



View from Europe: Uncertainty Batters European Corporate Bonds

By Dr. Holger Sandte,
Chief Economist and
Dr. Walter Schepers,
Head of Product Marketing
WestLB Mellon Asset Management*

WestLB Mellon Asset Management discusses the recent steep fall-off in European investment grade and high yield bonds as renewed concerns about Europe's sovereign debt problems and possible recession fueled investor uncertainty and battered risk assets.



*WestLB Mellon Asset Management does not offer services in the U.S. It is a wholly-owned subsidiary of a 50/50 joint venture between BNY Mellon and WestLB AG.

Executive Summary

WestLB Mellon Asset Management discusses the recent steep fall-off in European investment grade and high yield bonds as renewed concerns about Europe's sovereign debt problems and possible recession fueled investor uncertainty and battered risk assets. While European corporate bond valuations now appear attractive, with substantial risk premiums available, the Düsseldorf-based fixed income manager believes ongoing uncertainty warrants a cautious approach, as rigorous credit analysis of each issue becomes more important than ever.

Investors are unlikely to soon forget the financial market turmoil that struck in mid-summer. Risk assets were battered, while, ironically, investors fled to the perceived safe haven of government bonds, which saw yields fall to all-time lows. Pictures are worth a thousand words, and Exhibit 1 goes a long way toward capturing just how bad the sell-off in European corporate bonds was. As of September 13, euro-denominated high yield bonds had fallen by more than 9% since the beginning of June and were down 4.5% year to date.¹ Investment-grade corporate bonds are still moderately positive year to date but significantly underperformed government bonds (see Exhibit 1).

Fragile Macroeconomic Environment Reins in Risk Appetite

In our view, the uncertainty that had been plaguing financial markets for some time is now also taking its toll on the real economy in developed countries, particularly in terms of consumer and business confidence. In the U.S., we believe the strong decline in consumer confidence as well as the sluggish labor market suggest at least a slight recession in the winter of 2011/12. Unfortunately, policymakers in the U.S. have limited ammunition to stimulate the economy as

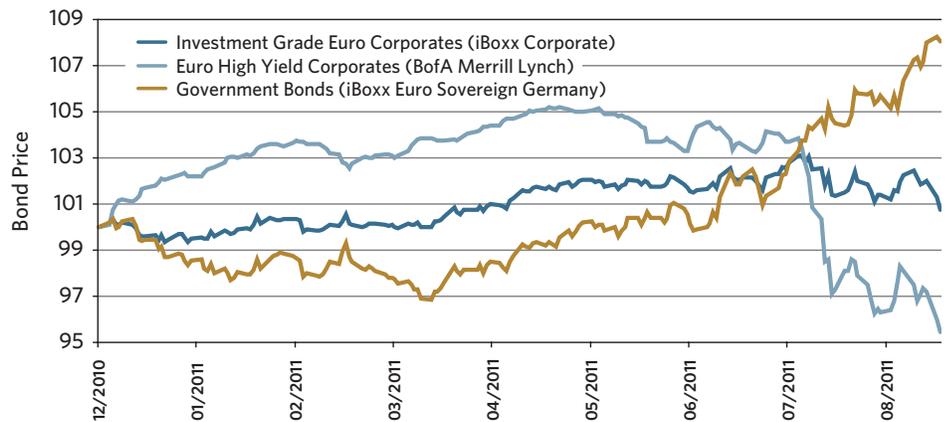
¹ According to Bloomberg data, as of September 13, 2011.

The survey results from German purchasing managers as well as the business confidence survey published by the German Ifo Institute both suggest that the once buoyant German economy, Europe's largest, has lost steam.

already ultra-low policy rates in the U.S. combined with substantial government debt and high budget deficits dampen the impact of monetary and fiscal policy measures. Accommodative policy generally seeks to improve confidence in corporate and household sectors, but we believe it is doubtful whether this can be achieved under the current circumstances.

Meanwhile, the eurozone continues to be characterized by slowing growth and ongoing divergences among member countries. Government austerity measures in the form of spending cuts and tax increases are hindering growth in the weak economies of southern Europe, and we don't see how these economies will strengthen if foreign trade remains muted. The survey results from German purchasing managers as well as the business confidence survey published by the German Ifo Institute both suggest that the once buoyant German economy, Europe's largest, has lost steam. In our view, the eurozone will face recession risk over the next few quarters. Given the subdued growth environment and the very real threat of a recession, we believe the European Central Bank (ECB) should either keep its key policy rate at the current 1.5% or cut rates.

Exhibit 1 - Performance of Investment Grade Euro Corporates, Euro High Yield Corporates and Government Bonds



Source: WestLB Mellon AM, using Datastream data, as of September 13, 2011. As measured by the respective iBoxx and BoA Merrill Lynch performance indices. See disclosures at back.

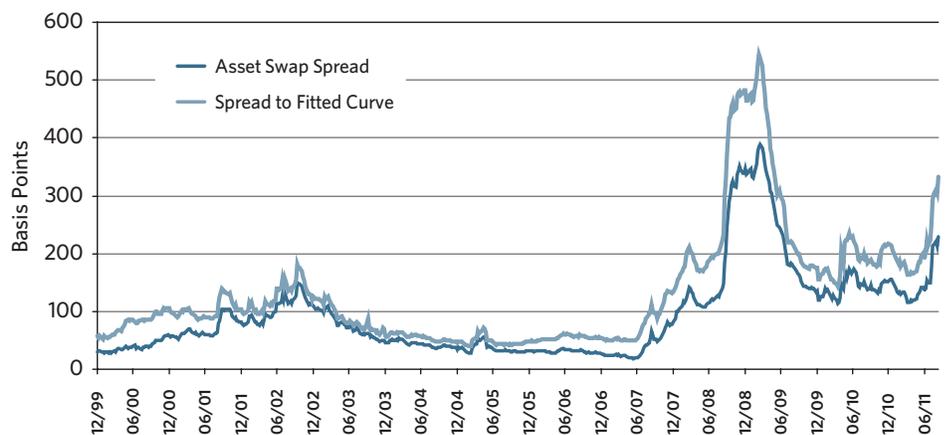
European politics will likely remain dominated by the sovereign debt crisis. To us, it is becoming ever more obvious that Greece is struggling to implement meaningful austerity measures. We therefore expect that markets will continue to speculate about whether Greece will leave the monetary union. At the same time, we believe markets still have doubts about Italy and Spain's fiscal health. In our view, the dilemma facing many of the eurozone countries is that while increased savings make sense in the longer term, they are also a drag on short-term growth which, in turn, can further dent government finances — and thus increase market misgivings.

In terms of non-financial investment-grade corporate bonds, we believe European issuers are generally well positioned: balance sheet leverage has fallen, many firms have adopted a cautious stance and some have ample liquidity.

Euro Investment-Grade Corporate Bonds

In terms of non-financial investment-grade corporate bonds, we believe European issuers are generally well positioned: balance sheet leverage has fallen, many firms have adopted a cautious stance and some have ample liquidity. In general, they seem to us to be braced for a pronounced economic slowdown. European banks have further reduced risks over the last quarters while improving their capital structures; still, for us the refinancing stress in the inter-banking market is very obvious. The deterioration of the economic environment and the escalating sovereign debt crisis have been reflected in significant spread widening (see Exhibit 2). Spreads have now exceeded levels last seen during the recession in 2002 and should, in our opinion, prove supportive to the asset class. However, we believe investors should navigate cautiously in these rougher waters in spite of attractive valuations.

Exhibit 2 - Spreads of Euro Investment-Grade Corporates



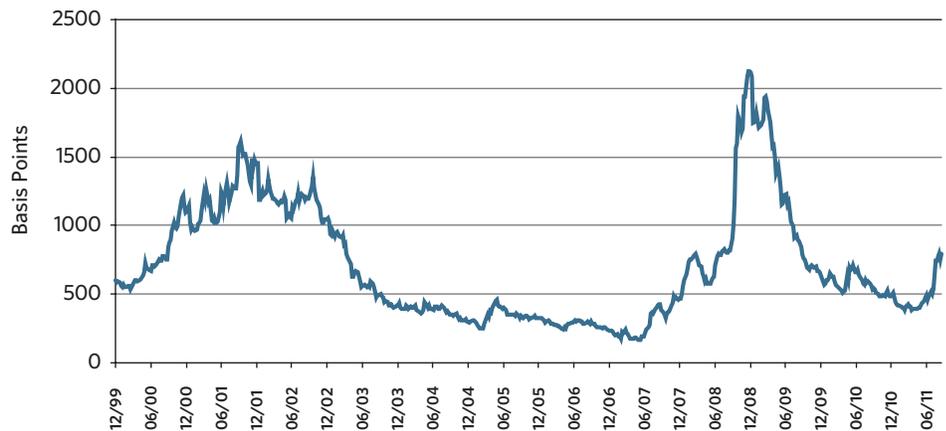
Source: DB Index Quant.
Based on the iBoxx Euro: Corporate All.

High Yield Corporates

High yield corporates have largely performed tolerably well in the second quarter; there were, however, a number of disappointments particularly in the commodity sector but also in banking and retail. Global default rates remain very low (1.8%²), but the strong spread widening reflects the market's expectation of higher defaults (see Exhibit 3). While the market anticipates an increase in default rates to recession levels of 8 — 10% (depending on the recovery rates), we currently don't see any evidence to corroborate this view.

We believe the current environment of uncertainty and heightened volatility is likely to persist through the rest of the year and into early 2012.

Exhibit 3 - Spreads of Euro High Yield Corporates



Source: Bloomberg.

Based on the BofA Merrill Lynch Euro High Yield Fixed Rate Constrained Index until 29/12/2006, since then BofA Merrill Lynch Euro Currency High Yield Fixed Floating Rate Index ex Financials.

We believe the current environment of uncertainty and heightened volatility is likely to persist through the rest of the year and into early 2012. While corporate bond risk has increased meaningfully in a matter of months, we believe there is potential for investors to benefit from substantially higher risk premiums, as long as there is careful and in-depth credit analysis performed for each issuer.

² Moody's as of August 31, 2011.

Walter Schepers

Dr. Walter Schepers is Executive Director and head of product marketing for WestLB Mellon Asset Management. He has worked for WestLB AG for 20 years, including as chief fixed income analyst and head of the fixed income management team in Duesseldorf and London. Currently he is responsible for product development and marketing at WestLB Mellon Asset Management.

Holger Sandte

Dr. Holger Sandte is Chief Economist for WestLB Mellon Asset Management. Prior to that, he was head of the Economics Department at WestLB AG, having joined the team in 1998. Dr. Sandte covers macroeconomic trends in Europe and beyond.

Index Definitions

Markit iBoxx indices are designed to replicate investible investment grade and high yield fixed income markets, enabling investors to analyse and select benchmarks that reflect their specific investment profiles.

The **iBoxx Euro Corporate All** index covers European Corporate Debt. It is a rule based transparent index calculated by independent index provider IIC.

The **iBoxx Euro Sovereign Germany** reflects the returns of the German fixed coupon government bond market.

BofA Merrill Lynch Euro Currency High Yield Fixed-Floating Rate ex Financials Index does not contain any financials and limits exposure to any one issuer to 3% in order to ensure sufficient diversification at single issue level.

These benchmarks are broad-based indices which are used for comparative purposes only and have been selected as they are well known and are easily recognizable by investors. Comparisons to benchmarks have limitations because benchmarks have volatility and other material characteristics that may differ from an investor's portfolio. For example, investments made in an investor's portfolio may differ significantly in terms of security holdings, industry weightings and asset allocation from those of the benchmark. Accordingly, investment results and volatility of an investor's portfolio may differ from those of the benchmark. Also, the indices noted in this presentation are unmanaged, are not available for direct investment, and are not subject to management fees, transaction costs or other types of expenses that an investor's portfolio may incur. In addition, the performance of the indices reflects reinvestment of dividends and, where applicable, capital gain distributions. Therefore, investors should carefully consider these limitations and differences when evaluating the comparative benchmark data performance. The indices are trademarks and have been licensed for use by The Bank of New York Mellon Corporation (together with its affiliates and subsidiaries) and are used solely herein for comparative purposes. The foregoing index licensors are not affiliated with The Bank of New York Mellon Corporation, do not endorse, sponsor, sell or promote the investment strategies or products mentioned in this presentation and they make no representation regarding advisability of investing in the products and strategies described herein.

BNY Mellon Asset Management is one of the world's leading asset management organizations, encompassing BNY Mellon's affiliated investment management firms and global distribution companies. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation. • The statements and opinions expressed in this document are those of the authors as of the date of the article, are subject to change as economic and market conditions dictate, and do not necessarily represent the views of BNY Mellon, BNY Mellon Asset Management International or any of their respective affiliates. This document is of general nature, does not constitute legal, tax or investment advice, is not predictive of future performance, and should not be construed as an offer to sell or a solicitation to buy any security or make an offer where otherwise unlawful. The information has been provided without taking into account the investment objective, financial situation or needs of any particular person. BNY Mellon Asset Management International Limited and its affiliates are not responsible for any subsequent investment advice given based on the information supplied.

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and can fall as well as rise due to stock market and currency movements. When you sell your investment you may get back less than you originally invested. • While the information in this document is not intended to be investment advice, it may be deemed a financial promotion in non-U.S. jurisdictions. Accordingly, where this document is used or distributed in any non-U.S. jurisdiction, the information provided is for use by professional investors only and not for onward distribution to, or to be relied upon by, retail investors. • Products or services described in this document are provided by BNY Mellon, its subsidiaries, affiliates or related companies and may be provided in various countries by one or more of these companies where authorized and regulated as required within each jurisdiction. This document may not be distributed or used for the purpose of offers or solicitations in any jurisdiction or in any circumstances in which such offers or solicitations are unlawful or not authorized, or where there would be, by virtue of such distribution, new or additional registration requirements. Persons into whose possession this document comes are required to inform themselves about and to observe any restrictions that apply to the distribution of this document in their jurisdiction. **The investment products and services mentioned here are not insured by the FDIC (or any other state or federal agency), are not deposits of or guaranteed by any bank, and may lose value.** • This document should not be published in hard copy, electronic form, via the web or in any other medium accessible to the public, unless authorized by BNY Mellon Asset Management International Limited.

In **Australia**, this document is issued by BNY Mellon Asset Management Australia Limited (ABN 56 102 482 815, AFS License No. 227865) located at Level 6, 7 Macquarie Place, Sydney, NSW 2000. Authorized and regulated by the Australian Securities & Investments Commission. • In **Brazil**, this document is issued by BNY Mellon Serviços Financeiros DTVM S.A., Av. Presidente Wilson, 231, 11th floor, Rio de Janeiro, RJ, Brazil, CEP 20030-905. BNY Mellon Serviços Financeiros DTVM S.A. is a Financial Institution, duly authorized by the Brazilian Central Bank to provide securities distribution and by the Brazilian Securities and Exchange Commission (CVM) to provide securities portfolio managing services under Declaratory Act No. 4.620, issued on December 19, 1997. • Investment vehicles may be offered and sold in **Canada** through BNY Mellon Asset Management Canada Ltd., a Portfolio Manager, Exempt Market Dealer and Investment Fund Manager. • In **Dubai, United Arab Emirates**, this document is issued by the Dubai branch of The Bank of New York Mellon, which is regulated by the Dubai Financial Services Authority. • In **Germany**, this document is issued by WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH, which is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht. WestLB Mellon Asset Management Holdings Limited is a 50:50 joint venture between BNY Mellon and WestLB AG. WestLB Mellon Asset Management Kapitalanlagegesellschaft mbH is a wholly owned subsidiary of this joint venture. • If this document is used or distributed in **Hong Kong**, it is issued by BNY Mellon Asset Management Hong Kong Limited, whose business address is Level 14, Three Pacific Place, 1 Queen's Road East, Hong Kong. BNY Mellon Asset Management Hong Kong Limited is regulated by the Hong Kong Securities and Futures Commission for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities, and its registered office is at 6th floor, Alexandra House, 18 Chater Road, Central, Hong Kong. • In **Japan**, this document is issued by BNY Mellon Asset Management Japan Limited, Marunouchi Trust Tower Main Building, 1-8-3 Marunouchi Chiyoda-ku, Tokyo 100-0005, Japan. BNY Mellon Asset Management Japan Limited is a Financial Instruments Business Operator with license no 406 (Kinsho) at the Commissioner of Kanto Local Finance Bureau and is a Member of the Investment Trusts Association, Japan and Japan Securities Investment Advisers Association. • In **Korea**, this document is issued by BNY Mellon AM Korea Limited for presentation to professional investors. BNY Mellon AM Korea Limited, 21/F Seoul Finance Center, 84 Taeyungro 1-ga, Jung-gu, Seoul, Korea. Regulated by the Financial Supervisory Service. • In **Singapore**, this document is issued by The Bank of New York Mellon, Singapore Branch for presentation to professional investors. The Bank of New York Mellon, Singapore Branch, One Temasek Avenue, #02-01 Millenia Tower, Singapore 039192. Regulated by the Monetary Authority of Singapore. • This document is issued in the **UK** and in **mainland Europe** (excluding Germany), by BNY Mellon Asset Management International Limited, 160 Queen Victoria Street, London EC4V 4LA. Registered in England No. 1118580. Authorized and regulated by the Financial Services Authority. • This document is issued in the **United States** by BNY Mellon Asset Management.

BNY Mellon holds over 90% of the parent holding company of The Alcentra Group. The Group refers to these affiliated companies: Alcentra, Ltd and Alcentra NY, LLC. Only Alcentra NY, LLC offers services in the U.S. • Ankura Capital, BNY Mellon Western FMC, Insight Investment and WestLB Mellon Asset Management do not offer services in the U.S. This presentation does not constitute an offer to sell, or a solicitation of an offer to purchase, any of the firms' services or funds to any U.S. investor, or where otherwise unlawful. • BNY Mellon holds a 20% interest in Siguler Guff & Company, LP and certain related entities (including Siguler Guff Advisers LLC). • BNY Mellon Beta Management is a division of The Bank of New York Mellon, a wholly-owned banking subsidiary of BNY Mellon. • BNY Mellon Cash Investment Strategies is a division of The Dreyfus Corporation. • BNY Mellon Western Fund Management Company Limited is a joint venture between BNY Mellon (49%) and China based Western Securities Company Ltd. (51%). The firm does not offer services outside of the People's Republic of China. • BNY Mellon holds a 19.9% interest in The Hamon Investment Group Pte Limited, which is the parent company of Blackfriars Asset Management Limited and Hamon U.S. Investment Advisors Limited, through whom Hamon offers services in the U.S. • The Newton Group refers to the following group of companies: Newton Investment Management Limited, Newton Capital Management Limited, Newton International Investment Management Limited, Newton Capital Management LLC, and Newton Fund Managers (CI) Limited. Except for Newton Capital Management LLC and Newton Capital Management Limited, none of the other Newton companies offers services in the U.S. • BNY Mellon Asset Management International Limited and any other BNY Mellon entity mentioned above are all ultimately owned by BNY Mellon.



BNY MELLON ASSET MANAGEMENT

The Alcentra Group
Ankura Capital Pty Limited
Blackfriars Asset Management Limited
BNY Mellon ARX
BNY Mellon Beta Management
BNY Mellon Cash Investment Strategies
BNY Mellon Western Fund Management
Company Limited
The Boston Company Asset Management, LLC
The Dreyfus Corporation
EACM Advisors LLC
Hamon Investment Group
Insight Investment
Mellon Capital Management Corporation
The Newton Group
Pareto Investment Management Limited
Siguler Guff & Company LP
Standish Mellon Asset Management Company LLC
Urdang Capital Management, Inc.
Urdang Securities Management, Inc.
Walter Scott & Partners Limited
WestLB Mellon Asset Management