Degroof Petercam | Asset Management

Asset Allocation Flash

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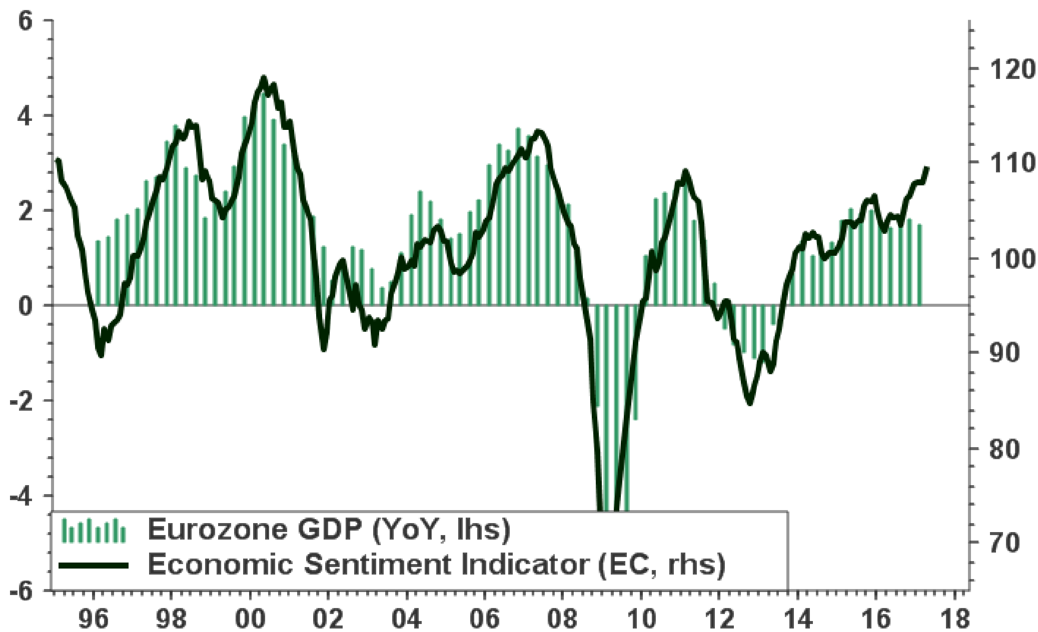
Graph of the month (May 2017)

Eurozone cyclical recovery continues



Source: Thomson Reuters Datastream, Degroof Petercam

Global

Dependent on loose monetary policy

- Economic confidence indicators continue to point to a solid cyclical growth momentum across sectors and regions. Besides, global trade is showing early signs of improvement. Following numerous false starts in recent years, the current recovery looks stronger, more broad-based and more sustainable. That said, the significant difference between (soft) confidence indicators and (hard) measures of economic activity is questioning this to some extent.
- What's more, the world economy is still largely dependent on very loose monetary policy. Political risks remain tilted to the downside but appear to have eased somewhat more recently. And the latest drop in energy and metal prices warrants some caution.
- Base effects linked to commodity prices continue to support inflation

but have now started to fade. This means headline inflation is heading somewhat lower again. Though expected to gain strength as the cyclical recovery confirms, underlying inflation remains modest and below target in most developed markets for the time being. This implies that monetary conditions will stay loose for now even though the Fed is eying a gradual tightening of monetary conditions.

- The structural economic outlook is still clouded against the back of demographic headwinds, slower productivity growth, the debt overhang, geopolitical concerns and the difficult economic rebalancing process in China.

United States

Accommodative monetary policy

- US economic activity got off to a disappointing start as expected with Q1 GDP expanding only 0.7% in QoQa terms. Indeed, the downbeat message from the Atlanta Fed GDP tracker was proven right. That said, this was only a temporary setback. Also the Fed has labelled the Q1 figures as 'transitory'. Judging from the upbeat levels of consumer and business confidence this analysis seems correct indeed.
- April's employment report was generally strong with job growth of 211k and a further declining unemployment U3 and U6 unemployment rate.
- Disposable income growth, consumer sentiment and the favourable housing and labour market backdrop still point to solid household consumption growth. It's also encouraging to witness early signs of an upturn in private investment.
- 'Trumponomics', meanwhile, 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 although the document provided very little detail and appears to rely heavily on optimistic growth assumptions.

Eurozone

GDP expanding at 1.8%

- Economic activity confirmed in Q1 with GDP expanding at 1.8% in QoQa terms. Economic confidence indicators throughout the whole of Europe and across sectors are on the rise and the European labor market continues to improve.
- Household consumption growth remains firm, illustrated by a further rise in passenger car registrations. Real disposable income growth is slowing somewhat on rising inflation but could be

compensated by a further fall in the savings rate.

- Whereas the eurozone is experiencing a cyclical recovery, structural headwinds in the form of ageing and insufficient progress towards a budgetary, political and banking union remain present.
- Headline inflation jumped back up to 1.9% in April due to this year's timing of Easter but is projected to fall from current levels. Underlying inflation was subject to the same seasonal distortion but remains stubbornly low. All in all, even though core price pressures should rise somewhat against the back of a more positive growth momentum, the ECB still looks to experience difficulties in getting inflation up to its target of 2% in a sustainable way.
- Therefore, 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' will become more pronounced as the year proceeds and economic activity confirms.

Emerging Markets

China set for a comeback

- China's challenging rebalancing exercise and uncertainties linked to monetary policy tightening in the US could still expose more EM weakness. Moreover, Trump's presidency bodes risks for EM (~trade policy, ~protectionism) even though risk of fierce US protectionism do not seem to materialize for now. Geopolitical tensions surrounding the Korean peninsula and South China Sea remain present.
- Although very difficult to time, concerns about China look set for a comeback. Indeed, the background of soaring house prices and continued rapid credit growth is far from comfortable. In the March National People's Congress, Chinese policymakers have changed the growth target to 'around 6.5%, or higher if possible', down from '6.5% to 7%' last year while highlighting the need to cut excess supply and monitor financial risks.
- 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*	**2.0**	**2.1**	*1.3*	**2.3**	**2.2**
		2.2	*2.4*		*2.5*	*2.3*
Eurozone	*1.7*	**1.8**	**1.4**	*0.2*	**1.6**	**1.4**
		1.7	*1.5*		*1.6*	*1.4*
Japan	*1.0*	**1.1**	**1.0**	*-0.2*	**0.6**	**0.8**
		1.3	*1.0*		*0.7*	*1.0*
China	*6.7*	**5.5**	**5.0**	*2.0*	**2.3**	**2.5**
		6.5	*6.2*		*2.3*	*2.3*

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

Currencies (vs. EUR)

USD has become expensive

- The USD lost some ground in recent weeks against the back of easing political risks in Europe and further confirmation of the economic recovery. The currency 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. All in all, downward risks for the USD remain present in a medium to longer term perspective.
- EM currencies experienced downward pressure again since Trump got elected but most recovered since then. In general, China's challenges, the unimpressive growth outlook and political risks warrant caution.

Asset Classes

Prudent stance on risky assets

Cash | Neutral

- Cash is neutral

Periphery bonds on a tear

Government bonds | Underweight

- Base effects linked to commodity prices continue to support inflation but have now started to fade. This means headline inflation is heading somewhat lower again. Though expected to gain strength as the cyclical recovery confirms, underlying inflation remains modest and below target in most developed markets for

the time being.

- Our scenario for the 10-year Bund fluctuating in the 5 - 65 bps range remains valid, but a test of the upper bound is in the cards. However, a significant move above 65 bps would indicate the market starting to anticipate a rate hike by the ECB sooner than the current expectation of the 1st quarter of 2019. This is not our view. We confirm our Underweight stance for EU Government Bonds and Underweight duration. However, we expect no sudden shock: EUR core rates will remain near historical low levels, as the longer term outlook remains challenging for the euro area.
- Periphery government bond markets saw best performance in between election rounds in the French presidential elections and experienced some profit taking after the second round.
- Despite the weak growth in the US (+0,7%) in the first quarter, rightly described by the Fed as temporary, the market expects the next rate hike in June. The Fed has become less driven by market expectations and looks to apply rules based on incoming data points. Inflation readings have more upside than downside risks attached. We stick to our scenario for a total of 3 rate hikes in 2017 and another three hikes in 2018 and still favour US TIPS over nominal Treasury bonds for an overall Neutral call on US government paper.

Downgrade to 'neutral'

Euro IG Corporate Bonds | Neutral

- Credits spreads have been driven tighter by combination of low supply, decent earnings and continued low real yields in government bonds. Following the outcome of the first round of the French election spreads trended tighter.
- The ECB purchase program will continue to be supportive. The Euro system has bought € 82bn of corporate bonds since June 8th 2016 under its corporate sector purchase program. Over April as a whole, the ECB purchased €6.8bn – a substantial reduction in the pace seen between September and March (excluding December). The slowing pace is likely due to the ECB slowing the overall pace of its asset purchases from €80bn to € 60bn in April. We could think that monthly purchases are likely to hold in the €6 -€7bn range, down from an average of €9bn seen between September and November.

ECB will be beneficial to HY

Euro High Yield Bonds | Neutral

- The macro and micro fundamentals are supportive for the asset class. However, the current spread level fully reflect this condition. At current levels, spreads do not provide sufficient cushion to protect against any important increase in rates or any decline in equity market valuation.
- Nevertheless, we keep our Neutral stance on European HY. The

increase in core rates, foreign exchange volatility or equity volatility must be substantial before the high yield sector loses its buffer to defend total returns.

Potential consolidation

LC Emerging Market Debt I Overweight

- Medium term fundamentals remain very supportive. However, we are seeing a number of short term factors signalling a potential consolidation/correction in the market, e.g. weaker commodity prices, higher US real interest rates and underperformance of manufacturing PMIs vs. Developed Market economies.
- As a result, we are still positive, but in the short term more cautious about the sector.

Better macro outlook

Developed market equities I Slight overweight

- With the political risk in Europe now pushed to the background – for now – after the French elections, we have moved to a Slight Overweight position (from Neutral), favouring European equities.
- Q1 earnings season was very strong, and earnings revisions continue to be positive.
- Recent performances have slightly reduced the expected returns.
- Volatility is historically low, especially in US.
- Geographical allocation remained unchanged. We remain Overweight European equities and are Slightly Underweight on US equity.
- We are also Underweight equities in Japan even if valuations are attractive (13.9x forward earnings) and earnings revisions are improving.
- Sustainability and further improvement of margins and profitability is still a big question mark.
- Japan's relative performance still linked to the evolution of JPY.

Valuations more appealing

Emerging market equities I Slight underweight

- Emerging Markets equities' valuations (11.9x forward earnings) are more appealing than in developed countries, but the China risk partly accounts for this.
- Commodity prices have been weak recently.
- The rise in the USD (USD denominated debt held by EM companies) and the possibility of protectionist measures by the US indicate an elevated risk for the region.
- The stabilization noticed earlier in next twelve months Emerging Markets consensus earnings forecasts do not seem convincing, earnings growth is still missing.

Asset Allocation Flash

In a nutshell

Asset	Apr-17	Change	May-17
	ASSET ALLOCATION DECISIONS		
Cash	**N**		**N**
Fixed Income	**N**		**N**
Government Bonds	UW		UW
Inflation-Linked	OW		OW
Euro IG Credit	OW	↓	N
International IG	N		N
EM Debt	OW		OW
Euro High Yield	N		N
Equities	**N**	↑	**OW**
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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