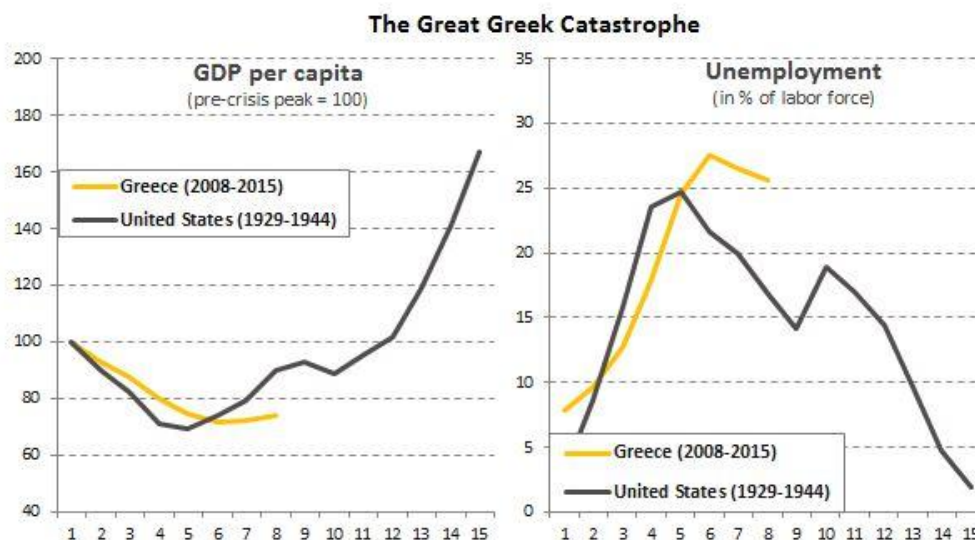


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Petercam IAM Asset Allocation Committee | August 2015

GRAPH OF THE MONTH



GLOBAL

Headline inflation will rise

- | Both the Greek crisis and China's recent stock market crash have contributed to doubts about the strength of the economy. While we think the risks are real, there are good reasons to believe the global recovery will not end abruptly. This is in line with the picture portrayed by regional confidence indicators.
- | Despite the recent new fall in commodity prices, base effects will send headline inflation higher over the next months. Core inflationary pressures, while firming in some regions, look set to remain modest. This implies that monetary policy will stay very loose in the foreseeable future.

UNITED STATES

Recovery in the labour market continues

- Though most confidence indicators have softened a touch and momentum slowed down from the spectacular growth rates seen in the spring and summer last year (around 5% annualized), almost all indicators paint a picture of a continuing recovery. Most recent confidence indicators are consistent with growth between 2 and 2.5%, not too far from most estimates of long term potential growth in the US.
- The recovery in the labor market continues. Over the spring job gains averaged 221k each month. Moreover, survey indicators are still consistent with around 200K new jobs per month. Other indicators including initial jobless claims and job openings all point to a continuing labor market recovery.
- Headline inflation, currently at 0.2%, will increase significantly in the coming months as the drop in energy prices seen earlier starts to have less of a negative impact. But given the recent volatility in energy prices, it's actually more useful to look at underlying measures of inflation. At 1.7% and 1.2% for core inflation and core PCE (personal consumption expenditures) inflation respectively, underlying inflation remain below the Fed's 2% target over the medium term. In fact, over the last five years the Fed has failed to deliver on this front. Looking forward, however, underlying inflation is set to pick up from current levels. Importantly, leading indicators suggest that wage growth will accelerate further. Without seeing acceleration in productivity growth at the same time (an assumption which remains to be tested) this will translate into higher inflation.
- Against the back of a continuing recovery and upward inflation pressures the Fed is still on course to start hiking interest rates before the end of the year. As things currently stand, an increasingly tighter monetary policy stance can be expected in the years thereafter.

EUROPE

Economic momentum remains fairly strong

- In the Eurozone, leading indicators show economic momentum remains fairly strong. Earlier ECB stimulus measures resulting in lower interest rates and EUR depreciation reduced budgetary tightening efforts and lower oil prices are driving this cyclical recovery. This is encouraging following years of stagnation. That said, a renewed escalation of the Greek crisis could easily hit economic confidence throughout the region.
- A third follow-up program for Greece is taking shape. Despite some hurdles left, the plan looks set to be implemented soon. That said, the agreement between Greece and its creditors looks also very unbalanced. Against the back of a deepening economic depression, it's very unlikely that Greece will be able to meet the conditions. Unless Greece's creditors loosen their stance and allow for more budgetary flexibility (an assumption that seems not very plausible at the moment), a Greek exit from the monetary union is almost inevitable. Timing this of course is very difficult.
- Headline inflation in the Eurozone will increase significantly in the second half of the year as the base effects linked to the decline in energy prices fade. Underlying inflation, although set to pick up from the current 0.8%, is likely to stay low by historical standards. The ECB has been completely missing its 2% inflation target over the last couple of years and it remains unlikely that the ECB will achieve it anytime soon.
- In the Eurozone, the ECB's QE program has already had a substantial impact on equity markets, interest rates and the euro.

ASIA AND EM

Japanese inflation has come down

- In Japan, most leading indicators point towards a small improvement in economic sentiment. That is reassuring following the decrease in confidence witnessed since begin 2014. As a result, industrial production growth is likely to jump back into positive territory. That said, economic momentum is still modest at best. Moreover, the 3.6% annualized growth rate seen in the first three months of the year is very much flattered by a build-up in inventories. Growth figures in the next couple of quarters are likely to make clear that growth is still fairly weak.
- In Japan, inflation has come down quite significantly as the base effect from the April 2014 tax hike has disappeared from the numbers. On the other hand, household's expectations about future inflation remain clearly positive and survey indicators suggest wage growth will accelerate somewhat in the next couple of quarters. Despite all this, we remain far from convinced that the Bank of Japan will structurally achieve its 2% inflation target. Therefore, the most likely scenario is that monetary policymakers will scale up the pace of the current asset purchase program.
- EM are clearly on a slower growth path. The divergence between EM remains large with confidence in net commodity exporters significantly below the levels seen in the net commodity importing countries. In China, economic growth in the next couple of years will continue to slow from current levels as the gradual switch from investment and export-led growth towards consumption economy takes place. As things currently stand, ample monetary and budgetary room for maneuver substantially reduces the risk of an imminent hard landing.
- The downward pressure on inflation stemming from lower commodity prices will ease over the coming months. This means that overall inflation in EM will accelerate somewhat in the months ahead so that most of the monetary policy easing seen in EM over the past year is behind us. But with core inflation staying modest in most parts of the emerging world, there is good reason to believe that monetary policy will stay relatively loose in the foreseeable future. In China, policymakers have already responded to the deteriorating economic momentum by cutting interest rates and bringing down the required reserve ratios for commercial banks. More easing can still be expected but a massive stimulus program is not on the cards given the huge financial imbalances built up since 2008.

FORECASTS

	GDP			Inflation		
	2014	2015	2016	2014	2015	2016
US	2.4	2.1	2.4	1.6	0.2	1.9
		2.3	2.8		0.3	2.1
Eurozone	0.9	1.4	1.3	0.4	0.2	1.3
		1.5	1.7		0.2	1.3
Japan	-0.1	1.5	1.2	2.8	0.7	0.9
		1.0	1.4		0.9	1.2
China	7.4	6.5	6.0	2.0	1.4	1.7
		7.0	6.7		1.5	2.0

Petercam forecasts in bold, consensus forecasts in regular font

CURRENCIES

Further EUR weakness expected versus the USD

- The diverging outlook for **monetary policy** in the US and the Eurozone, with the Fed heading towards a first rate hike, while the ECB has just started its QE-program, has been a key driver of the significant strengthening of the dollar versus the euro in recent months. On fundamental valuation measures, the dollar is now starting to look expensive. A strong USD appreciation from the current levels should not be taken for granted. That said, the risks surrounding Greece and the possibility of an extra round of ECB QE pose downward risks for the EUR.
- Over the past two years the **UK economy** has been recovering significantly faster than the Eurozone. Against that backdrop the GBP has been strengthening versus the EUR. All in all, on valuation measures most of the upward GBP potential seems to have been realized.
- In **Japan**, bold monetary policy measures over the last two years have clearly affected the yen. Between late 2012 and the end of 2014, just before the ECB embarked on its full-blown quantitative easing plan, the yen had depreciated more than 35% versus the euro. However, since mid-December the yen has won back around 5%. EUR/JPY is currently hovering around 135, the level corresponding to the long-term purchasing power parity valuation. Looking forward, we see downward risks for the JPY as the BoJ is likely to scale up the pace of its asset program.
- Against the back of broader **EUR weakness** seen since the beginning of this year, most **EM currencies** have appreciated against the EUR. EM currencies could come under pressure again once the Fed moves on to the first rate hike. However, given the depreciation already seen since the spring of 2013, the risks of another sharp hit now looks significantly smaller. That said, some currencies including the KRW, THB and PHP seem expensive.

ASSET CLASSES

Returns are very low

- Cash | **Neutral**
- Cash is neutral
- It reflects our prudent stance on risky assets

Bonds have done very well

Government bonds | **Neutral**

- Bonds have performed extraordinarily well over the last few years thanks to interest rates falling to all-time lows in Europe on the back of concerns about low growth and deflation earlier, and more recently driven by the ECB QE program.
- Interest rates in Europe reached a low in April, started to rise until mid-June and fell back again afterwards. The risk of a significant uptick in interest rates is limited for now as the ECB QE program is likely to keep interest rates in check. That said, volatility is likely to stay.
- Within the government bond universe, inflation-linked bonds offer a more interesting opportunity as they are likely to benefit from the coming uptick in headline inflation.
- We remain negative on government bonds. Within the government bond space, we prefer global inflation-linked bonds.
- In the light of the modest running yield and the limited potential for further declines in interest rates and/or the risks of an increase in interest rates we remain neutral on government bonds.

Modest return outlook

Euro IG Corporate Bonds | **Underweight**

- ECB actions are likely to keep spreads on IG corporate bonds low.
- That said, corporate bonds have become 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.
- Because of the modest return outlook, we are negative on IG corporate bonds.

Quality of issuance is deteriorating

Euro High Yield Bonds | **Neutral**

- HY bonds provide carry (which sets them up as targets in the search for yield climate), even though they have become expensive. As long as central banks stick to their current policy the search for yield should support HY bonds.
- The quality of HY issues is clearly deteriorating.
- Within the bond universe, we are neutral on HY bonds.

Awaiting the Fed hike

Emerging Market Debt | **Neutral**

- EMD provides the most interesting carry within the fixed income universe. That said, EMD is highly dependent on EM currencies.
- The move by the Fed towards a first rate hike will impact EMD, especially through significantly higher volatility for EM currencies.
- There is important divergence within EM. Especially current account deficit countries are likely to once again prove vulnerable when the Fed really moves towards the first rate hike.
- Within the bond universe, we are neutral on EMD.

US markets looking expensive

- Developed market equities| **Overweight**
- The combination of global economic recovery and monetary stimulus has pushed equity markets higher over the last few years. Both drivers have further to go, even though markets have already anticipated this to a large extent.
- In the Eurozone, the combination of positive dynamics in the economy and the announcement of QE by the ECB has pushed equity markets significantly higher. The translation of the improving economic situation in improving corporate earnings should continue to support markets for now.
- Even though an agreement between Greece and its creditors looks set to be implemented soon, Grexit (see higher) has now become our base case scenario. Equity markets rebounded on the latest Greek deal but European stocks could come under pressure again once it turns out that this deal is not workable.
- In Japan, earnings continue to improve. The weak currency helps exporters. Managements are embracing a renewed focus on profitability.
- In the US and the Eurozone, markets are looking expensive. In light of the recent rally and in the run-up to the first rate hike by the Fed, we are becoming more cautious about equities. For now, we remain positive on European and Japanese equities, which is reflected in small overweight positions.

Valuations remain attractive

- Emerging market equities| **Neutral**
- EM equities valuations are attractive. However companies' earnings growth is still slowing down.
- EM equities are also likely to prove vulnerable to changes in liquidity conditions on the back of the Fed moving to a first rate hike.

KEY TAKE-AWAYS

- We do not alter our stance versus last month : still prefer equities over bonds.
- However, we do trim our OW position in equities as we fear the Greek crisis may have an impact on the economy in Europe and Chinese equity market volatility has unnerved investors.
- Eurozone equities have recovered nicely.
- The financial repression keeps real rates low.
- German Bunds are pressed down by financial repression and the Greek situation, but what will happen when the ECB tapers?
- For EUR Credit and EUR High Yield, the liquidity situation is worrisome.
- Regarding US equities, earnings momentum is expected to recover
- Equity valuations are becoming a headwind in some regions, while bonds are not cheap.

IN A NUTSHELL

Asset	ASSET ALLOCATION DECISIONS		
	Jul-15	Change	Aug-15
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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