Market Insights

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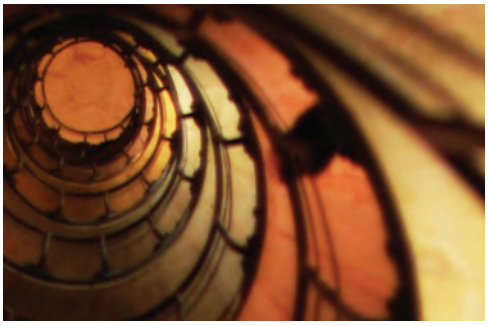

CIO View: Cautious Optimism for 2012 as Growth Diverges and Geopolitical Risk Hovers

By David Leduc, CFA
Chief Investment Officer
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With improved valuations over the past 12 months, Standish says it sees opportunities across a number of global bond sectors and currency areas for 2012.

Executive Summary

Standish Chief Investment Officer David Leduc shares his firm's views of the global macro backdrop for fixed income investors in 2012 as well as the opportunities and risks they face. According to Standish, investors should expect greater divergences in global growth rates in 2012. The global bond manager expects U.S. growth to be positive, but below consensus; while Europe, it believes, has already entered into recession. It expects emerging market growth to continue to outpace that of developed markets, albeit at a slightly lower rate than in 2011. Inflation pressures, in its view, will remain subdued and are not likely to be a risk to fixed income investors in 2012. However, investors will have to contend with a high degree of geopolitical risk and policy uncertainty over the coming year. In addition, reduced trading liquidity as a result of lower capital available for dealer positions will likely weigh on risk/return expectations. Credit characteristics, it says, remain fundamentally sound in many areas, including U.S. corporate bonds, emerging market debt and high quality structured finance. With improved valuations over the past 12 months, Standish says it sees opportunities across a number of global bond sectors and currency areas for 2012. The bond manager also discusses changing conditions for bond market liquidity and their impact on investors.

Cautious Beginnings

We begin 2012 with many of the same risks to our outlook that we had at the start of 2011, the European debt crisis chief among them. In contrast to last year, however, the market consensus now is more conscious of and cautious about the risks and less optimistic about the outlook than at the beginning of last year. We think this level of caution is warranted, given that many of these risks are nearly impossible to quantify or factor precisely into investor risk models. Geopolitical and policy risks in Europe, Asia, and the Middle East represent major sources of potential volatility to our outlook for coming year. As a result, our view is slightly more conservative than market consensus with respect to growth, and slightly more sanguine about the prospects for lower inflation.

STANDISH

February 2012

Notwithstanding our cautious view on risk, we do see areas of opportunity and value, particularly in the context of a stable and modestly growing U.S. economy and continued strong growth from developing economies. As always, we believe opportunities can be found where value intersects with strong fundamentals. The following discussion summarizes our views on the macro outlook for 2012, potential risks to those views as well as the investment opportunities and structural market changes we see, as articulated at our firm's first Monthly Bond Strategy Forum of the New Year in January.

We believe investors should expect greater divergences in global growth rates in 2012.

Growth and Inflation Around the World

We believe investors should expect greater divergences in global growth rates in 2012. Developed market growth is likely to remain below trend as both the consumer and financial sectors continue to delever. U.S. growth will be positive, in our view, but below consensus and below trend at about 1.5% to 2.0%. We expect growth in the U.S. will be challenged on all fronts. Consumption is likely to remain weak, given persistently high unemployment. Net exports may suffer from a strong dollar and a weak global growth environment. Continued fiscal cutbacks at both the state and national levels will also likely weigh on growth. The good news is that inflation should remain subdued. Given the continued deleveraging of the consumer sector, we see little in the way of inflation pressures from increased consumer demand until employment improves. We expect U.S. consumer prices to rise by only 2% this year.

The European debt crisis will continue to be a major drag on economic activity. We expect the eurozone's economy to contract by more than 0.5% in 2012, as the ongoing debt crisis and austerity measures weigh on activity. The aggregate numbers mask a wide and growing divergence between the periphery and the core of Europe. Our own leading indicator for Germany suggests that its recession may be shallow, lasting only two quarters. By contrast, all indicators point to much deeper and longer contractions in most peripheral economies. Another impediment to European growth is the undercapitalized banking sector. Lending capacity will remain constrained, as banks attempt to raise capital ratios through a number of expedients including asset sales and reduced lending activity.

We believe emerging markets will continue to outpace developed markets, albeit at slightly lower growth rates than in 2011. Despite accumulating risks to the outlook for China, we believe Asia will continue to grow faster than the rest of the world, with GDP expanding at nearly 8%. We believe near-term growth prospects and longer-term structural dynamics continue to support strategic asset allocations to emerging markets, particularly with respect to bonds denominated in local currencies.

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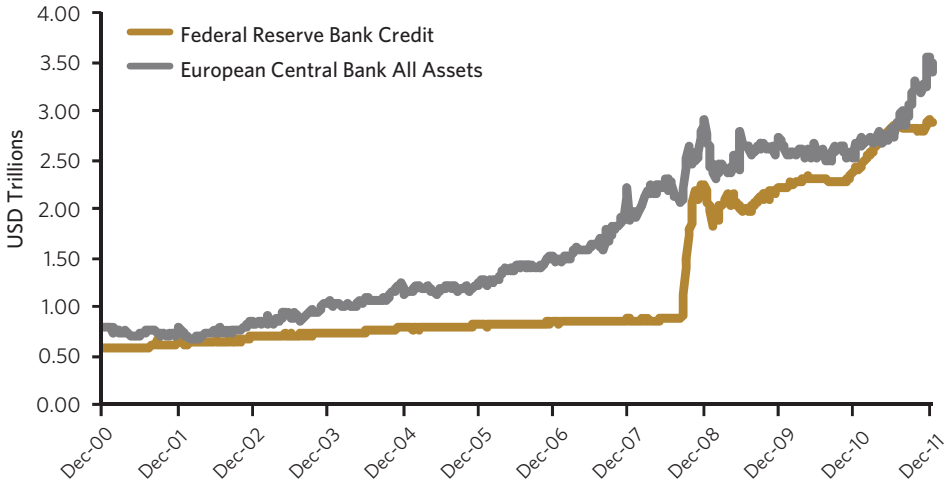
Global Monetary Policy Consistency

There is one significant and critical difference in the policy environment as we begin 2012. The Federal Reserve, the European Central Bank (ECB), the Bank of England (BoE) and now the People's Bank of China (PBoC) are all on the same page in terms of monetary policy. Last year, both the ECB and the PBoC tightened monetary policy as the BoE and Fed eased. By contrast, this year we expect all four banks to lean toward easing. The Fed recently conveyed that interest rates will likely be on hold through late-2014, and we believe there is a high probability of additional quantitative easing aimed at the U.S. mortgage market in 2012. The ECB is expanding its balance sheet through its Long-Term Refinancing Operation (LTRO), which has dramatically lowered the risk of a liquidity-driven bank failure in Europe. The BoE increased its quantitative easing program back in October 2011, bringing the total to date to £275 billion, and we believe they will add another £50-75 billion at their February meeting. Lastly, in December 2011, the PBoC cut its reserve requirement ratio by 0.5%, in its first easing since the end of 2008. In our view, these actions should, at a minimum, help support demand for risky assets. In general, we think U.S. growth will be broadly supportive for assets such as investment grade corporate bonds in 2012 where fundamentals remain strong. But we continue to be cautious about investments in Europe, particularly in the financial sector, which remains highly exposed to possible further deterioration in credit quality in the event of a severe contraction.

Exhibit 1 – ECB Joins Fed in Expanding Balance Sheet



Source: Federal Reserve and European Central Bank as of December 31, 2011.

The King Is Dead, Long Live the King: Geopolitical Risk in 2012

Geopolitical events have the potential to be a major influence on financial markets in 2012. The French presidential election in April will be a critical event, given the strong working relationship now between French President Nicolas Sarkozy and German Chancellor Angela Merkel. France's leading opposition candidates have been very critical of Merkel, so a Sarkozy loss could potentially delay progress on key eurozone policy initiatives such as the recently proposed fiscal compact. In the Middle East, developments in countries such as Syria and Iran could create another wave of volatility in the region. There are also potential trouble spots in Asia. Apart from the high degree of uncertainty regarding the transition of power in North Korea, there will also be several membership changes in China's ruling Politburo in the third quarter. Our view is that the change in leadership in China may actually bode well for continued progress on financial reforms but this is uncertain.[1] Finally, we also have an election year in the United States, with a key risk being further policy paralysis, the main concern cited by Standard & Poor's when it downgraded the U.S. credit rating last summer.

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Historically, political uncertainty has typically accompanied prolonged economic weakness. More recently, the democratization of information through social media and cellular technology has added a new and unpredictable element to this dynamic. The protests and social unrest surrounding the Russian election last year is a good example. We believe popular protest against perceived wealth inequality and corruption, from demonstrators in Syria to Wall Street, may continue to cause bouts of higher volatility across all asset markets.

Exhibit 2

	Election Date	Likelihood of Leadership Change	Key Economic Issues
France	Spring 2012	Uncertain	Sovereign Debt Crisis
Russia	Spring 2012	Low	Corruption / Democratization
China	Fall 2012	High	Hard Landing
United States	Fall 2012	Uncertain	Policy Paralysis

Source: Standish

1 See recent Standish analysis by Thomas D. Higgins, Edward Ladd and Ai Ling Ngiam, "Rising Uncertainty in China," Standish/BNY Mellon Asset Management, January 2012.

Structural Changes to Bond Market Liquidity

Apart from the macroeconomic and geopolitical influences on bond markets in 2012, we also expect that continued structural changes in bond market liquidity will affect fixed income investing. We liken liquidity in bond markets to the oil necessary to lubricate a car engine to keep it running smoothly. The oil reduces the friction that would otherwise cause the pistons to overheat and eventually become fused to the engine block. In an over-the-counter market, capital is the oil that keeps it from seizing up and facilitates trading. Despite the advent of electronic trading in certain bond and currency markets, many fixed income assets continue to trade primarily over the counter. However, this liquidity has been declining steadily over the past two decades as the financial industry has continued to consolidate. More recently as a result of the global financial crisis that began in 2007, asset quality problems have caused a further erosion of capital in the global financial system. At the same time, increased bank capital ratios imposed by Basel III as well as additional requirements under various U.S. and European regulations (e.g., Dodd-Frank, the Volcker Rule, new FSA rules) have increased the challenges faced by market makers to provide liquidity for certain types of risks.

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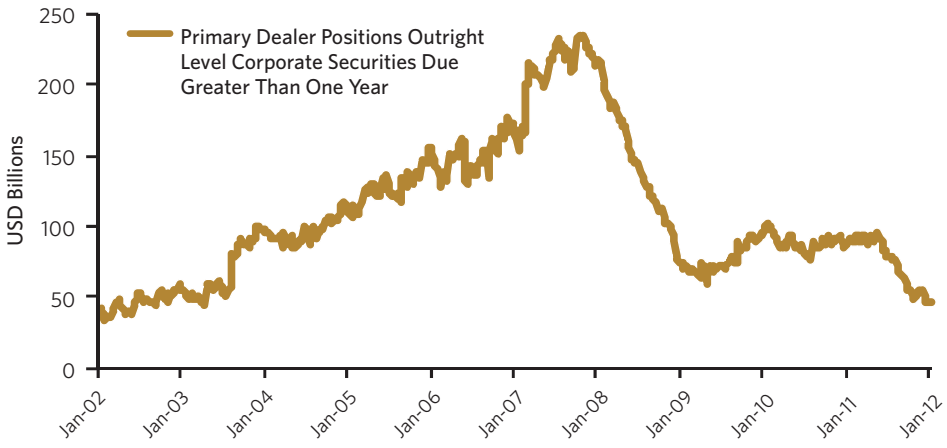
In our view, the market-making ability of dealers to provide liquidity for many types of fixed income assets has already been permanently and structurally diminished. We believe this has important implications for bond investors. With less market liquidity, investors might have to adopt a longer investment time horizon and be prepared for a higher degree of performance volatility. For investors unwilling or unable to tolerate higher volatility, we think their return expectations might have to be moderated relative to historical experience. It is important to point out that less liquidity not only impacts investors looking to reduce risk in risk-off markets, but also makes it harder to add risk in risk-on markets. In our view, trading less frequently and taking advantage of the new-issue market to build positions will be critical in this less liquid environment. We believe this environment will likely be particularly difficult for very large bond managers trying to make substantial and rapid changes in their market exposures; while relatively smaller and more nimble managers are likely to be better positioned to execute efficiently. At the very least, we think it is important for investors to recalibrate their risk and return assumptions as they look to the year ahead, given these structural market changes.

Exhibit 3 – Primary Dealers Shrink Their Balance Sheets



Source: New York Federal Reserve as of January 11, 2012.

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Opportunities in 2012

As we consider pockets of opportunity in 2012, we remain cautiously optimistic about global growth outside Europe. As mentioned, we expect emerging market growth to remain strong, even if it slows somewhat from elevated levels. For us, the greater synchronization of monetary policy among major central banks and a focus on easing will be a significant and positive change from last year. While we remain mindful of risk, we observe that a variety of fixed income and currency markets have already priced in some of our concerns. Yields in safe-haven developed market bonds such as U.S. Treasuries have fallen, and the spreads on riskier sovereign bonds and corporate credit have generally widened over the past 12 months.

We continue to favor assets with strong fundamentals and attractive valuations that can withstand occasional bouts of volatility. We see opportunities across global fixed income markets, including in investment grade and select high yield corporate bonds as well as local currency emerging market bonds. We believe investments in the securitized sector where fundamentals have improved dramatically over the past several years could also be attractive. In our view, European residential

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mortgage-backed-securities (RMBS), U.S. consumer structured assets, and U.S. agency mortgage securities might provide a stable and highly liquid foundation for fixed income investors. Agency mortgage securities are particularly attractive, because we expect they will benefit from the stability in interest rates as the Fed continues to be transparent about its intentions to keep rates low over the next two years. Mortgage-backed securities could also benefit if the Fed decides to embark on a further round of quantitative easing and resumes asset purchases. Balance sheet expansion from the Fed and other central banks is likely to elevate longer-term inflation expectations and may create an opportunity in both U.S. and global inflation-linked bonds. Still, even with strong fundamentals, we expect some fixed income assets such as U.S. high yield to remain highly correlated with global risk sentiment. Our analysis suggests that municipal bond yields are attractive relative to comparable high grade debt and may present an opportunity for investors in multi-sector strategies in 2012. As we continue to seek clarity on some of the major risks to our 2012 outlook, our view will be to avoid assets with deteriorating fundamentals such as the sovereign bonds and senior and subordinated bank bonds from certain peripheral European economies.

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