

## View from Europe: Uncertainty Batters European Corporate Bonds

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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.

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### 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.

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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.<sup>1</sup> 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

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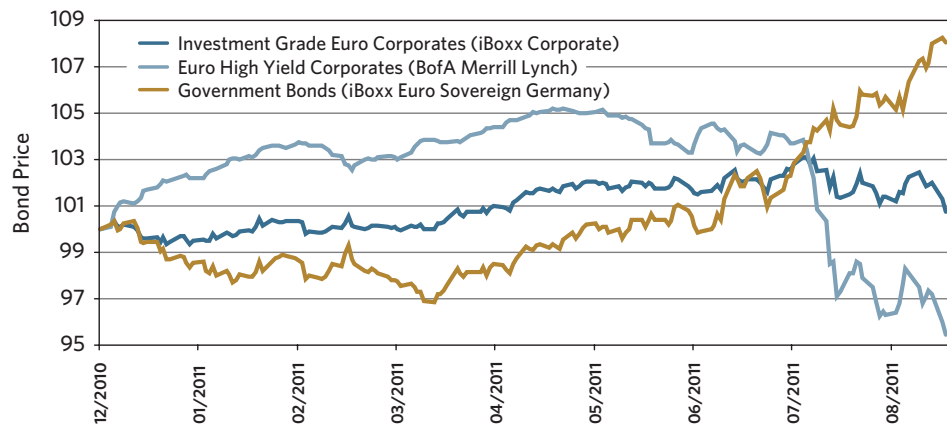
<sup>1</sup> According to Bloomberg data, as of September 13, 2011.

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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.

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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.

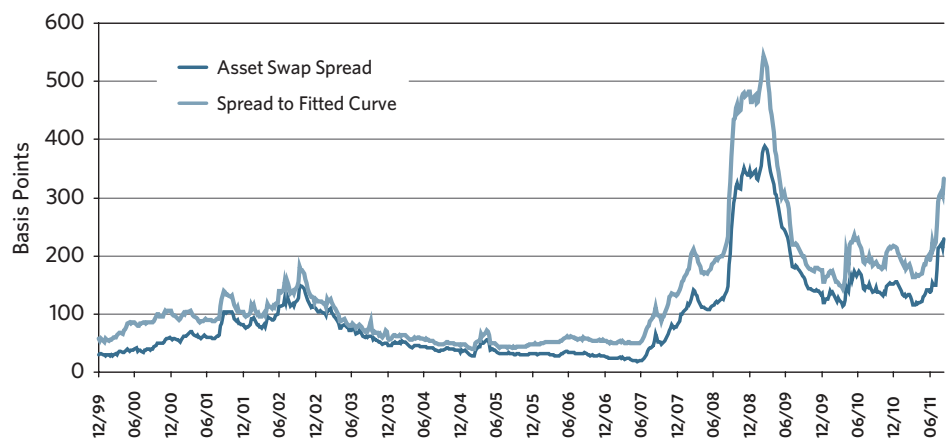
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### **Euro Investment-Grade Corporate Bonds**

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.

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**Exhibit 2 - Spreads of Euro Investment-Grade Corporates**



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

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## 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%<sup>2</sup>), 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.

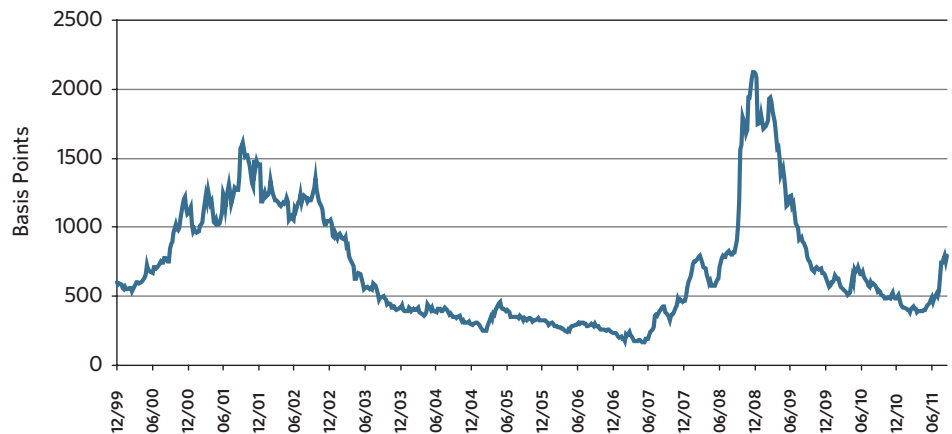
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We believe the current environment of uncertainty and heightened volatility is likely to persist through the rest of the year and into early 2012.

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**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.

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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.

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<sup>2</sup> 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.

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