ROBECO

Monthly Outlook
The global economy continues to weaken

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Highlights

- The world economy continues to weaken. Risks of a synchronized slowdown are on the rise. On the positive side, the decline of the oil price is bringing down headline inflation, paving the way for further conventional and unconventional monetary stimulus. Real income in the developed world should rise. Furthermore, Europe's leaders have once again managed to give the can a firm kick down the road.

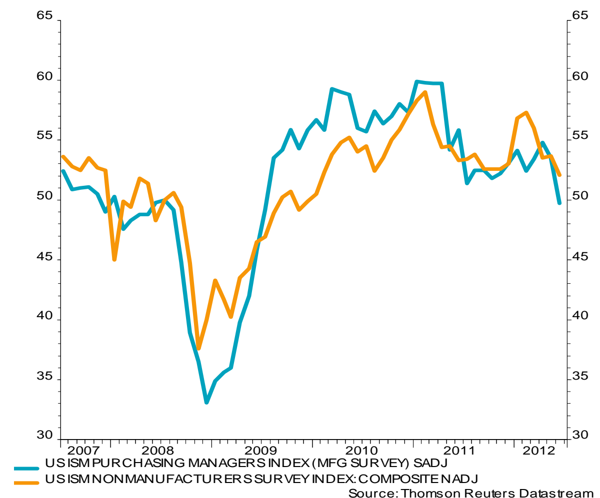
- We expect the world economy to show renewed strength in the fourth quarter. A global recession is not our baseline scenario, but it could be the consequence of a renewed deterioration of the eurozone debt crisis or a major oil price shock resulting from a unilateral Israeli strike against Iran.

- The prospects for emerging debt are better than those for government debt. Local currency government bond yields are currently averaging 6.1%. This is attractive compared with developed markets government debt. But we continue to prefer investment-grade credits to emerging debt thanks to a better risk/reward pay-off.

- Within equities, we remain hesitant to upgrade our still somewhat negative view on financials. Outside financials, we continue to have a slight preference for selected cyclical sectors, IT and consumer discretionary. Until recently, these sectors had beaten the market. Earnings revisions are still above the market average. But the current economic conditions warrant a cautious approach.

Macroeconomic view

US ISM Manufacturing and Non-Manufacturing



The world economy continues to weaken. Risks of a synchronized slowdown are on the rise. The sharp decline in the US manufacturing sector, with the ISM slipping from 53.5 in May to 49.7 in June, was a major disappointment. But the ISM non-manufacturing for June offered some stability; although it also weakened, a 52.1 reading still signals expansion. There was some slightly more positive news elsewhere. In Japan, the quarterly Tankan index was stronger than expected, rising from -4 in March to -1 in June. And the final eurozone PMI for June rose from May's reading, but still pointed to a significant contraction (46.4). The malaise in the eurozone has reached the core. Even Germany is seeing a modest drop in output. Large emerging markets continue to show signs of weakness. On the positive side, the decline in the oil price is bringing down headline inflation, paving the way for further conventional and unconventional monetary stimulus. Real income in the developed world should rise. Furthermore, Europe's leaders once again managed to give the can a firm kick down the road, relieving tensions—at least temporarily—in the eurozone. China has plenty of scope to implement expansionary policy. As a result, we expect the world economy to show renewed strength in the fourth quarter. A global recession is not our baseline scenario, but could be the consequence of a renewed deterioration in the eurozone debt crisis or a major oil price shock resulting from a unilateral Israeli strike against Iran.

North America

The US economy is weakening. June's PMI for the industrial sector suggests that the US manufacturing will contract, albeit slightly. But as the US is a developed service economy, what happens to the services PMI is much more important. This gauge also weakened in June but with a 52.1 reading is still signaling expansion. Developments in the labor market have been disappointing, but the private housing market is—at last—showing signs of strength.

The sword of Damocles hanging over the US economy is the looming year-end fiscal tightening thanks to automatic budget cuts and the ending of tax breaks and temporary reductions in income tax. The timing is unfortunate. It will take place in a political vacuum, just after the presidential and congressional elections in November. It is thus understandable that the Republicans and Democrats have started negotiations to postpone the day of reckoning until at least March. We believe it is likely that the parties will reach a settlement. The US president will thus be given some time to formulate a medium-term solution to the significant budgetary challenges facing the US government.

Against the backdrop of moderate economic growth and the approaching elections, the US central bank has refrained from new initiatives. However, policies designed to flatten the yield curve further by buying bonds with longer maturities (Operation Twist) continued. The advantage is that no further balance-sheet expansion, which could be controversial politically, will occur. Of course, further quantitative easing (QE3) would be possible if economic conditions—and thus employment—deteriorate.

Europe

The UK economy has weakened further. The ISM survey for the services sector fell from 53.5 in May to 51.3 in June. Aided by a significant fall in inflation, the Bank of England has launched a third tranche of quantitative easing, expanding its asset purchase facility by GBP 50 billion.

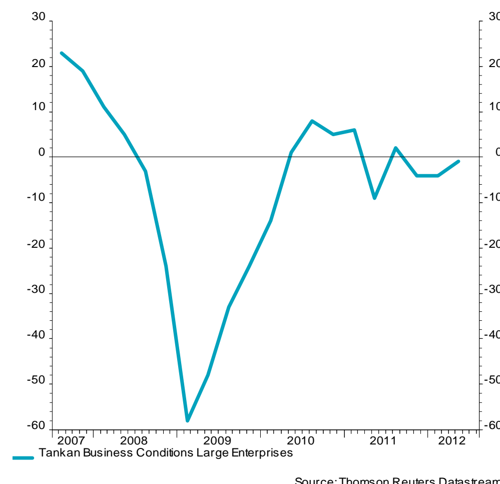
The eurozone economy is sinking deeper into recession. This now includes Germany: hitherto relatively thriving, its economy is showing signs of slowing. So far, this has not affected German unemployment. This makes it difficult for German politicians to gain support for radical measures to combat the lingering eurozone debt crisis. In the absence of decisive action by Europe's political leaders, the ECB remains reluctant to engage in dramatic quantitative easing that would result in the risk premiums on European bonds being more in line with Germany's. No unconventional measures accompanied the ECB's widely expected 25 bps cut in early July, which reduced the benchmark rate to 0.75%.

Europe's leaders are trying to paint an upbeat picture of the long-term prospects for political, fiscal and banking union. But their proposals are vague and—in the current perilous circumstances—will probably fail to restore confidence. In part, this is because the plans to strengthen the competitiveness of Southern European countries are unsatisfactory. Spain is seeking a recapitalization of its banks through the safety net. Italy is also a candidate for an eventual entry into the net, which is clearly too small to handle a country of this size. Eventually, eurozone governments will attempt to muddle through with a mix of limited short interest-rate cuts (although the room is limited) and quantitative easing by the ECB, supplemented by the EU member states increasing the size of the safety net. It remains an open question whether Greece will eventually leave the euro. Additional debt restructuring in Ireland and Portugal is still a serious possibility. The precedent of a bank recapitalization that did not further burden the sovereign, as occurred in Spain, is in principle good news for Ireland: the country's economy remains weak. Moreover, the reorganization of the Spanish banking sector could lead to the breaking of more European taboos (such as the one on haircuts on non-subordinated bank debt). The costs of a break-up of the currency union are so large that muddling through is an option that will be pursued by all. If the eurozone's governments are successful in regaining financial markets' trust, the economy will recover in the fourth quarter. Growth in 2013 is set to be very moderate, but at least it should be positive, in contrast to the moderate decline this year.

Pacific

The Japanese economy has recovered remarkably strongly after the Fukushima nuclear disaster and the Thai floods. But the temporary stimulus from the rebuilding efforts is fading. Moreover, leading indicators are pointing to declining optimism in the industrial sector, while exports are slumping. The slowdown in emerging markets is taking a toll.

Japanese Tankan



The Prime Minister, Yoshihiko Noda, has scored an important political victory by gaining the support of the opposition for his plans to increase Japan's sales tax. The plans comprise an initial increase from 5% to 8% in April 2014 and then to 10% in October 2015. A *sine qua non* condition is that the economy is sufficiently strong. The measures were welcomed by Moody's. With debt running at more than 200% of GDP, it is high time that government finances were radically improved. Even at

10%, the sales tax will still be relatively low by Western standards. One consequence of the higher sales tax will probably be consumers bringing forward spending, thus giving the economy a temporary boost. Nevertheless, we expect growth in 2013 to be around 1.0 percentage point lower than in 2012. Given the slowing growth and the decline in oil prices, more quantitative easing by the Bank of Japan is likely. It is doubtful, however, whether it will come anywhere near its ambitious 1.0% target for the Japanese inflation within the next 12 months.

The second major developed economy in Asia, Australia, is heavily dependent on developments in China. In light of the economic downturn there, the Australian central bank has cut rates in an unexpectedly rapid fashion; two reductions have taken the policy rate from 4.25% to 3.5%. The sharp fall in inflation, which has dropped from 3.1% in Q4 2011 to 1.6% in Q1 2012, has made room for these moves. Further interest-rate cuts are likely, until the Chinese economy shows signs of acceleration, which could well be in Q4 2012. The growth of the Australian economy in 2013 will probably be in line with 2012's rate.

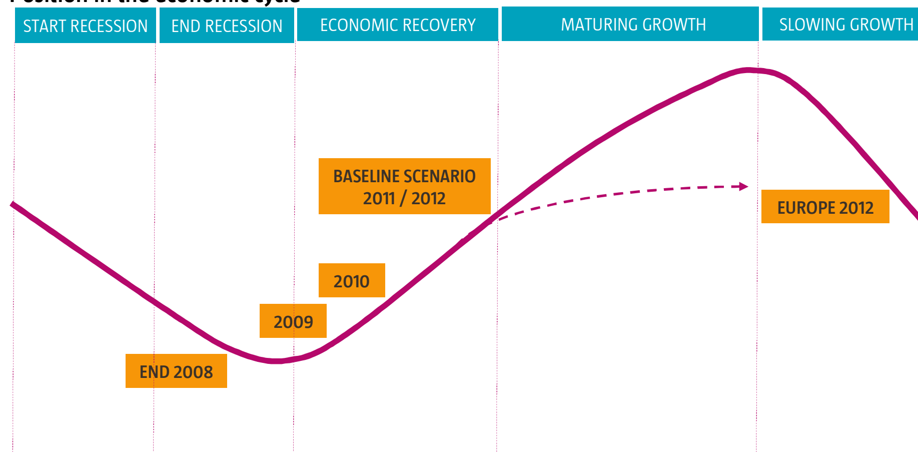
Emerging markets

The Chinese economy is showing signs of cooling. In part, this is due to declining exports, one result of the escalating eurozone debt crisis. It is also partly the result of Chinese policies to rein in the housing market and combat overcapacity in sectors such as steel. A hard landing is still unlikely, as the Chinese government has loosened the reins on a broad front, including a rate cut and a reduced reserve requirement ratio in early July. Indian economic growth fell sharply in Q1 2012 to 5.6%, a very modest level by Indian standards. Political paralysis, a dogged current-account deficit, a budget deficit and persistently high inflation have hurt sentiment and sown grave doubts about the country's long-term growth prospects. Inflation, as measured by the benchmark Wholesale Price Index, has come down but is hovering around 7.5%. The Indian central bank is taking a rightly cautious approach. But with the economy likely to cool further and with oil prices falling, there is room for additional rate cuts. The Brazilian government and central bank are expected to continue their activist policy regarding the country's economy. The falling oil price is bad news for the Russian economy, which received a boost from government spending prior to the elections in early March. Growth is declining.

Position in the economic cycle, macroeconomic scenarios & Robeco's view versus consensus

The current environment can be characterized as a cyclical recovery that is being tempered by structural problems. Deleveraging, austerity measures, the ongoing euro crisis and a lack of political decisiveness continue to be major themes. The corporate sector is relatively strong.

Position in the economic cycle



This means that, with the exception of Europe, the global economy is still in a recovery phase. However, as a result of the structural problems, economic growth is set to be lower than historical trend growth. Our baseline scenario is therefore one of sub-trend growth (probability 65%), while we feel that there is currently a 25% chance of a renewed recession. The likelihood of a traditional recovery is 10%.

Macroeconomic scenarios

Source: Robeco

Consensus estimates of economic growth and Robeco's expectations

GDP growth by region (%)	*2011*	*2012*	*2013*	*Δ-1m 2012*	*Robeco**
US	1.7	2.2	2.4	-0.1	=
Eurozone	1.5	-0.4	0.7	0.0	-
UK	0.7	0.3	1.8	-0.4	=
Japan	-0.7	2.5	1.3	0.5	-
China	9.2	8.1	8.4	-0.3	-
India	6.5	6.6	7.3	-0.5	=
Brazil	2.7	3.0	4.3	-0.3	=
Russia	4.3	3.8	3.9	0.1	+
World	2.4	2.3	2.7	-0.1	=

* indicates whether we expect a higher (+), matching (=) or lower (-) growth rate than the current consensus estimate for 2012

Source: Consensus Economics, Robeco

Consensus estimates of inflation and Robeco's expectations

CPI by region (%)	*2011*	*2012*	*2013*	*Δ-1m 2012*	*Robeco**
US	3.1	2.2	2.0	-0.2	=
Eurozone	2.7	2.3	1.7	0.1	=
UK	5.3	3.2	2.6	0.0	=
Japan	-0.3	0.1	0.0	0.3	=
China	5.4	3.3	3.6	0.0	=
India	8.3	7.7	6.9	0.7	+
Brazil	6.5	5.1	5.4	-0.3	+
Russia	6.1	6.3	6.0	-0.1	=
World	3.3	2.6	2.3	0.0	=

* indicates whether we expect a higher (+), matching (=) or lower (-) inflation rate than the current consensus estimate for 2012

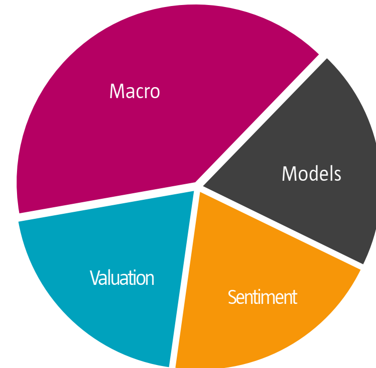
Source: Consensus Economics, Robeco

Financial markets outlook

Our expectations are based on qualitative as well as quantitative analyses. As a starting point, we look at the long-term macroeconomic environment. We then determine our expectations for the economy for the next three- to six months to find out which developments could take the market by surprise, as this is a common factor for all asset classes. From this macroeconomic analysis follows our initial preference for assets.

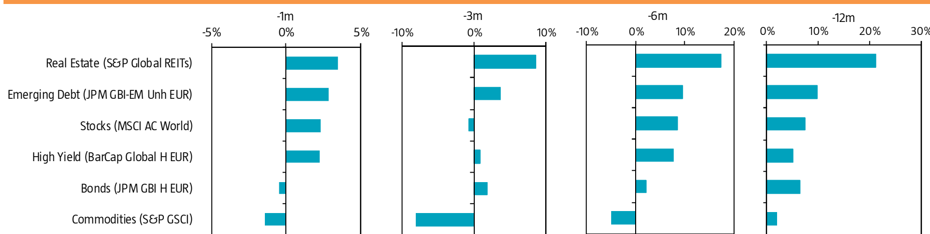
Next, we challenge our macro analysis with input from financial markets. Here, we take valuation into account as, at extreme levels, this might induce a turn in the performance of an asset class. Sentiment also plays a role, as markets tend to extrapolate shorter-term trends as investors put too much weight on recent developments. Finally, we use quantitative models to steer our expectations.

Input factors for our investment policy



Asset allocation

Performance of asset classes (gross total return in euros)

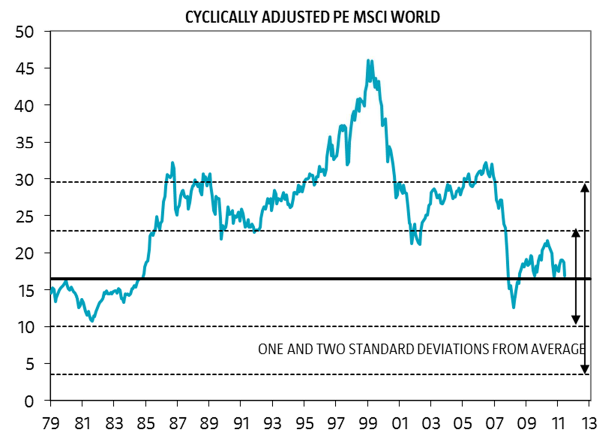


Source: Thomson Reuters Datastream, Bloomberg, Robeco

Equities

We maintain a neutral stance on equities. Uncertainties around the eurozone debt crisis continue to play a role, although the latest steps towards a banking union have eased the pressure in the short term. Aside from this, we expect continuing moderate global economic growth, with risks on the downside. Most recent economic data has disappointed, inducing more negative earnings revisions. Analysts are currently forecasting that earnings will grow by 10% in 2012, which we believe is too optimistic. On the other hand, the oil price has declined significantly; this is a bonus for the economy and for earnings. Valuation is still in neutral territory, as shown in the graph to the right. Stocks are not cheap, but that is no surprise, as the MSCI AC World Index rose by 8.8% in the first half of 2012 (5.8% in USD). At present, there is no trigger for us to become enthusiastic about equities during a period of the year that is known historically for its lackluster performance.

Valuation of equities

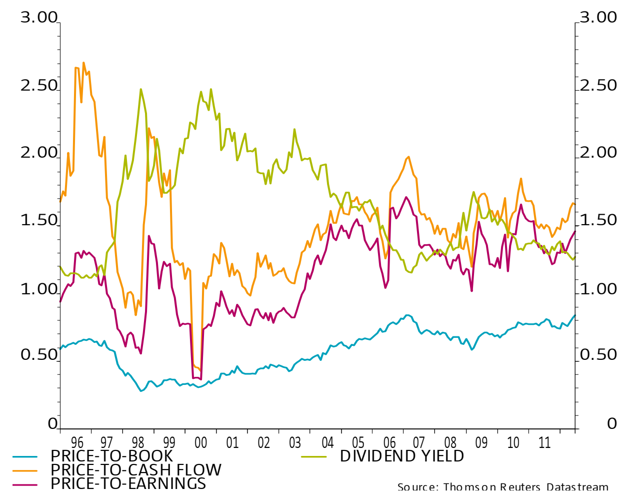


Source: Thomson Reuters Datastream

Real estate

The outlook for real estate remains similar to equities'. For a fourth month in a row, real estate has outperformed equities. This outperformance adds up to nine percentage points in the first half of the year. The asset class's stable cash flows attracted investor interest during the risk aversion of recent months. Equities have been hit by downward earnings revisions, while in real estate upward and downward revisions are counterbalancing each other. Falling long-term interest rates through May probably also played a role. Finally, there are increasing signs of a recovery in the US housing market that might be supporting demand for commercial real estate as well. Despite these positives, we rate real estate as neutral. That is because investors are increasingly paying a price for their desire for safe assets. The dividend yield on real estate versus equities is close to a low. Ten years ago, the dividend yield on real estate was twice as high as the yield on equities. Now, it has fallen to only a quarter above equities' dividend yield. Other valuation indicators (see the graph above right) also suggest that the relative valuation compared with equities is becoming a bit stretched.

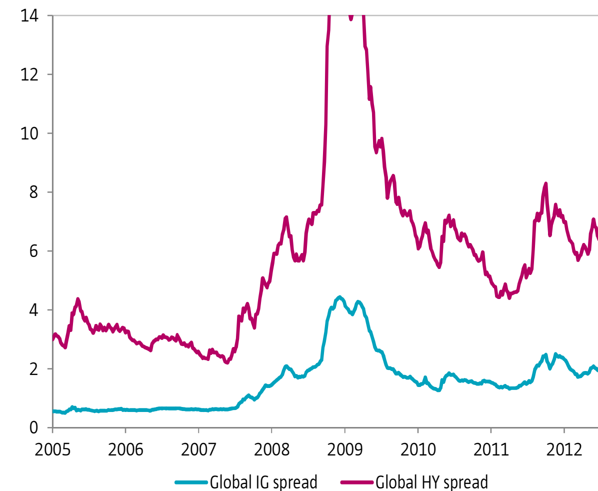
Valuation indicators of real estate versus equities (global)



Credits and high yield

We maintain our positive view on investment grade credits relative to government bonds. Spreads are attractive, with the current global spread at 1.9%. The implied break-even default rate for corporates is a cumulative 11% over the next five years, while the highest default rate since the late 80s has been 4%. A deep recession and heavy downgrades are risks, of course. But balance sheets are strong. We therefore think that such a risk scenario is unlikely to materialize. Spreads on high yield bonds are also high. Default rates are currently low—at 2.2% in the US, for example—and are likely to rise somewhat, with weaker economic data coming in. High yield also offers good value, but from a risk/return perspective, high yield bonds are less attractive than investment grade credits.

Global spreads for investment grade and high yield bonds



Source: Thomson Reuters Datastream

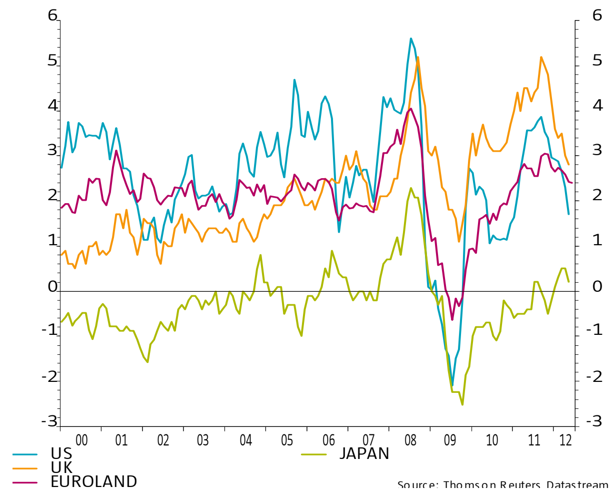
Emerging debt

The prospects for emerging debt are better than those for government debt. Low fiscal deficits and low government-debt ratios are the main characteristics of sovereign issuers in the emerging debt arena. Moreover, inflation in countries that have a significant weight in the emerging debt market is now unambiguously declining. These are all positive factors. Disappointing economic growth data could—in the end—increase the perceived risk of emerging debt. In a bid to stimulate economic growth, emerging countries may be implementing policies that are too loose. Although we are positive on the long-term outlook for emerging currencies, these current policy steps are likely to delay further strengthening. Local-currency government bond yields are currently averaging 6.1%. This is attractive compared with government debt from developed markets. We continue to prefer investment grade credits to emerging markets debt as they offer a better risk/reward pay-off.

Government bonds

Long-term interest rates are extremely low. But given the downward move of inflation (see chart right), the correction in the oil price, disappointing economic data and the ongoing debt crisis in the eurozone, interest rates are likely to stay low. In addition, a structural issue is developing in the shape of a shortage of safe bonds. The supply of safe assets is shrinking because of downgrades, while risk aversion and regulatory changes (Solvency II, central clearing) are increasing demand for them. As a result, we do not expect a correction in the bond market in the foreseeable future. Nevertheless, we remain negative on government bonds relative to investment grade credits, as the latter offer the opportunity to pick up a high spread. They are also benefiting from the shrinking supply of safe assets, as investment grade is the next 'safe asset' available.

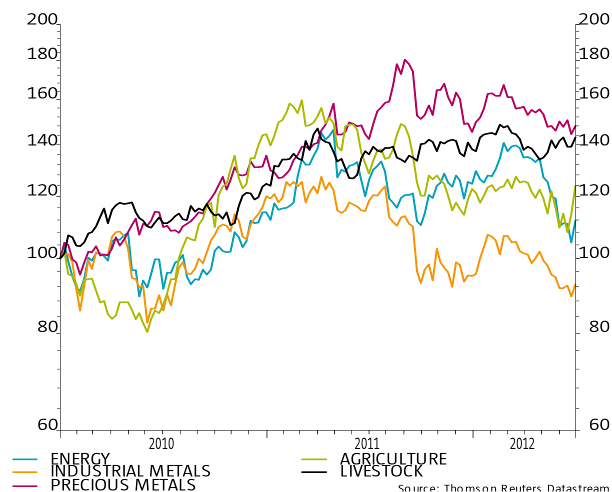
Headline inflation for major developed economies



Commodities

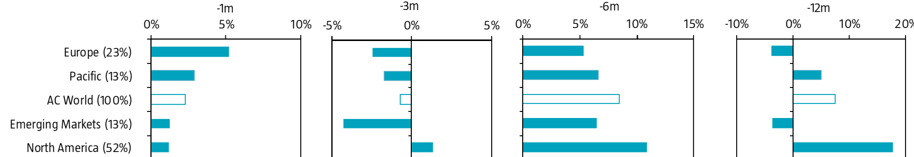
We remain somewhat cautious on commodities in the short term. We expect economic growth to be moderate. But after some disappointing data from around the globe, risks have clearly increased to the downside of our baseline scenario. Not only have consensus economic growth rates for the major emerging markets been lowered, but economists are also becoming less optimistic about the US. Producer confidence indices around the world are pointing to a further slowdown in the months ahead. The correction in the oil price and—to a lesser extent—in industrial metals is no reason for us to abandon our cautious stance towards commodities. Precious metals have outperformed cyclical commodities, as weak economic data is likely to lead to more quantitative easing. Gold is benefiting from fears of over-active printing presses. It thus remains far from certain that the peak of the gold price has already occurred.

Commodity spot prices (USD)



Regional allocation

Performance of regions (MSCI AC World unhedged EUR; index weights between brackets)



Source: Thomson Reuters Datastream, Robeco

Within equities, North America and emerging markets still are our favorite regions. The case for the US is becoming weaker, given that macroeconomic data there is deteriorating. Furthermore, earnings revisions in June were weak as well, while valuation relative to other markets has been

high for a while now. From an economic point of view, however, the US is an outperformer. Moreover, beyond the horizon of one month, relative momentum is strong and the US stock market does tend to do well in election years. For now, we maintain our view that North America is an attractive region. Our other favorite region, emerging markets, was already suffering from macroeconomic disappointments. Here, more monetary or fiscal stimulus should spur performance. Valuation is attractive but we would not expect it to drive performance, as it is far from an extreme level. We are negative on Europe because the downward risks to the mild recession are on the rise. Valuation there is becoming more attractive, but we think it is too early for an upgrade. The Pacific region, dominated by Japan, is not impressing, either.

Earnings and valuation data of regions (MSCI AC World)

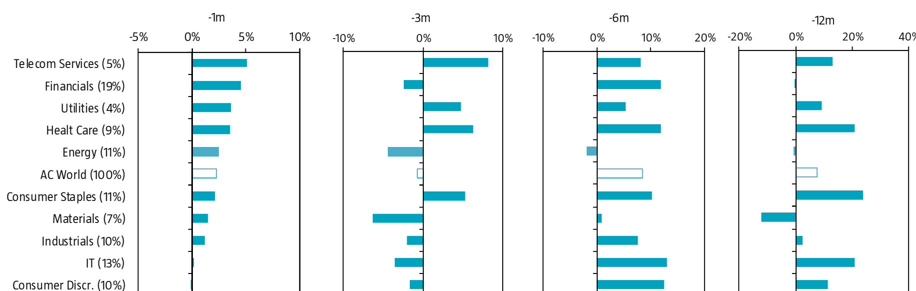
	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd earn.*	
	FY1	***FY2***	***12m***	***3m***	***1m***	***Current***	***10y avg.***
North America	8.1	12.9	10.8	-2.1	-36.5	12.3	14.5
Europe	2.7	11.9	8.0	-13.7	-21.4	9.7	12.5
Pacific	36.7	13.9	32.2	-11.1	-25.3	11.2	15.9
Emerging Markets	11.1	11.6	11.2	-24.9	-37.1	9.5	10.7
AC World	9.9	12.6	12.3	-11.0	-30.9	11.1	13.7

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 Reuters Datastream, Robeco

Sector allocation

Performance of sectors (MSCI AC World unhedged EUR; index weights between brackets)



Source: Thomson Reuters Datastream, Robeco

We remain hesitant to upgrade our still somewhat negative view on financials. Financials performed strongly in June, earnings revisions are more or less in line with the market and a case can be made that valuation is cheap. But financials have underperformed the market by 40 percentage points since 2007. On this horizon, the current improvements are marginal. As the sector has to deal with tougher regulation and rising capital requirements, it is hard to tell whether the current prices are a fair reflection of the true value of the new business models. We doubt whether the turning point in the sector's performance has yet been reached. Outside financials, we still have a slight preference for selected cyclical sectors, namely IT and consumer discretionary. Until recently, these sectors had beaten the market. Earnings revisions are still above the market average. But the current economic conditions warrant a cautious approach.

Earnings and valuation data of sectors (MSCI AC World)

	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd earn.*	
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
Energy	-3.2	7.9	2.6	-32.5	-54.7	9.0	11.5
Materials	0.0	17.7	11.9	-41.1	-59.8	9.9	12.5
Industrials	12.6	13.2	14.2	4.1	-37.2	11.3	14.6
Consumer Discr.	39.1	16.5	31.9	3.1	1.0	12.1	15.8
Consumer Staples	7.0	10.0	9.2	-17.1	-31.5	15.0	15.8
Healthcare	3.2	8.3	5.9	7.0	-1.5	12.2	14.9
Financials	12.4	12.5	12.7	-7.5	-35.1	9.4	11.5
IT	17.4	16.6	16.6	-9.5	-25.3	11.8	17.8
Telecom Services	2.4	8.7	5.7	-9.0	1.6	11.9	17.3
Utilities	18.3	14.7	18.9	-19.5	-26.5	14.6	13.4
AC World	9.9	12.6	12.3	-11.0	-30.9	11.1	13.7

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 Reuters Datastream, Robeco

Closing date text: 05 July 2012.
In our data tables, we refer to calendar months.

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