ALLOCATION PERSPECTIVE

Document intended for professional clients

Interest-rate driven

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The equity market rally among developed economies came to an abrupt halt in April. The trend reversal was caused by a sudden shift in long-term rates, rather than by any downgrades in economic forecasts for developed countries.

The long-term rate shock began in mid-April in Europe, as German yields reached record levels. The ECB had effectively begun buying up sovereign bonds massively in March under its quantitative easing repurchase program. German 10-year yields even reached an all-time low of 0.05% on April 17, 2015. The market was thus dominated by buying inflow from the ECB, whereas liquidity was already significantly reduced, since banks had ceased proprietary trading, exacerbated by the new regulations which oblige banks and insurance groups to hold significant bond assets. The lack of liquidity and the prospect of massive buying by the ECB, which has far exceeded total issuance this year, disconnected the market from fundamentals.

From this date onwards, above-consensus European inflation indicators convinced the market that the ECB's strategy was bearing fruit and that the valuation of long-term rates in Europe should include a maturity premium as well as an inflation premium. Furthermore, seasonal factors influencing the market suddenly turned negative, as net issues increased sharply from May onwards. Finally, a number of asset managers in major funds announced that they were considering massively reducing their German bond holdings. The bond market, which was entirely in the hands of the ECB, started to behave more 'fundamentally', causing rates to surge to levels which were in line with macroeconomic factors (inflation and growth). German 10-year bonds are now trading close to their fundamental value of 1% (see chart 1).

Chart 1

German 10- years yields

Source : DataStream

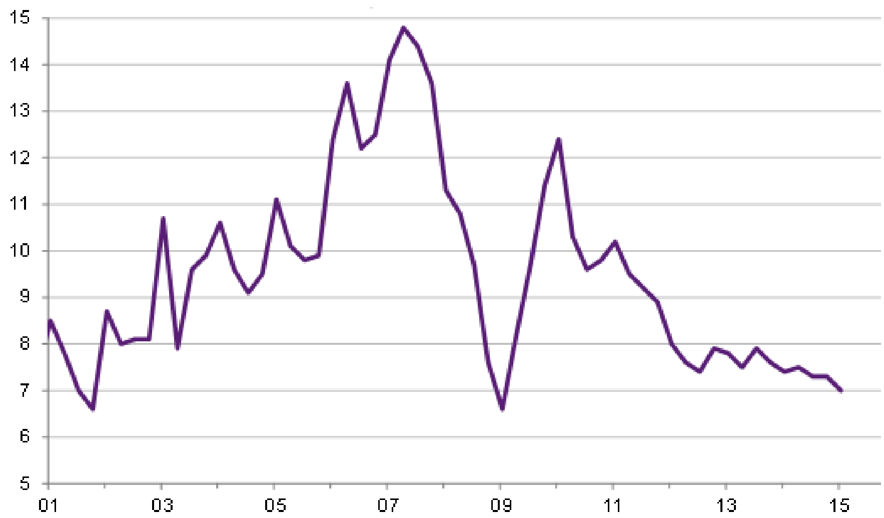
The rally in European interest rates immediately drove the euro higher, which, combined with the recovery in the oil price, ended the "alignment of the planets" which had fuelled the equity rally in Europe.

Meanwhile in the US, despite disappointing economic data, salary pressure forced the Fed to adopt a more hawkish tone, promising the market a rate hike by the end of 2015 at the latest. Steeper US rates also helped reduce risk appetite among investors, which brought the US equity rally to a halt.
With the Fed reducing dollar liquidity and the German bond bubble bursting, we are confronted with a situation whereby long-term rates no longer seem able to act as a shock absorber against the ills of the world. However, the world is always faced with numerous threats. In addition to the geopolitical risks in Ukraine and in Syria and Iraq, which threaten major upheavals in the oil market, other risks are looming, including a sudden slowdown in Chinese growth, a Greek default and also the risk of a sharp depreciation among the currencies of emerging economies running high current account deficits (Turkey, South Africa, and Brazil).

We are therefore in an environment characterized by modest global growth and forthcoming tensions in dollar liquidity, whereas long-term rates are trending higher. Furthermore, this new paradigm in the bond market is occurring in a context in which risky assets are staring to appear fairly valued or even slightly overpriced, as was the case with US equities. Moreover, we consider corporate bonds to be fairly valued, but steeper rates are undermining this asset class, which is also suffering from a chronic lack of liquidity. Commodities are at historically low levels, but persistently sluggish growth in China (see chart 2) has removed a late-cycle marginal buyer. These valuations therefore appear justified.

Chart 2

Chinese real growth (%growth/year)

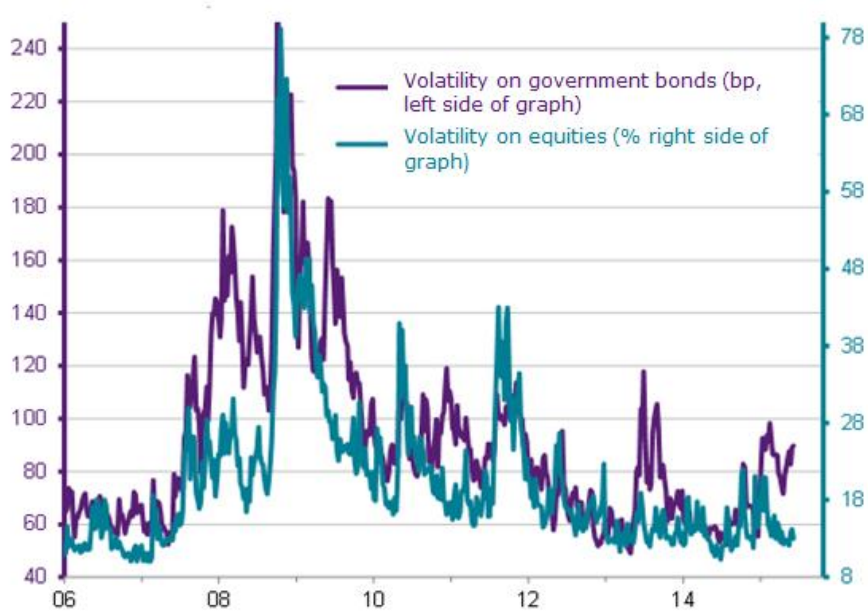


Source : Bloomberg

In the current environment, we have considered it appropriate to reduce portfolio risk. We have cut our equity overweight to 1.5% and reduced its beta by closing-out our European small-cap bias. We have maintained geographical diversification, overweighting euroland, US and Japanese markets. We have adopted a neutral bond weighting, with the exception of a minor long position in US long-term rates, which provide protection against equity volatility. Finally, we are continuing to avoid commodities and emerging assets. As demonstrated in the chart below, implied interest-rate volatility has not yet fed through to equities, but the next few weeks will tell us whether the convergence in volatility between the two asset classes occurs from the top down, or from the bottom up (see chart 3).

Chart 3

Implied volatility on US bonds and equities



Source : Bloomberg

Written on 11 June 2015

Tactical positioning

We remain overweight equities, emphasizing the preference for Euroland market versus the US and emerging markets.

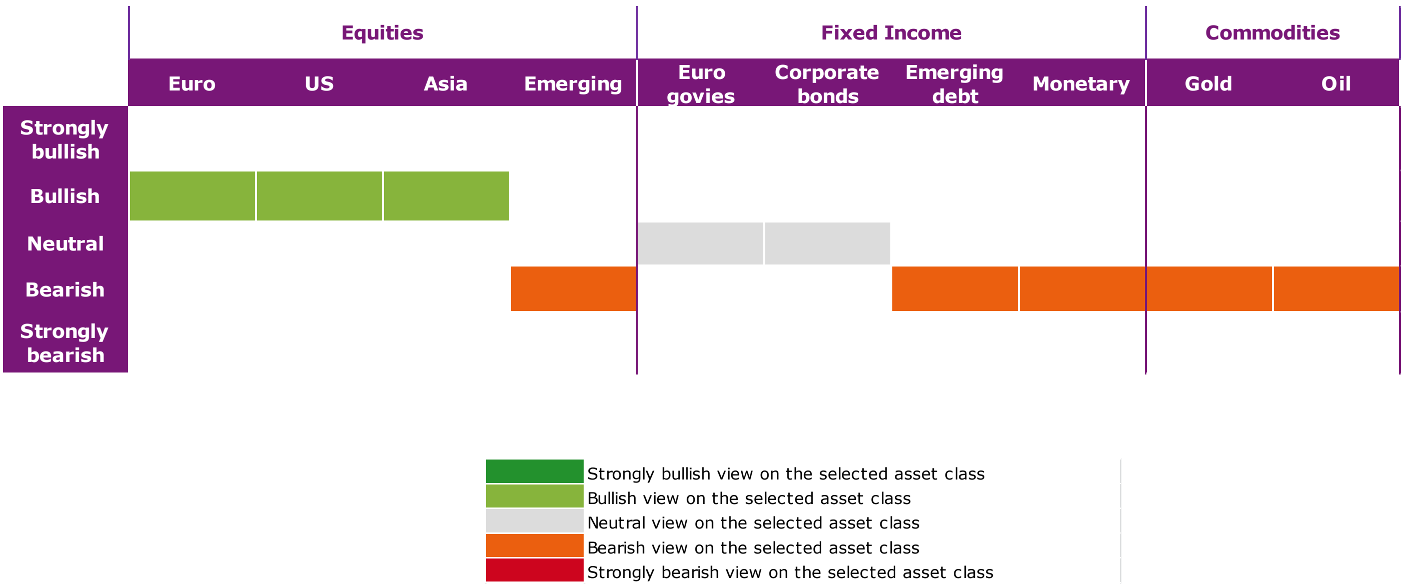
<u>Fixed-income</u> : After weeks of market correction, the ECB announcement contributed to the stabilization of interest rates : the ECB should accelerate "moderately" its bond purchases in May and June, taking the lead over the program in July and August where liquidity is more reduced. If powerful technical factors of the QE should continue to exert downward pressures on interest rates for an extended period, new volatility movements are not excluded. Peripheral bonds didn't benefit of this stabilization, since mid-May. Their spreads against the Bund are still sitting on their highest levels since the beginning of the year, collateral victims of the fears of a "Grexit".

<u>Equities</u> : In May, our overweight on Japanese market has been profitable: supported by the recent decline of the yen, Japan is now at the top of the 2015 performances, among the major developed geographical areas. In Europe, the victory of the Conservative party in the UK involves a referendum by 2017 about keeping the country inside the EU. In addition, the Greek debt renegotiation is still the subject of harsh negotiations. However, the European market posted a performance in line with the rest of the world in May.

<u>Currencies</u> : The Euro / Dollar renews with volatility, but has no specific direction. We are of the view that the parity should remain range-bound in the 1.10-1.15 area, due to mutually neutralizing forces: US slowdown pushing back Fed rate hikes, and fears of an exit of Greece from the euro area.

<u>Commodities</u> : Commodity prices remain highly related to dollar variations : in May, the rebound led to a further decline in the global index. Macroeconomic disappointments in China and an abundant production have severely impacted the industrial metals (-8%). Oil prices, with a market remaining in oversupply, stabilized around $ 65. Gold is still weighed down by selling flows and remains stable around $ 1,200.

Tactical view by asset class



Annex : Theoretical model portfolio

Benchmark	Min	Strategic Allocation	Max	Asset Classes		Tactical Allocation	Change from previous Month	Previous Month
50%	**30%**	**50%**	**70%**	**Bonds**	↓	**50.0%**	**-7.5%**	**57.5%**
40%	20%		60%	Bonds €	↓	40.0%	-5.0%	45.0%
				Inflation €		0.0%		0.0%
10%	0%		20%	World Bonds*		5.0%		5.0%
				Emerging Debt***		0.0%		0.0%
				Investment Grade €	↓	2.5%	-2.5%	5.0%
				High Yield €		2.5%		2.5%
35%	**20%**	**35%**	**50%**	**Equities**	↓	**36.5%**	**-1.5%**	**38.0%**
12.5%	5%		20%	Euro	↓	7.0%	-1.5%	8.5%
				Europe ex Euro*		7.0%		7.0%
12.5%	5%		20%	USA*		13.5%		13.5%
				Japan*		4.0%		4.0%
5.0%	0%		10%	Developed Asia*		2.0%		2.0%
5.0%	0%		10%	Emerging Asia**		3.0%		3.0%
				Emerging Europe - Africa - Middle East**		0.0%		0.0%
				Latin America**		0.0%		0.0%
5%	**0%**	**5%**	**10%**	**Commodities**		**2.5%**		**2.5%**
				Energy		1.3%		1.3%
				Industrial Metals		0.0%		0.0%
				Agriculture		0.0%		0.0%
				Precious Metals		1.3%		1.3%
10%	**0%**	**10%**	**20%**	**Currencies**	↑	**11.0%**	**9.0%**	**2.0%**
5.0%	0%		20%	Cash €	↑	11.0%	9.0%	2.0%
1.0%			5%	Dollar / €		0.0%		0.0%
1.0%			5%	Pound / €		0.0%		0.0%
1.0%			5%	Swiss Franc / €		0.0%		0.0%
1.0%			5%	Yen / €		0.0%		0.0%
1.0%			5%	Emerging currencies / €		0.0%		0.0%
100%		**100%**				**100.0%**		**100.0%**
				Volatility		7.3%		7.3%
				Tracking error		1.3%		1.4%

* Hedged against currency risk.
** Unhedged against currency risk.
*** Debt issued in dollar hedge in €uro.

The views used as input for the model portfolio are consistent with specialist's ones but may lead to different relative weighting versus benchmark compared to single asset class model portfolios.

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