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FORUM FINANCE GROUP

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INVESTMENT PERSPECTIVES 2017
MID-YEAR REVIEW & OUTLOOK

JULY 2017

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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 increased our equity allocation at the beginning of the year

On the back of our positive macro-economic and equity outlook for 2017, we positioned the portfolios dynamically by increasing the allocation towards the equity asset class. We had also expressed our confidence that equity prices should be supported by an acceleration of global earnings' growth and, so far, this has effectively proven to be the case. We had reaffirmed our strong conviction on emerging markets and our early-year global equity exposure was well diversified into the different regions. We have since increased our allocations towards European and also emerging markets equities. Hedge funds were an area of concern following a disappointing 2016 performance, but the different funds to which we are exposed have performed much better so far this year and contributed to the strong performance of portfolios.

Global growth has not been derailed by the many political and geopolitical events

Global economic growth is broad based and, for once, has matched expectations. Contrarily to the previous years, growth forecasts have been upgraded generally as confidence is high and investment and trade are picking up from low levels. Europe was facing a series of elections that could have had negative consequences for the European project, but populist candidates failed to beat those in favour of more European integration. The election of Emmanuel Macron as French president has boosted the chances for serious reforms in France and for stronger unity in Europe, especially at a time when economic growth in the Eurozone has surprised on the upside. Donald Trump's administration continues to make many headlines but is struggling to introduce a new health bill and much promised pro-growth reforms. US equity markets have so far proven to be resilient to such disappointments.

The main central banks are still hoping for higher inflation

For various reasons, the monetary policies of the Federal Reserve and the European Central Bank have diverged markedly over the last years. While the ECB remains extremely accommodative, the Fed has turned more hawkish through the acceleration of the pace of interest rates' hikes and the announcement of a plan to start shrinking its balance sheet. On one issue however, both banks are in perfect agreement: the lack of persistent inflation, which is one of the last indicators to really pick up momentum in recent years. At this stage, the Fed appears more confident that inflation will move closer eventually to its target as wage pressures finally push prices higher, hence its confidence in its ability to pursue policy normalization. On its side, the ECB continues to tread cautiously, despite a significant reduction of political risks and strong economic trends. Inflation numbers will continue to be observed closely during the second half of the year to help to determine the likely path of future monetary policies.

We remain in risk-on mode for the time being

The supportive global macro environment and the prospect of strong corporate earnings lead us to remain in risk-on mode, with an overweight allocation into equities being the main driver of portfolio performance. Despite ongoing concerns about the stretched valuations of most asset classes, in the wake of unprecedented monetary policies, we believe it is still too early to turn cautious. Equity prices are being supported finally by an acceleration of earnings' growth and no longer just by the provision of massive liquidity and the anticipation of stronger growth. Finally, markets are not yet showing any signs of euphoria which typically characterize the end of a bull market, hence our overweight equity exposure.

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.

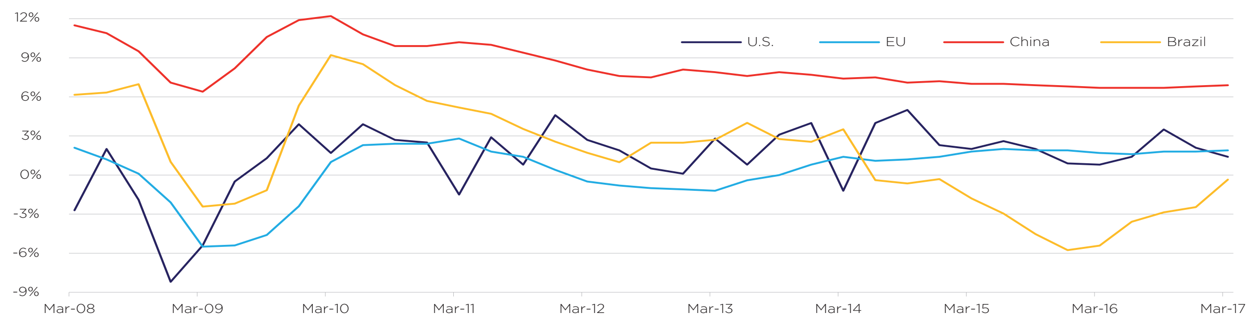
THE MACRO ENVIRONMENT

WORLD ECONOMIC GROWTH

Economic growth is broad based and expected to improve modestly

Global economic activity has accelerated during the first half of 2017 and, contrarily to the previous years, expectations of future growth have not been downgraded. The OECD and the IMF both forecast global growth of 3.5% for this year and of 3.6% for 2018 compared to 3% observed in 2016. Growth has been much more synchronized across the different regions and a recovery of industrial activity has coincided with a pick-up in global trade, after two years of marked weakness. The World Bank is forecasting world trade volume to rise by 4% this year compared to only 2.5% in 2016, despite rising trade policy uncertainty following the election of Donald Trump. Investment has been another area of improvement on the back of higher levels of confidence and more supportive business conditions. Confidence indicators have generally been pointing to very strong activity but they might have been overstated and, in the US in particular, they appear to have peaked. The extension of the current weakness of commodity prices, substantial changes in trade policies and a lack of progress on pro-growth US policies figure amongst the most obvious risks to the prevailing optimism.

GDP growth



Source: Bloomberg LP

The U.S. economy has, once again, been weak during the first quarter (1.4% annualized GDP), but is widely expected to improve in the coming quarters despite the lower expectations relative to tax cuts and infrastructure spending. In the Eurozone, economic activity has been stronger than anticipated and this trend appears to be resilient. Across the large developing economies, while the pace of growth continues to gradually decline in China, significant recoveries have been observed in countries such as Brazil and Russia.

A POSITIVE ENVIRONMENT FOR THE EURO AREA ECONOMY...LESS SO FOR THE UK

At the onset of 2017, the Eurozone was facing a high level of political uncertainty due to general spring elections in the Netherlands and France, with German voters also heading to the polls later in the year. In a nutshell, populist parties have failed to topple pro-European ones and, at a time when economic activity was already trending higher, these results have triggered stronger confidence towards the euro area. The dazzling rise of Emmanuel Macron as the new president of France has also resulted into an overwhelming legislative majority for his young party, “La République en Marche!” This should provide him with the platform to introduce much-needed reforms in France and simultaneously bring a new impetus to the European project alongside its main ally Germany. For financial markets, this political development has boosted the perception of international investors towards the region and translated into strong demand for European assets, primarily for equities, the common currency and peripheral sovereign debt.

In the UK, meanwhile, the path towards Brexit has only become even more complicated. Prime Minister Theresa May's decision to call a snap general election to secure a clear Brexit mandate dramatically backfired as her party lost its outright majority. A year after the UK decided to leave the European Union, the negotiating position of the UK remains unclear and May's initial plans for a clean break from the single market and the customs union have been thrown into turmoil. At this stage, it is still impossible to predict what kind of deal will be agreed upon and what the future relationship between the UK and the EU will look like. From an economic point of view, a slowdown of UK growth is to be expected as private consumption is likely to be impacted by shrinking real income. The current situation also adds to the uncertainty for UK banks and businesses hoping to retain access to the EU's single market for goods and services.

THE IMF CUTS ITS OUTLOOK ON THE US

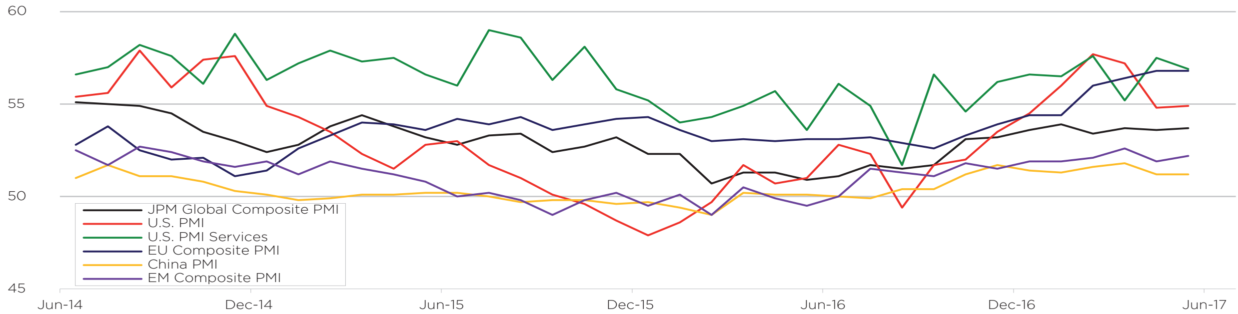
In contrast to the optimism observed within the European and emerging markets' economies, the American economy has lost some momentum and failed to mirror the elevated levels of consumer and business confidence following Donald Trump's election. Confidence indicators had been boosted by campaign promises to replace Obamacare, cut taxes, increase infrastructure spending and lighten regulations. The Trump administration's struggle to make any significant progress so far has dampened the outlook for US growth which is very unlikely to meet Trump's 3% target. The International Monetary Fund has cut recently its outlook for US growth to 2.1% from its April forecast of 2.3%, without discounting the effects of any tax reforms. The IMF said that "the US is having trouble adapting to trends such as changes to the job market from technology, low productivity growth and an aging population". The main impact of this shift in expectations has been felt on the US dollar and on Treasury yields which have, until recently, consistently trended lower this year.

LEADING INDICATOR

The Eurozone leads the developed world

Global economic growth has maintained its strong momentum over the last six months, according to the closely observed Purchasing Managers' Indexes (PMIs), even if the latest readings have come off their early-year highs. The Eurozone has been the brightest spot out of the four largest developed economies and growth could well continue to surprise on the upside, whereas the US economy has been expanding at a slower rate than at the end of last year. Another key development has been the revival of emerging markets, whose global growth has been accelerating for the first time in six years.

Purchasing Manager Indexes



Source: Bloomberg LP

The chart above shows that the strongest trend has been observed on the Eurozone PMI as it has enjoyed its best quarter for six years, even if the latest reading has dipped a little since May. The Emerging Market PMI reached 52.6 in March, a 31-month high, after showing a significant recovery from the near-stagnation signalled a year earlier. The US economy ended the second quarter on a softer note but official GDP data are expected to turn higher after a weak start to the year.

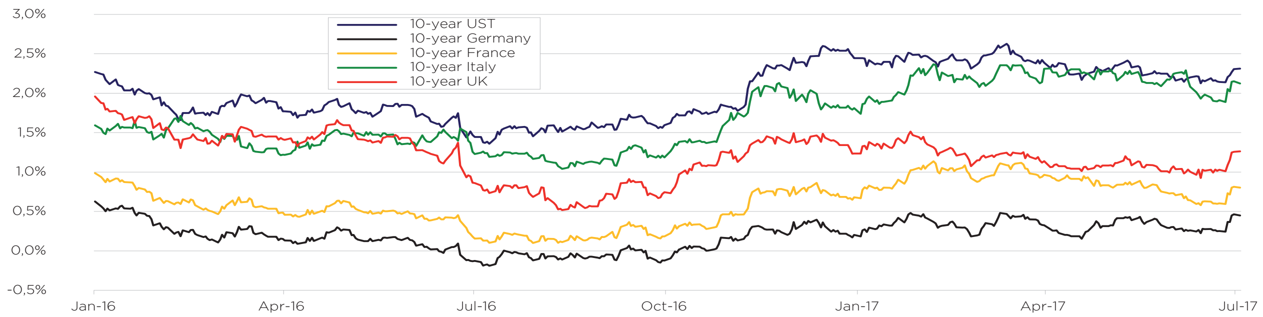
FINANCIAL CONDITIONS

THE END OF A MONETARY CYCLE?

The ECB closer to adjusting its policy

Even if the monetary policies of the main central banks remain very accommodative, there is a feeling that we are approaching an inflection point where the monetary cycle finally enters into a normalization phase. The Federal Reserve is leading the way, reflecting the more advanced stage of its economy in the credit cycle. On the back of solid economic activity and abating political risks, the ECB has started cautiously to hint that it is getting closer to gradually removing some of its extremely accommodative policy mix. ECB President Mario Draghi has expressed more confidence in the recovery of the Eurozone and said that factors weighing on inflation were temporary. While short-term interest rates are likely to remain in negative territory for some time yet, a tapering announcement is now widely expected by the markets in September.

Bond yields have remained low…but should end the year higher



Source: Bloomberg LP

Following an early-year rise, G-7 sovereign debt yields have had a tendency to decline as inflation expectations have dropped gradually. Despite the more hawkish stance of the Federal Reserve and the improving dynamics in the Eurozone, government bond yields have not risen much, even though they spiked towards the end of June following less dovish comments by ECB President Mario Draghi and BOE Governor Mark Carney. The lower yields on French and peripheral European debt can be explained by fading political risks and a stronger appetite for European assets, but the yields on long-term Treasuries and Bunds reflects investors' caution. This contrasts with the higher degree of optimism expressed in the equity markets and also a lack of belief in the Fed's conviction that the recent fall of inflation is temporary and reversible.

INTEREST RATES AND INFLATION

INTEREST RATES

Low expectations over a rise of benchmark interest rates

With the exception of the US, where the benchmark interest rate has now been raised four times up to a 1-1.25% range, short-term interest rates in most of the major economies have remained at record low levels. At this stage, their central banks still appear as being very reluctant to raise them even if recent speeches have been interpreted as being more hawkish. If the ECB seems to be tilting increasingly towards a slightly less accommodative stance, no initial hike of its current negative - 0.4% deposit rate is expected before the second quarter of 2018, at the earliest. The Bank of England finds itself in a trickier situation as it attempts to balance higher inflation risks with an expected slowdown of growth; only a week after saying that it was premature to talk of an imminent rise of interest rates, BOE Governor Mark Carney has now admitted that some removal of stimulus may be necessary. Finally, the Bank of Japan remains fully committed to its extremely accommodative policy and no changes are in sight.

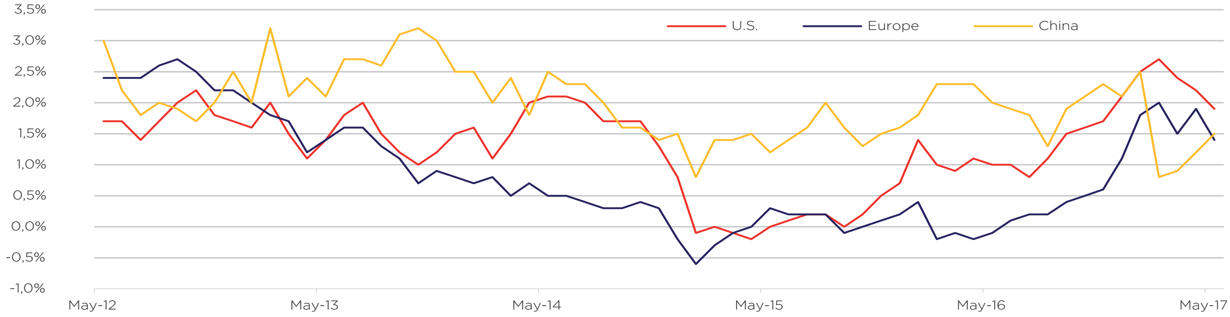
The Fed appears determined to normalize its policy

The Federal Reserve has moved away from its extremely cautious approach towards policy normalization and demonstrated a more determined stance during this year's first half. After single rate hikes in both 2015 and 2016, the central bank has accelerated its hiking pace by already raising rates twice this year and affirming its commitment to hike further. Financial markets appear sceptical, however, about the bank's ability to tighten again in 2017 due to the apparent lack of inflation pressures. The central bank has also already announced a detailed plan on the way it intends to implement QE tightening by starting progressively to shrink its balance sheet.

The BOJ to remain very accommodative

In contrast to its peers, the BOJ has not yet given any indication that it is considering any form of tapering at this stage and it remains fully committed to its QE program, including the cap on 10-year government yields around the zero percent level.

Inflation across the world

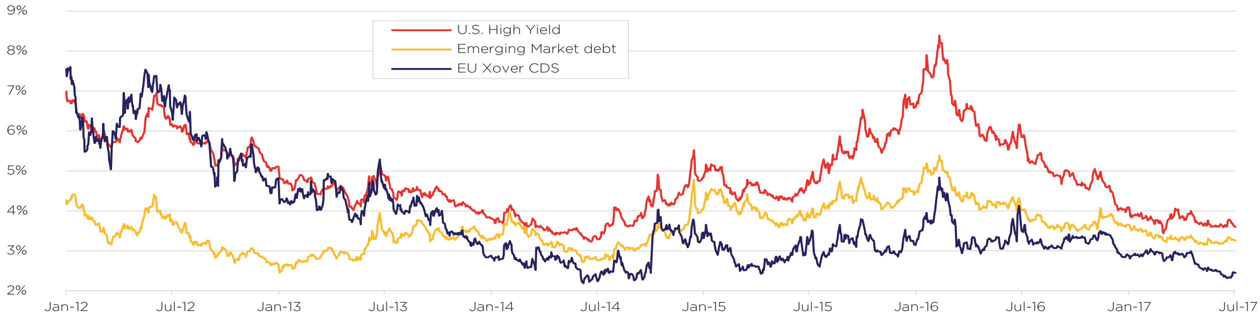


Source: Bloomberg LP

Following a period where the levels of inflation were at last trending towards the central banks' targets, the latest data have disappointed. The effect of a higher oil price from its 2016 lows is already over and, in the US, pressures from tight labour markets are not yet apparent. The Federal Reserve's preferred indicator, the Atlanta Fed's Wage Growth Tracker, has been rising by 3.5% to 4% over the last six months and the bank remains of the view that wage growth will push prices higher eventually. The ECB has also affirmed that the factors weighing on inflation are mainly temporary ones that typically the bank can look through.

BOND SPREADS

Emerging market debt and high yield spreads



Source: Bloomberg LP

The spreads of emerging market bonds over US Treasuries and credit over its respective sovereign debt have narrowed further during the first half of the year. Credit spreads have benefited from an environment of stronger economic growth, healthy credit fundamentals, especially in Europe, and low default rate expectations. Interest coverage ratios are also solid. If spreads are tight compared to historical averages, they are not yet at the record lows of 2007; we do not anticipate much more tightening from the current levels, but the asset class should remain well bid. Emerging market debt has also been in a good shape due to strong international inflows as EM assets benefit from an economic recovery and favourable conditions related to the dollar and US interest rates.

THE MACRO ENVIRONMENT/FINANCIAL CONDITIONS: CONCLUSIONS

Key central banks seem to be recognizing that the time to start removing some of their monetary stimulus is getting closer and investors have reacted recently by pushing government debt yields higher. Central banks will, however, be very careful to avoid creating any shocks in the financial markets. They will tread very cautiously following an extended period where capital markets have become accustomed to ultra-loose monetary policies.

Financial conditions are very supportive as credit and EM debt benefit from healthy fundamentals and benign default rate expectations. Companies are able to easily access refinancing at favourable conditions and credit growth is also trending higher. One can also feel more confident towards the state of the banking sector in Europe where solutions to sort out failing banks, particularly in Italy, are being applied.

A cycle of synchronized global growth with optimistic levels of business and consumer confidence provide a good background for the economy. It is too early to be anticipating any recession and the regained optimism in Europe as well as the recovery in emerging markets are contributing to a more balanced global economy. For once, there are some rising doubts about US activity as it is further along the economic cycle and facing a lot of uncertainty relative to the implementation of much promoted pro-growth reforms.

THE FINANCIAL MARKETS

	End 2016	May 2017	June 2017	MTD	2017
EQUITIES					
S&P 500	2238.8	2411.8	2423.4	+ 0.5%	+ 8.2%
Euro Stoxx 50	3290.5	3554.6	3441.9	- 3.2%	+ 4.6%
MSCI EM	862.3	1005.3	1010.8	+ 0.5%	+ 17.2%
YIELDS					
UST 10-year	2.44%	2.20%	2.31%	+ 11bps	- 13bps
Bund 10-year	0.20%	0.30%	0.47%	+ 17bps	+ 27bps
BBB EU	1.30%	1.40%	1.56%	+ 16bps	+ 26bps
CURRENCIES					
EUR/USD	1.052	1.124	1.143	+ 1.7%	+ 8.7%
USD/CHF	1.019	0.968	0.958	- 1.0%	- 6.0%
EUR/CHF	1.072	1.088	1.095	+ 0.6%	+ 2.1%
USD/JPY	116.9	110.8	112.4	+ 1.4%	- 3.8%
GBP/USD	1.234	1.289	1.303	+ 1.1%	+ 5.6%
COMMODITIES					
CRB Index	192.5	179.8	174.8	- 2.8%	- 9.2%
Oil, WTI	$ 53.7	$ 48.3	$ 46.0	- 4.8%	- 14.3%
Gold	$ 1152	$ 1269	$ 1242	- 2.1%	+ 7.8%

A supportive environment for equity markets

The first half of 2017 has been a very favourable period for global equity markets, reflected by the 7% rise of the MSCI World Index in local currencies. Emerging markets have outperformed markedly as fears over higher interest rates, a stronger dollar and US protectionism have failed to materialize. Instead, international investors have been attracted by EM equities' cheaper valuations and by a positive outlook for corporate earnings. Despite a slow start, European equities have performed well since on the back of strong economic activity, declining political risks and better-than-expected corporate earnings. Meanwhile, US equities have reached all-time highs, even if under the leadership of a limited number of large technology names, and the stock market has so far looked past policy disappointments as the so-called “Trump trades” have been unwound largely.

Bond markets have held up better than anticipated

The consensual market view that bond yields were most likely to keep on rising has once again proven to be contradicted by market action. While the yields of core European sovereign debt have edged higher due to the positive momentum of the Eurozone economy and the dissipation of political risk, 10-year US Treasury yields have dropped by 0.13% to 2.31%, despite the Fed's decision to hike interest rates in March and June. Dwindling inflation expectations, the lower belief in the introduction of pro-growth policies by the Trump administration and market scepticism about the Fed's ability to raise rates further have pushed yields lower. Credit and emerging market debt segments have performed well as investors continue to look for assets that still generate some income.

The dollar has weakened while the euro has benefited from regained confidence

Within the currency markets, the main trends have been the weakness of the dollar and the general outperformance of the euro. The end-2016 strength of the dollar, in the wake of Donald Trump's election, came to a halt in 2017 and extremely long dollar positioning has been undone gradually. Lower Treasury yields and a lack of progress on policy reforms were the main drivers behind this trend reversal. Simultaneously, the euro has regained investors' confidence due to stronger-than-expected economic growth in the Eurozone and the positive outcome of high-risk elections in the Netherlands and France. Finally, sterling has been one of the more volatile currencies; it has continued to be impacted by Brexit discussions as well as by the outcome of the UK general election where PM Theresa May's party lost its outright majority unexpectedly.

Most commodity prices have been under pressure

Since the end of February, the prices of most commodities have been declining. Despite the depreciation of the dollar, historically a supportive factor, it has been a tough first half for the commodity space, in particular for oil exporters. The price of a barrel of WTI Crude has dropped by more than 15% from its early-year level despite a decision by OPEC and non-OPEC members to extend cuts in oil output until March 2018. In contrast, gold has appreciated by close to 8% on the back of low real interest rates and the impact of a weaker dollar.

MARKETS' OUTLOOK

The economic environment is conducive for risk assets

The macro environment continues to improve gradually, in the shape of synchronized global growth and declining political risks in Europe. Notwithstanding the disappointment relative to the pace of pro-growth reforms in the US, positive economic momentum in Europe, Japan and most emerging countries as well as solid corporate earnings provide supportive conditions for risk assets. While the Federal Reserve has hiked interest rates twice in 2017 and already announced plans to start shrinking its balance sheet, the tightening of its monetary policy must be seen as being very gradual. The ECB will also tread very carefully in view of the removal of some of its extremely accommodative policy.

We maintain a dynamic asset allocation

Solid economic fundamentals, strong earnings' growth, contained inflation, still easy monetary policies and low volatility are supportive for a risk-on positioning of the portfolios. Despite ongoing concerns about the stretched valuations of most asset classes in the wake of unprecedented monetary policies, we believe it is too early to turn cautious. Equity prices are being supported at last by higher earnings and no longer just by the provision of massive liquidity and the anticipation of stronger global growth. The positive year-to-date contribution of hedge funds is also reassuring. It can be attributed partly to a gradual return to an environment where fundamental factors take precedent over attempting to predict the outcome of binary events.

DEBT INSTRUMENTS

We remain underweight debt instruments and expect yields to rise gradually

Our main scenario is for G-7 sovereign debt yields to end 2017 at higher levels than currently as the Federal Reserve and the European Central Bank start to unwind, or at least commit to remove, some of their ultra-accommodative policies. Admittedly, we would have expected bond yields to have already moved higher by now, but we feel that markets might be underestimating future inflation as well as the Fed's determination to hike again and to begin the process of balance sheet normalization. We believe that equities and also hedge funds offer better return prospects, hence our underweight exposure to debt instruments. Our main exposures in the fixed-income space are corporate credit, high-yield bonds, loans and convertible bonds. We also remain exposed towards flexible credit strategies, which include the management of duration risk and the ability to allocate capital tactically across various credit segments.

EQUITIES

We have a positive outlook on the equity asset class

Our allocation to equities was increased at the beginning of the year and we remain overweight. The asset class should continue to be well supported by a positive macro environment, favourable financial conditions and the strong growth of corporate earnings. We agree that valuations cannot be considered as particularly cheap, but neither are they excessive and they still appear as much more attractive than those of debt instruments. Furthermore, capital markets are not yet showing any signs of euphoria which typically characterize the end of a bull market.

In our opinion, investors' higher level of confidence on European equities is fully justified and international flows should provide additional support. Political risks have declined significantly and companies appear as more likely to boost business investment and also try to raise output prices; these factors should benefit the prices of equities. Emerging markets' equities have outperformed since the beginning of the year and we continue to see good value in this market segment. We also consider the outlook for Japanese equities to be supportive; structural changes of corporate governance and better profitability of Japanese companies are just two of the many factors that should contribute to higher equity prices.

FX

We expect FX volatility to be contained

The huge swing away from an extremely long market positioning on the dollar likely reduces the risk of much additional depreciation, against the euro in particular. A pick-up of inflation expectations could add credence to the Federal Reserve's stance and translate into a more stable second half for the greenback. We continue to recommend avoiding sterling risk and expect the USD/JPY parity to strengthen. For the Swiss franc, we forecast some weakening from the current level of 1.095 francs per euro due to the much higher level of confidence towards the European currency and the anticipated path of ECB policy announcements.

ASSET ALLOCATION 2ND HALF 2017

CASH (6%)

Neutral

The allocation to cash is close to its early-year level. As we had added more equity risk to the portfolios during the early part of the year, the exposure to cash had quickly dipped below 3%. The current exposure must be considered as a neutral position.

DEBT INSTRUMENTS (27%)

Underweight

With an aggregate allocation of 27%, we remain very underweight. Our exposure to investment-grade bonds has been increased modestly before the summer period, which tends to be more volatile for risk assets. Our main scenario is for the yields on G-7 sovereign debt to rise gradually and our main investment-grade positions are into sovereign and quasi-sovereign bonds issued by the most creditworthy nations and also into Euro-denominated corporate credit.

Our allocation to high-yield bonds is neutral and is implemented through investments into senior secured loans, European high-yield as well as a maturity-dated high-yield fund. We consider the fundamentals for European high-yield and for loans to be supportive even if we do not anticipate spreads to tighten much from the current levels.

The "specialist bonds" allocation is overweight and has remained stable around 10%. It is composed of convertible bonds and unconstrained fixed-income strategies which are not linked to a benchmark and whose duration risk is managed actively.

EQUITIES (51%)

Overweight

We increased quickly our exposure to equities at the onset of the year. We initiated new positions into frontier markets, European banks and US Small Caps. Over the first half, we also increased our regional allocation to European equities in anticipation of international inflows in light of abating political risks. In contrast to last year, we decided not to hedge any of our equity allocations before the elections which took place in the Netherlands, France and the UK. This has contributed positively to the portfolios' performance as the outcome of the Dutch and French elections were very well received by the markets.

Our equity allocation is overweight as we believe that the current environment remains supportive for the asset class. Our regional exposure is well diversified with a bias towards Europe, Japan and emerging markets.

COMMODITIES (0%)

Underweight

We continue to avoid any direct investments into the commodity space. It appears to us that the aggregate demand/supply picture does not provide a very favourable backdrop for the general price outlook on most commodities.

HEDGE FUNDS (16%)

Overweight

The allocation to alternative strategies has so far proved to be much more rewarding than it was during 2016. We believe that the headwinds for a number of strategies are subsiding, including the impact of central banks' QE, a number of binary political events and a low dispersion of equity returns. We therefore maintain our overweight allocation to hedge funds and hold positions in Global Macro, volatility arbitrage, CTA, Merger & Arbitrage and Long/Short equities.

ASSET ALLOCATION GRID 2ND HALF 2017

For our EUR and USD balanced accounts, we apply the following grid

	ALLOCATION	JULY 2017
SHORT-TERM DEPOSITS	**0 – 20%**	**6%**
DEBT INSTRUMENTS	**15 – 55%**	**27%**
Investment grade bonds	5 – 45%	8%
EM & high-yield bonds	0 – 20%	9%
Specialist bonds	0 – 15%	10%
EQUITIES	**20 – 60%**	**51%**
Developed markets	15 – 50%	46%
Emerging markets	5 – 30%	5%
COMMODITIES	**0 – 15%**	**0%**
Physical gold	0 – 5%	0%
Other commodities	0 – 10%	0%
HEDGE FUNDS	**0 – 25%**	**16%**
		100%

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