Forum Finance Group

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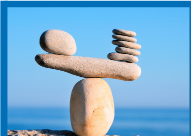
July 2015

Investment Perspectives 2015
Mid-Year Review & Outlook



INVESTMENT PERSPECTIVES 2015 MID-YEAR REVIEW

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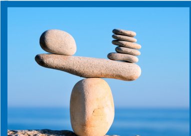


EXECUTIVE SUMMARY

In this mid-year publication, we review our January expectations and analyse some current key economic indicators before outlining the asset allocation that we recommend for the second half of the year.

Our key message was that equities should do well...

In January, our main message was that risk assets, and equities in particular, should continue to be supported by a slowly improving economic background, by the accommodative policies of central banks and by better risk-adjusted valuations than those of debt instruments. We also expected the assets of the developed markets to outperform those of the emerging markets and for the U.S. dollar to appreciate against its peers.

Global economic growth has disappointed during Q1...but should improve during the 2nd half...

First quarter global economic growth turned out to be weaker than we had anticipated as the various economies produced mixed results. This weakness was largely due to an unexpected contraction of the U.S. economy which was affected by extreme weather on the East coast, port strikes on the West and consumers refraining from spending the money saved from lower oil prices. Lower rates of economic growth were also observed across most emerging markets with all the BRIC countries slowing down. However, on a brighter note, the Eurozone showed signs of a recovery on the back of a weaker euro, lower energy costs and ECB stimulus; the combined first quarter GDP of the 19 Eurozone countries was 0.4% higher than in the final three months of 2015. Japan also fared better-than-expected with first quarter growth being 1% higher than the previous quarter, mainly due to strong business spending. Overall, the signs for the second quarter show some improvement across the board and, looking ahead, we expect global economic activity to be stronger during the second half of 2015 and in 2016.

Equities remain our favourite asset class...with a bias towards Europe and Japan...

Our positive outlook on equities, and our bias in favour of developed markets, translated into solid portfolio returns until the end of May with Japanese and European stocks contributing the most. The month of June proved to be more challenging as equity markets gave up some of their earlier gains; increased uncertainty about Greece reduced some of the appetite for risky assets. Our caution towards highly-rated sovereign debt was vindicated (finally) by the sudden reversal of yields which had confounded expectations for so long. Our preference for leveraged loans, high-yield and convertible bonds turned out to be rewarding due to their low levels of duration and contraction of their spreads. Finally, our positive outlook towards the U.S. dollar generated a strong contribution to performance; more recently, we have locked in some of the dollar gains and adopted a more tactical approach towards currency exposures.

Risk management has led us to temporarily hedge some equity exposure...

The prevailing uncertainty surrounding the Greek crisis has led us recently to hedge part of our allocation to European equities as a way of managing risk in face of an unpredictable outcome. At this stage, we are still committed to an overweight of the equity asset class and an avoidance of highly-rated sovereign debt. Early in the year, we reinitiated a position into physical gold as a hedge against extreme risks and as a way to diversify the portfolios.

In the next section of the document, we will evaluate the macro environment and the prevailing financial conditions by highlighting several key indicators that we observe. Following a brief overview of the first half returns of the different asset classes, we will outline our current market outlook and asset allocation.

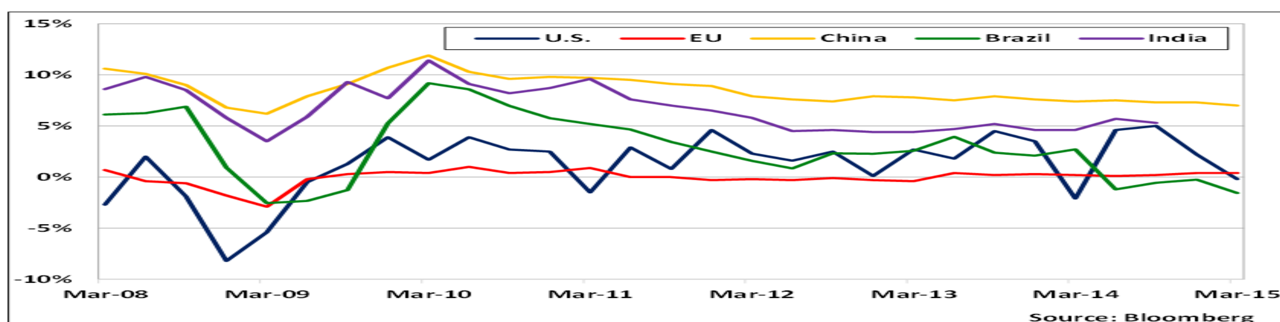
THE MACRO ENVIRONMENT

World economic growth

Economic growth forecasts for 2015 have been cut...

Global economic growth has yet again disappointed, especially in the United States, in oil exporting countries and some large developing ones. Growth forecasts for the whole of 2015 have recently been cut by the IMF, the World Bank and the OECD; the World Bank now expects the global economy to grow by 2.8% in 2015 compared to 3% predicted in January. The recovery in high-income countries is expected to gather some momentum, especially in the United States and in Europe, while a broad-based slowdown can be observed in developing countries, with growth expected to slow to 4.4 percent in 2015 from 4.6% in 2014. Developing countries are being negatively impacted by weaker capital flows due to dollar strength as well as by a reduction of activity in oil exporting countries.

GDP growth

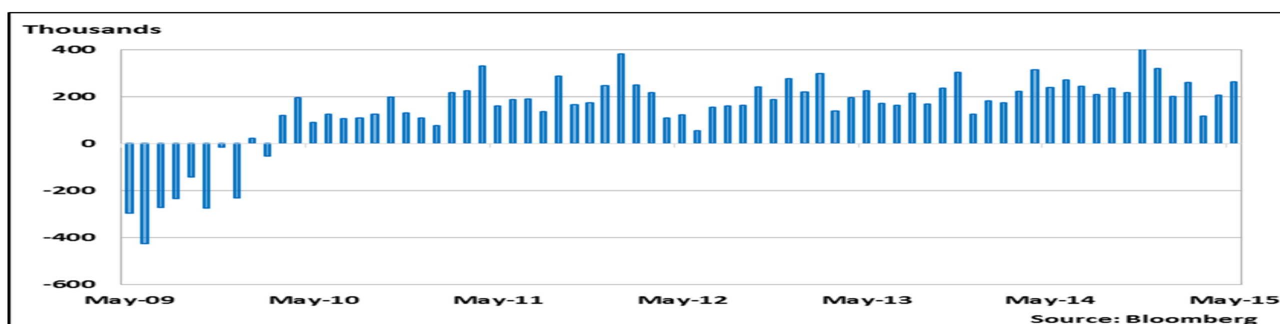


The chart shows the severe slowdown of the U.S. economy during this year's first quarter, largely due to arctic climatic conditions, port strikes and weaker exports; economic activity has started to rebound and U.S. growth is now expected to reach 2 percent for the year. In the Eurozone, the recovery appears to be gathering momentum across the region's different countries, with growth forecasted at 1.5% for the whole of 2015. Across the large developing economies, the pace of growth has continued to decelerate, with Brazil being particularly affected by fragile confidence and low commodity prices.

The job markets

Conditions in the job markets have continued to improve across the developed economies. Modest progress has been observed in the Euro zone although the unemployment rate remains extremely high at 11.1%. In the U.S. and in the UK, there have been some signs of wage growth as a result of a tighter job market.

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 resilient despite a dip in March of the number of new jobs created. The unemployment rate ended May at 5.5%, compared to 6.3% a year ago.

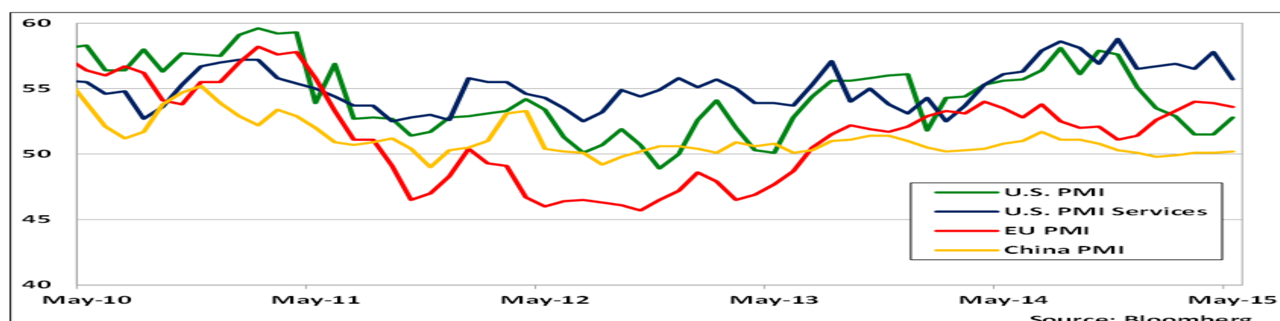
Leading indicator

Eurozone PMIs have picked up...

Business conditions across the world's major economies have diverged during the first half of the year, according to the closely observed Purchasing Managers' Indexes (PMI). Despite the cloud of the Greek debt crisis hanging over the region, the Eurozone saw economic growth accelerate to a four-year high in June and PMIs have been rising. The U.S. economy has experienced an unexpected contraction during the first quarter and is yet to show signs of a significant rebound even though growth is widely expected to accelerate during the second half.

Activity in China continues to disappoint and the manufacturing sector has been cutting jobs at the fastest rate since 2009 as companies have been scaling back capacity. This suggests that companies have relatively low growth expectations due to subdued demand conditions both at home and abroad. The latest data from Japan shows that the manufacturing sector is also struggling to gain momentum, reflected by the drop of the Manufacturing PMI to 49.9 from 50.9 in May.

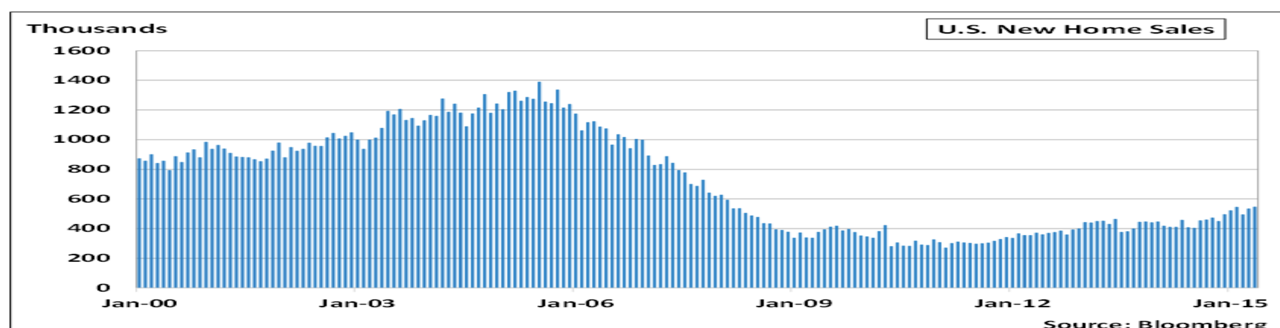
Purchasing Manager Indexes



The chart above shows the generally weak trends of most Purchasing Managers' Indexes since the beginning of the year, with the exception of a distinct improvement observed in Europe; the Eurozone Composite PMI has risen from 51.4 in December 2014 to 54.1 in June, its highest level since May 2011. In contrast, U.S. Composite PMIs have drifted lower as output growth has been slowing since March and the U.S. Manufacturing PMI has dropped to its lowest level since October 2013. China's numbers have kept on hovering at 50, a level which indicates that the industry is only just expanding.

U.S. real estate

U.S. New Home Sales



As shown above, the purchases of new homes in the United States rose in May to the highest level in seven years; other reports, such as the number of new building permits and house price indexes, are also a confirmation of the positive trends exhibited by the real estate market; the sector is being supported by a strengthening jobs market and steps by the government to ease lending conditions for first-time buyers.

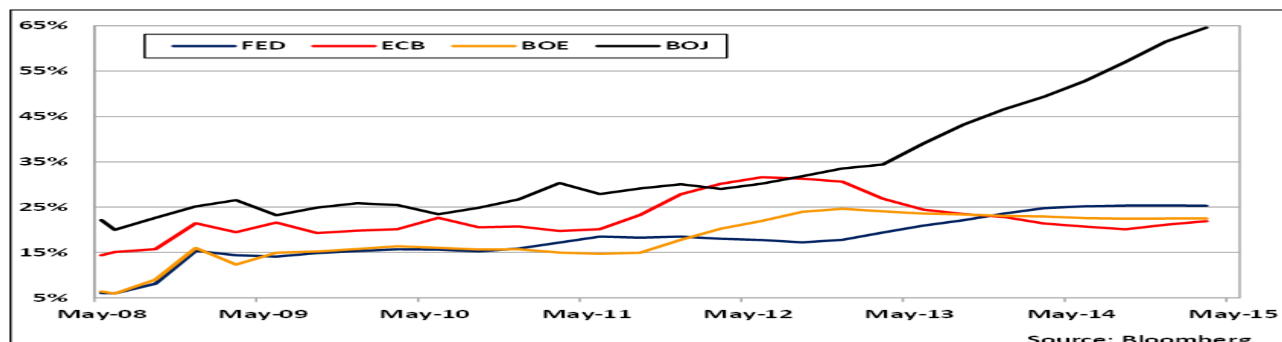
FINANCIAL CONDITIONS

The ECB joins the quantitative easing party

The ECB introduces QE ...

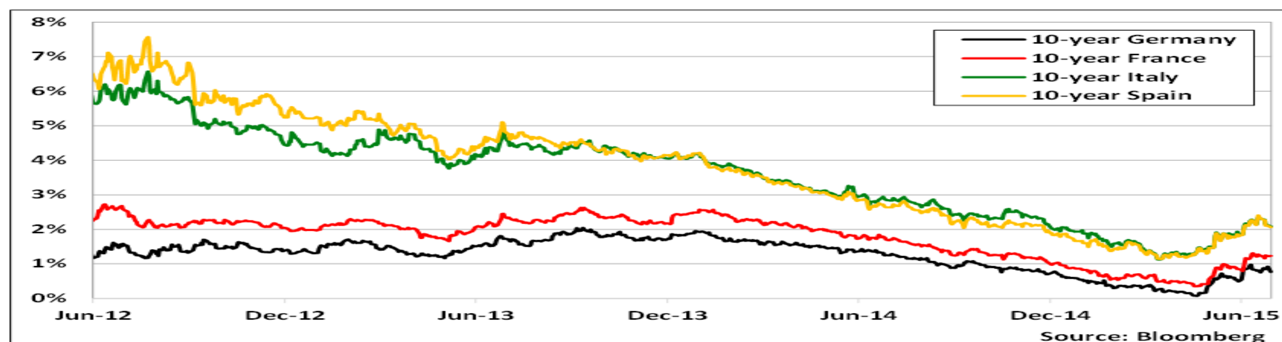
The major central banks remain the biggest influence on the behaviour of financial markets and their respective policies have translated into a dispersion of returns for similar assets across the different regions. The balance sheets of the Federal Reserve and the Bank of England are no longer expanding, but their respective committees have so far refrained from increasing rates; in contrast, the Bank of Japan continues to carry out its massive purchases of assets while the European Central Bank has belatedly introduced an extensive QE programme. In January, the central bank unveiled a plan to buy sovereign debt on top of its buying of covered bonds and asset-backed securities; the size of the QE programme is of € 60 billion per month for a minimum period of 18 months.

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



The sizes of the balance sheets of the Federal Reserve and the Bank of England are no longer increasing, but the Bank of Japan's continues to expand rapidly. The most significant change over the last year has been the ECB's decision to start acting more decisively to generate some inflation and weaken its currency; even if it does not appear that obvious in the chart above, the size of its balance sheet has started growing again.

European sovereign 10-year yields



The first quarter of 2015 saw the yields of European sovereign debt extend their decline to record low levels under the influence of the ECB's purchase program; 10-year Bund yields were just 7bps away from reaching zero while Spanish and Italian debt with the same maturity traded below 1.15%. From then onwards, the bond markets experienced a period of wild volatility as the trend of yields suddenly reversed and as spreads of peripheral debt widened significantly. This sovereign debt sell-off can partially be explained by a situation where bonds had become heavily overbought at a time when the economic outlook was improving and deflation risks were fading away. The never-ending saga related to a deal with Greece has also been having a major impact on the spreads of peripheral debt.

Interest rates and inflation

Interest rates

A trend of lower rates across the world...

Short-term interest rates in the major economies remain at record low levels. The Federal Reserve and the Bank of England keep on delaying the timing of a first rate hike, while the prospects of higher interest rates in Japan and in the Euro zone appear as remote as ever. The threat of deflation that incited the ECB to unveil quantitative easing also explains to a large extent the series of interest rate cuts observed throughout the world at the beginning of 2015; the central banks of China, India, Canada, Australia and Denmark figure amongst the many that have lowered interest rates this year.

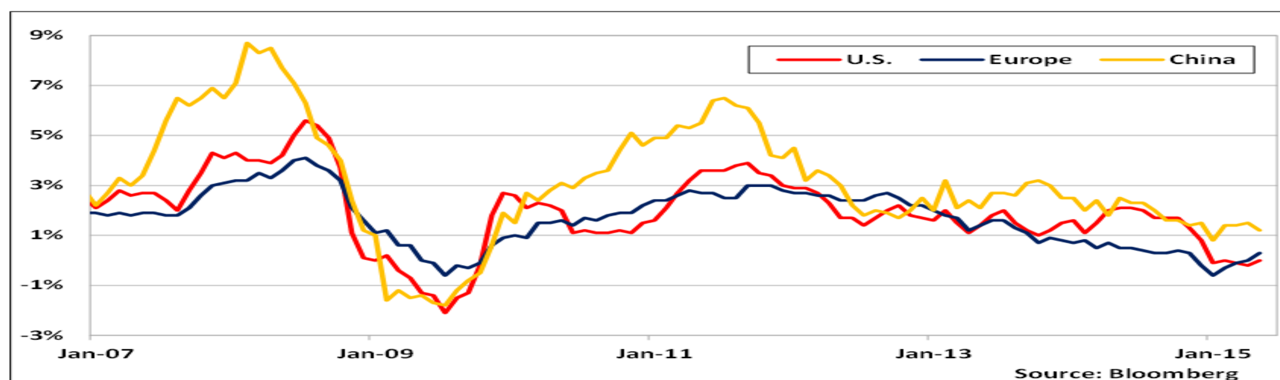
Will the Fed finally hike?

The key message emanating from the Federal Reserve's Chair, Janet Yellen, is that the central bank still intends to hike interest rates this year but that it will be a very gradual process; since no action was taken in June, the consensus now expects a first rise in September, but this is far from being a foregone conclusion. The only certainty is that the FED's policy members are very fearful of making a policy mistake, which explains their hesitancy and extremely cautious approach.

The Swiss National Bank shocks the markets...

On January 15, the Swiss National Bank shocked the markets as it unexpectedly ended its main monetary policy of capping the franc's appreciation against the euro; the bank also cut rates on sight deposit account balances by 0.5% to a negative rate of - 0.75%. Since September 2011, the central bank had prevented the EUR/CHF parity from dropping below 1.20, resulting in a massive expansion of its balance sheet (equivalent to over 80% of Switzerland's GDP). According to the bank, the cost of pursuing this policy had become prohibitive; the anticipated introduction of QE by the ECB also clearly played a major role behind this decision.

Inflation across the world



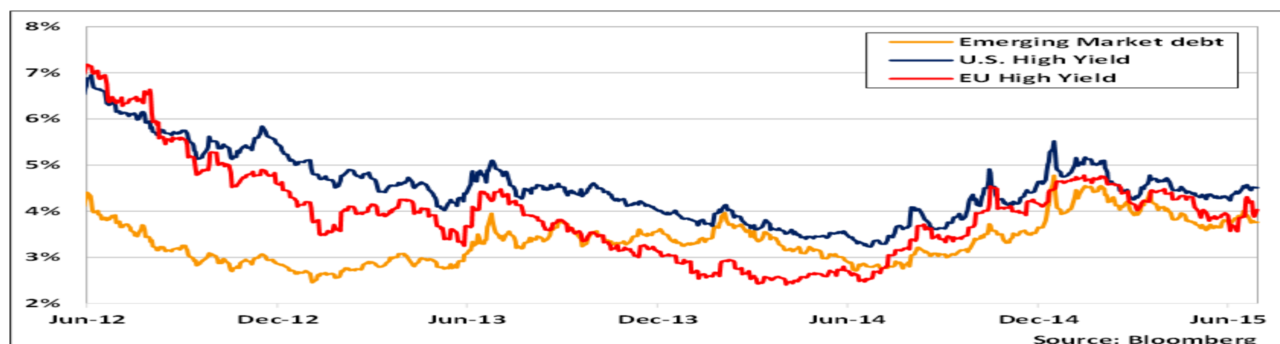
The chart above shows that the declining trend of inflation in the Euro zone appears to have troughed in January; inflation had clearly turned negative towards the end of 2014 but is now starting to rebound thanks to an improving economy and the impact of the ECB's supportive policy measures. In the United States, the headline inflation rate is flat on a year-on-year basis, while core inflation (ex-food and energy) is currently at a level of 1.7%, which is still below the Federal Reserve's inflation target of 2%. In China, inflation fell to a five-year low of 1.2%, reflecting slowing growth and weak domestic demand.

Credit spreads and bond volatility

Tighter spreads for HY and EM debt...

The spreads of higher yielding bonds have tightened during the first half of the year despite a challenging start to the year due to the weakness of the energy sector and its impact on the U.S. high yield market and certain emerging markets. The most noteworthy behaviour has been the resilience of high yield bonds and emerging market debt in face of the sell-offs of sovereign debt from April onwards.

Emerging market debt and high yield spreads



The spreads of emerging market debt initially widened by 50bps to reach 4.5% before the recovery of the energy sector contributed to push prices of debt issued by countries such as Russia and Venezuela higher; as of the end of June, the spread has contracted to 3.9%. A similar pattern can be observed for U.S. high yield credit with spreads widening by 40bps to 5.2% before narrowing to an end-June level of 4.8%. Until the beginning of June, European high yield had been one of the best performing asset classes with spreads contracting by 1.1% since the end of 2014; spreads have recently moved higher to a level of 4.1%.

Volatility of bond markets

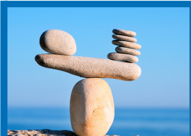
Until the middle of April, rates in Europe had become a one-way bet in the wake of the ECB's quantitative easing programme and over 30% of all government debt was trading on a negative yield. Then, two sudden massive sell-offs triggered unprecedented market volatility as yields on 10-year Bunds spiked from an all-time low of 7bps to 72bps, before dipping to 49bps and then briefly climbing above 1%. These repetitive sell-offs of sovereign debt reflect the pronounced distortions prevailing in capital markets and, although their future behaviour is impossible to predict, it appears likely that the volatility of these "safe-haven" assets will remain well above its long-term average.

The macro environment/financial conditions: conclusions

The major central banks continue to provide vast amounts of liquidity and remain in accommodative mode, notwithstanding the expectations that the Federal Reserve is moving closer to start raising its interest rates. Following a series of rate cuts by many central banks of the emerging economies, some might be forced to tighten monetary conditions in order to prevent capital outflows and contain inflation in the light of depreciating currencies and a slowdown of economic activity.

Generally speaking, economic conditions in the high-income economies are improving, while developing countries are facing headwinds and experiencing decelerating rates of growth. The latter will need to carry out reforms to boost future economic growth and they are still struggling to rebalance their economies in order to reduce their dependence on exports.

The spreads of credit and peripheral debt indicate a high level of investor confidence in the issuers' ability to repay their debt and preclude any anticipation of a deterioration of economic activity. Following a long period of low volatility, the year-to-date shocks observed in the currency and bond markets could forebode a period of higher volatility for financial markets.



FINANCIAL MARKETS

	End 2014	June 2015	June performance	1st half 2015
Equities				
S&P 500	2058.9	2063.1	- 2.1%	+ 0.2%
Euro Stoxx 50	3146.4	3424.3	- 4.1%	+ 8.8%
MSCI EM	956.3	972.2	- 3.2%	+ 1.7%
Yields				
UST 10-year	2.17%	2.35%	+ 23bps	+ 18bps
Bund 10-year	0.54%	0.76%	+ 27bps	+ 22bps
BBB EU	1.61%	1.95%	+ 50bps	+ 34bps
Currencies				
EUR/USD	1.210	1.115	+ 1.5%	- 7.9%
USD/CHF	0.994	0.936	- 0.5%	- 5.8%
EUR/CHF	1.203	1.042	+ 0.8 %	- 13.4%
GBP/USD	1.558	1.571	+ 2.8%	+ 0.8%
Commodities				
CRB Index	230.0	227.2	+ 1.8%	- 1.2%
Oil, WTI	$ 53.3	$ 59.5	- 1.4%	+ 11.6%
Gold	$ 1185	$ 1172	- 1.5%	- 1.1%

QE underpins European and Japanese equities...

During the first half of 2015, global equity markets have trended higher but with very disparate returns observed across the different regions, in local currency terms; this divergence is largely explained by the contrasting monetary policies between the major central banks, with Japanese and European equities being underpinned by massive quantitative easing and U.S. equities failing to gain much traction. Performance dispersion across emerging markets was also wide with Chinese and Russian equity markets amongst those performing the best.

Bond markets impacted by massive sell-offs...

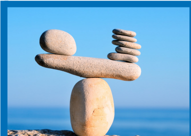
A lot of action has taken place in the bond markets so far this year. A trend of low volatility and ever declining yields for European sovereign debt was suddenly inversed as massive liquidations triggered a spike of yields and unprecedented volatility; within a two-month period, 10-year Bunds' yields rose from 0.07% to over 1%, while U.S. Treasuries with a similar maturity saw their yields rise from 1.9% to 2.5%. High-yield credit and emerging markets debt spreads have tightened, reflecting investors' ongoing demand for debt instruments offering higher yields.

The Swiss franc soars...

Within the currency markets, the main event was the shock decision by the Swiss National Bank to end its key policy of capping the franc's appreciation against the euro; this move initially propelled the franc nearly 30 percent higher against the euro in chaotic trading. The EUR/CHF parity has since stabilised around a level close to 1.04, representing a 13% depreciation from end-2014. The other key development has been the consolidation of the dollar since the middle of March; until then, the greenback had strongly appreciated against most peers, in particular against the Euro.

Oil prices have rebounded...

The commodity space, in particular industrial metals and agricultural products, has continued to be impacted by oversupply and a stronger dollar. Oil prices troughed in March and have since stabilised around a level of $60 per barrel of WTI. Following a strong start to the year, the price of gold has retreated to its end-2014 level.



MARKETS' OUTLOOK

Volatility is on the rise...

The policies of the most influential central banks will continue to be the main drivers of the returns of financial assets, especially as it becomes more likely that the Federal Reserve will finally start raising its interest rates for the first time since 2004. Since the beginning of the year, currency and bond markets have experienced severe bouts of volatility and similar patterns could well be repeated until the end of 2015.

We prefer European and Japanese equities...

Economic fundamentals and the capacity of companies to grow their profits will take on added importance for equity markets. Our favourite regions remain Europe and Japan, where the potential for higher equity prices is supported by the most accommodative monetary policies. Overall, we maintain our risk-on positioning by overweighting equities and the more dynamic debt instruments, but expect having to implement more tactical trades to manage higher levels of market risk.

Debt instruments

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

Our allocation towards the fixed-income asset class remains under-weight. The recent events in the bond markets have shown that, despite the massive support from central banks, sovereign debt prices can be subject to huge price swings; in such a context, we prefer credit where higher coupons will cushion some of the impact of rising yields and where there is still some potential for spreads to contract. Our main scenario is for rates in Europe to remain relatively close to the current levels, with spreads of peripheral debt tightening again. In the U.S., we expect rates to gradually edge higher, with the Federal Reserve seeking to avoid any market tantrum. Our main exposures in the fixed-income space are corporate credit, high-yield bonds, loans and convertible bonds. Over the course of the last year, we have gradually shifted the allocation towards more flexible credit strategies, which include the management of duration risk and the ability to tactically allocate capital across various credit segments.

Equities

We still overweight equities...

We have a positive outlook on the equity asset class despite valuation levels of most equity markets being higher than their 10-year historical averages; this leaves little room for any significant re-rating and it will be important for earnings to match expectations for the rally to continue. Equities should be supported by loose monetary conditions, attractive dividend yields (vs. extremely low interest rates), solid balance sheets and the increase of corporate activity in the form of share buybacks and acquisitions. At this stage, we maintain our strong bias towards equities of the developed markets.

FX

We have a positive outlook on the dollar...

The dollar consolidation period should eventually give way to another leg of appreciation by the end of 2015. For the uptrend to resume, economic data will need to be strong enough for the Fed to have sufficient confidence to start the tightening cycle in earnest. About the Swiss franc, we do not expect a significant move away from the current level of 1.04 francs per Euro due to opposing forces; on one side, the SNB will not want the franc to appreciate much against the Euro, on the other, the ECB's QE programme should contribute to keep the lid on the Euro.

ASSET ALLOCATION 2nd HALF 2015

Cash

Neutral (10%)

The higher cash position results from a tactical hedging of part of the European equity exposure in view of the risks linked to the Greek crisis. In case of a positive agreement well received by the markets, the hedge would be removed and the allocation to cash would immediately drop back to 3%.

Debt instruments

Underweight (27%)

With an allocation of 27%, we are underweight. Our exposure to investment-grade bonds is heavily underweight, as we refrain from holding 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 secured loans which has been a strong performer year-to-date. In April, we decided to reinitiate a position in US high yield bonds after having exited the asset class last summer. The fundamentals for high-yield and loans (low expected default rates, low leverage, and strong demand) are supportive and the overall duration risk is low.

The "specialist bonds" allocation is composed of convertible bonds and flexible fixed-income strategies which are not constrained by a benchmark and whose duration risk is actively managed.

Equities

Overweight (45%)

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

In the current environment, Japanese equities appear particularly attractive as their valuations are still lagging the broader market and as a combination of corporate reforms and institutional inflows provide support for the asset class. We remain cautious towards emerging markets' equities as the larger economies are facing a structural slowdown of activity and as the growth of earnings is still decelerating.

Commodities

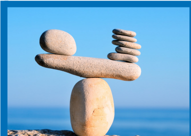
Underweight (3%)

For the time being, we are comfortable with our exposures into physical gold and gold mining equities; their main purpose is to bring diversification to the portfolios and to protect against some of the impact of the more extreme scenarios.

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; with the exception of CTA, the low level of volatility of these strategies contributes to reduce portfolio risk. The need for differentiated returns from uncorrelated strategies is important in a context where traditional fixed income allocations no longer provide the adequate level of income and protection.



ASSET ALLOCATION GRID 2nd HALF 2015

For our balanced accounts, we apply the following grid:

	Allocation	*July 2015*
Short-term deposits	***0 – 20%***	***10%***
Debt instruments	***15 – 55%***	***27%***
Investment grade bonds	*5 – 45%*	*8%*
EM & high-yield bonds	*0 – 20%*	*10%*
Specialist bonds	*0 – 15%*	*9%*
Equities	***20 – 60%***	***45%***
Developed markets	*15 – 50%*	*41%*
Emerging markets	*5 – 30%*	*4%*
Commodities	***0 – 15%***	***3%***
Physical gold	*0 – 5%*	*3%*
Other commodities	*0 – 10%*	*0%*
Hedge funds	***0 – 25%***	***15%***
		100%

CONTACT

The Forum Finance Group S.A.
6, rue de la Croix d'Or
P.O. Box 3649
CH-1211 Geneva 3
Switzerland

Phone : +41 22 311 8400
Fax : +41 22 311 8465
E-mail : info@ffgg.com
Web : www.ffgg.com

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