



Staying the course

Quarterly Outlook Q2 2013

Investment
Strategy

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Staying the course

The investment landscape is finally normalising, after years of uncertainty. The almost-systemic stress that the world encountered is receding and making way for the return of more familiar investment notions such as “cyclical” and “asset rotation”. Broader economic recovery is in sight, even if the coast may not yet be completely clear.

ABN AMRO believes that it is important for investors not only to navigate these traditional risks during the second quarter but also to position themselves to harness coming economic momentum. This means voyaging further into equities – carefully selected by sector and region – away from bonds, for which challenging central-bank policy adjustments could create cross-currents that push yields higher.

Despite the recent rise in equity markets, ABN AMRO sees an enormous gap between the apparent bullish consensus on equities and low positioning in equity markets. Our confidence is underpinned by the growing market resilience to bad news and we also see a positive correlation between rising stock markets and the US dollar.

On the following pages, the ABN AMRO Private Banking Research & Strategy team closely examines these and other views – including alternative investments such as hedge funds, property and private equity – to help you stay the course and invest successfully. Your Relationship Manager or nearest Investment Advisory Centre (see back cover) is also ready to assist you in selecting the asset allocation reflecting the risk/return strategy that best meets your investment objectives.



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Staying the course

To navigate effectively towards return, investors should re-enter equities during the second quarter and benefit from the broader economic momentum on the horizon

Global industrial production recently re-accelerated and the United States housing market showed early signs of an upturn, launching a sharp pick-up in risk assets worldwide. Yet this very upswing could prompt a second-quarter correction as the positive economic news flow takes a breather and central bankers become less uniform in their policies for reflating the global economy.

Still, we recommend staying the course and navigating traditional cyclical risks, which have replaced the previous systemic uncertainty. A reliable route to return for investors this quarter is therefore a well-timed departure from the expensive safe haven of fixed-income assets – which could see higher yields (and thus a capital loss) sooner rather than later – into equities. Equities, selected with care and precision, can position investors to gain from broader economic improvements expected later this year.

Key trends: Cross-currents mask gradual improvement of business conditions

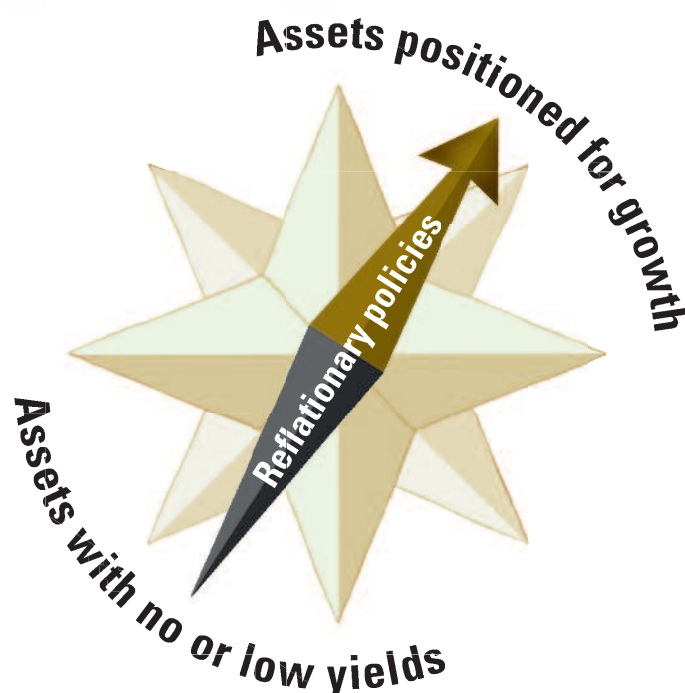
- **Global economic momentum will broaden** to establish a more stable recovery driven by the consumer and by corporate and public investment. The global economy is emerging from the Great Recession with fewer international imbalances than it had a few years ago despite strenuous fiscal adjustments.
- **Competition by central banks** aims to reflate domestic economies, not wage a currency war. The currency divergences reflect different targets – employment in the US, inflation in Japan and Europe, and quantitative controls in China.
- **Central banks will progressively normalise** their hyper-stimulative stance, rather than make an abrupt exit. Markets are likely to show irregular waves of anticipation of moves towards the exit, suggesting investors should be prudent by keeping a low interest-rate exposure for the bulk of the portfolio.

Key challenges: Separate the signal from the noise

- **The short cycle of inventory rebuilding has to become broader effective demand.** The challenge for policymakers is to recreate the conditions for a trend of capital expenditure, as firms have hoarded their cash and delayed their expansion plans.
- **Yen depreciation** is creating tension for the European Central Bank (ECB) in adopting an explicit exchange-rate policy. A still clear euro is challenging any effort to support the export sector and lift eurozone economies out of recession.
- **Investors should not chase yields with long bonds and excessive credit risk** – tight selection of bonds is key.

Key opportunities: Overweight positioning in equities with wide diversification

- **Equities offer price appreciation potential** and opportunities to move in during moments of economic weakness. An enormous gap exists between the apparent bullish consensus for equities and the effective (low) positioning in equity markets by pension funds and private investors.
- **In emerging Asian markets and Brazil**, recent underperformance has rebuilt valuation relative to developed markets.
- **An avenue of diversification comes from growth stocks** related to our “Closing the productivity gap in manufacturing” theme and related IT stocks, from the high-dividend equities that have outperformed over the last 18 months.
- **Hedge-fund selection** can stabilise portfolio returns and insure against higher bond yields.
- **Real estate yields income** and exposure to the broadening recovery.
- **Emerging-market currencies** may well benefit from the recovery of global trade. USD is seen appreciating in anticipation of the US pick-up.



Economics – Opposing forces fight to settle the outlook

**Research & Strategy
and Group Economics**

Han de Jong – Chief Economist

... but a positive outcome is likely

Global economic prospects for the remainder of the year and beyond depend on the outcome of several strong but opposing forces. While this implies risks, we believe that the global economy will generally develop well this year.

On the positive side, private balance-sheet repair in the US is making good progress, and households and banks have strengthened their positions materially. Banks have arguably most of the deleveraging process behind them, allowing them to ease credit conditions somewhat when economic circumstances warrant that. Households have also strengthened their balance sheets through debt repayments, defaults and rising asset prices. They seem to be in a position to increase spending in line with income growth. The US housing market is clearly picking up and is expected to make an important contribution to the economic recovery in the next few quarters. US corporates have also recently appeared more willing to step up investment spending.

Another positive factor is the financial market response in Europe to the mix of reform of eurozone governance, progress in structural reform, budget adjustment and the pledge by Mario Draghi, President of the ECB, in July last year “to do whatever it takes” to preserve the euro. The resulting ease in stress in financial markets should allow for a virtuous circle to develop of lower borrowing costs encouraging growth and making the adjustment process less painful. In addition, falling inflation in Europe should underpin real spending power over this year. Finally, while many feared a hard landing of the Chinese economy last year, that did not happen and stable to fractionally higher growth in emerging economies overall now seems likely this year. After five years of crisis and sub-trend growth globally, enough pent-up demand should have built to allow for an upside surprise to global growth before too long.

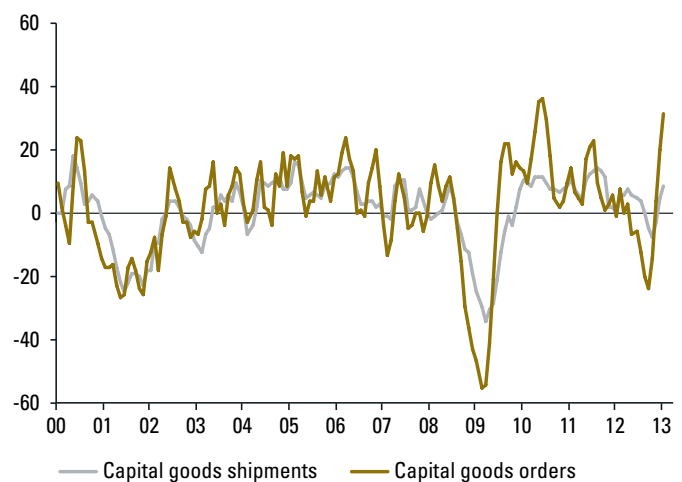
Having said all that, some negatives stand out. First, the political stalemate in the US and the significant tightening of fiscal policy there will keep a lid on US economic growth and may undermine confidence. Second, the euro crisis is far

from over. Adjustment fatigue and political uncertainties may cause stress at any time. Emerging economies could be hit if commodity prices developed less favourably than expected.

Positive on balance

Weighing up both sides, we believe that the positives outweigh the negatives, particularly as central banks will provide support if necessary. We believe that the global economic recovery will gradually broaden and the capital goods can finally take off beyond the US this year (see graph), setting the scene for more convincing growth in 2014.

US capital goods and shipments orders in % year-on-year



Source: ABN AMRO Group Economics

Economic sea change in China

After spectacular multi-decade growth, rebalancing is needed

At around 5% in 2012, economic growth in emerging markets continued to outperform that of the advanced economies, but at a slowing pace over the year for most of them as global weakness weighed on external demand. GDP growth in emerging markets in Asia, for instance, reached almost 9% in 2010 and 2011 but dropped to about 6.5% in 2012. In China, there were even fears of a hard landing at times last year, although it ultimately managed a respectable 7.8%, despite the global slowdown.

Stabilising economic growth

China – with the world's second-largest GDP – surpassed the US as the world's leading trading nation in December 2012 and remains the largest foreign holder of US debt. But Chinese policymakers are rightly keen to raise domestic consumption and reduce dependency on investment and exports, focusing their efforts on rebalancing the economy, which suggests that they will now aim to stabilise rather than boost growth. At only 35% of GDP (see graph), consumption is among the lowest in Asia, partly reflecting extremely high investment until only recently. This transformation from economic miracle to new normal is not without challenges, nor will it happen overnight.

China's 12th five-year plan announced in 2011 identifies the initial steps towards this shift. The drive to stimulate consumption requires reforms to unlock household savings and boost household income. These include expanding currently limited access to financial services and improving the social safety net, while upgrading the artificially low returns that households receive for their deposits. At the same time, urban and social reforms must be accelerated, and further steps taken to liberalise capital flows as a precursor to internationalising the yuan.

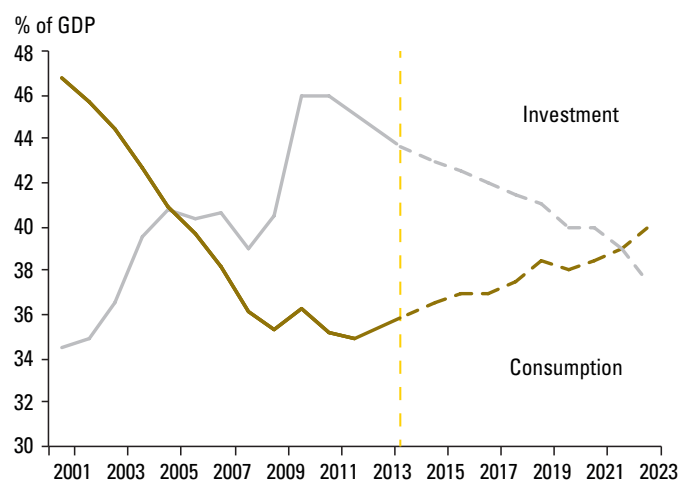
Longer than a five-year plan

Last year saw some signs of rebalancing towards private consumption – indeed, during the slowdown in 2012, the authorities maintained a cautious approach to stimulating the economy, unlike 2009–2010 when they induced a surge in investment to support recovery. This time, capital expenditures were mainly frontloaded and easing policies were more restrained, while the property market was subject to increasingly strict measures. Some progress was also made in interest rate-liberalisation and we expect further steps this year.

The new urban reforms, including migrant registration systems, are pivotal to unleashing consumption, but are still at the planning stage. Moreover, an “income redistribution plan” of February this year considers sweeping reforms to reduce income inequality, but many details remain vague.

Still, we think the authorities are focusing on the right strategy to favour domestic demand and allow more sustainable GDP growth at an average of 8% in the next two years. Several other Asian economies have successfully made the transformation from investment- to consumption-led growth, including Singapore, South Korea and Taiwan. Given others' experiences, we believe the structural reforms and the gradualist approach to rebalancing to be the right course for this long-term project.

Rebalancing China's economic model



Source: Thomson Reuters Datastream, ABN AMRO

Economics – Central banks not yet ready to exit

Success needs proper timing

Financial markets' bouts of the blues

Monetary policy in developed economies is ultra-accommodative. Key policy rates are effectively zero, while central banks have aggressively expanded their balance sheets. A key way in which these policies stimulate the economy is by supporting asset markets. Asset purchase programmes have helped to drive long-term interest rates to historically low levels, while boosting risky asset prices. With economic conditions starting to look up, financial markets have suffered attacks of "exit blues," reflecting worries that monetary stimulus will be withdrawn.

Whose democratic deficit?

The Federal Reserve is not a democracy. Indeed, the publication of the minutes of the January meeting of the key Federal Open Market Committee (FOMC) last month caused unrest in markets. Investors interpreted the discussion as signalling that the Fed would soon start to slow the pace of asset purchases (at the meeting several members commented to this effect). However, the FOMC is not really a democracy, with Federal Reserve Chairman Bernanke ultimately the driving force behind decisions, and he wants to sustain monetary stimulus, confirmed by his recent testimony before Congress. This approach makes sense because it would be illogical for the central bank to risk the recovery at this stage, given all the actions it has taken so far.

Eurozone inflation set for low levels

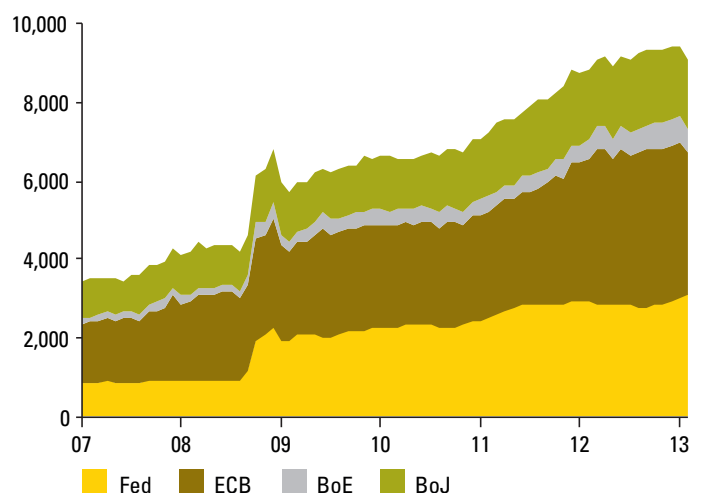
Markets have also speculated that the ECB would reverse accommodative monetary policies. Short-term interest rate expectations rose, while there was even conjecture about a policy rate hike. Yet these expectations proved to be unfounded. With inflation set to fall to levels well below the ECB's price stability goal and the risk to the recovery, monetary policy is likely to remain accommodative. In the United Kingdom, the Bank of England is considering additional stimulus, given the risk of falling back into recession, while change of leadership at the Bank of Japan heralds much more aggressive monetary easing aimed at reversing deflation.

A silver-lined exit

So, none of the major central banks is currently considering an exit. And for all the talk of currency wars, the reality is that central banks are attempting to meet domestic policy objectives rather than devalue their currencies. Of course at some stage these objectives will justify a withdrawal of monetary stimulus. We think that the Federal Reserve will be the first mover, and expect it to wind down the pace of asset purchases early next year. By autumn 2014, unemployment is likely to have fallen below its target of 6.5%, which could trigger the first rate hike in early 2015.

We expect the ECB to keep interest rates on hold this year and next, but early in 2015, its 3-year LTRO loans – accounting for a large portion of its balance sheet expansion – mature. With the likely exception of Japan, 2015 could therefore be the year that we start to see moves towards the exit. The silver lining is that if central banks are considering winding down stimulus, it will most likely be because the economic growth outlook will have significantly improved by then.

Cumulative balance sheet expansion of major central banks in US bln



Source: ABN AMRO Group Economics and Thomson Reuters Datastream

Equities – Market outlook

Finding the right path

The good news for equity investors is that systemic risks have fallen sharply, especially in Europe, helped by ECB policy actions. This means that equity positioning will be more related this year to the classical cyclical risks rather than the extreme uncertainty of the last few years. The roadmap for the investor is to rediscover the new world of equities and stay the overweight course, despite the downside risks that could temporarily distort market sentiment.

Earnings and valuations support equity investment

Below-trend global GDP growth created stagnation in earnings growth in 2012, although this was no surprise to the market as earnings expectations had already been heavily downgraded. In fact, in the US, aggregate earnings for 4Q 2012 came in some 5% above expectations. We believe the subdued earnings growth momentum in the first quarter of 2013 is largely factored in. And expecting the global economy to strengthen throughout 2013, we see earnings trends improving again from the second half of the year.

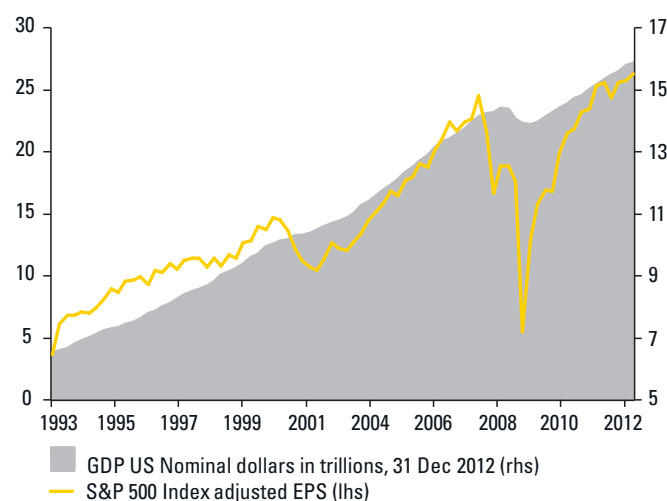
Equity valuations remain attractive and there is ample financial liquidity at a time when the future return potential of fixed-income investments is shrinking. Equity risk premiums versus cash and safe government debt remain high by historical standards (in excess of 5%). In an absolute perspective, earnings multiples are in line with historical averages.

Keeping cyclical exposure

The valuation discount of Europe to the rest of the world has partly closed. For that reason we have nearly closed our active overweight Europe versus underweight US markets. We maintain our overweight emerging markets, which we

discuss in more detail on the next page. In a sector perspective, we keep our cyclical exposure with overweight positions for Industrials. This fits in very well with our theme, “Masters of manufacturing 2.0 – Closing the productivity gap in manufacturing”, an elaboration on the theme we introduced last quarter. As a defensive element, we keep an overweight Healthcare, which continues to perform well, even in a strong equity market environment. We keep our underweight positions on typically defensive sectors Telecoms and Utilities, but upgrade Consumer Staples to neutral. The Energy sector has recently been downgraded to neutral, due to structural changes in oil supply.

Earnings per share versus US nominal GDP



Source: Bloomberg

Asset class	Fundamental view	Our recommendations
Equities: Overweight	<p>Economic recovery in US, supporting global growth and helping 2H 2013 results</p> <p>Renewed earnings recovery expected in Asia, particularly China and other emerging markets</p> <p>Megatrends support strength of balance sheets, allowing for corporate investment to stimulate profitability</p>	<p>Large industrial stocks in US, EU; mid-sized suppliers</p> <p>Emerging markets exposure, either directly or indirectly</p> <p>Get highly efficient companies with a competitive cost base, developed in the Masters of manufacturing theme. Gain selected IT exposure, for companies that support the manufacturing process</p>

Equities – Emerging markets Asia

A cyclical opportunity

Research & Strategy

Daphne Roth – Head Equities Asia

Emerging-market (EM) equities present several bright investment spots. These reflect the capacity of some – notably Asian – emerging economies to maintain competitiveness and raise productivity, push through economic and social reforms, with policies aimed at avoiding the excess of the credit cycle.

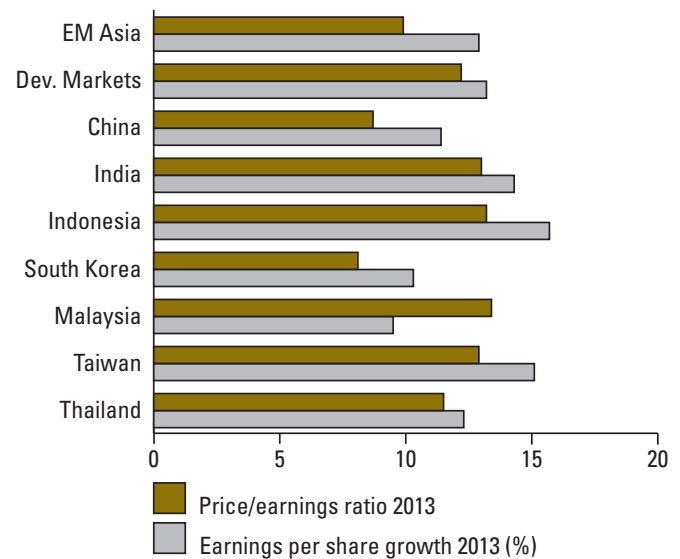
Improving medium-term cyclical conditions in the US and the economic transition in China are potentially underpinning a cyclical upswing for Asian exporters, boosting their top-line growth and profits.

Low interest rates and abundant liquidity have spawned easy credit and availability of finance for infrastructure projects and the corporate sectors. Some of this liquidity has of course seeped into the Tier-1 residential property market in China. The authorities have over the last year or more responded with tighter fiscal and credit mechanisms, but going too fast could end the risk-on party for China – as would similar moves in other emerging markets.

Nevertheless, equity risk premiums have been falling, driven by receding systemic tail risks and an improving growth backdrop. As borrowing rates have fallen significantly, providing lower interest expense and a reasonable cushion against higher operational costs, they have also contributed to the fall in equity risk premiums.

Corporate profitability in emerging markets has fallen steeply over the past 18 months (when that in the US is flirting with record highs) but should be lifted as the global recovery takes shape. Earnings downgrades are therefore slowing and earnings themselves should gain momentum this year. In fact, the two biggest sectors in Asia – Financials and IT – are now close to posting net earnings upgrades.

Room to catch up for emerging markets



Source: Bloomberg

A weaker Japanese yen (JPY) could trigger competitive devaluations among emerging-market currencies, but we only expect major policy measures from emerging economies (to stem local currency appreciation) if their exports are seriously affected by the JPY's depreciation.

Emerging markets in Asia are trading at a valuation discount to the developed world (see graph). Meanwhile, regional politics will remain a concern for markets and indirectly for earnings in 2013 and 2014 as elections and political leadership change will impact economic development in 2013 and beyond.

Region	Fundamental view	Our recommendations
Emerging Markets Asia	<p>Global growth normalising, with risk premiums falling – so earnings and cash flows should improve</p> <p>Premature self-imposed tightening in China, potential rising short-term uncertainty</p> <p>Asian earnings per share growth is estimated at 12.9% for 2013. China and South Korea are at a deep valuation discount (8.7x and 8.1x 2013 earnings)</p>	<p>Overweight in emerging markets Asia</p> <p>Play value and risk via China</p> <p>Play quality and defensive via Thailand and Indonesia</p> <p>Taiwan is now neutral as a play on global economic recovery and lower political uncertainty</p> <p>Malaysia and India are moved from neutral to underweight</p>

Equity theme – Megatrend update

A continuation of our previous theme, Masters of manufacturing, the new theme (see next page) fits well with our current portfolio of themes. As global industrialisation continues and the fast-growing economies (especially China)

move up the value chain and have to pay higher wages, automation, quality control and a streamlined production process are the main areas to invest in for corporations.

Theme	Launch	Investment case	Key components	Current theme recommendation
New age of services	3Q08	As global trade expands, the need for transport, storage and inspection of goods is accelerating	Vopak, SGS, Intertek, Burlington Northern (taken over by Berkshire Hathaway)	Buy
Big is beautiful	4Q09	Investors focus on large companies that can expand in emerging markets (EM) to become real global players	Samsung Electr., HSBC, Roche, Oracle, Coca-Cola, LVMH, Caterpillar, Walmart	Buy
Taking care	2Q10	The rising and changing needs of consumers in EM as they move up Maslow's triangle of needs	Samsung Electr., Adidas, Genting B., Mead Johnson, Heineken, Prudential, Intertek	Strong buy
European gems	3Q10	Large European expertise and brand names are in demand with the rising middle classes worldwide, helped by a weakening euro	BASF, DSM, Daimler, Fresenius, L'Oréal, Intertek, Sanofi, Siemens	Buy
Quality counts	4Q10	As production in EM moves up the value chain and global trade keeps on growing, the need for global quality standards, including environmental and safety regulations, is on the rise	Mead Johnson, Bureau Veritas, Thermo Fischer, Symrise, Vopak, Fresenius, DSM, Keppel Corp.	Buy
Mergers and acquisitions for a reason	2Q11	Companies are cash rich. Vertical integration and scarcity issues lead to more acquisitions	Mead Johnson, Mosaic, Gea, Symrise, Starbucks, Actelion, Macarthur Coal, Qiagen	Buy
Pricing power	3Q11	In an age of austerity, pricing power is proving paramount for companies to maintain margins and secure long-term earnings growth	Apple, Philip Morris, Allergan, Lanxess, Coca-Cola, Nestlé, Reckitt Benckiser, Starbucks	Buy
High-quality dividends	4Q11	In an uncertain and low interest rate environment, investors focus on dividend-paying stocks as a stable source of yield	BASF, DSM, Philip Morris, Royal Dutch, Roche, AT&T, Nestlé, Bristol Myers, SingTel, Vodafone	Buy
Step on the gas	2Q12	Shale gas revolution in the US will have profound impact on different companies	Dow Chemical, BASF, LyondellBasell, Intl. Paper, Kinder Morgan	Strong buy
Biological solutions	4Q12	New solutions in biotechnology help find and develop renewable alternatives for fossil-based commodities and for pharmaceuticals	Ecolab, Actelion, Agrium, Amgen, BASF, Biogen, Celgene, DSM, Gilead, Mosaic, Roche, Sanofi, Syngenta	Strong buy
Masters of manufacturing	1Q13	Investment in production automation needed: productivity gaps have to be closed to stay competitive in the global market place	ABB, Siemens, BASF, GE, BMW, Bureau Veritas, EMC, Hyundai, Intertek, Michelin, Qualcomm, Samsung, Schneider	Strong buy

Research & Strategy

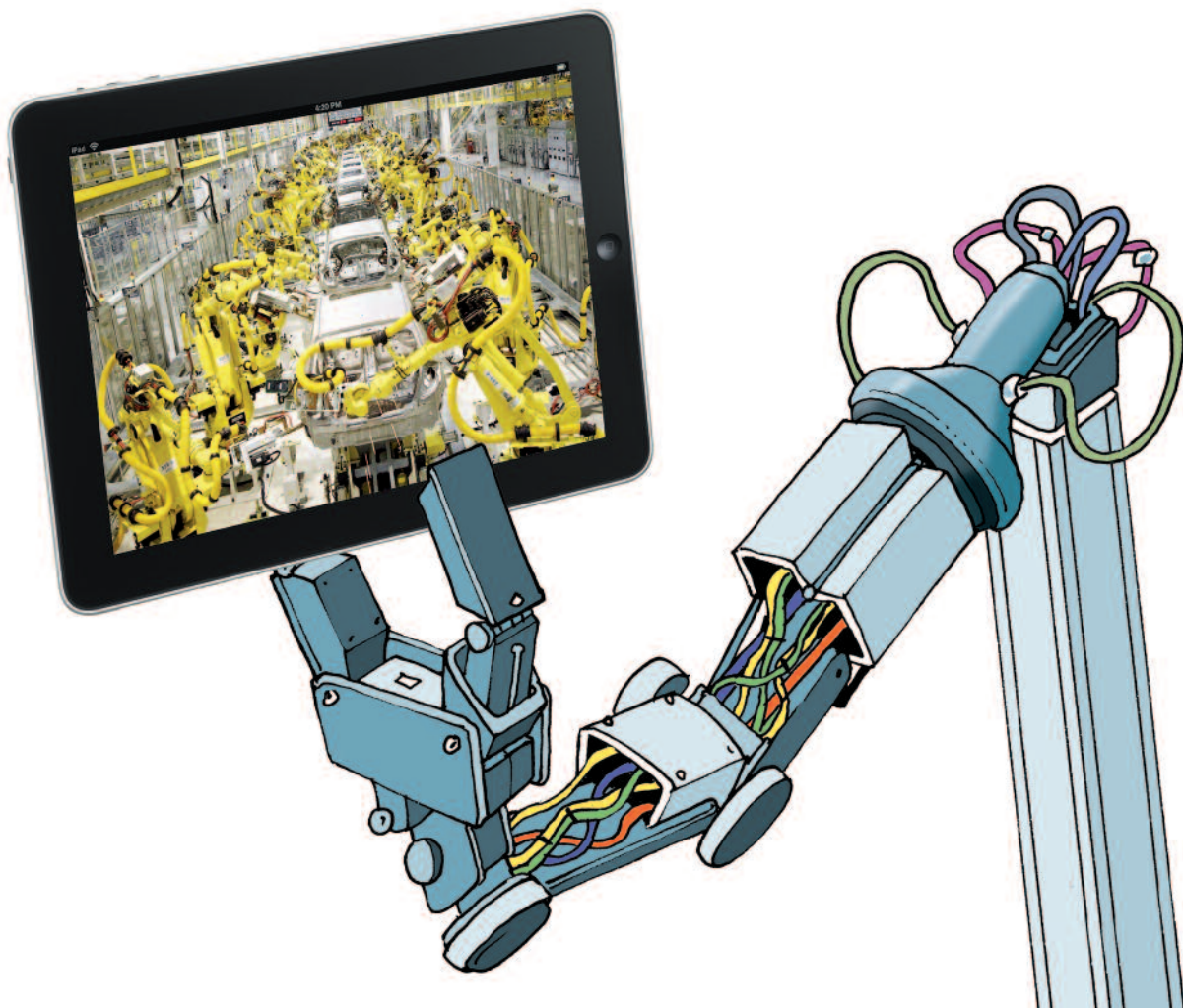
Edith Thouin - Head Equity Theme Research

Equity theme – Closing the productivity gap in manufacturing

In the previous *Quarterly Outlook* we introduced our views in “Masters of manufacturing” on the accelerating trend of automation as companies in fast-growing markets and mature economies ramp up investment spending. The investment focus on this theme seems timely: the current cyclical upswing now seen in the economies of the US, Germany and China coincides with the need for producers in the fast-growing markets to replace costlier labour with massive investments in robots and machinery. There is a sense of urgency to this: the productivity gap with mature economies is large and could lower competitiveness of fast-growing markets.

Investments in hardware like robots, electronics and machinery as mentioned in Masters of manufacturing I are

now complemented by the German machine tool maker Gildemeister and the global electronics giant General Electric. Naturally, the field of software and systems also needs to be addressed. Here, developers of computer-aided design (CAD) and computer-aided manufacturing (CAM) systems, and of standardised leading business optimisation software as designed by Oracle, are in high demand. Increasingly, information and communication is done by wireless devices like tablets and smart phones produced by Apple using networks developed by Cisco. The new generation of chips needed for these instruments is developed in cooperation with the Netherlands-based leading chip machinery maker ASML. We add Volkswagen to our favourites list as it is a major user and beneficiary of automation.



Bonds – Market outlook

Rising long-term benchmark yields herald a bleak outlook for bonds

The policies of the Federal Reserve and the ECB to flood the market with liquidity and to keep benchmark rates low must come to an end at some point. Long-term government bond yields at historical lows have resulted in a strong performance in bond portfolios. Also, as real yields have fallen into negative territory, many bond investors have been tempted to lengthen duration in their portfolios in their quest for better yields. However, long-term bond yields have begun to trend upwards in recent months, with negative effects on bond prices (see graph).

Although central banks will very likely keep short-term interest rates low in 2013, yields on long-term government bonds are market, rather than policy, driven. Markets anticipate changes in policy and this will be reflected by a sell-off leading to higher benchmark yields. The recent improved outlook for growth in the US points to the US Treasury market being the first on this – indeed, data for the past six months suggest that the process has already begun, and US dollar investment-grade bond portfolios showed a negative performance in January 2013 as bond prices fell.

Short duration as a defensive strategy

So that investors do not see their gains of the past two years gradually wiped out by rising bond yields, we recommend that they take profits on longer maturities and shorten the average duration of bond portfolios to five years or less. Nobody can be certain on the precise timing of higher yields, but they will happen. Although credit spreads still look

generous relative to the historical average, actual yields are low because of extremely low benchmark yields.

This low-yield environment offers little potential upside in holding onto long-duration bonds – further yield compression is unlikely – but the downside is considerable due to the capital losses caused by rising long-term yields. Investors are strongly recommended to shorten durations, quickly.

The lighthouse signals danger: US Treasury 10- and 30-year yields



Source: Bloomberg

Asset class: Underweight	Fundamental view	Drivers	Our recommendations
Government: Underweight	Historically low yields give investors poor returns and little upside	Real yields on core government bonds are negative	Consider opportunities in eurozone periphery sovereigns (Spain and Italy) as a way to enhance yield
Corporate: Overweight	Long-dated US Treasuries will be first to sell off, anticipating policy changes Low debt and good liquidity add strength to corporate balance sheets Credit fundamentals are supported by a moderate return to global recovery	Investors fearing losses from rising yields could exit positions Corporate default rates are falling to a cyclical low Rating upgrades in EM will support outperformance of EM bonds	Shorten duration in bond portfolios by exiting longer-dated bonds and by selling long-dated investment-grade bonds Buy global high-yield and selected EM corporate bonds

Bonds – Portfolio allocation

Making the best of a low-yield environment

Research & Strategy

Roel Barnhoorn – Head Bond Theme Research
Stephen Evans – Global Head Bonds

Dangers in low bond yields

Investors face dangers in bond investing at ultra-low yields, and with yields on quality sovereign bonds at all-time lows, it makes sense to stay underweight on bonds. The temptation for many investors has been to seek better yields by investing in bonds with longer maturities. But although this strategy may have worked for the past two years, we believe it is in danger of reversing as long-term benchmark yields begin to rise. Our overall strategy is therefore to keep average maturity short and to seek enhanced yield by taking some calculated credit risk at the shorter end of the yield curve. In our view, a judicious balance of high-quality investment-grade, BBB corporate risk and some selective exposure to high yield in developed and emerging markets represents the most sensible course.

Look for opportunities in peripheral eurozone government bonds

Last year's clarification of the ECB's role in stabilising sovereign debt crises has led to a reduction in yields on peripheral eurozone government bonds, such as Spain and Italy. We still believe that eurozone governments in the BBB rating space offer better yield opportunities and we recommend investors make some allocation to these countries. We also still expect growth to remain sluggish in most of the eurozone with economic recovery measured in years. Nevertheless, we believe the trough of the crisis is behind us and the risks of a eurozone meltdown have largely receded.

Within investment-grade credits, we recommend shortening duration and taking profits on longer-dated bonds. Corporate bonds from eurozone peripherals such as Spain and Italy offer better yield opportunities and we continue to like Telecoms and Utilities.

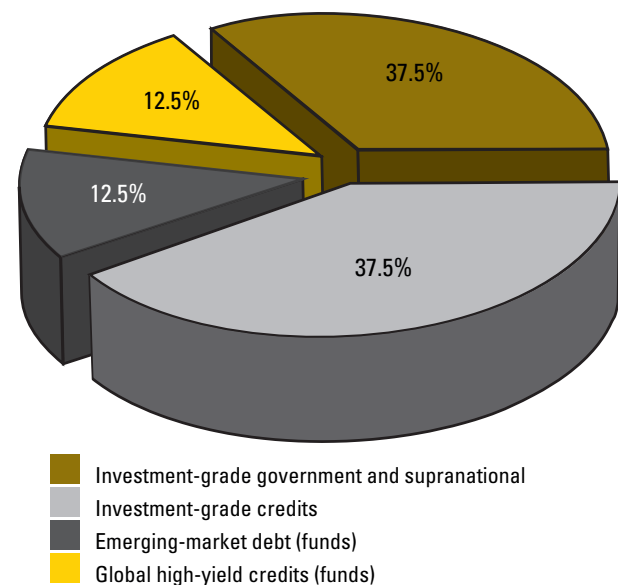
We stay overweight on credit risk

The search for yield by global investors within the bond space has led many to look further down the credit curve to improve portfolio yield. Certainly, the high-yield space in both developed and emerging markets offers much better returns than the investment-grade sector. But yield compression has been stark there: yields on shorter-duration bonds have been falling and much new issuance is at increasingly longer maturities. Although high-yield bonds have historically been less sensitive to changes in benchmark yields than investment-grade bonds, we still advise caution in increasing duration in the high-yield space.

We particularly like Asian corporates as offering an attractive balance between risk and reward, and more selectively, corporate bonds from some Latin American countries. Economic growth remains strong in both regions and fundamentals are improving. In contrast to the succession of sovereign downgrades in developed countries, EM sovereigns still enjoy rating upgrades, which often feed through to corporate upgrades. EM corporate risk offers the best opportunities for yield in shorter maturities.

Recommended bond portfolio duration: Slightly underweight

Increase investment-grade government and supranational bonds and reduce investment-grade credits



Source: ABN AMRO Private Banking

Currencies

Trading on economic strengths

Group Economics

Georgette Boele – Coordinator FX and Commodity Strategy

Bullish on the US dollar

At the start of the year, the euro posted a sharp and broad-based rise, at first linked to the dissipating fear of systemic failure in the eurozone and more recently to (for us, unrealistic) expectations of higher short-term interest rates. Comments from the ECB, weaker eurozone growth data and political uncertainty in Italy were a reality check for EUR/USD, which subsequently fell back rapidly to our end-March target of 1.30.

In the next three months, political, social and economic challenges in the eurozone on the one hand and the restraining impact of fiscal consolidation on US economic growth on the other will likely keep the main currency pair (EUR/USD) in a relatively small range around 1.30. But under the surface, sentiment on the US dollar appears to be changing.

In recent years, improving investor sentiment was US dollar negative, but this appears to be no longer the case (see our FX monthly reports). With both economies' official rates near zero, the choice leans to the currency with better economic growth (see graph) and valuation. The dollar is clearly the favourite on these grounds and slowly but surely the mood in the market could shift in its favour. We expect the greenback to start a medium-term ascent versus the euro in the second half of this year, accelerating next year with improving US economic data and increasing prospects of Federal Reserve rate hikes from early 2015.

Positive on emerging-market currencies

Our positive view on emerging-market (including non-Japan Asian) currencies for 2013 reflects stronger global growth prospects; improved risk sentiment; emerging-market catch-up; and significant undervaluation relative to long-term fundamentals – and these factors look likely to stay in place in coming years. However, in 2014 the case could be altered in the context of a more aggressive anticipation of the Fed's exit from its ultra-accommodative policy, which could limit or even reverse emerging-market appreciation against the dollar. The global economy is expected to progress by 3.9% in 2014.

Positive relation between the dollar index and the Dow Jones



Source: Bloomberg, ABN AMRO Bank

Asset class	Fundamental view (Group Economics)	Recommendations (ABN AMRO Private Banking)
Currency	Positive economic momentum unfolding in US	Long USD
	Positive on emerging and Asian currencies besides the JPY in 2013	Top picks versus EUR: GBP, SEK, BRL, MXN, ZAR Top picks versus USD: MXN, BRL, ZAR, INR, KRW, TWD as good proxies for moderate strength of Asian currencies

Forecasts

The best thing about the future is
that it comes one day at a time.
Abraham Lincoln

Research & Strategy
and Group Economics

Our central scenario is based on the conviction that the US and developing Asia will accelerate in the second half of 2013, supported by broader sources of demand that finally lift the eurozone and Japan out of their structural doldrums. The risk of being above or below the market forecasts will partly

depend on the major economies' capacity to recoup the growth lost in the Great Recession, but more so on the power of the financial liquidity and excess savings of individuals and corporates to find a way back into the real economy.

Macro indicators (%)

6 March 2013	Real GDP Growth 2013		Inflation 2013	
	ABN AMRO	Market view	ABN AMRO	Market view
US	2.0	1.9	1.7	1.8
Eurozone	-0.2	-0.2	1.5	1.8
UK	0.8	0.9	2.2	2.7
Japan	2.3	1.2	0.3	-0.1
Other countries*	2.0	2.0	1.8	1.4
Em Asia	6.6	6.8	4.6	4.3
Latin America	3.8	3.5	6.4	6.4
EEMEA**	2.5	2.8	5.0	5.8
World	3.3	3.2	3.7	3.3












All forecasts are annual averages of quarterly year-on-year changes.




* Australia, Canada, Denmark, New Zealand, Norway, Sweden and Switzerland

** Emerging Europe, Middle East and Africa

Source: ABN AMRO Group Economics, Consensus Economics, EIU

Equity indexes

	Spot 6 March 2013	Active strategy	Forward P/E 2013
MSCI ACWI	358.4		12.2
S&P 500	1539.8		12.5
Euro Stoxx 50	2695.9		10.0
FTSE-100	6453.5		10.8
Nikkei 225	11932.2		18.0
DAX	7955.0		10.4
CAC 40	3795.4		10.3
AEX	347.9		10.5
Hang Seng Index	22777.8		10.1
Shanghai SE Comp.	2347.2		8.8
Straits Times Index	3291.8		13.6

 = Underweight  = Overweight  = Neutral

Interest rates and bond yields (%)

	6 Mar 2013	Jun 2013	Sep 2013	Dec 2013	Mar 2014
United States					
US Fed	0.25	0.25	0.25	0.25	0.25
3-month	0.28	0.30	0.30	0.30	0.30
2-year	0.25	0.25	0.30	0.40	0.50
10-year	1.93	1.90	2.10	2.50	2.70
Germany					
ECB Refi	0.75	0.75	0.75	0.75	0.75
3-month	0.20	0.20	0.20	0.20	0.20
2-year	0.04	0.18	0.20	0.40	0.60
10-year	1.46	1.60	1.80	2.00	2.20

Currencies

FX pair	6 Mar 2013	Jun 2013	Sep 2013	Dec 2013	Mar 2014
EUR/USD	1.30	1.30	1.25	1.20	1.20
GBP/USD	1.51	1.49	1.45	1.41	1.43
EUR/GBP	0.86	0.87	0.86	0.85	0.84
USD/CHF	0.94	0.96	1.00	1.08	1.08
EUR/CHF	1.23	1.25	1.25	1.30	1.30
USD/JPY	93.4	90	92	95	97
EUR/JPY	121.7	117	115	114	116
USD/CAD	1.03	1.00	0.98	0.96	0.96
AUD/USD	1.21	1.03	1.02	1.00	0.98
NZD/USD	0.83	0.83	0.82	0.81	0.80
EUR/NOK	7.43	7.50	7.50	7.50	7.50
EUR/SEK	8.31	8.00	8.00	7.75	7.50

Hedge funds

Back to business

Research & Strategy

Olivier Couvreur – CIO Multimanager Hedge Funds

Erik Keller – Senior Hedge Fund Analyst

Hedge funds benefit as markets normalise

As financial markets continue to normalise and refocus on economic and company fundamentals and less on systemic and policy risks, hedge funds are getting back into the business of making money for their investors with controlled volatility. The opportunity set for the various hedge fund strategies is rich and hedge funds should be able to deliver good returns without taking excessive bets on the direction of equity and bond markets. Declining asset correlations and slow economic growth can induce a dispersion of returns between securities. In this environment, hedge funds—notably long/short managers—can profit from buying equity and debt of good companies and shorting equity and debt of companies with struggling business models or operating in declining industries.

Yield enhancement without interest rate risk

Bond investors should look at diversified funds of funds and long/short fixed-income funds for enhancing yield and mitigating interest rate risk. These funds have demonstrated these benefits during the recent bond market correction and should pay their way in directionless or falling fixed-income markets (see the correlation table below). Although mortgage-backed securities, leveraged loans, distressed debt, hybrid bank capital and credit pair trades are too complex for individual private clients to operate directly, multi-strategy funds of hedge funds and single manager long/short fixed-income funds can use these areas to generate a decent return with limited interest rate risk.

Overweight hedge funds in portfolios with significant bond exposure

The rationale is based on the capacity of the hedge fund industry to adapt and propose strategies to generate return with low volatility even in markets moving sideways. Where

investors have the ability to invest in more focused strategies we recommend long/short fixed-income and credit focused funds for more defensive portfolios and long/short equity funds for balanced or more offensive portfolios.

Hedge fund strategies are good diversifiers of bond exposure due to their low or negative correlations (see graph).

Positive on long/short equity and relative value

Neutral on global macro/commodity trading advisors (CTA)

Negative on event-driven

Long/short equity: Current market conditions are favourable for a variety of long/short equity funds, including equity market neutral and more variable biased long/short equity funds. Investors should be cautious with long biased funds as they are more sensitive to short-term market corrections.

Relative value: We will not see a repetition of last year's remarkable returns. Long/short credit funds are now more focused on short ideas. There is a favourable dispersion in the field of specialised credit strategies.

Macro/CTA: These strategies could face headwinds if financials and commodity future markets lack strong and persistent trend momentum. Many CTA hedge funds are now long risky assets and may be exposed to short-term market reversals. With a cautious neutral recommendation, our preference goes to specialised discretionary macro managers in the areas of currencies and fixed income.

Event-driven: Arbitrage spreads are tight on announced deals and the regulatory environment for mergers and acquisitions has become more challenging – the collapse of the TNT/UPS deal is a good example. We remain underweight.

Estimated Hedge fund correlations with different types of bonds in %

	US Treasuries	German Government	UK Government	Spanish Government	Global Government	US Corporates	EMU Corporates	Global Corporates
Macro / CTA	9	8	19	1	9	6	6	12
Relative Value	-14	14	11	6	2	15	25	30
Event Driven	-29	23	12	18	0	5	35	31
Hedge Funds	-30	24	21	17	3	1	35	30

Source: APT risk model and ABN AMRO

■ -35 < correlation < 0 ■ 0 < correlation < 35

Commodities

A neutral view but with
downside near-term risks

Group Economics

Hans van Cleef – Energy Economist

Georgette Boele – Coordinator FX and Commodity Strategy

Stable commodity prices despite improving macro conditions

The improving global economy does not automatically foreshadow a return of the commodity “super cycle,” partly because the expected upswing in demand is likely to be moderate, with both global GDP and trade growth below historical averages. Another factor is China’s gradual rebalancing to more consumer-driven growth, which should be less commodity intensive (see page 4). Finally, stronger supply is less favourable for price gains. Thus commodity prices are likely to be fairly flat overall with downside risks in precious metals, ferrous metals and oil in the near term, but a recovery in metals and natural gas in the medium term.

Oil prices to ease further

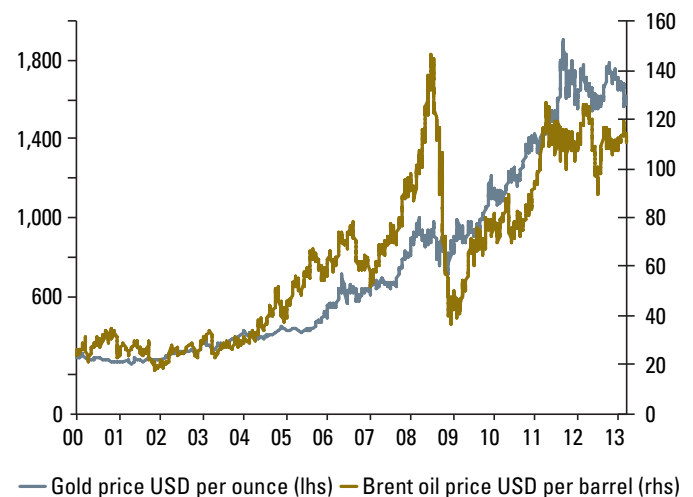
We believe that the longer-term trend for oil is downward, assuming that a moderate global economic recovery will lead to a modest rise in demand. New technologies, a rise in Iraqi oil production, more US shale oil coming to market and an easing in geopolitical tensions will lead to higher supply and a further decline of the political risk premium. A stronger US dollar in 2013 and 2014 will also add to the pressure on oil prices. We expect an average Brent price of USD 105 in 2013 and USD 100 in 2014.

Gold: the path to \$1,000

Faith in gold is fading rapidly and prices look to have further downside. Assets beyond safe havens are becoming more attractive given the gradual economic recovery and decline in systemic risks. A significant part of the demand for gold is

speculative, based on the view that prices would keep on rising. Conviction in this view has been severely challenged and is now fast weakening. We expect gold to trend lower to \$1,400 by year-end, and could become even more bearish over the longer term. We see the price dropping to \$1,200 by end-2014 and \$1,000 by end-2015, as the exit from unconventional monetary policies comes into view.

Hay days could be over for gold and oil



Source: Bloomberg

Asset class	Fundamental view (Group Economics)	Recommendations (ABN AMRO Private Banking)
Commodities	Neutral, but with downside price risks in near term	Commodity index exposure
Neutral		Sell gold

Property

Capturing the quality dividend

Research & Strategy

Manuel Hernandez Fernandez – Property Specialist

The US property sector is recovering and momentum is building, supported by the broadening economic recovery. Investors are showing interest in more cyclical real estate sectors, such as offices and industrial properties, due to positive trends in pricing, inventory and sentiment across the US.

This is not to say that US valuations are particularly cheap: US real estate investment trusts (REITs) are trading at a 7% premium to their net asset value (NAV).

Sector valuation discrepancies offer opportunities in listed markets

The average US valuation, however, masks a dispersion among different property subsectors, which represents an opportunity linked to the strength of the broader economy.

On the one hand, REITs in the most defensive subsectors, such as healthcare and self-storage, represent a haven in a sputtering (or worse) economic scenario, based on secure dividend yields and justified premiums to NAV (see graph).

On the other, REITs in cyclical sectors, such as offices, lodgings (and hotels) and apartments, are trading below the industry's average valuation, and in some cases, independent of quality.

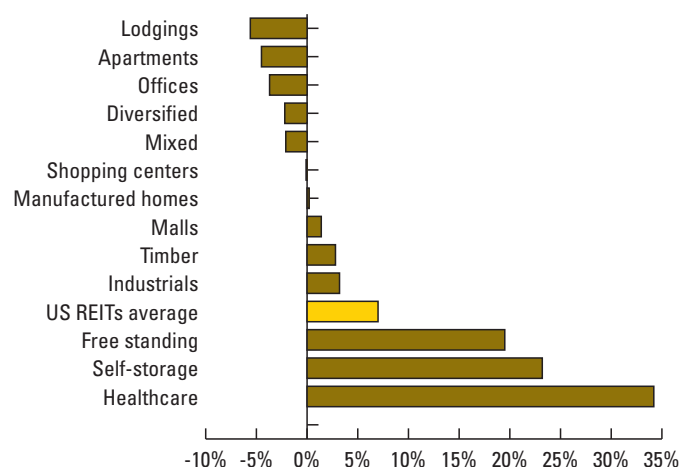
These discrepancies between defensive and cyclical subsectors distinguish property from other asset classes, and mean that a property portfolio can be balanced to benefit from both the uncertain, short-term economic outlook as well as medium-term potential upside. Moreover, the lowest valuations are most prevalent in sectors that have lagged during the past few years.

Property fundamentals are stabilising

US property remains supported by stabilising company fundamentals and a reallocation of risk by investors. Dividend payout ratios are low, while cash flow is rising and new supply is limited.

The global sector's average dividend yield is expected to remain at 3–4%. We maintain our expected total return (12 months) at 7–10%. By region: 8–10% US, 7–9% Asia and 7–11% Europe.

Opportunities from discrepancies: US REIT discounts (-ve negative) or premiums (+ve positive) to NAV



Source: SNL Financial, Raymond James Research

Asset class	Fundamental view	Our recommendations
Overweight	<p>US REITs: Sector rotation favours cyclical-tilted REITs (i.e. offices, industrials)</p> <p>Asia: Preference for developed Asian markets over emerging Asian markets. The risks of tightening measures are increasing, but we forecast robust developer sales and stable residential prices</p> <p>Europe: Economic headwinds remain and the refinancing from the banking sector is a challenge. We favour top-tier companies</p>	<p>Overweight: North America</p> <p>Neutral: Asia</p> <p>Underweight: Europe</p>

Private equity

A focus on small to medium deals

Research & Strategy

Olivier Palasi – Head Private Equity

With some 1,940 private equity funds seeking an aggregate USD 795 billion of investable assets, the competition between investment managers will be intense for the rest of the year if we consider that investors now frequently invest more with fewer managers. Further, with greater regulation weighing on investors – including the Volcker Rule that will limit the capital that US banks can invest in private equity and Basel III requiring European banks to hold more liquid assets by 2019 – we may see investment managers struggling to source new investors. In June 2008, banks accounted for 11% and insurance companies for 13% of the total capital invested in private equity – figures down to 6% and 8% in June 2012. As these old investors fade away, we see an emerging category of investors based in Asia, and sovereign wealth funds.

Buyouts

In Europe, after a year of expensive acquisitions – 9.6 times EBITDA has been reached as entry price on an undisclosed transaction – 2013 should see a slow market outside Germany, the UK and Nordic countries. The US and Canada remain attractive for investors, as the US is considered a bastion of safety even if growth is slow. Expensive deals are coming back, however, and we may continue to see investment managers targeting non-core businesses spun off by large corporations at book price. Small to medium buyouts are doing well everywhere.

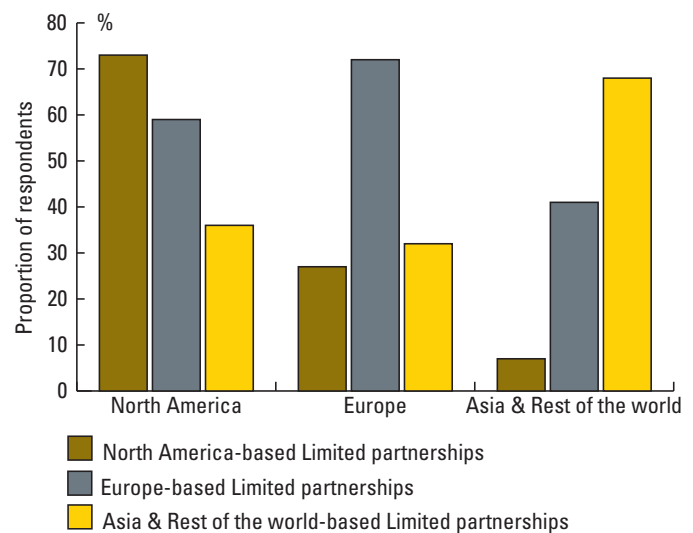
In Asia we favour Asia-Pacific countries' funds because China (and India less so) have liquidity to be invested of more than USD 70 billion. Deploying this capital may be challenging for them this year.

Investment opportunities in Brazil remain strong given the important demand for infrastructure and a more prosperous middle class. Careful due diligence and a strong local network are key, though.

Clean technologies (Cleantech) private equity fundraising and cleantech deals fell in the last quarter of 2012 and may have difficulties getting going again. With USD 2.8 billion raised in 2012 – the lowest since 2007 – cleantech activity seems to be affected by fluctuations in natural gas prices as well as policy uncertainties and reduced support-tariffs for renewable energy.

As illustrated in the graph, investors tend to consider the region in which they originate as the best source of opportunities. Despite volatility in European markets, investors consider Europe as presenting attractive opportunities in the long term.

Regions targeted in the next 12 months by private equity investors



Source: Preqin

Asset allocation

Stepping ahead

Asset allocation: Careful selection and diversification

As the global economic recovery is expected to broaden further and systemic risk continues to lessen, the current asset allocation bears in mind the profit potential stemming from this strengthening. Overall exposure to risky assets has therefore been increased (equities), while positions in bonds and hedge funds have been cut back.

Yet diversification remains key to navigating the traditional cyclical risks that have replaced the last few years' systemic turbulence, and so the profiles that have a larger share of bonds than equities (profiles 1 and 2) keep hedge funds overweight as they provide a diversification effect to the bond positions. In the central profiles (profiles 3 and 4) hedge funds are neutral, while in the equity-driven profiles (profiles 5 and 6) the hedge fund positions are underweight.

In equities, we prefer emerging markets (reflected in the overweight) versus Europe (neutral), the US (mildly underweight) and Japan (underweight).

Risk: Short-term noise

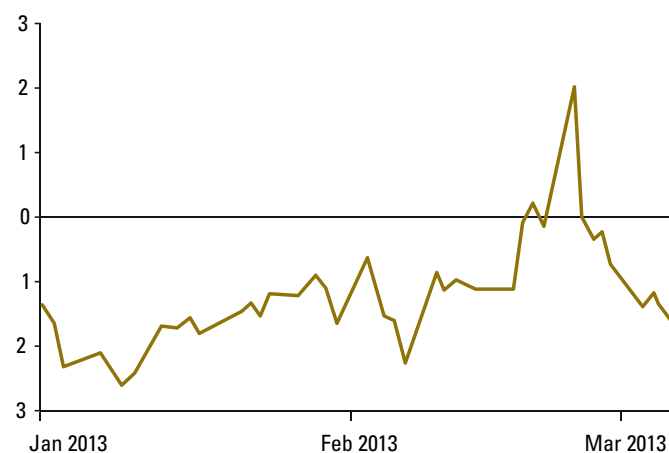
Volatility – measured by the VIX – is well below its long-term mark. However, occasional and short-lived erratic behaviour in volatility (especially near term) is expected as markets transition into traditional cyclical risks. We have recently observed, for example, that short-term volatility (VINX) has risen well above the long-term volatility index (VIF) as markets reacted to political uncertainties in the European periphery as well as fears about the future of monetary policy easing in the US. However, the spread quickly returned to normal as clarity improved (see graph).

Because the new asset allocation features a stronger overweight in equities it also implies slightly higher risk, which remains within the predefined risk boundaries of ABN AMRO's Global Investment Committee.

Performance: A positive first quarter

During the first months of the year we have seen positive returns in the equity markets, especially in the MSCI World ex-Europe and MSCI USA indices. Alternative investments have also had good returns, particularly property. On the back of these outcomes, the performance in all our profiles since 1 January 2013 has been positive, also outperforming the benchmark.

Short- versus long-term volatility (VINX-VIF)



Source: Bloomberg

Audited performance of our Tactical asset allocation vs. its Strategic asset allocation in %

	EUR						USD					
	22 May 2003 to 28 February 2013*			2013 YTD (28 February 2013)			22 May 2003 to 28 February 2013*			2013 YTD (28 February 2013)		
	Strategic	Tactical	Excess Return	Strategic	Tactical	Excess Return	Strategic	Tactical	Excess Return	Strategic	Tactical	Excess Return
Profile 1	53.97	62.44	8.47	0.20	0.26	0.05	54.10	62.09	7.99	0.12	0.20	0.08
Profile 2	57.22	68.93	9.71	1.08	1.47	0.41	59.96	88.81	8.85	0.97	1.40	0.43
Profile 3	72.67	93.18	20.51	1.78	2.39	0.61	80.43	96.12	15.70	1.71	2.34	0.63
Profile 4	76.57	97.77	21.20	2.74	3.40	0.66	87.28	103.26	15.98	2.69	3.36	0.67
Profile 5	85.95	111.93	25.98	3.71	4.15	0.44	98.73	119.44	20.71	3.66	4.13	0.46
Profile 6	88.97	115.04	26.08	4.43	4.67	0.24	103.97	124.40	20.43	4.39	4.65	0.26

* Profiles 1 and 2 are linked to the "old" Conservative profile, profiles 3 and 4 to the "old" Balanced profile and profiles 5 and 6 to the "old" Growth profile.

Research & Strategy

Hans Peters – Head Investment Risk
 Emilia Bruera – Quantitative and Risk Analyst

The difficulty is not in the new ideas,
 but in escaping from the old ones.
 John Maynard Keynes

ABN AMRO's Global Investment Committee model portfolios showing EUR/USD risk profiles in %, starting with our most conservative (Profile 1) and ending with that most exposed to market risks (Profile 6).

Profile 1						Profile 2				
Asset class	Strategic			Tactical	Deviation	Strategic			Tactical	Deviation
	Neutral	Min.	Max.			Neutral	Min.	Max.		
Money markets	5	0	60	18	+13	5	0	70	4	-1
Bonds*	90	40	100	74	-16	70	30	85	58	-12
Equities	0	0	10	0		15	0	30	23	+8
Alternative investments	5	0	10	8	+3	10	0	20	15	+5
Funds of hedge funds	5			8	+3	5			8	+3
Real estate	0			0		3			5	+2
Commodities	0			0		2			2	
Total Exposure**	100			100		100			100	

Profile 3						Profile 4				
Asset class	Strategic			Tactical	Deviation	Strategic			Tactical	Deviation
	Neutral	Min.	Max.			Neutral	Min.	Max.		
Money markets	5	0	70	0	-5	5	0	70	0	-5
Bonds*	55	20	70	44	-11	35	10	55	23	-12
Equities	30	10	50	44	+14	50	20	70	65	+15
Alternative investments	10	0	20	12	+2	10	0	30	12	+2
Funds of hedge funds	5			5	0	5			5	0
Real estate	3			5	+2	3			5	+2
Commodities	2			2		2			2	
Total Exposure**	100			100		100			100	

Profile 5						Profile 6				
Asset class	Strategic			Tactical	Deviation	Strategic			Tactical	Deviation
	Neutral	Min.	Max.			Neutral	Min.	Max.		
Money markets	5	0	70	0	-5	5	0	60	0	-5
Bonds*	15	0	40	11	-4	0	0	25	0	
Equities	70	30	90	84	+14	85	40	100	95	+10
Alternative investments	10	0	30	5	-5	10	0	30	5	-5
Funds of hedge funds	5			0	-5	5			0	-5
Real estate	3			3		3			3	
Commodities	2			2		2			2	
Total Exposure**	100			100		100			100	

* Recommended duration: **Slightly underweight**. Benchmark: Bank of America, Merrill Lynch Government Bonds 1 – 10 years.

** Foreign exchange exposure; only equity markets and a small portion of alternative investments are exposed to foreign currencies.

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Editorial and Communication Support
Editor Supporting Documents
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