Asset Allocation Flash

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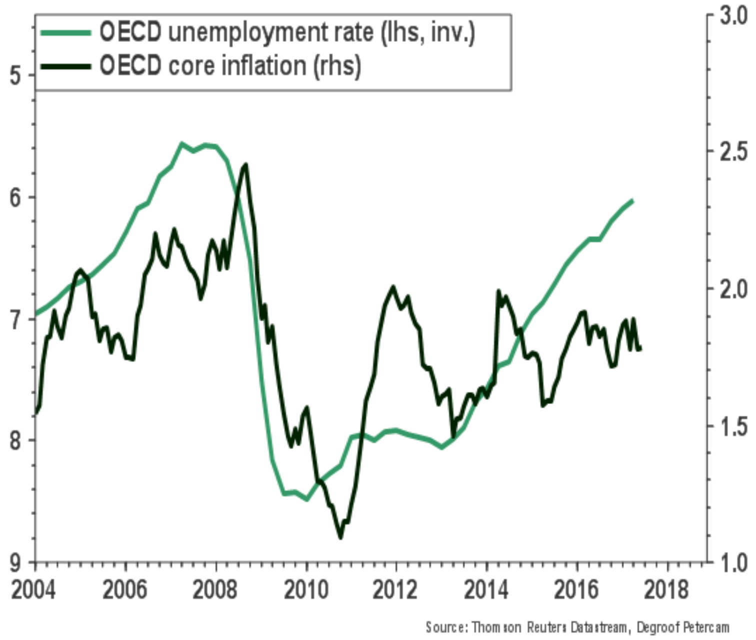
Graph of the month (August 2017)

Falling unemployment versus low and broadly stable core inflation



Global

Structural outlook still clouded

- Economic confidence indicators continue to point to a solid cyclical growth momentum across sectors and regions. Besides, global trade is showing early signs of improvement. Following numerous false starts in recent years, the current recovery looks stronger, more broad-based and more sustainable. That said, the significant difference between (soft) confidence indicators and (hard) measures of economic activity is questioning this to some extent.
- Base effects linked to commodity prices are fading. This means headline inflation is heading somewhat lower again. Underlying inflation is expected to gain strength as the cyclical recovery confirms, even though it remains modest and below target in most developed markets for the time being. This implies that monetary conditions will stay loose for now even though the Fed is eying a

gradual tightening of monetary conditions. The structural economic outlook is still clouded against the back of demographic headwinds, slower productivity growth, the debt overhang, geopolitical concerns and the difficult economic rebalancing process in China.

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United States

Trump does not deliver

- The second quarter came in at 2.6% QoQa, confirming the expectation that first quarter growth at 1.4% QoQa was a temporary setback.
- July's nonfarm payrolls at 209k are indicating that the US labor market continues to recover at a strong pace. Moreover, June's employment gains were revised upwards from 222k to 231k.
- Disposable income growth, consumer sentiment and the favourable housing and labour market backdrop still point to solid household consumption growth. It's also encouraging to witness early signs of an upturn in private investment. The spectre of a 'debt ceiling crunch' later this year obviously poses downward risks.
- Thus far, the Trump administration has not been able to deliver on anything serious. 'Trumponomics remains subject to a lot of uncertainty (~trade policy, ~investment policy, ~tax policy) at this point in time. The White House announced a slightly revised proposal for tax reform earlier in April although the document provided very little detail and appears to rely heavily on overly optimistic growth assumptions.
- Following the June rate hike and given the recent batch of decent economic data the Fed is still on track to tighten monetary policy further. In recent policy meetings, the Fed announced that it will start to wind down the size of its balance sheet (currently close to USD 4.5 trillion) later this year, not by actively selling but by reinvesting increasingly less as assets mature over time. As things stand, we expect the Fed to initiate the balance sheet runoff in September before again hiking interest rates in December. This being said, the upcoming debt ceiling discussion may affect this timing.

Eurozone

Strong economic growth

- Economic activity in the eurozone continues its strong pace. Economic activity confirmed in the second quarter with GDP expanding at 2.3% in QoQa terms. Confidence among firms and consumers is high which points to more positive economic news in the months ahead. Inflation, on the other hand, remains subdued. Against this background, the ECB is shifting its tone away from stimulus but only so in a gradual and cautious way.
- Going by the most recent evolution of confidence indicators, economic activity looks set to easily surpass the 2%-level (on an annualized basis), more or less double the estimates of eurozone potential growth (around 1%). This implies that the large negative output gap is gradually closing and that unemployment (currently at 9.3%) is coming down significantly from high levels.
- Therefore, it is only logic that the ECB has struck a more positive tone in recent weeks. More observers are now arguing in favor of tighter monetary policy. However, there's no need to fully hit the brakes at this point in time. The ECB is in no hurry to leave its zero interest rate policy or dismantle its asset purchase program (60bn EUR each month until the end of 2017) program for now. That said, 'ECB tapering talk' will become more pronounced as the year proceeds and economic activity confirms. This month's Jackson Hole speech might provide more insight into the ECB's stance.
- Encouragingly, structural labour market reforms are bearing fruit and there is more hope that Merkel and Macron can bring about a more positive vibe throughout Europe. If this is followed by concrete action on the institutional front and more public and private investment, the structural issues related to the ageing of the population and slowing productivity growth could prove somewhat less hard to bite. Importantly, higher interest rates, in return, imply there would be more room for monetary policy easing when the next recession hits further down the road.

Emerging Markets

Sentiment has improved

- Sentiment towards EM has improved since early 2016 against the back of a more cautious Fed, stabilization in commodity prices and reduced concerns about China's near term prospects. In addition, EM have experienced an export-led cyclical recovery on the back of an improved global environment. While the 'reflationary trade' has supported commodity-dependent countries, this effect seems to have passed now. Moreover, recent softness in energy and metal prices is weighing on confidence indicators of important EM such as China.

- China's challenging rebalancing exercise and uncertainties linked to monetary policy tightening in the US could still expose more EM weakness. Moreover, Trump's presidency bodes risks for EM (~trade policy, ~protectionism) even though risk of fierce US protectionism do not seem to materialize for now. Geopolitical tensions surrounding the Korean peninsula and South China Sea remain present.
- Although very difficult to time, concerns about China look set for a comeback. Indeed, the background of soaring house prices and continued rapid credit growth is far from comfortable. In the March National People's Congress, Chinese policymakers have changed the growth target to 'around 6.5%, or higher if possible', down from '6.5% to 7%' last year while highlighting the need to cut excess supply and monitor financial risks. There is now early evidence that the soft tightening of monetary conditions is starting to have a dampening effect on economic activity.

Forecasts

	GDP			Inflation		
	2016	2017	2018	2016	2017	2018
US	*1.6*	**2.0**	**2.0**	*1.3*	**2.3**	**2.2**
		2.1	*2.4*		*2.4*	*2.2*
Eurozone	*1.7*	**1.8**	**1.6**	*0.2*	**1.5**	**1.5**
		1.7	*1.6*		*1.6*	*1.4*
Japan	*1.0*	**1.4**	**1.0**	*-0.2*	**0.6**	**0.9**
		1.4	*1.1*		*0.7*	*1.0*
China	*6.7*	**5.5**	**5.0**	*2.0*	**2.1**	**2.5**
		6.6	*6.2*		*2.1*	*2.3*

Degroof Petercam forecasts as of August 2017, *Consensus forecasts*

Currencies (vs. EUR)

Downward pressure on EM

- The USD lost some ground in recent weeks against the back of easing political risks in Europe and further confirmation of the economic recovery. The currency still looks expensive in a long term theoretical perspective. That said, more evidence of the Fed turning more hawkish could still lead to a somewhat stronger USD. All in all, downward risks for the USD remain present in a medium to longer term perspective.

- EM currencies experienced downward pressure again since Trump got elected but most recovered since then. In general, China's challenges, the unimpressive growth outlook and political risks warrant caution.

Asset Classes

Prudent stance on risky assets

Cash | Neutral

- Cash is neutral

Sintra speech influential

Government bonds | Underweight

- The economic expansion remains robust and well supported by global trade. In the US we are seeing improving Q2 growth versus Q1, as private consumption is supported by a strong jobs market and capital expenditure is resuming (reflected through rising new order PMI's in manufacturing). Chinese data releases are reassuring and in line with expectations going into the autumn Party Congress. The weaker USD vs other developed markets' currencies is supportive for US inflation. EU inflation will at the margin be negatively impacted by the 4% rise in EUR Trade Weighted Index since May.
- The 10 year bond yield jumped higher in the Eurozone and the US, following the Sintra speech by ECB president Draghi at the end of June, but have dwindled over summer. German 10 year bond yield came close to the upper margin of the 5bp to 65bp range that we have been putting forward for several months now. We confirm this 5bp to 65bp range going forward, as we remain confident that the low rates are here to stay for longer due to structural factors and because further positive surprises for confidence indices will become much harder from current high levels. Furthermore, the euro strength witnessed over past three months can become a headwind for growth and European inflation readings (ECB inflation forecast might be impacted).
- Euro break-up probabilities expressed through investor surveys are receding. This supports the EU periphery and further spread convergence is to be expected. All in all we can state that markets are less worried about the impact of LT structural issues surrounding the European construct. We maintain our Underweight position : from a portfolio construction point of view,

we do not want to "double up" on risk, bearing both equities and sovereign bonds risk in the Eurozone.

- Despite recent 'dovish' comments by Fed-members, we expect to the Fed to stick to its projected hiking path. The constructive macro-economic context for inflation, in particular the pent-up pressure in the labour market, and the supportive financial conditions (lower USD) lead us to confirm our base case scenario for Fed monetary policy : 1 more hike in 2017 and adjustment of the reinvestment programme in order to start balance sheet normalisation (some timing uncertainty in case of debt ceiling issues). For 2018, we continue to see 3 more rate hikes. The market view is 2 rate hikes until the end of 2018.
- Inflation linked bonds price a very mediocre inflation outlook. They remain a cheap hedge to rising rates. Inflation linked bonds remain attractive both from a short term tactical perspective, long-term value and as a hedge against non-base case scenarios. We remain overweight Global Inflation Linked Bonds.

Default risk in check

Euro IG Corporate Bonds | Neutral

- Given our EUR government bond outlook and that the ECB's Corporate Sector Purchase Programme remains in place, spreads may continue to hover broadly around current (low) levels.
- Default risk is to remain under control for the foreseeable future thanks to sufficiently robust credit fundamentals and low interest rates. However internal credit analysis is required and acts as a cornerstone to the investment process when valuations are becoming rich and company or sector specific issues might impact aggressively.

Valuations quite high

Euro High Yield Bonds | Neutral

- Valuations become frothy, in the sense that current spreads for European High Yield cover for a cumulative default rate of 17.1% (40% recovery). The average 5y cumulative default cycle will see default rates between 20% to 25%. So valuation is becoming rich.
- However, in the benign European macro backdrop and very little defaults on the horizon, we continue to have a neutral stance on European HY.

Potential consolidation

LC Emerging Market Debt | Slight overweight

- No change to our forecast: fundamentals remain supportive. However, as indicated over the past few months, we are seeing a bit of overcrowding in some parts of the markets, e.g. India, Indonesia, Russia. However, longer term factors are still in positive territory, including hard economic data forecasts, attractive valuations and positive flows into the EM Debt segments.

- EUR strength has been detrimental for euro-based investors but we think it is also a positive signal for risk assets.
- In the short term we remain more cautious about the sector and confirm our Slight Overweight position.

Downgrade to neutral

Developed market equities l Neutral

- Our position for Equity as an asset class was lowered to Neutral (from Slight Overweight). It is our opinion that markets have reacted to the positive economic surprises globally in the past months and to the third consecutive quarter of clearly positive earnings growth. Positive surprises will be more difficult to realize from this point onwards. Furthermore valuations are no longer cheap, especially in the US. Also, some sentiment indicators point to complacency in the market: Short Interest for the S&P 500 median is at a record low (as % of market cap), the number of NYSE stocks at a new low is spiking while the S&P reaches a record, inflows are at record highs. However there are reasons to maintain a neutral equity position in the portfolios: earnings growth will continue over the next quarters, and risk premiums are – especially in Europe – still at decent levels.
- The geographical allocation reflects the change in our overall position, where the US is reduced to Underweight (from Slight Underweight), while we remain Overweight European equities.

    - The Trump administration has only been able to deliver uncertainty. Expectations for Trumponomics (~trade policy, ~investment policy, ~tax policy) have been reduced considerably. Thus far, the market has ignored this.
    - Q2 earnings releases were positive for both regions. FY2017 has been stable for US equity and more positive for European equity.
    - US investors are continuing to buy European equity, albeit at a slower rhythm than 3 months ago.
    - **Valuations remain more appealing in** Europe (15.0x forward earnings) than in the US (18.2x) but this is consistent with better quality of US market

- We are also Underweight equities in Japan even if valuations are attractive (14.2x forward earnings) and earnings revisions are improving.
    - Sustainability and further improvement of margins and profitability is still a big question mark.
    - Japan’s relative performance still linked to the evolution of JPY.
    - EPS revisions are strong for 2017, but mainly coming from

cyclical sectors, less so for 2018.

Latin American political risk

Emerging market equities | **Slight underweight**

- Emerging Markets equity performed well on the back of a Chinese economy holding up better than expected, a weaker dollar and favourable global outlook (hence higher commodity prices). Earnings revisions have been upwards for the region.
- Emerging Markets equities' valuations (12.6x forward earnings) are more appealing than in developed countries, but the China risk partly accounts for this.
- We are slightly underweight for Emerging Markets because the Chinese credit picture looks a lot like that of the US in 2008.

In a nutshell

	ASSET ALLOCATION DECISIONS		
Asset	**Jul-17**	**Change**	**Aug-17**
Cash	**N**		**N**
Fixed Income	**N**		**N**
Government Bonds	UW		UW
Inflation-Linked	OW		OW
Euro IG Credit	OW	↓	N
International IG	N		N
EM Debt	OW		OW
Euro High Yield	N		N
Equities	**OW**	↓	**N**
Europe	OW		OW
World ex-Europe	UW		UW
Emerging Markets	UW		UW
Alternatives			
Convertible Bonds	N		N
Real Estate	OW		OW
Commodities	N		N
Others	N/A		N/A
		Up / Down	

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