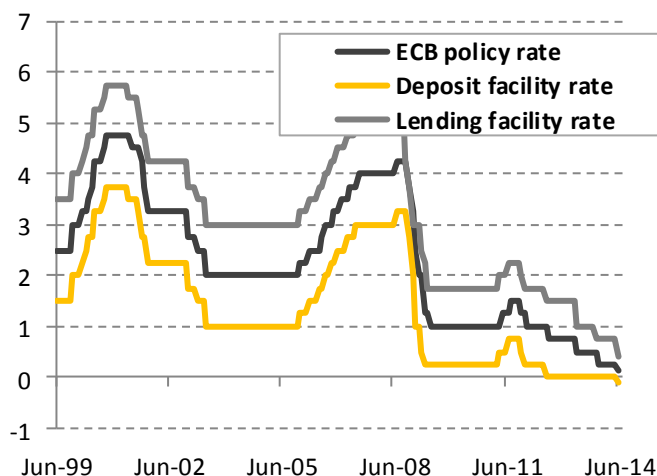


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Petercam IAM Asset Allocation Committee | June 2014

GRAPH OF THE MONTH

ECB cuts rates further



GLOBAL

Global recovery remains on track

- The **global recovery** remains on track. Moreover, some of the earlier concerns are easing: the US economy is recovering for its winter weakness, the Chinese economy is confirming its managed slowdown (rather than a hard landing) and Japan seems to be coping with its consumer tax increase. There are still economic risks out there, but overall the world economy continues along its path back to normality following the past couple of years of crisis: improving confidence, reduced fiscal tightening, accelerating global trade and supportive monetary conditions should translate into continued economic recovery.
- Inflation** remains very **low**, and this isn't about to change any time soon. There is still slack in the global economy that's holding inflationary pressures in check, while commodity prices continue to move sideways (except for food prices that have turned up recently). Higher inflation is not a risk for 2014 or 2015.
- Even though the Fed and the BoE are gradually moving towards a turn in monetary policy (along with a number of emerging markets that have raised interest rates to tackle inflation and/or capital flight risks), global monetary policy remains supportive. That said, overall the **monetary stimulus cycle** is bottoming out (although any tightening will be slow).

UNITED STATES

Inflation under control, but not ultra-low anymore

- The **economy** actually shrank in Q1 as severe weather hit activity hard. However, following the weather-related weakness of the early months of the year, leading indicators on the US economy 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.
- The **labour market** continues to recover. April showed the strongest job growth in over 2 years (+288k). Basically, the labour market continues to generate about 200k additional jobs a months, which has the average pace of job creation since the start of 2011. Meanwhile, the unemployment rate fell to 6.3%, the lowest level since 2008. Falling unemployment is likely to push wage growth. There are increasing signs that the latter is picking up from low levels.
- Indications on the **housing market** have been mixed, with home builders' confidence easing significantly. On the other hand, construction activity has been picking up again. Moreover, mortgage rates have eased back again. And most importantly, the outlook for structural housing demand, which is linked to demographic, is quite positive for the next few years.
- As expected, **headline inflation** has moved back to 2%. Meanwhile, core inflation remains well-behaved at 1.8%. Inflation remains firmly under control, but is no longer ultra-low.

EUROPE

Confidence continues to improve

- As in the US, **economic growth** in Q1 disappointed in the Eurozone. That said, leading indicators still suggest recovery is underway. Both consumers and business leaders have become significantly more upbeat in the past few months. This should increasingly be reflected in increasing economic activity throughout 2014. Meanwhile, the UK economy is really powering ahead. Leading indicators are in line with economic growth of about 3% in the UK.
- **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.
- **Headline inflation** has now been below 1% for 7 months in a row, while core inflation remains stuck at about 1%. Talk of deflation throughout the region still seems overdone, but inflation is clearly too low.

ASIA

Many EM are still 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. For now, the authorities have held back on additional stimulus measures to re-launch the positive dynamic, but such a move remains very likely in coming months.
- In **EM**, the outlook for the BRICs (although the election outcome could provide a new drive in India) and the commodity-exporters remains clouded. Outside of these, the economic outlook has been improving in recent months. The outlook for EM exporters is looking quite 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, which has now explicitly been confirmed by the authorities. The economy is likely to continue to slow down gradually for several years to come as the authorities try to reign 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 is moving to tighten monetary policy

- 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. There are signs that wage growth is starting to pick up, which will push the Fed towards gradual monetary tightening. 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. The Fed 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, which suggests the BoE will have to reconsider its policy stance. The BoE is getting closer to the start of its exit strategy, and is likely to be the first of the major DM central banks to start increasing its policy rate.
- In Japan, the **BoJ** sticks to its earlier monetary stimulus plan and appeared a bit complacent about the economic outlook in its recent speeches. However, the positive dynamics of the new policy line seem to be stalling. Moreover, the increase in inflation up to now has been mainly thanks to temporary factors (weaker currency). If the BoJ is serious about fighting deflation and about its 2% inflation target it will have to add stimulus. Recent BoJ statements make this unlikely for the very near future. However, the probability of additional stimulus after the summer remains quite high.

FORECASTS

	2013	2014	2015
GDP projections			
USA	1.9	2.4 (2.5)	3.2 (3.1)
China	7.7	7.0 (7.3)	6.5 (7.2)
EMU	-0.4	1.2 (1.1)	1.7 (1.5)
Japan	1.7	1.4 (1.4)	2.0 (1.3)
CPI projections			
USA	1.5	1.8 (1.7)	2.2 (2.1)
China	2.6	3.0 (2.6)	3.0 (3.0)
EMU	1.4	1.0 (0.8)	1.5 (1.3)
Japan	0.4	2.6 (2.6)	1.8 (1.7)

Petercam forecasts, consensus forecasts between brackets

CURRENCIES

EM currencies have regained their footing

- With the **ECB** stepping up with additional monetary stimulus, the euro has weakened somewhat versus the dollar in recent weeks, moving back to 1.36. However, the real divergence between the Fed and the ECB still has to come, when the latter actually adds stimulus, while the former continues to move gradually towards monetary tightening. 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** has weakened significantly in 2013. Since the beginning of the year this weakening trend has paused. However, 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 partly. That said, there are still risks, especially for countries that are highly dependent on external capital inflow. 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 another 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 an increase in interest rates and/or financial repression 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 very modest, and this does not justify the risk related to this asset class.
- The interest rate risk for government bonds is also relevant for IG credit.
- Because of the modest return outlook, we are negative on IG corporate bonds.

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 change versus last month.
- The global recovery remains on track
- Inflation remains low across the board
- New stimulus measures by the ECB will support the economy as well as risky assets
- The big question for European equities will be whether European earnings growth will finally come through after three years
- Emerging markets are still cheapest from an historical perspective, with considerable upside
- US equities have become expensive from a historical point of view

IN A NUTSHELL

Asset	ASSET ALLOCATION DECISIONS		
	May-14	Change	Jun-14
Cash	UW		UW
Fixed Income	UW		UW
Government Bonds	N		N
<i>Inflation-Linked</i>	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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