Forum Finance Group

since 1994

July 2013

Investment Perspectives 2013
Mid-Year Review & Outlook

INVESTMENT PERSPECTIVES 2013 MID-YEAR REVIEW

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2013 ECONOMIC OUTLOOK REVISITED

In this mid-year review, we will revisit our investment perspectives for 2013 before outlining the asset allocation we recommend for the second half of the year. In January, we expressed the view that the risks within the Euro zone had receded and expected an on-going improvement of conditions in the sovereign debt markets. We also emphasized the ***key role played by the major central banks*** and their impact on the behaviour of capital markets has, if anything, become even more overwhelming during the first half of 2013. As anticipated, the ***threat of inflation has been non-existent*** and ***short-term interest rates have remained stable or even been driven lower*** by central banks, concerned about a slowdown of growth and currency appreciation.

As forecasted, ***global economic growth has been lacklustre*** and the perspectives for the major economies are quite divergent. The U.S. economy has coped well with the automatic budget cuts and ***appears to be in a good position to experience an acceleration of the pace of growth***. The Euro zone economy contracted during the first quarter but ***the prospects for a pick-up of activity are slightly more encouraging***. ***Emerging countries have continued to prioritise a more balanced path of growth*** instead of growth at any cost; this has translated into below-par growth figures, in particular for China and Brazil.

We recommended a ***more dynamic positioning of the portfolios at the beginning of the year*** due to receding tail risks and, to a certain extent, to the lack of fixed-income assets with reasonable yields. This lead us to ***increase our allocation to equities and convertible bonds, reduce the exposure to investment-grade credit and maintain our positions into high-yield and emerging market debt***. We also excluded any investments into highly-rated government bonds. Our assessment that the lower valuations of European and emerging market equities should help them to outperform US ones has proved to be off the mark. However, we had refrained from over-weighting positions in emerging market equities, which has turned out to be a positive decision.

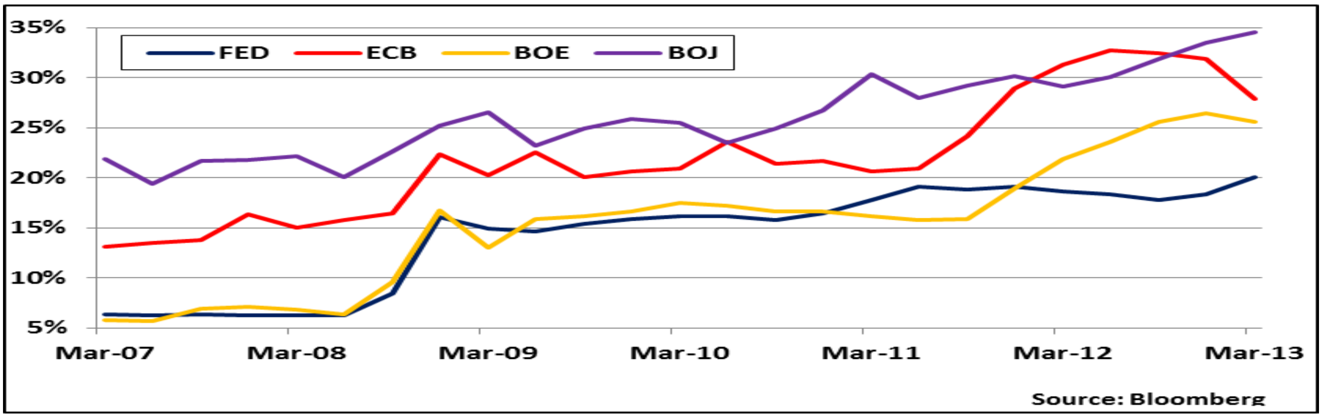
When looking at the prevailing market conditions since the beginning of the year, ***the asset allocation of our portfolios appears to have been quite well-suited***. We must however express a ***genuine dissatisfaction with the year-to-date performances of our portfolios***. Generally speaking, the returns produced by the managers of our selected funds have been very satisfactory and the impact of currency variations has been limited. ***What really hurt portfolio performance was our exposure to gold mining equities, to commodities including physical gold and, to a lesser extent, our equity and debt positions in emerging countries***. Our exposure to commodities has since been cut and profits been taken on certain equity positions, leaving our portfolios with ***above-average levels of cash***. This positioning has contributed to limit the impact of the June correction and will enable us to redeploy this cash in an optimal way during the months ahead. Finally, we must also point out that the performance of the widely referred to MSCI World Equity Index is influenced by the heavy weightings of a limited number of equity markets and does not reflect the ***very diverging performances observed in equity markets across the world*** this year.

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.

Central banks continue to provide abundant liquidity

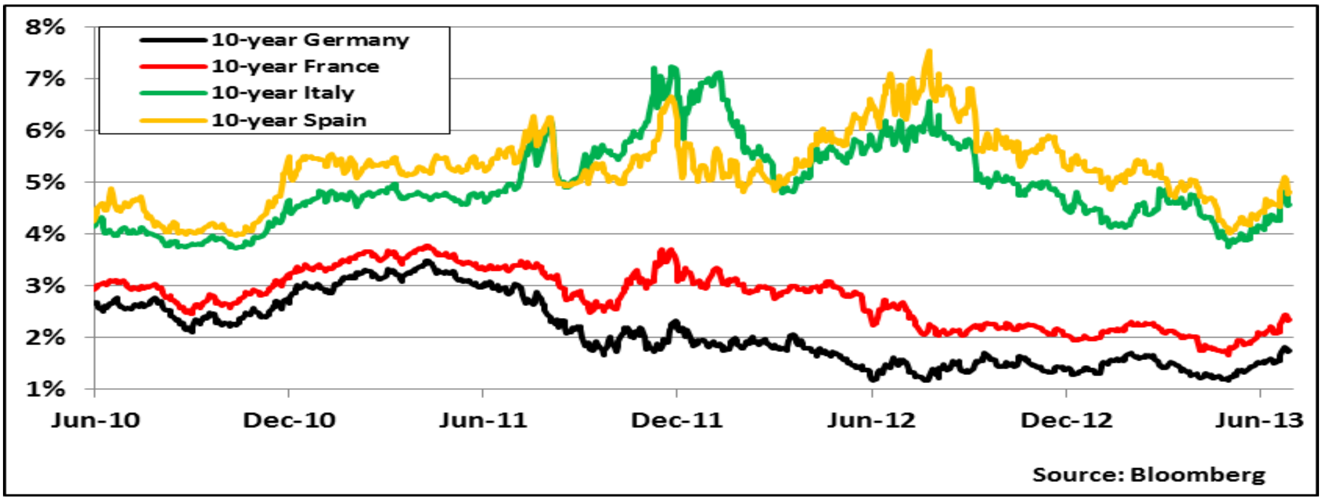
Capital markets continue to be largely driven by the policies of the main central banks (Federal Reserve, European Central Bank, Bank of England and Bank of Japan); the abundance of liquidity provided by these banks largely contributed to the positive performances of their equity and credit markets until the middle of May. Since then, ***poor communication emanating from the Bank of Japan has triggered a correction of Japanese equities and higher government bond yields***; an indication that ***the Federal Reserve was moving closer to scaling back the size of its asset purchase program*** has also caused ***a rise of Treasury yields and of equity market volatility***.

The balance sheets of the main central banks (% of GDP)



The chart above shows that ***the size of the main central banks' balance sheets remain extremely large in relation to the GDP of their countries/region***. Even if the balance sheet of the ECB declined at the beginning of the year as Euro area banks returned some of the cheap loans they took from the central bank last year, the ***Federal Reserve and the Bank of Japan have pursued their expansionary policies*** through the purchase of various types of financial assets.

European sovereign 10-year yields



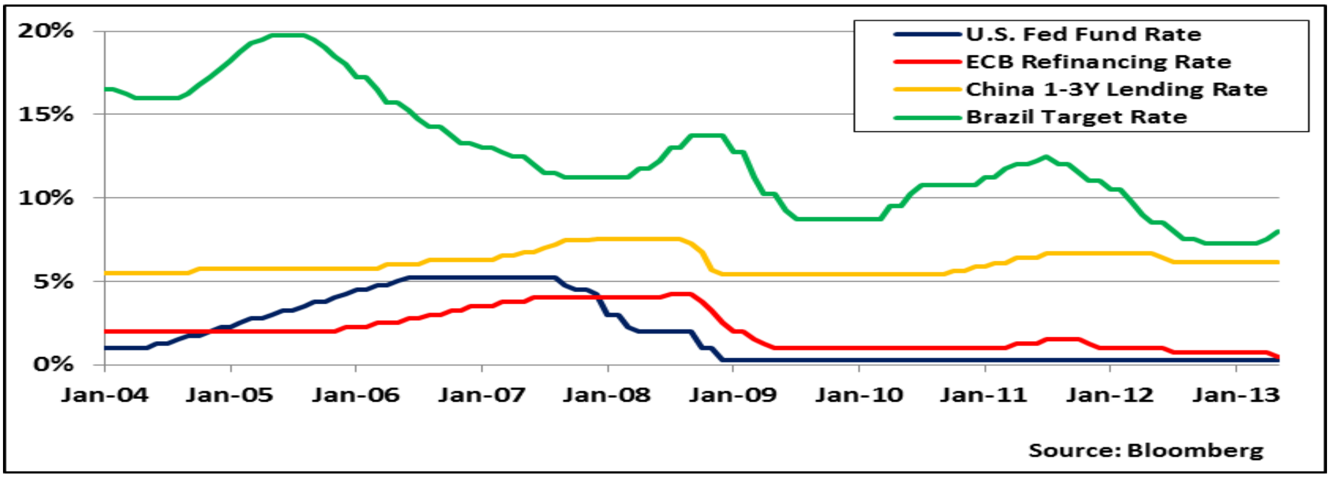
The positive trends observed on Italian and Spanish sovereign debt since July 2012 has extended into 2013; the respective ***yields on 10-year Italian and Spanish government bonds decreased from 6.6% and 7.6% last summer to around 4% in early May***. The recent correction within the global bond markets has pushed yields somewhat higher, but ***the spreads over German Bunds have respectively tightened by 2.5% and 3.3% in less than a year***. This is reflective of investors' confidence in the ability of the ECB to prevent another flare-up of the sovereign debt crisis.

Interest rates and inflation

Short-term interest rates have largely been kept at record low levels and this environment is unlikely to evolve much within the next quarters. With the exception of a rate hike by Brazil's central bank, other central banks, including the European Central Bank and those of Australia, India, Korea and Poland ***have recently cut interest rates***, reflecting fears of a further slowdown of growth and used as a measure to limit any unwarranted appreciation of their currencies.

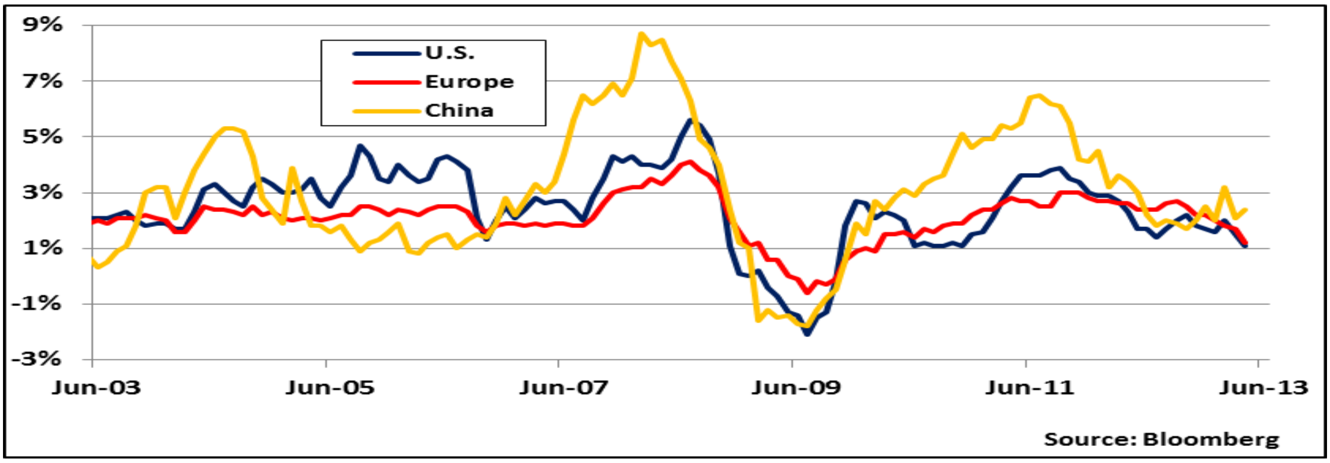
Inflation fears have proved to be overdone so far as ***inflation rates have sunk to levels that have not been observed for a long time***. Expectations for future inflation have also continued to drop due in particular to lower commodity prices and the lack of any wage pressure.

Interest rates



Interest rates remain close to zero across the G-4 economies. The ECB lowered its main rate by 25bps in May to a record low 0.50% and remains committed to introducing further policy action. Several ***other central banks have also lowered borrowing costs*** with the exception of Brazil whose central bank recently raised the benchmark Selic rate by 50 bps in order to contain inflation.

Inflation across the world

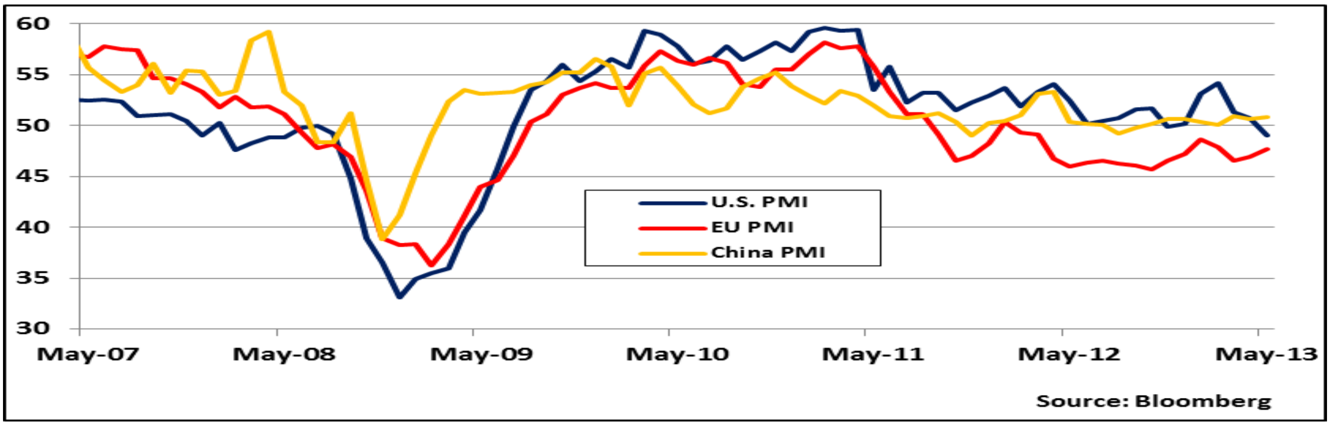


The chart above shows that ***inflation continues to trend lower in the U.S. and in Europe and remains well anchored in China.*** The slow pace of economic activity and declining commodity prices, in particular those of industrial metals, explain the on-going absence of price pressures. At the end of April, ***inflation in Europe and the U.S. had respectively dropped to 1.2% and 1.1%.***

Leading indicators

The ***leading macro-economic indicators*** observed during the last quarter have shown a mixed picture. Whereas the ***numbers in Europe have started to improve*** from a very low base, ***recent data in China have been disappointing*** and indicative of slower growth. In the United States, ***improving economic conditions have incited the Federal Reserve to boost its economic forecasts*** for 2014 and to consider removing some of its support to the economy.

Purchasing Manager Indexes

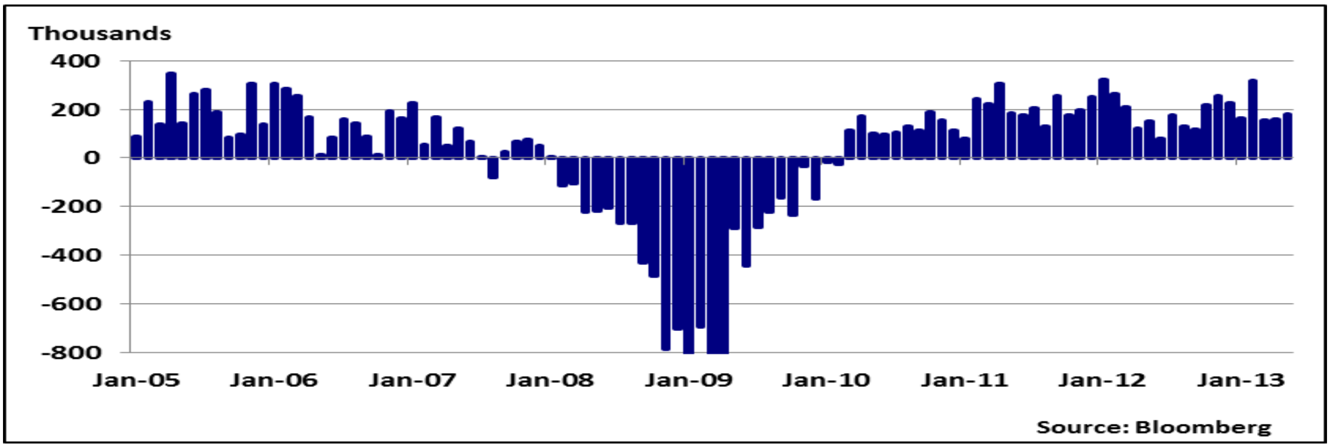


The chart above shows the trends of ***Purchasing Manager Indexes***. In contrast to the majority of economic data showing an improvement, U.S. PMI numbers have been declining. China's numbers are struggling to stay above 50, indicative of an expansion, while the latest reading for the Euro zone is showing a slightly more positive outlook.

Job markets

Conditions in the job markets have continued to worsen in Europe, while ***the trend has been more positive in the United States***. The Euro zone unemployment rate reached a ***record level of 12.2%*** for April with no signs of any near-term improvement of the situation.

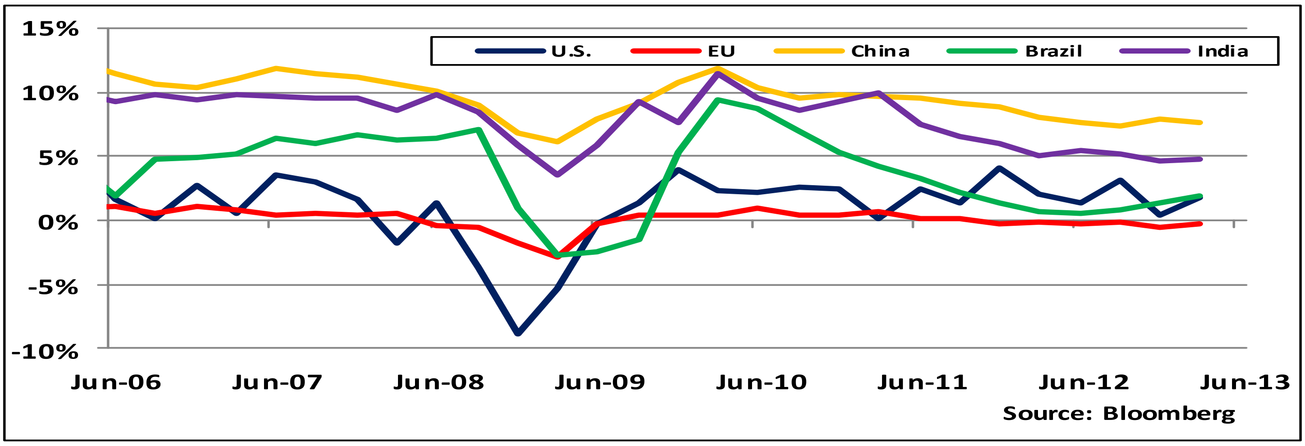
U.S. Nonfarm Private Payrolls (month on month net change)



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, ***have remained quite steady*** during the first months of 2013. The unemployment rate ended May at 7.6%, a slight increase from April, due to a higher participation rate within the workforce.

World economic growth

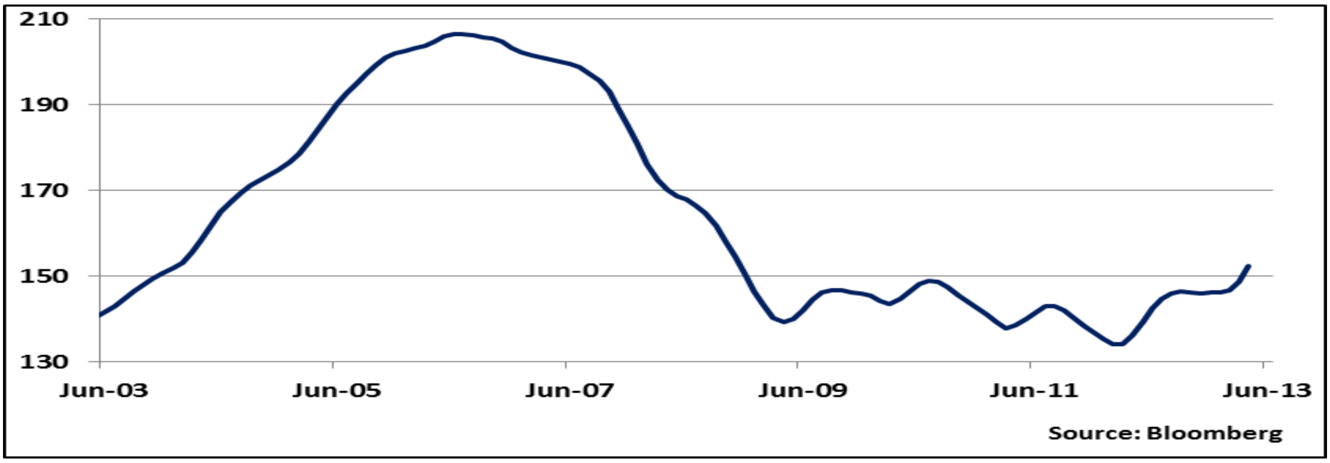
Global economic growth has remained below par and the International Monetary Fund (IMF) has recently trimmed its global growth forecast for 2013 to 3.3% from a previous forecast of 3.5%. This is mainly due to the on-going contraction of the Euro zone economy and an anticipation of slower growth in China, India and Brazil.



As shown above, the ***pace of economic growth (GDP) has started to pick up in the United States***, despite the negative impact of spending cuts known as sequestration. ***In Europe***, growth is non-existent and even ***Germany struggled to generate any growth*** during the first quarter (0.1%). Within the larger emerging economies, ***Brazil grew at an annualised pace of only 1.9%*** during the first quarter, while ***India's growth rate was of 4.8%*** and ***China's first quarter GDP rose at a 7.7% annualized rate***, below market expectations of 8.0%.

U.S. real estate

Case-Shiller Home Price Index

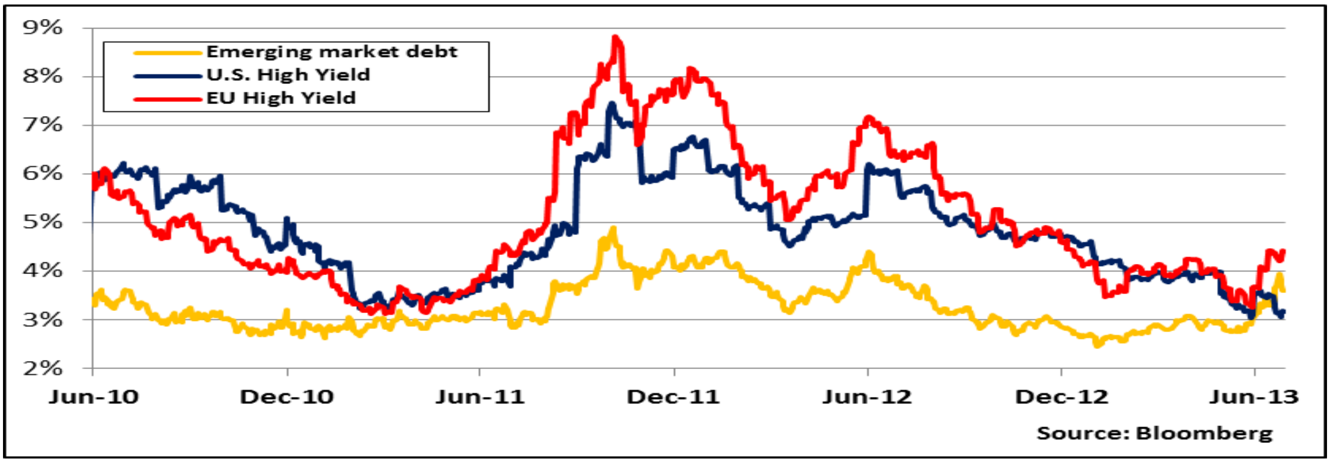


The recovery of the US housing sector, which effectively started during the first quarter of 2012, has been confirmed by the latest data. ***Residential real estate prices***, as observed through the Case-Shiller Home Price Index, ***have appreciated by 12%*** on a year-to-year basis as of end of April. This on-going improvement of the sector has had a positive impact on consumer confidence reports and should contribute to the decrease of unemployment levels.

Credit spreads and equity markets volatility

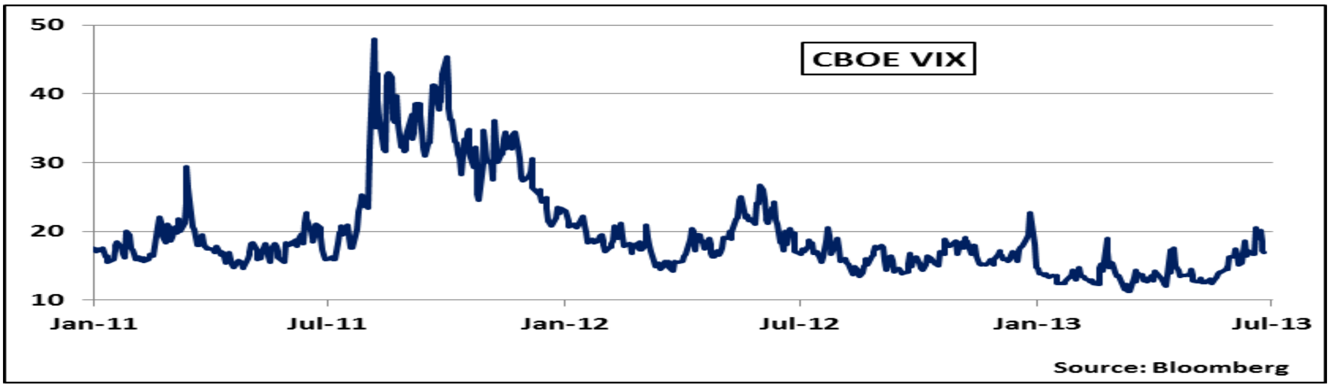
Following a positive start, the ***higher yielding bonds*** within the fixed-income asset class have seen their spreads significantly widen since the middle of May. ***Emerging market debt denominated in local currencies has been hit particularly hard*** due to the prospects of a strengthening US dollar and higher yields on US Treasuries.

Emerging market debt and high yield spreads



US high yield bonds have proved to be quite resilient in the face of higher Treasury yields and their spreads have tightened by 110bps since January. The spreads on European HY are close to the levels observed at the end of 2012, while those on ***EM debt have widened from 2.7% to 3.6%***.

Chicago Board Options Exchange Volatility Index (VIX)



The ***level of volatility observed in equity markets has been extremely low*** during the first six months of 2013. Over the period, the CBOE VIX Index has averaged a level of 14 and ***it has only recently moved higher***, as a consequence of the sell-off observed in equity and bond markets.

Economic outlook: conclusions

In the light of the charts shown throughout this section, it is clear that ***the global economy is struggling to gather any strong momentum.*** However, it appears that ***GDP growth is currently at trough levels*** and that ***economic conditions are expected to gradually improve*** during the next quarters. The ***US economy appears to be well positioned to experience an acceleration of growth***, while ***conditions in the Euro zone have most likely bottomed***. Despite the recent talk of "tapering" by the Federal Reserve, central banks are committed to their very accommodative monetary policies and it is even conceivable that ***additional measures could be taken by the ECB***. This framework leads us to ***maintain our bias towards equities*** over the second half of 2013.

FINANCIAL MARKETS

	December 2012	June 2013	June performance	1st half 2013
Equities				
S&P 500	*1426.2*	*1606.3*	*- 1.5%*	*+ 12.6%*
Euro Stoxx 50	*2635.9*	*2602.6*	*- 6.0%*	*- 1.3%*
MSCI EM	*1055.2*	*940.3*	*- 6.8%*	*- 10.9%*
Yields				
UST 10-year	*1.76%*	*2.49%*	*+ 36bps*	*+ 73bps*
Bund 10-year	*1.32%*	*1.73%*	*+ 22bps*	*+ 41bps*
BBB EU	*2.98%*	*3.25%*	*+ 45bps*	*+ 27bps*
Currencies				
EUR/USD	*1.319*	*1.301*	*+ 0.1%*	*- 1.4%*
USD/CHF	*0.915*	*0.945*	*- 1.1%*	*+ 3.3%*
EUR/CHF	*1.208*	*1.229*	*- 1.0 %*	*+ 1.7%*
GBP/USD	*1.626*	*1.521*	*+ 0.1%*	*- 6.5%*
Commodities				
CRB Index	*295.0*	*275.6*	*- 2.2%*	*- 6.6%*
Oil, WTI	*$ 91.8*	*$ 96.6*	*+ 5.0%*	*+ 5.2%*
Gold	*$ 1675*	*$ 1235*	*- 11.0%*	*- 26.3%*

Until the month of May, global equities had been trending higher thanks to the strong returns recorded by a ***limited number of the larger equity markets***, in particular the ***US, Japan and the UK***. In contrast, ***global emerging markets were already underperforming***, under the leadership of Brazil, China and Russia. While US and European equities managed to close higher in May, the prices of Japanese and emerging markets' equities were under pressure and ***this negative trend spilled over to all equity markets during a very difficult month of June***.

In May, ***record low yields were observed on 10-year US Treasuries (1.63%) and German Bunds (1.17%)*** while ***credit spreads remained on a tightening trend until the end of the month***. Since then, emerging market debt has been badly hit by the talk of Fed tapering and ***yields on 10-year Treasuries and Bunds have respectively spiked to 2.49% and 1.73%.***

Following an ***initial appreciation of the EUR/USD parity to 1.365*** in early February, the ***common currency dropped as low as 1.28*** due to ***inconclusive elections in Italy and a botched Cyprus bailout deal***. Thereafter, the Euro recovered up to 1.34 until it was hit by the June global sell-off of all risky assets, leaving it virtually unchanged year-to-date. The ***depreciation of the Swiss franc against the Euro to a level of 1.258 in May*** lead to some speculation that the Swiss National Bank might consider raising its 1.20 floor to a higher level. The recent market movements have brought the ***EUR/CHF parity back to a level of 1.23***, making this scenario most unlikely in the near term.

The steep drop of the price of gold was firstly due to the ***heavy selling of index-tracking exposures***, reflecting a reduction of the aversion to risk. More recently, the prospects of a ***reduction of the Federal Reserve's quantitative easing policies and a rise of bond yields*** have added further pressure on the gold price, which has dropped by 26% during the first semester.

OUTLOOK

The current environment leads us to temporarily adopt ***a more defensive positioning,*** explaining our ***higher-than-usual level of cash.*** While we believe that ***markets are overreacting to the Fed's stance***, it will probably take some time for markets to settle and determine a fair value of bond and equity prices in a post-QE world. The decision of the Federal Reserve to start decreasing the size of its purchase program is data dependent and its current growth outlook is more optimistic than the consensus. The low level of inflation and an unemployment rate just below 8% are still some way off the Fed's targets and ***a steep rise of bond yields would undo a lot of the work carried out until now***. The sell-off in bonds and equities is a negative for the economy which could ultimately dent some of the Fed's optimism and revert some of the expectations for a less supportive policy.

Debt instruments

Our overall outlook on the fixed-income asset class is neutral. Short-term interest rates are anchored close to zero in the mature economies and are unlikely to be raised anytime soon despite the shift in expectations regarding the Fed's policy. While long-term bond yields have recently spiked, we do not believe that this trend will extend much further. ***Our allocation within debt instruments favours secured loans, high-yield and convertible bonds*** to the detriment of highly-rated sovereign debt, investment-grade credit and emerging market bonds.

Equities

We consider that equities remain the asset class of choice. Despite the fact that equity markets have recently experienced higher volatility, our ***positive outlook for equities*** is based on valuations that generally remain below long-term historical averages and on an improving outlook for global growth. The strong financial health of companies will ensure that shareholders will continue to benefit from ***growing dividends*** and ***share buyback programs***. At this stage, we maintain a clear ***preference for developed equity markets*** over emerging ones.

FX

The ***market conditions have become more supportive for the US dollar***; we expect the increase of volatility and a reversal of some of the QE trades to benefit the dollar against most currencies, in particular those of commodity producing countries. Concerning the Swiss franc, the situation has evolved in favour of the Swiss National Bank as ***the EUR/CHF parity has trended away from the 1.20 floor***; we do not anticipate any changes of the central bank's policy in the near term.

Gold

The environment for commodities in general and for gold in particular remains challenging. The perspective of positive real interest rates and the downgrades to growth in emerging countries are acting as negative forces and pushing prices lower. This situation is unlikely to evolve much in the near term and ***our exposure to commodities is limited to physical gold and a small allocation to gold mines.***

ASSET ALLOCATION 2nd HALF 2013

Cash (10%)

Since January, the allocation to cash has been increased from 6% to 10%. We feel that the current environment needs to stabilize before we decide to deploy this cash position to build new positions at attractive entry levels.

Debt instruments (28%)

The exposure to fixed-income has been reduced from 30% to 28%, representing a neutral allocation to the asset class. The exposure to investment-grade bonds has been reduced in favour of senior secured loans, offering more attractive yields and a much lower duration risk.

During the first quarters, we sold the convertible bond fund investing into commodity-related convertible bonds, hence the decrease of the “specialist bonds” pocket from 12% to 10%. Additionally, the exposure to emerging market debt has been cut by half in most of the portfolios.

The fund investing into emerging market convertible bonds that was bought towards the end of 2012 has performed extremely well in absolute and relative terms and convertible bonds in general represent an asset class that we continue to favour.

Equities (45%)

The allocation to equities has been increased to 45%. We consider that the asset class remains the most attractive one as valuations are still below long-term average levels and that the prospects for a modest macroeconomic recovery should be supportive despite expectations of higher yields.

We continue to favour an exposure to the equities of developed markets at this stage. International companies with strong brands and dominant market share are those best positioned to generate higher earnings in a consistent manner.

Commodities (4%)

Physical gold (4%)

The depreciation of the price of gold has brought the position down to 4% of the portfolios. This allocation to physical gold represents an insurance against extreme shocks and must be seen as a store of value over the long term.

Other commodities (0%)

We have sold our 2% position into a balanced and diversified commodity index due to the lack of catalysts that could trigger higher prices of the asset class’ main components in the near term.

Hedge funds (13%)

The allocation to funds of hedge funds has decreased slightly following some adjustments. These non-correlated assets reduce the volatility of the portfolios and hedge fund managers have generated very respectable returns year-to-date with a good control of the levels of risk.

ASSET ALLOCATION GRID 2nd HALF 2013

For our balanced accounts, we apply the following grid:

	Allocation	July 2013
Short-term deposits	**0 – 15%**	**10%**
Debt instruments	**15 – 40%**	**28%**
Investment grade bonds	5 – 30%	8%
EM & high-yield bonds	5 – 20%	10%
Specialist bonds	5 – 15%	10%
Equities	**20 – 50%**	**45%**
Developed markets	10 – 40%	35%
Emerging markets	10 – 30%	10%
Commodities	**0 – 15%**	**4%**
Physical gold	0 – 5%	4%
Other commodities	0 – 10%	0%
Hedge funds	**10 – 30%**	**13%**
		100%

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