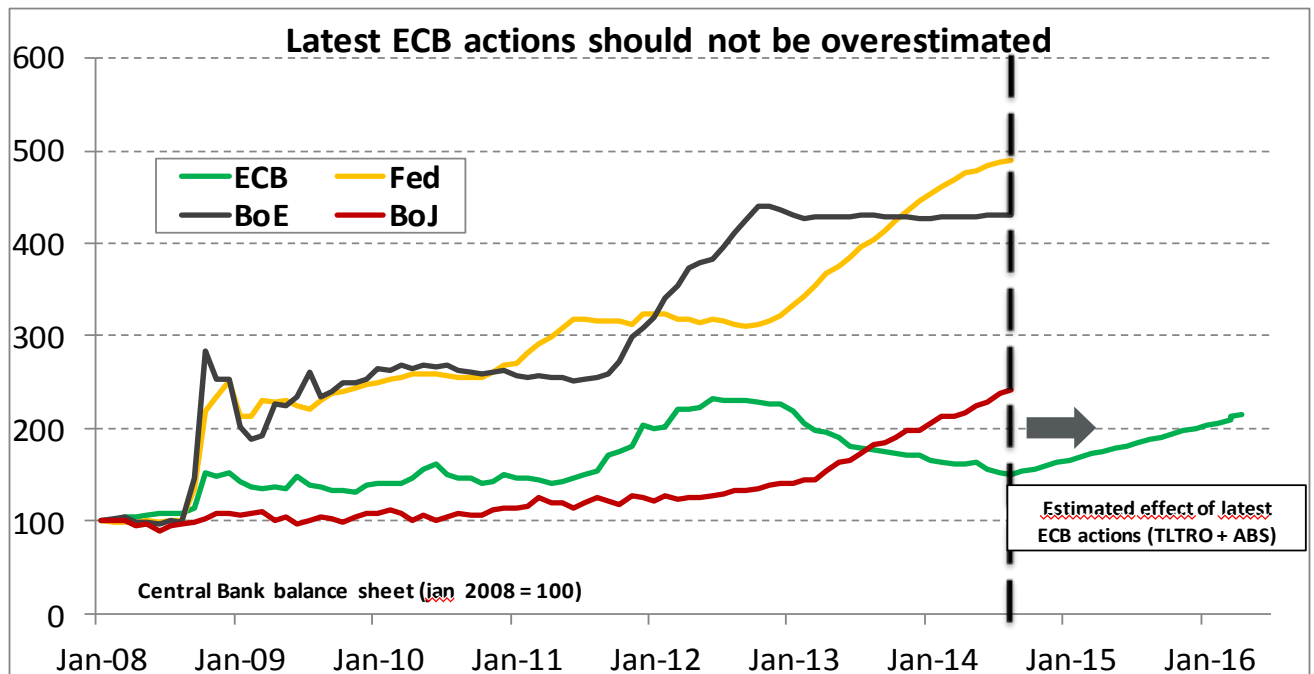


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Petercam IAM Asset Allocation Committee | October 2014

GRAPH OF THE MONTH



GLOBAL

Global monetary policy remains supportive

- The **global recovery** remains on track. Especially in the US, economic figures are promising, suggesting the US economy could pick up its role as engine of the world economy again. Improving confidence, reduced fiscal tightening, accelerating global trade and supportive monetary conditions suggest that this gradual recovery will continue in coming quarters. In Europe, economic growth remains weak and leading indicators have taken a turn for the worse again. That said, talk of a new recession is still premature.
- Inflation** remains low, and this isn't about to change any time soon. There is still slack in the global economy that's holding inflationary pressures in check. On top of that, commodity prices have been easing again of late, with especially oil prices dropping substantially.
- The next big risk for the world economy and financial markets lies in **monetary policy**. While the ECB and the BoJ are still on the easing path, the Fed and the BoE are heading for rate hikes in the first half of next year. That said, for now the Fed and the BoE are moving extremely cautiously as they are still far more concerned about economic growth than about inflation/bubbles. As long as that remains the case, global monetary policy will remain broadly supportive.

UNITED STATES

Unemployment continues to ease

- Recent data on the US have been **quite positive**, confirming that the economy is on track for 3% growth on annualized basis. The labor market continues to generate about 200.000 additional jobs every month, the housing market continues to recover, companies are investing and the credit mechanism is starting to function again. These factors suggest the recovery is set to continue in coming quarters. Overall, the economic situation is gradually getting back to normal and this move has further to go.
- In recent weeks, **credit growth** has been increasing, an early indication that extremely supportive monetary policy is finally starting to feed through into the real economy. If this trend is confirmed in coming months, this would be very promising.
- Headline inflation** softened a touch last month on the back (to 1.7% from 2%) of lower energy prices. Meanwhile, following the acceleration in the beginning of the year, the Fed's preferred inflation indicators (personal consumption deflators) have been moving sideways over the last couple of months. Upward domestic price pressures are likely to be counterbalanced (at least partially) by the strengthening USD, keeping a lid on import inflation.
- Since mid-2011 the **labour market** has been generating about 200k additional jobs a months. Meanwhile, the unemployment rate continues to ease (currently down to 6.1%). On top of that, leading indicators suggest wage growth is about to pick up from low levels in coming quarters. Eventually, this is likely to push inflation higher.

EUROPE

Recent readings have been disappointing

- Recent data on the **Eurozone** have been disappointing with growth all but stopping in Q2, while important economies like Germany and Italy actually registered declines in economic activity. In combination with the Russia/Ukraine situation this has raised fears about the Eurozone outlook. Leading indicators have come under pressure again. That said, lower energy prices, low interest rates, decent growth in important trading partners like the US and the UK, a weaker euro, easing bank lending standards and reduced fiscal tightening imply that the Eurozone economy will continue to grow in coming quarters (even if that growth will be fairly modest).
- Headline inflation** has now eased to 0.4%, with core at 0.8%. Talk of deflation throughout the region still seems overdone, but inflation is clearly too low and inflation expectations continue to decrease. The recent depreciation of the euro should help to lift import inflation. The ECB has clearly become more serious about the risks of ultra-low inflation in recent months. Still, the Eurozone is only one negative shock away from deflation, and this remains a dangerous situation.

ASIA

Japan is feeling the pinch of the VAT increase

- | In **Japan**, the economy is feeling the hit of April's consumption tax increase. Recent data were disappointing but Japanese export growth should accelerate in coming months as the world economy continues its gradual recovery. Meanwhile, inflation has been pushed up by temporary factors (yen weakness and VAT hike). As the effect of these temporary factors gradually fades, inflation is likely to ease back in coming quarters, raising questions about the exit out of deflation, especially as wage growth is not taking off for now.
- | In **EM** there is significant divergence between commodity-exporters and the BRICs (with the exception of India) that are in trouble and most commodity-importers where the outlook is reasonable. In recent months, there have been increasing signs that EM exports are picking up in line with the recovery in DM.
- | That said, many EM are still facing **domestic issues**: a number of EM are looking at inflation and capacity issues (Brazil), while others have been relying on too much credit growth (Turkey, Thailand). The diversity in the region is quite important in any assessment of the economic outlook. Countries like India, Indonesia, the Philippines and Poland are doing quite well currently.
- | Most recent **Chinese economic data** were disappointing. Recent official comments confirm that Chinese leaders are prioritizing structural reforms while allowing growth to gradually decrease from current levels. The economy is likely to continue to slow down gradually for several years to come as the authorities continue to take measures to rein in credit growth.
- | **Inflation** throughout EM remains broadly under control, although there are several EM where inflation is at the high end of or above the inflation target (Turkey, Russia, Brazil, South-Africa).

MONETARY POLICY

US focus is still on the labour market

- | Fed Chair Yellen continues to confirm that the Fed exit will be data-dependent and the main focus is still on the **labour market** (instead of inflation). Still, the Fed is moving towards a first rate hike, most likely to come next Spring. Increasing credit growth, inflation and wage growth suggest the time for a turn in monetary policy is coming closer. The Fed will continue to communicate carefully on this in an attempt to prevent large market reactions. However, the question remains whether it is capable to do this. In any case, the upcoming hiking cycle is likely to be slower than usual, but faster than markets currently anticipate. For the next 6 to 12 months, this is likely to be the key issue for financial markets.
- | The **ECB** has finally become serious about the threat of deflation. Following the ECB's actions begin June, the ECB took further monetary stimulus measures in its latest policy meeting. In addition to the TLTRO program launched last June, the ECB cut interest rates again (with the deposit rate further into negative territory) and introduced a new ABS program. However, optimism about the scale of the latest policy measures should be tempered. In best case, they bring back the size of the ECB's balance sheet to the levels seen in 2012. More policy action may still be needed to fend of the risks of ultra-low inflation.
- | The **UK economy** and especially the housing market have been performing quite strongly. This has already pushed the BoE to scale back its non-conventional measures. On top of that, the BoE is likely to be the first of the major DM central banks to start increasing its policy rate, even though expectations for this have now been pushed back to early next year.
- | In **Japan**, the BoJ sticks to its earlier monetary stimulus plan. BoJ-president Kuroda has acknowledged that inflation (outside of the consumption tax increase) will ease in coming months as the impact of earlier yen weakness fades. For now, Japanese leaders stick to the current stimulus program unleashed in April 2013. However, if the BoJ is serious about fighting deflation and about its 2% inflation target, it will probably have to accept the need for additional stimulus towards the end of the year.

FORECASTS

	2013	2014	2015
GDP projections			
USA	1.9	2.1 (2.1)	3.2 (3.0)
China	7.7	7.0 (7.4)	6.5 (7.2)
EMU	-0.4	0.8 (0.8)	1.4 (1.4)
Japan	1.7	1.4 (1.1)	2.0 (1.2)
CPI projections			
USA	1.5	1.9 (1.9)	2.2 (2.1)
China	2.6	2.5 (2.3)	2.7 (2.9)
EMU	1.4	0.6 (0.6)	1.3 (1.1)
Japan	0.4	2.8 (2.8)	1.8 (1.8)

Petercam forecasts, consensus forecasts between brackets

CURRENCIES

EM currencies are likely to remain volatile

- The Fed is now gradually preparing for a **first rate hike**, while the ECB is moving towards additional stimulus measures. This is a reflection of diverging inflation and economic activity trends in the US and the Eurozone. In the US inflation is gradually moving back up to the 2%-target, while the Eurozone is flirting with deflation with headline inflation falling to 0.4%. The relative trend in monetary policy is finally having its long-awaited impact on the eurodollar. Since early May the dollar has gained more than 6% versus the euro. Expect more of this to come as the divergence in monetary policy in the US and the Eurozone continues. Over the next three years, the Fed is highly likely to move towards substantially higher policy rates, while the ECB is likely to stick to extremely loose monetary policy. This divergence should push the euro significantly lower versus the dollar.
- The **pound** has already strengthened substantially versus the euro as the UK economy is performing better than the Eurozone. Still, this move has further to go as the BoE is likely to start raising interest rates in the next 6 months.
- On the back of its **aggressive monetary easing**, the yen weakened significantly in 2013. Since the beginning of the year this weakening trend has paused. However, eventually the BoJ still looks likely to add more stimulus, which should further weaken the yen in the next few quarters.
- **EM currencies** have come increasingly under pressure against the USD over the last two months (around 5% against USD). As the EUR depreciated against the USD, EM currencies vis-à-vis have remained broadly stable. Recipient countries (i.e. countries with large current account deficits) are likely to remain vulnerable against the back of expected changes in global liquidity conditions because of the Fed's actions. EM currencies could see significant volatility in coming months, even if the earlier correction has created opportunities.

ASSET CLASSES

Returns are very low

- **Cash | Neutral**
- We raise exposure to cash from underweight to neutral
- This tactical move expresses our more cautious stance on risky assets

Expected returns are low at best

■ **Government bonds| Neutral**

- Bonds are continuing their great run, with especially European bonds registering a stellar performance. Very low inflation and expectations of additional monetary stimulus in the Eurozone have pushed interest rates lower. On top of that, the global search for yield has been a key driver. However, with interest rates at record lows the potential for further declines in rates has become quite limited.
- As long as central bankers are sticking to their current strategy the search for yield can continue. Moreover, central banks in the US and the UK are clearly not looking for a significant increase in rates. However, markets are probably too relaxed on the upcoming change in Fed policy, even if the Fed will try to avoid shocks. From current levels, the risk of an increase in rates is larger than that of a further decline.
- The expected returns on government bonds for the rest of the year are low at best.

Modest return outlook

■ **Euro IG Corporate Bonds| Underweight**

- In line with the recovery the default outlook is quite favourable for IG credit.
- However, corporate bonds have become quite expensive, suggesting the return outlook is limited. Even without an increase in interest rates, the expected return for IG is modest, and this hardly justifies the risk related to this asset class.
- The interest rate risk for government bonds is also relevant for IG credit.

Quality of issuance is deteriorating

■ **Euro High Yield Bonds| Neutral**

- HY bonds still provide carry, even though they have become quite expensive and the room for further spread contraction has all but disappeared.
- The quality of HY issues is clearly deteriorating.
- Within the bond universe, we are neutral on HY bonds.

Still interesting carry

■ **Emerging Market Debt| Neutral**

- EMD provides the most interesting carry within the fixed income universe.
- Following the earlier turbulence in EM, things seemed to have calmed somewhat more recently. Important risks remain.
- That said, there is important divergence within EM. Especially current account deficit countries remain quite vulnerable.
- EMD is highly dependent on EM currencies, which are likely to continue to be volatile as the Fed's actions raise questions about global liquidity conditions.
- Within the bond universe, we are neutral on EMD (but are highly selective of which EM we invest in).

US equities are expensive

■ **Developed market equities | Overweight**

- The global recovery looks set to continue. This recovery and still very supportive monetary policy create a positive climate for equities, even if markets have already anticipated this to an extent, and some markets (mainly the US) have become quite expensive.
- The US has already seen a substantial profit recovery, while in Europe we definitely see the first signs of improvement. Indeed, there have been fewer negative pre-announcements of companies and fewer downward revisions by analysts. European earnings are effectively growing, albeit at a slow pace. The currency headwind that was felt in Q1/Q2 should disappear in H2.
- US equities are expensive, while European and Japanese equities offer more attractive opportunities.
- Japanese equities are likely to benefit from a further weakening of the yen on the back of additional action by the BoJ and the close link to global economic activity.

Valuations remain attractive

■ **Emerging market equities | Neutral**

- Leading indicators are mixed and continue to fall behind their DM peers. China continues its managed slowdown and commodity exporters are suffering.
- Valuation remains overall attractive.
- We become more cautious on the back of a stronger USD

KEY TAKE-AWAYS

- **We increase our exposure to cash from underweight to neutral, and decrease our exposure to emerging market equities from overweight to neutral.**
- **Overall, we continue to prefer equities over bonds.**
- The gradual global recovery remains on track with recently stronger data in the US, disappointments in Europe and mixed data in EM. Current geopolitical concerns (Ukraine, Iraq, ...) are unlikely to derail the positive trend.
- The US economy remains on track for annualized 3% growth in coming quarters. The US economy is normalizing, while monetary policy is still far from normal. The Fed is slowly but surely moving in the direction of tighter monetary policy.
- In Europe, recent data have been disappointing, but the combination of lower energy prices, strong growth in the US and the UK, a weaker euro and reduced fiscal tightening should result in slightly stronger growth in coming quarters (even though growth will remain quite modest).
- In Japan, the latest data were disappointing. For now, the BoJ stick to its program, but it still seems likely that more stimulus is needed in order to reach the 2% inflation target.

IN A NUTSHELL

Asset	ASSET ALLOCATION DECISIONS		
	Sep-14	Change	Oct-14
Cash	UW	↑	N
Fixed Income	UW		UW
Government Bonds	N		N
<i>Inflation-Linked</i>	OW		OW
Euro IG Credit	UW		UW
International IG	N		N
EM Debt	N		N
Euro High Yield	N		N
Equities	OW		OW
Europe	OW		OW
World ex-Europe	N		N
Emerging Markets	OW	↓	N
Alternative			
Convertible Bonds	N		N
Real Estate	N		N
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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