Forum Finance Group

since 1994

June 2010

Investment Perspectives 2010
Mid-Year Review & Outlook

INVESTMENT PERSPECTIVES 2010 MID-YEAR REVIEW

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2010 ECONOMIC OUTLOOK REVISITED

With nearly the first half of the year behind us, it is time to revisit our investment perspectives for 2010. In January, we expressed the view that economic and financial market conditions would become increasingly complicated and challenging; five months later, this has clearly turned out to be the case and, in that respect at least, we have not been disappointed! Market participants have had to face extreme levels of stress within the European sovereign debt markets, interbank rates creeping higher, the return of volatility and erratic political decisions affecting the capital markets.

During the same period, companies have been busy reporting strong earnings for the first quarter of 2010 and issuing overall optimistic outlook statements for the following quarters. We wrote in January that it would be important for companies not only to be able to produce good results due to the implementation of cost-cutting measures and higher margins, but also to be able to generate top line growth. This has largely been the case and has proved to be supportive of higher equity prices during the reporting season of earnings.

At the time, we also highlighted the need to observe an improvement of the labour markets in order to feel more confident that the economic recovery could become self-sustainable. On this issue, there have been mixed signals and one has to note that the economic recovery has not created many new jobs so far. In the U.S. for example, even if the economy is no longer destroying jobs, companies have been more inclined to hire temporary workers rather than take on new employees and the recent nonfarm payrolls data underlined that fact. It appears most likely that the current economic recovery will only contribute to the creation of new permanent jobs at a moderate pace and that unemployment levels will remain elevated for a long period.

The positioning of our clients' portfolios during the first quarter enabled us to generate strong performances, as credit spreads narrowed and equity markets appreciated, reflecting the growth of earnings. Since then, the portfolios have clearly been impacted by the correction of riskier assets, but still remain in positive territory at the time of writing.

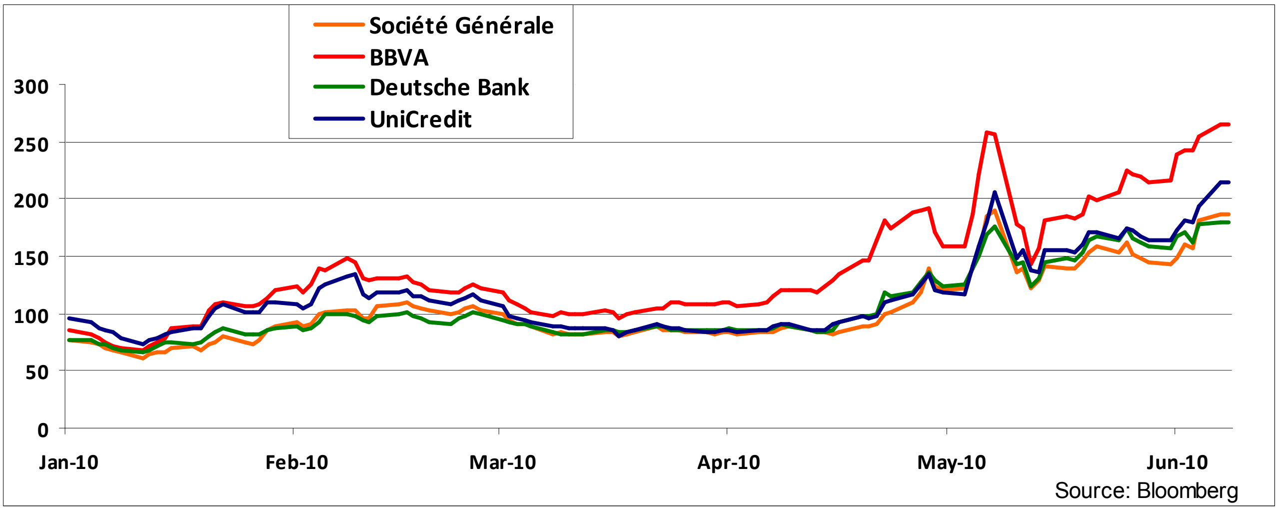
The recent sell-off in risky assets seems to be pricing in an increasing probability of a double-dip recession scenario. We do not believe that the economy is heading for another period of recession, but the increasing level of uncertainty about systemic and cyclical risks has led us to tactically reduce the sensitivity of our clients' portfolios to risk assets. At this stage, our view is that risk perceptions have taken precedence over earnings delivery, hence our beginning of May decision to reduce the allocation to global equities.

In the next section of the document, we will review the current economic conditions through ***five of the key economic indicators*** that we observe. This will be followed by a brief overview of what took place in the financial markets over the last six months, leading us to outline our outlook and recommended asset allocation for the second half of 2010.

1st indicator: the banking sector

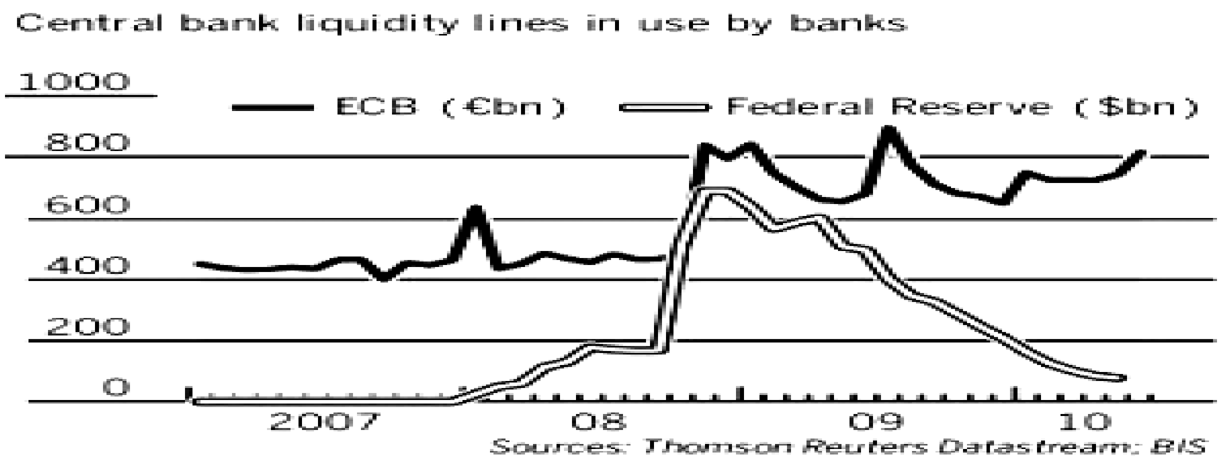
After having reported strong results for the first quarter of this year, the banking sector has found itself under renewed pressure due to concerns over its exposure to European sovereign debt and to the negative impact of financial reforms on both sides of the Atlantic. The following charts will serve to illustrate the most recent developments impacting the sector.

Credit default swaps on European Banks (bps)



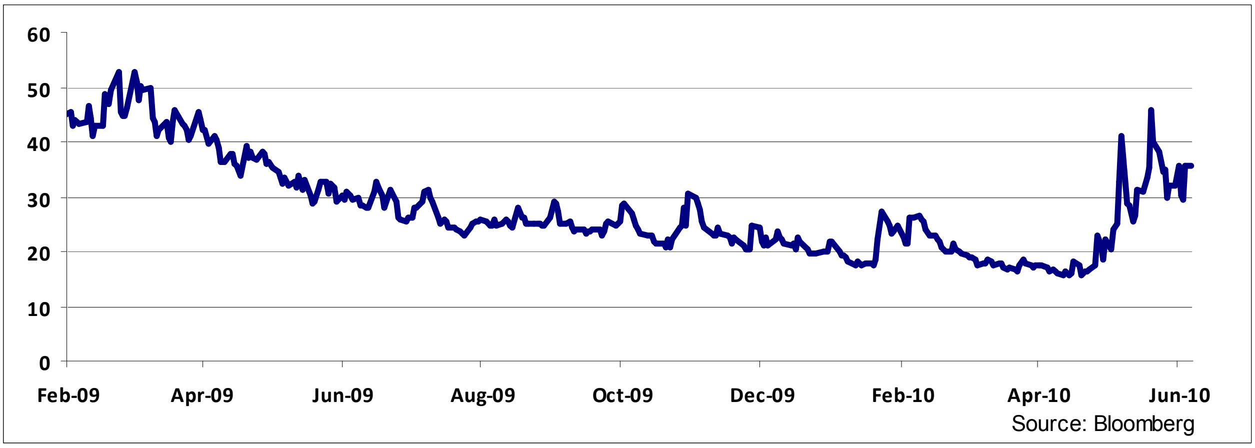
Credit default swap spreads on even the biggest European banks have considerably widened since the end of April, indicating that the risk of default, while still low, has risen. These wider spreads reflect concerns not just about banks' exposure to sovereign debt of the weaker European countries, but also about the interlinked nature of that exposure.

Reliance on Central Bank credit



While US and UK banks have been able to increasingly access credit in the private markets, European banks remain extremely reliant on credit from the European Central Bank. As shown in the chart above, the ECB is providing at least 800 billion euros in loans to banks, more than at the beginning of the year, while the Federal Reserve has been withdrawing its special liquidity programmes.

Chicago Board Options Exchange Volatility Index (VIX)



The concerns of the markets over sovereign debt solvency and the health of the banking sector have been reflected by a spike of the volatility level in equity markets. The implied volatility of the S&P 500 index options, known as the VIX, has recently rebounded from the high teens to a level well above 30, implying a higher cost to protect equity positions. A stabilization of the VIX index at lower levels would contribute to support a sustainable rebound of equity markets.

Euro zone sovereign debt

The solvency of the weaker members of the Euro zone remains the most pressing issue facing investors at this stage. In its latest quarterly report, the Bank of International Settlements said that European banks had 210 billion euros of loans to the governments of Greece, Ireland, Portugal and Spain at the end of 2009, which made up 16 per cent of their overall exposures to these countries. The 750 billion euros European Stabilization Mechanism programme announced in May should resolve the short-term liquidity issues by providing fiscal support to any Euro zone government running into difficulty. However, ***this is not a liquidity crisis, but a solvency crisis***. The fiscal and political resources of the capital providers of last resort – the governments – are virtually exhausted and it currently appears that the risk of Greece eventually defaulting remains elevated. This event would lead to a restructuring of its existing debt and translate into important losses for bondholders, including the banks.

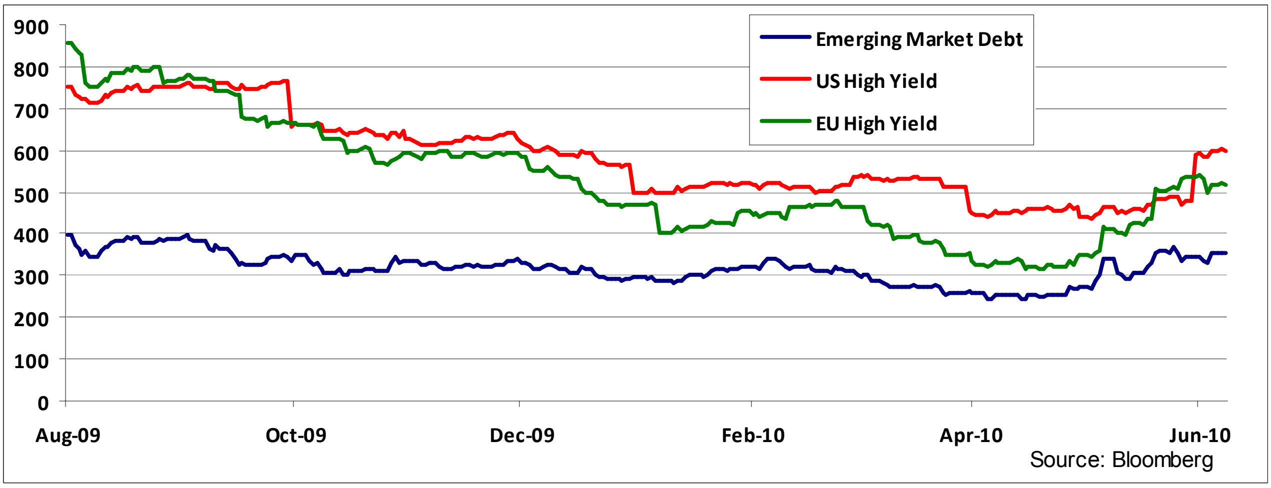
Over the last years, countries such as Greece and Spain have become less and less competitive vis-à-vis other countries within the European currency union and on the international stage. The absence of extensive labour market reforms and the reliance on cheap financing have produced huge current account deficits. It looks as if the only option left to bring down the enormous budget deficits in order to prevent bankruptcy is through massive wage and spending cuts. Taking into account Greece's extreme levels of gross debt and interest and the domestic resistance to severe austerity measures, it seems likely that it will fail to achieve the objective of rebalancing its fiscal position. This largely explains the current stress within the capital markets and the re-pricing of the risk assets.

Taking into account the above, we continue to avoid being exposed to sovereign debt of European countries, but remain invested into the debt of emerging countries and companies due to more attractive yields and better prospects for these fixed-income segments.

2nd indicator: credit spreads

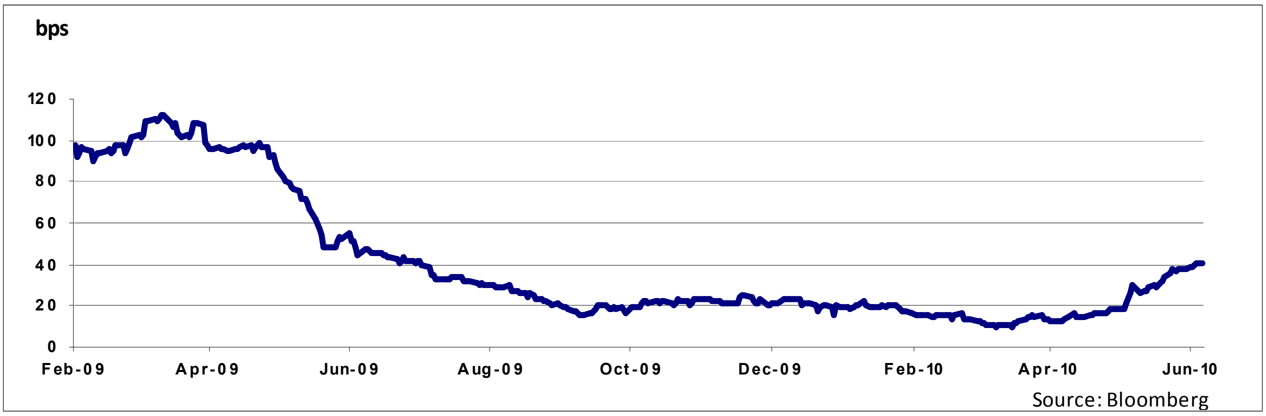
Until the middle of April, credit markets had performed well as new issuance was met with strong demand and as spreads continued to contract. Since then, money has been withdrawn from emerging market and high yield bonds and invested into the perceived safety of G-7 government debt. In our opinion, this is not a sustainable trend.

Emerging market debt and high yield spreads (bps)



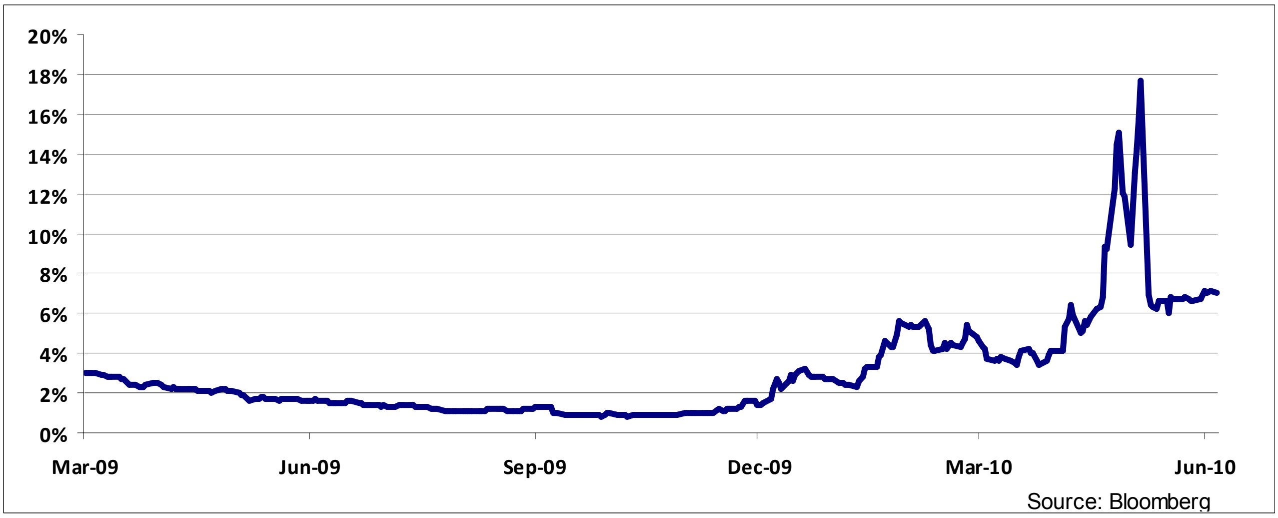
High yield and emerging market bonds have been negatively impacted by the recent turmoil. While spreads have widened, we believe this is more a reflection of market fear than a deterioration of fundamentals within these markets. Over the longer term, high yield bonds should continue to benefit from a decreasing risk of default, while higher growth and improving fundamentals should underpin the debt of emerging market countries.

TED Spread



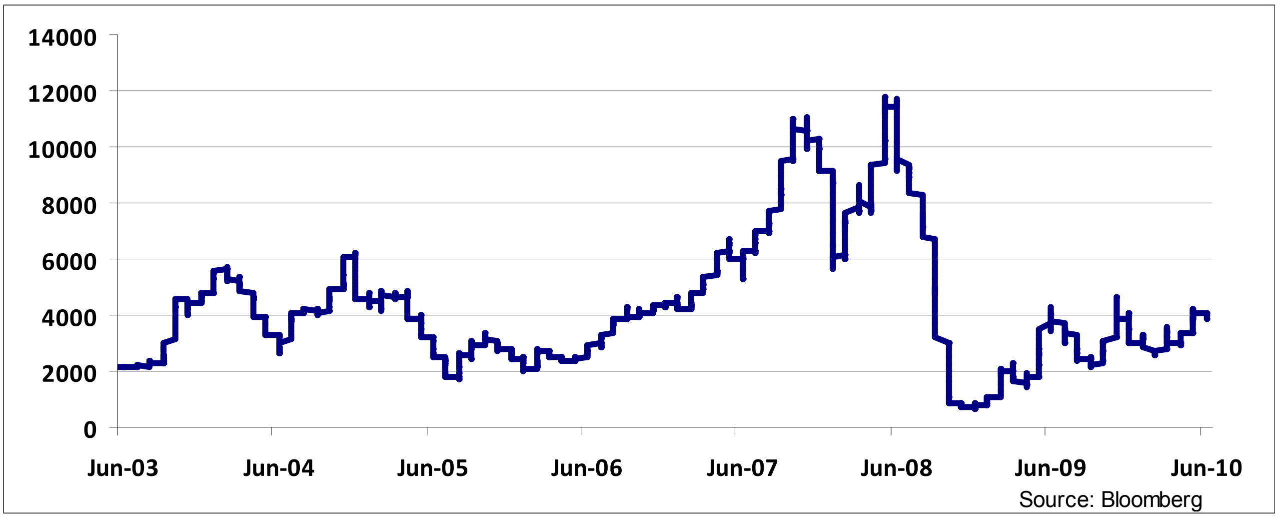
The spread between 3-month LIBOR rates and 3-month Treasury bills has been moving up since reaching a multi-year low in the middle of March. While still being well below the extreme spread of 465 bps observed in October 2008, this widening TED spread suggests that banks are hoarding cash rather than making it available on the interbank market, a sign of diminishing trust within the financial system.

Sovereign Debt Spreads (Greece-Germany 2 year)



The yield spread between Greek and German 2-year government bonds is no longer at the extreme levels observed at the beginning of May. The announcement of the 750 billion euros bailout plan and purchases of government bonds in the secondary market by the ECB have effectively relieved some of the recent pressure on the bonds of the most fragile European countries. However, concerns remain acute as reflected by wider CDS spreads on the debt of countries such as Spain, Portugal or even France.

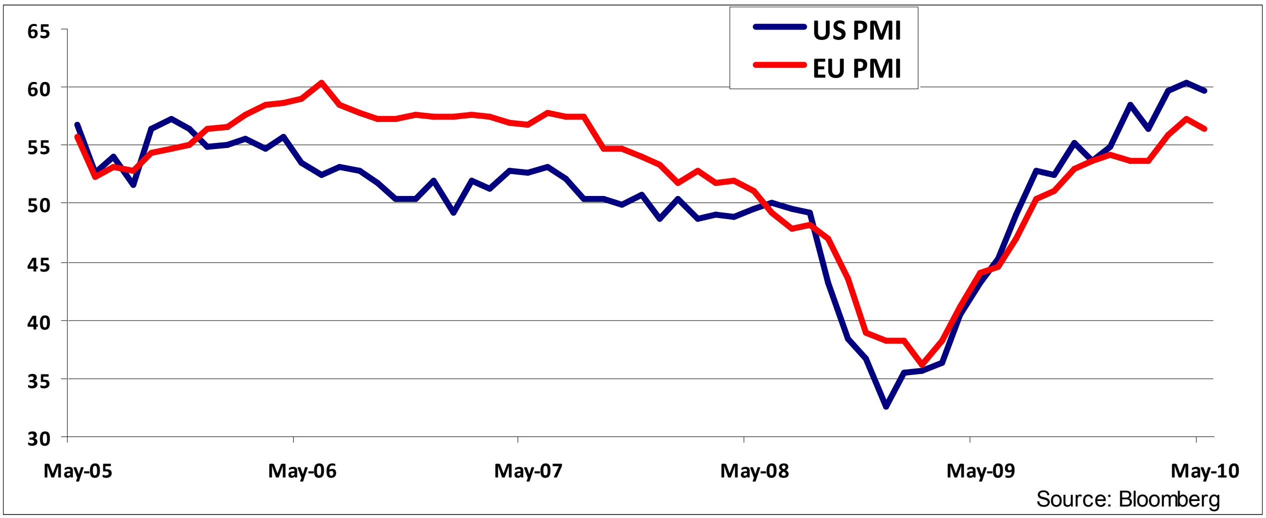
3rd indicator: the Baltic Dry Shipping Index



The recent improvement in the Baltic Dry Index, which tracks global shipping prices of various dry bulk cargoes, like coal, iron ore and grains, suggests that physical trading of commodities is still very active and has not suffered too much from the recent turmoil in the financial markets.

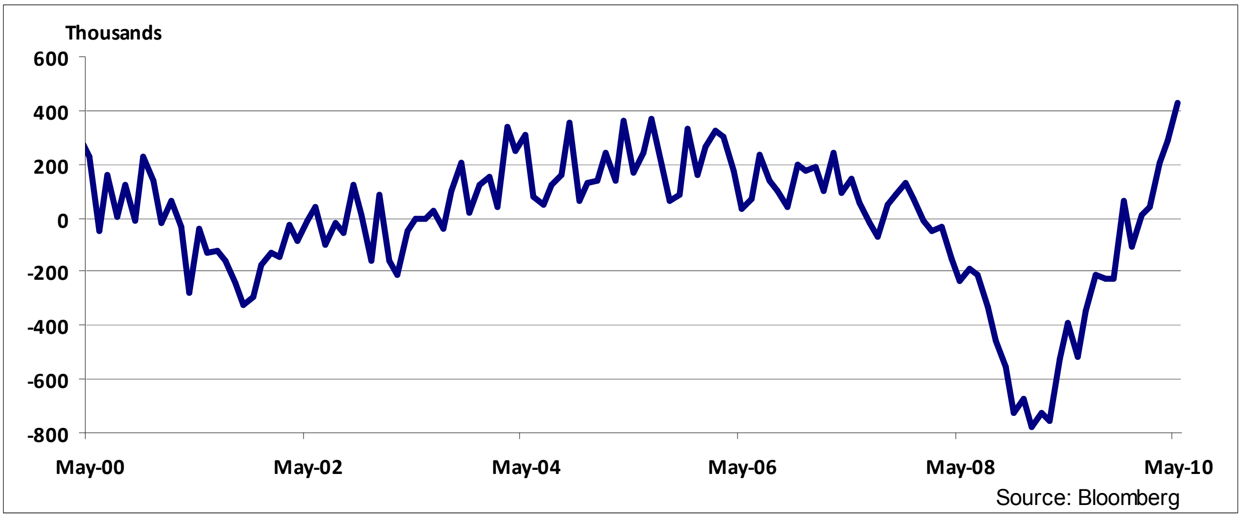
4th indicator: macro indicators

Purchasing Manager Indexes



Purchasing Manager Indexes across the world have rebounded strongly over the last eighteen months. Current readings are well above 50, a level signalling an expansion of the economy.

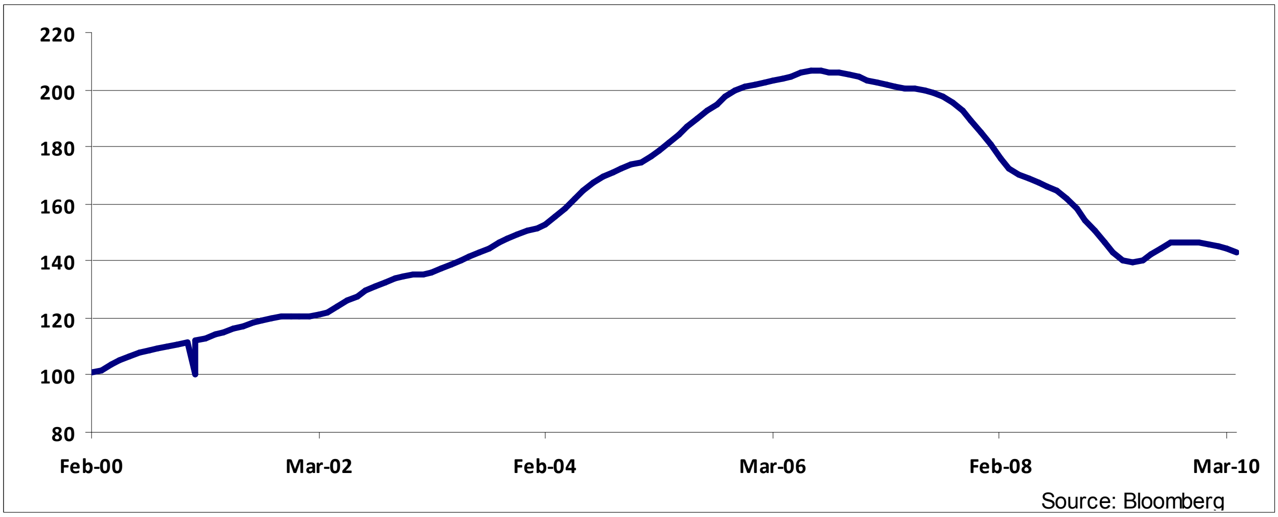
US Nonfarm Payrolls (Month on Month net change)



Since the beginning of the year, the U.S. economy has started generating new jobs, but only at a moderate pace. The improvement of the U.S. economy has led to the hiring of an increasing number of temporary workers, while the average work week rose to 34.2 hours in May from a low of 33.7 hours in October 2009. However, the latest data proved to be disappointing as private employers only added 41’000 payrolls in May compared to projections for a 180’000 gain.

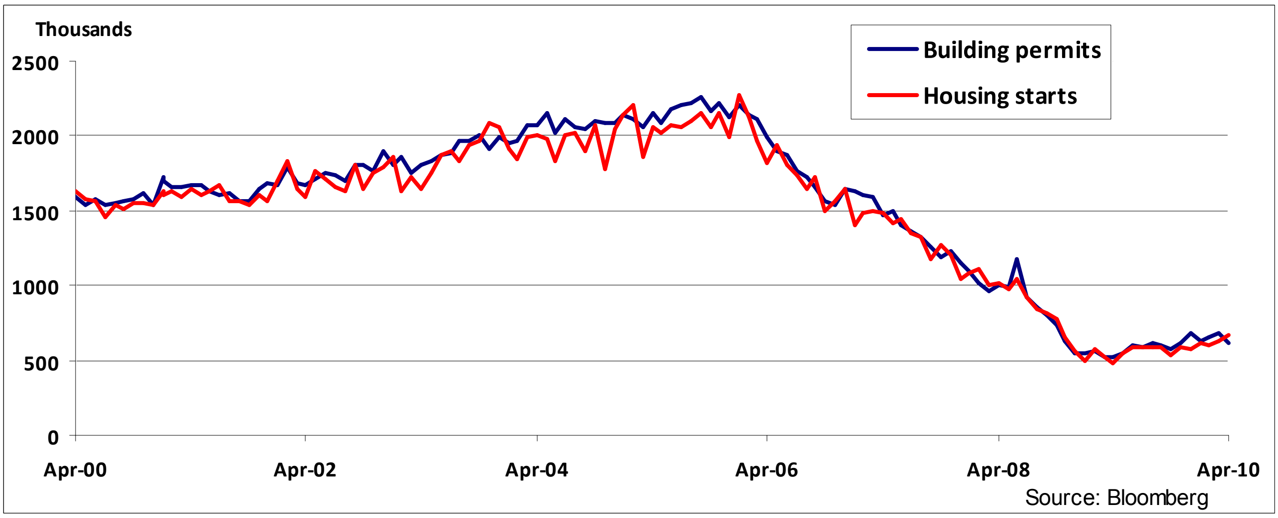
5th indicator: Real Estate

Case Shiller Home Price Index



Real estate prices in the U.S. have stabilized but are still not showing signs of significant strength. Mounting foreclosures and an excess of vacant houses are preventing price appreciation despite growing demand.

U.S. Housing Starts and Building Permits



New housing starts and delivered building permits in the U.S. have picked up since bottoming out in April 2009, but remain well below their long term averages. While housing starts continued to increase in April at an annual rate of 672'000, building permits, which are considered a leading indicator, fell to a 606'000 annual rate as the tax credit for first-time homebuyers expired.

The conclusion we draw from these ***five indicators*** is that, while clearly finding itself in recovery mode, the economy is still facing major challenges, which will take a long time to overcome.

FINANCIAL MARKETS

	End 2009	April 2010	May 2010	MTD	2010
Equities					
S&P 500	1115.1	1186.7	1089.4	- 8.2%	- 2.3%
Euro Stoxx 50	2965	2816.9	2610.3	- 7.3%	- 12%
MSCI EM	989.5	1020	926.4	- 9.2 %	- 6.4%
Yields					
UST 10-year	3.84%	3.66%	3.29%	- 37bps	- 55bps
Bund 10-year	3.39%	3.02%	2.66%	- 36bps	- 73bps
BBB EU	5.41%	4.86%	4.80%	- 6bps	- 61bps
Currencies					
EUR/USD	1.432	1.329	1.231	- 7.4%	- 14%
USD/CHF	1.035	1.078	1.155	+ 7.2%	+ 11.6%
GBP/USD	1.617	1.527	1.454	- 4.8%	- 10.1%
Commodities					
CRB Index	283.4	277.7	254.8	- 8.3%	- 10.1%
Oil, WTI	$ 79.4	$ 86.2	$ 74	- 14.1%	- 6.8%
Gold	$ 1097	$ 1179	$ 1216	+ 3.1%	+ 10.8%

After getting off to a good start, equity markets had to overcome an early correction in January before moving higher. The strong growth of companies' earnings within a low interest rate environment contributed to enhance the prices of equities until markets turned lower towards the end of April. Concerns over fiscal deficits and the ability of troubled European countries to meet their debt obligations triggered a reduction of investors' exposures to risk assets, in particular to equities of the regions under scrutiny.

Contrarily to our expectations, the yields on AAA-rated G-7 government bonds declined significantly due to the flight-to-quality market action and delayed expectations for a hike of interest rates in the major economies. High yield bonds and emerging market debt continued to perform positively until the middle of April, when spreads started to widen under market stress.

The fallout of Europe's debt crisis has been the severe depreciation of the European common currency. Selling pressure has remained intense since last December as concerns about sovereign debt and political uncertainty have led investors to exit the Euro. In this context, safe haven demand for the Swiss Franc has been met with foreign-exchange intervention on an unprecedented scale by the Swiss National Bank. So far this year, the SNB has managed to limit the Franc's appreciation to some 6.5% against the Euro compared to a 15.5% gain for the dollar.

The price of gold has appreciated by over 30% since the beginning of the year in Euro terms as it has benefited from the persistent fears over public debt and the health of the financial system in the major economies. As expected, gold has continued to play a strategic hedging role within investment portfolios and has been supported by safe haven demand during this volatile period.

OUTLOOK

To summarize our macro-economic outlook, we do not believe that the global economy will fall back into recession. We accept that the sovereign debt crisis in Europe will continue to affect financial markets and that investors will most likely be pricing in a higher level of risk due to a more unstable economic environment. However, we also think that the worst fears about a complete financial meltdown in the Euro-zone appear to have abated and that the near-term threat of a sovereign default has receded.

Fixed-income

Our outlook on the fixed-income asset class has not been affected by the recent market developments. We are of the opinion that the current yields on G-7 government bonds are not sustainable as we do not adhere to a scenario of deflation. We will avoid any exposure to the sovereign debt of troubled countries and prefer maintaining our current exposures in emerging market debt and high yield bonds. Emerging market debt looks increasingly attractive after the recent correction, as fundamentals continue to improve. Institutional inflows should remain positive while local currencies should appreciate over the longer term due to higher levels of growth and strong fiscal positions.

Equities

We consider that the equity asset class remains attractive. Valuations are not overstretched, the level of cash on the balance sheets is at or close to record highs and companies have been able to satisfy their refinancing needs at good market conditions. We expect earnings to continue growing at a strong pace and were reassured by the positive outlook statements issued during the first quarter earnings' reporting season.

FX

Our assessment is that the bulk of the downside of the Euro is most likely behind us. However, we do expect investors to maintain a cautious stance towards the European currency. The dollar should continue to outperform the Euro due to the more advanced stage of the U.S. recovery and as the Euro is unlikely to benefit from the support of relative interest rate differentials any time soon. The Swiss Franc should also remain stronger against the Euro as the Swiss National Bank cannot pursue its interventions in the foreign exchange markets at the same rate as recently.

Gold

In our opinion, gold will continue to be well supported during the next quarters. Even if gold is trading above its long term average price, it is not particularly expensive compared to other assets. For example, the ratio of gold to oil prices is currently just over 16, its average level since 1970. Similarly, the ratio of the Dow Jones to gold prices is now around 8.5, slightly lower than the long term average of 10, but well above the extreme level of 1 observed at the beginning of the 1980s.

ASSET ALLOCATION

Cash (11%)

The allocation to cash increased by 8% since the beginning of the year to a current level of 11%. The main purpose of this decision was to reduce the level of risk within the portfolios due to a higher level of volatility and a certain disregard for corporate fundamentals at this stage.

We consider this to be only a temporary measure and we will be looking to deploy some of this liquidity as soon as markets show signs of stabilization.

Fixed-Income (22%)

The allocation to fixed-income is maintained at 22%. We did not implement any changes to the allocations within the fixed-income asset class during the period under review.

In our opinion, G-7 government bonds are even less attractive than in January and we remain invested into local currency emerging market debt and global high yield credit funds.

The potential for price appreciation of investment grade corporate credit is limited but a core allocation serves as a portfolio stabilizer.

Equities (30%)

The allocation to equities was reduced from 38% in January to 30%. This decision, which was taken at the beginning of May, reflects reduced visibility due to higher political risk and the prevailing fragile market sentiment, but not a deterioration of corporate fundamentals.

We still consider that equities are the most attractive asset class and that current valuations do not fully reflect the prospects of future earnings. Our preference goes to shares of high-quality companies offering high dividend yields.

Alternative Investments (32%)

Hedge Funds (22%)

No change to the recommended allocation.

Structured Products (10%)

The recommended allocation of 10% remains unchanged. We continue to favour yield enhancement products offering conditional attractive coupons with a high level of downside protection.

Gold (5%)

We recommend maintaining the current 5% exposure to gold. Even if its price is trading well above its long term average, the unusually high uncertainty about the economic and financial outlook means this condition is most likely to be sustainable.

ASSET ALLOCATION GRID 2nd HALF 2010

For our balanced accounts, we apply the following grid:

	Allocation	July 2010	+/- (end 2009)
Short-term deposits	**0 – 20%**	**11%**	**+8%**
Fixed-income	**15 – 40%**	**22%**	**-**
Investment grade corporate bonds	10 – 30%	10%	-
Investments in funds	5 – 25%	12%	-
Equities	**20 – 50%**	**30%**	**-8%**
Direct investments	10 – 30%	10%	-5%
Equity funds	10 – 30%	20%	-3%
Alternative Investments	**15 – 35%**	**32%**	**-**
Funds of Hedge Funds	10 – 30%	22%	-
Structured products	5 – 15%	10%	-
Gold	**0 – 5%**	**5%**	**-**
		100%	**0%**

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