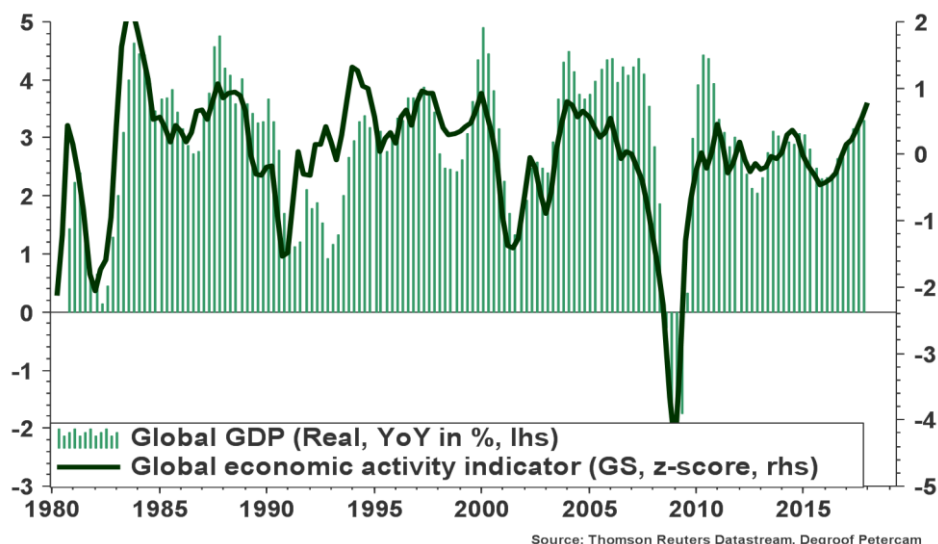


## Asset Allocation Flash

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## Graph of the month (May 2018)

Buoyant economic growth



## Global

### Tighter financial conditions

- Economic indicators remain solid for now, even though some leading indicators suggest that the pace of the recovery is slowing. The aggressive rhetoric on global trade and the fact that Trump's attention shifted to China contributed to a worsening of business sentiment. Further retaliatory measures are possible if the US escalates tensions. However, both sides seem willing to reach an agreement.
- A tech equity rout in an environment of elevated valuations is not helping confidence either. Still, the economic outlook remains solid. This means that neither trade nor tech worries will easily affect the global recovery. Trade volumes are still growing, corporate profits are on the rise and unemployment rates are reaching new lows. The combination of extremely loose monetary policy, relatively low commodity prices and neutral fiscal policy has come to fruition. So far, however, this is only modestly translating into rising wage and

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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.

## United States

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### 4 rate hikes in 2018

- 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. The Fed under new chair Powell hiked interest rates in March. During his press conference, Powell signalled faster rate hikes over the coming years. As things currently stand, we expect the Fed to raise rates a total of four times in 2018.
- Stock market gyrations are not a good measure of the state of the economy. This means that recent bouts of volatility will not be enough to deter the Fed from changing its course. In case significant volatility in financial markets persists and business confidence indicators are affected, 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

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### Rate hike in 2019

- Since the second half of 2016, the European economic cycle has advanced rapidly. All sectors are recovering, and the labour market is thriving again. The Eurozone unemployment rate reached a new low of 8.5% in February. However, there are major divergences between countries. Moreover, there are many discouraged workers

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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

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### US-China trade war

- The US-China trade spat adds to the uncertainty. With the threat of a 25% tariff on \$50bn worth of US exports to China, Chinese leaders have taken a firm position. At the same time, China has much at stake and will avoid further escalations. Small concessions including lower import tariffs on cars and relaxed restrictions on foreign ownership could be enough to ease the tensions.
- In the rest of the emerging world, economic activity is holding up well although leading indicators are showing signs of a reduced momentum similar to DM. 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. After Russia and Hungary confirmed support for their leaders last month, there are still a lot of elections coming up in EM. 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

	<b>GDP</b>			<b>Inflation</b>		
	2017	2018	2019	2017	2018	2019
<b>US</b>	2.3	<b>2.4</b>	<b>1.9</b>	2.1	<b>2.1</b>	<b>2.2</b>
		2.8	2.4		2.4	2.2
<b>Eurozone</b>	2.3	<b>2.3</b>	<b>1.7</b>	1.5	<b>1.5</b>	<b>1.7</b>
		2.4	2.0		1.5	1.6
<b>Japan</b>	1.7	<b>1.5</b>	<b>1.0</b>	0.8	<b>1.3</b>	<b>1.5</b>
		1.3	1.0		1.4	1.6
<b>China</b>	6.9	<b>6.2</b>	<b>5.7</b>	2.2	<b>2.2</b>	<b>2.3</b>
		6.5	6.2		2.2	2.2

Degroof Petercam forecasts as of May 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.
- The RMB has appreciated significantly against the USD since the

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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

Peripheral bonds did well **Government bonds | Underweight**

- We maintain our view that bond yields have upward risk. The inflation figures for the US will be closely watched in the coming months for the expected pick-up in inflation to materialize. In the Eurozone, bond markets (government and credit) are still protected by the ECB's Asset Purchase Program and inflation pressure is still absent.
- We continue to believe that German bond yields will evolve towards 0.8% by the end of 2018 and are therefore maintaining our Underweight position for core EUR government bonds in a balanced portfolio. We confirm our Underweight duration stance.
- Peripheral bonds performed well as rate convergence continued. We expect this trend to continue on the back of improving macroeconomics, rating migration and ECB purchases. We prefer the periphery to the core within the euro government asset class.
- Given the risk of increasing inflation in the US, 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.

Credit spreads have widened **Euro IG Corporate Bonds | Neutral**

- Over the past month, we saw credit spreads widen for the second month in a row. But this was almost completely offset by a substantial German bund rally which led to a duration gain. Heavy issuance volumes in March contributed to spread widening in the market. We expect that this may potentially impact spreads in the coming months.
- 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 as it a way to keep duration low and find some spread, but risks to this outlook have increased.

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### Relatively tight spreads

#### Euro High Yield Bonds | **Underweight**

- March continued to be a volatile month driven by the trade war rhetoric.
- The fundamental picture remains ok, though, and the first quarter earnings season might give a clue of where fundamentals are headed. We still see little signs of distress in Europe, as there were more rating upgrades than downgrades.
- Despite having repriced a bit, the pricing of the high yield market still remains relatively tight (spreads remain close to 2007 lows). We believe current spreads do not compensate for liquidity and the increased volatility.
- Even if defaults are expected to remain low, we believe the good news is priced in.
- We have an Underweight position on European HY.

### Uncertainty in some markets

#### LC Emerging Market Debt | **Overweight**

- Local currency debt shows a significant outperformance over hard currency debt in recent months. The environment of weak dollar has allowed EM currencies to appreciate and EM hard currency yields have been hit by higher US rates.
- However, it seems wise to proceed with caution, as Developed Market yields are expected to move higher.
- There is an increasing uncertainty unfolding out of key emerging economies like Mexico, Brazil... (political calendar) and Turkey.
- In the short term we remain more cautious about the sector but confirm our Overweight position.

### Europe first

#### Developed market equities | **Neutral**

- Macro news has surprised somewhat negatively recently, especially in Europe. However, we think this is mainly due to expectations that got carried away. The picture currently depicted by leading indicators is still one of robust growth. Besides, this situation has tempered worries of overheating and, as a benefit, kept bonds yields low. This in turn has reinforced the relative value of equities to a small extent.
- On March, 31 (the start of the earnings season for Q1 2018), the consensus estimated the earnings growth rate for the S&P500 was 17.1%. At the start of the year, this expectation stood at 11.3%. While it is positive to see a high growth level, the bar for the coming quarters has been raised and shall be more difficult to beat going forward.
- EPS revisions are positive in USA (tax impact) and flat elsewhere.
- For now, we believe the combination of decent growth and low inflation will continue. Our Neutral position for equity remains appropriate.

Our geographical allocation has not changed :

- **European equity: Overweight**
  - Valuations remain reasonable in Europe (14.1x forward earnings). The market correction, combined with earnings growth, has pushed valuations down to the lowest level in 3 years.
  - Macro momentum is fading and the strong EUR poses a

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- risk: European earnings momentum is flat.
      - Monetary policy remains accommodative
    - **US Equity: Underweight**
      - Tax reform provides short term support but seems to be priced by the market.
      - 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 16.5x, low dividend yield to bond yield)
      - Monetary policy is becoming less supportive, with the possibility for a rate hike surprise.
      - Moreover, the companies that led the huge rally, mostly e-commerce and other technology stocks, are suffering lately on the back of potentially more regulation.
    - **Japanese equities: Neutral**
      - Japan has the highest “beta” to the global economy as the equity market is very cyclically oriented with high operational leverage. This implies opportunity and risk!
      - Margins in Japan have already surpassed the last cyclical peak: the sustainability and further improvement of margins/profitability are a question mark but not impossible given improved corporate governance and increased focus on the stockholder
      - 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).
      - Valuation (forward P/E at 13,0) is below the long term average.

EPS has been improving

### Emerging market equities | **Underweight**

- Weak performance from Turkey, Russia, South Africa, or Indonesia, some linked to tariffs and sanctions imposed by the US and Trump administration (in particular Russia). Cyclical sectors suffered relatively more than defensive sectors.
- EPS has been improving in Asia while Latin America lost ground.
- Exposure to Information Technology (>28%) is major source of risk given elevated valuations in this sector
- Even if Emerging Markets have an exposure to the global growth recovery, we see risks for the region

## Asset Allocation Flash

### In a nutshell

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

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