

January 2012

# Outlook on **European Fixed Income**

The final quarter of 2011 will likely be remembered as one of the most volatile in European bond market history. October's mixed results (continued widening of European sovereign spreads contrasted with recovery in corporate credit markets) was followed by an exceptionally weak November for European bonds, where basically all market segments, from safe-haven Bunds via Eurozone peripheral government bonds to corporate credits, experienced significant losses. The roller coaster ended with a decent recovery in those segments in December, although it is not clear how long this recovery might persist.

European bond markets were once again primarily driven by political news, with good news from the latest European Union (EU) summit in early December where the following decisions were made, among others:

- No change in the EU treaty; however, there was an agreement to formulate a new “fiscal compact” among member states (except the United Kingdom) to increase fiscal coordination and supervision, including stricter penalties for those countries in breach of fiscal plans (rule-based fiscal policy)
- Earlier enactment of the European Stability Mechanism (ESM), at a sooner-than-planned date in 2012, and review of the maximum limits of the European Financial Stability Facility (EFSF) and ESM in March 2012
- Introduction of the idea of leverage for the EFSF; softening of governments' stance on Private Sector Involvement (PSI)
- Provision of €200 billion to boost International Monetary Fund (IMF) resources via bilateral loans to support weaker countries in the Eurozone

As measured by the J.P. Morgan EMU Government Bond Index, Spanish government bonds were among the top five performers for 2011, with a return of 6.7%, outperforming core countries, such as Austria and France. We believe that this highlights the differentiation among countries and acknowledges the individual economic circumstances of each country. Finally, we believe that the bond market is no longer treating the European sovereign debt crisis as a uniform problem afflicting countries in the periphery. Instead, we believe that the market is pricing each country individually with regard to progress, with a high default probability for Greece and less so in Portugal. At the same time, Ireland was rewarded for its austerity measures this summer and, Spain, despite all risks related to unemployment or its banking sector, now has 10-year yields approximating 5% and was the second best performing EMU government bond market in December.

Spain still has its problems, but it is tackling them, both under the former socialist government as well as under the new conservative Rajoy administration, as evidenced by recent austerity measures and tax hikes worth €14.9 billion, which were agreed to by the government in the final week of 2011. Further, Spain remains proactive with regard to reshaping its banking system via directives to write off mortgage-backed loans, while simultaneously offering bank issuance facilities guaranteed by the state. Spain's relative success has been rewarded with 3-year yields that are currently 2% less than Italy's. Meanwhile, we believe Greece remains a potential source of contagion risk. Details of PSI are due to be set between the Greek government and investor groups over the course of January. We believe that markets have had enough time to deal with Greece and some bank exposure has been partly written off. News that Greece missed its austerity targets has received less attention from the media.

Whatever the news in 2012, (our base case scenario assumes that Greece will continue its EU/EMU membership), the passage of time will help to limit contagion risk, in our view. As we argued a year ago, Italy is the main risk factor for the Eurozone and further European integration, due to its sizable bond market and refinancing needs. The head of the Italian debt agency, Maria Cannata, has recently announced that Italy is planning to issue €450 billion worth of bonds and Treasury bills in 2012. If Italy manages to recapture its domestic investor base, contagion risk could be limited. Herein lies the key for stabilization. In addition, there are ways to sweeten the purchase of

domestic government bonds for investors, especially if the European Central Bank (ECB) continues its purchases in the secondary market, which is our expectation.

While it is disappointing from a political point of view to see the United Kingdom choosing to disengage from the EU, we consider it unlikely that the country will actually leave the Union and, thus, sacrifice the common European free-trade platform for short-term political benefits. With regard to the Eurozone and its common currency, a more active role from the United Kingdom would have been desirable, in our view, but is not essential to a solution.

In terms of political sentiment surrounding the euro, certain segments of the German media favor the idea that Germans should not pay for Greek pensioners opting for early retirement, but this may not be a representative view. We have not sensed any real anti-euro sentiment in the major Eurozone countries. In Germany, for example, a rising share of the electorate is discussing the merits of a common currency; whereas in France, the government is commonly blamed for economic weakness, not the currency. These differences appear to be frequently confused in media reports outside Europe. In Germany, the big domestic issue lies in dealing with the broad public consensus to limit the power and systemic relevance of financial conglomerates. Europe has historically been a lively, dynamic, and diverse continent. Economic diversity might be one of the causes for this crisis, but it is also the key to the solution, in our view.

Investor sentiment stabilized toward the end of 2011, and broadly speaking underweights in stocks and corporate bonds have been slightly reduced in line with the expectation that investors will be less risk averse at the start of the New Year. However, there is still distinct skepticism surrounding the medium-term outlook as evidenced in investor surveys. Our core scenario assumes an unchanged composition of the Eurozone, and a stabilization of spreads versus Germany. Even without a major spread tightening, the attractive yield pick-up makes investments in countries, such as Italy or Spain, an interesting portfolio diversifier for 2012, in our view, although spread volatility will likely remain high over the first few months of 2012. Besides the urgent problem of refinancing and solvency, the other paramount challenge for Eurozone countries is restoring growth. A technical recession in the fourth quarter of 2011 and/or the first half of 2012 cannot be ruled out, in our opinion, which underscores the importance of raising the competitiveness of industries in the various Eurozone countries. Italian Prime Minister Mario Monti is expected to unveil such plans for Italy at the EU finance ministers' meeting on January 23.

As previously stated, the ECB continues its path of accommodation, delivering supportive measures in exchange for progress with regard to austerity or other policy action, as agreed to by national governments. While the ECB lowered the main refinancing rate to 1% over the fourth quarter of 2011, it has not embarked on unsterilized purchases (real quantitative easing) of government bonds, but public discussion on such a plan, even within the ECB, indicates that such a move should not be ruled out in case of another round of financial market stress. Further, German Chancellor Angela Merkel has softened her stance regarding eurobonds. The EU commission has already produced a Green Paper on so-called "stability bonds" which will be further examined over the course of 2012. As with the ECB's stance on quantitative easing, the introduction of some variety of eurobond remains an option in battling a crisis. A major step forward is the ECB's decision to provide unlimited liquidity to Eurosystem banks via a 3-year term funding repo operation, combined with relaxed collateral requirements. In our view, this is proof of the ECB's commitment to fulfill its responsibility in helping to solving the crisis. In fact, the ECB has already announced a second 3-year tender to take place later in 2012.

One should not underestimate the political will and determination of the German and French governments to move along with the European Union and the European project. German finance minister Wolfgang Schäuble recently stated his expectation to have contained contagion risk over the next 12 months and to have the Eurozone stabilized. Undoubtedly, an academic discussion on how to dissolve a monetary union is taking place and, at its heart, is an analysis of the potential cost of such a step. For reasons such as the uncertainty of the cost of disintegration, upcoming elections in France and Germany over the next two years, and the political consequences of disintegration in Europe, we sympathize with those who have maintained that a monetary union should be the last step in integrating countries, but favor the view that a disintegration of the EMU would be irresponsible. This year, February 7 marks the 20th anniversary of the Maastricht treaty, the foundation of the monetary union. We believe this is a worthy reminder to European leaders to continue working toward a solution to Europe's troubles.

## Important Information

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