Petercam
Institutional Asset Management

ASSET ALLOCATION FLASH

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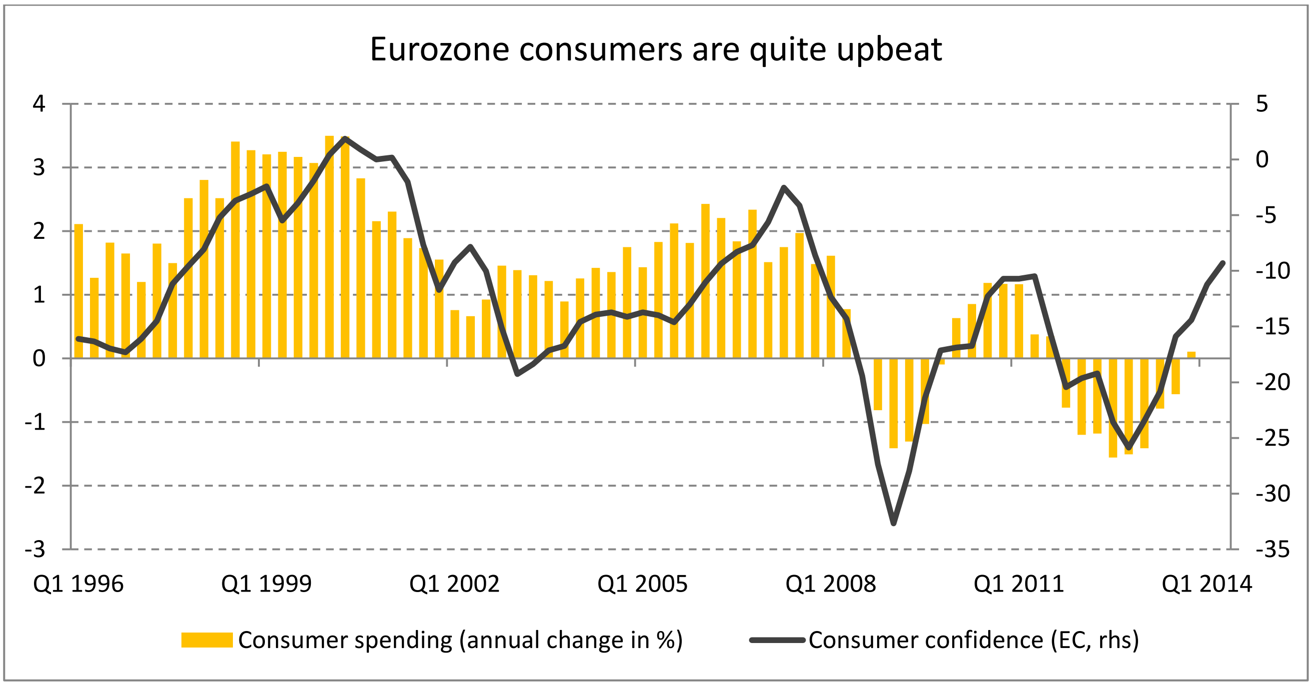
GRAPH OF THE MONTH



GLOBAL

Higher inflation is not a risk for 2014

- In spite of recent concerns about **Russia's** antics in Ukraine and the medium term outlook for the Chinese economy, the global recovery remains on track. Economic activity is picking up in the US and Europe and in several emerging markets (mostly non-BRICs and non-commodity exporters). There are economic risk out there, but overall the world economy continues along its path back to normality following the past couple of years of crisis: improved 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 substantial 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.
- Even though the **Fed** is gradually moving towards a turn in monetary policy and a number of emerging markets have raised interest rates to tackle inflation and/or capital flight risks, global monetary policy remains very supportive. That said, additional stimulus measures can be expected in some countries, but overall the monetary stimulus cycle is bottoming out.

UNITED STATES

Household plans to buy a house are currently at all-time highs

- As the **weather** has normalized, several economic indicators are picking up from recent weakness. This positive trend should continue in coming months, confirming that disappointing news in Q1 was mainly due to the exceptionally cold weather. Overall, the recovery remains on track as the housing market, the labour market, household finances … continue to improve. The economic situation is gradually getting back to normal and this move has further to go.
- The financial position of **US households** has been improving rapidly, with net worth currently approaching pre-crisis levels. Meanwhile, consumer confidence has climbed back to the level of 2007.
- The **labour market** continues to generate just under 200k additional jobs a months, which has the average pace of job creation since the start of 2011. Meanwhile, there are increasing signs that wage growth is picking up from low levels. Annual wage growth is now up to 2.3%, and likely to accelerate further.
- The **housing market** recovery has shown signs of (weather-related) hesitation. However, leading indicators confirm that the recovery should continue in coming quarters. Household plans to buy a house are currently at all-time highs.
- While **headline inflation** has been fluctuating in line with energy prices, core inflation has been stable around 1.7% for the past year. Headline inflation is likely to gradually climb back towards 2% in the rest of the year.

EUROPE

Confidence continues to improve

- In the Eurozone, **confidence** continues to improve. 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. Leading indicators are currently suggesting about 1.5% growth for 2014. Meanwhile, the UK economy is really powering ahead. Leading indicators are in line with economic growth of about 3%.
- **Consumer confidence** in the Eurozone is now back up to pre-crisis levels (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.
- **Inflation** remains uncomfortably low with headline at 0.5% and core inflation below 1%. Talk of deflation throughout the region still seems premature (even if parts of the periphery are already there), but inflation is clearly too low.

ASIA

Many EM are still facing domestic issues

- In Japan, the **consumption tax** was raised from 5 to 8% at the beginning of April. This is hurting consumer spending. In combination with some concerns about the global recovery this has erased part of the earlier optimism about the Japanese recovery. 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. It seems unlikely that the authorities would let the economy falter again without reacting.

- In EM, the outlook for the **BRICs** 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, India), 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 for several years to come as the authorities try to reign in credit growth, which has been too high in recent years. At the same time, the authorities probably 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. The Fed will continue to communicate carefully on this in an attempt to prevent exaggerated market reactions. The Fed is moving to tighten monetary policy, but still wants to move very slowly on this 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 seemed to be shocked by the latest downward surprise on the **inflation** numbers, while the improving leading indicators provide some comfort. In any case, the ECB has stepped up its talk on additional monetary stimulus. Such additional measures have now become quite likely, but the hope for outright quantitative easing seems overdone. The ECB is more likely to stick to more modest initiatives like a further rate cut and/or a new LTRO. For the ECB to move to QE would probably require a clear deterioration in the economic outlook. 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 could very well be the first of the major DM 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, as the positive dynamics seem to be stalling, the BoJ is likely to add another push by the summer. 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 it will have to add stimulus in the near future.

FORECASTS

	2013	2014	2015
GDP projections			
USA	1.9	2.8 (2.7)	3.2 (3.0)
China	7.7	7.0 (7.4)	6.5 (7.3)
EMU	-0.4	1.6 (1.1)	1.6 (1.5)
Japan	1.7	1.4 (1.4)	2.0 (1.3)
CPI projections			
USA	1.5	1.8 (1.6)	2.1 (2.0)
China	2.6	3.0 (2.7)	3.0 (3.1)
EMU	1.4	1.0 (0.9)	1.5 (1.3)
Japan	0.4	2.6 (2.6)	1.8 (1.8)

Petercam forecasts, consensus forecasts between brackets

CURRENCIES

EM currencies have regained their footing

- The **euro** has been hovering around 1.38 dollar in the past month. The ECB has been stepping up its talk about the risks of a strong euro in attempt to bring the euro down, but this did not have much of an effect. For now, the Fed continues to expand its balance sheet (in spite of the tapering), while the balance sheet of the ECB continues to shrink as banks pay back LTRO-money. That said, the Fed is gradually moving towards an exit out of its extremely loose monetary policy, while the ECB is expected to add more stimulus. On the current outlook, the Fed could very well be increasing its policy rate in 12 months' time, while the ECB is unlikely to take any steps towards tighter monetary policy for another three years. At some point in time, this should be reflected in the currency. 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.
- 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 coming months.
- 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 most of 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 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 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 negative 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.**
- **Equity valuations are expensive in the US. Moreover, they are also starting to become 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 quite attractively valued.**
- **We are prudent on EM, although cheap valuation provides important upside.**
- **US equities are looking expensive.**
- **Bonds have performed well since the beginning of the year, but this stellar performance will not continue in coming months (even though if the risk for a sharp increase in interest rates remains limited).**
- **Valuations for high yield have become expensive. This worries us, but liquidity remains supportive.**
- **On currencies we remain positive on the dollar, negative on the yen.**

IN A NUTSHELL

Asset	ASSET ALLOCATION DECISIONS Apr-14	Change	May-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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