2pm PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly marketsreview

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July 2013

« Sell in May and go away"

This old stock market adage once again proved to be true, even though the month had started brightly for global equity markets, which were supported by the abundant liquidity provided by central banks. Indeed, the Stoxx 600 index rose by +4.67% between 30 April and 21 May. Unfortunately, on 22 May, Mr Bernanke's ambiguous testimony before the U.S. Congress led investors to believe that the end of QE3 was approaching. The minutes of the 30 April FOMC meeting were then published, showing that several participants wanted to scale down the asset purchasing program as early as June if macroeconomic figures pointed to sufficiently strong and autonomous economic growth. This marked the beginning of a global selloff that affected all asset classes with unusual violence. Indeed, the Stoxx 600 index has lost -11.25% since 22 May, while the MSCI Emerging Markets index, which had already struggled since the start of the year, lost another -15.72%. Long-term European and U.S. interest rates, which had already started to rise following the publication of encouraging macroeconomic figures, rose sharply at the beginning of June. The ten-year U.S. Treasury yield is now at 2.60%, some 100 basis points higher than at the start of May. Similarly, the ten-year German Bund yield has risen from 1.15% to 1.80% over the past two months. These losses spread to corporate bonds, with the Iboxx index losing -3.08% since 22 May, as well as high yield bonds and local currency emerging market debt. Indeed, most asset classes suffered a sharp correction, even traditional safe havens such as gold and the USD, which would have been expected to rise in such an environment of increasing nervousness and risk aversion, as is reflected by the spike in the VIX index.

WORLD MARKETS ON 28/6/2013

WORLD INDEXES	Perf Q2*	Perf YTD*	Volatility
STOXX600	-2,98%	1,91%	24,77
S&P 500	0,92%	14,29%	21,15
NIKKEY 225	3,15%	15,93%	20,53
BEL20	-2,55%	2,03%	25,79
AEX	-1,01%	0,55%	27,48
MXEF Emerging Markets	-10,44%	-9,57%	25,53
HFRI (Alternative)	-0,09%	2,92%	5,37
BONDS EUR (EFFAS 1y-10y)	0,03%	0,38%	3,28
COMMODITIES	**Perf Q2***	**Perf YTD***	**Volatility**
GOLD	-23,88%	-25,22%	19,31
BRENT	-2,09%	6,71%	40,16
MONETARY			**Rate**
EURIBOR 1 month			0,11%
CURRENCIES			**Spot**
EUR/USD			1,3010
EUR/GBP			0,8552
EUR/CHF			1,2292

*All performances are expressed in EUR

Since 22 February, the Federal Reserve has clarified its rhetoric, but markets have yet to respond positively, even though the situation is not fundamentally bad: the central bank has revised its 2014 growth forecasts to the upside and should start to taper its asset purchases by the end of 2013. According to Mr Bernanke, these asset purchases will end when the unemployment rate falls to around 7% and growth will be sufficient to create new jobs. This is forecast to take place by mid-2014, which should help to reduce uncertainty in financial markets.

At the portfolio level, we believe that the recent fixed income market correction was mostly driven by financial flows and risk aversion, not by company fundamentals, which remain robust. This correction could constitute an interesting entry point for corporate bond investors. Indeed, corporate cash levels and interest coverage ratios are still above long-term historical averages, default rates remain low and profits per share should continue their positive trend. We will therefore aim to continue to have a well-diversified portfolio of bond issuers while concentrating on healthy companies and controlling the duration of the portfolio.

On the equity side, the recent correction should constitute an interesting entry point for long-term investors. However, equity markets remain volatile. Emerging markets have suffered, particularly China, which is a cause for concern. The Chinese central bank's lack of reaction to the major tensions that have rocked the interbank credit market have confirmed that the authorities wish to put a swift end to the excessive credit growth, even if this risks hampering economic growth in the short-term. Valuations remain reasonable, both in absolute terms and relative to bonds. In addition, economic growth forecasts should improve in the U.S. and in Europe in 2014. We therefore maintain our scenario of sub-par global growth with very few risks of inflation in the short-term. We remain very cautious about the deflationary forces in financial markets, particularly in Europe.

Macro economy

USA

- GDP growth continued its moderately positive trend during the second quarter. We remain convinced that the U.S. economy could reach a growth rate of 2.5% to 3% in 2013.
- The upturn in employment is being confirmed but at a weaker pace than in previous economic cycles. The unemployment rate should fall towards 7% in coming quarters, which is still above the Federal Reserve's 6% to 6.5% target.
- Consumer confidence is also improving rapidly, but remains at low levels for this stage of the economic cycle.
- Following its rise during the second half of last year, the ISM Manufacturing PMI index has weakened since February. The last reading was below 50, which signifies a contraction that is unusual at this stage of the economic cycle.
- The contraction in public spending should end during the second half of 2013.
- The Federal Reserve announced that it would shortly start reducing its monetary stimulus measures by tapering the size and frequency of its asset-purchasing program if, and only if, the U.S. economy continues to show signs of robust growth. We believe that the central bank will act carefully and will not take the risk of pushing the U.S. back into recession by acting too fast. We do not believe that interest rates will be raised for the time being, especially not as long as the unemployment rate remains above 6.5%.
- We consider the recent correction in the U.S. fixed income market to be a normalisation rather than a complete change in trend. Even if ten-year yields were to rise from current levels of 2.6% to 3.0%, it should not generate any significant problems for the real economy or for equity markets.
- Inflationary pressures have continued to soften despite a higher monetary mass and better growth figures. We do not believe that there are any significant inflation risks at present.

EUROPE

- The economic situation has continued to deteriorate during the second quarter, albeit at a slower rate than in the first quarter. GDP growth for 2013 should be negative. Certain indicators are starting to give investors hope, but we do not believe that a durable recovery can take place as long as the EUR remains at current levels.
- Unemployment remains at very high levels and industrial production is anaemic, in line with the recent slowdown seen in emerging markets.
- The ECB cut its leading interest rate to 0.5%, but this did little to boost consumer confidence or stimulate personal consumption. We doubt that the ECB can be more aggressive in terms of liquidity injections before the German elections in September and do not anticipate any further interest rate cuts.
- Our main worry is the lack of money velocity in Europe. Credit activity is still abnormally low, which is not good for personal consumption.
- Inflation is falling from month to month. Europe finds itself in a deflationary environment rather than in an inflationary situation.
- The EUR rose following the recent Federal Reserve statements, which is unusual. We believe that this movement was a short-term reaction and that the EUR should weaken progressively against the USD. An exchange rate of 1.20 would be much more appropriate given the underlying fundamentals.

EMERGING MARKETS

- Economic growth should remain solid at around 4% in emerging economies, where the focus is increasingly shifting from exports to domestic demand.
- According to the IMF, emerging economies now represent 50% of the world economy and generate 80% of global economic growth.
- Barring a few exceptions, inflation in emerging markets is generally falling despite robust economic growth rates, even if these have been softening in recent months.
- Recent credit tightening measures in China spooked investors, of which many started to fear a hard landing scenario later this year. We do not hold such fears and believe that these measures are healthy and should support economic growth in the long-term. In the short-term however, these measures could weigh on the economy.
- The recent selloff in China and emerging markets also caused emerging market local currencies to depreciate. This does not affect our positive long-term view on emerging currencies.
- Healthier public finances and trade surpluses in a large number of emerging economies are supportive of a more balanced growth environment than in developed economies. This is currently being ignored by stock markets due to the outflows that followed fears of the consequences of the tapering and potential end of QE3.

Equities

For the past few months, equity markets have appeared to be completely disconnected from macroeconomic fundamentals. The Stoxx 600 index, for example, rose by +11.05% between the start of the year and 22 May, while Europe was falling deeper into recession with first quarter GDP growth of -0.2%, the sixth consecutive quarter of economic contraction. All this took place in a rather deflationary environment, as illustrated by the evolution of the inflation rate in Europe: +1.8% in February, +1.7% in March and +1.2% in April. The core inflation rate, where more volatile elements such as food and energy are excluded, has even dropped below +1.0%. Paradoxically, since 22 May, the Stoxx 600 index has lost -11.25% while news flows had been improving. Indeed, Germany published some encouraging figures as the IFO and ZEW surveys were slightly higher and industrial production rose. According to optimistic analysts, Europe could even reach an inflection point in the near future and return to weak positive growth in 2014 in an environment of accommodative monetary conditions. Following the interest rate cut in June and discussions about negative deposit rates and unconventional corporate financing measures, ECB President Mr Draghi recently stated that the central bank remained extremely vigilant about recent market volatility and would, if necessary, intervene through its OMT asset purchasing program. The ECB rhetoric comes as a stark contrast to the Federal Reserve's recent comments, which partly explains the correction of the past few weeks: investors overreacted to anticipations of the end of QE3 in 2014 as they feared that closing the liquidity tap in the U.S. would remove an important support for equity markets. Paradoxically, equity market losses in the U.S. have been far smaller than in Europe in recent weeks.

Another paradox is the incredible underperformance of emerging market equity markets since the beginning of the year. It is not surprising that countries such as Brazil have had disappointing stock market returns, since its growth rate has slowed to +0.6% and inflation remains above 6%. The violent corrections in Asian and Chinese stock markets appear to be exaggerated however. Even though the Chinese growth rate has been slowing and is now closer to 6% than 10%, as it was still a few years ago, inflation is under control and forecasts for next year are encouraging, despite the fears surrounding the credit tightening measures that have been implemented by the authorities. Since the beginning of the year, the Chinese stock market, which is supposed to be the reflection of a country with 4% real growth, has lost over -20%. Conversely, the Stoxx 600 index, which is supposed to reflect an over-indebted area where unemployment is rife, austerity measures are penal and the end of the recession is still a long way away, has lost only -1.12% so far this year.

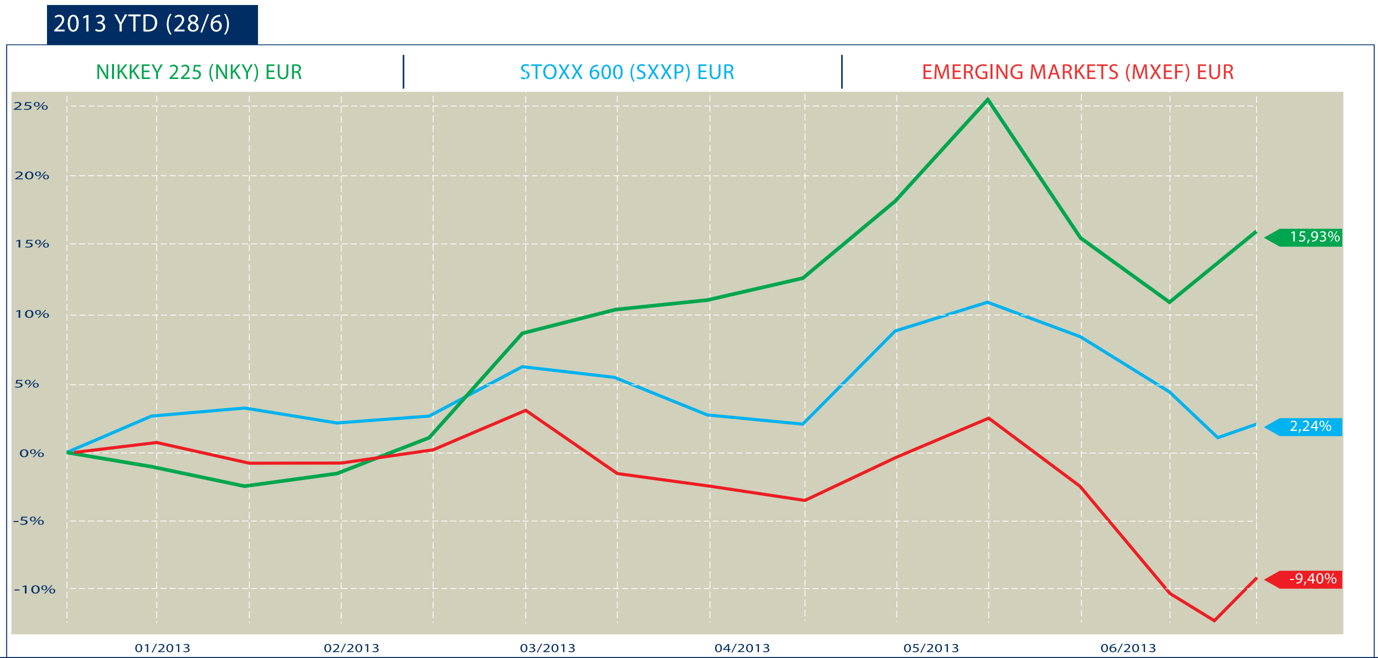
Firstly, despite far better fundamentals, emerging market stock markets can still accumulate very large underperformances compared to developed markets over short periods of time. Indeed, since the start of the year, the spread in performance between the MSCI Emerging Markets index and the Stoxx 600 index is 15%, and it rises to 26% when compared to the S&P 500. Secondly, emerging markets remain heavily impacted by capital outflows. As soon as fear rises among investors, they can suffer massive losses despite fundamentals being solid, as witnessed during the second half of 2011. Fortunately, emerging market indices also rise much more sharply than their developed market counterparts in periods of higher investor confidence. In conclusion, even though emerging markets now represent nearly 50% of the world economy and despite the fact that their forecast macroeconomic fundamentals for the coming years are better than those of developed markets, especially Europe, it will probably be necessary to reduce our relative allocation to emerging market equities in order to reduce the volatility of our clients' portfolios.

SPECIAL TOPIC

The Bank of Japan's perilous task.

At the beginning of April, the Bank of Japan announced an ambitious program of monetary easing with a clear objective: removing the country from its deflationary cycle and targeting an inflation rate of 2%. In order to achieve these objectives, Mr Kuroda, the new Governor of the Bank of Japan, aims to double the monetary base over the next two years. The central bank will buy government debt and other assets to the tune of about EUR 55bn per month. The scale of this strategy has surprised investors. The Bank of Japan clearly intends to do in just a few months what the Federal Reserve has been doing for the past five years. This strategy has been rendered even more complex by the fact that Japan's new economic policy has already created imbalances in global financial flows. Indeed, Japanese institutions, which own most of Japan's debt, have registered losses due to the rise in Japanese ten-year interest rates from 0.5% to 1.0%. In order to compensate for these losses, they subsequently sold off their foreign assets, contributing to the widespread losses for global equities and bonds in recent weeks. Long-term Japanese interest rates should logically converge towards the inflation target of 2%. Should this be the case, these same institutions that recently sold their foreign assets could change their strategy and start buying assets outside of Japan in order to avoid further losses. Such violent balancing movements could destabilise the global financial system, unless the Bank of Japan can intervene decisively in order to keep government borrowing rates below 1%. The question is whether inflation expectations can rise without interest rates rising too.

It will be difficult for the Bank of Japan to put an end to the deflationary spiral, and it will need to prove its credibility and clarify its rhetoric. Although a number of macroeconomic indicators have improved over the past six months, the prolonged weakening of the JPY has made energy and import prices more expensive, which is hurting Japanese purchasing power. The Nikkei 225's sharp correction over the past two months reflects this uncertainty.



NIKKEY vs STOXX 500 vs MXEF

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