Degroof Petercam

Asset Allocation Flash

Editing & Co-ordination:
Petercam Institutional Asset Management
Asset Allocation Committee
Contact: piam@degroofpetercam.com
www.degroofpetercam.com
funds.petercam.com
insights.petercam.com
Twitter: @bdp_nl + @bdp_fr + @bdp_uk

Graph of the month

Global

Economic activity in DM holding up well

- Recent worries about the Chinese economy have caused a lot of financial market turbulence. Even though the downward risks are substantial, we believe the global recovery will not end abruptly and instead continue moderately against the background of both loose monetary and budgetary policy and also lower energy prices. This is consistent with the picture portrayed by current global confidence indicators.
- Economic activity in DM is holding up relatively well while EM are going through difficult times.
- Despite the recent new fall in commodity prices, base effects will send headline inflation higher over the next months. Core inflationary pressures, while firming in some regions, look set to remain modest. This implies that global monetary policy will stay very loose in the foreseeable future.

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United States

Confidence in the manufacturing sector is lagging

- Following the growth stall (0.6% QoQa) in the first months of the year (largely due to temporary factors), economic activity accelerated during the spring (3.7% QoQa). Leading indicators have come down more recently but are still consistent with around 2% growth.
- Confidence in the manufacturing sector is suffering from a stronger USD and low oil prices, respectively weighing on exports and investment in the energy sector.
- Confidence in the service sector, although softening a touch, is still close to historically high levels. This is consistent with relatively upbeat consumer confidence. Consumer spending should remain healthy against the back of the ongoing housing and labour market recovery.
- The recovery in the labour market continues albeit at a somewhat slower pace. In the first half of the year 211K monthly new jobs were created on average. Over the last 2 months, however, the average dropped below 167K with figures for August and September (136K and 142K respectively) quite disappointing. That said, survey indicators in this respect remain upbeat. In addition, other indicators including initial jobless claims and job openings all point to further labour market strength.
- Headline inflation, currently at 0.2%, will increase 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 1.8% and 1.3% 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 modestly from current levels. Importantly, leading indicators suggest that wage growth will accelerate further. Without seeing a meaningful acceleration in productivity growth at the same time (an assumption which remains to be tested) this will translate into higher inflation.
- While US policymakers are not in a hurry, the Fed is still on course to start hiking interest rates in the near future. Clearly, recent market turmoil and the fact that inflation remains below the Fed's target imply that it is likely to adopt a very cautious approach. Financial markets are now expecting that the first rate hike will be

delayed until spring 2016 but uncertainty around the exact timing looms large. That said, the most important message is that monetary policy looks set to remain highly accommodative in the foreseeable future.

- As things currently stand, an increasingly tighter monetary policy stance can be expected in the years to come. That said, the Fed is likely to proceed gradually and only if the underlying economic momentum remains strong enough.

Europe

European economy growing at a moderate pace

- European economy continued to grow at a moderate pace. Economic activity came out at 1.4% on a quarterly annualized basis in the second quarter, a slight disappointment given all the positive supports. Oil prices hover close to $50 per barrel, monetary policy is very accommodative and the EUR depreciation is a welcome development for the external sector. Leading indicators are still in line with a growth rate around 2%
- Consumption should continue to increase at a moderate pace supported by the slow but gradual improvement observed within the labour market, resilient consumer confidence and low oil prices
- The latest ECB's actions (QE, TLTRO) reduced credit fragmentation between core and peripheral companies and thus contributed to the pick-up in credit activity and augur for a modest recovery for investment
- Inflation (-0.1% yoy) came back in negative territory in September. This negative reading is expected to be temporary. If CPI should remain close to 0 in October and November, a rebound is expected in December and January (positive base effects from lower oil prices). However, inflation should remain below the ECB's 2% inflation target in 2016
- Limited increase in growth combined with low inflation increase the likelihood the ECB will extend its QE beyond September 2016 meaning European rates could remain at low levels for a longer period than initially expected
- Greece is for the moment out of the new thanks to the new bailout package but should soon come back in the spotlight as nothing has been done to reduce its indebtedness. With the new austerity measures, the country will probably miss both its primary surplus and growth targets. A haircut on debt is unavoidable.

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Asia And Em

Japanese industrial production going in the red

- In Japan, industrial production growth slipped back into negative territory in August and confidence indicators weakened further in September. All this suggests that economic activity is still very modest at best. The tightening labor market points in the direction of accelerating wage growth though other evidence paints a more nuanced picture. Inflation, meanwhile remains significantly below the Bank of Japan's 2% target. Most likely, the combination of sluggish economic activity and below target inflation will prompt the BoJ to expand its monetary stimulus program in the near future.
- More broadly in EM, the slowdown witnessed over the last few years reflects several factors including the negative effect of lower commodity prices, tighter external financial conditions linked to the prospect of the first rate hike in the US, the economic rebalancing in China, structural bottlenecks as well as distress related to (geo)political factors.
- Economic growth in EM has slipped below the average over the past 35 years. Moreover, Brazil and Russia are struggling with recession. Several observers are now arguing that EM are in fact submerging. Although this seems exaggerated, it is hard to overlook the big difference with the spectacular growth story seen last decade. In its July update on the world economy the IMF projects that growth in EM will slow to 4.0% this year from 4.6% in 2014. The latter already marks a clear slowdown from the 6.1% growth figure seen between 2000 and 2012.
- Economic activity in EM is still very sluggish, particularly in Latin America. Several observers argue that the ongoing market turbulence will trigger a 1997-style crisis. However, this is not our base case scenario because there are several important differences. More flexible exchange rates, lower levels of external debt and significant amounts of international reserves should protect most EM against a full-blown financial crisis. Moreover, China's stimulus measures are likely to make sure that imminent hard landing fears will soon start to fade. Finally, the currency depreciation seen in many EM since 2013, should eventually translate in improved competitiveness when combined with further productivity enhancing reforms. To be clear, as mentioned earlier, current financial and economic conditions as well as structural issues will make sure that EM are not up for a rapid recovery
- Disappointing Chinese economic data, the recent stock market

crash and especially the (still minor) RMB devaluation have all caught the attention of international investors. To be sure, there are reasons to worry about economic activity in China. On the other hand, this is not new and policymakers have acknowledged this since they started to ease monetary policy late last year. Both earlier and additional policy measures (both monetary and fiscal) should soon ease the current hard landing fears. The recent RMB depreciation is probably not the start of a broad based attempt to boost exports, in turn triggering monetary retaliation efforts by other central banks. As market forces will be allowed to play a more important role in the future, it cannot be excluded however that the RMB will see further minor and gradual depreciation in the foreseeable future.

Forecasts

	GDP			Inflation		
	2014	2015	2016	2014	2015	2016
US	*2.4*	**2.5**	**2.2**	*1.6*	**0.1**	**1.7**
		2.5	*2.7*		*0.3*	*2.0*
Eurozone	*0.9*	**1.4**	**1.3**	*0.4*	**0.1**	**1.2**
		1.5	*1.6*		*0.1*	*1.2*
Japan	*-0.1*	**0.6**	**1.0**	*2.8*	**0.7**	**0.7**
		0.7	*1.2*		*0.8*	*1.0*
China	*7.4*	**5.0**	**6.0**	*2.0*	**1.5**	**1.9**
		6.8	*6.5*		*1.6*	*2.0*

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

Currencies

BoJ policy has influenced the yen

- 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 quarters. On fundamental valuation measures, the dollar is 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 Japan, 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 (minor) downward risks for the JPY as the BoJ is likely to scale up the pace of its asset program in the near future.
- EM currencies performed well during the first months of the year (on the back of euro weakness) but experienced severe downward pressure more recently. Investor appetite for EM assets has waned and sustained EM currency weakness is likely. However, given the depreciation already seen since the spring of 2013, the risk of another sharp hit now looks significantly smaller. Indeed, in real effective exchange rate terms, EM currencies have depreciated on average around 10% since May 2013 which implies that the average level is now close to 3% lower than the 30y-average.

Asset Classes

Prudent stance on risky assets

Cash | Neutral

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

Inflation-linked bonds are more compelling

Government bonds | Underweight

- Bonds have performed extraordinarily well over the last few years thanks to interest rates falling to all-time lows in Europe.
- Yields should gradually increase supported by stronger growth and higher inflation.
- A significant uptick in interest rates in the months to come is not our main scenario: the rebound in growth should be moderate, inflation should remain below the ECB's 2% target and an extension of the QE beyond September 2016 is not to exclude.
- Within the government bond universe, inflation-linked bonds could offer an interesting opportunity as they are likely to benefit from the coming firming in inflation.

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Valuations remain stretched

Developed market equities | **Neutral**

- Absolute valuations are no longer cheap but relative valuations versus fixed income assets are still attractive
- Possible QE extension in the Euro area push us to be more constructive on this area compared to the US
- The recent correction offer some opportunities but major risks remain: Chinese deceleration, tightening cycle in the US, Greece could come back in the spotlight

Expected returns very low

Euro IG Corporate Bonds | **Underweight**

- Corporate credit spreads widened following the recent turmoil and appear more attractive than a few months ago
- However, they still evolve well below the level reached in 2009 or in 2012
- Expected return for investment grade bonds remains very modest due to the low absolute yield. Small uptick in government bonds or spreads could rapidly lead to negative performance

Appealing valuations, but…

Emerging market equities | **Neutral**

- Emerging valuations are quite appealing
- However earnings growth are still revised downwards
- EM equities are also likely to prove vulnerable to changes in liquidity conditions on the back of the Fed moving to its first rate hike.
- Wait for a better macroeconomic environment in emerging countries to become more constructive

Recent spread widening

Euro High Yield Bonds | **Neutral**

- HY were quite expensive at the beginning of the year. The recent spread widening makes valuation more attractive
- The quality of HY issuer is clearly deteriorating

Stay put

Emerging Market Debt | **Neutral**

- Chinese devaluation during the summer led to a strong decline in emerging currencies, which appear attractively valued compared to the EUR or USD
- The postponement of the first rate hike is also a positive short term support for this asset class
- Macro environment is rather weak in emerging countries. Wait for a stabilization / improvement to become more positive on the asset class

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Key Take-Aways

- Neutral on developed market equities
- We do keep a preference for equities to bonds
- European equities are the preferred choice in terms of region
- Recent spread widening makes HY valuation more attractive
- It is still too early for EM debt
- Weak economic activity in EM is likely to persist for some time

In A Nutshell

	ASSET ALLOCATION DECISIONS		
Asset	**Sep-15**	**Change**	**Oct-15**
Cash	**N**		**N**
Fixed Income	**UW**		**UW**
Government Bonds	UW		UW
Inflation-Linked	OW		OW
Euro IG Credit	UW		UW
International IG	N		N
EM Debt	N		N
Euro High Yield	N		N
Equities	**N**		**N**
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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