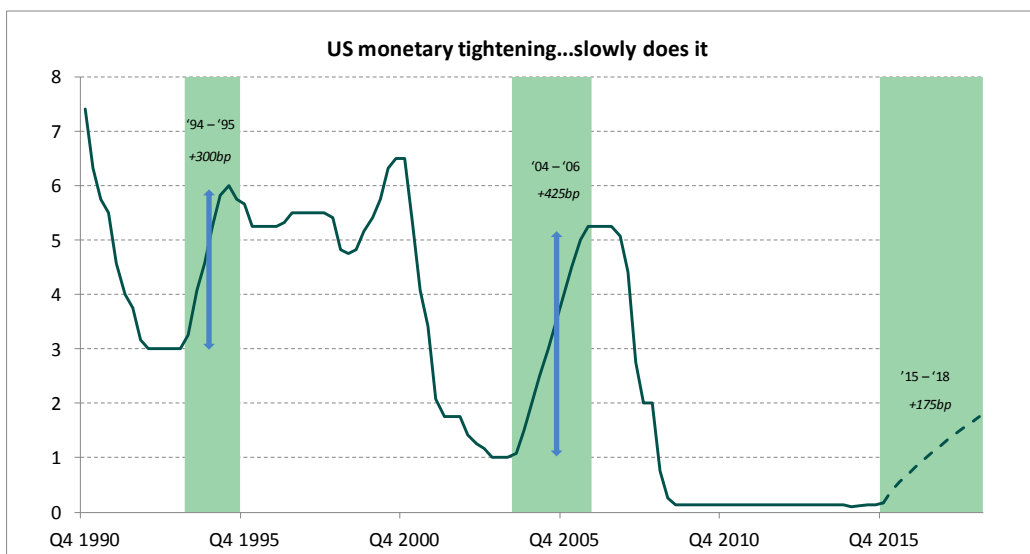


Asset Allocation Flash

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

Graph of the month (December 2015)



Global

Economic activity in DM holding up well

- Worries about the Chinese economy have caused a lot of financial market turbulence last summer. Even though the downward risks remain 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.
- Economic activity in DM is holding up relatively well while EM are going through difficult times. This is consistent with the picture portrayed by current global confidence indicators. From a global view, confidence indicators edged up in October and November. Encouragingly, data from China, while remaining subdued, are showing early signs of improvement against the back of earlier stimulus measures.
- Although concerns over both eased in recent weeks (in line with our scenario), the two most important risks arguably remain faster than expected monetary policy tightening in the US and a hard

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landing in China. A 'perfect storm' in this respect would further expose EM balance sheet fragilities.

- Despite the general low level of 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.

United States

Confidence in manufacturing sector under pressure

- The US economy is still expanding at healthy levels but is facing headwinds. Leading indicators are in line with around 2% headline growth. The sharp discrepancy between the manufacturing and services sector remains in place according to the latest survey indicators.
- 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 is close to historically high levels. This is consistent with relatively upbeat consumer confidence. Consumer confidence dropped in November but still consistent with real consumption growth of close to 2.5%. Looking ahead, consumer spending should remain healthy against the back of the ongoing housing and labour market recovery.
- The recovery in the labour market continues. In the year up to November 210 monthly new jobs were created on average. 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. The unemployment rate in November remained unchanged at 5% (=NAIRU). U6, a broader measure of unemployment ticked up (to 9.9%) and remains above its LT-average of 8.9% (1994-2007).
- Headline inflation, currently at 0.1%, 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 1.9% and 1.3% for core inflation and core PCE (personal consumption expenditures 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

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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 underlying inflation.

- The Fed hiked interest rates for the first time since 2006 as widely anticipated. The most important message is that monetary policy looks set to remain 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.

Eurozone

Consumption to increase at a healthy pace

- European economy continued to grow at a moderate pace. Economic activity came out at 1.2% QoQa in Q3, a disappointment given all the positive supports (low oil prices, accommodative monetary policy and the current low yields environment and EUR weakness). Leading indicators, on the other hand, are still in line with a growth rate of around 2%.
- Looking ahead, 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. The latest ECB lending survey was also encouraging in this respect.
- Inflation (0.1% yoy) was flat in October but the base effects in energy prices will send inflation higher over the next couple of quarter. Underlying price measures on the other hand remain weak reflecting the slack in the labour market. Given the persistence of the large negative output gap, core inflationary pressures are expected to stay fairly weak.
- The decisions taken by the ECB last Thursday negatively surprised the market. In the latest weeks, the market had strongly anticipated an increase in the monthly pace of purchases of government bonds from €60 billion to €80 billion, a 15-20 bps cut in the deposit rate and an extension of quantitative easing beyond September 2016. Instead, the ECB decided to extend its asset purchase programme

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from September 2016 until March 2017, the Governing Council did not increase the size of its monthly purchase. The latter remained unchanged at €60 billion meaning the total increase in the size of the programme will amount to €360 billion. On top of that, the ECB also announced its intentions to reinvest principal payments of maturing bonds purchased under the asset purchase programme. In addition, the ECB decided to lower its deposit rate by 10 bps to -0.3% but left unchanged the refinancing rate (0.05%) and the marginal lending facility rate (0.3%). Lowering the deposit rate has the advantage to increase the stock of eligible bonds for purchase. Indeed, the ECB cannot buy bonds with yields below the deposit rates nor hold more than 33% of any specific bond or more than 33% of the outstanding stock of a country government debt.

- Overall, according to financial market reactions, the ECB did not meet expectations. That said, the easing bias is sustained with significant chance of more stimulus coming up next years.
- 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 future haircut on debt is unavoidable.
- In a longer term perspective, European politics remain worrying in the sense that the currency union still faces existential challenges. In the near term, Spanish elections will now increasingly draw attention. Unlike the current situation, no single party will be able to have absolute majority which risks increasing political uncertainty somewhat. At the same time, a conservative-liberal coalition between PP and Ciudadanos, the most likely scenario as things currently stand, should also work. The Catalan issue should not be a major problem either, 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).

Asia and EM

Technical recession in Japan

- The Japanese economy is technically in recession but we should not make too much of this as inventories are an important explaining factor. While the most recent leading indicators improved somewhat in Japan, economic activity is still very modest at best. 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

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of Japan's 2% target. Most likely, the combination of modest economic activity and below target inflation will still prompt the BoJ to expand its monetary stimulus next year.

- 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 somewhat exaggerated, it is hard to overlook the big difference with the spectacular growth story seen last decade. In its September 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 where a weak growth momentum is accompanied with above target inflation. Several observers argue that the ongoing market turbulence will trigger a 1997-style crisis. We acknowledge this risk. That said, it is not our base case scenario because there are several important differences. 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 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

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soon ease the current hard landing fears. Indeed, the latest confidence indicators were encouraging in this respect. We expect this recent evolution has still further to run. Obviously, China's economic rebalancing and ageing population imply that the structural growth downtrend continues. Looking ahead, hard landing fears will come and go. This is unlikely to change anytime soon.

- RMB depreciation seen over the summer 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	2.1	1.6	0.1	1.7
		2.4	2.6		0.1	1.7
Eurozone	0.9	1.5	1.5	0.4	0.1	1.0
		1.5	1.7		0.1	1.1
Japan	-0.1	0.7	1.0	2.8	0.8	0.6
		0.6	1.3		0.8	0.8
China	7.3	5.0	6.0	2.0	1.6	2.0
		6.9	6.5		1.5	1.9

Petercam forecasts in bold, consensus forecasts in regular font

Currencies

Don't take a continued USD appreciation for granted

- Expectations about the diverging path for monetary policy in the US and the Eurozone, with the Fed slowly hiking interest rates and the ECB implementing more stimulus, have been a key driver of the significant strengthening of the dollar in recent quarters. Moreover risks surrounding Greece still exist and the increased likelihood of extra ECB stimulus (even beyond announcement in December) poses downward risks for the EUR. Importantly, on fundamental valuation measures, the dollar is starting to look expensive. Therefore, a strong USD appreciation from the current levels should not be taken for granted.
- Over the past three years the UK economy has been recovering significantly faster than the Eurozone. Against that backdrop the

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GBP has been strengthening versus the EUR. All in all, on valuation measures most of the upward GBP potential seems to have been realized even though the case for tighter monetary policy becomes stronger in the UK. The risk surrounding “Brexit”, an issue that looks set to gain more attention in 2016, poses downward risks for the GBP.

- 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 130-135, the level corresponding to the long-term purchasing power parity valuation. With the ECB and BoJ still in easing mode, this seems an appropriate level.
- 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. 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. For some currencies, including the BRL or RUB the depreciation has been as high as 30%. Tighter monetary conditions alongside the Fed’s path away from the ZLB still provides a challenging background for EM currencies, particularly for those running large CA deficits (Turkey, S. Africa most notably). On the other hand, EM assets are also very much determined by investor sentiment. Therefore, easing fears about a Chinese hard landing and stabilizing global commodity prices should reduce downward currency pressures.

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.

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- 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.

Eurozone valuations more compelling | **Developed market equities** | **Neutral**

- Relative valuations versus fixed income assets are still attractive. However; absolute valuations are no longer cheap.
- We prefer the Euro area to the US:
 - Possible QE extension in the Euro area
 - 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.

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, which were particularly attractive entry points
- 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.
- Macroeconomic environment is slowly but surely improving

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 issuers is clearly deteriorating

Stay put | **Emerging Market Debt** | **Neutral**

- The Chinese devaluation during the summer led to a strong

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decline in emerging currencies, which appear attractively valued compared to the EUR or USD

- A gradual tightening cycle in the US should not be too damaging for the asset class
- Macro environment is rather weak in emerging countries but we noticed early signs of improvement recently

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
- Early signs of improvement in EM
- The list of risks to our asset allocation includes a sharp rise in interest rates, European politics (and its effect on confidence), geopolitics, China crash and bubbles/runaway inflation

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In A Nutshell

Asset	ASSET ALLOCATION DECISIONS		
	Nov-15	Change	Dec 15
Cash	N		N
Fixed Income	UW		UW
Government Bonds	UW		UW
<i>Inflation-Linked</i>	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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