Robeco

Financial Markets Research

Lackluster equity markets as growth softens

Léon Cornelissen
Lukas Daalder
Ronald Doeswijk

financialmarketsresearch@robeco.com

Highlights

- Global economic growth's momentum seems to be slowing. Inflation is being taken more seriously in several major emerging markets, with central banks exceeding expectations in their tightening measures.

- One should not expect too much from equities in the months ahead, although we do believe risk premiums will be positive on a 12-month horizon. The difference in earnings revisions between cyclical sectors and their defensive counterparts is narrowing. This is another indication that positive surprises are increasingly unlikely as the economic cycle progresses.

- Real estate has also been affected by a change in investors' risk appetite. As with stocks, a sideways trading pattern is likely.

- Corporate bonds are not being hurt by the weakening of the economy. We believe there is still room for further spread tightening, given the low default rates and the improving credit quality.

- The outlook for commodity prices continues to be good in the long run. In the short term, however, the outlook is being affected by the waning of the social unrest in the Middle East. In addition, manufacturing surveys are likely to decline from historical highs, which might put some further pressure on prices.

- Within equities, we favor North America and emerging markets over Europe. Earnings revisions in both regions are better. Furthermore, the US consumer is back and exports will benefit from the dollar's weakness. In emerging markets, the inflation risks are manageable, given the ongoing monetary tightening and a softening of food prices, while government finances are healthy.

- We have a slight preference for cyclical and defensive sectors over financials. For quite some time, earnings developments in cyclical sectors have been more robust than in other sectors. Now, earnings growth rates and earnings revisions have converged. Financials is the sector most vulnerable to a possible eurozone debt restructuring.

Summary

Global economic growth's momentum seems to be slowing. Inflation is being taken more seriously in several major emerging markets, with central banks exceeding expectations in their tightening measures. One should not expect too much from equities in the months ahead, although we do believe risk premiums will be positive on a 12-month horizon. The outlook for commodity prices continues to be good in the long run. In the short term, however, the outlook is being affected by the waning of the social unrest in the Middle East. In addition, manufacturing surveys are likely to decline from historical highs, which might put some further pressure on prices.

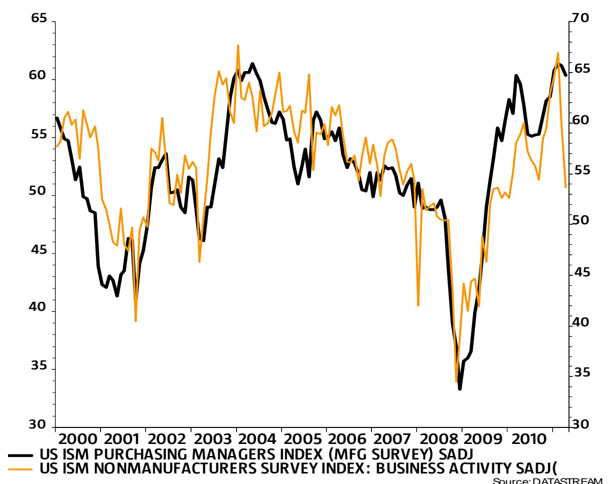
Macroeconomic view

Global economic growth's momentum seems to be slowing. China, the eurozone, Japan and the UK are all functioning as brakes, though for different reasons. Despite a weakening dollar, the momentum in the US economy appears to be slowing, despite a strong ISM manufacturing reading. The non-manufacturing ISM index has taken a nosedive, probably reflecting the government's fiscal tightening. Inflation is being taken more seriously in several major emerging markets, with central banks exceeding expectations in their tightening measures.

North America

The US economy weakened somewhat in Q1, with GDP expanding by 1.8% on an annual basis, down from 3.1% in Q4 2010 and slightly below the 2.0% consensus expectation. Neither the speed of the slowdown, nor the break-down of the individual components, is that threatening, though. Extreme winter weather had an impact, while breaking down the components shows that the main drag has been government spending, which declined by 5.2%, thereby subtracting a full percentage point from the total growth number. Consumer spending (+2.7%) and gross investment spending (+8.5%) remained brisk, although the latter was mostly the result of inventories being re-accumulated following the sharp drop recorded in Q4. All in all, these figures suggest that the US economy has managed to perform steadily, despite the increase in energy related prices.

ISM MANUFACTURING AND NON MANUFACTURING INDEX



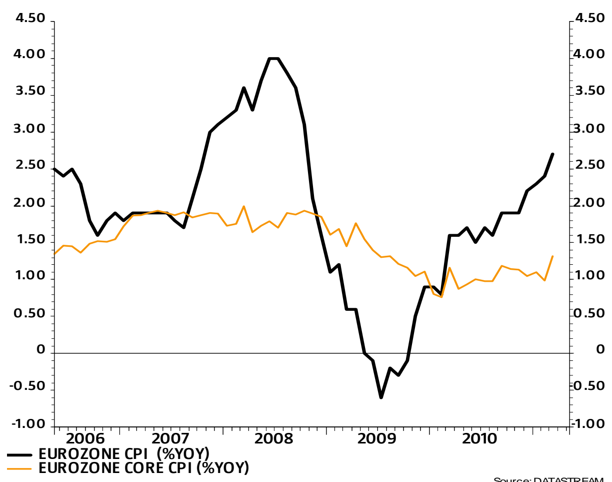
S&P surprised the markets by issuing an unambiguous warning to the US government by switching its outlook for the country's long-term debt rating to negative. Uncertainty about future budgetary policy and debt prompted the ratings agency to take this step. S&P stated that the odds of an actual downgrade from the current triple-A rating in the next two years are now one in three. It seems unlikely that S&P—or the other ratings agencies, for that matter—will ever come to the point of actually downgrading the US. But even if it were to come to that, the direct impact would probably be limited. As long as the dollar remains the world's main reserve currency, demand for US Treasuries will be maintained, enabling continued US government borrowing. It would take a radical change in China's yuan policy for that situation to change, which is not very likely at this moment.

Europe

UK GDP growth was a disappointing 0.5% in the first quarter, barely compensating for the snow-induced contraction in the fourth quarter of 2010. The PMI index for the services sector fell from 57.1 in March to 54.3 in April, pointing to an expected loss of growth momentum due to government tightening. The level above 50 suggests continuing growth, but the general picture is weak. At the same time, a gauge measuring output prices rose to the highest level in more than two years. EU harmonized inflation came down in March from 4.4% to 4.0%, offering some relief to the Bank of England, as it makes it easier for the central bank to remain on hold for a while.

The core eurozone economy continues to expand, although it is only a matter of time before the consequences of monetary tightening—and the accompanying strength of the euro—start to kick in. The manufacturing PMI indices for April featured rises for Germany, the Netherlands and France. The growth divergence within the eurozone also shows no sign of abating. Greece's PMI reading was below 50, while Spain's fell close to 50. Portugal has reached an agreement with the IMF and the EU on a bail-out package for three years. It is the third country in need of rescue. The package has to be unanimously agreed by all the eurozone's finance ministers in mid-May. The EU will probably finalize its permanent crisis-handling mechanism (the ESM, the successor to the temporary EFSF) by the end of June. But bail-out fatigue is on the rise within the eurozone. At the same time, Spain's efforts to distance itself from other peripheral countries are being hindered by the ECB's tightening measures; the eurozone central bank hiked rates in April for the first time in three years because of a worsening inflation picture. The ECB indicated at the beginning of May, however, that it is in no hurry to tighten again soon.

HEADLINE AND CORE INFLATION RATE (% YOY) EURO AREA

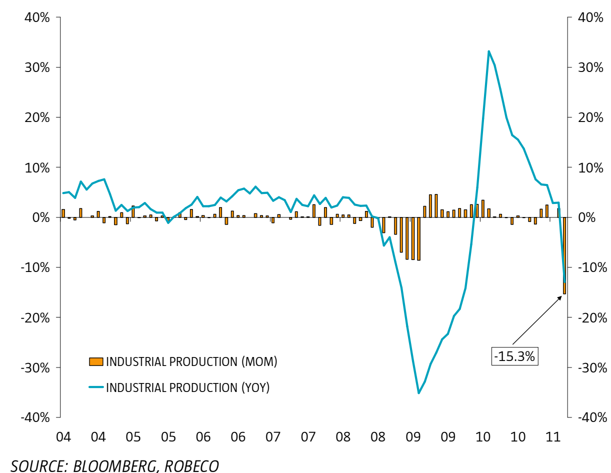


Source: DATASTREAM

Pacific

One aftershock that usually follows a major earthquake is the publication of economic data for the month in which the natural disaster took place. In Japan, the impact was even worse than feared. In March, industrial production plunged by more than 15% compared with February, much more than the 10.6% decline expected by consensus. According to indicative polls, this record decline is likely to be followed by a recovery in the months ahead, although the expected output increases for April (+3.9%) and May (+2.7%) will be insufficient to compensate for the drop in March. At the same time, overall household spending (a notoriously volatile number) declined by 8.5% year-on-year, compared with a 0.2% decline the previous month. It remains to be seen whether Q1 GDP will be negative but that is a matter of detail: there is certain to be a large negative GDP growth number in Q2. Consensus is expecting a rebound—and a strong one at that—from there on, as the rebuilding of infrastructure boosts production. The OECD, for instance, has halved its 2011 growth estimate (from 1.7% to 0.8%) but has increased its 2012 estimate by roughly the same amount (from 1.2% to 2.3%). This would be a classic V-shaped recovery following a natural disaster. However, we reiterate that there are some risks that this scenario will not materialize. The Fukushima nuclear power plant is one uncertainty, but the biggest question mark is over the financing of the recovery. So far, the Japanese government has announced an extra budget of JPY 4 trillion, but given the estimated direct costs of JPY 16 to 25 trillion (government estimates), this can only be seen as a first step. With debt above 200% of GDP and the primary budget deficit estimated to reach 7% in 2011, it is not such a surprise that S&P issued a new warning about Japan's credit rating. In addition, statements by several BoJ officials suggest that the knee-jerk reaction of Japan's consumers has been to reduce spending further, which means that a return to deflation looks inevitable. All in all, we remain very cautious about the medium-term prospects of the Japanese economy.

BIG AFTERSHOCK RECORDED IN JAPANESE INDUSTRIAL PRODUCTION

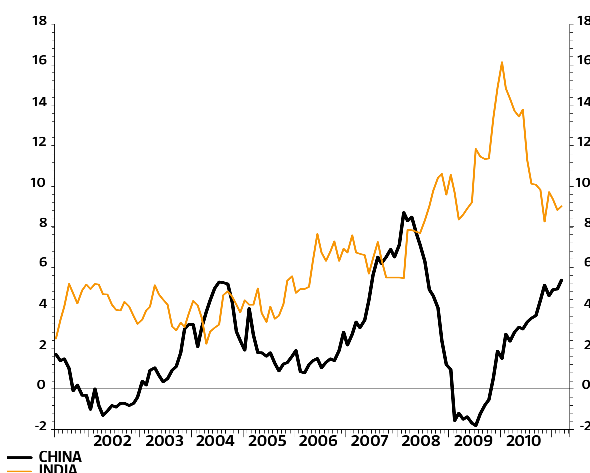


SOURCE: BLOOMBERG, ROBECO

Emerging markets

The gradual tightening measures implemented by the Chinese authorities have succeeded in cooling down the economy somewhat. The PMI index fell from 53.4 to 52.9 in April. Inflation remains a headache, reaching 5.4% on a yearly basis in March. The Chinese authorities have allowed the appreciation of the yuan against the US dollar to increase a little. But that is because the US dollar has been weak on a very broad front. Nevertheless, the Chinese central bank views the taming of inflation as its top priority.

CHINESE CPI (% YOY) AND INDIAN BENCHMARK WPI (% YOY)



By hiking interest rates by an unexpectedly high 50 basis points (bps) in early May, the Reserve Bank of India indicated that it is starting to take inflationary risks more seriously. Meanwhile, the PMI index for the services sector continued to rise, up from 58.8 in March to 59.2 in April. There is more room for monetary tightening in the coming months as inflation (as measured by the benchmark wholesale price index) is expected to stay in the 8.0 to 9.0% range on a yearly basis.

In Brazil, inflation accelerated to 6.4% on a yearly basis in April. The central bank raised interest rates by 25 bps in April, after hiking by 50 bps in both January and March. With economic growth easily exceeding 4.0%, further monetary tightening this year is inevitable.

The Russian central bank also appears to be taking inflation more seriously; it unexpectedly hiked rates for the second time this year. Inflation came in at 9.6% in April, even though the ruble has been allowed to rise by 12% against the dollar this year.

GDP GROWTH BY REGION (%)

	2010	2011	2012	Δ -1M 2011	ROBECO*
US	2.9	2.9	3.3	-0.3	=
EUROZONE	1.7	1.7	1.7	0.1	=
UK	1.4	1.8	2.2	0.0	-
JAPAN	3.9	0.3	2.7	-1.2	=
CHINA	10.3	9.3	8.9	0.1	=
INDIA	8.7	8.2	8.5	-0.1	+
BRAZIL	7.5	4.1	4.5	-0.3	+
RUSSIA	4.0	4.6	4.6	0.2	+
WORLD	3.8	3.2	3.6	-0.2	=

* INDICATES WHETHER WE EXPECT A HIGHER (+), MATCHING (=) OR LOWER (-) GROWTH RATE THAN THE CURRENT CONSENSUS ESTIMATE FOR 2011
SOURCE: CONSENSUS ECONOMICS, ROBECO

CPI BY REGION (%)

	2010	2011	2012	Δ -1M 2011	ROBECO*
US	1.6	2.7	2.1	0.8	=
EUROZONE	1.6	2.4	1.8	0.4	+
UK	4.7	4.8	2.9	0.4	+
JAPAN	-0.7	0.2	0.2	0.3	-
CHINA	3.3	4.6	3.7	0.1	=
INDIA	10.2	7.9	7.0	0.6	=
BRAZIL	5.9	6.0	4.9	0.5	=
RUSSIA	8.8	8.5	7.5	0.1	=
WORLD	2.3	3.1	2.4	0.5	=

* INDICATES WHETHER WE EXPECT A HIGHER (+), MATCHING (=) OR LOWER (-) CPI THAN THE CURRENT CONSENSUS ESTIMATE FOR 2011
SOURCE: CONSENSUS ECONOMICS, ROBECO

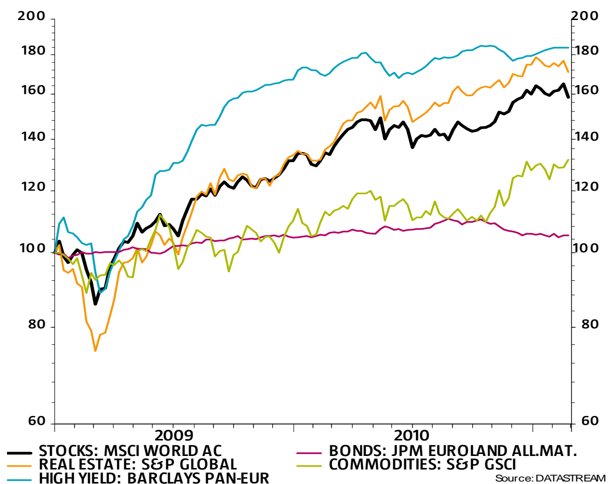
Outlook financial markets

Asset mix

Last month's review

Risky assets have lost momentum, especially when measured in euros. Despite decent macroeconomic data and continued strong earnings figures, equities have stalled. In euros, they moved lower over the last month, with a decline of 2.7% (in dollars, they rose by 1.4% due to the US currency's weakness). Real estate and commodities also fell back, declining by 1.0% and 5.3% respectively. Commodity prices corrected after a surge; the six-month return is still a very decent 13.4%. High yield and investment grade spreads have been rather stable over the last few months, allowing investors to benefit from the yield spread. The dollar has remained surprisingly weak. A month ago, the exchange rate was USD 1.42 per euro; now, it is USD 1.49. Eurozone investors' unhedged assets are benefiting, but the competitive position of the region's companies is deteriorating.

PERFORMANCE OF ASSET CLASSES (TOTAL RETURN EUR)



PERFORMANCE OF ASSET CLASSES (TOTAL RETURN IN EUROS)

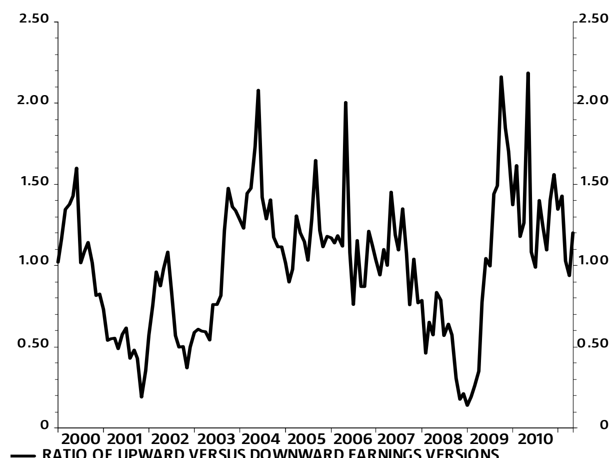
	-1M	-3M	-6M	-12M	-3Y	-5Y
STOCKS (MSCI AC WORLD)	-2.7%	-5.4%	4.1%	5.3%	1.8%	-0.5%
REAL ESTATE (S&P GLOBAL REITS)	-1.0%	-4.7%	1.3%	7.2%	-3.6%	-8.1%
HIGH YIELD (BARCLAYS PAN-EUR)	0.9%	0.7%	0.2%	3.3%	11.5%	-4.1%
BONDS (JPM EUROLAND ALL MAT.)	-0.1%	-0.9%	-4.2%	-1.6%	12.6%	19.5%
COMMODITIES (S&P GSCI)	-5.3%	0.3%	13.4%	8.1%	-36.1%	-31.2%

SOURCE: THOMSON FINANCIAL DATASTREAM

Equities

One should not expect too much from equities in the months ahead, although we do believe that risk premiums will be positive on a 12-month horizon. The first-quarter earnings season was good—once again—with most companies beating their consensus earnings estimates. But analysts' expectations are becoming harder to beat. Although the ratio of upward versus downward earnings revisions is still above one, the revision ratio has been in a decline since the second half of 2009 (see graph right). At the same time, the clear difference in earnings revisions between cyclical sectors and their defensive counterparts is diminishing. This is another indication that positive surprises are increasingly unlikely as the economic cycle progresses.

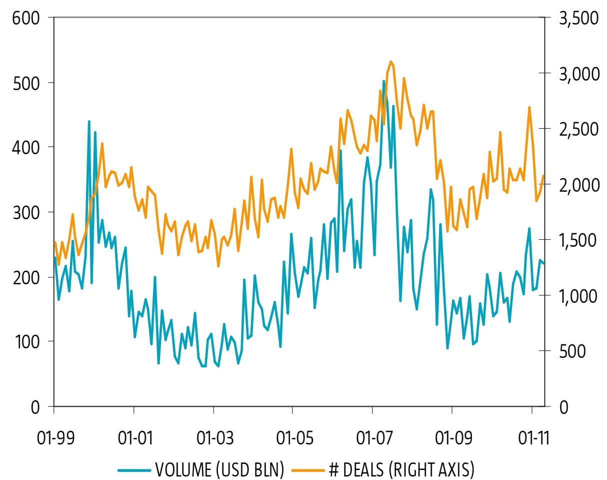
UPWARD VERSUS DOWNWARD EARNINGS REVISIONS



Responsible Investing
www.robeco.com

On the positive side, the economy is still rebounding from a deep recession. The recovery is far from steep, given the severity of the recession, but continued muddling through is likely, with reasonable economic growth globally of around 3.0-3.5%. The merger & acquisitions market is now clearly rebounding as well, signaling increasing long-term confidence on the part of companies. This is a supportive factor for the equity markets. Valuation is neutral, with a prospective price-to-earnings ratio of 12.3x. Historically, equities have had trouble making progress during the May-through-October period. This year, such a summer lull would be in line with our view that the macroeconomic picture is as good as could be expected given that the eurozone debt crisis remains unfixed.

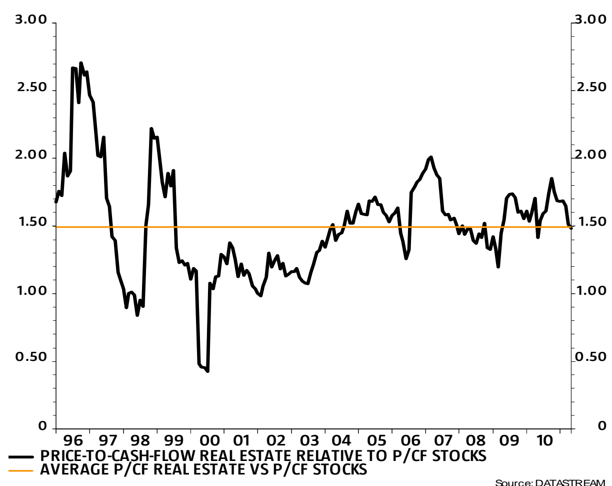
GLOBAL M&A MARKET



Real estate

Real estate has also been affected by a change in investors' risk appetite. As with stocks, a sideways trading pattern is likely. Analysts expect earnings growth of around 9% for the current year and for the next year. On balance, they have hardly changed their earnings estimates over the last three months. Real estate is not so seriously affected by the rise in the oil price and continues to benefit from the low interest-rate environment, as its sensitivity to interest rates is higher than equities'. But from a valuation point of view, there is no difference from stocks. The price-to-cash flow ratio for real estate is 1.5x the one for stocks, which is exactly in line with the historical average. Finally, note that the seasonal pattern of real estate performance matches the one for equities.

PRICE-TO-CASH FLOW REAL ESTATE VERSUS EQUITIES

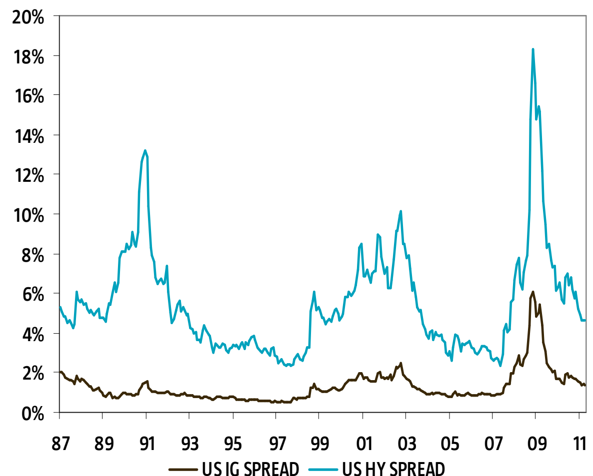


Source: DATASTREAM

Corporate bonds

We remain positive on corporate bonds. Spreads have not changed significantly over the last three months, but that does mean that investors have been rewarded with a risk premium. Corporate bonds are not being hurt by the weakening of the economy. We believe there is still room for further spread tightening, given the low default rates and the improving credit quality. For example, high yield spreads in the US have dropped below their historical mean and median levels, but they are still in the fifth decile of interest rate spreads in the period since 1987. The main risk for corporate bonds is that the eurozone's debt crisis flares up. This could happen in the event of a sudden debt restructuring.

US INVESTMENT GRADE AND HIGH YIELD SPREADS

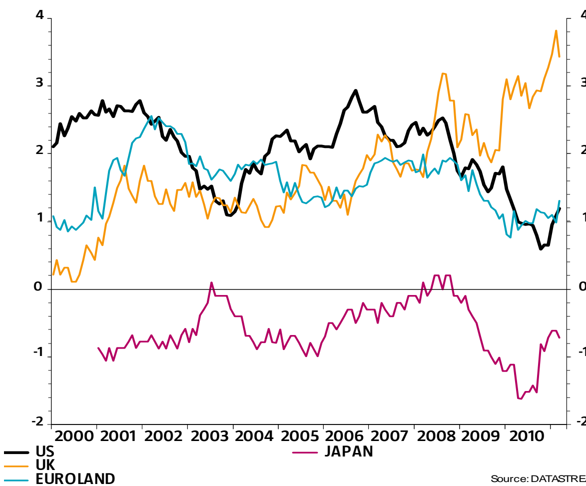


SOURCE: BARCLAYS. ROBECO

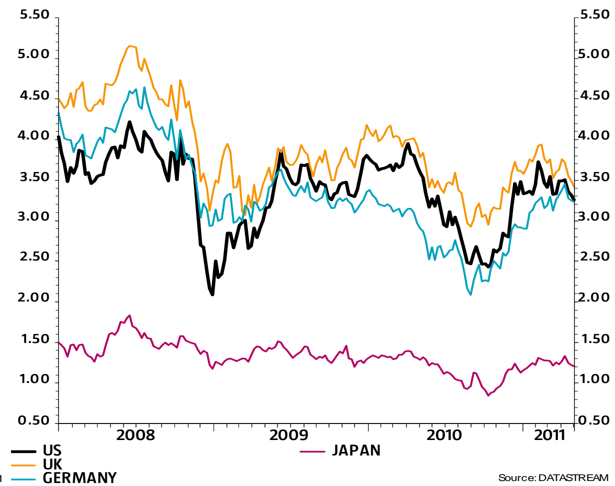
Government bonds

We maintain our view that government bonds are unattractive, as corporate bonds are likely to continue their outperformance of sovereigns. In the medium term, inflation risks are clearly on the upside, with commodity prices having surged over the last six months and with loose monetary policy set to continue for the time being. The Federal Reserve at least is in no hurry to hike rates this year, while it remains to be seen whether the ECB can continue its aggressive stance towards inflation given the eurozone's peripheral troubles. We do not believe the market is yet close to an upward move in long-term rates. Core inflation rates have turned up in all the major regions, but with labor markets generally weak, we expect it to be a while before core inflation really takes off.

CORE INFLATION RATES (%)



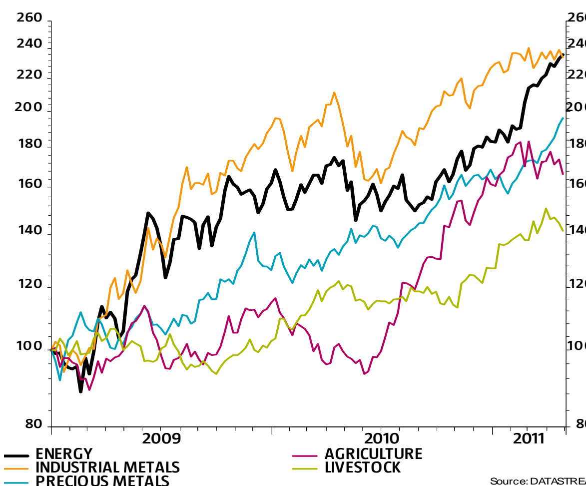
TEN-YEAR INTEREST RATES (%)



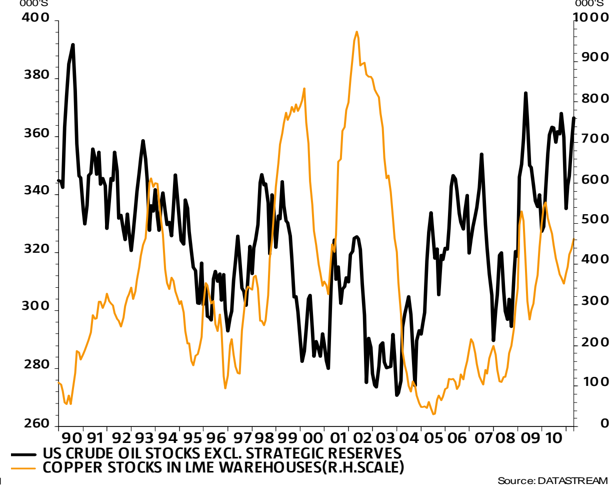
Commodities

Within commodities, agricultural and livestock prices have corrected somewhat, which is great news for emerging markets' inflation risk. Sentiment for industrial and precious metals, as well as energy, is also being affected after the impressive run-up over the last 6-12 months. Oil and copper stocks remain above average, but as we believe that the uptrend in commodity prices is a reflection of the growing demand from the global middle class meeting tight supply, we think that the outlook for commodity prices in the long run continues to be good. In the short term, the outlook is being affected by the waning of the social unrest in the Middle East. Furthermore, manufacturing surveys will probably decline from historical highs, which might put some pressure on prices as well.

GSCI COMMODITY SPOT PRICES (USD)



OIL AND COPPER STOCKS



Regional mix

PERFORMANCE OF REGIONS (MSCI AC WORLD; UNHEDGED TOTAL RETURNS IN EUROS)

	-1M	-3M	-6M	-12M	-3Y	-5Y
NORTH AMERICA (47%)	-3.6%	-6.0%	6.7%	3.3%	6.7%	0.2%
EUROPE (26%)	0.0%	-1.4%	4.4%	13.6%	-6.2%	-3.1%
PACIFIC (13%)	-1.3%	-10.8%	1.2%	-2.4%	-2.6%	-17.1%
EMERGING MARKETS (13%)	-5.8%	-5.0%	-1.9%	6.2%	8.5%	31.0%
AC WORLD (100%)	-2.7%	-5.4%	4.1%	5.3%	1.8%	-0.5%

SOURCE: THOMSON FINANCIAL DATASTREAM

We remain skeptical about the top performer over the last month, Europe. Its performance has been exceptionally strong, primarily due to the rise in the euro. Furthermore, producer confidence is strong, but that appears to be temporary, unless the euro's rally takes a breather. Retail sales in the eurozone are still flat, but exports are up by more than 20% in a year. The main risk is that the debt crisis flares up. It is becoming increasingly likely that a Greek debt restructuring will take place soon, rather than in 2013. How that will play out is uncertain, but it might hurt European banks and the euro itself. We prefer North America and emerging markets to Europe. Earnings revisions in both regions are better. In addition, the US consumer is back and exports will benefit from the dollar's weakness. In emerging markets, the inflation risks are manageable, given the ongoing monetary tightening and a softening of food prices, while government finances are healthy.

EARNINGS AND VALUATION DATA OF REGIONS (MSCI AC WORLD)

	EARNINGS GROWTH (%)			ST.DEV. ESTIMATES (%)		EARN. REV. INDEX		P/E ON 12M FWD EARN.	
	FY1	FY2	12M	CURRENT	10Y AVG.	3M	1M	CURRENT	10Y AVG.
NORTH AMERICA	17.0	14.2	15.8	6.6	5.3	21.7	31.7	13.4	15.5
EUROPE	13.0	12.8	12.6	15.2	12.7	-6.4	-7.8	10.8	13.5
PACIFIC	10.0	19.7	10.5	1.4	1.5	-8.2	-50.3	13.2	17.1
EMERGING MARKETS	16.7	13.2	15.6	14.0	9.6	-2.6	-1.1	11.2	10.7
AC WORLD	14.9	14.3	14.2	2.7	2.0	5.3	9.2	12.3	14.6

THE EARNINGS REVISIONS INDEX IS CALCULATED AS THE DIFFERENCE BETWEEN THE NUMBER OF UP- AND DOWNWARD REVISIONS RELATIVE TO THE NUMBER OF TOTAL REVISIONS.
SOURCE: THOMSON FINANCIAL DATASTREAM

Sector mix

PERFORMANCE OF SECTORS (MSCI AC WORLD; UNHEDGED TOTAL RETURNS IN EUROS)

	-1M	-3M	-6M	-12M	-3Y	-5Y
ENERGY (12%)	-8.1%	-5.6%	11.5%	10.8%	-2.0%	11.3%
MATERIALS (9%)	-5.2%	-6.9%	3.4%	13.8%	1.2%	30.6%
INDUSTRIALS (11%)	-3.0%	-4.8%	8.1%	9.5%	4.0%	2.5%
CONSUMER DISCRETIONARY (10%)	-0.3%	-3.9%	5.1%	8.7%	22.1%	3.2%
CONSUMER STAPLES (9%)	1.2%	-0.2%	3.2%	7.2%	26.1%	37.7%
HEALTH CARE (8%)	1.9%	0.9%	7.6%	5.1%	23.4%	7.0%
FINANCIALS (21%)	-3.7%	-7.4%	-0.1%	-1.6%	-22.8%	-35.0%
IT (12%)	-1.5%	-10.2%	2.7%	-1.2%	12.2%	4.0%
TELECOM SERVICES (5%)	-2.8%	-3.7%	1.1%	13.5%	5.3%	23.9%
UTILITIES (4%)	-1.1%	-6.3%	-2.0%	-1.6%	-10.2%	6.2%
AC WORLD (100%)	-2.7%	-5.4%	4.1%	5.3%	1.8%	-0.5%

SOURCE: THOMSON FINANCIAL DATASTREAM

At present, we do not have a strong view on sectors. We do have a slight preference for cyclical and defensive sectors over financials. For quite some time, earnings developments in cyclical sectors have been more robust than in other sectors. Now, earnings growth rates and earnings revisions have converged. This is logical, as the economic cycle progresses. The relative performance of financials is still weak, earnings revisions do not stand out and it is the sector most vulnerable to a possible eurozone debt restructuring.

EARNINGS AND VALUATION DATA OF SECTORS (MSCI AC WORLD)

	EARNINGS GROWTH (%)			ST.DEV. ESTIMATES (%)		EARN. REV. INDEX		P/E ON 12M FWD EARN.	
	FY1	FY2	12M	CURRENT	10Y AVG.	3M	1M	CURRENT	10Y AVG.
ENERGY	22.2	11.9	18.2	3.6	2.5	13.6	14.8	11.0	12.2
MATERIALS	39.1	13.4	26.5	4.1	2.5	6.0	9.7	11.5	13.1
INDUSTRIALS	17.7	15.1	17.1	1.1	0.7	19.3	31.9	13.4	15.5
CONSUMER DISCRETIONARY	12.2	22.4	13.9	1.0	0.7	6.7	2.0	14.1	17.0
CONSUMER STAPLES	8.6	11.4	10.0	0.4	0.3	-11.4	-9.3	14.8	16.3
HEALTH CARE	4.7	6.1	5.4	0.4	0.3	10.9	24.3	12.0	16.4
FINANCIALS	15.4	18.2	16.2	0.8	0.9	4.0	5.1	10.9	12.0
IT	14.2	13.4	13.2	0.6	0.4	2.5	1.3	12.9	20.4
TELECOM SERVICES	5.6	8.2	6.5	0.5	0.5	-25.8	-19.7	12.0	19.9
UTILITIES	-8.0	16.1	-4.4	1.5	0.7	-15.3	-26.8	13.9	13.3
AC WORLD	14.9	14.3	14.2	2.7	2.0	5.3	9.2	12.3	14.6

THE EARNINGS REVISIONS INDEX IS CALCULATED AS THE DIFFERENCE BETWEEN THE NUMBER OF UP- AND DOWNWARD REVISIONS RELATIVE TO THE NUMBER OF TOTAL REVISIONS.

SOURCE: THOMSON FINANCIAL DATASTREAM

Closing date text and tables 05 May 2011.
In our text and data tables, we do not refer to calendar months but look back from this closing date.

Important information

This document has been carefully prepared by Robeco Institutional Asset Management B.V. (Robeco). It is intended to provide the reader with information on Robeco's specific capabilities, but does not constitute a recommendation to buy or sell certain securities or investment products. Any investment is always subject to risk. Investment decisions should therefore only be based on the relevant prospectus and on thorough financial, fiscal and legal advice.

The content of this document is based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness. This document is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation. The information contained in this document is solely intended for professional investors under the Dutch Act on the Financial Supervision (Wet financieel toezicht) or persons who are authorized to receive such information under any other applicable laws.

Historical returns are provided for illustrative purposes only and do not necessarily reflect Robeco's expectations for the future. Past performances may not be representative for future results and actual returns may differ significantly from expectations expressed in this document. The value of your investments may fluctuate. Results obtained in the past are no guarantee for the future.

All copyrights, patents and other property in the information contained in this document are held by Robeco Institutional Asset Management B.V. No rights whatsoever are licensed or assigned or shall otherwise pass to persons accessing this information.

The information contained in this publication is not intended for users from other countries, such as US citizens and residents, where the offering of foreign financial services is not permitted, or where Robeco's services are not available.

Robeco Institutional Asset Management B.V., Rotterdam (Trade Register no. 24123167) is registered with the Netherlands Authority for the Financial Markets in Amsterdam.