

# OPPORTUNITIES IN THE EUROZONE

*Short-term fixed-income strategies lead the way among promising investment opportunities as a result of a confluence of regulatory events and market trends.*

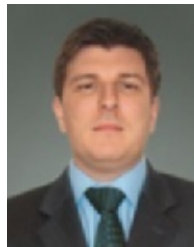
**T**hanks to healthy growth in the Eurozone economy, favorable trends with respect to interest rates, currency and regulatory matters — as well as an abundance of available cash — near-term prospects are very positive for the short end of the fixed-income market. Promising areas include regular money market funds as well as enhanced cash strategies, encompassing passive and active currency overlays in a niche that falls between AAA-rated money market funds and short-term bonds.

Institutional investors have a very good opportunity to achieve relatively high absolute returns within the low-risk segment of the European fixed-income market.

Before delving into specific investment opportunities and strategies, it helps to set the stage. To start, there are a few headwinds that could pose challenges to European fixed-income investors.

## Challenges: Rising Rates and a Strong Euro

Continental interest rates continue their ascent. They've been rising since December 2005, as the European Central Bank (ECB) has hiked its key interest rate seven times. This May, the rate stood at 3.75% with an additional 25-basis-point increase priced into the market ahead of the ECB's June meeting. On top of this, rates could well climb an additional 50 to 100 basis points before



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the ECB considers its mission accomplished. While this scenario is traditionally less than ideal for fixed-income products in general, it does tend to favor the short end of the yield curve.

Export-based economies could face challenges as the euro continues to strengthen. "The euro is strong and getting stronger against the U.S. dollar, as well as the yen and other Asian currencies," says David Blake, senior fixed-income portfolio manager at Northern Trust in London. "The impact of this growing euro strength could be to make Eurozone exports pricier. Additionally, with the trade-weighted euro and British pound at or near all-time highs, monetary conditions are getting tight, which could give central banks less reason to raise rates much further."

When Germany introduced a 3% increase in its value-added tax (VAT) in January, there was concern that it could potentially depress that country's impressive economic growth of the last few years.



### Strong Global Growth

Fortunately, these headwinds have thus far proved fairly minor and are easily outweighed by an abundance of encouraging news. Even the trend of ECB monetary tightening is widely seen as a positive, as the central bank has done an effective job of normalizing interest rates and restoring life and confidence to a lackluster economy.

As for Germany's growth, thus far there isn't much evidence that the Eurozone's largest exporter and its primary growth engine is feeling any particularly strong ill effects from the VAT increase. In fact, Germany continues to benefit from good economic momentum, as a strong global export market teams up with improving domestic consumer sentiment. In April 2007,

Germany's Ifo Business Climate Index posted its second-highest reading since the country's reunification. Growth continues to be fairly strong and consistent in France as well, where annual real GDP growth has averaged a shade under 2% in the past three years and unemployment is declining. In addition, the election of a pro-growth, right-leaning president may improve prospects for structural reform.

Even as the U.S. economy is noticeably slowing — with a first-quarter initial GDP reading of 0.6% in annualized growth — the Eurozone won't necessarily be affected to a great extent because it is becoming less and less dependent on the United States as an export market. "The U.S. makes up only around one quarter of global economic growth today," Blake says.

In contrast, 20 years ago, it represented near half of the world's growth.

"Germany has developed significant export relationships with the so-called 'BRIC' countries — Brazil, Russia, India and China — in addition to the U.S.," notes Wayne Bowers, director of global fixed income at Northern Trust in London. As a result of these trends, the cross-currency focus should increasingly be on the euro-yen rate, rather than the euro's strength versus the U.S. dollar, particularly with unrelenting double-digit economic growth in India and China.

There are even positive indications coming from Japan, which serves as a proxy for Asia because the yen is the major free-floating currency in the region. "We see Japan becoming increasingly sure-footed as long as its economy is allowed to evolve without too much government protectionism or anything too restrictive from its central bank," Blake says.



"The use of a currency overlay can create an additional layer of potential return without significantly adding risk."

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### Short-Duration Strategies

Given the continued trend toward higher interest rates throughout the Eurozone, the most attractive risk/return characteristics among fixed-income investment strategies have existed — and should continue to exist — on the short end of the yield curve.

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In addition, the less restricted cross-border flow of labor within Europe is bound to improve the Eurozone economy's efficiencies. However, the ongoing growth of the Eurozone — as it brings in new, economically weaker members — may dilute the region's economic strength as resources migrate across the zone.

### Growing Demand

Feeding the natural forces of market demand are very favorable regulatory developments. First, there are the Basel II rules on capital adequacy requirements, which now put AAA-rated money market funds on equal footing with banks, making them more attractive to conservative institutional investors.

Furthermore, when enacted this November, measures included in the EU's Markets in Financial Instruments Directive (MiFID) will further level the playing field between money market funds and bank accounts and help make money market funds relatively more attractive from a capital adequacy viewpoint.

Accompanying these key economic factors is a powerful new phenomenon — healthy corporate balance sheets. "Unprecedented amounts of cash are in need of the right home — somewhere with an attractive rate of return along with good security," adds Bowers.

"As an asset class," Blake says, "cash has performed very well in the past few years in the face of higher interest rates when compared with more traditional longer-duration fixed-income mandates." And, that is to be expected when interest rates rise by more than 200 basis points in just over two years.

"We have seen positive and increasing returns in three distinct areas. In addition to the safest short-term money market funds, enhanced cash strategies and short-term bonds have done well," Blake adds. An investor's selection from among the three choices would depend in part on that entity's comfort level with risk and need for additional absolute return.

### Enhanced Cash

Enhanced cash refers to a middle ground between standard money market funds and short-term bond funds in terms of duration and overall risk level. An advantage to enhanced cash is that it is an actively managed strategy by design that seeks to generate higher total returns.

"Money market funds tend to operate with a maximum duration of three months," Bowers notes. "Short-duration bond funds might fill a niche of 18-month to two-year duration. Enhanced cash products have an average duration of six months to a year. Bond quality tends to be in the A or AA range."

An enhanced cash fund could invest in a mix of common money market instruments, short-term government bonds and high-quality, short-term corporate and multinational issues.

“As with any fixed-income strategy, an enhanced cash portfolio would take interest-rate risk, credit risk and liquidity risk. There would be higher levels of risk in each category than in a money fund, but less than in a traditional core bond portfolio,” explains Blake.

Enhanced cash can also help support liability driven investing (LDI) strategies, as an investor seeks to immunize

the LDI strategy through a swap portfolio that transforms longer-term liabilities into three- or six-month money market liabilities.

**Currency Overlays**

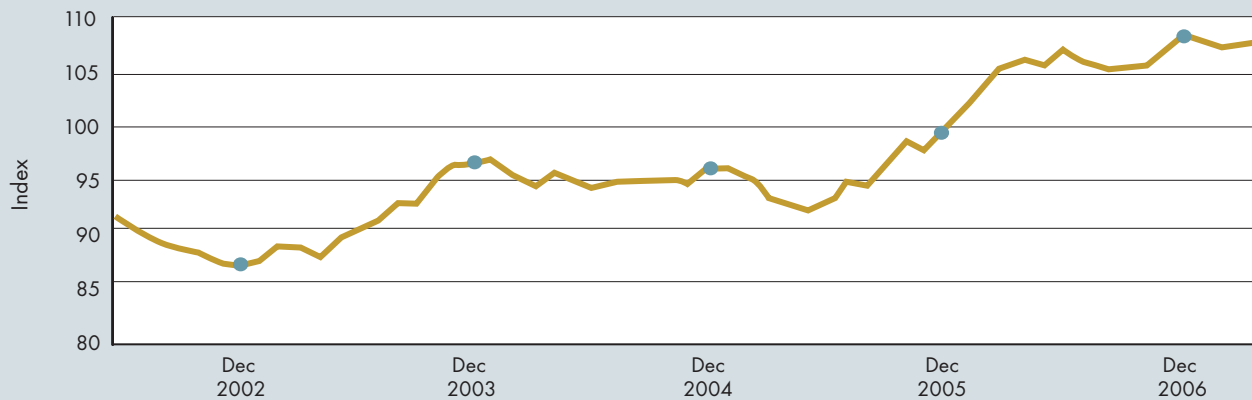
To further capitalize on Eurozone opportunities, Bowers notes that an additional level of diversification and/or potential alpha generation can be achieved by utilizing various currency strategies.

“We know that enhanced cash strategies can boost investment performance versus the relatively weak returns

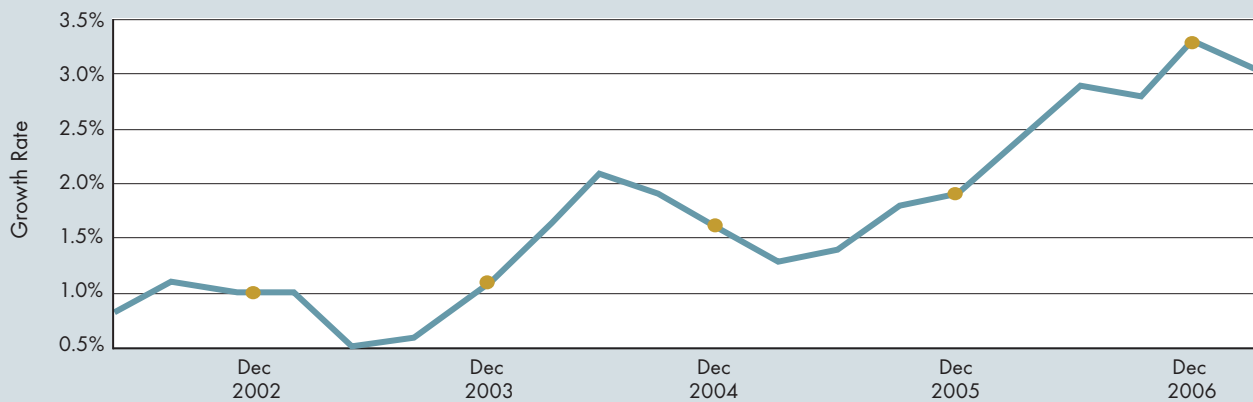
## Economic Indicators Support Trend

A side-by-side comparison of the Ifo Business Climate Index and the annualized quarterly Eurozone GDP, beginning in January 2002, clearly illustrates continued strong performance in the region. The steady upward trend for each figure follows the myriad regulatory matters and market trends that have occurred during this time period.

**IFO BUSINESS CLIMATE INDEX<sup>1</sup>**



**ANNUALIZED QUARTERLY EUROZONE GDP**



<sup>1</sup>The Ifo Business Climate Index tracks the results of a monthly survey among German companies on current and expected business performance. A rating of 100 serves as a centerline between positive and negative outlooks.

Source: Bloomberg



offered by bank accounts or traditional money market funds,” he explains. “The use of a currency overlay can create an additional layer of potential return without significantly adding risk. Currency overlays can be applied through active or passive strategies.”

In a passive currency overlay, an investor might seek higher returns in offshore cash, but desire to fully hedge any currency risk. Through a currency swap, the investor could remove any exposure to foreign currencies. This would limit risk to the investment risk of the offshore cash strategy itself without any currency risk. In a partial hedge, an investor might seek to lessen, but not fully remove, any exposure to other currencies. This could also be achieved through similar methods, but by limiting the extent of their application.

Of course, not all investors are averse to currency risk. “Some might choose not to hedge,” Blake says. “They could pursue another strategy — to treat currency as an asset class and use a currency overlay alpha-generation product. In its most basic form, an investor would invest in a money market or enhanced cash fixed-income product and then allocate a notional exposure — up to 100% for a nonleveraged strategy — to a currency-trading book. The investment manager would then take positions in selected currency markets via forward contracts margined using the cash allocation.”

### Risk Appropriate

The strategic possibilities are vast as derivative instruments and interest in alpha separation continue to grow. However, a couple of factors that continue to make the short end of the yield curve attractive are the ongoing trend toward higher interest rates in Europe and the appropriateness of short-term products with regard to risk tolerance.

Blake notes that the key benefits of money market and enhanced cash strategies — principal preservation, liquidity and maximization of current income — are particularly attractive for investors looking to move away from bank balance sheet type products. These investors have little need or desire to climb very high along the risk/reward spectrum.

In addition, cash products also form part of the solution for a variety of diverse client needs. For example, for cash that backs a currency overlay or an LDI swap portfolio, it may not be appropriate to increase investment risk through a longer-duration or high-yield bond investment especially if absolute money market type returns are required. Instead the cash component either funds the overlay strategy or complements the alpha component.

“We continue to see a really good match for cash from a variety of sources and strategies in the front end of the market,” Blake says. ❖