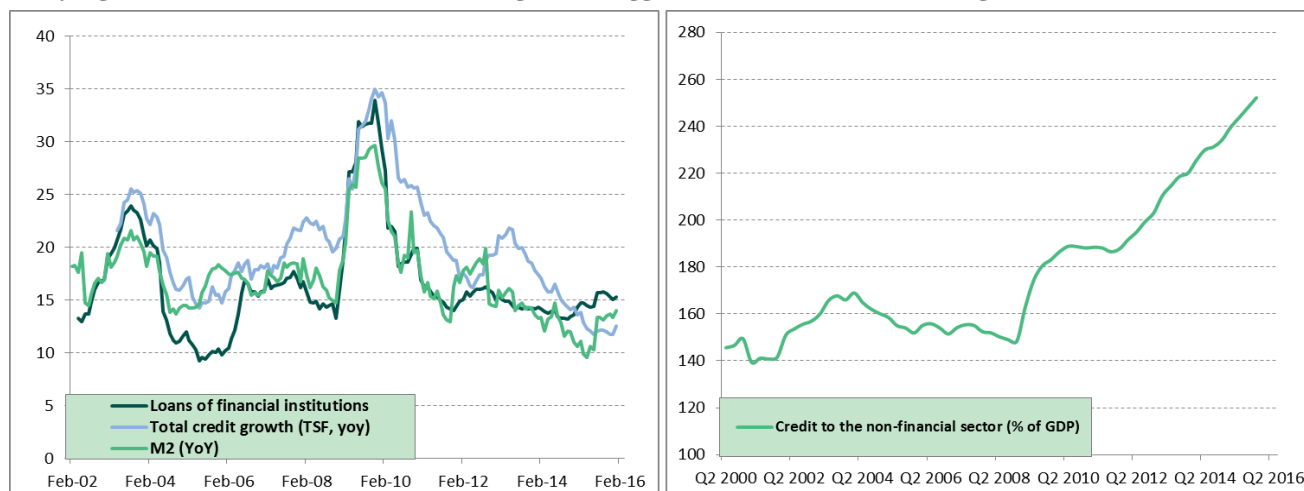


## Asset Allocation Flash

Editing & Co-ordination:  
 Degroof Petercam Asset Management  
 Asset Allocation Committee  
 Contact: dpam@degroofpetercam.com  
 www.degroofpetercam.com  
 funds.degroofpetercam.com  
 insights.petercam.com  
 Twitter: @bdp\_nl + @bdp\_fr + @bdp\_en

### Graph of the month (February 2016)

Early signs of acceleration in Chinese credit growth suggest no imminent hard landing but LT trend unsustainable



## Global

### Volatility continues

- For quite some time now financial markets are seeing lots of volatility. Investors seem to be worrying about several different factors at the same time including China's slowdown and its impact on emerging markets, clear signs of hesitation in the US economy, the non-linear fall in oil prices and its disruptive effects, geopolitical risks and the handling of the European refugee crisis, uncertainty linked to future monetary policy as well as its effectiveness to boost demand, stretched equity market valuations, high private and public debt levels and so on. Importantly, the latest market turmoil is not only about China.
- It's widely accepted that a severe economic crisis in China is one of the most important risks again for this year. Our scenario that China will avoid a hard landing in 2016 remains in place even though the challenges that stem from rebalancing the economy loom large and hard landing fears are likely to continue to linger around. (<https://insights.petercam.com/emerging-markets/crossing->

---

## Asset Allocation Flash

- [the-chinese-river](#))
- Downward risks remain substantial but we believe economic activity will not fall of a cliff against the back of loose monetary and budgetary policy and also lower energy prices. That said, our global composite confidence indicator shows clear signs of hesitation.
- Despite the general very low level of commodity prices, base effects will send headline inflation higher in late 2016. Core inflationary pressures look set to remain modest, implying that global monetary policy will stay very loose in the foreseeable future.
- The USD has appreciated significantly since the summer of 2014 and this has come with serious challenges. (<https://insights.petercam.com/developed-markets/more-thoughts-on-the-state-of-the-world-economy>)
- Looking beyond the short-term, we think the chances of a prolonged period of relatively slow growth (in combination with interest rates around the ZLB) are high against the back of strengthening demographic headwinds and less scope for debt accumulation going forward. We would not agree that budgetary and monetary policymakers have lost all ammunition to fight this extremely challenging situation. At the same time, it is not clear whether policymakers are ready to think more 'out of the box' in this respect. (<https://insights.petercam.com/developed-markets/unconventional-monetary-policy-pushing-on-a-string>).

## United States

---

Confidence in manufacturing sector is suffering from strong USD and low oil

- The US economy is facing headwinds based on most recent confidence indicators. Consensus growth estimates for 2016 (2.4%) seem too high as we have been arguing several months now.
- Confidence in the manufacturing sector is suffering from a stronger USD and low oil prices, respectively weighing on exports and investment in the energy sector. Somewhat worryingly, confidence in the service sector has also come down since last October to a level that is slightly below its LT-average.
- Consumer confidence has been stabilizing over the last three months and points to real consumption growth of close to 2.5%. Looking ahead, consumer spending should hold up against the back of the ongoing recovery in the labour and housing market and low energy prices. That said, there's a real chance that the recent bout of financial market turmoil affects consumer confidence in a

---

## Asset Allocation Flash

negative way. On the other hand, the impact should be mitigated because of the further fall in energy prices, another important driver of consumer confidence.

- Most recent data on the labour market are mixed. The unemployment rate decreased further to 4.9% (=NAIRU), but initial jobless claims have increased somewhat over the last couple of months. The U6 unemployment rate remains at 9.9% (against LT-average of 8.9% between 1994 and 2007), suggesting that the labour market is not yet running at full capacity.
- Headline inflation jumped up in December (to 0.7% from 0.4% in November) as the earlier sharp drop in energy prices seen earlier starts to have less of a negative impact. Base effects linked to energy prices will make sure that headline inflation will trend higher in the second half of the year. At 2.1% and 1.4% for core inflation and core PCE inflation (which is more important for Fed) respectively, underlying inflation pressures remain subdued. In fact, over the last five years the Fed has failed to achieve its 2% inflation target. Looking forward, however, evidence is mixed with unit labour costs suggesting that core inflation should move up while other survey based price expectations are not signalling any clear acceleration in inflation.
- Future wage growth will be key in this respect. At this point, despite the acceleration witnessed in recent quarters, wage growth is still subdued at around 2.5% yoy. NFIB survey indicators suggest wage growth should continue to pick up over the next couple of quarters. If sluggish productivity growth would remain in place, then core inflation will increase further.
- All in all, US policymakers are not in a hurry to raise interest much further in 2016. Clearly, recent market turmoil, signs of hesitation in the US economy and the fact that inflation remains below the Fed's target imply that it is likely to adopt a very cautious approach. The most important message is that monetary policy looks set to remain accommodative in the foreseeable future. The Fed is likely to proceed gradually and only if the underlying economic momentum remains strong enough.

## Eurozone

---

### Modest growth continues

- The European economy continues to grow at a modest pace which is fairly disappointing given several positive elements (low energy prices, accommodative monetary policy and the current low yields environment and EUR weakness) in place. Leading indicators are

## Asset Allocation Flash

---

still in line with expansion of around 1.5%- 2%. This is encouraging after years of standstill though still nothing to cheer about. Indeed, Eurozone economic activity has just pasted its 2008 level. What's more, the upward economic momentum seems to be levelling off according to latest confidence survey data. Finally, it will prove close to impossible for the Eurozone to escape the current global growth deceleration. Therefore, consensus growth forecasts look somewhat too optimistic. It's not entirely clear at this moment to what extent risks stemming from a few players in the banking sector could spread more widely.

- Looking ahead, consumption should continue to increase at a modest pace supported by the slow but gradual improvement observed within the labour market, resilient consumer confidence and low oil prices.
- Headline inflation (0.2% yoy in December) is held down by the recent steep fall in energy prices but base effects will send it higher in the second half of the year. Underlying price measures on the other hand 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 fairly weak. The ECB is likely to experience major difficulties in getting inflation up to its target of 2%.
- Our long-held stance that the ECB would be forced to do more is proven right. In its December meeting, the ECB left the size of monthly asset purchases unchanged at €60 billion but decided to extend its program until March 2017. In addition, the ECB decided to lower its deposit rate by 10 bp to -0.3. In its January meeting, the ECB implicitly committed to do more in March. A further deposit rate cut to -0.4% seems the absolute minimum the ECB will have to deliver next month in order to more or less meet financial market expectations.
- The Greek situation remains extremely difficult. Although funding is secured following the agreement reached in July, further imposed budgetary tightening will keep Greece stuck in recession with unemployment and public debt at unsustainably high levels. In this context, political and economic risks will stay high.
- In a longer term perspective, European politics remain worrying in the sense that the currency union still faces existential challenges. Further integration, while very much needed, looks far from evident at this point. Both the refugee crisis and rising popularity of extreme political parties in recent years is likely to make things

---

## Asset Allocation Flash

only more complicated in this respect.

- The political situation in Spain is now increasingly drawing attention because, unlike in the past, no single party has an absolute majority and forming a coalition is difficult. The ECB's QE program, however, is likely to prevent that government bond spreads widen sharply. The Catalan issue should not be a major problem at least for now. First, Catalans are highly divided. Second, EU membership would not be possible without all other EU members approving it (highly unlikely).
- The Brexit risk is real. Polls suggest opinions are highly divided (latest figures show that 'leave camp' is leading). The debate is likely to intensify in the near future. All in all, our scenario is that Brexit will be avoided eventually. That said, risks remain high. This situation once again underlines the very challenging European political context. (<https://insights.petercam.com/developed-markets/brexit-fears-likely-to-intensify>)

---

## Japan and EM

Chinese hard landing will probably be avoided for now

- Economic activity is still very modest at best. 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. The combination of modest economic activity and below target inflation, as we argued before, would prompt the BoJ to expand its monetary stimulus program. Indeed, in its latest policy meeting the BoJ applied a negative interest rate of -0.1% to current accounts that commercial banks hold at the BoJ (three-tier system). The BoJ also made clear that it will not hesitate to cut interest rates further into negative territory if necessary.
- 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. Economic activity in EM is still very sluggish, particularly in Latin America where a weak growth momentum is accompanied with above target inflation. More flexible exchange rates, lower levels of external debt in general and significant

## Asset Allocation Flash

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 diminish somewhat for now. 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. Risks remain on the downside even though confidence indicators are not signaling a further deterioration in economic momentum more recently.

- A Chinese hard landing will probably be avoided for now as the stabilizing effect of earlier stimulus measures slowly starts to kick in. The latest confidence data show early signs of stabilization. On the other hand, the medium to longer term outlook still looks incredibly challenging against the back of the huge Chinese debt overhang, ageing population, less potential to catch up from behind and difficulties linked to further economic rebalancing. Hard landing fears, therefore, are likely to stay with us for many more years.
- Although it's impossible to exclude the scenario of a large one-off RMB depreciation, we don't think this will happen in the coming months (<https://insights.petercam.com/developed-markets/sharp-cny-depreciation-just-around-the-corner>). A gradual managed depreciation remains our base case scenario for now.

## Forecasts

	GDP			Inflation		
	2015	2016	2017	2015	2016	2017
<b>US</b>	2.4	<b>1.5</b>	<b>1.9</b>	0.0	<b>1.3</b>	<b>2.0</b>
		2.4	2.5		1.5	2.3
<b>Eurozone</b>	1.5	<b>1.3</b>	<b>1.4</b>	0.1	<b>0.9</b>	<b>1.4</b>
		1.7	1.7		0.8	1.5
<b>Japan</b>	0.7	<b>1.1</b>	<b>1.2</b>	0.7	<b>0.5</b>	<b>1.4</b>
		1.2	0.6		0.6	2.0
<b>China</b>	6.9	<b>5.5</b>	<b>5.0</b>	1.5	<b>1.9</b>	<b>2.2</b>
		6.5	6.3		1.6	1.7

---

## Asset Allocation Flash

---

### Currencies

---

#### Downward risks for the EUR

- Expectations about the diverging path for monetary policy in the US and the Eurozone, with the Fed slowly hiking interest rates and the ECB implementing more stimulus, have been a key driver of the significant strengthening of the USD versus the euro since the start of 2014. Risks surrounding Greece still exist and more ECB stimulus measures (with real possibility of measures that go beyond what was announced in December 2015) pose downward risks for the EUR. Importantly, however, on fundamental valuation measures, the dollar is starting to look expensive. Therefore, a strong USD appreciation from the current levels is not our base case scenario. We see several reasons why further USD strength should not be taken for granted. See here for more information: <https://insights.petercam.com/developed-markets/fed-moving-closer-to-first-rate-hike-but-stronger-usd-far-from-guaranteed>)
- Over the past years the UK economy has been recovering significantly faster than the Eurozone. Against that backdrop the GBP has been strengthening versus the EUR. With inflation pressures still very modest and the Fed to adopt a very cautious stance, it is clear that the BoE is not in a hurry to hike interest rates despite the fact that domestic demand remains solid. All in all, on short-term valuation measures most of the upward potential for the GBP seems to have been realized. The risk surrounding “Brexit”, an issue that looks set to gain more attention in the coming months, poses downward risks for the GBP.
- In Japan, past monetary policy measures 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 its peak at the end of 2014 the yen has won back around 15%. EUR/JPY is trading at 129 at the time of writing. This is slightly above the level corresponding to the long-term purchasing power parity valuation (around 135). With more BoJ stimulus still a real possibility, we think the JPY is likely to face downward pressure against EUR, albeit only slightly.
- EM currencies experienced serious downward pressure since the May 2013 taper tantrum. Investor appetite for EM assets has waned and sustained EM currency weakness is likely given the subdued growth outlook. That said, given the depreciation already seen

---

## Asset Allocation Flash

since the spring of 2013, 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 12% since May 2013. For some currencies, including the BRL or RUB the depreciation has been as high as 30%.

---

### 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 in the later part of the year.
- 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 the ECB will probably extend its monetary program.
- 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. We remain positive on the longer part of the US Treasury curve as well.

Expected returns very low

**Euro IG Corporate Bonds** | **Overweight**

- Corporate credit spreads widened following the recent turmoil in the financial sector linked to NPLs at Italian banks and market stress surrounding Deutsche Bank. Spreads are now much more appealing
- However, they still evolve well below the level reached in 2009 or in 2012, which were particularly attractive entry points in hindsight
- We recently moved to an overweight position on the asset class.

Recent Spread widening

**Euro High Yield Bonds** | **Neutral**

- HY bonds 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**



## Asset Allocation Flash

---

- 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

Eurozone valuations more compelling

### Developed market equities | **Neutral**

- Japanese equities suffered in line with JPY strength. Japanese equities are once again a 'currency trade' as during the period before 2015
- 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.

Appealing valuations, but...

### Emerging market equities | **Neutral**

- Emerging valuations are quite appealing
- However earnings growth is still revised downwards.
- Macroeconomic environment is slowly but surely improving
- Commodities seem to bottom out. This process may need time but would help those emerging market countries that suffered severely from the fall in commodity prices.

## Key Take-Aways

---

- Neutral on developed market equities
- We do keep a preference for equities to bonds
- Eurozone equities are the preferred choice in terms of region
- Recent spread widening makes IG Credit more attractive
- EM equity markets are cheap but we do not see an improvement on the earnings front
- 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 China hard landing

## Asset Allocation Flash

### In A Nutshell

Asset	ASSET ALLOCATION DECISIONS		
	Jan-16	Change	Feb-16
<b>Cash</b>	N		N
<b>Fixed Income</b>	<b>UW</b>		<b>UW</b>
Government Bonds	UW		UW
<i>Inflation-Linked</i>	OW	↑	OW
Euro IG Credit	N		OW
International IG	N		N
EM Debt	OW		OW
Euro High Yield	N		N
<b>Equities</b>	<b>N</b>		<b>N</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	

### Disclaimer

The information contained in this document and attachments (hereafter the 'documents') is provided for pure information purposes only.

Present documents don't constitute an investment advice nor do they form part of an offer or solicitation for shares, bonds or mutual funds, or an invitation to buy or sell the products or instruments referred to herein.

Applications to invest in any fund referred to in this document can only validly be made on the basis of the Key Investor Information Document (KIID), the prospectus and the latest available annual and semi-annual reports. These documents can be obtained free of charge at the financial service provider (Bank Degroof Petercam sa, rue de l'Industrie 44, 1040 Brussels and Caceis Belgium sa, Avenue du Port, 86c, b 320, 1000 Bruxelles) or at the website [funds.degroofpetercam.com](http://funds.degroofpetercam.com).

All opinions and financial estimates herein reflect a situation on the date of issuance of the documents and are subject to change without notice. Indeed, past performances are not necessarily a guide to future performances and may not be repeated.

Degroof Petercam Asset Management sa ("Degroof Petercam AM") whose registered seat is established Rue Guimard 18, 1040 Brussels and who is the author of the present document, has made its best efforts in the preparation of this document and is acting in the best interests of its clients, without carrying any obligation to achieve any result or performance whatsoever. The information is based on sources which Degroof Petercam AM believes to be reliable. However, it does not guarantee that the information is accurate and complete. Present document may not be duplicated, in whole or in part, or distributed to other persons without prior written consent of Degroof Petercam AM.

This document may not be distributed to private investors and is solely restricted to institutional investors.