Forum Finance Group

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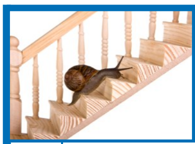
July 2014

Investment Perspectives 2014
Mid-Year Review & Outlook



INVESTMENT PERSPECTIVES 2014 MID-YEAR REVIEW

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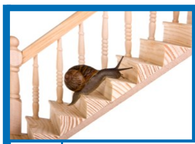


2014 ECONOMIC OUTLOOK REVISITED

Our key message was that risky assets should do well...

In this mid-year review, we will take a brief look back at what was written in our January 2014 investment perspectives and analyse some key economic indicators before explaining the asset allocation that we recommend for the second half of the year. In January, our main message was that risk assets, and equities in particular, should be supported by a slowly improving economic background, the reduction of tail risks and more attractive valuations than those of the safest debt instruments. We also expected the major central banks to extend their supportive monetary policies and, in the case of the Federal Reserve, to cautiously manage the markets' expectations for a hike of short-term interest rates.

Global economic growth has disappointed during Q1...but should improve...

Global economic growth turned out to be below forecasts during the first quarter. The weather-affected US economy recorded a totally unpredictable contraction of its GDP at a 2.9% annualized rate, while the Euro-zone economy also grew less than expected as it only expanded by 0.2% compared to expectations of 0.4%; growth was only positive thanks to the rude health of the German economy, which compensated for the stagnation observed in France and the shrinking activity in economies such as Italy and the Netherlands. Finally, growth has also disappointed in the developing economies, due to political turmoil, rebalancing in China and slow progress on structural reforms. Looking ahead, however, global economic activity should gather speed as the year progresses and continue to build momentum in the years ahead.

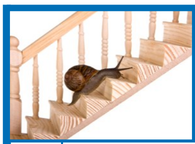
Equities have been gathering momentum...and remain our favourite asset class...

Our positive outlook on equities was challenged by the weak start to the year, but the asset class quickly recovered and is now behaving more in-line with our expectations. In contrast, the safest debt instruments have fared better than what we were expecting; however, our preference for high-yield and convertible bonds proved to be equally rewarding due to the positive impact of lower interest rates and tighter spreads. The contribution of hedge funds has been underwhelming and has not matched our expectations so far. Finally, our long-term bias towards the US dollar seems finally to be paying off as we believe that the EUR/USD parity of 1.40 represents a level unlikely to be revisited for some time.

Our overall asset allocation remains much the same...

The prevailing financial and economic conditions have not led to major changes of the portfolios' structure; the allocations to the different asset classes have remained much the same since the beginning of the year, but there has been some turnover within the different asset classes. At this advanced stage of the recovery cycle, we are cognizant of the potential pitfalls ahead and are prepared to implement significant allocation changes in due course.

In the next section of the document, we will review some of the factors that have had the biggest impact on financial markets so far this year and also highlight several 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 market outlook and the asset allocation we currently recommend.



The disparity of the major central banks' monetary policies

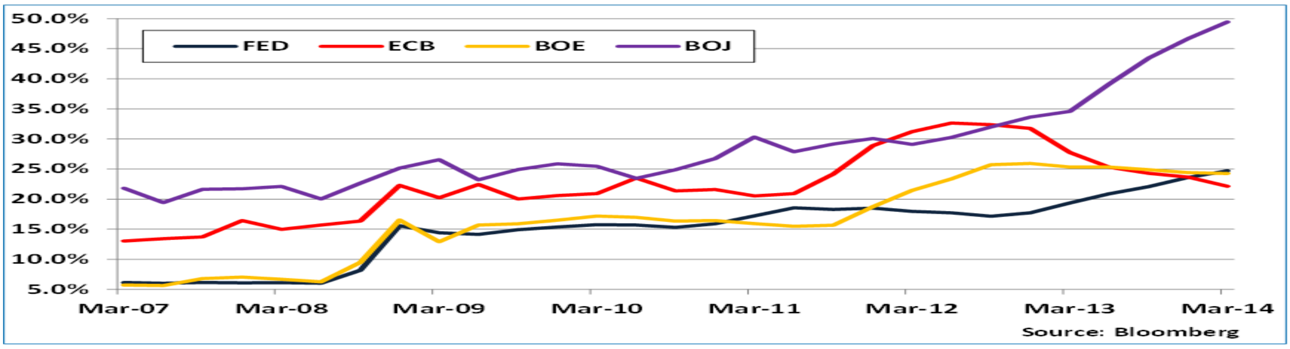
Central banks continue to be effective and dominant, but policies are now diverging...

The capital markets remain hooked on the liquidity provided by the major central banks; however, their monetary policies are starting to diverge in accordance with the different economic cycle stages of their respective economies. The improvement of the US economy has enabled the Federal Reserve to progressively reduce the size of its purchases of financial assets but, even at this stage, its balance sheet remains in expansion mode. The path to a normalisation of short term interest rates is still not written in stone and is being cautiously managed by the new Fed Chair Janet Yellen.

The Bank of England is most likely to be the first to hike interest rates...

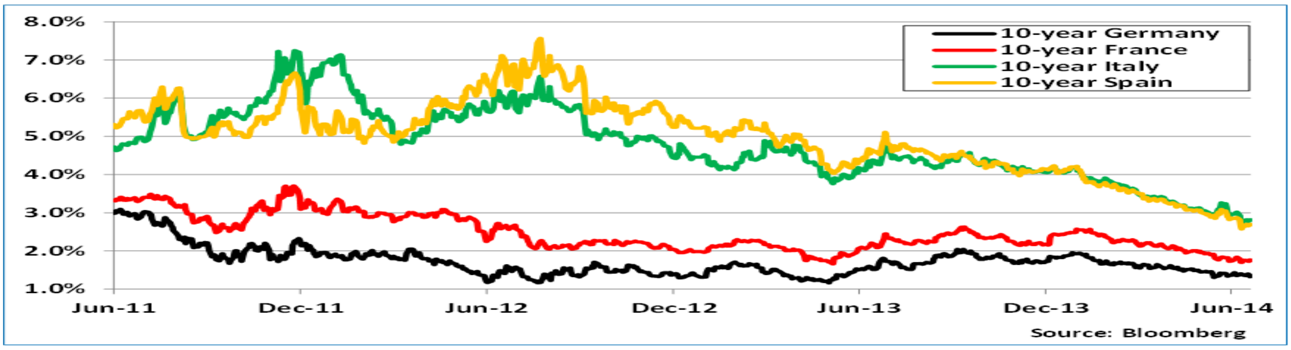
The most hawkish central bank is the Bank of England, with its Governor Mark Carney recently stating that interest rates could be lifted sooner than expected. In contrast, the Bank of Japan is maintaining its monetary policy framework, under which it has pledged to dramatically increase the base money supply each year ($588 billion to $686 billion) through aggressive asset purchases. Finally, the European Central Bank has had to introduce new measures in order to fight against the risks of deflation and to stimulate the growth of credit.

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



The chart shows that the balance sheet of the Bank of Japan is expanding at the fastest pace, while the size of the Bank of England's balance sheet has peaked. The European Central Bank has recently been forced to introduce an easing of its monetary policy without, however, directly intervening in the bond markets.

European sovereign 10-year yields



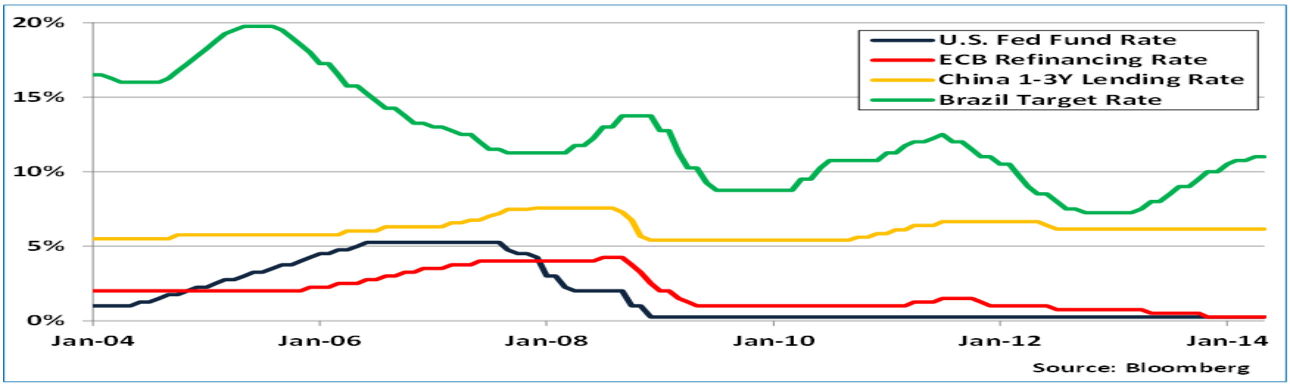
Unexpectedly, the yields of the most highly-rated government bonds have continued to decline this year. The chart above shows that the yields of peripheral sovereign debt such as Italy and Spain have declined at a much faster pace than those of the core. From an end-2013 level of 4.2%, yields on 10-year Italian and Spanish government bonds have dropped well below 3%.

Interest rates and inflation

Low short term interest rates for some time yet...

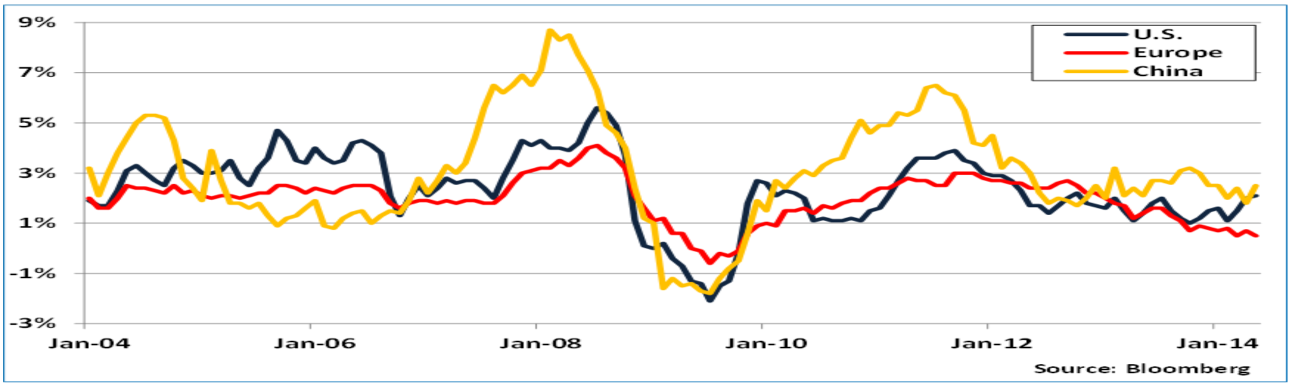
Short-term interest rates in the major economies have been kept at record low levels and even been recently cut by the European Central Bank. The prospect of higher interest rates in the Euro zone appears very remote with most economists expecting interest rates to stay at present levels through at least 2016. In the US, the Fed Chair Janet Yellen is sticking to a balanced and non-committal position relative to the first hike of rates; market expectations are for them to start rising from mid-2015 onwards on the back of a stronger economy and rising inflation pressures. The Bank of England is most likely to be the first to raise interest rates due to the strong recovery of the UK economy and climbing domestic house prices.

Interest rates

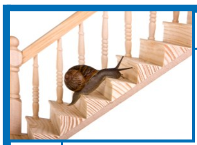


In contrast to the interest rate levels within the developed economies, those of several large emerging economies have been rising due to inflationary pressures in the wake of depreciating currencies. This is illustrated in the chart above with climbing short term interest rates in Brazil; Turkey and South Africa also figured amongst emerging countries hiking their rates this year.

Inflation across the world



The chart above shows the declining trend of inflation in the Euro zone; inflation in May was of 0.5 percent, matching the slowest pace in more than four years. This level of inflation is well below the 2 percent target of the European Central Bank and one of the key reasons behind the latest measures taken by the bank.

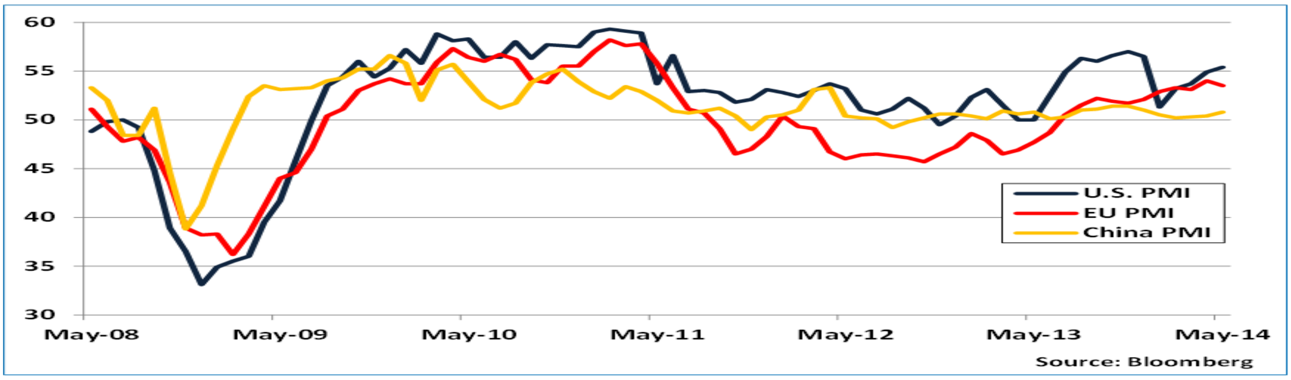


Leading indicators

Leading indicators have been showing improvement...

The leading macro-economic indicators observed during the last months have generally been pointing to an improvement of the global economy. Some of the concerns about a hard landing for the Chinese economy have been allayed by a recent pick-up of data, whereas the US is rebounding strongly following the first quarter dip. In Europe, the global picture remains mixed as some countries are struggling to build positive momentum following last year's recessionary period.

Purchasing Manager Indexes



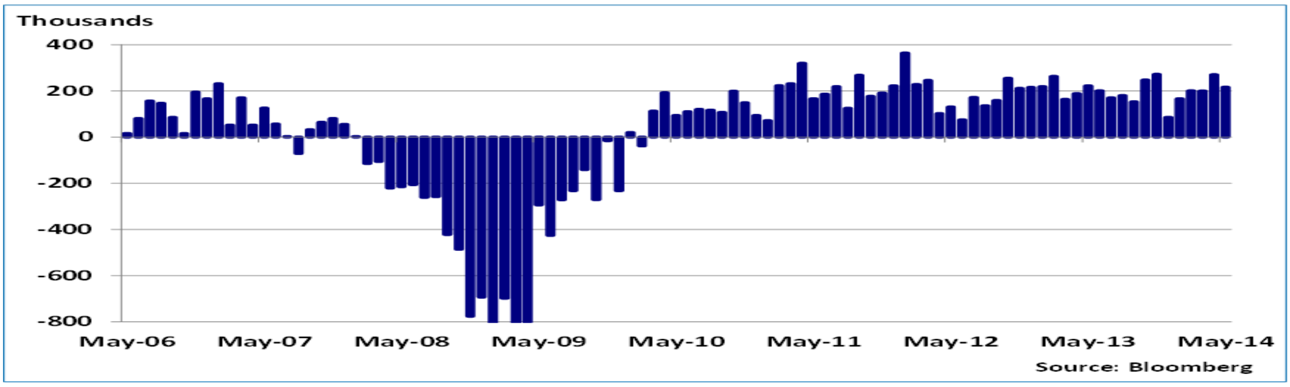
The prevailing trends of the Purchasing Manager Indexes are generally positive, with the US PMI climbing for the fourth straight month, reflecting a gain of momentum following a slowdown at the start of the year. China's numbers have recently been modestly improving after having hovered just above the 50 level, indicative of an expansion. The last year has seen a sharp improvement of the readings for the Euro zone, even though the numbers for May have dipped a little.

Job markets

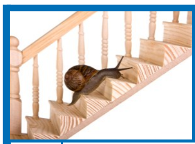
Unemployment in Europe remains close to peak levels...

Conditions in the job markets have been improving across the developed economies; the unemployment rates in the US and the UK have been steadily declining (-1.2% from a year ago in both cases). Some modest progress has also been made in the Euro zone (May unemployment rate at 11.6% compared to a 12% peak).

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



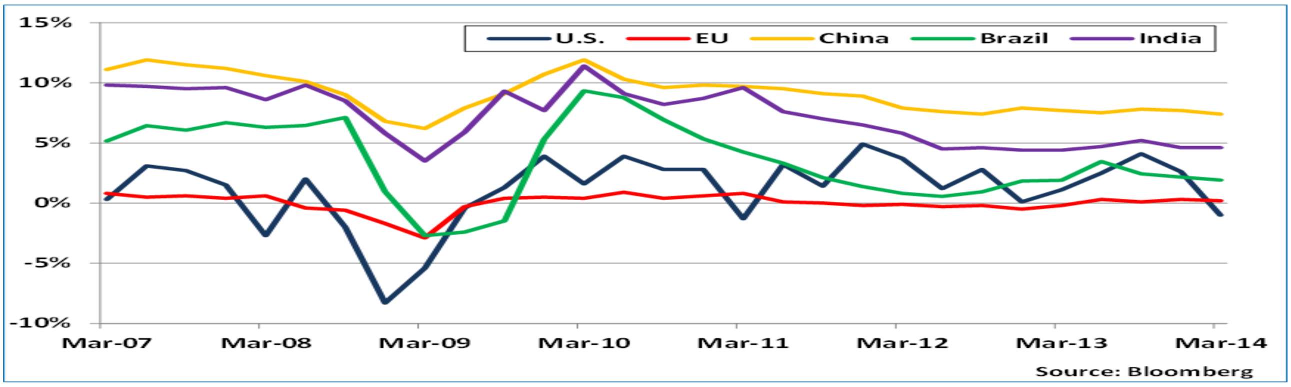
In the U.S., conditions in the labour markets, as measured by demand for initial jobless claims and the number of nonfarm jobs created in the private sector, have been improving during the first months of 2014. The unemployment rate ended May at 6.3%, a 1.2% decrease from a year ago; this progress must however be tempered due to a lower labour force participation rate standing at 62.8%.



World economic growth

Economic growth forecasts have been lowered...

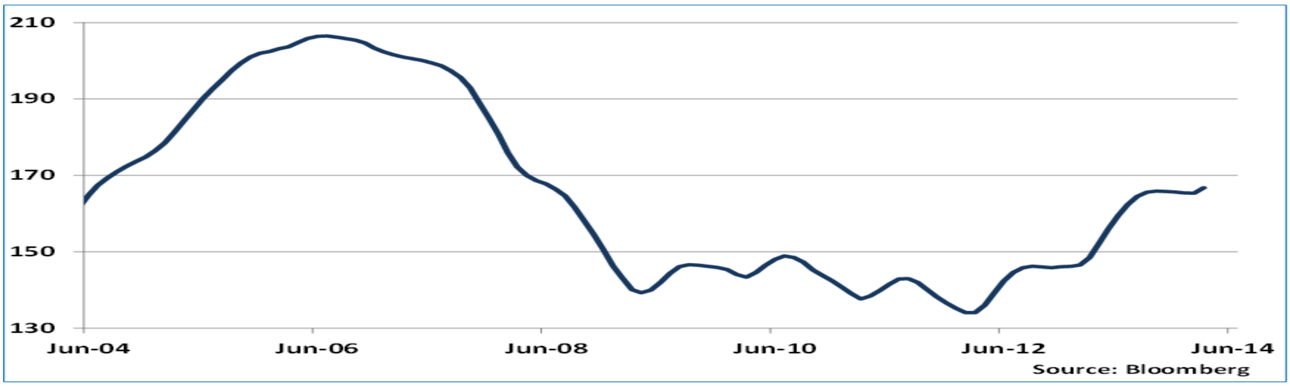
Following a weak start to the year in both rich and poor countries, growth forecasts for the whole of 2014 have recently been cut by the World Bank; the bank now expects the global economy to grow by 2.8% compared with the 3.2% predicted in January. The International Monetary Fund (IMF) has also recently cut its forecast for U.S. economic growth by 0.8% to 2%, citing a harsh winter and a struggling housing market. Nevertheless, global economic activity is still expected to improve during the rest of the year and accelerate in the years ahead.



The chart shows the steep slowdown of the US economy during this year's first quarter, largely due to unusual climatic conditions; economic activity has since rebounded strongly. In the Eurozone, the recovery is still fragile and uneven between the region's different countries. Across the large developing economies, the pace of growth is relatively stable but modest in comparison to longer-term levels.

U.S. real estate

Case-Shiller Home Price Index



The recovery of the US real estate market is slowing...

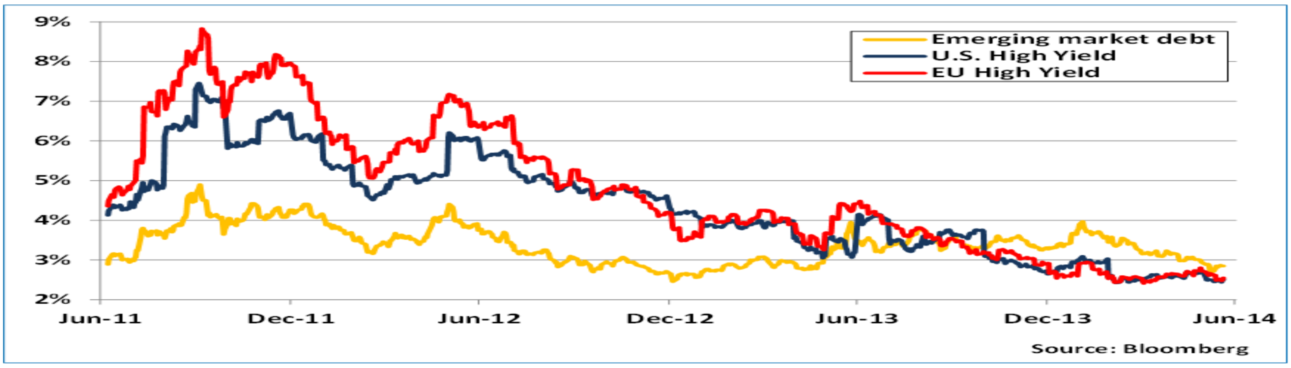
As shown above, the price of US residential real estate has been appreciating since early 2012; however, the recovery of the housing market is stalling due to the rising prices, stagnant incomes and the lack of credit. The percentage of new and existing homes affordable to families earning the national median income dropped to 66% during the first quarter from 74% a year earlier (according to the National Association of Home Builders).

Credit spreads and equity markets volatility

The ongoing search for yield pushes spreads lower...

The spreads of higher yielding bonds have tightened during the first half of the year despite a difficult month of January due to political turmoil and investors' bias towards defensive assets. The spreads of emerging market bonds are back to the previous year's levels while high-yield bonds have continued to perform well.

Emerging market debt and high yield spreads



Emerging market debt has started to recover since February with its spread dropping from a recent high of 4% to the current level of 2.8%; the European high yield asset class has been a strong performer year-to-date, reflected by the contraction of its spread level from 2.9% to 2.7%.

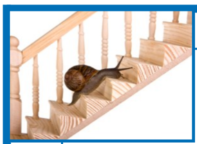
Chicago Board Options Exchange Volatility Index (VIX)

Volatility observed across all asset classes has continued to decrease and is close to all-time record lows; by way of example, the most widely followed volatility indicator, the Chicago Board Options Exchange Volatility Index (VIX), has dropped from 13.7 to 11.6 during the first semester. This low volatility results from the policies of the major central banks and any mismanagement of their exit policies is likely to negatively impact the markets and trigger a higher volatility regime.

Economic outlook: conclusions

*We believe that **economic conditions are slowly improving** but that **there remains a lot of progress to be achieved before central banks can feel sufficiently comfortable to withdraw their support**; this is clearly reflected by the Fed's cautious stance and the latest measures taken by the ECB.*

***Inflation remains low** and **macro tail risks continue to abate**, reflected by the tighter spreads of peripheral debt and lower volatility. There is little reason to believe that this environment will evolve much in the coming months in view of the **overwhelming influence exerted by the major central banks**.*



FINANCIAL MARKETS

	End 2013	June 2014	June performance	1st half 2014
Equities				
S&P 500	1848.4	1960.2	+ 1.9%	+ 6.0%
Euro Stoxx 50	3109.0	3228.2	- 0.5%	+ 3.8%
MSCI EM	1002.7	1050.8	+ 2.3%	+ 4.8%
Yields				
UST 10-year	3.03%	2.53%	+ 5bps	- 50bps
Bund 10-year	1.93%	1.25%	- 11bps	- 68bps
BBB EU	3.42%	2.26%	- 11bps	- 116bps
Currencies				
EUR/USD	1.374	1.369	+ 0.4%	- 0.4%
USD/CHF	0.893	0.887	- 0.9%	- 0.7%
EUR/CHF	1.227	1.214	- 0.6 %	- 1.1%
GBP/USD	1.656	1.711	+ 2.1%	+ 3.3%
Commodities				
CRB Index	280.2	308.2	+ 0.9%	+ 10.0%
Oil, WTI	$ 98.4	$ 105.4	+ 2.6%	+ 7.1%
Gold	$ 1206	$ 1327	+ 6.2%	+ 10.0%

Equities are on track to produce high single-digit returns in 2014...

Following an unexpectedly weak month of January, global equity markets have been consistently trending higher; at the current pace, they are on track to produce high single-digit annual returns for 2014, which would be largely in-line with most market expectations. Equity markets have brushed off geopolitical issues and been supported by central banks' accommodative policies, corporate activity and relatively attractive valuations. In contrast to the previous year, the returns of equity markets across the different regions have been less disparate, with comparable performances observed in the US, European and most emerging markets.

Bund yields are close to record low levels...

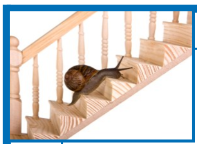
The trends within bond markets have continued to surprise, with key yields trending much lower; those on benchmark 10-year US Treasuries and German Bunds have respectively dropped by 50bps and 68bps to reach 2.53% and 1.25%. Bund yields are approaching the record low levels observed in May 2013 when Ben Bernanke, at the time Fed Chairman, first mentioned tapering. Credit and emerging markets debt spreads have tightened during the period under review, reflecting investors' ongoing demand for debt instruments offering higher yields.

The Euro has peaked at a 1.40 parity against the USD...

Within the currency markets, the main development has been the reversal of the EUR/USD exchange rate; until May, the Euro had been climbing towards a parity of 1.40 against the USD. Since then, the Euro has been slowly depreciating following the ECB's decision to introduce a series of new measures destined to stave off the threat of deflation and to stimulate credit growth. As widely expected, the EUR/CHF parity has remained within a 1.21-1.24 trading range, reflecting the commitment of the Swiss National Bank to defend its 1.20 floor policy.

Gold has benefited from lower real interest rates...

The price of gold got off to a strong start on the back of geopolitical tensions across several regions and the decrease of real interest rates; by the middle of March, the price of an ounce of gold had climbed by close to 15% to reach a year-to-date peak of $1'380. At the time of writing, gold is trading close to a $1'320 level.



OUTLOOK

The economic backdrop should continue to support risky assets...

The policies of the most influential central banks continue to dictate the returns of financial assets and this is unlikely to change soon. The prevailing environment of slowly improving growth, low inflation and loose monetary policies provides a positive backdrop for risky assets despite the appearance of some excessive optimism and complacency.

We are sticking to our asset allocation...

The zero interest rate policies and low volatility are supportive for high-yielding assets and should push equity prices higher. This framework explains why we maintain our risk-on positioning by overweighting equities and the more dynamic debt instruments. Despite a relatively disappointing first six months for hedge funds, the importance of sticking to a disciplined portfolio construction approach justifies the ongoing exposure to this kind of investment strategies.

Debt instruments

We are underweight debt instruments and avoid G-7 sovereign debt...

Our allocation towards the fixed-income asset class is very selective, due in particular to our negative outlook on government bonds. We recognize that the central banks are focused on managing the expectations of the markets and that the low growth environment is also supportive for the asset class; however, the low yields of bonds with the highest ratings would not offer much protection if the Federal Reserve were to raise rates sooner than anticipated. At this stage, our main scenario is for rates to rise only moderately and we still feel comfortable holding corporate credit, high-yield bonds, loans and convertible bonds. Our current approach within the asset class is to gradually shift the allocation towards more flexible credit strategies, including the management of duration risk and of market risk.

Equities

Equities are our favourite asset class...

We have a positive outlook on the equity asset class despite the fact that the current valuation levels leave little room for any significant re-rating as equities are trading around their fair value levels. Equities are the most attractive asset class in relative terms when taking account of dividend yields, solid balance sheets, the increase of corporate activity and a tendency for companies to take measures that are more beneficial for shareholders than for bondholders.

FX

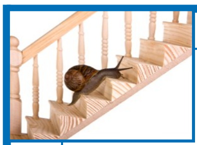
We have a positive outlook on the dollar...

The latest measures announced by the ECB have reinforced our reckoning that the US dollar should outperform the common currency in the medium term; the disparity of growth rates between the US and Europe, diverging monetary policies and higher inflation expectations in the US should contribute to an appreciation of the dollar. Concerning the Swiss franc, the policy of the Swiss National Bank is still in place and the EUR/ CHF parity is expected to evolve within a tight trading range.

Gold

We do not hold physical gold at this stage...

Our outlook on gold is neutral and we do not intend to build a new position in the precious metal at this stage. From the current very low starting level, we would expect real interest rates to gradually increase in the context of the progressing economic normalisation; this should contribute to keep a lid on gold prices.



ASSET ALLOCATION 2nd HALF 2014

Cash

Neutral (4%)

The cash position results from the lack of compelling opportunities within the debt instruments universe and from equity valuations being slightly stretched refraining us from holding a larger overweight position.

Debt instruments

Underweight (29%)

With an allocation of 29% to the asset class, we are underweight. Our exposure to investment-grade bonds is heavily underweight, as we do not hold any G-7 government bonds. Our investment-grade allocation is composed of Euro-denominated corporate credit as well as sovereign and quasi-sovereign bonds issued by the most creditworthy nations.

We are overweight high-yield bonds, including an exposure to loans which has recently been increased. The fundamentals for high-yield (low default rates, low leverage, strong demand, extension of maturity) are supportive even though the potential for tighter spreads appears limited.

The "specialist bonds" allocation is composed of convertible bonds, which have been contributing well to the portfolios' performance; these exposures are maintained at the current levels.

Equities

Overweight (52%)

We have an overweight allocation to the equity asset class with a clear bias towards European and US equities. We recognize that valuations are not cheap in absolute terms, but the financial and economic conditions should continue to provide support for the asset class.

We have recently strengthened our allocation to Japanese equities following a period of consolidation. Our position in Chinese equities has not yet contributed to the portfolios' returns, but we believe that the Chinese economy will avoid a hard landing; a slight improvement of Investors' sentiment should translate into a more buoyant equity market during the rest of the year.

Commodities

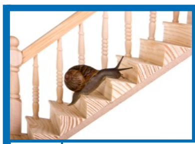
We have no direct exposure to commodities...

We are not exposed to physical gold, but our allocation to gold mining equities has been a strong contributor year-to-date. We do not hold any direct exposure to commodities.

Hedge funds

Neutral to positive (15%)

We are sticking to our 15% allocation in the hedge fund space; we hold positions in Global Macro, volatility trading, CTA and Multi-Strategy Funds of Funds; our exposure to the CTA strategy has been reduced to the benefit of Global Macro and Multi-Strategy. The need for differentiated returns is important in a context where traditional fixed income allocations may no longer provide the adequate level of protection.



ASSET ALLOCATION GRID 2nd HALF 2014

For our balanced accounts, we apply the following grid:

	Allocation	July 2014
Short-term deposits	***0 – 20%***	***4%***
Debt instruments	***15 – 55%***	***29%***
Investment grade bonds	*5 – 45%*	*8%*
EM & high-yield bonds	*0 – 20%*	*13%*
Specialist bonds	*0 – 15%*	*8%*
Equities	***20 – 60%***	***52%***
Developed markets	*15 – 50%*	*47%*
Emerging markets	*5 – 30%*	*5%*
Commodities	***0 – 15%***	***0%***
Physical gold	*0 – 5%*	*0%*
Other commodities	*0 – 10%*	*0%*
Hedge funds	***0 – 25%***	***15%***
		100%

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since 1994

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