ZURICH

30th June 2014

The week gone by

Global **equities** finally had a negative week following eight straight weeks of rises for the world index (in euro terms). Stocks reacted adversely to the sharply downward revision to US Q1 GDP data on Wednesday. Equities continue to be supported by the expectation of reasonably strong corporate earnings' growth and low interest rates. Valuations, however, have crept up somewhat with the 2014 price earnings (P/E) multiple now trading at 15.3X; albeit equities remain better value relative to other asset classes.

The global index (in euro terms) fell by 0.7% last week giving a total return year-to-date of a strong 7.5%. A number of the major **markets** were in negative territory in local currency terms last week led by Europe (-2.2%), Japan (-1.2%) and the UK (-1.0%). The bellwether US market was virtually flat on the week.

Eurozone **bond** markets overall were up again (+1.0%) last week, supported by weaker US GDP data, and are up an impressive 10.5% year-to-date led by Spain (+14.7%) and Italy (+12.7%). The German 10-year bond yield fell again from 1.34% to 1.26% last week; its 2013 low was 1.17%. Equivalent US yields fell from at 2.60% to 2.53%. Commodity prices in general fell back by 0.7% last week (in dollar terms); commodities, however, remain one of the best performing asset classes so far this year (+10.9%) led by livestock, soft commodities and grains.

	Index	1 Week Return 20.06.14 to 27.06.14		Year to Date Return 31.12.13 to 27.06.14	
		Local Currency %	Euro %	Local Currency %	Euro %
Global (euro)	FTSE World	-0.7	-0.7	7.5	7.5
US	S&P 500	-0.1	-0.2	6.1	7.2
Europe	FT/S&P Europe Ex. U.K.	-2.2	-2.2	3.8	3.8
Ireland	ISEQ	-1.9	-1.9	4.1	4.1
UK	FTSE 100	-1.0	-1.2	0.1	4.0
Japan	Topix	-1.2	-1.0	-3.8	-3.8
Hong Kong	Hang Seng	0.1	-0.2	-0.4	0.7
Australia	S&P/ASX 200	0.5	0.5	1.7	8.5
Bonds	Merrill Lynch Euro over 5 year	1.0	1.0	10.5	10.5

The week ahead

- Virtually no corporate news or events are expected in the US given the shortened schedule heading into the Independence Day holiday on Friday. In the June employment report (Thursday) it is forecast that non-farm payrolls will rise by 210k (last: 217k) and the unemployment rate to remain at 6.3%.
- In Europe, it is expected that the ECB (Thursday) will keep rates on hold at 0.15%.
- It is expected that UK May mortgage lending (Monday) increased by £1.7bn and consumer credit by £0.7bn.
- In Japan's Q2 BoJ Tankan (Monday), it is forecast that the Diffusion Index dropped to 15 for large manufacturers (last: 17).
- China's June NBS manufacturing PMI (Tuesday) is expected to edge up from 50.8 to 51.0.

Global Outlook

Observations at the 2014 Calendar Mid Point:

- Whilst the general economic backdrop for 2014 still continues to necessitate a reasonably loose monetary policy in several of the major regions, the Fed and BoE are withdrawing some of their policy accommodation whilst the ECB and BoJ continue with their aggressively easy policies.
- Capital return to shareholders remained a focus, continuing the theme that persisted throughout 2013. Many sectors suffered from the absence of an acceleration in fundamental growth and capital return was a key source of shareholder value creation. Expectations for 2H 2014 are for some capital re-allocation towards capex spending and a cooling off in the rate of return of capital to shareholders. There is risk to this thesis if the overall growth environment remains subdued.
- M&A activity and IPO activity has been buoyant year to date. M&A deal levels (in $) are expected to continue to trend well above average for the remainder of the year. Tax inversion buyouts from the US into Europe are ongoing.
- Equity markets look reasonably valued, although not cheap, but alternatives such as cash or bonds are still not compelling on a relative basis. The S&P is making new highs, but unusually this is against a backdrop of very low volumes. Volatility across markets remains low.
- In the US, despite a weak GDP reading, most other economic data points looked healthier (housing data, consumer confidence), the labour market is slowing improving, wage pressure remains modest and after a weak Q1 report from most sectors, expectations for Q2 are high as earnings season approaches in the US.

General Commentary

- Strategists continue to favour equities over bonds, based on relative valuation. Equity markets are expected to continue to perform strongly into 2014, as long as growth expectations continue to be met. The broadly positive equity market outlook for 2014 is driven largely by expectations for earnings growth, as valuation multiples in many sectors and many markets are relatively high. We view market weakness as an opportunity to add to positions.
- The broadly positive outlook for equity markets in the US has been somewhat in conflict with the behaviour of the US 10 year treasury yield over recent weeks. US bond yields (10 yr) have dropped from 3% at the beginning of this year to 2.5%, despite continued tapering in asset purchases by the Fed, an improving economic outlook and the consensus expectation for rate rises in 2015. Although inflation has outpaced growth levels YTD, inflation expectations are low. If yields remain low, there is a risk of more volatility across styles and sectors, given the low level of yields could imply low future growth prospects.
- A slow climb in the 10 year UST yield and a re-bound in inflation towards its 2% level is needed to help support equity markets over the coming months. Wage pressure could help lift inflation. However, there are varying views on the level of slack that remains in the labour force and the change in labour force participation (labour supply) is being watched closely,
- In the US, consensus expectations continue to be for the Fed to end over half a decade of QE by Sep 2014. Yellen is perceived to weigh unemployment more heavily than inflation in the Fed goals. Therefore expectations are for rates to remain low for an extended period beyond the end of QE which the market is pricing in. The Fed is still expected to remain heavily data dependant ahead of raising interest rates. US growth is still sub-par by historic standards but confidence appears to remain in the US growth story.
- Export led Emerging markets may see some benefit from an accelerating US economy and easy monetary policy in Europe; however, this will be overshadowed by the headwinds facing Emerging markets, including rising US interest rates, a stronger US$ and negative sentiment and uncertainty around China. This may keep investors sceptical on emerging market in the near term. Uncertainty around China will persist near term; however, there are signs of more positive policy co-ordination which will impact financial markets favourably in the region. We don't expect major easing in the region.
- Peripheral bond yields have resumed their downward trend, post the recent policy actions by the ECB. The ECB has reduced interest rates. The second initiative has been the introduction of a targeted LTRO which is aimed at reducing the cost of funding for Eurozone banks provided they lend to the corporate sector. The ECB's aim is to reduce corporate funding costs especially those in the peripheral economies. In addition, the ECB indicated that they are looking at further monetary easing to combat weak lending in the Eurozone and very low inflation.
- The governor of the Bank of England, Mark Carney has signalled that interest rates in the UK will rise sooner then market expected. The strength of UK economy has exceeded market expectations and unemployment has fallen faster then expected. Official interest rates may arise in the UK before year end.
- The Nikkei has outperformed in the last few weeks in parallel with a small weakening of the Japanese's currency. Monetary policy is expected to remain loose for some time to come. There are continued expectations that the Bank of Japan may announce further stimulus in 2014, however, economic data points are coming in favourably and the BoJ may potentially push QE out further as long as the data remains strong. The latest consumer tax hike doesn't appear to have had a significant impact on inflation in the region to date
- Zurich Life funds are slightly overweight in equities and neutral to slightly underweight in bonds versus the manager average. The funds are underweight energy and financials and overweight consumer goods and industrials. Geographically, the funds are underweight the UK and Asia Pacific region, neutral Europe, overweight North America and overweight Ireland.