Degroof Petercam

Asset Allocation Flash

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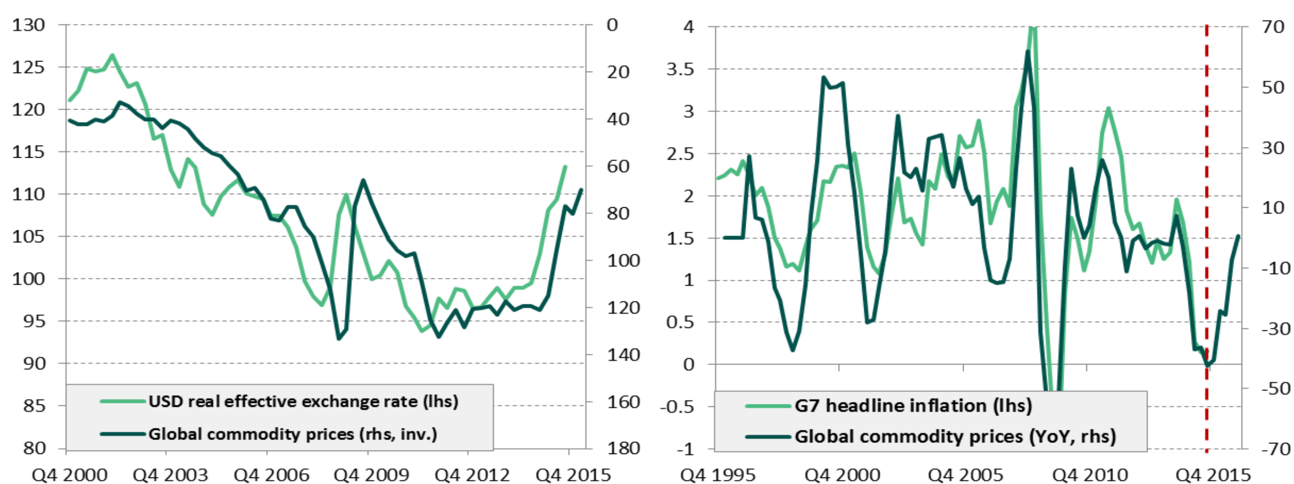
Graph of the month

Global commodity prices look set to stay relatively low against the back of a strong USD. Nevertheless, baseline effects will send headline inflation higher into 2016.



Global

EM in dire straits

- During the summer, 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.
- Economic activity in DM is holding up relatively well while EM are facing more difficult times. However, the macro environment was less negative recently in EM and the situation seems to stabilize at low level in China.
- 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

Activity to expand at a healthy pace

- US economy grew 1.5% on a quarterly annualized basis in the third quarter negatively affected by a large inventory drag. There is no specific reason to worry as private domestic demand remained relatively resilient.
- Activity should continue to expand at a decent pace. Leading indicators remained in line with a growth around 2% still supported by strong services activity. Confidence in the manufacturing sector is still suffering from a stronger USD and low oil prices, respectively weighing on exports and investment in the energy sector
- Consumption should continue to grow at a healthy pace still supported by better labour market conditions, high consumer confidence and low oil prices.
- The recovery in the labour market continues. Since the beginning of the year, the US economy created on average 206k jobs on a monthly basis, a very decent level. The unemployment rate fell further to 5% while U6 (9.8%) declined below 10% for the first time since 2008. Despite the strength of the labour market, increase in wages have been so far relatively limited
- 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. At 1.9% and 1.3%, core inflation and core personal consumption expenditures are still below the Fed's 2% target.
- The Fed is still on course to start hiking interest rates in the near future. A December rate hike seems likely. The most important message is that monetary policy looks set to remain accommodative. Furthermore, the Fed is likely to proceed gradually.

Europe

Inflation back in positive territory

- European economy continued to grow at a moderate pace. Economic activity came out at 1.2% on a quarterly annualized basis in the third quarter, a slight disappointment given all the positive supports. Oil prices hover close to $50 per barrel, monetary policy is very accommodative and the EUR depreciation is a welcome development for the external sector. Leading indicators are still in

line with a growth rate around 2%

- Consumption should continue to increase at a moderate pace supported by the slow but gradual improvement observed within the labour market, resilient consumer confidence and low oil prices.
- The latest ECB's actions (QE, TLTRO) reduced credit fragmentation between core and peripheral companies and thus contributed to the pick-up in credit activity and augur for a modest recovery for investment
- After a negative reading in September, inflation (0.1% yoy) came back in positive territory in October. Base effects from lower oil prices should gradually push inflation higher in the quarters to come. Given the persistence of the negative output gap, inflation should remain below the 2% targeted by the ECB
- Limited increase in growth combined with low inflation increase the likelihood the ECB will announce additional measures in December. It has a number of options available including increasing the size of its monthly government bonds purchases, extend QE beyond September 2016, changing the composition of asset purchases and cutting the deposit rate further in negative territory.
- Greece is for the moment out of the new thanks to the new bailout package but should soon come back in the spotlight as nothing has been done to reduce its indebtedness. With the new austerity measures, the country will probably miss both its primary surplus and growth targets. A haircut on debt is unavoidable.

Asia and Em

Economic activity in China is worrisome

- In Japan, economic activity came back into recession. After a 0.7% contraction in the second quarter, GDP fell 0.8% between July and September. The tightening labour market points in the direction of accelerating wage growth though other evidence paints a more nuanced picture. Inflation, meanwhile, remains significantly below the Bank of Japan's 2% target. Most likely, the combination of sluggish economic activity and below target inflation will prompt the BoJ to expand its monetary stimulus program in the near future.
- More broadly in EM, the slowdown witnessed over the last few years reflects several factors including the negative effect of lower commodity prices, tighter external financial conditions linked to the prospect of the first rate hike in the US, the economic rebalancing in China, structural bottlenecks as well as distress

related to (geo)political factors.

- Economic growth in EM has slipped below the average over the past 35 years. Moreover, Brazil and Russia are struggling with recession. Several observers are now arguing that EM are in fact submerging. Although this seems exaggerated, it is hard to overlook the big difference with the spectacular growth story seen last decade. In its July update on the world economy the IMF projects that growth in EM will slow to 4.0% this year from 4.6% in 2014. The latter already marks a clear slowdown from the 6.1% growth figure seen between 2000 and 2012.
- Economic activity in EM is still sluggish, particularly in Latin America where a weak growth momentum is accompanied with above target inflation. Several observers argue that the ongoing market turbulence will trigger a 1997-style crisis. However, this is not our base case scenario because there are several important differences. More flexible exchange rates, lower levels of external debt and significant amounts of international reserves should protect most EM against a full-blown financial crisis. Moreover, China's stimulus measures are likely to make sure that imminent hard landing fears will soon start to fade. Finally, the currency depreciation seen in many EM since 2013, should eventually translate in improved competitiveness when combined with further productivity enhancing reforms. To be clear, as mentioned earlier, current financial and economic conditions as well as structural issues will make sure that EM are not up for a rapid recovery
- 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 (both monetary and fiscal) should soon ease the current hard landing fears.
- 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.

Forecasts

	GDP			Inflation		
	2014	2015	2016	2014	2015	2016
US	*2.4*	**2.4**	**2.1**	*1.6*	**0.1**	**1.6**
		2.5	*2.6*		*0.2*	*1.8*
Eurozone	*0.9*	**1.4**	**1.5**	*0.4*	**0.1**	**1.0**
		1.5	*1.7*		*0.1*	*1.1*
Japan	*-0.1*	**0.6**	**0.8**	*2.8*	**0.8**	**0.6**
		0.6	*1.3*		*0.8*	*0.8*
China	*7.3*	**5.0**	**6.0**	*2.0*	**1.6**	**2.0**
		6.8	*6.5*		*1.6*	*2.1*

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

Currencies

Diverging monetary policy between EU and US

- The diverging outlook for monetary policy in the US and the Eurozone 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. Furthermore, the first rate hike in the US seems already priced as well as the likely QE expansion in the Euro area. A strong USD appreciation from the current levels should not be taken for granted even though risks surrounding Greece still exists
- 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. The case for a tighter monetary policy should support the GBP in the months to come but should be partially offset by the risk surrounding "Brexit"
- In Japan, bold monetary policy measures over the last two years have clearly affected the yen. EUR/JPY is currently hovering in the 130 – 135 range, 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 program in the near future.
- EM currencies performed well during the first months of the year (on the back of euro weakness) but experienced severe downward pressure more recently. However, given the depreciation already seen since the spring of 2013, the risk of another sharp hit now

looks significantly smaller. Easing fear of Chinese hard landing, stabilizing commodity prices and the search for yields could reduce downward pressures on EM currencies.

Asset Classes

Prudent stance on risky assets

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.
- Yields should gradually increase supported by stronger growth and higher inflation.
- A significant uptick in interest rates in the months to come is not our main scenario: the rebound in growth should be moderate, inflation should remain below the ECB's 2% target and an extension of the QE beyond September 2016 is not to exclude.
- Within the government bond universe, inflation-linked bonds could offer an interesting opportunity as they are likely to benefit from the coming firming in inflation.

Eurozone valuations more compelling

Developed market equities | Neutral

- Relative valuations versus fixed income assets are still attractive. However; absolute valuations are no longer cheap.
- We prefer the Euro area to the US:
  - Possible QE extension in the Euro area
  - The profit cycle for Euro area companies is less mature than in the US
  - Valuations are more appealing in the Euro area than in the US.

Expected returns very low

Euro IG Corporate Bonds | Underweight

- Corporate credit spreads widened following the recent turmoil and appear more attractive than a few months ago
- However, they still evolve well below the level reached in 2009 or in 2012, which were particularly attractive entry points
- Expected return for investment grade bonds remains very modest due to the low absolute yield. Small uptick in government bonds or spreads could rapidly lead to negative performance

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Appealing valuations, but…

Emerging market equities | **Neutral**

- Emerging valuations are quite appealing
- However earnings growth are still revised downwards
- 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.
- Macroeconomic environment is slowly but surely improving

Recent spread widening

Euro High Yield Bonds | **Neutral**

- HY were quite expensive at the beginning of the year. The recent spread widening makes valuation more attractive
- The quality of HY issuers is clearly deteriorating

Stay put

Emerging Market Debt | **Overweight**

- The Chinese devaluation during the summer led to a strong decline in emerging currencies, which appear attractively valued compared to the EUR or USD
- A gradual tightening cycle in the US should not be too damaging for the asset class
- Macro environment is rather weak in emerging countries but we noticed early signs of improvement recently

Key Take-Aways

- Neutral on developed market equities
- We do keep a preference for equities to bonds
- European equities are the preferred choice in terms of region
- Recent spread widening makes HY valuation more attractive
- Early signs of improvement in EM -> overweight position
- The list of risks to our asset allocation includes a sharp rise in interest rates, European politics (and its effect on confidence), geopolitics, China crash and bubbles/runaway inflation

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In A Nutshell

Asset	ASSET ALLOCATION DECISIONS Oct-15	Change	Nov-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	Up	OW
Euro High Yield	N		N
Equities	**N**		**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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