BANQUE INTERNATIONALE À LUXEMBOURG

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EUROMONEY AWARDS FOR EXCELLENCE 2015

BEST BANK IN LUXEMBOURG

BIL BOARD

Financial market news

Autumn 2015

Dear Madam, Dear Sir,
Dear Investor,

This was one of the hottest summers in recent history. Our May predictions for China and volatility proved correct. The major indices of risk asset classes lost between 5% and 25% in the third quarter of this year. The good news is that the euro zone has closed the Greek chapter for now, but investors are nervous about global growth as recession fears have escalated and shaken the markets.

We believe that there are plenty of opportunities in these markets despite (or as a result of) the environment being extremely challenging. We strongly believe that failing any monetary mistakes, risk assets in the US and the euro zone still have plenty to offer. Even Asia will jumpstart its engine. We are here to assist you with your investments. We draw on our impartial expertise to offer you transparent advice and investment services. Please do not hesitate to contact your BIL adviser or any of our investment management experts for assistance.

Yves Kuhn
Chief Investment Officer

Investors are confused

after the IMF warning of the worst global growth since the financial crisis for 2015.

Emerging markets such as China, Brazil and Russia will experience significant slowdowns. The fund has cut its 2015 global growth forecast from 3.5% to 3.1%. However, the outlook for 2016 remains solid.

Without China as the main engine driving global growth, investors have been banking on the US to repeat last year's stellar performance and provide support for the global economy. However, recent data suggests the US recovery could be stalling. Investors fret that this may trigger a broader economic slowdown. Over the coming months, the main question on investors' minds will be whether the recent weakness in the US is a temporary blip or the beginning of a prolonged downward trend.

Forward-looking estimates for US GDP, based on "nowcasts" from the Atlanta Federal Reserve, point to growth of just 0.9% during the third quarter, significantly slower than the final estimate for GDP growth in the second quarter, which came in at 3.9%.

So what is going on in the US? Recent US economic data has been unexpectedly poor. Manufacturing activity has been on a downward trajectory and the latest survey data is suggesting that the sector could be substantially slowing down. Data from ISM Manufacturing, the main index for forward-looking business activity, fell to 50.2 in September, its lowest level since May 2013. In particular, inventory levels appear to have reached capacity, paving the way for a production slowdown. A stronger US dollar has also eaten into US exports, which fell by 2% month-on-month in August. Meanwhile, imports increased by 1.2% over the same period. But the focus on manufacturing and trade in the US draws attention away from the US consumer, very much alive and kicking. Car sales are at their highest for 10 years, while housing starts are at a post-crisis high, as a result of improved mortgage lending. More importantly, there are signs that wages in the US are also recovering, which will in turn boost consumer spending.

Meanwhile, the euro zone is slowly trudging along. The German economy has cooled over the past two quarters as a result of the decline in emerging markets, which has severely hit its export markets. However, the slowdown in Germany has been offset by growth in the European periphery, with countries like Italy, France and Spain exceeding expectations. The ECB's commitment to pursuing accommodative policies will be the main growth driver in the euro zone during the coming period. While the ECB may announce additional stimulus measures over the next three months, Mario Draghi will continue to pay lip service to markets, which alone will provide some support to the broader economy in the near term.

Yves Kuhn
Chief Investment Officer

Olivier Goemans
Head of Portfolio Management

BIL's macro outlook for the next 6 months

Global growth in 2015 has continuously been marked down by the OECD and the IMF (from an initial 3.6% to 3.1%). The outlook remains solid for 2016 (3.6%). The spillover from China is due to direct linkages, financial conditions and volatility. As we mentioned in the last BILBoard, the Chinese economy slowed substantially over the summer.

A closer look at China shows that much of the shortfall in growth is a result of China's declining manufacturing sector, which, according to China's Caixin Manufacturing PMI, has been contracting for seven straight months. We see the slowdown in China as part of a managed transition from an industrial export-led economy to a more sustainable domestically-driven, consumer-led country. For that reason, we expect the Chinese economy to slow down gradually over the next few quarters, rather than to experience a hard landing. In the event that there is another severe economic shock in China, we are confident that the authorities will be able to cushion the blow, as they possess a vast amount of FX reserves. A more pressing issue is the potential spill-over effects of a slowdown in China on the rest of the world.

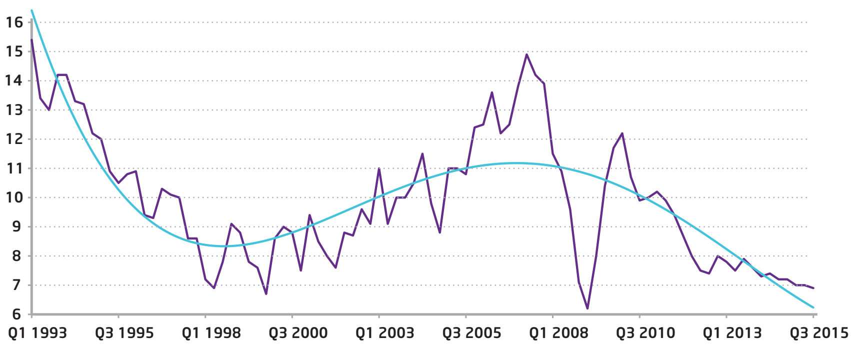
Global growth is driven by solid growth in US employment and high US consumer confidence (housing, car sales), plus the cyclical revival of the consumer in Europe (slow growth). The moribund US energy sector, with crude prices hovering around USD 50, has initially had a limited impact on consumers. However, the US economy has had to digest the cut in capital expenditure and layoffs by the energy sector. We believe it is a question of time before consumers take advantage of the low crude prices. It is interesting to note that, according to Bloomberg, real US GDP growth forecasts are somewhere between 1.5% and 2.5% for the third quarter and 1.2% and 3% for the fourth quarter. The ranges are enormous and this adds to the confusing picture the Fed gave the world when it did not raise rates in September.

In Europe, the Bloomberg GDP forecast predictions for the third quarter are for between 0.8% and 1.8% and between 0.9% and 2% for the fourth quarter. The range for both quarters is not comparable to the US situation. The European economy is driven by consumers and less by capex spending. Finally, consumer spending is supported by the European Central Bank's (ECB) quantitative easing programme. The ECB continues to pursue very accommodative monetary policies and there are rumours that it might extend its quantitative easing programme by six months. Exports to emerging markets are weak. Germany, being the most cyclical market, has exposure to key emerging markets such as Brazil and China. Consequently, the European periphery is replacing Germany in the role of pulling Europe forward, with Spain, Italy and France having surpassed expectations in particular.

Inflation is low, globally, and low commodities present a downside risk to global inflation. On the other hand, the tightening housing market in the US will translate into steady inflation expectations; in the short term, yearly headline inflation is likely to bottom out in the coming months (below zero). Commodity weakness, dollar strength and concerns over Chinese growth are the main drivers. Inflation dropped in the US from 0.8% YoY in December 2014 to 0% YoY in September 2015. In the euro zone, the harmonised CPI is -0.2% after reaching -0.6% in January this year. Clearly, monetary policy will drive Europe's inflation expectations over the next 12 months. The market is expecting the ECB to extend its quantitative easing programme.

In Europe, a steepening of the curve is possible since short-term rates will remain low, whereas any quantitative easing might continue to push up long-term rates.
A hike in US rates is expected in December/March (market expectations for March 2016 stand at over 50%). Long-term rates will move once we see the first signs of inflationary pressures. Market pricing of rate hikes seems to be complacent and will become a topic during 2016.

Real Chinese GDP Growth



Source: BIL, Thomson Reuters Datastream

“Emerging markets are still a concern in the shorter term”

Key risks to our assumptions

Markets reacted strongly to the fact that China's growth was slowing. This time it was not the usual rumours of ghost cities that unnerved investors, but the combination of Chinese trade balance figures with a weakish quarterly GDP figure. As a consequence, crude dropped as well, since China and Japan (whose exports are strongly dependent on China) are major crude importers. As a result, the move towards emerging markets and the countries they export to was made. German exports were not helped by having a large market share of emerging markets such as China and Brazil.

The market is spooked by fears that global growth will disappoint and more importantly that US growth might derail. What are the reasons behind these fears?

- US growth lead indicators have slowed remarkably (ISM, OECD); recent US economic data was not encouraging. Third quarter US Atlanta growth (often used as an unofficial proxy) is close to 0.9%.
- The Fed seems to be hesitant about increasing rates and confirming the strength of the US economy.
- Japanese growth is slowing.
- Emerging markets have to overcome a stronger dollar (see Brazil), rising rates, low commodity prices and a slowdown in China.

Any subsequent drop in earnings per share (20% drop for any mild recession) and rise in fixed income would lead to a major sell-off in global stock markets, as the US is seen as being the pull factor for global growth. European economic growth and Japanese growth are seen as too fragile. In this context of mounting fears, it does not help that during the US reporting season many companies failed to show revenue growth (with, so far, less than 50% of US companies reporting).

Although fears in Europe have eased after the Greek elections, there has clearly been a right-wing push through recent elections in Europe. The message is clear: less Europe rather than more Europe. It does not help that Europe's periphery seems to have profited from the ECB's quantitative easing. The reality is that unemployment is still high, and fragile growth of 1.5% will not make any substantial change to many people's lives.

Commercial banks are faster at providing consumer loans, and the recovery is mainly driven by the consumer segment in Europe. However, in order to ensure a continuous recovery in Europe, companies need to be seen to be investing and, especially, capital expenditure needs to increase (it's currently at a 20-year low). However, it is hard to convince European companies to do so with operating margins close to 8.5% – some 30% below US operating margins.

Looking at emerging markets, many cracks are clear. The largest comes from low commodity prices and a strengthening USD. Although we believe that crude's lows have passed, some metals and food commodities might stay low for longer. The revenues of selected emerging markets are questioned and a key market besides China is Brazil. As Moore Capital Management puts it, “Brazil, the pre-eminent beneficiary of China's rise, has suffered most from its subsequent weakening. With a political stalemate forestalling any significant deficit reduction, Brazil suddenly finds its debt dynamics on an explosive trajectory”. Stresses in Brazil can morph into systemic risk through losses borne by common lenders. Economists predict a 3% contraction of the economy this year. The rating agency, Fitch, has subsequently downgraded Brazilian debt to a notch above junk with a negative outlook.

There are other political sources of risk; Russia's hands-on approach in Syria might lead to further confrontation with the West. The Ukrainian war is not yet resolved and a significant amount of petrodollars are being invested in a war in Yemen.

European equities

During the sell-off, Germany was one of the worst markets, as it has a strong cyclical component. Nevertheless we remain constructive on European equities. A combination of a weaker euro, lower input costs from falling oil and metal prices and persistently low financing costs will boost most of Europe's corporate earnings over the next quarter. Interestingly, forecasts for 2015 earnings-per-share growth in the euro zone went down from 14% to 12% over the summer. Denmark and Italy were among the most resilient markets last quarter.

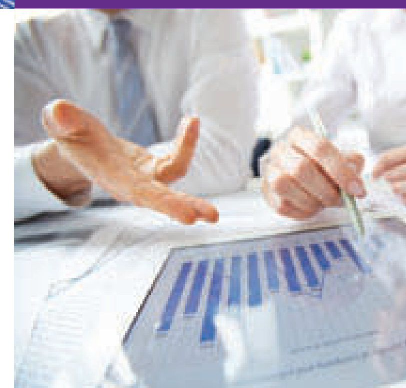
Emerging markets are still a concern in the shorter term, as some selected European companies are highly dependent on their exports to these regions. We may see continued periods of volatility and consensus downgrades. On the back of this, valuations, as measured by the 12-month forward price-to-earnings ratio, came down to 14.7x – a 10% discount on the US, despite showing superior growth. The valuation gap even widened during the summer, and while US earnings are not far from their peak, European earnings are still 20 to 25% lower than their 2007 highs, leaving a strong upside potential.

We should note that in Europe, it took analysts some nine months to fully downgrade the energy sector's earnings. Energy and materials were the biggest detractors to performance last quarter, declining 16% and 20% respectively. In the mining sector, the response

has been to sell some assets and to downsize operations. Multinationals such as Rio Tinto, BHP Billiton, Glencore and Alcoa made changes to their corporate structures by selling some of their commodity assets or splitting operations.

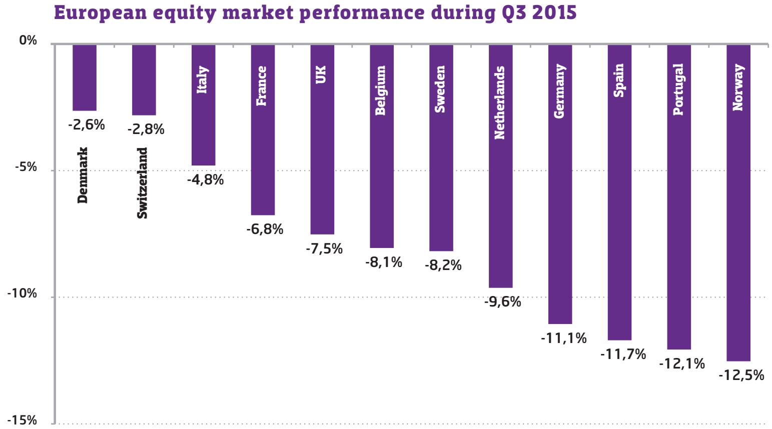
Our preference is for domestically-exposed sectors as a way of benefitting from the European recovery, while being relatively insulated from the emerging market turmoil. We are positive on selected peripheral retail-oriented banks (excluding the main Spanish banks, BBVA and Santander, which have substantial exposure to Latin America) and believe the sector is set to benefit from a rising return on equity through a reduction of non-performing loan provisions and trades on a price/book ratio of 0.86x. While these valuations are in line with those seen at the end of 2013, their return on equity has increased by some 10%.

We also like the more defensive telecommunication services sector. Strong balance sheets and superior cash generation should support M&A activity, buybacks and increasing dividends (the sector's dividend yield is 4.7%). We remain very selective, however, as the strong sector re-rating offers fewer investment opportunities.



> "The decision by the Federal Reserve to delay its rate increase was not taken positively"

European equity market performance during Q3 2015



Source: BIL, Bloomberg

US equities

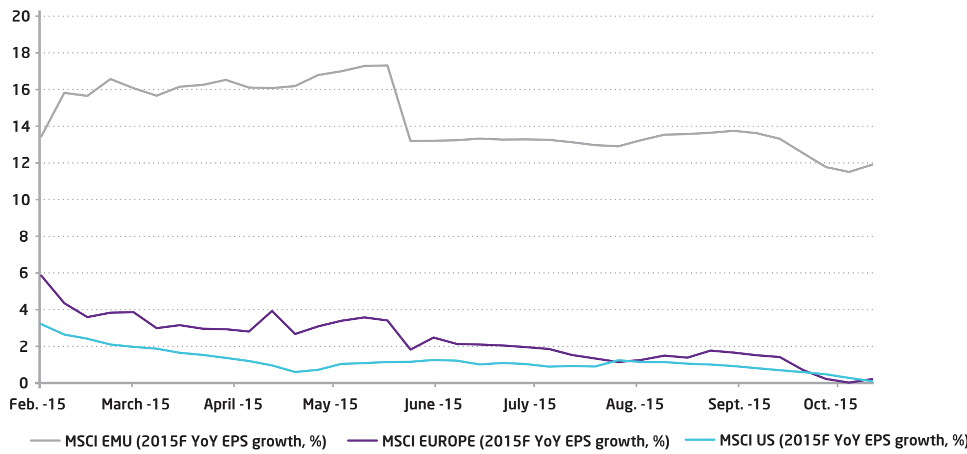
US equities performed poorly over the last quarter and fell 7%, in line with global equities, as investors were worried about the extent of the slowdown in China and other emerging markets. The decision by the Federal Reserve to delay its rate increase was not taken positively either, since Fed chair Janet Yellen pointed to the uncertainty surrounding global economic growth as the main factor behind the decision. As a result, market participants focused on revenue per share, which has been coming down in recent quarters.

So far, we've had a rather uninspiring earnings season during the third quarter, with earnings expected to contract by 4% and driven mostly by commodity-related sectors. Earnings in the energy sector should contract by 65%, while materials are expected to fall by 17%. Other sectors are also seeing a slowdown in growth. This can be explained by the strength of the USD, which is taking its toll on exporters. There is also a sense that US corporate margins have peaked and are under increasing pressure from increasing operating costs. Buybacks and M&A continue apace and should provide structural support for US equities, but the prospect of a rate hike might put a halt to that. With the MSCI US trading at 16.6x 12m forward price/earnings ratio – just 6% below its highest level in more than 10 years – we are seeing better opportunities elsewhere.

“The effectiveness and credibility of central bank policy is increasingly coming under scrutiny”

Our preferred sectors in the US continue to be IT and healthcare. IT offers strong growth (13% EPS growth expected for 2015); its balance sheets are healthy and valuations not stretched. Healthcare is also relatively attractive in terms of earnings growth potential (12% for 2015), despite periods of volatility surrounding drug prices. Meanwhile, balance sheets are robust with a net debt/Ebitda ratio of only 1.1x, placing the sector in a strong position to grow dividends and to feature some corporate activity.

EPS Growth



Source: BIL, Thomson Reuters Datastream

Japan

The Bank of Japan (BoJ) is miles away from its inflation target of 2%.

This is entirely due to low energy prices. The economy may be in a technical recession. The BoJ will have advance notice and could act based on that. The external environment remains weak for exporters and the central bank could use this argument to further ease monetary policy. In Japan, the public pension fund (GPIF) now has 25% of its assets in equities, which was its goal. While it has room to go up to 34%, this is far from certain. On the other hand, other pension funds have yet to make the shift into equities.

From an investor point of view, further quantitative easing (QQE) would be bullish as the BoJ would have to buy ETFs. There is, however, a chance of a supplementary budget of JPY 3-5 trillion, instead of more QQE. This would be highly beneficial for construction companies. EPS growth remains strong in the non-manufacturing sector.

The BoJ is holding one third of all outstanding Japanese government bonds and there is a limit to further purchases. They could buy other assets, such as ETFs; this would be bullish for equities.

Note that the BoJ balance sheet is now 74% of GDP, compared with 25% for both the Fed and the ECB. Since we are in uncharted territory, we don’t know how much further this can go.

Fixed income

The enthusiastic view on US real bond yields is that they are absurdly low and liable to shoot up several hundred basis points as soon as the Fed starts tightening.

The more sober view is that real yields are historically very low, but more likely to “normalise” gradually and remain low relative to nominal GDP growth. There seems to be a growing realisation that our financial systems are facing too much debt for the gradient of economic growth and a lack of inflation. The effectiveness and credibility of central bank policy is increasingly coming under scrutiny. A further extension of unorthodox monetary policy is probably on the agenda for some central banks (e.g. ECB and BOJ), while the US Federal Reserve’s internal debate on the timing of the first rate hike remains at the forefront of investors’ minds.

For the Fed, past experience suggests that there is a greater opportunity cost attached to raising rates too early than there is to raising rates too late. Furthermore, the current fallout from emerging markets will take some time to assess, and the excess supply of commodities that is helping to depress developed world inflation will not dissipate anytime soon.

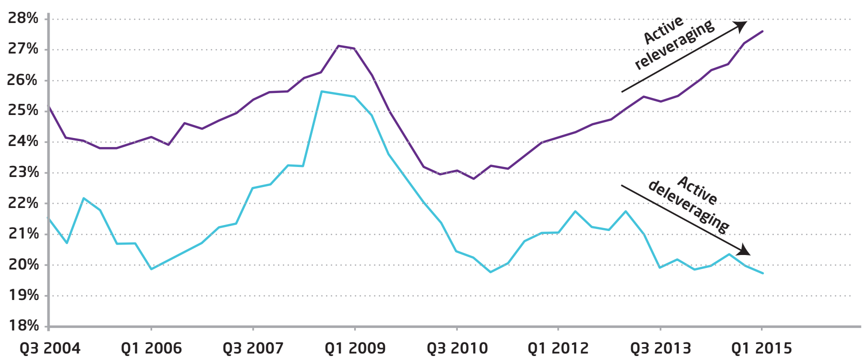
Nevertheless, from a tactical view, developed government bond yields may trend lower for longer. When considering observed inflation, for most developed markets, real yields are now attractive in light of current macroeconomic uncertainties.

Reflecting the downward pressures and the stronger euro, we expect that the ECB will announce an expansion of its QE programme in the coming months. In addition, the market is pricing a 40% probability of a 10 basis point deposit rate cut.

US spreads widened most acutely around quarter-end, as liquidity, EM selling pressure and elevated funding costs for collateral drove the move. EUR spreads, conversely, have narrowed, reflective of expectations for additional easing from the ECB, suggesting that the ECB has served to buffer EM selling.

Investment grade and high-yield bonds still offer relative value versus government bonds and versus historical default cycles, but quality needs to come under scrutiny. When looking at credit markets, our preference is still for European credit vs. US credit, based on a clear divergence in fundamentals and prospective defaults (see graph).

Seasonally-adjusted median ratios of net debt to total assets for US and core European bond issuers



Source: BIL, Goldman Sachs Global Investment Research

The crisis has forced improvements to European periphery labour market regulation, leading to better-functioning labour markets. Reforms are boosting potential growth from the labour force participation side. Lending rates are converging; ECB measures are supporting improvement in funding rates for peripheral small and medium sized enterprises (SMEs):

- Spanish and Italian SME lending rates are falling rapidly.
- ECB quantitative easing is reducing peripheral sovereign financing costs.
- Italian debt servicing costs are expected to fall by 1% of GDP.
- Savings could be used to accelerate debt reduction.
- Fiscal capacity of support growth measures is being used.

We are cautious on the outlook for duration: we're now looking for confirmation as to whether the recent slowdown in data is just a blip, or the start of a more prolonged slowdown in growth. In our base case, we think the softening will prove temporary, but given how sensitive the market is to downside data surprises, we recommend a neutral duration stance until there is more clarity. As a result, a cautious stance towards global corporate debt remains warranted.

Conclusions

Fears about global growth have escalated over recent months. If there is no monetary policy error we believe that risk momentum will recover and spike during 2016. Interestingly, this is one of those moments where macro really is decisive. Although equity markets have stabilised in the short term, panic selling is still possible, driven by volatile macroeconomic news from China and the US. However, we believe that the Chinese administration will confront the slowdown with a basket of liquidity that will help the engine to run faster.

In the short term, we are positioning ourselves carefully:

- We still like equities overall, but as stated, panic selling remains on the cards. We prefer European equities to Japanese and US stocks. European small caps might continue to profit from a renewed quantitative easing. Instead of increasing our equity positions by a vast amount, we will play it safe by carefully selecting consumer sectors and high-dividend payers.
- We believe inflation is not an enemy to investors over the short term. We are looking for high real yields; selected emerging markets' USD bonds and high yield bonds of companies exposed to European growth and consumer spending are of interest to us.
- As mentioned, we are careful not to be long-duration as we believe the softening in (US) rates will be limited over time.
- Over the long run, we are positive on the USD as we believe the US cycle has further to go. The key point is that the Fed won't raise rates well ahead of any concrete evidence of growth abroad.

So what shall we do with emerging markets? The USD (liquidity) and commodity prices are key. Given that we believe commodities will stay lower for longer and the USD will not appreciate straight away, we are faced with contrarian trends. It would probably make sense to buy emerging equities while there is some panic selling.

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