2pm
PERSONALIZED PORTFOLIO MANAGEMENT

Quarterly market review

October 2014

Editorial

The third quarter was eventful both in geopolitical and economic terms, which led to erratic movements in equity markets: first a strong correction in July and the first week of August, then a sharp rebound off important technical support levels from August 8th onwards. The last two weeks of September saw another correction. Although equity index returns in Europe and in the U.S. were relatively similar over the course of the quarter, with the Eurostoxx 50 losing -0.07% and the S&P 500 gaining +0.62%, European stocks were much more volatile and investors were more nervous than in the U.S. Economic conditions in the Eurozone have worsened: GDP growth was close to zero in Q2, the PMI Manufacturing index fell in August and economic activity and consumer confidence indices are stagnating . In addition, fears of deflation are rising: Eurozone inflation fell from +0.4% in July to +0.3% in August, its lowest level since October 2009. This continued to push long-term interest rates lower: the 10-year German government bond yield fell from 1.24% at the end of June to a fresh low of 0.94% on September 30th.

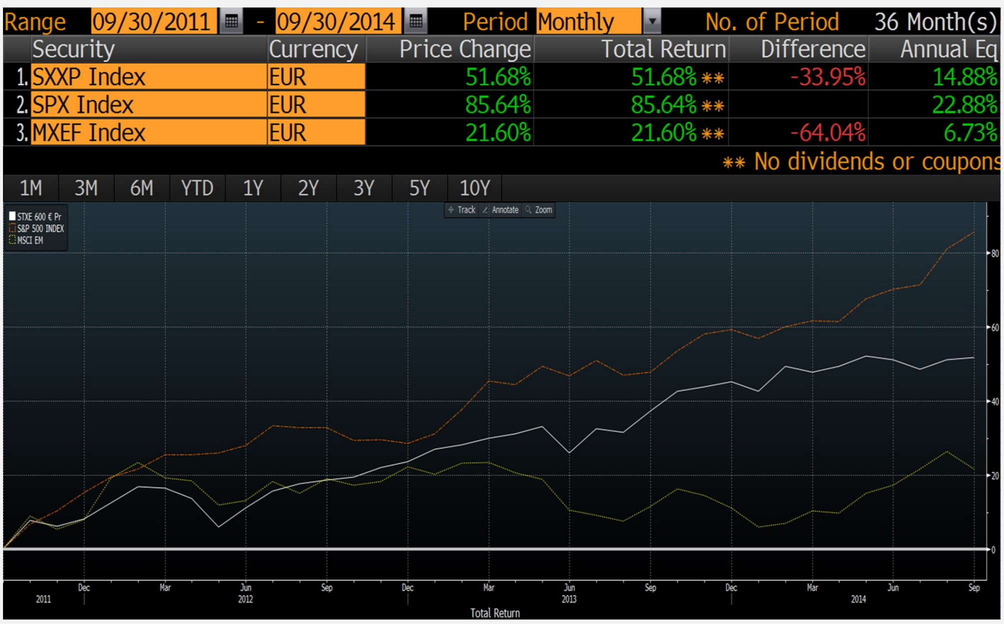
On the geopolitical front, the destruction of the Malaysian Airlines flight in the Ukrainian airspace rekindled tensions between Russia and the West. Markets feared that an escalation of tensions could lead to a slowdown of the German economy which, in turn, would weaken other European countries. Of all the Eurozone members, Germany is the most exposed to Russia and the Eastern European countries, and its recent macroeconomic data publications have been disappointing. A number of other external factors also contributed to the rise in volatility this summer: the intensification of the Israel – Palestine conflict, the U.S. intervention in Iraq following the rise in power of the Islamic State, the July 30th Argentine debt default, the Banco Espirito Santo debacle and the rapid spreading of the Ebola virus. In addition, Q2 European corporate earnings publications were mitigated, with some significant profit warnings such as Tesco or Adidas. The EUR continued to weaken, from 1.40 in May to 1.26 at the end of September.

In the U.S., annualised GDP growth rose to +4.2% in Q2 and strong macroeconomic figures were in stark contrast with the European sluggishness. Better prospects for the real estate market have also been confirmed. In this context, and as opposed to Europe, 10-year Treasury rates were virtually unchanged, falling from 2.53% at the end of June to 2.49% at the end of September. Q2 U.S. corporate earnings reports were strong.

The situation in China has improved markedly as Q2 GDP growth rose to +7.5%, supported by strong consumption figures and encouraging industrial production and retail sales growth. These strong Chinese macroeconomic figures, which are partly a result of recent stimulus measures, appeared to buoy the rest of the emerging sphere, leading to generally higher than expected statistics and some spectacular equity market performances in July and August: equity markets in China rose by +8.9%, in India by +4.7% and in Brazil by +14.8%. The MSCI Emerging Markets index lost -7.5% in September amid uncertainty and fears over the end of the Federal Reserve's QE program, Russia's poor macroeconomic data publications made worse by international sanctions and the pre-presidential election turbulence in Brazil.

	YTD%	QTR%	Close 30/09/14
DOW JONES	2,81%	1,29%	17 042,90
S&P 500	6,70%	0,62%	1 972,29
FTSE	-1,87%	-1,80%	6 622,72
BEL20	10,18%	3,01%	3 221,40
AEX	4,82%	1,93%	421,14
MXEF	0,26%	-4,33%	1 005,33
IBEX	9,16%	-0,90%	10 825,50
CRUDE OIL	-7,38%	-13,49%	91,16
GOLD	0,21%	-8,98%	1 208,16
EUR/USD			1,2631
EUR/CHF			1,2063
EUR/GBP			0,7791
EURIBOR 1M			0,0070

In the coming months a number of factors could favour a rebound in European equity markets, starting with the ECB's recent support measures: interest rates have been cut to 0.05%, long-term financing is being provided through the TLTRO program and a securitised asset purchasing program has been implemented. The strengthening of the USD is making European companies more competitive and could hopefully lead to imported inflation. Merger and acquisition operations are set to continue and valuations remain reasonable at 13.5x 2015 earnings. The U.S. stock market is more expensive at 15x 2015 earnings, slightly above its historical average, but we remain optimistic, as explained in our "Special Topic" section overleaf. Indeed, the economic environment is positive and long-term rates should remain low for a prolonged period, as in Europe, despite the Federal Reserve reaching the end of its QE program. It will be important to stay vigilant in the coming months because the geopolitical environment remains fragile in Ukraine and the Middle East. In fixed income we remain positioned in bonds with shorter durations with a particular focus on the BBB/BB segment. Stock selection is crucial for lower ratings, as illustrated by the violent corrections suffered by some high yield issuers during the summer.



Comparative returns of American, European and Emerging Markets since 2011

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Macroeconomics

Europe:

- The European Central Bank has clearly reviewed its stance and is taking unprecedented measures to fight against disinflation for fear that it could lead to a Japanese deflation scenario. September inflation was estimated at +0.3%.
- In addition to the TLTRO program providing financing for banks, Mario Draghi has lowered the main refinancing rate to 0.05% and announced an asset-backed security purchasing program to start in October.
- Although economic growth in the Eurozone has remained positive, the trend is weakening due to events in France and Italy and consequences of the reciprocal economic sanctions between the EU and Russia.
- The recent weakening of the EUR and fall in price of commodities, combined with ECB liquidity measures should support companies and could help economic activity to rebound in late 2014 and in 2015.

USA:

- Supported by strong consumer spending and capital spending, Q2 GDP growth rose by +4.6%. The world's leading economy is in good health.
- The Federal Reserve will end its asset purchases in October and should start to raise interest rates between the Q2 and Q3 next year, reaching +0.75% by the end of 2015. Unless a sharp rise of the USD causes delays.
- Inflation has remained subdued, at+1.7% annualised in August.

Emerging markets:

- As in 2013, anticipations of interest rate rises in the U.S. have caused a fall in emerging market equity indices and currencies.
- In Brazil markets continue to move according to pre-Presidential election opinion polls in a difficult social and economic environment.
- Doubts persist about the situation in China and investors have regularly shown fears of a hard landing. We do not believe in this scenario. The slowdown that has been observed remains inevitable but contained. The authorities are in the process of rebalancing the economy towards services and domestic consumption, which will bring benefits in the longer-term.

Japan:

- The Japanese economy appears to have come to terms with the sales tax hike.
- Economic activity indicators have rebounded sharply since April's lows and have moved back into expansionary territory.
- Inflation has stabilised around +2.3%.

EUR/USD 2011-2014

Do American equities still hold any potential?

Since 2010, 70% of the rise of the S&P 500 has come from profit growth and 30% from valuation multiple appreciation. Most of the profit growth is a result of the internal reorganisations and reductions in operational costs and financial costs. This phenomenon is perfectly normal for an economy in the recovery stage. In order for U.S. equity markets to continue to progress calmly without excessive valuations, turnover will need to increase through internal growth and investments or external growth and acquisitions. This is a perfectly conceivable scenario: the world's largest economy is growing and advanced indicators suggest that the trend could last. American consumers have emerged from the crisis much less highly leveraged and employment market improvements could lead to increased consumption. Another support factor should come from the real estate market: it has been in a state of underinvestment since the bursting of the housing bubble in 2005, both in the residential construction sector and the infrastructure sector.

American corporations' turnover is expected to grow by +3.9% in 2014 against +2.7% in 2013. Analysts are even more optimistic about 2015 and expect revenue growth to reach +5.2%. Recent surveys of industry leaders suggest that optimism is returning. We remain cautious about possible disruptions as the USD continues to strengthen and geopolitical tensions remain abundant.