

Bond Market Observations

November/December 2011



The Global Economic Outlook: Diverging Paths

“Two roads diverged in a wood, and I – I took the one less traveled by, and that has made all the difference.”

– Robert Frost

Executive Summary

- We believe the global economy can weather a mild euro zone recession. However, the global economic recovery is too fragile to absorb a severe financial shock, such as a breakup of the euro.
- We expect a greater degree of economic divergence between Europe and the rest of the global economy with emerging market economies in Asia and Latin America performing best.
- Looking beyond the current market volatility, we see long-term opportunities in US non-financial corporate credit as well as emerging market local currency debt given better economic fundamentals.
- However, we anticipate further weakness in European sovereign debt markets, the euro currency, and European financials.

Anxieties Remain High

Investor anxiety has been high due to concerns about global contagion from the European sovereign debt crisis, a double dip recession in the United States, and a hard landing in China. Yet, recent economic indicators suggest that the probability of a US recession remains low and that China is successfully engineering a soft landing for its economy. By contrast, the euro zone is probably headed for a recession.

We believe the global economy can weather a euro zone recession. With the exception of Central and Eastern Europe, there are few direct linkages between the problems in peripheral Europe debt markets and the rest of the world. Moreover, Europe has not been a major contributor to global economic growth in recent years. Nevertheless, the global economic recovery is too fragile to absorb a severe financial shock, such as a breakup of the euro.

Our base case scenario is that European leaders will react in time to avoid a breakup of the euro, but not a euro zone recession. Therefore, we expect a greater degree of economic divergence between Europe and the rest of the global economy in the year ahead with emerging market economies in Asia and Latin America performing best. Looking beyond the current market volatility, we see long-term opportunities in US non-financial corporate credit as well as emerging market local currency debt given better economic fundamentals. However, we anticipate further weakness in European sovereign debt markets, the euro currency, and European financials.

European Recession Taking Hold

The euro zone economy appears to have stalled in the third quarter of 2011. Region-wide economic growth rose at an annual rate of just 0.6% with most of this growth coming from the core economies, specifically France and Germany. Deep recessions are apparent in most of the peripheral economies and forward-looking indicators, such as purchasing managers' surveys, indicate that manufacturing activity has begun to contract in the core economies as well.

We anticipate a further deterioration in the euro zone economy as credit conditions tighten and financial contagion spreads to some of the higher-rated sovereigns. European banks are heavily exposed to peripheral European debt, have low average capitalization rates, and many are dependent on wholesale funding markets where liquidity can dry up quickly. Indeed, roughly three-quarters of the \$3 trillion in public and private sector debt of Greece, Portugal, Ireland, Spain and Italy is held by the European banking system at book value.¹ Yet, the market value of these holdings is considerably lower, which will eventually force a write down of these assets and a contraction in credit.²

At the same time, government borrowing costs have begun to rise for European sovereigns with top credit ratings including Austria, Finland, France and the Netherlands as the crisis in the peripheral economies spreads. In late November, French 10-year government bonds were trading more than 200 basis points above comparable German Bunds, a level unseen since the early 1990s. This contagion effect has increased the urgency of finding a comprehensive solution to Europe's sovereign debt crisis.

Such a solution will, by necessity, entail some socialization of the debts of the peripheral economies to include the entire euro zone. This action is being resisted by the more fiscally responsible core countries, especially Germany. But we believe an agreement will be reached at some point whereby the core economies accept joint-liability for peripheral debts in exchange for more stringent fiscal oversight and commitments to deficit reduction by peripheral governments. This is the basis for the proposed European Redemption Fund that the German Council of Economic Experts, the so-called Five Wise Men, put forward in mid-November.

Unfortunately, more pain may be necessary before European leaders and their constituents agree that it is in their common interest to preserve the currency union. Even if the political will existed, the euro zone lacks the ability to respond quickly given the need for national parliamentary approvals by the 17 member governments to adopt new measures. Consequently, we expect a euro zone recession in 2012 accompanied by periodic bouts of financial market volatility.

Implications for the Global Economy

There are at least four ways in which a European recession might impact the global economy: 1) Amount of direct holdings of peripheral European debt; 2) Level of exposure to the European banking system; 3) Degree of reliance on European export markets; and 4) Extent of increased correlations between risky assets during periods of stress.

Channels for European Contagion

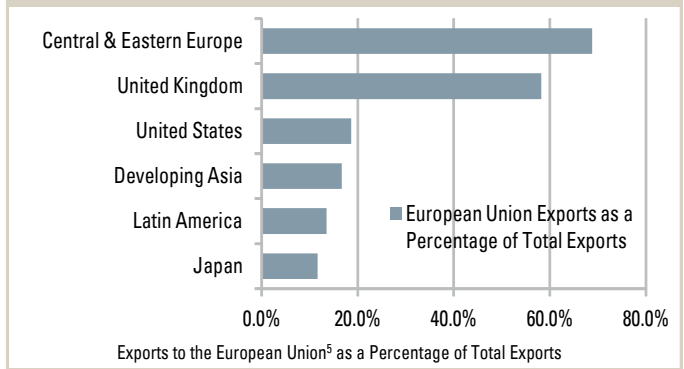
	Holdings of Peripheral European Debt	Linkages to the European Banking System	Dependence on European Export Markets	Capital Markets Contagion
Central & Eastern Europe		X	X	X
United Kingdom		X	X	X
United States		X		X
Japan				X
Latin America				X
Developing Asia				X

Source: Standish

As we mentioned previously, holdings of peripheral European debt outside of Europe are relatively small. For instance, American and Japanese holdings of peripheral European debt amount to less than 2% of their respective GDPs. However, the United States is indirectly exposed to peripheral Europe through the wholesale funding markets. According to Fitch, European bank debt represented 37.7% of total holdings of \$654 billion of the 10 largest US prime money market funds as of the end of September. While this is down from 47.2% at the end of July, it remains sizeable.³

As wholesale funding from the United States dries up, European banks have been forced to reduce their loan books. This threatens to undermine economies in Central and Eastern Europe where borrowing from European banks accounts for one-third of regional GDP.⁴ Central and Eastern Europe also have strong trade ties with the European Union where more than two-thirds of the region's exports are headed. By contrast, less than 17% of Asian exports and 13% of Latin American exports are destined for the European Union.

Central And Eastern Europe Are More Vulnerable



Source: International Monetary Fund Direction of Trade Statistics, June 2011

Overall, we expect a euro zone recession to be a drag on global growth, but we do not believe it is sufficient to cause a global recession. The euro zone has not been an important contributor to global economic growth since the recovery began in mid-2009. In fact, the euro zone only accounted for about 7% of global GDP growth in 2010 compared to 13% for the United States and 65% for emerging markets.⁶

We expect the impact of a euro zone recession to vary by region. Central and Eastern Europe would probably be most negatively affected followed by the United Kingdom given stronger trade and investment linkages through the European Union. After that, the most at risk would likely be the United States due to its exposure to European banks. The US and other advanced economies are also vulnerable because households and governments are still in the midst of deleveraging from the last financial crisis and policy makers are running out of ammunition to stimulate economic activity. The least vulnerable regions to a euro zone recession would be Asia and Latin America, both of which have ample room for countercyclical policies given better fiscal positions and higher interest rates.

The most worrisome source of contagion from the euro zone is through global capital markets from which no region is immune. The good news is that we think a repeat of the 2008 global liquidity crisis is less likely today given the reduced amount of leverage in the financial system and the fact that global policy makers have put tools in place to mitigate this risk. However, recent experience suggests that correlations amongst risk assets tend to increase in periods of market stress no matter how good the economic fundamentals. The only place to hide during these periods is in safe haven assets such as US Treasuries and gold. Yet, we see little value in these asset classes on a long-term basis. Instead, we remain focused on long-term fundamentals which favor US non-financial corporate credit as well as emerging market local currency debt.

¹ Preliminary International Banking Statistics. Bank of International Settlements. Second Quarter 2011.

² Global Financial Stability Report. "Grappling with Crisis Legacies." The International Monetary Fund. September 2011.

³ Fitch Credit Ratings. "US Money Funds and European Banks: French Exposure Down." October 2011.

⁴ Op. Cit. Bank of International Settlements.

⁵ The euro zone is an economic and monetary union of 17 European Union member states that have adopted the euro as their common currency and sole legal tender. Members include Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain. Other European Union members who participate in the economic and political union but not the common currency are Bulgaria, the Czech Republic, Denmark, Hungary, Latvia, Lithuania, the Netherlands, Poland, Romania, Sweden, and the United Kingdom.

⁶ International Monetary Fund and Standish

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