Forum Finance Group
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Investment Perspectives 2011
Mid-Year Review & Outlook

INVESTMENT PERSPECTIVES 2011 MID-YEAR REVIEW

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2011 ECONOMIC OUTLOOK REVISITED

We have reached the time when we revisit our investment perspectives for 2011 and outline the portfolio positioning we will be recommending for the remainder of the year. In January, we expressed the view that the problems faced by the public sector would represent the biggest dangers for the markets and this has clearly proven to be the case. As during last year's spring, ***market participants have once again had to face extreme levels of stress within the European sovereign debt markets*** as Portugal finally requested a bail-out and the risk of a Greek debt default exploded. The issues related to the size of U.S. government debt also took on more importance, reflected by Standard & Poor's decision to cut the outlook on U.S. debt from stable to negative.

Our beginning-of-the-year observation that it was still too early to be optimistic about a significant improvement of the trends in the ***real estate*** and ***job markets*** has been confirmed by ***data*** that has ***overall been disappointing***. As widely expected, inflation concerns have translated into the tightening of monetary policies by many central banks of emerging countries, leading to relative underperformance of their equity markets. Finally, ***markets have also had to face unforeseen and unpredictable events***, most notably social upheaval in the Middle East, leading to higher oil prices, and a massive natural disaster in Japan, which has triggered supply chain disruptions.

The listing of all these negative forces makes it easy to forget that there have also been some more supportive ones. The reporting of earnings for the first quarter already seems to be a distant memory due to the fact that markets have been so intensely focussed on macro-economic issues. Nevertheless, it is important to remember that these results once again demonstrated the ability of ***companies to keep on growing their profits and top-line growth despite the below-par growth environment in the U.S. and in Europe***. In our opinion, this positive trend should subsist even if earnings momentum is expected to somewhat slow down. On a less favourable note, one has had to observe the difficulty of equity fund managers to outperform their benchmarks due to the extremely challenging conditions within equity markets.

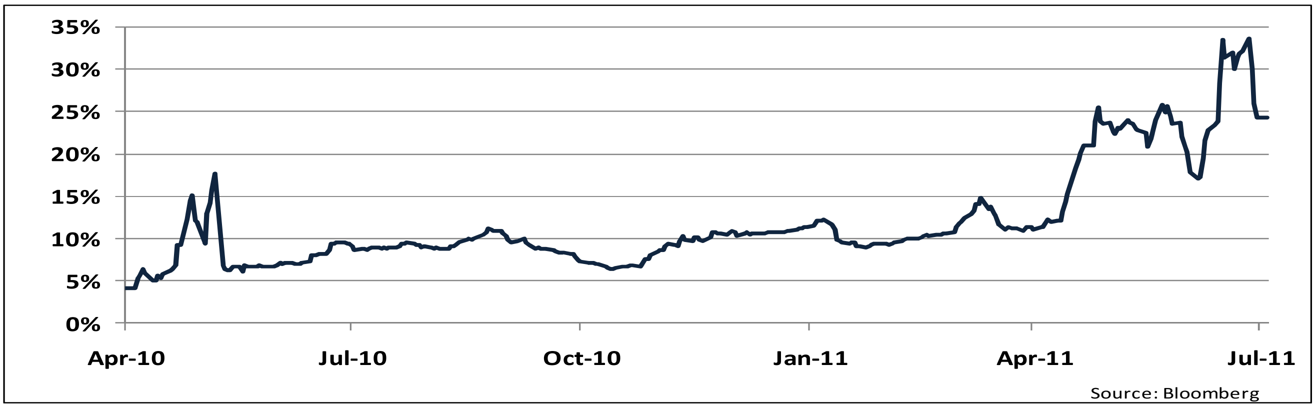
As often the case, it has been ***extremely difficult to predict the trends of currencies*** and our anticipation of a recovery of the dollar against the Euro has proved to be well short of the mark. Despite the crisis in Euro-zone sovereign debt markets and its overvaluation against the dollar, the ***European common currency has performed unexpectedly well***. Taking into account the difficulty to extract positive contributions from the different asset classes so far this year, currency movements have continued to have a big impact on the performance of portfolios that are not hedged, especially those based in ***Swiss francs, the strongest currency year-to-date***.

In the next section of the document, we will review the factors that have had the biggest impact on financial markets so far this year and also highlight some of the ***key economic indicators*** that we observe to evaluate economic conditions. Following a brief overview of the year-to-date trends of the different asset classes, we will outline our outlook and the asset allocation we recommend for the quarters ahead.

The Euro zone sovereign debt issue

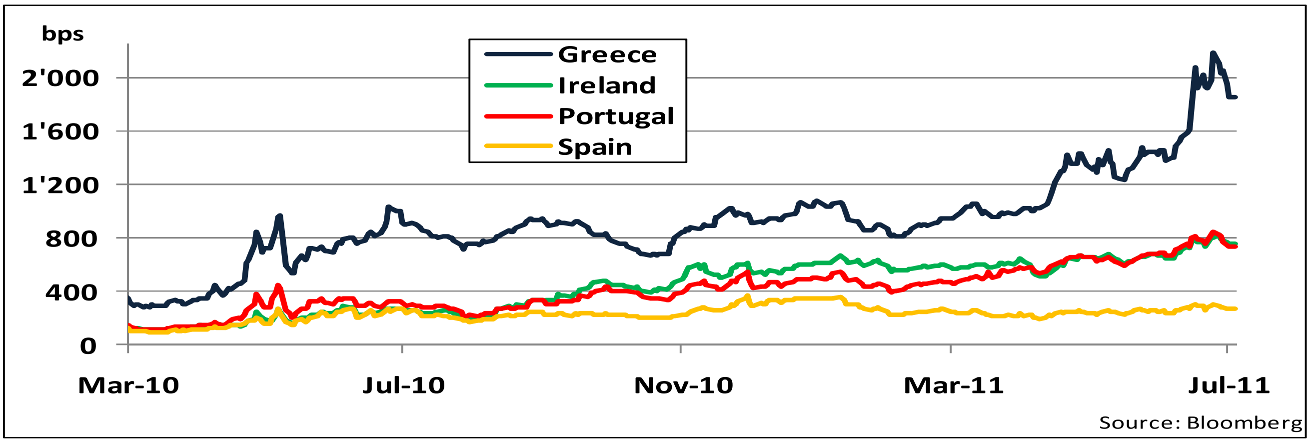
The solvency of the weaker members of the Euro-zone remained the most pressing issue facing financial markets during the first half of 2011. Less than a year after the initial EUR 110 billion bail-out, the issue of a possible Greek debt default came back to haunt investors. It wasn't until the Greek government survived a vote of confidence and the parliament passed additional austerity measures towards the end of June that risk assets stabilized and ended the period on a stronger note. The decision to keep on preventing a sovereign default aims essentially to buy time and allow the banking system to be better prepared for a restructuring of the debt at a later date.

2-year sovereign debt spread Greece-Germany



The yield spread between Greek and German government bonds had remained relatively stable following last year's bail-out. However, increasing worries about a Greek debt default translated into unprecedented pressure on Greek bonds from the end of March 2011 onwards. The chart above shows that the yield spread between Greek and German 2-year government bonds spiked from 11% at the end of March to nearly 34% towards the end of June.

European sovereign debt CDS USD spreads

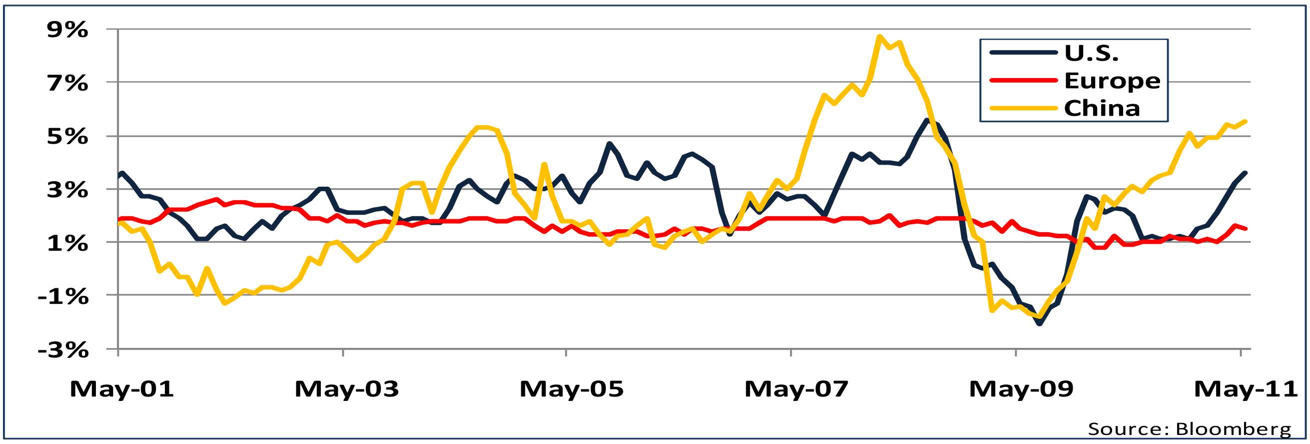


The Greek debt crisis has continued to impact the sovereign debt of other peripheral countries in quite a dramatic fashion. The interest rates demanded by investors to hold such debt rose to their highest levels in seven months on June 27th, before slipping back. The chart above shows the steep increase of the cost of insuring peripheral debt against a default. For example, the cost of protection for $ 1 million of 5-year Greek debt has exploded from $ 70'000 in June 2010 to over $ 200'000 a year later. This cost signals that there is more than an 80 percent probability the nation will fail to meet its commitments within the next five years.

Inflation and interest rates

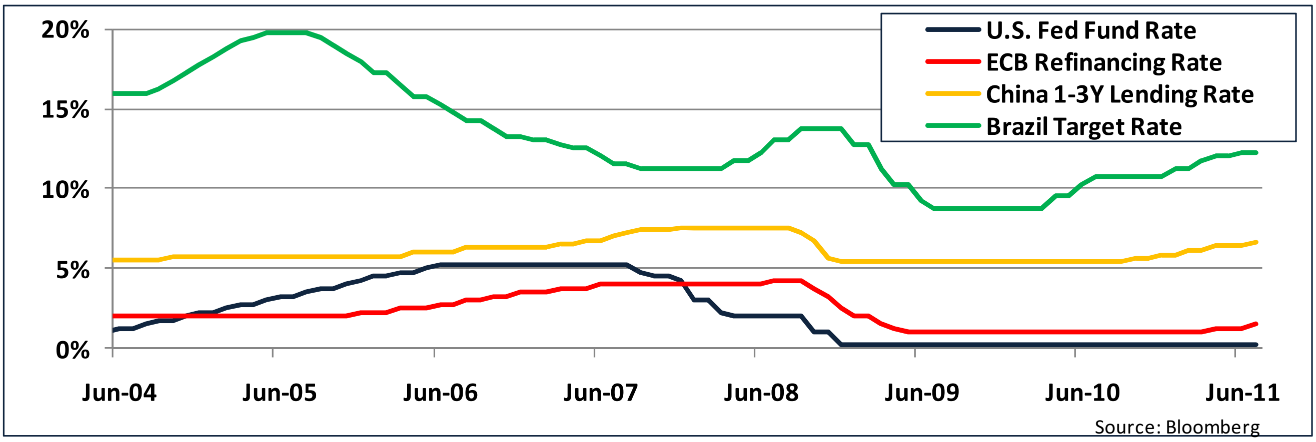
Higher levels of inflation, particularly in emerging countries, have been a major source of concern over the last quarters. A significant rise of food prices has been the most contributing factor due to the important weight of this component in the basket of goods used to measure inflation in those regions. ***The higher cost of food was one of the reasons for the social upheaval in the Middle East***, which consequently led to the spike of oil prices. While the strength of the Euro has helped to limit inflation pressures in Europe, the increase of the price of gasoline has had a significantly negative impact on consumer spending growth in the U.S. It would appear that ***inflation across the world is now likely peaking***. If this turned out to be the case, it would improve the prospects for more supportive economic conditions during the second half of 2011.

Inflation across the world



Sustained demand for commodities in emerging countries, combined with geopolitical issues and adverse climatic conditions, have resulted in much higher levels of inflation as shown in the chart above. Also, areas such as the United States and the United Kingdom have had to face significant imported inflation due to the ongoing depreciation of their currencies.

Interest rates

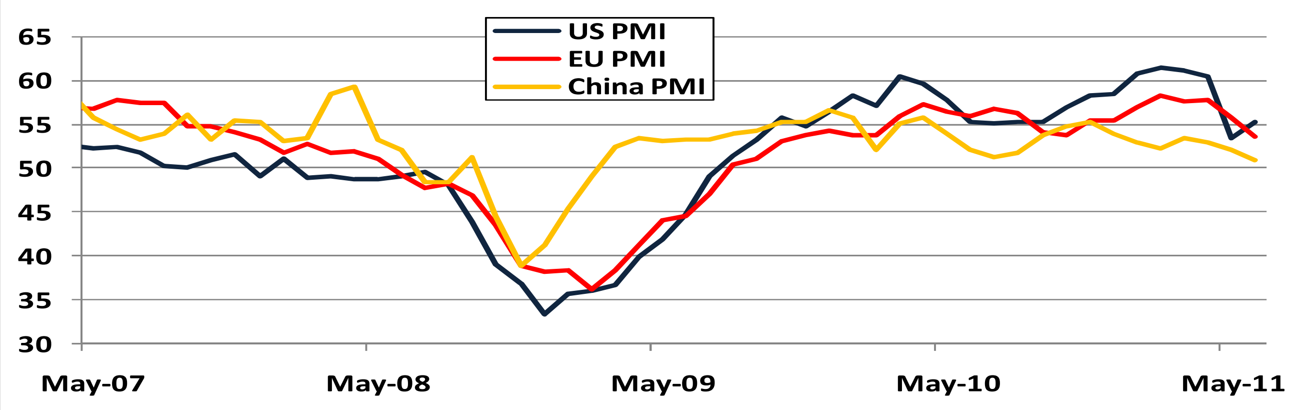


Central banks of the emerging economies have had to increase the level of interest rates to fight against persistent inflation. While the U.S. Federal Reserve has clearly indicated it is unlikely to change rates anytime soon, the ECB has already increased its reference rate to 1.50% with two quarter-point rises in April and in July.

Leading indicators

The second quarter has seen leading macro-economic indicators across all regions come in below consensus expectations. The global economy has had to face a number of headwinds in the first half of the year such as supply chain disruptions due to Japan's disaster, higher oil prices and tighter monetary conditions. Under these circumstances, a dip at this stage of the recovery cycle appears quite normal and some of ***these headwinds are likely to dissipate during the second half***.

Purchasing Manager Indexes



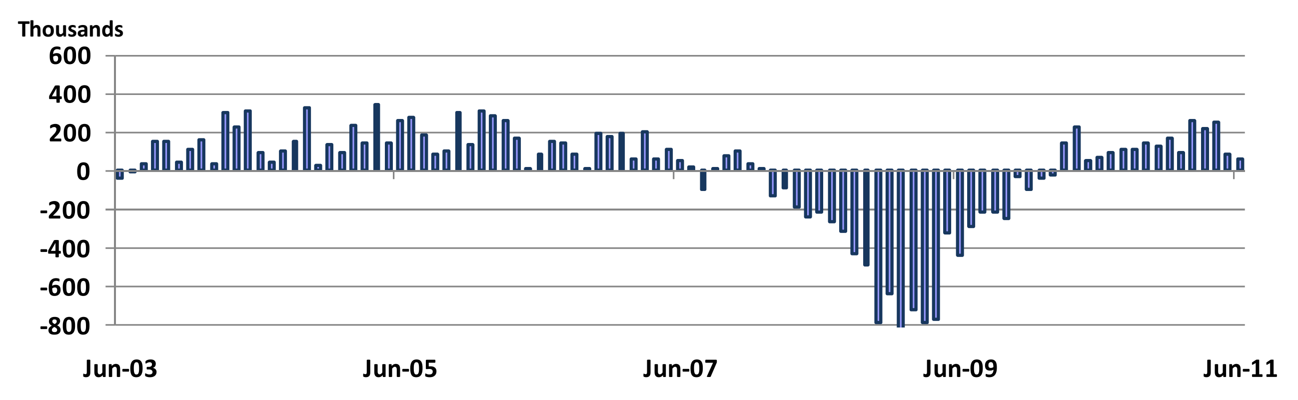
Source: Bloomberg

The chart above shows that ***Purchasing Manager Indexes*** have dropped from their highs over the last few months. While these readings reflect the soft patch the economy is going through, they have not collapsed and are still ***well above 50, a level which indicates an expansion***.

Job markets

The slow recovery in the Western economies has not allowed conditions in the job markets to improve in a significant way. Companies are still more inclined to hire temporary workforce or to ask employees to work longer hours rather than create new jobs.

U.S. Nonfarm Private Payrolls (month on month net change)

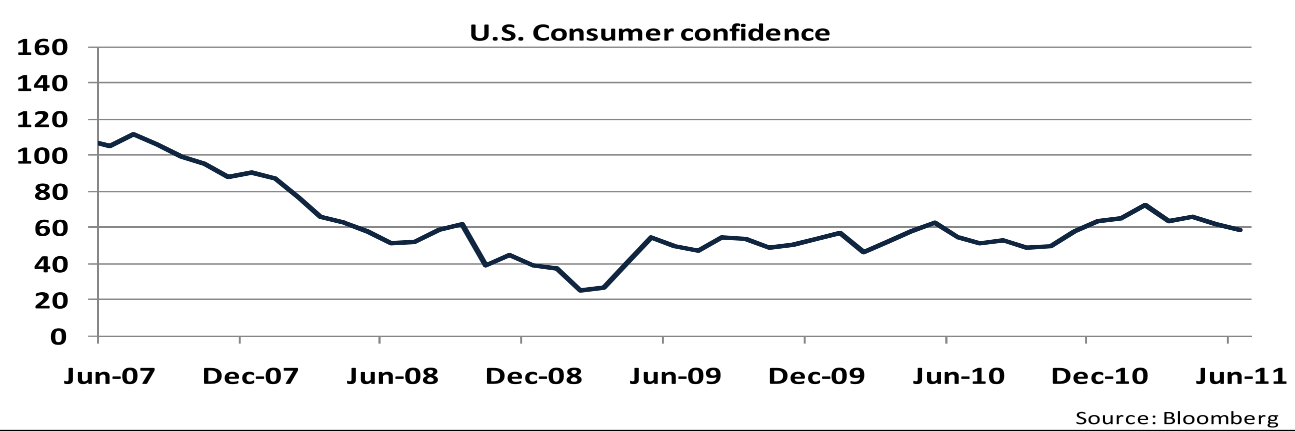


Source: Bloomberg

In the U.S., ***conditions in the labour markets***, as measured by demand for initial jobless claims and the number of nonfarm jobs created in the private sector, showed some improvement until the end of April. More recently, ***data has disappointed and cast doubt on the strength of the recovery***.

U.S. consumer confidence

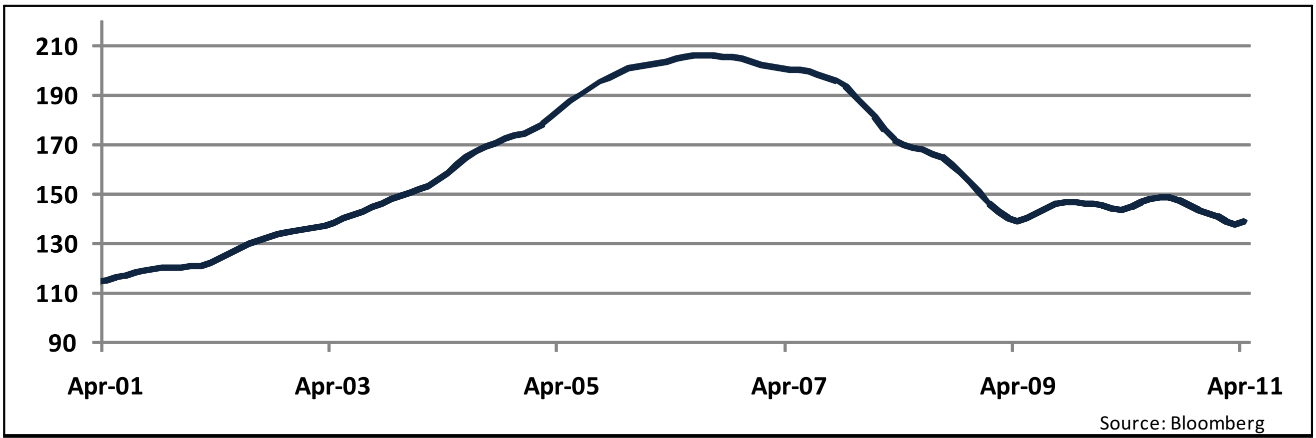
The confidence level of American consumers remains well below its long-term average and the last months have seen this level drop even further. This can be largely explained by the unsupportive conditions within the labour markets, the negative impact of higher gasoline prices and of goods in general as well as the ongoing depressed valuations of real estate.



As shown above, ***consumer confidence in the U.S. has dropped to a seven-month low in June***. Americans have become more pessimistic about the prospects for new jobs and higher income, while recent surveys also indicate that less of them are planning to purchase cars, major appliances or homes within the next six months. This lack of confidence has translated into a drop of consumer spending during the second quarter. In both April and May, consumer spending fell 0.1 percent after adjusting for changes in prices and this was the first back-to-back decline in 2 years.

U.S. real estate

Case Shiller Home Price Index

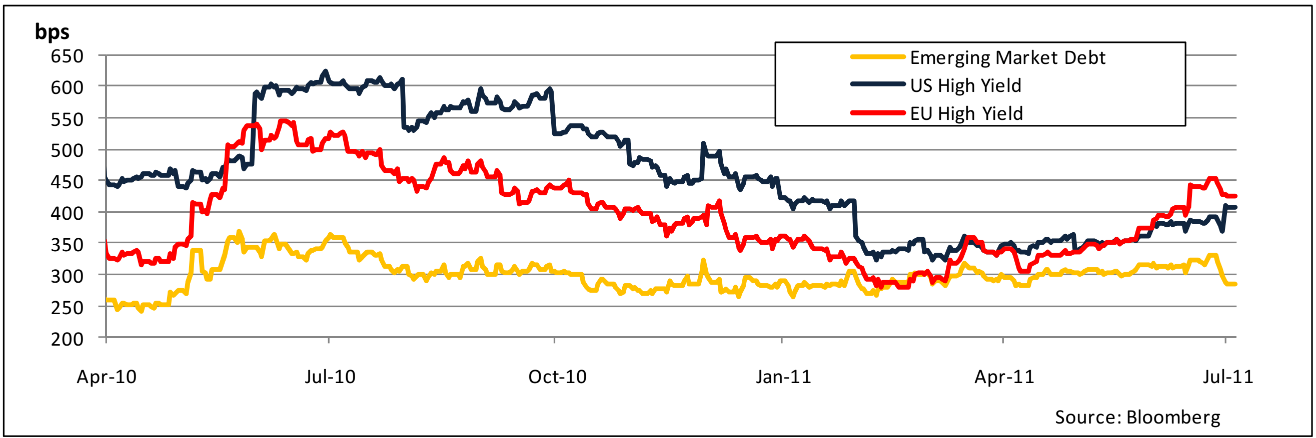


The spring housing season in the U.S. has been a major disappointment as ***home prices*** have continued to edge down. ***This critical component has had a negative impact on the levels of consumer confidence and spending***. The housing sector is one of the headwinds that is likely to stay around for some time and its wealth effect on consumer spending can not be expected to be a positive factor in the foreseeable future.

Credit spreads and equity markets volatility

After a solid start to the year, the ***higher yielding bonds*** within the fixed-income asset class ***suffered from outflows as investors opted for the safety of G-7 government debt***. This was reflected by the 88 basis points drop of the 10-year U.S. Treasury Note yield between February (3.74%) and June (2.86%), with the 10-year German Bund experiencing a similar move (3.49% to 2.83%).

Emerging market debt and high yield spreads



High yield and, to a lesser extent, emerging market bonds, have been negatively impacted by the recent tension in the financial markets. The widening of spreads is ***more a reflection of an overall increase of the aversion to risk than a deterioration of fundamentals within these markets***.

Chicago Board Options Exchange Volatility Index (VIX)

The level of volatility in equity markets has remained low for the first six months of 2011, with the CBOE VIX Index moving within a 15 to 20 range for most of the time. The brief spike observed in March, following the natural disaster in Japan, was well below last year's sovereign debt crisis levels.

Conclusions

In the light of the charts shown throughout this section, it is clear that the global economy has hit a soft patch. However, we believe this is a ***mid-cycle slowdown*** rather than a return to recession. Monetary conditions remain ***stimulative*** in the U.S., the Euro-zone and in Japan and ***global growth indicators are still at a healthy level***. The ***Euro-zone sovereign debt issue will not be resolved anytime soon*** and this will continue to hang over financial markets with various degrees of intensity. While headwinds such as weak labour and housing markets will subsist, other ones such as inflation, and supply chain disruptions are likely to recede and contribute to a ***cyclical upswing***, supported by ***better economic conditions*** for the remainder of the year.

FINANCIAL MARKETS

	End 2010	May 2011	June 2011	MTD	2011
Equities					
S&P 500	*1257.6*	*1345.2*	*1320.6*	*- 1.8%*	*+ 5.0%*
Euro Stoxx 50	*2792.8*	*2861.9*	*2848.5*	*- 0.5%*	*+ 2.0%*
MSCI EM	*1151.4*	*1167*	*1146.2*	*- 1.8 %*	*- 0.5%*
Yields					
UST 10-year	*3.30%*	*3.06%*	*3.16%*	*+ 10bps*	*- 14bps*
Bund 10-year	*2.97%*	*3.02%*	*3.03%*	*+ 1bps*	*+ 6bps*
BBB EU	*4.88%*	*4.89%*	*5.15%*	*+ 26bps*	*+ 27bps*
Currencies					
EUR/USD	*1.338*	*1.440*	*1.450*	*+ 0.7%*	*+ 8.4%*
USD/CHF	*0.935*	*0.854*	*0.840*	*- 1.6%*	*- 10.2%*
EUR/CHF	*1.251*	*1.229*	*1.219*	*-0.8%*	*- 2.6%*
GBP/USD	*1.561*	*1.645*	*1.605*	*- 2.4%*	*+ 2.8%*
Commodities					
CRB Index	*332.8*	*350.1*	*338.0*	*- 3.5%*	*+ 1.6%*
Oil, WTI	*$ 91.4*	*$ 102.7*	*$ 95.4*	*- 7.1%*	*+ 4.4%*
Gold	*$ 1421*	*$ 1536*	*$ 1500*	*- 2.3%*	*+ 5.6%*

Developed equity markets started the year on a strong note, but equities of emerging markets were hit by outflows. After climbing by up to 10 % by mid-February, equity indexes then gave up all of their year-to-date gains due to higher oil prices and the impact of an extremely destructive earthquake and tsunami in Japan. From their mid-March lows, equities then performed well until they peaked at the end of April. Thereafter, disappointing economic data and major concerns over the risk of a Greek sovereign debt default triggered a significant correction. However, ***a strong performance during the last week of June enabled a recovery of some of these losses, resulting in half-year gains for most indexes***.

In line with our expectations, the yields on ***AAA-rated G-7 government bonds*** initially moved higher. However, this trend did not last and ***10-year yields declined significantly*** *until the* ***last week of June***. Following an initial period of strength, high yield bonds and emerging market debt were impacted by the higher aversion to risk. Spreads of emerging market debt and U.S. high yield bonds ended the period under review virtually unchanged while European high yield ones ended wider.

Despite the ongoing crisis surrounding European sovereign debt, only the Swiss Franc appreciated against the Euro during the first half of 2011. The ***ongoing strength of the Swiss Franc***, due to safe haven flows, has so far prevented the Swiss National Bank from taking any tightening measures. The ECB's decision to start hiking interest rates provided support for the European currency, which gained 8.4% against the dollar during the period under review.

The price of gold has appreciated by 5.6% in dollar terms since the beginning of the year, but has lost ground when measured against the Euro and Swiss Franc. This seems to be indicating that ***gold is playing more of a hedging role against a weaker dollar than a pure risk aversion trade***.

OUTLOOK

To summarize our macro-economic outlook, ***we believe that the global economy has been going through a soft patch and that we will observe an improvement in the second half***. The sovereign debt crisis in Europe will continue to worry markets, but we feel that European leaders will do what is necessary to further delay the final outcome related to a restructuring of the debt. Italy has become the latest country to find itself under market stress but it is nowhere close to being Greece. Its maturity profile is not as worrisome and its investor base is less volatile. In our opinion, ***a lot of negative news is already priced into risk assets and even just a stabilisation of certain leading indicators should suffice to push the prices of equities and other risk assets higher***.

Fixed-income

Our outlook on the fixed-income asset class has not been affected by the recent market developments. On the contrary, we are still puzzled by the propensity of investors to invest into G-7 government bonds around the current yield levels, which we consider unattractive. Even if we do not anticipate a sudden change in the Fed's monetary policy or the ECB to pursue an aggressive tightening policy, bond yields are more likely to move higher. We continue to avoid having any exposure to the sovereign debt of troubled countries, but we feel comfortable with our current exposures in emerging market debt and especially high yield bonds.

Equities

We consider that the equity asset class remains the most attractive one. Valuations are far from being overstretched and equity risk premiums are at elevated levels, between 5.5% and 7%, making them more appealing than bonds. Even if the momentum of earnings is expected to slow down, this has probably already been priced in. Finally, companies should be able to maintain operating margins close to record levels due to spare capacity and labour's limited pricing power.

FX

Our assessment is that the bulk of the downside of the dollar is most likely behind us. We do not, however, anticipate any strong rebound in the short term and are neutral on the EUR/USD parity. On the other hand, the Swiss Franc appears clearly overvalued against both the dollar and the Euro, based on purchasing power parities. While it can take a long time for currencies to return closer to their fair value, we would expect improved sentiment in the financial markets to reverse some of the Franc's recent strength even if safe haven flows could persist in the shorter term.

Gold

We do not anticipate strong gains for the price of gold over the next quarters, based on our expectations for higher prices of equities and risk assets. Under the current market conditions, the main drivers for gold prices have been the evolution of the dollar and US bond yields rather than the level of stress within financial markets.

ASSET ALLOCATION 2nd HALF 2011

Cash (2%)

We recommend reducing the allocation to cash from 5% to 2%. We feel that the markets have already priced in a lot of negative news and that economic indicators will pick up. This should help risk assets to perform well during the second half of the year.

Fixed-Income (21%)

The allocation to fixed-income is maintained at 21%. 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 at unattractive levels and we prefer to remain invested into emerging local currency debt and global high yield credit funds.

The spreads in the high-yield universe have room to tighten. Their recent widening is more the result of higher risk aversion than a reflection of any deterioration of the solid fundamentals and improving credit quality of high-yield companies.

Equities (40%)

We recommend increasing the allocation to equities from 37% to 40%. We feel that their current valuations are undemanding and that this asset class should eventually benefit from an allocation shift out of bond positions as investors are still underinvested.

In terms of regional exposure, we find a lot of value in large international companies which are benefiting from the growth of the global economy and the substantial size of their market share. These companies have the capacity to pass on higher costs and also deploy a portion of their large cash reserves under the form of dividends or share buy-backs.

Alternative Investments (32%)

Hedge Funds (20%)

No change to the recommended allocation.

Structured Products (12%)

The recommended allocation of 12% remains unchanged. We continue to favour yield enhancement products offering conditional attractive coupons with a high level of downside protection. Structured products offering an exposure to strategies uncorrelated to the direction of underlying assets will also be a key focus in the medium term.

Gold (5%)

We recommend maintaining the current 5% exposure to gold. This position represents an insurance against extreme shocks and we expect gold to remain a key asset across portfolios as long as real interest rates stay low.

ASSET ALLOCATION GRID 2nd HALF 2011

For our balanced accounts, we apply the following grid:

	Allocation	July 2011	+/- (January 2011)
Short-term deposits	**0 – 20%**	**2%**	**- 3%**
Fixed-income	**15 – 40%**	**21%**	**-**
Investment grade bonds	5 – 30%	6%	-
EM & high-yield bonds	5 – 20%	9%	-
Specialist bonds	5 – 10%	6%	-
Equities	**20 – 50%**	**40%**	**+ 3%**
Developed markets	10 – 30%	30%	+ 3%
Emerging markets	10 – 30%	10%	-
Alternative Investments	**15 – 35%**	**32%**	**-**
Funds of Hedge Funds	10 – 30%	20%	-
Structured Products	5 – 15%	12%	-
Gold	**0 – 5%**	**5%**	**-**
		100%	**0%**

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