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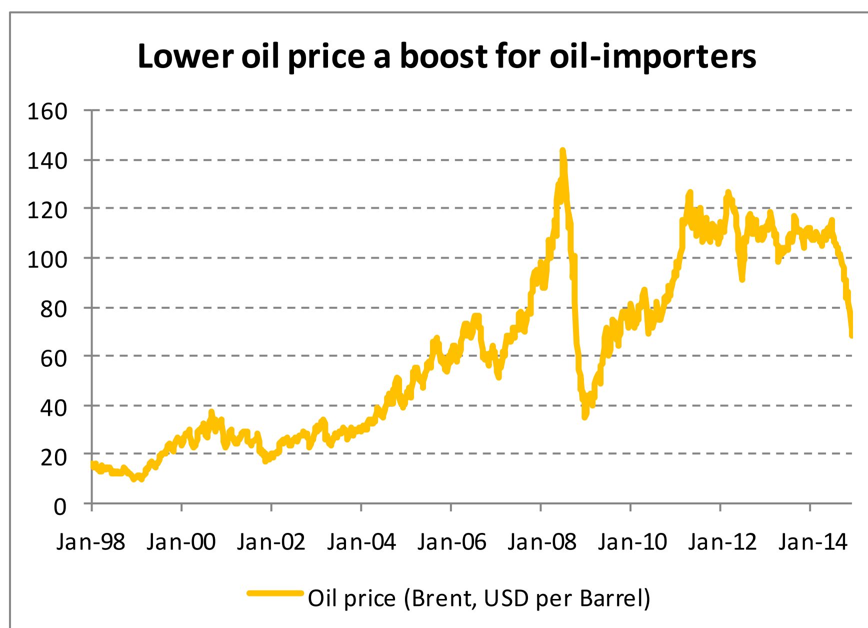
Petercam IAM Asset Allocation Committee | December 2014

GRAPH OF THE MONTH



GLOBAL

Falling oil prices are a boon

The scenario of a **gradual global recovery** led by the US was confirmed during the past month. The US continued to show signs of economic strength, while in the Eurozone there were signs that earlier pessimism was somewhat overdone. Meanwhile, additional policy moves in Japan and the Eurozone should also have positive effects. Improving confidence, reduced fiscal tightening, cheaper commodities and supportive monetary conditions suggest that this gradual recovery has further to go. For the world economy as a whole, the fall in oil prices is a positive. For oil-importing countries it should be seen as a huge boost.

Inflation remains low, and will fall even further in coming months on the back of lower commodity prices. On top of that, there is still slack in the global economy that's holding inflationary pressures in check. Meanwhile, deflation risks remain uncomfortably high in Japan and the Eurozone.

The next big risk lies in **monetary policy**. The Fed is moving to rate hikes in the next 12 months. Following six years of unseen monetary stimulus, this will have an impact, especially on markets. For now the Fed is still far more concerned about economic growth than about inflation/bubbles. As long as that remains the case, monetary policy will remain broadly supportive.

UNITED STATES

A political deadlock is in the cards

- The **US economy** grew by 3.9% in Q3 and leading indicators confirm a positive outlook for the next couple of quarters. The recovery is now quite broad with the housing market continuing its recovery, business investment picking up, the credit mechanism functioning again and the labour market generating decent job growth. The last leg missing is wage growth, but this looks set to change in the next few quarters. Overall, the economic situation is gradually getting back to normal and this move is likely to continue in coming quarters.
- Since mid-2011 the **labour market** has been generating about 200k additional jobs a months. Meanwhile, the unemployment rate continues to ease (currently down to 5.8%), initial jobless claims is below pre-crisis levels and the number of job openings is back at the highest level since 2001. For now, wage growth remains subdued, but leading indicators suggest that is about to really pick up from low levels in coming quarters. This is likely to put Joe Sixpack back on the map.
- Both **core and headline inflation** have been fairly stable just below 2% in recent months. Lower energy prices will push headline inflation lower in the near term.
- Republicans taking full control of Congress will lead to **political deadlock**. However, a repeat of earlier damaging episodes like the government shutdown is unlikely. Politicians are unlikely to risk damaging the recovery again.

EUROPE

The credit mechanism is showing signs of revival

- Recent data on the **Eurozone economy** have restored some calm as most indicators suggest fears of a triple dip recession are overdone. The Eurozone remains on track for low but positive economic growth. Euro weakness should provide a significant boost to exports, low oil prices and low interest rates are generating purchasing power and the fact that credit growth is no longer deteriorating also bodes well for domestic demand. All in all, the Eurozone seems to be heading towards 1 to 1.5% growth.
- On the back of **lower energy prices**, headline inflation is likely to flirt with zero in the near term. Meanwhile, core inflation is at its all-time low of 0.7%. Talk of deflation throughout the region still seems overdone, but inflation is clearly too low. As it stands, the Eurozone is only one negative shock away from deflation, and this remains a dangerous situation.
- The **credit mechanism** is starting to show signs of life again. Surveys indicate both credit demand and supply are picking up again. In combination with the stress tests and the other action from the ECB this implies that the credit impulse is turning positive again. This should support domestic demand.
- There seems to be a consensus growing that the Eurozone needs **more public spending**, especially under the form of investment. New EC chair Juncker has proposed an investment plan, but this is unlikely to impact growth much in the near term.

ASIA

Inflation throughout EM remains broadly under control

- In **Japan**, the authorities now seem to be going all in in their fight against deflation. Abe has called for December elections in an attempt to strengthen his mandate. He proposes to postpone the scheduled fiscal tightening (a second consumption tax increase in October 2015), and to move to more fiscal stimulus. This should help to economy to recover from the first consumption tax. Meanwhile, underlying inflation remains very subdued.

- In **EM** there is significant divergence between commodity-exporters and the BRICs (with the exception of India) that are in trouble and most commodity-importers (India, Mexico, Philippines, Poland, Indonesia) where the outlook is reasonable. This divergence will continue in the next couple of months.

- That said, many EM are still facing **domestic issues**: a number of EM are looking at inflation and capacity issues (Brazil, where the election victory of Rousseff will not help to improve the outlook), 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. Countries like India, Indonesia, the Philippines and Poland are doing quite well in the current climate.

- The **Chinese economy** continues on its path of managed slowdown. The economy is likely to continue to slow down gradually for several years to come as the authorities continue to take measures to reign in credit growth.

- **Inflation** throughout EM remains broadly under control, although there are several EM where inflation is at the high end of or above the inflation target (Turkey, Russia, Brazil, South-Africa).

MONETARY POLICY

The BoJ stepped up its asset purchase programme

- The Fed continues its **exit strategy**. As it has now ended its asset purchases, the next step will an increase in policy rate. Timing of this will depend on the strength of the economy, but on the current outlook a first move by the Summer looks likely. Crucially, the Fed is still far more worried about economic growth than about inflation risks. As long as that remains the case, any move towards monetary tightening will remain gradual and very modest. Above all, the Fed does not want to derail the recovery.

- In the Eurozone the ECB finally seems to be focusing on the **deflation risk**. Mario Draghi already promised to bring the ECB balance sheet back up to the level of early 2012 by buying a range of assets (excluding government bonds). As the ECB looks set to miss its inflation target for another 5 years and deflation risks remain uncomfortably high, the ECB will have to do more. Outright government bond purchases and a significantly higher balance sheet target are unavoidable. Timing of this will depend on the struggle between Draghi and the Bundesbank.

- In Japan, the **BoJ** finally acknowledged that it was not going to reach its inflation target. In a reaction, the BoJ stepped up its asset purchase program. Moreover, it promised to continue the program for as long as necessary (instead of the earlier announced 2 years). Monetary policy theory suggests that deflation can be avoided simply by printing enough money. Japan now seems willing to fully test that theory in practice. This is likely to imply additional monetary stimulus going forward.

- In **China**, the central bank cuts its interest rate in November. This is intended to guide the gradual, managed slowdown of the economy. The move should reduce the interest burden for households and companies. As the quota for credit have not been increased, it is not intended to boost credit growth. For the latter, credit quota are the key driver, not the policy rate. China keeps its managed slowdown on track. Every time that slowdown is going a bit too fast, the authorities add some more stimulus. This dynamic is likely to continue in the next couple of years.

FORECASTS

	2013	2014	2015
GDP projections			
USA	2.2	2.1 (2.2)	3.2 (3.0)
China	7.7	7.0 (7.4)	6.5 (7.0)
EMU	-0.4	0.8 (0.8)	1.3 (1.2)
Japan	1.7	1.2 (0.9)	1.5 (1.0)
CPI projections			
USA	1.5	1.7 (1.7)	2.0 (1.7)
China	2.6	2.5 (2.1)	2.7 (2.5)
EMU	1.4	0.5 (0.5)	1.0 (0.9)
Japan	0.4	2.8 (2.8)	1.8 (1.8)

Petercam forecasts, consensus forecasts between brackets

CURRENCIES

Things have calmed down for EM currencies

- Since the Fed has ended its asset purchases, the obvious **divergence** between the Fed and the ECB has really started to impact the Eurodollar exchange rate. This move has further to go: the former is gradually preparing for a first rate hike, while the ECB is moving towards additional stimulus measures. This is a reflection of diverging economic trends in the US and the Eurozone. While the US is currently growing above trend pace, the Eurozone is flirting with stagnation/deflation. This will increasingly be reflected in diverging monetary policy. The relative trend in monetary policy is finally having its long-awaited impact on the eurodollar. Since early May the dollar has gained about 11% versus the euro. Expect more of this to come as the divergence in monetary policy in the US and the Eurozone continues. 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 **pound** has already strengthened substantially versus the euro in the past year as the UK economy is performing much better than the Eurozone. In spite of the recent hesitation, this move has further to go as the BoE moves closer to the first rate hike next year.

- In a rerun of what happened late in 2012, the announcement of **extra monetary stimulus** by the BoJ clearly affected the yen, pushing it down another 9% versus the euro (12% versus the dollar). The yen has now depreciated more than 50% versus the euro since late 2012. The BoJ will continue to push for a weaker currency, so further weakness remains likely. That said, most of the move is obviously behind us.

- 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. coming months.

ASSET CLASSES

Returns are very low

- **Cash | Neutral**

- Cash is neutral
- This tactical position expresses our more cautious stance on risky assets

Expected returns are low at best

Government bonds| Neutral

- Bonds have performed extraordinarily well this year thanks on the back of concerns about low growth and deflation. On top of that, the global search for yield has been a key driver. However, with interest rates at record lows the potential for further declines in rates has become quite limited.
- The subdued outlook for growth and inflation in the Eurozone in combination with the expected reactions of the ECB is likely to keep interest rates low for a long time to come. In the US and the UK the move towards rate hikes could have an effect on rates, but central bankers will move carefully on this. Nevertheless, from current levels the medium term risk of an increase in rates is larger than that of a further decline.
- The expected returns on government bonds for the rest of the year are low at best.

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.

Quality of issuance is deteriorating

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.

Selectivity is key

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.
- 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 neutral on EMD (but are highly selective of which EM we invest in).

A rally in recent weeks

Developed market equities| Overweight

- The combination of global economic recovery and aggressive monetary stimulus has pushed equity markets higher in recent weeks.
- In the Eurozone, even modest economic growth is likely to generate decent profit growth. Moreover, a more active ECB should also help to create a positive climate for equity markets. Meanwhile, in Japan markets are driven by the actions of the BoJ.
- We expect that the move of the Fed towards a first rate hike will lead to increased volatility in coming quarters, and not only in the US.

Valuations remain attractive

Emerging market equities| Neutral

- Increasing export opportunities linked to the DM recovery should be a positive for EM companies.
- Valuation remains attractive.
- However, we are neutral to reflect the impact of a stronger USD.

KEY TAKE-AWAYS

- **Our overall positioning has not changed versus last month**
- The global economic recovery continues, despite several risks
- The US economy is on track for 3% growth in the coming quarters, while the European economy remains fairly weak, although falling oil prices and a depreciating EUR provide some tailwinds
- Emerging Markets are recovering somewhat, but remain vulnerable to higher US rates and an appreciating USD
- We believe the ECB will step up its monetary stimulus as of next year

IN A NUTSHELL

Asset	ASSET ALLOCATION DECISIONS		
	Nov-14	Change	Dec-14
Cash	**N**		**N**
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	N		N
Alternative			
Convertible Bonds	N		N
Real Estate	N		N
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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