd Briddell
Chief Executive Officer and Chief Investment Officer, Urdang

Urdang Securities Management (Urdang) is a leading specialist asset manager focused on the real estate securities market, including publicly traded real estate investment trusts (REITs). The firm's value-oriented investment approach combines fundamental and quantitative analysis.

The current investment climate is one of heightened uncertainty, but also one filled with possibility. Many investors are adopting a 'wait-and-see' approach to investing. They are waiting for governments to act, for policies to take effect, or for problems to be resolved — anything to provide direction and clarity to the market.

Against this backdrop, we believe that despite (appropriately) lowered return expectations, real estate can continue to satisfy investors' thirst for sustainable yield, while capturing the growth opportunities presented by the improving underlying fundamentals of the asset class.

Demanding times

Real estate fundamentals continue to improve, driven by a number of global- and region-specific factors: modest supply, demand improvement and 'safe haven' capital flows.

During the global financial crisis, the pipeline of new development projects quickly diminished, and, as a result, most markets have not seen a glut of supply as they did during the downturn of the early 1990s. In markets where the pace of development has again gathered pace, such as the City of London, construction will typically not proceed without a substantial tenant pre-let commitment. Furthermore, the limited availability of construction financing favours listed property companies with the financial wherewithal for balance sheet expansion, unlike many of their privately owned peers.

On the demand side, although employment growth is muted and prospects for economic expansion are limited in most developed market economies, many companies have no option but to move as they outgrow their existing space and require modern, purpose-built offices. Global and regional retailers continue to expand through new store openings with a focus on the best locations. Prime shopping centres, many of which are owned by listed real estate companies, are still experiencing strong demand for space, and thus, rental growth.

Finally, the continued flow of capital towards 'safe haven' markets has resulted in a robust investment environment. Strong transaction volumes, in turn, have provided support for prime asset valuations. The relatively attractive yield spread that quality real estate offers over prevailing low interest rates[1] has driven global investor demand in markets such as London and New York City. Additionally, with many rents index-linked, real estate can act as a potential hedge against inflation.

1. Bloomberg, 30 September, 2012.

Building for the future

As we see macroeconomic risks lying ahead that have the potential to cause volatility in the market, we are focusing on quality companies with growing, covered dividends and stable asset bases. Indeed, there have been significant capital inflows into the sector in the past year, due largely to today's low interest rate environment. Even at moderate leverage levels, we have seen very attractive cash-on-cash returns with borrowing costs at their current lows. In a yield-starved world, real estate securities continue to look attractive, with an average yield spread over local government bond yields of more than 2.5%, as illustrated in the chart below.

Although risk aversion continues to oscillate, we have seen an encouraging trend of positive performance among global property securities, as well as the sector's outperformance relative to equity markets more broadly. Our focus remains on quality companies, proven management teams, quality assets and regions with firm economic fundamentals. However, we are carefully monitoring weaker regions, and are looking to capitalise on recovery trends and value opportunities.

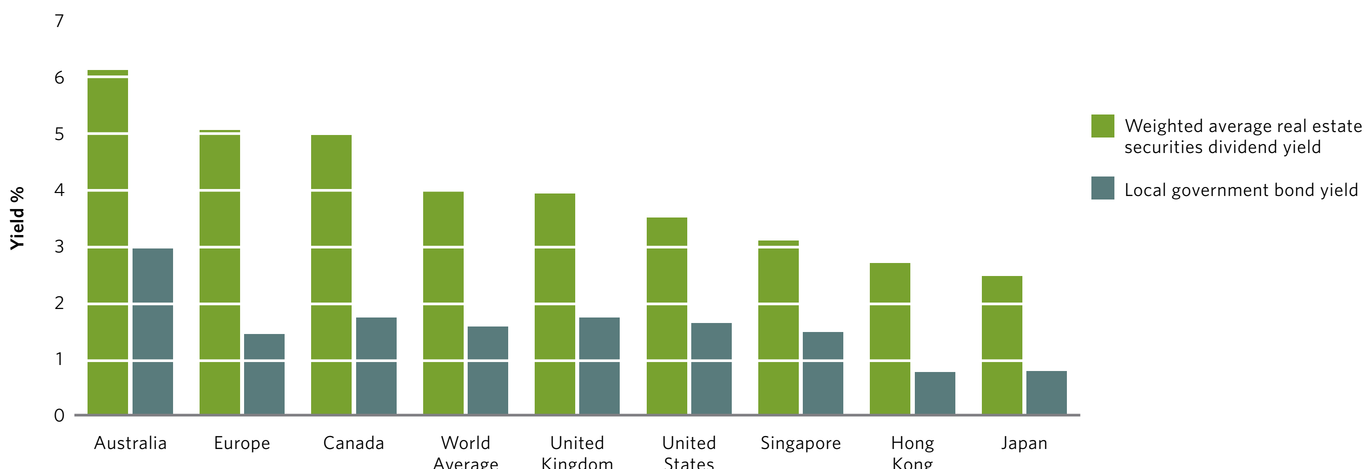
Property stocks are, and will likely continue to be, strongly influenced in the short term by market sentiment, which takes its cues from the broader global macroeconomic environment. Limited political leadership on sovereign debt problems and continued banking woes obscure the path forward. Although long-term worries about global fiscal and monetary health are likely to persist, we do not see signs of a catastrophe ahead. Instead, we expect the next 12 to 24 months to bring more clarity to the markets.

Weathering the storm

Our outlook for global real estate securities in 2013 remains optimistic. We continue to see decent flows into real estate investment trusts, with large institutions ramping up investments in the space. The demand for yield is high, and we expect to see multiples expand across the global equity markets, even in the face of sluggish economic growth.

As we enter the fifth year of this deleveraging cycle, the private liabilities that plagued the economy in past years have now become public liabilities, and it will be up to governments and pension managers to determine the best resolution. Growth remains elusive, making yield even more attractive. From both a current income and growth perspective, we believe real estate continues to be an attractive investment. Spreads relative to other low-risk yield vehicles remain wide, and favourable supply and demand fundamentals across the globe should support rental rate growth. Despite continued deleveraging, we believe real estate is well positioned to weather the long-term storm.

PROPERTY SECURITIES OFFER INVESTORS AN ATTRACTIVE YIELD COMPARED WITH GOVERNMENT BOND RETURNS



Source: Bloomberg, 30 September, 2012

BNY MELLON

Currency management opportunities in an uncertain world

Arnaud Gerard, CFA
Senior Vice President,
Pareto

Pareto Investment Management Limited (Pareto) is one of the world's foremost currency managers, offering both overlay and absolute return strategies. Combining investment expertise and academic excellence, Pareto was founded on the principle that advanced technology could be applied to currency management.

No attempt is made in this article to predict the direction of global currency markets for 2013. Many successes have been achieved in explaining the reasons for currency moves after the event, but currency fluctuations remain very hard to forecast consistently, especially when it matters the most. We are in no doubt that economic variables play a role, and more recently, exogenous shocks, political intervention, central banks, and the psychology of participants have played their part in influencing markets – but these do not help with prediction. We believe that it is therefore more relevant to focus on the outlook for currency managers and their clients.

Similar to equity management where various styles and their characteristics are known to the market (growth, value, large and small cap), style differences are quite critical in the currency space. From 2003, an approach favouring trend-following/momentum had worked well with developed currencies. This was then followed by the carry trade (selling low interest rate currencies to buy higher rate currencies), although the credit crisis put an end to the carry 'bull' rally in dramatic fashion (sharp increase in volatility, rally in the low-yielding currency triggered by its 'safe-haven' status). Since then, we have had to accommodate a fluid, continuous change of regimes (dominated by the risk-on/risk-off trade) – with an increasing influence from the emerging markets.

Looking at currency management more generally, there are a number of different outlooks that we can organise logically by investors' individual objectives.

Currency hedging

The management of pre-existing currency exposures to protect against losses from international investments should form part of any investment process. International investors may be exposed to potentially adverse cumulative moves in foreign currencies that may overwhelm asset allocation and stock selection efforts. We believe that investors should consider reviewing their currency hedging policy statement to recognise the significant shift in the market. Today, traditional asset classes are seeing a lower expected return, which increases the significance of currency volatility. In addition, diversification benefits, return assumptions, volatility and interest rate differentials have all been tested during the crisis; interest rate differentials around the developed world have been reduced practically to zero, with no medium-term expectation of change.

1. Source: iShares
2. ICAP, Spot Foreign Exchange, Volumes reported in USD using monthly FT exchange rates, October 2012.

The effects of currency risk develop over a number of periods and are traditionally managed through trend-following or fundamental valuation methods. With the exception of 2008, most developed currency market behaviours today appear to have been 'tamed' – some investors might get a false level of comfort from this environment.

Currency markets are once again experiencing extremely low levels of implied volatility, similar to levels last observed in late 2006 and early 2007. This clearly runs against the current economic situation, and against the deleveraging process which is under way. We suspect that this phenomenon has been driven by central bank support and market intervention.

A move from active to passive portfolio management can lead to disappointment in the field of currency, since currency risk is recognised to go unrewarded (unlike in the case of any other asset classes). A passive hedge is likely to replace foreign currency-return uncertainty with cash flow uncertainty. In our view, currency hedging is about risk management – the priority is therefore to get a handle on risk at a reasonable cost (not to replace or convert it).

Absolute return currency strategies

We have observed that, on the whole, investors seeking to take foreign currency positions to seek profit via absolute return currency strategies have been disappointed. Consequently, such strategies have seen limited interest since the crisis. In the main, investors' experience has been determined by the carry-trade style as it was on a 'bull run' at the time when investors became the most interested in absolute currency return (2006-2008).

The various currency management styles are now better understood in terms of performance profile and timing; this knowledge has led to a growth in multi-strategy approaches (including extension into the macro space) being offered. We believe that this appetite for a broader opportunity set should continue into 2013.

More recently, market observers have seen a fashion for anything called 'emerging markets' – currency strategies have also been caught by this. Clearly, these regions exhibit great dynamism. We believe that investors should, however, guard against extrapolating an impressive run (conversion trend) too far out into the future. Indeed, the past 18 months have been less easy for such currencies.

Currency as a means to an end

Currency markets are among the most liquid, transparent and inexpensive markets to trade. They can offer a great medium for expressing market sentiment (risk-on/risk-off) or trade ideas (playing commodities through the Australian dollar or the Canadian dollar). Accordingly, they are well suited to addressing specific portfolio needs (like volatility).

We believe that the risk of imperfect hedging, or basis risk, can be overcome when compared to the current negative return seen on many tail-risk exchange-traded funds[1] – or when interested in capturing the volatility, rather than the direction, of markets.

Overall, we think that investors should consider currency managers in the context of the type of strategy and its use. For hedging, we believe the current, lower-expected return paradigm, and the prevailing economic challenges will make the foreign currency effect greater.

For absolute return, uncertain times lead to greater diversification; it is important for clients to consider not putting all of their 'eggs in one basket'. Finally, we believe that using currency as a proxy hedging tool should get recognition among the few looking for an alternative to the high cost of traditional tail-risk strategies, or pioneers looking for alternative sources of market opportunities (like volatility).

Since the beginning of the credit crisis in 2008, inter-currency volatility has increased, driving down the volume of carry trades implemented. According to ICAP's monthly volume data, average daily volumes in foreign exchange fell 28% in October 2012 from a year earlier.[2] Similarly, profits from the carry trade are at their lowest levels since early 2011. Why? Making a profit in what was once a high return area of the currency market has become more difficult. Over the life of the crisis, in an environment of near-zero interest rates and experimental monetary policy, the trading ranges across major currency pairs have narrowed consistently (as have the interest rate differentials on offer). The interest rate advantage enjoyed by higher-yielding currencies has begun to dwindle. As long as interest rates remain low, the situation is likely to remain unchanged.

"Asset bubbles in the more fundamentally sound markets will remain a distinct possibility as economic fundamentals diverge further, with well-balanced economies the beneficiaries."

Ivo Batista & Pierre Chartres, Investment Strategy and Solutions Group

Asset Allocation

GLOBAL **44**
Flexible asset allocation approach well suited to navigate challenges ahead
Ivo Batista, Portfolio Strategist, Investment Strategy and Solutions Group &
Pierre Chartres, Portfolio Strategist, Investment Strategy and Solutions Group

GLOBAL **46**
Asset allocation opportunities in 2013
Vassilis Dagioglu, Managing Director, Head of Asset Allocation Portfolio Management, Mellon Capital

BNY MELLON

Flexible asset allocation approach well suited to navigate challenges ahead

Ivo Batista
Portfolio Strategist, ISSG

Pierre Chartres
Portfolio Strategist, ISSG

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Policy and politics will continue to drive the sentiment cycle in markets in 2013. In order to frame our expectations, we have created three distinct scenarios based on our assessment of the current environment, combined with several secular issues that we believe will play out in 2013 and beyond.

Greater visibility

Under our first scenario, European policymakers would be able to resist domestic pressures and act in a coordinated and pro-active manner with a view to tackling the Eurozone's main challenges. This would mean addressing the region's lack of international competitiveness, establishing a plan to achieve sustainable government finances, recapitalising the fragile banking sector, and pushing for fiscal and monetary integration.

Simultaneously, the divided US government would be able to avoid brinksmanship with regard to the fiscal cliff, preserving businesses and consumers from a wave of tax rises and government spending cuts. Under this scenario, investors worldwide could take advantage of plentiful liquidity and reduced uncertainty to move out on the risk-return curve, potentially sending equity prices higher. This scenario would be most detrimental to 'safe-haven' bonds and emerging markets bonds denominated in hard currencies, as investors would be likely to shun safe-haven assets in search of greater yields and the potential for capital appreciation.

Status quo in EMU

In our second scenario, EU policymakers would be unable to act in a coordinated manner, and only achieve piece-meal structural reform when market pressure becomes too great. This increased uncertainty would most likely prevent the corporate sector from investing in new projects, profit margins would remain under pressure, and unemployment would remain stubbornly high. Low interest rates in developed markets could lead to strong net capital flows into emerging markets, limiting central banks' ability to maintain accommodative monetary policies. Stock markets would remain volatile as investors' confidence ebbs and flows and, given current valuations, developed equity returns could potentially be low or even negative. Emerging market equities would probably fare better, as would the stocks of companies with high dividend yields and strong cash-flow-generating capabilities, or dominant market shares. In fixed income, credit could perform relatively well compared to other assets, but sovereign bonds of countries with weak fundamentals would be put under pressure.

The perfect storm

Under the third scenario, rising social tensions caused by the accumulated weight of fiscal austerity would pressure Greece into exiting the euro. Without effective ring-fences in place, Spain and Italy would lose market access and be forced into the European Stability Mechanism programme. Financial conditions could quickly deteriorate as banks increased provisions for non-performing loans in the periphery and throughout Europe.

The ripple effects of a deep European recession would be quickly felt in the US, where the deteriorating business climate and discontent from constituents may exacerbate fissures between politicians on the fiscal cliff. We might see factory output decline in China and the investment and credit bubbles come to an abrupt halt, causing a credit crunch and bankruptcies. The Chinese central banking system would step in to provide some relief, but would still be faced with significant net capital outflows and a prolonged period of below-potential growth. Social unrest could rise as governments are confronted with higher unemployment rates and commodity price subsidies they can no longer afford.

Simultaneously, the global economic slowdown would exacerbate tensions and income inequalities in the Middle East, creating potential domestic or international conflicts and a global oil supply shock.

Asset prices could potentially fall and correlations would rise indiscriminately affecting most asset classes. Cash and safe-haven government bonds would be the assets for investors to consider in this case.

Subdued, sub-par recovery set to continue in 2013

Regardless of how our above scenarios play out, we believe that the subdued, sub-par recovery we have seen in developed markets should continue in 2013. Secular deleveraging in developed nations will continue in a world where developed market central banks play a lesser role in the sentiment cycle, with unlimited quantitative easing programs already factored into asset valuation assumptions. Asset bubbles in the more fundamentally sound markets will remain a distinct possibility as economic fundamentals diverge further, with well-balanced economies the beneficiaries. Nimble investors with a flexible asset allocation approach will be best positioned to navigate the turbulence in 2013 and, with market dislocations a distinct possibility, downside-aware investors have the potential to outperform.

SCENARIO / PROBABILITY	KEY OUTCOMES	POTENTIAL POSITIVE IMPACT ON	POTENTIAL NEGATIVE IMPACT ON
GREATER VISIBILITY 20%	• Eurozone sovereign debt crisis is contained to the periphery • New US government correctly addresses budget and debt issues • Loose monetary policy worldwide encourages aggregate demand and employment growth	• Developed equities • Emerging market equities • Basic resources equities • Asia Pacific equities • Oil and industrial metals • High yield and Eurozone periphery bonds	• 'Safe-haven' government bonds • High-quality corporate bonds • Emerging market debt (US or euro-denominated)
STATUS QUO IN EMU 60%	• Pressure from financial markets forces discordant policymakers to take incoherent actions • Uncertainty remains high and growth remains low in developed markets • Increased capital flows lead to stubbornly high inflation rates in emerging markets	• Emerging market equities • Real estate • Corporate and emerging market debt • Active management • Absolute return strategies	• Developed market equities • Peripheral European bonds
PERFECT STORM 20%	• Adjustment fatigue leads to a spreading of EMU crisis • Political gridlock in divided US Congress causes sustained fiscal contraction and recession • Abrupt end to China's investment and credit super-cycle leads to a sharp slowdown in economic growth • Intensified geopolitical stresses cause oil supply shock • Central banks, perceived as having failed in supporting global economy, lose credibility	• Cash • 'Safe-haven' government bonds • Investment grade credit • Absolute return strategies	• Emerging markets equities • Developed equities • Oil and industrial metals • High yield • Real estate

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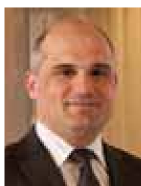
Asset allocation opportunities in 2013



Vassilis Dagioglu
Managing Director, Head of Asset Allocation Portfolio Management, Mellon Capital

Mellon Capital Management Corporation (Mellon Capital) is a leading innovator in the investment industry, and has provided global multi-asset solutions for nearly thirty years. The firm's precise understanding of global markets, and its fundamentals-based, forward-looking analytical methods are the foundation for tailored client solutions. Mellon Capital's investment capabilities range from indexing to alternatives, with the infrastructure and skill to transact in all liquid asset classes.

As we cross over to the New Year, global economies and financial markets continue to appear unsettled and face large headline risks. A looming tightening of the fiscal purse strings in the US and the 'make-up or break-up' scenario within the Eurozone have the potential to bring the engines of global economic growth to an unpleasant halt. In spite of several uncertainties, we believe that investors cannot afford to simply duck and take cover, overlooking asset allocation rebalancing decisions. On the contrary, we believe that sticking to a well-balanced and dynamic asset allocation process, focused on fundamentals, is critical to meeting investors' return objectives.

So, what are fundamentals likely to look like in 2013? We expect to see positive global economic growth, although at slow and geographically uneven tempos. A recovery in consumer spending and the housing market is likely to drum a positive economic beat in the US, while European economies will probably experience the blues of austerity and near-zero growth. In 2013, we expect that emerging market economies such as China and India will continue their marching pace and grow at higher rates, pulling along other economies that export raw materials and industrial goods, including Australia, Brazil and various Asian economies.

From an asset allocation perspective, we prefer the approach of moderately tilting a portfolio in favour of riskier asset classes such as equities, which have the potential to benefit from relatively attractive valuations and positive growth momentum. In our view, equity markets should continue to benefit from the fact that many corporations have built sizeable war chests of cash, have managed costs well and have effectively tapped growth opportunities worldwide.

An unpredictable environment leads to a search for safety

A strategic allocation to asset classes such as fixed income appears to be an effective way to manage downside economic risks. However, it is important to recognise that even certain asset classes perceived as 'safer', such as government bonds, have the potential to spoil portfolio returns should long-term interest rates rise, even moderately.

In fact, we find that at current yield levels, most fixed income assets, particularly the sovereign bonds of developed economies, are not sufficiently pricing in expectations for future inflation. We believe that inflation is a risk that investors should consider in the medium term, given the overhang of the extraordinary liquidity provided by central banks around the world.

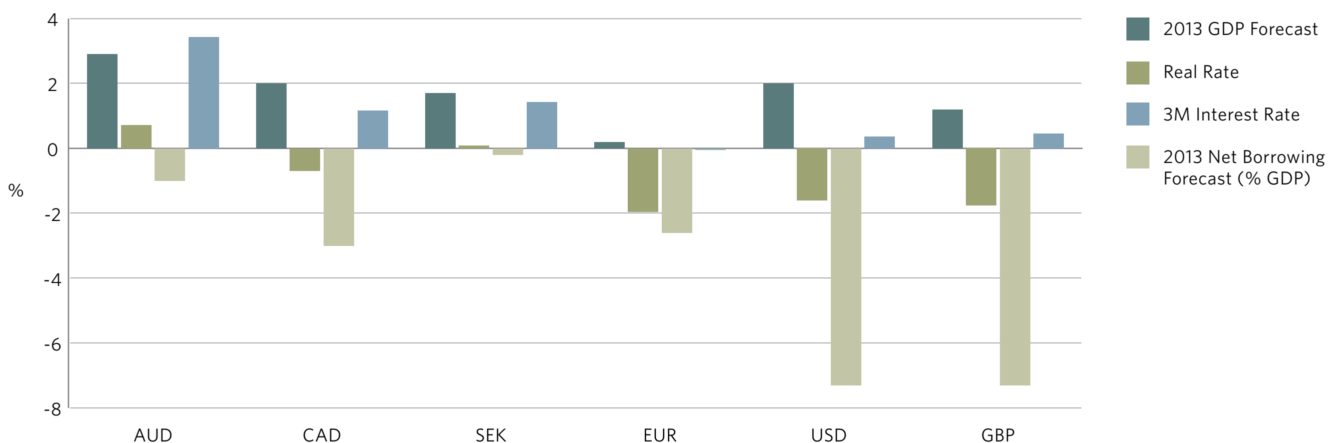
Despite worsening economic fundamentals in Europe, we think large-capitalisation companies in Germany, France and the Netherlands are favourable. We find that stocks in these markets can trade at attractive discounts, as they benefit from exports to many faster growing economies, a relatively weak euro and lower funding costs. In addition, we see a modest preference for emerging market equities, especially in China, South Korea and Brazil. Emerging markets are trading at more attractive valuations than many developed markets, and are expected to benefit from higher domestic growth rates and the easing of monetary policies around the world. Among our least favoured stock markets are Japan, Switzerland and Hong Kong, due to what we perceive as anaemic earnings-growth momentum.

Within fixed income, we prefer corporate and emerging market debt to developed market sovereign bonds. Across sovereigns, we prefer German bonds to those issued in the UK. Despite the historically low interest rates in Germany, we find that growth and structural concerns in the Eurozone are likely to continue to direct euro-denominated asset flows into the safety of German bonds. Within credit, we favour US high-yield debt. In our view, the sub-investment grade sector has a lower exposure to interest rate risk than do higher-quality bonds. In addition, the abundance of liquidity provided by the US Federal Reserve is expected to lend support to the US economy and credit markets. Relatively healthy public finances in many emerging economies should continue to make emerging market debt an attractive asset class.

Within a global asset allocation framework, we find that dynamic currency cross-hedging can provide an additional source of return, as well as providing a form of risk control. Despite the appeal of euro-denominated assets, we prefer the approach of partially hedging exposure to the euro, as well as to sterling and the US dollar. We expect a prolonged period of economic weakness in the Eurozone, during which monetary policy will need to remain accommodative and interest rates low, potentially leading to a weaker euro. Generally, we tend to favour currencies that are backed by stronger economic growth expectations, sounder fiscal standings and higher yields, such as the Australian dollar, the Swedish krona and the Canadian dollar. We believe that the rate of economic growth in China will be an important determinant of the strength of commodity-related currencies. Although Chinese economic growth has clearly decelerated recently, we regard the chance of a continued slowdown, or a 'hard landing', as rather low.

We believe that an actively managed allocation to commodities, and exposure to the shares of natural resource companies, are effective ways of hedging against inflation risk. Within the commodity markets, we prefer commodities that are in lower supply relative to demand; for this reason, we like the energy and agriculture sectors. Within energy, we have a preference for crude distillates like gasoline and heating oil due to their relatively tighter inventories compared with crude oil and natural gas, for example. We also see attractive opportunities in precious metals, which we believe are likely to benefit from the potential inflationary effects of monetary policy easing.

CURRENCIES THAT ARE BACKED BY STRONGER ECONOMIC GROWTH EXPECTATIONS, SOUNDER FISCAL STANDINGS AND HIGHER YIELDS ARE LIKELY TO OUTPERFORM IN 2013 AS GLOBAL GROWTH REMAINS LOW AND GEOGRAPHICALLY UNEVEN



Source: IMF WEO October 2012

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