

“Let us never negotiate out of fear. But let us never fear to negotiate.”

John Fitzgerald Kennedy

Five years after the Lehman Brothers bankruptcy, could the biggest threat to the world economy once again come from the U.S.? At the time of writing, the partial Federal Government shutdown has lasted for over a week, and its first effects on domestic consumption are already being felt. Hardline Republicans and members of the Tea Party movement are using the current budget debate to force changes to “Obamacare,” the healthcare reform that is set to be implemented in 2014. Worse still, the political stalemate could have catastrophic consequences on another imminent political debate: the U.S. debt ceiling. If the U.S. Congress fails to raise the debt ceiling by 17 October, the U.S. will no longer be able to issue debt and will therefore be unable to honour its debt repayments, resulting in a default.

It is hard to imagine such a chain of events unfolding. If the Federal Government were unable to issue further debt, it would immediately have to balance its budget, which could impact economic growth by up to -4%. The U.S. would quickly fall into recession and drag global growth down in its wake. But the most significant consequences would be felt in credit markets with the unfathomable default of the risk-free asset by definition, U.S. Treasuries. This would lead to an unprecedented financial catastrophe! It is likely that American public opinion will force Republicans to back down at the last minute as President Obama will continue to want to push through the healthcare reform that has become the symbol of his second term.

The political stalemate put an end to the formidable rally in U.S. stock markets that had started three months earlier and was justified by the healthier state of the American economy. Indeed, Q2 GDP growth rose to +2.5% from +1.1% in Q1, consumption continued to improve and advanced indicators were encouraging. The Federal Reserve revised its 2014 economic growth forecast downwards to +3.1% due to the fragile state of the U.S. labour market and the convalescent nature of the housing market. The central bank also maintained its ultra-accommodative monetary policy and surprised markets by delaying the start of the QE tapering that was widely expected in September. Long-term interest rates have consequently fallen in the U.S. as well as in Europe, which has favoured our bond portfolios. We remain cautious, however, and continue to invest mainly in bonds with 5 to 7-year maturities in order to limit the sensitivity of our portfolios to interest rate rises.

Q2 GDP growth figures in the Eurozone showed improvements, with Germany progressing by +0.7%, France by +0.5% and even Portugal by +1.1%, while the recession in Spain appeared to abate. With the Italian political drama momentarily on hold, investors can once again focus on improving Eurozone fundamentals, where advanced indicators continue to point to a fragile recovery. This justifies the ECB’s cautious stance, with no monetary tightening on the horizon.

The situation is more contrasted in emerging markets, where countries such as Brazil or India face serious difficulties. Emerging market equity indices have rebounded sharply since late August as investors flocked back to these areas, where valuations are relatively low and growth potential remains high. The political deadlock in the U.S. is pushing investors to reallocate resources towards countries whose policies are oriented towards growth, like China or Japan.

Despite the political impasse in the U.S., we remain calm. We have taken profits on some of our equity positions recently, but overall we remain positive about the asset class, which should continue to benefit from the global environment of moderate economic growth and accommodative monetary policies, even if QE tapering is likely to take place in 2014. We remain cautious about the duration of our bond portfolios and have kept a position in commodities, which should gradually pick up as the economic cycle matures.

WORLD MARKETS ON 30/9/2013

WORLD INDEXES	Perf Q3*	Perf YTD*	Volatility
STOXX600	8,93%	11,01%	21,66
S&P 500	0,62%	14,99%	19,09
NIKKEY 225	2,74%	19,10%	18,55
BEL20	10,93%	13,19%	22,47
AEX	8,80%	9,40%	22,47
MXEF Emerging Markets	0,93%	-8,73%	22,79
HFRI (Alternative)	0,99%	3,96%	3,65
BONDS EUR (EFFAS 1y-10y)	1,16%	1,56%	3,15
COMMODITIES	Perf Q3*	Perf YTD*	Volatility
GOLD	3,46%	-22,63%	18,14
BRENT	1,86%	8,70%	39,24
MONETARY			Rate
EURIBOR 1 month			0,13%
CURRENCIES			Spot
EUR/USD			1,3527
EUR/GBP			0,8356
EUR/CHF			1,2239

*All performances in EUR

Macroeconomics

USA

- U.S. GDP has continued to grow in line with our forecasts. The economy should grow by +2.5% in 2013 and the growth rate could even reach +2.75% by the end of the year. We do not think that the partial Federal Government shutdown will have a lasting effect on growth.
- The unemployment rate has been fluctuating between 7.2% and 7.4% recently and should continue to fall gradually in 2014.
- Domestic consumption has remained robust despite the deleveraging process. It should continue to support growth, but at a slower rhythm than in previous economic recoveries. Confidence indices are positive.
- The PMI Manufacturing index has progressed further towards 54 levels. Increased confidence in the economic recovery and expected – and necessary – improvements in productivity should support capital expenditure and investments.
- 10-year Treasury rates shouldn't rise above 3.5% in coming months. Although this will have a negative impact on the housing market, it shouldn't affect the sector's impact on U.S. economic growth.
- Government spending cuts will continue to weigh on growth, as will necessary debt reduction measures. In the long-run, these measures will be positive.
- Inflation has fallen back to +1.3% despite the expansion of the monetary base and improving growth figures. We expect inflation levels between +1.5% and 1.7% in 2014.
- In hindsight, the Federal Reserve clearly communicated poorly in May. It will not start to reduce asset purchases before the end of the year because the recovery remains fragile and the unemployment rate is still above its target.
- The current account balance has benefitted from the weak USD.

EUROPE

- The macroeconomic environment has improved, as illustrated by favourable recent economic data publications and production figures. Disparities between Eurozone member states remain huge. Despite better recent quarterly figures, 2013 growth should fall by between -0.25% and -0.5%.
- Unemployment is still high and continues to weigh on household consumption and confidence. This represents an important structural obstacle for GDP growth.
- Despite the anaemic economic growth environment and the strong EUR, the ECB has maintained a relatively restrictive monetary policy.
- Long-term interest rates have risen, but not as much as in the U.S. After falling slightly in recent weeks, we expect 10-year Bund rates to rise towards 2% to 2.25%.
- The new German coalition is even more pro-European than the previous one, and should continue to support efforts towards a fiscal and banking union.

EMERGING MARKETS

- Signs of an economic slowdown have surfaced in emerging markets since the beginning of the year. We remain confident that these economies can continue to generate decent growth in coming quarters, even if the growth rate will be slower than in the past. Economic growth is forecast between +4% and 5% for 2013.
- Inflationary pressures remain relatively strong, especially after local emerging market currencies weakened following Mr Bernanke's tapering statement in May. Inflation should become less problematic in the future though as monetary policies in emerging economies such as Brazil or India, for example, have generally been rather restrictive and local governments have been keen to control growth. This should lead to a progressive strengthening of their currencies against the USD.
- Valuations are still attractive, both in absolute terms and relative to developed markets, especially after the underperformance of emerging stock markets in the last 18 months.
- Structural reforms are still taking place. China, in particular, is strengthening its role as the driver of Asia's development.
- We still consider emerging markets an interesting investment opportunity, especially Asia.

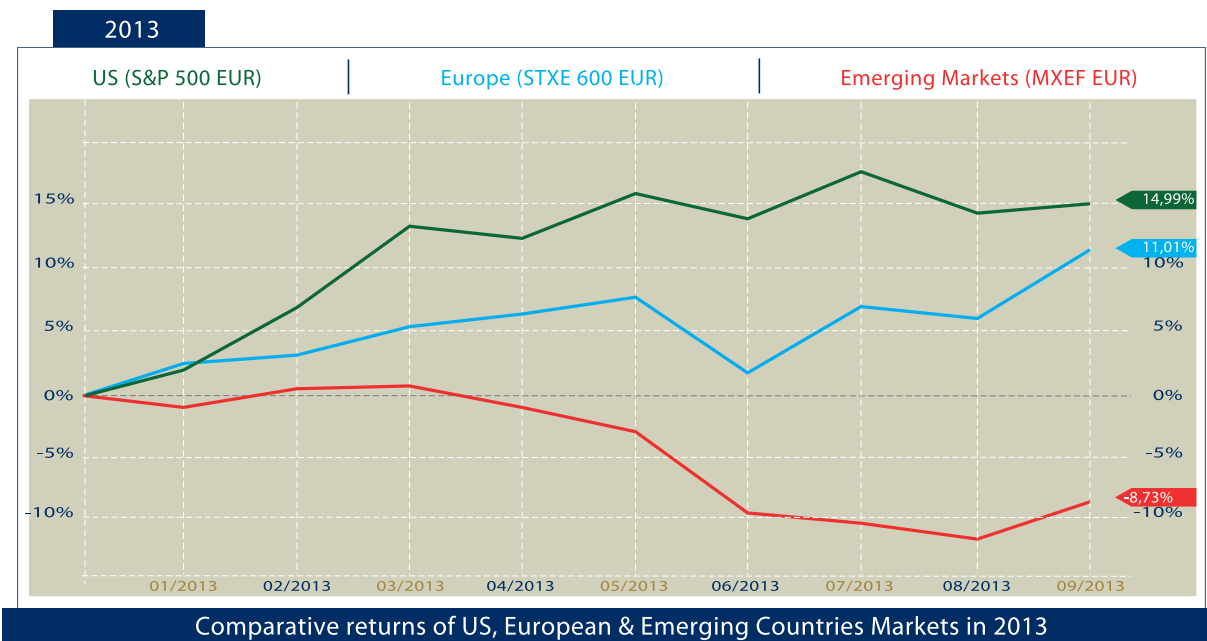
Equity

Stock markets benefitted from gradual economic improvements in developed countries during the summer and then from the fact that the Federal Reserve will maintain its accommodative monetary throughout 2013. The S&P 500 rose to 1,722 on 19 September before falling back due to the uncertainty surrounding the budget negotiations and the debt ceiling. The productivity and profitability of American companies has continued to improve. Liquidity flows into U.S. equities, which correspond to outflows from bonds, accelerated. Mergers and acquisitions have also provided technical support to stock markets as a result of low interest rates and high corporate cash reserves. At current levels, U.S. equities are no longer cheap, but they still have upward potential thanks to forecasts of +7% profit growth in 2013 and P/E ratios of 14 in 2014, which is in line with long-term averages.

European stock markets also trended higher during the summer in the context of a slow emergence from the recession. Unlike U.S. indices, European indices are still far from their historic highs and probably hold more upside potential. Profit growth, which fell to -12% last year, should stabilise around +10% in 2013, with P/E ratios also forecast around 14.

Emerging market equity indices had a mixed summer but have rebounded sharply since the end of August. This recent surge gives us hope that the huge underperformance of emerging market equities relative to developed market equities during the past nine months could gradually reverse. From a macroeconomic point of view, there are huge disparities between the situations of different countries. Brazil, for example, has struggled for growth in an environment of high inflation for the past two years. This has led the central bank to raise interest rates to 9% in Au-

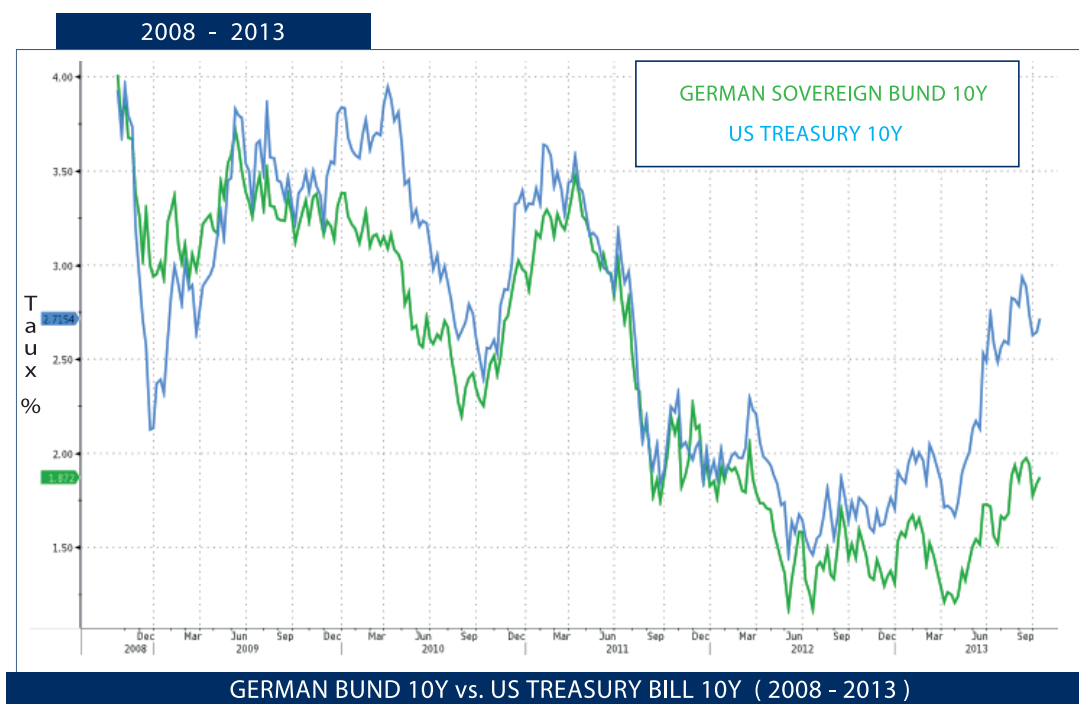
gust, 175bp higher than in April. Russian GDP growth fell to +1.2% in Q2 from +1.6% the previous quarter. Structural reforms have yet to be implemented but the authorities are unwilling to finance stimulus measures by increasing public debt, even though the country's debt to GDP ratios are low. Indian economic growth has also slowed sharply, from an average of +8% in recent years to +4.4% in Q2. The lack of a parliamentary majority has made it difficult to govern the country and implement the necessary structural reforms. This is illustrated by the country's budget deficit, which has reached 8% of GDP. In addition, although inflation was falling, the central bank decided to raise the marginal standing facility bank rate to 10.25% in order to halt the fall of the Indian currency, at the risk of slowing investments sharply. This difficult environment has not stopped Indian equities from rebounding strongly since late August. The macroeconomic situation is much better in Asia, especially in China where recent data publications have created optimism: retail sales have increased, industrial production rose by +10.4% in August, the highest level in seventeen months, advanced indicators have improved for the past six months and the PMI Manufacturing index has remained above 50, signifying expansion, for the second consecutive month. Considering these figures, the government's +7.5% economic growth target seems realistic, especially as the first stimulus measures such as easier fiscal conditions and infrastructure spending have had positive early effects. Similarly to European indices, emerging market equity indices are still a long way from their 2007 highs and appear to hold significant upside potential for 2014, as long as the global recovery continues on a solid basis and the U.S. politicians avoid creating another financial cataclysm.



Interest rates

On 22 May, Mr Bernanke caused widespread investor panic by somewhat hastily announcing the tapering and end of the QE program. This jolted fixed income markets, which had seen long-term rates fall for years. Between early May and 5 September, 10-year Treasury rates rose from 1.7% to 3%, which is virtually unheard of in recent financial history. Since then, interest rates have come down slightly, especially since 20 September, after the Federal Reserve decided to maintain its monetary policy unchanged. The problem for the U.S. economy is that 30-year mortgage rates also rose during the summer, from 3.5% to 4.6%. This has had negative effects on new home sales and real estate prices. The fall in long-term interest rates appears to be temporary. It could last for a few more days, until U.S. decision makers find an agreement to raise the debt ceiling. 10-year Treasury rates could fall to 2.6% or even 2.4% in the near future. As long as the political negotiations in the U.S. lead to a favourable outcome, investors should once again turn to fundamentals and growth perspectives after 17 October. 10-year Treasury rates should subsequently converge towards 3% or even 3.5% during the course of 2014. 10-year rates above 3.5% seem unlikely because their negative effect on economic growth would be too important.

Interest rates also rose in the Eurozone, although not as much as in the U.S. The 10-year Bund rate rose from 1.17% on 2 May to 2.03% on 5 September. The slower pace of the rise in German rates can be explained by the growth differential between the two continents. Europe is still recovering while the U.S. has already moved further along the cycle. The improvements in Europe's financial health during the summer have certainly been favourable for some of the riskier segments of the fixed income market. We remain cautious about the investment grade segment, which is overvalued, and prefer to invest in BBB issuers, or even selected BB-rated issuers. Europe's improving conditions have also resulted in Eurozone periphery bond spreads tightening. In the immediate future, we believe that 10-year Bund rates could fall somewhat, towards 1.6%, before the end of the political crisis in the U.S. Within the next six months, however, 10-year rates could rise towards 2.25% levels, but are unlikely to rise much further as the recovery remains fragile and tensions could once again flare up between stronger and weaker Eurozone members in 2013. Indeed, the weaker member states will be forced to continue to tighten their fiscal policies without benefitting from a monetary policy as accommodative as in the U.S.



DISCLAIMER

Text written on October 10, 2013

This document is for information purposes only. Although 2PM and its information providers seek to ensure that such information is accurate and has been obtained from sources presumed to be reliable, no warranty, expressed or implied is made to its accuracy and 2PM shall not be held liable for any inaccuracies or incompleteness.

This document is strictly confidential and cannot be copied or used without the authorization from 2PM