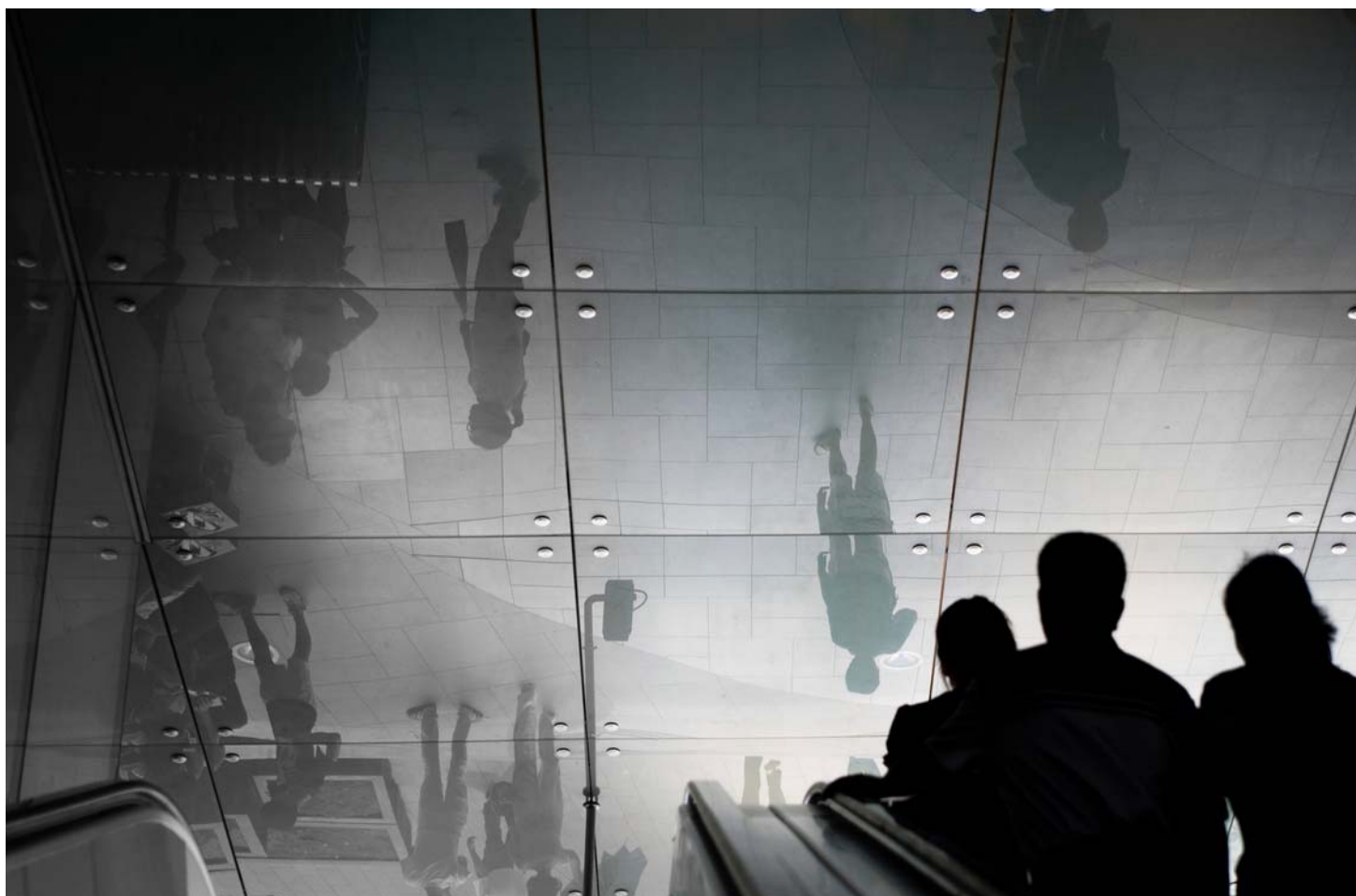


Monthly Bond Letter

July 2013

Pictet Asset Management



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Recent developments

Financial markets reacted violently to the prospect of the Fed tapering its quantitative-easing programme

A resurgence in concerns about the liquidity taps being turned off by the Fed triggered a correction on government bond markets and a widespread groundswell of aversion to risk. There was a significant sell-off of risk assets that had benefited so handsomely from the Fed's quantitative-easing programmes. Equities, corporate bonds and, above all, emerging-market debt all tumbled in June, with returns plunging deep into the red.

An end to cheap and plentiful liquidity looks to have been confirmed

The message coming out of the recent Federal Open Market Committee (FOMC) meeting confirmed the broad hints given by Fed Chairman Bernanke in his testimony on 22 May to Congress. The programme of buying USD85bn of bonds a month under QE3 is likely to be gradually scaled down between Q4 2013 and Q2 2014. This decision is warranted on the grounds of the Fed's increased confidence in the economic outlook, reflected in its slight upgrading of growth forecasts and downward revision of the jobless rate for 2014 and 2015. The Fed did not appear to deem it necessary to allow for momentum on inflation running well below the Fed's comfort zone as this is regarded as a temporary movement. Moreover, many economists are

increasingly convinced the slowdown in the US economy that can be blamed on the constraints of sequestration will be transitory. Against this backdrop, 10-year US Treasury bond yields bounced up to 2.66%.

In Europe, economic indicators have made more encouraging reading, but unemployment still hit a new record high of 12.2%

Against a background of hopes of the eurozone emerging from recession in the latter half of this year, fears of the Fed reining back QE3 and the turbulence on Japan's bond market, 10-year Bund yields went from 1.16% to 1.81% in the space of a few weeks and spreads on peripheral member states' sovereign debt widened by between 50bp and 80bp.

The Bank of Japan reported an upturn in the state of the economy and made no shift in its monetary stance

The monetary and fiscal policy mix being implemented by the new government and the Bank of Japan has helped GDP to rebound, with the economy posting 1.0% growth in Q1 2013 and deflation levelling out somewhat. With the IMF urging Japan to push through structural reforms, measures announced by Prime Minister Shinzo Abe in early June proved rather disappointing owing to a lack of any far-reaching reforms, especially for the labour market. It would appear he is keen to defer such politically awkward decisions until elections to the Upper

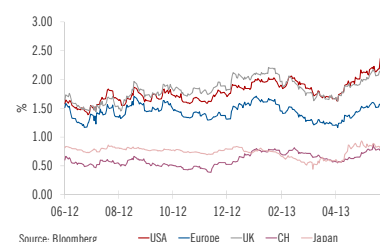
House of the Diet on 21 July are out of the way. He has already highlighted his intent to announce this autumn a second wave of strategic measures.

Just like other risky asset classes, European corporate bonds have been hard hit

Monthly returns deep into the red in June wiped out gains made during the first five months of the year. News from the Fed, fears of economic slowdown and liquidity problems in Asia resulted in a steep rise in risk premiums. Performance was also dented by poor trading liquidity and widening bid/ask spreads as banks struggled somewhat to cope with the selling flows owing to their downsized balance sheets. Emerging-market debt extended its downtrend.

Popular unrest in Turkey and Brazil continued to rattle confidence. The economic slowdown in China was confirmed by trade figures that fell short of expectations in May, and spikes in the interbank rate spawned a fresh threat to growth. Local-currency and dollar-denominated emerging-market debt fell steeply in June.

10-YEAR GOVERNMENT YIELDS



OVERVIEW

Forecasts

Numbers released for the USA would appear to back up the scenario of a return to increasingly self-sustaining growth

Upturns on the housing market, in unemployment and in lending to the private sector are giving weight to the argument of self-sustaining growth taking root. Moreover, the budget deficit is being reduced faster than predicted thanks to higher tax revenues than projected. On the downside, too early and too steep a rebound in interest rates could heighten the risk of a relapse.

With volatility on the increase again, investors are likely to remain nervy and will be keeping very close eyes on forthcoming economic statistics, especially jobs numbers. If the news flow on the economy is good, the bond market is likely to stay under pressure. Over the summer weeks, we expect yields on 10-year US T-bonds to hover in a trading range between 2% and 3%. Inflation running below the level being targeted by the Fed remains a key factor supporting the market though.

In Europe, the ECB is looking for things to pick up gradually between now and the year-end

Findings from economic and business surveys suggest the eurozone economy may have weathered the storm and might embark on its recovery phase soon. Nevertheless, the balance is still finely poised. Turns of events in Cyprus, Greece and other under-pressure eurozone

member states are always at risk of fuelling fresh bouts of turbulence in the region.

An uneasy calm has redescended in the eurozone as the reduction in some countries' potential GDP, which downsizes the fiscal base, might well undermine authorities' drives to redress public-sector finances and rekindle sovereign-debt risk. The process of raising rates might also cause a few upheavals.

The ECB has not announced any tangible measures to boost lending to small businesses and households, particularly in peripheral member states which are still struggling with financial difficulties. It has not, however, ruled out the possibility of pushing the rate on its overnight deposit facility, currently at 0%, into negative territory to encourage banks to lend more. Only if the economy fails to pick up or if inflation were to continue decelerating is the ECB likely to adopt fresh measures.

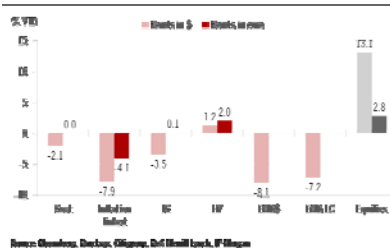
We expect yields on 10-year Bunds to level out, hovering in a trading band between 1.50% and 2.10%. Bond markets round the periphery can be expected to remain volatile, moving up and down in response to both economic and political news.

Corporates and emerging-debt markets remain exposed to the risk of the streams of liquidity drying up

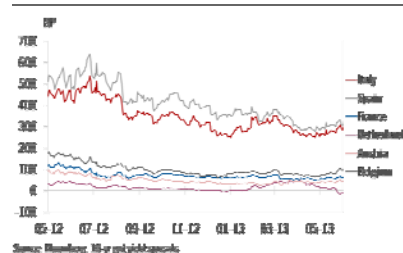
The era of hunting for yield at all costs to make up for interest rates being too low, encouraged by central banks and their ultra-accommodating monetary stances, has probably run its course. Investors are now having to make allowance for the possible prospect of quantitative easing being wound down, at least in the USA.

Although a rebound in interest rates and a widening of credit spreads and risk premiums will provide a higher-return entry-point in the corporates market, investors will need to err on the side of caution in the coming weeks owing to the danger of fire-sales and/or increased tensions at a time when market liquidity is quite tight. A fundamentals-based approach to choosing bonds and borrowers should become increasingly important on technical grounds.

PERFORMANCES 2013



10-YR GVT SPREADS VS GERMANY



Storm blowing up on real rates: normalisation kicking in or a knee-jerk reaction?

Fed hinting at QE coming to an end

The message coming out of the recent Federal Open Market Committee (FOMC) meeting confirmed the broad hints given by Fed Chairman Bernanke in his testimony on 22 May to Congress. The programme of buying USD85bn of bonds a month under QE3 is likely to be gradually scaled down between Q4 2013 and Q2 2014. This decision is warranted on the grounds of the Fed's increased confidence in the economic outlook, reflected in its slight upgrading of growth forecasts and downward revision of the jobless rate for 2014 and 2015. The Fed did not appear to deem it necessary to allow for momentum on inflation running well below the Fed's comfort zone as this is regarded as a temporary movement.

To understand more clearly the logic underpinning this programmed winding-down of QE3, it is instructive to look back at the reasons why it was put in place to start with. Although the forerunner quantitative-easing programmes (QE1 in December 2008, QE2 in November 2010 and Operation Twist in September 2011) were all instigated to redress market dislocations or counteract mounting deflationary expectations, that was not the case for QE3. The roots of the bond-buying programme lie in the need to counterbalance wide-ranging fiscal-policy readjustment measures instituted by the US government to redress public finances, following on from similar deleveraging undertaken by both households and business. In September 2012 when QE3 was launched, the USA's budget deficit was running at 7% of GDP, but the aim was to bring it down to around 4% by end-2013. A percentage of that order aligns precisely with the moment when the debt/GDP ratio stabilises as it matches the rate of nominal growth in the US economy. The budget deficit overshoot above that threshold, i.e. the 3% of GDP at the time of QE3's launch, corresponds exactly to the issuance each month of USD40bn worth of government debt, i.e. the monthly volume of US Treasuries bought up by the Fed. The prospect of the flow of new US government debt being issued by end-2013 drying up as the fiscal target is reached would warrant the Fed's bond-buying being reined in.

Does the halt to quantitative easing signal the onset of a monetary-tightening cycle?

The Fed's statements sparked a major correction on bond markets across the board, with real rates climbing more steeply than nominal rates. Real 10-year rates climbed from their lowest points of -0.8% to +0.6%, with real 30-year rates moving up from 0.2% to 1.5%. However, QE cannot be summed up solely by the mechanics of liquidity flows. As Fed Chairman Bernanke stated, halting bond-buying equates to the end of the extra degree of monetary easing, not a sea-change in the

direction of monetary policy. On this score, he highlighted the size of the stock of bonds amassed on the Fed's books. The timeline should run as follows: the end to QE3 should be followed by a lull, then a running-down of surplus reserves in the banking system (almost USD1,000bn) before any move is made to put up the Fed funds rate. Mopping up all the surplus reserves (or draining off excess liquidity) can be done in several different ways. The nervous reaction on real rates suggests markets are not only pricing in a halt to the bond-buying, but also a phase of liquidity being mopped up through the Fed selling off its accumulated positions in bonds.

Although the Fed did state clearly it would not be selling the mortgage-backed securities on its balance sheet, it omitted to provide the same clarification about the fate of its US Treasuries. The most likely scenario, however, is probably one involving no sales, with excess liquidity being soaked up via term deposits made by the central bank or reverse repo transactions with the Fed lending securities on its balance sheet in exchange for cash. This exit strategy should see real interest rates gradually reverting to more normal levels. Their current levels have overshoot as a result of factoring in, in the space of almost a month, much of the route mapped out by the Fed for the next three years.

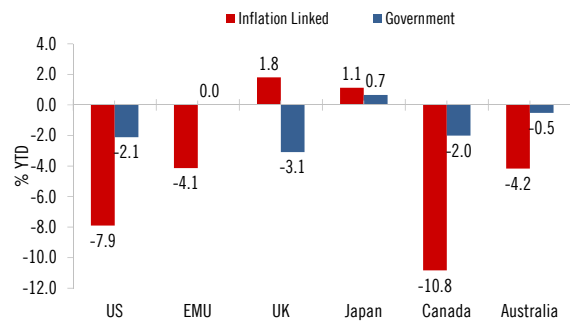
Which scenario will the pricing of inflation-linked bonds go for?

With real rates rising much more steeply than nominal rates, this implies inflation break-even levels have slumped. For the 10-to-30-year segment, the decline has been greater than 50bp, reflecting a toning-down of expectations about long-term inflation. The 5-year 5-year forward inflation measure, one of the Fed's preferred indicators, dropped from 2.8% to 2.3%. When this barometer moves close to the 2%-mark, the Fed begins to be concerned that expectations for inflation being pitched so low tends to prompt consumers to alter their spending habits. The last three times the indicator fell to this level triggered the instigation of QE1, QE2 and Operation Twist. If the correction seen on bond markets were to continue tracking the same pattern, it would very quickly enter uncomfortable territory for the Fed. Moreover, the yield curve is currently factoring in an initial hike in the Fed funds rate in November 2014, well before the Fed's provisional timetable suggests.

Current pricing levels are already consistent with the most upbeat scenarios for growth and employment in the Fed's forecasting ranges, but, paradoxically, the process of bond yields being forcibly and hastily readjusted could cast a worrying cloud over this prospect. On this score, inflation-linked bonds have again begun to look attractive for both their real and inflation elements.

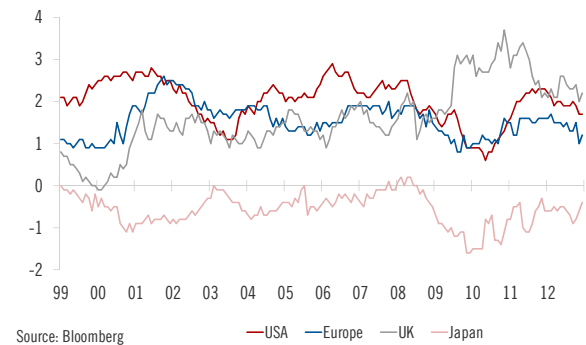
INFLATION-LINKED BONDS

PERFORMANCES 2013 (LOCAL CURRENCIES)



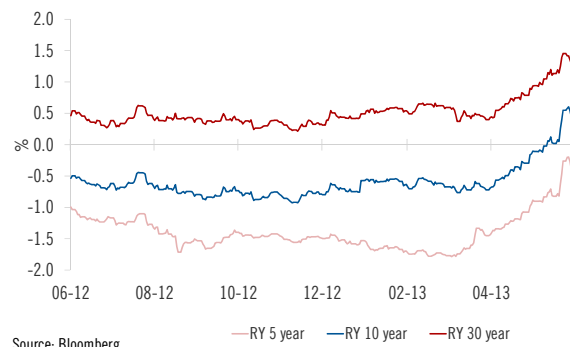
Source: Bloomberg, Citigroup, Barclays

CORE INFLATION



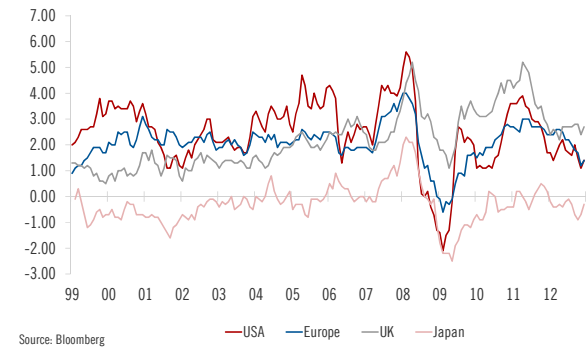
Source: Bloomberg

USA - REAL RATES



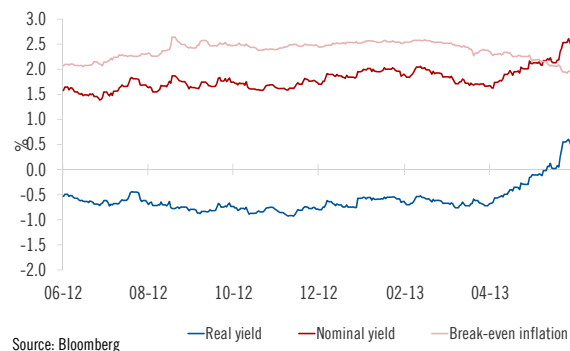
Source: Bloomberg

INFLATION



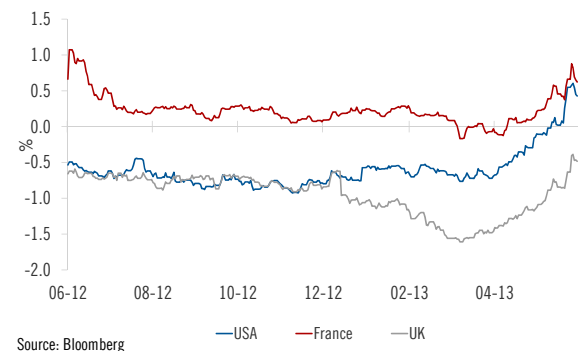
Source: Bloomberg

USA - 10-YEAR TREASURY YIELD COMPONENT



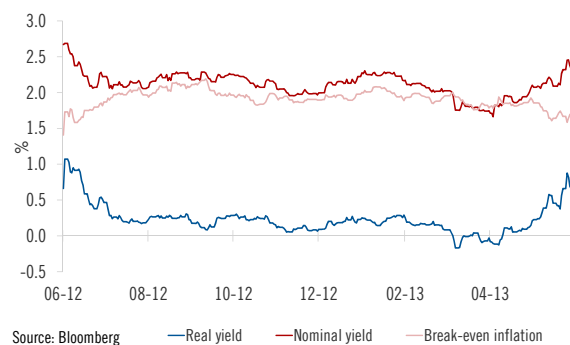
Source: Bloomberg

10-YEAR REAL YIELDS



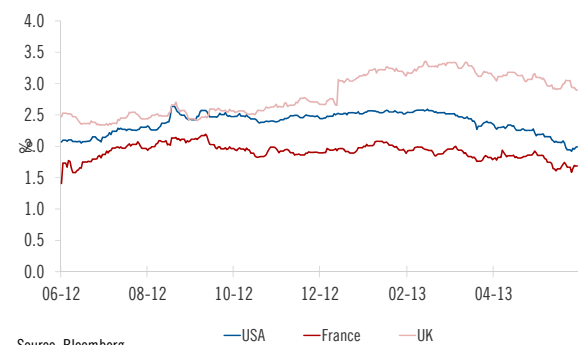
Source: Bloomberg

FRANCE - 10-YEAR YIELD COMPONENT



Source: Bloomberg

10-YEAR BREAK-EVEN INFLATION POINTS



Source: Bloomberg

Investment-grade corporates could not avoid the correction

Returns for the year to date from investment-grade corporates slid into the red

Just like other risk-based asset classes, European investment-grade corporate bonds were hard hit, notching up very negative returns in June which wiped out all gains made over the first five months of the year. News from the Fed about a possible shift in its monetary policy, fears of economic slowdown and liquidity problems in Asia resulted in a steep rise in risk premiums and spreads. However, although corporate bonds underperformed German Bunds, the rise in Bund yields can be held accountable for roughly two thirds of the negative return recorded for June. Performance was also dented by poor trading liquidity and widening bid/ask spreads as banks struggled somewhat to cope with the selling flows owing to their downsized balance sheets.

The worst-performing sectors were telecoms, mining & metals and non-financial companies' hybrid debt. Lower Tier 2 bank debt also underperformed, especially paper issued by UK banks like RBS, Nationwide and Barclays. The smallest negative returns came from the pharmaceutical, media and automotive sectors. The worst returns were registered by Italian and Spanish borrowers as well as issuers from emerging countries, like Votorantim or Vale, or those with extensive exposures to emerging economies like Standard Chartered.

Primary market drying up

The number of new bonds being issued slowed to a trickle in June. Only borrowers with better credit ratings were active, like Air Liquide, Paccar, Auchan or Rolls Royce, issuing bonds with maturities between 3 and 10 years. With interest rates climbing and volatility mounting, some companies postponed or cancelled plans to issue bonds. In the hybrid debt segment, the Italian group Enel pulled its launch. With no pressing need for refinancing, no banks came to the market to raise funds.

Developments on the banking union front

When it comes to the proposed banking union for the eurozone, most countries were in favour of preference being accorded to savers and depositors over creditors. After a spate of failures, the latest meeting of Finance Ministers did cobble together a deal confirming the priority accorded to a bail-in, but still leaving enough flexibility for governments to bail out a bank. The agreement also gave latitude to the ESM to pump capital into failing banks. The new legislation will not come into effect before 2018 though.

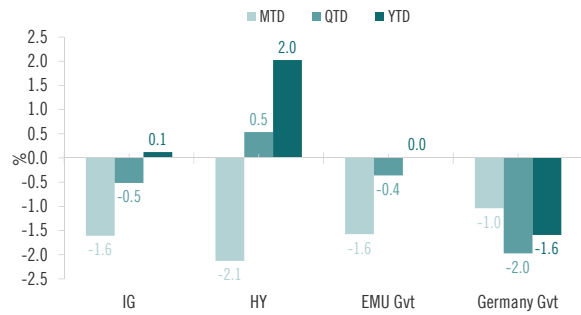
As far as banks' solidity is concerned, UK and Swiss regulatory authorities will now take the leverage ratio, i.e. measured as capital as a proportion of total assets, into account along with the conventional Core Tier 1 capital ratio based on risk-calculation models. A minimum leverage ratio of 3% is considered to be acceptable, but several banks, including Barclays, Nationwide, UBS and Credit Suisse, are still short of this threshold and must come up with plans to ensure they comply with this rule.

Outlook

The era of hunting for yield at all costs to make up for interest rates being too low, encouraged by central banks and their ultra-accommodating monetary stances, has probably run its course. Investors are now having to make allowance for the possible prospect of quantitative easing being wound down, at least in the USA. Although a rebound in interest rates and a widening of credit spreads and risk premiums will provide a higher-return entry-point in the corporates market, investors will need to err on the side of caution in the coming weeks owing to the danger of fire-sales and/or increased tensions at a time when market liquidity is quite tight. A fundamentals-based approach to choosing bonds and borrowers should become increasingly important on technical grounds.

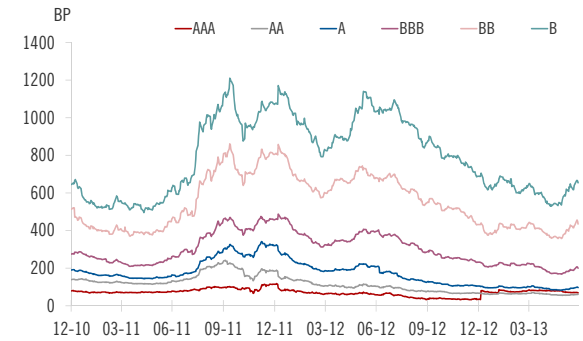
CREDIT RISK

RETURNS ON BONDS IN EURO



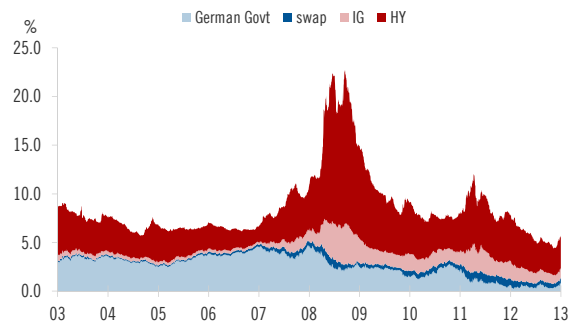
Source: Bloomberg, BoA Merrill Lynch, Citigroup

CREDIT SPREADS (EURO)



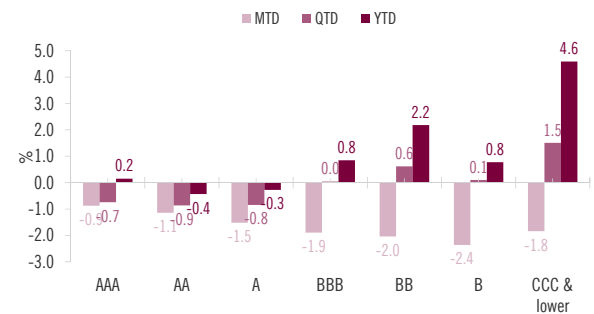
Source: Bloomberg, BoA Merrill Lynch

YIELD COMPONENT (EURO)



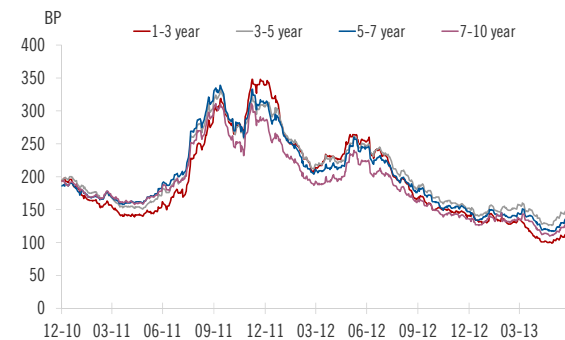
Source: Bloomberg, Barclays

RETURNS ON BONDS IN EURO



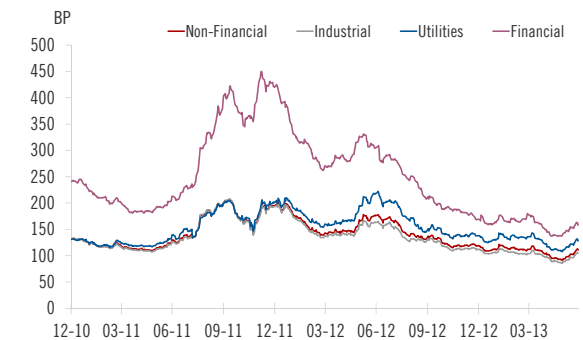
Source: Bloomberg, BoA Merrill Lynch

INVESTMENT GRADE SPREADS BY MATURITY (EURO)



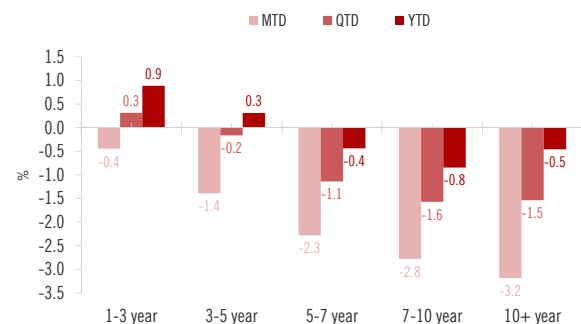
Source: Bloomberg - BoA Merrill Lynch

INVESTMENT GRADE SPREADS BY SECTOR (EURO)



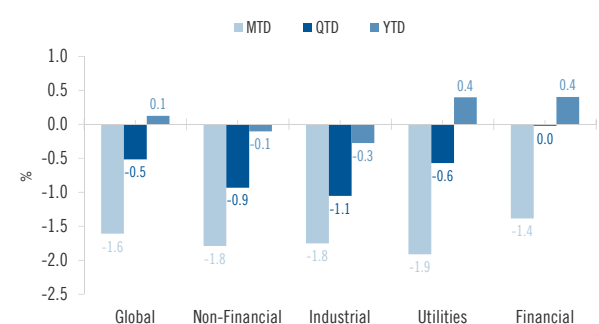
Source: Bloomberg - BoA Merrill Lynch

INVESTMENT GRADE RETURNS BY MATURITY (EURO)



Source: Bloomberg, BoA Merrill Lynch

INVESTMENT GRADE RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merrill Lynch

Eurozone high-yield corporates down across the board

Recent developments

European high-yield corporate bonds retreated in June. After several months of benign markets awash with liquidity and dominated by the search for yield, concerns over a QE exit indiscriminately hurt government bonds and risky assets. Since 22 May, the market has remained spell-bound by comments made by the Fed Chairman. The FOMC meeting held on 19 June confirmed that tapering of QE is in sight as the Fed delivered an optimistic economic outlook. In addition, Mr Bernanke stated that the Fed may “*moderate the monthly pace of purchases later this year*” and clearly indicated a definitive halt to the QE when unemployment is “*in the vicinity of 7%*”. The comments triggered a global sell-off. US Treasuries collapsed. The 10-year yield broke the 2.5% level, last seen in August 2011. Emerging markets continued their slide. In Turkey and Brazil, social unrest further rattled confidence. China proved not immune from the emerging-market slump as the slowdown was confirmed after May trade data trailed estimates and spikes in the Chinese interbank rate posed a new risk to growth. In Europe, despite some economic improvements in peripheral countries, Spanish and Italian yields widened relative to German Bunds as current market tremors spread far and wide. On 22 June, European Finance Ministers failed to agree on a standard ‘bail-in’ procedure amid bickering over the contribution from depositors.

In this context, the European high-yield market retreated, all sectors being weak. The short-term high-yield segment posted limited losses as it proved more resilient and less volatile. In terms of country allocation, UK issuers underperformed relative to eurozone issuers on the back of more aggressive correction on gilt yields, combined with the traditionally longer duration of this market. Eastern European issuers finished the month in negative territory as they were hit by the sell-off in emerging markets. Sector-wise, the most cyclical issuers unsurprisingly lagged behind the rest of the market, but the auto sector managed to limit its losses. As for financials, senior debt lost ground as it proved more exposed to the general rise in interest rates.

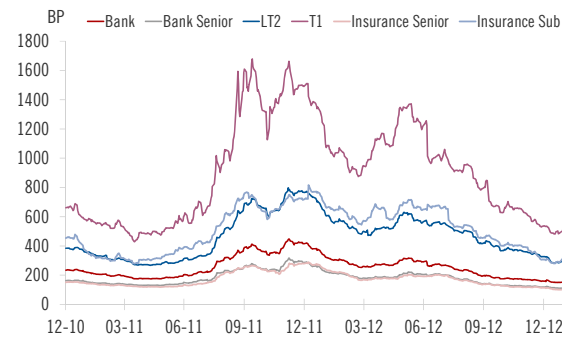
In June, the primary market closed as ‘risk-off’ sentiment predominated. US high-yield bond funds experienced significant outflows, mostly triggered by retail investors, as did, to a lesser extent, global high-yield funds. Some hedge funds were also reportedly liquidating positions across all markets. On the issuers’ side, the earning seasons came to an end. Some corporates proved weaker, such as Codere, the Spanish gaming company facing near-term restructuring risks, and Magyar Telekom, the largest Hungarian telecommunication company. New World Resources, the Eastern European coal producer, performed poorly, too. On a brighter note, Kabel Deutschland accepted an offer from Vodafone after being wooed by Liberty, the US-based cable multinational company.

Outlook

Our macroeconomic outlook remains broadly unchanged, envisaging sub-par growth and low inflation in Europe. The recent fall in commodity prices may even reduce inflation expectations in the eurozone. On the market front, our outlook is skewed towards risk-off positions due to the recent rise in risk aversion. Although high-yield corporates delivered negative returns, the market proved reasonably resilient. Non-European investors, who triggered the current sell-off, perceive duration as the primary risk and have a light exposure to the European high-yield market. Overall, yields rose to 6% for the euro high-yield main index, the crossover index is trading above 500bp and the spread between the crossover and main indices exceeds the level of December 2012. As a result, the market is becoming more attractive and may offer opportunities once excessive volatility is skimmed off. On a more fundamental basis, defaults remain benign for both US and European high-yield companies. However, in the short run, we are set to remain prudent at a portfolio level and at an issuer level as, for the latter, idiosyncratic risks remain prominent.

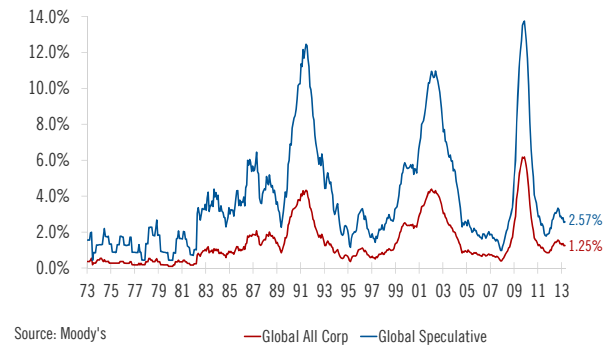
CREDIT RISK

FINANCIAL INVESTMENT-GRADE SPREADS (EURO)

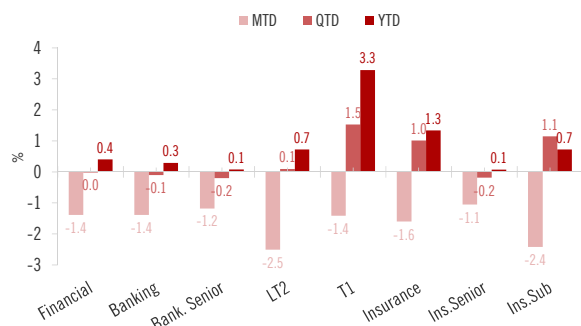


Source: Bloomberg - BoA Merrill Lynch

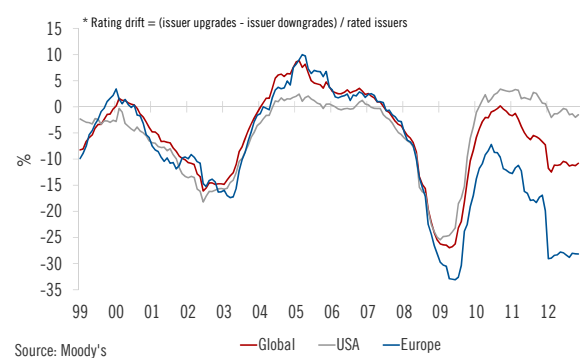
MOODY'S - DEFAULT RATES



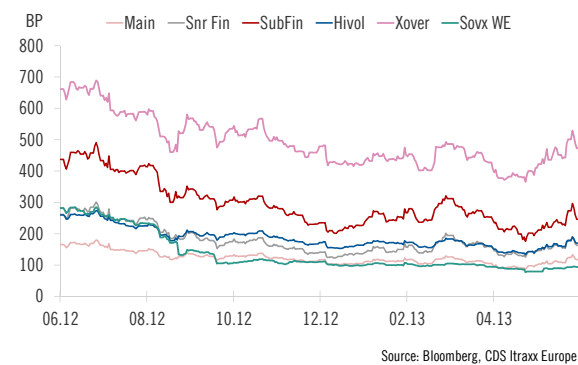
FINANCIAL INVESTMENT-GRADE RETURNS (EURO)



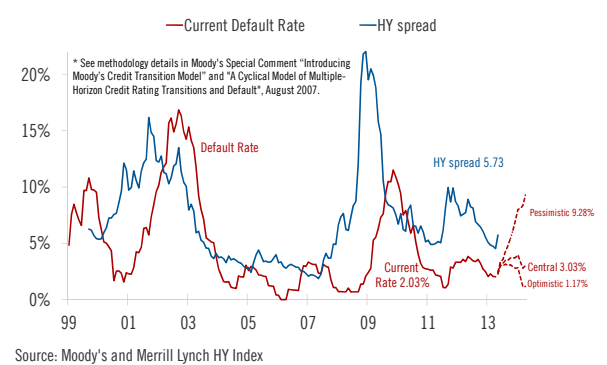
MOODY'S - RATING DRIFT



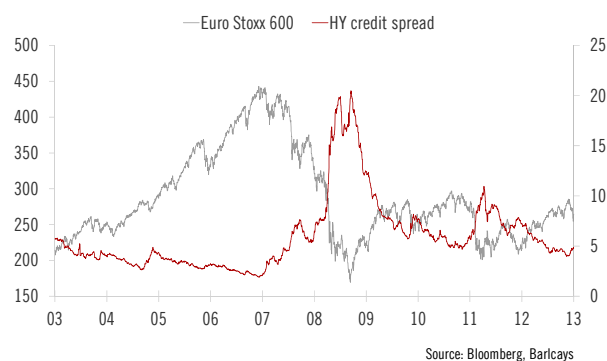
CDS - ITRAXX INDICES



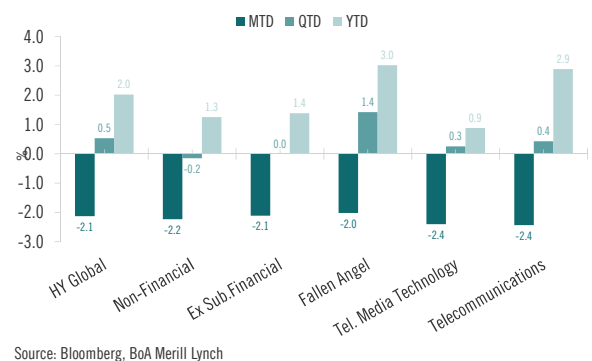
HIGH-YIELD SPREAD AND DEFAULT RATES (EURO)



STOCK MARKET & HIGH-YIELD SPREAD (EURO)



HIGH-YIELD RETURNS BY SECTOR (EURO)



Prospect of halt to QE hit emerging debt particularly hard

Local-currency debt – Recent developments

The sharp US rate spike after Bernanke's 22 May comments resulted in widespread risk-reversal globally. Hardest hit have been emerging-market bonds, with the sell-off intensifying into its sixth week as we near the end of June and the market continuing to underperform, down by over 6% in the month to date. There was some relief in parts, but, since the Fed outlined its schedule for tapering QE, risk assets have plummeted further in reaction to a sharp rise in US Treasury yields and the drop in global equity markets. We also saw disappointing Chinese flash PMI figures which added to the repercussions seen in the market. Yields on local-currency bonds surged this month to around 6.5%, their biggest increase in 5 years. Outflows for the past month amounted to around 2.5% of total AuM, relative to 3.4% seen during the sell-off in 2011. Hungary lowered its 2-week benchmark policy rate to 4.25% with the 11th consecutive 25bp cut despite debates over the external environment, but inflation remains moderate. Even Mexico, with stronger fundamentals compared to many of its peers, saw growth continuing to be weak. Anti-government protests are still rumbling on in Brazil and Turkey, posing a challenge to development plans requiring extra funding.

Local-currency debt – Outlook

The outlook has seen some change in the short term, but the long-term case is intact. The themes of a firmer US dollar, soft commodity prices and mixed global growth, with continued hints quantitative easing will be phased out early, are pressurising emerging-market currencies and increasingly local rates. However, given the better growth potential in emerging countries and attractive yields with relatively good fundamentals, the potential for returns are still good, but possibly less than forecast at the start of the year. Many of the risks remain the same, such as possible protectionist measures to limit currency

appreciation, macroeconomic risks and rising inflation. All these factors will see continued idiosyncrasies and market differentiation.

External debt – Recent developments

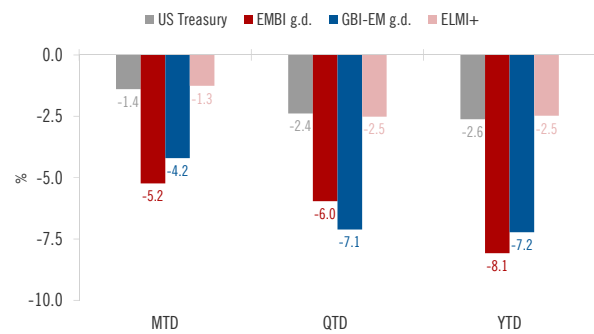
External debt again came under immense pressure, being down over 7% in the month to date, especially in the aftermath of Bernanke's comments detailing the Fed's timeline to taper QE, with it ending in 2014, which caused US Treasury yields to spike and led to a sell-off across asset classes, with emerging-market debt hardest hit. Spreads have widened out further to 375bp, and, this month, unlike the previous month, we saw high-beta countries performing worse than low-beta ones, such as the Ivory Coast, Georgia and Iraq. Growth forecasts have been downgraded, especially in Latin America, with Brazil, Chile, Colombia, Mexico, Peru and Venezuela all seeing numbers being revised lower.

External debt – Outlook

The 10-year US T-bond yield rose to 2.66% in the month, but it is probably unlikely we will see a much faster rise in yields in the near term. Lower-beta countries have an element of correlation with movements in US T-bonds while less correlated countries should continue to provide interesting opportunities. In addition, it is not a static opportunity-set as new bonds are issued along the curve, and new countries are potentially issuing for the first time, mostly sub-Saharan Africa. We see continued convergence of emerging-market credit ratings with developed markets as the latter continue to see downgrades versus upgrades in many emerging countries on the back of robust technical factors, such as debt/GDP levels a quarter that of developed countries, although we will see downgrades at the margins. The asset class is generally well supported by long-term strategic institutions and remains attractive given the low-rates environment, but the possibility of low or negative returns cannot be ruled out.

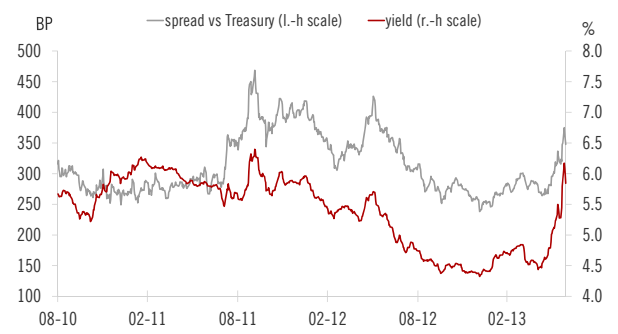
EMERGING DEBT

PERFORMANCES (USD)



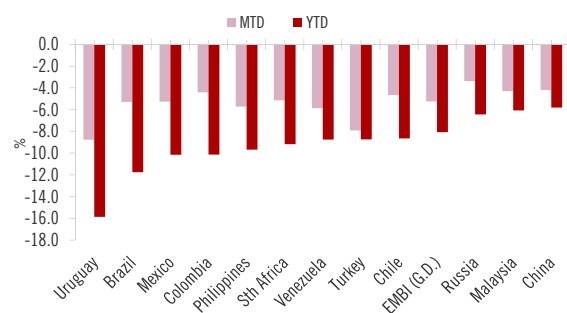
Source: Bloomberg, Index JP Morgan

US DOLLAR DEBT - YIELD & SPREAD



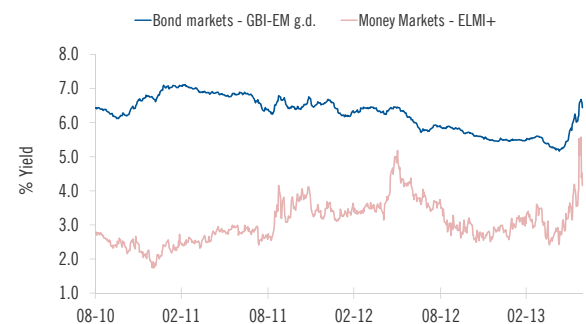
Source: Bloomberg, index JP Morgan EMBI global diversified

JP MORGAN EMBI GLOBAL DIVERSIFIED



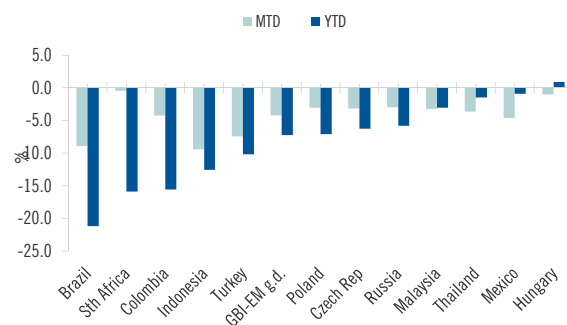
Source Bloomberg: Index JP Morgan

LOCAL CURRENCY DEBT - YIELDS



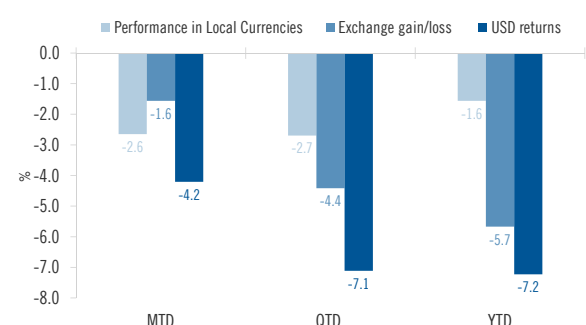
Source: Bloomberg, index JP Morgan GBI-EM g.d. & ELMI+

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



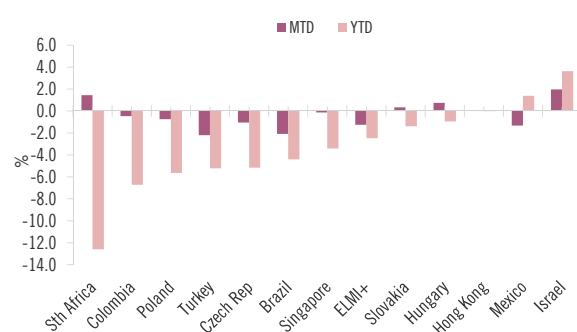
Source Bloomberg: Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



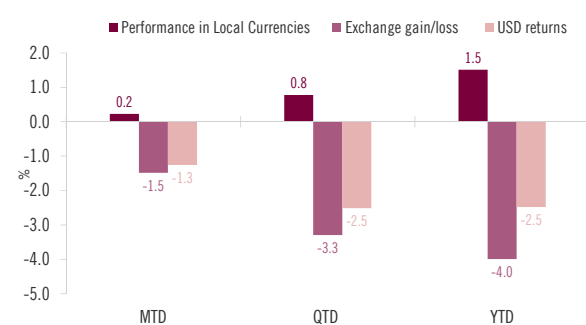
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg: Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

Ben Bernanke's comments sent 10-year T-bonds soaring to 2.66%

Economists increasingly convinced the slowdown in the US economy that can be blamed on the constraints of sequestration will be transitory

Numbers released for the USA, despite being mixed, would appear to back up the scenario of a return to increasingly self-sustaining growth. Upturns on the housing market, in unemployment and in lending to the private sector are giving weight to the argument of self-sustaining growth taking root. Moreover, the budget deficit is being reduced faster than predicted thanks to higher tax revenues than projected. The IMF, however, downgraded its forecast for growth in the US economy in 2014 owing to risks associated with pulling out too quickly from QE. Too early a rise in US long-bond yields might run the risk of hurting the economy, especially the housing sector.

The Fed, wary about allowing any new market bubbles to balloon, has been hinting at turning the liquidity taps off

The Fed has been showing increased confidence about the state of the economy and revised its growth forecasts up slightly, but it was keen to prepare the markets psychologically for its move to rein in its injections of liquidity, especially as all the cash has been propelling prices of some asset classes to stratospheric heights. Fed Chairman Ben Bernanke, in May, had suggested the mounting risk of speculative bubbles associated with monetary policy needed to be taken seriously into consideration.

The likelihood that Ben Bernanke will not be seeking a further term as Fed Chairman has been heightening the uncertainties as it is by no means clear who will step into his shoes next February. The decision will be taken by Barack Obama before ratification by Congress, so some combative exchanges lie ahead. For now, the front-runner would appear to be Janet Yellen who seems most likely to toe the policy line pursued by Bernanke whilst

offering the prospect of an orderly exit strategy.

Worried about the Fed changing tack on QE, the bond market extended its corrective trend begun in early May

US Treasury bonds reacted violently to news of possible tapering of QE3 over the coming months, a prospect hinted at by Ben Bernanke in his testimony to Congress in May. Although gradually tapering its quantitative-easing programme does not imply the Fed is about to start hiking interest rates earlier or faster than expected, adjustments on the market have occurred at lightning speed. The yield curve is already factoring in an initial hike in the Fed funds rate by late 2014, with the 10-year bond yield spiking sharply to 2.66%.

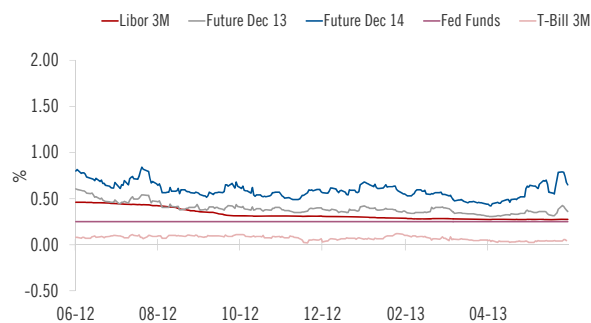
In spite of the bounce to current levels, the bond market still looks vulnerable

Any change in the pace at which the Fed is repurchasing bonds should not trigger a crash on the US bond market. Even if the Fed were progressively to rein in its buying of US Treasury bonds and other securities, its monetary policy would still be very accommodating. Moreover, decelerating inflation is giving the Fed some elbow room.

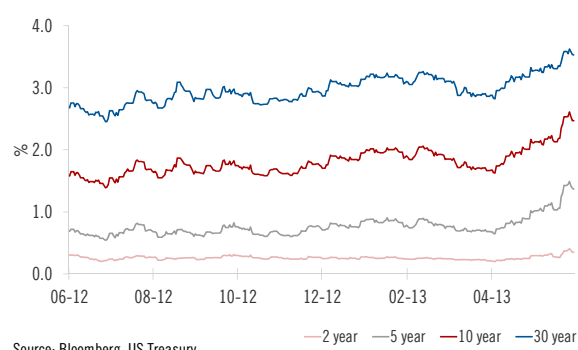
With volatility on the increase again, investors are likely to remain nervy and will be keeping very close eyes on forthcoming economic statistics, especially jobs numbers. If the news flow on the economy is good, the bond market is likely to stay under pressure even if it has already corrected quite severely. Over the summer weeks, we expect yields on 10-year US T-bonds to hover in a trading range between 2.0% and 3%. Inflation running below the level being targeted by the Fed remains a key factor supporting the market though.

USA

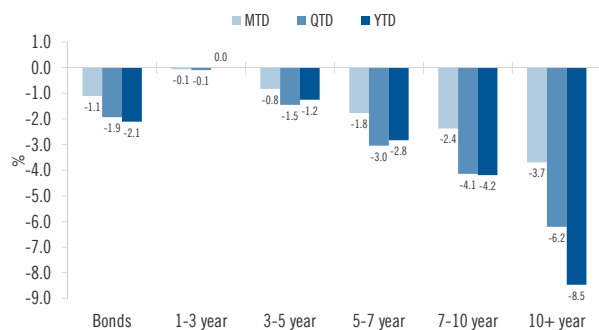
SHORT-TERM RATES (USD)



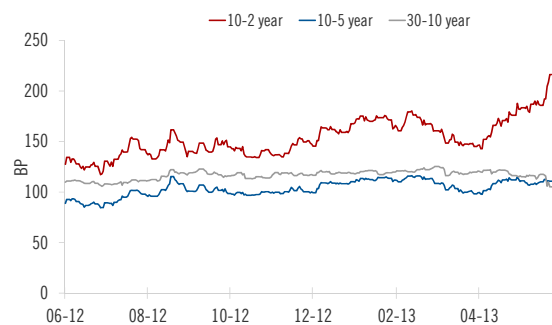
US TREASURY BOND YIELDS



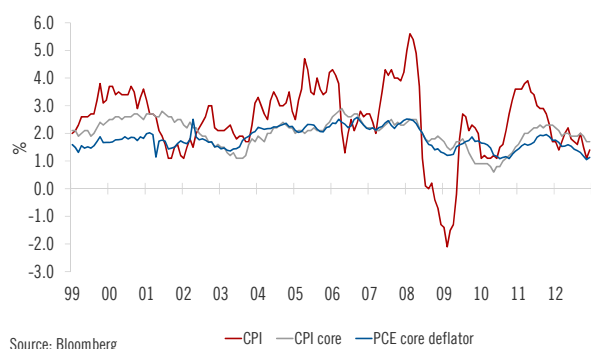
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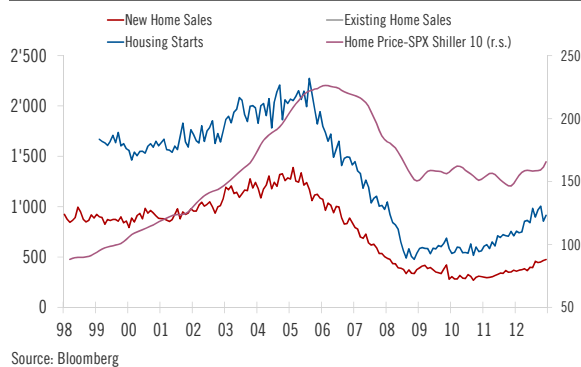
MOVEMENTS IN YIELD SPREADS



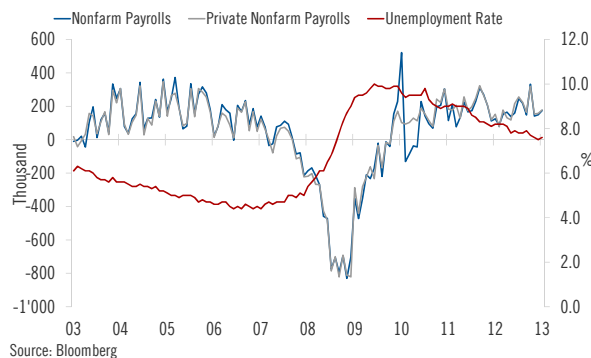
INFLATION



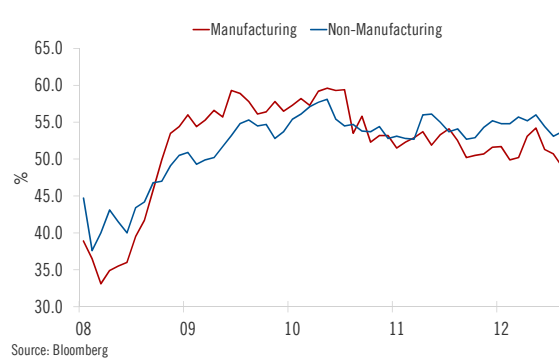
HOUSING



LABOR MARKET



PURCHASING MANAGER INDICES



Risk premiums on peripheral bonds stretching wider again

The ECB is looking for the economy to pick up gradually between now and the year-end

ECB President Mario Draghi indicated the eurozone situation would remain challenging, but some signals of it possibly stabilising had begun to surface. The ECB left its repo rate unchanged at 0.5% and will continue to provide support to the economy whilst ensuring price stability. Mario Draghi has not, however, ruled out the possibility of pushing the rate on the overnight deposit facility, currently at 0%, into negative territory to encourage banks to lend more to businesses and households rather than hoarding the cash in their vaults. However, the ECB has not announced any tangible measures to boost lending to small businesses and households, particularly in peripheral member states which are still struggling with financial difficulties.

The ECB will press ahead with its programme of one-week fixed-rate lending to banks in unlimited quantities for as long as necessary and at least up to July 2014. Its 3-month long-term refinancing operations (LTRO) will also be continued until then. Only if the economy fails to pick up or if inflation were to fall further is the ECB likely to adopt fresh measures.

European Commission allowing some governments more time to cut their public deficits

In its recent rounds of recommendations to national governments, the European Commissions softened its hard line so as not to curb economic growth any further. It commented that public-sector finances were being redressed and things were moving in the right direction. It proposed abrogating the Excessive Deficit Procedure (EDP) for five countries: Italy, Hungary, Latvia, Lithuania and Romania. In contrast, it advised opening an EDP for Malta. A further half-dozen states (France, the Netherlands, Poland, Portugal, Slovenia and Spain) were accorded an

extension to the deadline for pruning their excessive deficits. As the eurozone has just registered its sixth quarter of negative GDP growth in a row, the decision to postpone the requirement to hit budget targets in those countries in trouble is good news and will cushion the recessionary impact of structural reforms. Nevertheless, an uneasy calm has redescended in the eurozone as the reduction in some countries' potential GDP, which downsizes the fiscal base, might well undermine authorities' drives to redress public-sector finances and rekindle sovereign-debt risk. The process of raising rates might also cause a few upheavals.

Recent economic indicators have been more encouraging, but joblessness still hit a new record high of 12.2%

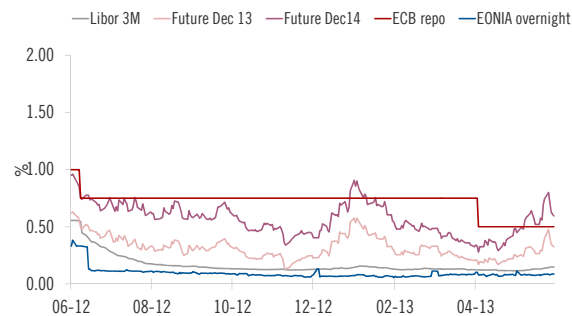
Findings from economic and business surveys suggest the eurozone economy may have weathered the storm and might embark on its recovery phase soon. Nevertheless, the balance is still finely poised. Turns of events in Cyprus, Greece and other under-pressure eurozone member states are always at risk of fuelling fresh bouts of turbulence in the region.

German long-bond yields extended their uptrend and spreads on peripheral states' sovereign debt widened

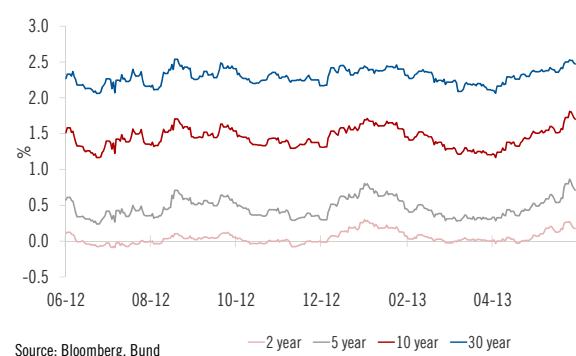
Against a backdrop of hopes of the eurozone emerging from recession in the latter half of this year, fears of the Fed reining back QE3 and the turbulence on Japan's bond market, 10-year Bund yields went from 1.16% to 1.81% in the space of a few weeks and spreads on peripheral member states' sovereign debt widened by between 50 and 80 basis points. We expect yields on 10-year Bunds to level out over the summer months, hovering in a trading band between 1.50% and 2.10%. Bond markets round the periphery can be expected to remain volatile, moving up and down in response to both economic and political news.

EUROZONE

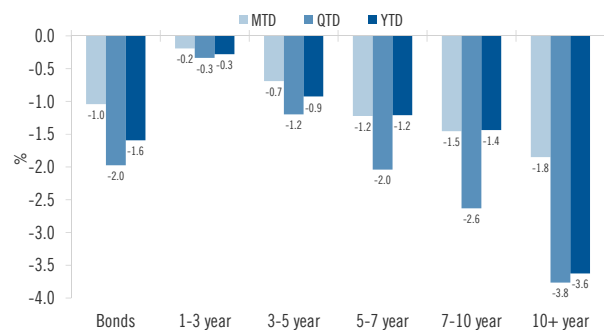
SHORT-TERM RATES (EURO)



BUND YIELDS



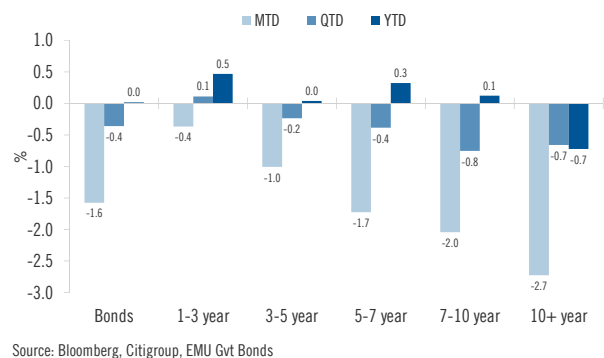
RETURNS BY MATURITY (BUND)



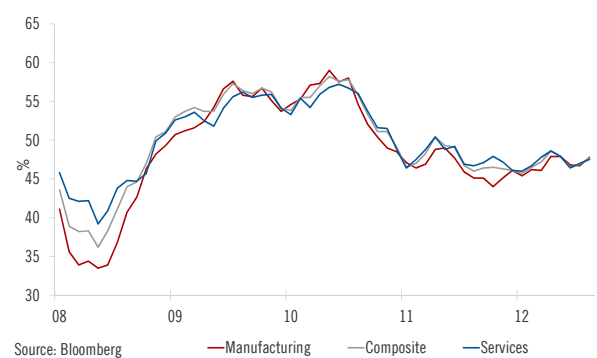
MOVEMENTS IN YIELD SPREADS



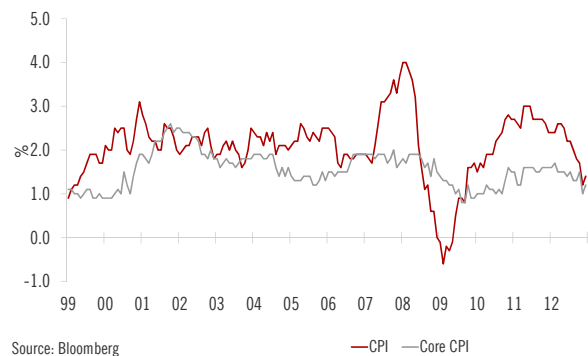
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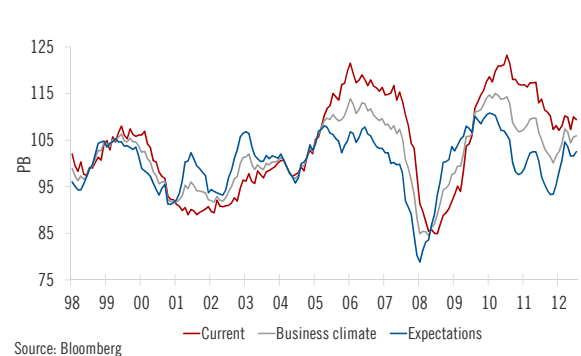
EUROZONE - PURCHASING MANAGER INDICES



EUROZONE - INFLATION



GERMANY - IFO



The BoE likely to stick with status quo for quite some time

Economic indicators are suggesting the UK economy might at long last stage an upswing

For some weeks now, the main economic statistics and indicators have provided confirmation of the economic recovery, but the government's ongoing austerity programme will limit the extent of the rebound. Industrial output rose for the third month in a row, the unemployment rate fell, retail sales bounced back up and Purchasing Managers Indices extended their uptrend, with the Services PMI climbing to 54.9 and the Manufacturing PMI to 51.3. House prices are rising and the index compiled by the Royal Institution of Chartered Surveyors, regarded as a leading indicator for the sector, advanced by 4 points. Lastly, the GfK consumer confidence index jumped by 5 points to -22. The British Chambers of Commerce have also revised their economic diagnosis, revealing themselves to be more optimistic and indicating that GDP should register stronger growth than expected over the next three years. The BCC is now predicting GDP growth of 0.9% for this year, followed by 1.9% in 2014 and 2.4% in 2015. Over the summer, the UK economy seems likely to benefit from a feel-good impact from the birth of Prince William's first baby. Experts are predicting 'royal baby mania' could generate windfall trade of GBP280m for retailers.

The budget deficit was smaller than expected in May thanks to exceptional one-off income from the tax agreement struck with Switzerland. This helped to limit the deficit, but it did not prevent public debt from setting a new record high.

Although the economic upturn is still fragile, the government has confirmed its resolve to continue administering austerity medicine

The Chancellor of the Exchequer, encouraged by recent economic news flow, unveiled the latest set of budget spending cuts for GBP11.5bn for the 2015/16 tax year. Budget

allocations to local authorities will be pruned particularly hard. George Osborne had indicated in advance that it was vital to press ahead with deficit-cutting measures to make businesses more competitive and to create new jobs. Some of the savings made will be ploughed back into social programmes to cushion the harsh impact of the draconian austerity programme.

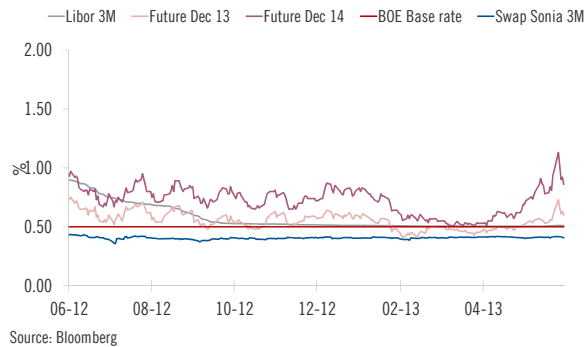
BoE opting for the status quo before the new Governor takes over and issued tougher solvency rules for UK banks

As expected, the Bank of England's Monetary Policy Committee (MPC) decided to leave the base lending rate unchanged at 0.5% and left the amount of its asset-repurchase programme at GBP375bn. The Bank of England (BoE) had expanded the *Funding for Lending* programme geared towards encouraging banks to lend to smaller businesses. This diminished the chances of any increased buying of UK gilts before the new BoE Governor Mark Carney takes over, especially against a backdrop of inflation quickening from 2.4% to 2.7%. The BoE has reassessed UK banks' recapitalisation requirements at GBP27.1bn. The bank with the most capital to find is RBS, followed by Lloyds TSB and Barclays. The new prudential regulation authority has demanded that every bank in the country must have a leverage ratio, i.e. capital as a percentage of total assets, of at least 3%.

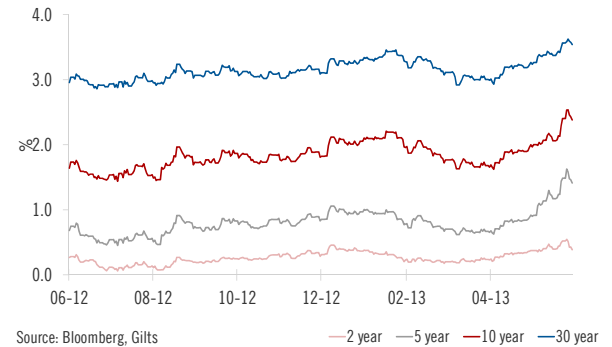
With the economy looking a little stronger, gilts yields corrected further

The turn of events on the economic front have diminished the likelihood of the BoE implementing further non-conventional monetary-policy measures. As prospects for the UK economy are still shrouded in uncertainty and heavily dependent on international developments, the base lending rate is likely to remain steady for quite some time, which will help the gilts market to consolidate.

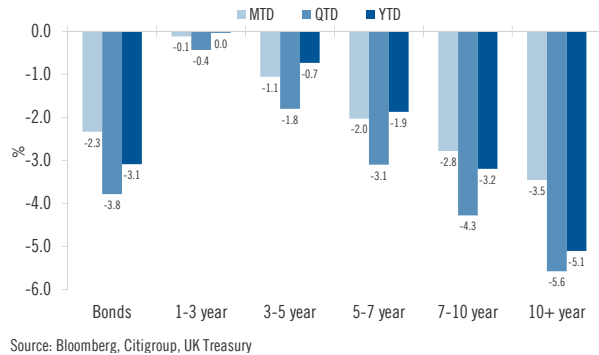
SHORT-TERM RATES (GBP)



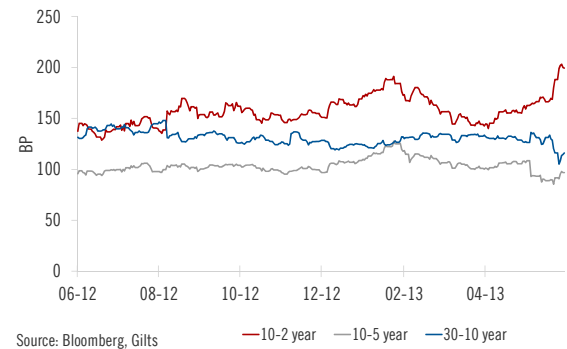
GILTS YIELDS



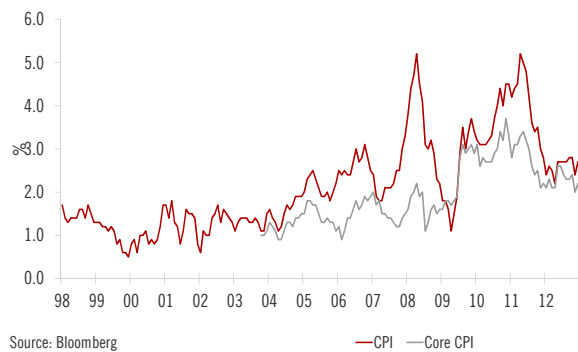
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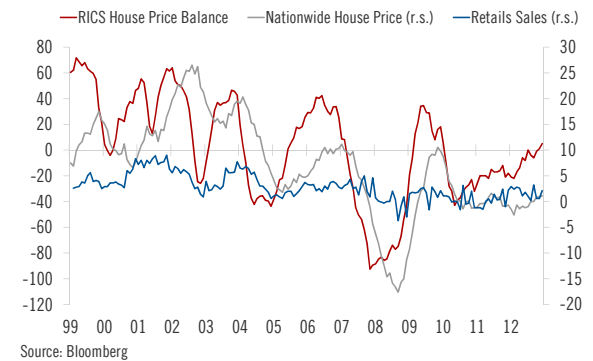
MOVEMENTS IN YIELDS SPREADS



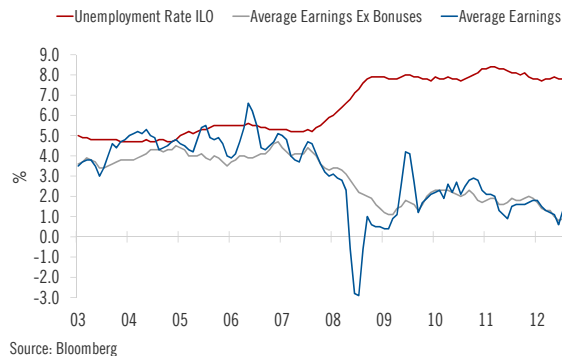
INFLATION



HOUSING AND RETAIL SALES



UNEMPLOYMENT RATE AND AVERAGE EARNINGS



ECONOMIC SURVEYS



The SNB standing its ground

At its quarterly meeting in June, the SNB made no change to its monetary-policy stance

The Swiss National Bank (SNB) declared it would be keeping its target range for its key interest rate, the 3-month LIBOR, unchanged at 0.0% to 0.25%. It also confirmed it would continue defending a ceiling level for its exchange rate at CHF1.20 to the euro. The SNB had instigated this upper limit for the Swiss franc's value in September 2011, considering the franc was still too high and any further appreciation would jeopardise both price stability and economic growth in Switzerland. The SNB's foreign-exchange reserves expanded further in May to total CHF441bn, but the SNB remains quite ready to buy foreign currency in unlimited quantities to defend the level. If needed, it is also prepared to push through further measures.

The SNB made no change to its GDP growth forecast: it is still projecting a rate of between 1.0% and 1.5% this year. Although growth was a little more vigorous than expected in the opening quarter of 2013, the SNB believes it will slow down during the year. As for inflation, the ECB only fine-tuned its forecasts, projecting a rate of -0.3% for 2013, compared to its previous forecast of -0.2%. It made no change to its projections for 2014 (+0.2%) or 2015 (+0.7%).

The SNB believes risks confronting the Swiss economy are still quite considerable, associated in the main and as they have done for some time with developments on the international scene. SNB President Thomas Jordan commented that, although Switzerland's economy had picked up in Q1 2013 with GDP rising by 0.6%, this was primarily fuelled by domestic demand items, namely consumer spending and investment in residential construction, whereas there were no lasting signs of any upswing in exports.

In its annual report on the country's banking system, the SNB, as it had done in 2012, highlighted dangers lurking in the property

market. It is worried about banks' exposure to and dependence on the mortgage business, being concerned particularly about the prospect of rising interest rates.

Influential economic forecasts are still confident about the Swiss economic outlook

Key economic indicators, such as the KOF economic barometer, the PMI compiled by Credit Suisse and the UBS Consumption indicator, have been sending out encouraging signals. The influential economic forecasting institutes remain upbeat about prospects for this year. On average, they are projecting GDP growth of 1.4% although economists are still guarded about prospects for exports and investment.

Consumer prices rose by 0.1% in May, but Switzerland remains in the grip of deflation, with the headline rate running at -0.5%. The ongoing rises in rents and prices for food, clothing and package holidays did in part offset further declines in the price of oil and petroleum products.

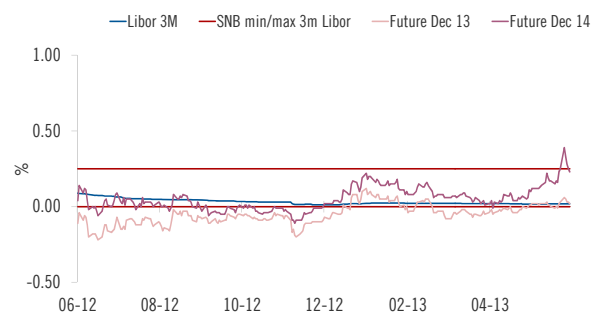
Even though monetary policy is set to stay accommodating, the Swiss bond market suffered a correction

As deflation is unlikely to be eradicated before the end of this year and things remain quite fraught economically in the eurozone, which could result in fresh influxes of capital towards the Swiss franc, the SNB will have to persevere with its highly accommodating stance in the coming months in spite of the property market overheating.

The likelihood of official rates staying close to zero should lend some support to the Swiss bond market on which yields have already risen quite steeply in step with similar movements on leading bond markets worldwide. Over the summer, Swiss bonds look likely to embark on a spell of consolidation.

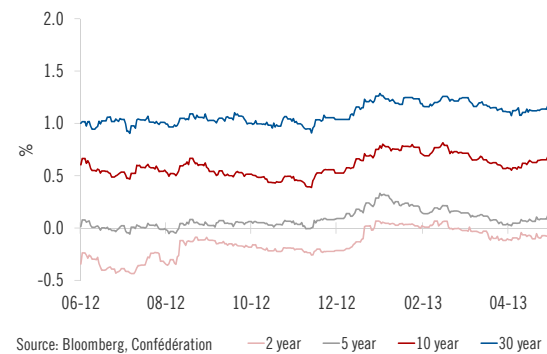
SWITZERLAND

SHORT-TERM RATES (CHF)



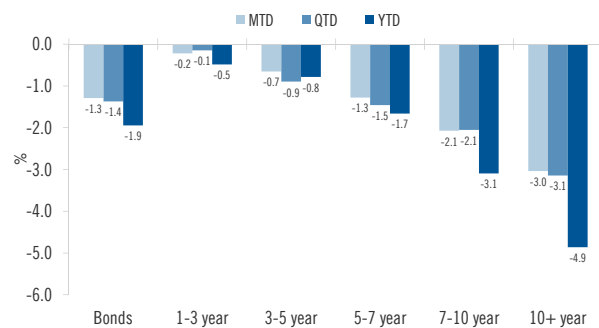
Source: Bloomberg

CONFEDERATION YIELDS



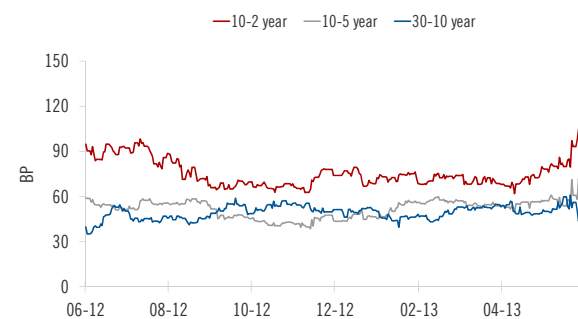
Source: Bloomberg, Confédération

RETURNS FROM GOVERNMENT BONDS BY MATURITY



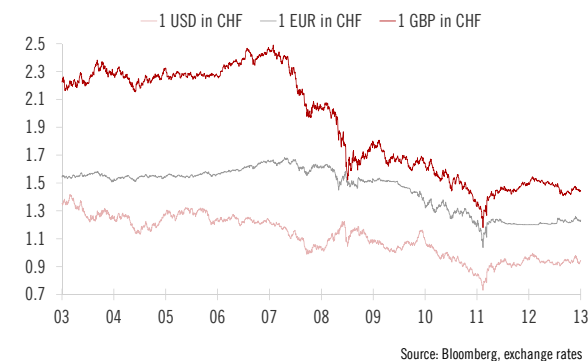
Source: Bloomberg, Citigroup, Switzerland Gvt Bonds

MOVEMENTS IN YIELDS SPREADS



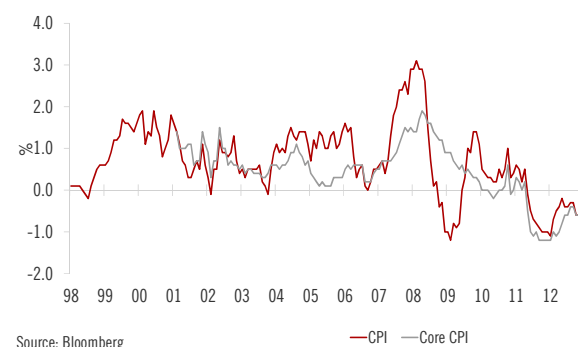
Source: Bloomberg, Confédération

SWISS FRANC EXCHANGE RATE



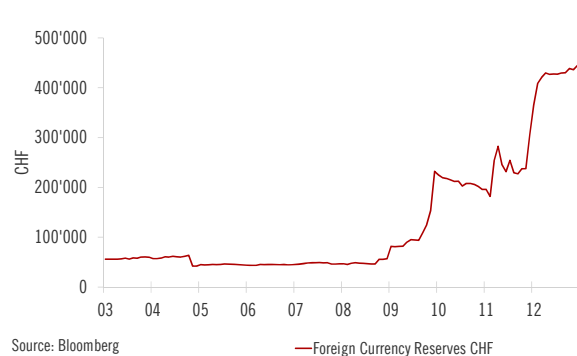
Source: Bloomberg, exchange rates

INFLATION



Source: Bloomberg

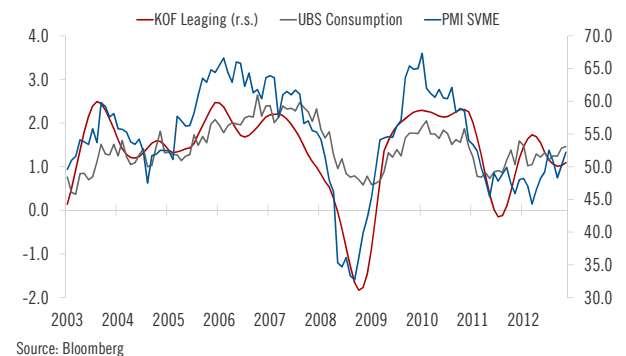
SNB - FOREIGN CURRENCY RESERVES



Source: Bloomberg

Foreign Currency Reserves CHF

ECONOMIC SURVEYS



Source: Bloomberg

Milestone elections coming up in July

The BoJ reported that Japan's economy has been improving and voted at its early June session to leave interest rates where they were

The 9 members of the Bank of Japan's Monetary Policy Committee unanimously voted to continue with the recently introduced quantitative- and qualitative-easing measures. The Bank of Japan (BoJ) is still intending to double the size of the monetary base by purchasing assets, particularly government bonds, in its drive to turn deflation into an inflation rate of 2%. As a result, the BoJ can be expected to buy up 70% of the bonds being issued by the Japanese Treasury each month. The BoJ reported that Japan's economy was turning round and that overseas economic conditions were also showing signs of improving.

The monetary and fiscal policy mix being implemented by the new government and the Bank of Japan has helped GDP to rebound, with the economy posting 1.0% growth in Q1 2013 and deflation levelling out somewhat. Growth is likely to be sustained over the next few quarters by spending on public-works projects and, to a lesser extent, by consumer spending which seems likely to retain some momentum before the scheduled hike in the consumer sales tax rate in April 2014.

The Third Arrow of the Prime Minister's 'Abenomics' disappointed a little

With the IMF urging Japan to push through structural reforms to ensure its recovery is sustainable, measures announced by Prime Minister Shinzo Abe in early June proved rather disappointing owing to a lack of any far-reaching reforms, especially for the labour market. It would appear he is keen to defer such politically awkward decisions until elections to the Upper House of the Diet on 21 July are out of the way. He has already highlighted his intention to announce a second wave of strategic measures in the autumn.

The ruling Liberal Democratic Party secured a comfortable victory in elections to Tokyo's local assembly, an outcome that augurs promisingly ahead of the key vote in July as it suggests the electorate are broadly happy with the new government's policies. In order to have *carte blanche* to push through its political agenda, the LDP needs to secure an outright majority in the Upper House in the July elections.

Consumer confidence has perked up unmistakably since the LDP was returned to office last December, with consumer spending being a key driving force behind the growth rebound early this year. This upturn might not last though if wages continue to stagnate. Exports also picked up, boosted by increased sales of cars to the USA, but the slowdown in China and the blurred outlook for the rest of Asia are casting a shadow over Japan's foreign-trade prospects.

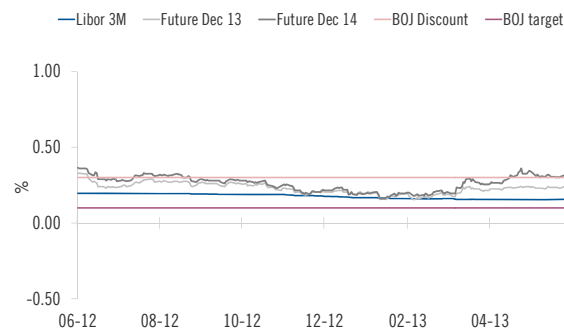
After correcting in early May, yields on long-dated JGBs have levelled off

The Japanese government bond (JGB) market endured a severe correction in May, responding to shifting expectations as regards economic growth and inflation. The break-even threshold on 6-year inflation-linked bonds has risen by 55bp since the BoJ's announcements. The JGB market was also influenced by the upswing in bond yields spreading from the USA and Europe.

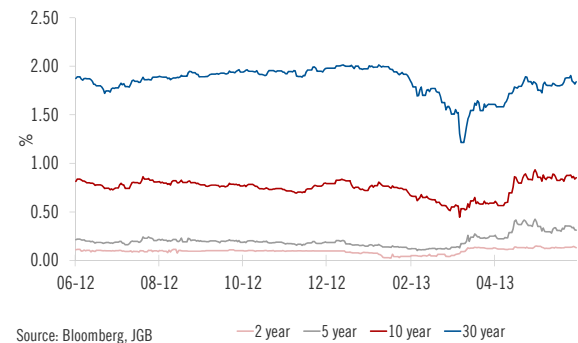
Over the next few months, we expect JGBs to continue being underpinned by the BoJ's wholesale purchases. Even with new bond issuance round the corner, yields on JGBs, which are predominantly owned by domestic investors, are likely to remain tightly range-bound over the next few months.

JAPAN

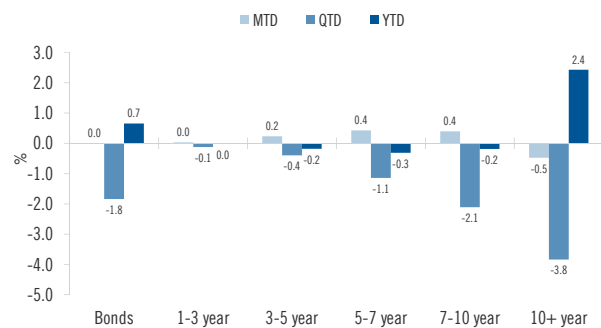
SHORT-TERM RATES (YEN)



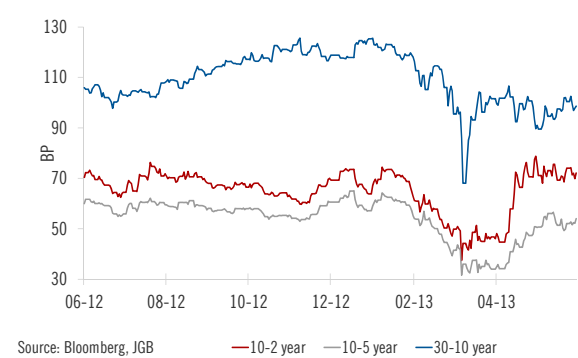
JAPANESE GOVERNMENT BOND YIELDS



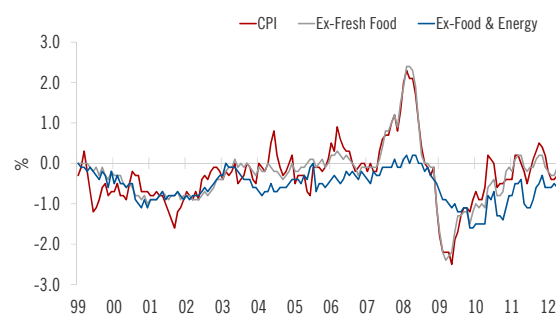
RETURNS FROM GOVERNMENT BONDS BY MATURITY



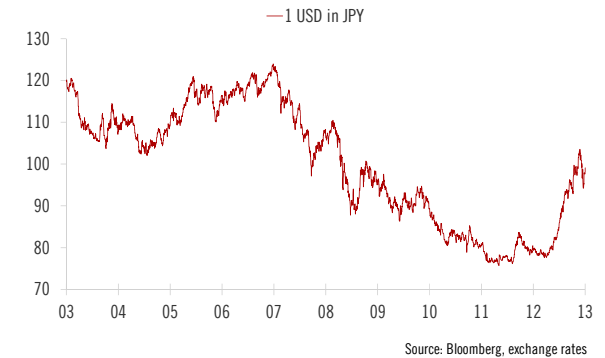
MOVEMENTS IN YIELDS SPREADS



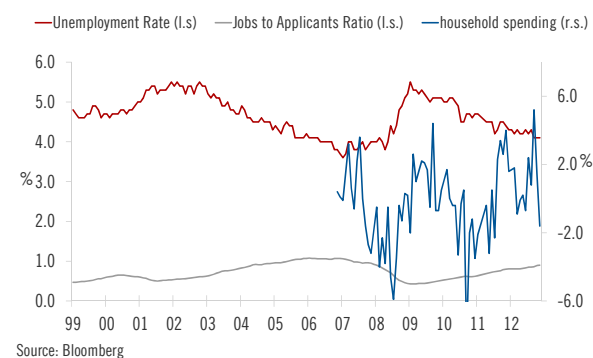
INFLATION



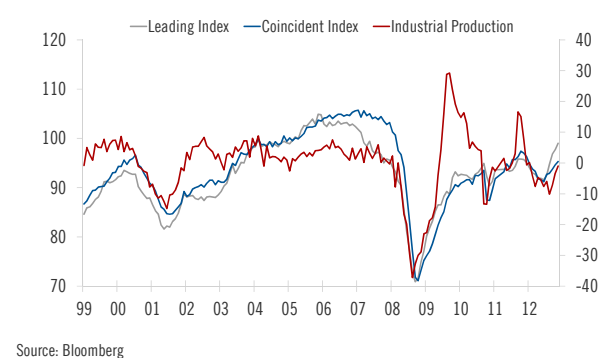
JAPANESE YEN VERSUS DOLLAR



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