Monthly Bond Letter
November 2013

Pictet Asset Management

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OVERVIEW

Recent developments

Finalisation of US Federal budget and raising of the Federal debt ceiling deferred

The disaster scenario of the USA technically defaulting was averted at the 11th hour thanks to a deal cobbled together by Congress that has become so skilfully versed in the art of brinkmanship. Finalisation of the budget has been postponed to 15 January 2014, with the decision on resetting the Federal debt ceiling deferred until 7 February 2014. The plan is for a bicameral committee to be set up to formulate by 13 December the outline budget for the rest of 2014. This short-lived respite triggered a powerful rebound not just in risk assets, but in government bonds as well. Real interest rates experienced a second move downwards, with the rate on the 10-year US yield in real terms sinking to 0.3%, down some 63 basis points from its early-September peak.

Janet Yellen's nomination to be the next Fed Chairman barely raised an eyebrow on the markets that had already amply priced this likelihood in

The market's relief that the budget shipwreck had been averted seems out of proportion to the lack of real concerns this looming deadline had seemed to have in terms of its influence on pricing. The reasons for this euphoric response and renewed appetite for risk can be explained by the neatly matching fit of the monetary and fiscal policy mix since the crisis first flared up. As the Fed's Chief-in-waiting is regarded as being very dovish and concerned about employment, her nomination boosted the expectation of quantitative easing continuing into next year.

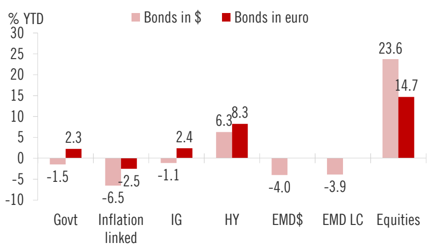
In response to some disappointing US figures, doubts have been mounting about the European recovery

The lack of any deal on a European banking union, talks in Germany aimed at stitching together a ruling coalition and a still brittle eurozone economy, handicapped by worryingly high joblessness and ever ballooning public debt, ensured the prevailing climate remained one of great uncertainty. This helped to push German Bund yields lower and caused the yield curve to flatten out. Peripheral eurozone markets also held their form, benefiting from a dispelling of political fears in Italy and 0.1% GDP growth registered by Spain for Q3 after the Spanish economy had shrunk for nine quarters in a row. On top of that, the Madrid government also issued an upbeat forecast for 1.5% growth in the economy in 2014. Unemployment in the eurozone also retreated for the first time in two and a half years, with the jobless rate edging down from 12.1% to 12.0%. Nobody is getting overexcited though as job creation remains anaemic.

On the back of an encouraging Tankan report, Japan's Prime Minister confirmed the forthcoming hike in the rate of consumer sales tax

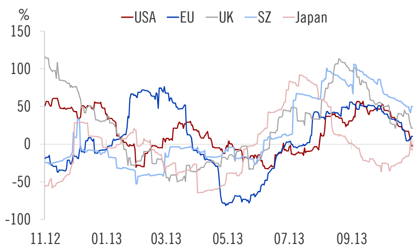
A revival in business confidence, coupled with a string of numbers suggesting Japan's economy has at long last shrugged off its lethargy, encouraged Prime Minister Shinzo Abe to press ahead with his policy of hiking the rate on the consumer sales tax – this will go up from 5% to 8% as of 1st April 2014. The government is of the opinion that the extra support underpinning demand should help to offset any slide in consumer spending stemming from this tax increase. To this end, the Prime Minister announced a new budget stimulus package worth JPY5,000bn (CHF46bn), plus a raft of structural reforms geared towards boosting the country's growth potential. The hike in consumer sales tax should see an extra JPY8,000bn a year flowing into public coffers.

PERFORMANCES 2013



Source: Bloomberg, Barclays, Citigroup, JP Morgan, perf in local currencies

ECONOMIC SURPRISE INDEX



Source: Bloomberg, Citigroup Economic Surprise Index

OVERVIEW

Forecasts

Against a backdrop of signs of economies in both the USA and Europe slackening, central banks look set to steer the same steady course

US GDP growth is already likely to be a little slower in Q3 2013 (consensus at +1.8%) than in Q2 (+2.5%), with the fortnight shutdown of the Federal administration set to slice around 0.6 of a percentage point off Q4 growth.

The Fed will probably have to bide its time for a few more quarters to confirm the economy is expanding strongly enough to allow it to scale down its buying of bonds

Recent statistics released would appear to confirm this likely course of events. The number of new jobs created in September (+148,000) was not that impressive. The preliminary Markit Purchasing Managers' Index (PMI) for manufacturing slipped from 52.8 to 51.1 in October. Housing-market data have been mixed too. Lastly, consumer confidence has unmistakably been rattled, as can be seen from the Conference Board index plummeting from 80.2 to 71.2 in October.

The Fed's steady-as-she-goes course and economic figures distorted by the two-week government shutdown should enable the bond market to hold fairly steady in the run-up to the year-end. Although yields do appear to have amply priced in the Fed's inactive stance, we cannot rule out the possibility of some volatility associated with Ben Bernanke handing the Fed's reins over.

The ECB pointed out it would use any means available to it to keep the eurozone travelling down the recovery road as it regards the upturn as "weak", "uneven" and "fragile"

Although economists are still presuming the eurozone will pull out of recession, the relapse in eurozone PMIs in October and the fall in the Ifo business sentiment index for Germany suggested forward momentum was diminishing this autumn. Pundits pointed out growth in Europe was most likely to remain lethargic for quite some time to come. For now, even though investors are relieved by the fact the eurozone economy officially emerged from the recessionary doldrums in Q2, they are still very guarded as regards the scenario of a full-blown recovery in the making.

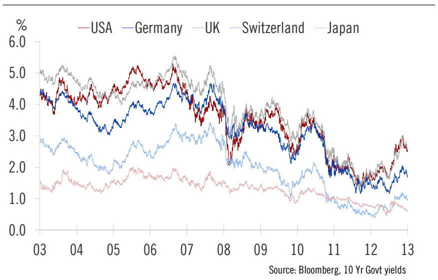
As we move towards the end of 2013, the eurozone bond market should remain fairly range-bound until clarity over what is happening to the economy noticeably improves.

European corporates should retain their verve in the run-up to the year-end

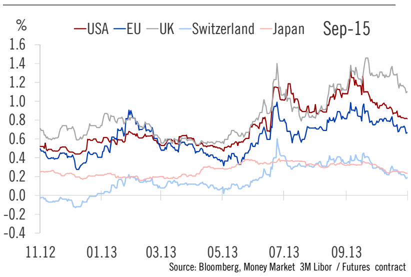
The potential for credit spreads to narrow further looks fairly limited near-term, but the process should continue thanks to a comparatively significant contribution from movements on financials and borrowers from the eurozone's periphery. This scenario does, however, hinge on confirmation of an improvement – no matter how gentle – in the economic outlook and the absence of any confidence-knocking political crisis. Lastly, the risk of further derailment on emerging markets, as witnessed in June this year, is still lurking in the shadows.

European companies' balance sheets are still pretty healthy as managements are erring on the side of discipline and caution. All in all, we are still confident in prospects for high-yield corporates as deleveraging at the banks is throwing up some attractive opportunities and non-European investors have been venturing back into Europe's equity and bond markets.

10-YEAR GOVT BOND YIELDS



3-MONTH RATES - SEPT. 2015



US Federal Reserve whistling the same tune

Decisions on finalising the US budget and Federal debt ceiling adjourned to next year

The disaster scenario of the USA technically defaulting was averted at the 11th hour thanks to a deal cobbled together by Congress that has become so well versed in this sort of brinkmanship. Finalisation of the budget has been postponed to 15 January 2014, with the decision on resetting the Federal debt ceiling deferred until 7 February 2014.

This short-lived respite triggered a powerful rebound not just in risk assets, but in government bonds as well. Real interest rates experienced a second move downwards, with the rate on the 10-year yields in real terms sinking to 0.3%, down some 63bp from their early-September peak.

The market's relief that the budget shipwreck had been averted seems singularly out of kilter with the lack of any really pressing concerns this looming deadline had seemed to have in terms of its influence on pricing. The reasons for this euphoric response and renewed appetite for risk can be explained by the neatly matching fit of the monetary and fiscal policy mix since the crisis first flared up.

QE tapering postponed until at least March 2014

The prospect of a fresh bout of heated budget wrangling and another government shutdown from 15 January 2014 does not inspire much optimism. The issue of raising the debt ceiling will only really become critical well after the date reset for 7 February 2014 as the US Treasury can, by resorting to some exceptional technical ruses, keep things ticking over until early summer.

This sustained atmosphere of uncertainty over fiscal matters does not argue in favour of any accelerated investment by companies which is crucial at this stage of the economic cycle. This may well apply a brake to US growth over the coming 12 months.

The new tax year which began on 1st October should, however, bring less fiscal tightening than in the past fiscal year, with the negative impact on GDP lessening from -1.8% in 2013 to an estimated -0.7% in 2014. This less punitive fiscal framework should give the Fed the latitude to countenance moving ahead with its QE tapering.

This hazy fiscal-policy skyline, coupled with the noticeable slowdown in the tempo of new jobs being created, convinced markets that the Fed's switch to scaling down its purchases of bonds will not happen before March, at the earliest, with the risk it may well be delayed for even longer than that.

Could the Fed buy all of the US Treasury's net issuance?

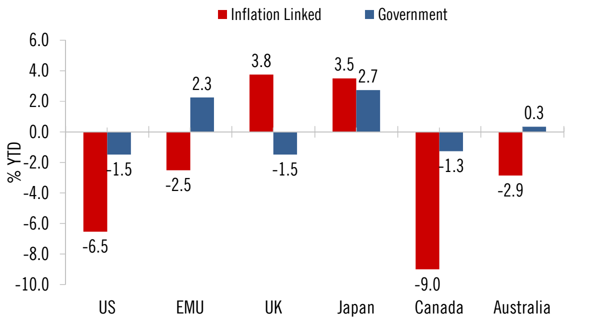
In 2013, the Fed will have taken onto its books through its QE programme some 60% of net bonds issued by the US Treasury (USD540bn out of a total of USD895bn). The downsizing of the budget deficit achieved so far will result in net issuance of US Treasuries declining to USD546bn, which would imply the Fed buying up all of that volume unless it modulates the rhythm (i.e. USD45bn a month) at which it has been buying up US T-bonds.

If this scenario were to materialise, it would intensify the pressure pushing down both nominal and real US interest rates. It would, however, only really be plausible if there were to be a distinctly serious slowdown in growth. This suggests to us that the markets' rather complacent interpretation of virtually never-ending QE will most likely be confounded during Q1 2014.

The state of affairs likely to prevail up to the year-end does throw up some uncomfortably troubling similarities with the euphoric atmospherics that preceded the May-June correction in response to QE tapering being first mooted.

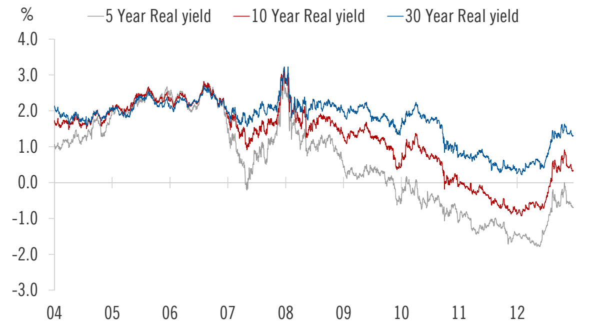
INFLATION-LINKED BONDS

PERFORMANCES 2013 (LOCAL CURRENCIES)



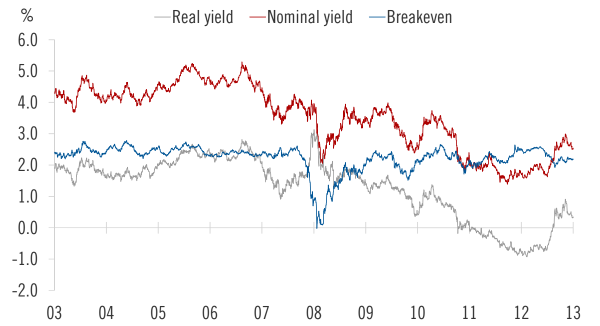
Source: Bloomberg, Citigroup, Barclays, Citigroup

USA - REAL RATES



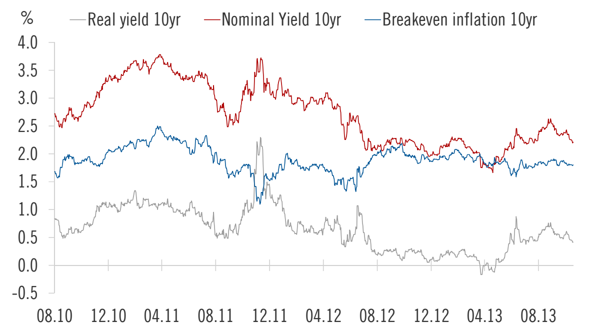
Source: Bloomberg, US Treasury

USA - 10-YEAR TREASURY YIELD COMPONENT



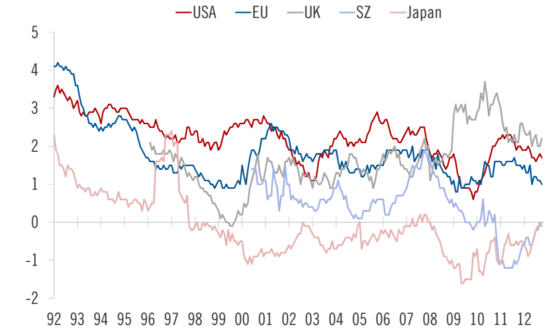
Source: Bloomberg, US Treasury 10 year

FRANCE - 10-YEAR YIELD COMPONENT



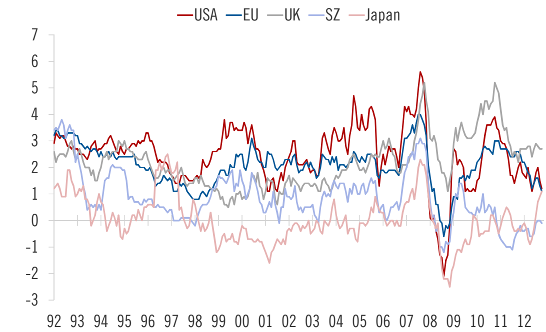
Source: Bloomberg, 10-yr French OAT

CORE INFLATION



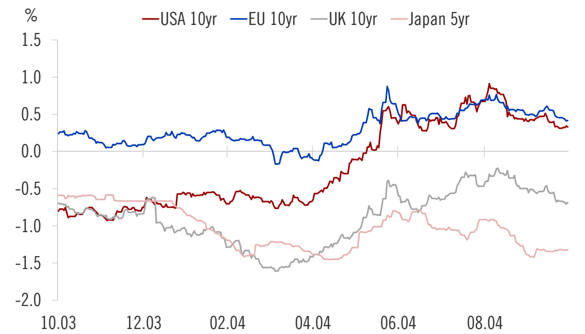
Source: Bloomberg, Core CPI

INFLATION



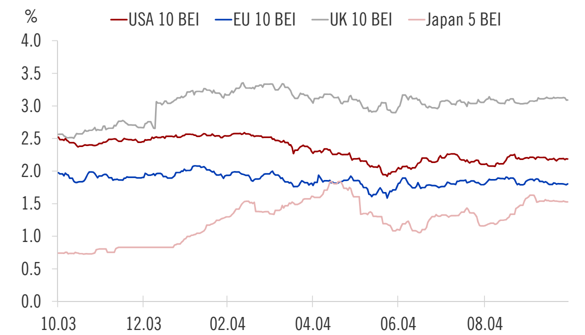
Source: Bloomberg, CPI

10-YEAR REAL YIELDS



Source: Bloomberg, Real Yields

10-YEAR BREAKEVEN INFLATION POINTS



Source: Bloomberg, Break-even Inflation Rates

Liquidity flowing back in

Handsome returns in October

The tightening of credit spreads quickened in October as appetite for risk surged again in reaction to the makeshift solution to the issue of the Federal debt ceiling and expectations that monetary policy on both sides of the Atlantic would stay in accommodating mode. Bonds' good run did, however, stall a little in late October as worries emerged over Asia's financial markets and a stream of less heartening economic data. In the end, the 'credit risk' component provided the main thrust to the return from investment-grade corporates in the month as rates on benchmark German Bunds only inched down a little.

A look at the sectors

The best performers were to be found among insurance groups, telecom operators, utilities and banks. The laggards were the consumer sector and pharmaceuticals. Among insurers, subordinated debt from Axa, Aviva and Generali generated the most handsome gains. Moving to telecoms, America Movil, with both its hybrid and senior debt, delivered some of the best returns after it withdrew its bid for KPN. Telefónica and Telecom Italia also performed strongly even though Moody's trimmed the Italian telecom operator's credit rating to Ba1 at the start of the month. In contrast, spreads on Telekom Austria stretched wider as the company's financing requirements were lifted to fund its purchase of LTE spectrum licences. The good showing by utilities can be put down, partly, to the sector's hybrid debt and, partly, to returns generated by Italian and Spanish companies in the sector. Among banks, those in peripheral eurozone countries turned in the best performances. Generally speaking though, Tier 1 and Lower Tier 2 bank debt did not outperform in October. RBS's subordinated debt registered a negative return for the month as the UK was still looking into the possibility of splitting the bank to set up a 'bad bank'. Lastly, news of the record fine imposed on JP Morgan hit home, with the bank's bonds in the red for October.

Stress testing of European banks

The ECB disclosed some details of its Asset Quality Review (AQR) and the stress testing of banks to be conducted over the next 12 months. Banks will have to reach a common equity Tier 1 (CET1) capital ratio threshold of at least 8%. In an accompanying statement, ECB President Mario Draghi declared that, for the credibility and success of the exercise, some banks were likely to have to fail. As Europe's banking union has still progressed no further than the drawing-board, any issues of capital increases or further capital injections from shareholders or creditors will have to be sorted out at national level.

Primary market

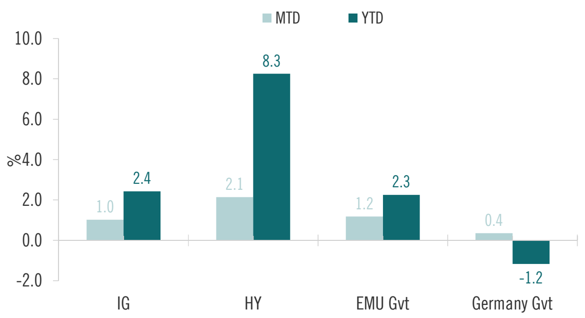
Issuing volume rose in the financial sector in October, with Spanish and Italian banks to the fore, the likes of San Paolo IMI, Mediobanca, Caixa and Banca Carige leading the way with senior debt having maturities from 5 to 10 years. Unicredito also launched fresh Lower Tier 2 subordinated debt. Other banks, such as Lloyds, Commerzbank and JP Morgan, also raised funds. In other sectors, we also witnessed a return of some Asian borrowers, like Sinopec or Korea Gas, to the euro-denominated bond market.

Outlook

On the back of the solid showing in October, the potential for credit spreads to narrow further looks fairly limited near-term, but the process should continue thanks to a comparatively significant contribution from movements on financials and borrowers from the eurozone's periphery. This scenario does, however, hinge on confirmation of an improvement – no matter how small – in the economic outlook and the absence of any confidence-rattling political crisis. Lastly, the risk of further derailment on emerging markets, as witnessed in June this year, is still lurking in the shadows.

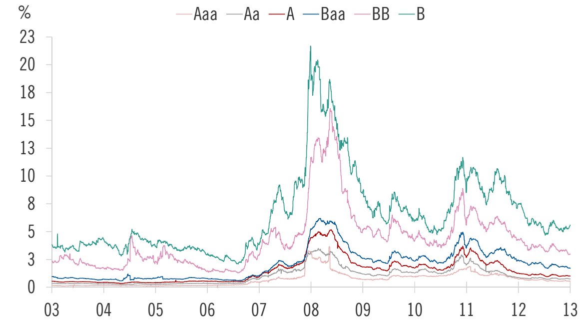
CREDIT RISK

RETURNS ON BONDS IN EURO



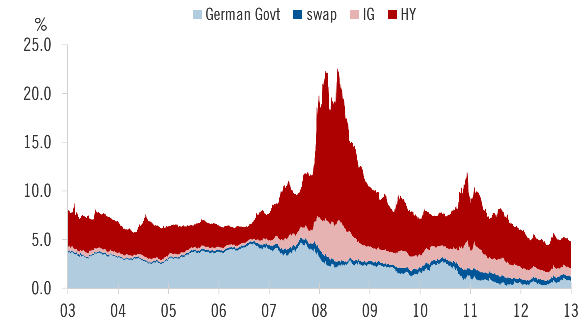
Source: Bloomberg, Barclays, Citigroup, Bonds in euro

CREDIT SPREADS (EURO)



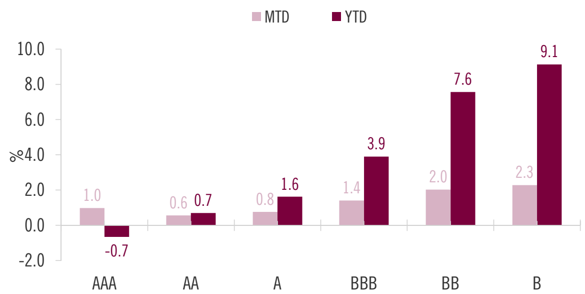
Source: Bloomberg, Barclays, EUR yield spreads

YIELD COMPONENT (EURO)



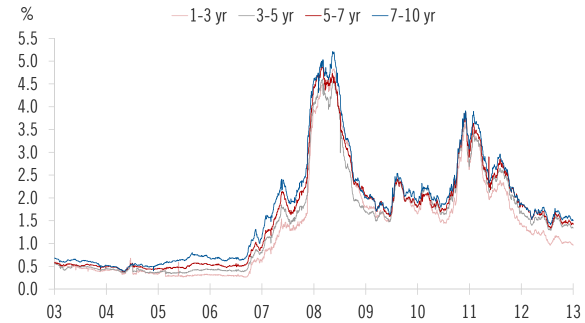
Source: Bloomberg, Barclays, Eur yields

RETURNS ON BONDS IN EURO



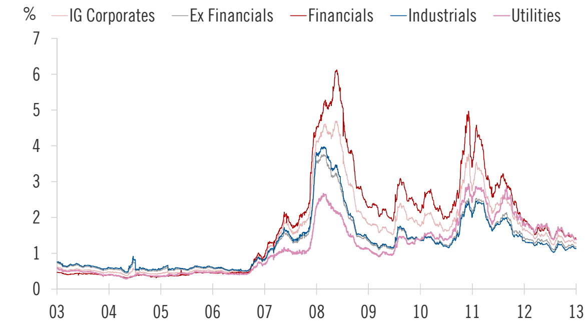
Source: Bloomberg, Barclays, Corporate Bonds in euro

INVESTMENT GRADE SPREADS BY MATURITY (EURO)



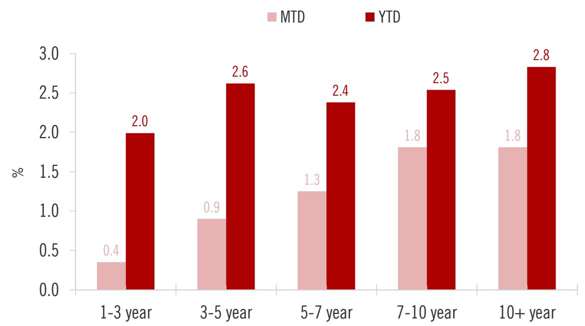
Source: Bloomberg, Barclays, EUR yield spreads

INVESTMENT GRADE SPREADS BY SECTOR (EURO)



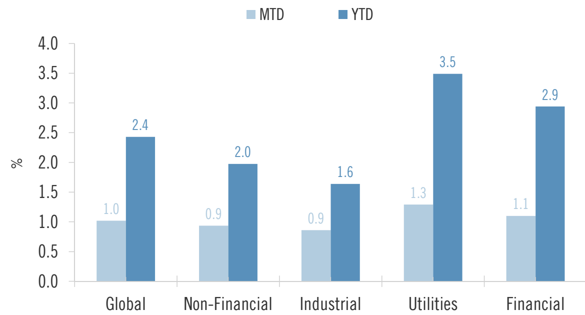
Source: Bloomberg, Barclays, EUR yield spreads

INVESTMENT GRADE RETURNS BY MATURITY (EURO)



Source: Bloomberg, Barclays, Corporate Bonds in Euro

INVESTMENT GRADE RETURNS BY SECTOR (EURO)



Source: Bloomberg, Barclays Corporates Bonds in Euro

European high-yield corporates continued to post solid gains

Positive performance in October

European high-yield bonds continued to post solid gains in October. The shutdown in the USA had a limited impact on high-yield corporate bonds which proved resilient overall. As US politicians managed to strike a deal on the debt ceiling, the high-yield market was further lifted as QE tapering was taken off the table for the rest of year. In Europe, economies continued to show signs of moderate improvement as Spanish growth returned to positive territory. In contrast, French unemployment figures in September disappointed, hitting an all-time high. The long-term unemployment rate was also on the rise. Following Angela Merkel's – personal – victory, German parties were still in talks to devise a coalition whereas elections in the Czech Republic did not cause any tremors.

Most issuers advanced very evenly in October irrespective of their ratings. Sector-wise, there was no clear differentiation among borrowers. Insurance and real-estate names slightly outpaced other sectors. As for country allocation, the month of October confirmed the good showing by peripheral issuers as investors upgraded their expectations for Spain, especially. Italian, Greek and Portuguese names also posted decent returns over the month. Portuguese issuers benefited from some stabilisation on the political landscape after the government crisis this summer.

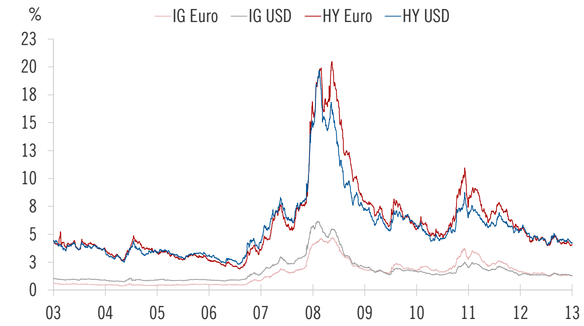
In October, activity on the primary market was broadly in line with last month. UK first-time issuers came in strength to the primary market, such as Domestic & General, an insurance company providing extended warranties for electrical appliances and central heaters, which issued a bond after the company changed hands from one private-equity company to another. Hastings Insurance, another UK insurer rated B-, issued a 2020 bond in sterling. Jerold, a B+-rated niche mortgage lender issued a callable bond with a 9.75% coupon. In terms of corporate activities, America Movil withdrew its bid on KPN, whose hybrids are rated below investment grade. Telecom Italia was downgraded by Moody's and put on 'Negative' credit watch by S&P. Both rating agencies cited management uncertainties and an inability to raise capital. Despite the move by Moody's, Telecom Italia is still not eligible for the main high-yield indices as only one rating agency downgraded the issuer. Elsewhere in the high-yield space, activity from rating agencies remained muted. Paper and pulp companies, along with banks, kicked off the earnings reporting season. The former proved disappointing as the sector is facing declining demand on the back of the advent of the Internet. UK retailers posted profits broadly in line while not triggering any specific excitement. Cable companies' earnings proved fine.

Outlook

Our macroeconomic outlook for Europe has turned more constructive since August as PMIs have rebounded Europe-wide. Balance sheets remain in decent shape on the back of conservative management. A key macroeconomic variable to watch in the coming months is the unemployment rate as any deterioration may comprise the recovery and weigh on consumer cyclical and on the auto sector. We are still monitoring developments in the political situation in Europe closely. The appointment of a new Fed Chairman may also engender some short-term volatility. All in all, we remain positive on high-yield corporates as banks' deleveraging offers attractive opportunities and as non-European investors are returning to European equity and credit markets.

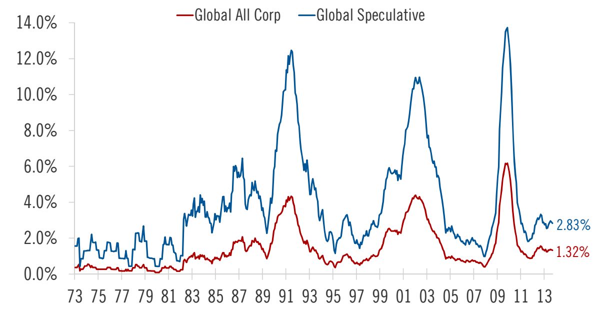
CREDIT RISK

SPREADS IN USD AND EURO



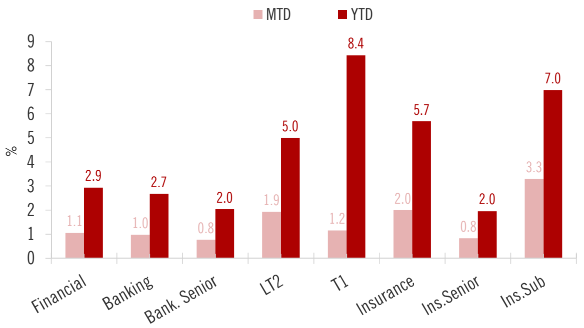
Source: Bloomberg, Barclays, yield spreads

MOODY'S - DEFAULT RATES



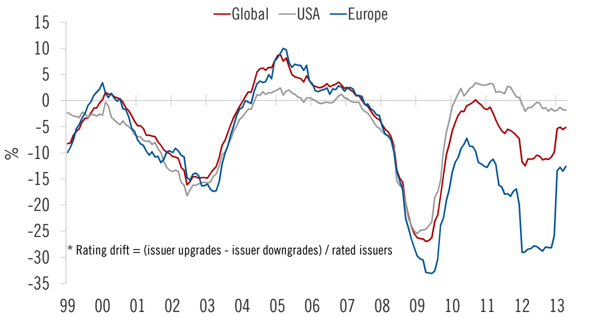
Source: Moody's

FINANCIAL INVESTMENT-GRADE RETURNS (EURO)



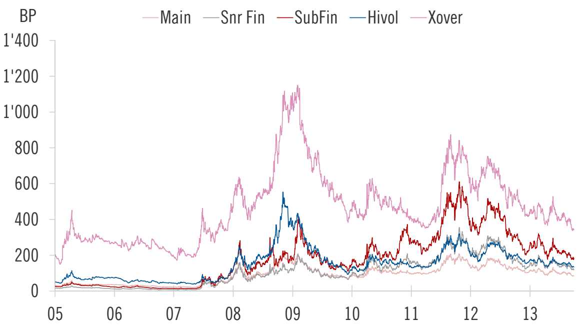
Source: Bloomberg, BoA Merill Lynch

MOODY'S - RATING DRIFT



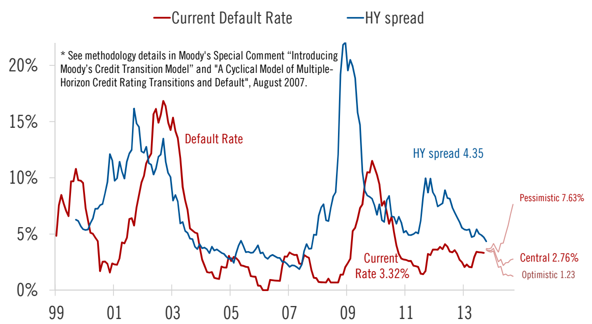
Source: Moody's

CDS - ITRAXX INDICES



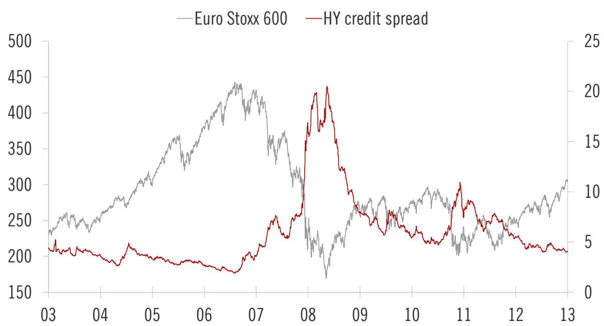
Source: Bloomberg, CDS Itraxx Europe

HIGH-YIELD SPREAD AND DEFAULT RATES (EURO)



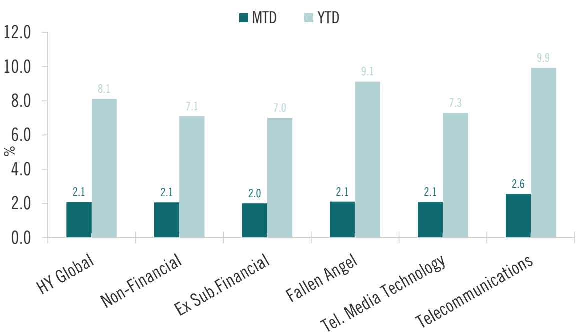
Source: Moody's and Merrill Lynch HY Index

STOCK MARKET & HIGH-YIELD SPREAD (EURO)



Source: Bloomberg, Barclays

HIGH-YIELD RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merill Lynch

Ongoing recovery, but investor demand still subdued

Local-currency debt – Recent developments

October saw some continued recovery: the market-leading benchmark was up by over 4%, with approximately half of the contribution from currencies and half from local rates, but there was significant differentiation seen between countries. Questions surrounding the robustness of the US recovery and fiscal gridlock pushed forward expectations of Fed tapering until potentially early next year. In addition, Chinese growth matched analysts' forecasts at 7.8%. This helped the ongoing recovery in local-currency bond prices as well as emerging currencies. In terms of investor flows, these have been flat or small drips out, which has translated into sub-optimal market liquidity and some 'choppy' price action. The Brazilian real was up by around 2% and interest rates were hiked 50bp to 9.5% as inflation remains a concern, but still within tolerance. Russia left rates on hold, but the chances of a rate cut are slowly mounting as inflation drifts lower whereas, in Mexico, disappointing data such as retail sales point to another rate cut at the time of writing. The Indonesian rupiah was strongly up, supported by good demand from investors attracted by the highest yields in the region. Romania cut rates by 25bp on the last day of September.

Local-currency debt – Outlook

Increased volatility, more differentiation between markets and scrutiny by investors, little improvement in growth, more political risk due to several upcoming elections and lower returns overall will be key characteristics of the asset class. Despite these challenges, it remains one of the more attractive areas in the fixed-income universe given the investment-grade status, attractive yield and good fundamentals, even though they may have passed their peak for now. Flows and positioning remain key drivers and, while institutional investors remain supportive, we have not seen any meaningful return of inflows as eventual US Fed tapering remains a headwind. Improving growth in developed markets has historically led to better growth in emerging markets, but we worry whether this time the leverage effect may be somewhat lower although weaker currencies are part of the right remedy.

External debt – Recent developments

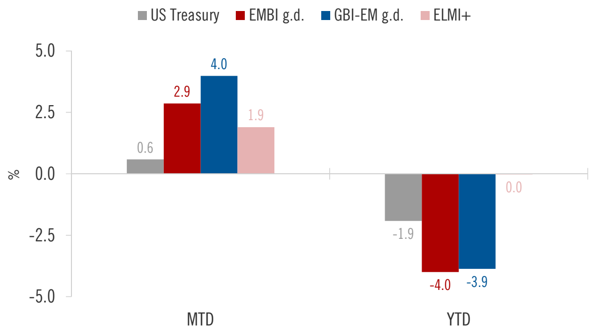
The asset class saw further recovery, particularly given that the onset of Fed tapering may be delayed until early next year given the less robust US recovery. The yield has come down to 5.5%, its lowest since July, with a spread of 314bp over US Treasuries at the time of writing. Below-investment-grade countries performed strongly in October as they caught up with the better recovery in investment-grade countries seen in September. Temporary resolution of US fiscal gridlock and delayed tapering opened the door to new issues, including a Mexican quasi-sovereign and a 2024 maturity government bond from the Dominican Republic which was several times oversubscribed as the country seeks to fund infrastructure spending. Argentina was up over 15% as the US Supreme Court refused to hear the ongoing legal case involving 'hold-out' creditors. Despite Ukraine's downgrade to Caa1 last month, investors were attracted by the near-10% yield, sending the bonds up almost 8% at the time of writing. Returns from many of the highest-grade countries, like Poland, Russia or Malaysia, were restricted to the 2% level.

External debt – Outlook

The asset class's well-known long-term fundamentals, such as lower debt/GDP ratios than developed countries and an attractive yield, remain broadly intact, but eventual Fed tapering is going to continue causing downward pressure. What is clear is that, in a world which relies less on quantitative easing, more focus will be placed on the fundamentals of each country, leading to increased differentiation. A number of countries have seen some signs of economic improvement, and one could argue there is value given the attractive yield and good support from longer-term investors such as pension funds who remain underweight. However, the asset class remains subject to investor sentiment, and we have not yet seen signs of a reversal in investor flows.

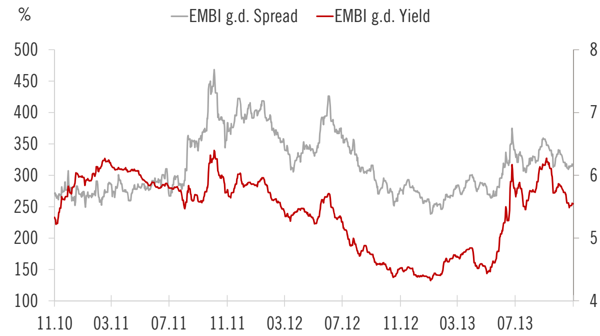
EMERGING DEBT

PERFORMANCES (USD)



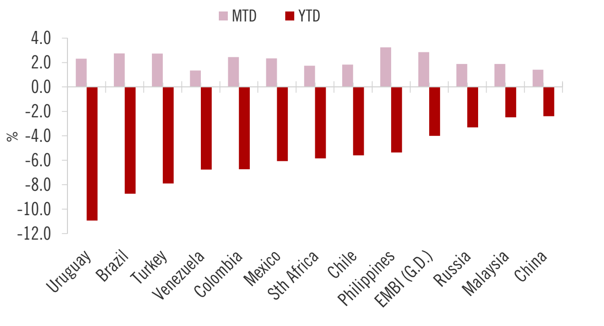
Source: Bloomberg, Index JP Morgan Source: Bloomberg, Barlcays

US DOLLAR DEBT - YIELD & SPREAD



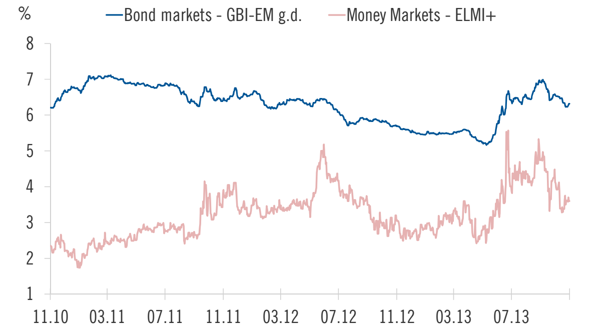
Source: Bloomberg, JP Morgan Indices

JP MORGAN EMBI GLOBAL DIVERSIFIED



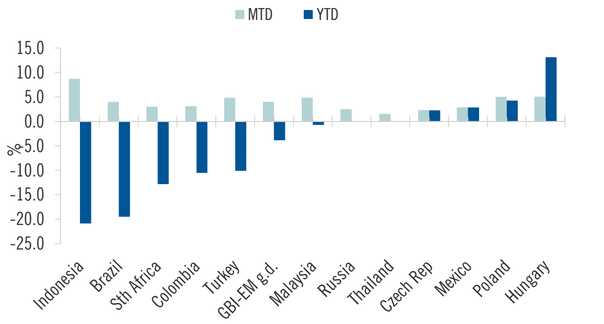
Source Bloomberg: Index JP Morgan

LOCAL CURRENCY DEBT - YIELD



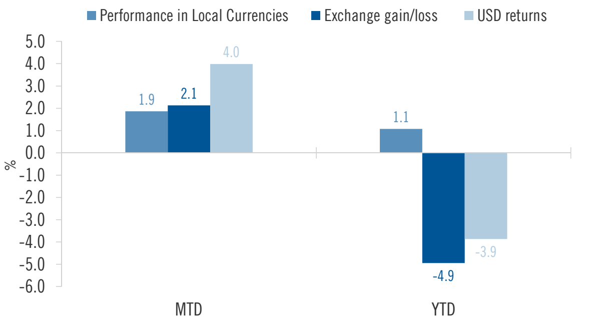
Source: Bloomberg, JP Morgan Indices

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



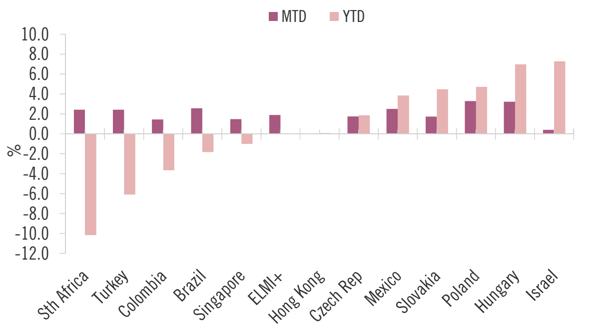
Source Bloomberg: Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



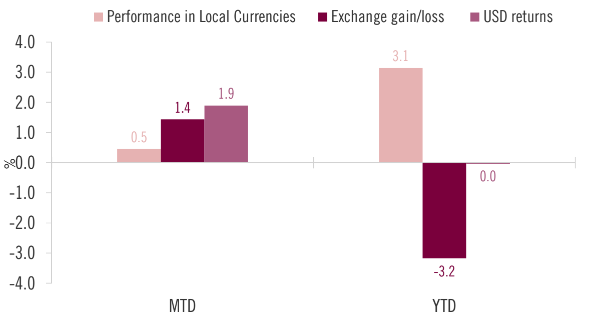
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg: Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

USA

QE tapering put off until next year

The arm-wrestling between Republicans and Democrats, signs of growth easing and the prospect of no change in the Fed's stance worked to bonds' advantage

As no deal on the budget had been struck by the 1st October deadline, the White House had no option but to instruct Federal government offices to close their doors at the start of the month. This shutdown of the Federal administration will have had a noticeable impact on the economy which had already been betraying worrying signs of running out of steam. GDP growth is already likely to be a little slower in Q3 2013 (consensus at +1.8%) than in Q2 (+2.5%), with the fortnight shutdown of the Federal administration set to slice around 0.6 of a percentage point off Q4 growth. Worse yet, this paralysis has cast a fog over statistics as many releases had to be postponed. Bearing testament to spreading nervousness about this shutdown, the Fitch agency declared it was contemplating downgrading its rating, still at triple-A, on the USA's sovereign debt whilst the Chinese agency Dagon went ahead and cut its grade from A to A-.

Congress eventually cobbled together a flimsy stopgap deal which means the Administration could open for business again, but the Federal debt ceiling conundrum has not been solved

The compromise gives the US Treasury powers to borrow up to 7 February and to finance the Federal government up to 15 January. The plan is for a bicameral committee to be set up to formulate by 13 December the outline budget for the rest of 2014. The Congress green light has provided some breathing-space, but it has not resolved the underlying problems.

President Obama's nomination of Janet Yellen to be the next Fed Chairman barely impinged on the markets that had already amply priced this likelihood in. The Fed's Chief-in-waiting is regarded as being very dovish and concerned about employment, and her nomination boosted the expectation of quantitative easing continuing into next year.

As budget wrangling will be ongoing and as economic growth will be dented by the shutdown, the Fed looks most unlikely to modify its monetary stance

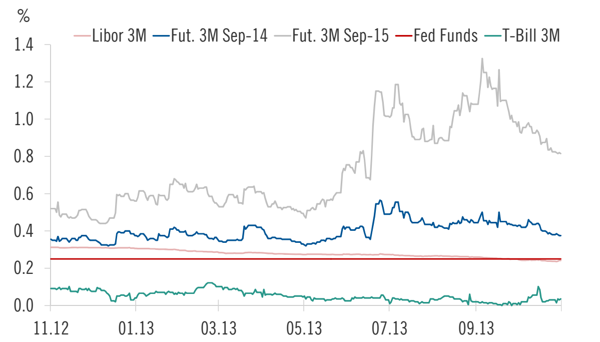
The Fed will probably have to bide its time until next year to confirm the economy is expanding strongly enough to allow it to scale down its buying of bonds. There seems little doubt that growth will be more pedestrian than had been initially predicted owing to the knock to confidence from the politically-induced budget crisis. Recent statistics released would appear to confirm this likely course of events. The number of new jobs created in September (+148,000) was not that impressive. The preliminary Markit Purchasing Managers' Index (PMI) for manufacturing slipped from 52.8 to 51.1 in October. Housing-market data have been mixed too: the NAHB/Wells Fargo Housing Market Index, purported to be a reliable barometer for the sector, dipped from 58 to 55 in October; sales of existing homes fell by 1.9%; pending sales dropped by 5.6%. On the plus side, housing prices continued to climb. Lastly, consumer confidence has unmistakably been rattled, as can be seen from the Conference Board index plummeting from 80.2 to 71.2 in October.

FOMC confirmed in late October the prospect of no change to monetary stance until next year

Uncertainty shrouding the budget and the slower tempo of job creation will push the onset of monetary tightening into next spring or even later. The Fed's steady-as-she-goes course and economic figures distorted by the two-week government shutdown should enable the bond market to hold fairly steady in the run-up to the year-end. Although yields do appear to have amply priced in the Fed's inactive stance, we cannot rule out the possibility of some volatility associated with the handing-over of the Fed's reins by Ben Bernanke.

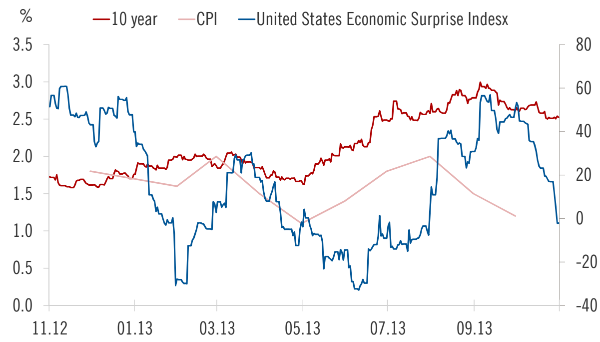
USA

SHORT-TERM RATES (USD)



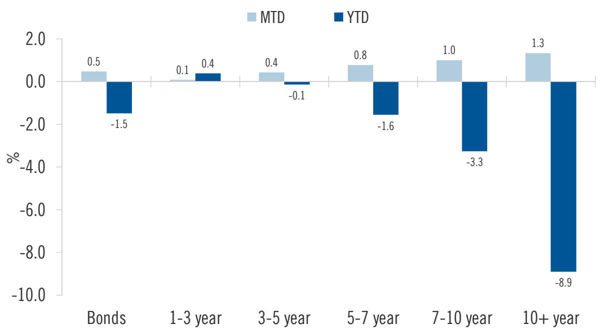
Source: Bloomberg, Money Market, USA

10-YR US TREASURY BOND YIELDS



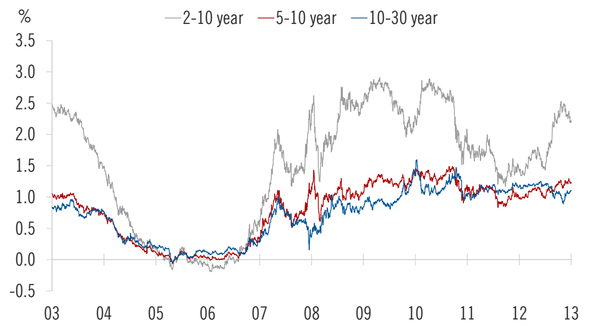
Source: Bloomberg, Citigroup, USA

RETURNS FROM GOVERNMENT BONDS BY MATURITY



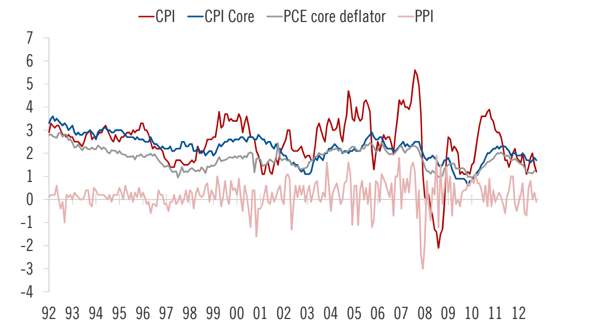
Source: Bloomberg, Citigroup, US Treasury

MOVEMENTS IN YIELD SPREADS



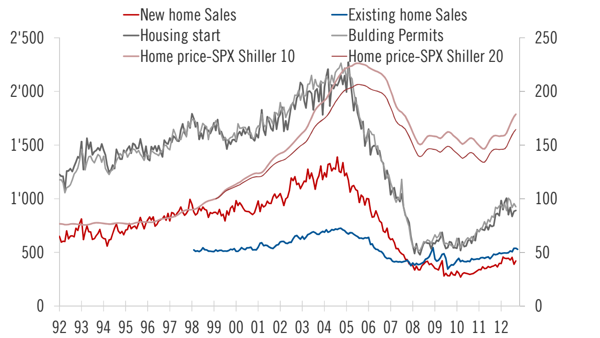
Source: Bloomberg, US Treasury

INFLATION



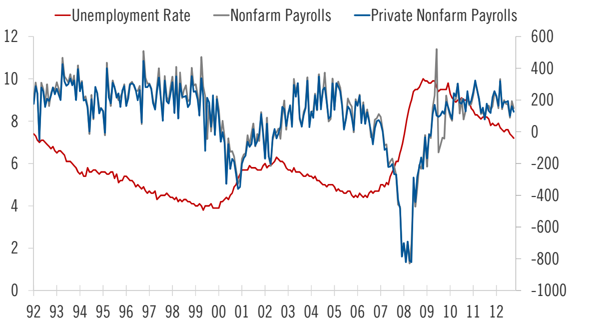
Source: Bloomberg, USA

HOUSING



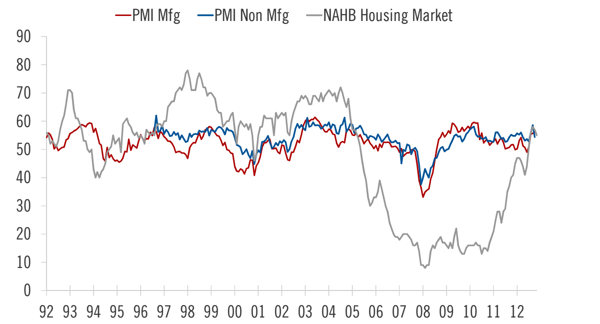
Source: Bloomberg, USA

LABOR MARKET



Source: Bloomberg, USA

PURCHASING MANAGER INDICES



Source: Bloomberg, USA

Doubts about the economic rebound persist

European bond yields drifted back down in response to signs of the US economy slackening in tempo and subdued inflation in Europe

The lack of any deal on a European banking union, talks in Germany aimed at stitching together a ruling coalition and a still brittle eurozone economy, handicapped by worryingly high joblessness and ever ballooning public debt, ensured the prevailing climate remained one of great uncertainty. This helped to push German Bund yields lower and caused the yield curve to flatten out. Peripheral eurozone markets held their form, benefiting from a dispelling of political fears in Italy and 0.1% GDP growth registered by Spain for Q3 after the Spanish economy had shrunk for nine quarters in a row. On top of that, the Madrid government also issued an upbeat forecast for 1.5% growth in the economy in 2014. Unemployment in the eurozone also retreated for the first time in two and a half years, with the jobless rate edging down from 12.1% to 12.0%. Nobody is getting overexcited though as job creation is still not spreading region-wide.

Although economists are still presuming the eurozone will pull out of recession, the relapse in eurozone PMIs in October and the fall in the Ifo business sentiment index for Germany suggested the forward momentum was diminishing this autumn. Pundits pointed out growth in Europe was most likely to remain lethargic for quite some time to come. For now, even though investors are relieved by the fact the eurozone economy officially emerged from the recessionary doldrums in Q2, they are still very guarded as regards the scenario of a full-blown recovery in the making.

Eurozone public debt still ballooning, now up to 93.4% of GDP

The ongoing increase brought back fears of public debt being likely to go on climbing worryingly in most peripheral eurozone nations over the next few years.

Although consumer prices did rise by 0.5% m-o-m in September, the headline y-o-y rate of inflation extended its downtrend, sinking to 1.1%, its lowest ebb since February 2010. The underlying rate also inched down, from 1.1% to 1.0%. This pattern of monthly inflation figures revived fears of deflation ahead.

ECB unveils methodology for its stress testing of banks, but EU governments have still not secured a deal on banking union

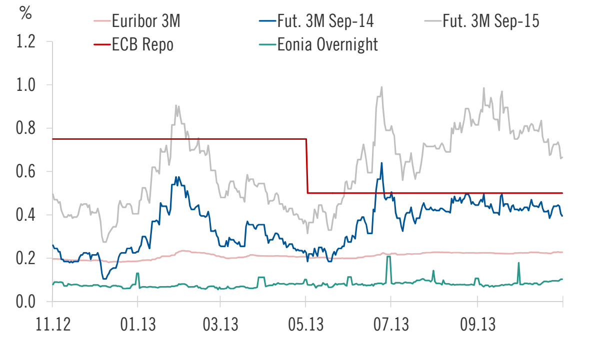
For the purpose of conducting its review of the quality of the balance sheets of the 128 banks which come under its supervision as from November 2014, the ECB has already painted the broad brush-strokes of capital requirements the banks will have to fulfil, the headline solvency buffer for banks being a common equity Tier 1 (CET1) ratio of 8%. It warned it would leave no stone unturned and would scrutinise banks' investment portfolios, especially their exposure to sovereign bonds, under a magnifying-glass. As for their loan books, it will be applying stricter criteria as it will classify any loans with arrears of more than 90 days as being bad and doubtful debt. If this threshold is applied, it could weigh heavily on some Spanish, Italian and Slovenian banks. The ECB's determination to assess the quality of European banks' balance sheets much more carefully, as this stress-testing exercise is supposed to reassure investors about their creditworthiness, might well turn out to be counter-productive if EU governments fail to come to any agreement on a banking union. There is a danger the ECB will bring to light capital shortcomings, which, with no EU-wide resolution mechanism in place to bail out or wind up troubled banks, it might not be possible to remedy. Each country would then be left individually to shoulder the burden of any of its failing banks.

The ECB opts for the status quo, pointing out it would employ any means available to it to keep the eurozone travelling down the road to recovery it regards as "weak", "uneven" and "fragile"

As we move towards the end of the year, the eurozone bond market should remain fairly range-bound until clarity over what is happening to the economy noticeably improves.

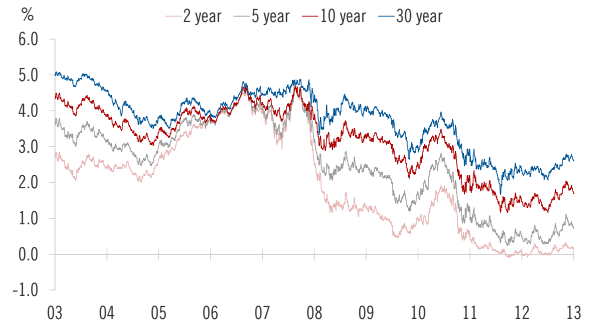
EUROZONE

SHORT-TERM RATES (EURO)



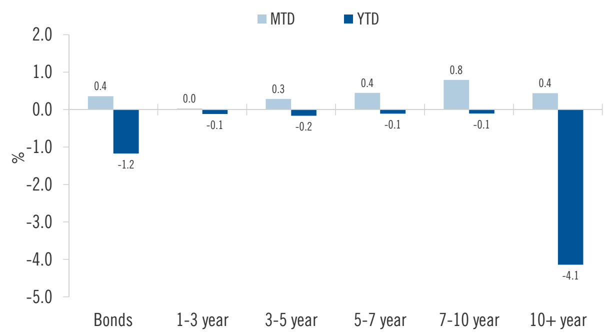
Source: Bloomberg, Money, EU

BUND YIELDS



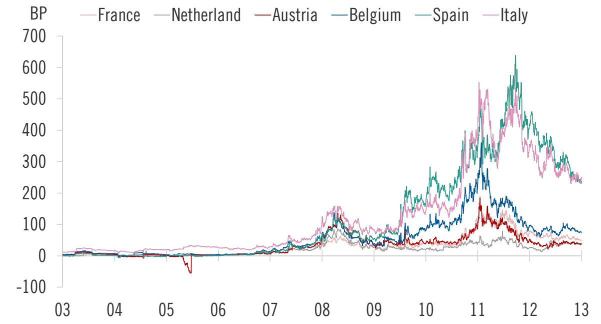
Source: Bloomberg, Bund

RETURNS BY MATURITY (BUND)



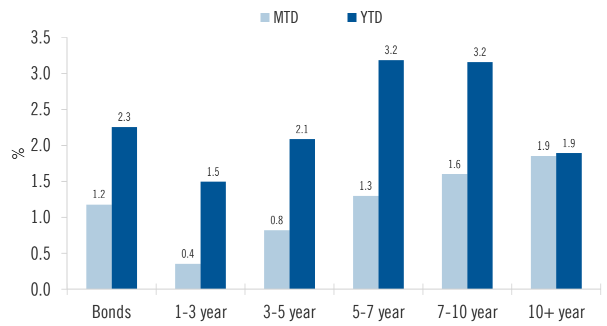
Source: Bloomberg, Citigroup, Germany Bund

10-YR GVT SPREADS VS GERMANY



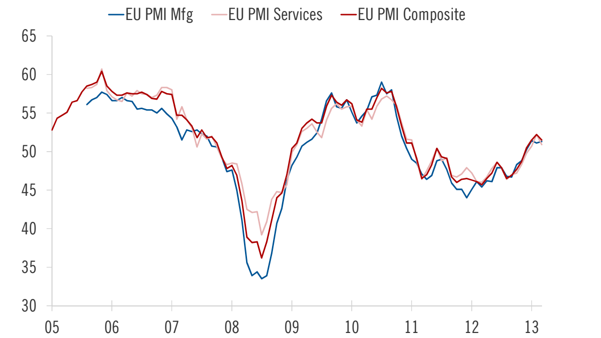
Source: Bloomberg, Govt yield spreads

RETURNS BY MATURITY (EMU GVT)



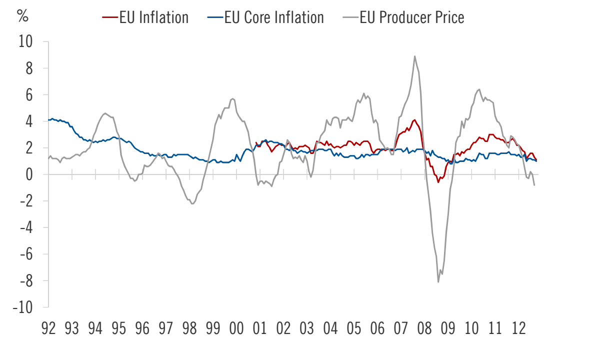
Source: Bloomberg, Citigroup, EMU Gvt Bonds

EUROZONE - PUCHASING MANAGER INDICES



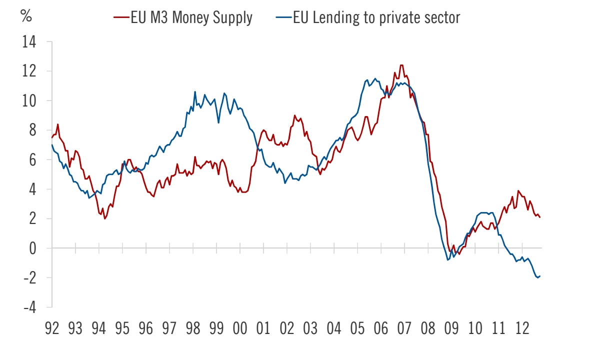
Source: Bloomberg, Eurozone PMI index

EUROZONE - INFLATION



Source: Bloomberg, Eurozone

EUROZONE - M3 AND LENDING TO PRIVATE SECTOR



Source: Bloomberg, Eurozone

Sound economic numbers

Both hard economic stats and findings from surveys confirmed the UK economy is on the recovery trail

PMIs did edge down a fraction in September, but it should be remembered they had bounced up quite high in August. They are still pitched at elevated levels: 56.7 for the Manufacturing PMI, 60.3 for the Services PMI and 58.9 for the Construction PMI. The property market is prospering too. Mortgage approvals are currently running at a 5-year high, construction spending rose for the fifth month in a row, house prices are still moving upwards and the index compiled by the Royal Institution of Chartered Surveyors from its monthly residential-market survey, regarded as a reliable measure for the sector, jumped in September from 41 to 54. This overall pattern fuelled fears of a property-market bubble being inflated. Retail sales advanced by 0.6% in September. The car market also posted its highest level since 2010, with new registrations climbing for the 19th month in a row and registering a 12.1% y-o-y increase. The UK economy expanded soundly in Q3 2013: GDP expanded by 0.8% q-o-q.

The upturn in the economy boosted tax receipts, which helped to improve the state of the budget deficit

According to the Office for National Statistics, the public-sector deficit this September was reduced to GBP11.1bn, excluding temporary support provided to the banking sector, a whole billion lower than in September 2012. The government is projecting a deficit for the current tax year equal to or less than GBP120bn or the equivalent of 7.5% of GDP, a figure from which cash transfers from the Royal Mail and the Bank of England have been stripped out. The running deficit for the first half of the tax year from April to September is GBP56.7bn, down by over 9% y-o-y. Tax revenues booked totalled GBP265.3bn, up from GBP237bn for the same six-month period a year earlier.

BoE's Monetary Policy Committee unanimously sticks with the status quo, but appears more upbeat about the state of Britain's economy

As expected, the Bank of England's Monetary Policy Committee (MPC) made no change to monetary policy at its early-October meeting. The base lending rate was left unchanged at 0.5% – it has been anchored there since March 2009 – and the asset-repurchase programme envelope remains fixed at GBP375bn. Minutes from the meeting indicated that the MPC noted unemployment was coming down a little faster than expected against the background of an economy expanding ahead of expectations.

This acknowledgement is unlikely, however, to persuade the BoE to shift its monetary stance in the short term. It is worth remembering the Bank of England (BoE) had unequivocally declared its pledge not to raise interest rates until the jobless rate had come down below the 7%-barrier. Nonetheless, if unemployment figures were to go on springing very positive surprises, the BoE might contemplate making a start on tightening monetary screws earlier than it had implied this summer. In August this year, it was of the opinion unemployment looked unlikely to drop that far before 2016.

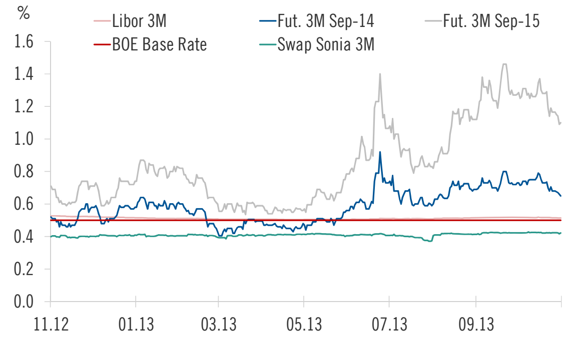
The BoE also noted that the pound had been firming in value, which will help to take some of the sting out of imported inflation, with overall inflation running consistently above its 2% target since end-2009. Consumer prices rose by 0.4% m-o-m in September, but the headline y-o-y rate was flat at 2.7% although the core inflation rate did moved up a little, quickening from 2.0% to 2.2%.

In spite of things looking rosier in the UK's economic garden, gilts yields drifted down in the slipstream of the decline in US T-bond yields

Although the base lending rate will remain glued to the floor until employment has expanded enough, the gilts market will continue to be influenced by evidence of how sustainable the recovery is.

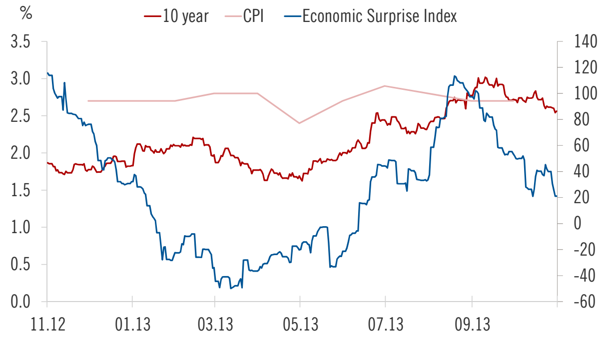
UK

SHORT-TERM RATES (GBP)



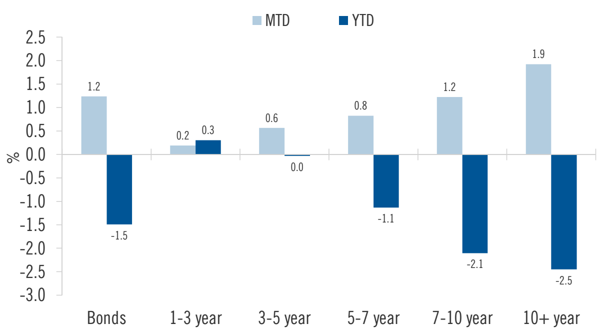
Source: Bloomberg, Money Market, UK

10-YEAR GILT YIELD



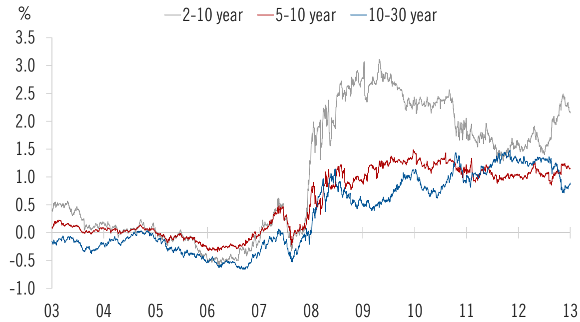
Source: Bloomberg, Citigroup, UK

RETURNS FROM GOVERNMENT BONDS BY MATURITY



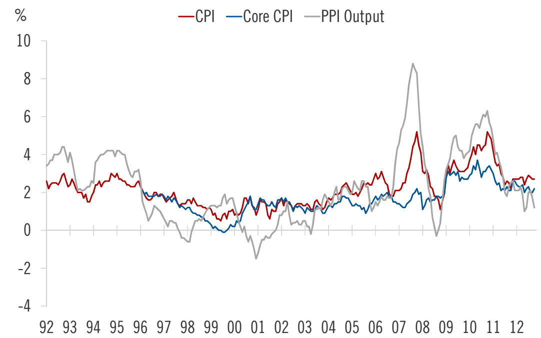
Source: Bloomberg, Citigroup, UK Treasury

MOVEMENTS IN YIELD SPREADS



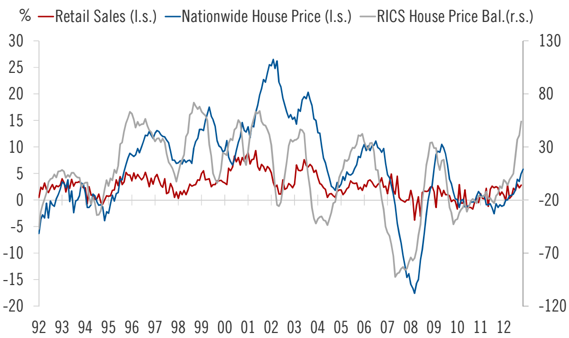
Source: Bloomberg, GILT

INFLATION



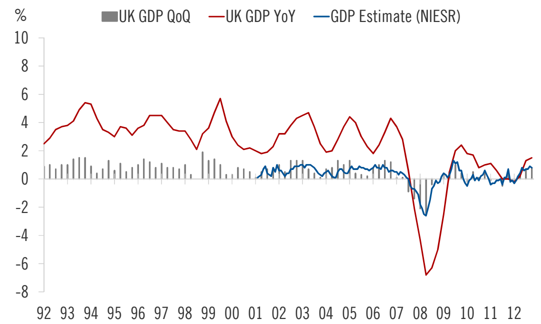
Source: Bloomberg, UK

HOUSING AND RETAIL SALES



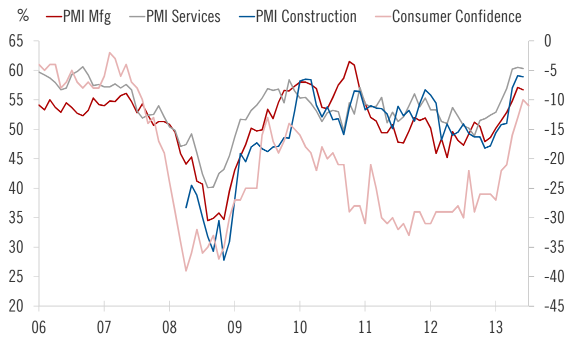
Source: Bloomberg, UK

GDP



Source: Bloomberg, UK

ECONOMIC SURVEYS



Source: Bloomberg, UK

Swiss franc benefiting from renewed uncertainties

The wrangling between Republicans and Democrats in the USA and signs of the US economy losing some engine power gave the Swiss franc a boost as it climbed in value against most currencies

The combination of uncertainties on both economic and political fronts in the coming months is likely to enhance the franc's appeal even though interest rates offered on the Swiss currency are so paltry. As wrangling in the USA between the parties over the budget and the Federal debt ceiling will be ongoing and as economic growth will be dented by the shutdown, the Fed looks most unlikely to start tapering QE in the coming months. Considering this outlook, the dollar's value could well remain under pressure. As for Europe, the lack of any deal on a banking union, talks in Germany aimed at stitching together a ruling coalition and a still brittle eurozone economy, handicapped by worryingly high joblessness and ever ballooning public debt, do not suggest the euro will be heading for a rebound in value against the franc. Some valuation models are suggesting the franc's value is slowly, but surely, edging back towards its equilibrium value. As the weeks roll by, it will begin to look less and less overvalued at a time when the situation worldwide is likely to remain blanketed under clouds of uncertainty.

The franc's firmness means Swiss interest rates have remained pegged to the floor in spite of a soaring property market and sturdy resilience being shown by Switzerland's economy where GDP rose by 0.5% q-o-q in Q2 2013, pushing the y-o-y rate to 2.1%.

As uncertainties internationally are set to persist in the coming months, the Swiss National Bank (SNB) will remain very vigilant as prospects for the Swiss economy still look quite bright even though exports are proving fairly slow in recovering. They grew by a sedate 0.4% over the first nine months this year. On the plus side, findings from economic and business surveys continue to provide encouraging reading. The Manufacturing PMI progressed by 0.7 of a point to 55.3 in September. KOF's Economic Barometer moved even higher in October, up by 0.18 to 1.72, which signalled a quickening in the uptrend that has been holding sway since April. Looking ahead to 2014, most economic forecasters are projecting GDP growth of around 2%, twice the rate being predicted for the eurozone.

SNB still, for now, resolutely defending its targeted exchange-rate limit of 1.20 francs to the euro

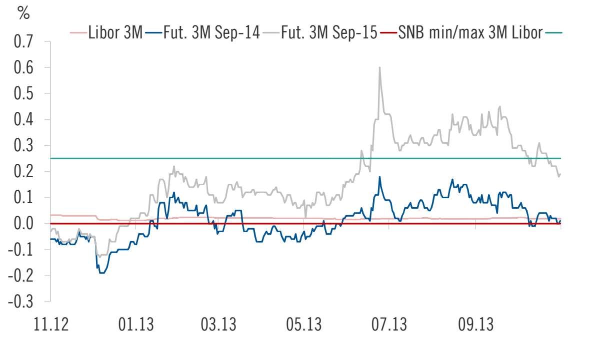
Even though the Swiss economy is progressing hearteningly, the SNB kept its target range for the benchmark 3-month LIBOR at 0.0%-0.25%. It also reiterated its resolve to continue defending the upper limit for the euro's exchange rate against the franc. It still regards the franc's value as high and, if it were to firm any more, it could compromise both price stability and economic growth in Switzerland. Non-existent inflation has enabled the SNB to keep its official rates close to zero, but the slippage in the dollar's value has already rekindled the debate about the size of the SNB's foreign-currency reserves. As for inflation, the SNB is forecasting an annual rate of 0.2% for 2014 and 0.7% in 2015.

Yields on Swiss bonds drifted lower in response to the franc's strength and falling government yields in both the USA and Germany

Although the Swiss economy has been performing solidly, Confederation bond yields look set to remain at rock-bottom in the months ahead. Both the Fed and the ECB persevering with their accommodating monetary stances, and US growth likely to flag somewhat in the latter stages of this year seem likely to work to the advantage of those bond markets that had undergone a severe correction in the aftermath of the prospect surfacing of an imminent scaling-back of the Fed's purchases of US T-bonds. Zero inflation in Switzerland and official SNB interest rates close to zero should help to keep Confederation bond yields on a fairly even keel.

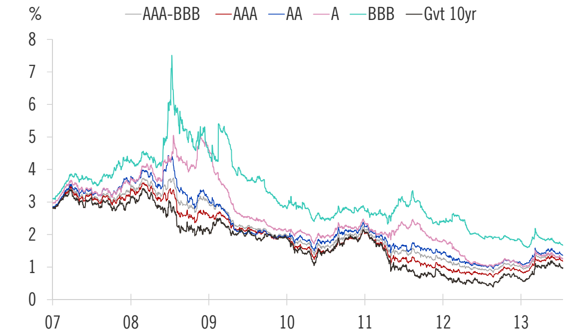
SWITZERLAND

SHORT-TERM RATES (CHF)



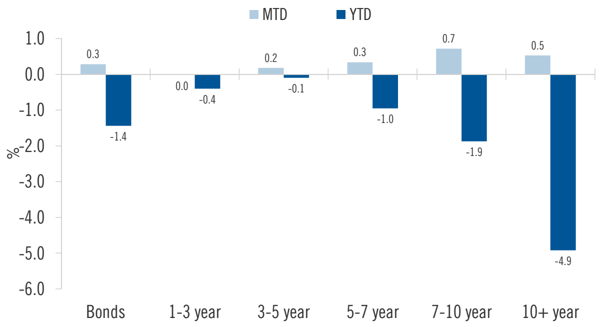
Source: Bloomberg, Money Market, CHF

CHF BOND YIELDS



Source: Bloomberg, Swiss Bonds yields

RETURNS FROM GOVERNMENT BONDS BY MATURITY

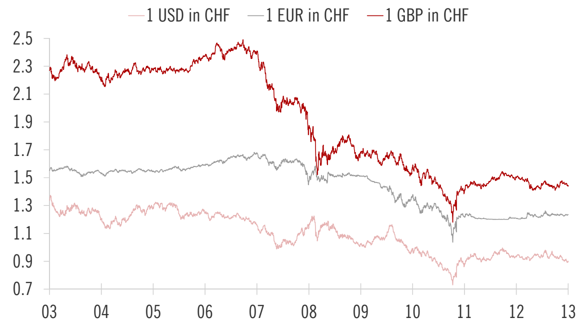


Source: Bloomberg, Citigroup, Switzerland Gvt Bonds

CONFEDERATION - MOVEMENTS IN YIELD SPREADS

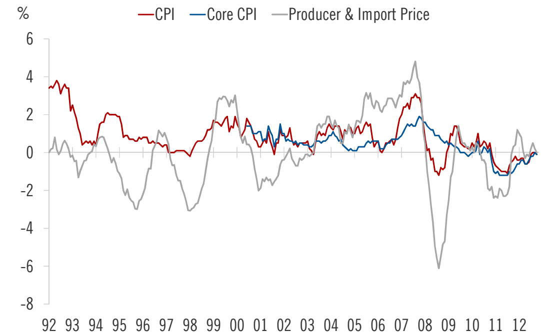
Source: Bloomberg, Confederation

SWISS FRANC EXCHANGE RATE



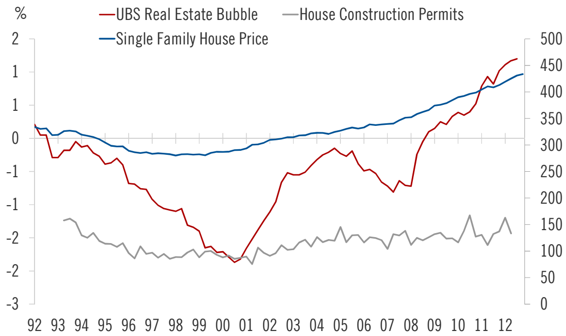
Source: Bloomberg, exchange rates

INFLATION



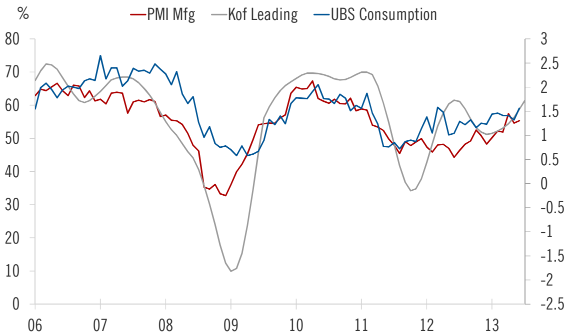
Source: Bloomberg, Switzerland

HOUSING MARKET



Source: Bloomberg, Switzerland

ECONOMIC SURVEYS



Source: Bloomberg, Switzerland

JAPAN

Government signs and seals the hike in consumer sales tax rate

On the back of an encouraging Tankan report, Japan's Prime Minister confirmed the forthcoming hike in the rate of consumer sales tax

According to the Bank of Japan's latest quarterly *Tankan* survey, the confidence barometer for the country's largest manufacturers has not registered such an optimistic reading for half a dozen years. This revival in business confidence, coupled with a string of numbers suggesting Japan's economy has at long last shrugged off its lethargy, encouraged Prime Minister Shinzo Abe to press ahead with his policy of hiking the rate on the consumer sales tax – this will go up from 5% to 8% as of 1st April 2014.

The purposes behind this audacious decision, much castigated by some, is to reduce Japan's chronic budget deficit, but it will create some risks for the economic recovery, especially consumer spending. A glance back to 1997 shows that the government, struggling with a similar issue of escalating public finances, had decided to lift the consumer sales tax rate from 3% to 5%. Shortly afterwards, domestic demand plummeted and economic growth spluttered. Japan's authorities, in their attempts to provide some reassurance, have indicated that, although the economy was indeed penalised by the tax rate hike in 1997, it was more seriously damaged by the Asian financial crisis that flared up just a few months later.

As things stand today, the government is of the opinion that the extra support underpinning demand should help to offset any slide in consumer spending. To this end, the Prime Minister announced a new budget stimulus package worth JPY5,000bn (CHF46bn), plus a raft of structural reforms geared towards boosting the country's growth potential. The hike in consumer sales tax should see an extra JPY8,000bn a year flowing into public coffers. The rise in the consumer sales tax rate is the boldest step taken by Japan's authorities since 1997 in their drive to cut public debt – already topping a staggering 240% of GDP, the highest ratio among major industrialised nations – and prune the budget deficit, over half of which is funded through new government bonds.

The hike in the consumer sales tax rate should help to put public finances back onto a sturdier footing, but not without posing some risks for the economy

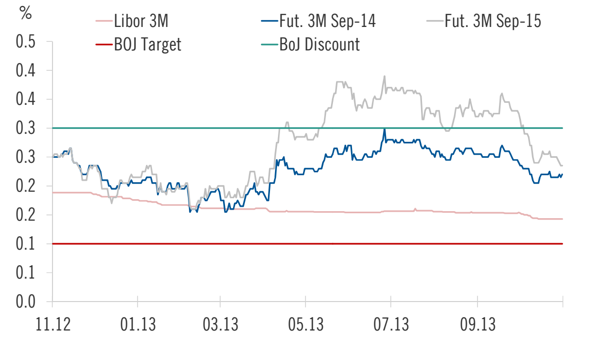
Japan's GDP posted 0.9% q-o-q growth in Q2 2013. Consumer prices also edged upwards, but this inflation is somewhat of an illusion involving smoke and mirrors. Consumer prices, with perishable goods stripped out, rose by 1.1% y-o-y, driven up by higher electricity and petrol prices. This does not necessarily mean Japan has shaken off the deflationary doldrums though as prices of manufactured goods and consumer products have continued to fall. Tightening of fiscal screws is a worry as, even though consumer spending bounced back strongly in September, it has been tracking an up-and-down pattern in recent months as households struggle to balance flat income with rises in energy prices. Households' consumer spending had slumped by 1.6% y-o-y in August, pushed down by a plummet in car sales and purchases of electronic goods. In September though, it bounced back by 3.7%. Unemployment is still particularly low although it has edged up a little from its August low-point.

Yields on Japanese government bonds extending their downtrend since early summer

The Governor of the Bank of Japan (BoJ) is of the view the hike in the consumer sales tax rate should not unduly punish the economy. Moreover, if needed, the BoJ is fully prepared to step in with new measures. Over the next few months, we expect JGBs to continue being underpinned by the BoJ's wholesale purchases. Yields seem likely to remain fairly range-bound. Confirmation that the Japanese economy is recovering sustainably, matched by deflation being genuinely vanquished, will be needed to bring about any significant shift.

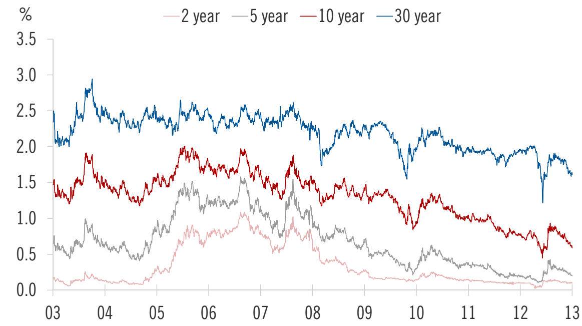
JAPAN

SHORT-TERM RATES (YEN)



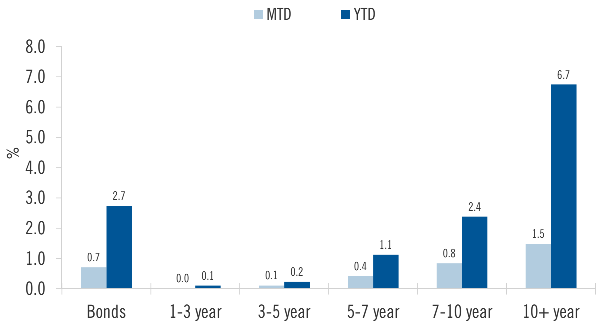
Source: Bloomberg, Money Market, Japan

JAPANESE GOVERNMENT BOND YIELDS



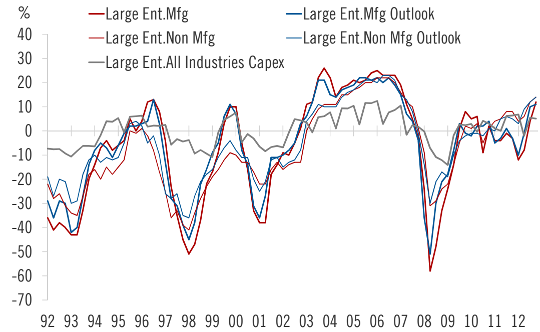
Source: Bloomberg, JGB

RETURNS FROM GOVERNMENT BONDS BY MATURITY



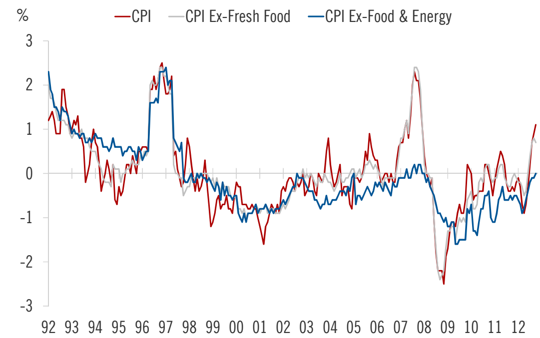
Source: Bloomberg, Citigroup, Japan Gvt Bonds

BOJ - TANKAN



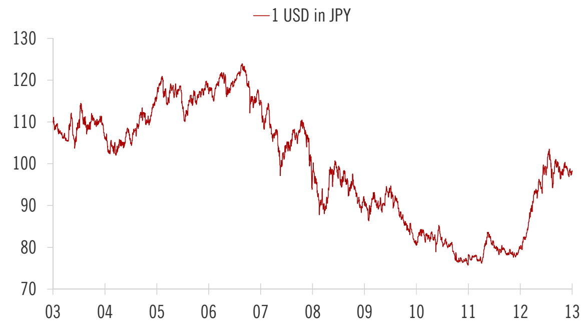
Source: Bloomberg, Japan

INFLATION



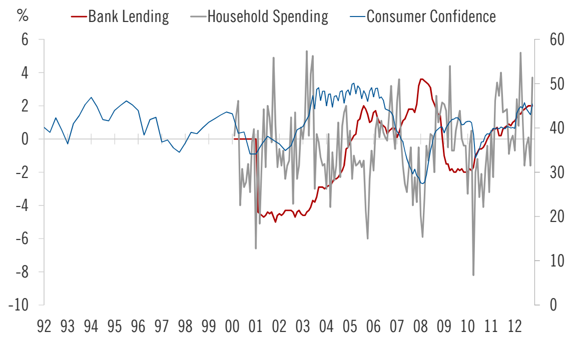
Source: Bloomberg, Japan

JAPANESE YEN VERSUS DOLLAR



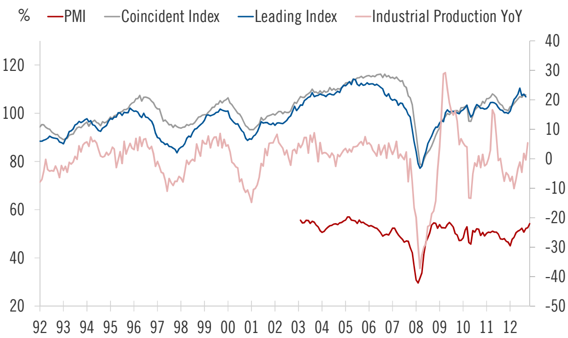
Source: Bloomberg, exchange rates

CONSUMPTION



Source: Bloomberg, Japan

LEADING INDICATOR AND INDUSTRIAL PRODUCTION



Source: Bloomberg, Japan

Pictet Asset Management
Route des Acacias 60
1211 Geneva 73
Switzerland

www.pictet.com

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