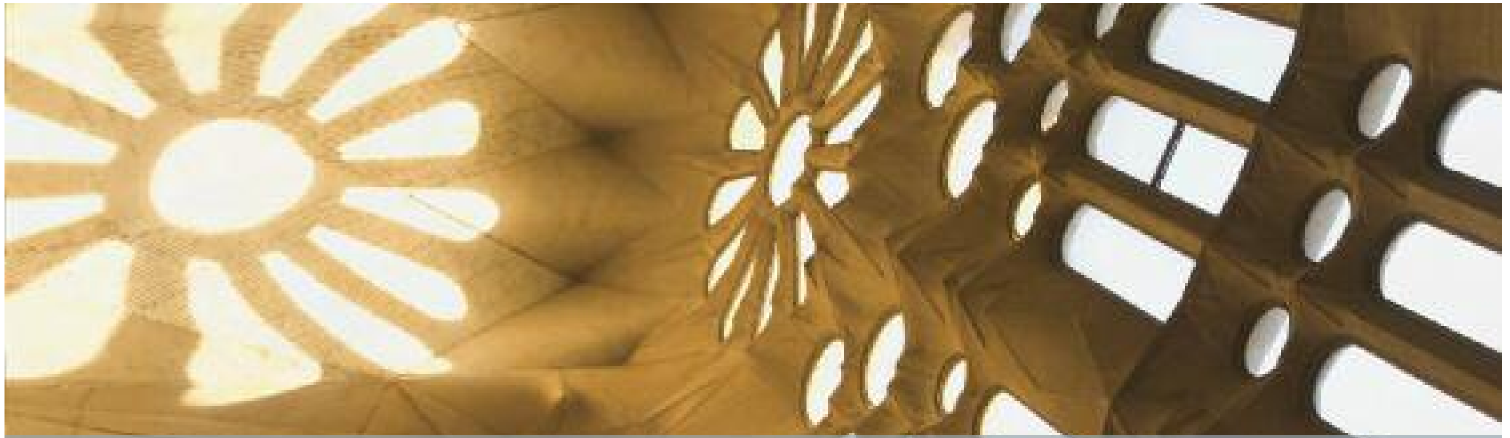

BNY MELLON
ASSET MANAGEMENT

From strength to strength?

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WestLB Mellon Asset Management (WMAM) is a 50:50 joint venture between WestLB and The Bank of New York Mellon Corporation. Headquartered in London, WMAM offers clients both core and specialist products. The firm has a distinct investment philosophy and process that combines fundamental driven bottom-up stock selection with disciplined quantitative analysis.

The beginning of March 2009 saw the start of an impressive recovery in investment grade European corporate bonds with the sharp fall in spreads delivering significant outperformance versus government bonds. Such a strong recovery was partly a correction of the sharp rise in spreads seen in the wake of the Lehman Brothers default. Indeed, at the turn of the year, the European high yield market implied default rates were well above those registered during the Great Depression of the 1930s. However, this pessimism soon receded, giving ground to the hope that unprecedented levels of monetary easing, fiscal stimulus and support for the banking sector would result in a stabilisation of the economy.

Quick, quick, slow...

Of course, the question remains as to how strong this recovery will be. Optimists bet on a 'V'-shaped recovery, pointing to historical evidence that sharp downturns are often followed by an equally dynamic recovery. However, in its World Economic Outlook published in April, the International Monetary Fund pointed out that financial crises induced recessions are typically followed by a slow recovery. This is because the fall in value of financial and real assets dampens private consumption as households raise their saving rates in a reaction to falling wealth. Similarly, credit is not as readily available as before as banks are forced to repair their balance sheets. Even so, there are some hopeful signs coming from emerging economies, especially in Asia, where the global banking crisis is not weighing directly on the economy. It is also reassuring that central banks in the developed markets are alert to the still fragile state of their economies. It is therefore unlikely that they will start to reverse their generous policies before an economic recovery is more broadly based. As such, we expect modest tightening by the European Central Bank, for example, but not before late 2010.

The main risk facing the economic outlook in the developed world is that consumer demand fails to pick up. High unemployment remains, while recent weak US consumer confidence data reminds us that there is still some way to go before a sound recovery is underway.

Weathering the storm

The obvious question is, how will investment grade corporates fair in this environment? It makes sense to distinguish broadly between financials and non-financials. Second quarter results for the latter were still weak, but mostly better than albeit lowered expectations. There are signs of stabilisation while cost cutting initiatives are also starting to bear fruit. The liquidity situation has also substantially improved and we have seen little sign of credit constraints on investment grade industrials, while record

*Source: Moody's Investor Service, Global Credit Research, as of October 7 2009

levels of new issuance this year has been met by broad investor interest.

Admittedly, there is continued pressure on ratings, but default risk is low as a result of reduced refinancing risk. Rolling 12-month global default rates are expected to peak at around 12% in the fourth quarter of 2009 – well below the expectations of earlier this year. On a 12-month horizon, global default rates are expected to fall to 4.5%*.

A game of two halves

Over the past 12 months, we have seen unprecedented levels of government intervention in the financial sector allowing many large banks to report positive results for the first half of 2009. Admittedly, it remains to be seen whether this recovery in results is sustainable because a substantial part of profits was due to trading results and one-offs but, all in all, we think that senior bonds from financials are generally well supported.

As far as subordinated issues are concerned, it depends very much on each specific case. These bonds differ in their loss absorption features, that is, the extent to which the 'promised' cash-flow can be reduced or deferred if the issuer suffers losses. Ironically, government support is not a resounding positive for these instruments, because the government may insist that holders of subordinated bonds share some of the pain when losses occur.

In addition, a 'call right' by the issuer is regularly embedded in these issues after five to 10 years. Before the financial crisis these bonds were traded on the assumption that the issuing bank – to keep their reputation – would redeem the bond at the first call date, even if a refinancing would be more costly than keeping to the bond. However, in December 2008, a prominent bank chose not to keep to this 'agreement' and since then 'extension risk' has become a factor with which to contend.

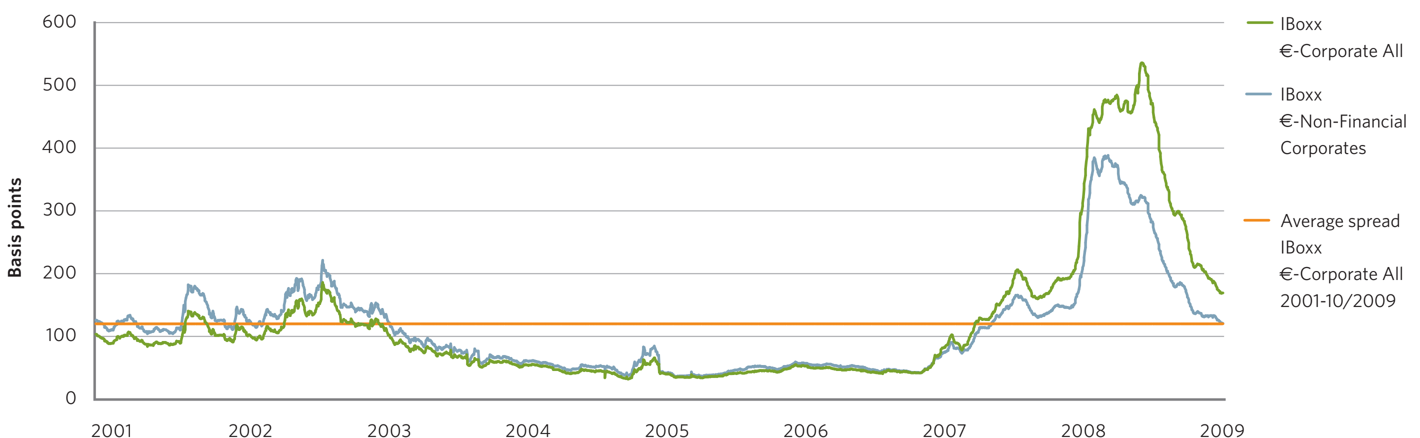
The economic outlook has improved relative to the expectations of earlier this year, but is the massive spread tightening seen since March justified? Current levels are still above the longer-term average and, in our baseline scenario of a moderate but stable recovery, this seems appropriate.

The senior bank segment seems to offer relative value compared to industrial companies, but as far as subordinated issues of financials are concerned, a highly selective approach is advisable.

All in all, over a 12-month time horizon, we regard the market as still being attractive on a risk-adjusted basis.

*Source: Moody's Investor Service, Global Credit Research, as of 7 October 2009

CORPORATE BOND SPREADS OVER GOVERNMENT BONDS



Source: DB Quant, WMAM as at end Sept 2009

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