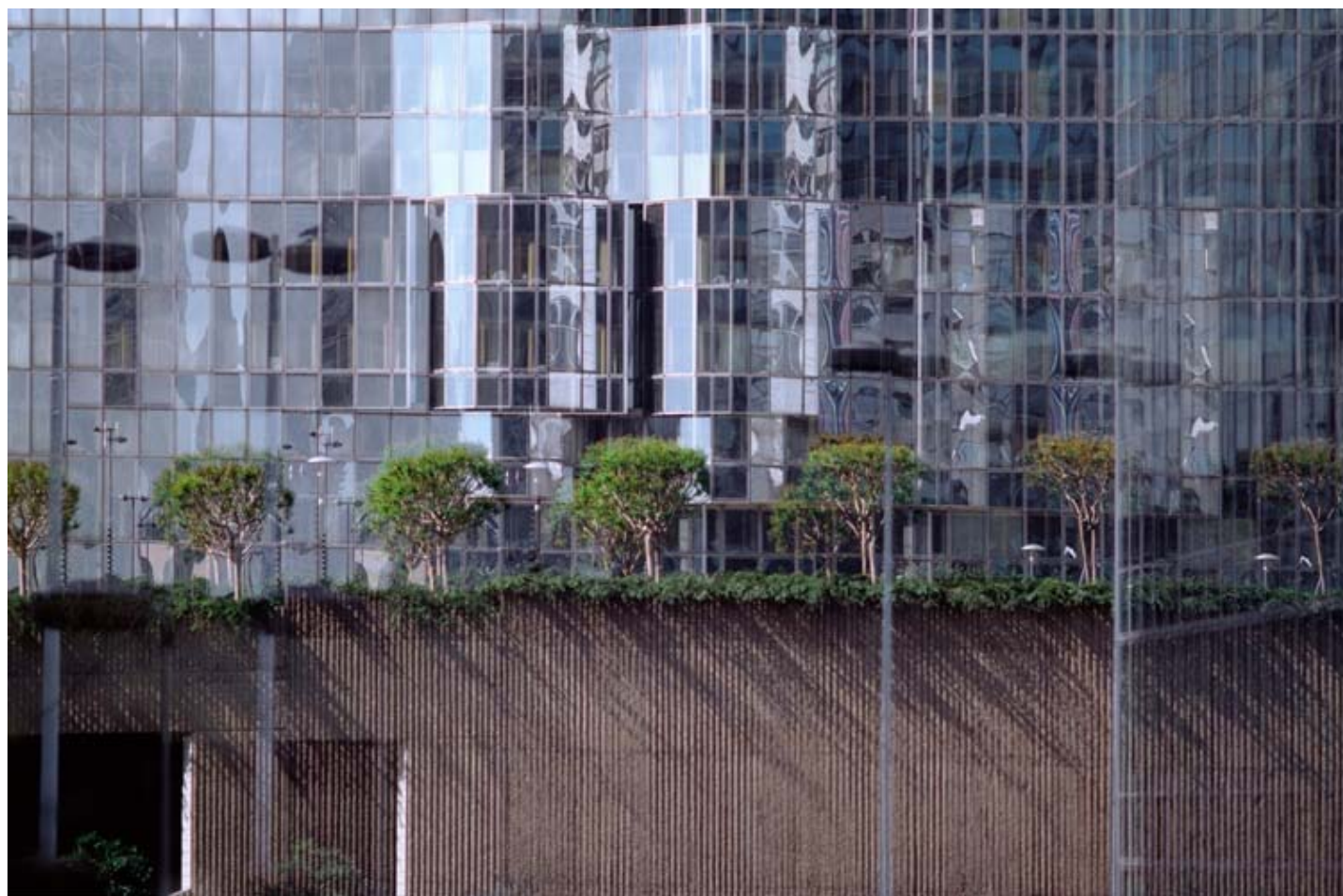


Monthly Bond Letter

June 2013

Pictet Asset Management



CONTENTS

Overview	3
Inflation-linked bonds	5
Credit risk	7
Emerging debt	11
USA	13
Eurozone	15
UK	17
Switzerland	19
Japan	21

Recent developments

Long-bond yields moved steeply upwards in May despite declining inflation and a still unsettled economic climate

The prospect of a slowdown in the Fed's quantitative-easing (QE) measures was the dominant theme over the past month. Recent numbers published in the USA suggested the slowdown in the economy, triggered by the fiscal tightening, might indeed turn out to be a temporary blip.

At its last FOMC meeting, the Fed decided to maintain its ultra-accommodating policies, but uncertainties over the future of quantitative easing have mounted

Economists are assuming the Fed will modulate the tempo at which it has been buying assets in the final quarter of this year. In these circumstances, the yield on 10-year US Treasury bonds climbed back to 2.16%, pulling up yields on equivalent safe-haven sovereign debt along with it.

The fiscal and monetary policy mix being pursued by the authorities in Japan has given the economy a welcome boost

Current policy measures have sent the yen downwards and pushed share prices upwards on the Tokyo stock market, but they also caused some turbulence on the bond market. Yields on 10-year Japanese government bonds (JGBs) dramatically doubled from their all-time lows in April. Various factors lay behind this

correction which unsettled the markets: rotation from bonds into equities; shift in expectations as regards future economic growth (GDP advanced by 0.9% in Q1 2013) and inflation (inflation break-even threshold on index-linked bonds moved up by 50 basis points). 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. In the aftermath of the upheavals on the JGB market, the BoJ's new Governor Haruhiko Kuroda indicated the BoJ would approach its buying of bonds more flexibly so as to prevent volatility on government bonds from having any adverse impact on the economic recovery.

With the eurozone economy still deep in recession, unemployment climbing and inflation on the decline, the ECB cut its benchmark rates

On top of the rate cut, ECB President Mario Draghi announced new ways were being investigated to underpin bank lending in troubled member states. Against a backdrop of hopes of the eurozone emerging from recession in the latter half of this year, fears of the Fed reining back its QE and the turbulence on Japan's bond market, 10-year Bund yields moved back up in May. As political developments in

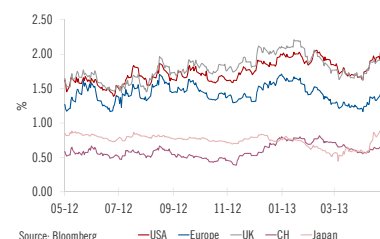
Europe had little impact on peripheral member states in recent weeks, spreads held quite steady.

European corporate bonds continued to benefit from investors' quest for yield, but the market was not immune to the jump in sovereign bond yields

Although returns from investment-grade corporates were modest in May, they comfortably outperformed government debt thanks to the further narrowing of credit spreads. For once, financials did not outperform non-financials.

The high-yield segment made strong progress again in early May in response to the ECB rate cut, but it later ran out of steam somewhat. All segments, apart from CCC-rated bonds, posted gains. BB bonds outperformed single B issues in a reversal of the previous month's fortunes. Sector-wise, banks set the pace, followed by energy. In contrast, consumer cyclicals lost ground. UK and Greek issuers performed best of all, with Spanish paper losing out.

10-YEAR GOVERNMENT YIELDS



Forecasts

Amid concerns about liquidity taps being turned off, the bond market might well extend its gentle corrective trend

The Fed reported that household consumer spending, investments and the housing market were exhibiting signs of turning upwards, but that fiscal policy was still acting as a drag on growth. As inflation has been steadily falling and is pitched well below the Fed's official target, the Fed is under no pressure to scale back its asset-repurchase programmes.

Any reining-in of quantitative easing is unlikely to trigger a crash on the bond market as the Fed's policy remains in highly accommodating gear

Investors have turned decidedly edgier and will be keeping a very close eye on forthcoming jobs numbers. If the jobless rate in the USA continues to drift downwards, monthly numbers of jobs being created run above 200k and the impact of tightening budget policy begins to diminish, investors may well continue to expect the Fed to change tack in its policy. Although the prospect of quantitative easing being toned down has already been noticeably priced in, yields on 10-year US Treasury bonds might well edge higher, moving up to test out the 2.50% barrier.

As the BoJ is set to buy up government bonds wholesale, the Japanese government will be under no time pressure to reduce the budget deficit

Japan's debt is set to go on ballooning. The debt/GDP ratio could climb to 245% in 2013. Although, as things stand, Japan's government financing is being covered almost entirely by domestic investors, any further rise in yields could well bring with it problems for public-sector finances. As Japanese banks own a sizeable chunk of Japanese government debt, any significant rise in yields would make a serious dent in their balance sheets in terms of both profits and solvency ratios. The BoJ has indicated it will adopt a more flexible approach to its asset-buying so as to damp down this volatility in JGB yields.

The state of affairs in Europe remains challenging, but the worst may well be over

Rebounds in eurozone Purchasing Managers' Indices, car registrations and the German business sentiment index, coupled with the prospect of less austere economic policies being pursued in some countries, suggest the eurozone economy

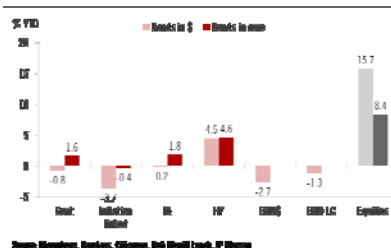
might well emerge from the recessionary tunnel in the not too distant future. Yields on German Bunds had sunk to rock-bottom levels, but they could well edge up a little further before the year is out if the scenario of a gradual upturn in eurozone economies were to materialise.

Credit spreads look set to narrow even further on the corporates market although this movement is likely to focus chiefly on bonds offering the highest yields

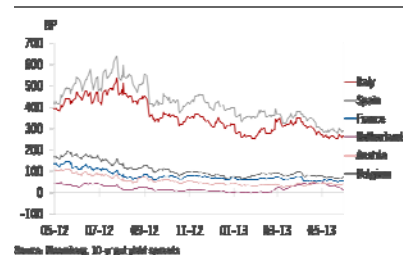
At today's levels, bonds issued by borrowers from eurozone peripheral member states offer more limited protection against any renewed downswing in the economy, political crisis or credit downgrades that might push several issuers into high-yield territory.

Fundamentals underpinning high-yield corporates in general still look sound enough though. Defaults should remain few and far between, but technical factors do make the bonds look a little more vulnerable. Other risks, such as the Fed's QE exit strategy, have also begun to loom large in investors' consciousness.

PERFORMANCES 2013



10-YR GVT SPREADS VS GERMANY



Inflation break-even points coming down, except for Japan

USA: the Fed has altered the correlations game

The prospect of a slowdown in the Fed's quantitative-easing (QE) measures was the dominant theme over the past month. The Fed hinted that it might make a move to slow down the pace of its QE repurchase programme rather sooner than the market had been counting on. Real interest rates reacted smartly to this hint, moving up by 40 basis points on 10-year paper. The scale of this swing upwards suggest that market operators were now positioning themselves in expectation of QE being reined in before the end of 2013. In contrast, the impact of this shift in expectations on inflation break-even thresholds was much less clear-cut.

It is reasonable to presuppose that, if macroeconomic conditions were robust enough, inflation break-evens should push upwards. But that did not happen in May as those thresholds continued to drift lower in response to the inflation rate being reported as declining to 1.1% and to comments made by a Fed that the market perceives as only being mildly concerned about the inflation-related aspect of its brief. Moreover, intriguingly, the positive correlation between equity markets and inflation break-even points recently snapped, which would seem to suggest shares might not be hit too hard by news of the Fed shifting to QE exit mode.

Heading towards the inflation curve flattening out in the eurozone

Eurozone inflation retreated to 1.2% y-o-y in April, some distance below the ECB's 2% target for price stability. Moreover, this subdued rate of inflation was not solely due to falling energy prices or seasonal factors (such as the moveable Easter holiday weekend). The underlying rate of inflation, from which the most volatile price components are stripped out, is also declining noticeably in the eurozone, sinking from 1.5% to 1.0%. Furthermore, considering the brittle state of the eurozone economy, it is hard to imagine inflation bouncing back up in the short term. In such circumstances, inflationary expectations look most likely to be toned down further, which would cause the inflation curve, that still has a

fairly steep upward profile at present, to flatten out.

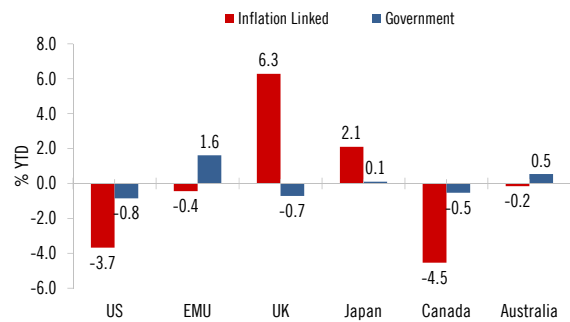
Will we see inflation quicken to 2% in Japan?

The election of the new government under Shinzo Abe's stewardship has, without a shadow of a doubt, modified the market's perceptions of the state of Japan's economy and its prospects. Of the so-called 'Three Arrows' forming part of the new Prime Minister's revamped economic strategy, popularly named 'Abenomics' – i.e. more credible and flexible fiscal policy, aggressive monetary-policy stimulus and structural reforms – the market reacted most enthusiastically to the second of these, the more aggressive line on monetary easing. Reacting to the Bank of Japan's announcement it was setting an ambitious target of 2% inflation in two years' time, the Nikkei share index extended its rally whilst the yen moved steeply lower. Although there are reasonable grounds for questioning the credible viability of achieving a 2% inflation target in a country plagued by deflation since the latter half of the 1990s, there is no denying the markets greeted the announcement very positively.

Although deflation has not been eradicated yet, inflation can be expected to move into positive territory in the medium term, partly on account of the hike in the consumer sales tax (on the cards for 2014) and partly owing to the rising import bill stemming from the fall in the yen's value. That is at least reflected in the market's expectations for inflation break-even points: the 5-year forward rate has jumped from 0.75% as of end-2012 to 1.75% of late. This increase in inflation break-even thresholds in Japan seems quite likely to reinvigorate the inflation-linked bond market (last new issue dates back to summer 2008), especially if new bonds being launched incorporate a guarantee of the principal sum being reimbursed at maturity, as the recent report coming out of the Japanese Finance Ministry would seem to suggest.

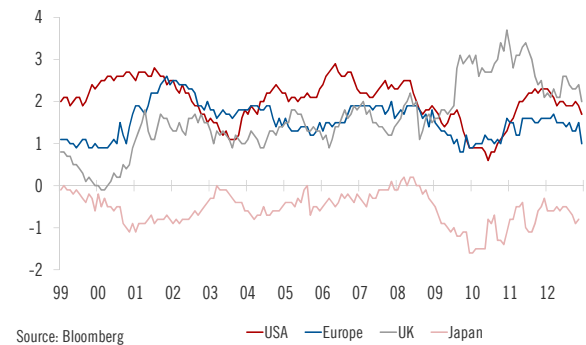
INFLATION-LINKED BONDS

PERFORMANCES 2013 (LOCAL CURRENCIES)



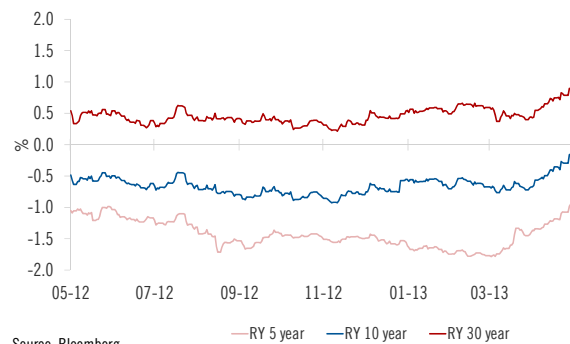
Source: Bloomberg, Citigroup, Barclays

CORE INFLATION



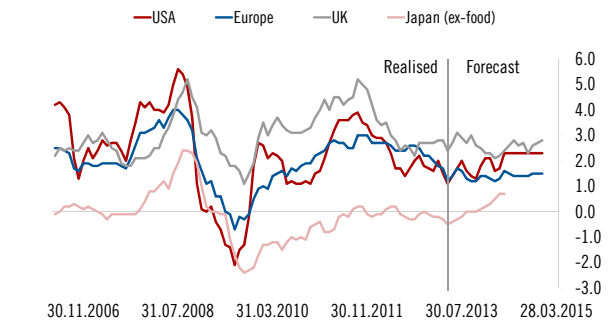
Source: Bloomberg

USA - RRAL RATES



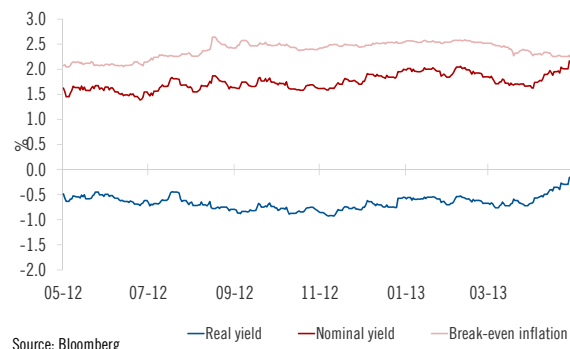
Source: Bloomberg

INFLATION



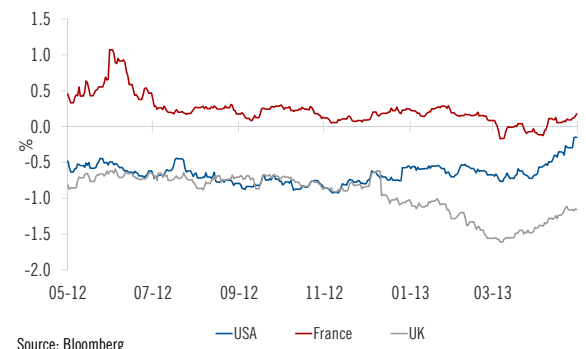
Source: Bloomberg, Barclays Capital

USA - 10-YEAR TREASURY YIELD COMPONENT



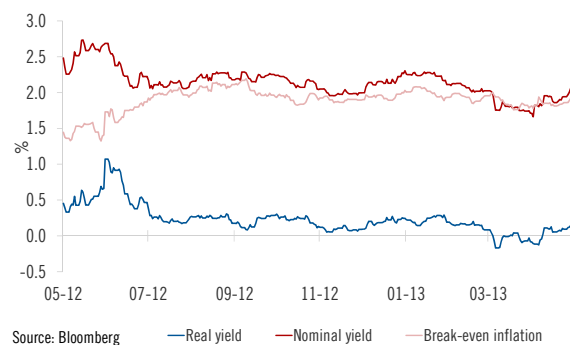
Source: Bloomberg

10-YEAR REAL YIELDS



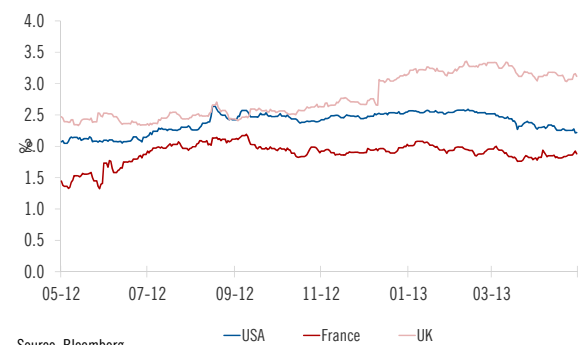
Source: Bloomberg

FRANCE - 10-YEAR YIELD COMPONENT



Source: Bloomberg

10-YEAR BREAK EVEN INFLATION POINTS



Source: Bloomberg

Less disparity between returns

Corporate bonds still benefiting from investors' search for yield

Although total returns from investment-grade corporates were modest in May, they comfortably outperformed government debt thanks to the further narrowing of credit spreads. In a market climate heavily influenced by central banks' highly accommodating and expansionary policies and much less by macro- or microeconomic fundamentals, the differences in issuers' credit ratings played very little part in performance last month, with credit spreads narrowing practically across the board. This was in stark contrast to events in recent months when disparities between sectors have been quite striking. Investors' hunt for yield also overshadowed concerns about interest-rate risk, which gave longer-dated bonds (above 10 years) a boost as they outperformed short- and mid-dated maturities.

For once, financials did not outperform the non-financials segment. Banks' senior debt turned out to be among the weakest performers sector-wise. The array of bail-in plans and preference for savers in distressed cases have reduced the potential for recouping principal in the event of a default or winding-up. On the other hand, Lower Tier 2 subordinated debt outperformed yet again, chiefly thanks to their significantly higher yields and an improvement in their relative positioning on account of banks' high capital levels. Very sound results, healthy capital positions and comfortable solvency ratios worked to the advantage of insurance groups, especially their subordinated debt, which delivered among the best returns in May. Regionally, Italian and Spanish issuers, generally speaking, outperformed borrowers from northern Europe in sectors such as utilities or capital-goods suppliers – Finmeccanica being a case in point. In the telecoms, banking and energy sectors though, the outperformance by periphery-based borrowers was not significantly greater. If we now turn to the rare instances of widening spreads and negative returns, we find bonds from the UK's Co-operative Bank and Italy's Banco Popolare di Milano, penalised by Moody's downgrading of their paper to high-yield status. Veolia's hybrid debt issued at the

outset of this year also underperformed in reaction to some poorish results being reported.

CDS contracts: 'bail-in' event included

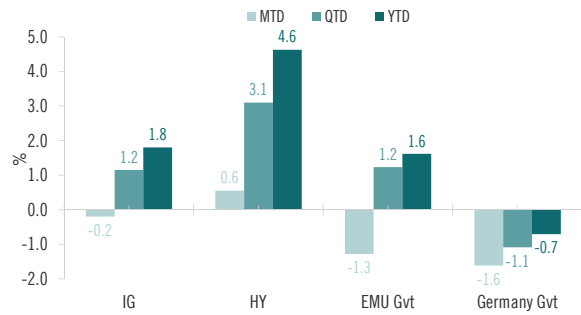
The International Swaps & Derivatives Association (ISDA), responsible for drafting standardised contracts for credit default swaps (CDSs), has tabled the proposal to include bail-ins as a possible trigger 'credit event'. Bonds whose value might have been reduced or even wiped out would become deliverable in the settlement of a CDS contract. With the change in rules under CRD 4 and the bail-in proposal plans in Europe, current Lower Tier 2 debt deliverable into subordinated financial CDSs has become increasingly rare, curtailing demand for this type of protection. As current subordinated CDS contracts are not retroactively affected by this proposal to include bail-ins as a credit event, their spreads came down steeply, and they comfortably outperformed senior CDSs.

Outlook

Trading on the markets demonstrated that the plentiful supplies of liquidity and investors' quest for yields have continued to have the upper hand over other fundamental factors. Credit spreads look set to narrow even further on the corporates market although this movement is likely to focus chiefly on bonds offering the highest yields, such as banks' and insurance groups' subordinated bonds or hybrid debt issued by non-financial borrowers. In other sectors, individual selection of corporate bonds will remain paramount as low yields are not providing sufficient reward for the risk of deteriorating creditworthiness due to economic factors or more shareholder-friendly decisions. As credit spreads have narrowed, bonds issued by borrowers from eurozone peripheral member states offer more limited protection against any further downswing in the economy, political crisis or credit downgrades that could push several issuers into high-yield territory.

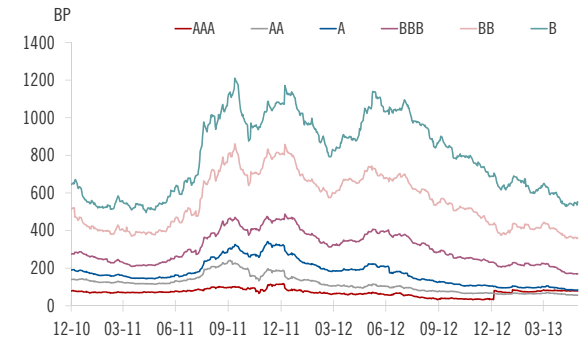
CREDIT RISK

RETURNS ON BONDS IN EURO



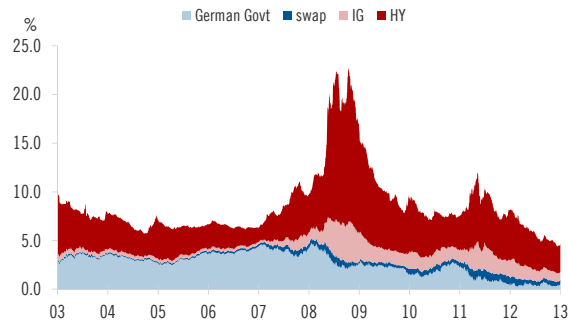
Source: Bloomberg, BoA Merrill Lynch, Citigroup

CREDIT SPREADS (EURO)



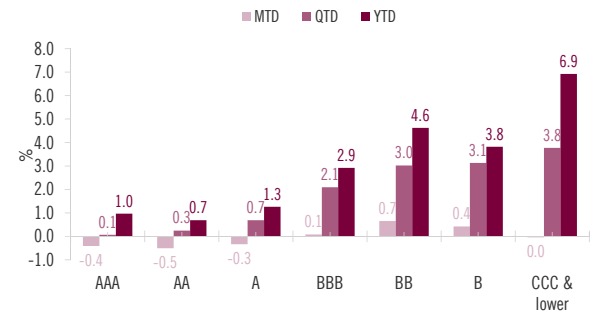
Source: Bloomberg, BoA Merrill Lynch

YIELD COMPONENT (EURO)



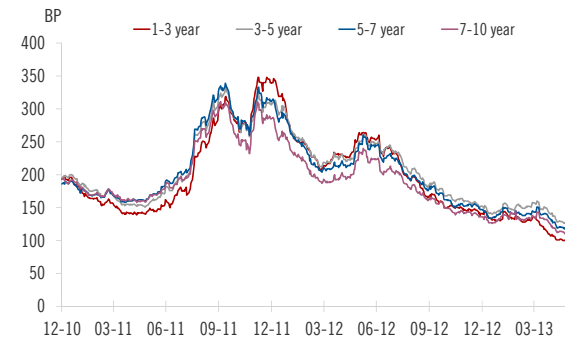
Source: Bloomberg, Barclays

RETURNS ON BONDS IN EURO



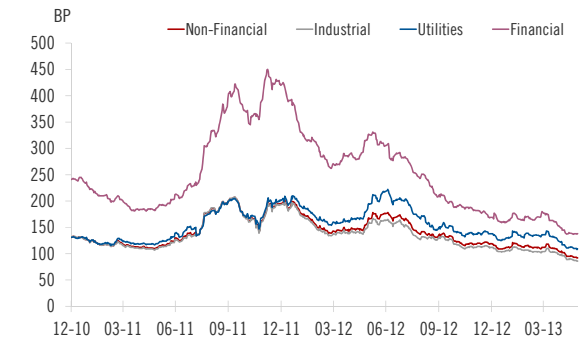
Source: Bloomberg, BoA Merrill Lynch

INVESTMENT GRADE SPREADS BY MATURITY (EURO)



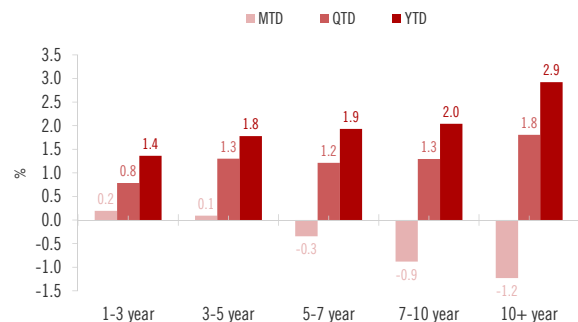
Source: Bloomberg - BoA Merrill Lynch

INVESTMENT GRADE SPREADS BY SECTOR (EURO)



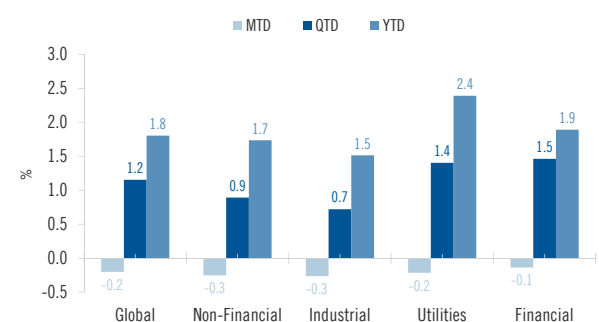
Source: Bloomberg - BoA Merrill Lynch

INVESTMENT GRADE RETURNS BY MATURITY (EURO)



Source: Bloomberg, BoA Merrill Lynch

INVESTMENT GRADE RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merrill Lynch

High-yield market advanced strongly before stuttering

Recent developments

May proved positive for the European high-yield corporates market, mainly thanks to this asset class's good showing at the outset of the month. The ECB's rate cut on 7 May shored up investor confidence and further boosted the search for yield. The ECB is also mulling over additional unorthodox measures specifically targeting small businesses as the credit market for such companies is still clogged. In the USA, volatility induced by Ben Bernanke's intervention on 22 May demonstrated investors' nerviness regarding the Fed's QE exit strategies. The market initially reacted positively, but then fell sharply, led by US Treasuries and equity markets. In Japan, the next day, investors echoed the reactions on US markets, with the Nikkei index sliding 7%. On the macroeconomic front, the latest developments were a mixed bag overall. As expected, US growth is slowing down slightly, with sequestrations acting as a drag. In Europe, unemployment is still creeping up, and fundamentals are deteriorating at both macro- and microeconomic levels. On that score, German business confidence rebounded at the month-end, providing unexpected support for European markets.

The high-yield market advanced strongly at the start of the month before stuttering. All segments advanced save CCCs. BBs outperformed B-rated issuers, reversing last month's trend. Regarding sectors, banks led the pack, followed by energy, whereas consumer cyclical names retreated. Issuers from the UK and Greece were among the top performers whereas Spanish borrowers stalled.

The primary market picked up in May, but remained below January levels. The secondary market was broadly unchanged. In terms of company news, the month proved busy with the reporting season. In early May, Kerling, the UK chemical company, announced the setting-up of a joint venture with Solvay, the investment-grade Belgium chemical group, to combine their PVC production. As a result, Kerling bonds moved higher. Most Q1 2013 results came out in line. Some companies, such as cement groups, suffered from the bad weather conditions. In

contrast, a few companies posted disappointing results: Codere, the Spanish gaming company, tumbled as risks of restructuring are mounting and were further exacerbated by Moody's downgrade. ATU, the German auto retailer, faced weaker than expected results and growing refinancing risk associated with its senior debt maturing in 2014. As a result, ATU bonds reacted negatively. Moody's also downgraded Banca Monte dei Paschi di Siena SpA's long-term debt and deposit ratings from Ba2 to B2. The UK's Co-operative Bank was downgraded to high yield by Moody's as the rating agency cited a capital shortfall and exposure to the commercial real-estate market. Both corporate issuers (ATU and Codere) are rated CCC, showing that the risk of credit events remained highly concentrated in the lower-rated segment of the high-yield market.

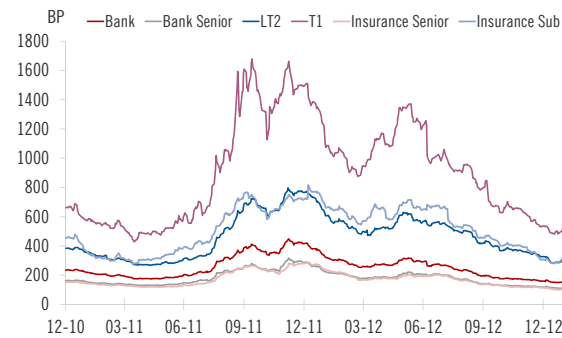
Outlook

The economic outlook is unchanged. Erratic reactions to early Fed tapering of its QE demonstrates the uphill challenges faced by Ben Bernanke or his successor. Massive liquidity injections worldwide are contrasting with weak macroeconomic fundamentals in Europe. Despite this dichotomy, the backdrop remains favourable to the high-yield market with sound balance sheets, tepid growth and receding tail risks. Relaxation of austerity measures in Europe may also help growth prospects in the short term. However, as spreads have tightened with the Crossover index touching all-time lows intra-month, volatility may resurface as investors are set to remain news-dependent. As a result and following the steady performance in April and early May, the high-yield market may take a breather. Single-name evolution has become more prominent although the reporting stream is now behind us.

Overall, fundamentals are still fine. Defaults are set to continue being low while technicals look more vulnerable. Other risks have emerged, such as exit strategies from quantitative easing in the USA.

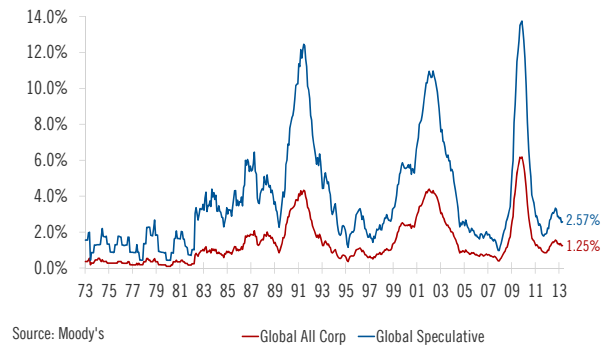
CREDIT RISK

FINANCIAL INVESTMENT-GRADE SPREADS (EURO)



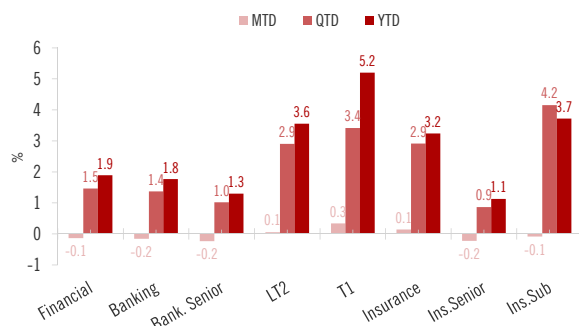
Source: Bloomberg - BoA Merrill Lynch

MOODY'S - DEFAULT RATES



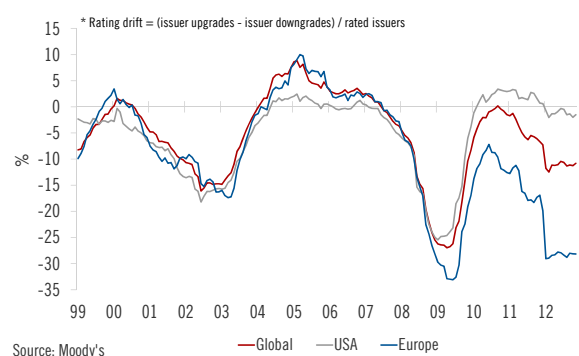
Source: Moody's

FINANCIAL INVESTMENT-GRADE RETURNS (EURO)



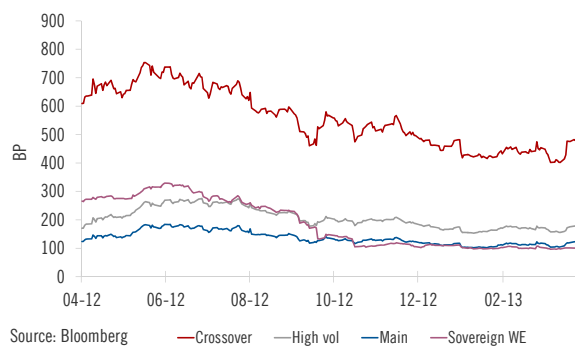
Source: Bloomberg, BoA Merrill Lynch

MOODY'S - RATING DRIFT



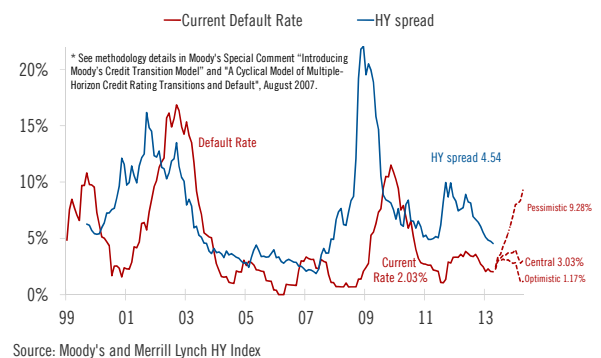
Source: Moody's

CDS - ITRAXX INDICES



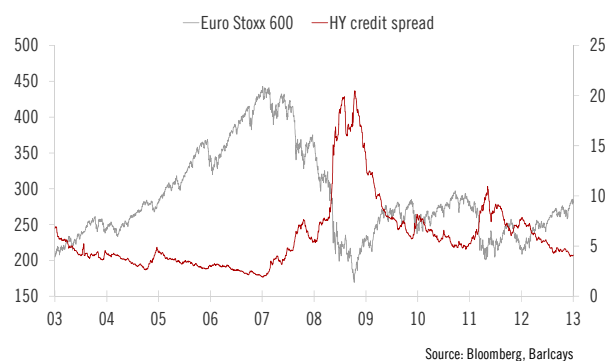
Source: Bloomberg

HIGH-YIELD SPREAD AND DEFAULT RATES (EURO)



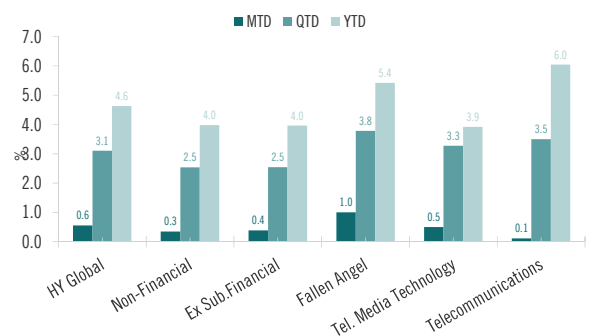
Source: Moody's and Merrill Lynch HY Index

STOCK MARKET & HIGH-YIELD SPREAD (EURO)



Source: Bloomberg, Barclays

HIGH-YIELD RETURNS BY SECTOR (EURO)



Source: Bloomberg, BoA Merrill Lynch

Global economic concerns resurface

Local-currency debt – Recent developments

May saw some risk aversion as global economic concerns returned, with slowing momentum in Chinese growth and negative growth in Europe. Despite some mixed data in the USA, the market consensus is for a recovery with the theme of a stronger dollar which dented emerging-market currencies in May. Apart from the South African rand's steep decline of around 8%, Latin America was the worst-hit region, partly due to recent weakness in commodity prices. Even the Mexican peso, the darling of the market in March and April which was just upgraded to BBB+, lost significant ground as growth for the quarter was the worst in three years. Colombia left rates unchanged, but the language seemed to suggest it might cut rates again. In Eastern Europe, Hungary was one of the few bright spots where the currency gained on the back of better than expected growth. Poland cut rates by 25bp to 3% and continued its dovish tone. Asia was more robust than other regions, with Malaysian and Chinese local markets posting gains. The Philippines was down as it saw some investors take profits after its rally following the upgrade by S&P to investment-grade status earlier in the month. Indonesia left rates unchanged at 5.75%, with the government planning to hike the subsidised gasoline price, which is likely to drive inflation higher.

Local-currency debt – Outlook

The outlook for the asset class has seen some changes in the short term, but the long-term case for the asset class is intact. The theme of a stronger US dollar, soft commodity prices and continued mixed global growth, coupled with continued hints quantitative easing will be phased out early, is applying pressure to emerging-market currencies and, increasingly, local rates. However, given the better growth potential in emerging markets and attractive yields with relatively good fundamentals, the potential for returns is 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 by governments to limit currency appreciation, macroeconomic risks and rising inflation. All these factors will see continued idiosyncrasies and market differentiation over the coming months.

External debt – Recent developments

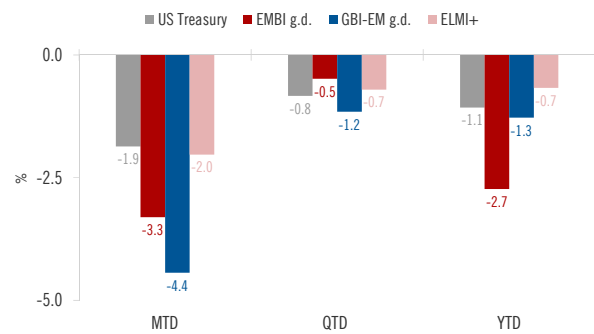
Emerging-market external/USD debt was down in May, primarily due to spread widening in investment-grade countries which have an element of correlation with US Treasuries. Some of the worst returns were seen in Brazil, Poland, Mexico and Peru, which were all down by 2%-4%. However, there were some bright spots among investment-grade countries, such as Russia which surprised by notching up a small positive return on the back of better than expected industrial production and stronger real GDP. Turkey was upgraded to investment-grade status by Moody's, but bonds saw a small negative return. Below-investment-grade countries where underlying fundamentals have a greater influence were only marginally down overall. For example, the Dominican Republic was positive where slower growth led to swift action by the central bank to cut rates by 75bp to 4.25%, but the higher yield of around 5% continues to attract investors in the current environment. It was similar with some other higher-beta names like Ecuador, Jamaica and Mongolia. Argentina was also up, but this is likely to be based more on speculative investors as the court case is still pending.

External debt – Outlook

The 10-year US T-bond yield rose to 2.2%, but it is unlikely we will see a much more rapid rise in yields in the near term. Lower-beta countries have an element of correlation with movements in US Treasuries whereas less correlated countries will 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 on 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 marginally negative returns cannot be ruled out.

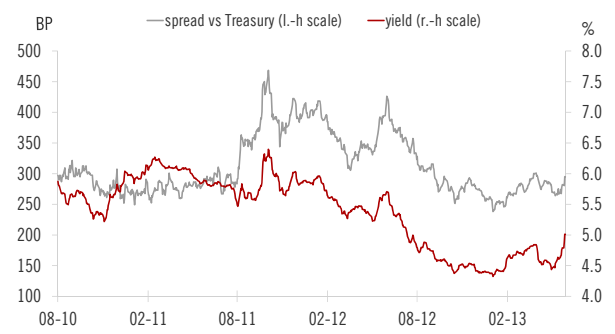
EMERGING DEBT

PERFORMANCES (USD)



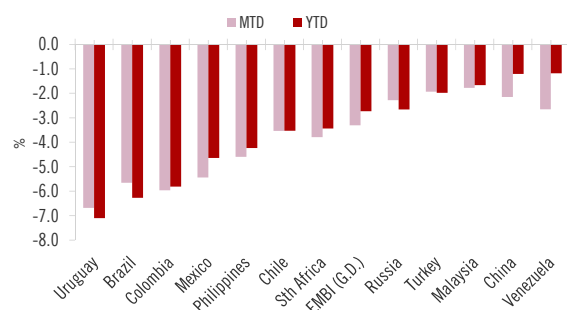
Source: Bloomberg, Index JP Morgan

US DOLLAR DEBT - YIELD & SPREAD



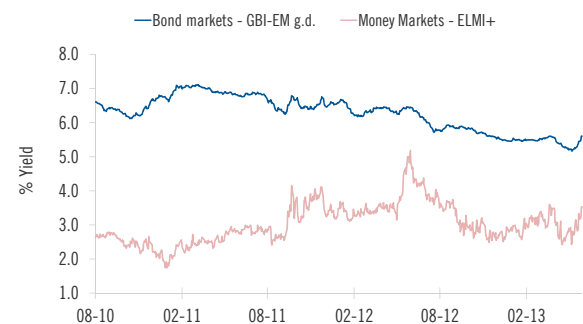
Source: Bloomberg, index JP Morgan EMBI global diversified

JP MORGAN EMBI GLOBAL DIVERSIFIED



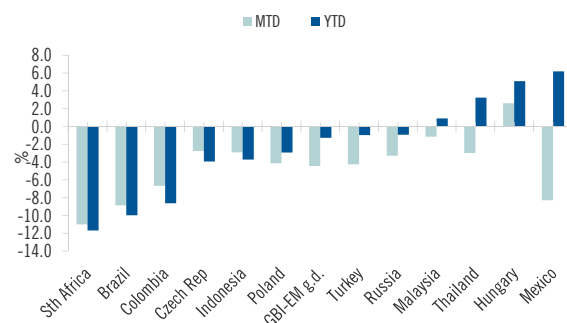
Source Bloomberg, Index JP Morgan

LOCAL CURRENCY DEBT - YIELD



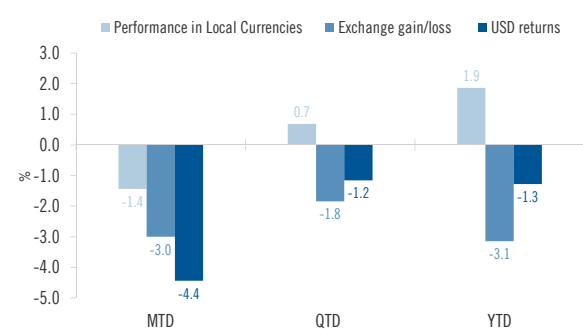
Source: Bloomberg, index JP Morgan GBI-EM g.d. & ELMI+

JP MORGAN GBI-EM GLOBAL DIVERSIFIED



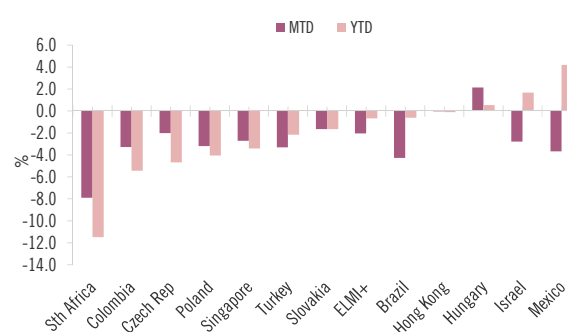
Source Bloomberg, Index JP Morgan

PERFORMANCE JP MORGAN GBI-EM G.D.



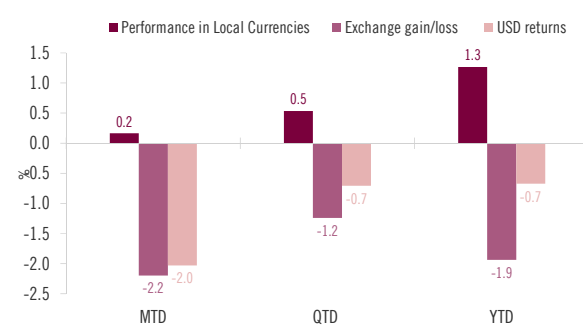
Source: Bloomberg, Index JP Morgan GBI-EM Global Diversified

JP MORGAN ELMI+



Source Bloomberg, Index JP Morgan ELMI+

PERFORMANCE JP MORGAN ELMI+



Source: Bloomberg, Index JP Morgan ELMI+ Global Diversified

Prospect of scaled-back QE pushing yields up

Economic numbers have made slightly better reading and inflation has continued to decelerate

Recent numbers suggested the slowdown in the US economy, triggered by the fiscal tightening, might just be a temporary blip. The two main barometers of consumer confidence bounced noticeably back up, retail sales (excluding cars and fuel) posted a 0.6% increase, durable goods orders rose by 1.2%, statistics for the housing market overall have been pretty encouraging and, lastly, the leading economic indicator was up by 0.6%, much better than the +0.2% expected. Moreover, the budget deficit has been reduced more quickly than expected thanks to higher tax receipts streaming in. However, as the Fed reported, although household consumer spending, investments and the housing market have been displaying signs of turning upwards, fiscal policy (with the cocktail of spending cuts and tax hikes) is still acting as a drag on growth.

At its last FOMC meeting, the Fed stuck with its ultra-accommodating policies, but uncertainties over the future of quantitative easing have increased

In its press release following its recent Federal Open Market Committee (FOMC) meeting, the Fed declared it was prepared to quicken – or slow – the pace at which it has been buying assets (USD85bn worth of US Treasuries and mortgage-backed bonds) depending on what is happening on the jobs and unemployment front. It reiterated its commitment to keep the Fed funds rate within the 0%-0.2% band for as long as the jobless rate stayed above 6.5% provided it did not call into question its inflation target.

The minutes of the last FOMC meeting and comments made by some Fed Board members sent shudders through the markets, fuelling fears that the amounts being spent in the QE programme might be cut back in the not too distant future. Fed Chairman Ben Bernanke's testimony to Congress during which he indicated there was no rush to begin tightening monetary screws again only went partway to soothing market nerves. At the outset of May, he had suggested it was necessary to take the mounting risk of financial bubbles associated

with monetary policy seriously into consideration. Economists are now assuming the Fed will modulate the tempo at which it has been buying assets in the final quarter of this year.

The most recent employment data were better than expected: some 165k new jobs were created in April, with the March figure being revised up as well; the unemployment rate declined to 7.5%. Consumer prices fell by 0.4% m-o-m in April, pushing the headline y-o-y rate down even further from 1.5% to 1.1%. The reduction can be attributed, to a large extent, to falling energy costs. Core inflation also decelerated, easing from 1.9% to 1.7%. As inflation has been steadily falling and is pitched well below the Fed's official target, the Fed is under no pressure to scale back its asset-repurchase programmes.

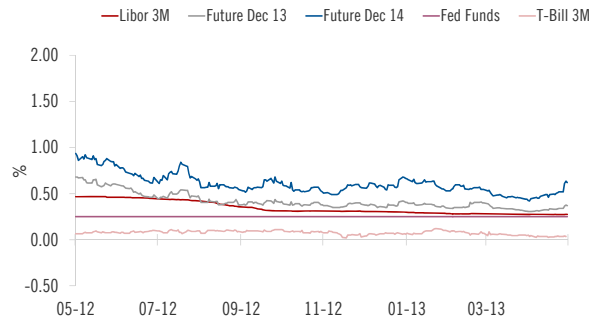
Worried by the prospect of the Fed changing tack on QE, the bond market might well extend its gentle corrective trend

Any change in the pace at which the Fed is repurchasing bonds should not trigger a crash on the US bond market as some appear to be dreading, particularly as inflation has come down quite steeply. Moreover, even if the Fed were progressively to rein in its buying of US Treasury bonds and other securities, its monetary policy would still be accommodating.

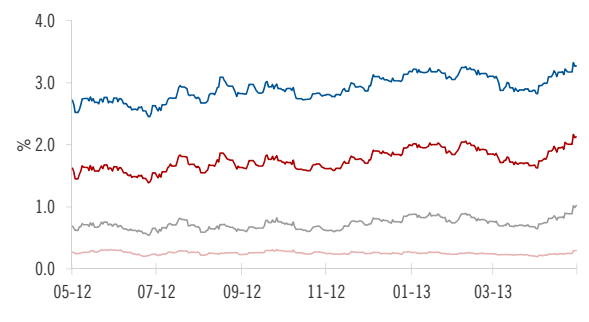
Investors have turned decidedly edgier and will be keeping a very close eye on forthcoming jobs numbers. If the jobless rate in the USA continues to drift downwards, monthly numbers of jobs being created run above 200k and the impact of tightening budget policy begins to diminish, investors may well continue to expect the Fed to engineer a U-turn in its policy. Against this backdrop, although the prospect of QE being toned down has already been noticeably priced in, yields on 10-year US T-bonds might well edge higher to reach 2.50%.

USA

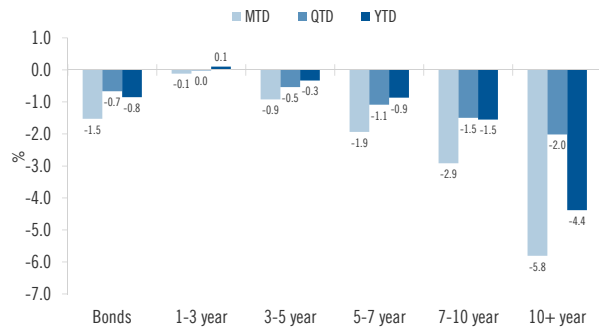
SHORT-TERM RATES (USD)



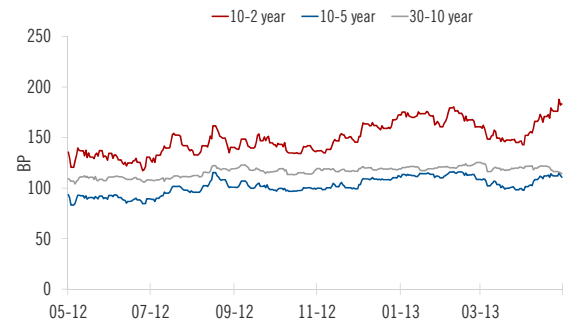
US TREASURY BOND YIELDS



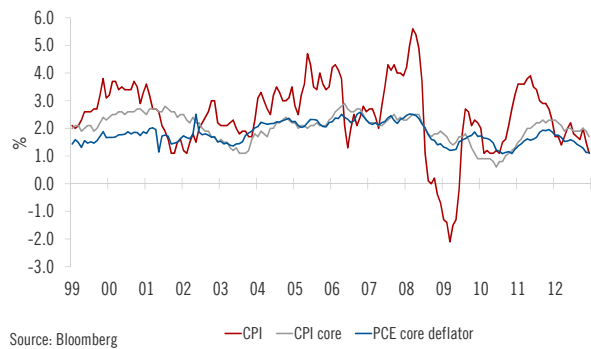
RETURNS FROM GOVERNMENT BONDS BY MATURITY



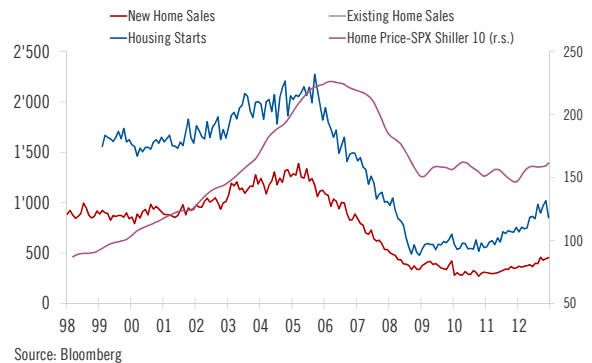
MOVEMENTS IN YIELD SPREADS



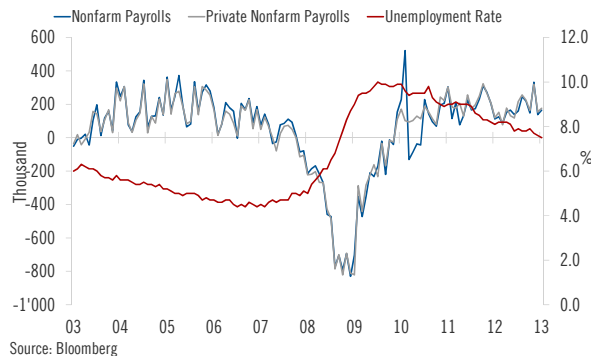
INFLATION



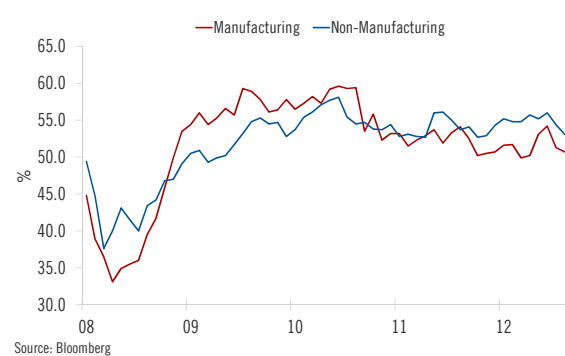
HOUSING



LABOR MARKET



PURCHASING MANAGER INDICES



ECB cuts its key refinancing rate

Jobless rate still climbing, findings from economic surveys a little less gloomy and inflation noticeably decelerating

In April, headline inflation in the eurozone fell steeply from 1.7% y-o-y to 1.2%, with the core underlying rate also coming down from 1.5% to 1.2%. Unemployment posted another record high in March. It totalled 19.2 million, 12.1% of the working population. According to the EU Commission's forecasts, the recession in the eurozone will be deeper than feared this year. The economy should, however, gradually, resume some growth as we move into the second half of the year. Although the state of affairs is still challenging, rebounds in eurozone PMIs, car registrations and the German business sentiment index, coupled with the prospect of less austere economic policies being pursued in some countries, suggest the eurozone economy might well emerge soon from the recessionary tunnel.

As political developments in Europe had little impact on markets in the last few weeks, spreads held fairly steady

Enrico Letta managed to stitch together a coalition government in Italy involving his own Centre-Left Democratic Party, Berlusconi's rightist People of Freedom party and centrist parties. This new government is expected to pursue a policy agenda geared more towards growth. Prime Minister Letta announced he was putting the unpopular IMU housing tax on first homes on hold. He is also proposing to reform electoral laws in the near future. The EU Commission declared it was prepared to close the procedure against Italy for overshooting the public-deficit criteria on condition that policies are implemented to ensure the deficit remains below the 3% ceiling over the long term. To date, Moody's has left Italy's sovereign debt rating unchanged at Baa2.

By a slim majority, the Cypriot parliament approved the eurozone bailout package envisaging a EUR10bn loan in exchange for draconian measures being pushed through to pull the island out of its troubles. The government in Lisbon reached a deal with its creditors over its new fiscal belt-tightening

programme to comply with budget criteria following the Constitutional Court's ruling that a number of austerity measures were illegal. Lastly, France, Spain and the Netherlands were given some extra breathing-space by the Commission to bring their budget deficits back down to the 3%-mark.

With the eurozone economy still in recession, unemployment climbing and inflation receding, the ECB cut its key benchmark rates

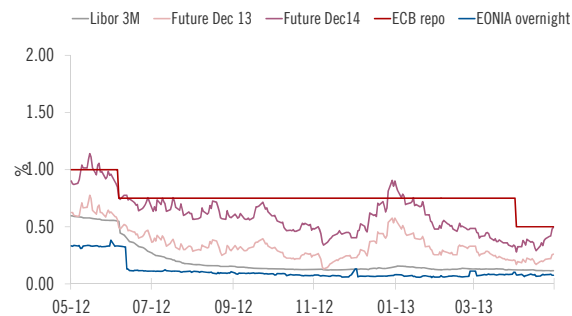
As expected, the ECB cut its key refinancing rate from 0.75% to 0.50% at its early May meeting. Although many commentators have been questioning the impact this interest-rate cut would have, the ECB is hoping to give a bit of lift to the recession-hit eurozone where inflation has been slowing down noticeably. ECB President Mario Draghi also announced new ways to underpin bank lending in troubled member states. 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. The ECB declared it was prepared to implement other measures to make it easier for small businesses and households to borrow, particularly in peripheral member states which are still in financial difficulties.

Yields on long-dated Bunds moved up in the slipstream of the increase in US Treasury yields

Against a backdrop of hopes of the eurozone emerging from recession in the latter half of this year, fears of the Fed reining back its QE and the turbulence on Japan's bond market, 10-year Bund yields moved back up in May. Yields on safe-haven sovereign debt had sunk to rock-bottom levels, but they may well edge up a little further before the year is out if the scenario of a gradual upturn in eurozone economies were to materialise.

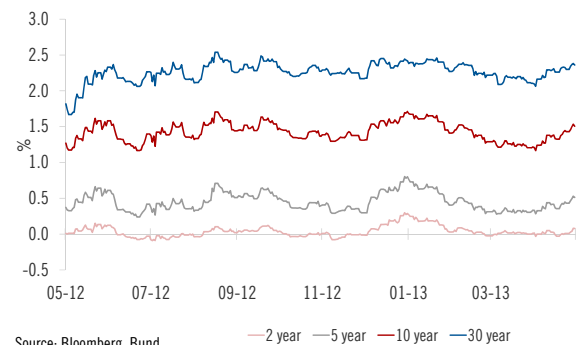
EUROZONE

SHORT-TERM RATES (EURO)



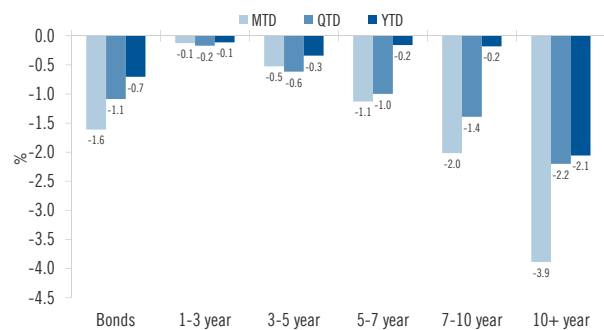
Source: Bloomberg

BUND YIELDS



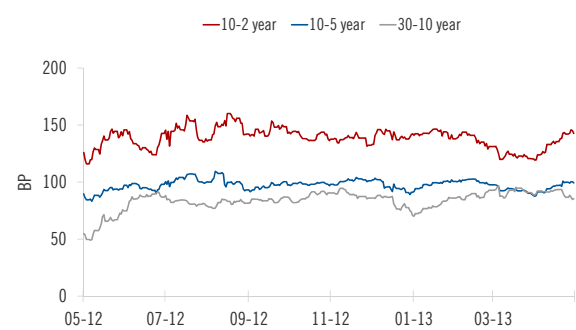
Source: Bloomberg, Bund

RETURNS BY MATURITY (BUND)



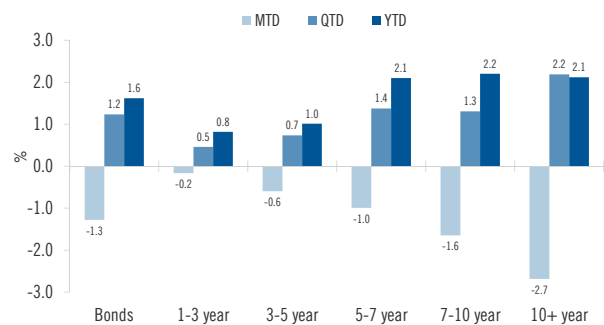
Source: Bloomberg, Citigroup, Germany Bund

MOVEMENTS IN YIELD SPREADS



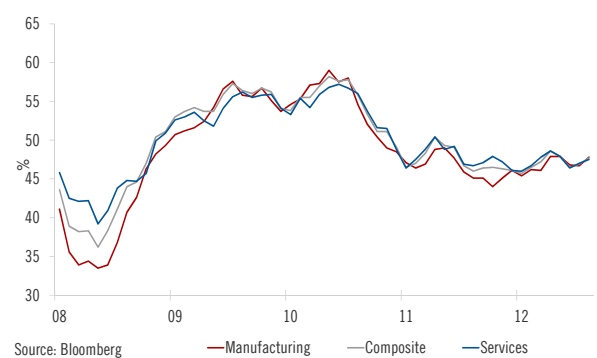
Source: Bloomberg, Bund

RETURNS BY MATURITY (EMU GVT)



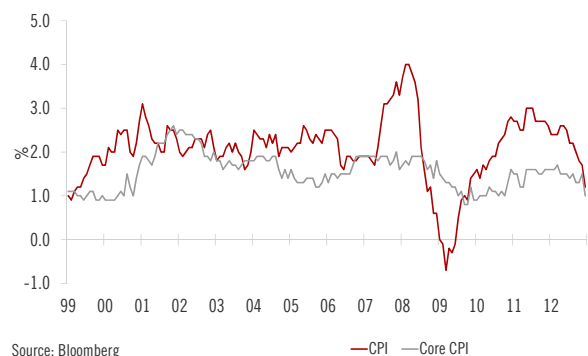
Source: Bloomberg, Citigroup, EMU Gvt Bonds

EUROZONE - PURCHASING MANAGER INDICES



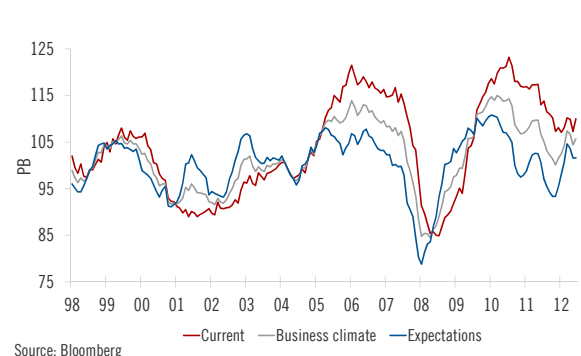
Source: Bloomberg

EUROZONE - INFLATION



Source: Bloomberg

GERMANY - IFO



Source: Bloomberg

Economy showing signs of improving

The BoE upgraded its growth forecasts and believes inflation will come down to meet its target sooner than previously thought

As expected at its recent meeting, 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. In April, 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 in the summer. In its quarterly report on inflation, the BoE did slightly amend its assessment of the UK economy. It remains guarded about the outlook, projecting that GDP growth should pick up speed to 0.5% in Q2 2013 and that inflation should dip below its 2% targeted rate sooner – in early 2015, instead of in early 2016.

In April, consumer prices in the UK rose by 0.2% m-o-m, but this pushed the headline y-o-y rate down more steeply than expected, as it dropped from 2.8% to 2.4%; core inflation moved down to 2.0%. Falling transport costs were primarily behind this decline. Although the upturn seen in the economy suggests the adoption of new pro-economy measures is less likely, further easing in the rate of inflation will give the new Governor some extra room to manoeuvre.

International Monetary Fund tempering its judgement of UK government strategy

Barely a few weeks ago when the threat of a triple-dip recession was looming large, the IMF's Managing Director voiced her scepticism about the UK government's austerity programme. After the rebound in GDP in Q1 2013 and in light of recent figures, the IMF expressed its criticisms in its annual report. Although recent data have added weight to the supposition of an improvement in the state of the UK economy (consumer/business confidence, industrial output, smaller monthly public deficit, slowing inflation, improving housing sector), IMF experts are still not expecting the recovery to be strong or sustainable. They are of the opinion the UK

would be best advised to boost investment in infrastructure to make up for the harshness of the austerity measures. The banking sector is also not yet back on a sound enough footing, with the IMF suggesting that the two big banks nationalised during the crisis, Royal Bank of Scotland and Lloyds TSB, should be reprivatised.

The economic upturn is likely to be both modest and fragile, impeded by austerity, strict lending conditions and households' purchasing power being restrained by unemployment and falling incomes. The 1.3% drop in retail sales in April, despite being partly due to poor weather, highlights what a brittle state the economy is still in.

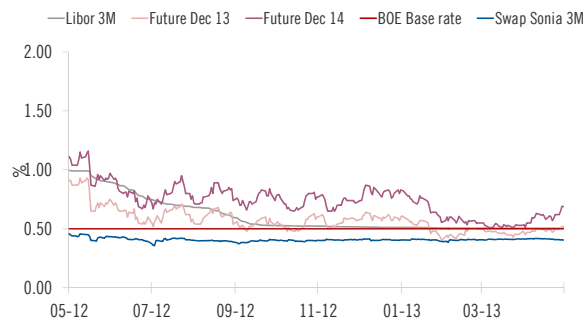
Eurosceptics emerged triumphant in the local elections, which could widen splits inside the ruling coalition

The UK Independence Party (UKIP), whose main policy is to take the UK out of the EU, took 26% of the votes in those local-authority wards the party contested, grabbing votes from both coalition parties: the Conservatives lost seats and the Liberal Democrats did particularly poorly. David Cameron who has already promised an all-or-nothing referendum on whether the UK should stay in the EU may well take a harder line on Europe in a bid to hold onto Tory voters.

With the economy looking a little stronger, gilts yields corrected slightly, in tandem with leading bond markets worldwide

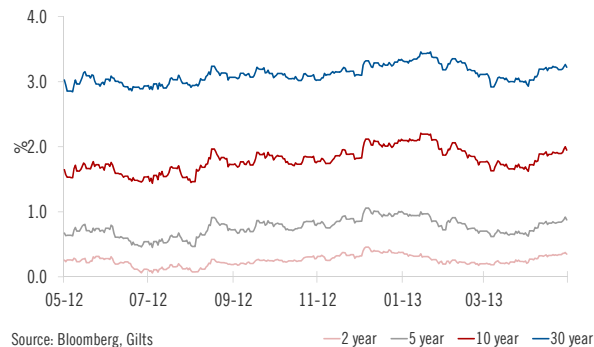
We do not expect gilts to experience any big swings in the weeks ahead against the backdrop of what is basically still a flagging economy, a stable base rate and the possibility of the BoE going for more quantitative easing. Investors are keenly monitoring statistics to gauge the well-being or otherwise of the UK economy, but the news flow seems unlikely to persuade the BoE to modify the long-held status quo, but it might well dash any lingering hopes of fresh quantitative-easing measures to support the economy.

SHORT-TERM RATES (GBP)



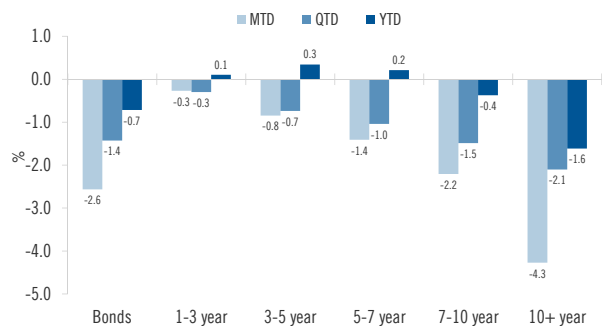
Source: Bloomberg

GILTS YIELDS



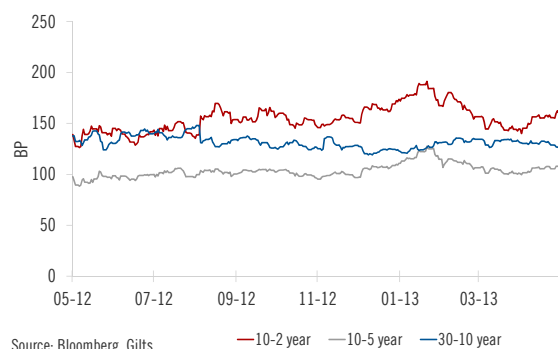
Source: Bloomberg, Gilts

RETURNS FROM GOVERNMENT BONDS BY MATURITY



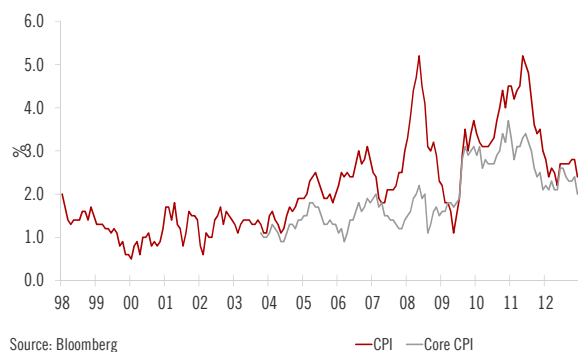
Source: Bloomberg, Citigroup, UK Treasury

MOVEMENTS IN YIELDS SPREADS



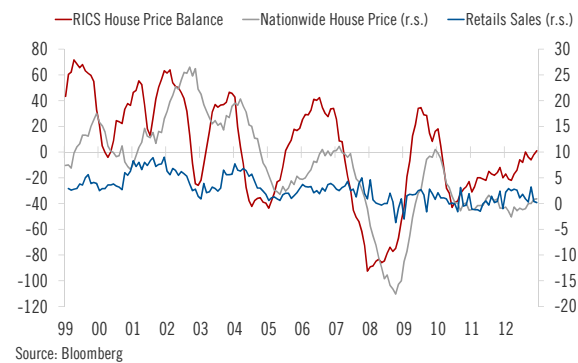
Source: Bloomberg, Gilts

INFLATION



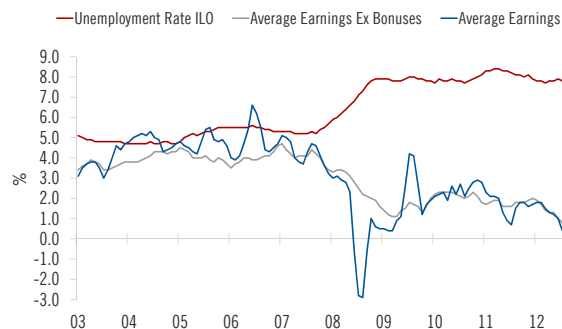
Source: Bloomberg

HOUSING AND RETAIL SALES



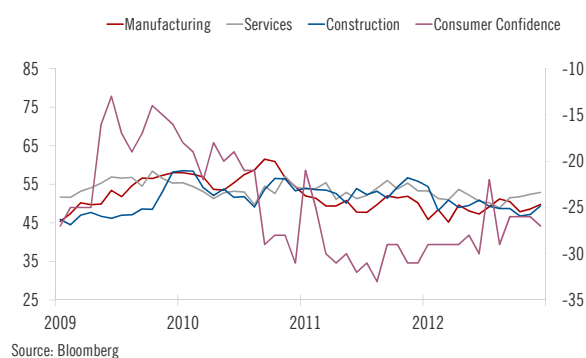
Source: Bloomberg

UNEMPLOYMENT RATE AND AVERAGE EARNINGS



Source: Bloomberg

ECONOMIC SURVEYS



Source: Bloomberg

SNB still on its guard

The IMF has approved measures taken by the Swiss government

The IMF believes imposition of a cap on the Swiss franc's value against the euro helped to safeguard the stability of Switzerland's economy even though the Swiss National Bank's interventions on a massive scale have bloated its balance sheet. The IMF cautioned the Swiss authorities to stay watchful, especially as regards developments in the eurozone. The IMF believes the exchange-rate floor must be maintained for as long as the threat of capital flooding into Switzerland persists. It urged the SNB to take advantage of any quieter spells on forex markets to scale down its foreign-currency positions. On the other hand, if the flight towards safe havens were to be resumed, the IMF believes the SNB should contemplate moving to a policy of negative interest rates. The IMF also welcomed the counter-cyclical measures being adopted to clamp down on overheating in the housing sector, suggesting the authorities should reform the tax regime should the boom run on.

SNB generated a profit of CHF11bn in Q1 2011 and is keen to stick with its policy stance to counter deflation

The SNB President, Thomas Jordan, stated towards the end of May that the SNB was determined to defend the cap on the Swiss franc's value against the euro, adding that he could not rule out the possibility of adjusting the current level of CHF1.20 to the euro if needed. His comments saw the exchange rate against the euro move to CHF1.2650 before it came back down in response to the steep drop in share prices in Tokyo. The SNB has not ruled out the option of instigating negative interest rates.

The SNB generated a CHF11.22bn profit in Q1 2013, its foreign-currency position earning it a CHF11.16bn gain and CHF4.9bn generated from holdings of equities which account for 15% of its assets. The SNB pointed out that gains made on the two main currencies in its portfolio – the US dollar and the euro – more than made up for losses on the yen and sterling. In contrast, its gold reserves of 1,040 tonnes produced a loss of CHF100m. The UDC party is spearheading a

campaign to prohibit the SNB from reducing its gold reserves.

KOF still confident about the future, the housing market is not slowing down and deflation is stubbornly persistent

The UBS Swiss Real Estate Bubble barometer has continued to climb, reaching 1.17. This latest increase reflects the ongoing rise in housing prices and expansion in mortgage lending at a time when, in tandem, household incomes and consumer prices are flat. The regions of Zurich, Geneva and Lausanne remain those where the risk of a property bubble inflating is the greatest.

Consumer prices were stable in April, but Switzerland remains in the grip of deflation, with the headline rate running at -0.6%. Falling prices for oil & petroleum products and overnight stays in hotels were counterbalanced by rising prices for airline package holidays and summer clothing. The SNB has ruled out the danger of inflation risks in the near term. In March when it last reported on the state of the Swiss economy, it was projecting inflation of -0.2% for this year, 0.2% in 2014 and 0.7% in 2015. The downtrend in oil prices suggests deflation may well persist throughout the summer.

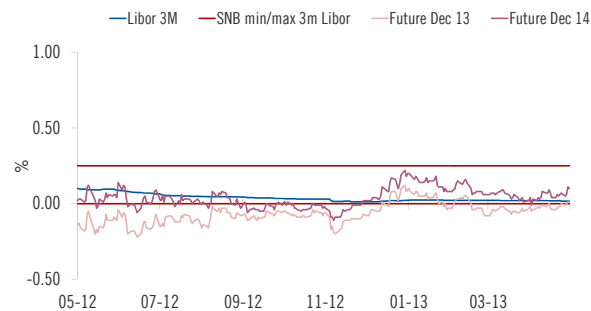
Recent economic data have remained fairly encouraging, with GDP posting growth of 0.6% in Q1 2013. Households are guardedly optimistic, with the consumer confidence index more or less stable at -0.5 in April. Businesses, especially in manufacturing, have been complaining about low backlogs and slowing order intakes, but KOF is still looking for business sentiment to perk up.

Swiss bond market unlikely to suffer any serious correction

The SNB is not expected to start pushing rates back up even though deflation is likely to ease later this year and the property market is booming. This should lend support to the bond market and cap any rise in bond yields even though investors are currently looking less eagerly for safe havens.

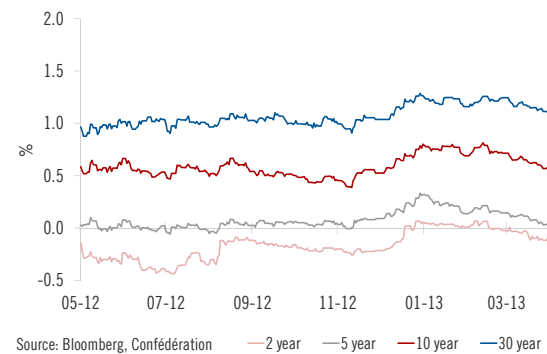
SWITZERLAND

SHORT-TERM RATES (CHF)



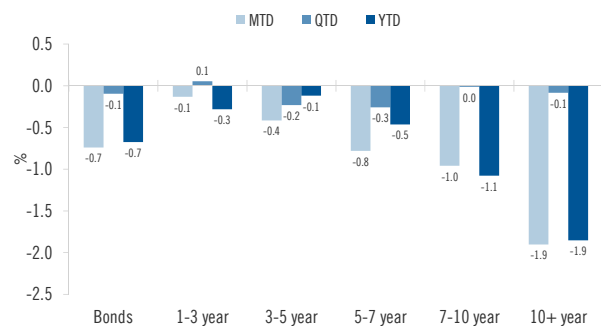
Source: Bloomberg

CONFEDERATION YIELDS



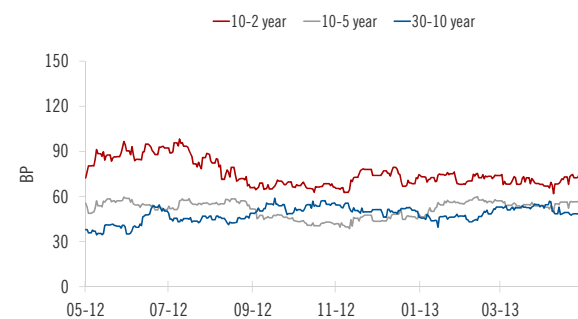
Source: Bloomberg, Confédération

RETURNS FROM GOVERNMENT BONDS BY MATURITY



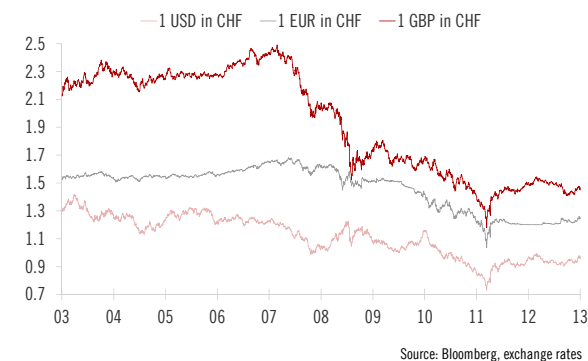
Source: Bloomberg, Citigroup, Switzerland Gvt Bonds

MOVEMENTS IN YIELDS SPREADS



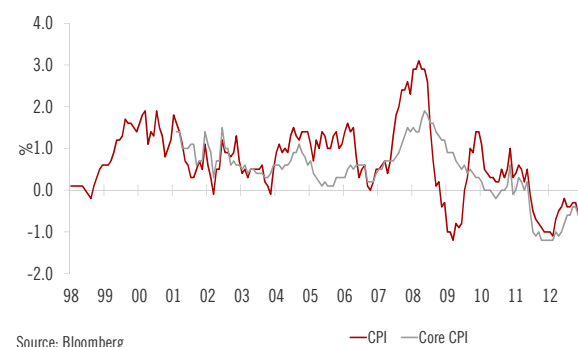
Source: Bloomberg, Confédération

SWISS FRANC EXCHANGE RATE



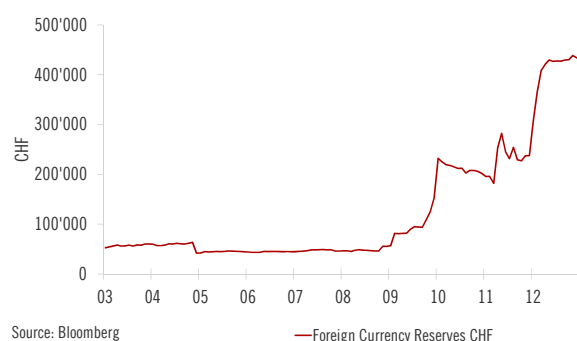
Source: Bloomberg, exchange rates

INFLATION



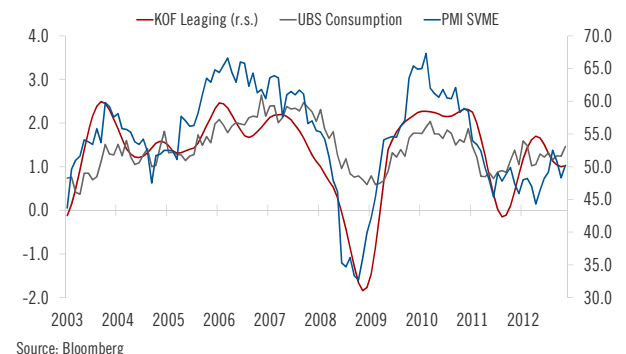
Source: Bloomberg

SNB - FOREIGN CURRENCY RESERVES



Source: Bloomberg

ECONOMIC SURVEYS



Source: Bloomberg

Economy improving, but uncertainties on the horizon

The shift in policies has helped Japan's economy to regain some momentum

The recovery in the US economy, coupled with a range of pro-growth measures adopted by Japan's new government, has given a boost to the flagging Japanese economy even though business leaders are still erring on the side of caution. Japan's GDP advanced by 0.9% q-o-q in Q1 2013. Consumer confidence has also perked up since the Liberal Democratic Party was returned to office last December. In the early months of this year, the main locomotive driving growth was consumer spending. This rose by 0.9%, but this rebound may well turn out to be temporary if wages continue to remain flat. Exports also fared well on the back of rising sales of cars to the USA. On the minus side, private-sector investment contributed negatively to growth (0.7%), reflecting business caution.

The fiscal and monetary policy mix being pursued by the authorities has given the economy a welcome boost. Current policy measures have sent the yen downwards and, pushed share prices upwards on the Tokyo stock market, but they have also caused some turbulence on the bond market. Looking ahead to the next few quarters, spending on public works and infrastructure should be the drivers behind growth whilst the prospect of a forthcoming hike in the consumer sales tax should give consumer spending a boost before it comes into force.

The BoJ upgrading its economic projections, but, for the time being, prices are still falling

Towards the end of May, the Bank of Japan (BoJ) decided to leave its monetary policy in ultra-accommodating mode, pointing out that the economic outlook was still unsettled in spite of the rebound in GDP growth. The 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. In the aftermath of the upheavals on the Japanese government bond (JGB) market and the 7% correction on the TOPIX index since 23 May,

the BoJ's new Governor Haruhiko Kuroda indicated the BoJ would approach its buying of bonds more flexibly so as to prevent volatility on government bonds from having any adverse impact on the economic recovery.

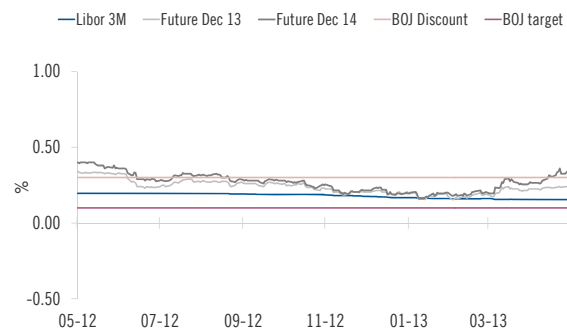
Confounding expectations, long-dated yields on JGBs shot upwards, and the market may well remain prone to nervousness

Yields on 10-year Japanese government bonds (JGBs) dramatically doubled from their all-time lows in April. Various factors lay behind this correction which unsettled the markets: rotation from bonds into equities; shift in expectations as regards future economic growth and inflation (inflation break-even threshold on index-linked bonds moved up by 50 basis points), compounded by the spike in yields on other bond markets prompted by fears the US Federal Reserve might slow down its pace of buying bonds under QE3.

As the BoJ is set to buy up assets wholesale, the Japanese government will be under no time pressure to reduce the budget deficit. Japan's debt is set to go on ballooning. The debt/GDP ratio could climb to 245% in 2013. Although, as things stand, Japan's government financing is being covered almost entirely by domestic investors, any rise in yields could well bring with it problems for public-sector finances. Dwindling current-account surpluses for Japan and the shutdown of nuclear reactors, which blew a hole in the country's balance of payments, are also posing concerns over future financing of Japan's public debt. As Japanese banks own a sizeable chunk of Japanese government debt, any significant rise in yields would make a serious dent in their balance sheets in terms of both profits and solvency ratios.

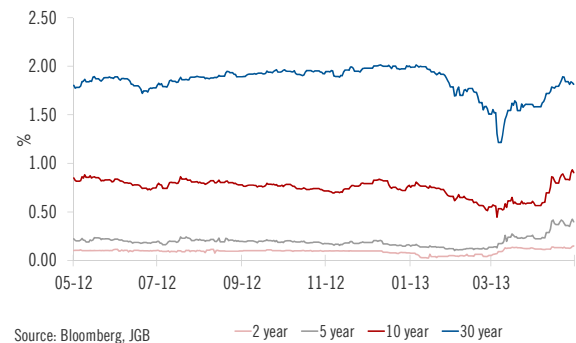
JAPAN

SHORT-TERM RATES (YEN)



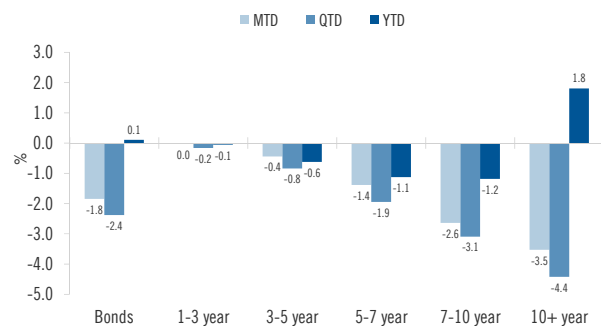
Source: Bloomberg

JAPANESE GOVERNMENT BOND YIELDS



Source: Bloomberg, JGB

RETURNS FROM GOVERNMENT BONDS BY MATURITY



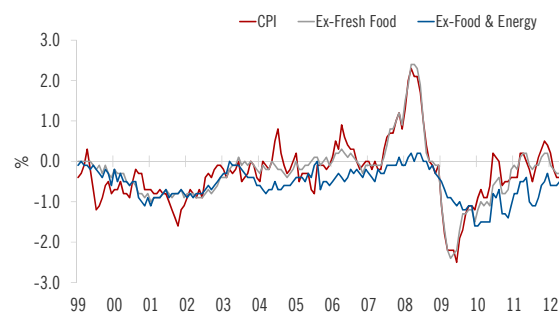
Source: Bloomberg, Citigroup, Japan Gvt Bonds

MOVEMENTS IN YIELDS SPREADS



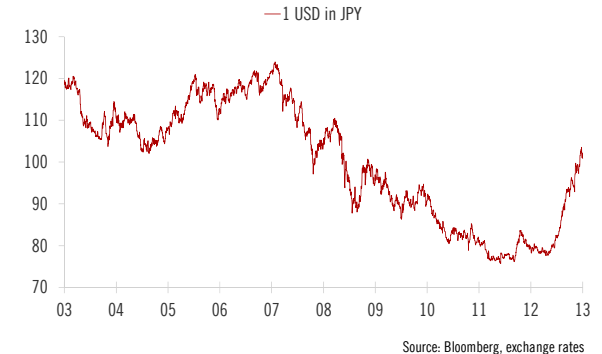
Source: Bloomberg, JGB

INFLATION



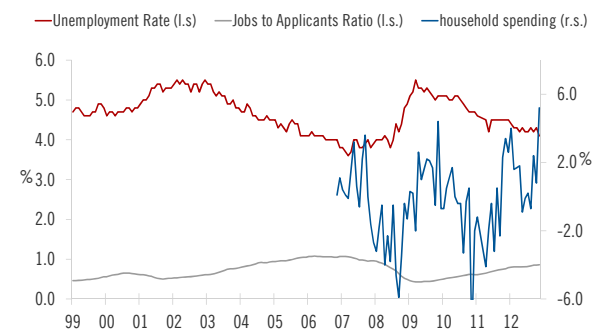
Source: Bloomberg

JAPANESE YEN VERSUS DOLLAR



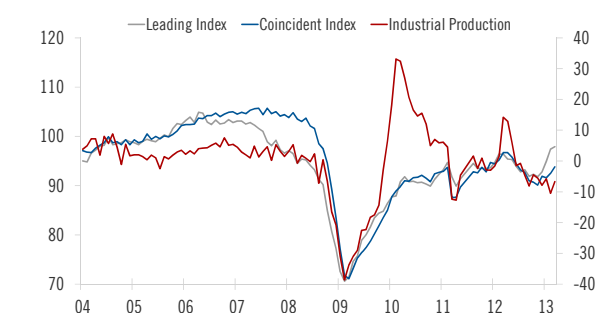
Source: Bloomberg, exchange rates

LABOR MARKET



Source: Bloomberg

LEADING INDICATOR AND INDUSTRIAL PRODUCTION



Source: Bloomberg

Pictet Asset Management

Route des Acacias 60
1211 Geneva 73
Switzerland

www.pictet.com

Disclaimer

The information and material presented in this document are provided for information purposes only and are not to be used or considered as an offer or solicitation to buy, sell or subscribe to any securities or other financial instruments.

This document does not take into consideration the specific investment objectives, financial situation or particular needs of any person who may receive this report and invest in any financial instrument. Pictet & Cie has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor.

This report is not to be relied upon in substitution for the exercise of independent judgment. The value and income of any of the securities or financial instruments mentioned in this document can go up as well as down. The market value may be affected by changes in economic, financial or political factors, time to maturity, market conditions and volatility, or the credit quality of any issuer or reference issuer. Furthermore, foreign currency rates may have a positive or adverse effect on the value, price or income of any security or related investment mentioned in this report.

Many factors may affect the value of a financial instrument, and accordingly, investors effectively assume all risks and may receive back less than they had originally invested. Any investors interested in buying a financial instrument should conduct their own investigation and analysis of the instrument as to the risks involved with transactions on such instrument.

Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, expressed or implied, is made by Pictet & Cie regarding future performance.

This document does not constitute the investment policy of Pictet & Cie or an investment recommendation, but merely the different assumptions, views and analytical methods of the analysts who prepared it. Furthermore, the information, opinions and estimates expressed herein reflect a judgment as of its original publication date and are subject to change without notice. Pictet & Cie may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report.

The information and opinions presented by Pictet & Cie analysts have been obtained from sources believed to be reliable. Although all reasonable care was taken in gathering the information and formulating the opinions contained herein, Pictet & Cie does not make any representation whatsoever as to its accuracy or completeness.

Accordingly, Pictet & Cie accepts no liability for any loss arising from the use of this document, which has been made available for information purposes only.

This report is issued by Pictet & Cie. This document may not be reproduced or distributed, either in part or in full, without prior authorization being obtained from Pictet & Cie.

This report is distributed by Pictet & Cie based in Geneva, Switzerland. Pictet & Cie and its affiliates (or employees thereof) may or may not hold a position in or with respect to the securities mentioned herein.

In the United Kingdom, this report has been approved for issue in the United Kingdom by Pictet Asset Management Limited (authorized and regulated by Financial Services Authority). Pictet & Cie is not regulated under the Financial Services & Markets Act of 2000 and the protections afforded to investors under the United Kingdom regulatory system are not applicable hereto.

In the United States, distribution by Pictet & Cie is permitted as provided by the exemption under article 15a-6 of the Securities Exchange Act of 1934, and is intended exclusively for major US institutional investors, as defined by the same article 15a-6 of the said Securities Exchange Act. All major US institutional investors wishing to carry out a transaction may only do so by contacting a US registered broker-dealer, such as Pictet Overseas Inc.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of, or located in, any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation.