

European Bond Market Update

January 18, 2012



Volatility Will Remain High Amidst Rating Agency and Political Uncertainty

Executive Summary

- S&P downgraded 9 of the 16 Euro area countries on credit watch negative. Germany is now the sole AAA country with a stable outlook. The primary drivers of the downgrades were reduced political and external scores.
- The near-term market impacts have been relatively muted, as the downgrades were not as bad as investors may have feared. However, the negative outlooks across the region and potential for further downgrades from Fitch and Moody's highlight the inherent risks.
- Medium term pricing will depend on to what extent the market seeks flight to safety. Within the euro area, further volatility is likely to be reflected in lower German yields relative to other Euro area bond markets. For global investors, however, we expect high quality and liquid non Euro area bond markets to outperform relative to the Euro area bond markets.
- European Central Bank (ECB) funding costs for banks do not change in light of S&P's actions. Moody's will likely affirm current ratings while downgrading the outlook in coming months. Fitch is expected to announce their assessment for credits already on watch negative.
- There are non-market implications of the downgrade to France's credit rating, on which Sarkozy has based much of his Presidential campaign. In our view, the balance between him and Hollande, his primary opponent, will be determined by the outlook of the real economy rather than a rating downgrade.

The Basics of the S&P downgrade

S&P views the recent European policy initiatives as insufficient in fully addressing the 'systemic stresses' of the Euro area, which is consistent with the Standish view. Specifically, S&P does not consider the agreement on December 9 to be sufficient in size and scope, or the additional resources satisfactory in size and flexibility to counter market pressures. On the other hand, the ECB's recent measures have been 'instrumental in averting market collapse'. Finally, S&P views the December agreement as too heavily weighted on fiscal consolidation, averting the issues of competitiveness and external imbalances.

S&P's opinion as to what would have been an acceptable and sufficient summit outcome in December is one that sparked renewed confidence and lowered borrowing costs for European sovereigns. Presumably the level of borrowing costs consistent with an optimal solution would stabilize and lower the debt trajectory – for Italy this break-even rate would be at least 200-300 bps below current rates, based on various assumptions of growth and primary deficits.

The ratings downgrades came primarily from a reduction in the political and/or external scores. Where downside risks are more acute, as is the case for Italy and Spain, the country rating was downgraded by two notches. On the other hand, those ratings which were affirmed were done so because the sovereign is likely to be more resilient, given its lower leverage and nimble economy. Finally, S&P sees the following factors as characterizing the main downside risks to a rating:

- Further significant fiscal deterioration due to deeper than expected recession
- Reform fatigue
- A lower monetary score due to insufficient monetary policy

	9-Dec-11		13-Jan-12	
	Rating	Outlook	Rating	Outlook
Austria	AAA	CWN	AA+	NEG
Belgium	AA	CWN	AA	NEG
Finland	AAA	CWN	AAA	NEG
Greece	CC	CWN	CC	
Ireland	BBB+	CWN	BBB+	NEG
France	AAA	CWN	AA+	NEG
Italy	A	CWN	BBB+	NEG
Netherlands	AAA	CWN	AAA	NEG
Portugal	BBB-	CWN	BB	NEG
Spain	AA-	CWN	A	NEG
Germany	AAA	CWN	AAA	STBL
Malta	A	CWN	A-	NEG
Slovenia	AA-	CWN	A+	NEG
Slovakia	A+	CWN	A	STBL
Cyprus	BBB	CWN	BB+	NEG
Estonia	AA-	CWN	AA-	NEG
Luxembourg	AAA	CWN	AAA	NEG
Euro Area Avg*	AAA		A+	

*The Euro average is the debt-weighted average of the 17 EA sovereign ratings. Source: S&P; CWN=credit watch negative; NEG=negative outlook; STBL=stable outlook

Expected Market Impact

Near-term pricing

To a large extent, we believe the downgrades had been priced into markets. In particular, markets were very fearful of a possible two notch downgrade to France and even of a potential downgrade to Germany, an outcome that did not transpire. The negative outlooks across the region and potential for further downgrades to come from Fitch and Moody's, however, highlight the inherent risks for these bond markets going forward.

The two notch downgrade to Italy potentially creates some selling pressure on the margin as haircuts on Italian collateral may eventually increase and some investors may restrict exposure to BBB rated securities in their portfolios. In terms of ECB collateral eligibility, the Italian banks face higher haircuts only if the remaining agencies move in line with S&P. At this time, bank funding at the ECB has not been affected.

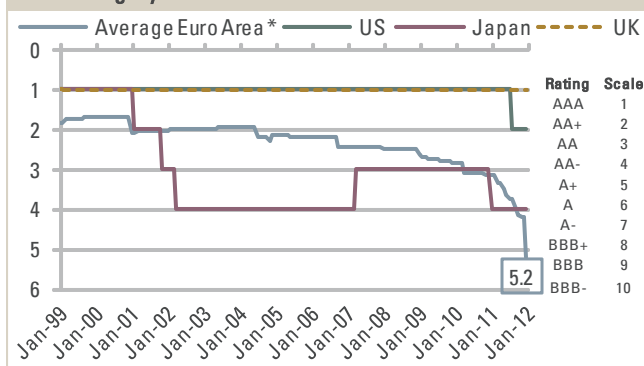
Medium-term pricing

In contrast to the near-term market pricing effect, we see three possible medium-term pricing implications of the downgrade for Euro area sovereign bond markets if the S&P ratings become consensus among the rating agencies. First, Germany comes out as the most liquid and 'safe' bond market in the Euro area, given its sole AAA stable status. Regional buyers especially are likely to push German rates further down relative to its core counterparts if volatility picks up. Related to Germany as the intra-Euro area safe haven is the fact that S&P has now defined a growing divergence in the core countries, Germany, Netherlands, Finland, Austria, and France.

Second, Foreign investors are likely to feel 'demand fatigue' for the broader Euro area debt market. In the aggregate, the credit of the debt-weighted Euro area average has diminished significantly in light of this ratings action. Before the January 13th S&P downgrade, the debt-weighted Euro area rating was AA-. Following the downgrade, the debt-weighted Euro area rating is A+.

The Euro area rates below its major developed counterparts, most notably that of the UK to which Global portfolios hold an overweight position.

S&P Rating Dynamics of the G4



*Euro area rating is implied by the debt-weighted average of 17 EA countries. Source: S&P; Bloomberg; Standish as of January 18, 2012

Third, selling pressures can be expected if the other ratings agencies come in line with S&P's ratings, as bond markets fall out of global indices. Currently, comments from Moody's suggest a negative outlook rather than a downgrade. Fitch is to announce ratings downgrades in the month for the credits that were already on negative watch. Many global bond indices have minimum credit quality of Baa3/BBB- by two out of three rating agencies. Cyprus is the only market subject to breaching this quality constraint if either Moody's or Fitch downgrades the debt to come in line with S&P's rating, BB+. Global portfolios hold no exposure to Cypriot debt.

	Moody's	Fitch	S&P
Austria	Aaa	AAA	AA+
Belgium	Aa3	AA+*	AA
Finland	Aaa	AAA	AAA
Ireland	Ba1	BBB+*	BBB+
France	Aaa	AAA	AA+
Italy	A2	A+*	BBB+
Netherlands	Aaa	AAA	AAA
Spain	A1	AA-*	A
Germany	Aaa	AAA	AAA
Malta	A2	A+	A-
Slovenia	A1	AA-*	A+
Slovakia	A1	A+	A
Cyprus	Baa3*	BBB*	BB+

*Rating is currently under review with + or - implications

Global Positioning

Based on our own proprietary sovereign rating model, we were able to anticipate these downgrades (which bring ratings closer to our internal ratings). We have held a general underweight to peripheral Europe and chosen to express it most directly in underweight positions in France and Spain. These underweight positions in France and Spain represent a substantial amount of our risk budget in global portfolios. We also maintain a short position in the Euro although we have recently reduced the short on concerns about market positioning and to take profit.

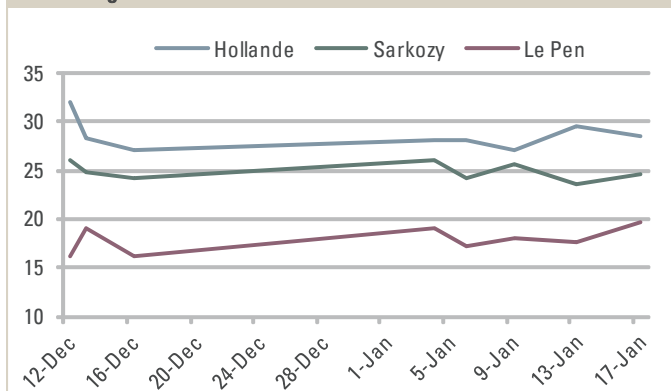
The French Election

Incumbent President Nicolas Sarkozy to some extent tied his election campaign to France's AAA rating. With the lowering of S&P's rating to AA+, this may affect Sarkozy's chances of re-election in the spring elections.

Pres. Sarkozy is currently trailing his opponent, François Hollande in the polls, largely due to the rise of his unpopularity based on deteriorating economic conditions and the inflamed sovereign debt crisis. Hollande gained by default. More broadly, our view is that if Marine Le Pen were not in the ballot – the anti-Euro area candidate - it would reduce Sarkozy's chances of being re-elected, as the balance would shift to Hollande.

Both Hollande and (especially) Le Pen would be a step back in the negotiations. Hollande opposes Merkel more forcefully than Sarkozy and Le Pen wants to leave the euro zone outright. The elections are still 3 months away, and many factors could shift the balance, such as the real economy in Q1 2012.

The Ratings Poll: A Close Race



Source: Sondages en France; Standish, data through January 14-17, 2012

Summary

We believe there will continue to be volatility in asset markets in Europe through 2012 related to political tension and deteriorating credit profiles. In our view, the most attractive ways to position for this volatility are through underweight positions in France, Spain and the Euro. We have positioned portfolios to benefit from regional divergences in growth and the subsequent relative value opportunities. While the near term impact from S&P's downgrade was mostly priced into markets, volatility is likely to remain elevated over coming months.

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