



Quarterly marketreview

January 2014

Editorial: The lessons of 2013

A year ago, nearly to the day, we wrote that we did not believe that European corporate bonds could continue to outperform equity markets and predicted that performance levels for 2013 would be around the average coupon level. In this respect, our forecasts were correct, as the Iboxx index rose by +1.42% during the year in an environment where European interest rates stopped falling. Indeed, 10-year Bund rates, which were at 1.40% at the beginning of the year, are now above 1.80%. On the equity front, we had predicted a moderate rise in global equity markets and maintained our emerging market bias for a number of fundamental reasons. In this respect, we must unfortunately concede that our analysis of the macroeconomic and fundamental environment did not enable an optimal interpretation of global stock markets this year. Stock market performances do not always reflect GDP growth patterns. The Stoxx 600 index has risen by close to +30% in the past two years, while growth in the Eurozone has stagnated and even fallen in a number of member states. The same can be said of corporate earnings growth: European stock market performances over the past two years have been far superior to the rate of earnings growth. Since the beginning of 2013, the Stoxx 600 index has risen by over +12%, while the MSCI Emerging Markets index has lost

-6.14%, despite globally better growth forecasts in emerging markets. Brazil stands out as an unfortunate exception to the better growth picture in emerging markets.

These observations must guide us in 2014: although higher earnings growth, around +18%, is expected next year in Europe, this does not guarantee strong equity market returns next year. Financial markets have become highly interconnected in recent years and are affected strongly by psychological factors. The best example of this interconnectedness is the fact that both U.S. and European interest rates have risen simultaneously since Mr Bernanke's somewhat clumsy QE tapering statement in May. The 10-year U.S. Treasury yield's rise from 2% to 2.9% appears justified by the improving U.S. economic outlook. The 10-year Bund yield's rise, on the other hand, is much more surprising given the weakness of fundamentals in the Eurozone. As far as psychological factors are concerned, the best illustration is Mr Draghi's speech in the summer of 2012, reassuring investors about the survival of the single currency. This can be pointed to as the starting point of the stock market rally.

In this context, caution and diversification will remain central to our portfolio management in 2014.

Product	YTD %	QTR %	Close
▶ DOW JONES	+23.38	N/A	16,167.97
▶ S&P 500	+26.96	+6.59	1,810.65
▶ FTSE	+10.08	-1.12	6,492.08
▶ BEL20	+12.88	-1.14	2,794.69
▶ AEX	+11.22	+0.85	381.17
▶ MXEF	-0.53	-0.16	46,484.88
▶ IBEX	+15.62	+1.85	9,618.50
▶ CRUDE OIL	-1.33	+0.38	109.63
▶ EURIBOR	+124.77	N/A	0.25
▶ GOLD	-27.10	-7.75	1,221.30
▶ EUR/USD	+3.61	+1.41	1.37
▶ EUR/CHF	+1.28	-0.30	1.22
▶ EUR/GBP	+2.73	-0.73	0.83

Outlook for 2014

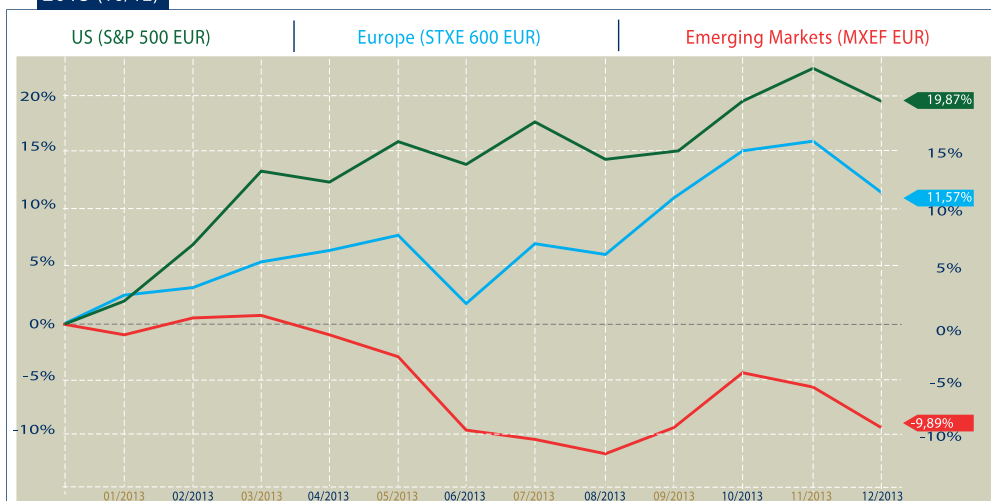
The coming months should confirm the signs of recovery that emerged in 2013. The U.S. economy will remain an important driver of global growth. Its growth should stabilise between +2.5% and +2.8% in 2014, while Europe will struggle to reach growth of +0.7%. Emerging markets should benefit from higher demand from developed countries, but the situation is varied: Asia, and China in particular, currently appear to have more upside potential than South America. 2014 will be a crucial year for Japan. It is still too early to determine whether the country will manage to confirm the positive dynamic that emerged in 2013. The sharp depreciation of the JPY should boost exports and the domestic market is showing signs of recovery, but the demographic dynamic remains negative.

In this environment of moderate global growth, what stock market behaviour can we expect in 2014? What are the main risks?

QE tapering, or the gradual reduction of and end to asset purchases by the Federal Reserve under its third Quantitative Easing program, will continue to be the centre of investor attention. Last May we saw how sensitive investors were to Mr Bernanke's announcement of the future tightening of monetary stimulus.

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2013 (16/12)



Comparative returns of US, European and Emerging markets in 2013



Outlook for 2014 (cont.)

The U.S. equity market's valuations are high and the longer end of its interest rate curve contains risks. It will be important that future statements by the Federal Reserve do not cause investor panic as this would lead to profit taking in both equity and fixed income markets. Another risk factor specific to the U.S. will come from negotiations to raise the debt ceiling. These will shortly return to the centre stage and could lead to another political impasse between Republicans and Democrats.

In Europe, the main risk continues to come from the important deflationary forces present in the economy. Recent macroeconomic data were disappointing: the Eurozone economy grew by a mere +0.1% in Q3 and disparities between the

North and the South remain important.

Unemployment is still high and has reached catastrophic levels in Spain, while Italy and France continue to face elevated social and political risks. All of this affects confidence, domestic consumption and consequently economic growth. Following the formidable rally that started in the summer of 2012, European equity markets, without being overvalued, have reached levels that leave them vulnerable to potential bad news.

Emerging markets could, logically, benefit from a catch-up effect after their huge underperformance of 2013. Here too, it is important to remain cautious as elections in Brazil, South Africa, India and Indonesia could generate some volatility. Encouraging signs continue to come from China.

In summary, our macroeconomic scenario of a moderate global recovery should lead to modest rises in global stock markets. We enter 2014 with a neutral to cautious view on equity markets, which should be more volatile than in 2013. Our view is determined by the high equity market valuations already reached, the risks linked to investor sentiment about the evolution of the Federal Reserve's monetary policy, the worryingly low level of economic activity in Europe, the doubts about Japan's policies and lack of restructuring, the elections that will take place in a large number of emerging countries and the persistence of geopolitical risks, particularly in the Middle East.

Macroeconomics

Europe

- European GDP growth should reach -0.5% in 2013 and +0.7% in 2014.
- Advanced indicators and industrial production figures are improving.
- The worst of the austerity measures has probably already passed, but many problems remain, among which the persistently high public debt levels.
- Unemployment has stayed high and is having a negative structural effect on economic growth.
- Although consumer confidence and spending will remain weak in 2014, they should improve in relation to 2013.
- The latest CPI figure was published below 1%. Powerful deflationary forces remain in place and should push the ECB to further loosen its monetary policy and make use of unconventional measures.
- In these circumstances, the USD should logically strengthen against the EUR in 2014..

US

- As long as there are no unexpected external shocks, the U.S. GDP is expected to grow between +2.5% and +2.8% in 2014.
- Improving employment figures and rising asset prices have supported consumer confidence.
- The deleveraging process is nearing its end for households, but we do not expect consumption to increase dramatically.
- At the corporate level, balance sheets have become healthier thanks to the low interest rate environment, but capital spending and investment remain low.
- The weakness of the JPY against the USD has weighed on the trade balance, which should only contribute very little to growth in 2014.
- Reductions in government spending should continue to weigh on growth in 2014, but less so than in 2013.
- Inflation continued to slow and the latest CPI figure came out below expectations.
- The Federal Reserve has little room left to manoeuvre, especially after the error in communication last May. Mrs Yellen is likely to remain cautious about QE tapering and maintain the zero interest rate policy in 2014.

Emerging Markets

- In 2013, emerging equity market performances were not representative of an overall improvement in their macroeconomic environment. This environment remains uneven though, with major headwinds in Brazil and Russia for example.
- Globally, GDP growth should reach +5% in 2013 and between +4.6% and +4.8% in 2014.
- Inflationary pressures generally remain strong, especially after the weakening of a large number of local currencies. Inflation should reach between +3% and +6%.
- Equity valuations are attractive, but emerging equity markets must face two major challenges: wage increases are eroding profit margins and the QE tapering will reduce the amount of assets available to allocate to these markets.
- China is increasingly imposing itself as a major economic force, as important as the U.S.A., Europe or Japan. Structural reforms continue to be implemented. If Japan's deflation policy is successful, the entire Asian region could benefit from an improved growth environment.

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