The Actuarial Profession
making financial sense of the future

Investment Strategies for Pensions Actuaries
David Parsons, Director, Portfolio Management Group

Bond Market Outlook

BlackRock

As a Wise Man Once Said…..

"You cannot escape the responsibility of tomorrow by evading it today…"

Abraham Lincoln (1809-1865)

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Agenda

Topics I covered last year…..

The Fragile State of Markets

Sovereign Debt – The next bubble?

Corporate Debt – the new equity?

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Where are we Now?

Markets are Still Fragile

Sovereign Debt is the ‘New’ Bubble

Corporate Debt is becoming closer to Equity (but not in a good way!)

….But there have been some profound changes since last year, which bear re-examination.

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How fragile are Markets?

What has changed for the better?

Corporate Defaults have been much lower than anticipated

- **Labour market Flexibility, Pre-Funding of Financing Needs and Cash Hoarding have all contributed to fewer Defaults**

The Banking Sector has been Stabilised (somewhat)

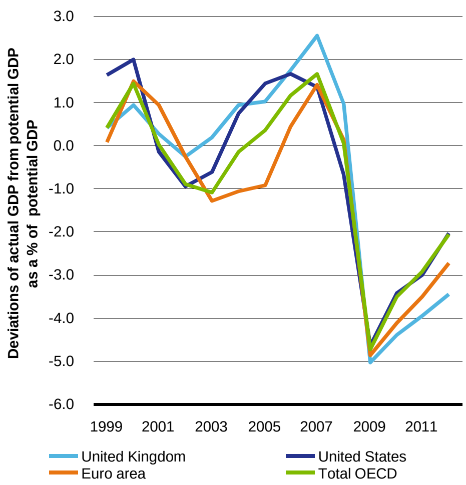
- **Public Money (Lloyds/HBOS and RBS) and Liquidity Support Schemes such as those provided by the Bank of England, Federal Reserve and ECB have kept the Banks Alive**

Efforts have been made to De-Leverage the Global Economy

- Governments recognise the need to reduce the size of deficits, although the extent that this has been embraced varies widely

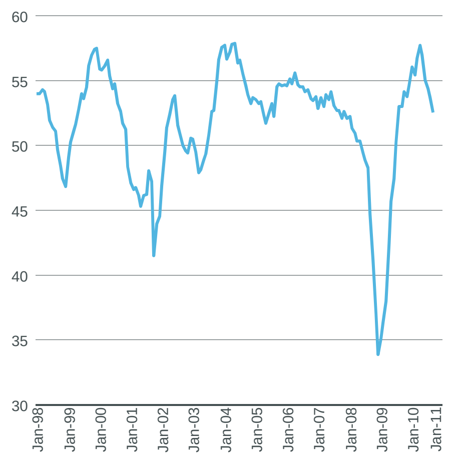
Global Macro Update: Slowdown but no Double Dip

Global Output Gap



Source: BlackRock/OECD

Global Business Confidence



Source: BlackRock/Datastream

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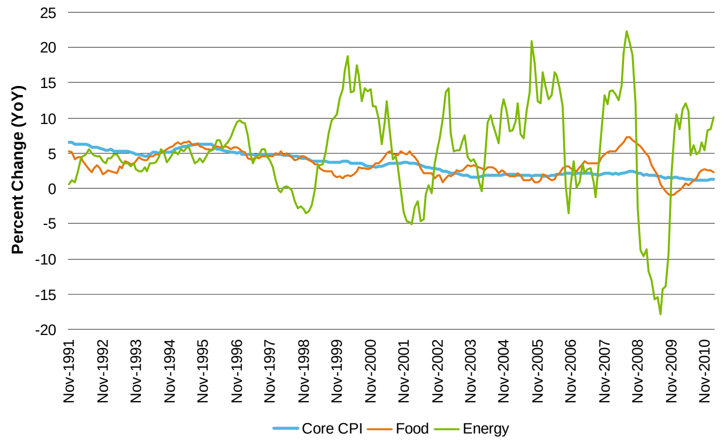
Global Monetary policy: No rush for the exit

OECD Inflation (% change YoY, to February 2011)



Source: BlackRock/DataStream/OECD Data

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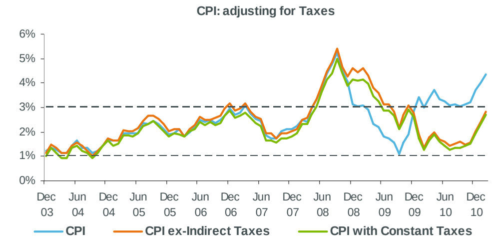
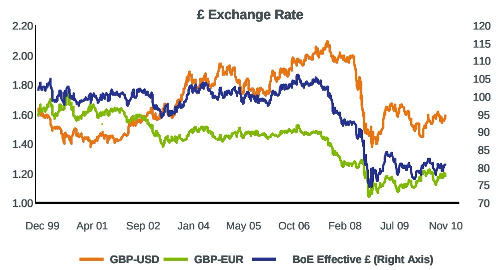
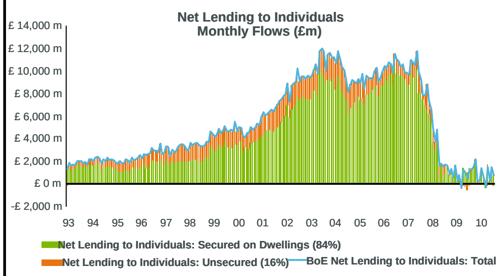
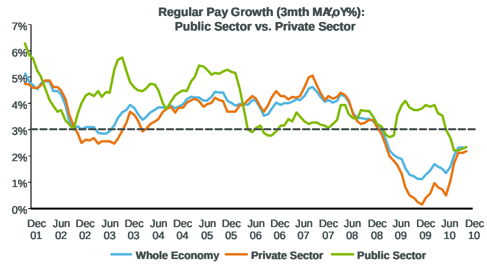
UK Economy: Current and Future Inflation









Source: BlackRock, ONS, Bank of England, Bloomberg As at 28 February 2011

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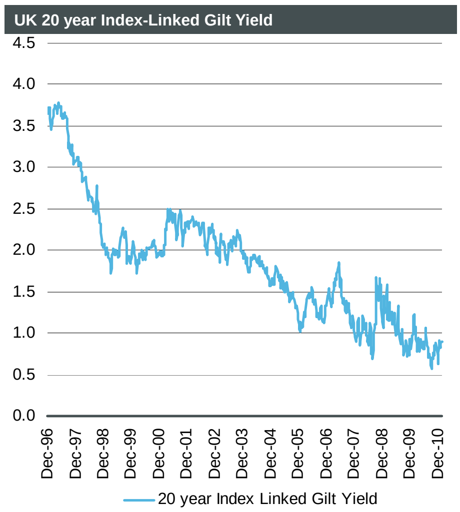
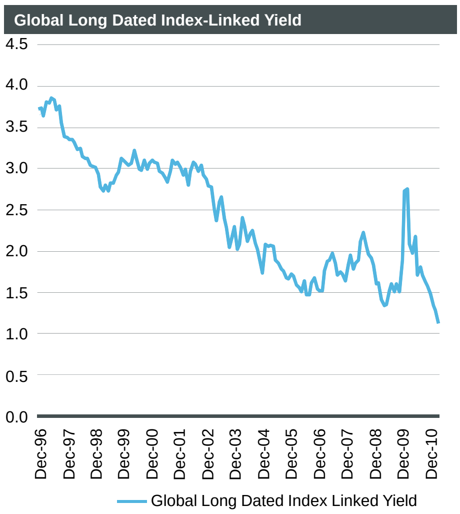
Low Real Yields are not just a UK phenomenon





Source: BlackRock/Bloomberg As at 28 February 2011

Source: BlackRock/Datastream As at 28 February 2011

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Policy Makers are walking a Tightrope….

We have reached the Bottom of the Rates Cycle….only the threat of Deflation would prompt further easing

- This would be most likely through further 'Extraordinary Measures' e.g. Quantitative Easing, provision of unlimited liquidity

The risks are Pronounced:

Tighten too soon….

- Growth is crushed
- Disinflationary pressure builds
- Asset Prices Fall

….Is the ECB in danger of falling into this trap?

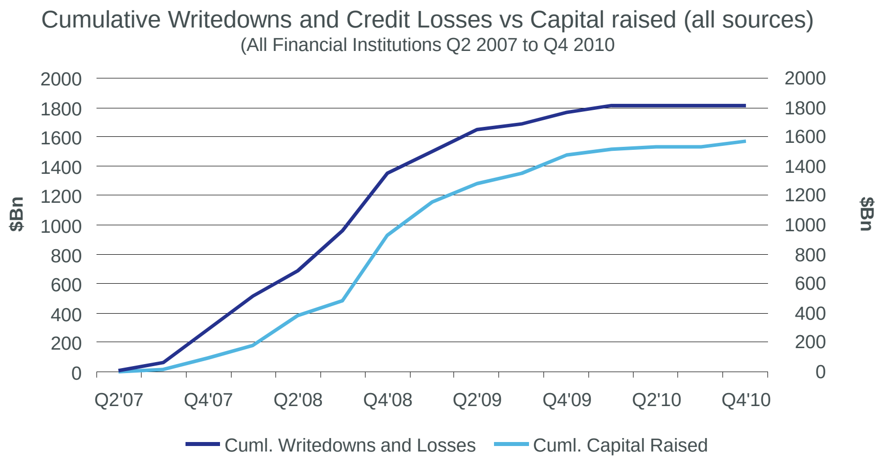
Tighten too Late….

- Growth speeds up
- Inflation becomes embedded
- Asset bubbles re-emerge

….Is the Bank of England in danger of falling into this trap?

Sovereign Debt – Still a Bubble?

Public Money is No Longer Flowing to the Banks



Government Life Support will be Gradually withdrawn during 2011/12

Source: Bloomberg, BlackRock. As at 31 December 2010

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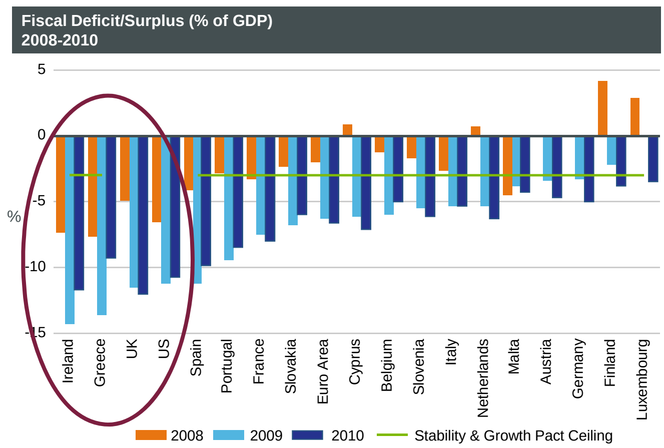
Fiscal Discipline Lapsed as Bank Debts were Socialised



Private Capital has been replaced by Public Expenditure – current levels of global Government Expenditure are not sustainable in anything other than the Short term

Source: European Commission, OECD for US data

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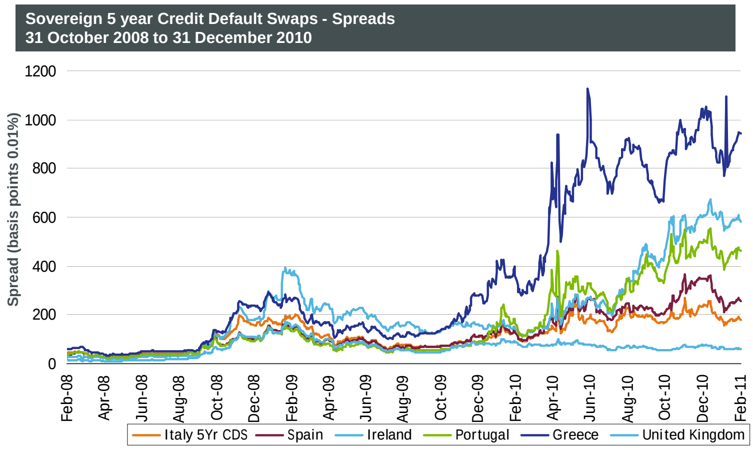
Increasing Sovereign Risk: The consequence of rising deficits



Ballooning Government Deficits have become the focal point for markets with the contagion spreading from Greece to Ireland and to other Peripheral European states

Source: BlackRock/Bloomberg. As of 31 December 2010

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Further Downward Rating Migration is Likely

Country	Moody's		S&P		Fitch	
Austria	Aaa	Stable	AAA	Stable	AAA	Stable
Belgium	Aa1	Stable	AA+	Stable	AA+	Stable
Finland	Aaa	Stable	AAA	Stable	AAA	Stable
France	Aaa	Stable	AAA	Stable	AAA	Stable
Germany	Aaa	Stable	AAA	Stable	AAA	Stable
Greece	B1	**Negative Outlook**	BB-	**Review for Downgrade**	BB+	**Negative Outlook**
Ireland	Baa1	**Negative Outlook**	BBB+	Stable	BBB+	**Review for Downgrade**
Italy	Aa2	Stable	A+	Stable	AA-	Stable
Netherlands	Aaa	Stable	AAA	Stable	AAA	Stable
Portugal	A3	**Negative Outlook**	BBB-	**Negative Outlook**	A-	**Review for Downgrade**
Spain	Aa2	**Negative Outlook**	AA	**Negative Outlook**	AA+	**Negative Outlook**
UK	Aaa	Stable	AAA	Stable	AAA	Stable

Further downwards rating migration likely near term as agencies digest the credit implications of the ESM, whilst the medium term costs of the financial crisis escalate and additional fiscal consolidation gets harder to achieve politically

Source: BlackRock//Moody's/Standard & Poor's/Fitch as at 31 March 2011

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Eurozone funding requirements: Falling from 2012

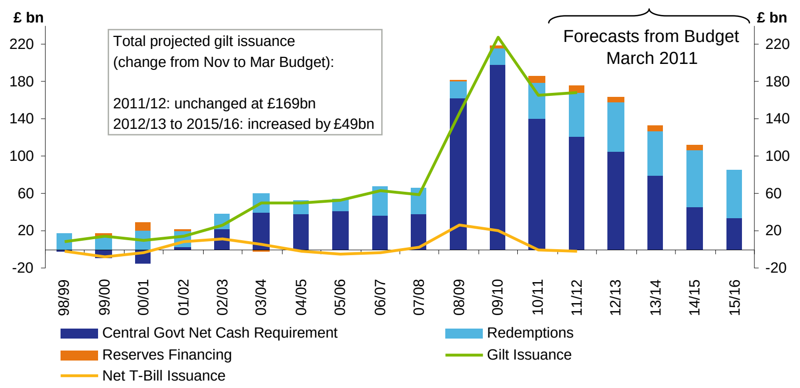
	2011	2012	2013	2014	2015	Gross issuance (€Bn.)	Net issuance (€Bn.)	Net as % Gross
Germany	198	256	181	177	158	970	156	16%
France	194	219	188	165	194	960	282	29%
Italy	205	273	230	194	205	1,107	238	21%
Spain	95	101	120	94	93	503	190	38%
Nether.	52	52	58	34	48	244	58	24%
Belgium	36	36	29	21	37	159	14	9%
Austria	17	15	16	25	19	92	24	26%
Portugal	17	17	17	21	23	95	37	39%
Ireland	23.5	23	22	26	23	118	75	64%
Finland	15	12	11	10	12	60	22	37%
Greece	0	0	0	0	0	0	0	0%
Total € Bn.	**853**	**1,004**	**872**	**767**	**812**	**4,308**	**1,096**	

This funding will compete with Bank re-financing/recapitalisation over the same period; the risk of crowding out by one of the other could have serious consequences

Source: BlackRock/RBS estimates as at 22 November 2010

Focus on the UK Deficit: Gilt Issuance

Primary Determinants of Gilt Issuance – Budget March 2011

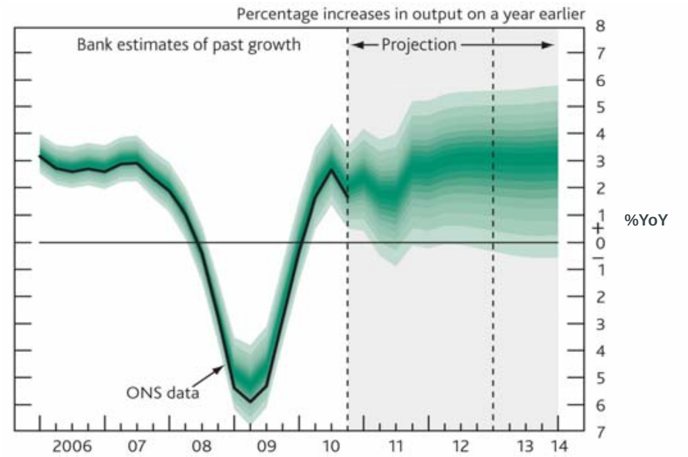


Forecast deficit reductions remain ambitious, but total Gilt issuance was revised up to c.£645bn; Fiscal plans remain reliant on a benign economic backdrop

Source: BlackRock/HM Treasury As of 23 March 2011

How credible is the Bank of England: Growth

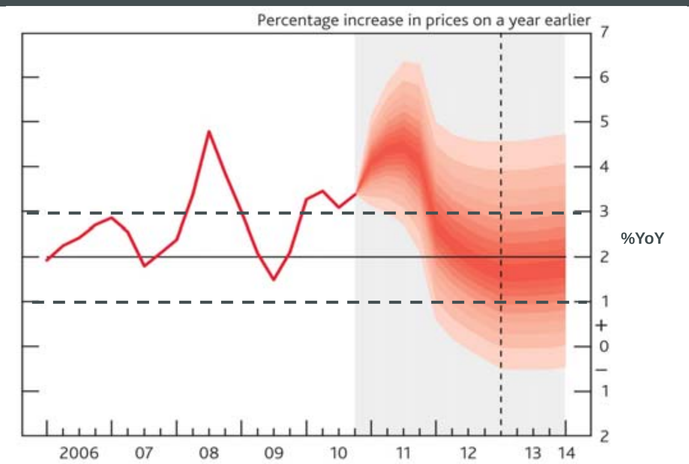
GDP projection, based on market interest rates and no addition to £200bn of QE



Source: Bank of England Quarterly Inflation Report, February 2011

How credible is the Bank of England: Inflation

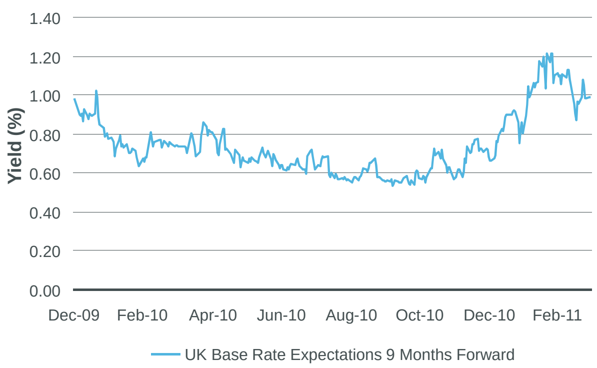
CPI Inflation projection, based on market interest rates and no addition to £200bn of QE



Source: Bank of England Quarterly Inflation Report, February 2011

Market Expectations of UK Official Rates (Base Rate)

UK Base Rate expectations – 9 months forward (rolling)



Current forward market expectation is that Base Rates will be approx 1% by Q4 2011

Source: BlackRock/Bloomberg as at 29 March 2011

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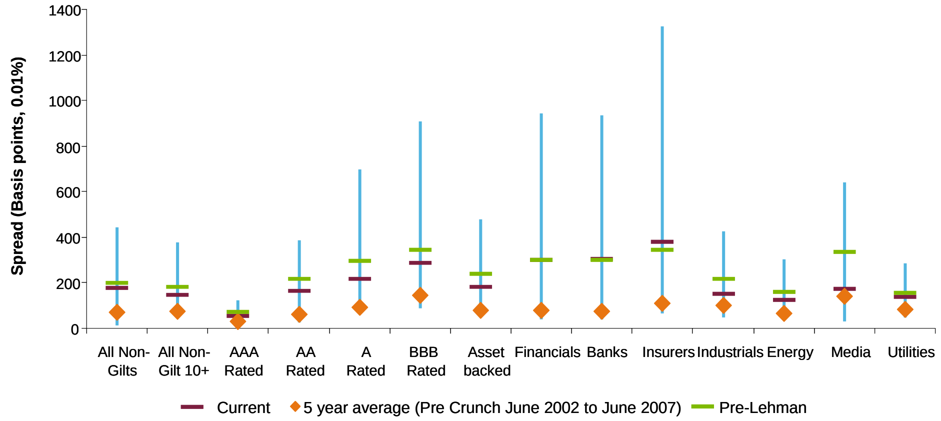
Corporate Debt – Still attractive?

Credit Sectors: expect return to 'normal' returns in 2011

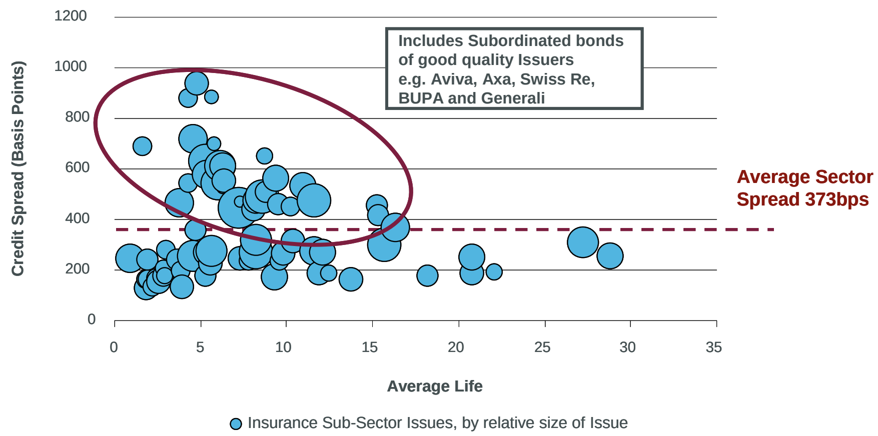
BofA Merrill Lynch Indices – Spread Range (Minimum/Maximum)
31 January 1997 – 28 February 2011 (UK)



Source: BlackRock/BofA Merrill Lynch As of 28 February 2011

Stock selection Opportunities not Beta will drive returns in 2011

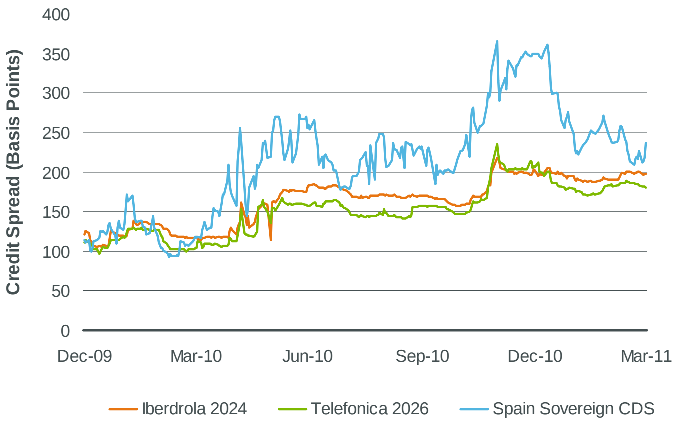
Insurance SubSector – Spread
28 February 2011 (UK)



Source: BlackRock/BofA Merrill Lynch/iBoxx As at 28 february 2011

Diversified Corporates are able to distinguish themselves from Sovereign Risk

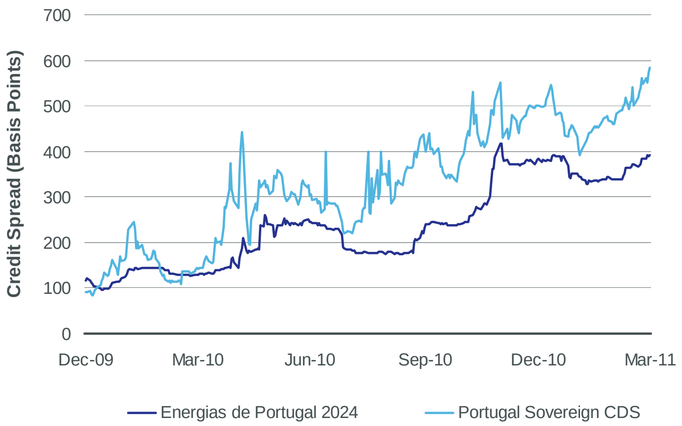
Sterling Bonds: Spanish Credit Spread vs Spanish Sovereign Credit Spread
31 December 2009 – 31 March 2011



Source: Bloomberg/BlackRock. As of 31 March 2011

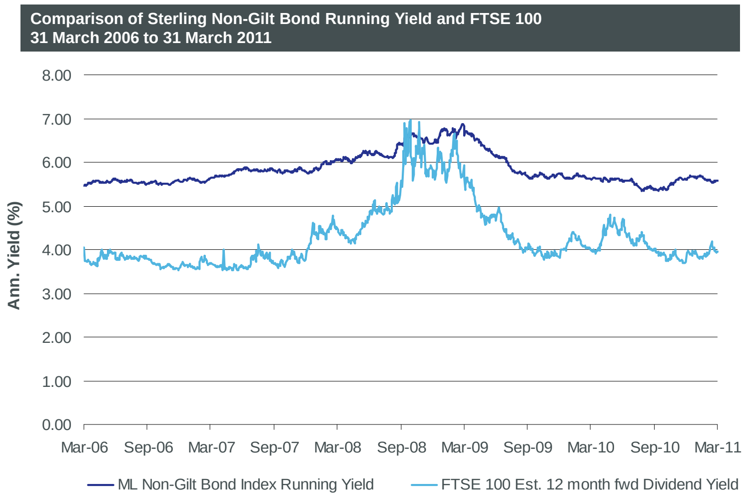
Less Diversified Corporates are becoming correlated with Sovereign Risk

Sterling Bonds: Portuguese Credit Spread vs Portugal Sovereign Credit Spread
31 December 2009 – 31 March 2011



Source: Bloomberg/BlackRock. As of 31 March 2011

Corporate Bonds remain attractive from a Yield perspective



Source: BlackRock/Bloomberg/BofA Merrill Lync/ FTSE. As of 31 March 2011

Post-Lehman, Regulation will shape Financial Sector bond markets

Possible Implications for Bond Holders of greater regulation:

Regulators will have more say in how bank debt is structured and the extent to which bondholders 'share the pain'

This will inevitably increase volatility of 'new' instruments; 'new' bank debt will likely be lower rated and have more equity-like risks

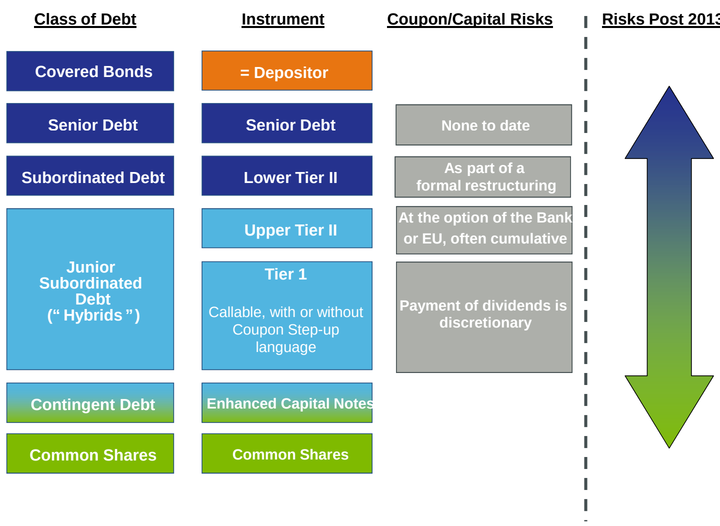
It will be harder for Banks, especially weaker less well capitalised Banks, to raise capital in the new regulatory environment

Banks may look to raise more capital from other sources e.g. rights issues, private placements

Proposed changes to Lower Tier 2 bonds will require non-callable bonds to be phased out gradually if they don't similarly meet loss absorption criteria

In the very long-run the changes in Regulation will be positive, strengthening Bank capitalisation; in the short run it could have significant stock specific impact

When is a bond not a bond; whenever the regulator says so!



Current EU proposals suggest that Senior Debt holders may be forced to take write-downs and/or equity conversions as well as subordinated debt holders

Basel III proposals will require banks to substantially increase capital by 2018, much of which will be convertible to equity in a worst-case

Source: BlackRock

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Summary of Risks and Opportunities in 2011

The major issues facing Bond markets today can be summarised as follows

Policy Risk – Governments/Central Banks

- Inflation/policy responses

Sovereign Risks – Debts and Deficits

Credit Stock Selection will become increasingly important

Regulatory Risks – The laws of unintended consequence

Bond Markets are difficult to navigate in good times….

…Today they are exceptionally challenging!

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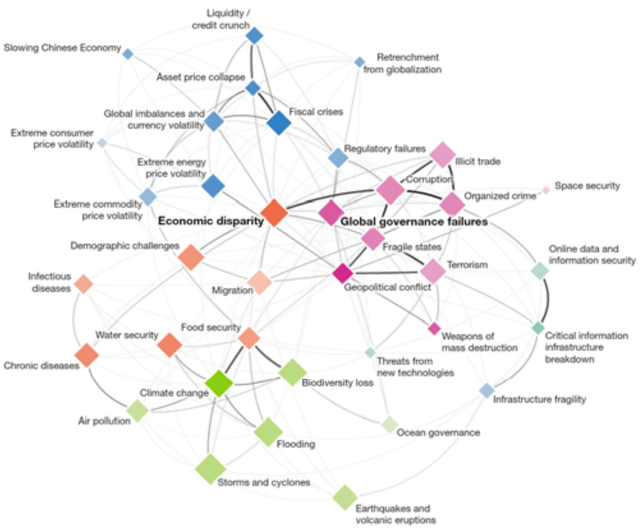
“There may be trouble ahead…”

Global Risks like Global Markets are interconnected



According to the World Economic Forum, Economic Disparity and Global Governance Failures are the hub of the Risks and Challenges facing the world in the next 10 years

Source: Reproduced by kind permission of the World Economic Forum, Global Risk 2011 6th Edition.

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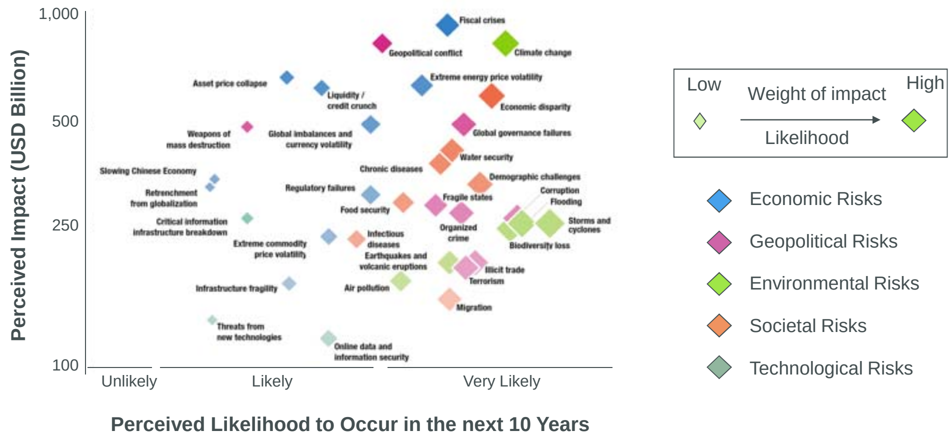
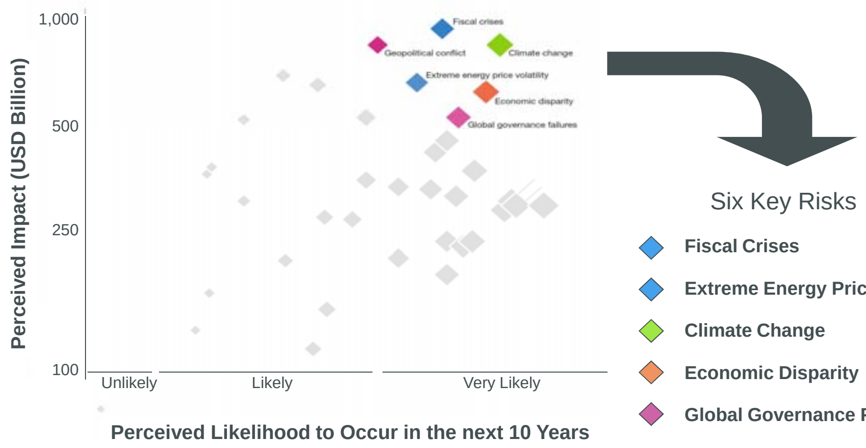
… What about the future? Global Risks Landscape to 2021



Source: Reproduced by kind permission of the World Economic Forum, Global Risk 2011 6th Edition.

The Road to 2021 will not only be Bumpy, but it could be Expensive



Six Key Risks

- **Fiscal Crises**
- **Extreme Energy Price Volatility**
- **Climate Change**
- **Economic Disparity**
- **Global Governance Failures**
- **Geopolitical Conflict**

Source: Reproduced by kind permission of the World Economic Forum, Global Risk 2011 6th Edition is presented as an interactive presentation at http://riskreport.weforum.org/#/data-explorer (NB takes about 1 min to load viewer)

A Final Thought…

"… you know where you are with equities…"

Consider…

Bond Price: Discounted value of known cashflows
Equity Price: Discounted value of unknown cashflows

…and if things go Bang…

Bond holders rank ahead of equity holders
(who only get paid if there is anything left!)
(…and there usually isn't)

"Simples!"

Questions or comments?

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