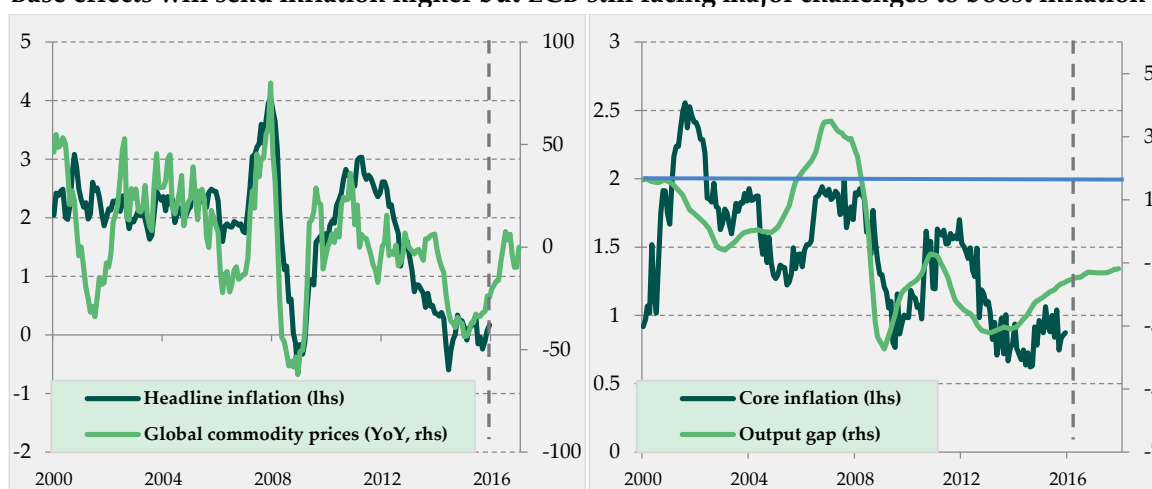


Asset Allocation Flash

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Graph of the month (August 2016)

Base effects will send inflation higher but ECB still facing major challenges to boost inflation



Global

Prolonged period of slow growth expected

- Global recession fears have eased over the past three months and the wider Brexit fallout remains limited, at least so far. That said, our global composite confidence indicator suggests that global economic activity is still weak. What's more, downward risks remain substantial. The global economy still seems stuck in a catch 22 situation as explained [here](#).
- Monetary policy rates are hovering near zero in the Western world. The same goes for real yields on longer term bonds. At the same time, confidence indicators suggest global economic activity remains weak following what has been a very lackluster recovery since the Great Recession thus far.
- Looking beyond the short-term, we think the chances of a prolonged period of relatively slow growth (in combination with interest rates around the zero lower bound) are high against the back of strengthening demographic headwinds and less scope for debt accumulation going forward. That said, budgetary and monetary

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policymakers have not lost all ammunition to fight this extremely challenging situation. There is still room to do more (see [here](#) for example). Encouragingly, there is a growing awareness about the need for more expansive budgetary policies. This should translate in stronger economic activity and higher inflation prints. At the same time, statements remain vague implying that actual implementation might take time.

- Meanwhile, despite record low policy rates and huge expansions in the size of their balance sheet, most central banks are still looking for higher inflation prints.
- Even with the low level of commodity prices in place, however, base effects will send headline inflation higher in the second half of 2016. Core inflationary pressures look set to remain fairly modest for now, implying that global monetary policy will stay very loose for the time being. The outlook for inflation in a medium to longer-term perspective, on the other hand, is still subject to major uncertainty as explained [here](#) in more detail.

United States

Q2 growth disappointed again

- Following a very weak start of the year, growth in Q2 disappointed again. That said, when corrected for inventories, GDP growth came in above 2% annualized. The manufacturing sector still suffers from the stronger USD and problems in the energy sector. The service sector, on the other hand, holds up better in line with healthy consumer spending. Overall productivity growth remains very disappointing and the outlook for investment remains weak against the back of negative profit growth and relatively low capacity utilization rates. This is a key risk factor for the US economy.
- Household consumer spending is growing at around 2% in year-on-year terms and several factors, including disposable income growth, consumer sentiment and the relatively favourable housing and labour market backdrop, all suggest consumption growth should hold up.
- Adding 204K jobs on average over the past 12 months, the labour market has been performing solidly. Leading indicators suggest future job gains will come in somewhat lower. Initial jobless claims, meanwhile, remain at very low levels, indicating that the labour market is doing fine overall.
- Wage growth plays a key role with regard to the future path of inflation and is slowly picking up. At around 2.5%, however, the level nevertheless remains below its 30-year average of around 3%.

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- Base effects linked to energy prices will make sure that headline inflation (now at 1.1%) will trend higher towards the end of the year, albeit less because of the latest oil price drop. At 2.2% and 1.6% for core inflation and core PCE inflation (which is more important for Fed) respectively, underlying inflation has been stabilizing over the last 3 months. Looking forward, however, leading indicators paint a mixed picture with the evolution in unit labour costs suggesting that core inflation should pick up further (accelerating wage growth in combination with slow productivity growth) while price surveys point to only very modest upward price pressure.
- All in all, Q2's disappointing GDP number implies that a summer rate hike is off the table. US policymakers are not in a hurry to raise interest rates. Modest growth in combination with below target inflation means that the Fed continues to adopt a very cautious wait-and-see approach as has been the case for several years now.
- The November Presidential elections are drawing lots of attention. As things stand, according to election polls, Mrs Clinton is very comfortably leading the race to the White House. That said, political experts advise not to pay not too much attention to polls at this stage because of the typical convention bounce ahead of the elections later this year. Polls later this month are expected to paint a clearer picture but should still point to the prospect of a Democratic win.

Eurozone

Confidence indicators post-Brexit holding up

- Following a solid start of the year (with GDP growth at 2.2% QoQa), Eurozone economic growth moderated in Q2 (1.2%QoQa). Encouragingly, most confidence indicators in the immediate aftermath of the Brexit vote are holding up. This suggests that the fallout on Eurozone economic activity remains limited, at least so far.
- This recovery is still far from spectacular. What's more, confidence indicators are not pointing to further growth acceleration and structural headwinds remain strong (more [here](#))
- Moreover, trade negotiations between the UK and the EU still need to start and this looks set to be a complex and prolonged negotiation process against the back of a challenging political calendar with Dutch, French and German elections in 2017.
- Sentiment in the UK has been hit hard pushing the Bank of England towards more stimulus in the form of a rate cut and more asset purchases. But it can only do so much when interest rates are near zero. A more expansive fiscal policy has a better chance to counter

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the effect of the Brexit vote on economic activity. It remains to be seen whether the UK government comes up with a convincing stimulus package later this year.

- Headline inflation (0.2 % yoy in July) is held down by the earlier steep fall in energy prices but base effects will send it higher in the second half of the year. With core inflation hovering around 1% for several years, underlying price measures remain very weak reflecting the slack in the labour market.
- Given the persistence of the large negative output gap, core inflationary pressures are expected to stay very weak. All in all, despite the latest easing measures taken in March, the ECB still looks to experience major difficulties in getting inflation up to its target of 2% anytime soon (see [here](#) for more information), keeping monetary policy in easing mode for longer.
- It should be clear, however, that opposition to more monetary easing is rising and also that it is no panacea in a liquidity trap situation. Indeed, a more expansive budgetary stance is likely to prove more helpful in this respect. The ECB has also been hinting in this direction more recently.

Japan and EM

EM activity still weak

- In Japan, despite sluggish economic activity, JPY appreciation and falling stock prices, the BoJ basically refrained from adding stimulus in its late July meeting. Meanwhile the Abe government announced a new fiscal stimulus package of 28.1 trillion JPY (around 5.6% of GDP). That said, only a fraction of that constitutes fresh public spending (7.5 trillion JPY of which 4.6 JPY in 2016), so that all talk of big fiscal stimulus is vastly exaggerated. It should nevertheless translate in somewhat higher GDP numbers next year.
- At the same time, indicators suggest it remains very doubtful whether inflation will pick up meaningfully going forward so that the BoJ is still likely to add monetary stimulus in the near future.
- More broadly in EM, the slowdown witnessed over the past few years reflects several factors including the negative effect of lower commodity prices, tighter external financial conditions linked to the prospect of the hiking cycle in the US, the private sector debt overhang, economic rebalancing in China, structural bottlenecks as well as distress related to (geo)political factors. Moreover, there are signs of premature deindustrialization in several important EM which is worrying in a medium to longer term perspective.
- Sentiment towards EM has improved in recent months against the

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back of reduced USD strength and stabilization in commodity prices. But EM are not out of the woods yet. China's challenging rebalancing exercise and uncertainties linked to monetary policy tightening in the US could easily expose more EM weakness (see [here](#) for more information). Additionally, recent developments in Turkey remind that political risks are real in some EM. And more recently, commodity prices are experiencing downward pressure again.

- Chinese hard landing fears have been receding over the past three months and a large one-off depreciation has been avoided, at least for now. This is completely in line with the scenario we described earlier (see [here](#) and [here](#) for example). The combination of monetary and budgetary measures is driving a cyclical recovery. But while we were right on this call, we are still convinced that the medium to longer term outlook for China will prove extremely challenging.
- From an EM wide perspective, inflation remains under control. That said, significant differences between countries exist. While inflation in countries like Brazil and Turkey is still at uncomfortably high levels, inflation in other countries including Korea, the Philippines, Poland or Hungary remains below target. All in all, the combination of subdued economic activity, stabilization in EM currencies and commodity prices should make sure EM inflation remains in check.

Forecasts

	GDP			Inflation		
	2015	2016	2017	2015	2016	2017
US	2.4	1.3	1.6	0.1	1.2	2.1
		1.9	2.2		1.3	2.3
Eurozone	1.6	1.5	1.2	0.0	0.3	1.3
		1.5	1.3		0.3	1.3
Japan	0.6	0.7	1.6	0.8	-0.1	1.0
		0.5	0.8		-0.1	0.6
China	6.9	5.5	5.0	1.5	2.2	2.3
		6.5	6.3		2.0	2.0

Degroof Petercam forecasts as of August 2016, *Consensus forecasts*

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Currencies

Don't just assume the USD will continue to appreciate

- Our long-held stance that the consensus view of a continued USD appreciation should not be taken for granted, has been proven right so far (more [here](#)). We continue to think that a sharp appreciation from current levels should not be expected. Despite the latest depreciation the USD still looks rather expensive from a long term theoretical perspective. That said, more evidence of the Fed moving towards another rate hike could lead to a slightly stronger USD in the next couple of quarters.
- The BoE is not in a hurry to ease nor hike interest rates. This being said, the impact of Brexit has increased expectations of monetary policy to be loosened in August. GBP is currently trading more than 15% below its 20-year average real effective exchange rate, although there is still substantial room left for depreciation towards its PPP-level. While we cannot completely rule out overshooting in the short-term, the current account shock absorption seems its most important driver at this point. Additionally, as in past crises, it will be the political developments (more details [here](#)) that provide guidance for the GBP going forward.
- The JPY has been strengthening in recent months. From a LT-perspective, it seems that the JPY has now become a little bit too expensive versus the EUR. A further sharp appreciation from current levels looks unlikely. That said, this will largely depend on upcoming central bank moves from BoJ and ECB.
- EM currencies experienced serious downward pressure since the May 2013 taper tantrum but entered calmer waters more recently. Investor appetite for EM assets has waned and sustained EM currency weakness cannot be ruled out given the subdued growth outlook and political risks. That said, given the depreciation already seen since the spring of 2013 and the recent stabilization in leading indicators, the risk of another sharp hit now looks smaller. Indeed, in real effective exchange rate terms, EM currencies (weighted by GDP ex China) have depreciated around 10% since May 2013 on average (strong difference from country to country).
- In contrast to what many observers have feared since the summer of 2015, the RMB has not seen a large one-off depreciation so far just like we had expected (see [here](#) for more details). More recently, following the latest G20 meeting in Shanghai late February, there seems to be more consensus on this call. That said, we would

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certainly not rule out the possibility of a big depreciation altogether. The reason is that we have become even more concerned about the sustainability of China's economy as explained higher.

Asset Classes

Prudent stance on risky assets **Cash | Neutral**

- Cash is neutral

US Treasuries and global linkers interesting option

Government bonds | Underweight

- Bonds have performed extraordinarily well over the last few years thanks to interest rates falling to all-time lows in Europe. Being exposed to long term government bonds has enabled many balanced portfolio managers to weather the volatility of equities markets.
- While low yields are characteristic of our low growth / low inflation environment, Bund yields have reached extreme levels which can, we think, only be explained by the elevated level of risk aversion. Although this risk aversion is the result of the many uncertainties facing the world economy in general and the euro area in particular, there are reasons to expect it to subside as uncertainties get removed. We therefore expect 10y German Bund yields to move higher from current levels, possibly towards the top end of our trading range of 0.25%. In the US, we don't think the policy rate cycle is over yet, although it has been endlessly delayed. Any move towards normalization by the Federal Reserve would help Bund yields to be lifted out of negative territory.
- However, a major uptick in interest rates in the months to come is not part of that base case scenario: global growth is set to remain moderate, and inflation is expected to remain below target. Also, more quantitative easing is back on the agenda of the some major central banks: the Bank of England has recently just implemented a new GBP 70bn asset purchase programme and, at its next meeting on 8th September 2016, we expect the Governing Council of the ECB to further extend its programme by another 6 months, until September 2017 (without lowering its policy rates).
- Within the government bonds universe, US Treasuries and global inflation-linked bonds (both partially EUR hedged) offer an interesting opportunity. The latter could benefit from the expected firming in headline inflation late in 2016 (due to base effects).

More attractive asset class in low-yield environment

Euro IG Corporate Bonds | Overweight

- After widening during 2015, Investment Grade (IG) credit spreads

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reached attractive levels at the end of February this year. Since then, they have tightened.

- IG corporate bonds have become a more attractive asset class in an environment of very low interest rates for longer.
- The ECB started purchasing corporate bonds in June. We estimate these purchases are currently amounting to approx. EUR 8bn per month. The implementation of this program could trigger further spread tightening although its effect is likely to be dampened by the rise of new issuance.

Covenant quality lowering

Euro High Yield Bonds | Neutral

- As for Investment Grade, High Yield (HY) credit spreads widened during 2015. Since the end of February, they have tightened.
- The yield on the asset class seems attractive at first sight, especially when compared to yields elsewhere. However, given assumptions on default rates, we think it only represents fair value.
- Covenant quality in Europe and elsewhere is deteriorating which could become a worrying sign if it continues.

More room for monetary stimulus

LC Emerging Market Debt | Overweight

- After five years of strong declines, emerging markets currencies are staging a come-back with double digit returns since the start of the year. Further upside from here depends on the confirmation that commodities prices have bottomed out and is likely to be volatile. Meanwhile, the Chinese currency continues its pace of gradual decline.
- Yields of certain emerging market issuers appear attractive. In particular in Brazil, where Industrial and Consumer Confidence seem to have stabilized at very low levels and most recent statistics are showing an uptick. Also, it seems inflation has finally started to come down. If these recent trends continue, Brazilian Local Currency (LC) debt could be viewed as a selective opportunity.
- We think certain central banks of EM countries have room to provide monetary stimulus, should circumstances warrant.

European valuations more appealing

Developed market equities | Underweight

- The Brexit vote reinforces the sentiment that it will be difficult to find a structural solution to Europe's inherent issues in the short term. There is also the issue of European banks (heavyweights in European indices) which suffer from the flattening of the yield curve. That said, we are not negative. As long term investors we find the risk premium offered on European equities attractive. We are also mindful of the fact that cheap access to capital (a positive of low financing rates) is a clear positive for listed European companies.

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- We prefer Europe (where we are Overweight) to the US (where we are Underweight):
 - Valuations are more appealing in Europe than in the US. At 15.1x, the Next Twelve Months (or Forward) P/E of European equities sits at its historic average. In the US, the Forward P/E is 17.5x, comfortably above its historic average.
 - QE in the Euro area until 2017
 - The profit cycle for European companies is less mature than in the US where margins have reached peak levels.

We are also Underweight equities in Japan. Earnings estimates in Japan are subject to the worst downward revisions in developed markets.

More appealing valuations than elsewhere

Emerging market equities | Neutral

- Sitting at a 12.7x Forward P/E, Emerging Markets equities valuations are more appealing than elsewhere. This compensates partly for the risks building up in China.
- Margins appear to have stabilized at very depressed levels. Upside from here depends on the confirmation that commodities prices have bottomed out and improving prospects for the Chinese bank sector.
- Meanwhile, the macro environment remains weak, although there are early signs of improvement.

Key Take-Aways

- Underweight on developed market equities, with an underweight in US and Japanese equities. US equities are expensive while Japan has limited prospects of higher growth.
- Eurozone equities are the preferred choice in terms of region. The risk premium is back at very high levels. On the other hand, a positive risk premium is necessary to compensate for the larger weight of financials in European indices.
- EM equity markets are relatively cheap, but that risk premium is necessary to compensate the risk of a stronger slowdown in the Chinese economy, which remains one of the main risks.
- Within fixed income, we continue to prefer especially emerging bonds in local currency as well as euro-denominated investment grade corporate bonds.
- The list of risks to our asset allocation includes slower growth in the US than consensus forecasts, European politics (and its effect on confidence), and especially a potential Chinese hard landing.

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In A Nutshell

Asset	ASSET ALLOCATION DECISIONS		
	Jul-16	Change	Aug-16
Cash	N		N
Fixed Income	OW	↓	N
Government Bonds	UW		UW
<i>Inflation-Linked</i>	OW		OW
Euro IG Credit	OW		OW
International IG	N		N
EM Debt	OW		OW
Euro High Yield	N		N
Equities	UW		UW
Europe	OW		OW
World ex-Europe	UW		UW
Emerging Markets	N		N
Alternative			
Convertible Bonds	N		N
Real Estate	OW		OW
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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