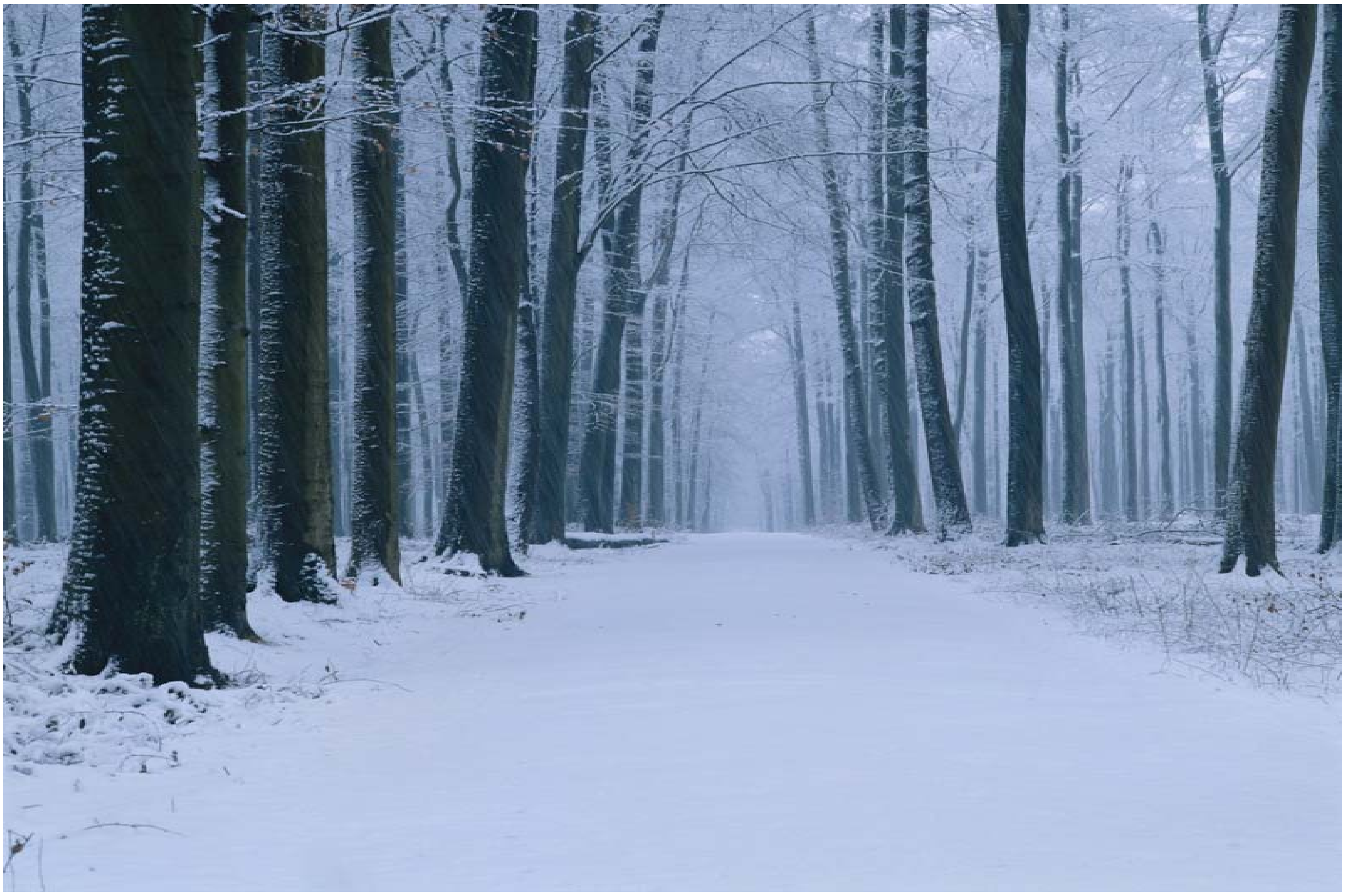
Monthly Bond Letter

January 2014

Pictet Asset Management



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OVERVIEW

Recent developments

Markets waiting with baited breath for final FOMC meeting of 2013

Good economic numbers, an uptick in inflation and the budget deal in the US rekindled worries about the Fed embarking on its tapering process in the not too distant future. Upgrading of Q3 2013 GDP growth to 3.6%, the increase in the Purchasing Managers' Index (PMI) for Manufacturing to 57.3, more jobs being created than expected, the drop in the unemployment rate to 7%, a rebound in consumer confidence and a 0.8% rise posted by the leading economic indicator provided considerable reassurance about the well-being of the US economy after October's fortnight-long shutdown of government.

Agreement on budget was viewed as removing one of the obstacles to the onset of the Fed's tapering

The budget deal secured by Democrat and Republican negotiators, which still has to be ratified before the deadline date of 15 January, should forestall any renewed shutdown of government agencies, deliver smaller-scale automatic spending cuts and prune the deficit by USD23bn. The package being proposed should provide financing for the Federal government up to September 2015.

Slightly better figures for Europe lowered the tone of speculation about a further rate cut by the ECB

The ongoing uptrends on European economic and business surveys and PMIs, the dip in the jobless rate from 12.2% to 12.1% and the gentle quickening in inflation from 0.8% to 0.9% tempered expectations of another cut in the European Central Bank's benchmark interest rates. Moreover, the ECB made no fresh policy announcements in December, with ECB President Mario Draghi adopting a slightly less accommodating tone than expected in reaffirming his confidence about the recovery underway.

Changes in some European countries' credit ratings by Standard & Poor's had barely any impact on the markets: the Netherlands lost its triple-A status, trimmed to AA+, Cyprus' rating was upgraded from CCC+ to B-, and the 'Outlook' label for Spain has been lifted from 'Negative' to 'Stable'.

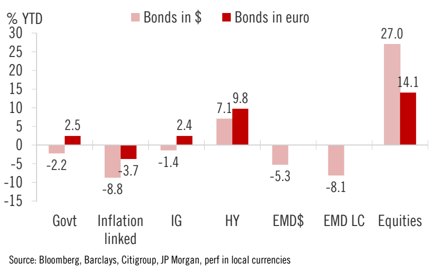
In Japan, question-marks still hang large over the effectiveness of Abenomics

Many forecasters and commentators are of the view that the Bank of Japan's monetary easing and the government's reflationary stimulus plans are just not going to be enough to ensure Japan returns to the path of sustained and sustainable growth. Moreover, the tempo of the recovery has been slowing noticeably since the summer, with the proposed hike in the consumer sales tax, which will dent consumers' spending power, looming menacingly on the horizon.

Yields on 10-year US Treasury bonds and Bunds held reasonably steady in December

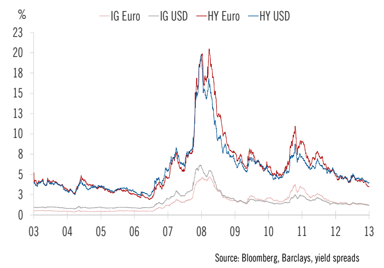
Spreads on both peripheral eurozone bond markets and various corporate bond segments narrowed further in December as investors continued to hunt around for yield. Emerging-market debt was the only category to remain under pressure, sidelined by investors concerned about the negative implications for capital flows once the Fed does decide to curtail its QE3 bond buying.

PERFORMANCES 2013



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

CREDIT SPREADS



Source: Bloomberg, Barclays, yield spreads

Forecasts

Central bankers look set to persevere with their highly accommodating stances in 2014, but interest rates are likely to continue moving back towards more 'normal' levels

Looking ahead to 2014, growth in the global economy should pick up some speed whilst inflation, which has dropped quite steeply in recent months, pushed down by falling energy prices, should accelerate gently in both the USA and Europe. The US economic recovery is on course to gain momentum in 2014 whereas Europe's economy, which has finally shrugged off recession, seems likely to make modest progress. Lastly, the fate of Japan's economy will hinge on whether Abenomics turns out to be a success or not. Given that sort of outlook, yields on sovereign debt issued by countries regarded as 'safe havens' may well climb somewhat higher. As investors are still keenly hunting around for yield, risk assets should remain in reasonably good form in spite of the prospect of the Fed scaling back its bond purchases.

The impact from the onset of tapering by the Fed should be cushioned by carefully worded forward guidance which should not be seriously called into question unless the unemployment rate moves close to the Fed's 'trigger' threshold and provided inflation keeps below the 2% barrier. Nevertheless, with smaller budget cuts and improving economic prospects, the market may well start to factor in the possibility of the Fed pressing ahead more energetically with its tapering over the coming months. In spite of assertions confirming the Fed funds rate will be kept pinned to the floor for many months to come, long-bond yields could well edge a little higher.

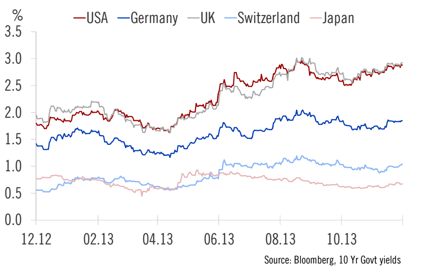
Economic recovery likely to be moderate in Europe, with GDP growth projected at 1% for 2014

As for Europe, it cannot be taken for granted that the plentiful supplies of low-cost liquidity will be converted into the lending needed to underpin the recovery. For now, growth in M3 and bank lending to the private sector remain sluggish. The ECB has not ruled out the possibility of more rate cuts, even a move to shift to negative interest rates, or recourse being made to non-conventional measures, like quantitative easing, if needed. Investors are waiting for further clarification about what is likely to happen to the eurozone economy. If the prospect of the ECB making further rate cuts or pushing through new non-orthodox monetary-policy measures (asset-purchasing programme) were to mount, then the 10-year Bund yield might well decouple even more noticeably from its US T-bond equivalent, especially if US Treasuries are penalised by shifting expectations over the scale and tempo of Fed tapering.

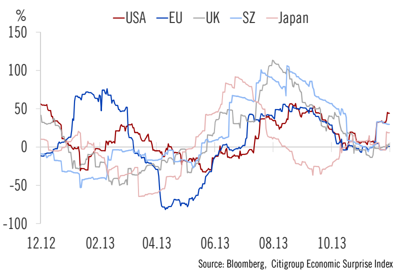
High-yield segment should retain its good form

The European high-yield corporates segment offers investors a risk premium compensating for the credit risk inherent in such instruments. The spreads offer less by way of compensation for peripheral or political risk though. The next steps likely to be taken by the ECB (banking regulation; quantitative easing) will need to be watched closely, as indeed will the state of political affairs in the eurozone. 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 investors remain keen on this particular asset class.

10-YEAR GOVT BOND YIELDS



ECONOMIC SURPRISE INDEX



Annus horribilis, but brighter prospects round the corner

2013 was far from being a typical year for inflation-linked bonds

In 2013, inflation-linked bonds, barring those issued by Japan and Italy, delivered some fairly dismal returns compared to those from their nominal-rate equivalents. Worse still, returns in absolute terms were in the red zone for most. This unexpected turn of events against the backdrop of rising yields on government bonds wrong-footed investors, sparking off a mass exodus from this particular asset class since May.

A climate of subdued domestic inflation associated with the main economic players pressing ahead with deleveraging was exacerbated by a downward trend on imported inflation, stemming from the steep drop in commodity prices. Inflation break-even thresholds, in general, moved lower, but not really by enough to explain why performances were so disappointing in 2013. The shock to the system came from the real component as real rates on 10-year bonds moved smartly upwards by 140 basis points in the USA, by 55bp in the UK and by 70bp in Germany.

From never-ending QE to the timing of the QE exit strategy

Stabilising economies in the key developed nations and the dawning acknowledgement that the peak for fiscal belt-tightening had been reached triggered a shift in market convictions, away from endless QE towards expectations of a dismantling of the array of QE measures. This sea-change, first mooted in May when the Fed initially outlined the notion of 'tapering', led to a major correction in real rates.

Although the Fed has taken the decision to rein in its purchases of bonds, should we expect real rates to go on climbing in 2014 with no impact on the component of expected inflation? The most plausible scenario is predicated on a more pronounced reduction in bond purchases by the Fed over the coming months, but accompanied by very carefully and shrewdly worded forward guidance, pointing towards the Fed funds rate being kept close to zero for at least the next couple of years.

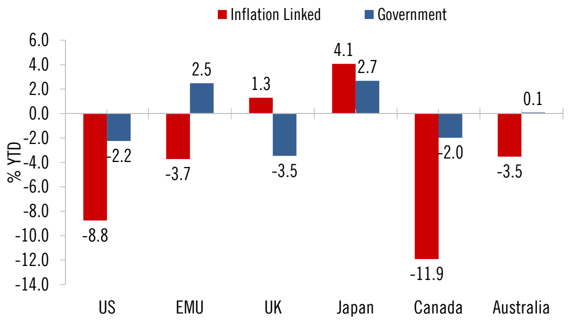
The very short-dated end of the interest-rate spectrum is likely to stay with a negative real yield, equating in absolute terms to the prevailing rate of inflation. The real yield on 30-year bonds has already moved up to 1.60% after starting 2013 at 0.30%. That suggests, unless expectations mount of an imminent hike in official interest rates, we are fairly unlikely to see any extra shock from real rates as the yield curve is already exhibiting a steepish upward shape.

Inflation-linked bonds rediscovering their merit as diversification vehicles

The deleveraging still in progress in the developed world and the transition of China's economy from an export-led to domestic model should help to keep a lid on inflationary pressures connected, respectively, to lending growth and commodity prices. The fairly attractive-looking break-even points, together with real rates being more in line with fundamentals, have enhanced once again not just the intrinsic appeal of inflation-linked bonds, but also, above all, their merits for diversification purposes for a balanced portfolio.

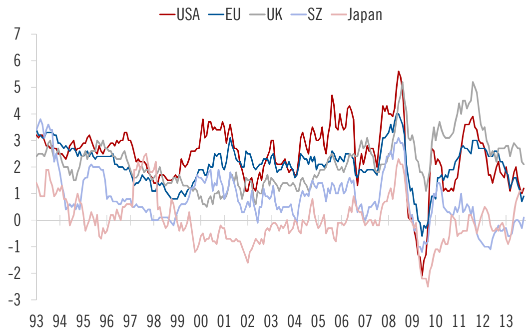
INFLATION-LINKED BONDS

PERFORMANCES 2013 (LOCAL CURRENCIES)



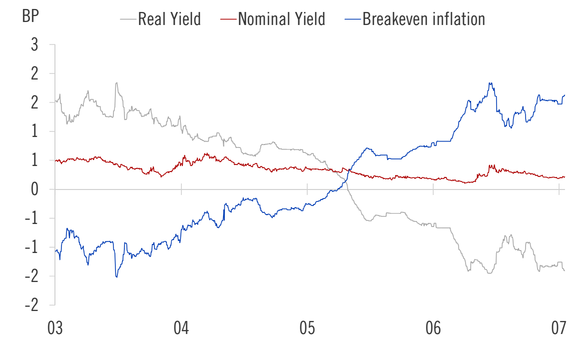
Source: Bloomberg, Citigroup, Barclays, Citigroup

INFLATION



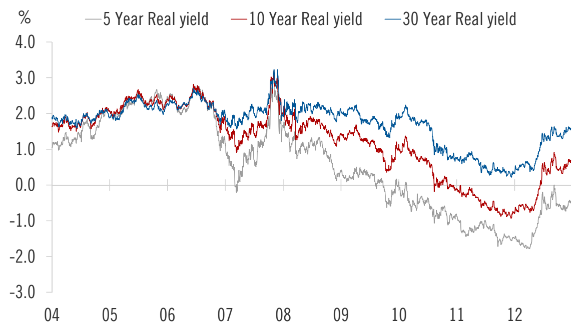
Source: Bloomberg, CPI

JAPAN - TREASURY YIELD COMPONENT



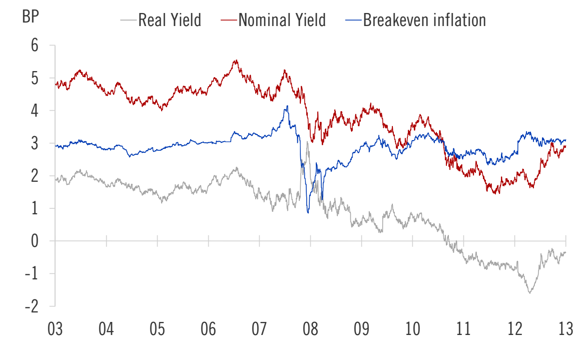
Source: Bloomberg, Japan

USA - REAL RATES



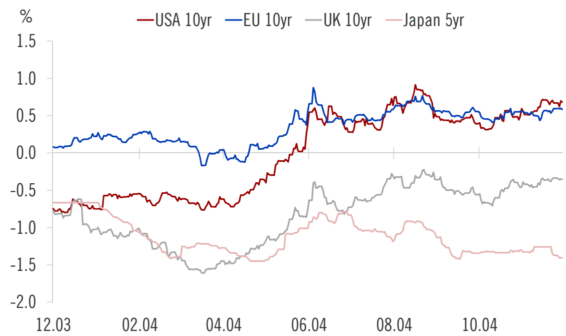
Source: Bloomberg, US Treasury

USA - 10-YEAR TREASURY YIELD COMPONENT



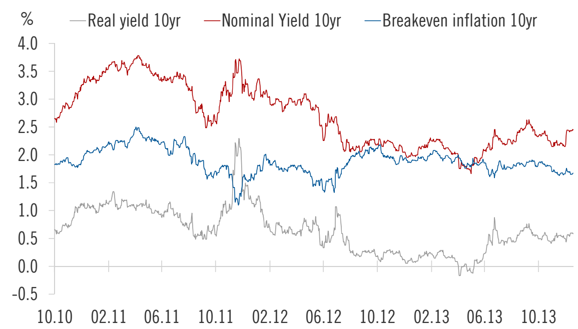
Source: Bloomberg, UK

10-YEAR REAL YIELDS



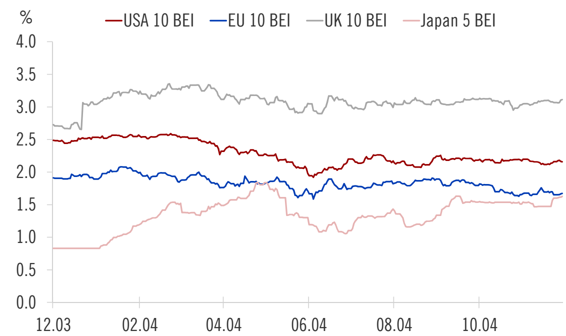
Source: Bloomberg, Real Yields

FRANCE - 10-YEAR YIELD COMPONENT



Source: Bloomberg, 10-yr French OAT

10-YEAR BREAKEVEN INFLATION POINTS



Source: Bloomberg, Break-even Inflation Rates

Spreads narrowing

Investors still searching eagerly for yields

The investment-grade corporate bond market delivered a negative return in December owing to the uptick in interest rates, but it still managed to outperform benchmark German Bunds. It should be borne in mind that one of the main reasons influencing things in recent weeks has been the decline in swap rates relative to German Bund yields. This narrowing of swap spreads, which had begun in November, picked up momentum after the ECB's recent meeting in early December, with the process working to the advantage of senior debt in most sectors. Credit spreads relative to German interest rates, generally speaking, narrowed whereas spreads relative to swap rates remained more or less unchanged, with the notable exception of high-yielding segments that are still being so eagerly sought after by investors. As a result, hybrid debt from borrowers in the telecom, utilities, basic industrials and car-manufacturing sectors, along with subordinated debt issued by banks and insurance companies, tended to outperform their senior debt equivalents. Both K+S, a potash producer, and tyre-maker Continental also featured among the best performers, chiefly for company-specific reasons associated with an improving risk profile. Regions-wise, spreads on bonds from Spanish and Italian issuers continued to narrow, and they once again outperformed their core eurozone counterparts. In contrast, Austrian banks, in response to the possibility of the guarantee for some types of Hypo Alpe Adria bonds being withdrawn, incurred quite hefty losses.

Brief look back at 2013

The return from investment-grade corporate bonds for the whole of 2013 has been positive, with the segment doing better than AAA-grade sovereign bonds. The gains made in the opening half were, however, practically wiped out in June in the aftermath of the Fed's comments about possible tapering and fears associated with slowing economies in emerging countries. However, against a backdrop of low interest rates and ongoing accommodating monetary policy, hybrid and subordinated debt outperformed as various different categories of investor pursued their quest to find yields. Another striking feature of 2013 has been the significant reduction in spreads on bonds issued by Spanish and Italian borrowers as the economic climate has improved, perceptions of political risk have been toned down and confidence has mounted in the ECB's resolve and the means at its disposal.

Banking union

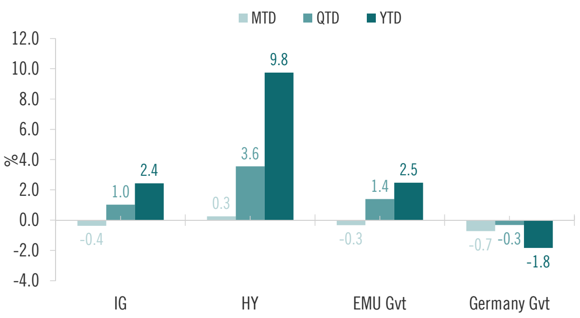
The first stage, the Single Supervisory Mechanism (SSM), has been achieved with the ECB being designated as the sole supervisory agency for eurozone banks as from end-2014. Significant progress was made in December towards the second stage, the setting-up of the resolution mechanism for failing banks. The purpose behind the Single Resolution Mechanism (SRM) is to avoid, as far as possible, public funds having to be mobilised, primarily by ensuring shareholders and senior/subordinated creditors make a contribution. The SRM will kick in from 2015 and will be applicable directly to the 130 biggest banks in the eurozone.

Outlook

The corporate bond market remains in good shape for the time being, and spreads should narrow even further, with the financials sector outperforming and spreads for peripheral borrowers continuing to fall. The low level of yields at present, however, limits the appeal of this asset class and, as a knock-on effect, its likely returns. Globally, the Fed's decisions on implementing its tapering process will remain a source of volatility for credit-risk instruments.

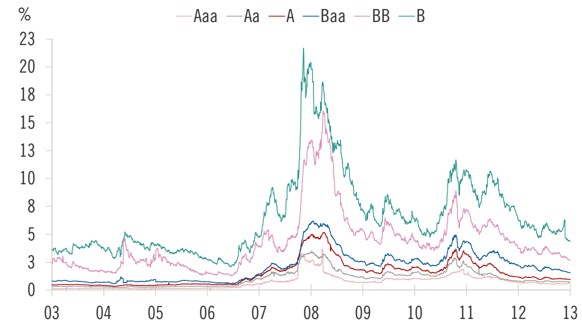
CREDIT RISK

RETURNS ON BONDS IN EURO



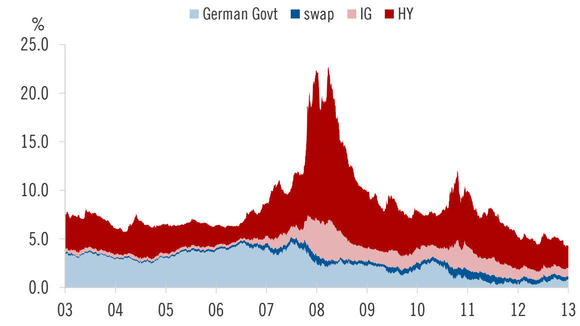
Source: Bloomberg, Barclays, Citigroup, Bonds in euro

CREDIT SPREADS (EURO)



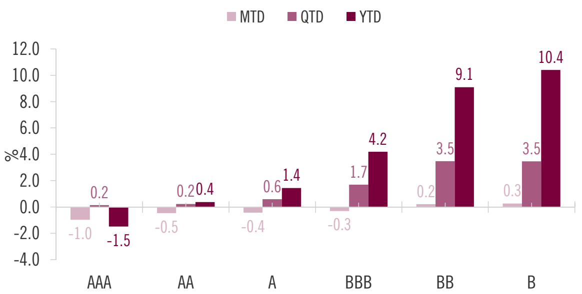
Source: Bloomberg, Barclays, EUR yield spreads

YIELD COMPONENT (EURO)



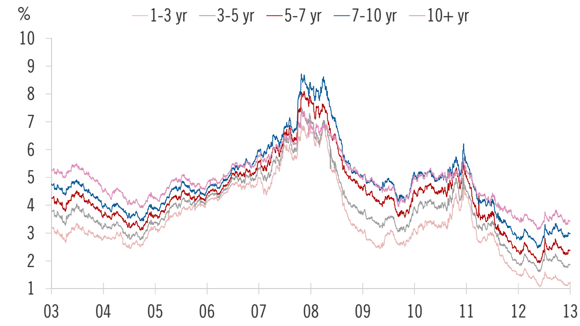
Source: Bloomberg, Barclays, Eur yields

RETURNS ON BONDS IN EURO



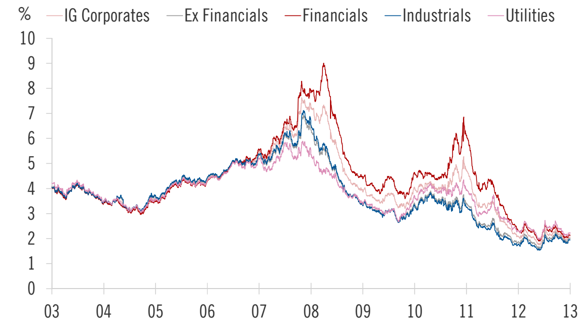
Source: Bloomberg, Barclays, Corporate Bonds in euro

INVESTMENT-GRADE SPREADS BY MATURITY (EURO)



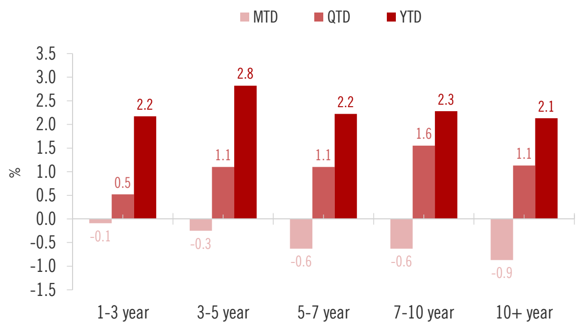
Source: Bloomberg, Barclays, EUR yields

INVESTMENT-GRADE SPREADS BY SECTOR (EURO)



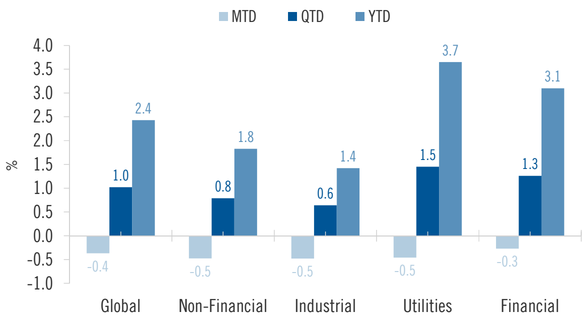
Source: Bloomberg, Barclays, EUR yields

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

High-yield bonds ending the year on a high note

High-yield corporates still benefiting from investors' search for yield

High-yield bonds notched up gains for the fifth month in a row. Flows into high-yield bonds have remained robust in the USA and Europe, especially for short-term solutions. The cut in ECB interest rates and the ECB's highly accommodating monetary stance rebooted investors' search for yield, boosting the appeal of high-yield corporate bonds. The gradual economic upswing in Europe has also underpinned the high-yield corporates segment. The attractiveness of high-yield corporates extends beyond the confines of Europe as overseas investors have once again been buying European corporates, especially since June when high-yield bonds have held up better than other risk assets. Sector-wise, financials extended their outperformance over the rest of the high-yield segment.

Issuers from the eurozone's periphery showed their mettle in December, much as they have done over the whole year. Turning to the fundamentals themselves, companies' balance sheets are still healthy. We have seen a slight increase in net leverage, but other key financial ratios have held stable at good levels. This suggests the default rate should stay low in 2014, as it has done in 2013. The third-quarter reporting season has been unfolding, confirming the reassuring trend as regards fundamentals. Results overall made for good reading, especially for companies in the chemicals and packaging sectors. Vehicle manufacturers delivered a mixed bag of results, but with no clear-cut rise in margins. Those companies that reported setbacks or falling results were rapidly punished, highlighting the low degree of complacency among investors.

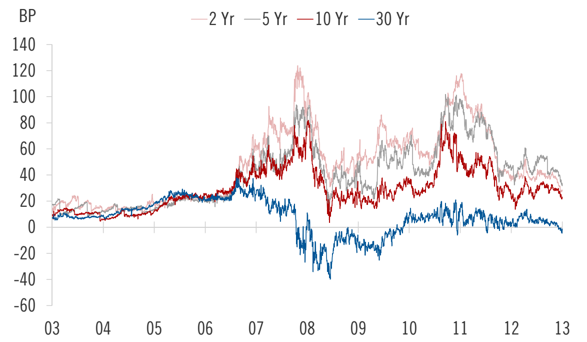
The primary market was quite lively in December. Alcatel issued short-term paper. Astaldi, the B+-rated Italian building company, launched a 7-year bond for the first time. As is common, issuance volume is likely to dry up as the end-of-year festive season approaches. All in all, around fifty of so borrowers made their issuing debts on the high-yield market in 2013. In the telecom sector, rumours of consolidation have continued to do the rounds after Liberty Global's takeover of Virgin Media in Q1 2013 and Polsat's more recent purchase of Polkomtel. In addition, speculation has been whirling around Wind and Ziggo, with the latter, the Dutch cable operator, once again being courted by Liberty Global, already one of its main shareholders.

Outlook

We remain positive about the prospect of a gradual economic recovery in Europe continuing. Growth looks likely to continue picking up speed gently. Balance sheets are still in comparatively good shape. Credit spreads have narrowed unmistakably over the last three months, with the iTraxx Crossover index now pitched at around 320bp. The high-yield segment offers investors a risk premium compensating for the credit risk inherent in such instruments. The spreads offer less by way of compensation for peripheral or political risk though. The run-up to the end of the year, which is traditionally good for credit-risk instruments, will act as a support for the markets. We will be closely monitoring the next steps likely to be taken by the ECB (banking regulation; quantitative easing) as well as, more generally, the state of political affairs in the eurozone. 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 investors remain keen on this particular asset class.

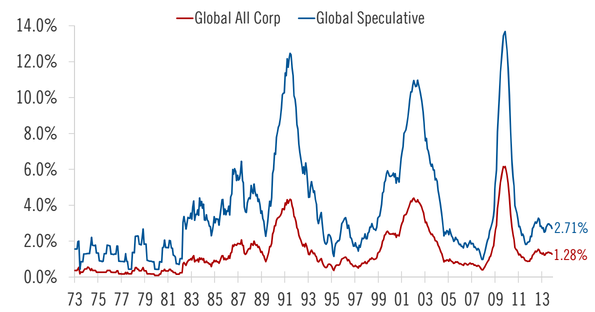
CREDIT RISK

EURO SWAP SPREADS



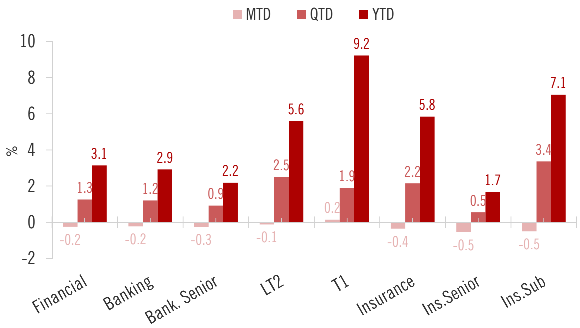
Source: Bloomberg, Swap spread EUR

MOODY'S - DEFAULT RATES



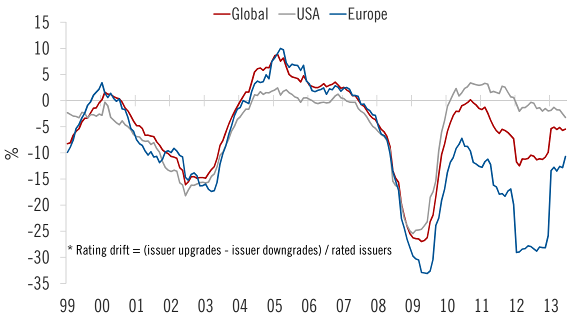
Source: Moody's

FINANCIAL INVESTMENT-GRADE RETURNS (EURO)



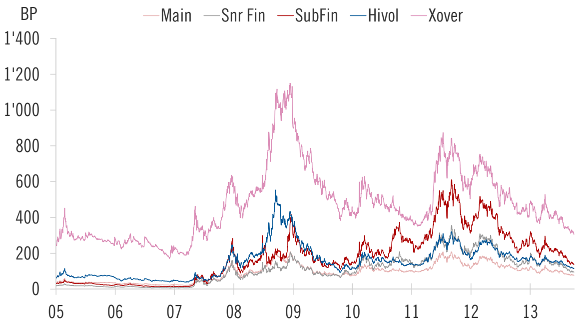
Source: Bloomberg, BoA Merill Lynch

MOODY'S - RATING DRIFT



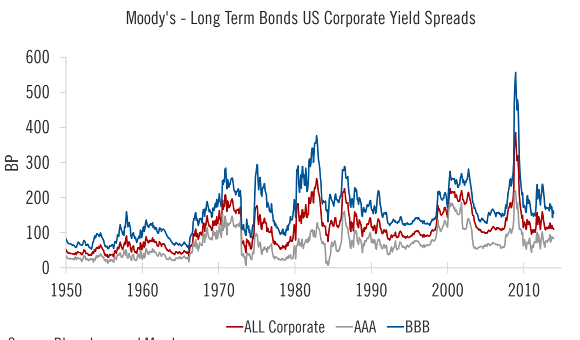
Source: Moody's

CDS - ITRAXX INDICES



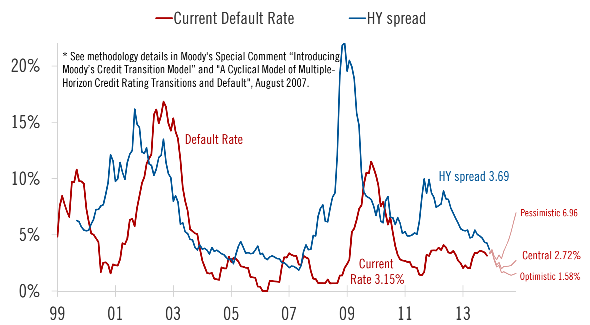
Source: Bloomberg, CDS Itraxx Europe

MOODY'S – LONG-TERM BOND SPREADS



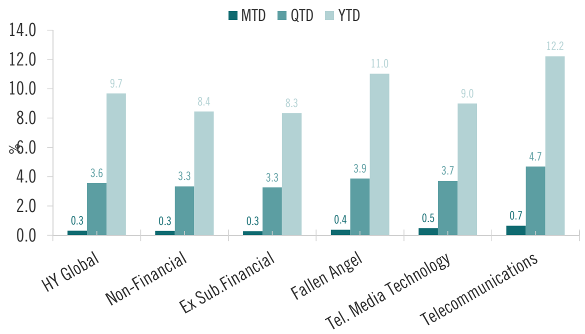
Source: Bloomberg and Moodys

HIGH-YIELD SPREAD AND DEFAULT RATES (EURO)



Source: Moody's and Merrill Lynch HY Index

HIGH-YIELD RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merill Lynch

Fed tapering is going to continue causing downward pressure

Local-currency debt – Recent developments

2013 was a disappointment, with the asset class returning -8% for the year to date, compared with a return of 16.8% for 2012, which had been driven by the search for yield and growth which continued into early 2013. That was until the Fed's QE 'taper talk' in May led to a rise in US Treasury yields and a summer sell-off having an almost equal impact on currencies and local bonds. The yield component of 6% cushioned the blow, and it currently stands at 6.7%. The September Fed meeting surprised markets with the unexpected decision to delay tapering, resulting in some recovery until things weakened again in November as we moved closer to tapering. Over the year, we saw increased differentiation as investors punished markets most affected by rising borrowing costs, such as those with current-account deficits, low growth, lack of reforms, over-reliance on commodities or large foreign investor bases. Indonesia, South Africa, Brazil and Turkey were key examples of those worst hit. Conversely, some markets held up relatively well, like Mexico given its reform agenda particularly in the energy sector, stable growth and low inflation whereas Hungary surprised with its turnaround to twin surpluses and better than expected growth. Poland also fared well as several rate cuts lessened the pressure on bond prices while the currency benefited from stabilisation in the eurozone.

Local-currency debt – Outlook

We have entered a period of lower market liquidity around the year-end and ongoing uncertainty over the timing and market reaction to Fed tapering which we continue to see as a headwind for local bond prices as well as emerging currencies, particularly the more vulnerable ones. We see increased volatility, more differentiation between markets and scrutiny by investors, plus greater political risk due to several forthcoming elections, as in Brazil. Despite these challenges, it remains one of the more attractive areas in the fixed-income universe given the investment-grade status, attractive yield, good fundamentals and potential for healthy returns over the long term. Improving growth in developed markets has historically led to better growth in emerging markets although we do believe this will take longer this time round given the global rebalancing, with weaker currencies being part of the right remedy.

External debt – Recent developments

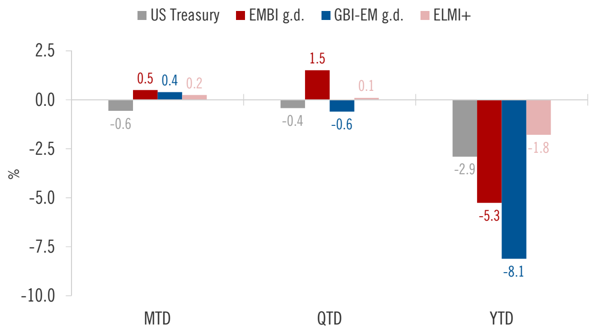
2013 started with almost the tightest spread levels in 5 years at 238bp after 2012's massive return of 17.4% as investors searched for yield. However, the asset class started to see weakness early in 2013 as more positive US data led to rising US Treasury yields, which had the biggest impact on some of the tighter-spread countries from Mexico to the Philippines. Brazil was one of the worst hit given it also suffered from generally worsening fundamentals. The Fed's QE 'taper talk' in May aggravated the downward pressure whereas the unexpected decision not to taper in September resulted in a small, but short-lived, recovery. Below-investment-grade countries held up better overall as they tend to trade more on underlying fundamentals, although part of this may have been due to lower liquidity levels in selected smaller countries. There were a number of credit-rating actions, such as the Philippines being upgraded to investment-grade status by all three major rating agencies. However, Venezuela was downgraded to Caa1 whereas Argentina's downgrade to CCC+ was not helped by its ongoing messy litigation with 'hold-out' creditors. In a market with over 60 different countries, we have seen an enormous amount of differentiation, but it has remained investment-grade overall despite the disappointing year.

External debt – Outlook

The long-term fundamentals of the asset class remain largely intact, such as lower debt/GDP ratios than in developed countries and an attractive yield, but Fed tapering is going to continue causing downward pressure. In a world less reliant on quantitative easing, more focus will be placed on the fundamentals of each country. One could argue that there is value given the spread level relative to spreads on other high-grade asset classes and good support from longer-term investors who remain underweight and, we believe, will continue to allocate. However, it remains subject to investor sentiment, and we have not yet seen signs of a reversal in investor outflows. Once we get past the volatility spike at the start of tapering, we may see investors taking advantage of current levels, but the outlook remains unclear.

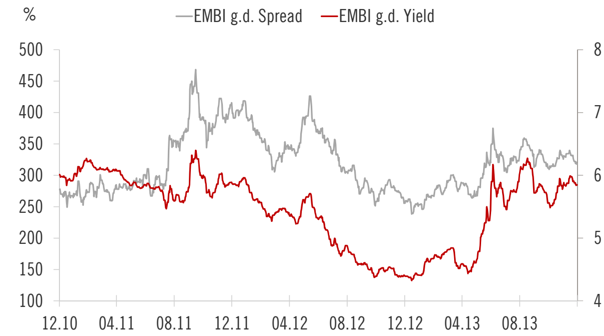
EMERGING DEBT

PERFORMANCES (USD)



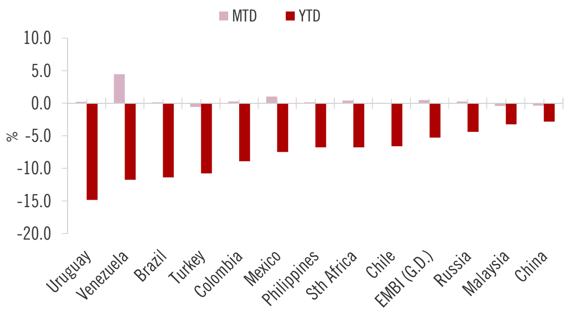
Source: Bloomberg, Index JP Morgan

US DOLLAR DEBT - YIELD & SPREAD



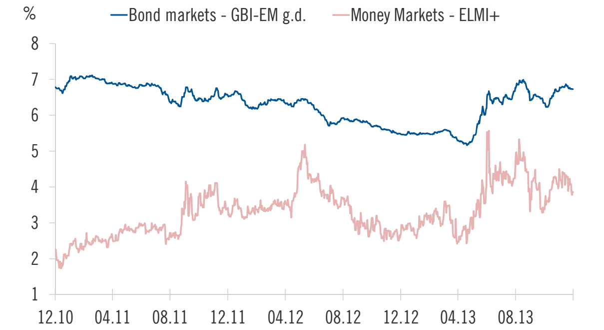
Source: Bloomberg, JP Morgan Indices

JP MORGAN EMBI GLOBAL DIVERSIFIED



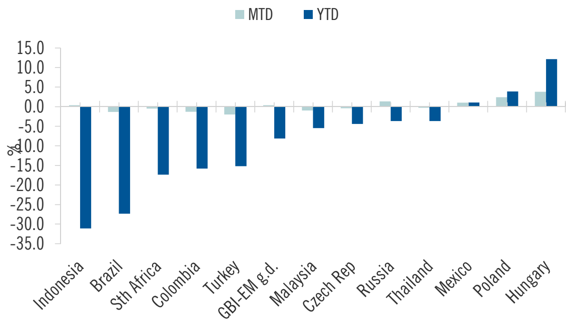
Source Bloomberg: Index JP Morgan

LOCAL CURRENCY DEBT - YIELD



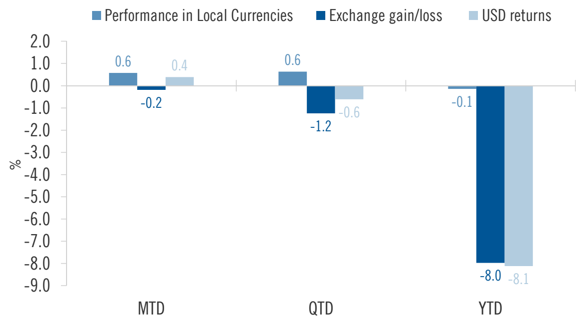
Source: Bloomberg, JP Morgan Indices

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



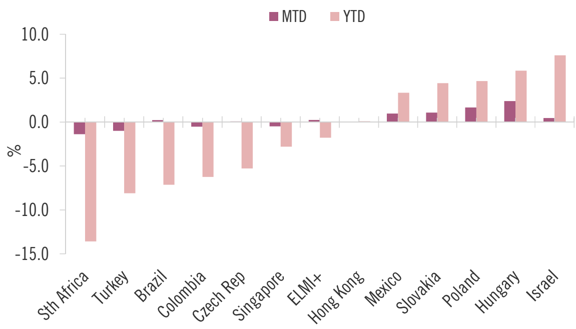
Source Bloomberg: Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



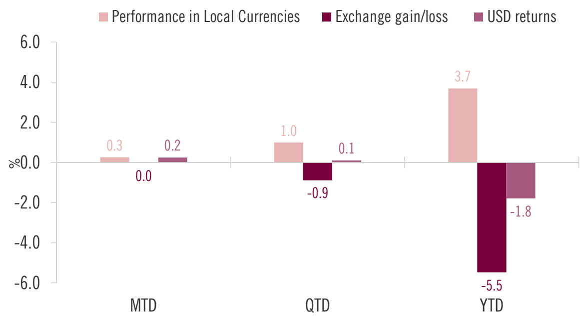
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg: Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

Onset of tapering more or less already priced in by markets

Good economic numbers and the uptick in inflation rekindled worries about the Fed embarking on its tapering process in the not too distant future

Figures for Q3 2013 GDP growth were revised upwards, for a second time, from the previous estimate of 2.8% to 3.6%. The Manufacturing PMI advanced from 56.4 to 57.3. More new jobs were created in November than had been expected (203k as opposed to 185k), and the unemployment rate came down from 7.3% to 7.0%. Retail sales were 0.7% higher, with car sales rising by more than expected. The rebound in the University of Michigan's consumer confidence barometer also came as a pleasant surprise as it climbed to 82.5, compared to the expected 76. The leading economic indicator advanced by 0.8% in November. The y-o-y rate of headline inflation, which had sunk to 1%, moved back up to 1.2% whereas the underlying rate held firm at 1.7%. Figures for the housing market were on the reassuring side, with house prices climbing further and the NAHB/Wells Fargo Housing Market Index, regarded as a reliable bellwether for the sector, moving up to 58. These developments fuelled ongoing speculation that the Fed would make a start fairly soon on reining in its asset purchases.

The deal on the Federal budget has dispelled risks of yet another government shutdown

The compromise deal cemented by Democrat and Republican negotiators passed a crucial stage in the Senate and should be definitively adopted before the year is out and then being ratified by President Obama. The agreement should forestall any renewed shutdown of government agencies, deliver smaller-scale automatic spending cuts and prune the deficit by USD23bn. The package will make it possible to fund the Federal government up to September 2015, but it does not represent a significant shift in the core positions of the two opposing camps as it has not settled the issue of reforms to the tax code and welfare provision (social security and Medicare), which could, in the long run, be a heavy burden on public finances. Agreement on the budget was viewed as removing one of the obstacles to the onset of the Fed's tapering.

The Fed reiterated its intent to persevere with its highly accommodating monetary stance

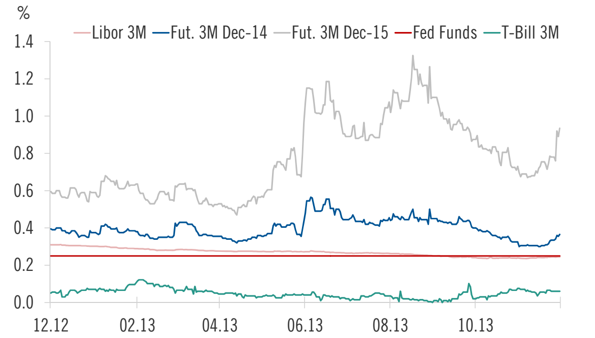
The cocktail of economic statistics and the budget deal had fuelled speculation of an imminent U-turn on quantitative easing, especially as the Fed had already hinted at its intention to start tapering soon. After the final Federal Open Market Committee meeting of 2013, the Fed decided to rein in in its monthly purchases by a modest USD10bn. The impact from the onset of tapering by the Fed should be cushioned by carefully worded forward guidance which should not be seriously called into question unless the unemployment rate moves close to the Fed's 'trigger' 6.5% threshold and provided inflation keeps below the 2% barrier.

Bond market looks to offer barely any upside with the process of normalisation set to continue in 2014

With smaller budget cuts on the table and improving economic prospects, the market may well start to factor in the possibility of the Fed pressing ahead more energetically with its tapering over the coming months. In spite of assertions confirming the Fed funds rate will be kept pinned to the floor for many months to come, long-bond yields could well edge a little higher.

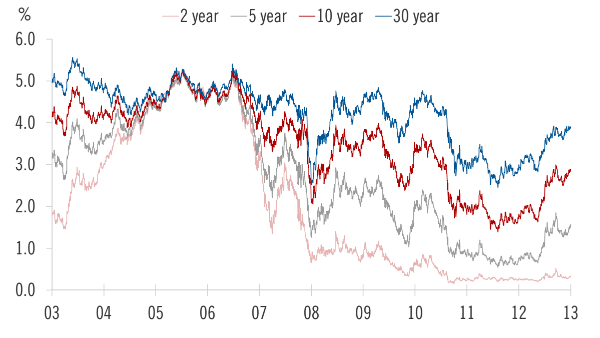
USA

SHORT-TERM RATES (USD)



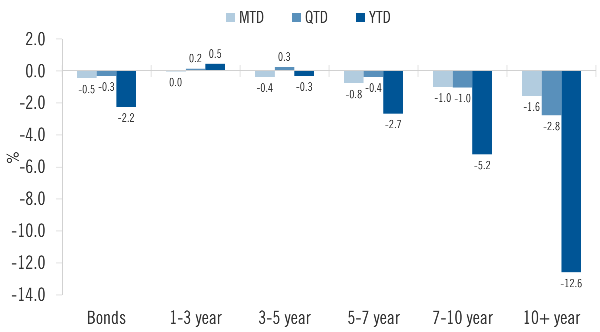
Source: Bloomberg, Money Market, USA

US TREASURY BOND YIELDS



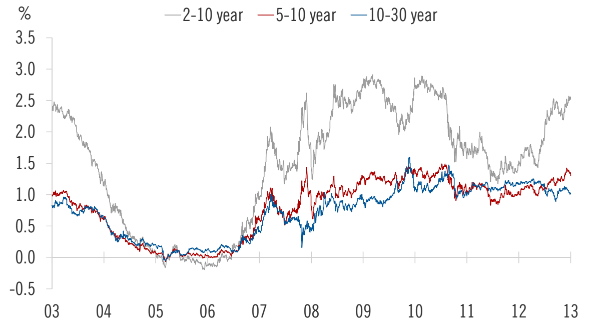
Source: Bloomberg, Us Treasury

RETURNS FROM GOVERNMENT BONDS BY MATURITY



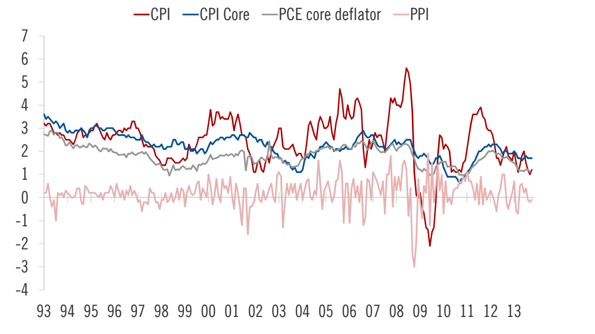
Source: Bloomberg, Citigroup, US Treasury

MOVEMENTS IN YIELD SPREADS



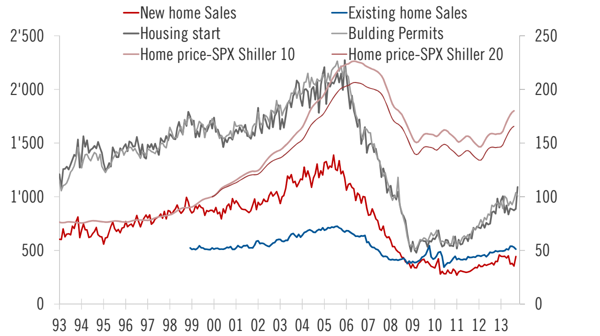
Source: Bloomberg, US Treasury

INFLATION



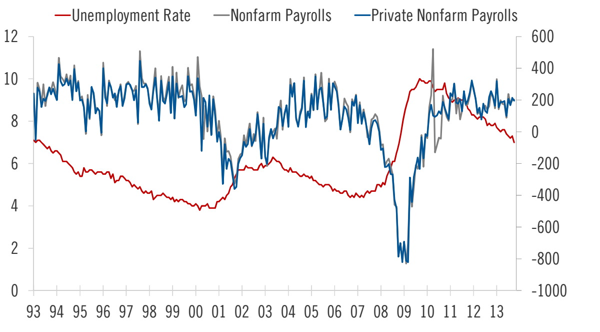
Source: Bloomberg, USA

HOUSING



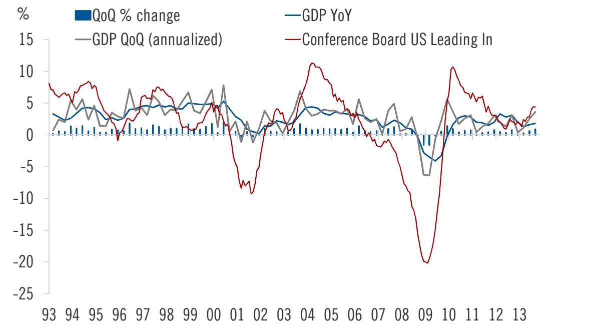
Source: Bloomberg, USA

LABOUR MARKET



Source: Bloomberg, USA

GDP



Source: Bloomberg, USA

ECB envisaging a prolonged spell of mild inflation

Slightly better figures for Europe lowered the tone of speculation about a further rate cut by the ECB

The ongoing uptrends on European economic and business surveys and PMIs, the dip in the jobless rate from 12.2% to 12.1% and the gentle quickening in inflation from 0.8% to 0.9% tempered expectations of another cut in the ECB's benchmark interest rates. Although figures were less bleak, the eurozone economy is still languishing in the doldrums. Economic forecasters are projecting very lacklustre 0.2% growth in GDP for the final quarter of 2013. According to the European Commission, eurozone GDP is on course to shrink by 0.4% over the whole of 2013 before expanding by 1.1% in 2014, with unemployment set to remain very high.

Economic figures for France remain very disappointing, prompting fears of the economy sliding back into recession. Germany, where a grand coalition has finally been stitched together as a government, is looking for moderate growth in the last quarter of 2013 owing to sluggish industrial activity this autumn, but findings from economic and business surveys have been heartening. The recession's vice-like grip on Greece has been softening, with exports rebounding in Q3 for the first time since 2008, but talks are dragging on with the country's creditors (ECB, EU authorities and the IMF) about overcoming disagreements on financing, with the Athens government looking to reduce debt again in 2014. Portugal's economy returned to the path of growth, with GDP advancing by 0.2%.

Changes in some European countries' credit ratings by S&P had barely any impact on the markets

The Netherlands' credit rating was lowered from triple-A to AA+ owing to economic prospects being duller than expected. Cyprus saw its credit rating upgraded from CCC+ to B-, with a 'Stable' outlook tag attached as Standard & Poor's considers the country will continue to adhere scrupulously to the rescue package instigated by the Troika, enabling Cyprus to cover its borrowing requirements up to March 2016. S&P also upgraded its outlook for Spain from 'Negative' to 'Stable', commenting that the stabilising economy was lessening the risk of a further rating downgrade.

The ECB left the markets wanting more at the end of its final meeting of the year

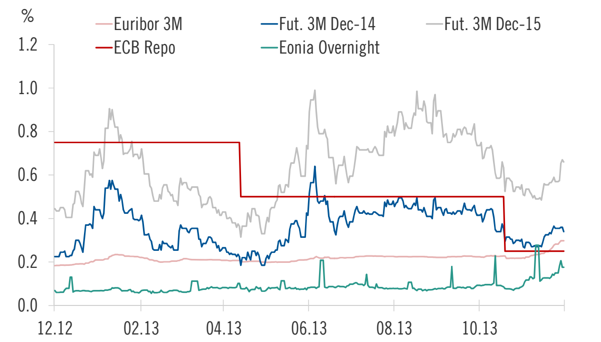
The markets had been expecting the ECB to take some new measures, but, in the end, it made no fresh policy announcements in December, with ECB President Mario Draghi adopting a slightly less accommodating tone than expected in reaffirming his confidence about the recovery underway. According to the ECB, production is set to recover thanks to a revival in domestic demand, boosted by monetary policy and a gradual upswing in external demand. Mario Draghi indicated that the ECB was envisaging a lengthy period of mild inflation, followed by gradual acceleration towards a rate just under 2%. He confirmed indications about the future direction of interest rates which should remain at current levels or be pushed lower, if deemed necessary.

In the latter stages of 2013, European bonds have been pretty much range-bound

Investors have been left waiting for further clarification about what is likely to happen to the eurozone economy. If the prospect of the ECB making further rate cuts or pushing through new non-orthodox monetary-policy measures (asset-purchasing programme) were to mount, then the 10-year Bund yield might well decouple even more noticeably from its US T-bond equivalent, especially if US Treasuries are penalised by shifting expectations over the scale and tempo of Fed tapering.

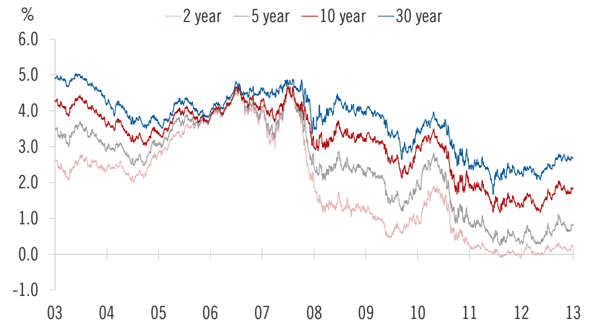
EUROZONE

SHORT-TERM RATES (EURO)



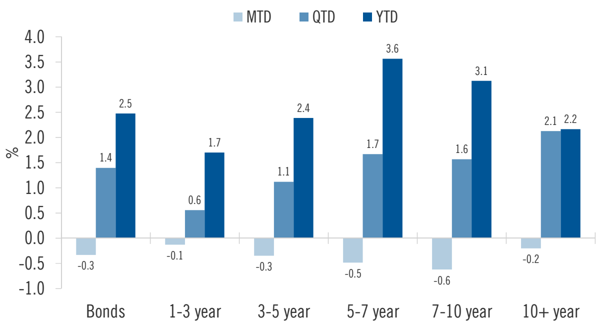
Source: Bloomberg, Money, EU

BUND YIELDS



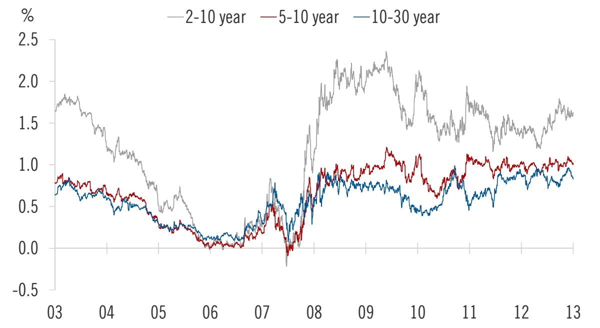
Source: Bloomberg, Bund

RETURNS BY MATURITY (EMU GVT)



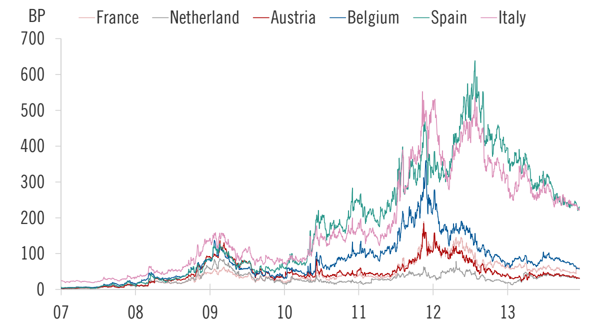
Source: Bloomberg, Citigroup, EMU Gvt Bonds

MOVEMENTS IN YIELD SPREADS



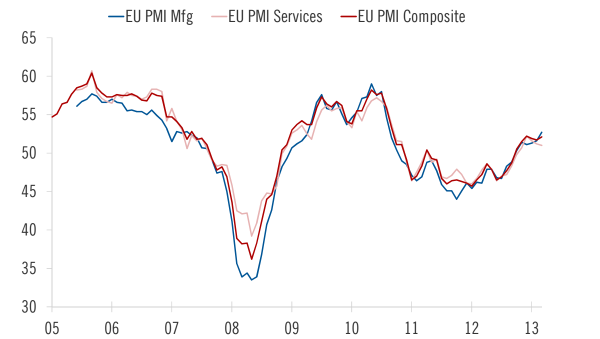
Source: Bloomberg, Bund

10-YR GVT SPREADS VS GERMANY



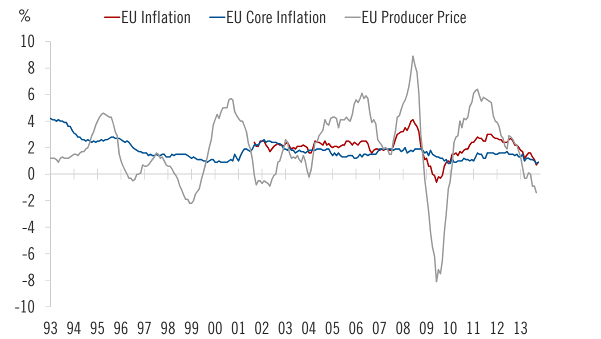
Source: Bloomberg, Govt yield spreads

EUROZONE - PURCHASING MANAGER INDICES



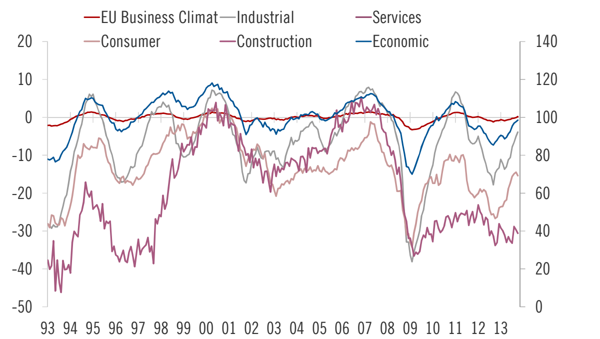
Source: Bloomberg, Eurozone PMI index

EUROZONE - INFLATION



Source: Bloomberg, Eurozone

EUROZONE - ECONOMIC SURVEYS



Source: Bloomberg, Eurozone Economic Survey

Economic upswing helping to improve the budget position

George Osborne confirmed the government was sticking with its austerity line and voiced confidence about cutting the budget deficit thanks to the quickening recovery

In his Autumn statement to the House of Commons, Chancellor of the Exchequer George Osborne reiterated his resolve to persevere with the government's austerity measures aimed at rehabilitating public-sector finances over the coming years. With the general election pencilled in for 2015, he expressed his confidence that the current policies would see a return to a balanced budget during the 2018/19 fiscal year. The UK debt/GDP rate should start to come down from 2016. The opposition Labour Party had been vociferously critical of the government's severe budgetary belt-tightening, but the Chancellor made great play of pointing out that they had been mistaken. He also pointed out that unemployment was on course to continue declining, reaching around 7% by 2015.

As the economy has been growing more robustly than expected, recording among the fastest rates in the developed world, the British government looks likely to attain its budget targets. If the impact of transfers from the Bank of England and the Royal Mail are disregarded, the deficit should total 6.8% of GDP this year, lower than the 7.5% projected in March. According to the most recent projections from the Office for Budget Responsibility, GDP is set to expand by 1.4% in 2013, by 2.4% (previously 1.8%) in 2014 and 2.2% in 2015. The deficit should duly disappear by 2018.

The Bank of England has not modified its monetary policy, but is taking measures to forestall any house-market bubble from inflating

At its early December meeting, the Bank of England (BoE) left the base lending rate and the total envelope for its bond-purchasing programme unchanged, but did spring a surprise by announcing changes to its 'Funding for Lending' programme, particularly measures to give house-buyers a helping-hand. This programme will no longer be available to individual mortgage borrowers, but will be refocused on lending to small businesses. The BoE justified this move on the grounds of the fast-rising housing prices, fuelling fears of a new bubble ballooning. BoE Governor Mark Carney pointed out that incentives were no longer needed to boost mortgage borrowing by individuals and that the BoE would still be prepared to take other measures to slow the pace of rising property prices.

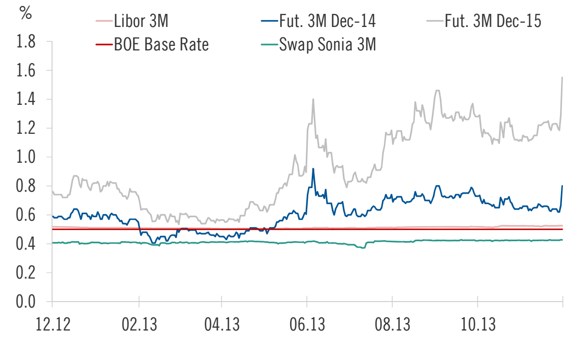
The BoE Governor also commented that the UK economy, handicapped by the pedestrian eurozone economy, still needed a stimulus from monetary policy and that, even if the jobless rate were to sink towards its targeted 7% in 2014, a possibility the BoE is not ruling out, this would not automatically trigger a hike in interest rates. He also cautioned those thinking about buying property about the risks of interest rates having to be raised in the more medium term.

With the economy swinging upwards, interest rates will continue reverting more to normal

Recent data confirmed the scenario of the ongoing upturn in the UK economy. Inflation has also continued to slow, coming down to 2.1% and almost in line with the official target. The Manufacturing PMI advanced from 56.0 to 58.4 in November and the Construction PMI progressed from 59.4 to 62.6. Industrial production and manufacturing output both registered 0.4% increases, numbers of new cars being registered climbed by 7% and the unemployment rate declined to 7.4%. As we move into 2014, the gilts market might remain under some pressure even if the base lending rate stays unchanged until employment improves enough in the BoE's assessment.

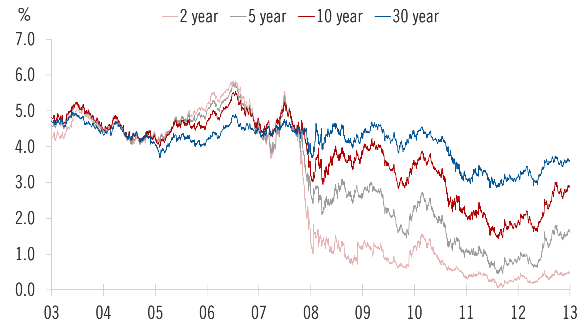
UK

SHORT-TERM RATES (GBP)



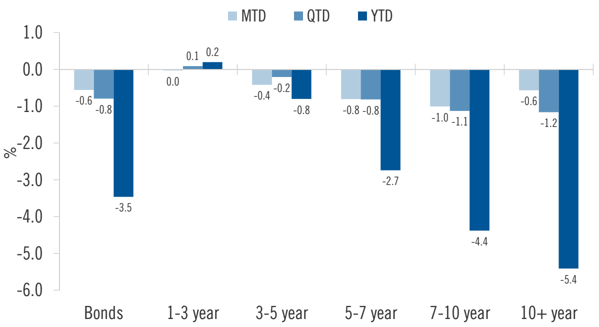
Source: Bloomberg, Money Market, UK

UK TREASURY YIELDS



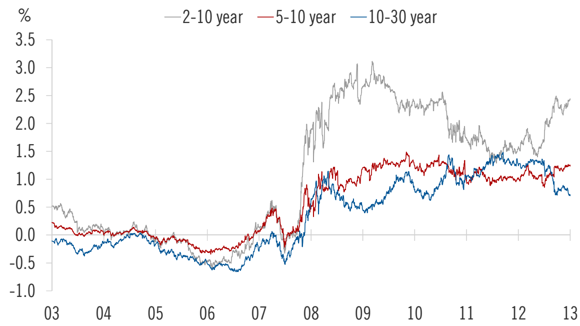
Source: Bloomberg, GILT

RETURNS FROM GOVERNMENT BONDS BY MATURITY



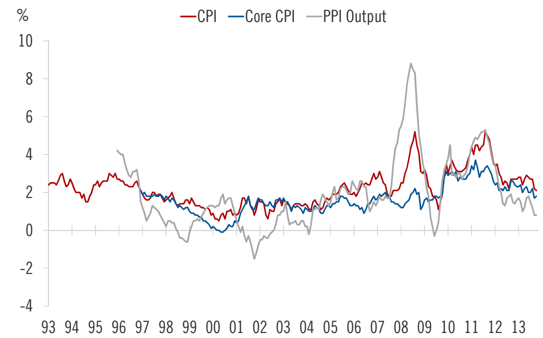
Source: Bloomberg, Citigroup, UK Treasury

MOVEMENTS IN YIELD SPREADS



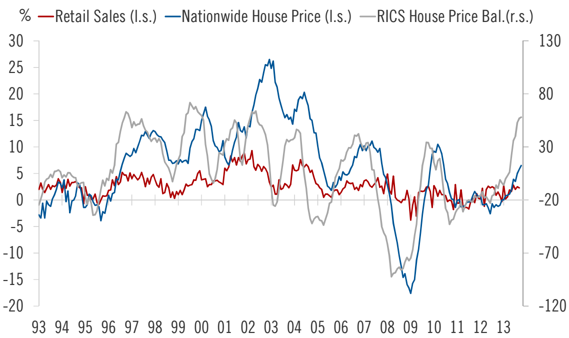
Source: Bloomberg, GILT

INFLATION



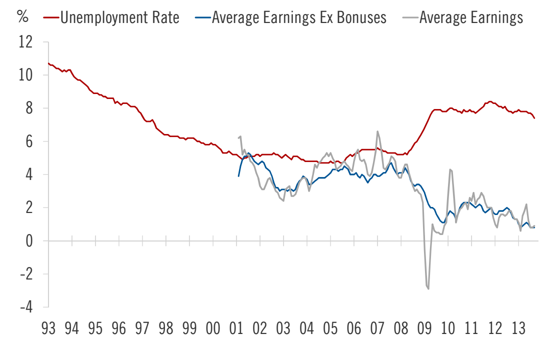
Source: Bloomberg, UK

HOUSING AND RETAIL SALES



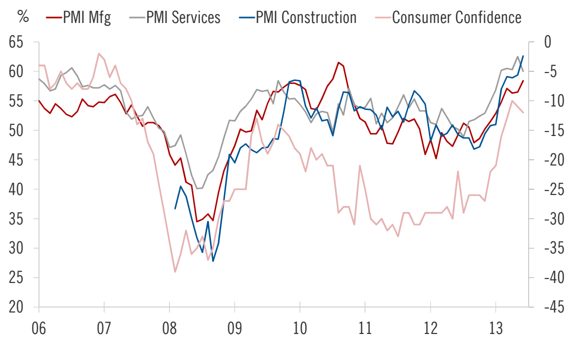
Source: Bloomberg, UK

INFLATION



Source: Bloomberg, UK

ECONOMIC SURVEYS



Source: Bloomberg, UK

SNB concerned by the lively mortgage market

Growth in Switzerland has remained robust in spite of the generally anaemic international economic climate

Switzerland's GDP advanced by 0.5% q-o-q and by 1.9% y-o-y in Q3 2013. The slight uptick in the global economy did give exports a boost whereas consumer spending growth slackened off a little, posting a 0.2% rise compared to 0.6% in the two previous quarters. The KOF economic barometer extended its uptrend in November, advancing from 1.72 to 1.85, and the Manufacturing PMI rebounded from 54.2 to 56.5, which augurs promisingly for a good start to 2014 for the Swiss economy. The KOF research institute highlighted a quickening in the positive momentum in the economy, pointing out that three components (Swiss consumer spending and industrial activity, exports to the EU) were tracing an upward curve. After Fitch the previous month, it was the turn of Standard & Poor's to reconfirm Switzerland's triple-A status with a 'Stable' outlook. The rating agency is of the opinion that, with a diversified and prosperous economy, Switzerland looks quite capable of coping with most potential economic shocks. S&P also praised the initiatives taken to strengthen regulations applicable to banks.

Consumer prices held steady m-o-m in November. Package holiday costs, rents and the price of meat all rose, offsetting the fall in telecommunications tariffs, the cost of petroleum products and vegetable prices. The y-o-y rate of headline inflation advanced from -0.3% to +0.1% whereas the underlying rate climbed from -0.1% to +0.1%.

The SNB not executing any U-turns

At its quarterly meeting in December, the Swiss National Bank (SNB), as expected, stuck with its range for the 3-month LIBOR at 0.0%-0.25% and made no change to its threshold for the exchange rate against the euro at CHF1.20, highlighting its belief that the franc was still strong. The SNB reiterated its resolve to buy foreign currencies in unlimited quantities if circumstances demanded it, and did not rule out pushing through further measures if needed. The SNB confirmed its forecasts for GDP growth, projecting a rate between 1.5% and 2% for 2013 and around 2% for 2014, estimates that are close to those of the main economic forecasting institutes. It also stated that, even though the economy maintained its forward momentum in Q3, it might experience a temporary lull in the latter stages of the year. As for inflation, the SNB saw no real risks surfacing, considering that annual inflation should work out at -0.2% in 2013, +0.2% in 2014 and +0.6% in 2015.

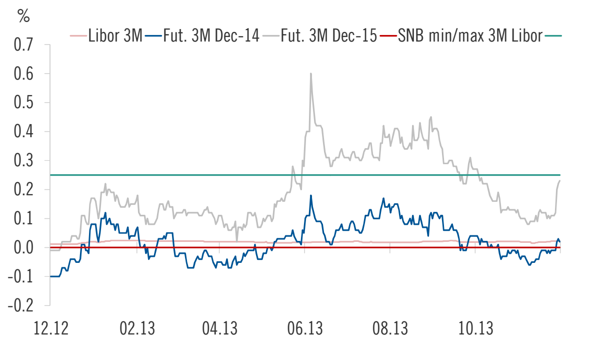
SNB still worried about the property market being fuelled by interest rates stuck at rock-bottom levels

The SNB is continuing to monitor developments on the property market very closely and will contemplate making any changes, if it proves necessary, to the level of the countercyclical capital buffer (CCB) banks are required to comply with. The CCB became active as from September, with the level set at 1%, but there is scope under the legislation for this to be raised up to 2.5%. SNB Vice-President, Jean-Pierre Danthine, warned that developments on the mortgage market constitute the main risk menacing banks' stability in the medium term as they do not appear to be paying close enough attention to borrowers' financing capabilities.

Even though Switzerland's economy is fairly buoyant, yields on Confederation bonds are likely to remain low in the coming months as the SNB is not going to lift interest rates as long as it considers a rise in the Swiss franc would pose a threat to the well-being of the economy.

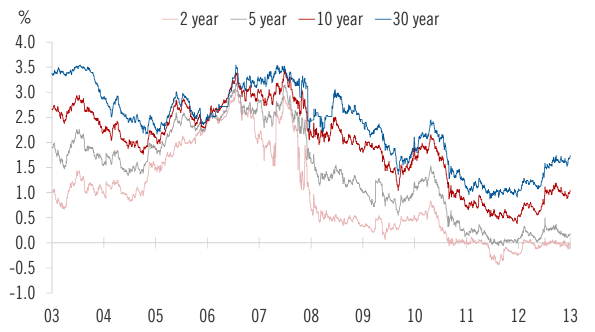
SWITZERLAND

SHORT-TERM RATES (CHF)



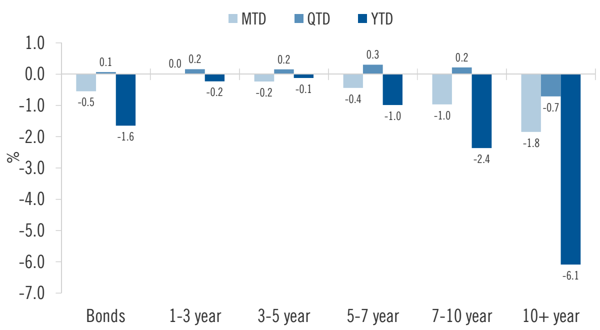
Source: Bloomberg, Money Market, CHF

CONFEDERATION BOND YIELDS



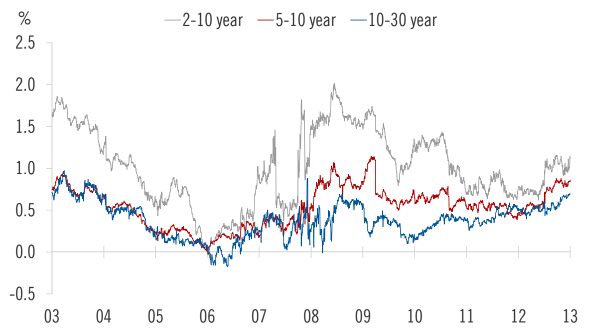
Source: Bloomberg, Confederation

RETURNS FROM GOVERNMENT BONDS BY MATURITY



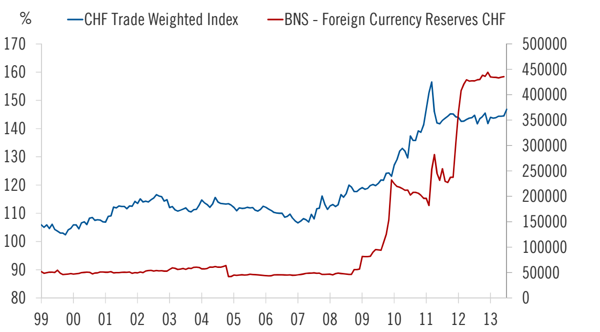
Source: Bloomberg, Citigroup, Switzerland Gvt Bonds

CONFEDERATION - MOVEMENTS IN YIELD SPREADS



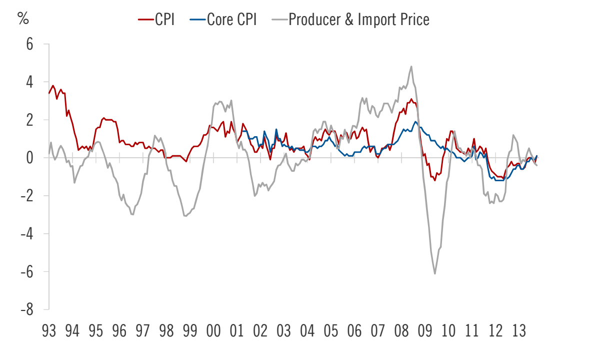
Source: Bloomberg, Confederation

SNB EXCHANGE RESERVES



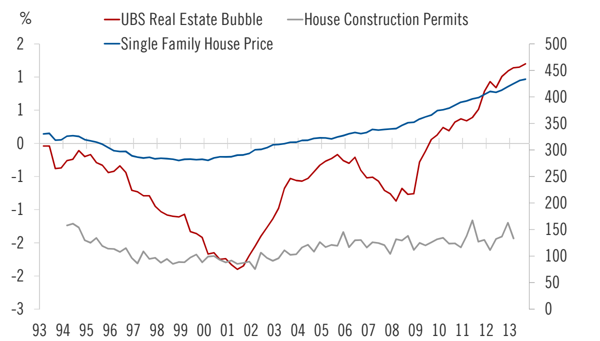
Source: Bloomberg, Switzerland

INFLATION



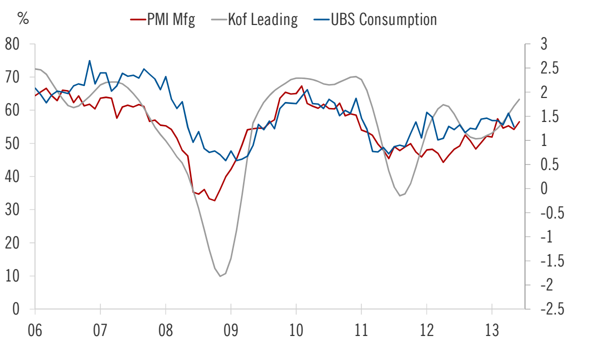
Source: Bloomberg, Switzerland

HOUSING MARKET



Source: Bloomberg, Switzerland

ECONOMIC SURVEYS



Source: Bloomberg, Switzerland

Question-marks still hang over effectiveness of Abenomics

Economists consider the economic upswing is still fragile and structural reforms are necessary

Many forecasters and commentators are of the view that the Bank of Japan's monetary easing and the government's reflationary stimulus plans are just not going to be enough to ensure Japan returns to the path of sustained and sustainable growth. Moreover, growth has been spluttering since the summer months. GDP growth, which had already slowed, was revised further downwards to just 0.3% for Q3 2013, compared to 0.9% in Q2. Anaemic consumer spending, a weak yen which is making imports more expensive, together with a decline in exports, explain this stumble by Japan's economy. This dip in growth at a time when the proposed hike in the consumer sales tax rate in spring 2014 is likely to act as a damper on consumer spending has revived concerns about the effectiveness of Japanese authorities' policy mix. Households' spending is being dented by a combination of rising prices and the ongoing decline in pay. As the hike in consumer sales tax will further hurt consumer spending, wage-bargaining rounds in early 2014 will need to come up with pay increases in order to restore some balance to the equation.

In recent months, price indices have been edging upwards, but that should not be construed as Japan emerging from deflation as the rise has primarily been due to higher electricity and petrol prices. Increased gas and oil prices, which have been imported in huge quantities since the Fukushima disaster and the shutdown of the country's nuclear power plants, are driving inflation upwards and causing a lasting trade deficit. To compensate for this, the government's new long-term energy plan has put nuclear power back on the agenda, and it has not ruled out building new plants.

The government has approved a new reflationary package to offset the rise in consumer sales tax and to stimulate growth

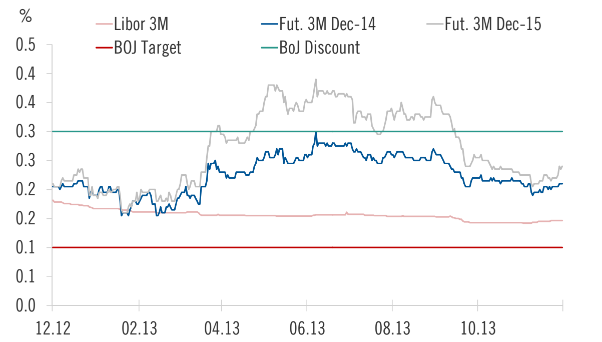
The government's stimulus package, worth JPY18,600bn (CHF165bn), comprising lending already granted by public bodies and spending already envisaged by local authorities, bears a striking resemblance to budget packages pieced together over recent years by previous governments. According to the experts, new spending only appears to amount to some JPY5,500bn or 1% of GDP. Details of the plan, to be financed without recourse to further debt, have still not been unveiled.

With the BoJ taking an activist approach, Japanese government bond yields are set to stay range-bound

Some BoJ Policy Board members have been more pessimistic than the BoJ Governor about the effectiveness of the Abe government's economic reflationary programme. Governor Harukiro Kuroda vaguely referred to modest adjustments to the central bank's policy whereas Sayuri Shirai was of the view that new measures would probably be needed to ensure inflation hit the target of 2% and to relaunch the economy on a course of sustainable growth. She highlighted three risks hanging over growth which has been unmistakably losing speed in recent months. This trio of risks comprises uncertainties in the global economy, the labour market in Japan and pay levels which, to underpin domestic demand and prices, need to rise. Minutes from the November meeting of the BoJ's Policy Board offered an insight into the mounting scepticism being expressed by some of the Board's nine members on the chances of hitting the inflation target. The BoJ declared it is still willing to increase its purchases of bonds if necessary.

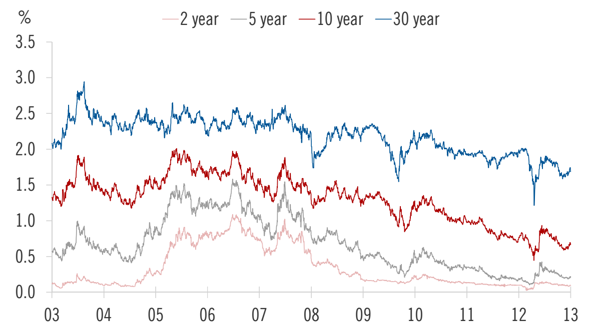
JAPAN

SHORT-TERM RATES (YEN)



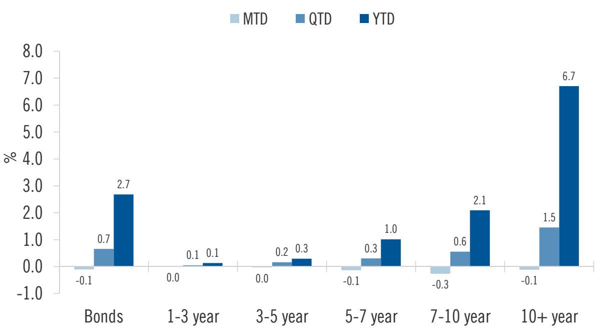
Source: Bloomberg, Money Market, Japan

JAPANESE GOVERNMENT BOND YIELDS



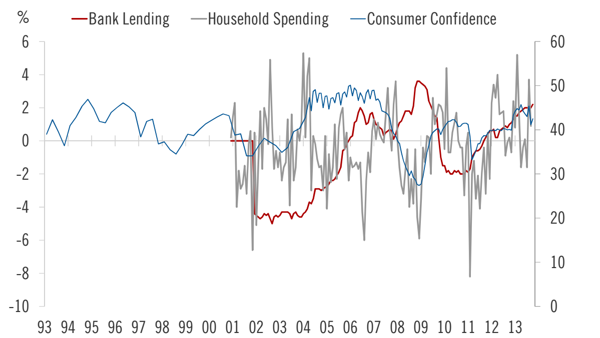
Source: Bloomberg, JGB

RETURNS FROM GOVERNMENT BONDS BY MATURITY



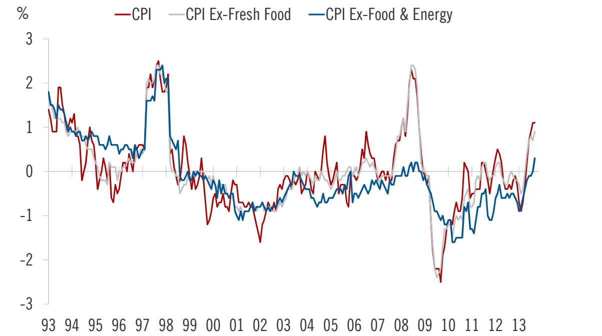
Source: Bloomberg, Citigroup, Japan Gvt Bonds

CONSUMPTION



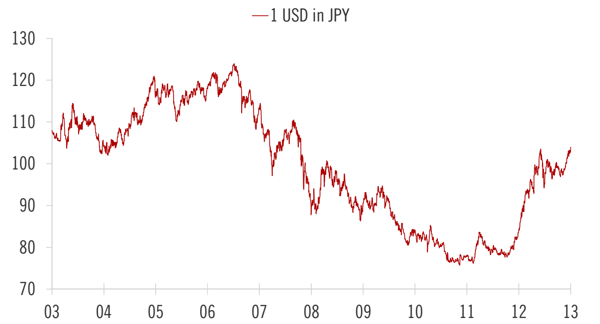
Source: Bloomberg, Japan

INFLATION



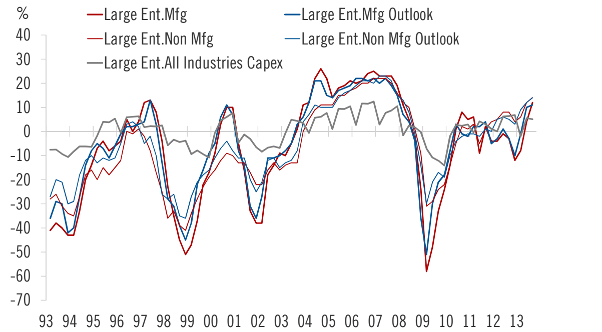
Source: Bloomberg, Japan

JAPANESE YEN VERSUS DOLLAR



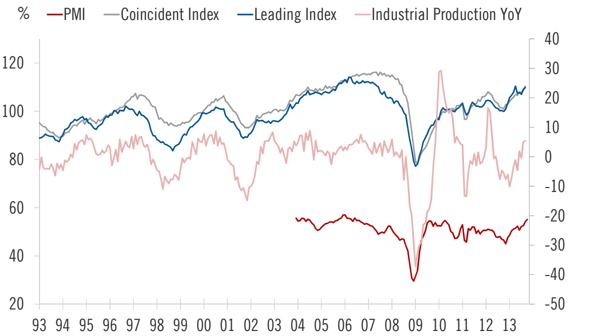
Source: Bloomberg, exchange rates

TANKAN



Source: Bloomberg, Japan

LEADING INDICATOR AND INDUSTRIAL PRODUCTION



Source: Bloomberg, Japan

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