2pm PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly marketsreview

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"A political problem is an economic problem without a solution."

This statement by Georges Elgozy, a French economist (1909 – 1989), describes the problems faced by a large number of European countries perfectly. The first quarter of 2013 has indeed clearly seen political risks in Europe resurface: the legislative elections in Italy did not yield a majority, so that a new government could not be formed, which has given rise to a period of uncertainty for the country. The French government's popularity is reaching record lows in the face of scandals, rising unemployment, factory closures, company relocations and the rising pauperisation of the population. The manner in which the Cypriot crisis was handled has shown a certain level of amateurism within the European technocracy. Fortunately, after a few initial mistakes, Cyprus obtained a EUR 10bn international bailout. In exchange, Cyprus will have to drastically restructure its banking system. This will cause the big deposit-holders of the country's two biggest banks, Laïki and Bank of Cyprus, to lose a large part of their assets. Accounts above EUR 100,000 have been frozen at both banks. Laïki will be liquidated and large accounts will suffer a haircut that could reach 60%. This type of bailout sets a precedent and has created doubts in the minds of savers about the security of their deposits.

WORLD MARKETS ON 31/03/2013

WORLD INDEXES	Perf Q1*	Volatility
STOXX600	5,04%	24,91
S&P 500	13,24%	21,54
NIKKEY 225	12,39%	20,08
BEL20	4,70%	26,20
AEX	1,57%	27,69
MXEF Emerging Markets	0,97%	25,46
HFRI (Alternative)	3,01%	5,36
BONDS EUR (EFFAS 1y-10y)	1,29%	3,29
COMMODITIES	Perf Q1*	Volatility
GOLD	-1,76%	18,52
BRENT	8,99%	40,60
MONETARY		Spot
EURIBOR 1 month		0,01%
CURRENCIES		Spot
EUR/USD		1,2819
EUR/GBP		0,844
EUR/CHF		1,217

*All performances are expressed in EUR

This is the last thing that Europe needed as the recession drags on. According to the most recent European Community previsions, Eurozone GDP should contract by -0.3% in 2013, which could push the ECB to once again cut its interest rates. Despite this bleak picture, all is not bad, and some investors believe that this could be a year of transition for Europe during which the trough in terms of economic activity could be reached. Structural reforms implemented by periphery countries are starting to bear results as improvements are being noted in competitiveness, exports and current account balances, all of which will make these countries less dependent on external financing. At the same time though, improvements in public finances will need to be complemented by economic growth in order for unemployment in the worst affected countries to fall. Europe could even have to contend with social unrest, not just with political problems, if the situation continues to deteriorate. It will therefore be important to be cautious about countries like Spain, where macroeconomic indicators continue to worsen and unemployment has now risen above 25%. There are, however, a number of factors that stop us from being too pessimistic: the ECB's actions have sharply reduced the risks of an implosion of the Eurozone and the main macroeconomic surveys (INSEE, IFO) have confirmed that the prospects for economic activity are improving slowly but surely.

In addition, news flows from the U.S. have been rather positive. Mr Bernanke defended his asset purchasing policy in front of the Senate Banking Committee, explaining that the advantages of this policy far outweighed its disadvantages. This reassured investors about the durability of the accommodative monetary policy, especially after the Fed minutes had been published on 20 February. It is crucial that interest rates remain low for the time being in the U.S. because it enables household refinancing at a time when the housing market is recovering after several years of crisis. Residential investment has started growing again and should provide a powerful support for economic growth. Similarly, jobs in the private sector have started to rise again while consumer spending is growing. It will be important to keep an eye on the effects of the budget spending cuts that came into effect on 1 March. These could have a negative influence on employment and economic growth and could impact GDP growth by up to -0.5%.

Positive news also emanated from Japan, where an end to the period of deflation appears to be in sight. Mr Abe's government has overseen a rise in credit and mergers and acquisitions, while the BoJ, under the leadership of its new Governor Mr Kuroda, has now set a 2-year inflation target of 2%. Like the U.S., emerging markets will be an important contributor to global economic growth in 2013. Advanced indicators point to a rebound in economic activity in BRIC countries. China, in particular, has published some very solid macroeconomic data, especially in the steel and construction sectors. PMI Manufacturing and Services statistics currently indicate a 2013 economic growth rate of 7% to 8% with a manageable inflation rate of about 2%.

In this contrasted environment, characterised by the opposition between Europe, with its gloomy growth prospects, and the U.S. and emerging markets, where the recovery is well underway, 2PM remains very cautious. Considering equity markets have already priced in a lot of good news, as illustrated by the S&P 500 that is testing its 2007 highs, caution is all the more important. Diversification, selectivity and the permanent search for quality remain our main guidelines. This applies to fund selection as well as fixed income investments, where we favour short maturities and remain invested in high yield and emerging market sovereign and corporate debt.

Macro economy

USA

- GDP growth should be robust and in line with our predictions, between 2.20% and 2.60%.
- The domestic recovery, which is mainly being supported by the housing market, now appears more solid and durable. This comforts our positive opinion about GDP growth.
- Capital expenditure figures have rebounded strongly. This is directly linked to the structural reforms that are currently taking place in the U.S., such as the repatriation of many major industries and the energy revolution.
- The fiscal cliff problem was resolved in an intelligent manner by the authorities: the negative effects that the budget cuts are going to have on economic growth in the short-term are being managed calmly and progressively.
- The ultra-accommodative monetary policy has been maintained in 2013 as the Fed continues its asset-purchasing programs.
- Inflation remains under control and should not pose any threats in 2013.

EUROPE

- The Cypriot crisis has been prejudicial for the credibility of the European Union and has opened the door to further uncertainty. Confidence in the Euro could once again be challenged, which could cause volatility spikes.
- Europe remains trapped in a vicious circle where austerity measures are being implemented in an environment of low growth, which leads to lower public spending and lower economic growth, which in turn pushes the debt/GDP ratio higher and necessitates further austerity measures.
- The second and third quarters of 2013 will certainly be the worst months in terms of the growth slowdown, and could mark the trough of the cycle. It is, however, too early to say whether the turnaround will be purely cyclical or more structural.
- Inflation is not a problem in the short-term, but reflating the economy will be difficult for Mr Draghi.

EMERGING MARKETS

- Both growth and inflation expectations in emerging markets have fallen gradually in 2012. In 2013, however, growth in these countries should rise above European and American levels and budgetary situations should remain healthier.
- Signs of stabilisation are appearing in important markets such as China or Brazil. Inflation has either stabilised, or is continuing to fall, which leaves room for further accommodative monetary policy. Indeed, inflation has fallen from 6% to 2% in China and from 7% to 5% in Brazil, year-on-year.
- Economic growth is being increasingly influenced by domestic demand rather than exports and should come in around 4% to 5% globally, or even 6% in India or 7% to 8% in China. China has been benefitting from very favourable macroeconomic data over the last few weeks, after a difficult month of February that weighed on investor sentiment.
- Foreign exchange reserves remain globally important and debt levels are low.
- Public deficits are lower than in OECD countries, apart from in India.

JAPAN

- The new Prime Minister, Mr Abe, has an important enough majority to effectively have a free hand to run the country.
- One of his close allies, Mr Kuroda, was named Governor of the BoJ. He shares the same objective of reflating the economy.
- Since November, and similarly to the U.S., Europe or china, Japanese markets have changed from being driven by worrying economic fundamentals to being driven by political decisions such as the doubling of debt-purchasing targets by the BoJ and the 2-year, 2% inflation target. The JPY has depreciated strongly as a result, while the Nikkei index has risen sharply.
- Mr Abe has understood that a country with a debt/GDP ratio of 240% and a public deficit of 7% of GDP is unmanageable. The only remaining solution is monetary leveraging.
- The weakening of the JPY since October has already benefitted exports and could do so even more if economic momentum in the U.S. and emerging markets picks up.
- Mr Abe is faced with a major challenge: that of consumption that has been anaemic for years due to the lack of household confidence. This time though, he has the support of the population and of corporations.

Equities

Global stock markets resisted surprisingly well to the return of tensions in the Eurozone. European equities only fell very slightly following the Italian elections, which have pushed the country back into uncertainty, and the Cypriot crisis. This can undoubtedly be viewed as proof of investors' confidence in the ECB following Mario Draghi's commitment to preserving the Eurozone and the implementation of stability mechanisms. This also shows that European companies are globally doing well despite the struggles of many member states that are forced to implement austerity measures in order to reduce their debt loads. Indeed, despite poor economic growth figures, particularly in Southern Europe, and despite a very high unemployment rate that threatens to cause social unrest, European equity indices have performed strongly since the start of the year. The Stoxx600 index has risen by +5.04% during the first quarter. In terms of historical P/Es, European stocks remain cheap, especially compared to their U.S. counterparts. Elsewhere, while Europe remains at a standstill, the U.S. has continued its recovery and the situation in emerging markets is improving progressively, particularly in China. This has created opportunities and revenues for a large number of European companies that have a majority of their activity outside the Eurozone. Disparities between sectors remain high however: in recent months, the financial and pharmaceutical sectors have outperformed heavier sectors such as utilities, telecommunications or basic resources. This might not last though, and we are cautious about the financial sector following the reappearance of political risks in Europe in recent weeks. Conversely, some good quality telecommunication companies could witness a rally, particularly in France where 4G margins are being redistributed, while mining stocks, which have sold off heavily for many months, appear ready to rebound.

As far as American companies are concerned, they are not faced with the problem of a depressed domestic market. The housing market is recovering and many leading indicators are positively oriented, such as ISM, industrial production and durable goods orders. U.S. stock markets have reflected this: the Dow Jones Industrial Average reached new historic highs on 5 March and the S&P 500, which is up +10.03% year-to-date, is approaching levels last seen in 2007. In the medium to long-term, we believe that U.S. equities should continue to outperform European equities thanks to the better fundamentals of the U.S. economy, especially compared to the long-lasting anaemic growth prospects of the Eurozone. Conversely, U.S. stocks appear a little more overbought in the short-term than their European counterparts from a technical perspective following the formidable recent rally. A round of profit taking cannot be excluded, especially in the context of rising tensions with North Korea.

2013 has so far been more complicated for emerging markets due to capital outflows and high correlation between emerging market companies and global growth. This is because of the cyclical and exporting nature of emerging market companies. The economic slowdown in Europe has penalised some emerging market companies. However, the U.S. recovery and the better macroeconomic perspectives in China lead us to remain optimistic about developing economies. In addition, valuations in emerging markets are reasonable and even cheap in countries such as India, Taiwan or China. The BRICS countries are continuing to structure themselves as an independent economic area and are aiming to create a development bank common to all five countries, with funds of USD 50bn. The objective of this development bank would be to finance new infrastructure projects without needing to call on the IMF or the World Bank.

In summary, we remain cautiously optimistic about equity markets in the medium to long-term. This optimism is based on three fundamental pillars: reasonable valuations from an intrinsic point of view, and compared to bonds, economic growth in the U.S. and BRICS countries and abundant liquidity. We maintain our bias towards emerging markets, which should pay off in the long-term. In the shorter-term, we are a little bit more cautious following the rally that we have witnessed during the second half of last year and the first quarter of this year. A large number of equity indices currently appear overbought from a technical perspective, and there are many reasons to be cautious: North Korea, Iran, the possibility of new elections in Italy, the seriousness of the situation in Spain, the lack of confidence of French citizens towards their leaders, the upcoming elections in Germany, etc.

Special Topic

THE NEED FOR FIXED REVENUES IN AN ENVIRONMENT OF NEGATIVE REAL RATES.

Investors could expect a risk-free rate of return of 4% to 5% barely five years ago by investing in U.S. Treasuries or German Bunds. In recent decades, investors could also assume that practically all asset types would provide positive returns over the duration of an economic cycle. In such a context, a basic process of diversification was logical. Out of USD 208trn invested in financial assets worldwide, USD 52trn are invested in equities, USD 45trn in government debt, USD 65trn in credit, of which real estate financing, and USD 45trn are invested in corporate debt. This means that about one quarter of global financial assets are invested in equities while three quarters are invested in debt, in the lower part of the risk spectrum.

Since 2008 however, most central banks of developed economies have implemented monetary policies that ensure real rates will remain negative for an indefinite period. The aim is to push investors away from high quality investments towards riskier assets. This, in theory, would accelerate wealth creation, create jobs and push western economies towards a more solid growth environment. The current risk matrix is therefore very different. Indeed, 75% of global assets are now locking in negative real rates even though inflation levels have fallen and a number of countries are facing deflationary risks. For example, a 2-year Treasury Bill yielding 0.25% is locking a -1.5% real capital loss for the next two years at current inflation levels of 1.7%. The same applies to Germany, the U.K. and France.

Assuming a Japanese-style deflationary scenario is avoided, equities would need to generate a real return of 4.5% each year to compensate for the capital destruction taking place in fixed income markets and leave global assets at the same level. This return of 4.5% is in line with long-term equity market returns. But it would not leave investors any richer, meaning that investors could face five years without capital growth, starting from 2009. Since the previous five years had seen no asset growth either, investors are facing a whole decade without capital accumulation.

In order to achieve equivalent returns to the risk-free rates of five or ten years ago, investors will now have to accept a much higher level of risk.

Given the world's ageing population and the fact that most pension funds are already underwater, this policy that locks in real losses for plan managers risks being problematic. Won't the world's pension funds that are sitting on real losses because of their existing large fixed income holdings prove ever more reticent to move further up the risk spectrum, in the same way as a pensioner who has a fixed amount of capital will buy ever more bonds to sustain his needs as interest rates are pushed down? In such a scenario, could negative interest rate policies, by destroying capital, guarantee the world a period of sub-par investment growth? That is what happened in Japan: zero-interest rates meant banks could not make much money, nor were they interested in taking more risks or issuing more loans. Without bank credit, the economy simply stuttered along and equity markets continuously de-rated. An illustration of this is taking place in the bond market right now, despite record-low yields: new bond issues are attracting record subscription levels in Europe, the U.S. and Asia as investors still appear traumatised by the risks inherent to equity markets and blind to the risks of the bond market following strong recent performances.

While logic and fundamentals should push investors to sell bonds and buy equities, which are reasonably priced in general, markets currently appear hesitant. Indeed, markets seem to remember that the short bond/long equity call is not a guaranteed winner, as was the case during Japan's decade of deflation. The big question for the coming quarters is how far up the risk scale will investors go in order to generate enough revenue for their needs? Will they stop at high yield and emerging market bonds or will they move higher up the risk spectrum towards equities?

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