Quarterly marketreview

July 2014

Edito

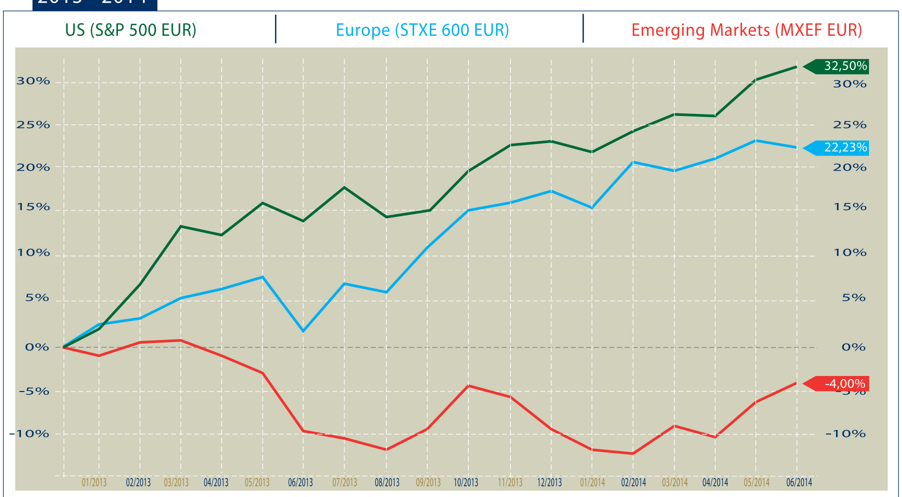
	Perf. YTD	Q2 2014	Close
Stoxx600	4.140%	2.260%	341.860
S&P500	6.820%	5.320%	1960.230
Nikkey	-2.670%	4.670%	15162.100
Bel20	6.960%	-0.090%	3127.210
AEX	2.830%	2.470%	413.150
MXEF	5.550%	6.280%	1050.780
HFRI	0.480%	1.520%	1153.010
EFFAS 1-10Y	5.090%	2.280%	202.0530
Gold	10.890%	3.990%	1327.320
Oil (WTI)	7.840%	4.350%	105.370
Euribor 1M			0.0990
EURUSD			1.36920
EURGBP			0.80040
EURCHF			1.21430

The second quarter of 2014 saw both equity and bond markets continue their upward trends despite an uncertain geopolitical environment (see Special Topic section on page 2). In addition, economic activity in the U.S. was less buoyant than expected as a consequence of the harsh winter conditions, and economic growth in Europe remains dramatically weak, at only +0.2% in Q1. Financial markets, however, have ignored this and concentrated on fundamentals and corporate earnings, which were generally positive. A formidable sector rotation has been taking place in recent months, which has tested the ability of less reactive and longer-term managers. The market's dynamism in terms of sectors and mergers and acquisitions, combined with the accommodative monetary policies in place in the U.S. and Europe, pushed equity indices higher: the Stoxx 600 index rose by +2.26%, while the S&P 500 index gained +5.32% in EUR terms. So far this year these indices have risen by +4.14% and +6.82% respectively. Interestingly, emerging equity markets have rebounded and capital flows into the area have turned positive. According to the IMF, global growth for the area is at +4.9%. Russia rebounded strongly after tensions in Ukraine eased somewhat, and Indian markets continued to perform strongly as a result of the general elections, which should be favourable for the country's economy and markets. In China, specific stimulus measures appear to be working and economic activity has improved slightly in recent weeks. The MSCI Emerging Markets index rose by +6.28% in EUR terms in Q2, and by +13.08% since the low of 4 February. European growth, on the other hand, remains much lower than in emerging markets. Even Germany's GDP growth is only +0.8%. Although Spain is in far better health than a year ago, France and Italy continue to disappoint because of anaemic domestic demand. The weakness of economic activity combined with continuously falling inflation levels pushed the ECB to take action on 5 June. Indeed, Mr Draghi announced that the refinancing rate would be reduced to 0.15% and took the unconventional measure of putting in place targeted LTROs supposed to favour credit. The TLTRO will have a capacity of EUR 400bn until 2018. The central bank also installed a new negative deposit rate of -0.10% in order to dissuade European banks from using the ECB's deposit facilities. All reserves held by banks above and beyond their obligatory reserves will also be remunerated at the same rate. This should favour inter-bank markets and the real economy. Finally, in addition to certain technical measures such as the end of the SMP program's sterilisation, Mr Draghi mentioned the possibility of a return of the asset-backed securities market and delivered a very clear forward guidance, suggesting that interest rates would remain accommodative for an extended period.

In bond markets, 10-year U.S. Treasury rates fell further to 2.5%. The Federal Reserve is currently concentrating on its second objective, full employment, since inflation remains low due to the important level of overcapacity in the economy. Despite recent improvements in the job market, the central bank believes that unemployment is still too high. 10-year German Bund rates reached new historical lows of 1.3% as expectations increased of an intervention by the ECB and the use of exceptional measures due to continuously low inflation levels and weak growth figures. European periphery borrowing costs also continued to fall: the yields of 10-year government bonds reached 2.66% in Spain and 2.84% in Italy. Finally, credit spreads of corporate bonds, high yield bonds and subordinated bank debt all tightened further. The IBOXX corporate index has consequently risen by +3.92% this year, while the EFFAS 1-10yr index, which represents government bonds, has risen by +5.09% this year. In 6 months, the index has achieved our performance expectations for the whole year. We therefore remain cautious about fixed income markets. We are mostly positioned in the 5 to 7 year maturity segment and we have avoided longer-term bonds. For equity markets, it is hard to tell whether the ECB's efforts have been fully priced into valuations, especially as uncertainty continues to reign concerning the timing and the size of interest rate hikes in the U.S. They are likely to take place in Q1, Q2 or Q3 of 2015.

Caution remains important in equity markets. Sectoral and geographical diversification will continue to be key performance drivers.

2013 - 2014



Comparative returns of American, European and Emerging Markets since 2013

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The return of geopolitics...

Since the end of the Arab Spring 4 years ago, which had started in December 2010, financial markets had all but forgotten about geopolitics. Over the last year, investor fears have been focused on the Chinese economic slowdown and the timing of the end of the Federal Reserve's unconventional measures.

Since the end of Q1, geopolitical tensions have reappeared. The Ukrainian crisis and the annexation of Crimea by Russia have raised fears of a cold war in Europe, with potentially negative economic consequences on both sides: economic and political sanctions for Russia, and disruptions in gas deliveries to Europe. Although the crisis has thawed in recent weeks, which has reassured investors, the situation remains fragile. In the meantime, another conflict has appeared, shifting investors' focus towards the Middle East. Indeed, the insurgence in the North of Iraq by Sunni militants (Isis) took observers by surprise and threatens to reach Bagdad. Oil prices consequently spiked, although in limited fashion. This renewed surge in violence is serious and complex, since it concerns more than just Iraq. Indeed, various alliances and interests involving Iran, Syria and Turkey can appear contradictory. President Obama, for instance, needs assistance from Syria's Assad regime in order to stabilise Iraq and combat the rebels, who are undoubtedly financed by certain Middle Eastern monarchies who are historical allies of the U.S.

Other sources of conflicts exist and could develop in the future. In Asia, China's territorial claims in the China Sea are becoming increasingly pressing. The international community's lack of reaction to the Crimean crisis could lead the Chinese authorities to step up their claims.

The common denominator of investors' geopolitical fears concerns the production and delivery of energy. Although current spikes in gas and oil prices have been manageable, any surge of violence in Ukraine or Iraq could hamper the global economic recovery.

Macroeconomics

Europa

- Mr Draghi's optimism about the short-term nature of the fall in prices has helped. The ECB unleashed a series of measures in June aiming to favour investments and finance small and medium-sized businesses. The secondary objective is to weaken the EUR against the USD.
- The Eurozone's strong positive momentum is fading. France's poor economic data is dragging the European average down. Economic activity indicators remain in expansionary territory.
- Economic activity in France has relapsed. Despite resounding electoral defeats, the new government is struggling to increase the pace of reforms. The country is slowly slipping towards mass unemployment and passivity.
- In the U.K., economic activity is thriving and interest rate hikes appear imminent. The BoE is implementing measures to avoid a real estate bubble.

U.S.

- The impact of the harsh winter climate conditions turned out to be much higher than expected: the GDP contracted at a -2.9% annualised pace in Q1.
- The good news is that, since the end of March, the rebound has been significant and economic activity indicators have improved.
- We have therefore revised our 2014 growth forecast down to 2%, against 3% previously.
- The Federal Reserve has not changed the timing of its asset purchase tapering measures, but has pledged to keep rates low for many more months.

Emerging Markets

- Stimulus measures aiming to support growth are being implemented in China, where manufacturing activity has improved slightly.
- Fears of a hard landing of the economy are fading. This has benefitted the rest of the emerging sphere. Surprise economic indicators have rebounded.

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