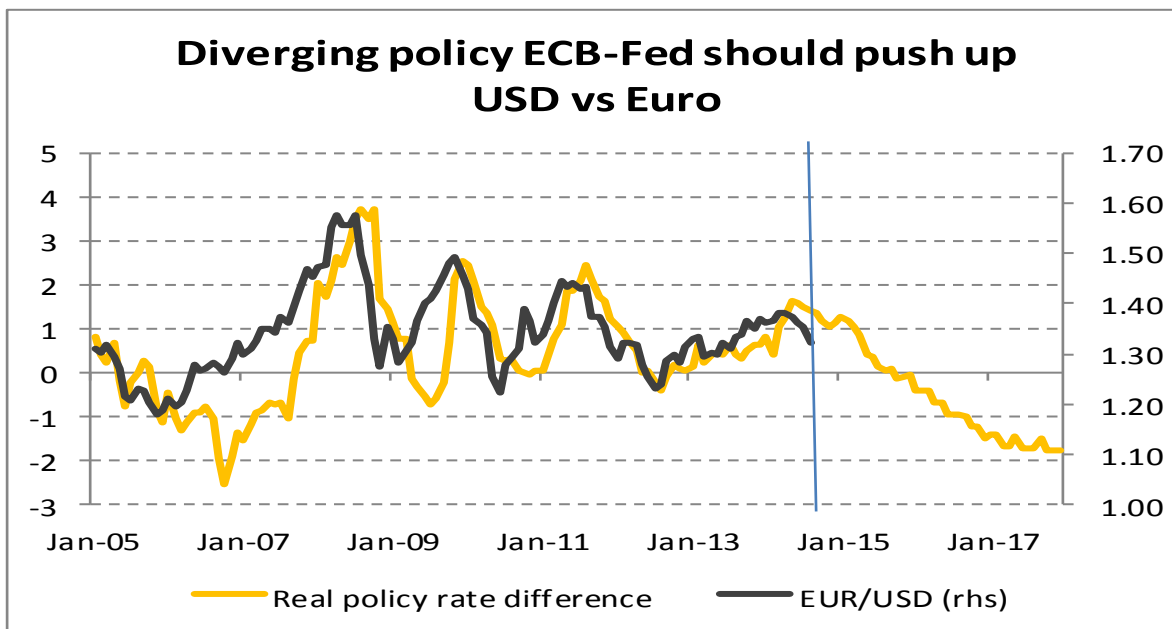


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Petercam IAM Asset Allocation Committee | September 2014

GRAPH OF THE MONTH



GLOBAL

The global recovery remains on track

- In spite of a number of **geopolitical issues** (in Ukraine, Israel, Iraq, ...) the global recovery remains on track. Especially in the US, recent data were quite 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.
- 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. The Fed and the BoE are heading for rate hikes in the next 6 to 12 months, and it is unclear what the impact of this will be. 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

Headline inflation has moved back to 2%

- Recent data on the US have been quite positive, confirming that the economy is on track for **3% growth** on annualized basis. The labour 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 for the recovery.
- 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 6.2%). On top of that, leading indicators suggest wage growth is about to really pick up from low levels in coming quarters.
- Headline inflation** has moved back to 2%, while the Fed's preferred inflation indicators (personal consumption deflators) are also moving up. There is no need to start to fret about rising inflation, but most inflation indicators are getting back to normal levels (while monetary policy is anything but). Inflation remains firmly under control, but is no longer ultra-low.

EUROPE

Modest growth in the coming quarters

- 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. That said, lower energy prices, low interest rates, decent growth in important trading partners like the US and the UK, a weaker euro and reduced fiscal tightening imply that the Eurozone economy will continue to grow in coming quarters (even if that growth will be fairly modest).
- The **relationship with Russia** remains an issue. However, direct export links to Russia are limited: Eurozone exports to Russia are only 1.2% of GDP (the US and the UK are far more important trading partners for the Eurozone). Gas could be an issue, but thanks to the mild winter gas prices are down 45% since last December.
- 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. As it stands, the Eurozone is only one negative shock away from deflation, and this remains a dangerous situation.

ASIA

The Chinese economy is on a path towards managed slowdown

- In **Japan**, the economy is feeling the hit of the consumption tax increase. Recent data were somewhat disappointing, but still the economy should be able to recover in coming months. Meanwhile, inflation (outside of the tax increase) seems to be stabilising. As the initial inflation push of the combination of commodity imports and yen weakness is now fading, 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.
- 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 in the current climate.
- The **Chinese economy** continues on its path of managed slowdown, even if recent data were positive. The economy is likely to continue to slow down gradually for several years to come as the authorities continue to take measures to reign 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

The Fed is moving towards a first rate hike

- The **Fed** continues its well-communicated exit in line with the improving economic outlook. With her Jackson Hole speech Yellen confirmed that the Fed exit will be data-dependent and that she remains very much focused on the labour market (and not too worried about 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.
- In the **Eurozone** the ECB finally seems to be focusing on the deflation risk. At Jackson hole, Draghi explicitly referred to falling inflation expectations. Moreover, he opened the door for additional stimulus in coming months. for the first time he acknowledged that the risks of doing too little outweigh the risks of doing too much. More initiatives can be expected in the next couple of months, although Fed-style QE still seems difficult.
- The **UK** economy is performing quite strongly, and especially the housing market is powering on. 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, but he expects this to be temporary (and no reason for additional action). 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 (2.0)	3.2 (3.0)
China	7.7	7.0 (7.4)	6.5 (7.2)
EMU	-0.4	0.8 (1.0)	1.4 (1.5)
Japan	1.7	1.4 (1.4)	2.0 (1.2)
CPI projections			
USA	1.5	1.9 (2.0)	2.2 (2.2)
China	2.6	3.0 (2.4)	3.0 (3.0)
EMU	1.4	0.6 (0.6)	1.3 (1.2)
Japan	0.4	2.6 (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 trends in the US and the Eurozone. In the US inflation has moved 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 5% 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 much 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 with the yen strengthening about 5% versus the euro. However, eventually the BoJ still looks likely to add more stimulus, which should further weaken the yen in the second half of the year.
- Things have calmed down somewhat for **EM currencies** in recent months. Overall, EM currencies have even recovered part of the earlier losses. That said, there are still risks, especially for countries that are highly dependent on external capital inflows. They remain vulnerable in a climate of expected changes in global liquidity conditions because of the Fed's actions. At the very least, EM currencies will continue to see significant volatility in coming months.

ASSET CLASSES

Returns are very low

- **Cash** | **Underweight**
- Returns on cash are extremely low in a reflationary world
- There are better opportunities in other asset classes.

The bull run continues

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.

HY still provides carry

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.

Earlier corrections have created opportunities

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. 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| Overweight**

- Cyclical dynamics in most EM (outside of the BRICs) are improving, thanks to increasing export opportunities. This should be a clear positive for EM companies.
- Valuation remains attractive.
- We continue to expect that these positives will drive the market.
- We remain positive on EM equities.

KEY TAKE-AWAYS

- There is **no allocation change** versus last month.
- US equities look expensive, Europe less so, while Japan and EM are still cheap.
- 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.
- Available indicators suggest the US economy is firmly on track for annualized 3% growth in coming quarters. The US economy is normalizing, while monetary policy is still far from normal. At Jackson Hole, Yellen illustrated again that the Fed is still far more concerned about keeping the recovery going than about inflation.
- 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). At Jackson Hole, Draghi sounded quite worried about low inflation, opening the door for additional stimulus by the ECB in the near term, which he effectively announced at the late September ECB meeting.
- In Japan, the latest data were disappointing. For now, the BoJ sticks to its program, but it still seems likely that they will add further stimulus towards the end of the year.
- In EM, recent leading indicators have not been very positive. There is substantial divergence between EM with commodity-exporters and the BRICs (excl. India) performing poorly. Meanwhile, China continues its trajectory of managed slowdown.
- We prefer equities over bonds over cash.
- Within equities, we prefer Europe, Japan and EM.

IN A NUTSHELL

Asset	ASSET ALLOCATION DECISIONS		
	Aug-14	Change	Sep-14
Cash	UW		UW
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		OW
Alternative			
Convertible Bonds	N		N
Real Estate	N		N
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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