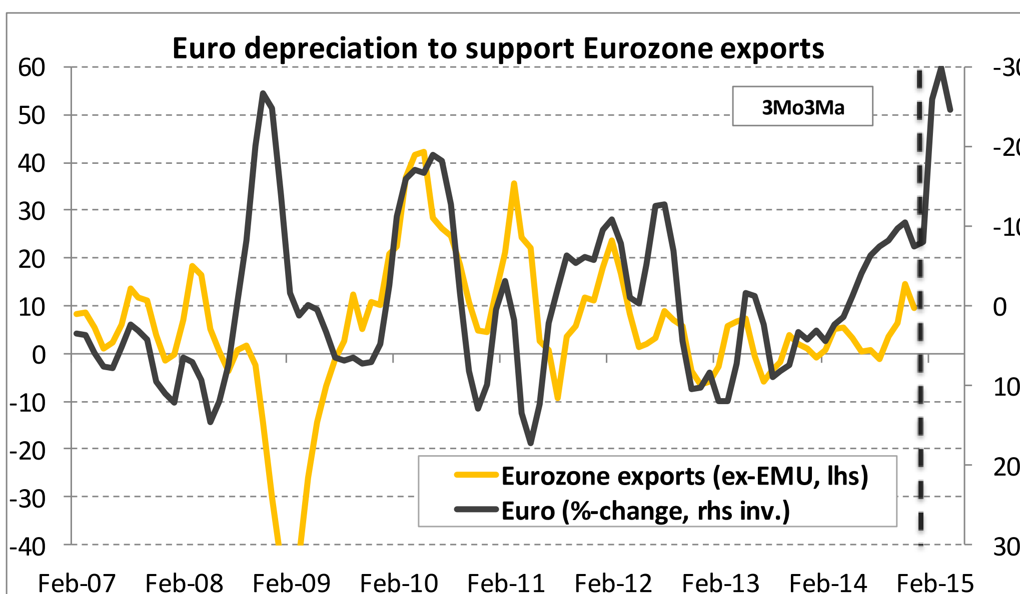
Editing & Co-ordination:
Petercam Institutional Asset Management
Asset Allocation Committee
Contact: piam@petercam.be
www.petercam.com
funds.petercam.com
insights.petercam.com
Twitter: @petercam

Petercam IAM Asset Allocation Committee | February 2015

GRAPH OF THE MONTH



GLOBAL

A gradual recovery remains in place

- Despite recent hesitation, the scenario of a **gradual global recovery** stays in place. The US continues to show signs of economic strength, while in the Eurozone there are signs that earlier pessimism is somewhat overdone. Meanwhile, additional monetary policy easing in the Eurozone and several EM should also have positive effects. Improving confidence, reduced fiscal tightening, supportive monetary conditions and cheaper commodities suggest that this gradual recovery has further to go. For the world economy as a whole, the fall in oil prices is a positive. For oil-importing countries it should be seen as a significant boost.

- **Inflation** remains low, and will 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 Fed is getting closer to its **first rate hike**, signaling the start of further monetary tightening in the US. Following six years of unseen monetary stimulus, this is likely to have an impact on financial markets. For now the Fed is still far more concerned about economic growth than about inflation/bubbles. As long as that remains the case, monetary policy will remain broadly supportive.

UNITED STATES

Core and headline inflation have come down

- **Leading indicators** continue to point to a positive near term outlook. The recovery is now quite broad with housing market conditions strengthening, the credit mechanism functioning again and the labor market generating decent job growth. The steep fall in energy prices provides a boost for consumer spending power. Overall, the economic situation is gradually getting back to normal and this move is likely to continue in coming quarters. That said, there is a risk that both a stronger USD (through reduced export prospects) and current low energy prices start to weigh on investment will start to have a negative impact on investment projects. Obviously, this risk only increases if the USD would continue to appreciate and oil prices decline further.

- Since mid-2011 the **labour market** has been generating about 200k additional jobs a months. Meanwhile, the unemployment rate continues to ease (currently down to 5.6%), initial jobless claims are 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 it is about to really pick up from low levels in coming quarters.

- Both **core and headline inflation** have come down on the back of lower energy prices. This will send headline inflation even lower in the next couple of months.

EUROPE

The credit mechanism is showing signs of revival

- Recent data on the **Eurozone economy** have restored some calm as most indicators suggest fears of a triple dip recession are overdone. The Eurozone remains on track for low but positive economic growth. Euro weakness should provide a significant boost to exports, low oil prices and low interest rates are generating purchasing power and the fact that credit growth is no longer deteriorating also bodes well for domestic demand. All in all, the Eurozone seems to be heading towards 1.5% growth.

- On the back of **lower energy prices**, headline inflation has slipped below zero. Meanwhile, core inflation is at an all-time low of 0.7%. 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 **credit mechanism** is starting to show signs of life again. Surveys indicate both credit demand and supply are picking up again. In combination with the stress tests and new ECB stimulus measures this implies that the credit impulse is turning positive again, which, in turn, should support domestic demand.

- There seems to be a consensus growing that the Eurozone needs **more public spending**, especially under the form of investment. New EC chair Juncker has proposed an investment plan, but this is unlikely to impact growth much in the near term.

ASIA

Managed slowdown in China

- In **Japan**, the authorities now seem to be going all in in their fight against deflation. Following his win in the December elections Abe now has a strong mandate to postpone the scheduled fiscal tightening (a second consumption tax increase in October 2015), and to move to more fiscal stimulus. This should help to economy to recover from the first consumption tax. Meanwhile, underlying inflation remains very subdued.
- 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 (India, Mexico, Philippines, Poland, Indonesia) where the outlook is reasonable. This divergence will continue in the next couple of months.
- That said, many EM are still facing **domestic issues**: a number of EM are looking at inflation and capacity issues (Brazil, S. Africa, Turkey), while others have been relying on too much credit growth (Turkey, Thailand, Brazil, China). 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. 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 rate hike in the US is drawing closer

- Although the Fed is not in a hurry to raise interest rates, **above-trend growth** for several quarters now suggests the first rate hike is coming closer in the US. Timing of this will depend on the strength of the economy, but on the current outlook a first move by the summer looks still likely. Crucially, 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 gradual and very modest. Above all, the Fed does not want to derail the recovery.

- In the **Eurozone** the ECB is now finally focusing on the deflation risk as it has moved to full-blown quantitative easing. The ECB will purchase Eur 60bn worth of bonds each month up until September 2016 and longer if necessary. This will bring the ECB's balance sheet to just above the level of early 2012 as promised earlier.

- In Japan, the BoJ finally acknowledged that it was not going to reach its **inflation target**. In a reaction, the BoJ stepped up its asset purchase program last October. Moreover, it promised to continue the program for as long as necessary (instead of the earlier announced 2 years). Monetary policy theory suggests that deflation can be avoided simply by printing enough money. Japan now seems willing to fully test that theory in practice. This is likely to imply additional monetary stimulus going forward.

- In China, the **central bank** cut interest rates in November. This is intended to guide the gradual, managed slowdown of the economy. The move should reduce the interest burden for households and companies. As the quota for credit have not been increased, it is not really intended to boost credit growth. For the latter, credit quota are the key driver, not the policy rate. China keeps its managed slowdown on track. At 1.5%, inflation is clearly below target (3.5%) and the fall in global commodity prices is likely to send it even lower. This opens the door for additional monetary policy easing.

FORECASTS

	2014	2015	2016
GDP projections			
USA	2.4	3.4 (3.2)	3.0 (2.8)
China	7.4	6.5 (7.0)	6.0 (6.7)
EMU	0.9	1.3 (1.1)	1.6 (1.6)
Japan	0.1	0.9 (1.0)	2.0 (1.4)
CPI projections			
USA	1.6	0.8 (0.9)	2.5 (2.2)
China	2.1	1.6 (2.0)	2.0 (2.5)
EMU	0.4	-0.1 (0.2)	1.4 (1.2)
Japan	2.7	1.3 (1.4)	1.6 (1.5)

Petercam forecasts, consensus forecasts between brackets

CURRENCIES

Further EUR weakness expected versus the USD

- Since the Fed has ended its **asset purchases** and the ECB moved closer to full-blown QE, the obvious divergence between the Fed and the ECB has really started to impact the Eurodollar exchange rate. 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 last May the dollar has gained about 21% 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 even euro lower versus the dollar.
- The **pound** has already strengthened substantially versus the euro in the past year as the UK economy is performing better than the Eurozone. This move has probably further to go as the BoE moves closer to the first rate hike next towards the end of 2015.
- 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 12%. Looking forward, both currencies are expected to fall further against the USD as both the BoJ and the ECB are adding stimulus while the opposite is true for the Fed. We see EUR/JPY stabilizing around the current 135 level which also corresponds to the long-term purchasing power parity valuation.
- Things have calmed down somewhat for **EM currencies** in recent months. Over the last two years the majority of EM currencies depreciated significantly against the USD so that they should now prove less vulnerable to the upcoming Fed tightening cycle.

ASSET CLASSES

Returns are very low

- **Cash | Neutral**

- Cash is neutral
- This tactical position expresses our more cautious stance on risky assets

Government bonds had an excellent year 2014

Government bonds| Neutral

- Bonds performed extraordinarily well last year and so far this year thanks to interest rates falling to all-time lows in Europe 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 limited.
- The subdued outlook for growth and inflation in the Eurozone in combination with further stimulus from the ECB imply that European interest rates will remain low for a long time to come. Against that backdrop, the risk of a sharp increase in Eurozone bond yields is limited. In the US and the UK the move towards rate hikes should have an effect on rates, but central bankers will move carefully on this.
- We prefer to remain neutral on 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 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.

Higher volatility ahead

Emerging Market Debt| Neutral

- EMD provides the most interesting carry within the fixed income universe.
- The move by the Fed towards a first rate hike will not be positive for EMD. At the very least, this will lead to significantly higher volatility for EMD.
- 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.
- EMD returns are highly dependent on EM currencies, which are likely to continue to be volatile as the Fed’s eventual move towards rate hikes raises questions about global liquidity conditions.
- Within the bond universe, we are neutral on EMD

A rally in recent weeks

Developed market equities| Overweight

- New policy measures by the ECB have sent equity markets higher in Europe while US equity markets softened a touch. However, given the further appreciation of the USD against the EUR, the return in EUR is still positive YTD (around 4%)
- In the Eurozone, even modest economic growth is likely to generate some profit growth. Moreover, the recent bolder ECB actions should also help to create a positive climate for equity markets. Meanwhile, in Japan markets are driven by earnings growth. In both regions, valuations remain fair to cheap.
- In the US markets are looking expensive.
- The move of the Fed towards a first rate hike will lead to increased volatility in coming quarters, and not only in the US.
- We expect that the move of the Fed towards a first rate hike will lead to increased volatility in coming quarters, and not only in the US.

Valuations remain attractive

Emerging market equities| Neutral

- Increasing export opportunities linked to the DM recovery and the fall in oil prices should be a clear positive for EM.
- Valuation remains attractive.
- However, we are neutral to reflect the impact of a stronger USD.

KEY TAKE-AWAYS

- **Our overall positioning has not changed versus last month**
- The global economic recovery continues, despite several risks
- Oil prices are increasing purchasing power
- The US economy is on track for 3% growth in the coming quarters, while the European economy remains fairly weak, although falling oil prices and a depreciating EUR provide some tailwinds
- Emerging Markets are recovering somewhat, but remain vulnerable to higher US rates and an appreciating USD
- The ECB has made a first move towards QE, but has a lot more to do as it completely misses its inflation target

IN A NUTSHELL

	ASSET ALLOCATION DECISIONS		
Asset	**Jan-15**	**Change**	**Feb-15**
Cash	**N**		**N**
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	N		N
Alternative			
Convertible Bonds	N		N
Real Estate	N		N
Commodities	N		N
Others	N/A		N/A
		Up / Down	

Disclaimer

The information contained in this document is provided for pure information purposes only and does not constitute an investment advice or recommendation. Present document is not part of an offer or solicitation to acquire equities, bonds, investment funds, or any other financial instrument, nor an invitation to buy or sell the products or instruments referred to herein. Present asset allocation model is based on a theoretical investment profile for (balanced) mandates, which may be very different as compared to the specific investment guidelines of a particular investor. If you are interested in this information, we would kindly ask you to contact your relationship manager. You may also want to get third party advice.

We remind you that past performances are not a guarantee of achievement of future performances and may not be repeated. Information and opinions in this document refer to a situation on the financial markets at the moment of issuance of the document, and are subject to change at any time without prior notice.

Petercam Institutional Asset Management has made its best efforts in the preparation of this document. The information is based on sources which Petercam Institutional Asset Management believes to be reliable. However, Petercam Institutional Asset Management does not represent that the information is accurate and complete. Petercam Institutional Asset Management is acting in the best interest of its clients, without carrying any commitment to achieve any result or performance whatsoever. Petercam Institutional Asset Management, its directors, officers, employees or connected persons do not accept any liability for any direct, indirect or consequential loss, cost or expense arising from any use of the document and its content.

This document is the property of Petercam Institutional Asset Management and may not be duplicated, in whole or in part, or distributed to other persons without prior written consent of Petercam Institutional Asset Management. This document may not be distributed to private investors and is solely restricted to institutional investors.