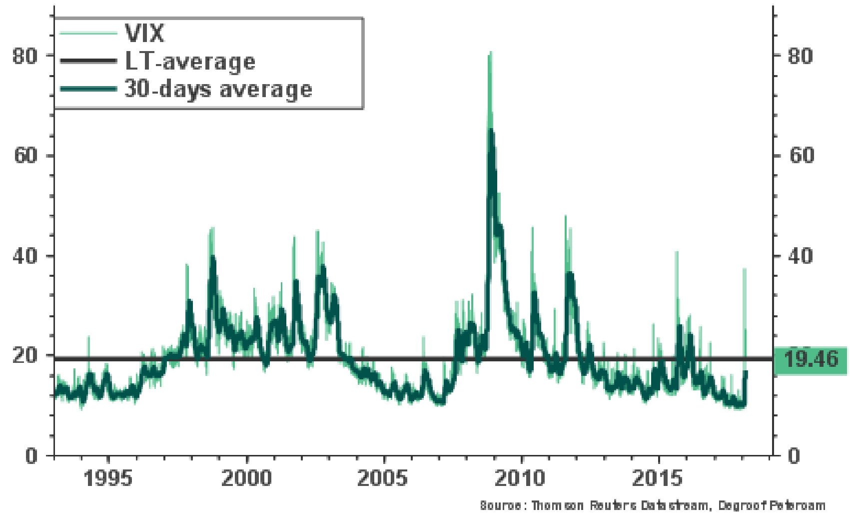
Asset Allocation Flash

Editing & Co-ordination:
Degroof Petercam Asset Management
Asset Allocation Committee
Contact: dpam@degroofpetercam.com
www.degroofpetercam.com
funds.degroofpetercam.com
blog.degroofpetercam.com
Twitter: @bdp_nl + @bdp_fr + @bdp_en

Graph of the month (February 2018)

Spike in volatility after long period of calm



Global

Volatility on the rise

- The recent rise in volatility demonstrates that the key challenge for the coming years will be the removal of monetary life support without hampering economic growth and upsetting market psychology too much.
- The global sell-off confirms the importance of market psychology after a long period of calm. However, the stock market is not the economy. Economic indicators remain solid for now. Ten years after the onset of the financial crisis, the global economy is showing signs of a synchronized recovery.
- Economic activity performs solidly, trade volumes are growing, corporate profits are on the rise and unemployment is falling. The combination of extremely loose monetary policy, relatively low commodity prices (though industrial metal and energy prices have rallied more recently) and neutral fiscal policy has come to fruition. So far, however, this is only modestly translating into rising wage and inflation readings.

- Financial conditions look set to become tighter from here eventually biting into economic activity, perhaps already later this year. Future equilibrium interest rates (and therefore real policy rates) are expected to remain lower compared to pre-crisis standards.

United States

Protracted economic recovery

- The United States are currently seeing the third-longest economic expansion in history, with the yield curve continuing its flattening trend. This is something to monitor closely. That said, we believe recession odds are low for now. Consumer confidence is still strong and the outlook for investment has been improving according to several leading indicators. Importantly, the low household savings rate in combination with expensive equity market and rising real estate prices bear watching.
- President Trump's tax looks set to give economic growth a small boost, but will primarily result in deteriorating public finances and growing inequality over time.
- We do expect core inflation to rear its head again as the labour market is nearing full employment. The latest rise in average hourly earnings seems to hint in this direction. Therefore, more tightening of monetary policy is in the cards, and as things currently stand it is plausible that the Fed will hike interest rates three to four times by the end of 2018, more than markets currently price in.

Eurozone

Unemployment remains high

- In the past two years, the European economic cycle has caught up significantly, and is doing very well today from a cyclical point of view. All sectors are recovering, and the labour market is thriving again.
- However, unemployment remains above pre-crisis levels, and there are major divergences between countries. Moreover, there are many discouraged workers who have dropped out of the labour force in the past few years, as well as part-time workers who would rather work full time.
- Hence, it does not come as a surprise that wage pressures will remain modest for some time to come, and that inflation will remain below the 2% target.
- As such, tighter monetary policy should not be expected any time soon. Here, the ECB will want to avoid the mistake it made in the

past, namely to tighten monetary policy too soon. In addition, a further euro appreciation on the back of higher rates would make it harder for the ECB to reach its inflation target.

- It is too soon for an actual rate hike, and this will only come after the ECB has put an end to its asset purchase program later this year. The first rate hike will probably come in the spring of 2019. Meanwhile, tough Brexit negotiations and the potential political deadlock that may arise after the Italian elections are the main short-term risks.

Emerging Markets

Slew of elections planned

- China's economy has settled down from earlier hard landing fears. Economic policy uncertainty has declined but we expect growth to decelerate in 2018 as the economy's credit-driven recovery is over and monetary policy remains rather tight. China continues to be one of the major risks to the global economy.
- A slowing Chinese economy will have some fallout in the rest of the world, resulting in lower trade volumes and commodity prices. However, concerns about a severely negative impact on the rest of the world remain subdued for the time being.
- The rule of thumb is that a 1% decrease in Chinese growth results in a 0.25% drop in global economic growth. In the rest of the emerging world, economic activity is holding up well. EM Inflation hit an eight year low in the middle of 2017 but this trend is unlikely to continue this year.
- Therefore, the monetary policy easing cycles witnessed throughout much of the EM world have come to an end. There is a slew of elections coming up: in March and May respectively Russia and Colombia will be holding presidential elections, and Indonesia has planned local elections in June.
- Furthermore, there will be general parliamentary elections in Mexico (July), Malaysia (August), Brazil (October) and Thailand (November). The elections in Mexico and Brazil in particular will attract a great deal of attention. Meanwhile, South Africa is preparing for general elections in 2019.

Forecasts 2018-2019

	GDP			Inflation		
	2017	2018	2019	2017	2018	2019
US	*2.2*	**2.4**	**1.9**	*2.1*	**2.1**	**2.2**
		2.7	*2.4*		*2.1*	*2.1*
Eurozone	*2.3*	**2.3**	**1.7**	*1.4*	**1.5**	**1.7**
		2.2	*1.8*		*1.4*	*1.6*
Japan	*1.6*	**1.5**	**1.0**	*0.8*	**1.3**	**1.5**
		1.4	*1.1*		*1.4*	*1.6*
China	*6.7*	**6.2**	**5.7**	*2.2*	**2.2**	**2.3**
		6.5	*6.3*		*2.2*	*2.2*

Degroof Petercam forecasts as of February 2018, *Consensus forecasts*

Currencies (vs. EUR)

USD still looks expensive

- The USD 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. Meanwhile, a stronger EUR has another dampening effect on Eurozone inflation numbers that are already considered too low. All in all, downward risks for the USD remain present in a medium to longer term perspective, provided that European political cohesion proves stable.
- The GBP has already depreciated significantly as a result of the Brexit referendum. This has led to higher inflation and hence negative real household disposable income growth for UK households, challenging the growth outlook. The BoE dovishly hiked interest rates this month for the first time since July 2007 but this was largely anticipated by markets. Meanwhile, Brexit negotiations seem to be going nowhere at this point. This could change of course but for now risks remain primarily on the downside from current levels.
- The JPY has been depreciating against the euro in recent quarters. Downward pressure remains as the BoJ sticks to its ultra-loose monetary policy in the foreseeable future. The fact that the JPY is now at its long-term PPP equilibrium level against the EUR, however, makes another significant depreciation less likely.
- The RMB has appreciated significantly against the USD since the

summer of 2016. But this has been mostly offset by depreciation against other currencies. In trade-weighted terms the RMB has remained broadly stable recently, in line with policy goals.

Asset Classes

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

- Cash is neutral

Turbulence **Government bonds | Underweight**

- Bond markets had a turbulent few weeks. 10 year yields for US treasuries and German bunds rose significantly, breaking out of the horizontal range in which they fluctuated during all of 2017, and reaching multi year highs.
- Bond markets had already become more volatile because of the more hawkish tone in central bank communication since the turn of the year. The impact of the US tax reform made markets feel additionally ill at ease. This impact will be double on interest rates. In the first place, the tax reform means an additional economic stimulus at a time when the economy is already on a roll and the labour market in the United States is already becoming tight, and this may result in higher inflation. Secondly, the tax reform will lead to a higher government deficit that will have to be financed through the issuance of bonds, this at a time when the US central bank has stopped its bond purchases and is reducing its balance sheet. The budget deal adds to this risk. The trigger for further market volatility – and spill over to equity markets – came with the publication of the hourly earnings figure for January in the US. This figure showed the strongest increase (+2.9%) since 2009. Even if this pick-up in wage growth may partly be a weather-related distortion, it drew the market's attention to its complacent view on inflation and monetary policy.
- Even if more abrupt than expected, the current yield trend is in line with our view. In the US, the recent steepening of the 10 year – 2 year curve that accompanied the rise in 10 year yields gives room for the Fed to raise policy rates further, we think we will see 3 rises this year, the first one in March. Having said that, the Fed is still likely to tread with caution and, although inflation is moving up, there are no signs that it is accelerating either. In the Eurozone, additional growth surprises are unlikely and we do not expect a broad-based inflation shock any time soon, as there is still labour market slack. EMU bond markets (government and credit) furthermore still receive protection by the ECB Asset Purchase Program. However, the risk of overshooting is significant, especially if inflation data comes through. We are maintaining an

Underweight position for EUR Government Bonds in a balanced portfolio and confirm our Strong Underweight duration stance.

- Spreads for Eurozone periphery bonds have continued to fall. The fixed income team sees spreads narrowing even more as the Franco-German relationship becomes stronger.
- Mainly in the US, breakeven rates have continued to increase, but inflation linked bonds price a very mediocre inflation outlook and consequently they remain a cheap hedge to rising rates. Real yields are expected to remain structurally low over the longer term. Inflation linked bonds remain attractive both from a short term tactical perspective and as a hedge against non-base case scenarios. We remain overweight Global Inflation Linked Bonds.

Reaction to turmoil limited

Euro IG Corporate Bonds | Neutral

- EUR IG has reacted relatively limited to the market turbulence because of lower duration and the fact that spreads behaved relatively well.
- From what we have seen so far, it looks as if the ECB has not scaled back the CSPP and in fact favours IG credit in the early part of the year.
- 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. Individual accidents could have been costly for those that have no internal research team.

Good news priced in

Euro High Yield Bonds | Underweight

- The effect of rising rates will affect EUR HY in various ways: the asset class's duration has gone up by 0.5 years over the last 12 months and outflows are possible given the growing number of alternatives.
- Spreads remain close to 2007 lows and the market segment has become very expensive.
- Even if defaults are expected to remain low and there are little signs of distress in Europe, we believe the good news is priced in.

Uncertainty in some markets

LC Emerging Market Debt | Slight overweight

- We remain cautiously optimistic on EM Bonds Local Currency. The bond yield differential remains slightly above long-term averages.
- Taking into account the sudden increase in Developed Market yields, it seems wise to proceed with caution.
- There is an increasing uncertainty unfolding again in specific markets like Argentina and some markets have become very well

priced, like the Ivory Coast bonds.
- In the short term we remain more cautious about the sector but confirm our Slight Overweight position.

Europe first

Developed market equities | Neutral

- The cyclical upturn remains fairly strong going into 2018. The market rout has not affected our outlook for strong economic growth and earnings growth.
- Even though a moderately higher interest rate level (our scenario) is not generally seen as a threat to equity markets, it does cause a rotation between sectors away from high-yield shares (sectors such as utilities, real estate and telecom). Financial shares then again benefit from the steeper yield curve.
- Given the potential for rates to rise somewhat further, there is no need to already buy the recent dip in markets and prefer a wait-and-see attitude.
- Our geographical allocation:
    - **European equity (Overweight)**
        - Valuations remain reasonable in Europe (15.0x forward earnings, dividend yield to bond yield high)
        - Earnings growth likely underestimated given macro momentum, but strong EUR risk: European earnings momentum is flat
        - Monetary policy remains accommodative
    - **US Equity (Underweight)**
        - US equity remains expensive; the correction has not significantly changed that. Several metrics point in that direction (forward P/E 18.7x, low dividend yield to bond yield)
        - Earnings revisions are strongly positive because of tax reform
        - Monetary policy becoming less supportive
    - **Japanese Equity (Neutral)**
        - Margins in Japan have already surpassed the last cyclical peak but we think the gathering cyclical momentum means this situation can carry on for a while. Earnings momentum is still improving in Japan.
        - The JPY has recently stopped eroding the equity market performance. By many measures, the JPYUSD now looks undervalued (it is currently trading at an unusual discount to its PPP-implied level).
        - The likely reappointment in April of BOJ president

Koruda will allow for a continuation of the aggressive monetary easing.

We prefer Japan

Emerging market equities | Underweight

- EM equity performed relatively well during the recent market turbulence, because of valuation. It is however unlikely that EM equity would escape in case of a further correction, especially if this correction would be combined with a firmer dollar and falling commodity prices.
- Even if Emerging Markets have an exposure to the global growth recovery and equities' valuations are more appealing (12.4x forward earnings) than in developed countries, we see growing risk for the region:
  - leading indicators are lagging those of developed markets
  - tightening monetary conditions in China. With the National Congress now behind us, the focus may shift from supporting growth to correcting the imbalances, which will have an impact on the growth outlook.
  - the elections in several EM countries in 2018.
- We prefer Japan to Emerging Markets for Asia exposure.

In a nutshell

	ASSET ALLOCATION DECISIONS		
Asset	**Jan-18**	**Change**	**Feb-18**
Cash	**N**		**N**
Fixed Income	**N**		**N**
Government Bonds	UW		UW
Inflation-Linked	OW		OW
Euro IG Credit	N		N
International IG	N		N
EM Debt	OW		OW
Euro High Yield	UW		UW
Equities	**N**		**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	

Asset Allocation Flash

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, 44 rue de l'Industrie, 1040 Brussels and Caceis Belgium sa, 86c b320 Avenue du Port, 1000 Brussels) or on the website 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 18, Rue Guimard, 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.