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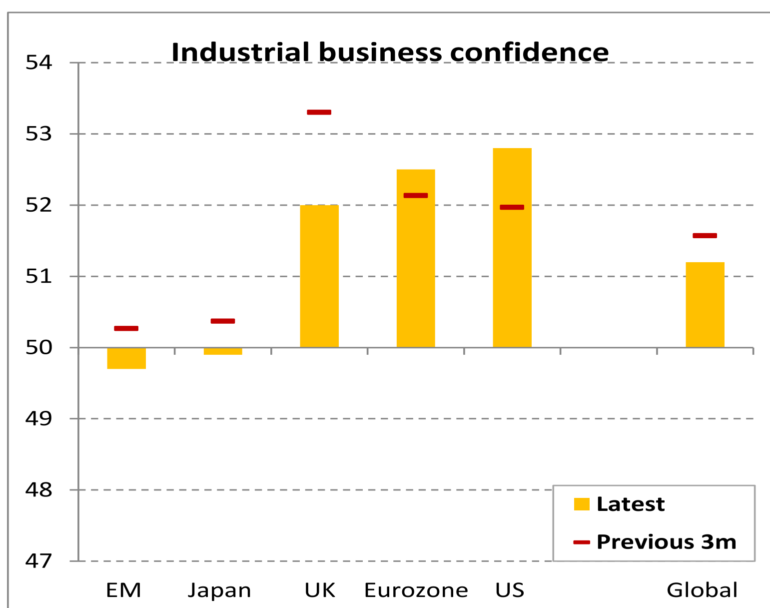
Petercam IAM Asset Allocation Committee | July 2015

GRAPH OF THE MONTH



GLOBAL

Q1 growth in the US was very weak

- More recently, several factors including a **very weak** Q1 growth figure in the US, Greek issues threatening to undermine the early Eurozone recovery and more alarming sounds from China have contributed to doubts about the strength of the world economy. Though the risks are real, we have good reasons to believe that the global recovery will not end abruptly and instead continue against the background of very loose monetary policy, less budgetary tightening and lower energy prices. This is also consistent with the picture portrayed by current global confidence indicators.

- **Headline inflation** in developed markets will pick up from current very low figures as the downward pressure of lower oil prices fade. That said, there is still slack in the global economy that's holding underlying inflationary pressures in check.

UNITED STATES

Confidence indicators are consistent with growth

- The **complete growth stall** in the first quarter of this year is not representative for the actual state of the economy. Even though most confidence indicators have softened a touch and momentum slowed down from the spectacular growth rates seen in the spring and summer of 2014 (around 5% annualized), almost all indicators paint a picture of a continuing recovery. Indeed, there are convincing reasons to believe that economic activity earlier this year was largely held down by transitory factors. The unseasonably cold winter, the scaling back of investment in the shale oil industry following the fall in the oil price, the port strikes at the West Coast and the stronger USD have all weighed on economic activity. While the negative effect of the first three factors has largely disappeared, it's very unlikely that the recent dollar appreciation will derail the fairly closed US economy.

- All in all, in contrast to the complete absence of growth in the first three months of the year, most recent **confidence indicators** are consistent with growth between 2 and 2.5%, not too far from most estimates of long term potential growth in the US.

- **Headline inflation**, currently at 0%, will increase significantly in the coming months as the drop in energy prices seen earlier starts to have less of a negative impact. But given the recent volatility in energy prices, it's actually more useful to look at underlying measures of inflation. At 1.7% and 1.2% for core inflation and core PCE (personal consumption expenditures) inflation respectively, underlying inflation remain below the Fed's 2% target over the medium term. In fact, over the last five years the Fed has failed to deliver on this front. Looking forward, however, underlying inflation is set to pick up from current levels.

EUROPE

Economic momentum is improving

- In the Eurozone, leading indicators show **economic momentum** is improving. Earlier ECB stimulus measures resulting in lower interest rates and EUR depreciation, reduced budgetary tightening efforts and lower oil prices are driving this cyclical recovery. This is encouraging following years of stagnation. That said, the economic recovery is still nothing to cheer about and could easily be derailed if the negotiations between Greece and its creditors fail.

- A **last minute compromise** on the final payment of the second bailout plan still seems the most likely scenario. But even in this case, given the scheduled debt repayments and the fact that the Greek government cannot tap financial markets, a follow-up program is needed. Negotiations looks set to remain difficult in this respect.

- **Headline inflation** in the Eurozone will increase significantly in the second half of the year as the base effects linked to the decline in energy prices fade. Underlying inflation, although set to pick up from the current 0.9%, is likely to stay low by historical standards. The ECB has been completely missing its 2% inflation target over the last couple of years and it remains unlikely that the ECB will achieve it anytime soon.

ASIA

Japanese economic sentiment slightly improving

- In Japan, most **leading indicators** point towards a small improvement in economic sentiment. That is reassuring following the decrease in confidence witnessed since begin 2014. As a result, industrial production growth is likely to jump back into positive territory. That said, economic momentum is still modest at best. Moreover, the 2.4% annualized growth rate seen in the first three months of the year is flattered by a build-up in inventories. Growth figures in the next couple of quarters are likely to make clear that growth is still fairly weak.

- EM are clearly on a **slower growth path**. The divergence between EM remains large with confidence in net commodity exporters significantly below the levels seen in the net commodity importing countries. In China, economic growth in the next couple of years will continue to slow from current levels as the gradual switch from investment and export-led growth towards consumption economy takes place. As things currently stand, ample monetary and budgetary room for maneuver substantially reduces the risk of an imminent hard landing.

- The **downward pressure on inflation** stemming from lower commodity prices looks set to ease over the coming months. This means that overall inflation in EM will accelerate somewhat in the months ahead so that most of the monetary policy easing seen in EM over the past year is probably behind us. But with core inflation staying modest in most parts of the emerging world, there is good reason to believe that monetary policy will stay relatively loose in the foreseeable future.

MONETARY POLICY

Inflation in Japan has come down significantly

- Against the back of a continuing recovery and upward inflation pressures the **Fed** is still on course to start hiking interest rates before the end of the year. As things currently stand, an increasingly tighter monetary policy stance can be expected in the years thereafter. That said, the Fed is likely to proceed gradually and only if the underlying economic momentum remains strong enough.

- In the **Eurozone**, the ECB's QE program. This has already had a substantial impact on equity markets, interest rates and the euro. Criticism about the negative consequences of this policy is increasing. In combination with improving economic data, this is likely to put pressure on the ECB to reduce the program prematurely. However, given the still fragile recovery and the presence of massive challenges in the Eurozone, the chances that this will happen remain small.

- In **Japan**, inflation has come down quite significantly as the base effect from the April 2014 tax hike has disappeared from the numbers. On the other hand, household's expectations about future inflation remain clearly positive and survey indicators suggest wage growth will accelerate somewhat in the next couple of quarters. Despite all this, we remain far from convinced that the Bank of Japan will structurally achieve its 2% inflation target. Therefore, the most likely scenario is that monetary policymakers will scale up the pace of the current asset purchase program.

- In **China**, policymakers have already responded to the deteriorating economic momentum by cutting interest rates and bringing down the required reserve ratios for commercial banks. More easing can still be expected but a massive stimulus program is not on the cards given the huge financial imbalances built up since 2008.

FORECASTS

	GDP			Inflation		
	2014	2015	2016	2014	2015	2016
US	2.4	**2.2**	**2.4**	1.6	**0.2**	**1.9**
		2.2	2.8		0.3	2.2
Eurozone	0.9	**1.4**	**1.4**	0.4	**0.2**	**1.3**
		1.5	1.7		0.2	1.3
Japan	-0.1	**1.0**	**1.2**	2.7	**0.7**	**0.9**
		0.9	1.5		0.8	1.2
China	7.4	**6.5**	**6.0**	2.0	**1.4**	**1.7**
		7.0	6.7		1.5	2.1

Petercam forecasts in bold*, consensus forecasts in regular font*

CURRENCIES

Most EM currencies have appreciated against the EUR

- The **diverging outlook** for monetary policy in the US and the Eurozone, with the Fed heading towards a first rate hike, while the ECB has just started its QE-program, has been a key driver of the significant strengthening of the dollar versus the euro in recent months. On fundamental valuation measures, the dollar is now starting to look expensive. A strong USD appreciation from the current levels should not be taken for granted. That said, the risks surrounding Greece and the possibility of an extra round of ECB QE pose downward risks for the EUR.
- Over the past two years the **UK economy** has been recovering significantly faster than the Eurozone. Against that backdrop the GBP has been strengthening versus the EUR. All in all, on valuation measures most of the upward GBP potential seems to have been realized.
- In **Japa**n, bold monetary policy measures over the last two years have clearly affected the yen. Between late 2012 and the end of 2014, just before the ECB embarked on its full-blown quantitative easing plan, the yen had depreciated more than 35% versus the euro. However, since mid-December the yen has won back around 5%. EUR/JPY is currently hovering around 135, the level corresponding to the long-term purchasing power parity valuation. Looking forward, we see downward risks for the JPY as the BoJ is likely to scale up the pace of its asset program.
- Against the back of **broader EUR weakness** seen since the beginning of this year, most EM currencies have appreciated against the EUR. EM currencies could come under pressure again once the Fed moves on the first rate hike. However, given the depreciation already seen since the spring of 2013, the risk of another sharp hit now looks significantly smaller. That said, some currencies including the KRW, THB, INR and PHP look expensive.

ASSET CLASSES

Returns are very low

- Cash | **Neutral**

- Cash is neutral
- It reflects our prudent stance on risky assets

Risks are more broadly balanced

- Government bonds | **Neutral**

- Bonds have performed extraordinarily well during 2014 and the start of 2105 thanks to interest rates falling to all-time lows in Europe on the back of concerns about low growth and deflation, and more recently driven by the ECB QE program.
- The risk of a significant uptick in interest rates is limited and the symmetry in potential rate moves is broadly balanced. The return potential of European government bonds nonetheless remains small but in line with the low growth and inflation environment. In that sense, it does not offer compensation for the associated risk, but government bonds still have significant potential as a diversifying asset in mixed portfolios.
- Within the government bond universe, inflation-linked bonds offer a more interesting opportunity, especially outside the Eurozone, as they are likely to benefit from the coming uptick in headline inflation. The market is also pricing a more balance inflation outlook. Earlier this year, the main risk was a deflationary shock whereas now the risks are more broadly balanced.

Drop over the month

- Euro IG Corporate Bonds | **Underweight**

- After six years of stellar performances in Euro IG corporate bonds we witnessed a stumble during H1 2015. Over H1 2015 € IG corporate bonds retreated by 1.55%. The drop into negative territory occurred in only 1 month, the month of June 2015 with the Iboxx corporate index dropping 1.97%.
- On a sector level we like the recovery theme within Basic resources. We are overweight on technology as well given their pricing flexibility in combination with margin stability. We favor US Telco vs EU Telco. Healthcare closes the list of sectors that we attribute an overweight positioning to.

Investors remain disciplined

- Euro High Yield Bonds | **Neutral**

- Euro high yield bonds are trading at their widest spread since the start of the year.
- At a spread of 412 bps, the implied default rate is above 6%. (40% recovery rate).
- Latest deals show that investors remain disciplined over credit quality and the spread they request.

Steep yield curves

- Emerging Market Debt | **Neutral**

- Euro EMD offers high liquidity & volatility-adjusted carry opportunities within the fixed-income universe, in both nominal and real terms.
- EMD also offers powerful diversification in a global fixed-income portfolio.
- Yield curves are steep and currencies are cheap in real effective terms, uncomplacently pricing in the Fed rate hike cycle, the uncertainty around Greece as well as China economic slowdown.
- Institutional positioning is low and poised to grow a lot further, given the strong weight of emerging economies in global GDP, international trade and central banks' FX reserves.

US markets looking expensive

Developed market equities| **Overweight**

- The combination of global economic recovery and aggressive monetary stimulus has pushed equity markets higher. Both drivers have further to go, even if markets have already anticipated this to some extent.
- In the Eurozone, the combination of positive dynamics in the economy and the announcement of QE by the ECB has pushed equity markets significantly higher. The translation of the improving economic situation in increasing corporate earnings in coming months should support markets going forward. The Greek crisis has reached a tipping point, but our assumption is still that a Grexit will eventually be avoided, even if we acknowledge that the probability of such a worst case scenario has risen.
- Earnings growth continues to be very strong in Japan, is improving in Europe, but deteriorating in the US.
- In the US, markets are looking expensive, while other developed markets have also become more expensive.
- The move of the Fed towards a first rate hike will lead to increased volatility in coming quarters, and not only in the US.
- In light of the recent rally and in the run-up to the first rate hike by the FED, we are becoming more cautious about equities. For now we remain positive on European and Japanese equities, but negative for US equities.

Vulnerable to liquidity changes

Emerging market equities| **Neutral**

- Recent strong performance in EM equities has been mainly linked to the boom in Chinese equities following changes in regulation.
- EM equities are likely to prove vulnerable to changes in liquidity conditions on the back of the Fed moving to a first rate hike.

KEY TAKE-AWAYS

- We do not alter our stance versus last month : still prefer equities over bonds.
- Eurozone unemployment remains uncomfortably high
- Greece has the potential to catch up if confidence is restored
- Sustainable growth in southern Europe is key
- Eurozone consumers are becoming more optimistic
- The US labour market continues to improve
- Emerging markets remain on a slower growth path

IN A NUTSHELL

	ASSET ALLOCATION DECISIONS		
Asset	**Jun-15**	**Change**	**Jul-15**
Cash	**N**		**N**
Fixed Income	**UW**		**UW**
Government Bonds	N		N
Inflation-Linked	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	N		N
Alternative			
Convertible Bonds	N		N
Real Estate	N		N
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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