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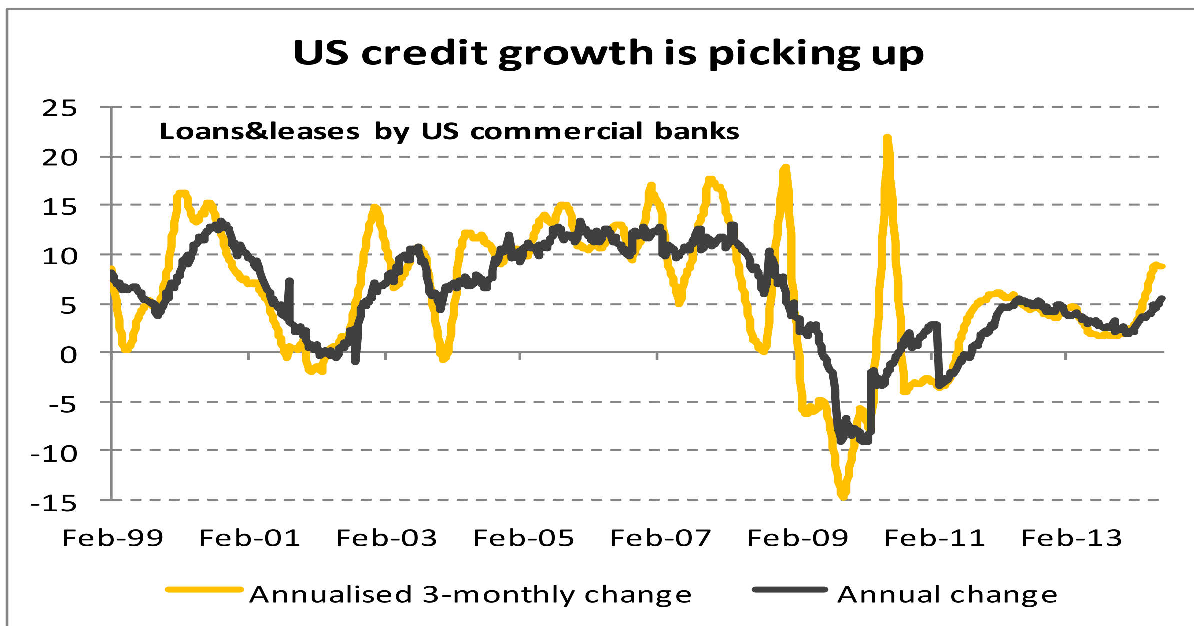
Petercam IAM Asset Allocation Committee | August 2014

GRAPH OF THE MONTH



GLOBAL

The major economic risk lies in monetary policy

- In spite of a number of **geopolitical issues** (in Ukraine, Israel, Iraq, …) the global recovery remains on track. Improving confidence, reduced fiscal tightening, accelerating global trade and supportive monetary conditions suggest that this gradual recovery will continue in coming quarters.

- **Inflation remains low**, and this isn't about to change any time soon. Recent developments in commodity prices suggest the disinflation trend is over, but a significant increase in global inflation is not on the cards. There is still slack in the global economy that's holding inflationary pressures in check. On top of that, global demand is still not strong enough to force a significant increase in commodity prices.

- The main risk for the world economy and financial markets lies in **monetary policy**. The Fed and the BoE are heading for rate hikes in the next 6 to 12 months, and it is unclear what the impact of this will be. That said, for now the Fed and the BoE are moving extremely cautiously. Their main focus remains on supporting economic growth, rather than on inflation/bubbles. In that sense, global monetary policy remains supportive.

UNITED STATES

Housing market recovery remains on track

- Following the **weather-related weakness** in Q1, the US economy is getting back to the expected 3% growth path. Leading indicators have been picking up again recently. Confidence of both large companies and SMEs is improving, confirming that the recovery remains on track. Overall, the economic situation is gradually getting back to normal and this move has further to go.
- In recent weeks, **credit growth** has been increasing, an early indication that extremely supportive monetary policy is finally starting to feed through into the real economy. If this trend is confirmed in coming months, this would be very promising for the recovery.
- Since mid-2011 the **labour market** has been generating about 200k additional jobs a months. Recent months have shown some signs that this could be accelerating slightly. Meanwhile, the unemployment rate continues to ease (currently down to 6.1%). On top of that, leading indicators suggest wage growth is about to really pick up from low levels in coming quarters.
- **Headline inflation** has moved back to 2%, while the Fed's preferred inflation indicators (personal consumption deflators) are also moving up. There is no need to start to fret about rising inflation, but most inflation indicators are getting back to normal levels (while monetary policy is anything but). Inflation remains firmly under control, but is no longer ultra-low.
- Although there have been some doubts, the **housing market recovery** is set to continue to strengthen.

EUROPE

The relationship with Russia is deteriorating

- Recent data on the Eurozone have shown signs of hesitation of late, although the first indications for July **business confidence** were positive again. All in all, most Eurozone indicators are currently at levels consistent with economic growth in a 1.5 to 2% range. As the Eurozone economy is unlikely to see much stronger growth in the near future, some sideways moves in leading indicators are to be expected.
- The **relationship with Russia** is deteriorating. However, direct export links to Russia are limited: Eurozone exports to Russia are only 1.2% of GDP. Gas could be an issue, but thanks to the mild winter gas prices are down 45% since last December.
- As a share of GDP, **investment spending** has fallen to the lowest level in more than 20 years. This opens up potential for a catch-up move in business investment. The increase in capacity utilisation and improving business confidence suggest that an upturn in the investment cycle is coming.
- **Headline inflation** is at 0.5%, with core at 0.8%. Talk of deflation throughout the region still seems overdone, but inflation is clearly too low (as there is no buffer for any new negative shocks).

ASIA

Many EM are facing domestic issues

- In Japan, the economy is feeling the hit of the **consumption tax increase**. However, leading indicators suggest the hit should be temporary. Meanwhile, inflation (outside of the tax increase) seems to be stabilising. As the initial inflation push of the combination of commodity imports and yen weakness is now fading, inflation is likely to ease back in coming quarters, raising questions about the exit out of deflation.

- **Leading indicators** for most EM have been easing recently, which contrasts with the improvements in sentiment in financial markets in the region. EM still look set to benefit from the continuing recovery in DM, which implies that the outlook for EM exporters is looking promising.

- That said, many EM are still facing **domestic issues**: a number of EM are looking at inflation and capacity issues (Brazil), while others have been relying on too much credit growth (Turkey, Thailand). The diversity in the region is quite important in any assessment of the economic outlook. Importantly, most of the BRICs are in trouble: China continues its managed slowdown, while Russia and Brazil are hovering on the edge of recession. On the other hand, the outlook for India is improving.

- The **Chinese economy** continues on its path of managed slowdown, even if recent data were positive. The economy is likely to continue to slow down gradually for several years to come as the authorities continue to take measures to rein in credit growth.

- **Inflation** throughout EM remains broadly under control (Turkey, India and Indonesia are notable exceptions).

MONETARY POLICY

The Fed continues to head for the exit

- The Fed continues its **well-communicated exit** in line with the improving economic outlook. The monthly bond purchases will be concluded in October, and now the focus is shifting towards the first rate hike. This is likely to come next Spring. Increasing credit growth, inflation and wage growth suggest the time for a turn in monetary policy is coming closer. The Fed will continue to communicate carefully on this in an attempt to prevent large market reactions. However, the question remains whether it is capable to do this. In any case, the upcoming hiking cycle is likely to be slower than usual, but faster than markets currently anticipate. For the next 6 to 12 months, this is likely to be the key issue for financial markets.

- In the **Eurozone** the ECB introduced additional monetary stimulus at its June meeting, reducing its policy rate further and moving the deposit rate into negative territory, announcing a new LTRO specifically targeted to push credit growth. On top of that, the ECB confirmed its willingness to move to outright QE if necessary. Whether this materially changes the outlook of too low inflation remains questionable. Further steps towards the end of the year remain a possibility. In any case, on the current outlook the ECB is unlikely to take any monetary tightening steps for at least another three years.

- The **UK economy** is performing quite strongly, and especially the housing market is powering on. This has already pushed the BoE to scale back its non-conventional measures. On top of that, the BoE is likely to be the first of the major DM central banks to start increasing its policy rate (probably before year-end).

- In Japan, the **BoJ** sticks to its earlier monetary stimulus plan. BoJ-president Kuroda has acknowledged that inflation (outside of the consumption tax increase) will ease in coming months as the impact of earlier yen weakness fades, but he expects this to be temporary (and no reason for additional action). However, if the BoJ is serious about fighting deflation and about its 2% inflation target, it will probably have to accept the need for additional stimulus towards the end of the year.

FORECASTS

	2013	2014	2015
GDP projections			
USA	1.9	1.7 (1.7)	3.3 (3.0)
China	7.7	7.0 (7.4)	6.5 (7.2)
EMU	-0.4	1.0 (1.0)	1.6 (1.5)
Japan	1.7	1.6 (1.5)	2.0 (1.2)
CPI projections			
USA	1.5	1.9 (2.0)	2.2 (2.2)
China	2.6	3.0 (2.5)	3.0 (3.0)
EMU	1.4	0.7 (0.7)	1.4 (1.2)
Japan	0.4	2.6 (2.7)	1.8 (1.8)

Petercam forecasts, consensus forecasts between brackets

CURRENCIES

Things have calmed down for EM currencies

- During the past month, the **dollar** strengthened from 1.37 to just under 1.35 euro. This is in line with the diverging outlook for the Fed and the ECB, but it is too early to talk about a new trend. Nevertheless, there should be more to come on this as the Fed continues to move towards a first rate hike, while the ECB sticks to its current supportive policy for quite some time. In line with the difference in economic outlook between the US and the Eurozone monetary policy will diverge. Over the next three years, the Fed is highly likely to move towards substantially higher policy rates, while the ECB is likely to stick to extremely loose monetary policy. This divergence should push the euro significantly lower versus the dollar. The diverging outlook for monetary policy and economic activity suggests a weaker euro is warranted. As such, our baseline scenario continues to see a weaker euro versus the dollar in 2014.
- The **pound** has already strengthened substantially versus the euro as the UK economy is performing much better than the Eurozone. Still, this move has further to go as the BoE is likely to start raising interest rates in the next 6 months.
- On the back of its aggressive monetary easing, the **yen** weakened significantly in 2013. Since the beginning of the year this weakening trend has paused. However, eventually the BoJ still looks likely to add more stimulus, which should further weaken the yen in the second half of the year.
- Things have calmed down somewhat for **EM currencies** in recent months. Overall, EM currencies have even recovered part of the earlier losses. That said, there are still risks, especially for countries that are highly dependent on external capital inflows. They remain vulnerable in a climate of expected changes in global liquidity conditions because of the Fed's actions. At the very least, EM currencies will continue to see significant volatility in coming months, even if the earlier correction has created opportunities.

ASSET CLASSES

Returns are very low

- **Cash | Underweight**
- Returns on cash are extremely low, and fail to cover inflation.
- There are better opportunities in other asset classes.

Strong start to the year

Government bonds| Neutral

- Bonds have started the year strong as concerns about the global recovery have pushed interest rates lower. However, part of this move is likely to be reversed as economic indicators pick up again.
- The gradually strengthening recovery and further moves by the Fed towards the exit of ultra-loose monetary policy suggest the risk of slowly increasing interest rates remains very real.
- Central bankers will prevent a sharp interest rate increase (like in 2013). Nevertheless, the expected returns on government bonds from here on are low at best.
- As confirmed again in the past few months, bonds provide insurance against negative economic surprises.

Modest return outlook

Euro IG Corporate Bonds| Underweight

- In line with the recovery the default outlook is quite favourable for IG credit.
- However, corporate bonds have become quite expensive, suggesting the return outlook is limited. Even without an increase in interest rates, the expected return for IG is modest, and this hardly justifies the risk related to this asset class.
- The interest rate risk for government bonds is also relevant for IG credit.

HY still provides carry

Euro High Yield Bonds| Neutral

- HY bonds still provide carry, even though they have become quite expensive and the room for further spread contraction has all but disappeared.
- The quality of HY issues is clearly deteriorating.
- Within the bond universe, we are neutral on HY bonds.

Earlier corrections have created opportunities

Emerging Market Debt| Neutral

- EMD provides the most interesting carry within the fixed income universe.
- Following the earlier turbulence in EM, things seemed to have calmed somewhat more recently. Important risks remain, but at least in some EM the earlier corrections have created opportunities.
- That said, there is important divergence within EM. Especially current account deficit countries remain quite vulnerable.
- EMD is highly dependent on EM currencies, which are likely to continue to be volatile as the Fed's actions raise questions about global liquidity conditions.
- Within the bond universe, we are cautiously positive on EMD (but are highly selective of which EM we invest in).

US equities are expensive

Developed market equities| Overweight

- The global recovery looks set to continue. This recovery and still very supportive monetary policy create a positive climate for equities, even if markets have already anticipated this to some extent, and some markets (mainly the US) have become quite expensive.
- The US has already seen a substantial profit recovery, while in Europe we definitely see the first signs of improvement. Indeed, there have been fewer negative pre-announcements of companies and fewer downward revisions by analysts. Earnings are effectively growing, albeit at a slow pace. The currency headwind that was felt in Q1/Q2 should disappear in H2.
- US equities are expensive, while European and Japanese equities offer more attractive opportunities.
- Japanese equities are likely to benefit from a further weakening of the yen on the back of additional action by the BoJ and their close link to global economic activity.

Valuations remain very attractive

Emerging market equities| Overweight

- Cyclical dynamics in most EM (outside of the BRICs) are improving, thanks to increasing export opportunities. This should be a clear positive for EM companies.
- Valuation remains very attractive.
- Even though EM equities have lagged behind, both the near term cyclical outlook and valuation are positive. We continue to expect that these positives will drive the market. We remain positive on EM equities.

Other

- Gold: has a place in portfolios as insurance against monetary accidents.

KEY TAKE-AWAYS

- There is **no allocation change** versus last month.
- The gradual global recovery remains on track. Recent data were strong in the US, somewhat weaker in the Eurozone. Current geopolitical concerns (Ukraine, Iraq, …) are unlikely to derail the positive trend.
- In Europe, leading indicators are showing signs of hesitation, which should not come as a surprise as they had reached levels consistent with growth in the 1.5-2% range.
- In Japan, the consumption tax increase hit the economy in Q2 basically as expected, but the rest of the economy seems to be holding up well.
- In EM, recent leading indicators have not been very positive. Meanwhile, China continues its trajectory of managed slowdown.
- Central banks remain essential in the current cycle: the Fed and the BoE are heading towards a first rate hike within the next 12 months, while the ECB and the BoJ are likely to be looking into additional stimulus by the end of this year.
- We prefer equities over bonds over cash.
- Within equities, we prefer Europe, Japan and EM.

IN A NUTSHELL

	ASSET ALLOCATION DECISIONS		
Asset	**Jul-14**	**Change**	**Aug-14**
Cash	**UW**		**UW**
Fixed Income	**UW**		**UW**
Government Bonds	N		N
Inflation-Linked	OW		OW
Euro IG Credit	UW		UW
International IG	N		N
EM Debt	N		N
Euro High Yield	N		N
Equities	**OW**		**OW**
Europe	OW		OW
World ex-Europe	N		N
Emerging Markets	OW		OW
Alternative			
Convertible Bonds	N		N
Real Estate	N		N
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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