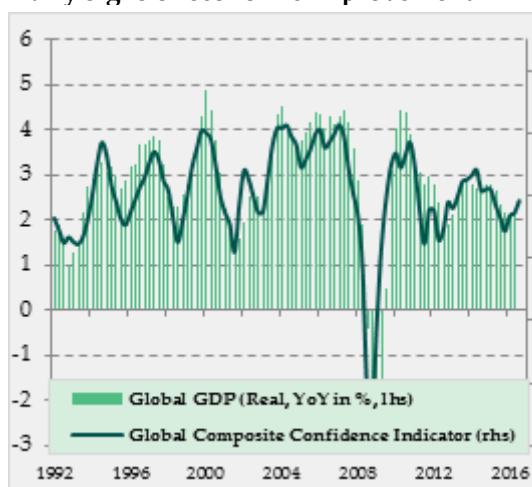


Asset Allocation Flash

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Graph of the month (December 2016)

Early signs of economic improvement



Base effects sending headline inflation higher



Global

Positive growth momentum c

- Our global economic activity indicator suggests that the positive growth momentum continued in October.
- That said, the risk of a prolonged period of subdued growth and low interest rates is real against the back of strengthening demographic headwinds and less scope for debt accumulation. ([More here](#)).
- Encouragingly, there is a [growing awareness](#) about the need for more expansive budgetary policies. In a liquidity trap situation this will prove far more efficient to close the output gap, especially in Europe and Japan. If followed up by concrete and sizeable policy action this could translate in stronger economic activity and higher inflation prints. For now at least, statements still remain vague implying that actual implementation might take time and the amounts concerned limited.
- Even with the low level of commodity prices in place, base effects will send headline inflation higher in the next couple of quarters. The prospect of a late November Opec deal to cut production could strengthen this effect.

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United States

Protectionism poses a risk

- US economic activity rebounded strongly in Q3 (2.9% QoQa following only 1% annualized in the first half of the year). That said, there was a big positive contribution from inventories and net exports. About three-quarters of the big increase in exports (10% QoQa), however, was due to a one-off spike in soybean exports to China. This implies that underlying economic activity is not as strong as the headline number suggests.
- Leading indicators are currently pointing to an underlying growth rate of around 2%.
- The US Presidential elections have been drawing lots of attention. In contrast to our expectations, Trump will now be nominated as the 45th President of the United States. But what this means for the US economy remains subject to a lot of uncertainty at this point. There's a good chance we will see more fiscal stimulus (though unlikely as much as his election promise). This could translate in higher domestic inflation and economic growth. A clear risk for the world economy is a strong shift towards more protectionism, lifting inflation further.

Eurozone

Challenging referendum in Italy

- Most confidence indicators in the immediate aftermath of the Brexit vote are holding up nicely. This suggests that the fallout on Eurozone economic activity remains very limited so far. Obviously, trade negotiations between the UK and the EU still need to start and this looks set to be a complex and prolonged negotiation process. Recent news reports suggest that the chance of a confrontational Brexit is high. On the other hand, the High Court ruled that the government does not have the power to trigger article 50 to leave the EU without a parliamentary vote. The government will now appeal against this decision in the Supreme Court.
- A yes vote in the upcoming constitutional referendum (about reducing the power of the Senate) in Italy is not a done deal. Furthermore, the 2017 European political calendar is challenging (Austrian, Dutch, French, German elections) and poses a risk to economic and financial market sentiment.

Emerging Markets

Hard landing fears in China have receded

- Sentiment towards EM has improved in recent months against the

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back of a more cautious Fed, stabilization in commodity prices and reduced concerns about China’s near term prospects. 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).

- Chinese hard landing fears have been receding over the past 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 very challenging.

Forecasts

	GDP			Inflation		
	2015	2016	2017	2015	2016	2017
US	2.6	1.5	1.8	0.1	1.2	2.2
		1.5	2.2		1.2	2.3
Eurozone	1.9	1.6	1.2	0.0	0.2	1.3
		1.6	1.3		0.2	1.3
Japan	0.6	0.6	1.0	0.8	-0.1	0.8
		0.6	0.9		-0.2	0.4
China	6.9	5.5	5.0	1.5	2.1	2.3
		6.6	6.3		1.9	1.9

Degroof Petercam forecasts as of December 2016, Consensus forecasts

Currencies

Sharp USD rise should not be taken for granted

- We continue to think that a sharp appreciation from current levels for the USD should not be expected. Despite the latest depreciation the USD still looks rather expensive in a long term theoretical perspective. That said, more evidence of the Fed moving towards another rate hike could lead to a somewhat stronger USD in the next couple of months. Therefore, we see upward risks for the USD.
- EM currencies experienced serious downward pressure since the May 2013 taper tantrum. Since February this year, however, appetite for EM currencies has been improving as investor’s expectations about higher policy rates in the US have been tempered. This intensified the search for yield and benefited EM

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assets. The subdued growth outlook and political risks warrant caution.

Asset Classes

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

- Cash is neutral

We continue to like linkers **Government bonds** | **Underweight**

- The uncertainty linked to the Trump victory in the US elections on November 8th, has only very briefly led to a run on safe haven assets like Treasuries and Bunds. Soon markets focussed on the implications of the (likely) economic policy of newly elected president: infrastructure works, trade protectionism and immigration (and the impact on wages). These elements have proven to be a game changer for inflation expectation: break even inflation (based on 30 year US treasuries) moved up substantially to 2.1%, above the long term average. The yield curve steepened significantly, magnifying the trend that had already started before the US election based on the shift in central bank stance on monetary policy.
- Given the decent economic data and increased inflation expectation, a December rate hike in the US is now almost a certainty with futures indicating a likelihood of over 90%. After that, the future path of Federal Reserve rate hikes may depend the extent to which the budgetary stimulus is implemented.
- However, a major uptick in EUR interest rates in the months to come is not part of the base case scenario: fiscal spending is likely to remain limited, quantitative easing will be extended and structural factors will keep growth at modest levels. Given this outlook, we remain underweight EUR government bonds but still like linkers.

Default risks contained **Euro IG Corporate Bonds** | **Overweight**

- IG corporate bond spreads versus core government bond yields are approaching the levels witnessed in 2014 and 2015. The bulk of spread tightening is likely behind us, but given our view that the default risks will remain contained, thanks to robust fundamentals and low financing rates, we maintain our overweight position.
- Furthermore, since June, the ECB has bought over EUR 32bn under its corporate sector purchase program. The continuation of this program is expected to keep spreads at a tight level.

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Still neutral

Euro High Yield Bonds | Neutral

- EUR HY - Keeping the neutral stance. Monetary policy should keep fundamentals in tune.
 - Within the asset class, we have a preference for B-rated emissions to BB-rated on the basis of relative valuation, as the latter has profited from “tourist” money.
 - European High Yield is strongly correlated to US High Yield: volatility periods could emerge.
- US HY - Moving to underweight
 - Declining corporate profits, risk of pressure on margin (wages increase), increase in leverage is weighing on the credit quality.

Room for additional stimulus **LC Emerging Market Debt | Overweight**

- Our conviction is that the major convergence trade in action between emerging and developed market rates remains on track.
- EM debt has already posted very solid gains year-to-date but we believe it has a way to go because the asset class is still cheap in terms of risk premium. Given the uncertainty observed after Trump’s election, volatility has risen.

Acceleration in EPS growth

Developed market equities | Neutral

- We remain Overweight European equities:
 - Valuations are moderately appealing in Europe (14.8x forward earnings),
 - We expect an acceleration in EPS growth, because of low financing costs and easier credit conditions, cheap oil, a weak EUR, better advanced indicators (PMI) and economic surprises and capex gaining strength.
- We reduce the Underweight for US equities:
 - The valuation drawbacks for US equities are still present: valuations are more expensive (16,8x forward earnings), and margins are at peak levels.
 - However, the expected infrastructure works of president-elect Trump could temporarily accelerate economic growth, even if long term growth is not impacted. Combined with lower taxation and deregulation for companies, this could contribute to the acceleration in earnings growth.
 - We tactically raise the geographical allocation for US equity, but remain slightly underweight.
- We are Underweight equities in Japan even if valuations are attractive (13.8x forward earnings) and earnings expectations are stabilizing. But the earnings forecast for 2017 is uncertain given

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profit margins at historically high levels.

Margins stabilized at very depressed levels

Emerging market equities | **Slight underweight**

- Next twelve months Emerging Markets consensus earnings forecasts and margins have confirmed their stabilization. However, with a rising US Dollar and the possibility of trade protectionist measures of the US, risks have increased for this region.
- After good performance this year, the EM risk premium has eroded somewhat.
- The longer term challenge for Chinese authorities to rebalance the economy continues to weigh on the outlook for the asset class.
- We tactically reduce EM equities to slightly underweight.

In A Nutshell

Asset	ASSET ALLOCATION DECISIONS		
	Nov-16	Change	Dec-16
Cash	N		N
Fixed Income	N		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	↑	N
Europe	OW		OW
World ex-Europe	UW		UW
Emerging Markets	N	↓	UW
Alternative			
Convertible Bonds	N		N
Real Estate	OW		OW
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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