Asset Allocation Flash

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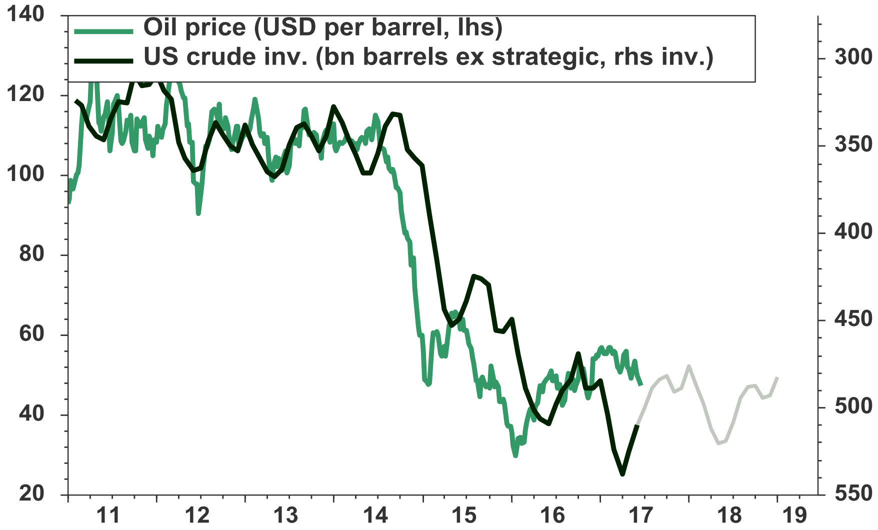
Graph of the month (June 2017)

Oil price kept in check by high US inventories



Source: Thomson Reuters Datastream, Degroof Petercam

Global

Solid cyclical momentum

- Economic confidence indicators continue to point to a solid cyclical growth momentum across sectors and regions. Besides, global trade is showing early signs of improvement. Following numerous false starts in recent years, the current recovery looks stronger, more broad-based and more sustainable. That said, the significant difference between (soft) confidence indicators and (hard) measures of economic activity is questioning this to some extent.
- What's more, the world economy is still largely dependent on very loose monetary policy. Political risks remain tilted to the downside but appear to have eased somewhat more recently.
- Despite the extension of the December agreement, OPEC and other major oil producers have failed yet again to alter the outlook for oil prices. The softness in energy and metal prices persists and this warrants some caution, considering for example their relation with Chinese confidence indicators.

- Base effects linked to commodity prices continue to support inflation but have now started to fade. This means headline inflation is heading somewhat lower again. Underlying inflation is expected to gain strength as the cyclical recovery confirms, even though it remains modest and below target in most developed markets for the time being. This implies that monetary conditions will stay loose for now even though the Fed is eying a gradual tightening of monetary conditions.
- The structural economic outlook is still clouded against the back of demographic headwinds, slower productivity growth, the debt overhang, geopolitical concerns and the difficult economic rebalancing process in China.

United States

Solid household consumption growth

- Even though revised upwards, economic activity growing 1.2% QoQa in the first quarter remains disappointing. However, this should only be a temporary setback. Judging from the upbeat levels of consumer and business confidence, the second quarter should come in better.
- May's job report was somewhat disappointing considering that employment gains were not as strong as previous months. At the same time, the U3 unemployment rate reached a new low of 4.3% and the U6 underemployment rate fell further to 8.4%.
- Disposable income growth, consumer sentiment and the favourable housing and labour market backdrop still point to solid household consumption growth. It's also encouraging to witness early signs of an upturn in private investment.
- Headline inflation is still close to the Fed's target of 2% but base effects are pushing it a bit lower again. Meanwhile, most survey evidence is not pointing to a swift acceleration for underlying inflation in the months to come while market-based measures of inflation remain low in historical perspective. Survey-based measures of inflation, meanwhile, are broadly stable in recent months. Moreover, wage growth is still modest at around 2.5% YoY.

Eurozone

GDP expanding at 1.8%

- Economic activity confirmed in Q1 with GDP expanding at 2% in QoQa terms. Economic confidence indicators throughout the whole of Europe and across sectors continue to surpass expectations, suggesting strong growth in Q2 as well. The unemployment rate fell to 9.3% in April demonstrating the ongoing improvement in the European labour market.

- The outlook for household consumption growth remains upbeat, illustrated by rising consumer confidence indicators, even though household disposable income growth may soften somewhat in the months ahead.
- Whereas the Eurozone is experiencing a cyclical recovery, structural headwinds in the form of ageing and insufficient progress towards a budgetary, political and banking union remain present.
- Headline inflation dropped back to 1.4% in May after moving higher in April due to this year's timing of Easter. Underlying inflation was subject to the same seasonal distortion and dipped below 1% in May. All in all, even though core price pressures should rise somewhat against the back of a more positive growth momentum, the ECB still looks to experience difficulties in getting inflation up to its target of 2% in a sustainable way.
- Therefore, the ECB is in no hurry to leave its zero interest rate policy or dismantle its asset purchase program (60bn EUR each month until the end of 2017) program for now. That said, 'ECB tapering talk' will become more pronounced as the year proceeds and economic activity confirms.

Emerging Markets

China set for a comeback

- Sentiment towards EM has improved since early 2016 against the back of a more cautious Fed, stabilization in commodity prices and reduced concerns about China's near term prospects. In addition, EM have experienced an export-led cyclical recovery on the back of an improved global environment. While the 'reflationary trade' has supported commodity-dependent countries, this effect seems to have passed now. Moreover, recent softness in metal prices is pointing to a slightly weaker growth picture in China.
- China's challenging rebalancing exercise and uncertainties linked to monetary policy tightening in the US could still expose more EM weakness. Moreover, Trump's presidency bodes risks for EM (~trade policy, ~protectionism) even though risk of fierce US protectionism do not seem to materialize for now. Geopolitical tensions surrounding the Korean peninsula and South China Sea remain present.
- Although very difficult to time, concerns about China look set for a comeback. Indeed, the background of soaring house prices and

continued rapid credit growth is far from comfortable. In the March National People's Congress, Chinese policymakers have changed the growth target to 'around 6.5%, or higher if possible', down from '6.5% to 7%' last year while highlighting the need to cut excess supply and monitor financial risks. There is now early evidence that the soft tightening of monetary conditions is starting to have a dampening effect on economic activity.

- From an EM wide perspective, inflation remains under control though base effects linked to commodity prices are also at play in most countries, including China. Significant differences between countries exist but in most EM remains within target corridor. All in all, the combination of modest economic activity, stabilization in EM currencies and commodity prices should make sure EM headline inflation remains in check.

Forecasts

	GDP			Inflation		
	2016	2017	2018	2016	2017	2018
US	*1.6*	**2.0**	**2.0**	*1.3*	**2.3**	**2.2**
		2.1	*2.4*		*2.4*	*2.2*
Eurozone	*1.7*	**1.8**	**1.6**	*0.2*	**1.5**	**1.5**
		1.7	*1.6*		*1.6*	*1.4*
Japan	*1.0*	**1.4**	**1.0**	*-0.2*	**0.6**	**0.9**
		1.4	*1.1*		*0.7*	*1.0*
China	*6.7*	**5.5**	**5.0**	*2.0*	**2.1**	**2.5**
		6.6	*6.2*		*2.1*	*2.3*

Degroof Petercam forecasts as of June 2017, *Consensus forecasts*

Currencies (vs. EUR)

USD has lost ground

- The USD has lost some ground in recent weeks against the back of easing political risks in Europe and further confirmation of the economic recovery. The currency 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. All in all, downward risks for the USD remain present in a medium to longer term perspective.

- EM currencies experienced downward pressure again since Trump got elected but most recovered since then. In general, China's challenges, the unimpressive growth outlook and political risks warrant caution.

Asset Classes

Prudent stance on risky assets

Cash | Neutral

- Cash is neutral

Underweight duration

Government bonds | Underweight

- Long term rates in the eurozone have trended lower, but remain broadly range bound. The combination of tepid inflation readings (reflected by low market based inflation expectations) and the QE purchase programs will continue to keep long term rates low and the steepness of the yield curve suppressed. Consequently, our scenario for the 10 year Bund fluctuating in the 5 - 65 bps range remains valid. We confirm our Underweight stance for EU Government Bonds and Underweight duration.
- Periphery spreads have narrowed but remain relatively high, given the reduced political risk in the eurozone. We remain cautious however on Italy, where early elections in the autumn of this year are still possible, albeit less likely following the failure of passing the new electoral law (proportional composition of the two chambers and 5% election threshold). The sale of Banco Popular also points to the fact that the weak banking system in Spain and Italy will be tackled.
- As expected, the Fed has hiked its key rate in mid-June. We stick to our scenario for a third rate hike later this year and another 3 hikes in 2018. More importantly, the Fed laid out plans for shrinking its balance sheet. The Fed will begin its balance sheet normalisation by reducing its asset holdings by a trivial $10bn per month. The run-off will increase by $10bn every three months until it maxes out at $50bn per month. The normalisation could begin 'relatively soon', which would probably mean the start of the fourth quarter.
- Inflation readings have more upside than downside risks attached.

Default risk in check

Euro IG Corporate Bonds | Neutral

- Default risk is to remain under control for the foreseeable future thanks to sufficiently robust credit fundamentals and low interest rates.
- Yield pickup is the main motivation for corporate IG bonds in an environment supported by the ECB's monthly purchases. We expect spreads to remain contained within narrow ranges.

Continue neutral stance

Euro High Yield Bonds | Neutral

- Spreads continued to grind tighter and at the same time € HY has reached an all-time low benchmark yield at 3.20%.
- The macro and micro fundamentals are supportive for the asset class. However, the current spread level fully reflect this condition. At current levels, spreads do not provide sufficient cushion to protect against any important increase in rates or any decline in equity market valuation.
- In an environment of elevated valuation levels but no immediate threats within the asset class to derail performance, we continue to have a neutral stance on European HY.

Potential consolidation

LC Emerging Market Debt | Slight overweight

- Valuation for EM bonds in Local Currency is beginning to look rich as too many investors are chasing a too small market. However, we are seeing a number of short term factors signalling a potential consolidation/correction in the market, e.g. weaker commodity prices, higher US real interest rates and underperformance of manufacturing PMIs vs. Developed Market economies. Medium term fundamentals remain very supportive.
- As in the short term we have become more cautious about the sector, we have lowered the position to Slight Overweight.

Favouring Europe

Developed market equities | Slight overweight

- With the political agenda for the most part behind us, markets are again focussing on earnings and monetary policy. Both seem to be supportive for equity in the foreseeable future. However, in absolute terms valuations are no longer cheap. We confirm our Slight Overweight position, favouring European equities.
- Geographical allocation remained unchanged. We remain Overweight European equities and are Slightly Underweight on US equity.
    - Economic surprises are far more positive in Europe, compared to the US,
    - EPS revisions are positive for Europe and flat for the US,
    - The US investors fled out of Europe in 2016 and are starting to come back: this will be key to forward outperformance of **Europe,**
    - **Valuations remain more appealing in** Europe (15.4x forward earnings) than in the US (17.9x) but this is consistent with better quality of US market,
    - In the US, the Trump trade is fading as potential for further deception for implementation of economic and fiscal

measures increases.

- We are also Underweight equities in Japan even if valuations are attractive (13.9x forward earnings) and earnings revisions are improving.
    - Sustainability and further improvement of margins and profitability is still a big question mark.
    - Japan's relative performance still linked to the evolution of JPY.
    - EPS revisions are strong, but mainly coming from cyclical sectors.

Latin American political risk

Emerging market equities | **Slight underweight**

- Political risk reappeared in Latin America following the corruption scandal involving the Brazilian president Temer. Brazil reforms could take longer and be more complicated than expected: we consider it too soon to buy the dip.
- We still recommend prudence for the EM region based on expected further USD strength (Fed), weak metal (and commodities) prices, tightening of China monetary conditions, steady growth in debt level and the Brazil risk.
- Emerging Markets equities' valuations (12.2x forward earnings) are more appealing than in developed countries, but the China risk partly accounts for this.
- We are slightly underweight for Emerging Markets.

Asset Allocation Flash

In a nutshell

Asset	May-17	Change	Jun-17
	ASSET ALLOCATION DECISIONS		
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	N		N
Equities	**OW**		**OW**
Europe	OW		OW
World ex-Europe	UW		UW
Emerging Markets	UW		UW
Alternatives			
Convertible Bonds	N		N
Real Estate	OW		OW
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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