Asset Allocation Flash

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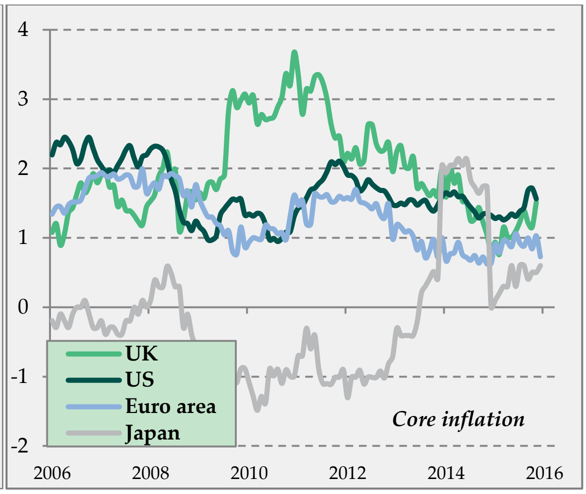
Graph of the month (July 2016)



Global

Odds of longer period of slow growth are high

- Global recession fears have eased over the past months. That said, our global composite confidence indicator suggests that global economic activity is still weak. What's more, downward risks remain substantial. The global economy still seems stuck in a catch 22 situation as explained here.
- 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.
- 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. That said, budgetary and monetary policymakers have not lost all ammunition to fight this extremely

challenging situation. There is still room to do more (see here for example). Encouragingly, there is a growing awareness about the need for more expansive budgetary policies. At the same time, statements remain vague implying that actual implementation might take time.

- Meanwhile, despite record low policy rates and huge expansions in the size of their balance sheet, most central banks are still looking for higher inflation prints.
- Even with the low level of commodity prices in place, however, base effects will send headline inflation higher in the second half of 2016. Core inflationary pressures look set to remain fairly modest for now, implying that global monetary policy will stay very loose for the time being. The outlook for inflation in a medium to longer-term perspective, on the other hand, is still subject to major uncertainty as explained here in more detail.

United States

Strong June payroll data

- Following a very weak start of the year, growth in Q2 should come in somewhat better. However, US economic activity remains modest. Leading indicators point to a recovery in the manufacturing sector after a period of weakness on the back of a stronger USD and problems in the energy sector. Confidence in the service sector, on the other hand, holds up better but has also come down in recent quarters. What's more, in line with the evolution seen over the past years, overall productivity growth remains very disappointing and the outlook for investment remains weak against the back of negative profit growth and relatively low capacity utilization rates.
- Though still in line with real consumption growth of around 2%, consumers' expectations about the future are 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.
- June's strong payroll report (adding 287k jobs) is raising uncertainty on the situation of the labour market after May's soft payroll report (only adding 38K jobs).
- Looking forward, however, evidence is mixed with the evolution in unit labour costs suggesting that core inflation should pick up further (accelerating wage growth in combination with slow productivity growth) while price surveys paint a more modest outlook in this respect.

- All in all, US policymakers are not in a hurry to raise interest rates. Modest growth in combination with below target inflation means that the Fed continues to adopt a very cautious wait-and-see approach as has been the case for several years now.

Eurozone

Brexit effect to be determined

- Looking forward, economic activity should hold up in the near future against the favourable backdrop of low energy prices, the current low yield environment and EUR weakness. That said, this recovery is still far from spectacular. What's more, confidence indicators are not pointing to further growth acceleration and structural headwinds remain strong. Brexit obviously doesn't help.
- In line with the improvement witnessed in economic activity, the labour market is also recovering. Unemployment rates have been coming down throughout the region. Importantly, however, youth unemployment remains worryingly high, especially in Greece and Italy.
- European politics remain worrying in the sense that the currency union still faces existential challenges against the back of rising populism and waning appetite for further fiscal integration. Confidence in government economic policy is very low in a significant number of European member states.
- Even though a new political agreement was found in late May, the Greek situation remains structurally unresolved and the can has been kicked down the road once again. Imposed budgetary tightening keeps Greece stuck in recession with unemployment and public debt levels at very high levels. The economic and social situation remains unsustainably weak. Therefore, political risks remain high.
- The political situation in Spain is still uncertain. The ECB's QE program, however, is likely to prevent that government bond spreads widen sharply.
- The impact of Brexit will depend on how hostile or friendly the exit from the EU would be organized in a short to medium term perspective. In a medium to longer-term perspective, the critical factor is whether Brexit would lead to further EU integration or disintegration.
- Underlying inflation measures 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, despite the latest easing measures taken in

March, the ECB still looks to experience major difficulties in getting inflation up to its target of 2% anytime soon (see here for more information).

- In its June and July press conferences, the ECB stood pat while it awaits the effects of the policy measures announced in March. President Draghi, meanwhile, left the door open to further policy action at a later stage but it should be clear that opposition is rising and also that more monetary easing is no panacea in a liquidity trap situation. Indeed, a more expansive budgetary stance is likely to prove more helpful in this respect. The ECB has been hinting in this direction more recently.

Japan and EM

EM activity still weak

- Economic activity in Japan is still weak and business confidence indicators are turning south again. Wage growth remains subdued despite the tightening labour market. Inflation, meanwhile, remains significantly below the Bank of Japan's 2% target. What's more, JPY has seen substantial appreciation in recent months, in turn weighing on Japanese stock prices. All this implies that the BoJ firmly keeps its bias towards further monetary easing.
- More broadly in EM, the slowdown witnessed over the past few years reflects several factors including the negative effect of lower commodity prices, tighter external financial conditions linked to the prospect of the hiking cycle in the US, the private sector debt overhang, economic rebalancing in China, structural bottlenecks as well as distress related to (geo)political factors. Moreover, there are signs of premature deindustrialization in several important EM which is worrying in a medium to longer term perspective.
- Sentiment towards EM has improved in recent months against the back of reduced (slightly) USD strength and uptick in commodity prices. But EM are not out of the woods yet. China's challenging rebalancing exercise and uncertainties linked to monetary policy tightening in the US could easily expose more EM weakness (see here for more information). Additionally, recent developments in Turkey show that political risks are real in some EM.
- Chinese hard landing fears have been receding over the past three months and a large one-off depreciation has been avoided, at least for now. This is completely in line with the scenario we described earlier (see **here** and **here** for example). The combination of monetary and budgetary measures is driving a cyclical recovery. But while we were right on this call, we are still convinced that the

medium to longer term outlook for China will prove extremely challenging.

- Moreover, it would not be surprising that worries about the sustainability of the current recovery soon pop up again. Indeed, the background of fake growth figures, soaring house prices and continued rapid credit growth is far from comfortable and will give rise to more and more concerns about the state of China's economy. How will Chinese policymakers reconcile the ambition of strong growth and the need for further economic rebalancing while at the same time avoiding the stop-and-go policies seen in recent years? The short answer is that this will prove close to impossible. That's why, despite the recent calmness, concerns about China look set for a comeback in the not so distant future as also explained here.
- From an EM wide perspective, inflation remains under control. That said, significant differences between countries exist. While inflation in countries like Brazil, Turkey or Russia is still at uncomfortably high levels, inflation in other countries including Korea, the Philippines, Poland or Hungary remains below target. All in all, the combination of subdued economic activity, stabilization in EM currencies and commodity prices should make sure EM inflation remains in check.

Forecasts

	GDP			Inflation		
	2015	2016	2017	2015	2016	2017
US	*2.4*	**1.7**	**1.7**	*0.1*	**1.2**	**2.2**
		1.8	*2.3*		*1.2*	*2.3*
Eurozone	*1.6*	**1.5**	**1.2**	*0.0*	**0.3**	**1.3**
		1.6	*1.6*		*0.2*	*1.3*
Japan	*0.6*	**0.5**	**0.8**	*0.8*	**0.0**	**1.4**
		0.5	*0.5*		*0.0*	*1.5*
China	*6.9*	**5.5**	**5.0**	*1.5*	**2.1**	**2.3**
		6.5	*6.3*		*1.9*	*1.8*

Degroof Petercam forecasts as of July 1st 2016, *Consensus forecasts*

Currencies

JPY has appreciated

- 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 (more here). 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 long term theoretical 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 quarters.
- The BoE is not in a hurry to ease nor hike interest rates. This being said, the impact of Brexit has increased expectations of monetary policy to be loosened in August. GBP is currently trading more than 15% below its 20-year average real effective exchange rate, although there is still substantial room left for depreciation towards its PPP-level. While we cannot completely rule out overshooting in the short-term, the current account shock absorption seems its most important driver at this point. Additionally, as in past crises, it will be the political developments (more details here) that provide guidance for the GBP going forward.
- The JPY has been strengthening in recent months. From a LT-perspective, it seems that the JPY has now become a little 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 BoJ and ECB.
- EM currencies experienced serious downward pressure since the May 2013 taper tantrum but entered calmer waters more recently. Investor appetite for EM assets has waned and sustained EM currency weakness cannot be ruled out given the subdued growth outlook and political risks. That said, given the depreciation already seen since the spring of 2013 and the recent stabilization in leading indicators, 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 on average (strong difference from country to country).
- In contrast to what many observers have feared since the summer of 2015, the RMB has not seen a large one-off depreciation so far just like we had expected (see here for more details). More recently, following the latest G20 meeting in Shanghai late February, there seems to be more consensus on this call. That said, we would

certainly not rule out the possibility of a big depreciation altogether. The reason is that we have become even more concerned about the sustainability of China's economy as explained higher.

Asset Classes

Prudent stance on risky assets

Cash | Neutral

- Cash is neutral

Bund yields at extremely low levels

Government bonds | Underweight

- Bonds have performed extraordinarily well over the last few years thanks to interest rates falling to all-time lows in Europe. Being exposed to long term government bonds has enabled many balanced portfolio managers to weather the volatility of equities markets.
- While low yields are characteristic of our low growth / low inflation environment, Bund yields have reached extreme levels which can, we think, only be explained by the elevated level of risk aversion. Although this risk aversion is the result of the many uncertainties facing the world economy in general and the euro area in particular, there are reasons to expect it to subside as uncertainties get removed. We therefore expect 10y German Bunds to move higher from current levels.
- The Brexit vote has lead us to revise downwards the top end of our trading range for German Bund yields to 0.25% (vs. 0.60% before). In the event of adverse political developments, we see downside to a low of -0.25% - in particular if the ECB does not resolve the scarcity issue on German Bunds.
- In the US, the market is currently pricing no rate hike in policy rates for the next two years. We think this is overdone and maintain our base case scenario which states that the US policy rate cycle is not yet over.
- However, a major uptick in interest rates in the months to come is not part of that base case scenario: global growth should be moderate, inflation should remain below target and more quantitative easing is back on the agenda of the some major central banks (Japan and the UK in particular).
- Within the government bonds universe, US Treasuries and global inflation-linked bonds (both partially EUR hedged) offer an interesting opportunity. The latter could benefit from the expected firming in headline inflation late in 2016 (due to base effects).

ECB purchase programme started in June

Euro IG Corporate Bonds | Overweight

- After widening during 2015, Investment Grade (IG) credit spreads reached attractive levels at the end of February this year. Since then, they have tightened.
- IG corporate bonds have become a more attractive asset class in an environment of very low interest rates for longer.
- The ECB started purchasing corporate bonds in June. We estimate these purchases could amount to approx. EUR 5 to 10bn per month. The implementation of this program could trigger further spread tightening although its effect is likely to be dampened by the rise of new issuance.

Covenant quality lowering

Euro High Yield Bonds | Neutral

- As for Investment Grade, High Yield (HY) spreads widened during 2015. Since the end of February, they have tightened.
- Covenant quality in Europe is deteriorating which could become a worrying sign if it continues.

Chinese currency stable

LC Emerging Market Debt | Overweight

- After 5 years of strong declines, emerging markets currencies a staging a come-back with double digit returns since the start of the year. Further upside from here depends on the confirmation that commodities prices have bottomed out and is likely to be volatile. Meanwhile, the Chinese currency continues its pace of gradual decline.
- Yields of certain emerging market issuers appear attractive. In particular in Brazil, where Industrial and Consumer Confidence seems to have stabilized at very low levels and most recent statistics are showing an uptick. Also, it seems inflation has finally started to come down. If these recent trends continue, Brazilian Local Currency (LC) debt could be viewed as a selective opportunity.

European valuations more appealing

Developed market equities | Underweight

- The Brexit vote reinforces the sentiment that it will be difficult to find a structural solution to Europe's inherent issues in the short term. There is also the issue of European banks (heavyweights in European indices) which suffer from the flattening of the yield curve. That said, we are not negative. As long term investors we find the risk premium offered on European equities attractive. We are also mindful of the fact that cheap access to capital (a positive of low financing rates) is a clear positive for listed European companies.
- We prefer Europe (where we are Overweight) to the US (where we are Underweight):
    - Valuations are more appealing in Europe than in the US. At

14.8x, the Next Twelve Months (or Forward) P/E of European equities sits at its historic average. In the US, the Forward P/E is 17.5x, comfortably above its historic average.

- QE in the Euro area until 2017
- The profit cycle for European companies is less mature than in the US where margins have reached peak levels.

We are also Underweight equities in Japan. Earnings estimates in Japan are subject to the worst downward revisions in developed margins.

Early signs of macro-economic improvement

Emerging market equities | Neutral

- Standing at a 12.3x Forward P/E, Emerging Markets equities valuations are more appealing than elsewhere. This compensates partly for the risks building up in China.
- Margins appear to have stabilized at very depressed levels. 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 an underweight in US and Japanese equities
- Eurozone equities are the preferred choice in terms of region. The risk premium is back at very high levels
- EM equity markets are relatively cheap, but that risk premium is necessary to compensate the risk of a stronger slowdown in the Chinese economy, which remains one of the main risks
- 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. Emerging market bonds are a welcome diversification with high real rates in some countries.
- 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.

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Asset Allocation Flash

In A Nutshell

Asset	ASSET ALLOCATION DECISIONS Jun-16	Change	Jul-16
Cash	**N**		**N**
Fixed Income	**OW**		**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	**UW**		**UW**
Europe	OW		OW
World ex-Europe	UW		UW
Emerging Markets	N		N
Alternative			
Convertible Bonds	N		N
Real Estate	OW		OW
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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