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FORUM FINANCE GROUP

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INVESTMENT PERSPECTIVES 2016
MID-YEAR REVIEW & OUTLOOK

JULY 2016

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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.

We had maintained a preference towards equities over high-grade bonds

Despite our long-term view that equities continue to offer better relative value to high-grade bonds, we took assertive measures in early January by significantly reducing our equity exposure, and raising cash to a high level, which contributed to limit part of the impact of severe market stress on the portfolios.

We had also indicated our increasing interest for emerging market equities, which became effective in March when we decided to increase our allocation to the asset class. Another key conviction was the need for additional portfolio diversification by investing into alternative strategies with low volatility and limited correlation to traditional assets.

Global economic growth has disappointed during Q1… and is not expected to pick up during the 2nd half

Once again, global economic growth has turned out to be inferior to forecasts, with the US economy only growing modestly during the first quarter and no other major economy being able to compensate for this disappointment. Growth forecasts for the whole of 2016 have recently been cut by the World Bank, the IMF and the OECD. These revisions were published before the unexpected decision of the British voters to leave the European Union, meaning that, if anything, uncertainties have only increased. One of the main reasons for this weakening outlook is the feeling that central banks are left with very few tools that can make a difference to the real economy and that governments are reluctant to introduce any kind of fiscal stimulus.

We are more defensively positioned and will look to increase risk only when attractive opportunities arise

In the light of deteriorating fundamentals, uninspiring prospects for companies to grow their profits and higher political risks, we have adopted a more defensive stance for the portfolios by reducing further our equity exposure and by maintaining the cash allocation above 10%. Our exposure to the US dollar was tactically increased during the first half and we took advantage of its appreciation after the UK referendum to take profits on half the position so, there again, we are now exposed to a lower level of risk. We have also consistently been adding to the alternative space in order to reduce portfolio volatility and to be less dependent on the direction of the markets.

Risk management has led us to hedge the exposure to European equities

The UK public opinion during the weeks preceding the referendum on whether to remain in or leave the European Union gave us very little conviction on the outcome of the vote. We also evaluated that the downside of equity markets in the case of a “Leave” vote would be much bigger than the potential upside if the “Remain” vote were to win. We decided to hedge our exposures to UK and European equities in the light of such an asymmetrical profile tied to a binary event. Following the result, the hedge on UK equities was quickly lifted. We will maintain the temporary protection unless the prospects for European equities significantly improve.

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.

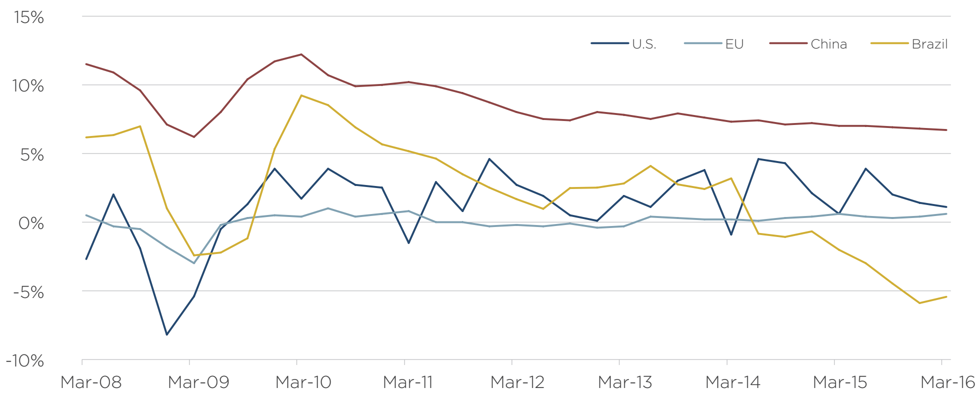
THE MACRO ENVIRONMENT

WORLD ECONOMIC GROWTH

Economic growth forecasts for the second half of 2016 continue to be downgraded

Global economic growth has yet again disappointed. Growth forecasts for the whole of 2016 have recently been cut by the World Bank, the IMF and the OECD; the World Bank now expects the global economy to grow by 2.4% in 2016 compared to 2.9% predicted in January. The bank cites sluggish growth in advanced economies, low commodity prices, weak global trade and diminishing capital flows as the main reasons for this downgrade. The IMF now projects global growth of 3.2% for 2016, 0.2% below its January forecast, mainly due to an "increase of uncertainty and the risks of weaker growth scenarios becoming more tangible." Finally, the OECD now anticipates growth of the combined economy of the 34 OECD countries to be of 1.8% this year compared to 2.2% predicted last November. The institution considers that "the world's economy is ensnared in weak growth and vulnerable to falling into another deep downturn unless governments take urgent action." It is also important to point out that these revisions were published before the UK referendum meaning that, if anything, risks and uncertainty have only increased.

GDP growth



Source: Bloomberg LLP

The chart shows that the U.S. economy has once again been weak during the first quarter (1.1%) and the trend has strongly declined since the strong growth recorded during the second quarter of 2015 (3.9%). In the Eurozone, the recovery appears relatively resilient, with growth forecasted to be close to 1.6%, on an annualized basis, for the whole of 2016. Across the large developing economies, the pace of growth has continued to decelerate, with China GDP consistently declining and Brazil still being in deep recession.

THE IMPACT OF THE BREXIT VOTE

The fallout of the UK's decision to leave the European Union has only started to unravel, but we will first cover the immediate consequences and then those that will take longer to be resolved. Firstly, the outcome of the referendum has only brought more doubt and uncertainty to the UK and European economies which are the elements that financial markets hate the most; however, Brexit does not represent a similar level of risk to the subprime crisis, but it is difficult to evaluate its consequences at this stage. The most immediate impacts have been the collapse of the sterling, a steep drop of UK business confidence, the freezing of withdrawals of several UK commercial property funds, weaker prices of European and domestic-orientated UK stocks and additional stress on the European banking sector. Without going into details, the political fallout in the UK has been very dramatic with the resignations of the Prime Minister and the UKIP leader as well as the no-confidence vote of Labour MPs in their leader, leaving political parties in a limbo.

Other factors that will take longer to evaluate will depend to a large extent on the outcome and the length of the negotiations that will take place between the European Union members and the UK; damage could ultimately prove to be limited if both parties focus on the best way to move forward quickly rather than camp on inflexible positions. Capital expenditure and foreign direct investments (FDI) into the UK are likely to be delayed, which will impact economic growth, while the issue of international banks and companies relocating their headquarters to another European city is another major threat to the UK economy.

THE STRESS ON THE EUROPEAN BANKING SECTOR

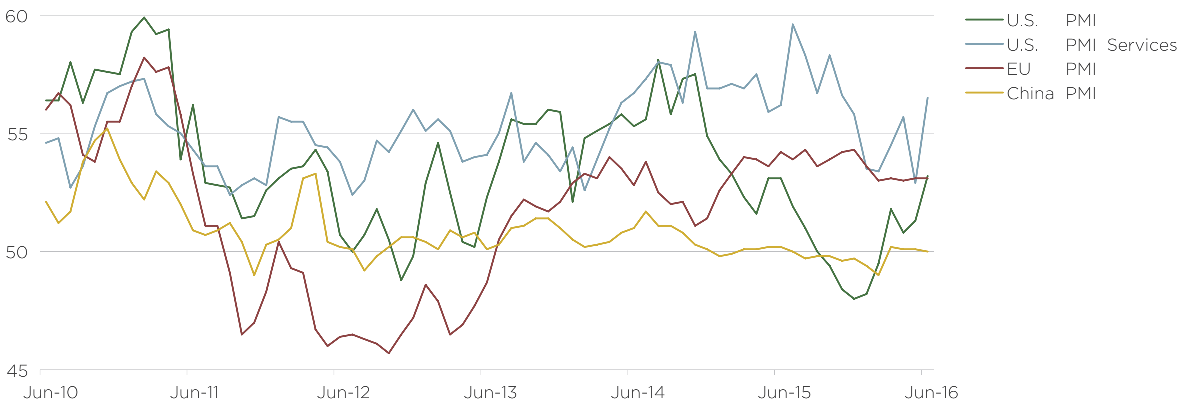
One of the major macro risks is represented by the banking sector in Europe. Despite the European Central Bank flooding the market with liquidity via Targeted Long Term Refinancing Operations (TLTROs) and quantitative easing (QE), capital concerns and counterparty fears are growing. European banking indexes are back to the lowest levels observed at the peak of the Eurozone crisis in 2011 and the market capitalisations of giants such as Deutsche Bank and Credit Suisse have dramatically decreased. With about 360 billion euros in non-performing loans (NPL), Italy's banking sector finds itself under huge pressure and rules limiting state aid are making it difficult to resolve the issue quickly. There is a genuine risk that Italy's banking crisis could spread to the rest of Europe and negatively impact the Eurozone economy.

LEADING INDICATOR

US PMIs are improving

Business conditions across the world's major economies have generally not improved much over the last six months, according to the closely observed Purchasing Managers' Indexes (PMIs). The Eurozone remains in expansion but the recovery is no longer accelerating and PMIs have remained flattish since February. Following a disappointing first quarter, the US economy is on a more positive trend and both manufacturing and services components are on the rise, indicating that upcoming growth numbers could be stronger.

Purchasing Manager Indexes



Source: Bloomberg LLP

The chart shows the more positive trends observed currently in the US than in the Eurozone and China. The US Manufacturing PMI has picked up from a level of 48 in December 2015 to the latest reading of 53.2, while the declining trend of the US Services PMI during the first quarter has given way to higher numbers. The Chinese Manufacturing PMI continues to indicate a struggling economy as the index has been unable to exceed the level of 50 since the end of 2014 (a PMI above 50 signals an expansion).

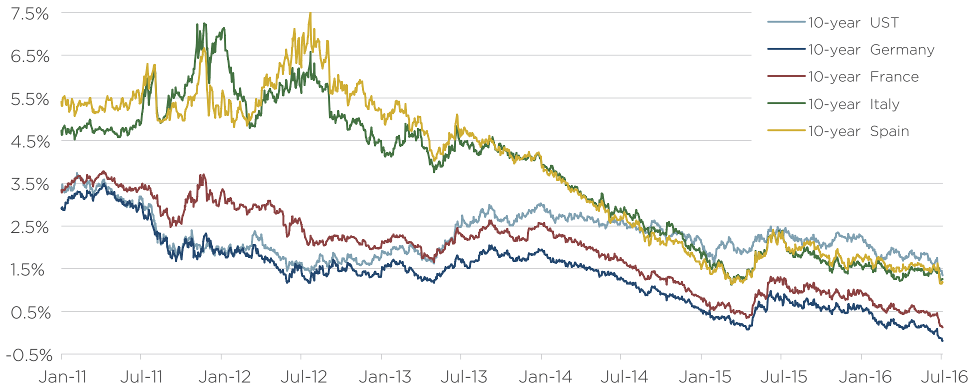
FINANCIAL CONDITIONS

THE ECB EXPANDS ITS ASSET PURCHASING PROGRAM

The ECB boosts QE further

The March meeting of the ECB was eagerly anticipated by investors. The bank did not disappoint the high expectations of the markets, with a 10bps cut of the deposit rate to -0.4% and a €20 billion expansion of monthly purchases to €80 billion. Furthermore, the bank announced that investment-grade corporate bonds would be included in the list of assets eligible for purchases. Finally, a new series of four targeted longer-term refinancing operations (TLTRO II), with a maturity of four years, will be launched, starting in June 2016. The main consequence of these measures were a further fall of yields on sovereign debt and credit. In contrast to when the ECB announced its QE program in January 2015, this time the euro failed to depreciate and rose from 1.118 against the dollar after the meeting to 1.153 at the beginning of May.

European sovereign 10-year yields



The first half of 2016 has seen the yields of European and US sovereign debt extend their decline to record low levels under the influence of the ECB's purchase program and the inability of the Federal Reserve to raise interest rates; 10-year Bund yields have entered into negative territory while Spanish and Italian debt with the same maturity are trading below 1.30%. As shown in the chart, the trend has been persistent and even during the periods when risky assets were performing well, yields did not move higher, reflecting the caution of investors. The result of the UK referendum has only added support for G-7 sovereign debt with yields dropping by up to 40 bps from June 23rd onwards.

INTEREST RATES AND INFLATION

INTEREST RATES

A case of "lower for longer" interest rates across the world

Short-term interest rates in most of the major economies are at record low levels and are likely to remain so for an extended period. Even if the Federal Reserve did decide to hike rates by 0.25% in December 2015, the probability of any additional rise appears extremely remote in the near term. The Bank of England had remained very cautious in the light of the uncertain outcome of the Brexit vote and is prepared to cut rates and add to quantitative easing to limit the impact of the unexpected democratic decision. The prospects of higher interest rates in Japan and in the Euro zone appear very distant and, if anything, the European Central Bank could well expand the universe of its asset purchasing program considering the increasing portion of bonds being out of its scope as yields turn increasingly negative.

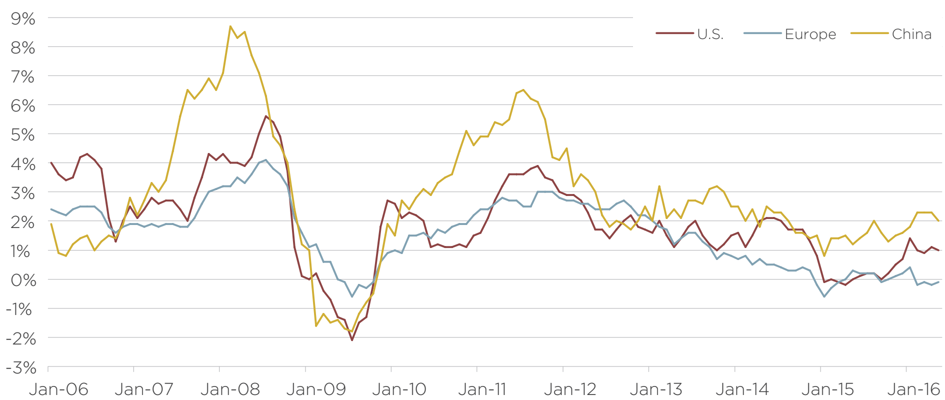
The path of the Fed's policy remains difficult to anticipate

Towards the end of May, it appeared that the Federal Reserve was committed to hike interest rates during the summer, but a very weak job report at the beginning of June triggered a collapse of expectations of any rate increase and put the Fed back on the back foot. At this stage it would be a major surprise if the Fed signalled its intention to move rates, especially when considering the potential turmoil in financial markets in the wake of Brexit. What is sure is that the Federal Reserve will continue to tread very cautiously in this environment.

The Bank of Japan appears to be running out of ideas

In late January, the BOJ surprised investors by adopting a negative interest-rate strategy to spur banks to lend in the face of a weakening economy; a rate of -0.1% was introduced in order to penalize excess holdings of cash and boost inflation. Following a brief drop of the yen in the wake of this decision, the Japanese currency has since continuously appreciated and reached a parity of 103 yens per dollar compared to 120.2 yens at the end of 2015. In March, the BOJ exempted money reserve funds from being subject to negative interest rates, reflecting the difficulty of extending its negative rates policy. At its April meeting, the central bank decided not to add further stimulus which proved to be a major disappointment for expectant investors. Finally the BOJ's policy was also kept unchanged in June, despite the poor run of equity markets and the strong rise of the yen. All this gives the impression of a central bank who is running out of measures to boost its economy.

Inflation across the world

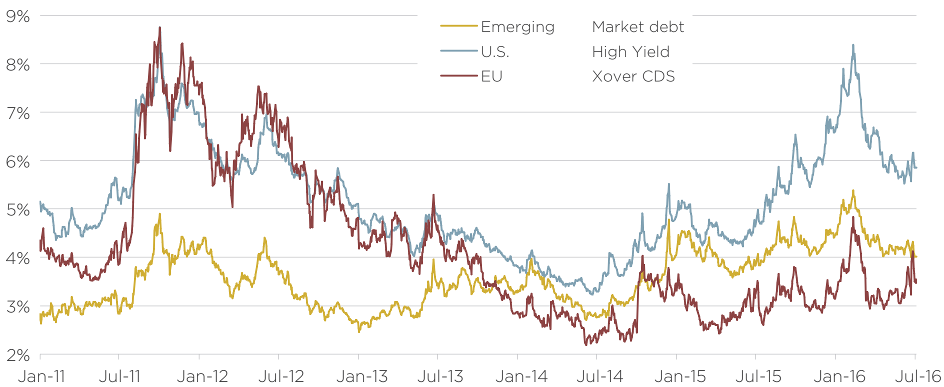


Source: Bloomberg LLP

In the light of the massive interventions by the world's major central banks, inflation remains well below the targeted levels. In Europe, inflation is still hovering just above 0% and has failed to pick up significantly since turning positive at the end of 2014. In the United States, the situation is a little more encouraging as the headline rate has been rising and core inflation (ex-food and energy) is now at 2.2%. In China, inflation has slightly picked up but remains very modest at a level close to 2%.

Credit spreads

Emerging market debt and high yield spreads



The spreads of emerging market debt and global high-yield credit widened significantly during January and early February as the stress on commodity prices and investors' aversion to risk triggered outflows. Emerging market debt has since performed well and produced strong returns due to lower US Treasury yields, tighter spreads, rebounding currencies and the extremely low expectations of any rate hike by the Fed.

The recovery of energy prices and commodity prices in general has also contributed to a recovery of US high-yield bonds, with the spread dropping from a peak of 8.4% in February to an end of June level of 5.9%. European high-yield followed a similar path to US high-yield even if spreads did not widen as much due to the lower exposure of the asset class to commodities.

Recently, however, the unexpected outcome of the British referendum has translated into wider spreads as reflected by the cost of protecting the iTraxx Crossover index against defaults (CDS).

THE MACRO ENVIRONMENT/FINANCIAL CONDITIONS: CONCLUSIONS

For the world's major central bankers, the recent developments have made their jobs even more challenging. The Federal Reserve's Chair Janet Yellen has admitted that the current conditions are likely to prevent the bank from normalizing interest rates, contrary to what was largely predicted at the beginning of the year. This should contribute to support emerging market assets, but does not help the central bank to be well positioned to act in the case of a recession.

In the aftermath of Brexit, the Bank of England and the European Central Bank will be under pressure to do even more. If they were to, the positive impact on certain financial assets could once again prove to be more significant than the impact on the real economy. There is now a higher risk of them repeating the experience of the Bank of Japan which might have already crossed the threshold between being not just ineffective but even counterproductive, with the unwelcome appreciation of the yen being the main example.

The declining trend of global growth will not be helped by the doubts and uncertainties resulting from the aftermath of the Brexit referendum, specifically the unclear future of the economic and financial relationships between the European Union and Britain, the world's fifth-largest economy. Business and household confidence levels are likely to be badly affected by the fallout from the vote and capital expenditure will be delayed within the UK and the Eurozone.

The concerns about the banking sector in the Eurozone are another major issue that the Eurozone has to face at a bad time. Once again, this situation has been left to gradually deteriorate and authorities are now struggling to find the most appropriate measures to fix this problem within the strict framework of European rules. This situation will likely continue to weigh on financial markets and the economy for some time.

On a more encouraging note, credit spreads are so far not showing signs of panic and emerging market debt has proven to be very resilient, helped by the extremely low prospects for a Fed rate hike. At least in this case, the very accommodative monetary policies of the main central banks are having positive effects as borrowing costs are being kept at record low levels.

FINANCIAL MARKETS

	END 2015	MAY 2016	JUNE 2016	MTD	2016
EQUITIES					
S&P 500	2043.9	2097.0	2098.9	+ 0.1%	+ 2.7%
Euro Stoxx 50	3267.5	3063.5	2864.7	- 6.5%	- 12.3%
MSCI EM	794.1	807.5	834.1	+ 3.3%	+ 5.0%
YIELDS					
UST 10-year	2.27%	1.85%	1.47%	- 38bps	- 80bps
Bund 10-year	0.63%	0.14%	- 0.13%	- 27bps	- 76bps
BBB EU	1.75%	1.31%	1.06%	- 25bps	- 69bps
CURRENCIES					
EUR/USD	1.086	1.113	1.111	- 0.2%	+ 2.3%
USD/CHF	1.002	0.994	0.976	- 1.8%	- 2.6%
EUR/CHF	1.088	1.107	1.084	- 2.1 %	- 0.4%
USD/JPY	120.2	110.7	103.2	- 6.8%	- 14.1%
GBP/USD	1.474	1.448	1.331	- 8.1%	- 9.7%
COMMODITIES					
CRB Index	176.1	186.2	192.6	+ 3.4%	+ 9.4%
Oil, WTI	$ 37.0	$ 49.1	$ 48.3	- 1.6%	+ 30.5%
Gold	$ 1061	$ 1215	$ 1322	+ 8.8%	+ 24.6%

EUROPEAN AND JAPANESE EQUITIES NO LONGER SUPPORTED BY ADDITIONAL QE; EM EQUITIES OUTPERFORM

It has been a turbulent six month period for global equity markets. The year started with a significant correction of equity prices as concerns about global growth, Chinese in particular, and collapsing commodity prices incited investors to strongly reduce their exposures to risky assets. This trend lasted until mid-February when a rebound of commodities and a dissipation of growth concerns contributed to push equity prices higher; US equities moved close to all-time highs and emerging market equities regained interest from largely under-exposed international investors.
In contrast, European and Japanese equity markets failed to recover all of their early-year losses due to appreciating currencies and the unanticipated impact of the British voters' decision to leave the European Union.

BOND MARKETS CONTINUE TO RALLY AND AN INCREASING PORTION OF THE MARKET IS IN NEGATIVE YIELD TERRITORY

The trend of bond markets has been very persistent as yields have consistently hit new all-time lows with yields of 10-year US Treasuries and Bunds ending June respectively at 1.47% and - 0.13% compared to end 2015 levels of 1.85% and 0.14%. An extension of the ECB's QE program and the inability of the Fed to hike rates contributed to these lower yields. Investment-grade credit behaved in a similar fashion, while the trend of high-yield debt has been much less straightforward. Following a stabilisation of emerging market currencies and commodity prices, added to the collapse of expectations for higher US rates, emerging market debt has fared well as international investors reinvested into the asset class.

STERLING CRASHES WHILE THE YEN SOARS

Within the currency markets, the main trends have been a rebound of EM currencies, but, more significantly, the strong appreciation of the Japanese yen and the steep drop of sterling from June 24th onwards. The decision by the BOJ to introduce negative interest rates has not had the desired effect and strong repatriation flows have led to a 14.1% rise of the yen against the dollar by the end of June. The pound was under some pressure during the year's early months but the £\$ parity recovered all of its losses as it climbed to 1.50 before the UK referendum. It has since plunged and is currently trading below 1.30 against the dollar, a 31-year low.

COMMODITY PRICES HAVE REBOUNDED STRONGLY

The declining trend of most commodity prices accelerated at the beginning of 2016. As an example, the price of a barrel of WTI Crude dropped as low as $26 from a starting price of $37. A significant rebound saw a recovery of the oil price above $51 in early June; recent events have seen oil slip towards a level of around $47.

Gold has been one of the best performing assets this year as a decline of real interest rates, a strong bid for safe haven assets and the unwinding of under-invested investors have contributed to a half-year gain of 24.5%.

MARKETS' OUTLOOK

An even more uncertain outlook following Brexit

The most influential central banks will continue to be expected to add to their already extremely accommodative policies despite investors' dwindling confidence in the banks' capacity to have a major impact on financial assets and, especially, on the real economy. At a time when the economic outlook is consistently being downgraded, the fallout of the Brexit vote and the major issues facing the European banking sectors represent serious threats.

For the time being we prefer to limit the level of risk within the portfolios

In the light of deteriorating economic fundamentals, uninspiring prospects for companies to grow their profits and higher political risks, we have adopted a more defensive stance for the portfolios by reducing the allocation towards equities and by maintaining the cash position above a level of 10%. We have also consistently been adding to the alternative space by investing into low volatility and uncorrelated strategies; this allocation will contribute to contain the drawdown of the portfolios during periods of stress and reduce the portfolios' dependence on the direction of the markets to generate positive returns.

DEBT INSTRUMENTS

We remain underweight debt instruments due to unattractive yields

Our underweight exposure to debt instruments has remained stable as the very unappealing yields of many bonds continue to prevent us from adding to the current exposures. The ever declining yields of G-7 sovereign debt were not our main scenario but we do not intend to invest more into this part of the market. We find very limited value in the valuations of many bonds, and still prefer credit where higher coupons will absorb some of the damage if yields were to rise again.

It is difficult to expect yields to drop much lower than the current levels, but most market participants, ourselves included, have been wrong-footed over the last years, so we will assign a low rating to any kind of forecasts! Our main exposures in the fixed-income space are corporate credit, high-yield bonds, loans and convertible bonds. We are also still exposed towards flexible credit strategies, which include the management of duration risk and the ability to tactically allocate capital across various credit segments.

EQUITIES

We have turned more cautious towards equities

Since the beginning of the year, we have taken several tactical measures, consisting essentially of selling equity index futures to protect against downside equity risks. Compared to January, we have reduced the portfolios' exposure to equities and are currently underweight. This underweight allocation is the result of all our European equity exposure being hedged since the beginning of June. Our current underweight towards the asset class reflects an uncertain economic outlook and valuations that are too high considering the prospects for future earnings.

Following an extended period of underperformance, we believe that emerging market equities are in a better position to fare well, hence our decision to invest into a new fund back in March. The latest minutes of the Federal Reserve's meeting has only strengthened the belief that the US central bank will find it difficult to justify an interest rate hike in the prevailing environment; for the assets of emerging markets, this represents a major support.

FX

A low level of conviction on the major FX crosses

The dollar is no longer supported by expectations of higher interest rates but its status as a safe haven asset, improving economic data and positive yields on US Treasuries and credit should all contribute to its ongoing resilience. We continue recommending hedging any exposure to the sterling for the time being and find it extremely difficult to make any predictions on the yen. For the Swiss franc, we would not expect any significant move away from the current level of 1.08 francs per euro; the SNB will carry on with its policy of intervening in order to prevent any undue appreciation of the franc against the common currency. Furthermore, it would be a surprise if the euro were to appreciate much based on the current fundamentals and the Italian banking crisis.

ASSET ALLOCATION 2nd HALF 2016

CASH (12%)

Overweight

The allocation to cash was already above long-term average levels following our significant early-year reduction of risk. The current slightly lower level of cash results essentially from a combination of: the sale of our US high-yield position in January, the later selling of gold and gold mining equities, the purchase of EM equities and other minor adjustments.

DEBT INSTRUMENTS (26%)

Underweight

With an allocation of 26%, we are underweight. Our exposure to investment-grade bonds is heavily underweight, as we continue to view the yields on G-7 sovereign debt as very unappealing. We continue to invest into sovereign and quasi-sovereign bonds issued by the most creditworthy nations and into Euro-denominated corporate credit.

Following the selling of our allocation into US high-yield in January, we have a neutral exposure to high-yield bonds, which we implement through investments into European high-yield and secured loans. The fundamentals for European high-yield and loans remain supportive, especially when taking into account the extended asset purchasing program of the European Central Bank. We are currently considering an investment into emerging-market debt as currencies have stabilised and yields on offer should offset potential risks.

The "specialist bonds" allocation has remained stable and is composed of convertible bonds and unconstrained fixed-income strategies which are not linked to a benchmark and whose duration risk is actively managed.

EQUITIES (42% with an 11% equity hedge)

Underweight

The severe drawdown of equities at the start of the year led us to reduce our allocation to the asset class by selling/trimming some positions and by selling index futures. We then totally unwound the hedges at the end of January and, in March, initiated a new position into an emerging-market equities fund. Finally, at the beginning of June, we hedged all our exposure to European and UK equities due to the elevated risks related to the outcome of the British referendum. Following Brexit, we quickly lifted our hedge on UK equities, but have maintained our protection on European equities, hence our current underweight towards the asset class.

If the prospects for European equities were to improve due to positive political/financial agreements or if valuations dropped to more attractive levels, we would consider lifting part or all of the hedge. We feel more confident with our allocations to US and EM equities, while Japanese equities offer potential but continue to be deeply affected by the strong appreciation of the yen.

COMMODITIES (0%)

Underweight

We currently hold no direct exposure to commodities as we took 2016 profits of 12% and 23% on our positions into physical gold and gold mining equities, respectively, during the first quarter.

HEDGE FUNDS (20%)

Overweight

We have gradually increased our allocation to alternative strategies due to the unattractive yields offered by many debt instruments and also because we want to depend less on the direction of markets to generate positive returns. We hold positions in Global Macro, volatility arbitrage, CTA, Long/ Short equities and Multi-Strategy Funds of Funds. We are currently close to initiating a new position into the Merger/Arbitrage space, a defensive and uncorrelated strategy.

ASSET ALLOCATION GRID 2ND HALF 2016

For our EUR balanced accounts, we apply the following grid:

	ALLOCATION	JULY 2016
SHORT-TERM DEPOSITS	**0 – 20%**	**12%**
DEBT INSTRUMENTS	**15 – 55%**	**26%**
Investment grade bonds	5 – 45%	6%
EM & high-yield bonds	0 – 20%	9%
Specialist bonds	0 – 15%	11%
EQUITIES	**20 – 60%**	**42%***
Developed markets	15 – 50%	38%**
Emerging markets	5 – 30%	4%
COMMODITIES	**0 – 15%**	**0%**
Physical gold	0 – 5%	0%
Other commodities	0 – 10%	0%
HEDGE FUNDS	**0 – 25%**	**20%**
		100%

* Net exposure of 31% (11% Euro Stoxx 50 futures hedge)
**Net exposure of 27% (11% Euro Stoxx 50 futures hedge)

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