SOCIETE GENERALE
Private Banking

STRATEGY
June 2014

Investment Strategy

Quarterly views

Lands of the Rising Sun

The first half of the year has been quite unusual for investors. Global equity markets have risen towards all-time highs, while bond markets have also registered solid positive returns. Traditionally, investors expect improving growth to feed into higher inflation and to push bond yields up. This year, although economic growth has accelerated relative to 2013 in most parts of the developed world, bond yields have continued to fall back to their previous lows. Oddly, 10-year bond yields in the UK, where economic data have strengthened, and in Japan, where inflation expectations have been rising, have declined by 50bp and 15bp respectively since January. At the same time, equities have continued to rise in the face of downward revisions to earnings forecasts while commodity prices have picked up again, as have some commodity-linked currencies (eg the Australian dollar). What does all this augur for the second part of the year?

Since the beginning of the current cycle in 2008, financial markets have been driven by economic data and monetary policy. But what happens when economic data and central bank policies become more predictable? We believe that investors will now once more focus on economic and corporate fundamentals, rather than on macro risk factors. The recent sell-off in expensive biotech and small capitalisation stocks in the US showed that valuations matter again. Although average valuations have returned to historical norms, the background remains positive: economic data are good, inflation rates remain low and interest rates should only rise gradually over the next six months. Fortunately, there are still pockets of value to be uncovered in some asset classes, particularly in global equities: for example, we believe that the current environment is promising in the Asia-Pacific region, where we find positive economic prospects, low valuations and accommodative monetary policies. We also see upside in CEE equities, as these economies will benefit from the improving health of the Western European banking sector, which controls more than two-thirds of bank assets in the region.

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Editorial

Lands of the Rising Sun

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A few years ago, it was not a foregone conclusion that deflation would be the most prominent risk in the aftermath of the global financial crisis. Widespread deleveraging has acted as a brake on the recovery, and bank lending has only recently started to take off in the US, while outstanding eurozone credit continues to contract.

Although it is probably too early to conclude that the “new normal” of lower economic growth and tamer inflation than before the crisis is here to stay, the recovery still appears more subdued than during previous business cycles.

In developed markets, central banks are maintaining a very accommodative stance, delaying the withdrawal of extraordinary stimulus measures as they fear a repetition of the Japanese “lost decades” of the 1990s and 2000s. The European Central Bank had been lagging its developed market counterparts, but it has now been forced to introduce credit easing measures and is about to embark on fully fledged quantitative easing as deflation risk appears increasingly entrenched.

However, 2014 is set to be a transition year for the US Federal Reserve, which is leading the global recovery. The Fed’s asset purchase programme is due to be phased out before year-end, but the reduction of its balance sheet will take years and no asset sales are on the cards for the moment.

Forward guidance on interest rates has become a common tool for central bankers as a way to anchor yields at low levels and influence investors’ expectations. Until early 2014, the market consensus had been more aggressive, with expectations of a significant pickup in US yields reflecting a sanguine view of US economic momentum.

US yields are set to be a key indicator of monetary policymaking, nominal growth prospects and asset price trends. As already observed when the then Fed Chairman Bernanke hinted at a gradual winding down of the asset-buying programme in May 2013, the US housing market is highly sensitive to a run-up in yields. Also, underemployment persists, with figures for long-term unemployment and part-time workers willing to work full time well above historical averages. All this means that the Fed is in no rush to hike rates, though investors will try to anticipate the first move.

Asset performance has posted a puzzling picture year to date, with only Japanese equities and oil in negative territory. Most asset classes, both safe havens and risky ones, have performed well. This unusual outcome reflects both the decline in US bond yields, which supported developed market fixed income assets, and the positive dynamics for equity markets sustained by loose monetary policy and portfolio reallocation in favour of equities.

From an asset allocation perspective we keep a pro-risk stance on developed market assets, as abundant liquidity, easy monetary policy and the recovery are set to continue. But with the steady rise in valuations, it is increasingly difficult to find attractive opportunities and more and more challenging to chase value within markets.

Concerning the key features of our asset allocation:

• We conclude that yields will rise, reflecting the improving outlook and gradual normalisation of monetary policies in the US and in the UK, where we recommend short-duration exposure. In the euro zone, where recovery remains patchy, we maintain durations at 3 to 5 years. Within the fixed income universe, we still like eurozone peripheral bonds and some bank debt. While spread compression has run its course, we still favour the high yield universe, which remains more appealing from a risk-adjusted standpoint than sovereign or investment-grade bonds. However, we reduce our eurozone high yield allocation to Neutral, in line with a less bullish view on equities in this region. As for emerging market corporate bonds, Eastern Europe credit is set to benefit for the spillover of ECB easing and from receding tensions between Russia and Ukraine.

• We continue to buy equities, but we are turning from the euro zone towards Asia-Pacific, where we see more value: GDP growth momentum has bottomed out, earnings growth is robust and downside risks look more contained. US equities are fairly valued and remain at Neutral. We take some profit on eurozone stocks but maintain a slight Overweight, as ECB monetary easing will help compensate for the uneven recovery and fragile profit dynamics.

• We turn more constructive on Asia-Pacific stocks, where we see the biggest potential for the months ahead. Japan, Australia, Singapore, Korea and Taiwan offer the best mix of sound macro fundamentals, growth upturn and positive earnings momentum.

• Within emerging markets, we also see more value than last quarter. We see Chinese stocks as undervalued, but we prefer to keep a neutral stance as slowing growth will drive policy intervention to engineer a soft landing. Regarding India, the new government offers bright prospects for structural reforms, but we prefer to adopt a wait-and-see attitude after the impressive performance of the equity market.

Tactical allocation

Q3 2014	Global	Advanced markets				EM
		Euro zone	US	UK	APAC*	
Cash	-					
Fixed income	=	=	=	=	=	=
Government	-	=	-	-	-	=
Corporate	=	=	=	=	=	=
Investment grade	-	=	-	-		
High yield	↘ =	↘ =	=	= ↘		
Duration		3-5y	1-3y	1-3y**	1-3y	
Equities	+	↘ +/=	=	=	++ ↗	= ↗
Alternative	+					
Commodities	=					
Hedge funds	+					
Currencies (vs US$)		=		= ↘	-	-

* APAC includes developped countries in Asia (Japan, Australia, Singapore)
** Shortening of duration from 3-5y to 1-3y

↗ *Upgrade since previous investment strategy* ↘ *Downgrade since previous investment strategy*

How to read the table:

Gradings	Investments	Portfolio (vs Benchmark)	Absolute expectations (vs cash)	Relative expectations (vs history)
++	Buy!	Strong overweight	High capital gain	High capital gain
+	Buy on dips	Overweight	Capital appreciation	Above average return
+/=	Selective buy	Slightly overweight	Capital appreciation	Slightly above average return
=	Hold	Neutral	Yield return*	Average return
-	Sell on rebond	Underweight	Cash return	Below average return
--	Sell!	Strong underweight	Capital loss	Capital loss

*Yield return: money market rate for FX, coupon yield for bonds and dividend yield for stocks

Major risks

We see four main downside risks and two upside risks. Some risks could hurt our positions, but most of our current tactical bias tends to mitigate downside risks.

Downside risks

- **Expensive valuations lead to a major sell-off:** Investor risk appetite wanes, driving risky assets down strongly.
- ▶ Underweight expensive stock markets, buy volatility and diversify portfolios by adding alternative non-directional strategies.

- **Eurozone inflation continues to fall, and the gradual economic recovery stalls:** On 5 June, the ECB revised down its inflation forecasts for the rest of the year. Should deflationary forces persist, we would expect correlation between bond yields and equities to turn from positive to negative,driving down eurozone stocks' performance.
- ▶ Stay long duration and avoid equities.

- **A sharp slowdown in China** remains the primary downside risk to our views. Any growth disappointment could have a magnified impact on risky assets.
- ▶ Long gold, CHF, JPY and Treasuries. Sell equities.

- **Interest rate shock**: US 10-year rates overshoot towards 4%. US housing stalls, corporates stop re-leveraging. Stock markets fall and emerging assets bleed further.
- ▶ Underweight EM assets (FX) and interest-sensitive US stocks.

Upside risks

- **Easing geopolitical risks** would support risky assets - particularly emerging market stocks - and encourage flows out of safe havens.
- ▶ Portfolios with risky assets will benefit. More defensive portfolios would struggle to deliver performance.

- **Emerging economies growth resumes:** China rebounds and lifts Asian and Latin American suppliers. EM stocks, carry currencies and metal commodities rebound.
- ▶ Portfolios with risky assets will benefit indirectly.

Fixed income – sovereign bonds

US yield increases in sight

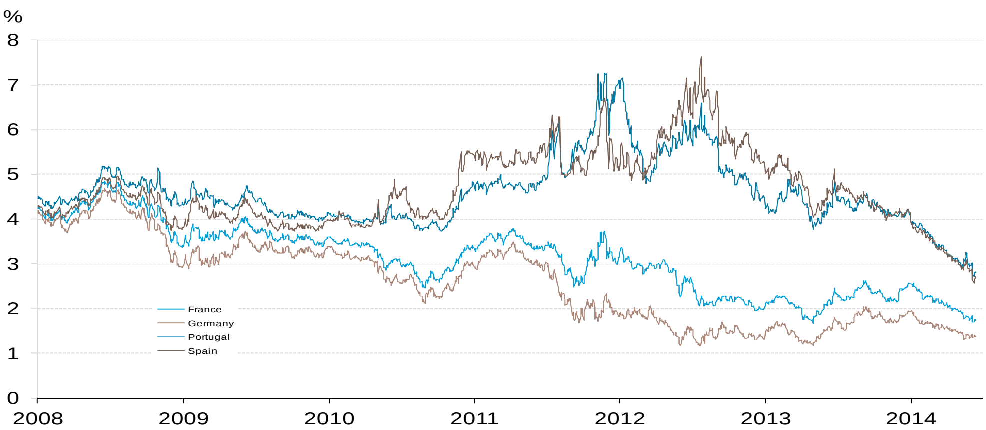
Most market participants were caught off-guard by receding US Treasury yields between early January and May. Ten-year yields came down from 3 to 2.4%, reverting to levels last seen before Bernanke hinted at phasing out the asset purchase programme last year. Several factors have contributed to the decline in US yields - emerging market turmoil and grim economic data due to bad weather conditions, as well as the Fed's commitment to keep interest rates low. As the US recovery is likely to gain traction in the quarters ahead, long-term yields should pick up. But we doubt that 10-year yields will substantially overshoot 3% by year-end. Although the recovery is broad-based, we do not think that the US economy can accelerate as fast as in the pre-financial crisis environment. The increase in capital expenditure has been modest so far, and credit conditions are significantly tighter than before 2008, curbing the use of debt in the economy. Over the long term, 10-year yields tend to track the nominal GDP growth rate. Against a backdrop of subdued inflation and deleveraging, the natural GDP growth rate is likely to be lower than before the crisis. We consider that, in anticipation of a monetary policy change, there is more risk of short-term rates picking up than of a significant upward move of longer-term rates.

US growth will drive interest rate moves

As far as shorter-term rates are concerned, the Fed's forward guidance has succeeded in keeping interest rates low, and the first rate hike is priced in for the third quarter of 2015. However, there is a risk that volatility might bounce back, as investors may bring forward expectations of the first rate hike should economic data surprise on the strong side.

Turning to the euro zone, the slowdown in inflation and the significant monetary easing decided by the European Central Bank (ECB) are set to push down yields, at least for the next few months. However, the ultimate objective of the ECB's new stance is to dispel deflationary forces and prop up bank lending. A positive outcome would be a further convergence of yields within the euro zone, with a rise for German Bund yields and a further reduction in yield spreads against bonds from 'peripheral' eurozone countries. At the current juncture, we tend to consider that peripheral bond spreads are nearing a bottom and that any further short-term spread reductions would essentially be due to ECB action rather than to a more benign market view on country fundamentals. We still want to buy peripheral bonds, with a preferred duration between 3 and 5 years, to take advantage of more attractive yields.

Eurozone government bonds – 10-year yields



Sources: Bloomberg, Societe Generale Private Banking

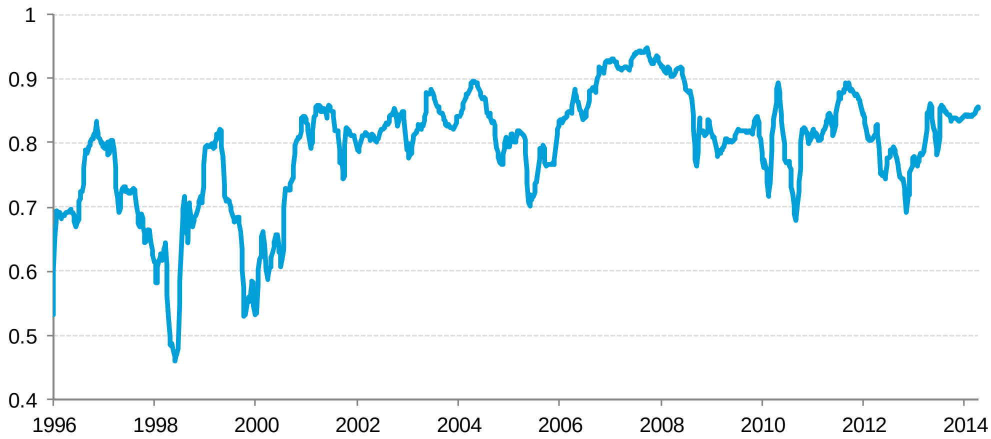
Limited contagion of US interest rates on eurozone yields

Although correlation between US and German sovereign yields tends to be relatively high – above 60% on average in the long run – we expect that the diverging monetary stances of the ECB and the Fed may significantly curb the contagion effect from rising US yields. However, there are more risks of a pickup in yield than of a move in the other direction, considering the current low-yield environment.

The long-term yields on UK gilts have moved down in sympathy with US and eurozone yields, due to receding inflation but also to investors' ongoing appetite for long-dated bonds. As economic activity is buoyant and markets still consider that the Bank of England could hike policy rates before the Fed, we prefer to keep short-duration exposure to UK bonds.

In emerging markets (EM), year-to-date performance has surprised on the strong side, but this is clearly largely due to the flattening of the yield curve (when the difference between shorter and longer-term rates decreases). As EM turmoil has abated and there is less EM-specific risk on the radar, investors are reconsidering investment opportunities in this space. However, EM ratings are on a downward trend and US Treasury yield pickup would be detrimental to this segment, as some countries are still facing significant current account and/or public deficits (Turkey, South Africa). Our preferred region is Central and Eastern Europe, which is likely to benefit from the side effects of ECB easing, the ongoing eurozone recovery and diminishing tensions around Ukraine.

<u>Correlation between 10-year Treasury and Bund</u>



Sources: Datastream, Societe Generale Private Banking

Fixed income – credit markets
Spread crunch

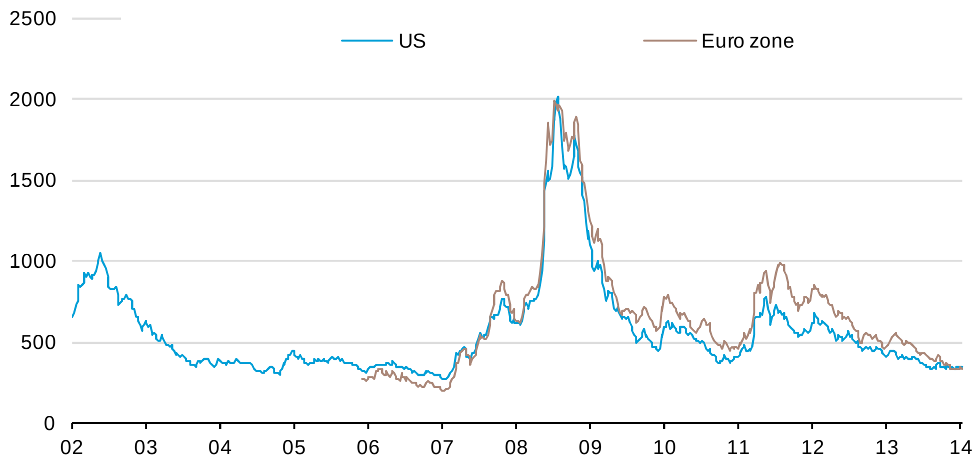
In the corporate bond universe, spreads have tightened further since early this year, reflecting the chase for yield and the unfolding recovery. Credit markets have performed well year-to-date, mainly because benchmark yield curves have flattened out. The ongoing recent rise in corporate debt ratios (releveraging) in the US has continued to harm credit metrics, but from a very healthy initial position. Some market segments have already turned over-expensive, such as the lowest-rated part of the high-yield universe and the safest investment-grade bonds. This indicates that investors are not being sufficiently discriminatory in their buying in the credit markets.

Further spread compression unlikely

In the US, we maintain a negative view on investment-grade credits, as the 'spread cushion' has become even thinner and would not be sufficient against the impact of a rise in Treasury yields. We are more constructive on the high-yield universe, as strong investor appetite supports valuation and the default rate remains below its historical average. But we tend to maintain our preference for eurozone credit markets, as valuation is generally less expensive and the ECB's monetary easing is supportive, in particular for corporate bonds out of peripheral eurozone countries. However, we move our Overweight exposure on high yield to Neutral, as spread compression has run most of its course, and we are turning more cautious on equity markets in the region as potential upside looks more limited. We tend to like financial issuers, but bond-picking is key. Issuers with strong balance sheets are offering unattractive yields, whereas as some weaker issuers offer good value, in particular in the fast-growing hybrid bank debt space.

As for emerging markets, we see returning investors chasing yields, but the consequences of the Fed's phase-out of its asset-buying programme and the US yield curve shift will be important drivers of performance. Any positions in Russian or Ukranian bond markets should be held, as tensions have recently receded. This, along with the ECB's easing, should underpin the Central and Eastern Europe credit market.

<u>Corporate bond spreads (bp), US and eurozone high yield, since 2002</u>



Sources: Datastream, Societe Generale Private Banking

Fixed income conviction

Eastern Europe back in the game

Central and Eastern Europe had been largely disregarded over the past few years. Considered to be a fragile emerging market (EM) environment, the region also suffered from the negative spillover of the lingering eurozone crisis. But certain countries – the Czech Republic, Hungary, Poland and Romania – now offer much more favourable macroeconomic prospects. From 2013, EM fixed income markets had been suffering from significant outflows, mainly from the retail investor base. Recently, however, we have been observing a renewed interest in this asset class, and we consider that the region is likely to benefit from this shift.

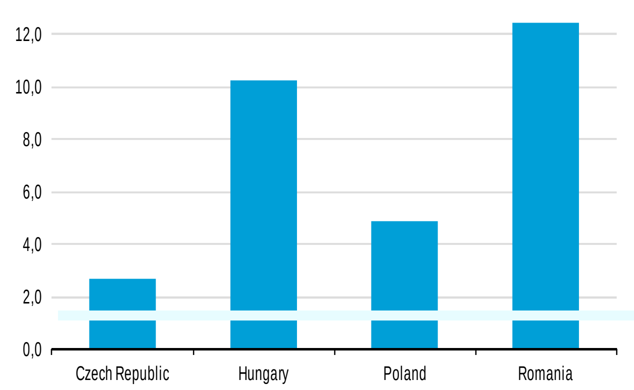
The macroeconomic backdrop in these countries has improved significantly. The consensus growth forecast for 2014 is 2.1% for the Czech Republic, 2.2% for Hungary, 3.2% for Poland and 3.0% for Romania, with a further acceleration expected in 2015. Moreover, the recovery is broad-based, underpinned by all components of the economy - net exports, private consumption and business investment.

Thanks to the improvement in current account balances, Central and Eastern Europe (CEE) currencies have remained stable since 2012, while most other emerging countries have experienced significant slides in their currencies. CEE countries are therefore also well-positioned to withstand the impact of rising yields in developed markets, notably in the US. At the same time, inflation is running very low (well below 1% yoy), allowing central banks to maintain an accommodative stance for the months ahead. The ECB's easing move is set to spill over into these countries, further improving financial conditions.

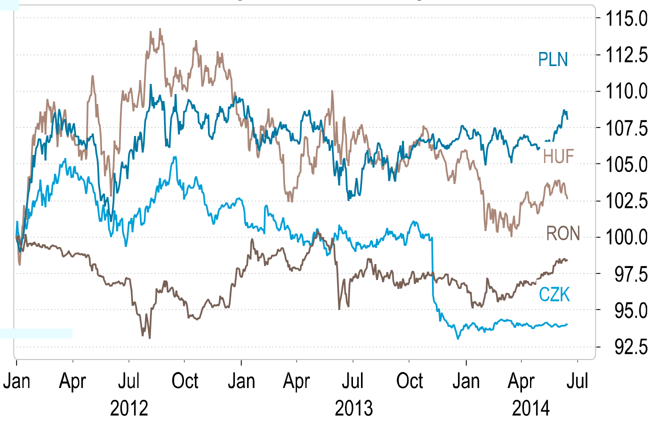
Against this favourable backdrop, we take a positive view on CEE fixed income markets, especially as tensions between Russia and Ukraine have abated. The chase for yield is set to benefit Poland, which offers potential for spread compression against the Bund (currently above 200bp) in a context where its government bond issuance programme has already reached 90% of the 2014 target and the Polish zloty may appreciate over the medium term. Hungary also offers a significant spread – close to 300bp – with a stable outlook for EUR/HUF. On the other hand, the Czech Republic is already trading at a tight spread against the Bund – 15bp – and thus offers less compelling value. As for Romania, S&P upgraded its sovereign rating to BBB- last May, which means that it is now rated investment grade by all the rating agencies. Also, the country has signed up for a 2-year precautionary credit line with the IMF and the EU, allowing it to maintain cheap access to capital markets and giving the government a strong incentive to achieve economic reforms.

A combination of improving growth momentum, accommodative monetary policies and attractive yields provide the ingredients for a strong performance by these markets in the fixed income space.

Changes in current account balance, % of GDP (2007-13)



CEE FX relatively resilient, except for HUF



Sources: Datastream, Bloomberg, Societe Generale Private Banking

Equity

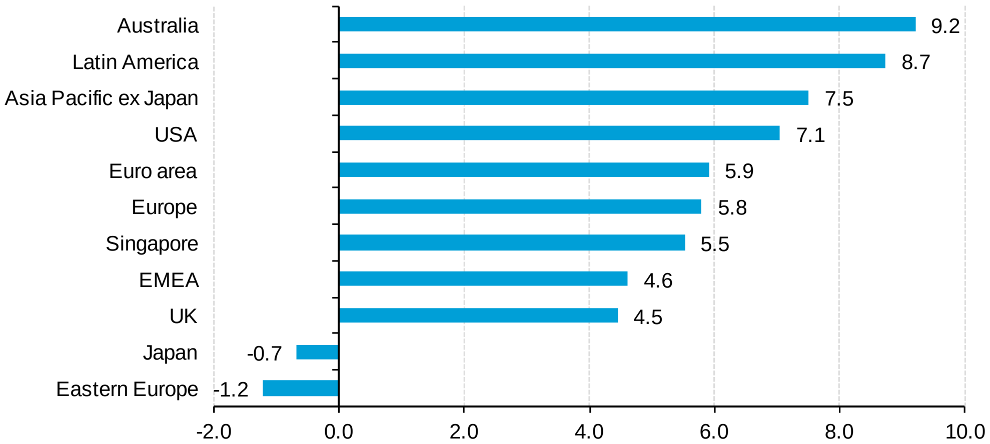
ECB, Earnings and East

Equity investors have had a challenging quarter, likely the toughest of the past two years. While volatility has remained extremely low, correlations between stocks have collapsed, making it more difficult for stock-pickers to achieve a positive performance. That said, indices have generally performed well, with the US and Europe the top performers year-to-date, and emerging markets have rebounded strongly over the past three months. Once again, central banks have played a major role. Anticipation of the European Central Bank's accommodative monetary policy, coupled with a more dovish tone from the US Fed, have sustained the expansion of price-to-earnings multiples this quarter. However, the ongoing recovery unfortunately still lacks profit growth, particularly in the euro zone, where earnings were revised down after the Q1 2014 results. Overall, equity performances have been good, but the lack of fundamental reasons for valuation increases makes these year-to-date performances very fragile. **We therefore take some profit on eurozone stocks and increase our weighting for the Asia-Pacific region**, which benefits from attractive valuation and positive growth in earnings-per-share (EPS).

ECB ready to act again

The European Central Bank (ECB)'s announcements on 5 June have clearly been particularly important in supporting the performance of equities from "peripheral" eurozone countries (i.e. Italy, Spain, Portugal and Greece). Along with its cutting of the main policy rate from 0.25% to 0.15%, the ECB has adopted a negative interest rate on bank deposits and has announced that it will offer €400bn in targeted, cheap loans to banks at relatively long maturities. It has also clearly expressed the possibility of buying Asset-Backed Securities (ABS) in the second half of the year. The Bank's determination to limit any risks that prolonged low inflation may have on price stability and economic growth has not only further supported the performance of eurozone stocks but has also strengthened risk appetite for global equities and cyclical sectors in emerging countries and, more recently, in the US.

Year-to-date performance (in €, %)



Sources: Datastream, Societe Generale Private Banking

Earnings growth still expected to recover in second half of the year

The first six months of this year have been characterised by downward profit revisions in developed markets - especially in the euro zone, the UK and most emerging countries. Only in the US have analysts probably been too conservative about their profit forecasts, and are now revising their figures for the rest of the year slightly upwards. Earnings growth is disappointing in the euro zone. While leading indicators (i.e. the Manufacturing and Consumer Confidence indices) and GDP figures have improved since the end of 2013, profit growth lags economic data. As final demand is not picking up, industrial production remains sluggish and so do earnings. The consensus forecasts for eurozone earnings per share (EPS) have been halved, with a 6% increase now expected by the end of the fiscal year (February 2015), in line with Societe Generale Private Banking figures. In the absence of a recovery in profits, euro stocks appear particularly fragile. Price-to-earnings (P/E) ratios have expanded by 50% since summer 2012, and excluding financials the EV/EBITDA ratio is close to previous historical highs. While US stocks are expensive they look more resilient, as profits are growing and margins will remain at the current high levels as long as wage inflation does not pick up strongly. In Japan, after a stellar 2013, 2014 EPS should rise by 6-8% according both to consensus and to our forecasts.

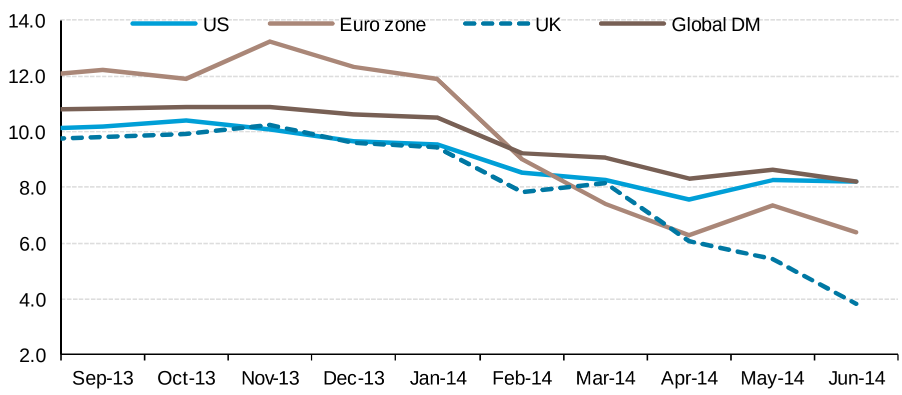
US stocks – stay exposed to the capex cycle

Small caps and biotech have been very volatile in the first part of the year. Indeed, low interest rates, low growth and low inflation have helped drive up valuations for growth sectors such as these. We believe that with US economic growth set to accelerate in the second half of the year, investors are less willing to pay high multiples for growth stocks. We therefore suggest exposure to **relatively cheap companies which are sensitive to GDP and capital expenditure** (i.e. Energy, Tech and Industrials); and to companies characterised by **relatively safe and rising dividends** (i.e. Energy).

Eurozone stocks – take profit on energy, but remain exposed to banks and pharma

At the beginning of the year, we were expecting a return of 10% on eurozone equities over 2014, maintaining our bullish stance toward these assets. While equity returns have primarily been fuelled by ECB easing, profit growth has disappointed. As previously mentioned, the lack of profit growth in the first part of this year has further sustained the expansion in the price to earnings (P/E) ratio which began in summer 2012, so valuation currently looks expensive.

Consensus 2014 profit growth expectations (%, data as of 10 June 2014)



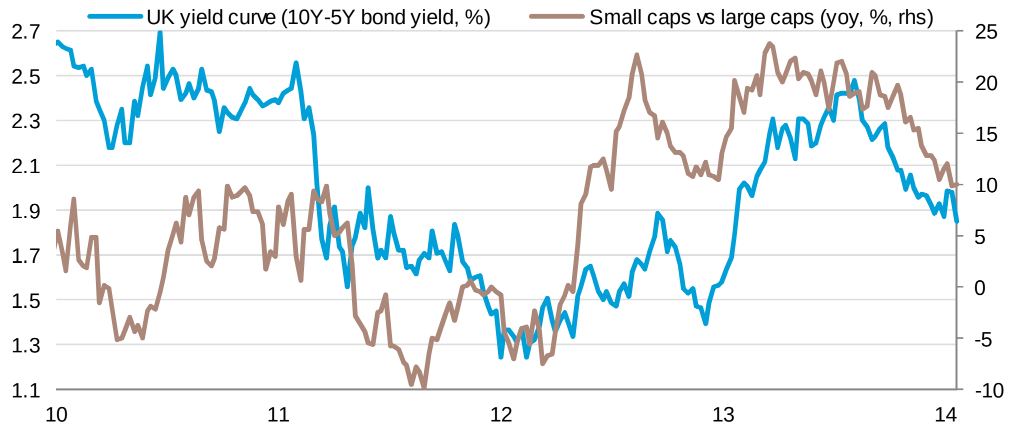
Sources: Datastream, IBES, Societe Generale Private Banking

Indeed, current 2014 P/E stands at a 15% premium to historical averages (2014 P/E 14.9x, 10-year average at 12.8x), and the 2014 Price to Book value (P/B) ratio, at 1.5x, is in line with historical averages. In this context of high valuation, we prefer countries and sectors with a low risk of downward earnings revisions and relatively attractive valuation ratios. In terms of countries, we therefore prefer the German stock market to France, as the former is less expensive and more resilient in the face of EPS downgrades. German names are also more exposed to the accelerating growth in the US economy and to increases in capex spending. Among southern eurozone countries, we now think that Spanish stocks' outperformance has gone too far, and that the risk on Italian stocks depends on the capacity of Prime Minister Matteo Renzi to implement all necessary reforms in order to increase the country's competitiveness and reduce unemployment. Sector wise, we move to Neutral on Energy after its strong performance since we upgraded it late last year, and we remain Overweight on banks and pharmaceuticals. Eurozone banks are still sustained by attractive valuation, potential sector consolidation and expectations linked to the results of the Asset Quality Review in October this year. While the recent cut in the deposit rate may put the banking sector's second-quarter results under pressure, anticipation of a positive outcome of the Review will largely offset disappointing results.

UK stocks – risk of sterling appreciation and yield curve flattening

We expect the UK stock market to underperform other developed countries. First, de-synchronisation between Bank of England (BoE) and ECB monetary policies should support a further appreciation of sterling against the euro and consequently reduce the competitiveness of UK large caps. Second, UK small caps usually underperform large caps when the UK yield curve flattens (i.e. the difference between long and short-term rates decreases), which is currently the case. We therefore keep a Neutral stance on UK stocks, despite their fair valuation.

When the UK yield curve flattens, UK large caps outperform



Sources: Datastream, Societe Generale Private Banking

Japanese structural changes still ongoing

Calling for an Overweight on Japanese stocks last year was very easy. Prime Minister Shinzo Abe's programme to depreciate the yen was the right one, considering that Japan's corporate sector has high operating leverage and so is sensitive to any currency depreciation. The hope that richer companies would boost wages and invest more did not disappoint. Profit growth was strong and the TOPIX stock index was one of the best performers among developed markets.

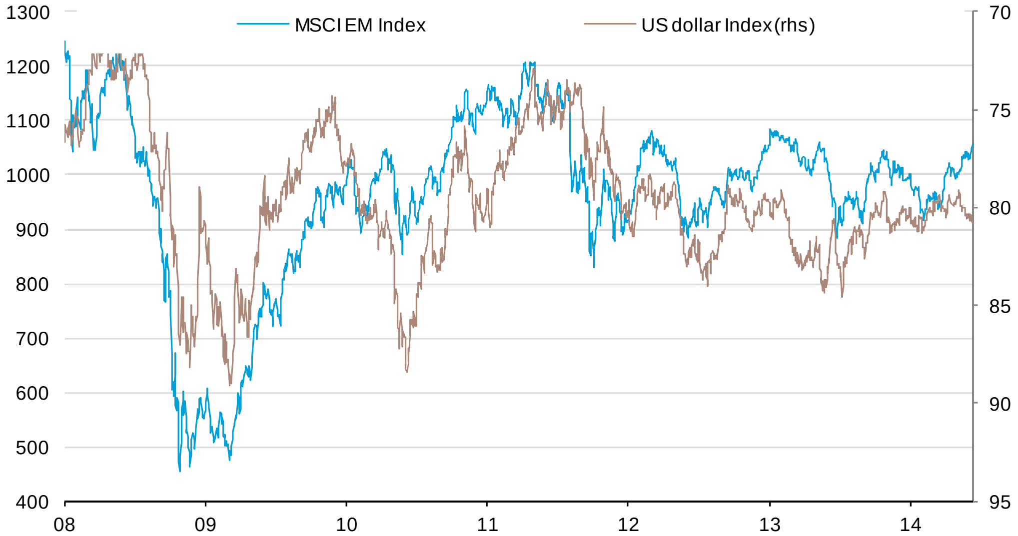
Our choice to continue to buy Japanese stocks is now more contrarian, not only because year-to-date performance is weak (-2.0% in JPY), but also because investors no longer expect an accommodative monetary policy from the Bank of Japan or an acceleration of the economy in the second half of the year. Unlike the market, we see Japan succeeding in its reflationary process, and we do not think that the Japanese stock market needs the yen to depreciate further in order to perform well. Wage increases and corporate tax cuts may sustain growth thank to internal demand. Moreover, Japanese stocks remain undervalued, while consensus forecasts see potential profit growth at 8%, close to that of other developed markets (i.e. the US, Germany, Australia).

Emerging markets sustained by low US bond yields but not by profit growth

Since the beginning of the year, there have been steady gains in many emerging market (EM) equities, as the Fed's commitment to keeping interest rates low has reduced fears of a liquidity squeeze. Despite this, many investors still see EM stocks as a value investment. The reality is that the low valuation of the MSCI EM Index is only due to the heavy weighting of China and Russia within the index. Both these countries benefit from low valuations - but they are both facing difficult situations.

The easing of tensions surrounding Ukraine since early May has helped Russian stock prices recoup a good portion of the losses triggered by the early March outbreak of the geopolitical crisis over Ukraine and Crimea. However, the prospect of a sharper economic downturn and the domestic policy response to the crisis will continue to weigh on Russian equities for at least six months. On China we have a fairly positive view, as we believe that budgetary and monetary policies will compensate for the risk of slowing economic growth due to reduced loans. Cheap valuation and resilient profit growth drive our Neutral rating on local stocks, despite reforms that have yet to be completed.

EM stock performance highly correlated to USD strength



Sources: Societe Generale Private Banking, Datastream

In **Latin America** (Underweight), we now Overweight Colombia and downgrade Mexico to Neutral, as the latter currently enjoys unrealistic consensus EPS growth estimates. In our view, the current 2014 earnings growth estimate of around 10% is too high considering economic dynamics, and thus is subject to a downside which will likely pressurise already-high valuations.

Within **Asian EM equity markets** (Neutral), we are Overweight countries with current account surpluses such as South Korea and Taiwan, as they are relatively insulated from a potential risk of EM selloffs, well-positioned to profit from the acceleration in US economic growth in the second half of 2014 and also relatively cheap. We see Indian equities (Neutral) remaining well-supported. Although valuation is expensive, economic fundamentals should gradually improve on the back of Modi's election.

In the **EMEA region** (Underweight), we reiterate our Negative outlook for South African equity and we remain Negative on Russian equity, even though Russia's rhetoric sounds less hostile to the new Ukrainian government. As with other Russian assets, current Russian equity prices seem to overlook the damage that the Ukraine crisis has inflicted on the Russian economy. We also confirm our Negative outlook on Turkish equity, as we see a further decline in Turkish bank earnings, and valuation is not appealing enough to cover the country's risk.

As **CEE countries** are heavily dependent on the health of the Western European banking sector, which controls more than two-thirds of banks' assets in the region, we are Overweight on the region. The combination of the ECB's accommodative monetary policy and the upcoming Asset Quality Review should thus clear the way for an improved situation in the East, which has seen economic expansion despite the low availability of credit. Moreover, Eastern European economies will benefit from better growth prospects in Western Europe. Within the region, we Overweight Polish and Czech stocks as they are cheap, and we are Neutral on Hungary.

Country/region allocation for Q3 2014

	March 2014	Changes	June 2014
US	Neutral		Neutral
EURO	Strongly overweight	↘	Strongly overweight
UK	Neutral		Neutral
ASIA PACIFIC INCL. JAPAN	Overweight	↗	Strongly overweight
EMERGING MARKET	Underweight	↗	Neutral
ASIA	Neutral		Neutral
EMEA	Underweight		Underweight
LATAM	Underweight		Underweight

Source: Societe Generale Private Banking

Equity conviction

Go East (Asia)

After the strong equity performances of the past two years, Asia-Pacific is the only region in the world which combines attractive valuation, potential upward earnings forecasts and supportive monetary and fiscal policies. Most other regions are characterised either by loose monetary policy but expensive valuations, by extremely low price-to-earnings ratios but high geopolitical risk (i.e. Russia) or by distressed economic situations. The recent improvement in economic data in China, the Modi-led government which should be positive for the economy in India and our expectations for further quantitative easing in Japan by year-end highlight the attractiveness of the Asia-Pacific region.

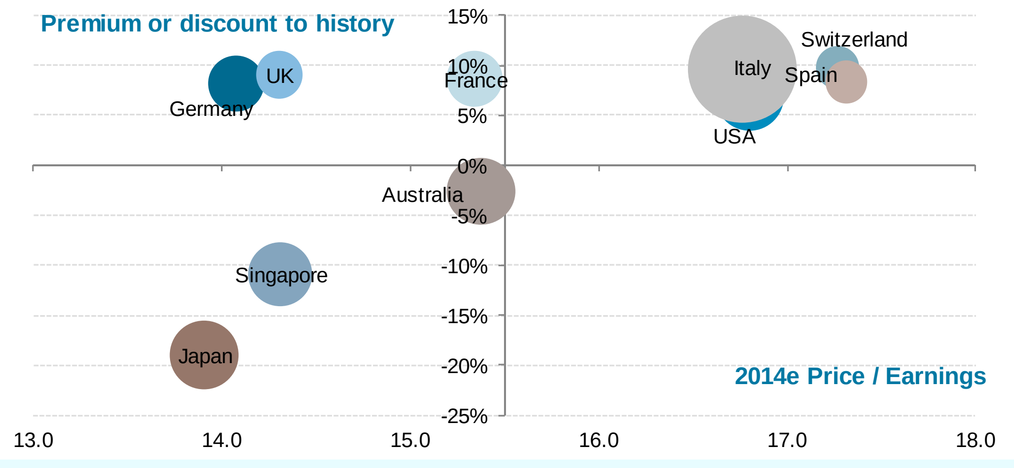
• Asia-Pacific valuations are cheap: As the chart below shows, Japan, Singapore and Australia are the most attractive equity markets among developed countries. Their valuation is not only below historical averages but also below the levels at which other developed markets such as the US, Switzerland - and even Spain - are currently priced. Among emerging markets, Taiwan and Korea (both at Overweight), and to a lesser extent China and India (rated Neutral), appear among the most attractive in terms of valuation.

•Supportive monetary policies: Some Asia-Pacific countries (e.g. Japan and Indonesia) also benefit from accommodative monetary policies which should sustain consumer spending and exports thanks to currency depreciation. Despite ongoing improvements in economic activity, Australia's central bank (the RBA) is committed to keeping interest rates steady for an extended period.

• Expansive fiscal policy: In late April, the Chinese government rolled out more stimulus measures to boost growth. We believe that this marks the beginning of a gradual fiscal policy easing which could accelerate as the negative effects of the property downturn on growth become clearer. In Singapore, the adoption of an expansionary policy will drive the overall balance from a surplus to a deficit.

• Positive earnings momentum: Earnings per share (EPS) growth has begun to accelerate in a number of countries in the region. Indeed, Australia, Taiwan and Indonesia are seeing strong positive revisions of profit expectations.

Japan, Singapore and Australia are the most attractive developed markets



Sources: Societe Generale Private Banking, Datastream

Equity conviction

German stocks go sky-high

With the European Central Bank (ECB) acting again on 5 June, cutting interest rates and announcing a new package of targeted long-term refinancing operations (TLTROs) for European banks, eurozone equities have probably found a final element of support. In this context of extremely accommodative monetary policy, stock valuations have reached fair levels while profit growth expectations have been constantly revised down, driving price-to-earnings ratios to historical highs.

Germany is currently the only country in the euro zone where stock valuations are fundamentally justified. Indeed, while their valuation is below the eurozone average (estimated 2014 price-to-earnings ratios at 13.9x vs 15x), the reduction of government, consumer and corporate debt levels does not constitute an obstacle to renewed growth. Strong consumer confidence, extremely low interest rates and attractive effective exchange rates make Germany fertile ground for a strong appreciation in both real and financial assets. We therefore believe that **German equities are set to strongly outperform the DJ Stoxx 50 index, particularly French and British stocks**. With the ECB busy fighting deflation risk in the periphery, Germany will continue to benefit from negative real interest rates and positive internal demand. In addition, with emerging market economies slowly improving, profit growth should not disappoint those who, like us, are expecting a 10% increase in earnings per share (EPS) by the end of the year. All these elements plus the highly cyclical local index should support a relative outperformance by German stocks versus European peers and drive Germany's DAX stock index up further, to 11,000 by year-end (compared with 9,920 on 17 June 2014).

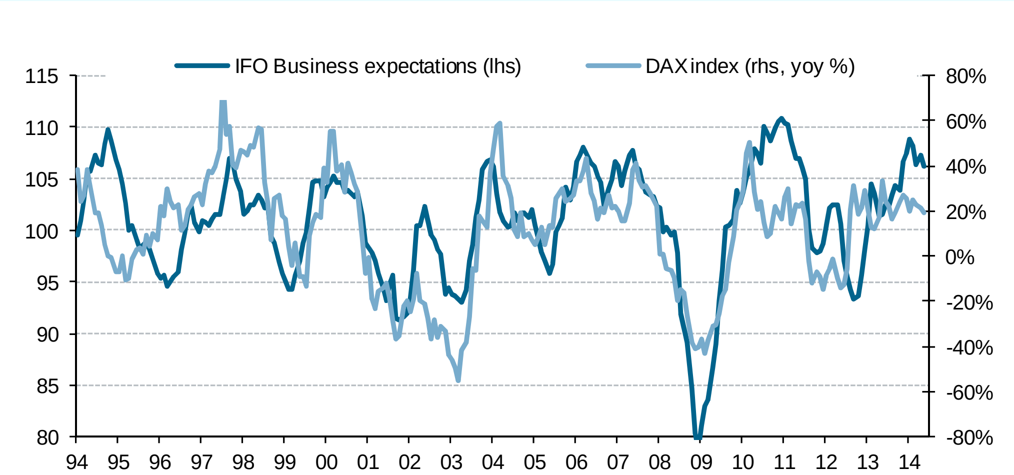
In Germany, we would suggest being exposed to stocks across all market capitalisation segments in the following sectors:

• Consumer discretionary (Autos, Leisure and Retailers), which benefits from negative real lending rates, rising wages and strong consumer confidence

• Industrials and IT companies, which will benefit the most from the upturn in the capital expenditure cycle both in the region and worldwide

• Construction materials and Real Estate Investment Trusts (REITs), which are exposed to the renewed appreciation in real assets caused by negative real rates and possible increases in consumer debt.

Further improvements in business conditions will drive the DAX up



Sources: Societe Generale Private Banking, Datastream

Equity conviction

The dividend edge

There are many reasons why dividend-paying stocks should be favoured over non-dividend stocks in the coming months, and why dividends should generally be seen as offering some protection against downside. Here are three:

• Most stocks rise and fall on average at the same pace as the market. However, stocks that pay dividends offer an extra incentive to hold on to them during tough times.

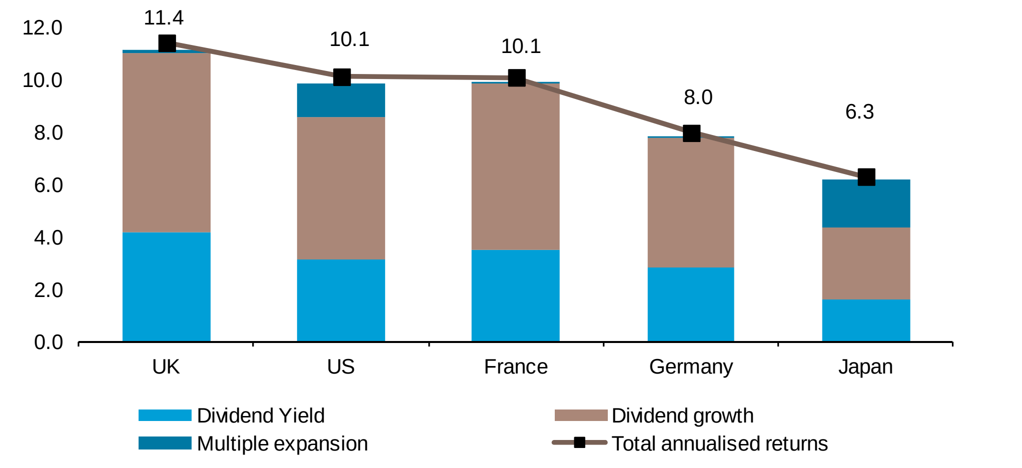
• Most dividend stocks come from mature companies with stable business models which generate much more in earnings than could be reinvested into the business. Slower-growth companies will generally experience much smaller drops in share prices than those in growth sectors.

• The quarterly dividend payment provides investors with a relatively stable cushion against stock market declines, as most companies will maintain dividend payments to their shareholders. During market declines, it is very difficult to generate any capital gains. The dividend is the only item that increases investors' total returns during severe corrections. So when markets become volatile, share dividends offer one way to reduce potential portfolio losses.

Investors are often not aware that over the medium and long term, dividend payments account for the biggest part of an equity's total return. Indeed, this total return is usually made up of three components: the increase in the price-to-earnings ratio, or "multiple expansion"; earnings growth; and dividend yield. The double-digit annual price returns of the 1980s and the 1990s make it easy to forget that in the long run, dividends account for more than three-quarters of total equity returns. 2013 and Q1 2014 saw strong multiple expansion in all developed equity markets, so we expect two major contributors to equity performance in the second half of 2014: earnings growth and dividends. And with earnings growth expected to pick up only later this year, dividends should take centre stage.

A logical way to assess the reliability of dividend payments is to look at a company's long-term track record of dividend increases. The data clearly show that dividend payers have outperformed the market in times of multiple (price-to-earnings) contractions or stabilisation and underperformed in times of multiple expansion (such as in 2013). We therefore believe that companies with a long track record of growing dividends should perform well this year.

Breakdown of the 10y nominal total return



Sources: Societe Generale Private Banking, Datastream

Emerging equity conviction

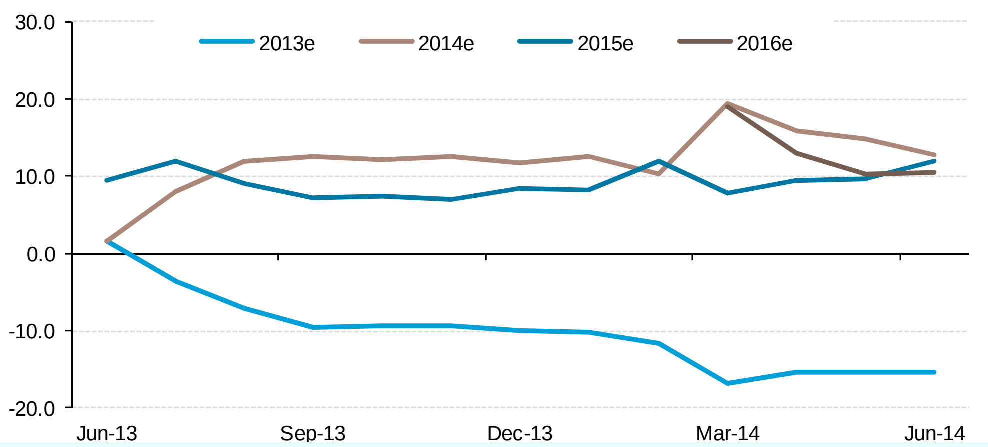
Colombia – the new El Dorado?

Colombia is the only country in Latin America to have seen its 2014 GDP growth forecasts upgraded in the IMF's latest World Economic Outlook, from 4.2% to 4.5%. GDP growth is likely to be 4%-5% over the next three years. Colombia owes this success to accommodative monetary and fiscal policies (such as increased government spending), and more specifically to its aggressive push on investment: in the second half of 2013, investment expanded by 9% yoy, and public works investment by close to 20%. The government's low-income housing initiative - in which private banks participated via mortgages subsidised by government transfers - as well as its aggressive road-building programme, have provided the economy with a much-needed boost in the face of less benign external conditions (i.e. lower capital inflows and falling commodity prices). A strong political consensus in favour of market-oriented policies means that the government is expected to continue with these economic policies after the 2014 national elections. Additionally, the current government has passed a new fiscal rule that seeks to tie the central government's structural fiscal balance (government spending vs government revenues) to potential GDP growth as well as to the price of oil, and introduced another fiscal rule that caps the structural fiscal deficit at 2.3% of GDP, declining to 1% by 2022. The current account deficit is likely to hover around 3% of GDP (3.4% in 2013) and the trade surplus around 1% of GDP in 2014 and the following couple of years. The projected financial account surplus (due largely to foreign direct investment, FDI) should outweigh the current account deficit, resulting in higher reserves. Inward FDI may be about 4% of GDP in 2014. Foreign exchange reserves exceeded USD 43.8 billion in December 2013, up from USD 37.4 billion at the end of 2012.

Colombia is more exposed to oil than to base metals, and more exposed to the US than to China. With the US economy growing healthily, the Colombian economy is expected to do well. Oil production is likely to increase in the coming three years following record investment by foreign and local companies. Over the past decade, the oil and mining sectors have nearly doubled their share of total GDP, from 6% to 11%. Similarly, oil output reached more than a million barrels per day in 2013 (compared with 525,000 in 2005).

We believe that Colombia's success story is not adequately appreciated by investors. Colombian stock price valuation for 2014 is estimated at 15.0x price/earnings (per share), a relatively small premium compared to the rest of Latin America (13x price/earnings), which is currently suffering from low growth and high inflation. Moreover, Colombia has seen a positive revision of earnings expectations - the 3-month moving average was revised up by 3.0% in March 2014, 3% in April 2014 and 6% in May 2014.

Profit expectations point to 10% growth over three years



Sources: Societe Generale Private Banking, Datastream

Currencies

EUR/USD: Easing paves way for modest euro slide

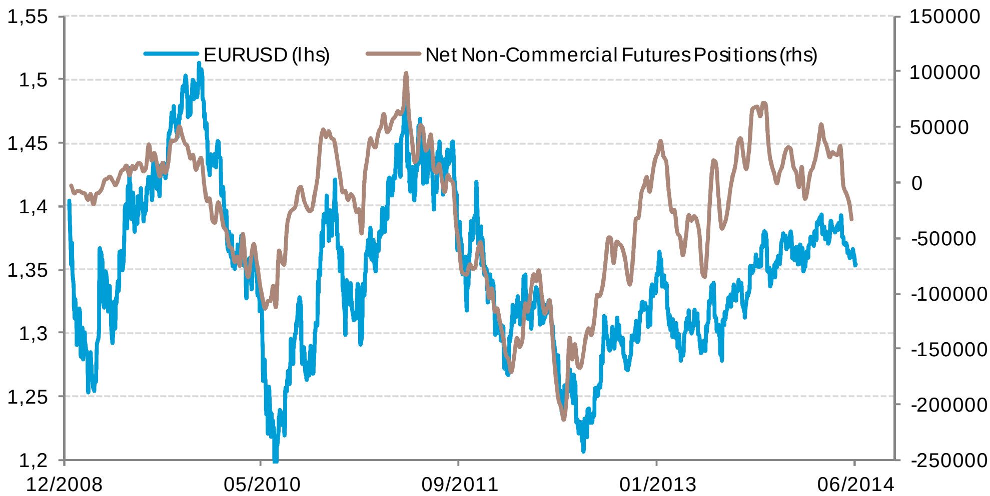
Several factors have disappointed the bullish view on a steepening US yield curve over the past few months. The euro drifted upward again early this year, and only the European Central Bank (ECB)'s signalling of significant monetary intervention triggered a modest downward slide. The comprehensive package presented on 5 June aims to expand money market liquidity and to encourage bank lending. But the liquidity infusion will remain bank-dependent, as the ECB has not yet launched a Fed-like asset purchase programme.

For the time being, the euro remains underpinned by its external surplus. From a fundamental perspective, although the US current account deficit has narrowed down to about 3% of GDP, the eurozone's current account surplus has topped 2% of GDP on the back of a steady contraction of domestic demand entailed by austerity programmes. As a consequence, the euro is structurally buoyed while the USD is dragged down by a similar but opposite force.

Turning to monetary policy, the Fed continues to inflate its balance sheet, as its asset-buying programme will not end before Q4 2014, while in the euro zone excess liquidity in money markets has shrunk steadily, pushing up very short-term interest rates (up to 1 year). At the current juncture, the ECB has initiated significant easing measures to combat deflationary forces, and there is probably more to come as this pressure may be fairly entrenched in southern European countries. As these measures may have a faster effect on financial markets than on banks' ability to make loans, with further capital inflows from non-resident investors, the euro is likely to remain well-supported. The recent slide observed ahead of the European Central Bank's 5 June policy meeting seems to have been largely engineered by selling the euro forward. On the other hand, although the Fed's communication may be perceived as vague, its "dovish" stance - its commitment to keeping interest rates low - will persist, as headline inflation may remain muted due to still significant job market slack.

In the coming months we expect the euro to soften, as stronger US momentum is set to lift yields - though potentially short-term ones rather than longer-term ones. On the other hand, increasing liquidity in the euro zone will keep rates anchored close to rock bottom. This points to the EUR trading in a 1.30-1.35 range until year-end, and only a soft downward drift later on as monetary policies diverge further.

<u>EUR losing ground, as short positions have increased</u>



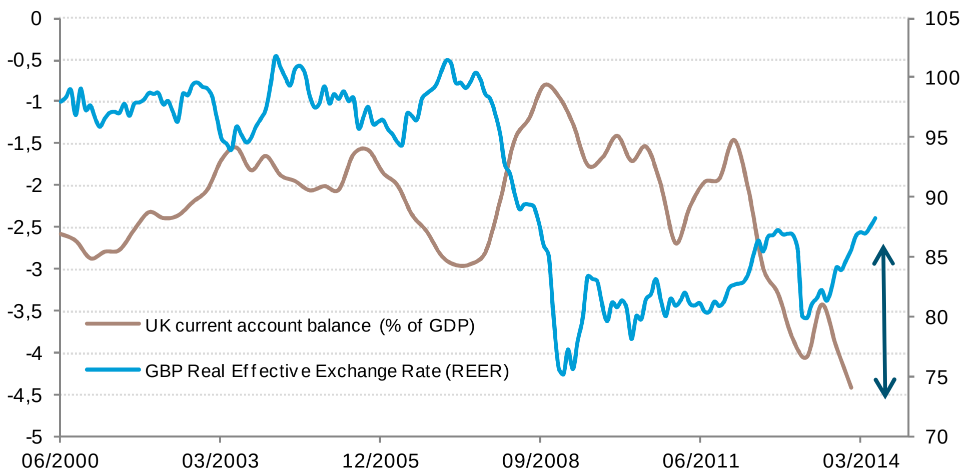
Sources: Bloomberg, Societe Generale Private Banking

USD/GBP: Buoyant pound faces current account deficit

As UK economic growth is buoyant, so are the market's expectations regarding the beginning of a rate hike cycle. It is true that a stronger pound has cooled inflation, providing some relief for the Bank of England (BoE). But at the same time, forward interest rates reflect anticipation of an early rate hike in the first quarter (Q1) of 2015. Although the BoE's Governor has reiterated his forward guidance about the need to keep interest rates low, markets have granted little credibility to this. At the current juncture, they continue to expect the BoE to raise rates before the Fed does, on the back of a stronger economic momentum in the UK and bubbly housing markets in London. However, prudential measures may seem more appropriate to address fast-rising property markets in London, which are flush with foreign money. As domestic demand has so far been the main growth driver in the UK, the current account deficit has been widening, heading towards 5% of GDP, a level unseen since the late 1980s. This is likely to drag the currency down sooner or later. Moreover, as the US economy will regain traction across the coming quarters, benefiting from a catch-up process after the contraction in activity recorded in Q1, we expect the market to price in the first US Fed rate hike around mid-2015, boosting the USD.

Although the pound may continue to trade on the strong side in the coming months, we expect it to lose ground against the USD later in the year, before levelling off.

Widening current account deficit set to cap GBP overshooting



Sources: Bloomberg, Societe Generale Private Banking

EUR/CHF: Dovish ECB to mitigate CHF softening

Remarkably, EUR/CHF has remained broadly stable despite the ECB's more dovish comments and the adoption of comprehensive monetary easing measures. The currency pair has not tested the 1.20 floor established in 2011 to cap excessive CHF appreciation. As the Swiss National Bank's policy rate and yields are close to rock bottom, the Bank has limited room to deliver additional easing. But such a move may be necessary, as inflation still hovers around zero. As we expect risk aversion and financial fragmentation in the euro zone to come down gradually, so should the CHF versus the euro.

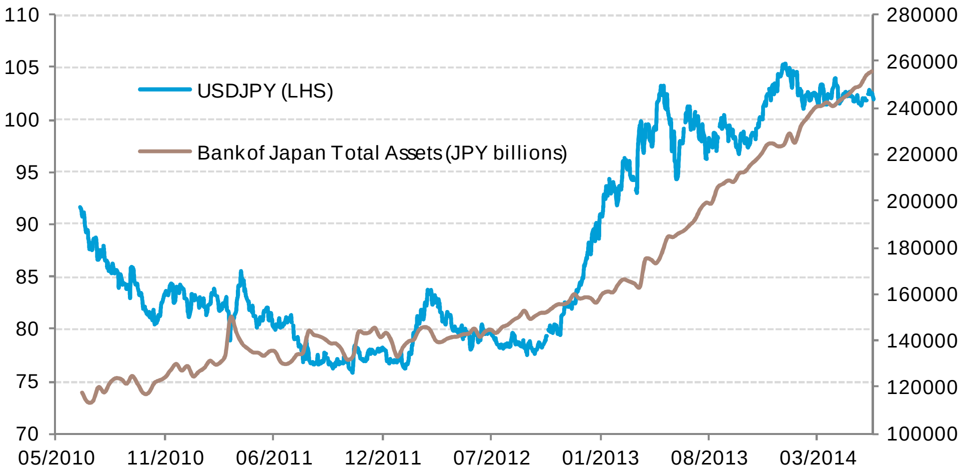
We expect a very modest slide of the CHF against the euro, but a more significant drop against USD.

USD/JPY: Monetary policy activism to drive yen down

The yen has been moving sideways, with no clear direction since early February. As the Bank of Japan has dispelled expectations of new qualitative and quantitative easing any time soon, markets have lost faith in a new currency weakening. However, structural drivers lead us to consider that the yen is set to weaken further. First, the Japanese government pension fund has stressed the need to further diversify its asset allocation in favour of higher-yielding assets, signifying purchases of foreign assets including both bonds and equities. Second, the Bank of Japan may be forced to implement additional easing measures to meet the 2% inflation target, as inflation dynamics remain tame. Eventually, expectations of the ending of the Fed's asset-buying programme will push up the USD versus the yen.

For these reasons, we keep our mildly bearish view on the yen, although the currency is not likely to weaken before the Bank of Japan moves again and rate action from the Fed becomes imminent.

Balance sheet inflation has weakened the yen



Sources: Bloomberg, Societe Generale Private Banking

Commodities

Gold: Long-term bearish; short-term upside possible

Gold: Neutral (spot: USD1,252, 3M: USD1,250, 6M: USD1,250)

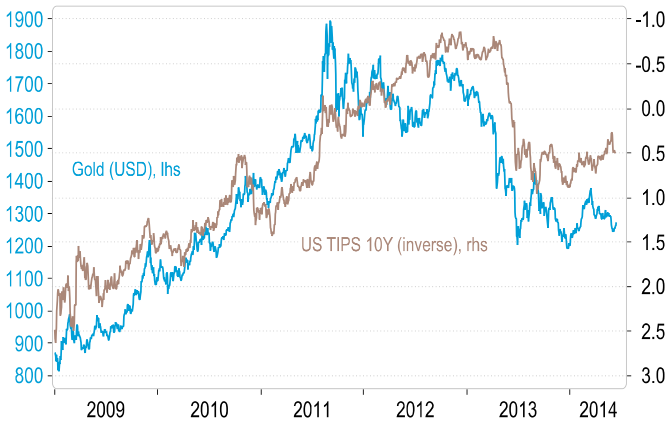
We have tried to identify the factors that drive long-term performance. According to our model, gold price performance in 1993-2014 has been positively driven by the S&P 500, the US money supply and net long CFTC futures positions, and negatively driven by USD and 10-year US Treasuries (UST) real yields.

Gold had a bumpy performance in the first half of the year, caught in a tug of war between long-term factors (US real yield) and geopolitical tensions. The precious metal reported a 4.22% gain between January and the end of May. Historical volatility fell to its lowest level since April 2013, as was the case for other asset classes. Since the March peak, Gold has retraced by almost $130 (per ounce), as investors have reacted to a number of factors. The easing of tensions between Russia and Ukraine contributed significantly to the plunge. US equity markets have continued to strengthen along with the US dollar, which is generally a bearish sign for gold, according to the model.

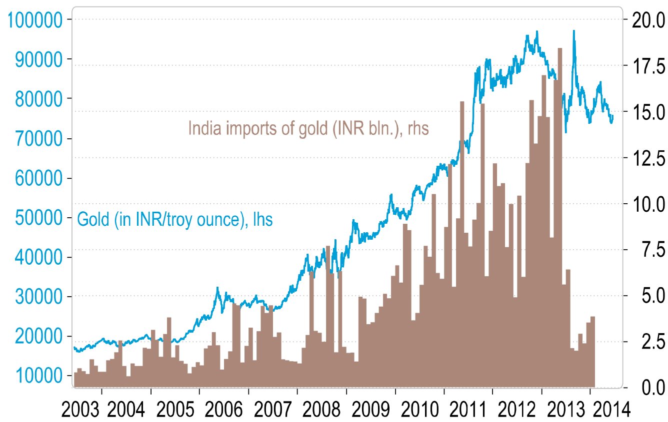
Despite all these bearish factors, there are also a couple of elements that could push up or at least consolidate gold prices in the short to medium term. First, global demand should be supported by a recovery in bullion and coin demand on lower gold prices in Indian rupees (INR), and import restrictions look set to be relaxed by the Modi government. A significant unknown with respect to gold statistics is demand from People's Bank of China (PBoC), which does not declare its purchases. In addition, investors believe that the PBoC is buying gold, as it is trying to diversify its foreign exchange reserves. Other central bank purchases were strong in April, as shown by the IMF. In our opinion, supply and demand fundamentals should remain supportive for gold after a multi-month correction. Second, 10-year UST real yields have tumbled, while 5-year UST real yields are now deep in negative territory. Limited upside is expected for US real yields, as the economy is not providing enough signs of a strong recovery. Furthermore, inflation prospects are likely to remain docile over the next 6-month investment horizon. Lower real yield is supportive for gold prices, as observed in our model.

While we have been bearish (pessimistic) on gold since the beginning of the year, geopolitical risks and macroeconomic developments might increase the appetite for it in the second half of the year, so we move to Neutral.

Recent decorrelation between real yield and gold



Subdued Indian gold imports weigh on gold



Sources: Societe Generale Private Banking, Macrobond

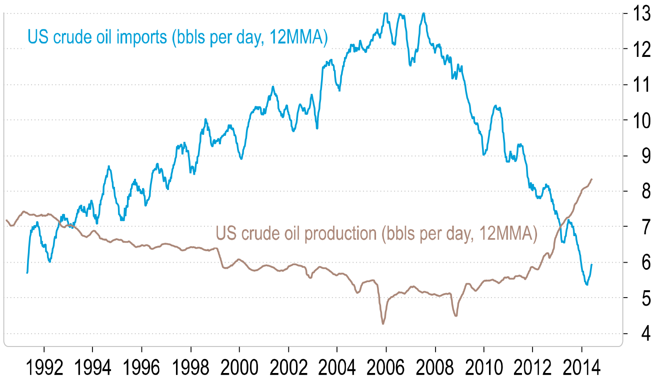
Oil: Geopolitics remain centre stage

Brent: Neutral (spot: USD 108; 3M: USD 110; 6M: USD 108)

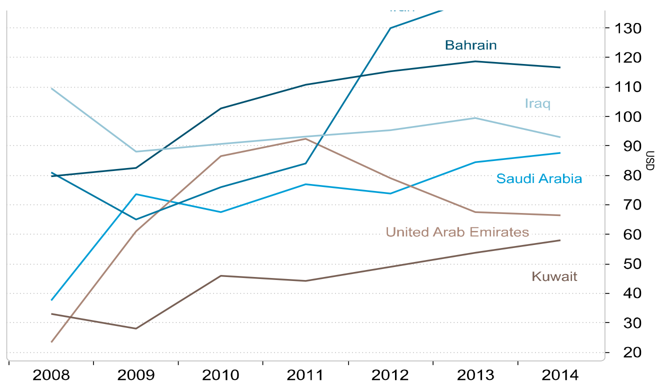
Crude oil markets have been at odds with bearish market anticipations. Brent markets have traded sideways within the USD 104-110 range in the second quarter of 2014, with no clear directionality. Geopolitical tensions have sustained precious metals and oil prices. The Ukrainian crisis drove Brent close to USD 112 in March, but it has since retraced, closing at 108 on 6 June. The early April rally in West Texas Intermediate (WTI) had also reversed by the middle of May. WTI has been trading at a discount to Brent since late 2010, but in the past few months the spread has been inflated. Increasing production from shale oil fields has reduced the US's need for offshore oil.

Global economic growth is expected at 3.5% this year and 3.8% next year, according to Societe Generale's Global Economic Outlook. Oil demand is therefore set to increase thanks to emerging market demand. Despite the recent worries about the effect of the Chinese slowdown on global consumption, aggregate non-OECD global oil demand growth remained resilient in Q1 2014, according to the Joint Organisations Data Initiative (JODI) database. OECD demand is expected to be flat this year, and is following a medium-term downward trend. In addition, US demand will gradually decline in the medium term as increased fuel efficiency and the use of alternative fuels for vehicles offset stronger demand from the accelerating US economy.

US economy becoming a net exporter



OPEC countries are vulnerable to oil weakness



Sources: Societe Generale Private Banking, Macrobond

Alternatives

Attractive alpha for hedge funds

The current mid-cycle is favourable for hedge funds, as the current recovery does not resemble previous ones. Indeed, we are currently seeing desynchronisation across economies – for example, the Fed and the Bank of England are flirting with a cautious approach to exiting quantitative easing (QE), while the European Central Bank has embarked on negative interest rate policy. The varying pace of reform implementation and big imbalances across countries offer a supportive environment to play relative value and diversification themes. The current macroeconomic backdrop points to more alpha generation and lower beta for portfolios. Long/Short (L/S) Equity, Event-driven (M&A, Special Situations) and Global Macro are the best-positioned strategies to take advantage of these conditions.

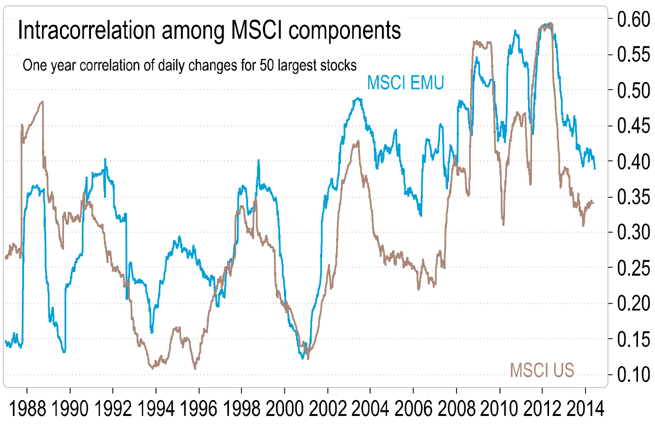
Year-to-date returns in **L/S Equity** have been hurt by the combination of a global growth slowdown and persistent emerging market imbalances. Funds exposed to highly valued and crowded stocks have suffered most. After the recent market correction, investors are paying more attention to fundamentals, regional momentum and EPS pricing. Lower intercorrelation between stock indexes suggests that specific factors should play out, allowing fund managers to extract alpha. However, bottom-up selection remains challenging and only a deep fundamental approach might be appropriate for L/S equity funds.

Event-driven strategy is well supported by the overall macro backdrop. M&A activity has shot up on lower systemic risks and cash-rich corporate balance sheets. CEO confidence is rising, showing decision-makers' optimism and willingness to pursue further M&A business. Furthermore, the cash-rich environment and lower yields are supporting acquirers, while targets remain affordable. This rationale is expected to remain intact, resulting in further encouragement of M&A. **Special Situations** should also benefit from the current environment. Fundamentals remain sound and the opportunity set is growing. The current phase of the business cycle is productive for this particular strategy.

Global Macro strategy is well-positioned to take advantage of the current situation. The universe of opportunities for this kind of strategy is growing, as systemic risk is low and fundamentals are taking centre stage. Furthermore, certain anomalies – such as overvalued EUR and Bund - have yet to correct. Monetary policy desynchronisation offers a variety of investment themes.

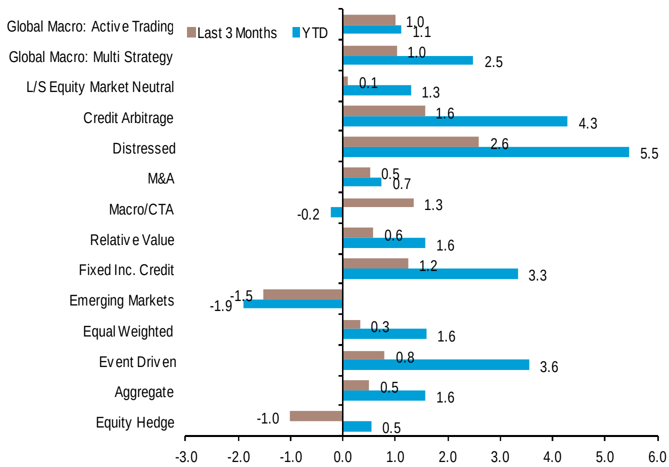
We strongly recommend increasing exposure to alternatives. The current macroeconomic backdrop offers more opportunities to extract alpha, while divergences across economies lowers the overall beta.

Intracorrelation has declined since last summer



Sources: Societe Generale Private Banking, Lyxor AM, Macrobond

Event-driven and Global Macro have benefited



Time to reshape your portfolio

High cross-asset correlation is a sign of a shared source of risk. Crises are typical examples of a highly correlated market environment, where risky asset prices move in the same direction. In times of high macroeconomic uncertainty (usually expressed by inflated volatility) such as financial crises, correlation between equities, bonds, credits and commodities moves towards a level that leaves investors with limited room for manoeuvre and portfolio diversification.

Cross-asset correlation shot up in the wake of the Great Recession (the sharp decline in economic activity in the late 2000s). This increase was largely due to the surge in macro volatility in the period following the bankruptcy of Lehman Brothers bank. We applied Principal Component Analysis (PCA) technique to 20 asset classes including equities, bonds, credits, commodities and currencies. We found that in December 2011, around 54% of the variance of those 20 assets could be explained by just one factor. We note that the previous sharp rise was during the dotcom crisis, confirming that cross-asset correlation sky-rockets during crises.

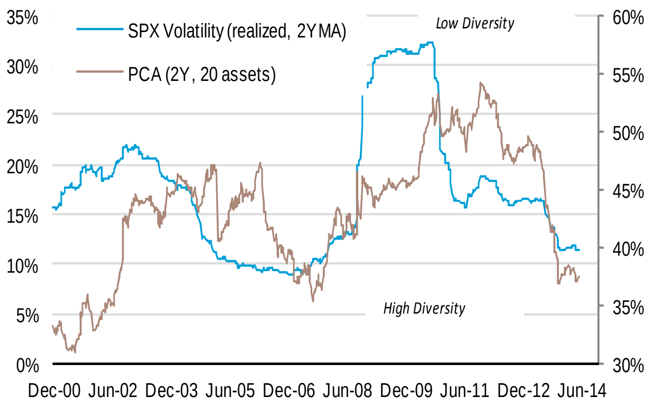
While interdependence between assets eased after the Great Recession, it has never returned to the levels seen in the 2000s. More integrated financial markets, economies and new techniques which seek outperformance against benchmarks have led to a general upward trend in market interdependence. We assume that the low dispersion after Lehman's failure was driven by coordinated global monetary easing. So the single factor explaining high correlation was the central bank macro factor.

Policy-driven cross-asset interdependence has started to fade since the Fed announced the end of quantitative easing in July 2013. Since last summer, decreased macro uncertainty (reflected by lower volatility) and divergent asset performances have curtailed the variance explained by the single factor, as we can see in the graph on the left below.

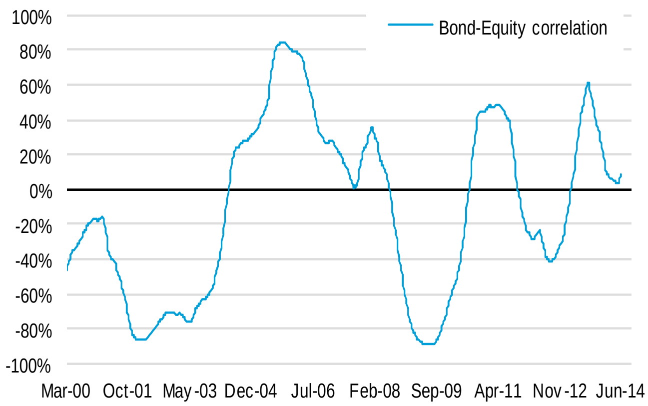
Interdependence between assets is now back to pre-crisis levels, generating opportunities for talented asset managers to reap higher returns. This high-diversity environment means that different specific factors are now the main drivers of asset classes.

The current environment is fruitful for portfolio diversification. Monetary policy, a driver for all assets since the financial crisis, is now no longer the main catalyst. If correlations remain at current levels, market behaviour should be driven more by economic and corporate fundamentals than by macro factors.

Asset performances driven less by common factor



Bond-equity correlation has declined



Sources: Societe Generale Private Banking, Macrobond

Follow-up on convictions

Inception date	Conviction	Currency	Performance since inception	Performance qoq	Performance Y.T.D.	Annualised performance	Status	Comments
February 20, 2013	**Conviction N°2**: Capital expenditure recovers in the US	USD	23.60%	1.57%	2.73%	18.10%	Open	With the US economy gaining momentum, we reiterate our conviction that US sectors linked to capital expenditure (capex) should outperform by the end of the year.
September 1, 2013	**Conviction N°3**: US de-equitisation	USD	14.41%	1.58%	2.82%	18.59%	Open	De-equitisation is still under way, sustained by large cash piles on company balance sheets.The most represented sectors in the share buyback universe are Consumer Discretionary, Health Care and Financials. Companies buying back shares tend to be strong performers.
December 1, 2013	**Conviction N°6a:** European banks beauty contest (Equity)	EUR	9.89%	5.67%	9.72%	18.80%	Open	Economic turnaround and accommodative monetary policy will further ease funding conditions. The ECB's Asset Quality Review should ease market concerns about the soundness of the eurozone banking sector and whet investor appetite. Bond redemptions will continue to overtake bond issuance, providing support for the financial bond market.
December 1, 2013	**Conviction N°6b**: European banks beauty contest (Bonds)	EUR	6.72%	3.39%	6.72%	12.78%	Open	
December 1, 2013	**Conviction N°7**: Value in European short duration high yield	EUR	6.36%	2.90%	5.64%	12.09%	Open	Default rates in European high yield are set to stay low ,while short maturity bonds provide protection against the risk of rising long-term yields. Structural factors are supporting increased market liquidity
December 1, 2013	**Conviction N°8**: Investment cycle gathering speed	USD	8.53%	2.49%	3.08%	16.22%	Open	Business fixed investment has been relatively weak in developed markets for several years, but we now expect a rebound in capex in Japan, the US and Europe. As financing conditions remain accommodative, company cash flows are very high and now that global growth is now accelerating we expect an increase in investments.
December 1, 2013	**Conviction N°10:** German stocks: Rocket-borne	EUR	5.96%	6.75%	4.24%	11.33%	Open	The low interest rate environment, attractive effective exchange rate and accelerating economic growth are all the factors needed to drive German stocks up further. In the eurozone the DAX remains our preferred index, as valuations are cheap. Small & mid caps in Germany are still attractive despite their 20% premium relative to large caps in the region.
March 19, 2014	**Conviction N°11**: TOPIX - Multiples rerating still under way (currency hedged)	EUR	8.56%	3.62%	0.00%	37.20%	Open	We believe Japan is moving towards a structural change. The exit of deflation should support re-rating. Recent stock weakness should be seen as a major buy opportunity.
March 19, 2014	**Conviction N°12**: Global Pharma - The only GARP Sector	USD	2.65%	1.93%	9.90%	11.51%	Open	There are many reasons why we like the Pharmaceuticals sector. Cheap valuations, safe dividend yields and defensive profiles in highly volatile markets are all supportive factors. However, profit growth remains the most important driver.
March 19, 2014	**Conviction N°13**: Europe: Prefer Value to growth style	EUR	12.60%	11.43%	17.67%	54.75%	Open	With bond yields set to rise in the US, emerging markets still facing a bumpy ride and profits expected to recover as soon as Q1, we suggest keeping a reasonable exposure to value stocks in Europe.
March 19, 2014	**Conviction N°14**: Qatar: Haven from the turmoil	USD	14.57%	12.60%	27.60%	63.31%	Open	Qatar should be joining the MSCI Emerging market index in June 2014, following the upgrade announcement in mid-2013. We expect that the market will experience a liquidity boost as we approach May 2014, when the MSCI reclassification of Qatar as an EM will become effective.
June 12, 2014	**Conviction N°15 :** Go East	USD	-	-	-	-	Open	Asia-Pacific is the only region which combines attractive valuation, potential upward earnings forecasts and supportive monetary and fiscal policies. The recent improvement in economic data in China, the new Modi-led government and our expectations for further quantitative easing in Japan by year-end highlight the attractiveness of the Asia-Pacific region.
June 12, 2014	**Conviction N°16**: The dividend edge	EUR	-	-	-	-	Open	Over the past 10 years, dividend payments have contributed the biggest part of an equity's total return. As P/E expansion has been impressive over the last two years, we expect earnings and dividends growth to explain the biggest part of the total return. We therefore favour stocks with strong cash flow and steady dividend growth rather than stocks with high dividend yields but a risk of dividend cuts.
June 12, 2014	**Conviction N°17 :** Colombia : The new El Dorado ?	USD	-	-	-	-	Open	Colombia is the only country in Latin America to have seen 2014 GDP growth forecasts upgraded in the IMF's lWorld Economic Outlook. Colombia owes this to lax monetary and fiscal policies, and more specifically to its aggressive pushing of investment.
June 12, 2014	**Conviction N°18 : Eastern Europe back in the game**	EUR	-	-	-	-	Open	The macroeconomic backdrop in the Czech Republic, Hungary, Poland and Romania has improved significantly. The consensus growth forecast for 2014 is 2.1% for the Czech Republic, 2.2% for Hungary, 3.2% for Poland and 3.0% for Romania, with a further acceleration expected in 2015. Moreover, the recovery is broad-based, underpinned by all components of the economy -net exports.
	Average Performance		**10.35%**	**4.90%**	**8.19%**	**24.97%**		

Convictions have either a Tactical horizon (3-12 months) or a Strategic horizon (1-3 years). The current position refers to our stance at the current time, thus strategies are Open then Closed and removed from the list. For the Strategic Convictions, we also have an additional 'Hold' position, when we think the theme is still valid over its stated horizon, but current conditions are not ideal to enter/sell.

Follow-up on convictions

Closing strategies

Conviction N° 1: Buy European stocks now or never

In November 2012, we proposed a theme based on low-valuation European stocks (P/E 9.5x in November 2012). We think it is now time to close this strategy. At the beginning of June, it had gained 36.04%, and valuations had risen by about 56% (P/E June 2014 : 14.9x).

Conviction N° 4: Commercial real estate: resilient yield

Our conviction on commercial real estate has also performed well, at +37.8% in less than a year. Low bond yields pushed investors towards these defensive investments in their hunt for yield. However, the prospect of a real-estate bubble and the probable change in UK monetary policy lead us to close this position.

Conviction N° 5: US bond yields back up!

Despite the low unemployment rate in the US, inflation remains weak and bond yields are trending down. Moreover, the monetary tightening expected for 2015 is tending to flatten the curve. This is why we have decided to close our conviction on the "normalisation" of American yields.

Conviction N° 9: Upside for depressed energy sector

The expected rebound for oil companies has taken place, and valuations have risen, with P/E increasing from 11.75x to 14.25x in 6 months – a 23% increase – and producing a performance of 17.37%.

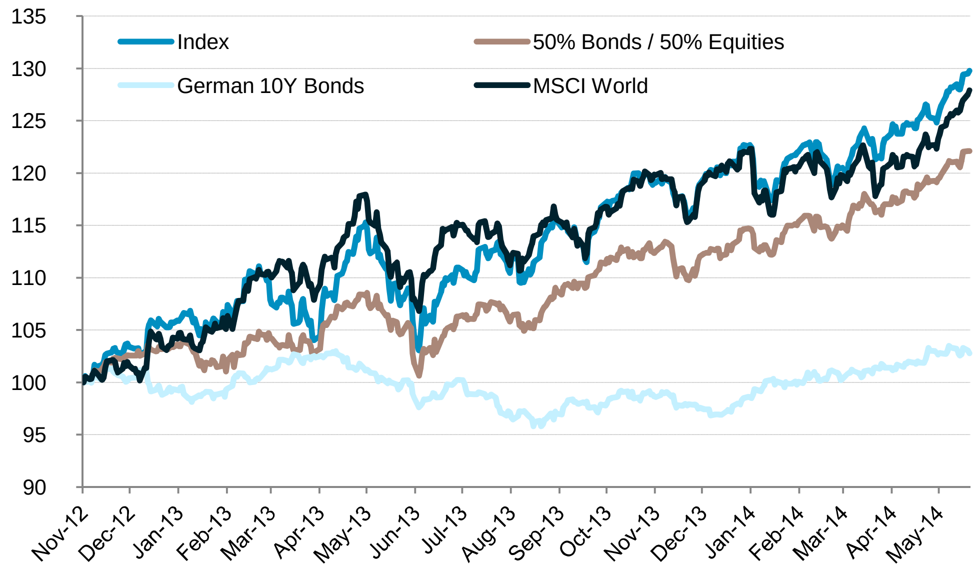
Inception Date	Conviction	Currency	Performance Since Inception	Performance Q.o.Q.	Performance Y.T.D.	Annualized performance	Status	Comments
November 22, 2012	**Conviction N°1:** Buy European stocks now or never	EUR	36.04%	6.62%	8.70%	23.24%	Closed	Low valuations are still the major drivers for European stocks
September 1, 2013	**Conviction N°4**: Commercial real estate: resilient yield	EUR	37.83%	8.20%	17.80%	48.79%	Closed	As fixed income returns have meaningfully come down, investors venture beyond traditional bond markets to meet their fixed return objectives. Commercial real estate markets look appealing as they offer a potential defensive profile, long term visibility and a hedge against inflation.
December 1, 2013	**Conviction N°5:** US bond yields back up!	USD	-2.80%	-0.90%	-4.80%	-5.32%	Closed	US monetary policy is entering a multi-year tightening phase and US long-term yields should keep rising in line with accelerating activity. This is a major trend that impacts portfolio structure and investments in bonds, currency and diversification techniques.
December 1, 2013	**Conviction N°9:** Upside for depressed energy sector	USD	17.37%	0.26%	4.36%	33.02%	Closed	Free cash flow generation is key for avoiding the ongoing Big Oil de-rating. Improved visibility on Big Oil's future cash flow, the near 10-year low valuation relative to the market, and higher cash returns to shareholders should whet investor appetite for energy stocks. In addition, the oil sector's defensive profile and high dividend yield look attractive for those investors wanting to avoid the likely increase in equity market volatility.
	Average Performance		**22.11%**	**3.55%**	**6.52%**	**24.93%**		

Convictions have either a Tactical horizon (3-12 months) or a Strategic horizon (1-3 years), the current position refers to our stance at the current time, thus they are Open then Closed and removed from the list. For the Strategic Convictions, we also have an additional 'Hold' position, when we think the theme is still valid over its stated horizon but current conditions are not ideal to enter/sell.

Follow-up on convictions

Performance index

Each quarter, the Strategy Team proposes investment themes or “Convictions”. Since November 2012, 18 strategies have been initiated. Four have since been closed, while 14 remain open. In order to measure the performance of our proposals, we have created an equal weight index consisting of the performance of each of our themes, converted into euros. Each time a theme is opened or closed, the weight of each theme is rebalanced to keep the weights equal.



Index performance	
Since November 2012	29.77%
1-month	3.05%
3-month	6.80%
1-year	18.54%
Annualised volatility	
1-month	5.77%
3-month	7.20%
1-year	9.58%
Performance since November 2012	
50/50 Equities Bonds	22.11%
MSCI World	27.92%
German 10Y Bonds	2.77%

Global Economic Outlook

Reconnecting growth and inflation

A global recovery, albeit an uneven one, has been underway since 2010. As growth forecasts have been revised higher, however, inflation has barely moved. This has raised the question of whether the world has moved to a new inflation paradigm with structurally lower inflation for a given level of output. We do not find evidence of that. Central banks, however, are changing. The recognition that the "Greenspan Put" fuelled leverage and asset price bubbles, even under price stability, is promoting new macro-prudential tools, targeting financial stability. The BoE is spearheading this effort, with the "Carney Call'. If anything, this suggests a lower level of output for a given level of inflation!

Looking ahead, we now expect growth and inflation forecasts to reconnect, but in different ways across different regions. With the resurrection of the Phillips Curve, we expect the BoE to hike rates in 1Q15, followed by the Fed in 3Q15. Once tightening is launched, we expect an accelerated pace and forecast the policy rate for both the BoE and Fed at 2.5% by end-2016. In the euro area, low inflation equates with low growth suggesting further ECB easing. Japan stands apart with growth forecasts lagging inflation. The BoJ has now hit the pause button awaiting Prime Minister Abe's third arrow of structural reform. Turning to China, monetary policy will remain cautious, lest it fuel a new round of destabilising credit-driven investment. We now set the probability of a China hard landing at 30% (up from 20%). Standing in contrast to China's struggle with overcapacity, other major emerging economies are battling supply constraints and/or entrenched food price inflation. The hope is that reform will soon come in India and we expect the RBI to be in a position to cut rates in 2H15. Pressure for the Central Bank of Russia to cut is mounting, but, given the balance of risks, we see the first cut only in early 2015. In Brazil, however, we look for a further 100bp of rate hikes.

1. **Reconnecting growth to inflation**: In the major advanced economies, consensus growth expectations have for some time now enjoyed upward revision while inflation expectations have remained subdued and, in the case of the euro area, seen downward revision. Japan is the notable exception, where upward revisions to the inflation outlook have run ahead of those on growth. This configuration of still-low inflation, even as recovery takes root, has led some observers to suggest a new inflation paradigm of lower inflation for a given level of output. Compared to the pre-crisis world, however, we do not find evidence to corroborate such a shift and expect growth and inflation forecasts now to reconnect, albeit in different ways across different regions.

2. **The "Carney call" is the new model:** That price stability is no guarantee of financial stability marks one of the most important lessons learnt during the crisis. This has driven a substantial change to the regulatory environment and has seen macroprudential tools introduced. Already, the Bank of England, the Swedish Riksbank and the People's Bank of China have made use of these tools and, looking ahead, we expect to see broader usage.

The new macroprudential tools remain at the formative stage and are still a work in progress. Investors should be warned that these tools target leverage either directly or indirectly, and the "Carney Call" clearly marks a change from the "Greenspan Put" of the past. Indeed, while markets seek to evaluate the "Yellen Put", we would urge caution that the threshold for more QE is very high, given the balance of costs and benefits.

3. **Wages to drive faster Fed tightening:** As recovery drives a further tightening of the US labour market, we forecast average earnings growth to head north, closing 2015 at around 3.5%. In response, the Federal Reserve is expected to engage a first rate hike in 3Q15 and then take the fed funds target rate to 2.5% by end-2016, well above market expectations.

4. **Time for capex expansion:** The story of cash-rich companies being good news for capex has lost credibility. Clearly it takes something else – in our opinion, the answers are simple: (1) normal level of capacity utilisation, (2) confidence in the future, (3) attractive financial conditions and (4) absence of structural frictions holding back investment. In the US, the foundations appear to be in place. In Japan too, if Abenomics delivers. For its part, the euro area remains very mixed. In India, hope is the new government will deliver supply-side reforms. In Brazil, however, our concern is that the sporting-driven infra-structure boom will prove short-lived. And in Russia, the concern is that politics will remain a hurdle for much-needed investment.

5. **China still bumpy landing:** Risks on China remain top of market concerns. Our central scenario remains that a hard landing can be avoided, but we have raised the probability hereof to 30% from 20% previously. For the world economy, we believe a China hard landing would translate to a 1.5pp decline in the pace of growth in the first year after this shock.

6. **A most uneven European recovery**: The euro area recovery is losing steam in line with our scenario of an uneven and bumpy recovery, and this despite significant fiscal drift. Against this backdrop, we expect the ECB to deliver further stimulus, but the risk is that the impact on the real economy will be slow to feed through. The euro area needs structural reform to secure sustainable recovery. These reforms, however, remain too slow in coming and insufficient in scope to solve the issues at hand.

Balancing the risk to our central scenario, these remain tilted to the downside. China hard landing is top of the list, both in terms of the probability (which we now set at 30%) and in terms of the global fallout from such a scenario. The triggers for a hard landing, however, are on the domestic front and we do not consider a sharp sell-off on the US Treasury market as a catalyst for China hard landing per se given the still relatively closed financial system.

This, however, is not the case for several other emerging market economies where financial integration has delivered several benefits, but also leaves these markets vulnerable to a US Treasury markets selloff. To our minds, markets may be placing too much confidence in central bank "puts". Indeed, we believe that in the event of downside risks appearing in the US, the hurdle for new QE is high as the Fed clearly sees both benefits and costs to this policy. Common to all the major central banks are new responsibilities on financial stability, and surveillance of leverage has clearly increased. In the euro area, the visible political divide leaves the region vulnerable in the event of new shocks. Finally, geopolitical risks merit on-going attention.

The upside risks in all regions come from faster-than-expected credit expansion. In the case of China and euro area public sector balance sheets, the short-term win will be off-set by higher downside risk for the future. The durable upside risk comes from structural reforms, a fact that holds true for the euro area, Japan and all the major emerging economies.

Michala Marcussen
Global Head of Economics
SG Cross Asset Research

Global economic forecasts

	Real GDP			CPI		
% change YoY	2013	2014f	2015f	2013	2014f	2015f
World (Mkt FX weights)	2.6	3.1	3.4	3.0	2.8	2.9
Developed countries	1.3	2.2	2.4	1.4	1.5	1.7 ▼
Emerging countries	4.7	4.7	5.1	5.9 ▼	5.3 ▼	5.2
G5						
Euro area	-0.4	1.0	1.3	1.4	0.8	1.2
Germany	0.5	2.0	1.5	1.6	1.2	1.6
France	0.4	0.7	1.3	1.0	1.0	1.4
Italy	-1.8	0.5	1.0	1.3	0.7	1.1
Spain	-1.2	0.7	1.0	1.5	-0.1	0.3
United States	1.9	2.5 ▼	3.3	1.5	2.0	2.6
China	7.7	7.1	6.8	2.6	2.3 ▼	2.8
Japan	1.6	1.3	1.7	0.4	2.6	2.0
United Kingdom	1.7	3.0	2.5	2.6	2.0 ▼	2.8
Other advanced						
Switzerland	2.0	1.7	1.8	-0.2	0.0	0.5
Australia	2.4	3.1	2.9	2.4	2.9	2.5
South Korea	3.0	3.8	3.8	1.3	1.7	2.3
Taiwan	2.1	3.0	3.4	0.8	1.4	1.6
Emerging economies						
Brazil	2.5	1.7	2.2	6.2	6.2	5.7 ▲
Russia	1.3	0.3 ▼	1.3 ▼	6.6	6.9 ▲	5.4 ▲
Poland	1.5	3.5	3.8	0.9	0.6 ▼	2.0 ▼
Czech Republic	-0.9 ▲	1.9 ▲	2.6	1.4	0.8	1.8
Slovakia	0.9	2.4	2.7	1.5	0.5 ▼	2.2 ▲
Mexico	1.3	2.4 ▼	3.8	3.8	3.6	3.5
Chile	4.1	3.0 ▲	3.5	2.1	3.7 ▲	2.8
India	4.7	5.2	6.0	9.5	8.3	7.8 ▲
Indonesia	5.8	5.3	5.6	7.0	6.5 ▲	5.7

Sources: SG Cross Asset Research/Economics, IMF

Significant changes from previous forecast

▼ Down

▲ Up

Market performance and forecasts

Developed Markets Performance		Δ1m	Δ3m	ΔYTD	Δ12m
(in local currency)	**Current Level**				
S&P500	1944	0.83%	4.08%	5.17%	19.5%
DJ Euro Stoxx 50	3289	1.6%	6.4%	5.8%	22.6%
FTSE100	6839	0.30%	2.29%	1.33%	7.9%
Nikkei 225	15069	0.01%	-1.02%	-7.50%	13.2%
MSCI World ($)	426	0.96%	4.24%	4.34%	17.4%
(in local currency)	Yield to Mat				
European IG	1.54%	0.71%	2.3%	4.3%	5.8%
European HY	4.15%	0.98%	2.8%	5.6%	13.0%
US IG	3.07%	0.53%	2.6%	5.0%	5.1%
US HY	5.72%	0.97%	2.5%	5.1%	10.0%
UK	3.84%	0.67%	2.0%	4.7%	5.5%
Japan	0.52%	0.16%	0.3%	1.1%	2.7%

Emerging Markets Performance		Δ1m	Δ3m	ΔYTD	Δ12m
(in USD)	**Current Level**				
MSCI EM	1036	3.19%	8.34%	4.08%	3.18%
MSCI EM Asia	466	4.67%	7.62%	5.50%	6.27%
MSCI EMEA	430	7.31%	10.54%	-2.37%	-0.96%
MSCI Latam	3267	-1.84%	11.18%	2.52%	-6.53%
(in USD)	**Yield to Mat**				
BAML EM SVGN	4.77%	1.60%	6.39%	8.46%	8.71%
Asia Svgn	4.19%	0.77%	5.01%	8.93%	6.82%
EMEA Svgn	4.18%	2.30%	5.89%	7.67%	8.68%
Latam Svgn	5.84%	0.92%	7.67%	9.41%	9.43%
BAML EM CORP	4.56%	1.71%	4.20%	5.76%	7.37%
Asia Corp	3.97%	1.30%	2.62%	4.65%	5.63%
EMEA Corp	4.45%	2.60%	4.47%	4.36%	7.02%
Latam Corp	5.23%	1.35%	5.54%	8.20%	9.37%

Sources: SG Cross Asset Research/Economics, IMF

Market performance and forecasts

Currencies forecasts	Performance YTD	Current	3-Month forecast	6-month forecast
EUR/USD	-1.79%	1.3533	1.34	1.32
USD/JPY	-3.01%	102.08	102	107
EUR/CHF	-0.69%	1.2185	1.22	1.25
GBP/USD	1.34%	1.6788	1.66	1.63
EUR/GBP	-3.12%	0.8061	0.81	0.81

10-year yield forecasts	Performance YTD	Current	3-Month forecast	6-month forecast
USA	-12.2%	2.6%	2.80%	3.10%
GER	-28.0%	1.4%	1.50%	1.60%
UK	-10.5%	2.7%	2.80%	3.00%

Commodity forecasts	Performance YTD	Current	3-Month forecast	6-month forecast
Gold in USD	4.53%	1262.53	1250	1250
Oil (Brent) in USD	-0.11%	109.83	110	108

Equities forcasts	Performance YTD	Current	3-Month forecast	6-month forecast
S&P 500	5.2%	1 944	2 000	1 950
DJ Euro Stoxx 50	5.8%	3 289	3 600	3 400
Topix	-4.9%	1 239	1 300	1 400

BAML : Bank of America Merril Lynch
Svgn : Sovereign
EM : Emerging Market
EMEA : Europe, Middle East, Africa

Corp : Corporate
IG : Investment Grade
HY : High Yield
Latam : Latine America

Sources: SG Cross Asset Research/Economics, IMF

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