Degroof Petercam

Asset Allocation Flash

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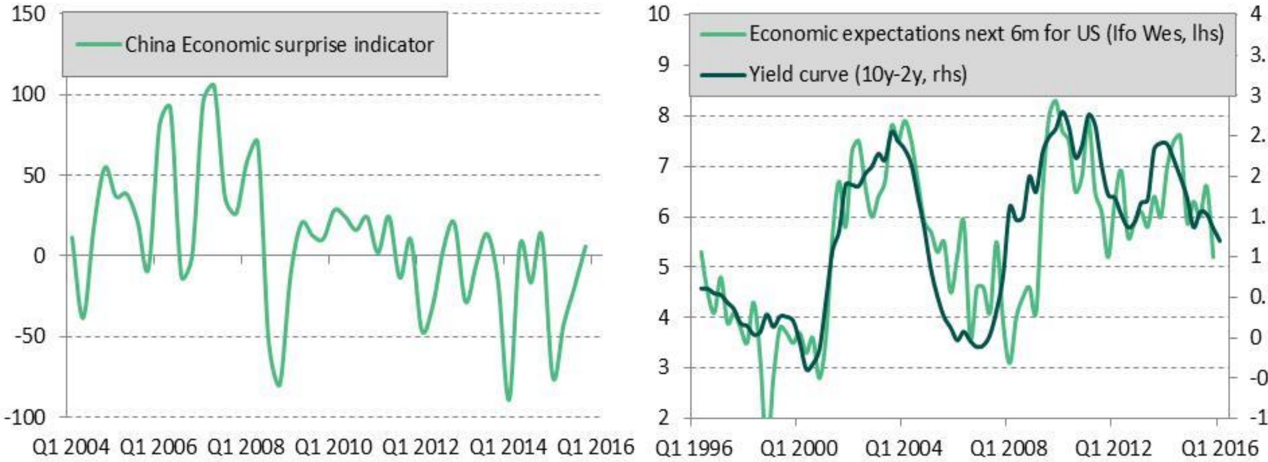
Graph of the month (January 2016)

Most recent Chinese economic data have not surprised on the downside, US economy is facing headwinds



Global

Not a good start to the year

- Financial markets took a serious hit at the start of 2016 on what seems another wave of worries about China. It's widely accepted that a severe economic crisis in China is one of the most important risks again for this year. We agree. Unlike what many investors seem to believe at the moment, however, the equity slide and downward pressure on the RMB tell us very little about the underlying economic picture in China. Our scenario that China will avoid a hard landing in 2016 therefore remains in place even though the challenges that stem from rebalancing the economy loom large.
- Is there something else investors are increasingly worried about? Equity market valuations that had become too expensive?, significant global economic slowdown coming up?, geopolitical risks?, expectations of less loose monetary policy going forward?,…? These are probably all valid concerns, yet very difficult to pin down at the same time.
- Even though the downward risks remain substantial, we believe

economic activity will not be cut abruptly and instead continue to grow at a modest pace against the background of both loose monetary and budgetary policy and also lower energy prices.

- Economic activity in DM seems to hold up while EM are still going through difficult times. This is consistent with the picture portrayed by current global confidence indicators. From a global view, leading indicators remain broadly unchanged.
- Global commodity prices continue to fall. Despite the general very low level of commodity prices, base effects will send headline inflation higher in 2016. 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

US economy facing headwinds

- The US economy is facing headwinds based on most recent confidence indicators with the sharp discrepancy between the manufacturing and services sector remaining in place. Consensus growth estimates for 2016 (2.5%) 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.
- Confidence in the service sector has decreased a bit in recent months but remains relatively high in historical perspective. This is consistent with relatively upbeat consumer confidence.
- Consumer confidence has been stabilizing over the last three months and points to real consumption growth of more than 2%. Looking ahead, consumer spending should remain healthy against the back of the ongoing housing and labour market recovery. That said, there's a real chance that the recent bout of financial market turmoil affects consumer confidence in a 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.
- The recovery in the labour market continues. Over the past year 220K monthly new jobs were created on average. Survey indicators in this respect remain healthy. In addition, other indicators including initial jobless claims and job openings all point to further labour market strength. The unemployment rate in December remained unchanged at 5% (=NAIRU). With the U6 unemployment

rate at 9.9% (against LT-average of 8.9% between 1994 and 2007), on the other hand, it seems that the labour market is not yet running at full capacity.

- Unsurprisingly, headline inflation (to 0.4% from 0.1%) jumped up in December as the earlier steep drop in energy prices seen earlier starts to have less of a negative impact. That said, it's actually more useful to look at underlying measures of inflation. At 2% and 1.4% for core inflation and core PCE (personal consumption expenditures and more important for Fed) respectively, underlying inflation remains 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, evidence is mixed with unit labor 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, wage growth is still subdued at around 2.5% yoy. NFIB survey indicators suggest wage growth should pick up significantly over the next couple of quarters. Admittedly, however, this signal has been in place for more than a year now without seeing a meaningful pickup in wage growth.
- All in all, US policymakers are not in a hurry to raise interest much further. Clearly, recent market turmoil 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

European consumption should increase

- European economy continued to grow at a moderate pace. Economic activity came out at 1.2% QoQa in Q3, a disappointment given all the positive supports (low oil prices, accommodative monetary policy and the current low yields environment and EUR weakness). Leading indicators, on the other hand, are still in line with a growth rate of around 2%. This is encouraging after years of standstill but still nothing to cheer about. Indeed, Eurozone economic activity has just pasted its 2008 level.
- Looking ahead, 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.

- Inflation (0.1% yoy) was flat in November but the base effects in energy prices will send inflation higher over the next couple of quarter. 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 on its mission of getting inflation up to the target of 2.
- The decisions taken by the ECB last month negatively surprised the market. In the last weeks up to that meeting, the market had strongly anticipated an increase in the monthly pace of purchases of government bonds from €60 billion to €80 billion, a 15-20 bps cut in the deposit rate and an extension of quantitative easing beyond September 2016. Instead, the ECB decided to extend its asset purchase programme from September 2016 until March 2017, the Governing Council did not increase the size of its monthly purchase. The latter remained unchanged at €60 billion meaning the total increase in the size of the programme will amount to €360 billion On top of that, the ECB also announced its intentions to reinvest principal payments of maturing bonds purchased under the asset purchase programme. In addition, the ECB decided to lower its deposit rate by 10 bps to -0.3% but left unchanged the refinancing rate (0.05%) and the marginal lending facility rate (0.3%). Overall, according to financial market reactions, the ECB did not meet expectations. That said, the easing bias is sustained with still significant chance of more stimulus coming up next years.
- The Greek situation remains worrying. 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 risks are likely to remain high.
- From a longer term perspective, European politics remain worrying in the sense that the currency union still faces existential challenges. The refugee crisis is likely to make things only more complicated in this respect against the back rising popularity of extreme political parties in recent years.
- 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. This risks increasing political uncertainty as Spain seems to move closer to

new elections. The ECB's QE program, however, is likely to make sure that government spreads remain contained. 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 following some (minor) concessions coming from the EU. Yet, the situation once again underlines the very challenging European political context.

Asia and EM

EM economic growth below 35 year average

- While the most recent leading indicators improved somewhat in Japan, economic activity is still modest at best. The tightening labor 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. More likely than not, the combination of modest economic activity and below target inflation will still prompt the BoJ to expand its monetary stimulus next year.
- 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. In its September 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 very 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. We acknowledge this risk. That said, it is not our base case scenario because there are several important differences. More flexible exchange rates, lower levels of external debt in general 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 diminish somewhat. 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.

- 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 (both monetary and fiscal) should soon ease the current hard landing fears. Indeed, the latest data and confidence indicators are showing signs of stabilization in this respect. Obviously, China's economic rebalancing and ageing population imply that the structural growth downtrend continues. Looking ahead, hard landing fears will come and go. This is unlikely to change anytime soon.
- RMB depreciation seen over the summer 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. For more info see https://insights.petercam.com/developed-markets/china-rattles-the-markets-but-economic-scenario-remains-unchanged.

Forecasts

	GDP			Inflation		
	2015	2016	2017	2015	2016	2017
US	*2.4*	**1.8**	**2.0**	*0.0*	**1.4**	**1.9**
		2.5	*2.6*		*1.7*	*1.9*
Eurozone	*1.5*	**1.6**	**1.5**	*0.1*	**1.0**	**1.4**
		1.7	*1.8*		*1.0*	*1.4*
Japan	*0.5*	**1.1**	**1.2**	*0.7*	**0.5**	**1.2**
		1.2	*0.7*		*0.7*	*2.0*
China	*6.9*	**5.0**	**5.5**	*1.5*	**1.9**	**2.2**
		6.5	*6.1*		*1.7*	*2.3*

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

Currencies

Japanese monetary policy has for sure impacted the yen

- 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 stimuls measures (with real possibility of further measures that go beyond what has been 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 4 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. All in all, on valuation measures most of the upward GBP potential seems to have been realized even though the case for tighter monetary policy has become stronger in the UK. The risk surrounding "Brexit", an issue that looks set to gain more attention in 2016, 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 128 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.
- 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. However, given the depreciation already seen since the spring of 2013, the risk of another sharp hit now looks significantly smaller. Indeed, in real effective exchange rate terms,

EM currencies (weighted by GDP ex China) have depreciated more than 10% since May 2013. For some currencies, including the BRL or RUB the depreciation has been as high as 30%. Tighter monetary conditions alongside the Fed's path away from the ZLB still provides a challenging background for EM currencies, particularly for those running large CA deficits (Turkey, S. Africa most notably). On the other hand, EM assets are also very much determined by investor sentiment. Therefore, easing fears about a Chinese hard landing and stabilizing global commodity prices at some point in the coming months should reduce downward currency pressure.

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

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- 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

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 | **Neutral**

- 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
- 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), China crash and bubbles/runaway inflation

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Asset Allocation Flash

In A Nutshell

Asset	Dec-15	Change	Jan-16
	ASSET ALLOCATION DECISIONS		
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	**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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