Asset Allocation Flash

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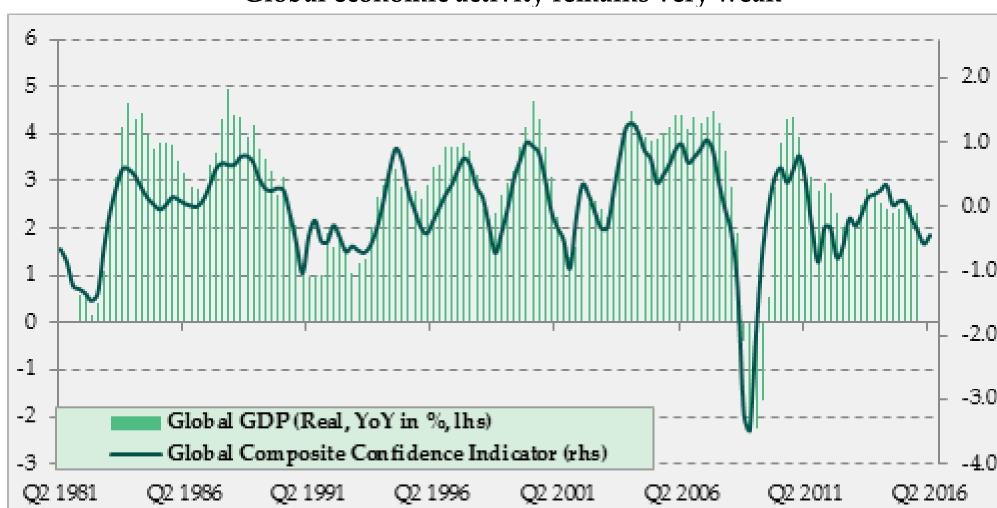
Graph of the month (April 2016)

Global economic activity remains very weak



Global

Uncertainty looms large

- Despite the improvement witnessed in recent weeks, our global composite confidence indicator still suggests that global economic activity remains very weak. What's more, downward risks remain substantial.
- Monetary policy rates are hovering near zero in the Western world. The same goes for real yields on longer term bonds. At the same time, confidence indicators suggest global economic activity remains weak following what has been a very lacklustre recovery since the Great Recession thus far. Meanwhile, despite huge expansions in the size of their balance sheet, most central banks are still desperately looking for higher inflation.
- Uncertainty looms large against the back of China's difficult economic rebalancing exercise, the future path of the RMB, increased awareness among international investors that monetary policy can only do so much when interest rates are near zero, geopolitical risks, signs of hesitation in the US economy, disruptive

effects of the earlier steep fall in oil prices, the shape of the global financial system, the risk of Brexit, the European refugee crisis and high levels of private and public debt,…

- A severe economic crisis in China is still a key risk. Our scenario that China will avoid a hard landing in 2016 remains in place even though the challenges that stem from rebalancing the economy loom large and hard landing fears are likely to continue to linger around. (https://insights.petercam.com/emerging-markets/crossing-the-chinese-river)
- Despite the general very low level of commodity prices, base effects will send headline inflation higher in late 2016. Core inflationary pressures look set to remain modest, implying that global monetary policy will stay very loose in the foreseeable future.
- The USD has appreciated significantly since the summer of 2014 and this has come with serious challenges. (https://insights.petercam.com/developed-markets/more-thoughts-on-the-state-of-the-world-economy). A further sharp appreciation from current levels, however, looks unlikely.
- Looking beyond the short-term, we think the chances of a prolonged period of relatively slow growth (in combination with interest rates around the zero lower bound) are high against the back of strengthening demographic headwinds and less scope for debt accumulation going forward. We would not agree that budgetary and monetary policymakers have lost all ammunition to fight this extremely challenging situation.
- Policy action really could make a difference and consensus is slowly building around the need for more infrastructure spending. Whereas most policymakers have been (wrongly) focusing on balancing public budgets in the aftermath of the Great Recession, they now seem to recognize that more investment could help to spur growth. As resources are idle in a liquidity trap, a crowding-out effect from higher interest rates should not be expected, making this policy (fiscal expansion) more effective. It's not entirely clear whether policymakers are ready to adopt this approach. The G20 Summit held in Shanghai last month did produce some encouraging results in this respect but remain vague at the same time.
- Our view on helicopter money going forward? If governments do spend more as we approach the ZLB, the insurance policy of helicopter money may not be needed. At the same time, even if governments want to do the right thing, lack of good projects or

information delays may mean they cannot do enough. As a result, the very quick action that central banks could take with helicopter money could be a useful compliment. That said, it is far from clear whether policymakers are ready to think more 'out of the box' in this respect. (https://insights.petercam.com/developed-markets/unconventional-monetary-policy-pushing-on-a-string).

United States

US policymakers not rushing to hike interest rates

- Even though most important confidence indicators improved in March, the US economy is not in great shape. 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. That said, survey data from March were more upbeat again with the ISM manufacturing recording the highest figure since last summer. Moreover, the deterioration in service sector confidence witnessed since last October came to a halt in March.
- Though still in line with real consumption growth of around 2%, consumers' expectations about the future are also softening a touch. All in all, consumer spending should hold up against the back of low energy prices, the continuing recovery in the housing market and decent job growth.
- With an average of almost 250K jobs created over the last 6 months, the labour market continues to perform solidly. At 5.0% the unemployment rate is in line with estimates of the NAIRU. Meanwhile the U6 unemployment rate stands at 9.8%, down from more than 11% since the start of 2015 though still higher than the average of 8.9% seen between 1994 and 2007. Surveys measuring employment expectations have been weakening more recently. Moreover, wage growth remains lacklustre.
- Base effects linked to energy prices will make sure that headline inflation (now at 1%) will trend higher towards the end of the year. At 2.3% and 1.7% for core inflation and core PCE inflation (which is more important for Fed) respectively, underlying inflation is moving up. Looking forward, however, evidence is mixed with unit labour costs suggesting that core inflation should pick up further while other survey based price expectations are pointing in the opposite direction. The Fed's board of governors is also struggling with this. While Stanley Fischer sees the first "stirring" of higher inflation, Lael Brainard for example remains sceptical.

Overall, the inflation outlook remains highly uncertain.

- Wage growth plays a key role with regard to the future path of inflation. At this point, despite the acceleration witnessed in recent quarters, wage growth is still subdued at around 2.3% yoy. Interestingly, earlier survey evidence of upward wage pressure now seems to be fading more recently.
- All in all, US policymakers are not in a hurry to raise interest rates. Clearly, recent market turmoil, signs of hesitation in the US economy and the fact that inflation remains below the Fed's target imply that it is likely to adopt a very cautious approach. The most important message is that monetary policy looks set to remain accommodative in the foreseeable future because the US economy is not doing all that great. The Fed is likely to proceed gradually and only if the underlying economic momentum remains strong enough. The recent stabilization in commodity prices, the recent USD depreciation and decreased worries about China could provide a window of opportunity to hike interest rates in June.

Eurozone

Modest growth continues

- The European economy recovery remains highly disappointing against the favourable backdrop of low energy prices, the current low yield environment and EUR weakness. What's more, leading indicators suggest economic activity is showing signs of hesitation.
- Looking ahead, household consumption should continue to increase at a modest pace supported by the slow but gradual improvement observed in the labour market and low oil prices.
- Headline inflation (-0.2 % yoy in February) is held down by the recent steep fall in energy prices but base effects will send it higher in the second half of the year. Underlying price measures on the other hand remain very weak reflecting the slack in the labour market. Given the persistence of the large negative output gap, core inflationary pressures are expected to stay very weak. All in all, the ECB is likely to experience major difficulties in getting inflation up to its target of 2%.
- Our long-held stance that the ECB would eventually be forced to do more was proven right again in March. The key policy rate was cut by 5bp to 0.0% and the interest rate on the deposit facility was decreased by 10bp to -0.4%. Furthermore, the amount of monthly was expanded to €80bn (from €60bn) and the list of eligible assets was increased with IG euro-denominated bonds. Finally, the ECB's March meeting saw the introduction of a new series of 4 LTROs

each with a maturity of 4y. Irrespective of what was announced, we still believe the ECB faces huge challenges to structurally achieve its goal of 2% inflation.

- The Greek situation remains unresolved. Imposed budgetary tightening keeps Greece stuck in recession with unemployment and public debt levels at unsustainably high levels. In this context, political risks remain high.
- In a longer term perspective, European politics remain worrying in the sense that the currency union still faces existential challenges. Further integration, while still very much needed, looks far from evident at this point. Both the refugee crisis and rising popularity of extreme political parties in recent years is likely to make things only more complicated in this respect.
- The political situation in Spain is now increasingly drawing attention because, unlike in the past, no single party has an absolute majority and forming a coalition is difficult. The ECB's QE programme, however, is likely to prevent that government bond spreads widen sharply. The Catalan issue should not be a major problem at least for now. First, Catalans are highly divided. Second, EU membership would not be possible without all other EU members approving it (highly unlikely).
- The Brexit risk is real and the debate has intensified in recent months. All in all, our scenario is that Brexit will be ultimately avoided. That said, risks remain high. The tense situation, however, once again underlines the very challenging European political context. (https://blog.degroofpetercam.com/en/article/brexit-fears-likely-intensify)

Japan and EM

Japanese economic activity still weak

- Economic activity in Japan is still weak. The tightening labour 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.
- The combination of weak economic activity and below target inflation, as we argued before, would eventually prompt the BoJ to expand its monetary stimulus program. Indeed, in its January policy meeting the BoJ applied a negative interest rate of -0.1% to current accounts that commercial banks hold at the BoJ (three-tier system). The BoJ also made clear that it will not hesitate to cut

interest rates further into negative territory if necessary. Serious doubts remain, however, whether this can deliver the desired results. Meanwhile, the JPY has been strengthening again more recently.

- 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, economic rebalancing in China, structural bottlenecks as well as distress related to (geo)political factors.
- Economic activity in EM is still very sluggish and this is unlikely to change soon. More flexible exchange rates, lower levels of external debt in general 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 diminish somewhat, at least for now. 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. Risks remain on the downside
- An imminent Chinese hard landing will probably be avoided as the stabilizing effect of earlier stimulus measures slowly starts to kick in. The latest confidence data show early signs of stabilization. The latest confidence indicators have risen in line with commodity prices and the recent RMB/USD appreciation seems to have reduced the general concern about a near term growth collapse.
- However, the medium to longer term outlook still looks incredibly challenging against the back of the huge Chinese debt overhang, ageing population, less potential to catch up from behind and difficulties linked to further economic rebalancing. Hard landing fears, therefore, are likely to stay with us for many more years. (https://insights.petercam.com/emerging-markets/6-graphs-illustrating-our-current-view-on-chinas-economy). More recently Chinese policymakers have set their new growth target between 6.5% and 7% for the next five year. However, meeting these targets while continuing to make significant progress with regards to structural reforms looks simply impossible. Credit growth remains unsustainably high and house prices are rising fast again, which adds to concerns about the Chinese economy.

- Although it's impossible to exclude the scenario of a large one-off RMB depreciation, we don't think this will happen in the coming months (https://insights.petercam.com/developed-markets/sharp-cny-depreciation-just-around-the-corner). A gradual managed depreciation remains our base case scenario for now.

Forecasts

	GDP			Inflation		
	2015	2016	2017	2015	2016	2017
US	*2.4*	**1.5**	**1.7**	*0.1*	**1.3**	**2.0**
		2.1	*2.4*		*1.3*	*2.2*
Eurozone	*1.5*	**1.1**	**1.4**	*0.1*	**0.6**	**1.3**
		1.5	*1.6*		*0.3*	*1.4*
Japan	*0.5*	**0.3**	**1.0**	*0.8*	**0.3**	**1.5**
		0.7	*0.6*		*0.0*	*1.6*
China	*6.9*	**5.5**	**5.0**	*1.5*	**1.9**	**2.2**
		6.4	*6.2*		*1.5*	*1.7*

Degroof Petercam forecasts as of 11April 2016, *Consensus forecasts*

Currencies

Sharp USD depreciation is not in the cards

- Our long-held stance that the consensus view of a continued USD appreciation should not be taken for granted, has been proven right so far. We continue to think that a sharp appreciation from current levels should not be expected. Despite the latest depreciation the USD still looks rather expensive from a LT-perspective. That said, more evidence of the Fed moving towards another rate hike could lead to a slightly stronger USD in the next couple of months.
- With inflation pressures still very modest and growth prospects weakening, the BoE is not in a hurry to hike interest rates. The risk surrounding "Brexit", an issue that has gained more attention in recent months, poses downward risks for the GBP. That said, the GBP has already depreciated significantly since late 2015. A "remain vote" is likely to result in some GBP appreciation although to a limited extent.
- The JPY has been strengthening more recently. From a LT-perspective, it seems that the JPY has now become a bit too expensive versus the EUR. A further sharp appreciation from current levels looks unlikely. That said, this will largely depend on

upcoming central bank moves from both sides.

- EM currencies experienced serious downward pressure since the May 2013 taper tantrum. Investor appetite for EM assets has waned and sustained EM currency weakness is likely given the subdued growth outlook. That said, given the depreciation already seen since the spring of 2013, the risk of another sharp hit now looks smaller. Indeed, in real effective exchange rate terms, EM currencies (weighted by GDP ex China) have depreciated around 10% since May 2013. For some currencies, including the BRL or RUB the depreciation has been almost 30%.

Asset Classes

Prudent stance on risky assets

Cash | Neutral

- Cash is neutral

ILBs to benefit from stronger headline inflation

Government bonds | Underweight

- Bonds have performed extraordinarily well over the last few years thanks to interest rates falling to all-time lows in Europe. In April, the German bund declined to 8bp, a similar level as last year in April.
- We expect 10y German Bunds to move higher (our trading range is 0.40%-0.60%) which is why we have an Underweight stance.
- In the US, the Fed is likely to use the window of opportunity provided by the recent USD weakness to raise US policy rates in June. Maybe, the FOMC will already provide us with a hint during the April meeting.
- However, a major uptick in interest rates in the months to come is not our main scenario: global growth should be moderate, inflation should remain below the ECB's 2% target and quantitative easing has been extended at least until March 2017. Moreover, the ECB added more stimulus at its March meeting, raising its Asset Purchase Programme (APP) by EUR 20bn to EUR 80bn per month.
- Within the government bonds universe, US Treasuries and global inflation-linked bonds (both partially EUR hedged) offer an interesting opportunity.

ECB surprised markets

Euro IG Corporate Bonds | Overweight

- Corporate credit spreads tightened at the end of February / beginning of March but they still offer an attractive entry point, especially in this environment of low interest rates for longer.
- Moreover, at its March meeting, the ECB surprised markets by announcing a corporate bond purchase program. We expect the

forthcoming announcement regarding the technical details of its implementation to trigger further spread tightening. Beware the expected return for investment grade bonds remains modest due to the low absolute yield.

Many falling angels arriving

Euro High Yield Bonds | Neutral

- High yield spreads also tightened at the end of February / beginning of March but they still offer an attractive entry point, especially in this environment of low interest rates for longer.
- The asset class is witnessing the arrival of many "fallen angels", mainly from the Materials sector.

EM currencies have attempted to stabilize

Emerging Market Debt | Overweight

- After their strong decline, which started in 2010, emerging markets currencies have recently attempted to stabilize. Further upside from here depends on the confirmation that commodities prices have bottomed out.
- The Chinese currency also seems to have stabilized after the devaluations of August 2015 and January 2016.
- Some currencies are starting to appear attractively valued compared to the EUR or USD
- Meanwhile, yields remain at attractive levels.

Eurozone valuations more compelling

Developed market equities | Underweight

- Valuations are less attractive after the market rally that started at the end of February. This is especially so in the US.
- Meanwhile, although forward earnings expectations have stabilised, earnings growth prospects are unexciting.
- We prefer the Euro area (where we are Overweight) to the US (where we are strongly Underweight):
    - QE in the Euro area until 2017
    - The profit cycle for Euro area companies is less mature than in the US
    - Valuations are more appealing in the Euro area than in the US
- We are also Underweight equities in Japan as earnings estimates there are continuously being revised downwards.

Valuations more appealing than elsewhere

Emerging market equities | Neutral

- Emerging valuations are more appealing than elsewhere
- Earnings expectations have stabilised. Further upside from here depends on the confirmation that commodities prices have bottomed out and improving prospects for the Chinese bank sector.

- Meanwhile, the macro environment remains weak, although there are early signs of improvement

Key Take-Aways

- Underweight on developed market equities, with a strong underweight in US equities
- Eurozone equities are the preferred choice in terms of region
- EM equity markets are cheap, but we do not see an improvement on the earnings front
- We are overweight bonds (but underweight duration) via investment grade credit. Eurozone investment grade credit has become even more interesting after the ECB's March meeting. The yield on US investment grade credit is attractive as well.
- The list of risks to our asset allocation includes slower growth in the US than consensus forecasts, European politics (and its effect on confidence), and especially a potential Chinese hard landing.

Degroof Petercam | Asset Management

Asset Allocation Flash

In A Nutshell

Asset	ASSET ALLOCATION DECISIONS Mar-16	Change	Apr-16
Cash	**N**		**N**
Fixed Income	**N**	↑	**OW**
Government Bonds	UW		UW
Inflation-Linked	OW		OW
Euro IG Credit	OW		OW
International IG	N		N
EM Debt	OW		OW
Euro High Yield	N		N
Equities	**N**	↓	**UW**
Europe	OW		OW
World ex-Europe	UW		UW
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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