Security Selection and Liquidity Key for Bonds in 2013

STANDISH GLOBAL BOND MARKET OUTLOOK

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EXECUTIVE SUMMARY

Standish CIO Dave Leduc says he expects government bond yields in developed markets to rise modestly in the coming year, given unattractive valuations and less event risk in the global economy. Peripheral European debt markets may also present opportunities, he says, though the global bond manager is focused on markets with better fundamentals due to the risk of further volatility. He calls global corporate credit valuations fair, but says there appears less room for price appreciation based on economic fundamentals. In general, Standish favors high yield over investment grade bonds and believes security selection will be paramount in both markets. Leduc continues to see value in emerging market local currency investments and anticipates some strengthening in certain currencies, including developing Asia and Latin America, as better economic fundamentals attract capital inflows.

"There are two levers for moving men – interest and fear."

— Napoleon Bonaparte

Financial markets are generally a barometer of the psychology of participants, and so it is no surprise that the levers that move men (and women) are the same levers that move the markets. In our view, global macro risks have diminished significantly, and we hope we are moving away from a market dominated by fear and toward one in which fundamentals again drive returns. Earlier this year, our Global Macro Strategist, Tom Higgins, described our expectations for global economic conditions in 2013. We believe that global growth will remain below trend as developed economies continue to deleverage and that inflation will be well behaved. While this view would normally create a supportive backdrop for fixed income investments, valuations according to our estimates have become stretched in a number of sectors.

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That said, we continue to see value in areas such as high yield, global corporates and emerging market debt. However, we believe an important driver of excess returns will be security selection within sectors and not just sector allocation decisions. In addition, trading liquidity continues to ebb and flow with overall risk sentiment, so we place greater emphasis on portfolio liquidity. That means that risks in our multi-sector portfolios are likely to be more distributed across opportunities in rates and currencies as well as credit sectors. Given our more optimistic view of economic conditions in the second half of the year, we will likely view any volatility that causes risk premiums to increase as an opportunity to add exposure to credit assets with strong fundamental characteristics.

A LOOK BACK AT 2012 PERFORMANCE

Before we look at opportunities and return expectations for 2013, let us quickly review fixed income performance in 2012. What is notable in the summary of fixed income performance in Exhibit 1 is the absence of any negative numbers. Indeed, fixed income investors benefited from the fact that Treasury yields declined and spreads contracted across almost all non-Treasury sectors. U.S. investment grade returns were driven by the strong performance of the financial sector as well as lower-rated BBB issuers across all sectors. Stable corporate sector fundamentals encourage investors to seek yield by moving down in credit quality. This was evident in the double-digit returns posted in both U.S. and European high yield bonds.

Returns across securitized markets were supported by stable and improving fundamentals in asset-backed securities (ABS), commercial mortgage-backed securities (CMBS) and residential mortgage-backed securities (RMBS) sectors. Agency mortgage returns were helped by lower volatility and the Federal Reserve's RMBS purchases, which benefited low coupon bonds especially well. The European Central Bank's (ECB) announcement of its own bond purchase plan, dubbed the Outright Monetary Transaction (OMT) program, caused spreads on both peripheral sovereign bonds and European corporates to narrow.

Finally, returns in emerging market bond investments, in both external and local currency markets, also experienced double-digit returns. Emerging local currency performance was driven by a combination of lower rates as well as strength in currencies. External debt markets benefited from the combination of lower Treasury yields and tighter spreads, particularly for emerging market corporate issuers. While the magnitude of returns is unlikely to be repeated, we believe a moderate growth and low inflation environment combined with strong sector fundamentals will continue to support returns in 2013.

Exhibit 1 – Fixed Income Returns in 2012

Sector	Excess Returns*	Total Returns
U.S. Treasury	NA	2.0%
U.S. MBS	0.9%	2.6%
U.S. Corporate	7.3%	9.8%
U.S. High Yield	13.9%	15.8%
ABS	2.5%	3.7%
Euro Treasury	3.6%	11.0%
Euro Corporate	8.6%	13.6%
Euro High Yield	23.0%	27.3%
EM External	NA	16.8%
EM Local	NA	18.5%
EM Corporate	NA	17.0%

*Versus a similar duration Treasury.

Source: Standish, Barclays and JP Morgan

Although we do not expect a meaningful change in inflation over the course of 2013, we will consider a more aggressive stance on duration as we begin to anticipate less accommodative Fed policy.

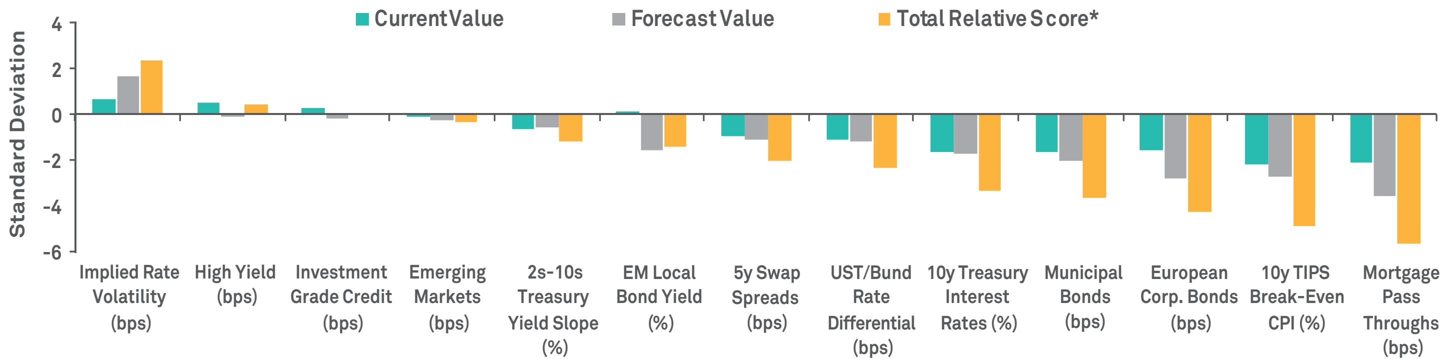
DURATION, CURVE AND INFLATION-LINKED BONDS

One of the most persistently overvalued sectors according to our valuation models over the past several years has been the U.S. interest rate market. Treasury yields have been driven below fair value as a result of two key influences: central bank policy and to a lesser extent the safe-haven demand for Treasury assets. In fact, we updated our model to reflect the influence of safety considerations on yields. Our proprietary valuation models estimate that 10-year Treasury yields are overvalued by approximately 70 basis points, which we believe is largely explained by Fed rate policy and the asset purchase program.

However, these influences may continue to wane as investors become more confident about stabilizing economic conditions around the world and reduced tail risk in Europe. We estimate that the flight-to-quality bid explains about 80 basis points of current yield levels. We expect that as investors' macro concerns abate in the second half of the year, an already steep yield curve could steepen further, given that Fed short-rate policy is unlikely to change until 2014. This means that we have slightly different views on duration depending on the portfolio strategy. Shorter duration portfolios are comfortably at duration targets, capturing the roll return with little price risk, while intermediate and longer duration portfolios are biased toward below-benchmark exposure to interest rate risk. Although we do not expect a meaningful change in inflation over the course of 2013, we will consider a more aggressive stance on duration as we begin to anticipate less accommodative Fed policy.

Real yields, like nominal yields, are fundamentally overvalued and could remain lower for longer with continued Fed balance sheet expansion. U.S. breakevens are trading at the higher end of the spectrum and appear overvalued, according to our models. Yet the market is supported by supply/demand factors. In a higher rate environment we would expect Treasury inflation-protected securities (TIPS) to outperform nominal counterparts.

Exhibit 2 – Standish Bond Model



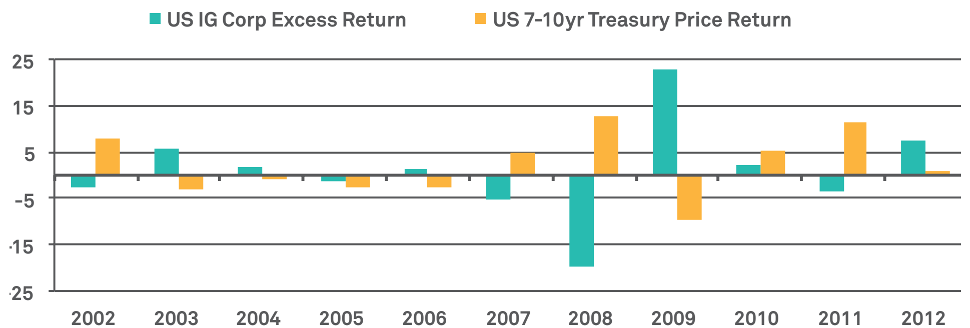
*Based on Standish proprietary valuations.

Source: Standish

GLOBAL CORPORATE CREDIT AND HIGH YIELD

Last year was the second best year for corporate bond returns in the last decade. Both high yield and investment grade spreads tightened dramatically as a result of stable economic and corporate fundamentals as well as investor thirst for yield in an unprecedentedly low rate environment. Corporate bonds as well as other risk assets experienced strong total returns as a result of a rare combination of spreads contracting at the same time that Treasury yields declined. As Exhibit 3 highlights, the reverse has been true historically, with excess returns on credit assets typically correlated with higher Treasury yields.

Exhibit 3 – Corporate Excess Returns* vs. Treasury Price Returns



*Versus a similar duration Treasury.

Source: Standish, Barclays and BofA Merrill Lynch as of December 2012

Our valuation models suggest that U.S. investment grade corporate bonds offer more value than their European counterparts. Our fundamental investment research concurs with that view. We believe that elevated credit fundamentals combined with positive technical factors will lead to further spread tightening, particularly in cyclical credits. Our expectation for modestly higher rates in 2013 is also supportive for excess returns.

We believe that an environment characterized by low yields and modest growth bodes well for high yield, especially mid-quality issuers. Fundamentals for high yield may have peaked but remain firm, as financial leverage and defaults continue to trend below historical averages. Liquidity and access to capital remains supportive, and near-term maturities appear manageable in the current funding environment. We observe that the proceeds from new issues continue to be used primarily for refinancing as opposed to leveraged buyouts (LBO) or merger activity. Within high yield, we continue to overweight single-B issues with an emphasis on the packaging and service sectors while underweighting retail and utility credits.

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One risk we see is a pickup in corporate restructuring and LBO activity. This has not been a major problem during the past several years because of deleveraging in the banking sector and a general lack of funding for leveraged transactions. However, we have seen an increasing willingness among companies to consider transactions to improve shareholder returns in light of the low cost of debt capital. This is the area where we believe the fortunes of the investment grade and high yield markets may diverge over the next several years.

High yield may have greater protection against event risk than investment grade because of covenants that often have change of control language allowing existing bondholders to put securities back to the issuer. Conversely, investment grade issuers have more financial flexibility to increase leverage and issue bonds that generally have fewer covenant protections.

Debt capital for leveraged transactions is still harder to come by than in the pre-crisis market prior to 2007, so we do not expect a dramatic increase in this type of activity. In fact, we would look at wider corporate spreads related to LBO concerns as an opportunity to add select credits with strong fundamentals and limited event risk at more attractive valuations. As this requires greater emphasis on bottom-up credit analysis, we believe the strength of our credit research teams will become increasingly important.

We expect major developed world currencies to underperform the currencies of countries with better public and private balance sheets.

MORTGAGE-BACKED SECURITIES (MBS) AND OTHER SECURITIZED SECTORS

Agency mortgages stand out as one of the richest sectors based on our valuation model. We expect this condition to persist, since interest rate and mortgage rate volatility remains low while there is continued demand for high quality assets. But net supply is low, and the sector benefits from purchases by the Fed. The Fed will drive the technical conditions for MBS, since it is purchasing close to 60% of the gross supply of agency mortgages. We are currently underweight mortgages in our multi-sector portfolios, but overweight lower coupons that have less prepayment risk.

We expect other asset-backed securities (ABS) to continue to exhibit stable performance amid low yields, positive technicals, and solid credit fundamentals. The low interest rate environment will continue to encourage investors with a higher quality bias to look for sectors where they can earn some incremental yield with minimal spread volatility. We believe more robust underwriting standards and bond structures should support stable collateral performance. Thus far, regulators have been willing to work with securitized markets to avoid crimping the availability of credit, but we would not be surprised to see some unintended consequences arise. Ironically, the sector once at the epicenter of the global financial crisis is now regarded as a safe haven for investors looking for high quality, short average life assets, as they rotate out of riskier, longer duration and credit-sensitive positions.

GLOBAL FIXED INCOME AND CURRENCIES

Global interest rate and currency markets present an interesting opportunity for dollar- based investors contemplating the potential for higher yields in U.S. interest rate markets. In fact, even as bond yields begin to rise in core Europe, particularly Germany, they have declined in the sovereign bonds of peripheral countries, including Italy, Spain, Portugal and Ireland. We have become more constructive on peripheral Europe because of ECB action to address convertibility risk and the overall risks of a eurozone breakup. Peripheral bond spreads are likely to trend tighter as economic fundamentals and debt sustainability improve. Yet the pace of improvement and implementation of policy will vary, so we will look for opportunities to exploit relative pricing differentials between countries rather than take large overweight or underweight positions in the entire region.

We also see value in certain European inflation-linked bonds. We believe the ECB now has more flexibility to let inflation run higher, and we express this view in more liquid linker markets tied to core Europe performance. It is our view that the weaker performance of the German bund market, the Japanese yen and Swiss franc point to an unwinding of safe-haven investments.

Major developed economies will continue down the path of reducing their imbalances (both fiscal and current account deficits), and we expect their recovery from the crisis to continue at a subpar rate of growth. However, very aggressive monetary policy in the developed world (i.e., low rates and ample liquidity), will support economic growth in the rest of the world. Hence, we expect major developed world currencies to underperform the currencies of countries with better public and private balance sheets.

EMERGING MARKETS

We remain positive on emerging markets (EM) debt. We believe that spreads on EM US dollar-denominated bonds (sovereign, quasi-sovereign, corporate, and supranational) will remain relatively supported by persistent growth differentials between emerging market countries and the developed world. We expect the positive growth differentials to benefit EM currency exposures as well.

The biggest threat to EM US dollar-denominated bonds remains the prospect of a further sell-off in the underlying US Treasury yields. Lower-beta, higher-rated sovereign and corporate names are particularly vulnerable. At the same time, with the asset class attracting large inflows, some higher-beta, lower-rated EM bonds no longer provide as attractive a compensation for credit risk as they used to. As such, consistent with the theme articulated across other fixed income sectors, security selection will be key to outperformance this year. On average, in our opinion, the overall level of spreads (currently in the high 200s), compensates for credit risks in this asset class, which has now become predominantly investment grade-rated. Moreover, the inclusion of EM US dollar-denominated bonds in the broader portfolio context helps to diversify issuer and country risks.

EM currencies have always been and will remain a heterogeneous group. Positive growth and interest rate differentials are likely to continue to attract capital inflows, thus exerting nominal appreciation pressures on EM currencies. On average, we expect moderate appreciation of a couple of percentage points this year against the US dollar. The biggest concern for EM currency exposure is volatility and the potential for underperformance in a rising risk aversion environment and a so-called “flight-to-quality” bid for the US dollar.

Local yields of around 5.5% remain attractive for carry, but further scope for capital gains from the local duration exposure appears limited to us. We find ourselves more often switching into inflation-linked bonds and moving to the shorter end of local yield curves.

FOCUSING ON FUNDAMENTALS

We believe global financial markets are beginning to move away from the volatile risk-on, risk-off behavior that was driven by systematic policy concerns and are now focusing more on fundamentals. As risk premiums have contracted, we think fixed income managers will need to be more discerning about investments and enlist bottom-up research to spot opportunities, since credit sector beta factors are unlikely to drive returns in the manner observed over the past several years.

Investors are likely to begin anticipating more stable economic activity in the second half of the year as well as the potential for higher inflation. Certain markets, such as U.S. Treasuries and German bunds, are vulnerable to these concerns. However, in our view there are a number of areas including global corporate credit, peripheral sovereign debt, and select emerging market local currency bonds which may perform well in that environment.

So the double-digit returns we experienced in many of these sectors in 2012 are likely to be in the single digits in 2013, but should still be attractive in this low-yield world. We expect generating alpha in fixed income markets will prove to be more challenging this year, and performance over the coming months will be dependent on prudent risk management, strong disciplined research capabilities, and an ability and willingness to capitalize on short-term market dislocations.

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