Forum Finance Group
since 1994

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Investment Perspectives 2012
Mid-Year Review & Outlook

INVESTMENT PERSPECTIVES 2012 MID-YEAR REVIEW

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2012 ECONOMIC OUTLOOK REVISITED

In this mid-year review, we will revisit our investment perspectives for 2012 before outlining the asset allocation we recommend for the second half of the year. In January, we expressed the view that the debt issues faced by the public sector would still represent the biggest dangers for the markets and this has clearly proven to be the case. ***Market participants have once again had to experience extreme levels of stress within the European sovereign debt markets***. A Greek exit from the Euro zone was narrowly averted following close elections, while Spain has found itself under intense market pressure since the end of February, leading to a 100 billion euro bailout for its ailing banking sector. The European summit on 28-29 June produced measures that triggered a ***massive relief-rally of risky assets on the last trading day of the month***. The announcement of the possibility for the European Stability Mechanism (ESM) to ***directly recapitalise European banks*** without adding to the level of sovereign debt was particularly well received by the markets.

As widely anticipated, a ***slowdown of economic growth has been observed in most regions***. Economies are contracting across the Eurozone and the 17-nation region is close to recessionary levels; the U.S. economy has been expanding at a below-par pace and the growth rates of emerging countries have been falling, at times considerably. As expected, the Chinese economy has expanded at a slower pace, but has avoided a hard landing. In most countries, ***inflation pressures have abated***, which has allowed the central banks of emerging countries to adopt looser monetary policies to provide some stimulus for their economies.

We were not expecting companies and households in Europe to benefit from an expansion of credit, despite the two massive longer-term refinancing operations (LTRO) run by the European Central Bank. These ***operations have contributed to ease funding pressures and decrease fears of a liquidity crunch, but have not improved credit conditions***. This has been due to the on-going ***deleveraging of the banking sector*** and its ***focus on capital requirements*** to the ***detriment of the accordance of new loans***.

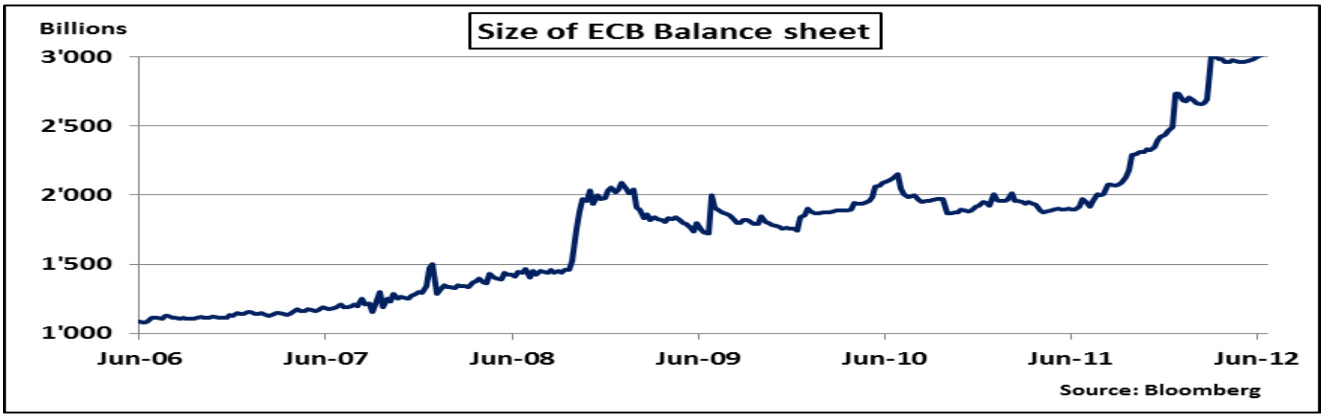
We recommended a ***cautious positioning of the portfolios at the beginning of the year*** due to the high level of uncertainty. The initial appreciation of risky assets came as a surprise, but the ensuing correction confirmed that it was premature to be carrying high levels of risk in the portfolios. Assets providing income such as ***investment-grade credit, high-yield bonds and high quality dividend paying stocks*** have generated positive performances and contributed to limit volatility. So far, our forecast for an ***appreciation of the U.S. dollar against the Euro*** has proven to be correct. The Federal Reserve has so far refrained from undertaking a new round of quantitative easing and the deterioration of the debt crisis in Europe has weighed on the common currency.

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

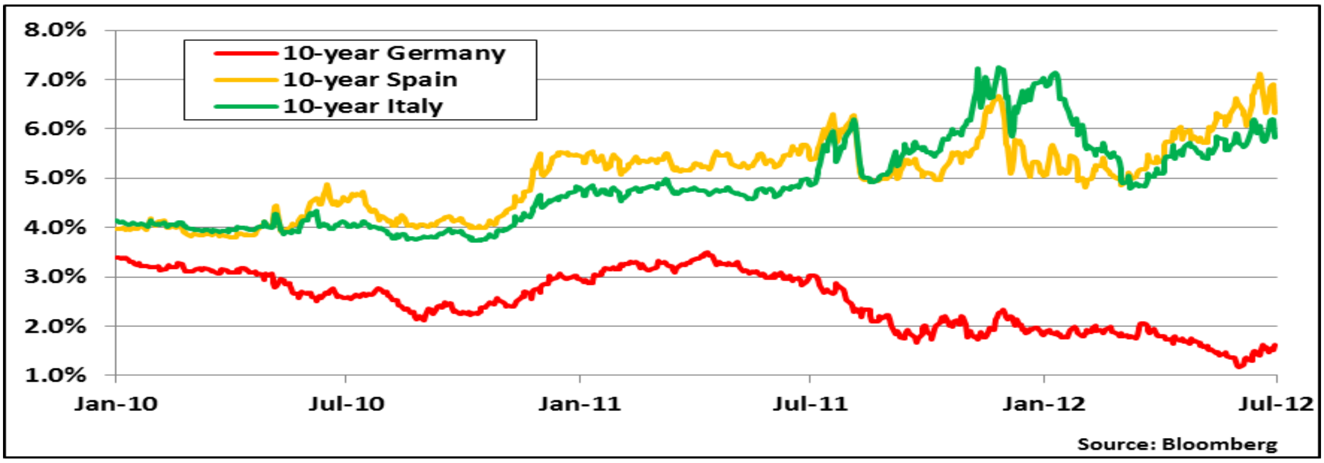
Following an early-year relief period, ***the fears of a Greek exit from the Euro zone*** and the ***solvency of Spain in face of the deterioration of its banking sector*** were at the forefront of investors' concerns from March onwards. The refinancing costs of Spanish and Italian sovereign debt rose to levels deemed unsustainable in the long term, while market participants desperately waited for the outcome of the end-of-June summit of European leaders. For once, the ***measures announced*** (direct recapitalisation of European banks, use of EFSF/ESM funds to stabilize markets, growth pact) ***surpassed the markets' low expectations*** and contributed to push yields significantly lower.

The balance sheet of the European Central Bank



Since the appointment of Mario Draghi as its President, the balance sheet of the European Central Bank has been expanding at a faster pace, reflecting a more pragmatic approach than under his predecessor Jean-Claude Trichet. Two rounds of ECB loans to European banks (LTROs), adding up to one trillion Euros, contributed to the rally of risk assets during the first quarter. The ***ECB's balance sheet now equals one-third of Euro-zone GDP***, a bigger share than the Federal Reserve's one.

European sovereign 10-year yields

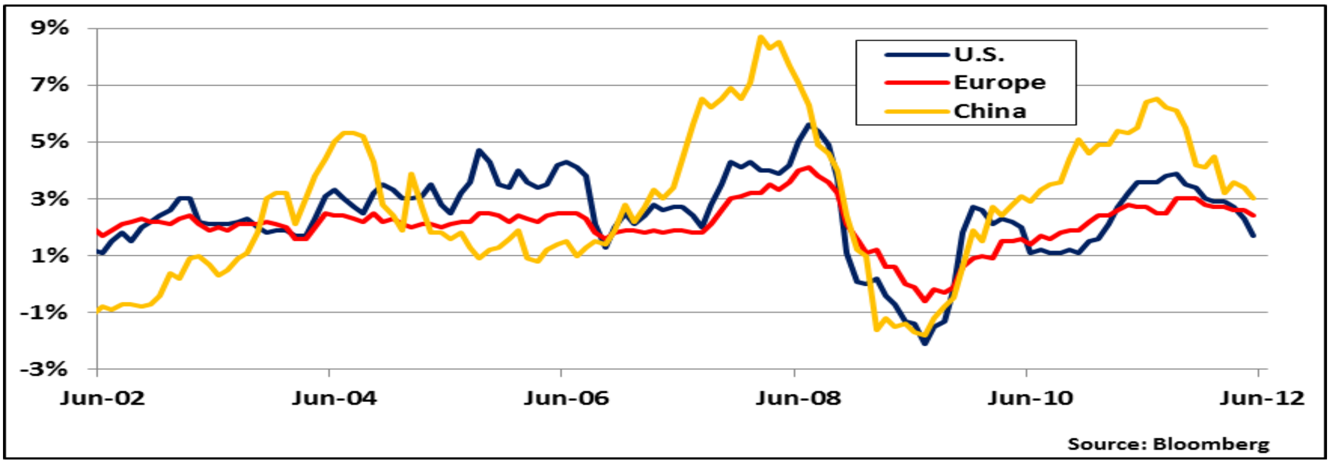


The pressure on Italian and Spanish sovereign debt decreased significantly at the beginning of the year, reflected by the collapse of 10-year Italian yields from 7% to below 5%. However, this trend proved to be only temporary as the impact of the ECB interventions waned off. From then onwards, the markets focussed on the ***deteriorating assets of the Spanish banking sector***, mainly due to the bursting of the country's property bubble. This situation lead to the nationalisation of Bankia and to the acceptance of European aid by an initially reluctant Spanish government in the shape of a ***100 billion Euros bailout***.

Inflation and interest rates

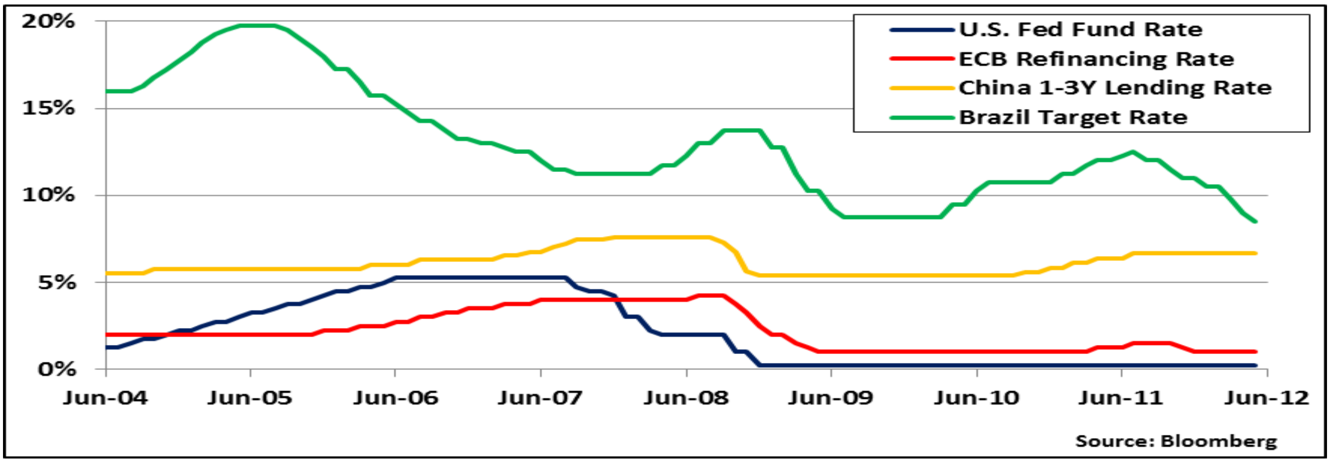
In contrast to 2011, ***global inflation concerns have receded*** as headline rates have declined steadily over the last quarters. The pressure on food prices observed last year, especially in emerging economies, has decreased and the slowdown of economic growth has affected the prices of industrial commodities. Furthermore, this downwards trend has been strengthened by the ***steep decline of the oil price*** from $110 for a WTI barrel in February to an end-of-June price of $85. Slower global activity in the quarters ahead is expected to push inflation lower. The outlook remains for a reduction in consumer price inflation towards an annual rate of close to 2% in the developed world, broadly consistent with policy targets. The drop of inflation levels in emerging economies will also allow their central banks to ***extend the current trend of looser monetary policies***.

Inflation across the world



The chart above shows that ***inflation across the world reached a peak during the second half of 2011***. The global slowdown of economic activity over the last quarters has extended this decline as ***commodity prices***, in particular those of industrial metals and more recently of oil, have been falling due to ***lower demand***.

Interest rates

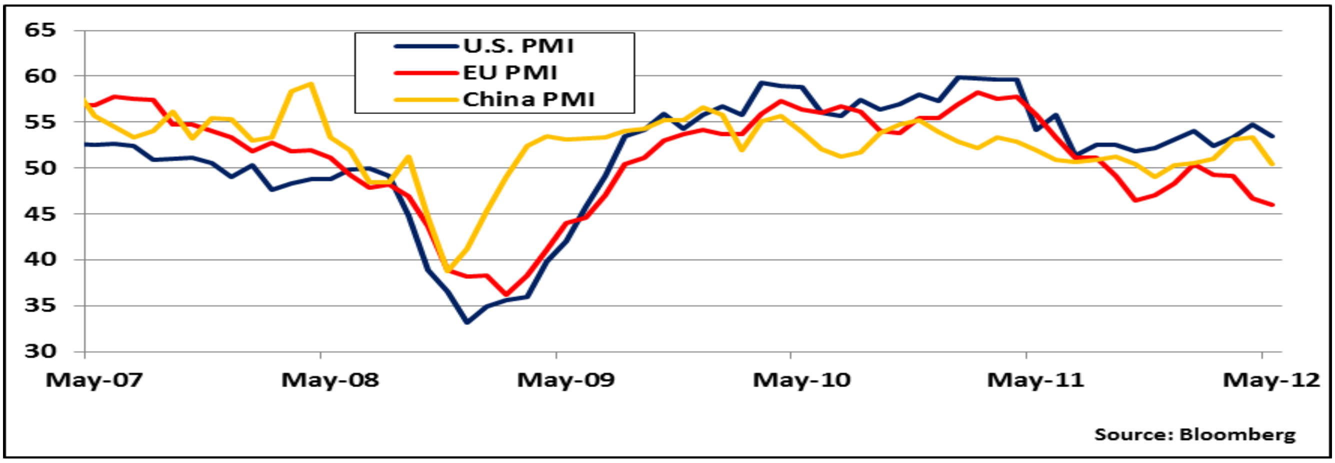


Interest rates remain close to zero across the G-4 economies and their central banks have committed to ***maintain their accommodating policies for as long as necessary***. Their ***counterparts in the emerging economies have been actively loosening their monetary policies*** by cutting their reference rates on the back of lower inflation levels.

Leading indicators

The second quarter has seen ***leading macro-economic indicators across all regions*** come in ***below consensus expectations***. Citigroup's Economic Surprise indices, which track how well economic data is doing in comparison to economic expectations, have plunged to levels not seen since last August. These weak numbers largely explain the ***increasing expectations for additional stimulus measures by central banks***.

Purchasing Manager Indexes

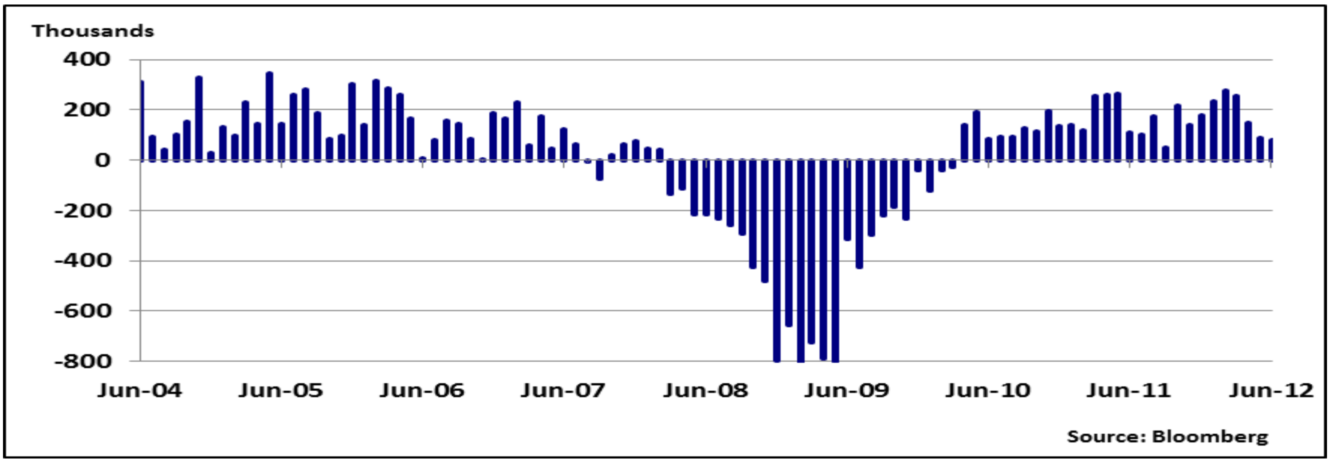


The chart above shows the fall of ***Purchasing Manager Indexes*** over the last year. Whereas U.S. PMI numbers are still indicative of an expansion, those of China are close to indicating a contraction of economic activity. The weakness of the Euro zone is reflected by an end-of-May reading of 46.

Job markets

Conditions in the job markets have recently been deteriorating. ***In Europe, the unemployment rate has now reached 11.1%***, its highest level since the data series started in 1995, and the tone of the business surveys suggest that ***labour market conditions are likely to get worse for some time yet***.

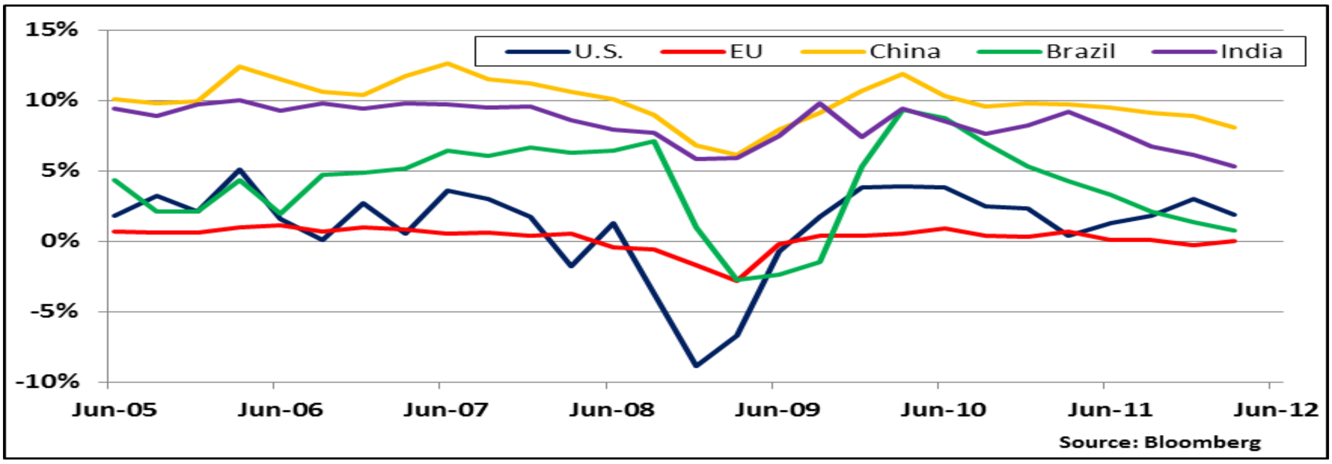
U.S. Nonfarm Private Payrolls (month on month net change)



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 February. More recently, ***data has disappointed and cast doubt on the strength of the recovery***.

World economic growth

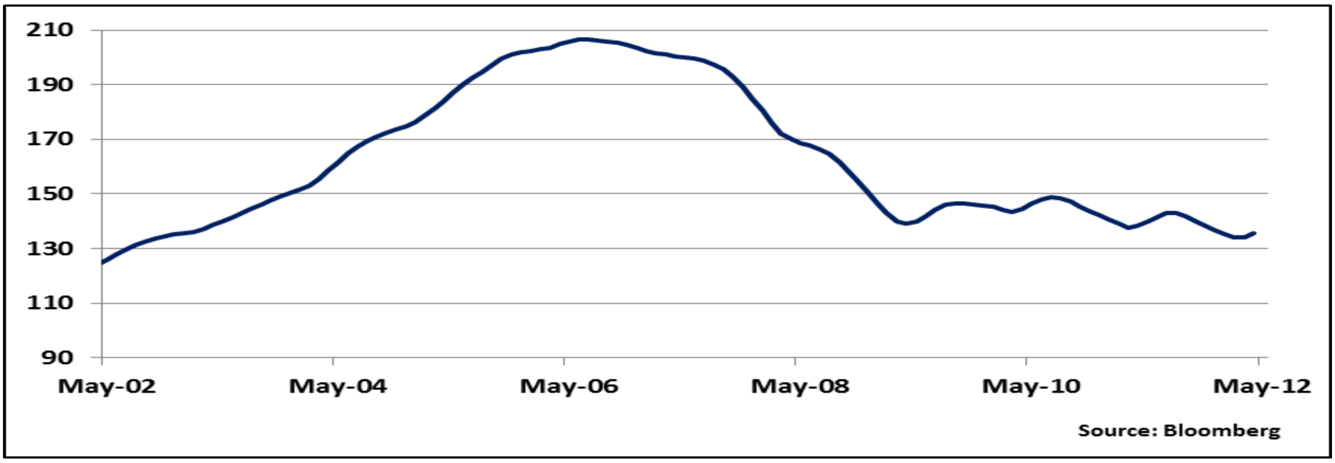
Weaker economic growth has been observed across all regions over the last quarters. However, it is important to point out that the world economy is still expected to expand by 3.5% this year and that the lower growth rates observed in the emerging countries are related to economies which have considerably increased in size over the last years.



As shown above, the ***pace of economic growth (GDP) has started to dip in the United States***, following a rebound during the second part of 2011. ***In Europe***, growth is non existent and ***expectations are for the region to experience recession conditions*** in the quarters ahead. Of even more significance has been the ***slowdown observed in the larger emerging economies***. During the first quarter, ***Brazil grew at an annualised pace of only 0.8%***, while ***India's growth rate was of 5.3%***, its slowest quarterly pace since early 2003 and well below economists' forecasts of 6.1%.

U.S. real estate

Case Shiller Home Price Index

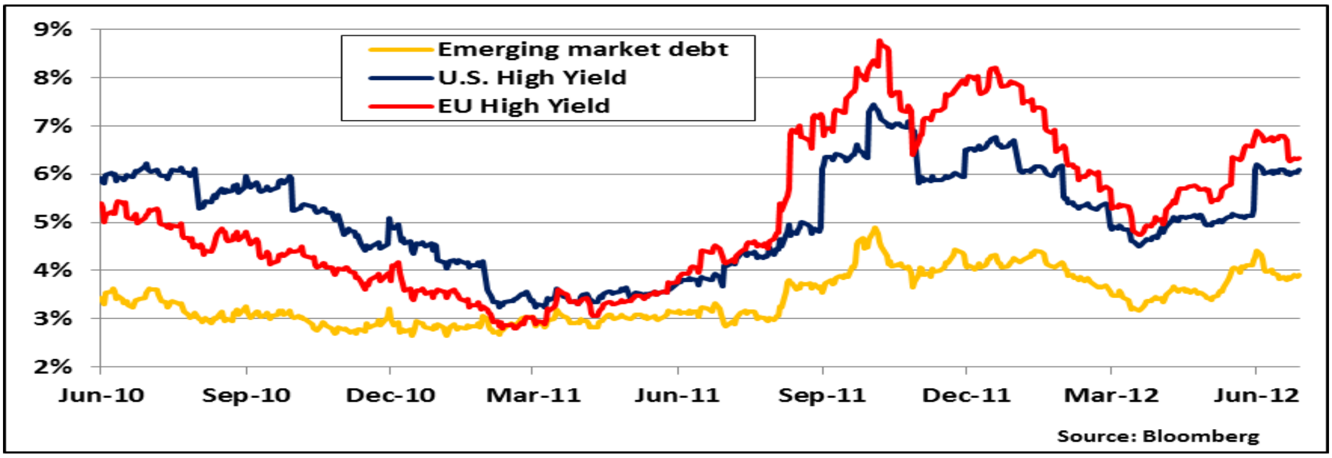


The ***US housing sector*** has been one of the ***rare bright parts of the economy*** during the recent period. It has showed signs of bottoming, with ***residential real estate prices falling at the lowest pace in more than a year*** and ***home sales rising faster than expected***. While this improvement has not yet been reflected in better consumer confidence reports, an extension of this trend would remove an important economic headwind for US households.

Credit spreads and equity markets volatility

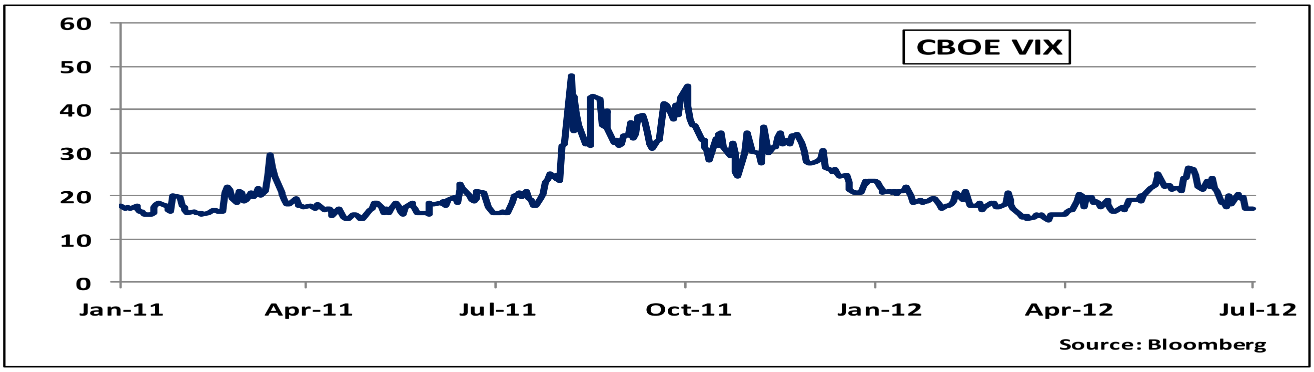
Following a strong start, the ***higher yielding bonds*** within the fixed-income asset class gave back some of their gains ***as investors opted for the safety of G-7 government debt***. This was reflected by the 93 basis points drop of the 10-year U.S. Treasury Note yield between March (2.38%) and May (1.45%), with the 10-year German Bund experiencing a similar move (2.06% to 1.17%).

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)



Despite all the turmoil due to the European debt crisis, the level of volatility in equity markets has remained relatively low for the first six months of 2012, with the CBOE VIX Index moving within a 15 to 25 range for most of the time, well below the 48 level observed in August 2011.

Economic outlook: conclusions

In the light of the charts shown throughout this section, it is clear that ***the global economy is facing less supportive conditions*** and it appears that the current slowdown has not yet reached its trough. Furthermore, the second half of the year will have to deal with uncertainties such as US Presidential and Congressional elections and ensuing negotiations over the debt ceiling and the expiry of tax cuts. However, it is also important to point out that there have been ***some positive developments*** relating to the debt crisis in Europe and a higher probability that central banks across all regions will introduce ***more stimulus measures*** to counter weaker activity. This framework leads us to maintain a ***neutral exposure to equities*** and an ***overweight allocation to debt instruments***.

FINANCIAL MARKETS

	December 2011	June 2012	June performance	1st half 2012
Equities				
S&P 500	1257.6	1362.2	+ 4.0%	+ 8.3%
Euro Stoxx 50	2316.6	2264.7	+ 6.9%	- 2.2%
MSCI EM	916.4	937.4	+ 3.4 %	+ 2.3%
Yields				
UST 10-year	1.88%	1.65%	+ 9bps	- 23bps
Bund 10-year	1.83%	1.58%	+ 38bps	- 25bps
BBB EU	4.80%	4.17%	+ 33bps	- 63bps
Currencies				
EUR/USD	1.296	1.267	+ 2.4%	- 2.2%
USD/CHF	0.938	0.949	- 2.3%	+ 1.2%
EUR/CHF	1.217	1.201	0%	- 1.3%
GBP/USD	1.554	1.571	+ 1.9%	+ 1.1%
Commodities				
CRB Index	305.3	284.2	+ 4.1%	- 6.9%
Oil, WTI	$ 98.8	$ 85.0	- 1.7%	- 14.0%
Gold	$ 1564	$ 1597	+ 2.4%	+ 2.1%

Global stock markets had a strong first quarter, with U.S. and European equities gaining close to 13% and equities of emerging markets appreciating by 18%. The ECB's refinancing operations and stronger-than-expected U.S. economic data were the main reasons that incited investors to add portfolio risk. ***During the second quarter***, however, ***this positive trend gave way to heavy selling pressure***, reflected by a ***21% decline of European equities between March 19 and the 1st of June***. A slight rise of equity prices in June was boosted considerably by a ***massive rally on the last day of the month***, due to the better-than-expected outcome of the highly-awaited EU summit.

The ***trends of high yield bonds and emerging market debt mirrored those of equity markets*** as a large part of the initial tightening of spreads was given up in April and May. During the same period, ***investors piled into US Treasuries and German Bunds, pushing their yields to all-time record lows***.

The Euro initially climbed from a parity of 1.30 against the dollar to 1.35 at the end of February. From then onwards, the ***many issues related to the sovereign debt crisis in Europe weighed heavily on the common currency,*** which ***dropped below 1.24*** at the end of May, before rebounding towards the end of June. Despite its firm commitment to defend the 1.20 floor set against the Euro, the Swiss National Bank has had to face ***significant safe haven buying of the Swiss franc***, leading the bank to ***increase its foreign exchange reserves to more than 50% of the country's GDP***.

The price of ***gold failed to gain much ground*** in dollar terms during the first semester, reflecting ***lower expectations of additional quantitative easing by the Federal Reserve*** as well as a ***change of its correlation relative to risky assets***.

OUTLOOK

We feel that ***the current environment does not favour an aggressive risk-taking approach***. While we could easily argue that the more dynamic asset classes should offer the best opportunities over the longer term, their prices still remain ***too dependent on key political decisions***, especially in Europe. Certain obstacles have been cleared, in particular the Irish "yes" referendum vote to a new EU fiscal pact and the Greek vote to remain committed to the Euro. The latest measures announced, most notably the one related to the breaking of the chains between banks and sovereigns, have also brought some confidence back to the markets. However, there are ***still many obstacles ahead (global slowdown, US fiscal cliff, lower earnings)*** and we are therefore retaining the cautious stance in our portfolios.

Debt instruments

Our outlook on the fixed-income asset class remains positive. Interest rates are anchored close to zero in the mature economies and are declining in the emerging ones. The ***corporate sector is*** by far ***the strongest part of the global economy*** and ***companies' balance sheets are healthy*** and less leveraged. The quality of sovereign and quasi-sovereign debt across emerging countries continues to improve and the yields on offer are often more attractive than those of countries facing serious financial issues. ***In the credit space, spreads are pricing in default rates that appear far too high***, both for investment-grade and high-yield bonds, which is why we remain exposed to those assets.

Equities

We consider that the ***short-term prospects for equities are likely to be capped***, mainly due to the uncertain economic and political environment. Markets will struggle to break out of their current trading range until political issues on both sides of the Atlantic are resolved and/or central banks unleash additional economic stimulus. Corporations are sitting on a mountain of cash, but are refraining from spending much of it and creating new jobs; this is unlikely to change until some degree of confidence has been restored.

FX

Our assessment is that ***the Euro is likely to remain under pressure*** in the coming months due to the prospects of further ECB easing and the unlikely resolution of long-term issues in Europe. Based on these assumptions, we expect the EUR/USD parity to mostly trade in the low 1.20s. We also expect the Swiss National Bank to have to pursue its defence of the 1.20 EUR/CHF floor by accumulating considerable foreign-exchange reserves.

Gold

The environment for an appreciation of gold and precious metals stocks appears more supportive following a protracted correction. The fundamental conditions that led gold to trade briefly above $1'900/oz. are, if anything, more vigorous while mining stocks have underperformed the metal for a lengthy period. A more positive bias towards the price of gold should contribute to a ***significant re-rating of gold mining stocks*** over the next quarters.

ASSET ALLOCATION 2nd HALF 2012

Cash (9%)

The allocation to cash has been increased from 7% to 9%. We feel that the risks related to political decisions remain elevated and that it is still too early to be increasing exposures to traditional assets, considering their current asymmetrical risk profile.

Debt instruments (35%)

The exposure to fixed-income is marginally decreased to 35%, but still represents an overweight allocation to the asset class. In the current economic environment and market conditions, we continue to favour income-generating investments.

During the first quarters, we took some profits on European high yield bonds and reduced our exposure to emerging market debt denominated in local currencies. New investments were made into investment grade debt of the creditor nations and into European convertible bonds offering high levels of yield.

We consider that G-7 government bonds do not offer value at the current yields and we continue to avoid the risks attached to peripheral sovereign debt.

Equities (35%)

The allocation to equities remains neutral at 35%. We consider that valuations are attractive and that a lot of negative news has already been priced in. However, the difficulties in Europe and the expectations of weaker earnings could prevent a re-rating of this asset class in the short term.

We like large international companies which are less exposed to the economic cycle and which can deploy a portion of their large cash reserves under the form of dividends or share buy-backs. In terms of regional exposure, we remain overweight in U.S. equities.

Commodities (7%)

Physical gold (5%)

The 5% allocation to physical gold represents an insurance against extreme shocks. The price of gold is supported by negative real interest rates and the increasing likelihood of more liquidity injections by central banks should provide more support during the second half of the year.

Other commodities (2%)

We maintain our 2% exposure into a balanced and diversified commodity index.

Hedge funds (14%)

The allocation to funds of hedge funds has decreased slightly after some adjustments. These non-correlated assets reduce the volatility of portfolios and their current positioning means they have the capacity to increase market risk if conditions improve sufficiently.

ASSET ALLOCATION GRID 2nd HALF 2012

For our balanced accounts, we apply the following grid:

	Allocation	July 2012
Short-term deposits	**0 – 15%**	**9%**
Debt instruments	**15 – 40%**	**35%**
Investment grade bonds	5 – 30%	13%
EM & high-yield bonds	5 – 20%	11%
Specialist bonds	5 – 15%	11%
Equities	**20 – 50%**	**35%**
Developed markets	10 – 30%	25%
Emerging markets	10 – 30%	10%
Commodities	**0 – 15%**	**7%**
Physical gold	0 – 5%	5%
Other commodities	0 – 10%	2%
Hedge funds	**10 – 30%**	**14%**
		100%

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