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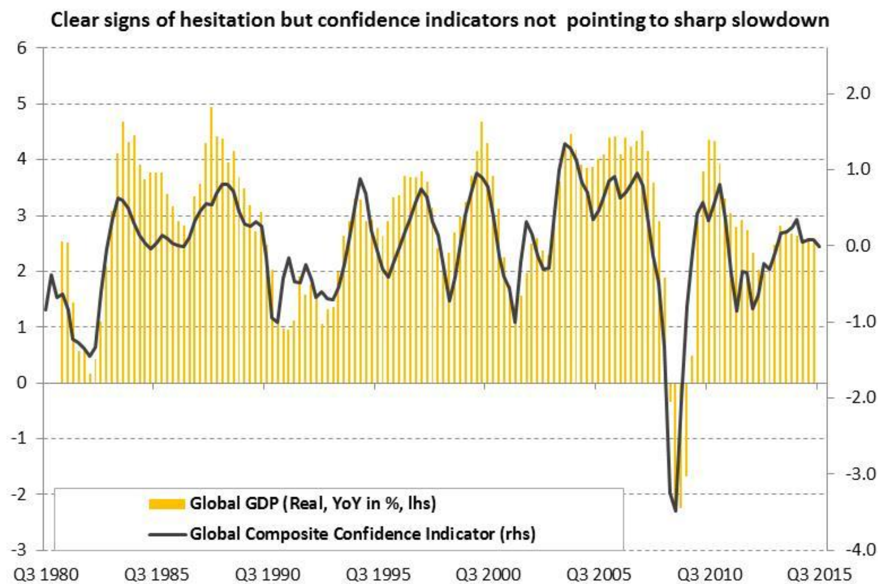
Petercam IAM Asset Allocation Committee | September 2015

GRAPH OF THE MONTH



GLOBAL

Market turbulence galore

- Recent worries about the Chinese economy have caused a lot of financial market turbulence. Even though the downward risks are substantial, we believe the global recovery will not end abruptly and instead continue moderately against the background of both loose monetary and budgetary policy and also lower energy prices. This is consistent with the picture portrayed by current global 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 global monetary policy will stay very loose in the foreseeable future.

UNITED STATES

Headline inflation will increase

- Following the growth stall (0.6% QoQa) in the first months of the year (largely due to temporary factors), economic activity accelerated during the spring (3.7% QoQa) Leading indicators have held up nicely over the summer with solid consumer and service sector confidence. Moreover, incoming data continue to confirm our ongoing recovery scenario.

- The recovery in the labour market continues. In the first half of the year 211K monthly new jobs were created on average. Survey indicators remain upbeat in this respect. In addition, other indicators including initial jobless claims and job openings all point to further labor market strength.

- Headline inflation, currently at 0.2%, will increase 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 1.8% and 1.3% 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 modestly 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. Clearly, recent market turmoil and the fact that inflation remains below the Fed's target imply that it is likely to adopt a cautious approach.

EUROPE

The Greek situation remains problematic

- 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. Business confidence indicators hold up nicely for the Eurozone as a whole but with significant regional divergence. Other leading indicators are softening a touch. All in all, despite the improvement witnessed in recent months, the recovery is still nothing to cheer about. Moreover, the positive effects stemming from temporary tailwinds may soon start to fade.

- The Greek situation remains problematic in several ways. A third follow-up program for Greece has started and will make sure that the country's funding issues are resolved at least temporarily. That said, the agreement between Greece and its creditors still looks 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.

- Headline inflation in the Eurozone will pick up 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 1%, 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.

ASIA AND EM

Chinese economic data have been disappointing

- 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. The 3.6% annualized growth rate seen in the first three months of the year was followed by negative growth in the second quarter (-1.6% QoQa). 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, it's a clear possibility that monetary policymakers will scale up the pace of the current asset purchase programme.

- Disappointing Chinese economic data, the recent stock market crash and especially the (still minor) RMB devaluation have all caught the attention of international investors. To be sure, there are reasons to worry about economic activity in China. On the other hand, this is not new and policymakers have acknowledged this since they started to ease monetary policy late last year. Both earlier and additional policy measures should soon ease the current hard landing fears. The recent RMB depreciation is probably not the start of a broad based attempt to boost exports, in turn triggering monetary retaliation efforts by other central banks. As market forces will be allowed to play a more important role in the future, it cannot be excluded however that the RMB will see further minor and gradual depreciation in the foreseeable future.

- Economic activity in EM is still very sluggish, particularly in Latin America. Several observers argue that the ongoing market turbulence will trigger a 1997-style crisis. However, this is not our scenario because there are several important differences. In general, the currency depreciation seen in most EM should have expansionary effects over time. China's slowdown, the backslide on structural reforms and low commodity prices, on the other hand, are likely to make sure that economic activity will remain subdued.

FORECASTS

	GDP			Inflation		
	2014	2015	2016	2014	2015	2016
US	*2.4*	**2.2**	**2.3**	*1.6*	**0.1**	**1.8**
		2.3	*2.7*		*0.3*	*2.1*
Eurozone	*0.9*	**1.4**	**1.3**	*0.4*	**0.1**	**1.2**
		1.4	*1.7*		*0.2*	*1.3*
Japan	*-0.1*	**0.9**	**1.0**	*2.8*	**0.8**	**0.9**
		0.9	*1.4*		*0.8*	*1.1*
China	*7.4*	**6.5**	**6.0**	*2.0*	**1.4**	**1.7**
		6.9	*6.7*		*1.5*	*2.0*

Petercam forecasts in bold*, consensus forecasts in regular font*

CURRENCIES

BoJ policy has influenced the yen

- 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 quarters. On fundamental valuation measures, the dollar is 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 (minor) downward risks for the JPY as the BoJ is likely to scale up the pace of its asset programme.

- EM currencies performed well during the first months of the year (on the back of euro weakness) but experienced severe downward pressure more recently. Investor appetite for EM assets has waned and sustained EM currency weakness is likely. However, given the depreciation already seen since the spring of 2013, the risk of another sharp hit now looks significantly smaller. That said, some currencies including the KRW, THB, INR and PHP still look expensive.

ASSET CLASSES

Returns are very low

- Cash | **Neutral**

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

Inflation-linked bonds are more compelling

Government bonds |**Underweight**

- 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. We expect interest rates to rise gradually from here. 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 firming in inflation.
- We remain negative on government bonds. Within the government bond space, we prefer global inflation-linked 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.

Currency valuations starting to look attractive

Emerging Market Debt | **Neutral**

- Against the back of recent financial market stress, EMD has come under severe pressure as EM currencies dropped sharply. Moreover, interest rates on government bonds increased further.
- The upcoming first rate hike by the Fed and worries about a Chinese hard landing are reasons for caution but the majority of EM (Turkey and S. Africa are notable exceptions) will not be forced to follow the Fed's example and hike interest rates in order to stem capital outflows
- We are neutral on EMD but current returns and currency valuations are starting to look attractive.

Downgrade to Neutral

Developed market equities| **Neutral**

- The combination of global economic recovery and monetary stimulus has pushed equity markets higher over the last few years
- Despite the recent fall in equity prices, valuations remain stretched (especially in the US)
- Against the back of recent financial market turbulence, the appropriate stance for equities is Neutral. That said, we still prefer equities over bonds.
- With regard to the regional allocation, we prefer European equities.

Vulnerable due to slowing earnings growth

Emerging market equities| **Neutral**

- Barring a doomsday scenario for China, EM assets equities are starting to look 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 its first rate hike.

KEY TAKE-AWAYS

- We downgrade the overweight in equities to Neutral on the back of recent market turbulence
- We do keep a preference for equities to bonds
- European equities are the preferred choice in terms of region
- The global economy is hesitant, but recent panic seems overdone
- The US economy is still on the recovery path.
- Weak economic activity in EM is likely to persist for some time

IN A NUTSHELL

	ASSET ALLOCATION DECISIONS		
Asset	**Aug-15**	**Change**	**Sep-15**
Cash	**N**		**N**
Fixed Income	**UW**		**UW**
Government Bonds	UW		UW
Inflation-Linked	OW		OW
Euro IG Credit	UW		UW
International IG	N		N
EM Debt	N		N
Euro High Yield	N		N
Equities	**OW**	⇓	**N**
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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