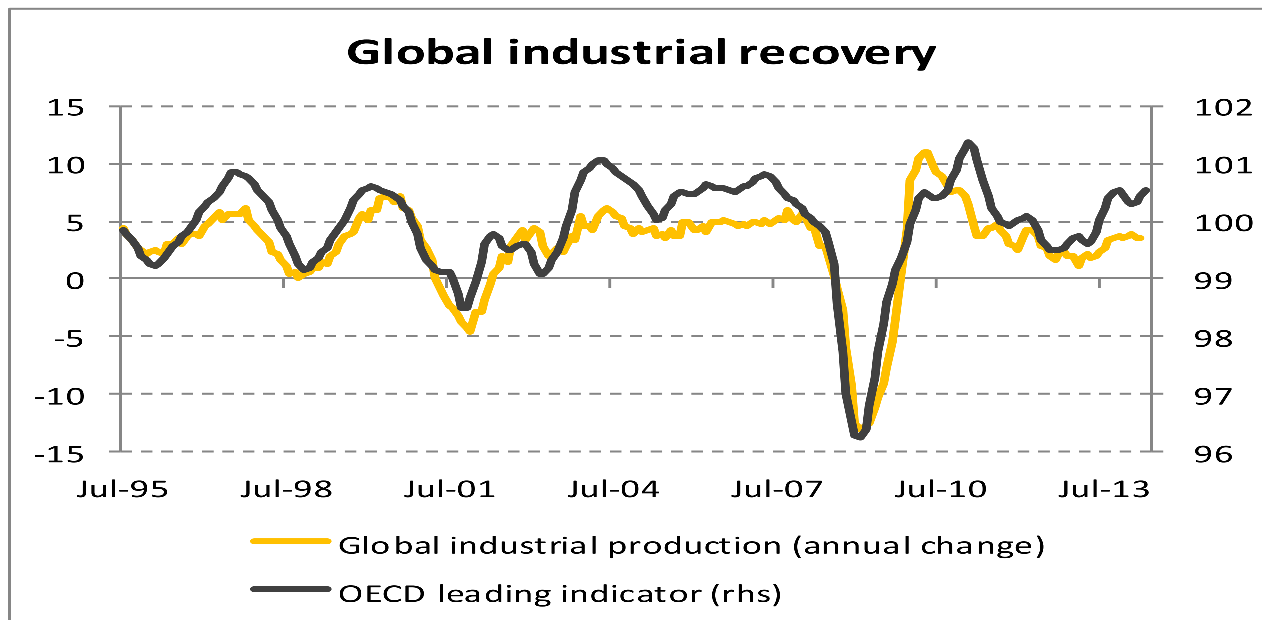
Editing & Co-ordination:
Petercam Institutional Asset Management
Asset Allocation Committee
Contact: piam@petercam.be
www.petercam.com
funds.petercam.com
insights.petercam.com

Petercam IAM Asset Allocation Committee | July 2014

GRAPH OF THE MONTH



GLOBAL

Inflationary pressures remain in check

- In spite of a number of issues like Ukraine, Iraq, a dismal Q1 for the US economy, signs of hesitation in Europe, slowdown in China, … the **global recovery remains on track**. Improving confidence, reduced fiscal tightening, accelerating global trade and supportive monetary conditions should translate into continued economic recovery led by the US.

- **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. The recent focus on oil prices linked to the deteriorating situation in Iraq is overdone. For now, oil prices remain stuck in the their trading range of the past three years. There is still slack in the global economy that's holding inflationary pressures in check, while commodity prices continue to move mostly sideways.

- Even though the Fed and the BoE are gradually moving towards a **first rate hike**, they are doing so cautiously. Their main focus remains on supporting economic growth, rather than on inflation/bubbles. In that sense, global monetary policy remains supportive. That said, overall the monetary stimulus cycle is bottoming out (although any tightening will be slow).

UNITED STATES

The first quarter was not good at all

- Q1 was the **worst quarter** of the past five years for the US economy with a contraction of an annualized 2.9%. This was mainly due to severe winter weather. Since the end of winter, the economy has been recovering from its weather-related weakness. Leading indicators are picking up again. 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 picking up rapidly, an early indication that extremely supportive monetary policy is finally starting to feed through into the real economy.
- The **labour market** continues to generate about 200k additional jobs a month, while the unemployment rate continues to ease (currently down to 6.3%). Total employment has now finally climbed back above its pre-crisis level. Meanwhile, there are increasing signs that wage growth is starting to pick up from low levels.
- **Headline inflation** has moved back to 2%, while the Fed's preferred inflation indicator (personal consumption deflator) is 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

Confidence continues to improve

- **Confidence indicators** have shown signs of hesitation of late. However, they are still 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. Meanwhile, the UK economy is really powering ahead. Leading indicators are in line with economic growth of about 3% in the UK.
- Helped by a 40% drop in gas prices, **consumer confidence** in the Eurozone is now back at the level of mid-2007 (even as unemployment remains very high). This bodes well for consumer spending in coming months.
- 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.
- Both **headline and core inflation** have been hovering just below 1% for quite some time now. 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

Japanese economy is struggling

- 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. Prime Minister Abe has provided more detail about his so-called third arrow (structural reform), but this is unlikely to have an important impact on the near term outlook for the economy.

- In **EM**, the outlook for the BRICs (with the exception of India) and the commodity-exporters remains clouded. Outside of these, the economic outlook has been improving gradually in recent months. The outlook for EM exporters is looking promising as they are benefiting from the recovery in DM and weaker currencies.

- 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.

- 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 rein in credit growth. At the same time, the authorities still have the tools and willingness to prevent this slowdown from turning into a hard landing.

- **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 along its path of gradual and well-communicated exit in line with the improving economic outlook. The Fed continues to reduce its monthly bond purchases, and has now begun to prepare markets for the first rate hike in the first half of 2015. 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 exaggerated market reactions and in order not to endanger the economic recovery. Moreover, it is still willing to let inflation move higher than in a 'normal' cycle.

- 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	2.2 (2.2)	3.3 (3.0)
China	7.7	7.0 (7.3)	6.5 (7.2)
EMU	-0.4	1.0 (1.1)	1.6 (1.5)
Japan	1.7	1.6 (1.5)	2.0 (1.2)
CPI projections			
USA	1.5	1.9 (1.8)	2.2 (2.1)
China	2.6	3.0 (2.5)	3.0 (3.0)
EMU	1.4	0.8 (0.7)	1.4 (1.2)
Japan	0.4	2.6 (2.7)	1.8 (1.8)

Petercam forecasts, consensus forecasts between brackets

CURRENCIES

The pound has appreciated substantially versus the euro

- In recent months, the **Eurodollar** has fluctuated around 1.36, as the Fed continues QE (even if it is at a reduced pace). However, it is very clear that the ECB and the Fed are on very different trajectories. The latter is heading towards a first rate hike in the next twelve months, while the former will probably be thinking about additional stimulus for another couple of years. 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 should raising interest rates in the next 12 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. In any case, the return outlook for the asset class remains modest as more than the expected return for the year has already been made. 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.
- In all, in light of the modest running yield and the risks of a potential increase in interest rates we remain cautious on government bonds.

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 this is not the case in Europe. Leading indicators suggest the acceleration in European profits should be expected in the course of 2014 as the economic recovery reaches corporate bottom lines. This should support the European market.
- 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.
- We remain positive on DM equities, preferring European and Japanese equities. We are cautious on US equities because of valuation.

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. 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.
- In the context of financial repression, almost all asset classes are becoming expensive. This trend can continue until either the recovery stalls, or monetary policy changes direction.
- We are monitoring both these options closely and are aware of risks.
- Equity valuations are expensive in the US. Moreover, they are also expensive in Europe, because up to now profit growth has not confirmed earlier optimism.
- The recovery scenario suggests that European profit growth should pick up in coming quarters. Japan and EM are still more reasonably valued.
- Bonds have performed well since the beginning of the year, but this stellar performance is unlikely to be repeated in the second half of the year.
- We prefer equities over bonds over cash.
- Within equities, we prefer Europe and Japan.
- EM equities remain compelling

IN A NUTSHELL

Asset	Jun-14	Change	Jul-14
	ASSET ALLOCATION DECISIONS		
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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