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Equities consolidate but a rebound is uncertain

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Highlights

- The world economy is slowing but it is not falling off a cliff, as some of the warnings signals—such as copper prices, credit spreads and stock markets—seem to suggest. Most of the data published over September managed to beat expectations, easing double-dip fears. At the same time, it is too early to say that the economy is rebounding.

- Europe is currently the weakest link, which should not come as a big surprise: austerity measures are being implemented, the export sector is easing thanks to weaker worldwide growth and the ongoing eurozone crisis is negatively affecting sentiment.

- As for the eurozone crisis, the one good thing to come out of the downfall of Dexia is that Europe's politicians have finally realized that a recapitalization of the banking sector is necessary. Only the small matter of who is going to pick up the tab has still to be decided...

- Equity markets have consolidated, although it is still highly uncertain whether there will be a rebound from here. For now, we maintain the view that a further fall is somewhat more likely than a rebound. Politicians need to deliver on the plans they are currently floating, while the business cycle is not moving in the right direction.

- Emerging markets equities have been badly hit by a shift in sentiment that resulted in indiscriminate risk-off selling. In only a month, the region lagged the broader market by 10%. Now, emerging markets are the region with the best fundamentals *and* the cheapest valuation.

- The valuation of corporate bonds has reached very attractive levels; interest-rate spreads are close to pricing in a recession. Moreover, the balance sheets of non-financial firms are stacked with cash. Nevertheless, we prefer to wait for more clarity on policymakers' choices before we become positive on corporate bonds.

Summary

The world economy has slowed in recent months, but—so far—has not entered recession territory. In general, with emerging markets staging a soft landing and with the US and Japan still showing some growth, no double dip is to be expected. However, that forecast is conditional on additional setbacks (such as a messy default in Europe, a new stand-off between the Republicans and the Democrats in the US, a fully fledged Sino/US trade war, or a new banking crisis) being avoided. The one exception to this no-double-dip forecast is the eurozone, which we feel will be unable to avert a recession.

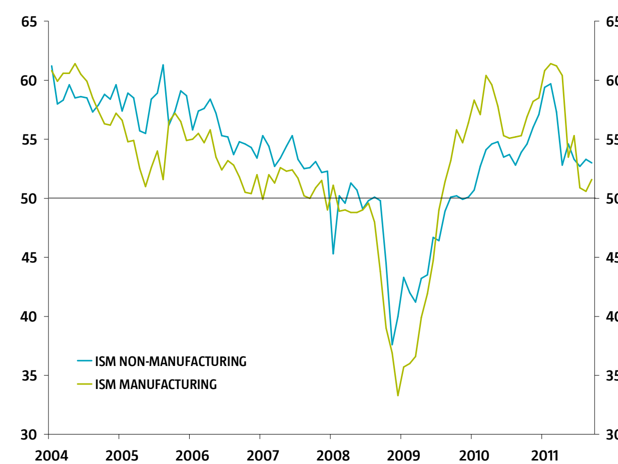
Macroeconomic view

The world economy continues to slow but it is not falling off a cliff. Most economic data published for September was better than expected, albeit by a small margin. Europe is by far the weakest link, as austerity measures and the ongoing uncertainty over the future of the eurozone as we know it are starting to bite…

North America

Looking at the various warning signals, one might be tempted to conclude that the US economy is heading for a recession. Commodity prices have fallen, either steadily (oil) or dramatically (copper). Corporate spreads have widened, hardly recovering on days that stocks markets have rebounded. While stock markets have been volatile, they started the fourth quarter with new year-to-date lows. None of these events by themselves is a reliable indicator that the US economy is heading for a recession. But their simultaneous occurrence has triggered much talk about a double dip.

NO RECESSION, BUT DON'T CALL IT A REBOUND EITHER



SOURCE: BLOOMBERG, ROBECO

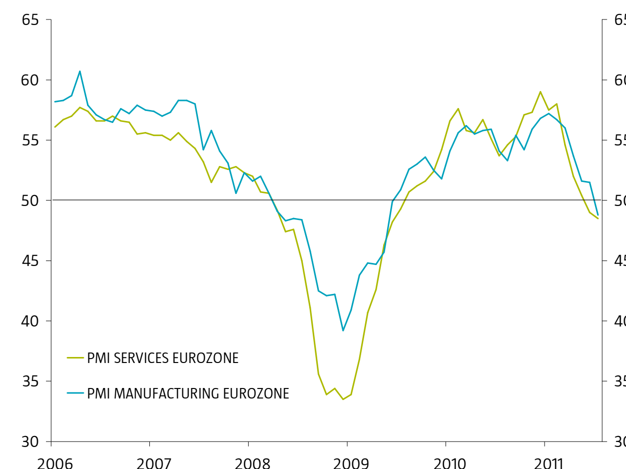
We do not expect a double dip in the US to happen—at least not for now. Most economic data published in recent weeks has been better than expected. Car sales rebounded nicely in September (domestic sales are back above 10 million units), indicating that the supply chain disruptions have been dealt with and that demand is still there. Producer confidence indicators generally beat expectations, with both ISM indices above the neutral 50 level. House prices—although helped by seasonal factors—appear to have stabilized. The GDP revision for the second quarter did not—for a change—contain any nasty surprises. Even statistics from the labor market have been better than expected, although at the time of writing the key non-farms payroll report had yet to be published. All this data indicates that the US economy is not falling off a cliff just yet. On the other hand, to call this a rebound would be just as premature: expectations have been depressed, making then easy to beat. To take the ADP jobs report as an example, US companies added 91,000 new jobs in September, which was "better" than the 75,000 expected. Suffice it to say that 91,000 new jobs a month will not be enough to keep the unemployment rate at 9%, let alone reduce it. All in all, the *slowdown* of the economy has taken a breather, suggesting—for now—that a recession will not materialize.

Does this mean that the US can steer away from a double dip? Under normal circumstances, we would suggest that yes, it can. Oil prices have drifted lower, real rates are now negative even when core inflation is used as a deflator, while consumers have steadily reduced their debt burden in recent years. The economy should be able to eek out a moderate growth rate of—on average—2% for some time to come. Having said that, sentiment is extremely fragile: it won't take much to set off a serious deterioration. Rising uncertainty about US banks, a potential messy default in Europe, a new standoff between the Republicans and the Democrats over the implementation of President Obama's ambitious American Jobs Act, a fully fledged trade war with China; the list of potentially destabilizing events that really should be avoided at the moment is worryingly long…

Europe

While the US economy has stabilized and is not in recession territory, we are far less confident about saying the same with respect to the eurozone as a whole. The economic performance of the core is probably comparable to the US: although growth is slowing, it is not yet in negative territory. The real drag is coming from the peripheral countries; economic data from Spain and Italy is clearly weakening. Purchasing managers' indices for both manufacturing (43.7 for Spain and 48.3 for Italy) and services (44.8 for Spain and 45.8 for Italy) are firmly below the neutral 50 level, as well as below the euro composite (48.5 for manufacturing, 48.8 for services). That's not to forget that the situation in Greece and Portugal is even worse.

PMIS FOR THE EUROZONE AS A WHOLE HAVE DROPPED BELOW THE NEUTRAL 50

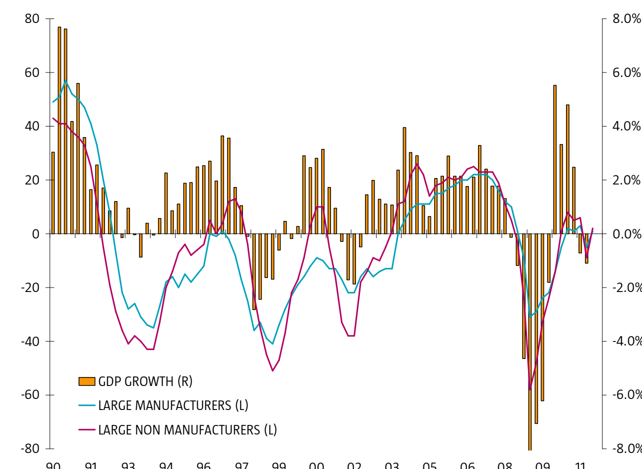


SOURCE: BLOOMBERG, ROBECO

Europe's role as the weakest link in the world economy should not come as a big surprise. Serious austerity measures are being implemented in both the north (the UK and Ireland) and the south; the center is—so far—making do with tough language. In addition, the stronger performance of the core (read: Germany) has not led to a consumer boom: in fact, consumer spending declined by 0.2% in the second quarter. Like Japan, the eurozone is dependent on the export sector, which is currently slowing because of the world economy. An additional factor is the ongoing eurozone crisis, which is negatively affecting sentiment and—via the shaken banking sector—is also starting to have a serious economic impact. Although this suggests that the ECB has ample reason to start lowering interest rates again, such a move was ruled out by the unexpected spike in inflation to 3.0% in September. Even though it is clear that inflation is set to decline in the months to come, the ECB has kept rates unchanged at 1.5%. It will now be up to incoming ECB president Mario Draghi to reverse the interest-rate hikes that were implemented earlier this year. It is clear that the Bank of England has a different mind set. The UK central bank has announced a GBP 75 billion increase in its bond-purchase program, even though inflation is still almost twice the target level. It is clear that the inflationary risks are much higher in the UK, but the Bank is probably correct in assessing that inflation is not the most pressing problem at this time.

As for the eurozone crisis, the forced French/Belgian government rescue of Dexia has taken the crisis to the next level. So much for the European stress tests. Uncertainty is back, which could result in the interbank market freezing up. We are not there yet, but the steady increase in funds deposited with the ECB is a tell-tale sign. The one good thing to come out of this appalling development is that politicians finally seem to have realized that a recapitalization of the banking sector is necessary. As long as this is done in a coordinated fashion, and combined with a restructuring of the government debt of Greece, Portugal and Ireland, it would be a major step in the right direction. The main problem, though, is execution: politicians talk the talk, but will they also walk the walk? It is when it comes to who is going to pay the bill that things tend to get problematic…

TANKAN IS POINTING TO A MILD RECOVERY



SOURCE: BLOOMBERG, ROBECO

Pacific

While most US data managed to beat expectations, the reverse seems to be the case for Japan. Industrial production, retail trade, household spending and the trade

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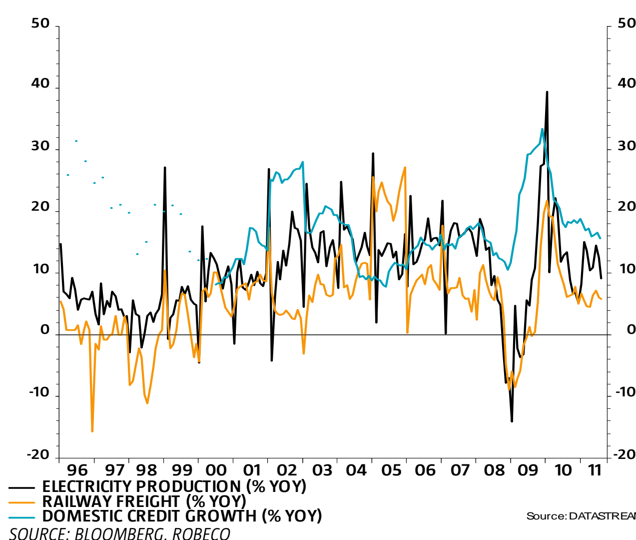
balance missed expectations, some by a wide margin. Given the more volatile nature of the data (compared with the US), it is too early to draw conclusions, however. The Japanese economy is currently in a post-tsunami reconstruction-related recovery, so the risk of a recession—or rather, the risk of Japan not ending the recession that started in Q1—is not that great. Still, most of the data published in recent months has led to a downward revision of growth targets for 2011 and 2012, though not radically so. The quarterly Tankan survey confirmed that the Japanese economy is currently experiencing an economic rebound—but also that the corporate sector is taking a cautious stance on future growth. Much depends on how the yen performs—it is still high, despite the Bank of Japan's efforts to keep the currency down—as well as developments in Japan's two main trade partners, China and the US. We continue to believe that the risk/reward trade-off for the Japanese economy as a whole, with its aging population and a government debt/GDP ratio of 230%, is not very enticing.

Emerging markets

The slowdown of the world economy is also making itself felt in the major emerging markets. As a consequence, inflationary risks in the region are diminishing, reducing the pressure on monetary policymakers.

Fears that the Chinese economy was heading for a hard landing have eased. The PMI indices for manufacturing have stabilized near the neutral 50 level, but the services PMIs have rebounded. The alternative growth indicators as defined by prominent Politburo member, Li Keqiang, also show that the Chinese economy is on course for a soft landing: domestic credit, electrical production and railway freight are all easing, but are still showing growth rates of between 5% to 15% (see chart right). Inflation has eased somewhat, but the 6.2% rate is still on the high side.

CHINA IS ON A SOFT LANDING TRAJECTORY



SOURCE: BLOOMBERG, ROBECO

Recent data from Brazil underscores that the economy is also softening, with industrial production down by 0.2% in August, taking the three-month moving average down to -0.4%. This softening is also reflected in the central bank's recent Q3 inflation report, in which it lowered the growth outlook from 4.0% to 3.5%. Weaker external demand and a moderate deceleration of the domestic economy are the main drivers of the slowdown. The key question remains whether the inflation rate will decline in the months ahead.

In India, the main questions continue to be when and at what level inflation will peak. Unlike Brazil, which recently administered its first rate cut, India is still in a monetary tightening phase. Rates were hiked by 25 basis points (bps) in September, with the central bank indicating that a further 25 bps rate hike is to be expected in October. This seems logical when looking at the continued rise of core inflation (up to 6.1% from 5.8% in August), but it could be postponed in the event of a rapid slowdown of the US economy and/or a further deterioration of the euro crisis.

As for Russia, officially there is still something called an election scheduled to take place. But the next president will be Vladimir Putin.

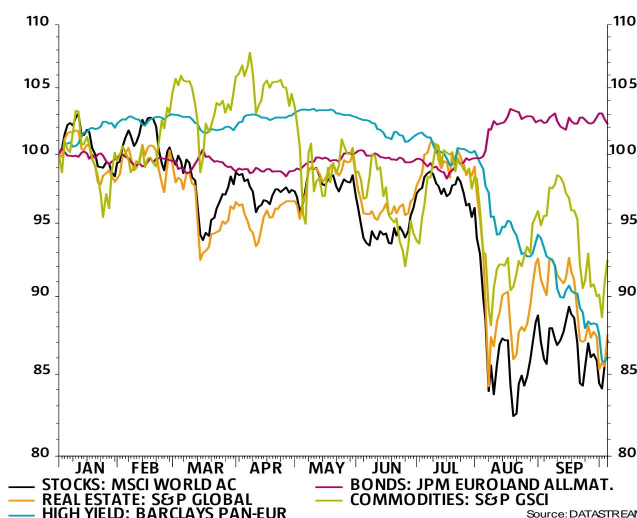
Outlook financial markets

Asset mix

Last month's review

Last month, investors' mood continued to be determined by the debt crisis in the eurozone. Most risky asset classes were down, while government bonds were flat. Nevertheless, market performance in August and September should be characterized as sideways trading, as no new lows were set as measured in euros, due to a weakening of the currency. Equities eked out a small gain of 1.8%. Real estate, down by 2.9%, lagged as funding worries increased. Corporate bonds continued to have a tough time with spreads rising further. High yield fell by 7.1% last month. Commodities also fell, with a loss of 3.2%. The oil price dropped by 8% to USD 106/bbl, gold retreated by 9% and copper corrected by a huge 21% over the last month. The VIX remained in a range between 30 and 50 for a second month in a row.

PERFORMANCE OF ASSET CLASSES (TOTAL RETURN EUR)



PERFORMANCE OF ASSET CLASSES (TOTAL RETURN IN EUROS)

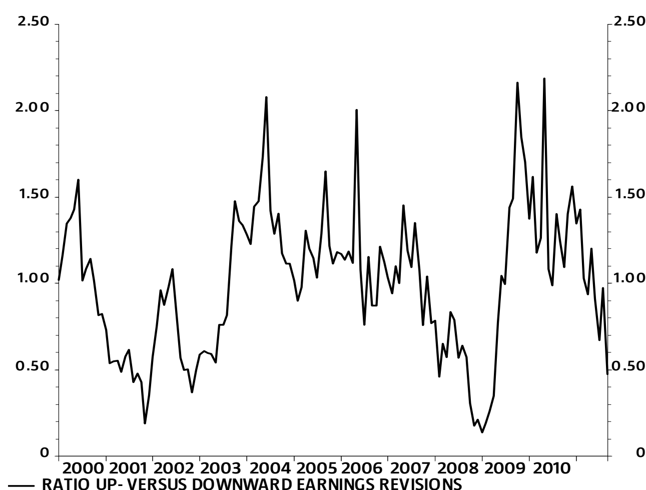
	-1M	-3M	-6M	-12M	-3Y	-5Y
STOCKS (MSCI AC WORLD)	1.8%	-11.4%	-11.1%	-3.1%	17.1%	-10.5%
REAL ESTATE (S&P GLOBAL REITS)	-2.9%	-12.5%	-8.5%	-4.8%	17.3%	-24.5%
HIGH YIELD (BARCLAYS PAN-EUR)	-7.1%	-15.1%	-16.3%	-16.1%	21.0%	-20.2%
BONDS (JPM EUROLAND ALL MAT.)	-0.1%	2.9%	3.4%	-2.1%	11.8%	19.8%
COMMODITIES (S&P GSCI)	-3.2%	-4.0%	-12.7%	6.9%	-30.1%	-25.4%

SOURCE: THOMSON FINANCIAL DATASTREAM

Equities

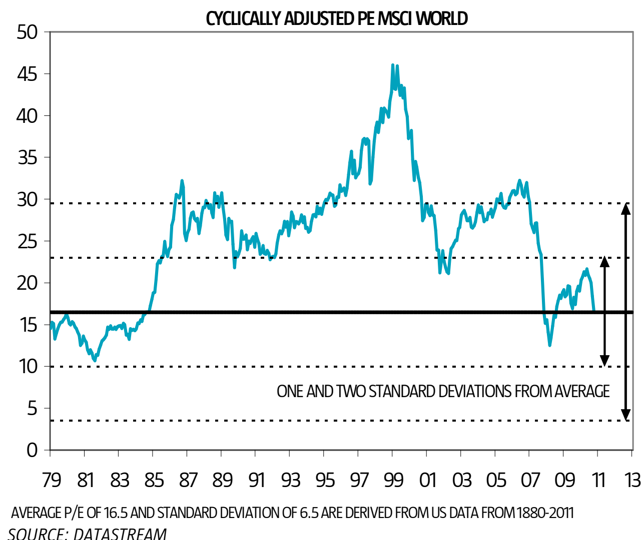
Equity markets have consolidated, although it is still highly uncertain whether there will be a rebound from here. For now, we maintain the view that a further fall is somewhat more likely than a rebound. Policymakers seem to recognize the need to strengthen banks' balance sheets. In addition, ideas are circulating about how to increase the safety net from a water pistol to a bazooka. Positive steps in both areas will help to restore confidence (other steps are required to shore up competitiveness in southern Europe). But the questions remain: how, when and whether these steps will be taken. In the meantime, a Greek default in the coming months is a real threat—and one whose impact on financial markets is unknown. In short, political choices, which are hard to predict, will determine the outlook for equities and other asset classes.

UPWARD VERSUS DOWNWARD EARNINGS REVISIONS



The debt crisis in the eurozone is affecting the real economy. As a consequence, analysts have significantly downgraded their earnings estimates, as shown in the graph above. Even so, they are still counting on earnings growth of 13% in both 2011 and 2012. That seems to be rather demanding, even if all the developed economies return to the track of moderate growth, which is a serious "if" in the case of Europe. Earnings margins are high in a historical perspective, so there is room for some disappointment. On a positive note, valuation for the MSCI AC World index based on the Shiller P/E is now in line with what we would see as normal. More important, a somewhat more advanced approach based on trend earnings now suggests that stock prices are roughly 10% undervalued. There is no serious undervaluation, but as a starting point, some undervaluation is more attractive than some overvaluation.

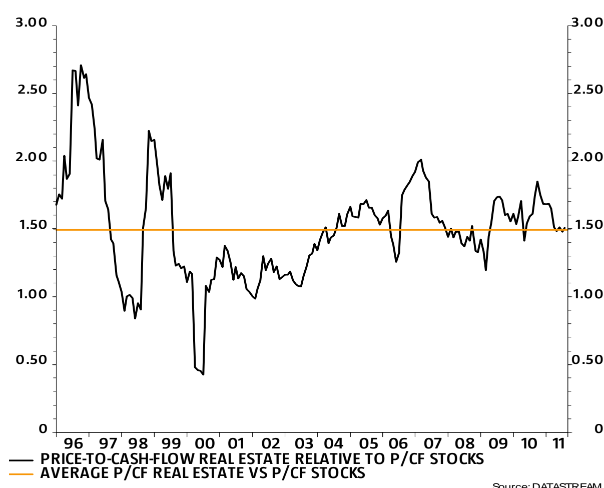
VALUATION OF EQUITIES



AVERAGE P/E OF 16.5 AND STANDARD DEVIATION OF 6.5 ARE DERIVED FROM US DATA FROM 1880-2011
SOURCE: DATASTREAM

Real estate
Real estate has recently lagged equities, which we ascribe to funding worries. But, in contrast to equities, earnings revisions over the last three months have not turned substantially downwards. While analysts are clearly becoming less optimistic on the asset class, the turn is less dramatic than for equities. At present, based on MSCI data, analysts are estimating that earnings will grow by 4% in 2011 and 7% in 2012. We believe that is far more realistic than the 13% earnings growth that analysts expect for stocks in 2011 and 2012. As valuation of real estate relative to stocks is in line with the historical average (see chart right), we believe the outlook for real estate isn't hugely different the one for equities.

VALUATION OF REAL ESTATE VERSUS EQUITY (x)



Source: DATASTREAM

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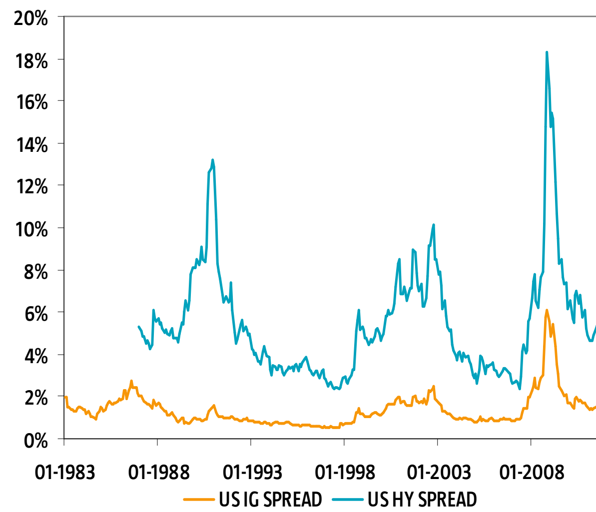
Corporate bonds

The valuation of corporate bonds has reached very attractive levels. As the chart to the right illustrates, interest-rate spreads are close to pricing in a recession, while it is by no means certain that one will occur. Moreover, the balance sheets of non-financial firms are stacked with cash. We are therefore inclined to take a positive view on investment grade and high yield bonds relative to their government counterparts. Nevertheless, we prefer to wait for more clarity on policymakers' choices before we become positive on corporate bonds. So far, policymakers have been surprisingly slow and unwilling to act. This is a threat to the economy.

US INVESTMENT GRADE AND HIGH YIELD SPREADS



SOURCE: BARCLAYS, ROBECO

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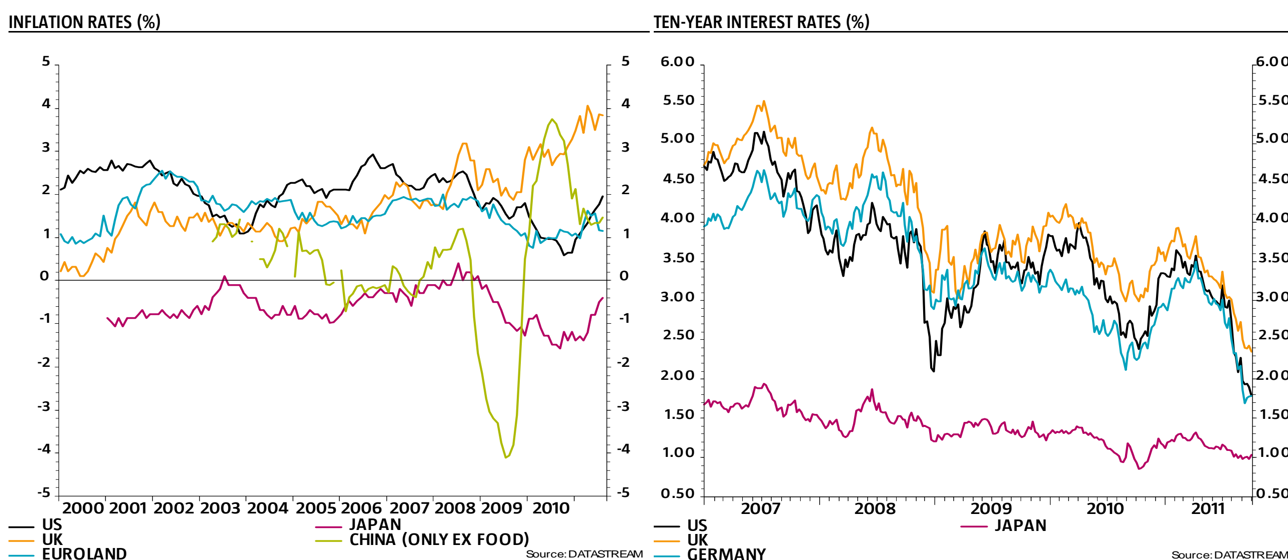
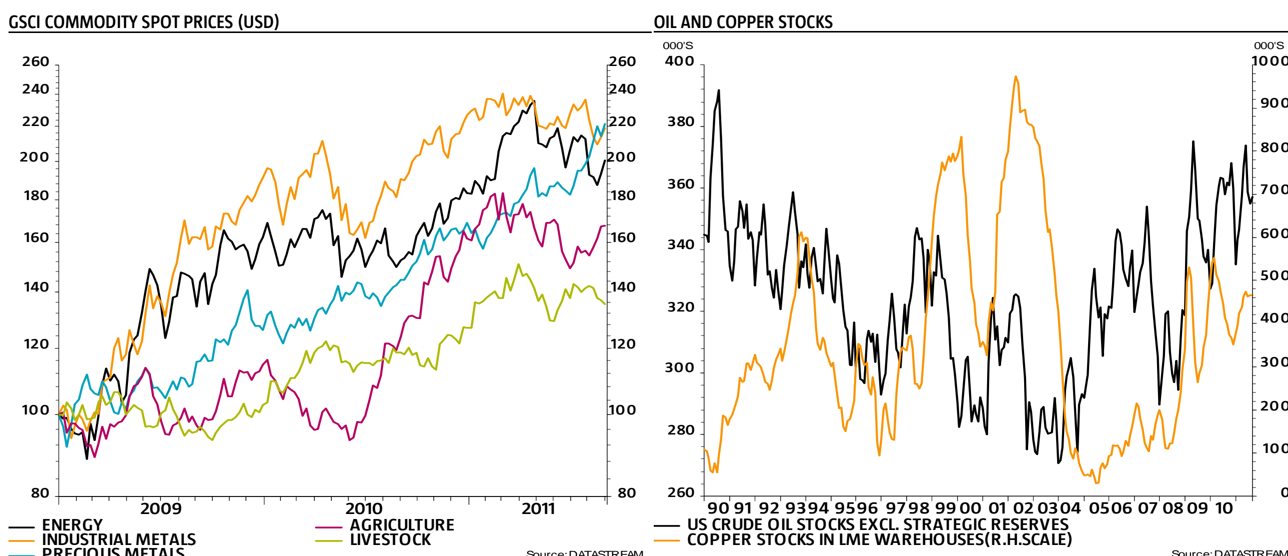
Government bonds

Government bond yields have fallen to such dramatic lows that investors should be worried about returns on a five-year horizon. Based on an investment horizon of one year, we have to take into account the low inflationary risks. Core inflation is clearly on the rise in the US, the UK and Japan, as the chart below left illustrates, but our Inflation Monitor is telling us that short-term inflation risks are falling. In addition, the uncertainty surrounding the eurozone debt crisis is likely to stay high. Furthermore, short-term interest rates will remain low during 2012. At this stage, we refrain from a negative view on the asset class.



Commodities

We expect the commodity market to continue to be characterized by capacity constraints on the supply side. For example, production of copper is likely to grow by less than 1% for a second consecutive year. That compares with demand growth of 4-5%. The risk for commodities is that the debt crisis in the eurozone drags the region into a severe recession, negatively impacting the fragile economies of the US, the UK and Japan. In such a scenario, supply would not appear to be that tight in 2012, and a further decline in commodity prices should be expected. That said, we expect the long-term uptrend that started a decade ago to hold up. For now, we have a neutral view on the asset class.



Regional mix

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

	-1M	-3M	-6M	-12M	-3Y	-5Y
NORTH AMERICA (50%)	3.6%	-7.4%	-7.0%	5.4%	20.5%	-7.0%
EUROPE (24%)	4.0%	-15.4%	-16.0%	-9.0%	5.9%	-20.7%
PACIFIC (13%)	1.1%	-8.9%	-4.6%	-5.1%	12.6%	-16.9%
EMERGING MARKETS (12%)	-8.2%	-19.8%	-21.6%	-16.9%	40.3%	17.7%
AC WORLD (100%)	1.8%	-11.4%	-11.1%	-3.1%	17.1%	-10.5%

SOURCE: THOMSON FINANCIAL DATASTREAM

Emerging markets equities have been badly hit by a shift in sentiment that resulted in indiscriminate risk-off selling. In only a month, the region lagged the broader market by 10%. Now, emerging markets are the region with the best fundamentals and the cheapest valuation as measured by the forward-looking P/E, which is at 8.7x against 9.9x for the market as a whole. Although economic growth estimates for emerging markets are declining, retail sales growth is still decent. Moreover, there are no sovereign-debt problems in emerging economies. We therefore remain positive on emerging markets despite the recent disappointing performance. As for Europe, we continue to be negative. The idea of recapitalizing banks and enlarging the EFSF is a good one, but it is unclear whether it will be achieved. In addition, the market's reaction to a Greek default is highly uncertain. In short, Europe is cheap for a reason. Finally, our negative view on the Pacific region is based on the downbeat fundamental outlook for Japan.

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	16.8	13.3	13.7	7.9	5.5	5.3	-29.4	10.7	15.1
EUROPE	6.3	11.1	10.1	15.3	12.9	-38.8	-59.7	8.8	13.2
PACIFIC	16.0	16.3	15.0	1.1	1.0	-22.4	-53.6	11.0	16.7
EMERGING MARKETS	11.3	12.8	12.8	15.1	10.1	-26.9	-36.7	8.7	10.7
AC WORLD	12.7	13.0	12.7	2.8	2.1	-17.0	-44.2	9.9	14.3

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 (11%)	-0.8%	-14.5%	-19.1%	0.9%	17.1%	7.1%
MATERIALS (8%)	-6.5%	-19.4%	-21.4%	-10.4%	40.0%	16.4%
INDUSTRIALS (10%)	1.2%	-17.3%	-16.7%	-6.9%	19.7%	-9.9%
CONSUMER DISCRETIONARY (10%)	3.0%	-11.6%	-5.8%	2.0%	41.8%	-4.4%
CONSUMER STAPLES (11%)	2.8%	-1.0%	5.0%	8.3%	33.9%	32.4%
HEALTH CARE (9%)	3.6%	-4.9%	2.7%	7.9%	19.9%	-0.1%
FINANCIALS (19%)	0.6%	-17.7%	-21.0%	-16.9%	-15.3%	-48.6%
IT (12%)	7.8%	-4.1%	-3.4%	5.1%	38.0%	2.6%
TELECOM SERVICES (5%)	3.2%	-3.3%	-3.0%	1.7%	28.1%	13.7%
UTILITIES (4%)	5.3%	-3.2%	-1.5%	-2.0%	3.6%	-4.4%
AC WORLD (100%)	1.8%	-11.4%	-11.1%	-3.1%	17.1%	-10.5%

SOURCE: THOMSON FINANCIAL DATASTREAM

For now, we maintain our preference for defensive sectors over financials. Financials should benefit when policymakers start to implement the policies described above. Even so, there are three reasons why we still prefer defensive sectors. First, we want to get an impression of the third-quarter earnings season before considering a change in our view. Second, momentum and earnings revisions for defensives are still relatively good. Third, the seasonal factor is still supportive: the May-to-October period is generally good for defensive stocks.

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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	23.4	7.9	10.1	3.7	2.6	-12.4	-51.8	8.0	12.0
MATERIALS	33.7	15.4	16.9	4.5	2.6	-31.1	-58.8	8.3	13.0
INDUSTRIALS	14.8	12.4	12.7	1.1	0.7	-20.7	-57.9	10.2	15.2
CONSUMER DISCRETIONARY	17.2	17.9	16.7	0.9	0.7	-1.3	-21.0	11.5	16.5
CONSUMER STAPLES	7.6	10.3	10.0	0.4	0.3	-22.3	-32.5	13.7	16.0
HEALTH CARE	5.5	5.2	5.4	0.5	0.3	1.6	-23.1	10.8	15.8
FINANCIALS	8.1	17.6	16.5	0.9	0.9	-27.8	-64.5	8.2	11.8
IT	9.4	13.3	11.4	0.7	0.4	-15.0	-34.9	11.3	19.6
TELECOM SERVICES	1.7	8.3	6.9	0.5	0.5	-12.4	-25.0	10.9	19.3
UTILITIES	-3.4	21.0	14.9	1.2	0.8	-18.6	-35.6	13.3	13.3
AC WORLD	12.7	13.0	12.7	2.8	2.1	-17.0	-44.2	9.9	14.3

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

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Closing date text and tables: 07 October 2011.
In our text and data tables, we do not refer to calendar months but look back from this closing date.

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