Asset Allocation Flash

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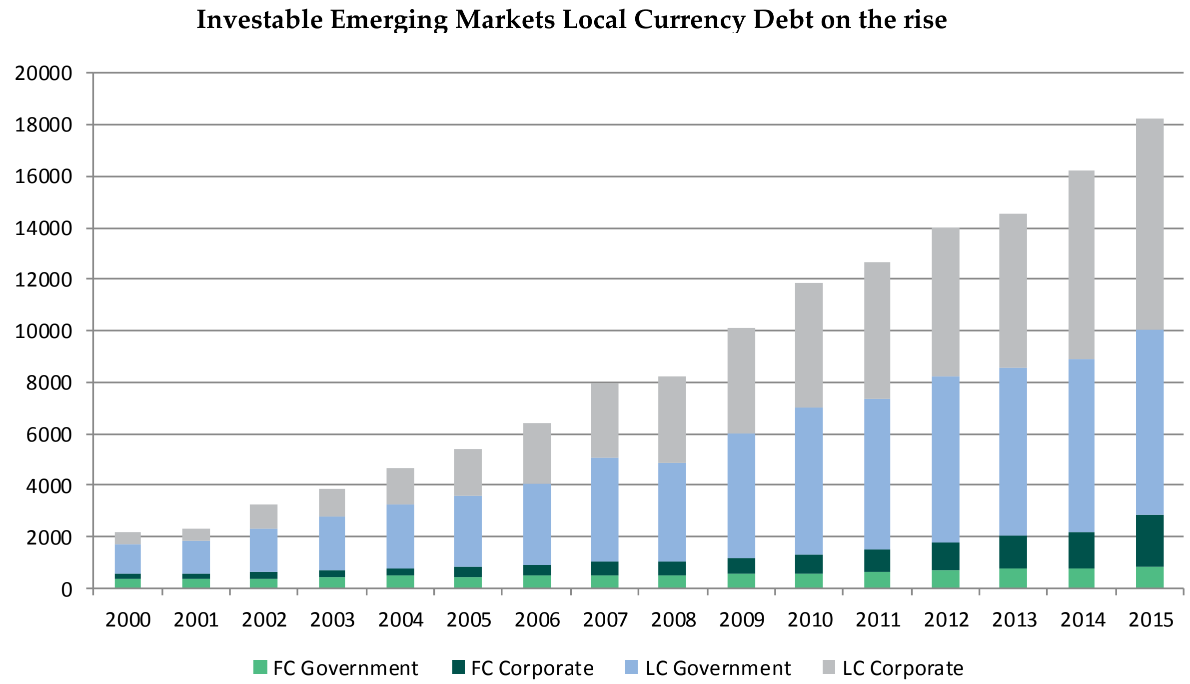
Graph of the month (September 2017)



Global

North-Korea is a risk factor

- Judging from core employment and broader measures of unemployment, it can be argued that there's still a fair amount of hidden labour market slack in place. At the same time, other factors including globalization, technological change and digitization, the ageing of the population, insufficient labour union power, lower anchored inflation expectations and sluggish productivity growth seem to be playing a role as well.
- From this point of view, central banks around are in no hurry to tighten monetary policy. The world economy is still dependent on loose financial conditions. On the other hand, policymakers are cautiously looking to gradually move away from the zero interest rate environment in order to create space for manoeuvre further down the road and to prevent stretched valuations in certain asset

classes from turning into bubble-like valuations.

- Unsurprisingly, how fast central banks will act is largely dependent on economic activity, inflation and market volatility. Financial market volatility has been very low over the past few years but looks set to go up from time to time, perhaps significantly. Indeed, scaling down the amount of central bank asset purchases is a relatively easy process from a technical point of view but it is clearly more difficult to factor in market psychology.
- North Korea is clearly adding to geopolitical uncertainty and as things stand a swift cooling of tensions seems unlikely. A full-blown war between North Korea and the US is not our base case scenario as diplomatic options are still available. Moreover, both human losses and economic costs would prove gigantic. Unfortunately, however, history is full of similar examples that have played out otherwise.

United States

Debt ceiling coming up

- All in all, for now, easy financial conditions, disposable income growth, consumer sentiment and the favourable housing and labour market backdrop still suggest household consumption to hold up. It's also encouraging to witness early signs of an upturn in private investment.
- The need for disaster relief has postponed the spectre of a debt ceiling debacle and government shutdown until mid-December. Failure to raise the debt ceiling by mid-October would have been potentially far worse as it could have led to an immediate and substantial fiscal contraction, a sovereign credit downgrade, more uncertainty and nervous financial markets. The three month deal between Trump and Democratic congressional leaders now averts a near-term fiscal showdown but without addressing the fundamental underlying issues, it could set up the prospect for an even bigger clash at the end of the year.
- Thus far, the Trump administration has not been able to deliver on anything serious. Trumponomics remains subject to a lot of uncertainty (~trade policy, ~investment policy, ~tax policy) at this point in time. The White House announced a slightly revised proposal for tax reform earlier in April although the document provided very little detail and appears to rely heavily on overly optimistic growth assumptions. Meanwhile, Trump is struggling on healthcare reform. For now, we still hold rather soft expectations with regards to tax reform or infrastructure investment. We could

still see some budgetary initiatives but they are unlikely to boost GDP growth by much.

- Headline inflation remains below the Fed's target of 2%. Meanwhile, most survey evidence suggests underlying inflation pressures remain modest for the time being. Recent USD depreciation should help lifting underlying inflation again from its latest level at 1.4%. Market-based measures of inflation remain low in historical perspective whereas survey-based consumer measures of inflation were broadly stable in recent months. Wage growth, meanwhile, is still modest at around 2.5% in YoY-terms even though several leading indicators are pointing to an acceleration.

Eurozone

Growth surpassing the 2% level

- Economic activity in the Eurozone continues to come in strongly from a cyclical point of view, with GDP expanding at 2.6% QoQa in the second quarter. Confidence among firms and consumers remains high which points to more positive economic news in the months ahead. Meanwhile, company profits and credit growth are picking up.
- Judging from the most recent evolution of confidence indicators, economic activity looks set to surpass the 2%-level (on an annualized basis), more or less double the estimates of eurozone potential growth (around 1%). This implies that the large negative output gap is gradually closing and that unemployment (currently at 9.1%) is coming down significantly from high levels. Differences between countries, however, remain substantial.
- Political concerns have been dropping significantly over the past few quarters. As expected, German elections have resulted in another mandate for Chancellor Merkel to form a coalition. Next year's Italian election could prove a far more difficult hurdle to pass as the Democrat Party and the Five Star Movement are neck and neck in the polls.
- While this recovery is more solid and more broad-based than anything we have witnessed over the last couple of years, in a way it is also the easiest part. The tailwinds stemming from low interest rates, low commodity prices, low exchange rate, the end of austerity and a more synchronized global recovery are very helpful but also likely to fade over time.
- Meanwhile, underlying inflation remains subdued at 1.2%. Looking forward, core inflation will rise only very gradually. The four criteria linked to the ECB's inflation objective (close but below 2%

in the medium term, durable, self-sustained and broad-based) have not yet been met.

- Wage growth is crucial in this respect but upward pressure is still very modest. Moreover, the recent appreciation of the euro exchange rate clearly won't help. Draghi clearly stated that the stronger euro is a source of uncertainty which requires monitoring.
- Against this background, the ECB is shifting its tone away from stimulus but only so in a very gradual and cautious way. The ECB is in no hurry to leave its zero interest rate policy or dismantle its asset purchase program (60bn EUR each month until the end of 2017) program for now. That said, ECB tapering talk or QE recalibration has become more pronounced. The ECB has moved closer to providing the market with more details about how it will scale down its asset purchases later this year, probably in October. With premature policy tightening in 2008, 2011 and 2013-2014 fresh in the memory, the ECB will want to avoid moving too fast.

Emerging Markets

Chinese Party Plenum mid-October

- The latest confidence indicators suggest that conditions in the manufacturing sector remain fairly upbeat throughout the entire emerging world.
- The Chinese economy has been in recovery mode since late 2015 following a year in which hard landing fears were omnipresent. Confidence indicators and commodity prices suggest that economic activity is holding up well at this stage even though broad credit growth has started to cool on the back of a modest tightening of monetary conditions since last fall. China's labour market continues to perform well. Survey evidence shows concerns about unemployment remain low and the ratio between job vacancies and job seekers remains high.
- Should economic activity slow down too much there is still sufficient room to ease monetary policy, to cushion FX depreciation and tighten capital controls. That said, China is on a slippery slope to keep economic growth high while keeping financial risks in check. Although very difficult to time, concerns about China look set for a comeback at one point in time. Attention is now shifting to the 19h Party Plenum in mid-October, revealing both more information about Presidents Xi's own priorities and a better gauge of where Chinese economic policy is heading.
- From an EM wide perspective, inflation remains under control though base effects linked to commodity prices are also at play in

most countries, including China. Significant differences between countries exist but in most EM remains within target corridor. All in all, the combination of modest economic activity, stabilization in EM currencies and commodity prices should make sure EM headline inflation remains in check.

Forecasts

	GDP			Inflation		
	2016	2017	2018	2016	2017	2018
US	*1.6*	**2.1**	**2.1**	*1.3*	**1.9**	**1.9**
		2.1	*2.4*		*2.0*	*2.0*
Eurozone	*1.7*	**2.1**	**1.8**	*0.2*	**1.5**	**1.3**
		2.0	*1.8*		*1.5*	*1.3*
Japan	*1.0*	**1.9**	**1.1**	*-0.1*	**0.4**	**0.7**
		1.4	*1.1*		*0.5*	*0.8*
China	*6.7*	**5.5**	**5.0**	*2.0*	**1.8**	**2.1**
		6.7	*6.3*		*1.8*	*2.1*

Degroof Petercam forecasts as of September 2017, *Consensus forecasts*

Currencies (vs. EUR)

Downward pressure on EM

- The USD has lost some ground in recent months against the back of easing political risks in Europe and further confirmation of the Eurozone economic recovery. The USD still looks expensive in a long term theoretical perspective. That said, more evidence of the Fed turning more hawkish could still lead to a somewhat stronger USD. Meanwhile, a stronger EUR has another dampening effect on Eurozone inflation numbers that are already considered too low. All in all, downward risks for the USD remain present in a medium to longer term perspective.
- The GBP has already depreciated significantly as a result of the Brexit referendum. This has led to higher inflation and hence negative real consumption growth for UK households, challenging the growth outlook. Meanwhile, Brexit negotiations seem to be going nowhere at this point. This could change of course but for now risks remain primarily on the downside from current levels.
- The RMB has seen a significant appreciation against the USD in recent months. In nominal effective exchange rate terms, the

currency is still significantly down from its 2015 levels but managed to stabilize over the past year. We expect the RMB to remain broadly stable against this broader basket of currencies but we think downward risks prevail as we remain concerned about the sustainability of China's economy in a medium to long term perspective.

Asset Classes

Prudent stance on risky assets

Cash | Neutral

- Cash is neutral

Still overweight linkers

Government bonds | Underweight

- The 10 year German bond yield has moved back to the middle of the 5bp to 65bp range that we have been putting forward for several months now. The brief upside rate shock post the Draghi speech in Sintra has been completely undone. We confirm this 5bp to 65bp range going forward, as we remain confident that the low rates are here to stay for longer. We confirm our Underweight stance for EU Government Bonds and Underweight duration.
- The ECB Asset Purchase Program will be supporting rate convergence at the long end for Italy, France, Belgium, Spain versus Germany, the Netherlands. Political positioning in Italy and Spain is for the moment just that: positioning. Spreads vs. German bonds for these two countries have remained stable. We maintain our Underweight position: from a portfolio construction point of view, we do not want to "double up" on risk, bearing both equities and sovereign bonds risk in the Eurozone.
- We adjust our base case scenario for the Fed's rate hiking path. We now expect the Fed to raise more than market expectation (no more rate hikes in 2017, 1 rate hike in 2018 and 0 rate hike in 2019), but less than our previous scenario (1 more rate hikes in 2017, 3 rate hikes in 2018 and 3 rate hikes in 2019). Given the slower realisation of the inflation target and the objective of the Fed to prevent a recession, we now believe the 1/3/3-scenario is too hawkish. On the other hand, in our view the market scenario (0/1/0) is too dovish because the Fed wants to continue the normalisation of rates (providing ammunition for the next crisis), especially when financial conditions as a whole are very soft. Furthermore the 0/1/0 scenario could give rise to the creation of asset bubbles. The ECB has been clear on the fact that they will deal with QE first and only start hiking policy rates well after the end of the active purchase program.
- Stronger labour market conditions have so far failed to generate meaningful upward price pressure because of remaining slack in

the economy. Often mentioned elements like digitalisation and robotization, globalisation and an ageing population only give a partial explanation. We believe that the recently weak inflation data (headline and core) in the US are transitory and linked to specific items. For the Eurozone, we expect limited deflationary impact of € strength. Currently, inflation linked bonds price a very mediocre inflation outlook and consequently they remain a cheap hedge to rising rates. We remain overweight Global Inflation Linked Bonds.

Default risk in check

Euro IG Corporate Bonds | Neutral

- Tapering concerns and geopolitical concerns have likely driven part of this risk reduction in August, with lower rated issuers underperforming. However IG credit in Europe remains robust.
- For the remainder of the year, massive issuance is expected, but unless the ECB changes its stance on QE, we could expect spreads to keep moving within a narrow range.
- Default risk is to remain under control for the foreseeable future thanks to sufficiently robust credit fundamentals and low interest rates. However internal credit analysis is required and acts as a cornerstone to the investment process when valuations are becoming rich and company or sector specific issues might impact aggressively.

Environment supportive

Euro High Yield Bonds | Neutral

- The environment remains supportive: decent earnings, ratings upgrades, low defaults, i.e. on average fairly good news. But a lot of the good news is priced in, knowing that stretched valuations can remain stretched for some time.
- However, in the benign European macro backdrop and very little defaults on the horizon, we continue to have a neutral stance on European HY.

Volatility ahead

LC Emerging Market Debt | Slight overweight

- We have witnessed a high dispersion in total returns (positive in Russia, Turkey, Chile…. negative in South Korea, Argentina, the Philippines).
- Some volatility is to be expected as the market prepares for more clarity by Developed Markets central banks in tackling their balance sheet management.
- No change to our forecast: fundamentals remain supportive. However, as indicated over the past few months, we are seeing some overcrowding in some parts of the markets, e.g. India, Indonesia, Russia. However, longer term factors are still in positive territory, including hard economic data forecasts, attractive valuations and positive flows into the EM Debt segments.

- In the short term we remain more cautious about the sector and confirm our Slight Overweight position.

Very low volatility

Developed market equities I Neutral

- The next 12 month EPS (earnings per share) are expected to grow 10% across regions, slightly down from last month. Revisions for European EPS are trending down, but not for domestically exposed companies.
- We still see very low implied volatility in equity markets (and in other asset classes).
- We maintain a Neutral position for equities. It is our opinion that markets have reacted to the positive economic surprises globally in the past months and to the third consecutive quarter of clearly positive earnings growth. Positive surprises will be more difficult to realize from this point onwards. However there are reasons to maintain a neutral equity position in the portfolios: earnings growth will continue over the next quarters, and risk premiums are – especially in Europe – still at decent levels.
- There is no change in the geographical allocation: the US is Underweight, while we remain Overweight European equities.
  - Expectations for Trumponomics (~trade policy, ~investment policy, ~tax policy) have been reduced considerably. Thus far, the market has ignored this. If a tax plan is eventually approved, it will most likely have no major impact on earnings.
  - Valuations remain more appealing in Europe (14.6x forward earnings) than in the US (17.9x) but this is consistent with better quality of the US market.
  - We are also Underweight equities in Japan even if valuations are attractive (13.7x forward earnings) and earnings revisions are improving. Margins have been improving in Japan, but it is our view that this is mainly due to cyclical and currency related reasons, and less to structural reasons. Sustainability and further improvement of margins and profitability is still consequently a big question mark. Japan's relative performance is still linked to the evolution of JPY.

Continued strong performance

Emerging market equities I Slight underweight

- Emerging Markets equity continued to perform well based on a favourable global outlook (hence higher commodity prices) and a weaker dollar.
- Earnings have been improving for the region, but growth is only slightly higher compared to Developed Market earnings growth.
- Emerging Markets equities' valuations (12.5x forward earnings) are

more appealing than in developed countries, but the China risk partly accounts for this.

In a nutshell

Asset	ASSET ALLOCATION DECISIONS Aug-17	Change	Sep-17
Cash	**N**		**N**
Fixed Income	**N**		**N**
Government Bonds	UW		UW
Inflation-Linked	OW		OW
Euro IG Credit	N		N
International IG	N		N
EM Debt	OW		OW
Euro High Yield	N		N
Equities	**N**		**N**
Europe	OW		OW
World ex-Europe	UW		UW
Emerging Markets	UW		UW
Alternatives			
Convertible Bonds	N		N
Real Estate	OW		OW
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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