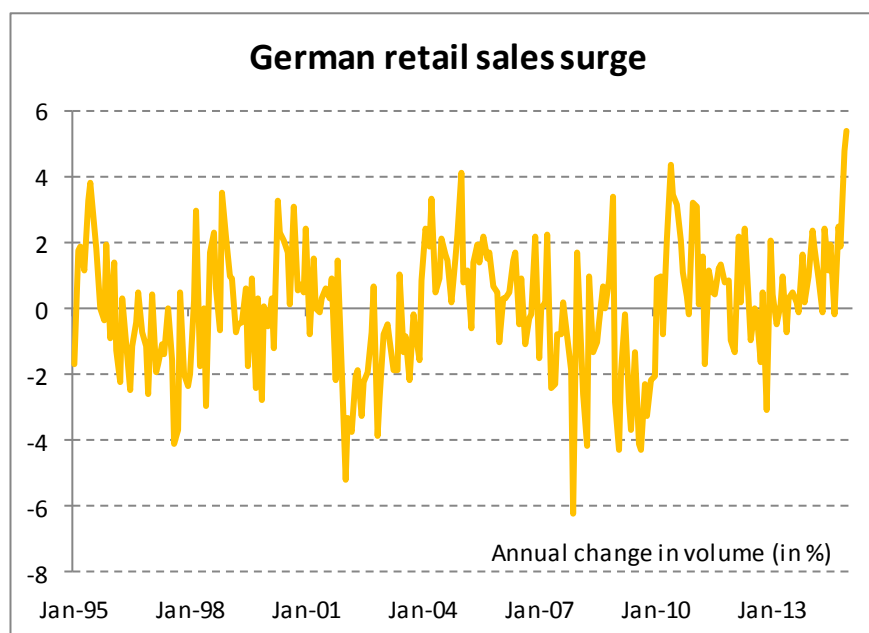


**Editing & Co-ordination:**  
 Petercam Institutional Asset Management  
 Asset Allocation Committee  
 Contact: [piam@petercam.be](mailto:piam@petercam.be)  
[www.petercam.com](http://www.petercam.com)  
[funds.petercam.com](http://funds.petercam.com)  
[insights.petercam.com](http://insights.petercam.com)  
 Twitter: @petercam

Petercam IAM Asset Allocation Committee | March 2015

## GRAPH OF THE MONTH



## GLOBAL

Inflation below zero in main industrialised countries

- The global economy remains in recovery mode. Lower oil prices are proving to be the expected boost for consumers. While the US economy is easing back somewhat, Japan and the Eurozone have been delivering positive surprises in recent months. This gradual global recovery has further to go on the back of improving confidence, reduced fiscal tightening, cheaper commodities and still extremely supportive monetary conditions.
- Inflation has dropped below zero in the main developed markets, pushed down by lower oil prices. This is a temporary phenomenon. With oil prices moving back up in recent weeks, inflation should climb back into positive territory again in a few months in most economies. That said, global inflation is likely to remain low for quite some time as there is still slack in the global economy that's holding inflationary pressures in check.
- Global monetary policy remains very supportive. That said, the Fed is edging closer to a first rate hike. Following more than six years of unseen monetary stimulus, this will have an impact on markets. For now, markets are enjoying additional monetary stimulus by the ECB and the BoJ.

## UNITED STATES

Headline inflation below zero

- Following very strong growth in the middle six months of the year (close to 5%), the US economy eased back somewhat in the final months of 2014. The first months of 2015 brought more of the same. Still the US remains on track for economic recovery with the housing market continuing its slow return to health, (non-oil related) business investment picking up, the credit mechanism functioning again and the labour market generating decent job growth. The last leg missing in this recovery is wage growth, but this looks set to change in the next few quarters. Overall, the economic situation is gradually getting back to normal and this move is likely to continue in coming quarters.
- The US is reaching the phase where a larger part of the benefits of the recovery are shifting from companies to workers. This is reflected in a strengthening labour market. Leading indicators suggest wage growth should pick up significantly in coming months. This should also be reflected in slower earnings growth of US companies.
- On the back of lower oil prices headline inflation has dropped below zero, but this shouldn't be for long. Meanwhile core inflation stands at 1.6%. Disappearing slack in the economy should gradually start to generate some underlying inflationary pressures in coming quarters.

## EUROPE

Several tailwinds, but important issues remain

- The weaker euro and lower oil prices are having their expected impact on the Eurozone economy, where sentiment has clearly turned up in recent months. Moreover, the credit mechanism is showing signs of life again. On the back of ultra-low interest rates credit demand has been picking up, and actual credit growth has also been improving substantially. In the past this was a clear indication of increasing domestic demand. All in all, the Eurozone is on track for 1 to 1.5% growth.
- The German consumer is really enjoying the boost from lower oil prices (on top of an already strong labour market). German retail sales are showing the strongest growth in more than 20 years.
- Mainly because of lower energy prices, headline inflation has been negative for three months now. Meanwhile, core inflation remains at a historic low of 0.6%. In spite of the improving economic climate, the Eurozone is still only one negative shock away from deflation (the dangerous kind), and this remains an uncomfortable situation.
- The difficult negotiations between Greece and the Eurozone remain very worrying, and the long term future of Greece within the Eurozone remains in doubt. That said, for the near term in spite of all the tough talk compromise is still the most likely outcome.
- Tailwinds should help the Eurozone in coming quarters. However, there are still important structural issues. It remains to be seen how the economy will hold up once the temporary stimuli of euro and oil fade. That said, the near term outlook is positive.

## ASIA

Japan profits from lower oil prices

- Japan is also feeling the benefits of lower oil prices and a weaker currency. Moreover, there are signs that the situation on the labour market is clearly improving, and even that wage growth is starting to pick up. The latter is a key element in the exit out of deflation that the authorities are aiming for. For now, Japanese companies are still the clear winners from the weaker yen with strong earnings growth, but part of this is starting to trickle down into the domestic economy.
- 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, Indonesia, but also Mexico, Philippines, Poland,) where the outlook is reasonable. This divergence will continue in the next couple of months.
- The Chinese economy continues on its path of managed slowdown. As this slowdown has been moving a bit too fast, the Chinese authorities have been adding some stimulus again through a policy rate cut. More of this can be expected in coming months. That said, 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.
- The diversity in Asia, and even broader in EM, 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.

## MONETARY POLICY

The ECB is starting its QE programme

- As the US economy continues to normalise, the Fed continues to move through its exit strategy. Chair Yellen is gradually preparing markets for the first rate hike, the timing of which will depend on economic data, especially on the labour market. A first move by the Summer still looks likely. In any case, when the Fed starts raising interest rates it is likely to do so in a gradual way as it is still far more concerned about the strength of the recovery, than about any upcoming inflation risk. Above all, the Fed does not want to derail the recovery.
- In the Eurozone, the ECB is starting its QE program to reduce the deflation risk. The ECB is planning to buy 1,140 bn worth of bonds up to September 2016. Moreover, the option to extend the program further out was left open. Whether or not this will suffice to really end the crisis remains to be seen (given the experiences in the US and the UK it is doubtful). For now, it is clearly supporting Eurozone financial markets.
- In Japan, the BoJ is continuing its open-ended asset purchase program. It has promised to do so for as long as necessary to escape deflation. 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.
- Chinese authorities have cut policy rates and loosened reserve requirements to ease financial conditions, especially for larger firms. Moreover, in the next couple of months some additional stimulus measures can be expected. This is intended to guide the gradual, managed slowdown of the economy. Every time that slowdown is going a bit too fast, the authorities add some more stimulus. This dynamic is likely to continue in the next couple of years.

## FORECASTS

	2014	2015	2016
<b>GDP projections</b>			
USA	2.4	3.5 (3.1)	3.0 (2.8)
China	7.4	6.5 (7.0)	6.0 (6.7)
EMU	0.9	1.3 (1.2)	1.6 (1.6)
Japan	0.1	1.1 (1.0)	1.7 (1.4)
<b>CPI projections</b>			
USA	1.6	0.8 (0.5)	2.2 (2.2)
China	2.1	1.6 (1.7)	2.0 (2.4)
EMU	0.4	0.0 (-0.1)	1.3 (1.2)
Japan	2.7	1.3 (1.0)	1.6 (1.3)

*Petercam forecasts, consensus forecasts between brackets*

## CURRENCIES

Further EUR weakness expected versus the USD

- The divergence between the Fed and the ECB has now become very clear: as the normalization of the US economy is pushing the Fed towards rate hikes, the fight against deflation in the Eurozone is forcing the ECB to start up the printing press. This divergence is likely to continue in the next couple of years. While the US is currently growing above trend pace, the Eurozone is flirting with structural stagnation/deflation (in spite of the current cyclical improvement). Since mid-2014 the dollar has strengthened from close to 1.40 to 1.12 dollar per euro. This move has further to go. 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 even lower versus the dollar.
- The pound has already strengthened substantially versus the euro in the past year as the UK economy is clearly performing better than the Eurozone. As the BoE is closer to a turn towards tighter monetary policy than the ECB, there is a possibility of further strengthening. That said, most of the potential has probably already been realized.
- The exchange rate between the euro and the yen has been driven by which central bank is surprising markets the most with additional monetary stimulus. The aggressiveness of the BoJ resulted in significant weakening of the yen versus the euro. The recent move by the ECB resulted in a slight reversal of that trend. The outlook is difficult to assess, but the BoJ seems more convinced than the ECB to go all-in for the QE-experiment. In that respect, some further yen weakness remains the more likely scenario.
- Things have calmed down somewhat for EM currencies in recent months (with the notable exception of Russia). Overall, EM currencies have even recovered part of the earlier losses versus the euro. 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
- It reflects our prudent 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.
- 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 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.
- We reduce our overweight equity stance but do remain overweight

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.
- The near term cyclical outlook and valuation for EM (with exception of commodity exporters) are positive. We continue to expect that these positives will drive the market.

## KEY TAKE-AWAYS

- We somewhat reduce our overweight position in equity, but remain overweight
- Except EM and Japan equities, everything is looking expensive
- The gradual global recovery remains on track with lower energy prices and ongoing supportive monetary policy providing further support. The Fed is slowly but surely moving in the direction of tighter monetary policy.
- In the US, the recovery looks set to confirm albeit at a somewhat slower pace. The labour market continues to tighten which, in turn, should start to translate in accelerating wage growth.
- In Europe, economic activity is likely to benefit significantly from several tailwinds including lower oil prices, cheaper exchange rate, reduced budgetary tightening, stronger US economy and the ECB starting its QE programme. The risks surrounding Greece and Ukraine remain present.
- In Japan, the recovery is still weak despite some better export data. For now, the BoJ sticks to its program, but it still seems likely that more stimulus is needed in order to reach the 2% inflation target.
- In EM, leading indicators are mixed and continue to fall behind their DM peers. There is substantial difference between EM with commodity exporters and the BRICs (India is an exception) performing poorly. Meanwhile, China continues its trajectory of managed slowdown.

## IN A NUTSHELL

Asset	ASSET ALLOCATION DECISIONS		
	Feb-15	Change	Mar-15
Cash	N		N
<b>Fixed Income</b>	<b>UW</b>		<b>UW</b>
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
<b>Equities</b>	<b>OW</b>		<b>OW</b>
Europe	OW		OW
World ex-Europe	N		N
Emerging Markets	N		N
<b>Alternative</b>			
Convertible Bonds	N		N
Real Estate	N		N
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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