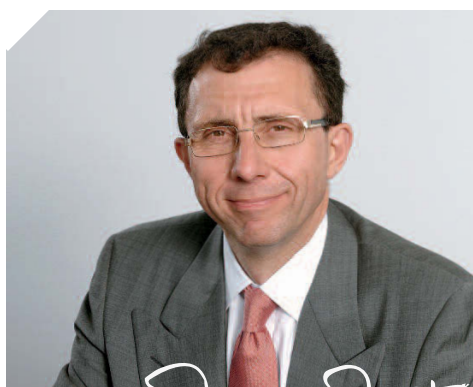


# Gaining traction

## Quarterly Outlook Q4 2013

Investment  
Strategy

# Quarterly Outlook Q4 2013



*Didier Duret*

**Didier Duret**

Chief Investment Officer,  
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September 2013

## **Gaining traction**

Investors are facing a dual challenge. First, higher rates on cash deposits are a distant reality. They will certainly not occur before the end of 2014, given the US Federal Reserve's plans for a gradual departure from quantitative easing. The second challenge is to effectively harness the momentum of the global economic recovery that is now gaining traction in the US and, even, to a certain extent in the eurozone.

The Quarterly Outlook Q4 2013 provides the inside track on a practical, medium-term approach to managing investment portfolios in the face of these challenges. We recommend, for example, investing in equities, which can be effective performance engines as the equity rally matures. In particular, we favour reasonably valued small and medium-sized companies at the junction of megatrends fuelling the renaissance underway in developed economies.

We also continue to suggest prudence regarding bonds. Selected fixed income investments, such as corporate credits, nonetheless remain sources of income, able to absorb the potential shock of rising government-bond yields. In addition, hedge funds have a new function in portfolios, operating as insurance against higher bond yields in conservative portfolios and as a hedge against market risk in growth-oriented portfolios.

The ABN AMRO Private Banking Research & Strategy team elaborates on these perspectives in the following pages. Our goal is to provide practical insights and investable ideas. Your Relationship Manager or local Investment Advisory Centre (see back cover) stand ready to assist you in developing the asset allocation that best meets your investment objectives as the global economic recovery gets going.

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# Gaining traction

The global recovery is accelerating. Central banks are on track to return to more normal monetary policies. The volatility around the transition is an opportunity to buy growth-oriented equities.

The global economic recovery is back on track, with 3.8% growth expected in 2014. The upturn is mainly led by the US, and paves the way for constructive corporate earnings expectations in the medium term. Simultaneously, the US Federal Reserve's strategy for exiting its accommodative stance is gaining traction, with the transition to a more-normal market environment already reflected in bond markets. Yet questions remain regarding the pace and timing of central-bank monetary policy adjustments, resulting in higher government-bond yields and recurring bouts of short-term market volatility.

ABN AMRO believes that just as central banks were able to successfully avert a global depression through unprecedented economic stimulus, they will pragmatically manage upcoming policy adjustments. This signals opportunities for selected equities (overweight). Less monetary stimulus will nevertheless require stock-selection discipline, as the equity market rally enters a more mature phase. In fixed income markets, US Treasuries now have positive real (after inflation) yields — for the first time since 2011. Nonetheless, we believe it is too early to buy. Our bond strategy (underweight) remains defensive, with low duration and corporate credits acting as a buffer against rising yields.

## Key trends

- **The global economy is gaining momentum.** The US economy will steadily gain speed, thanks to traditional capital-expenditure accelerators. The eurozone, including peripheral Europe, is finally bottoming out and Japan is committed to pursuing policies to stimulate the economy.
- **Developed economies are experiencing a renaissance.** A convergence of structural changes, such as the energy revolution and technological innovation, should activate capital expenditure. Developed (G8) economies are poised to contribute more strongly to global growth in 2014.
- **The US Federal Reserve is progressively returning to a normal monetary policy.** The process will be prepared and gradual – as opposed to the aggressive approach of 1994 – and will be calibrated to preserve confidence in the ongoing recovery. In addition, the recent weakness in emerging markets is exaggerated and cannot be compared with previous episodes.

## Key challenges

- **Maintaining a pragmatic policy approach.** The perception of a “hard exit” from monetary policy and indifference towards the global impact could affect confidence and increase volatility. This would jeopardise the recovery. Managing

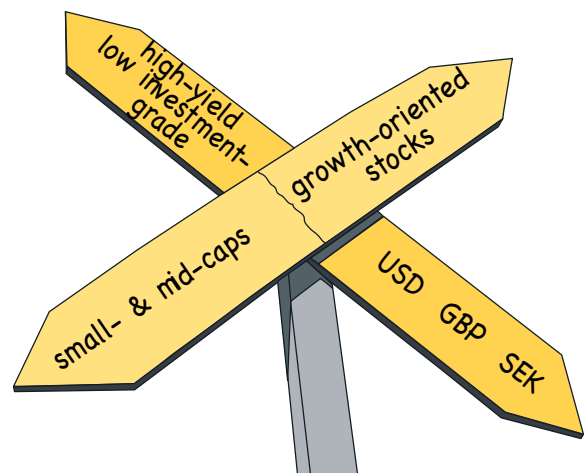
market expectations will be a delicate matter. It includes consideration of factors not directly related to the economy which can affect confidence, such as the very sensitive geopolitical context in the Middle East.

- **The risks of the economic transition in China.** Delays in the transition towards a more-domestic economy could lower the Chinese growth rate below 5%, carrying numerous risks for emerging and developed markets.
- **The value trap.** Investors should avoid blindly buying low valuation stocks and sectors, as the low price may be related to profitability deficiencies.

## Key opportunities

- **Growth-oriented stocks** should benefit from the growing economic momentum. Price/earnings expansion is realistic, based on the reduction of the equity earnings premium, particularly for companies with low-interest rate sensitivity. An ultimate sell-off in emerging markets will create entry points.
- **European mid- and smaller-sized companies** provide a potential for valuation parity with US peers.
- **High-yield bonds and lower-quality investment-grade bonds can act as interest-rate shock absorbers;** there are also opportunities in emerging-markets short- and medium-term bonds denominated in hard currencies.
- **Growth currencies.** The US dollar, British pound and Swedish krona are favoured developed markets currencies; in emerging markets, we prefer the Mexican peso, Polish zloty and Chinese yuan.

## Ways to diversify



**Group Economics**

Han de Jong – Chief Economist

# Accelerating, self-sustained economic growth

Global economic growth is accelerating, with the US and, surprisingly, Europe showing clear improvement. Many emerging markets, however, are having to come to terms with changed circumstances. The main driver is lessened headwinds for the US and eurozone economies. In addition, fiscal tightening is past its peak, creating room for a somewhat stronger expansion. Private-sector balance-sheet repair has also been more or less completed in the US, allowing for stronger spending and bank lending. Moreover, stress in the European financial system, which pushed Europe into a recession in 2011 and 2012, has eased significantly. And finally, inflation in the Western world is now considerably lower than a year ago, supporting real spending power.

Emerging economies, on the other hand, are trying to cope with the effects of lower commodity prices, the changed growth strategy of China and the drop in capital inflows following the US Federal Reserve's announcement that it will reduce its asset purchasing programme within the not too distant future. While growth has fallen across the emerging economies, they continue to register decent progress.

## Advanced indicators turning up

Business confidence has risen in recent months, and in many countries the improvement has been pronounced. The recent US manufacturing survey (see graphic), for example, reached its highest level since early 2011 in August. The non-manufacturing survey reached its highest level since the end of 2005! The European equivalents have also improved materially. While the absolute levels of the eurozone business surveys still indicate only modest overall economic growth, they are also at their highest levels since 2011. In virtually all of these indicators, the orders component has been strong, which is very encouraging and suggests that further gains of the overall indices in the months ahead is likely. The noticeable rise in business confidence indices implies that actual economic growth is currently accelerating or will do so shortly. Business confidence in China also appears to be on the mend, though less convincingly. Similar indicators for several other emerging economies have not yet picked up.

## Self-sustained momentum

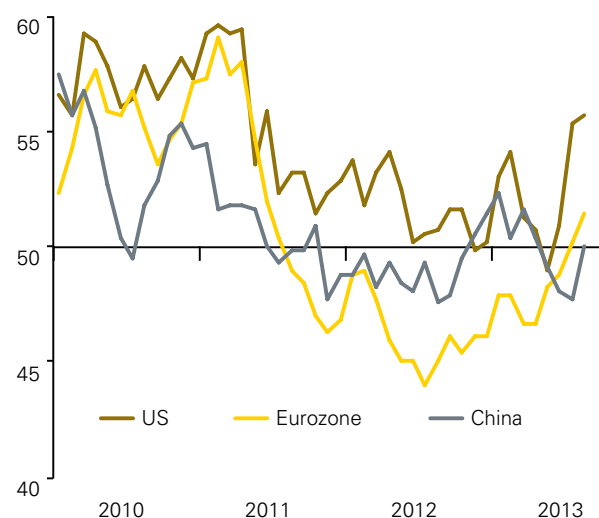
When the direction of economic growth changes, it tends to trigger mechanisms that reinforce themselves, adding momentum. As fiscal tightening eases and household financial positions improve, spending growth will strengthen.

As a result, companies will want to meet increasing demand by hiring more people and investing in new equipment. This boosts household incomes further, supporting continued growth. As this mechanism plays out, it is reasonable to expect global growth at a decent pace for some time.

## Risks to the outlook

There are always risks to what looks like a relatively positive picture. The US Fed has started its process of normalising monetary policy, the announcement of tapering being the first step. Since Chairman Ben Bernanke raised this issue in May, borrowing costs have risen, and it is unclear how well the economy can cope. So far, rising borrowing costs have not undermined the recovery. The capital outflows from emerging economies are also a risk. We do not expect this to turn into an actual crisis, as economic fundamentals across these countries are solid with a few exceptions. Finally, geopolitical risks always have the potential to disturb a generally rosy picture.

**Business surveys (Purchasing Manager Index) for the US, eurozone and China.**



Source: Thomson Reuters Datastream

# The developed world's renaissance

Structural improvements signal light at the end of the tunnel

## Advanced economies and emerging economies switch seats

Over the last five years, the advanced economies have lurched from one crisis to another and have generally recorded anaemic economic growth in between. From the 2008-2009 banking crisis, to the sovereign debt crisis, to worries about the future of Europe's single-currency area and the US fiscal cliff and government shutdown, the bad news for the advanced economies just kept on rolling. Meanwhile, the emerging markets went from strength to strength, reviving rapidly following the credit crisis and even triggering speculation about whether the emerging economies could save the global economy. There was even speculation as to whether they might literally bail-out some of the struggling eurozone countries. Indeed, while government deficits soared in the advanced economies, public finances generally remained healthy in the emerging economies. Recently, however, there have been some signs of life in advanced economies, just as the shine has come off emerging economies.

## Structural improvements for advanced economies

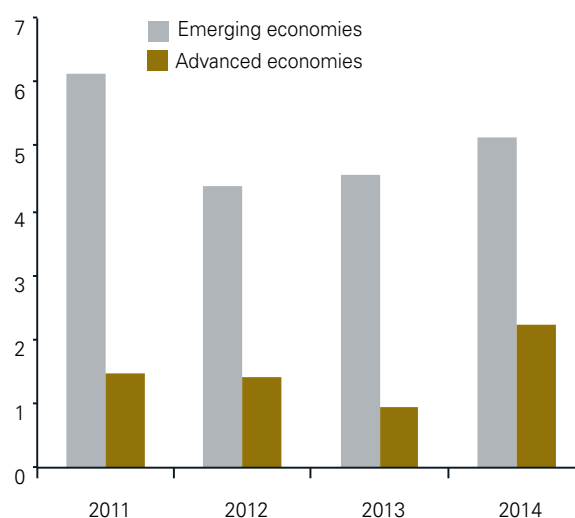
In recent months, economic growth appears to have shifted into higher gear in the US and Japan, and the recession in the eurozone has clearly ended. This follows a number of crucial improvements. First of all, systemic risks in the single-currency area have sharply receded, following the European Central Bank's commitment to a conditional sovereign safety net. This has meant that large uncertainties surrounding the outlook have lifted, while financial stress has eased.

In the US and the eurozone, household and corporate balance sheets have sharply improved. This means that the need for the private sector to deleverage has lessened, and consumers and corporates are in a better position to again spend and invest. Budget deficits have also declined in both regions, and the most acute phase of fiscal consolidation has passed. Finally, the shale-energy revolution is making the US less dependent on energy imports, providing a boost to energy-intensive manufacturing companies. Finally, there has been a significant re-balancing within the eurozone, with many peripheral member states rapidly regaining competitiveness and current-account deficits evaporating. In Japan, the government has finally become more serious about beating deflation, with the central bank putting in place an aggressive monetary-easing programme.

## But let's not get carried away

At the same time, economic growth is structurally slowing down in emerging economies, given the change in China's growth model and the related cooling of commodity markets, which has dampened growth in producer countries. It is now demand from the west that will help lift the prospects of the emerging economies. This is already apparent in improving export growth in China. At the same time, political and financial market instability has come to the fore. Despite the shift in fortunes, one should not get carried away, however. Emerging economies will still grow at a faster pace than the advanced economies, as they continue to catch-up with the west in terms of technology, education and organisation. In addition, the advanced economies still have work to do in terms of repairing public finances, not least in Japan. Meanwhile, the repair of bank balance sheets in the eurozone is ongoing.

GDP growth (%) emerging versus advanced economies



Source: Bloomberg, ABN AMRO Group Economics

# No hard exit for the Fed

Differences with 1994 will be decisive

## Group Economics

Nick Kounis – Head Macro Research

### Rising Treasury yields and an emerging markets sell-off evoke bad memories

Worries about the Federal Reserve moving away from its super accommodative monetary policy have intensified. This has been particularly visible in the Treasury market and in emerging markets. Investors have priced in the prospect of earlier and larger increases in policy rates by the Federal Reserve and other advanced-economy central banks (see graphic). At the same time, the prospect of the withdrawal of liquidity, higher US interest rates and, in some cases, deteriorating fundamentals have led to significant capital outflows from emerging markets. This reversed some of the large inflows seen over recent years, in an environment of sustained low interest rates and large central bank asset purchase programmes.

### Differences with 1994 will be decisive

The combination of rising US long-term interest rates and an emerging markets sell-off has brought back unpleasant memories of 1994. Given the Fed's monetary policy is unprecedented and the size of the inflows to emerging markets have been significant, it is natural that there are jitters related to the US central bank's change of course. However, there are major differences in terms of both the Fed and emerging markets that should prevent the situation from getting out of hand. Back in 1994, the Fed surprised financial markets when it started to increase rates, and it subsequently hiked rates abruptly. With inflation low, and central bank credibility on inflation still very much in place, we think it is likely that the central bank will not start to raise rates for an extended period. And when the central bank does start, most likely in early 2015, it will probably tighten relatively gradually. In addition, the element of surprise will almost certainly be missing this time, as the Fed has become increasingly transparent and has taken to telegraphing its moves well in advance.

### Emerging markets have more solid fundamentals

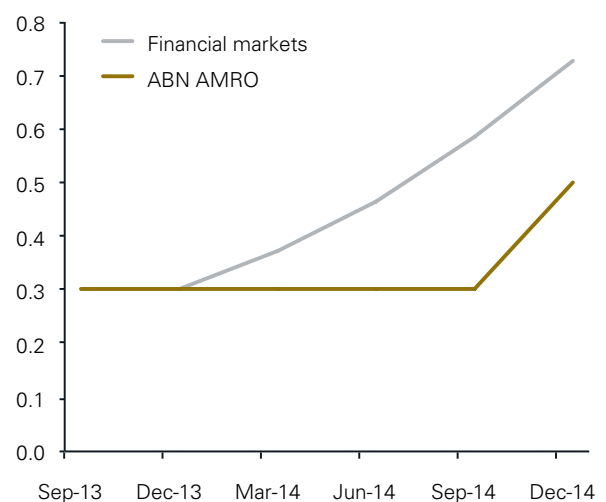
In addition, fundamentals for emerging markets have strengthened. For the emerging economies, there is, on aggregate, a current-account surplus, compared to a deficit in 1994. External debt is lower, currency reserves are much higher and more stable foreign-direct investment is now a much bigger share of capital flows than portfolio investment. Finally, pegs to the dollar are no longer common. The more healthy picture for emerging markets as a whole should limit

contagion, although acute vulnerabilities exist in a number of significant economies.

### Other central banks to keep policy accommodative

Changes in expectations about US monetary policy have also sent ripples through the advanced-economy government bond markets. The logic seems to be that where the Fed goes, others will follow. The European Central Bank (ECB) and Bank of England (BoE) have been at pains to stress that this is not the case, however. They have both stepped up their forward guidance with a view to dampening rate-hike expectations. Although the BoE may struggle, we think the ECB will ultimately be successful in convincing markets, given the eurozone's slow recovery and subdued inflation. Meanwhile, the Bank of Japan has continued its aggressive asset purchases and is more likely to step them up, rather than slow them down, given its determination to beat deflation.

Expectations of US three-month money-market rate (%)



Source: ABN AMRO Group Economics

# Equities – Market outlook

Strength and maturity

Research & Strategy

Sybre Brouwer – Global Head Equity Research

The stock market rally is entering a more mature stage: valuations have recovered from rock-bottom levels and are converging towards historical averages. We believe the price-earnings expansion may reflect a positive re-rating of equities by the broad investor community, after the negative re-rating that followed the recent recession. The scope for price-earnings expansion is also widened by the lack of performance drivers in other asset classes.

## The positive earnings trend is resilient

We believe the trend of positive earnings will continue. Corporate margins are at relatively high levels in a historical context — especially in the US. Top-line growth is expected to accelerate, as the global economy gathers pace and broadens over the coming quarters. Margins will be bolstered by stronger sales as well as by input costs, for both raw materials and labor, which are expected to remain moderate. While the cost of corporate borrowing could rise in tandem with higher government bonds yields, we expect the impact to be modest. Many companies have improved their balance sheets and covered their longer-term funding needs.

## Opportunities in mid- and small-caps

In the US (neutral) and Europe (neutral) domestic small- and mid-cap players will be in the front ranks of the acceleration of the domestic economies. These companies benefit from innovations and efficiency drives and are lagging blue-chip stocks in terms of valuation metrics. (See page 9 for more details.)

## Focus on growth-oriented stocks

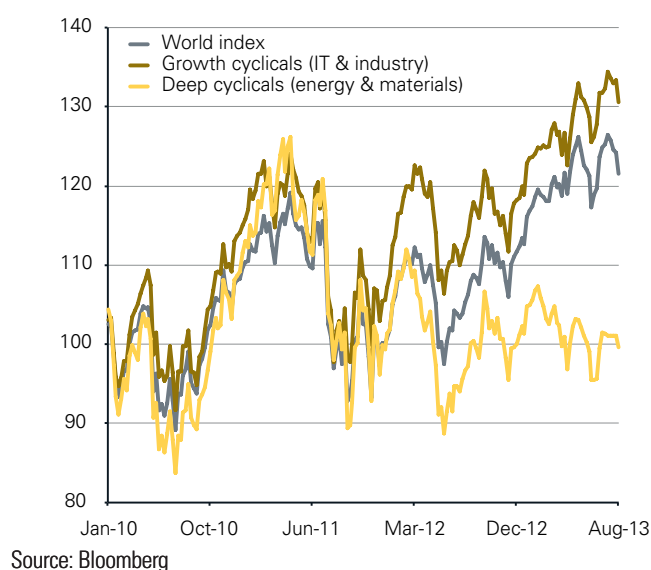
Our sector and sub-sector preferences (described on page 7) are mainly in the growth-oriented sectors of information technology (IT) and industrials. Nevertheless, we remain skeptical of the potential of deep-cyclical sectors, such as

materials and energy. One reason is that we do not expect a substantial recovery in commodity prices, partly because of overcapacity issues. Deep-cyclical sectors are also facing structural changes that go beyond the benefits of a cyclical recovery, at least for now.

## China remains overweight

After we reduced our exposure to emerging markets (neutral) in August, we retained an overweight allocation to China. This is based on the expected revival in global trade and the stabilisation of China's domestic growth at above 7%. The Chinese market is also supported by undemanding valuations and low earnings expectations.

Price index comparison of growth-cyclical versus deep-cyclical sectors



Asset class	Fundamental view	Our recommendations
Equities Overweight	<p>Economic recovery in developed markets, supporting global growth and earnings.</p> <p>Global interest rates are expected to rise gradually.</p>	<p>Focus on domestic mid- and small-cap stocks in US and Europe.</p> <p>Creates opportunities in growth-oriented sectors, such as large global industrial and IT stocks.</p> <p>China should benefit, due to global growth outlook, supported by low valuations and modest earnings expectations.</p> <p>Impact on global equities is limited, as it is largely discounted, but prudence is called for regarding expensive, high-yielding stocks (e.g. consumer staples and health care).</p>

# Equities – Sector outlook

Getting started with sector rotation

**Research & Strategy**

Sybren Brouwer – Global Head Equity Research

As the equity bull market returns, significant sector rotation is taking place. Our intention to tilt the portfolio toward growth-oriented stocks is reflected by the sub-sector ratings. They

also reflect that certain defensive, high-yielding parts of the market have performed very well and become fully valued.

Overweight - Neutral - Underweight

Sector/Subsector	Comments	Recommendations
<b>Energy</b>		
Oil Services	Complex projects financed by oil production companies benefit the services sector.	Halliburton, SBM Offshore
Integrated Oils	Large investments with low returns in exploration are balanced by better demand for refined products.	
Exploration & Production	Exploration is risky and very expensive, while end-prices for energy are in a downward trend.	
Refining	Benefit from higher demand is in the offing, but not yet visible.	
<b>Materials</b>		
Chemicals	Specialty chemicals benefit from lower input prices, base chemicals (mainly in the US) are attractive.	Dow Chemical
Metals & Mining	Negative trend in margins and balance sheets, as prices and demand fall.	
Construction Materials	Recovering, but remains difficult based on pricing and excess supplies.	
Paper & Forest	Good trend in US on lower energy costs and housing demand.	
<b>Industrials</b>		
Commercial Services & Supplies	Staffing enjoying better-than-expected results. Conditions to improve in some European countries.	
Capital Goods	Mining machinery remains difficult; aerospace is very strong; energy-related equipment sees delayed orders.	ABB, GE, Gildemeister
Transportation ▲	Largest airlines compete with price fighters. Railroads in US benefit from improving economy.	
<b>Consumer Discretionary</b>		
Consumer Durables	No re-rating expected, until emerging-markets growth improves.	
Consumer Services	Sector to benefit from recovering consumer and corporate spending.	Accor
Retailing	Retailers without a clear multi-channel strategy will have difficulties competing with online pure plays.	
Automobiles & Components	Sector to benefit from economic recovery and aged car fleets in both the US and Europe.	Daimler
Media	Print advertising still weak. Broadcasting remains resilient in the online world.	
<b>Consumer Staples</b>		
Household & Personal Care	Emerging markets economies are still the main growth driver, but tough competition and high valuations.	
Food & Drug Retailing	Holding up relatively well, due to measures to adapt to structural trading-down by consumers.	
Food, Beverage & Tobacco	Lower prices from low commodity prices; volumes hurt due to weaker emerging economies; high valuations.	
<b>Healthcare ▼</b>		
Health Care Equipment & Services	Lower prices and budget cuts to health care systems weigh on sector.	
Pharmaceuticals, Biotech & Life Sc.	Positive trend in biotech continues; M&A picking up and higher break-up values.	Gilead Sciences, Roche
<b>Financials</b>		
Diversified Financials	US investment banks surprised on the upside, while in Europe, they disappointed.	
Insurance	Mixed results; losses on natural catastrophes below average. Asset management strong.	AIA Group
Commercial Banks	US is doing well, with lower provisions; Europe more mixed with rising non-performing loans.	
Real Estate	Focus within retail real estate remains on quality assets.	
<b>Information Technology</b>		
Technology Hardware & Equipment	Rebound in corporate spending on IT should accelerate profit growth for hardware players.	eBay, Qualcomm
Software & Services	Cloud computing trend threatens large traditional players, such as Oracle and SAP.	
Semiconductors & Semicond.Equip.	Profit outlook for H2 2013 is unexciting for many semiconductor players.	
<b>Telecom</b>		
Telecommunication Services	Increasing M&A activity, but operational environment remains very difficult.	
<b>Utilities</b>		
Renewable Utilities ▼	Renewables becoming too costly compared to new resources (shale gas) and subsidies are shrinking.	
Regulated/Multi-Utilities	High costs and low prices continue to hurt cash-flow generation.	

# Equity theme – Megatrend update

Although our new equity theme focusing on small and medium-sized companies (see page 9) is largely grounded on the prospects of a valuation catch-up, the unfolding business

cycle is heavily shaped by three powerful megatrends: new ways of buying for consumers, the energy transition and a different operational model for the manufacturing industry.

Theme	Launch	Investment case	Key components	Recommendation
<b>The new retailer</b>	Q3 2013	This newly introduced theme is receiving increasingly more media attention. Online shopping is growing, with more news about bricks-and-mortar chains changing their strategies reported every day. Fast-rising sales at well-known providers, such as Amazon.com and the clothing retailers ASOS in the UK and Zalando in Europe, should be followed by increasing returns on the investments they have made in distribution and client services, resulting in higher share prices.	Amazon.com, FedEx, Simon Property, Unibail Rodamco, eBay, Google	Strong buy
<b>Closing the productivity gap and Masters of manufacturing</b>	Q1 and Q2 2013	Since the start of 2013, the US and European industrial sectors have outperformed the overall market. Technology stocks have also done well. The end-users of new automation systems and techniques, such as the auto industry and other previously labour-intensive industries, such as packaging and pharmaceutical manufacturers, have thrived. More investment in capital goods and IT is expected, as companies and consumers become more upbeat about growth prospects in Western countries and in emerging countries as well, as they continue to industrialize. Both large industrial capital goods manufacturers and specialized medium-size manufacturers are set to benefit.	ABB, ASML, BASF, Cisco, GE, BMW, EMC, Qualcomm, Schneider, Emerson Electric, Fanuc, Gildemeister, Kuka, Oracle, Siemens	Buy
<b>Step on the gas</b>	Q2 2012	Although the very low gas prices that were reached in 2012 put the brakes on several new shale gas developments in the US, the increase in gas prices to around USD 4 led to renewed investment. US oil and liquid-natural-gas exports are fueling expectations for lower energy prices once the current turmoil in the Middle East eases. This is good news for energy-intensive industries in the US as well as for the infrastructure used to process and transport these new energy supplies.	Dow Chemical, BASF, LyondellBasell, International Paper, Kinder Morgan	Strong buy

# Equity theme – Small- and mid-caps catch up

There are phases in the economic cycle when small- and mid-cap stocks should be favoured. We are now entering such a period for both US and European equity investments.

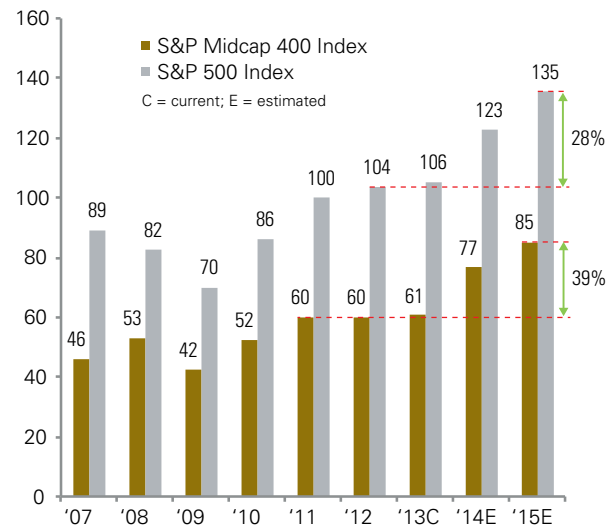
As the US recovery gets underway, investments are being made in the country's manufacturing base, which is a switch from relying on foreign outsourcing. This inward focus in the US is bolstered by the revival of the US energy industry and by the development of new technologies that can improve competitiveness. In Europe, the small- and mid-cap sector suffered tremendously during the credit crisis, but the survivors are now benefiting from the pick-up in business activity and in capital investments.

Mid- and smaller-sized companies supply the tools, intermediate goods and new technologies and services that support the growth and expansion of larger companies. A new wave of mergers and acquisitions is also possible among mid- and smaller-sized companies, as larger corporates take control of suppliers and add new technologies.

Historically, mid-size and smaller companies increase their profits more quickly than larger firms once the economic cycle gains traction. Moreover, current valuations are still modest, considering the consensus expectations for the next 27 months. The price/earnings (P/E) ratio of the US S&P 400 MidCap Index is currently at 21x, with earnings rising by 39%. For Europe, there is no specific index for mid-caps available. The broader Euro Stoxx 600 Index, however, trades at a PE of 20x current earnings, a 40% increase in earnings per share is expected through the end of 2015.

For the “Small- and mid-caps catch up” theme we have selected companies that are either involved in the industrial supply chain or in optimizing productivity levels. Our favourites appear below. (They are all recommended as Buys (as of 5 September 2013) with the exception of Kuka (Hold)).

US earnings forecasts mid-caps versus overall market



Source: Bloomberg

Company	Activities	Rating	Market cap (EUR bln)
Aalberts Industries	NL Flow control, industrial services	Buy	2.2
Arcadis	NL Infrastructure design and engineering	Buy	1.5
TKH	NL Cables, network components, industrial engineering	Buy	0.9
Gildemeister	DE Machine tools	Buy	1.4
Kuka	DE Robotics	Hold	1.1
Accor	FR Hotels	Buy	6.9
Expedia	US Online travel	Buy	5.3
Bouygues	FR Engineering, TV, telecoms	Buy	7.9

Source: Bloomberg, ABN AMRO Private Banking

# Bonds – Market outlook

A multi-year adjustment ahead

Research & Strategy

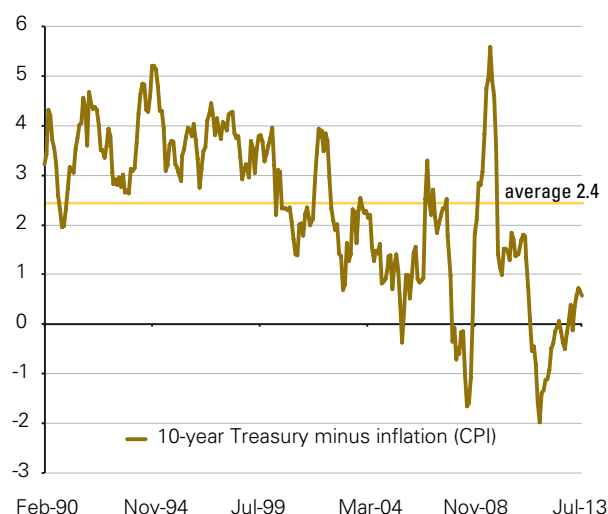
Stephen Evans – Global Head Bonds

Benchmark yields are well into the process of normalisation in response to the expected tapering of the Federal Reserve's asset purchases, which we expect to start in the fourth quarter of 2013. There are two strong indicators that this process is well underway. The first is the steepening of the US yield curve since the beginning of 2013, with the spread between two- and ten-year Treasury bond yields widening from 160 basis points (bp) to 240 bp. The second indicator is that following the recent rise in yields, US long bonds are again showing positive real yields, with the real yield of the 10-year US Treasury approaching 1% (see graph). Nevertheless, the normalisation process still has further to go. The spread between two- and ten-year Treasuries has still not reached the historical high; and the average real yield on 10-year Treasuries since 1993 was more than 2%. This tells us that we should expect the yield curve to steepen further. And higher long-term benchmark yields should bring real bond yields closer to the historical average. We see this as a gradual process over the next 12-18 months during which we expect the Fed funds rate to remain low for most of the period. Further, we believe there is little risk of the severe disruption that we saw in bond markets in 1994 after a rapid increase in interest rates.

A steeper US yield curve is consistent with the signs of economic recovery that we see in the US and other developed markets. We expect benchmark yields to continue

rising and the exit from bond funds in anticipation of higher yields to continue, putting pressure on bond prices. This will occur until institutional investors take the lead in the course of 2014 to re-enter the market to lock-in attractive yields. So it is not yet the time to re-enter government bond markets.

Return to positive real yields (%)



Source: Bloomberg

Asset class: Underweight	Fundamental view	Drivers	Recommendations
<b>Government:</b> Underweight	Real yields and the slope of the yield curves on core government bonds in US and the EU have only started to increase and are far from levels consistent with a progressive recovery.	Core government bonds (US and EU) are vulnerable to positive economic news and policy statements aimed at re-establishing the post-crisis monetary policy.	Consider opportunities in eurozone peripheral sovereigns as a way to enhance yield.
<b>Corporate:</b> Overweight	<p>Corporate balance sheets are currently strong with low debt and good liquidity.</p> <p>The gradual return to economic growth in core markets will support credit fundamentals.</p> <p>Emerging countries have significantly stronger fundamentals than in previous crisis periods.</p>	<p>Corporate default rates remain at a cyclical low historically. The economic upturn will benefit high-yield bonds in developed markets.</p> <p>Emerging countries with weak macro fundamentals will remain volatile until adjustment policies regain traction.</p>	<p>Prefer lower-quality investment-grade over higher-quality investment-grade credits. Buy global high-yield with medium-term maturities.</p> <p>In the turmoil, opportunities rest with short-to medium-term emerging markets debt in hard currencies (USD and EUR).</p>

# Bonds – Portfolio allocation

Installing shock absorbers

## Research & Strategy

Roel Barnhoorn – Head Bond Theme Research  
Carman Wong – Head Emerging Markets Bond Research

The debate on how and when the Federal Reserve will move to a more normal monetary policy should not distract fixed income investors from the goal of generating positive real returns. For investors with cash positions, the higher yield offered by bonds could be an opportunity to invest and to lock-in yields that are higher than cash rates. The focus should be on investing in a sufficient variety of government and corporate bonds.

### Use corporate credits to absorb shocks

Corporate credits continue to be shock absorbers, with the wider credit spreads providing a buffer against rising government bond yields. The improvement in economic conditions should also further strengthen the capacity of credit issuers to pay back debt. Low historic default rates remain a basic feature of non-government bonds, and for that reason we continue to see long-term value in credit spreads. We recommend using any potential weakness as a buying opportunity.

Non-investment-grade (high-yield) corporate credits offer more protection against rising yields than investment-grade credits. This is because the higher-grade corporate credits are more vulnerable to higher government bond rates. We therefore recommend a tactical overweight position, both in lower-quality investment-grade credits (20% allocation focused on BBB rated credits) and in the higher-quality segments of high-yield (15% allocation).

### Emerging markets: closer to developed market dynamics

The turbulence in emerging markets that has led to significant fund outflows over the past few months has only a small chance of turning into a full-fledged crisis. This is because fundamentals are significantly stronger than in the crisis periods of the 1980s and 1990s. Most emerging markets currencies are now floating or under a managed float currency regime, there are ample foreign-exchange reserves and low external debt levels. Finally, most emerging markets countries have solid fiscal positions. It is the countries with the weakest fundamentals that have been hardest hit.

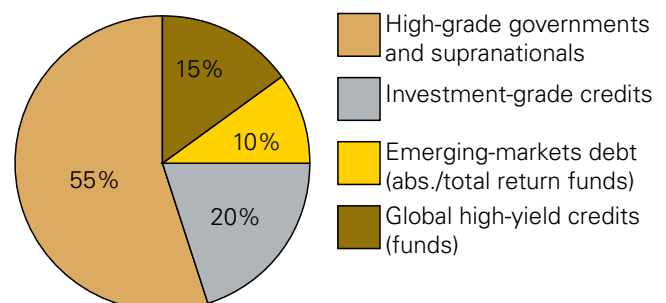
The triggers for stabilisation in emerging markets are, in our opinion, more visibility on the Federal Reserve's future actions, durable signs of a global recovery and the capacity of

markets to find their equilibrium. We believe that emerging markets bonds in hard currencies still offer opportunities.

### Europe: still facing challenges

Establishing a banking union could be the eurozone's major policy initiative over the next few years. We do not expect that a framework deepening the monetary union and reducing the link between sovereigns and their banks will be in place before 2015. Higher German ten-year bond yields could be viewed as a confirmation of the progress made by eurozone banking authorities. In the meantime, the safety net provided by the ECB's outright monetary transactions programme remains key. We expect that the yield spreads currently providing compensation for the risk of very liquid Italian and Spanish bonds versus German government bonds will further narrow, supported by the prospect of economic improvement.

### Recommended bond portfolio allocation



Source: ABN AMRO Private Banking

# Currency outlook

US-dollar appreciation delayed

## Group Economics

Georgette Boele – Coordinator FX and Commodity Strategy

### Differences in yield drive the euro versus the US dollar

One of the subjects in global financial markets that evokes a lot of head scratching is the level of the euro against the dollar. The immediate driver of the currency pair is actually relatively straightforward and directly related to yield differences. Indeed, a chart of short-term interest rate differentials, showing, for instance, the gap between two-year government bond yields on either side of the Atlantic, tracks the exchange rate extremely well (see graphic).

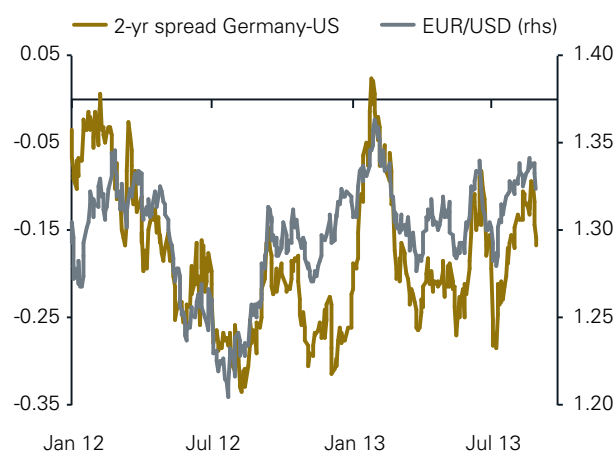
We believe the fundamentals are in place for a stronger dollar against other advanced economy currencies for this year and next. A big factor behind this view is our expectation that the US economy will outperform and that monetary policy differences will also favour the US dollar. In Europe, we expect the central banks to continue to strongly dampen expectations of early hikes in short-term interest rates. Other dollar-positive fundamentals will increasingly be seen, as the country's shrinking budget deficit and shale energy revolution are beginning to reduce external imbalances.

### Emerging markets currencies to recover until Fed hikes come into view

Rising US long-term interest rates and an emerging markets sell-off are an unpleasant reminder of past emerging market crises. There are major differences, however, this time around. In particular, emerging economies' fundamentals are much healthier than in the past; and we expect the global economy to strengthen in the coming quarters. At the same time, we are convinced that the Federal Reserve will withdraw its monetary stimulus very gradually. This combination should revive investor risk appetite. Moreover,

stronger global growth will support emerging markets exports. Against this background, we expect emerging markets currencies to regain some traction over the next few months.

Euro against the US-dollar and interest-rate differentials (%)



Source: Bloomberg, ABN AMRO Group Economics

Asset class	Fundamental view	Recommendations
Currencies	<p>Positive view on the US dollar, based on economic recovery.</p> <p>Peso should benefit from US growth. Polish currency attractive from a growth and yield perspective.</p> <p>Positive on the yuan, although we expect its appreciation to slow.</p>	<p>G4 top pick: US dollar</p> <p>European top pick: Swedish krona</p> <p>Emerging markets top pick: Mexican peso and Polish zloty (versus the euro)</p> <p>Asia: Chinese yuan</p>

# Forecasts

The best way out is  
always through  
Robert Frost

Research & Strategy  
and Group Economics

Our central scenario is based on the assumption that the major developed nations will contribute to a progressive acceleration, leading to 3.8% economic growth for the world economy. Emerging economies will maintain a decent pace and will recover from the deceleration of early 2013, supported by the demand from developed industrialised

nations. The risks to this scenario include a deeper deceleration in developing economies and a false start to growth in Europe. Because of these risks, we expect a prudent exit from central-bank supportive monetary policies.

## Macro indicators (%)

5 September 2013	Real GDP Growth 2014		Inflation 2014	
	ABN AMRO	Market view	ABN AMRO	Market view
US	3.2	2.6	1.9	1.9
Eurozone	1.3	0.9	1.1	1.5
UK	2.8	1.9	2.1	2.5
Japan	1.8	1.5	2.6	2.1
Other countries*	2.6	2.5	1.8	1.7
EM Asia	6.4	6.5	4.8	4.2
Latin America	3.6	3.6	8.3	6.7
EEMEA**	2.9	3.2	4.8	5.5
World	3.8	3.6	3.9	3.4

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 5 Sep 2013	Active strategy	Forward P/E 2014
MSCI ACWI	370.22	O/W	11.7
S&P 500	1655.08	Neutral	12.4
Euro Stoxx 50	2774.20	Neutral	10.2
FTSE-100	6532.44	Neutral	10.8
Nikkei 225	14064.82	Neutral	14.6
DAX	8234.98	Neutral	10.2
CAC 40	4006.80	Neutral	10.6
AEX	369.95	Neutral	10.9
Hang Seng Index	22598.00	Neutral	9.3
Shanghai SE Comp.	2122.43	O/W	7.7
Straits Times Index	3039.45	Neutral	12.0

Overweight - Neutral - Underweight

## Interest rates and bond yields (%)

	30 Aug 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014
<b>United States</b>					
US Fed	0.25	0.25	0.25	0.25	0.25
3-month	0.26	0.30	0.30	0.30	0.30
2-year	0.40	0.60	0.95	1.30	1.75
10-year	2.78	3.00	3.25	3.50	3.75
<b>Germany</b>					
ECB Refi	0.50	0.50	0.50	0.50	0.50
3-month	0.22	0.20	0.20	0.20	0.20
2-year	0.25	0.25	0.30	0.50	0.80
10-year	1.85	2.00	2.10	2.30	2.50

## Currencies

FX pair	30 Aug 2013	Q4 2013	Q1 2014	Q2 2014	Q3 2014
EUR/USD	1.3212	1.20	1.20	1.15	1.10
GBP/USD	1.5479	1.45	1.45	1.40	1.36
EUR/GBP	0.8536	0.83	0.83	0.82	0.81
USD/CHF	0.9315	1.08	1.08	1.13	1.18
EUR/CHF	1.2307	1.30	1.30	1.30	1.30
USD/JPY	98.32	110	112	115	118
EUR/JPY	129.91	132	134	132	130
USD/CAD	1.0533	1.06	1.06	1.06	1.07
AUD/USD	0.8919	0.86	0.86	0.84	0.82
NZD/USD	0.7751	0.76	0.76	0.76	0.75
EUR/NOK	8.0900	7.80	7.80	7.60	7.60
EUR/SEK	8.7599	8.30	8.20	8.20	8.00

# Hedge funds

Focused diversifiers

## Research & Strategy

Olivier Couvreur – CIO Multimanager Hedge Funds

Erik Keller – Senior Hedge Fund Analyst

Gone are the days of multi-purpose hedge funds. Our approach is to use specific hedge-fund strategies to deliver returns and offset certain risks, such as interest-rate sensitivity or equity market exposure. Multi-strategy funds of hedge funds and long/short fixed-income and credit hedge funds, for example, can be effective in diversifying bond portfolios. Other hedge fund strategies, such as long/short equity and event-driven hedge funds, can lessen equity risk.

### Enhancing return and mitigating risk in defensive portfolios

So far this year, multi-strategy funds of hedge funds have outperformed traditional bond portfolios and have done so with lower volatility. This success comes from emphasizing strategies exposed to the economic recovery, such as event-driven and long/short equity hedge funds. Multi-strategy funds have also benefited from reducing exposure to relative strategies and global-macro and commodity trading advisors (CTA) funds. As a result of this approach, multi-strategy funds of hedge funds were able to reduce interest-rate sensitivity, while capturing positive returns as the economy gained momentum. The downside of this approach, however, is an increased sensitivity to equity market corrections, as seen in June.

Absolute return and long/short fixed-income and credit funds can also be used to complement a traditional fixed-income portfolio. These funds have a more flexible mandate than traditional bond funds and are able to invest across various fixed-income segments, while hedging interest-rate risks.

### Adding diversification to equity-dominated portfolios

Long/short equity and event-driven hedge funds, which can lessen equity risk, have produced solid returns this year. They have benefitted from an increasing number of mergers & acquisitions, corporate restructurings and a favourable stock-selection environment.

For portfolios dominated by equity risk, we recommend adding either a fund of hedge funds investing in these strategies or a dedicated basket of long/short equity and event-driven hedge funds. Long/short equity funds that are dynamic in managing their net market exposure and event-driven funds that actively hedge their equity exposure can be particularly effective in diversifying the risk in offensive-oriented equity portfolios.

### Hedge fund strategy recommendations

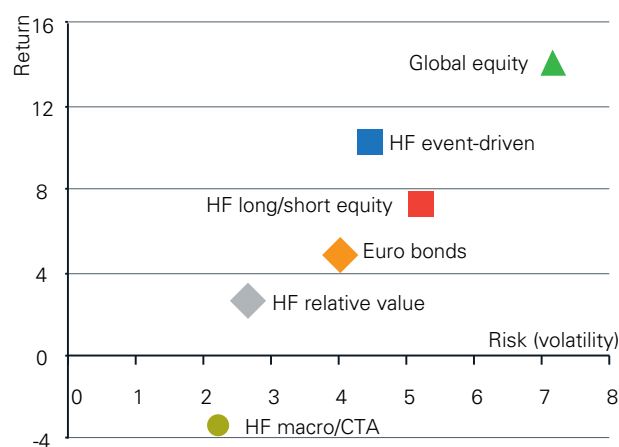
**Long/short equity (positive):** The current environment of growing momentum and significant dispersion in equity valuations (between and within sectors and industries) remains favourable for long/short equity hedge funds.

**Event-driven (positive):** The outlook remains strong for event-driven hedge funds, especially those with a strong focus on special situations or trading in the communications, consumer, financial and energy industries.

**Relative-value (neutral):** The diversification provided by relative-value hedge funds has been beneficial so far this year, as other hedge-fund strategies experienced drawdowns, especially in June and August. We therefore do not advocate an underweight position in relative-value hedge-fund strategies. We believe, however, that other, more growth-oriented strategies, such as long/short equity and event-driven hedge funds, offer more potential.

**Macro/CTA (negative):** Macro/CTA funds have disappointed this year; and we do not expect a major rebound in performance. Although discretionary global-macro funds have performed better in recent months, CTA strategies have been hurt by trend reversals in fixed-income and equity markets.

### One-year risk and return of hedge funds versus bonds and equities (%)



Source: Lipper Hindsight, data period: 30 August 2012 - 30 August 2013

# Commodity outlook

Not that cyclical anymore

## Group Economics

Hans van Cleef - Energy Economist

Georgette Boele – Coordinator FX and Commodity Strategy

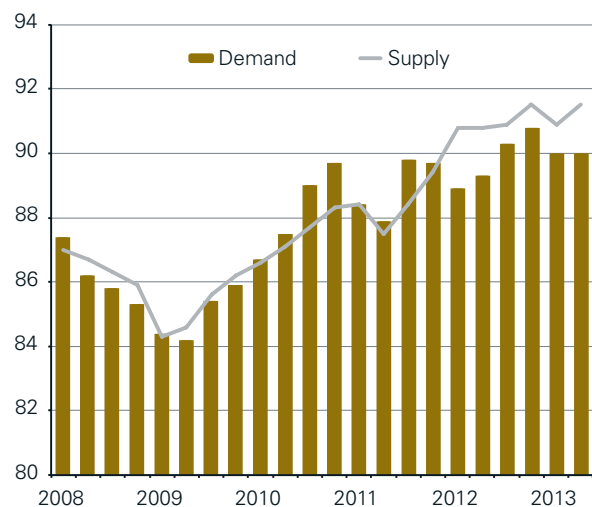
Since the end of June, commodity prices have headed higher. The main reasons for this are: 1) better-than-expected global macroeconomic data, which have supported cyclical commodities, including base metals, some precious metals and energy; 2) oil prices rising, based on an increase in the risk premium resulting from unrest in the Middle East; 3) agents covering their short positions; 4) physical demand for precious metals; and 5) safe-haven demand for gold and silver, driven by the slide in emerging-markets currencies and developments in the Middle East. In general, commodity prices are above our three-month forecasts, and we expect a downward correction. We therefore have a negative short-term view on commodities based on the components of the Commodity Research Bureau (CRB) Index.

The stronger economic activity that we expect later this year and in 2014 will balance out the excess supply of most commodities, which resulted from strong production during the boom years. In China, the shift from investment towards more private consumption does not mean that Chinese demand for commodities will disappear, although it may decline slowly. But, even given a greater emphasis on domestic consumption, construction will remain important. It will, however, proceed at a slower pace. Demand for food will also increase in China, boosting agricultural commodity demand.

The easing of monetary stimulus in the US and the dampening of credit growth in China will end the era of cheap financing. Lower commodity prices and higher credit costs will squeeze producer margins, resulting in a wave of rationalisation and increased efficiency. This, in turn, may lead

to possible lower mine supply in 2015-2016. As a result, we expect that cyclical commodities, such as base metals, will do well on a one-year horizon, depending on the balance between supply and demand. We continue, however, to expect weakness in oil (see graphic) and gold prices. On balance, we have a neutral view on the CRB Index using a one-year horizon.

**The persistent gap between oil demand and supply**  
In millions of barrels/day



Source: Bloomberg

Asset class	Fundamental view	Recommendation
Commodities Neutral	Negative view on the CRB Index in the short term; neutral on a one-year horizon. Bearish on oil and gold for both time horizons; more constructive on metals.	Take broad commodity exposure via indexes.

# Property

After the storm

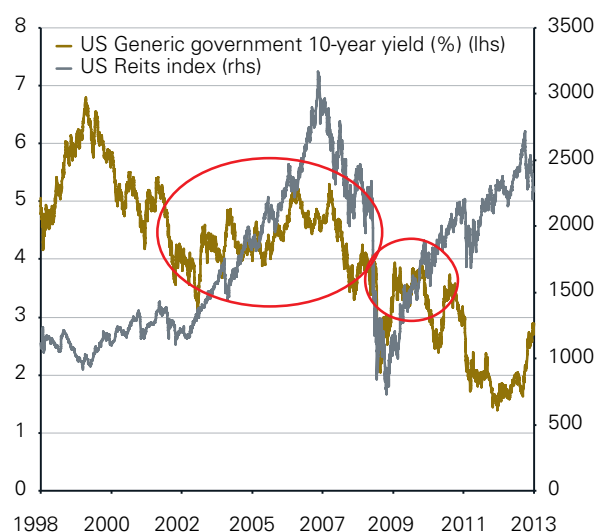
Listed property companies have declined significantly over the past few months, with real estate investment trusts (REITs) underperforming the broader market. The sell-off has been most dramatic in the US, driven by rising rates and potential shifts in monetary policy. But this is not entirely unexpected. REITs characteristically do poorly during periods of interest rate spikes and outperform when rates stabilise. (See graphic.) This time is no different. Since May, when the US Federal Reserve first signaled a potential tapering of its asset purchases, ten-year Treasuries have risen by 67 bp. REITs, in turn, declined by 13%.

When the shock of the sell-off recedes, investment flows should progressively return to the US (overweight) property sector, based on sound company fundamentals and above-average dividend growth. With the US economic recovery maturing, growth will be supported in cyclical sectors, such as hotels, offices and industrial sites. Our concerns regarding Europe (neutral) are lessening. We recommend quality companies, which should benefit from attractive valuations, interest from investment funds and growing demand. Asia, however, has become less attractive, with some exceptions, such as Australia.

## Research & Strategy

Manuel Hernandez Fernandez – Property Specialist

### Performance of US REITs versus ten-year Treasury yields



Source: Bloomberg

# Sustainability

Powering on with a new energy mix

The demand for cheaper energy and the need for cleaner energy has led to a dramatic change in the US energy mix, where shale gas has changed the energy equation. From a sustainability perspective and beyond the well-publicized economic benefits, shale gas can be considered a better alternative to oil, coal and, to a certain extent, biofuels — as it offers less competition to food production. The challenge is to make the technology less harmful to the environment and to develop a distribution infrastructure.

In Europe, shale gas is approached with more scepticism. The focus here is more on energy savings and renewable energy to meet carbon-reduction targets. Technological improvements, efficient processes and economies of scale have made solar and wind energy more efficient and almost fully competitive with traditional energy sources. Studies have also highlighted

the potential risks for investors in the fossil fuel sector, if politicians stick to their global carbon-reduction targets planned to be in effect by 2050.

The energy revolution illustrates that more sustainable solutions are possible through innovation; and they are already present in our daily life. For investors, a wider energy supply mix expands the scope of investment opportunity.

## Sustainable Development

Vincent van Assem – Senior Advisor

# Private equity

The art of selection

## Research & Strategy

Olivier Palasi – Head Private Equity

We expect private equity to continue attracting new capital. Last year was a very good year for private-equity-backed exits, with an estimated USD 373 billion being returned to investors, compared with USD 392 billion in 2011. Fund raising activity should remain robust until year-end, as distributions allow investors to reinvest their proceeds into new partnerships.

A total of 662 private-equity funds closed or held an interim close in the first half of 2013, securing an aggregate USD 270 billion. North America was responsible for 61%, an increase of 40% versus the previous six months, led by US endowments and pension funds.

Fund managers are satisfied with portfolio company development. Buyout managers have now succeeded in either refinancing their investments or resetting covenants. Growth technology equity, which is a combination of late-stage venture capital and buyouts, has evolved into a distinct asset class, generating strong returns and outperforming venture capital.

### Manager selection is the main challenge

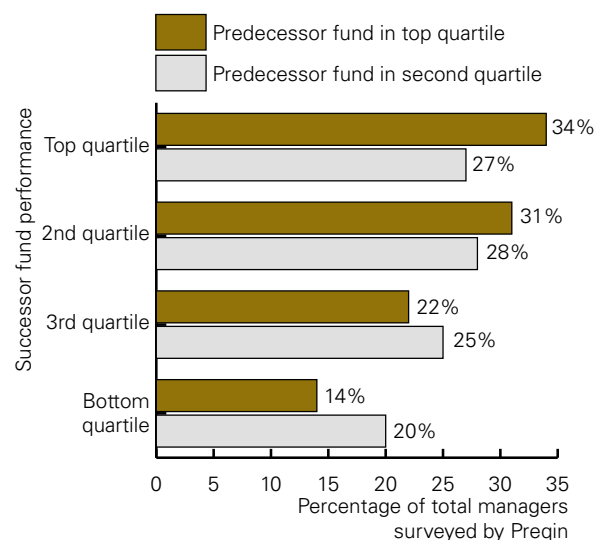
During fund selection, assessing a fund boils down to anticipating who the best fund managers will be in the future. A review of managers' histories illustrates the difficulty of identifying managers with consistent performance. The graphic below is based on research that compared the performance of a manager's previous (predecessor) funds with the same manager's subsequent (successor) funds. It provides insight into the performance sustainability of private-equity managers.

Based on the data analysed, the sad news is that past performance is not a solid indicator of future performance. Only 34% of fund managers with a top-quartile fund will manage thereafter a top-quartile fund. Conversely, there is a 66% chance of a top-quartile manager not having similar top performance with later funds. The research also found that 27% of fund managers with a second-quartile fund go on to manage a fund in the top quartile. As such, the level of expertise and the capacity to establish a proper deal flow can improve. In short, manager performance is not always consistent. This means that manager selection and due diligence must be dynamic to keep up with an industry that is always in flux.

### Regional opportunities

In Europe, Germany is perceived as the powerhouse in private equity. It offers an attractive location for unlisted investment, thanks to its rich industrial base and tradition of small and medium-size enterprises. In Asia, Chinese private-equity funds have had lacklustre performance, which has led to a drop in fundraising. The number of Chinese initial public offerings has declined dramatically, leading to a depletion of proceeds for investors. The Chinese private equity market is maturing and progressively adopting industry standards.

### Successor fund performance of top- and second-quartile fund managers



Source: Preqin and ABN AMRO Private Banking

# Performance and risk

The risk premium behind the tactical exposure

## Research & Strategy

Hans Peters – Head Investment Risk  
Emilia Bruera – Investment Risk Specialist

The current asset allocation features a strong overweight in equities (profiles 2 to 6) and an underweight in bonds (profiles 1 to 5). Hedge funds are positioned to provide diversification, with an overweight in profiles 1 and 2, a neutral position in profiles 3 and 4 and an underweight position in profiles 5 and 6. Property and commodities, on the other hand, are neutral. The allocation is designed to mitigate interest-rate risk exposure, while retaining the ability to capture the anticipated global growth recovery. Although interest rates have already increased to some extent, the equity risk premium still offers enough margin to accommodate further increases, which preserves the relative attractiveness of equities versus bonds.

### The equity risk premium behind the tactical exposure

In the current tactical asset allocation, the main driver of risk is essentially the polarity between the equity overweight and the bond underweight. It is therefore relevant to assess whether the risk premium offered by equities, estimated by the earnings yield of the S&P 500 Index, offers a substantial enough margin over the yield of US Treasuries. Despite the recent run-up in yields caused by the early expectation of a reversal of the extraordinary accommodative monetary policy of the Federal Reserve, the gap in favour of equities remains elevated (see graph). This is a comforting factor, as the equity markets that have rallied the most, the US markets, still benefit from a sufficient reward. Two conditions to watch for that will set the stage for a convergence to pre-crisis levels are a further improvement in overall confidence and the resulting higher yields.

### Performance: the rally of equities

On an absolute level, year-to-date performance is positive for all profiles (with the exception of profile 1 in US dollars). This

is mainly due to the good year-to-date results in equities (except in emerging markets). On a relative performance level, the year-to-date results are negative for all profiles in euros, due to the impact of emerging-markets bonds and emerging-markets equities. In US-dollar profiles, the results are positive in profiles 1 to 4, mainly due to the underweight in government bonds and the positive results in US equities. Results are negative for profiles 5 and 6, due to the impact of emerging-markets equities.

### Earnings yield of the S&P 500 Index versus ten-year US Treasuries



Source: Bloomberg

### Performance of the tactical asset allocation vs. the strategic asset allocation

	EUR						USD					
	22 May 2003 to 30 August 2013*			2013 YTD (30 August 2013)			22 May 2003 to 30 August 2013*			2013 YTD (30 August 2013)		
	Strategic	Tactical	Excess Return	Strategic	Tactical	Excess Return	Strategic	Tactical	Excess Return	Strategic	Tactical	Excess Return
Profile 1	54.9	64.4	6.1	0.9	0.2	-0.7	51.5	66.3	9.7	-1.6	-1.3	0.2
Profile 2	58.2	68.5	6.5	1.9	1.5	-0.4	58.6	72.8	8.9	0.2	0.6	0.4
Profile 3	73.6	94.4	11.9	3.0	2.8	-0.2	80.5	101.0	11.3	1.9	2.4	0.5
Profile 4	78.1	99.0	11.7	4.5	4.3	-0.2	89.5	108.1	9.8	4.2	4.5	0.3
Profile 5	88.1	112.9	13.2	6.0	5.4	-0.5	103.4	124.3	10.3	6.5	6.1	-0.4
Profile 6	91.7	115.8	12.6	7.1	6.2	-0.8	110.5	129.0	8.8	8.3	7.3	-0.9

\* 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.

# Asset allocation

In the long run, men hit only  
what they aim at.

Henry David Thoreau

## Global Investment Committee Private Banking

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	31	+26	5	0	70	14	+9
Bonds*	90	40	100	61	-29	70	30	85	49	-21
Equities	0	0	10	0		15	0	30	24	+9
Alternative investments	5	0	10	8	+3	10	0	20	13	+3
Funds of hedge funds	5			8	+3	5			8	+3
Real estate	0			0		3			3	0
Commodities	0			0		2			2	0
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	9	+4	5	0	70	7	+2
Bonds*	55	20	70	37	-18	35	10	55	19	-16
Equities	30	10	50	44	+14	50	20	70	64	+14
Alternative investments	10	0	20	10	0	10	0	30	10	0
Funds of hedge funds	5			5	0	5			5	0
Real estate	3			3	0	3			3	0
Commodities	2			2	0	2			2	0
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	1	-4	5	0	60	0	-5
Bonds*	15	0	40	9	-6	0	0	25	0	
Equities	70	30	90	85	+15	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	0	3			3	0
Commodities	2			2	0	2			2	0
Total Exposure	100			100		100			100	

\*Recommended duration: **Neutral**. Benchmark: Bank of America, Merrill Lynch Government Bonds 1-10 years.

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