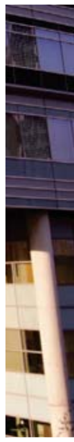
Standish Bond Market Update: Has Europe Finally Turned the Corner?



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Improving economic fundamentals have raised credit quality and lured yield hungry investors back to the market.

"They [Spain, Greece, Portugal and Ireland] have done many important structural reforms. They are continuing this effort. And you see in all four countries clear signs of recovery."

— ECB President Mario Draghi

EXECUTIVE SUMMARY

Peripheral European sovereign debt is trading at its tightest levels to German Bunds since 2010 raising concerns about whether the move is sustainable.

We believe spreads in some peripheral markets have room to tighten further based on fundamentals and we look to add on volatility.

Significant risks remain including high unemployment, political instability, low levels of inflation, and large sovereign debt burdens.

While there may be further upside in some of the peripheral markets, investors will need to be more selective going forward.

Government bond yields in peripheral European countries have fallen dramatically since European Central Bank (ECB) President Mario Draghi first committed to doing "whatever it takes" to keep the euro area together in July 2012. More recently, improving economic fundamentals have raised credit quality and lured yield hungry investors back to the market. There has also been some speculation that the ECB may take further policy action to support these markets adding to the downward pressure on bond yields. As a result, Italian, Spanish, Portuguese and Irish 10-year debt is trading at its tightest levels to German Bunds since 2010. Even Greece was able to issue 10-year government debt this spring at a yield of less than 5 percent just two years after its default.

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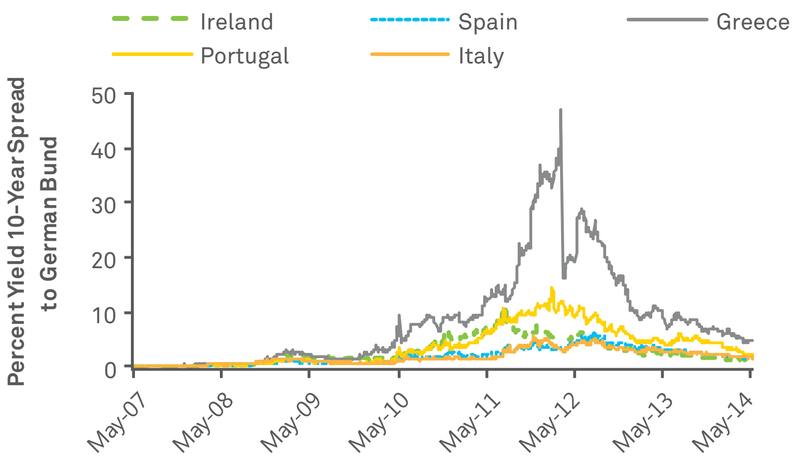
We believe spreads in some peripheral European markets have room to tighten further.

Figure 1: Peripheral European Spreads Tighten



Source: Thomson Reuters Datastream as of May 14, 2014

Positive economic growth returned to most peripheral economies late last year following at least two years of contraction. While the pick-up in growth was aided by a reduction in the pace of fiscal consolidation, there was also evidence of a quickening pace of exports. Stronger growth has had the added benefit of bolstering government revenues and bringing down fiscal deficits in these countries. However, high unemployment, low levels of inflation, the strong euro, large sovereign debt burdens, and an impaired credit transmission mechanism continue to pose risks to the recoveries in peripheral Europe.

Nevertheless, we believe spreads in some peripheral European markets have room to tighten further. Domestic demand in these economies could get a lift from easing credit conditions later this year following the ECB's asset quality review of the European banking system. These countries should also benefit from looser monetary policy if the ECB lowers interest rates into negative territory as is widely anticipated at its upcoming June meeting. Yet, the upside for peripheral European debt is probably limited given the recent rally and the large amount of supply that will need to be digested by the market in the coming quarters. Therefore, while we believe Europe may have turned the corner, there may be other areas of the fixed income markets, such as emerging market debt, which are much more attractive on a valuation basis.

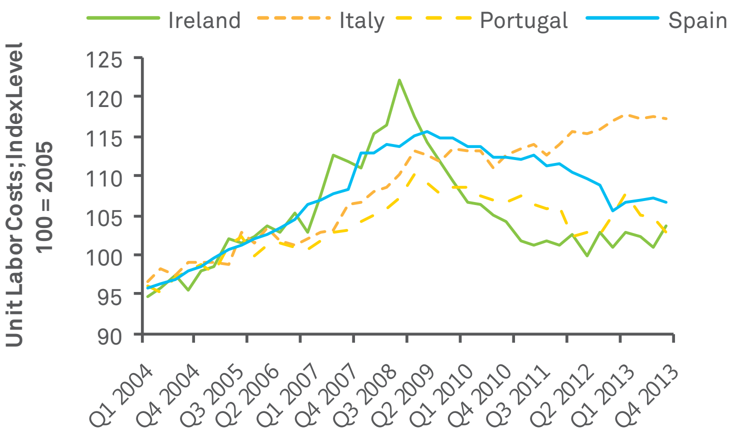
IMPROVING ECONOMIC FUNDAMENTALS

As recently as late last year, global investors remained cautious about the prospects for Europe. The announcement of the ECB's Outright Monetary Transactions bond purchase program in August 2012 had lowered tail risks, but there were still concerns about whether some of these countries would be able to finance themselves without the aid of the European Union (EU) and the International Monetary Fund (IMF).

Things began to change at the beginning of 2014. Ireland exited its three-year EU/IMF-backed reform program in December and Spain followed suit in January increasing confidence that the worst of the crisis had passed. Spain had only borrowed €41 billion of the €100 billion offered by the European Stability Mechanism (ESM) as part of its bank bailout. In addition, neither country requested a precautionary line of credit from the ESM.

Structural reforms have started paying off in terms of increased competitiveness in some peripheral economies

Figure 2: Competitiveness Has Improved in Some Peripheral Economies



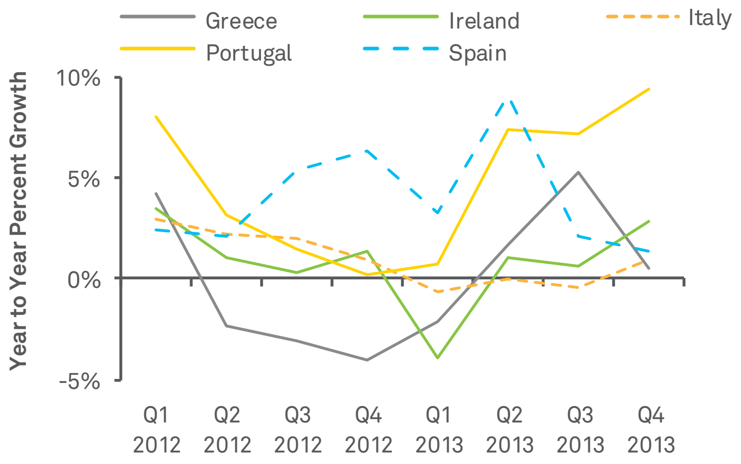
Source: Eurostat as of May 14, 2014

At the same time, structural reforms had started paying off in terms of increased competitiveness in some of the peripheral economies. Indeed, unit labor costs had fallen around 10 percent in Spain and Portugal and nearly 20 percent in Ireland, giving a boost to net exports and overall economic growth. Spanish growth accelerated to an annual rate of 1.6 percent in Q1 2014—its best quarterly outcome in more than five years. Although Irish growth has been more volatile and dipped into negative territory at the end of last year, a rebound is already evident in some of the high frequency data.

The performance of Portugal has probably been the most impressive. After a three year contraction, economic growth resumed in the middle of 2013 and the unemployment rate declined from a peak of 17.5 percent in March 2013 to 15.1 percent by March 2014. Although the economy contracted in Q1, positive surprises during prior quarters mean GDP growth is still up 1.2 percent year-over-year. The expansion has coincided with an improvement in the country's fiscal position. In fact, Portugal registered a budget deficit of 4.9 percent of GDP, which was well below the 5.5 percent target set by the EU/IMF, and lower than both Ireland and Spain.

Unfortunately, the improvement in peripheral Europe has not been uniform.

Figure 3: Exports Have Boosted Overall Growth



Source: Central Statistics of Ireland, ISTAT, Portugal National Institute of Statistics, Spain National Institute of Statistics, National Statistical Service of Greece as of May 14, 2014

In response, Portugal's 10-year benchmark bond has been among the top performers with yields tumbling from more than 6 percent at the end of 2013 to 3.5 percent by May 2015. Lower financing costs have allowed the country to make a "clean exit" from its rescue package, meaning it would not need a precautionary line of credit. In fact, the country has managed to build up a €15 billion cash buffer, which should cover its financing needs until early 2015. Portugal's progress was recently acknowledged by the credit ratings agencies with Standard & Poor's upgrading the country's outlook from negative to stable. From our perspective, this opens the door to an upgrade of Portugal's foreign currency debt rating to investment grade at some point over the next year, which will increase the pool of investors for the country's sovereign debt.

STILL WORK TO BE DONE

Unfortunately, the improvement in peripheral Europe has not been uniform. The strides made by Portugal, Spain, and Ireland have not been matched by Italy or Greece. Indeed, Italian unit labor costs have continued to increase as political instability has slowed progress on economic reform. Furthermore, the rising numbers of nonperforming loans (NPLs) in the banking sector are preventing banks from lending. According to the Bank of Italy, NPLs account for almost 17 percent of GDP compared to a euro area average of 11 percent and bank lending to non-financial corporations contracted 3.3 percent in March. Consequently, the Italian recovery has been lackluster and slower to materialize than elsewhere.

The Greek situation is even more challenging. Despite its default and restructuring back in 2012, Greece's sovereign debt remains unsustainable at 175 percent of GDP compared to a euro area average closer to 93 percent. While the Greek government managed to achieve a primary budget surplus of 1.5 percent of GDP in Q4 2013, the repeatability of that performance is questionable given the one off nature of some of the revenue. Moreover, the risk of backtracking on reform is high given political instability and waning public support as the country struggles to emerge from a six-year recession. Even though Greece's adjustment program with the EU/IMF runs through 2016, officials will want to see continued progress on reform before agreeing to release the coming tranches of aid. Hence, the situation remains precarious.

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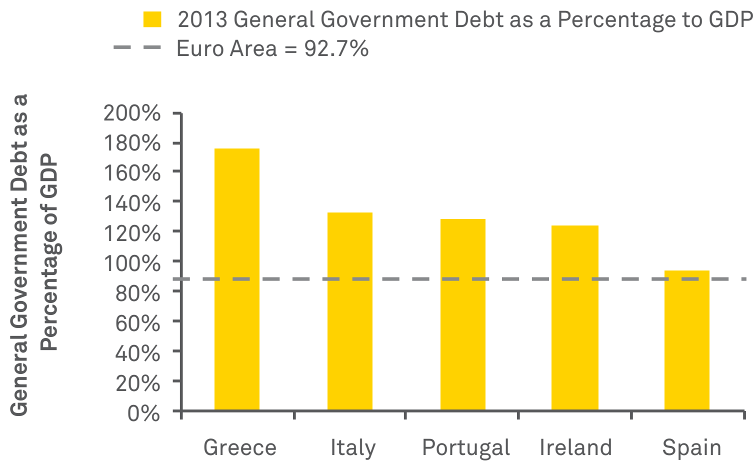
Figure 4: Elevated Debt Levels Pose Risks



Source: The European Central Bank (ECB) as of May 14, 2014

While we believe the downside risks are generally higher in Italy and Greece than elsewhere in the periphery, we remain concerned about the impact of high unemployment, low levels of inflation, the strong euro, large sovereign debt burdens, and political instability across peripheral Europe.

The ECB seems prepared to do what it can to mitigate these risks. We expect the central bank will lower its repo or deposit rate into negative territory at its June meeting to alleviate some of the upward pressure on the euro and help ease disinflationary forces in these economies. There is also an outside chance that the ECB will pursue some form of quantitative or credit easing later this year to help ease lending conditions in the euro area.

Moreover, the central bank's upcoming asset quality review should lessen uncertainty about the health of the banking system and foster balance sheet repair, which may eventually result in new credit creation. An expansion of credit is critical if the peripheral economies and the euro area more broadly, are to transition from a recovery driven by exports to one driven by domestic demand. For the time being, credit flows to the private sector continue to shrink and lending volumes to nonfinancial corporations are falling. The good news is that net issuance of long-term debt securities by nonfinancial corporations is buoyant, partly offsetting the weakness in bank lending as larger corporations continue the transition toward market financing.

While there may be further upside in some of the peripheral markets, investors will need to be more selective going forward.

MORE ATTRACTIVE OPPORTUNITIES ELSEWHERE

Overall, the economic recovery in peripheral Europe seems to be on track, but it is uneven and further policy support from the ECB seems likely. While much of the good news appears to be priced into the sovereign bonds, we believe volatility could create opportunities in some of these markets. For example, Portugal remains attractive given its improving fundamentals and the prospect for an upgrade to investment grade status by the credit ratings agencies.

By contrast, Greece still faces formidable obstacles in reforming its economy, which suggests to us that the recent performance of its bonds may come into jeopardy especially if political instability continues to rise. Greek government debt is currently trading on par with emerging market (EM) dollar denominated debt and it trades well through EM local debt. Indeed, the Greek government 5/10 year blended yield and the EM dollar yield with an option adjusted duration of 7.2 years were both trading at 5.5 percent as of mid-May. Yet, Greece is expected to grow just 0.6 percent this year compared to growth of 4.9 percent in emerging markets, Greek general government debt levels are more than five times higher than the average EM economy and Greece is rated well below investment grade compared to an average investment grade rating for the JP Morgan Emerging Market Bond Index (EMBI). Thus, while there may be further upside in some of the peripheral markets, investors will need to be more selective going forward.

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