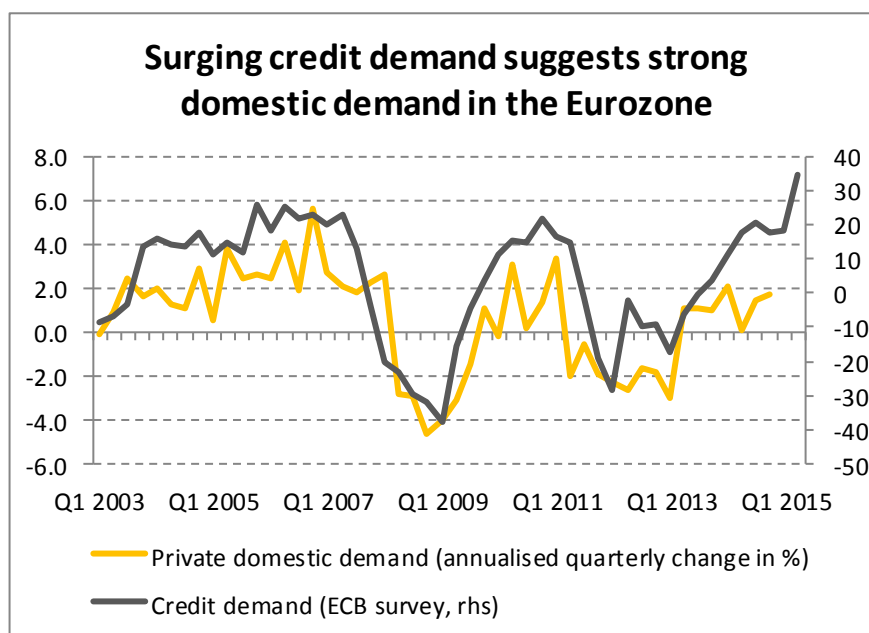


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Petercam IAM Asset Allocation Committee | May 2015

## GRAPH OF THE MONTH



## GLOBAL

Inflation has been pushed lower

- | The global economy has been **hesitating** somewhat with weaker activity in the US and China. On the other hand, the economic outlook in Europe has improved significantly. Overall, the global economy remains on track for gradual recovery, helped along by low commodity prices and supportive monetary policy.
- | The US economy had a **very weak Q1**, but this disappointment is likely to be reversed in coming months as once again an important part of it looks to have been weather-related. Meanwhile, the Eurozone economy looks set to continue its recent recovery. In Emerging markets the situation remains very divergent, depending mainly on the dependence of each economy on commodity exports.
- | **Inflation** has been pushed down by lower oil prices. However, the recent pickup in the latter and the fact that the downward impact will start to fade in coming months suggests headline inflation is likely to increase rapidly in the second half of the year. That said, there is still significant slack in the global economy that's holding underlying inflationary pressures in check.

## UNITED STATES

US economy has slowed down

- The US economy has **slowed down** significantly since the start of the year. This is partly due to temporary factors like exceptional weather conditions and strikes in the West Coast ports. On top of that, the fall in the oil prices has hit investment spending in the shale sector hard. The impact of the temporary factors should fade rapidly in coming months, while the outlook for consumer spending is very positive thanks to decent growth in disposable income. This combination should result in a clear re-acceleration of economic activity in the near term.
- Like last winter it will take some time to see how much of the recent weakness is really linked to the **weather**.
- The **labour market** remains key for the US recovery. There has been a slight setback in job creation recently, but a broad range of leading indicators for the labour market confirm continuing recovery. Wage growth still looks set to pick up in coming quarters.
- **Core inflation** has fluctuated around 1.7% for the past two years. Slack in the economy is disappearing and this should gradually start to generate some underlying inflationary pressures in coming quarters. Meanwhile, headline inflation, currently at zero, is likely to move back towards 2% by the end of the year as the downward impact from oil prices fades.

## EUROPE

The future of Greece in the Eurozone remains unclear

- Helped by the **weaker euro** and lower oil prices, the Eurozone economy has been on a good run since last Fall. The positive dynamic looks set to continue in coming months. The credit mechanism getting back to life is adding to this. Both credit demand and credit growth are picking up, which bodes well for domestic demand in the Eurozone. Leading indicators are currently showing the Eurozone to be on track for 1.5 to 2% growth this year.
- Helped by **lower oil prices** and some improvement in the labour market situation, Eurozone consumers have been substantially increasing spending. German retail sales are showing the strongest growth in more than 20 years.
- Whether or not the current **positive dynamic** can be sustained, will depend on the recovery also translating into increased investment spending and hiring. For now, the indications of this happening are not very convincing (yet).
- **Headline inflation** has been negative for four months now, while core inflation stands at an alltime low of 0.6%. Headline inflation is set to move up significantly towards the end of the year as the downward impact fades. Core inflation on the other hand is likely to remain subdued for quite some time.
- The **future of Greece** within the Eurozone remains in doubt. Any kind of Grexit is likely to be very negative for the Eurozone, especially in a longer term perspective. In the near term a last-minute compromise is still the most likely outcome.

## ASIA

Chinese economy  
continues to slow down

- **Leading indicators** for the Japanese economy remain subdued. Importantly, as the impact of last year's consumer tax hike disappears out of the inflation numbers, the latter are likely to fall back towards (or even below) zero. This will put Japan's exit out of deflation in doubt. That said, in spite of the unconvincing economic outlook, Japanese companies continue to show strong earnings growth as they remain the clear winners from the weaker yen.
- The **Chinese economy** continues to slow down, with growth easing to 7%. The Chinese authorities continue to guide the economy through a managed slowdown, and will continue to do so in coming years. As this slowdown has been moving a bit too fast, the authorities have been adding some stimulus again through cuts in the policy rate and in the reserve requirements for banks. More of this can be expected in coming months. In any case, 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 and the Philippines are doing quite well in the current climate. It is essential to assess every EM in isolation, with specific attention to its dependence on commodity exports and to its vulnerability to changes in external liquidity conditions.

## MONETARY POLICY

The ECB continues its QE programme

- Cautiously, the Fed continues to work on its **exit strategy**. The Fed is still heading towards a first rate hike later this year as slack in the economy has all but disappeared. Recent economic weakness suggests the most likely timing for this has moved to September. This is under the condition that recent weakness proves to be temporary. In any case, the subsequent hiking cycle will be slow, at least until wage growth starts picking up significantly. The main concern for the Fed is still the recovery, rather than upward inflation risks. Above all, the Fed does not want to derail the recovery. As such, Yellen is likely to continue to move very cautiously on this.
- The ECB continues its **QE programme**. With economic activity picking up, headline inflation to increase later in the year and mounting criticism about the fallout of negative interest rates for the financial sector, pressure on the ECB to reduce the programme prematurely is likely to increase in coming months. In its recent statements, the ECB confirmed it will continue its program as promised. The ECB still has a very long way to go to guide the Eurozone economy back to anything even remotely resembling normality.
- In Japan, the upcoming fall in **headline inflation** combined with disappointing economic activity could push the BoJ into additional stimulus measures. The probability of new stimulus efforts in the near term has increased significantly.
- Chinese authorities have cut **policy rates** and loosened reserve requirements to ease financial conditions, especially for larger firms. Moreover, officials have recently also mentioned the possibility of QE. In any case, in the next couple of months 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	2.4 (2.9)	2.8 (2.8)
China	7.4	6.5 (7.0)	6.0 (6.7)
EMU	0.9	1.7 (1.4)	2.0 (1.7)
Japan	0.1	0.9 (0.9)	2.0 (2.3)
<b>CPI projections</b>			
USA	1.6	0.8 (0.2)	2.2 (2.2)
China	2.1	1.6 (1.5)	2.0 (2.2)
EMU	0.4	0.3 (0.1)	1.2 (1.2)
Japan	2.7	1.0 (0.8)	1.4 (1.2)

*Petercam forecasts, consensus forecasts between brackets*

## CURRENCIES

Further EUR weakness expected versus the USD

- On the back of **diverging monetary policy**, the euro has weakened significantly versus the dollar in the past year. In the past two months, this move has more or less stabilized (just below 1.10), as economic weakness in the US has reduced the near term likelihood of a first Fed hike. The latter is still likely to come at the end of summer, and will add another push towards parity for the eurodollar. On fundamental valuation measures, the euro is now starting to look cheap. However, currencies have a proven tendency to overshoot fundamental fair values. Moreover, further steps in monetary policy (especially the first rate hike by the Fed) will add pressure for the dollar to strengthen further. As such, there is further upward potential for the dollar versus the euro, even if from current levels the case has become somewhat less convincing.
- 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 earlier in significant weakening of the yen versus the euro. The recent move by the ECB resulted in a part-reversal of that trend. The outlook is difficult to assess, but the next move is likely to come from the BoJ, which is expected to add stimulus in the next few months. In that respect, some renewed yen weakness remains the more likely scenario.
- In light of the **recent broad weakness** of the euro, most EM currencies have become quite expensive versus the euro on fundamental valuation measures. Moreover, EM could come under pressure again once the Fed moves onto the first rate hike, especially those 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. Even if it has been delayed somewhat, the Fed hike should still come later this year. At the very least, EM currencies will continue to see significant volatility in coming months.

## ASSET CLASSES

Returns are very low

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

Inflation linked bonds are more interesting

- Government bonds| Neutral
- Bonds have performed extraordinarily well during the past year 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 have now reached extremely low levels. Even though the risk of a significant uptick in interest rates is limited, the return potential on European government bonds has become very small. In that sense, it no longer offers compensation for the associated risk.
- 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.
- 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.

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

## A rally in recent weeks

- Developed market equities| **Overweight**
- The combination of global economic recovery and aggressive monetary stimulus has pushed equity markets higher. Both drivers have further to go, even if markets have already anticipated this to some 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 increasing corporate earnings in coming months should support markets going forward.
- Earnings growth continues to be very strong in Japan, is improving in Europe, but deteriorating in the US.
- In the US markets are looking expensive, while other developed markets have also become more 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.

## Valuations remain attractive

- Emerging market equities| **Neutral**
- Recent strong performance in EM equities has been mainly linked to the boom in Chinese equities following changes in regulation.
- EM equities are likely to prove vulnerable to changes in liquidity conditions on the back of the Fed moving to a first rate hike.
- 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

- The global recovery seems to be hesitating somewhat, albeit with significant regional differences. The US economy has had a weak Q1, while in the Eurozone activity has been picking up nicely. In EM, economic indicators remain quite subdued, while at the same time confirming the huge divergence between commodity exporters and importers.
- US disappointments are at least partly related to bad weather. In that respect, a reacceleration of US activity is likely in the next couple of months. Meanwhile, leading indicators remain quite upbeat for the Eurozone.
- Headline inflation in the US and the Eurozone is likely to jump up significantly in the second half of the year as base effects linked to oil prices fade. On the other hand, Japanese headline inflation will fall sharply as the base effect from the April 2014 tax hike disappears from the numbers.
- Monetary policy remains very supportive. In the US, the most likely timing for the first hike has now been pushed back to September. In the Eurozone, pressure on the ECB to taper its QE program is likely to increase, although the ECB is expected to continue the program as promised in the next few months.
- In Japan, there is a significant probability that the BoJ will inject additional stimulus, while in China the PBoC is also likely to add further measures.
- The near term outlook is fairly positive with economic activity picking up (mainly based on a US reacceleration), while monetary policy remains supportive. After the Summer, the Fed is still expected to start its hiking cycle, which will be a key event for markets.
- Almost everything has become expensive, with the exception of global inflation-linked bonds and EM equities.
- Earnings growth remains strong in Japan, looks set to pick in Europe and has weakened in the US and EM.
- Straightforward models for 10y yields in the US and Germany suggest the upward risk for US bonds is fairly

limited (even with the upcoming Fed moves), while German bunds are extremely expensive.

## IN A NUTSHELL

Asset	ASSET ALLOCATION DECISIONS		
	Apr-15	Change	May-15
<b>Cash</b>	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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