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EUROPEAN MARKET COMMENTARY

ASSESSING EUROPEAN INVESTMENT-GRADE CREDIT

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Introduction

With all the attention being paid to U.S. investment-grade corporate bonds of late observers might be forgiven for not realizing that spreads on European investment-grade issues have also blown out to record levels. In fact, interest in euro-denominated credit has been picking up, particularly among European investors.[1] We conclude that current pricing makes European credit a potentially viable option for investors willing and able to manage this sort of tactical bet (which might be part of a larger bet on credit globally, perhaps through a global debt manager). At the same time, investors should be aware that, in contrast to the United States, historical data is limited and provides little guidance. Moreover, the euro-denominated credit market offers lower absolute yields and presents greater uncertainties than is the case with respect to US$-denominated corporates.

An Overview of Investment-Grade Bonds

Although the euro-denominated investment-grade bond market is larger than the US$-denominated market according to the European Securitization Forum, the outstanding universe of index-qualifying bonds as represented by Merrill Lynch's Euro Corporate Index (Euro Index) contains only 1,556 issues (from 399 issuers), compared to 3,712 issues (734 issuers) in Merrill Lynch's U.S. Corporate Index (U.S. Index), the comparable U.S. index.[2] In terms of face amount of debt outstanding, the European universe covers some €1.2 trillion (US$1.5 trillion) in debt, roughly 62% as much as the U.S. Index. Presumably, the disparity results from index inclusion standards that, for example, require securities to have at least one year remaining to maturity and a fixed coupon payment schedule.

Bonds issued by German, French, and Dutch firms account for almost half of the Euro Index. In addition, debt issued by firms from over a dozen countries outside of continental Europe (most importantly the United States and the United Kingdom) makes up 25% of the index (Table A). Thus, investors need to be aware that an investment in funds focused on the entire euro-denominated debt market will include substantial non-European exposure.[3] Moreover, even European issuers may have a large part of their operations outside Europe, which means that investors in their debt will be highly exposed to global economic and political risks.

From a ratings perspective, issues rated A make up 42.7% of the index, with paper rated AA accounting for another 30.9% (Table B). Paper rated BBB (16.9%) and AAA (9.5%) accounts for much smaller proportions of the index. Finance-related bonds make up 55.6% of the index, with banking issues

[1] This includes retail, as well as institutional, investors. iShares announced on February 13, 2009, that its euro Corporate Bond exchange-traded fund had surpassed €2 billion in assets under management.
[2] The Barclays Capital Euro-Aggregate Corporate Bond Index is similar in size, number of issues, and composition. We use the Merrill Lynch index here because we have more underlying data on it than on the Barclays index.
[3] Likewise, about 21% of the debt in Merrill Lynch's U.S. Corporate Index is from non-U.S. issuers. We note here that Merrill Lynch's Euroland Index contains only euro-denominated investment-grade debt issued by European-domiciled firms. However, we consider this index the less representative of the European debt market than the Euro Index and therefore use the latter.

alone accounting for 43.7% (Table C). Higher-quality issuers, meanwhile, account for proportionately larger amounts of index debt (e.g., the average issuer rated AA accounts for a greater percentage of the index than does the average issuer rated BBB).

There have been a number of interesting changes in the composition of the Euro Index over the last year. Yields have risen, as we will discuss later. In addition, the percentage of banking issues within the index is up, as is the relative proportion of debt issued by U.S. and U.K. firms compared with that issued by firms in countries using the euro. Moreover, the percentage of bonds rated A within the index has increased by about 5% over the last year while the percentages of bonds in all other ratings categories have declined. Finally, maturities are much shorter today than they were one year ago (e.g., one- to three-year maturities have increased more than 6% while seven- to ten-year maturities are down 5%), although this may be due mostly to the decline in primary issuance in 2008.

Performance and Default History

Because of the limited data available, we were unable to analyze the long-term performance of European investment-grade bonds, including their performance in different economic cycles or in comparison to other asset classes. Over the 13 years of its existence, the Euro Index has had an average annual compound return (AACR) of 4.1% in euro (and 4.0% in US$) terms.[4] European corporates have actually *underperformed* the relevant government bond index,[5] which had an AACR of 5.3%, with all of the underperformance occurring after May 2007. At the same time, corporates have proved *less volatile*; returns had an annualized standard deviation of 3.1 versus 3.3 for five-year German government bonds.

Investment-grade bonds have also underperformed public equities, but by very little (27 basis points [bps])—and at far lower volatility. From January 1996 through February 2009 the MSCI Europe ex U.K. Index had an AACR of 4.4% (i.e., *less* than that of the German government bond index) but a standard deviation of 18.8.[6] Investment-grade debt has significantly outperformed high-yield bonds, however, which had an AACR of -0.1% (using data that begin in 1998[7]).

The 1996–2009 period is likely too short to be representative of either absolute or relative long-term performance among these different asset classes so we advise against placing too much stock in these numbers. The full-period performance statistics also mask the underlying cyclicality of relative performance, as equities generally outperformed bonds significantly, but underperformed sharply during the recessionary bear market at the start of the decade and after May 2007 (Table D). Instead, we must rely on our general intuition regarding how investment-grade debt should perform (on both a strategic and a tactical basis),

[4] Unless otherwise noted, all return and standard deviation numbers used in this section are in euro terms.
[5] Since there is no European government bond index, we have used the five-year German Government Benchmark Bond Index (which has a similar duration to bonds in the Euro Index) as a proxy.
[6] European equity returns have been even more volatile than European high-yield bonds, which had a standard deviation of 4.0 from January 1998 (when the data begin) through February 2009.
[7] The AACR of the Euro Index from January 1998 through February 2009 is 4.1%, the same as for the period from January 1996 through February 2009.

informed by the history of such debt in the U.S. market, and our assessment of the particular opportunities and risks that suggest themselves in the current European environment.

Our data on default and recovery rates for euro-denominated investment-grade debt date back further and offer nothing unexpected. This history shows a minimal historical default rate and modest recovery rate. From 1985 to 2007 the one-year default rate for European issuer debt,[8] according to Moody's, was just 0.04%, about half that of U.S. investment-grade debt. Five-year (0.30%) and ten-year (0.40%) default rates were substantially less than in the United States (1.05% and 2.13%, respectively). Recovery rates of 50% for loans and 32% for bonds, however, were less than in the United States (68% and 37%, respectively).

The Opportunity Set

Historically, we have not viewed investment-grade debt as having a strategic or tactical role in portfolios because we have viewed it as providing less long-term upside than equities in risk-embracing markets while offering less downside protection than government bonds in a deflationary environment. However, since the later part of 2008 we have seen a highly unusual *tactical* opportunity in U.S. investment-grade debt given the rise in spreads and absolute yields, the fact that bond markets appear to have discounted future headwinds to earnings more than have equities, widespread uncertainties about the equity markets, and the fact that sovereign bonds have been offering little in the way of yield.[9]

Since similar conditions prevail in Europe, there is, *prima facie*, a *tactical* case to be made for investing in investment-grade euro-denominated credits. As in the United States, spreads have blown out during the current financial crisis. Option-adjusted spreads (OAS) for all four ratings categories in this space are just off record highs, with the index as a whole having a 445 bp OAS over the euro curve (Table E).[10] This is 5 standard deviations above its historical average (which, admittedly, goes back less than 13 years) of just 78 bps and much closer to the average historical OAS of 691 bps on *high-yield* euro-denominated corporate debt. In addition, spreads *within* the investment-grade universe have diverged sharply, suggesting opportunities for managers with excellent credit skills (Table F).

The picture looks a bit more mixed on an absolute yield basis. To be sure, yields as a whole are near a record high and far above their historical mean (Table G). However, the range of spreads within this sector runs from a seemingly attractive 9.2% (paper rated BBB) and 7.6% (A), to a much less attractive 5.0% (AA) and 4.5% (AAA) (Table H). While this suggests opportunities for active managers, the modest yield on top-rated investment-grade debt should also give investors pause in such an uncertain environment. In the United States, by contrast, bonds rated AAA offer a 8.2% yield, with the yield on paper rated BBB reaching 9.5%. (The Euro Index as a whole yields 6.9% compared to 8.2% for the U.S. Index.) The market is thus pricing

[8] The data refers to debt issued by firms in 36 European countries, including the United Kingdom, Russia, and the countries of Eastern Europe. Therefore, it is not an exact match with the Euro Index data, which covers all firms issuing euro-denominated debt.
[9] Please see our November 2008 Market Commentary *The Case for Investment-Grade Corporate Bonds*.
[10] The euro curve is a duration-matched blend of French and German sovereign bonds.

U.S. debt as riskier, but it is by no means clear that this is warranted, given the risk factors in Europe discussed below. Finally, from a historical perspective, euro-denominated investment-grade corporate bond yields are high compared to euro-denominated high-yield debt, on both an OAS and an absolute yield basis though off the record levels recorded last fall.

Risk Factors

With opportunity comes risk. Although we believe the risk/return profile in Europe has improved from 2008 we judge the risks to be higher than in the case of U.S. corporates, as there are many more uncertainties affecting the euro bond market. For starters, the index's overwhelming concentration in financials is cause for concern. Despite various degrees of government support for financials, the outlook for this sector is extraordinarily unclear in Europe, as it is in developed markets generally, given (we are speaking here primarily of banks) the potential level of future write-offs, questions surrounding capital adequacy, and the ability to earn profits in a deep recession.

While these uncertainties may all be seen to affect equities more than debt, bondholders are deeply exposed as well. Ratings on financial issues could be downgraded, negatively impacting prices and perhaps causing forced sales. Moreover, the possibility of nationalization looms, with uncertain effect for bondholders. It is also worth noting that nonfinancials in the Euro Index presently yield 233 bps *less* than financials (5.5% versus 7.8%); until July 2007 nonfinancials had always (on a month-end basis) yielded more than financials. Finally, many older funds may actually be *overweighted* to financials given earlier bets against industrials (made in the belief that the leveraged buyout market was overheated) or in the event that funds unloaded more liquid, nonfinancial paper to meet investor redemptions.

Other uncertainties relate to the euro market generally, given the strain that the financial and economic crisis has placed upon the European Union. The losses suffered by banks in some countries are such that they threaten to overwhelm national governments, an issue made clear by the sharp rise in the cost of credit default protection against sovereign defaults and the fact that some government bond issues have had to be cancelled or scaled back. Meanwhile, the sharp divergence in the cost of protection against default by different European governments is evidence of market perceptions that some countries are much less creditworthy than others. Under such conditions, it is unclear whether the current Eurozone system can hold up let alone how well corporate debt markets will be able to function. Europe's heterogeneity, normally a source of strength, perhaps makes it a higher risk at times such as the present. Finally, non-euro-based investors must consider currency risk.

Implementation

For investors looking solely at euro-denominated credit, rather than a broader regional or global credit mandate, passive and quasi-index management have been the traditional methods of gaining exposure due to the dominance of large institutional investors in the market and the fact that active managers are often associated with the more conservative banks and insurers. Nevertheless, although beta appears cheap, with wide spreads across the full range of investment-grade debt, we believe that passive exposure could create an asymmetric risk profile given the broad economic distress and potential repercussions of one or two major blowups. Indeed, we would *not* recommend passive management. The high risk factors created by the depth of the current crisis, dominance of financials within the investable index, and looming presence of governments in the credit markets all call for active management.

In evaluating managers, investors should recognize the difficulty of assessing the risk of default of issues or firms operating under different regulatory and bankruptcy regimes. This may be particularly difficult for managers based outside of Europe. Bonds domiciled in different jurisdictions will behave differently, which will likewise work against those operating with an informational disadvantage. On the one hand, a global bond fund would provide managers with a broader opportunity set from which to add value, enabling them to select the best opportunities around the world. On the other hand, some investors might wish to make their own decision regarding euro-denominated credit or be of the view that local managers have an informational edge compared with global managers, even ones with European offices. Another option would be to work with a manager that invests across the entire spectrum of credit opportunities ranging from investment-grade debt to high yield and bank loans (whether just in Europe or globally).

Conclusion

Like its U.S. counterpart, euro-denominated investment-grade debt is worthy of consideration given the high absolute yields and record yield spreads it offers. Such debt has historically had extremely low default rates and current spreads offer generous compensation against historical experience of defaults and recovery. As for sourcing such an investment, we would recommend a similar strategy to our recommendations for sourcing a tactical allocation to U.S. investment-grade debt. Such investments might be funded from public equities or hedge fund mandates with high single-digit return/low standard deviation expectations. Debt's seniority to equities (at least with respect to European stocks) and lower historical volatility are both appealing in today's recessionary environment. Investment-grade bonds should also offer more protection than equities (or high-yield bonds) in the event of a prolonged deflationary contraction and much more protection than usual against a scenario of high inflation (thanks to the high absolute yield).

However, there are huge uncertainties in the European bond market, beginning with the outsized role of financials and extending to broader questions involving the euro and the viability of the European system in light of the severe strain it is now under. While we do not place ourselves in the camp of those who think the euro will be abandoned or the Eurozone will lose members, the possibility cannot be dismissed and makes investing in this debt market particularly difficult. The uncertainties suggest that for investors willing to make this bet active management is the way to go. However, given that we do not normally advocate investments in corporate bonds, we did not begin evaluating managers focused exclusively on euro-denominated debt until last year. As of yet, we have only uncovered a small number of active managers (at least for Europe-only mandates) we regard as of institutional quality.

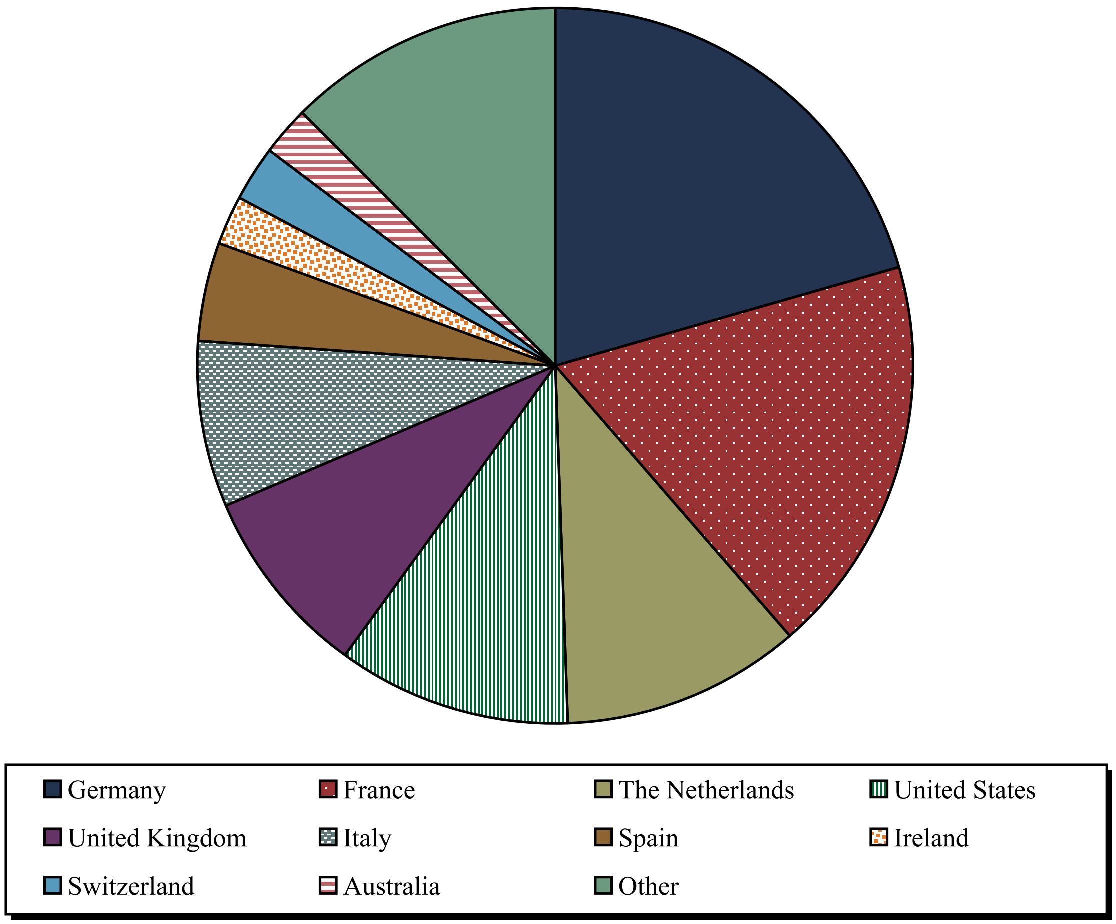
In any case, we would view an investment in this asset class as strictly a tactical bet. We expect that investment-grade debt will substantially underperform equities over the long term. Investors interested in gaining exposure must recognize the potential downside of timing decisions (when to get in and when to exit), which could mean (for any large allocation) a long lag in catching up to peers. The timing issue is exacerbated by the current popularity of investment-grade debt among retail investors in Europe. Investors should also recognize that as equity valuations across the globe continue to improve, the relative attractiveness of the debt-equity trade-off becomes a much tougher call absent a sharp widening of credit spreads. Still, as we have noted before, the recovery of credit markets is necessary for a sustained rally in equities,[11] meaning that investment-grade bonds should continue to outperform equities as long as current credit constraints hold.

[11] Please see our December 2008 Market Commentary *The Worst of Times—Or the Best of Times?*

Table A

MERRILL LYNCH EURO CORPORATE INDEX COUNTRY BREAKDOWN

As of 18 February 2009



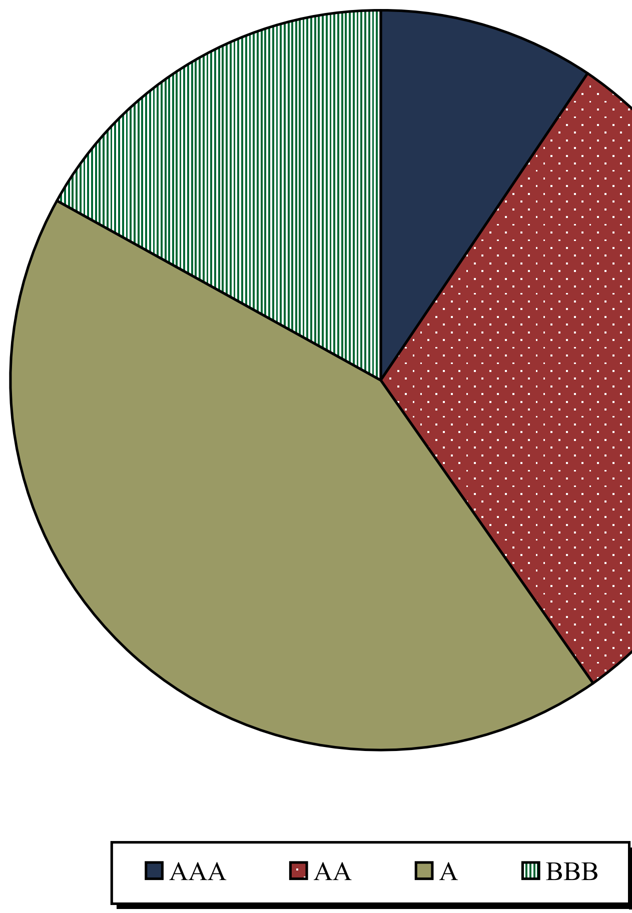
Country	Index Weight (%)
Germany	20.5
France	18.1
The Netherlands	10.7
United States	10.7
United Kingdom	8.4
Italy	7.7
Spain	4.2
Ireland	2.4
Switzerland	2.4
Australia	2.3
Other	12.5

Source: Merrill Lynch & Co.

Table B

MERRILL LYNCH EURO CORPORATE INDEX RATING BREAKDOWN

As of 18 February 2009



<u>Rating</u>	<u>Index Weight (%)</u>
AAA	9.5
AA	30.9
A	42.7
BBB	16.9

Source: Merrill Lynch & Co.

Table C

MERRILL LYNCH EURO CORPORATE INDEX SECTOR BREAKDOWN

As of 18 February 2009

Industry	Weight (%)
Finance Related	55.62
Utility	9.71
Telecommunications	8.58
Consumer Noncyclical	6.08
Consumer Cyclical	5.23
Basic Industry	3.68
Capital Goods	3.40
Energy	3.09
Services Cyclical	2.96
Media	0.94
Technology & Electronics	0.39
Cash	0.29
Services Noncyclical	0.03

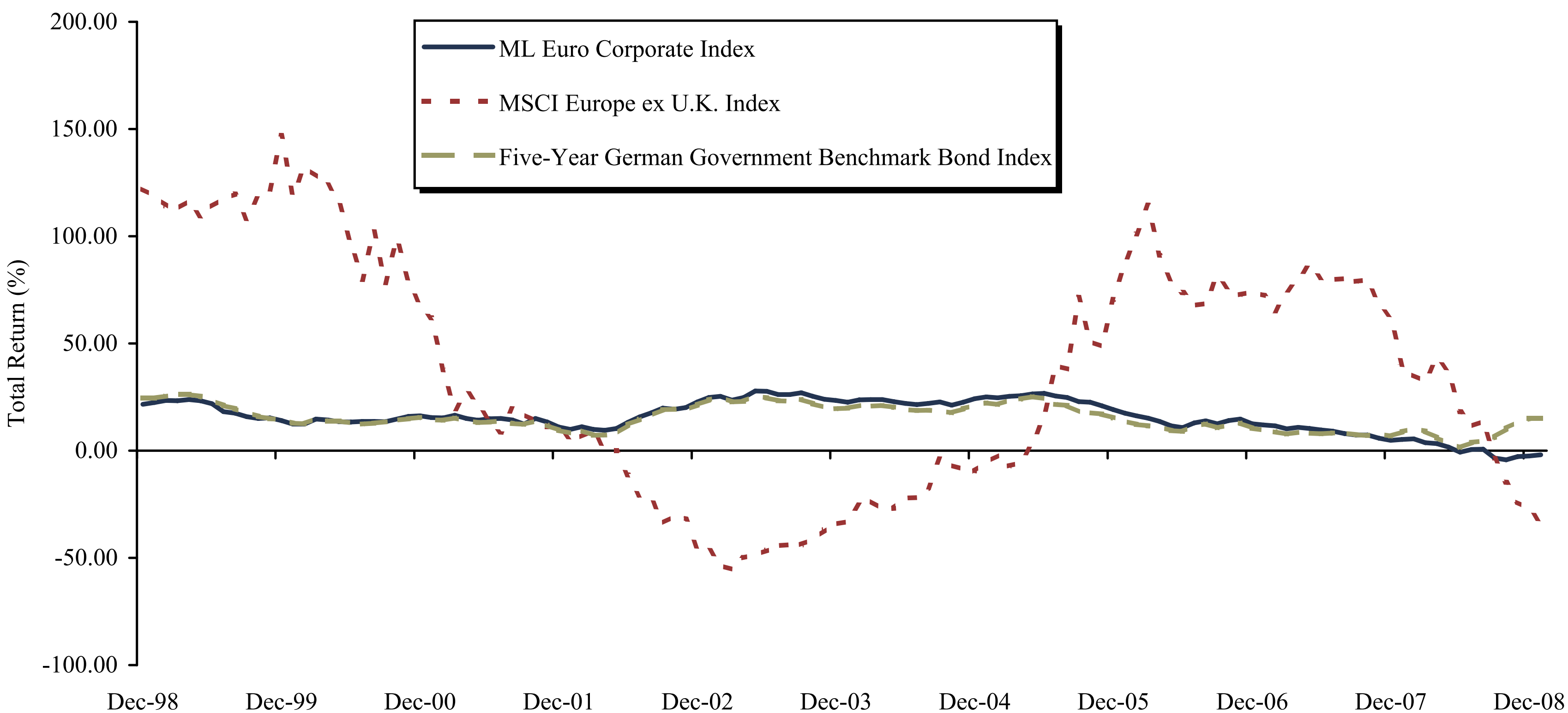
Source: Merrill Lynch & Co.

Table D

ROLLING 36-MONTH TOTAL RETURNS FOR EUROPEAN INDICES

31 December 1998 – 28 February 2009

In Euro Terms



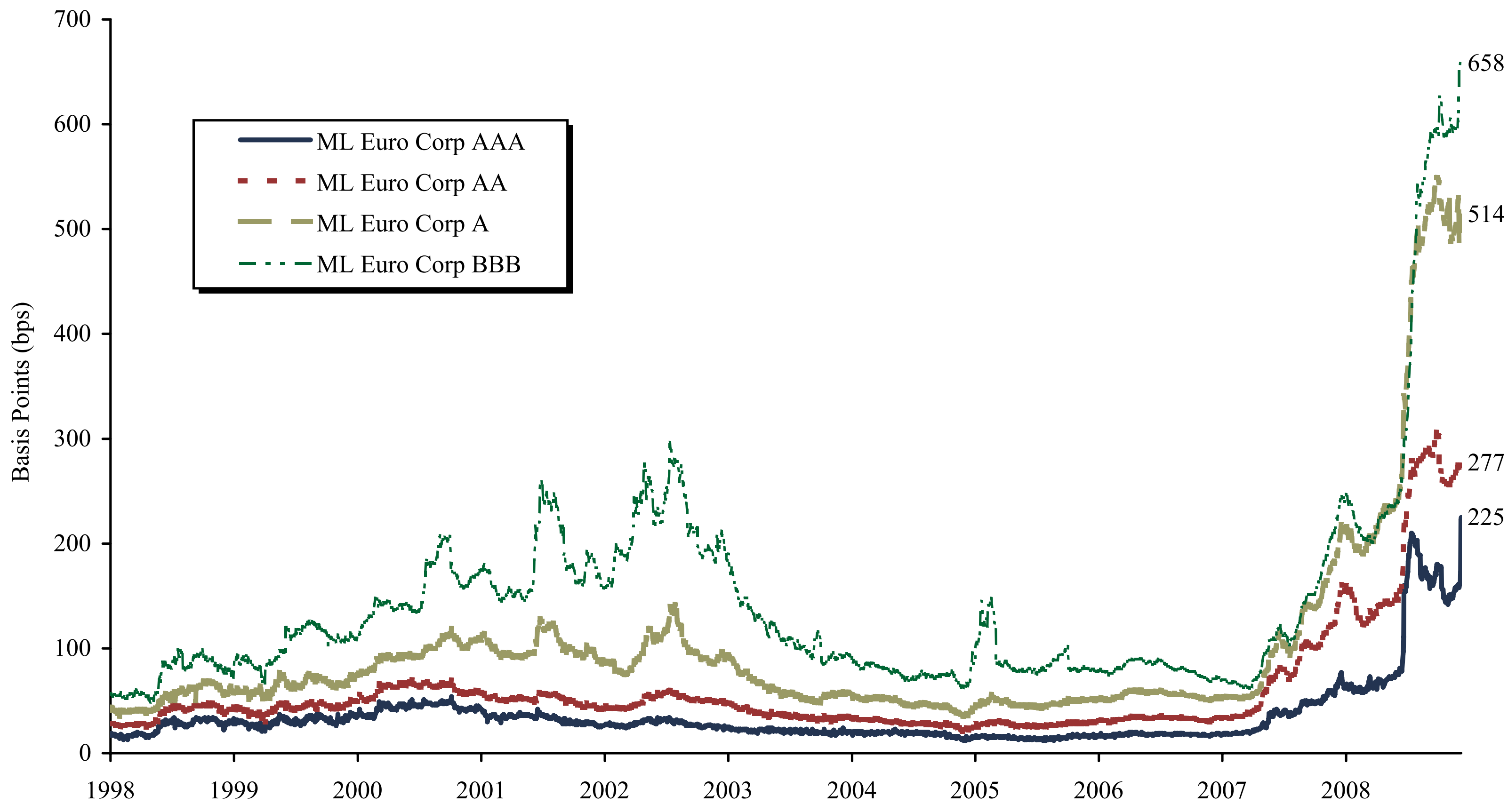
Sources: Merrill Lynch & Co., MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: The MSCI Europe ex U.K. Index is shown in euros converted from U.S. dollars. Prior to the inception of the euro in 1999, the European currency unit is used to make the conversion.

Table E

OPTION-ADJUSTED SPREADS FOR EUROPEAN INVESTMENT-GRADE BONDS OVER THE EURO CURVE

31 March 1998 – 6 March 2009



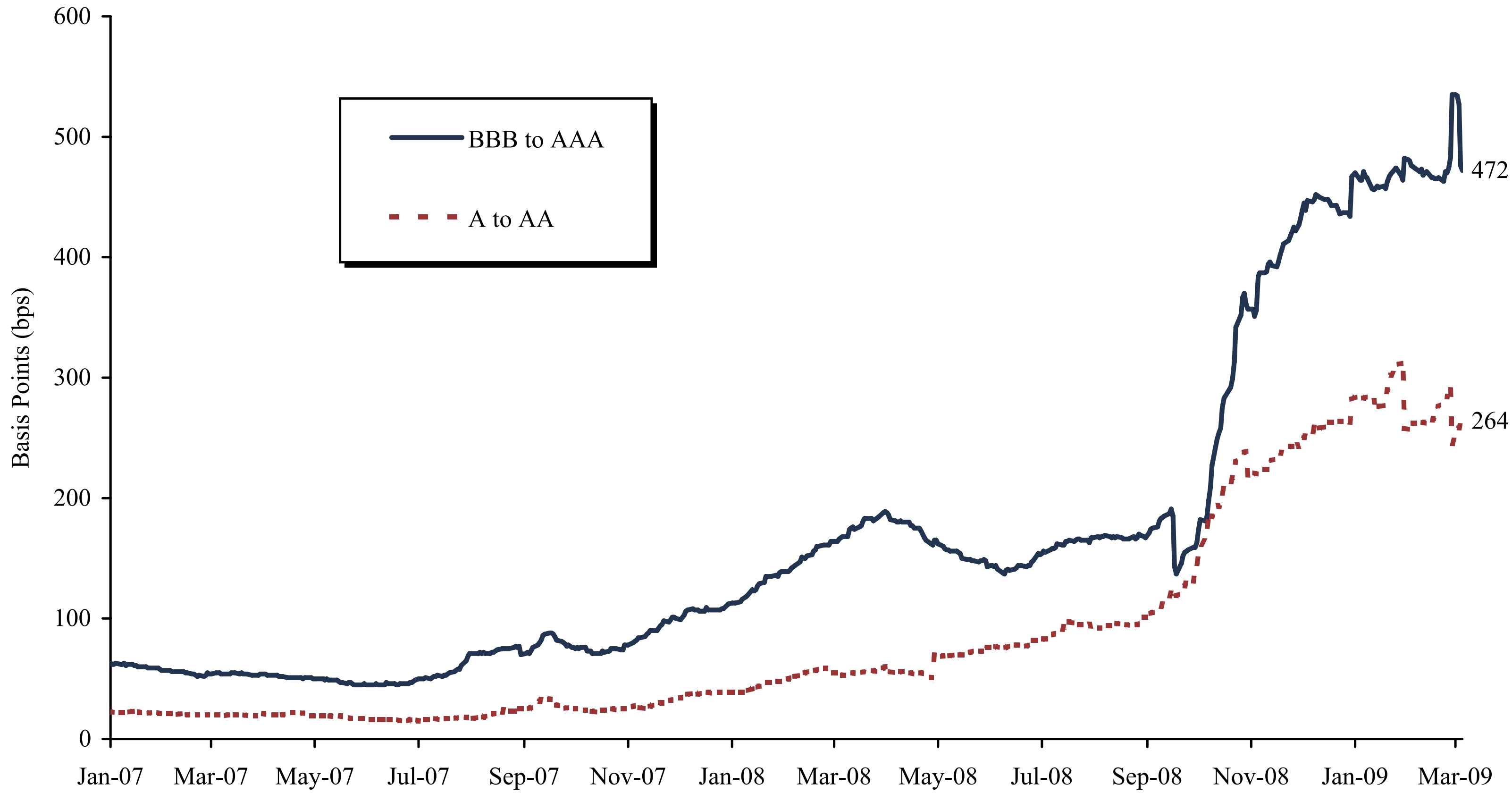
Source: Merrill Lynch & Co.

Notes: The euro curve is a duration-matched blend of French and German sovereign bonds. Graph uses daily data.

Table F

SPREADS ACROSS CREDIT RATINGS FOR EUROPEAN INVESTMENT-GRADE BONDS

1 January 2007 – 6 March 2009



Source: Merrill Lynch & Co.

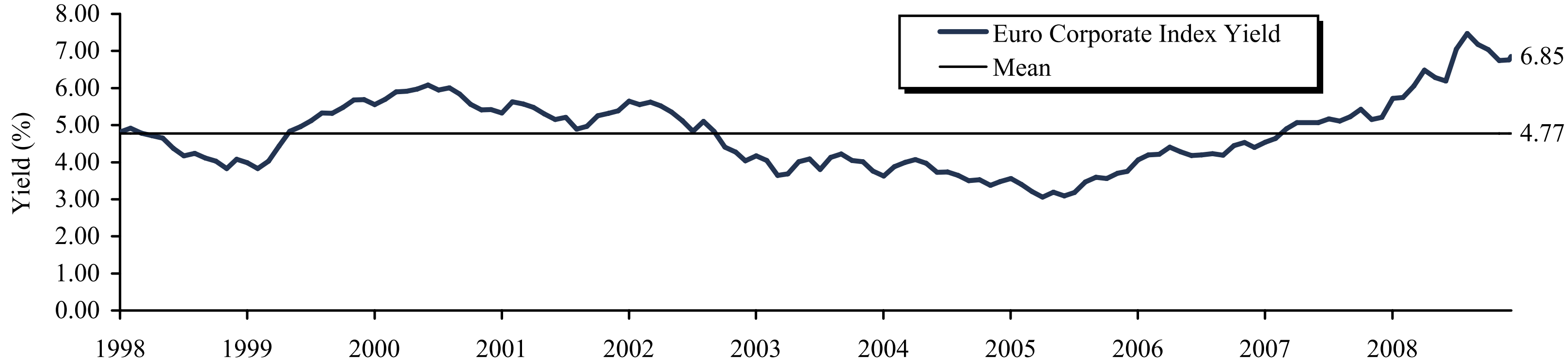
Notes: Spreads are the difference in yield-to-worst between the referenced rating categories of the Merrill Lynch Euro Corporate Index. Graph uses daily data.

Table G

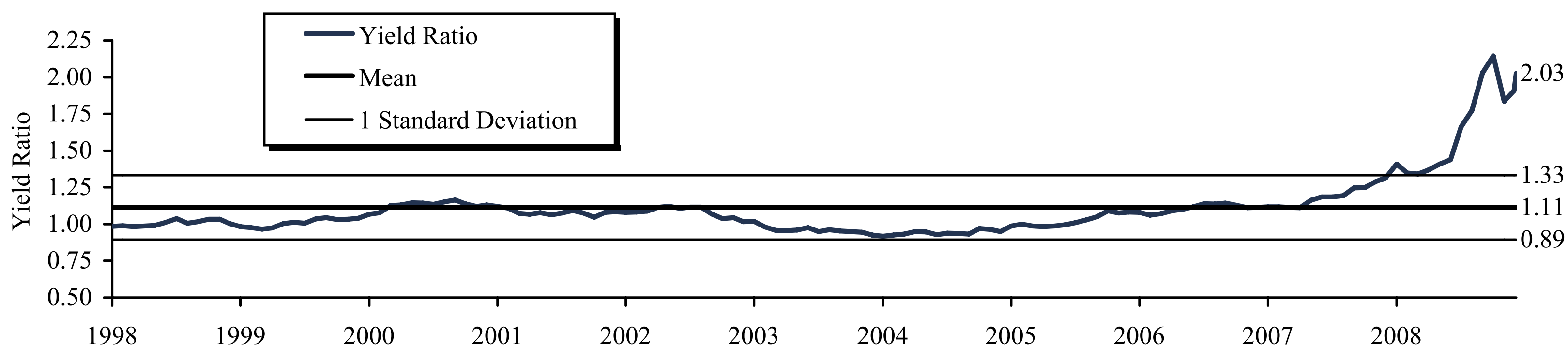
HISTORICAL EUROPEAN INVESTMENT-GRADE BOND YIELDS

31 March 1998 – 6 March 2009

Yield-to-Worst



Yield Ratio of European Investment-Grade Bonds Relative to the Euro Curve



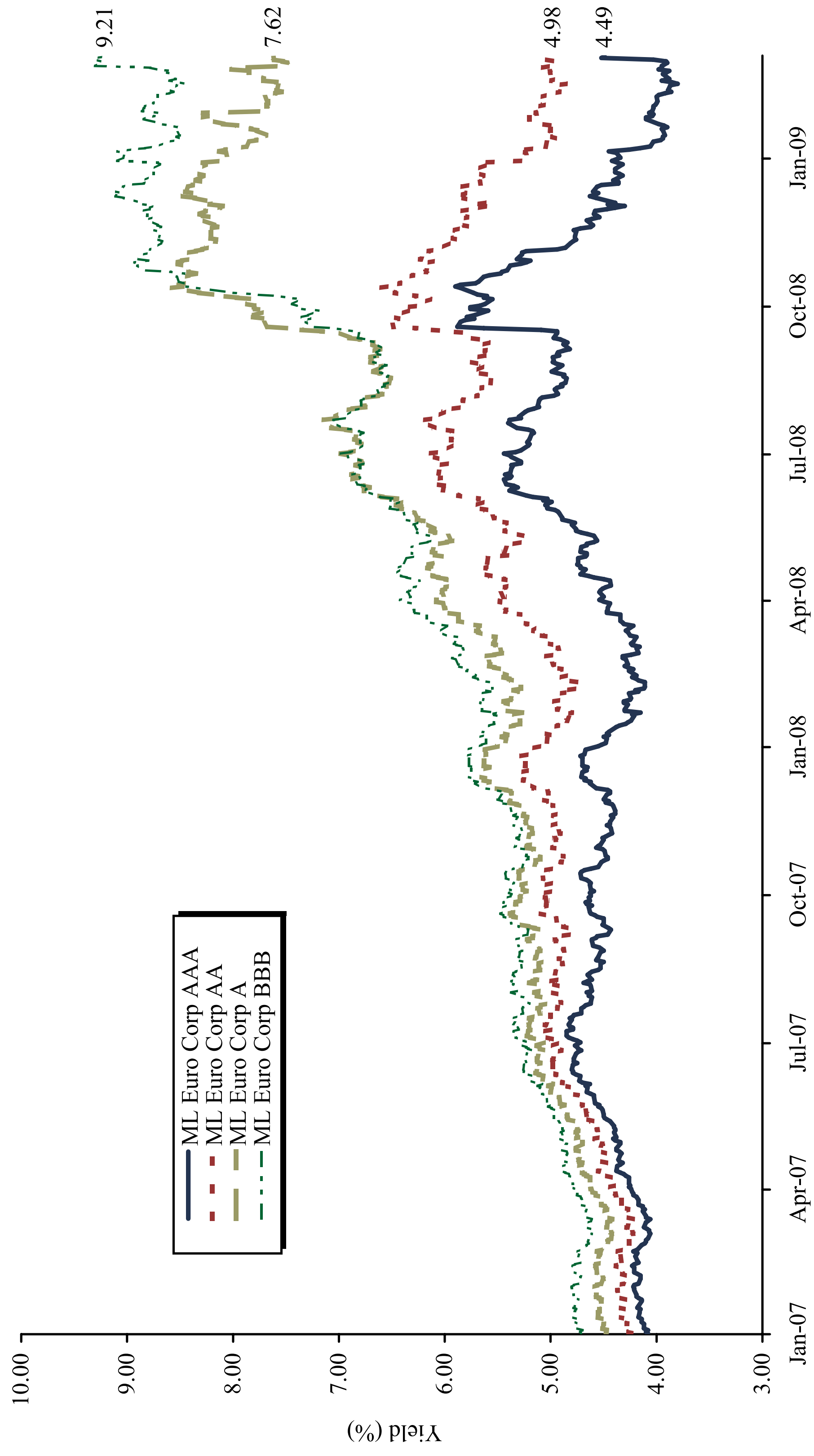
Source: Merrill Lynch & Co.

Notes: The euro curve is a duration-matched blend of German and French sovereign bonds. Graph uses monthly yield-to-worst data.

Table H

EUROPEAN INVESTMENT-GRADE BOND YIELDS BY RATING

1 January 2007 – 6 March 2009



Source: Merrill Lynch & Co.

Note: Graph uses daily yield-to-worst data.