

# Aviva Investors Economic and Market Outlook

## Update and impact from recent macro risks

August 17, 2011



This report is designed to update you on Aviva Investors economic and market insights and views following the macro risks and significant volatility experienced over the last two weeks.

### ECONOMIC AND MARKET OUTLOOK

As outlined in our mid-year outlook, we believe the top two risks facing the markets and the global economy were European debt fears and U.S. debt ceiling and fiscal policy issues. Over the past several weeks these two issues, combined with slowing U.S. and Global economies, have increased economists' and investors' expectations of a double dip recession and have driven the markets to heightened levels of volatility. Consistent with past volatile environments, rumors were rampant including rumors of a French bank on the brink of failing and Asian investors pulling funding from European financial institutions.

The market impact has been both volatile and severe; some of the major impacts include:

- U.S. and Canadian government bond yields declined substantially across the yield curve, as investors sold riskier assets and sought safe haven government debt
- U.S. and Canadian investment-grade corporate bond spreads widened
- High-yield bond spreads widened substantially
- Global equity markets dropped sharply
- Equity and credit spread volatility increased substantially

Following S&P's downgrade of U.S. debt last Friday night, technical sentiment dominated the markets as investors turned heavily to "risk off" mode resulting in rising volatility (VIX initially touched 48, from below 20 in mid-July) as the S&P 500 moved over 4% for four straight trading days for only the 3<sup>rd</sup> time since the great depression (October 1987, November 2008, August 2011). Credit spreads pushed wider as retail investors fled high yield and equity funds for the safety and liquidity of cash, and U.S. government bonds reached all time low yields on the "flight to safety" trade.

Central Banks and regulators actively moved to calm the markets. The ECB began buying Spanish and Italian bonds to calm the market fears of the peripheral European Sovereign debt contagion spreading. This helped drive Spanish and Italian 10-year yields lower by over 100 bps on the week (from above 6% to around 5%).

#### Key points

Market performance over the last two weeks has been marked by heightened volatility caused by a combination of concerns over slowing global growth, European Sovereign debt contagion fears and significant policy and political uncertainty.

Our base case market outlook calls for U.S. economic growth to be sluggish, but improve modestly during 2H2011. We expect credit fundamentals to be stable, market risk levels to remain heightened, interest rates to remain rangebound and credit spreads to begin to stabilize.

Markets question the ability of the economy to achieve sustainable growth without the extraordinary assistance of the Fed and the ability of the markets to absorb the continued supply of US Treasuries post QE2.

Modestly cautious investment stance with prudent risk positioning is very important in a world dominated by large and powerful macro risks.

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The Fed's assessment of the U.S. economy turned weaker and they surprised the markets by promising to keep rates "exceptionally low...at least through mid-2013". With three FOMC members dissenting, the announcement did little to calm the markets but did drive U.S. Treasury yields to all time lows. European regulators also temporarily banned short selling of financial stocks in several countries to help stem the global equity market downturn.

Sorting through the macro risks and market volatility over the past several weeks, our base case scenario remains that the U.S. and Global economy will avoid a double-dip recession. We continue to expect U.S. growth to be sluggish but improve modestly during the second half of 2011, as the supply disruption from the Japanese earthquake/tsunami and other temporary factors begin to fade and corporate profits continue to be strong. However, the stubbornly high unemployment rate and impacts from the required fiscal austerity will weigh on growth over the next 1-2 years. With the Fed holding short rates unchanged for the next two years, we believe the "lower for longer" rate environment is likely here to stay for the next 1-2 years, barring an improvement in economic growth to above 3%, a "flare up" in inflation, or a longer term resolution to the European Sovereign debt crisis resulting in a strong "risk on" trade.

### **In summary, our base case market outlook calls for:**

- Continued stable credit fundamentals
- Stabilizing technical sentiment as the economy turns away from double-dip recession and Europe moves to solve its debt crisis issues
- Market risk levels remain heightened and investor conviction levels remain lower; market migrates from "risk off" to a more "risk neutral" environment
- Credit spreads begin to stabilize and tighten as recent spread widening has created relative value opportunities, as demand for fixed income products remains strong and fundamentals remain stable
- 10-year Treasury rates adjust to a 2-3% yield range as rates stay lower for longer, in a "carry trade" environment fostered by a Fed on hold
- Modestly cautious investment stance with prudent risk positioning is very important in a world dominated by large and powerful macro risks

### **The key risks to our outlook and drivers of technical sentiment over the near term are:**

- European policymakers fail to craft a comprehensive response; peripheral European Sovereign debt ultimately experiences default/restructuring (Greece) and contagion fears spread
- Policy and political uncertainty further dampens consumer and business confidence, in turn hurting the economy and creating a negative feedback loop
- U.S. political gamesmanship as fiscal debt plan discussions unfold

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- Risks to the upside include:
  - Longer-term resolution to European Sovereign debt issues; orderly resolution of peripheral European Sovereign debt and avoidance of problems in Spain and Italy, helped by fiscal austerity and ultimate support from the EU. Sizeable capital raising by European financial institutions, enough to significantly eliminate the fears of sovereign debt crisis spilling over to U.S. banks
  - Sharp acceleration in global economic growth

### **CREDIT FUNDAMENTALS**

Our portfolio positioning and investment recommendations are anchored by our fundamental credit outlook of stable with a positive bias.

This continues to be reflected in strong corporate earnings, as 2Q is shaping up to be the seventh consecutive quarter of double-digit earnings growth for S&P 500, and the first quarter of double-digit revenue growth since 2Q10. Of the S&P500 companies that have reported so far, over 70% have come ahead of consensus earnings expectations, with blended earnings growth of 18% (vs. consensus expectation at the end of the quarter of ~8%). While prospective earnings expectations may come down modestly in light of the recent economic data, we believe the corporate sector remains well placed to withstand a prolonged low-growth environment that we expect to unfold. Compared to prior downturns, the corporate balance sheets are stronger, profit margins and cash generation higher, and leverage metrics meaningfully lower. The credit universe also is relatively better prepared for a liquidity squeeze, having built significant cash position on the balance sheet and having refinanced a large part of near-term maturities.

Recent volatility and spread widening has been especially concentrated in the financial sector; we view this as largely related to technical factors and in accordance with, for example, our Technical score of 1 (negative) for the Banking sector. However, we continue to assess fundamentals as stable, with asset quality at its best levels since 4Q09 and regulatory capital balances stronger than pre-crisis levels. We expect financial institutions to continue to de-risk through increased regulation, improved funding models, and tighter than normal lending standards.

We are watchful of our risk scenario where the recent political and economic volatility creates a negative feedback loop by adversely impacting consumer and business confidence. Our credit outlook is also constrained by the risk of increasing shareholder distributions by corporates, though the recent economic uncertainty paradoxically mitigates this risk somewhat, as we believe corporates to remain prudent in maintaining their liquidity and credit profile.

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### INVESTMENT GRADE CREDIT

Events over the past several weeks have led to a systematic widening of Investment Grade credit spreads of approximately 32 bps. The widening was led by banking and high beta industrials as investors looked to reduce risk. All sectors were wider, high quality credits with limited exposure to Europe widened out less.

**Fundamentals** (Stable, with positive bias): The widening that the markets experienced were partly in response to the macro issues related to high levels of government debt, both in Europe and the US and the lack of clarity with regards to a permanent solution. Although recent economic data in the US has been weaker than expected and potentially suggests that economic growth may be less than prior consensus expectations, company fundamentals remain strong. Recent second quarter earnings reports did not contain any significant negative earnings surprises that would suggest material credit quality deterioration. Balance sheet strength remains above average with high levels of liquidity across all sectors, including US banks. The events of recent days also are suggesting that companies may be turning more cautious and as a result would expect balance sheet strength to actually improve as companies are slower to increase leverage and/or deploy cash.

**Technicals** (Moderate Negative): Spread movement volatility has been high due to market structural issues. Since 2008, the sell-side inventory capacity has been much reduced. On the buy-side, there are fewer but larger players in the market. As a result, in "risk on" / "risk off" markets, spread movements can be amplified due to the lack of a strong market maker. During the recent sell off we did not see large sell lists from real money and insurance company investors. Selling tended to be very name specific and targeted and was not wholesale. The market tended to be driven by fast money reacting to macro headlines. Trading volumes have been higher than average, but not at "panic" levels like we saw in 2008. Net outflows for Investment grade have been averaging about 1 billion per week, which does not indicate a meaningful shift away from the asset class. Nevertheless, the market has currently re-priced risk higher.

In the near term, we expect spread volatility to continue to be high, with days in which the market gaps wider or tighter on Macro headlines. The new issue market continues to function, albeit with wider concessions. New issues that are coming to market are typically higher quality industrials and shorter maturities and were generally well received as investors believe they are being adequately compensated for the underlying fundamental credit risk.

**Valuation** (Fair): Strong credit fundamentals are being offset by weaker technicals driven largely by uncertainty around the outcome of the European debt crisis, US downgrade, and the impact on economic growth. The recent sell off is providing attractive opportunities in select names and sectors that are not as directly affected by the larger macro events.

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**Portfolio positioning:** Since May, due to concerns about macro issues, we have focused purchases on higher quality industrial names. We have avoided names that have direct exposure to Europe. The portfolios are well diversified and defensive with heavier weights in names that should perform well on a relative basis and have less exposure to European macro issues.

### HIGH YIELD

BB/B Index Spreads have widened over 150 bps MTD. The lack of liquidity in the high yield credit space was exacerbated this week with \$3.4B of outflows in the asset class. Forced selling was met with very few bids as investors scurried to meet the outflows. The lack of liquidity has left high yield in an oversold position. Our current FTV score is 4/1/5.

**Fundamentals** (Stable, with positive bias): Corporate earnings for high yield credits have been very strong, with a significant majority of companies beating analyst estimates. Furthermore, cash levels and balance sheets are much stronger than they were going in to the 2008 market downturn. Companies have been able to extend debt maturities and lower interest burdens, ultimately enabling them to absorb much of the anticipated economic downturn being projected by the capital markets and various economic indicators.

Default rates remain quite low at around 2%, well below the long term averages in the 4.5 to 5% range. Both Moody's and S&P project default rates to fall further over the coming 6 to 12 months before rising again towards the middle of 2012. This, of course, could change if Sovereign stress and US macro-economic numbers continue to disappoint, prompting a global double-dip recession scenario. At this point, we are not projecting a recession.

**Technicals** (Negative): High Yield technicals, which had been positive for most of the year, began eroding a few weeks back and have accelerated to the downside in recent days. Investors, particularly at the retail level, have begun to de-risk, including selling high yield holdings. Last week's AMG number represented \$3.4B of outflows in the high yield asset class. Taking the outflow number one step further, outflows have equaled \$7.5B over the past ten weeks, which is the largest ten week number ever.

**Valuations** (Cheap): With the fall in treasury yields and the rise in yields on high yield bonds, spreads in the high yield market have gapped out noticeably over the last few weeks. On the BB/B index, spreads are at 670 bps, well wide of recent tights and historical averages. Spreads in this range imply default rates in excess of 4.0%, something we don't foresee for quite some time. In this environment we remain market weight

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high yield, principally due to our forecast of lower yet sustainable economic growth and solid corporate balance sheet integrity.

**Portfolio positioning:** We employ a conservative approach to high yield bond management, focusing on the upper rating tiers for the high yield market throughout the course of a full market cycle. Due to the more domestic characteristics of the U.S. asset class direct European exposure is fairly limited. We continue to be positioned with a higher quality focus with the best risk adjusted returns in the BB ratings category. The uniformity of the selloff across ratings categories gives merit to the higher quality bias in a potentially slowing economy.

### SECURITIZED

Towards the end of July, as the debt ceiling debate became more contentious, economic data turned weaker than expected and a downgrade of the U.S. sovereign debt rating became more likely, securitized assets became more volatile and began to underperform U.S. Treasuries.

### **MBS**

We remain overweight MBS. Fundamentals are supported by an outlook for range bound interest rates and the inability for current borrowers to refinance their homes. Technicals are positive with strong investor demand (specifically REITs and banks) as the FOMC has given the green light to add carry trades and each is sitting on a substantial amount of cash. Valuations are still wide of where MBS started the month and well wide of their mid year levels. We expect MBS spreads to continue to tighten with a strong fundamental environment and a large potential investor base.

From the end of July to the FOMC meeting on Tuesday August 9<sup>th</sup>, MBS spreads widened by 35 bps. This led MBS to underperform duration adjusted treasuries by 99 bps. MBS spreads widened as the GSEs (FNMA and FHLMC) were explicitly downgraded, interest rate volatility spiked as the 10 year treasury rallied more than 65 bps and swap spreads widened by about 10 bps. Following the FOMC meeting and realization that rates will remain low well into 2013, investors have added to high quality carry trades. This has led to a snap back in swap spreads and MBS. Swap spreads have tightened by about 10 bps and MBS has tightened by 12 bps.

### **CMBS**

We remain moderately overweight in CMBS. Fundamentals continue to improve as the commercial real estate market continues to stabilize and access to capital remains plentiful. Technicals have recently turned negative as the environment has become more risk averse and CMBS continues to have a high correlation with equities. Valuations have become very attractive for the rating and relative to other asset classes.

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While we feel spreads are attractive longer-term, there could be some further widening in the current environment.

From the end of July to the August 9<sup>th</sup> FOMC meeting, CMBS spreads widened by 85 bps. This led CMBS to underperform duration adjusted treasuries by 347 bps. CMBS spreads remained highly correlated with equity markets. As equity markets dropped by more than 10%, CMBS spreads pushed materially wider, bid / ask spreads went from 25 bps to 100 bps and credit tiering between high and low quality CMBS has increased dramatically. Following the FOMC meeting, CMBS spreads have yet to experience any spread tightening.

### ABS

We remain overweight ABS. Fundamentals are supported by strong consumer loan performance, even in the face of an uncertain economic environment. Technicals remain positive as supply has been limited and ABS benefits from strong investor demand as a safe haven in volatile environments. Valuations are at their tights of the year, but we see limited downside to spreads in this environment and feel the additional carry should provide positive performance going forward.

From the end of July to the August 9<sup>th</sup> FOMC meeting, ABS spreads were 2 bps tighter. This led ABS to outperform duration adjusted treasuries by 2 bps. Over this period, ABS was viewed as a low volatility safe haven. Investors aggressively added short ABS bonds which drove spreads tighter. Following the FOMC meeting, investors have continued to add to high quality carry trades. This has led to further spread tightening in ABS, which are another 2 bps tighter.

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