Degroof Petercam | Asset Management

Asset Allocation Flash

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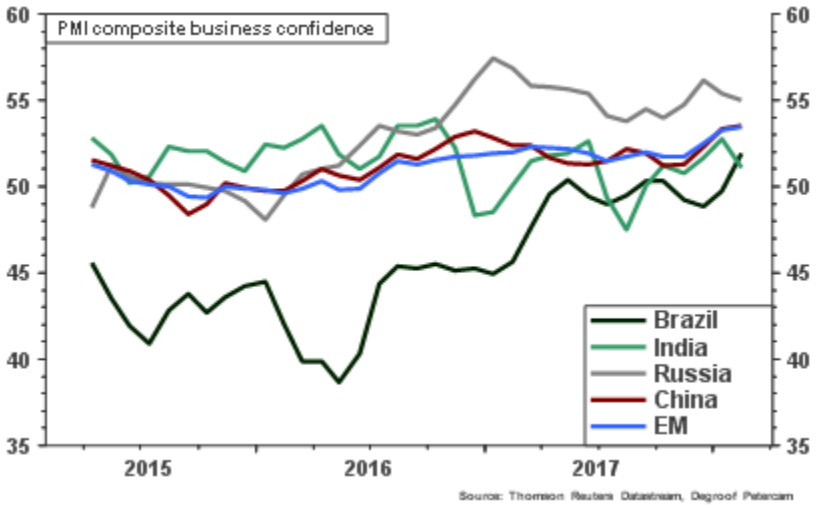
Graph of the month (March 2018)

An overview of business confidence in some EM



Global

Solid indicators for now

- Economic indicators remain solid for now, even though some leading indicators suggest that the pace of the recovery is slowing. Trade volumes are growing, corporate profits are on the rise and unemployment is falling. The combination of extremely loose monetary policy, relatively low commodity prices (though industrial metal and energy prices have rallied more recently) and neutral fiscal policy has come to fruition. So far, however, this is only modestly translating into rising wage and inflation readings.
- There has been a lot of talk about the death of the Phillips curve but it might be premature to confirm that message. Indeed, the absence of evidence is not the evidence of absence. Inflationary pressures are firming and we expect this to continue. At the same time, other factors including globalization, technological change and digitization, the ageing of the population, insufficient labour union power, lower anchored inflation expectations and sluggish productivity growth suggest that the negative relationship is

weaker than before. Financial conditions look set to become tighter from here eventually biting into economic activity, perhaps already later this year. Future equilibrium interest rates (and therefore real policy rates) are expected to remain lower compared to pre-crisis standards.

- A key risk to the outlook remains a rise in global protectionism, which has regained attention after Trump caused transatlantic tensions to rise with a proposal for import tariffs on steel and aluminium.

United States

More tightening coming up

- The United States are currently seeing the third-longest economic expansion in history, with the yield curve continuing its flattening trend. This is something to monitor closely. That said, we believe recession odds are low for now. Consumer confidence is still strong and the outlook for investment has been improving according to several leading indicators. Importantly, the low household savings rate in combination with expensive equity market and rising real estate prices bear watching.
- President Trump's tax looks set to give economic growth a small boost, but will primarily result in deteriorating public finances and growing inequality over time. We do expect core inflation to rear its head again as the labour market is nearing full employment.
- Therefore, more tightening of monetary policy is in the cards, and as things currently stand it is plausible that the Fed under new chair Powell will hike interest rates three to four times by the end of 2018, starting this month. In case significant volatility in financial markets resurfaces, it may convince the Fed to be more cautious. A higher Fed funds rate and an increased risk-off sentiment may result in a slight appreciation of the USD, but a significant boost should not be expected, given its current valuation.

Eurozone

Unemployment remains high

- While the latest leading indicators suggest that the expansion is set to moderate somewhat in the months ahead, the overall economic picture remains firm. Since the second half of 2016, the European economic cycle has advanced rapidly. All sectors are recovering, and the labour market is thriving again. However, unemployment remains above pre-crisis levels, and there are major divergences between countries. Moreover, there are many discouraged workers who have dropped out of the labour force in the past few years, as

well as part-time workers who would rather work full time. Hence, it does not come as a surprise that wage pressures will remain modest for some time to come, and that inflation will remain below the 2% target.

- As such, tighter monetary policy should not be expected any time soon. Here, the ECB will want to avoid the mistake it made in the past, namely to tighten monetary policy too soon. In addition, a further euro appreciation on the back of higher rates would make it harder for the ECB to reach its inflation target. It is too soon for an actual rate hike, and this will only come after the ECB has put an end to its asset purchase program later this year. This being said, the ECB could adjust its forward guidance and remove some of the easing bias in accordance with the general improvement of economic conditions in the euro area. The first rate hike will probably come in the spring of 2019.

Emerging Markets

Slew of elections planned

- China's economy has settled down from earlier hard landing fears. Economic policy uncertainty has declined but we expect growth to decelerate in 2018 as the economy's credit-driven recovery is over and monetary policy remains rather tight. China continues to be one of the major risks to the global economy. A slowing Chinese economy will have some fallout in the rest of the world, resulting in lower trade volumes and commodity prices. However, concerns about a severely negative impact on the rest of the world remain subdued for the time being.
- The rule of thumb is that a 1% decrease in Chinese growth results in a 0.25% drop in global economic growth. In the rest of the emerging world, economic activity is holding up well. EM Inflation hit an eight year low in the middle of 2017 but this trend is unlikely to continue this year. Therefore, the monetary policy easing cycles witnessed throughout much of the EM world have come to an end. There is a slew of elections coming up: this month Russia will be (re)electing its president. In May, Colombia will be holding presidential elections, and Indonesia has planned local elections in June. Furthermore, there will be general parliamentary elections in Mexico (July), Malaysia (August), Brazil (October) and Thailand (November). The elections in Mexico and Brazil in particular will attract a great deal of attention. Meanwhile, South Africa is preparing for general elections in 2019.

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Forecasts 2018-2019

	GDP			Inflation		
	2017	2018	2019	2017	2018	2019
US	*2.2*	**2.4**	**1.9**	*2.1*	**2.1**	**2.2**
		2.8	*2.4*		*2.3*	*2.2*
Eurozone	*2.3*	**2.3**	**1.7**	*1.4*	**1.5**	**1.6**
		2.3	*1.9*		*1.5*	*1.5*
Japan	*1.6*	**1.5**	**1.0**	*0.8*	**1.3**	**1.5**
		1.4	*1.1*		*1.5*	*1.5*
China	*6.7*	**6.2**	**5.7**	*2.2*	**2.2**	**2.3**
		6.5	*6.3*		*2.2*	*2.2*

Degroof Petercam forecasts as of March 2018, *Consensus forecasts*

Currencies (vs. EUR)

USD still looks expensive

- The USD still looks expensive in a long term theoretical perspective. That said, more evidence of the Fed turning more hawkish could still lead to a somewhat stronger USD. Meanwhile, a stronger EUR has another dampening effect on Eurozone inflation numbers that are already considered too low. All in all, downward risks for the USD remain present in a medium to longer term perspective, provided that European political cohesion proves stable.
- The GBP has already depreciated significantly as a result of the Brexit referendum. This has led to higher inflation and hence negative real household disposable income growth for UK households, challenging the growth outlook. The BoE dovishly hiked interest rates this month for the first time since July 2007 but this was largely anticipated by markets. Meanwhile, Brexit negotiations seem to be going nowhere at this point. This could change of course but for now risks remain primarily on the downside from current levels.
- The JPY has been depreciating against the euro in recent quarters. Downward pressure remains as the BoJ sticks to its ultra-loose monetary policy in the foreseeable future. The fact that the JPY is now at its long-term PPP equilibrium level against the EUR, however, makes another significant depreciation less likely.

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- The RMB has appreciated significantly against the USD since the summer of 2016. But this has been mostly offset by depreciation against other currencies. In trade-weighted terms the RMB has remained broadly stable recently, in line with policy goals.

Asset Classes

Prudent stance on risky assets

Cash | Neutral

- Cash is neutral

Prefer global linkers

Government bonds | Underweight

- Following the synchronized bond yield spike earlier this year, bond yields diverged in the US and the Eurozone over the past weeks. US bond yields were basically flat and maintained their elevated level, while Eurozone yields retreated somewhat. The recent macro-economic developments and central bank outlook account for this difference.
- We maintain our view that bond yields have upward risk. However this risk is clearly more present in the US than in the Eurozone, because of:
  - a different inflation outlook (inflation risk more tangible in US given tight labour market, weaker dollar and higher import fees),
  - a different phase in monetary policy normalisation (Federal Reserve rate tightening versus EMU bond markets (government and credit) still protected by the ECB's APP),
  - different supply / demand dynamics (US issuance of bonds due to larger budget deficit : lower tax income and more spending).
- We expect that German bond yields will evolve towards 1% by the end of 2018. We are therefore maintaining an Underweight position for EUR Government Bonds in a balanced portfolio and confirm our Strong Underweight duration stance.
- The Italian parliamentary elections had little impact on bond markets, as the result was largely as expected (advance for populist parties and difficult coalition formation). The longer term outlook for Italy remains cloudy however, as the instability of the eventual government will not provide an environment for the necessary structural reforms to take place. Other periphery countries performed solidly after the Italian election. In recent years they have improved substantially their competitiveness compared to core countries (through internal devaluations). We expect that periphery rate convergence will continue and highlight that we prefer the periphery to the core within the euro government asset class (that remains as such Underweight).
- Central banks slightly adapted their communication in recent weeks. The ECB dropped its pledge to increase the size and/or duration of its Asset Purchase Program if financial conditions or inflation worsened. The surrounding comments were generally seen as dovish. The Federal Reserve

raised its benchmark rate by another quarter-point in a widely expected move that also came with an outlook of a steeper path for future interest rate normalization: three rate hikes in 2018 (unchanged) and four in 2019 (upward revision).

- Inflation break evens have mainly in the US continued to move up, where price components of advanced indicators point to climbing inflation risk. In general, inflation linked bonds price a very mediocre inflation outlook and consequently they remain a cheap hedge to rising rates. Real yields are expected to remain structurally low over the longer term. Inflation linked bonds remain attractive both from a short term tactical perspective and as a hedge against non-base case scenarios. We remain overweight Global Inflation Linked Bonds.

Spreads widened somewhat

Euro IG Corporate Bonds | Neutral

- During the February equity market turbulence, EUR investment grade spreads widened somewhat and we saw a round of outflows in EUR IG bonds. Short-duration bonds, however, had inflows which partly offset the outflows from the long-duration bonds.
- Default risk is to remain under control for the foreseeable future thanks to sufficiently robust credit fundamentals and low interest rates. However internal credit analysis is required and acts as a cornerstone to the investment process when valuations are becoming rich and company or sector specific issues might impact aggressively.
- We remain Neutral EUR Investment Grade. It is a way to keep duration low and find (at least some) spread, but risks to this outlook have increased.

Wobbly markets

Euro High Yield Bonds | Underweight

- Given the wobbly market in February, primary issuance was relatively subdued.
- Despite having repriced a bit, the high yield market is still rather expensive (spreads remain close to 2007 lows). Higher core rates, increasing protectionism and a slower growing China can continue to weigh for the foreseeable future. We believe current spreads do not compensate for liquidity and the increased volatility.
- Even if defaults are expected to remain low and there are little signs of distress in Europe, we believe the good news is priced in.
- We have an Underweight position on European HY.

Uncertainty in some markets

LC Emerging Market Debt | Slight overweight

- EUR strength masks the very good performance of LC EM bonds driven by a relentless yield differential compression. Necessarily this raises the question how much of the road has been travelled already. The bond yield differential remains slightly above LT averages.

- Taking into account the sudden increase in Developed Market yields, it seems wise to proceed with caution.
- There is an increasing uncertainty unfolding out of key emerging economies like Russia, Mexico, Brazil… (political calendar) and Turkey.
- In the short term we remain more cautious about the sector but confirm our Slight Overweight position.

Europe first

Developed market equities | Neutral

- Markets have de-rated somewhat after the February/March turbulence. Resurfacing fears of a trade war following the US measures for steel and aluminium, and Chinese imports are keeping equity markets on edge. It is our scenario that, even though big in the news headlines, these measures will be watered down and hence do not expect irrational retaliation, triggering a full-blown trade war.
- EPS have been gaining further momentum and further EPS growth is expected. European companies that have a lot of US Dollar exposure have difficulty to beat expectations.
- EPS revisions are positive in US (due to tax impact) and flat elsewhere.
- Policy uncertainty is still trending down in Europe and stable in the US.
- We maintain our Neutral position for equity.

Our geographical allocation has not changed :

- **Overweight** for **European equity**
  - Valuations remain reasonable in Europe (14.3x forward earnings, dividend yield to bond yield high)
  - Earnings growth likely underestimated given macro momentum, but strong EUR risk: European earnings momentum is flat
  - Monetary policy remains accommodative

- **US Equity (Underweight)**
  - Tax reform provides short term support.
  - We remain underweight on valuation grounds : US equity remains expensive, the correction has not significantly changed that. Several metrics point in that direction (forward P/E 17.3x, low dividend yield to bond yield)
  - Monetary policy becoming less supportive

- **Japanese equities : Neutral**.
  - Margins in Japan have already surpassed the last cyclical peak but we think the gathering cyclical momentum means this situation can carry on for a while.
  - The JPY has recently stopped eroding the equity market performance. By many measures, the JPYUSD now looks undervalued (it is currently trading at an unusual discount to its PPP-implied level).

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- Valuation (forward P/E at 13,9) is below the long term average.

Strong commodity prices

Emerging market equities | **Underweight**

- EM equity performance has been underpinned by strong commodities.
- Even if Emerging Markets have an exposure to the global growth recovery and equities' valuations are more appealing (12.4x forward earnings) than in developed countries, we see risk for the region:
  - tightening monetary conditions in China. With the National Congress now behind us, the focus may shift from supporting growth to correcting the imbalances, which will have an impact on the growth outlook.
  - the elections in several EM countries in 2018.
- We prefer Japan to Emerging Markets for Asia exposure but have reduced the underweight in emerging markets.

In a nutshell

	ASSET ALLOCATION DECISIONS		
Asset	Feb-18	Change	Mar-18
Cash	N		N
Fixed Income	N		N
Government Bonds	UW		UW
Inflation-Linked	OW		OW
Euro IG Credit	N		N
International IG	N		N
EM Debt	OW		OW
Euro High Yield	UW		UW
Equities	N		N
Europe	OW		OW
World ex-Europe	UW		UW
Emerging Markets	UW		UW
Alternatives			
Convertible Bonds	N		N
Real Estate	OW	⬇	N
Commodities	N		N
		Up / Down	

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