Viewpoint

2012 BNY Mellon Fixed Income Seminar

At a time of great uncertainty and low interest rates, bond investors are perhaps more curious than ever to unearth solid opportunities in assets ranging from emerging market debt to high-yield corporate credit assets. At this year's BNY Mellon Fixed Income Seminar in Paris on May 15, some of the company's leading experts in the field helped channel that curiosity, offering a range of perspectives on the current environment and outlook, and on the kind of strategies the smart investor can adopt.

The seminar showcased BNY Mellon's multi-boutique model, featuring fixed income specialist speakers from Standish, Insight, Newton and WestLB Mellon Asset Management. The wide range of perspectives on offer during the day highlighted the strengths of this model, which offers clients access to a range of capabilities across the spectrum of fixed income.

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Addressing one of the key features of the current market, Peter Bentley, Head of UK and Global Credit at Insight, emphasised the poor balance of risk and reward in traditionally safer assets. There are, he said, a lot of scenarios in which such assets might deliver negative returns. And in a low interest rate environment, in which investors are looking for better returns, substantial investment is flowing to emerging market assets, said Insight's Head of Emerging Market Debt, Colm McDonagh.

US treasuries are the biggest concern, said Alexander Kozhemiakin, Head of Emerging Market Debt at Standish, echoing the views of other speakers. He stressed that investors should think carefully about the duration of investments in US treasuries.

If yields on US treasuries were to jump, yields on riskier assets would also likely rise in turn, and their prices would fall.

The speakers were also keen to update investors on Europe's sovereign debt and growth crisis, which they highlighted as one of the biggest current risks for growth in the world economy.

Standish's CIO & Senior Portfolio Manager David Leduc was among those who said the European Central Bank's recent liquidity injection, the LTRO, has significantly lowered the risk of a banking crisis in Europe.

However, the Chief Economist in Europe for Standard & Poors, Jean-Michel Six, warned that although the LTRO has helped reduce some risks, it also has had the effect of increasing the link between each country and its own sovereign debt.

On the subject of the EU's newfound focus on growth, Paul Brain, Head of Fixed Income at Newton said that while proposals such as using the European Investment Bank to help boost growth looked like a step in the right direction, he doubted they'd be able to make a decisive impact.

Europe is now closer to the 'endgame' in its debt crisis, Brain said, adding that the continent now has a better chance of surviving the shocks it faces than at the beginning of the crisis. The changing attitude of the ECB and the recent focus on different ideas are encouraging, he said.

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Meanwhile, Alexis Renault, Head of High Yield at WestLB Mellon AM said he didn't see the prospect of Spain asking for loans from the EU's crisis-fighting fund as a disaster. Spain, he said, is doing what it needs to.

The speakers also spent time analysing emerging markets - another central theme of the day. Insight's McDonagh underscored that emerging market assets currently make up just 12% of the world debt market, despite representing 36% of world GDP. They are, he added, predominantly investment grade assets. The risk profile of emerging market corporate debt has improved, with lower leverage than US companies even as yields remain higher, he also said.

Still, investors probably overestimate some of the risks in emerging markets and sometimes overestimate the levels of liquidity, McDonagh cautioned.

Standish's Kozhemiakin, concurred that emerging market bond assets are frequently misunderstood and that the term itself can be very misleading.

He also emphasised that demand for emerging market financial assets far exceeds the supply, providing another reason to be attracted to them.

Within the umbrella class of emerging market debt assets, the lines are blurring, said McDonagh. He pointed to companies like Petrobras, the Brazilian state-controlled oil giant, asking whether such a company should be viewed as an emerging market asset or, rather, as investment grade oil and gas.

Where some emerging market countries are vulnerable, McDonagh cautioned, is that capital flows are financing their current account deficits. He cited Turkey as an example.

In other remarks on the general investment environment in fixed income, Alexis Renault emphasised a significant improvement in companies' credit quality over the past three years. There is no sign so far of rising defaults, he said, also pointing to the prospect of a slow improvement of confidence indicators.

Meanwhile, Standish's Kozhemiakin said he is very comfortable at the moment with spreads on emerging market bonds denominated in US dollars. While these assets are vulnerable to shocks in a crisis, they would bounce back within 6 to 12 months, he also predicted.

Standard & Poor's Jean-Michel Six, meanwhile, pointed to easing inflation and lower oil prices as encouraging signs. Nevertheless, Standish's David Leduc said the prospect of continued high oil prices remains a risk.

Chinese growth, another major concern, has certainly moderated and remains a concern, Leduc also said. However, Leduc and other speakers also emphasised their belief that emerging economies like China have a lot more flexibility to pursue growth-stimulating policies than the largely debt-soaked developed world.

Looking ahead, Standard & Poor's Jean Michel Six tantalised bond investors, saying he foresees significant pressure on the supply side of bond markets over the next two or three years. He also predicted that European companies will increasingly issue bonds rather than borrow from banks. Sovereign refinancing is also likely to be fairly significant, he added.

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Moreover, as an economy evolves and develops its capital markets, there will be more possibilities for companies to issue bonds, said Insight's McDonagh, who forecast a lot more issuance from other countries such as Colombia or Indonesia.

While most of the over $1 trillion in emerging market issuance currently is of investment grade, that is also likely to change, with more sub-investment grade opportunities opening up as emerging markets deepen, he said. Liquidity should also improve, he added.

Newton's Paul Brain emphasised that yields below inflation mean savers are subsidising borrowers. This situation is likely to continue for the next two or three years at least as it helps reduce sovereign debt burdens, he said.

Meanwhile, Standish's David Leduc warned there may come a day when investors will question the wisdom of owning US treasury bonds, given all the country's structural problems, long term entitlement issues and other contingent liabilities. Investors may begin to wonder why they should take all that risk for such a low yield, he said.

Insight's McDonagh said that US treasury yields are unlikely to be a problem for some time. But when it does happen, he said, investors will have to manage it very carefully.

Addressing one of the key concerns for global growth, and echoing other comments at the seminar, Jean-Michel Six said he expects China and other emerging markets to orchestrate a soft landing for their economies in 2012, followed by a gradual recovery.

"Insight's Peter Bentley forecast increased volatility from the eurozone crisis as politicians are pushed to the brink."

He emphasised the concern in emerging markets about a potential shock from Europe. But if Europe were to experience severe recession, he said, China would probably take aggressive steps again to reflate its economy.

On the other hand, a slow growth environment in developed economies could last a very long time, as their problems persist, said Standish's Leduc. Inflation, however, isn't a particular concern in the current environment, Leduc said. A low growth environment will be supportive for high yield assets, he added.

Naturally given its importance and potential impact for global growth, many of the speakers' predictions for the future addressed the eurozone crisis.

Standard & Poor's Jean Michel Six predicted a recession in the eurozone into the third quarter of 2012, followed by diverging trends among its members.

Meanwhile, Insight's Peter Bentley forecast increased volatility from the eurozone crisis as politicians are pushed to the brink. He added that he only expects solutions and more economic integration when crisis points force the issue, also cautioning that feelings of helplessness in crisis-hit countries can lead to unintended consequences as events overtake political leaders.

Standish's Leduc and others predicted that the ECB would likely have to provide more liquidity to the market in the event of Greece leaving the eurozone. There will probably be a catalyst for more liquidity provision at some point in 2012, Leduc said.

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In today's highly uncertain environment, Newton's Paul Brain was keen to stress the importance of not being a slave to an index of certain sovereign issuers, cautioning against an index-oriented approach.

A number of the speakers underlined the importance of looking carefully at the fundamentals of each asset. Moreover, Insight's Bentley cautioned investors against basing decisions on one big view of the world. He emphasised the need for lots of different, independent views, pulled together in a sensible risk controlled fashion to build a well-diversified portfolio over time.

Strategies for investing in emerging markets were widely discussed. There was broad consensus that there are many good opportunities, and that emerging market assets in fixed income will probably continue to attract increasing investment flows, especially with safe-haven assets currently offering such low returns.

But participants were also keen to stress the great diversity of assets available, as well as the contrasts between them, and to warn of the potential effects of a jump in US treasury yields.

In a nod to the diversity of emerging market debt assets, Standish's Kozhemiakin stressed that buying corporate debt is akin to buying a house - the buyer must like both the house and the neighborhood.

Meanwhile, Insight's McDonagh warned against investing in companies in countries which themselves have a deteriorating position, no matter how attractive the company's fundamentals. If the government has a problem, corporate bonds will probably sell off heavily, he said.

Overall, McDonagh believed that investors as part of a diversified portfolio, may allocate 30% to emerging markets, saying such a level may soon seem much less surprising than it might today as emerging markets' share of global GDP continues to climb.

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Approaching the problem in a different way, Kozhemiakin of Standish spoke of a 'push factor', whereby rich country investors are concerned about investing too much at home. A 20% allocation to emerging markets, he noted, would mean 80% in rich countries and investors should be asking themselves if that is too high or too low.

Newton's Brain also underscored the opportunities available beyond the more traditional assets, as well as the superior credit position of many emerging market sovereigns. The prospect of a period of stability of low yields for safe-haven assets means that high yield assets can also herald opportunities, he also said.

However, he was also careful to note that a safe haven bond fund with very low yields has the advantage of providing protection in today's risky environment.

Insight's McDonagh, meanwhile, cautioned that emerging market economies might experience some volatility because of Europe, but said he would expect them to recover.

Looking ahead, Standish's Leduc argued that at some point, perhaps 10 years from now, investors may consider Brazilian debt as the safe haven asset rather than US treasuries. Similarly, McDonagh said that in five years he would expect to be

managing, say, a utility company in the Colombian peso, and even some bank risk in Nigeria.

On the subject of foreign exchange, McDonagh noted that currencies are effectively zero coupon liabilities of governments. The currency can be part of the structural investment opportunity in emerging markets, he said, adding that the conditions for a positive or strong bond market are typically the same as are required for currencies. Companies are likely to issue more local currency bonds, as it is in their interests to take on debt in the currency of their revenues, he also said.

"A Greek departure from the eurozone could provoke overreaction, especially if overall growth over the next two months proves disappointing."

The caveat attached to the attractiveness of emerging markets is what happens to US treasuries, McDonagh said. However, he said he doesn't expect treasury yields to rise for some time.

In other remarks, Newton's Brain said companies are generally in quite rude health, with corporate profits and balance sheets still good.

Insight's Bentley, meanwhile, pointed to opportunities in asset backed securities, where he said he sees hidden gems, notably in prime residential mortgage backed securities in Northern Europe. A lot of babies were thrown out with the bathwater after the collapse of Lehman Brothers in 2008, he said, adding that a lot of investors fled the asset class because they didn't understand it.

Given widespread sovereign debt strains, he outlined the risk of excessive exposure to nation states and emphasised the advantages of investments where it's all about the company's assets and fundamentals.

Plenty of discussion was reserved for Europe's troubled economy, but even that crisis could throw up opportunities.

Intriguingly, Standish's Leduc said that if the assumption is that the Euro project will continue in some form, even if Greece or Portugal were to leave, that means there's also the possibility that assets such as Italian bonds, on a firmer footing, could actually become an investment opportunity for clients. He also underscored another paradox, asking who in 2008 would have ever thought asset backed structured finance would be one of the safe allocations in a bond portfolio today.

Newton's Brain echoed Leduc, of Standish, on the prospects for opportunities in bonds of countries currently under stress. It comes down to whether they're solvent, he said. Greece hasn't been solvent for the past two years, Portugal is almost in the same position, but Spain and Italy are different, he said – with modest GDP growth, they could present investment opportunities, he added.

But alongside potentially surprising opportunities, the risks right now are not to be underestimated, the speakers stressed.

As WestLB Mellon's Alexis Renault put it, a Greek departure from the eurozone could provoke overreaction, especially if overall growth over the next two months proves disappointing. For high-yield debt, at least, overreaction could mean big outflows for the asset class, he warned.

Indeed, Newton's Brain said the current environment might require more of a ' risk-off' stance.

And when investors get worried about a significant change in trend, he cautioned, it is still a very small selection of markets that goes up.

Peter Bentley, Head of UK and Global Credit, Insight
Peter joined Insight in January 2008 as Head of UK Credit. He is portfolio manager of the BNY Mellon Absolute Return Bond Fund. Prior to joining Insight, Peter spent four years at Pimco Europe where he was a Senior Vice President Portfolio Manager responsible for the management and strategy of both long only and long-short credit funds. Peter holds a BA honours in Economics and Econometrics from Nottingham University and is an Associate of the CFA Society of the UK.

Paul Brain, Head of Fixed Income, Newton
Paul is investment leader of the fixed income team at Newton. He is portfolio manager of the BNY Mellon Global Bond Fund and the BNY Mellon Global Dynamic Bond Fund. He joined Newton in 2004, and has amassed 26 years' experience managing complex fixed income portfolios. He is chairman of the credit strategy and bond/FX strategy groups, and additionally a member of the macro strategy group and the investment committee.

Alexander Kozhemiakin, Head of Emerging Markets Debt, Standish
Alexander is Managing Director of Emerging Market Strategies and Senior Portfolio Manager responsible for managing all emerging market debt portfolios. He is portfolio manager of the BNY Mellon Emerging Markets Debt Fund and the BNY Mellon Emerging Markets Debt Local Currency Fund. He joined Standish from Putnam Investments, where he was Senior Vice President and Portfolio Manager for emerging market debt. He holds the CFA® designation and has 14 years of investment experience.

David Leduc, CIO & Senior Portfolio Manager, Standish
David is Chief Investment Officer of Active Fixed Income responsible for overseeing the management of all single and multi-sector taxable bond portfolios and strategies. Prior to this, he was Managing Director of Global Fixed Income and Senior Portfolio Manager responsible for overseeing the management of all non-US and global bond strategies, such as the BNY Mellon Euroland Bond Fund, BNY Mellon Global High Yield Bond Fund (EUR) and BNY Mellon Global Evolution Strategic Bond Fund. David holds the CFA® designation and has 24 years of investment experience.

Colm McDonagh, Head of Emerging Markets Debt, Insight
Colm joined Insight in November 2008 as Head of Emerging Market Debt. He is portfolio manager of the BNY Mellon Emerging Markets Debt Corporate Fund. Prior to Insight, Colm was a partner at Hydra Capital Management Ltd, an emerging market fixed income boutique he joined in January 2006, where he managed both alternative and traditional emerging market strategies. He graduated with a Bachelor of Business and Legal Studies honours degree in Finance and Law from University College Dublin.

Alexis Renault, Head of High Yield, WestLB Mellon Asset Management
Alexis Renault is Director, Head of High Yield at WestLB Mellon Asset Management (WMAM) in Düsseldorf. He is portfolio manager of the WestLB Mellon Compass Euro High Yield Fund and the WestLB Mellon Compass Euro Credit Short Duration Fund. He has more than 12 years of investment experience. He is graduated from ESLSCA in Paris and has a post-graduate diploma in Finance at the University of Paris II Assas. He holds the CFA® designation.

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[1] Source: BNY Mellon Asset Management International as at 31 March 2012

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