Degroof Petercam | Asset Management

Asset Allocation Flash

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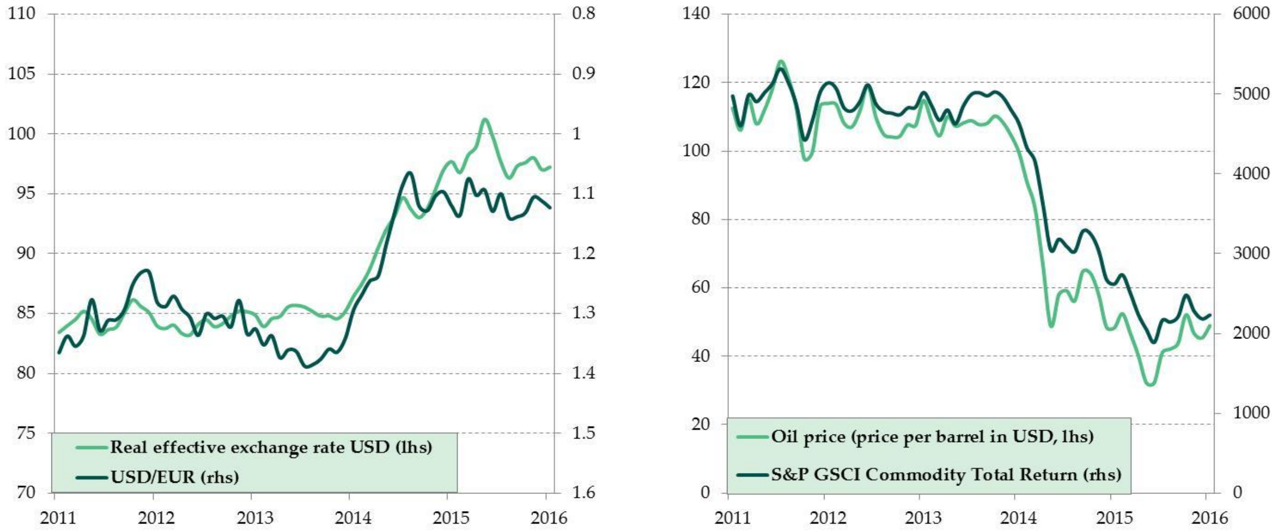
Graph of the month (September 2016)

Still living in a world of USD strength and low commodity prices



Global

Disappointing Jackson Hole conference

- The economic fallout from the Brexit vote remains limited, at least so far. That said, our global composite confidence indicator suggests that global economic activity remains subdued. What's more, downward risks remain substantial.
- Looking beyond the short-term, we think the risk of a prolonged period of subdued growth and low interest rates is real against the back of strengthening demographic headwinds and less scope for debt accumulation. (More here).
- Encouragingly, there is a growing awareness about the need for more expansive budgetary policies. This could translate in stronger economic activity and higher inflation prints. At the same time, statements remain vague implying that actual implementation might take time.
- This year's Jackson Hole conference was rather disappointing in the sense that it didn't deliver much out- of-the-box thinking with

regards to monetary policy. US policymakers highlighted that the case for a second rate hike has become stronger.

- 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.

United States

Q2 growth disappointed again

- Following a very weak start of the year, growth in Q2 disappointed again. The manufacturing sector still suffers from the stronger USD and problems in the energy sector. Worryingly, service sector confidence fell sharply in August. 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. This is a key risk factor for the US economy.
- Household consumer spending is growing at around 2% in year-on year terms and several factors, including disposable income growth, consumer sentiment and the relatively favourable housing and labour market backdrop, suggest consumption growth should hold up.
- Adding 204K jobs on average over the past 12 months, the labour market has been performing solidly. Leading indicators suggest future job gains will come in somewhat lower. Initial jobless claims, meanwhile, remain at very low levels, indicating that the labour market is doing fine overall.
- Wage growth plays a key role with regard to the future path of inflation and is slowly picking up. At around 2.5%, however, the level nevertheless remains below its 30-year average of around 3%.
- Base effects linked to energy prices will make sure that headline inflation (now around 1%) will trend higher towards the end of the year. At 2.2% and 1.6% for core inflation and core PCE inflation (which is more important for Fed) respectively, underlying inflation has been stabilizing over the last 3 months. Looking forward, however, leading indicators paint a mixed picture 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 point to only very modest upward price pressure.
- All in all, the combination of the latest drop in manufacturing and

service sector confidence, Q2's disappointing GDP number and below target inflation, suggest a summer rate hike is off the table. 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.

- The November Presidential elections are drawing lots of attention. As things stand, according to election polls, Mrs Clinton is leading the race to the White House (more here).

Eurozone

Large negative output gap remains

- Encouragingly, most confidence indicators in the immediate aftermath of the Brexit vote are holding up. This suggests that the fallout on Eurozone economic activity remains limited.
- Trade negotiations between the UK and the EU still need to start and this looks set to be a complex and prolonged negotiation process against the back of a challenging political calendar with Dutch, French and German elections in 2017.
- Meanwhile, it's becoming more likely that Spain will see a third round of elections. The upcoming constitutional referendum (about reducing the power of the Senate) in Italy also seems challenging. A yes vote is far from assured.
- This recovery is still far from spectacular. What's more, confidence indicators are not pointing to further growth acceleration and structural headwinds remain strong (more here). The Eurozone still faces major challenges beyond the short-term.
- Headline inflation (0.2 % yoy in August) is held down by the earlier steep fall in energy prices but base effects will send it higher in the second half of the year. With core inflation hovering around 1% for several years, underlying price 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), keeping monetary policy in easing mode for longer.
- It should be clear, however, that opposition to more monetary easing is rising and also that it 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 also been hinting in

this direction more recently.

Japan and EM

Chinese hard landing fears receding

- In Japan, despite sluggish economic activity, JPY appreciation and falling stock prices, the BoJ basically refrained from adding stimulus in its late July meeting. Meanwhile the Abe government announced a new fiscal stimulus package of 28.1 trillion JPY (around 5.6% of GDP). That said, only a fraction of that constitutes fresh public spending (7.5 trillion JPY of which 4.6 JPY in 2016), so that all talk of big fiscal stimulus is vastly exaggerated. It should nevertheless translate in somewhat higher GDP numbers next year.
- At the same time, indicators suggest it remains very doubtful whether inflation will pick up meaningfully going forward so that the BoJ is still likely to add monetary stimulus in the near future. Against this backdrop, Governor Kuroda's Jackson Hole presentation reiterated his commitment to achieving 2% inflation at the earliest possible time. He reinforced the case for action by arguing that there is room to use NIRP more aggressively.
- Sentiment towards EM has improved in recent months against the back of reduced USD strength and stabilization 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 Russia, Turkey or Brazil remind 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 inaccurate 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 and Turkey 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	*2.6*	**1.3**	**1.6**	*0.1*	**1.1**	**2.1**
		1.5	*2.3*		*1.2*	*2.3*
Eurozone	*1.6*	**1.5**	**1.2**	*0.0*	**0.3**	**1.3**
		1.5	*1.2*		*0.2*	*1.3*
Japan	*0.6*	**0.5**	**1.0**	*0.8*	**-0.1**	**1.0**
		0.5	*0.8*		*-0.1*	*0.6*
China	*6.9*	**5.5**	**5.0**	*1.5*	**2.1**	**2.3**
		6.6	*6.3*		*2.0*	*2.0*

Degroof Petercam forecasts as of September 2016, *Consensus forecasts*

Currencies

Don't just assume the USD will continue to appreciate

- 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 in 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 months.
- The BoE loosened monetary policy after its August meeting in response to the effects of Brexit. GBP is currently trading more than 16% below its 20-year average real effective exchange rate but there

is still room left for depreciation towards its PPP-level. Moreover, at 6% of GDP the current account deficit remains pretty big. Another rate cut is still likely over the coming months. Downward risks prevail for now.

- 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. Since February this year, however, appetite for EM currencies has been improving as investor's expectations about higher policy rates in the US have been tempered. This intensified the search for yield and benefited EM assets. The subdued growth outlook and political risks warrant caution.
- 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 G20 meeting in Shanghai late February, there seems to be more consensus on this call. That said, we would not rule out the possibility of a big depreciation altogether. The reason is that we have become more concerned about the sustainability of China's economy as explained higher.

Asset Classes

Prudent stance on risky assets

Cash | Neutral

- Cash is neutral

Disappointing ECB meeting

Government bonds | Underweight

- The ECB disappointed at its September meeting by not announcing additional stimulus measures. The market (and ourselves) had expected an extension of its asset purchase program.
- We still favour the normalization scenario: 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 Bund yields to move higher from current levels, possibly towards the top end of our trading range of 0.25%. In the US, we

don't think the policy rate cycle is over yet, although it has been endlessly delayed. Any move towards normalization by the Federal Reserve would help Bund yields to be lifted out of negative territory.

- The future path will therefore be partly dependent on policy action from other central banks. However, a major uptick in interest rates in the months to come is not part of that base case scenario: global growth is set to remain moderate, and inflation is expected to remain below target. The market implicit inflation expectation remains close to all-time lows.
- Within the government bonds universe, we remain positive on Spanish and Italian bonds on the medium term. Spreads have tightened during the summer, but we remain confident on the outlook for both countries. 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).

Further spread tightening following ECB programme

Euro IG Corporate Bonds | Overweight

- Although nominal levels of IG corporate bond yields are at historically low levels, spreads versus core government bond yields still are above levels witnessed in 2014 and 2015. Given our view that default risks will remain contained, thanks to robust fundamentals and low financing rates, our spread tightening bias remains intact. We therefore think that IG corporate bonds are still an attractive asset class.
- The ECB started purchasing corporate bonds in June. Since then, the ECB has bought EUR 22.9bn under its corporate sector purchase program. The implementation of this programme has triggered further spread tightening although the important amount of new issuance dampened this effect.

Covenant quality lowering

Euro High Yield Bonds | Neutral

- The current level of spreads implies an implicit default rate that is concurrent with a fair valuation of the High Yield (HY) asset class.
- Monetary policy should keep fundamentals in tune and the ECB's purchase program indirectly also benefitted the HY segment.
- Covenant quality in Europe and elsewhere is deteriorating which could become a worrying sign if it continues.

Room for convergence between DM and EM rates

LC Emerging Market Debt | Overweight

- Despite very recent volatility in currency markets, confidence seems to return to the asset class and we believe there is room for convergence between rates of developed and emerging markets. Risk premiums are still high and investor positioning has some catch-up to do.

- We also think certain central banks of EM countries have room to provide monetary stimulus, should circumstances warrant.

European valuations more appealing

Developed market equities I **Underweight**

- The Brexit issue has moved to the background given its limited near term impact . However, exit discussions with the EU still have to start and the outcome is still unclear.
- Political uncertainty (chief among them the Italian constitutional referendum in November) and banking sector issues (linked to the flattening of the yield curve) explain the high risk premium for European equity.
- We remain Overweight European equities and prefer this region to the US, where we are Underweight.
    - Valuations are more appealing in Europe (14.9x forward earnings) than in the US (17.2x)
    - The ECB's current Quantitative Easing programme will last until March 2017 and there is a chance this deadline will be extended
    - Operational margins in the US are at a peak and under pressure. In Europe on the other hand, margins are well below their peak and expected to improve.

We are also Underweight equities in Japan. Valuations are attractive (13.5x forward earnings) but consensus earnings forecasts have been heavily revised downwards until very recently.

Consensus earnings forecasts have stabilized

Emerging market equities I Neutral

- Next twelve months Emerging Markets consensus earnings forecasts have stabilised recently. We even note a small move upwards. Emerging Markets equities valuations (12.3x forward earnings) are more appealing than elsewhere.
- 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.
- The outlook for the Chinese banking sector weighs on the outlook for the asset class.
- Weighing risk and return, we maintain a Neutral position for Emerging Markets.

Asset Allocation Flash

Key Take-Aways

- Underweight on developed market equities, with an underweight in US and Japanese equities. US equities are expensive while Japan has limited prospects of higher growth.
- Eurozone equities are the preferred choice in terms of region. The risk premium is back at very high levels. On the other hand, a positive risk premium is necessary to compensate for the larger weight of financials in European indices.
- 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.
- Within fixed income, we continue to prefer especially emerging bonds in local currency as well as euro-denominated investment grade corporate bonds. Within government bonds, there is still a preference for inflation-linked bonds and we would like to remain slightly underweight duration.
- 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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In A Nutshell

Asset	ASSET ALLOCATION DECISIONS Aug-16	Change	Sep-16
Cash	**N**		**N**
Fixed Income	**N**		**N**
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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