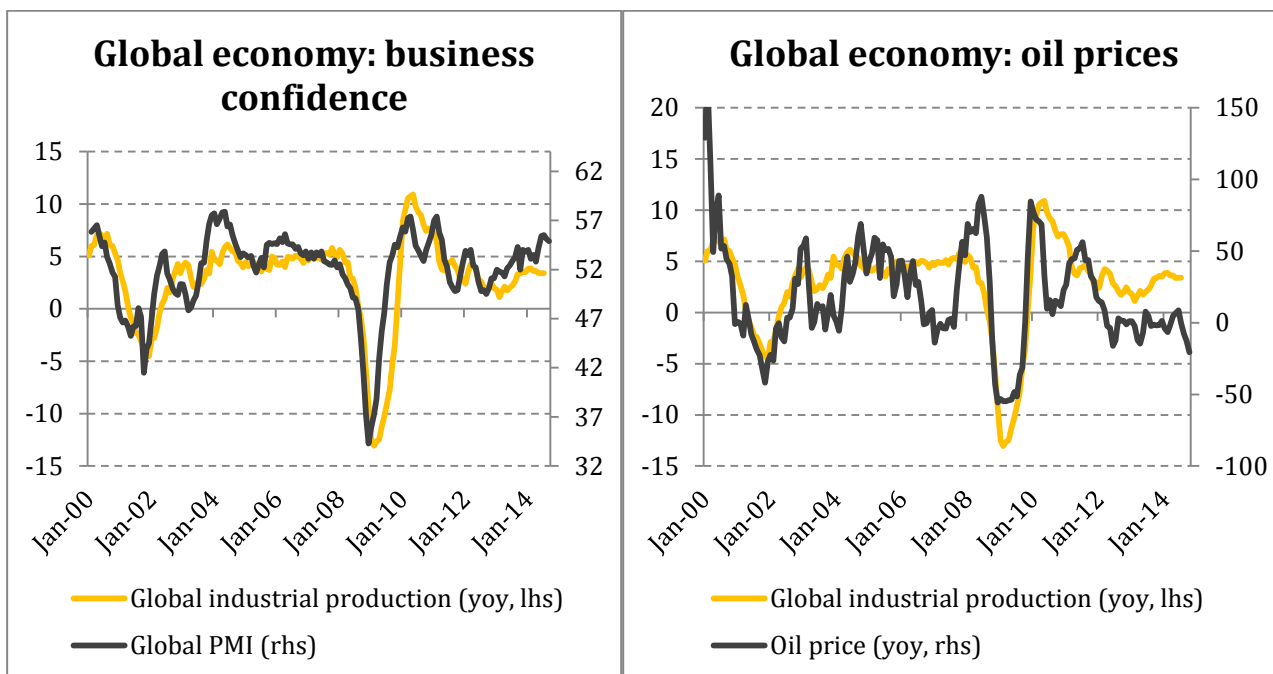


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Petercam IAM Asset Allocation Committee | November 2014

GRAPHS OF THE MONTH



GLOBAL

A growth scare that seems overdone

- During the past month, financial markets got hit by a **growth scare**. However, this seems somewhat exaggerated. Falling commodity prices are indeed raising questions about it, but other leading indicators continue to confirm a gradual global recovery led by the US economy. Improving confidence, reduced fiscal tightening, cheaper commodities, accelerating global trade and supportive monetary conditions suggest that this gradual recovery will continue in coming quarters.
- Inflation** remains low, and is likely to 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 for the world economy and financial markets lies in **monetary policy**. In spite of the recent market wobbles, the Fed and the BoE are still moving through a gradual exit strategy, which will lead to rate hikes in the next 12 months. It remains unclear what the impact of this will be. That said, for now the Fed and the BoE are still far more concerned about economic growth than about inflation/bubbles. As long as that remains the case, global monetary policy will remain broadly supportive.

UNITED STATES

Headline inflation has eased back to 1.7%

- **Economic data** in the US have been quite positive, confirming that the economy remains on track for 3% growth. The labour market continues to generate about 200.000 additional jobs every month, the housing market continues to recover, companies are investing and the credit mechanism is starting to function again. These factors suggest the recovery is set to continue in coming quarters. Overall, the economic situation is gradually getting back to normal and this move has further to go.
- Since mid-2011 the **labour market** has generated about 200k additional jobs a months. Meanwhile, the unemployment rate continues to ease (currently down to 5.9%), initial jobless claims is now 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.
- **Headline inflation** has eased back to 1.7%, mainly on the back of lower energy prices. This downward move has further to go. More remarkably, financial market indicators of long term inflation expectations have also eased significantly. This move is contradicted by the improving trend in the labour market. For now, inflation pressures remain firmly under control. That said, declining slack in the economy, as reflected in falling unemployment rates and increasing capacity utilization, suggests core inflation should pick up gradually over the next 12 months.

EUROPE

Germany has disappointed

- Recent data on the **German economy** have been very disappointing. Industrial activity took a remarkable hit in August, and leading indicators have continued to show weakness since then. Obviously, this does not bode well for the overall Eurozone economy, even if indicators on the entire region have been more mixed.
- Nevertheless, lower energy prices, low interest rates, decent growth in important **trading partners** like the US and the UK, a weaker euro and reduced fiscal tightening should support the Eurozone economy in coming quarters. All in all, the Eurozone remains on track for low, but positive economic growth in coming quarters.
- **Headline inflation** has eased to 0.3%, with core inflation stable now for about a year at 0.8%. 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 **stress test** for the larger European banks by the ECB showed 25 out of a 130 banks failing the test, although half of these already took measures throughout 2014 to fix this. This exercise should help rebuild confidence in the banking sector, but it is unlikely to be a miracle solution to kick-start credit growth in the Eurozone.

ASIA

Chinese economy maintains a controlled slowdown

- | In **Japan**, economic activity remains under pressure as the economy is having a hard time recovering from the consumption tax increase, while exports are picking up as expected. On top of that, inflation (outside of the tax increase) seems to be easing again. As the initial inflation push of the combination of commodity imports and yen weakness is now fading, inflation is likely to ease further in coming quarters, raising questions about the exit out of deflation, especially as wage growth is not taking off.
- | 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 where the outlook is reasonable.
- | 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, 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 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 is likely not to reach its 2% inflation target

- The Fed continues its **exit strategy**, although the recent concerns about the global economy (linked to bad news out of Europe and falling commodity prices) are another reason for the Fed to take things slow. The continuing normalisation of the economy highlights that the time for extreme monetary stimulus is drawing to a close. If the economy continues to recover at the current pace, the Fed is expected to move to a first rate hike by mid-2015. That said, 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 very modest.
- In the **Eurozone** the ECB finally seems to be focusing on the deflation risk. Recent data disappointments on economic growth (especially in Germany) and a rapid decline in financial markets' assessment of long term inflation expectations will put pressure on the ECB to do more. More stimulus is likely to come in 2015 as the ECB will continue to miss its inflation target by a wide margin. Deflation remains an important risk for the Eurozone, and the ECB should act forcefully to reduce this risk. This is likely to force the ECB into outright QE eventually, but it is likely to take some time to get there.
- The **UK economy** is performing quite strongly, and this had put the BoE on track for rate hikes in the near future. However, the deteriorating outlook in the Eurozone and the rapid decline in inflation imply the BoE will hold off somewhat longer on this. That said, the BoE is still in pole position to become the first major central bank to increase interest rates in this cycle.
- In **Japan** it's becoming more and more obvious the BoJ will not reach its 2% inflation target in a sustainable way any time soon (i.e. not taking into account the temporary impact of the consumption tax increase and yen weakness). BoJ-president Kuroda has already acknowledged this, opening the door for additional monetary stimulus in coming months.

FORECASTS

	2013	2014	2015
GDP projections			
USA	2.2	2.1 (2.2)	3.2 (3.0)
China	7.7	7.0 (7.3)	6.5 (7.0)
EMU	-0.4	0.8 (0.8)	1.3 (1.2)
Japan	1.7	1.2 (1.0)	1.5 (1.2)
CPI projections			
USA	1.5	1.7 (1.8)	2.0 (2.0)
China	2.6	2.5 (2.3)	2.7 (2.8)
EMU	1.4	0.5 (0.5)	1.2 (1.1)
Japan	0.4	2.8 (2.8)	1.8 (1.8)

Petercam forecasts, consensus forecasts between brackets

CURRENCIES

ECB and Fed are on different paths

- It has now become very clear that the Fed and the ECB are on different paths: the former is (very) gradually preparing for a first rate hike, while the latter 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 9% 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.
- 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 with the yen strengthening about 5% versus the euro (although it did weaken versus the dollar). 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.

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.

Still interesting carry

■ **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).

Growth scare hit markets

■ **Developed market equities| Overweight**

- Recent concerns about global growth have hit equity markets. Nevertheless, in spite of signs of weakness in Japan and the Eurozone, the global recovery remains on track with the US economy as the engine.
- Gradual economic recovery, low energy prices and low interest rates should support profit growth.
- The move of the Fed towards a gradual tightening of monetary policy is likely to lead to increased volatility in coming quarters.
- US equities are expensive, while European and Japanese equities offer more attractive valuations.
- Japanese equities are likely to benefit from a further weakening of the yen on the back of additional action by the BoJ and the close link to global economic activity.

Valuations remain attractive

■ **Emerging market equities| Neutral**

- Leading indicators are mixed and continue to fall behind their DM peers. China continues its managed slowdown and commodity exporters are suffering.
- Valuations overall remain attractive.
- We become more cautious on the back of a stronger USD

KEY TAKE-AWAYS

- **Our overall positioning has not changed versus last month**
- A growth scare hit global markets last month. We do believe it is somewhat exaggerated as the global recovery continues
- The European economy remains fairly weak, while the US economy is driving global economic growth
- 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		
	Oct-14	Change	Nov-14
Cash	N		N
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	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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