ROBECO

Monthly Outlook

Manufacturing soft patch seems over but risks loom

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Highlights

- The soft patch in worldwide industrial production seems to be in the past, as signaled by the uptick in the US purchasing managers index. The US economy will continue to grow modestly. But Europe is sinking further into recession, as is Japan. In China, we expect more stimulus once the newly appointed Politburo takes charge. The Indian government is finally taking action on economic reform. Brazil is doing fine.

- Huge risks loom. The US and Japan both face a fiscal cliff and political tensions in the Middle East and the East China Sea remain high. European politicians are not making much progress on the difficult road to create a fully-fledged banking, political and fiscal union.

- We maintain our neutral stance on equities. The driving force behind the decent recent performance has been the growing conviction that central banks, including the ECB, will continue to act aggressively. But investors might start to worry about the deteriorating earnings outlook. As a result, we prefer to remain neutral on equities.

- We rate the outlook for real estate as neutral. Real estate has lagged equities for the last two months, but we believe its defensive characteristics (provided by stable cash flows) will benefit the asset class in a world where investors are looking for yield.

- Credits and high yield bonds continue to benefit from a high yield pick-up compared with government bonds. Moreover, there is room for spreads on investment-grade credits to fall further. Corporate fundamentals are strong, while companies remain conservative and have high cash balances. These are positives for bondholders.

- We are negative on the outlook for government bonds, even though long-term interest rates are set to remain extremely low. We firmly hold on to our view that government bonds will lag investment-grade credits, as the latter offer a higher running yield and the opportunity to benefit from falling spreads.

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Macroeconomic view

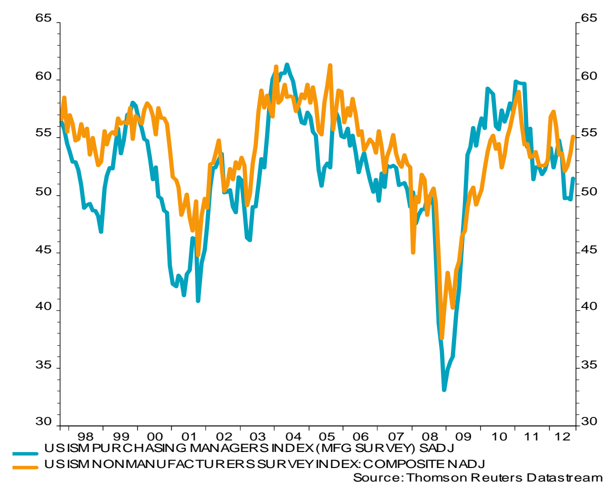
Global economy

The soft patch in worldwide industrial production seems to be in the past, as signaled by the uptick in the US purchasing managers index. The US economy will continue to grow modestly. But Europe is sinking further into recession, as is Japan. In China, we expect more stimulus once the newly appointed Politburo takes charge. The Indian government is finally taking action on economic reform. Brazil is doing fine. The US central bank is implementing unorthodox and unprecedented quantitative-easing measures, putting pressure on the Bank of Japan and the ECB to step up their efforts. In Europe, the ECB has delivered, preventing a severe liquidity crisis for Italy and Spain. Huge risks loom. The US and Japan both face a fiscal cliff and political tensions in the Middle East and the East China Sea remain high. Europe's politicians are not making much progress on the difficult road to create a fully-fledged banking, political and fiscal union.

North America

The overall US economy continues to expand at a slow pace, but recent ISM readings have ticked up, as has the labor market. The housing market is also recovering. In the coming months, we expect positive—albeit very moderate—growth. The oil price remains stubbornly high. We expect some politically induced relief, though, before the US elections in November. Even though expectations that the Federal Reserve would resume its quantitative easing program were high, the US central bank succeeded in springing a surprise on financial markets. Among other measures, its quantitative easing program is now open-ended. It will buy assets at a rate of USD 40 bln a month, until it is satisfied about developments in the labor market. It has also signaled its intention to remain firmly behind the curve when the economy strengthens. This radical approach provoked an immediate increase in the Bank of Japan's quantitative-easing program. The main short-term worry for the US economy is the looming fiscal cliff—the automatic expenditure cut-backs and tax increases that will click in unless a budget compromise can be agreed—which would almost certainly push the country's economy into recession in the first half of 2013. However, the logic of the situation—not least because of political factors—suggests a delay in the implementation of the automatic measures for at least six months. The long-term US debt situation remains troubling but not much progress is to be expected after the presidential elections. Whoever wins the election, we expect only a half-hearted effort in this direction.

US ISM Manufacturing and Non-Manufacturing



Europe

The UK economy is heading for a somewhat stronger third quarter. Growth will be painfully slow, however. In November, the Bank of England's asset-buying program will most likely be expanded. Inflation is trending downward.

The recession in the eurozone economy has reached the core. The leading German ifo index is weakening rapidly (see chart right). France's purchasing managers index was dismal as well, reaching 42.7 (Germany: 47.4). If the relative decline of France progresses, it could turn into a major headache for the eurozone. A further lowering of the refi rate by the ECB is only a matter of time but its economic impact will be limited. The ECB opted for a pause partly because of a disappointing flash CPI estimate for September (2.7% on a yearly basis). Unconventional monetary easing in the euro area is therefore a long way off, as the decision-making council would need deflation to be able to justify such a drastic course of action. The absence of a formal request for ESM assistance from Spain is another reason for the ECB's passivity. In principle, such a request would pave the way for bond market intervention by the ECB, although the bank's president, Mario Draghi, seemed to backpedal somewhat in his October press conference. We believe, however, that the formal request from Spain is only a matter of weeks away. The European Council meeting on 18 and 19 October will be crucial in this respect. Before seeking support for additional financial assistance from the German parliament, German chancellor Angela Merkel would probably like to arrange a package deal for all difficult cases apart from Spain: Cyprus, Greece and Slovenia. European leaders rightly consider that a Grexit would probably be too costly in economic and political terms, but it could still be unavoidable. Greece's weak government isn't delivering and the IMF may view the country as a lost cause. Playing for more time is a likely scenario, in part because of the upcoming US elections. On a 12-month horizon, we leave our estimate that there is a 50/50 chance of a Grexit unchanged.

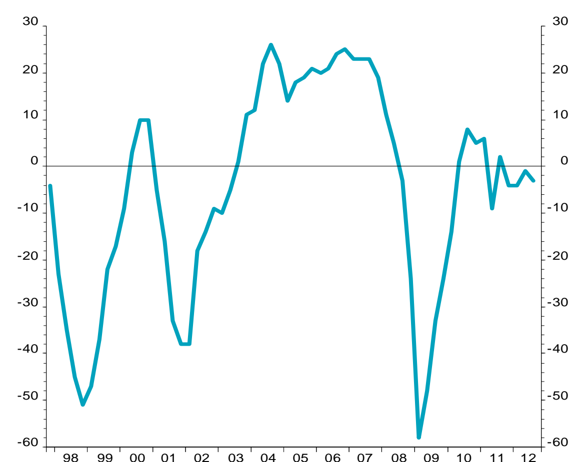
German producer confidence (ifo)

Source: Thomson Reuters Datastream

Pacific

As September's Tankan (see chart right) shows, the Japanese economy is weakening. A territorial spat with China about a group of islands in the East China Sea is further dampening the growth outlook, given the large importance of Japan's trade links with China. In the meantime, the Japanese government faces its own fiscal cliff. As in the US, the cliff will probably be avoided. If so, it will come at the cost of a general election in November or December. In response to the Fed's latest steps, the BoJ has raised its program of quantitative easing by 10%. As the LDP, the major opposition party, looks set to win the coming elections, pressure on the BoJ to ease more will only increase. The LDP will campaign on a pro-growth agenda and could change the mandate of the BoJ, for instance by forcing on it an inflation target of—say—2%. The BoJ could also be allowed to buy foreign government debt in an effort to weaken the yen. The BoJ may try to stave off such potential institutional changes—which would weaken its cherished independence—by implementing more quantitative easing. In any event, more unconventional monetary easing in Japan is to be expected.

Japanese Tankan



Source: Thomson Reuters Datastream

In Australia, the Reserve Bank of Australia has lowered its main interest rate further, now that the mining boom is over. There remains plenty of scope for further conventional monetary easing.

BRICs: a clear weakening of China but good news from Brazil and India

The Chinese economy is slowing, as indicated by the weakening of two of Li Keqiang's three preferred indicators. In part, this slowdown is being driven by an inventory correction, given that China appears to be switching to a somewhat lower structural growth path (around 7%). As expected, the Chinese government is trying to increase the momentum of the Chinese economy over a broad front, and it is doing so in a measured style, not a desperate one. This is highlighted by the recent weakening of the yuan against the US dollar. Appointments to the new Standing Committee of the Politburo of the Chinese Communist Party are widely awaited for clues on future policy. As the recent regional appointments went largely as expected, major surprises at the national level are unlikely.

Financial markets reacted euphorically to the unexpected wakening of the Indian government from its long stupor, which threatened to return the country's credit status to 'junk' once again. The government has announced a couple of sensible reform measures: while they will have limited economic impact, they have been helpful in restoring the confidence of foreign investors.

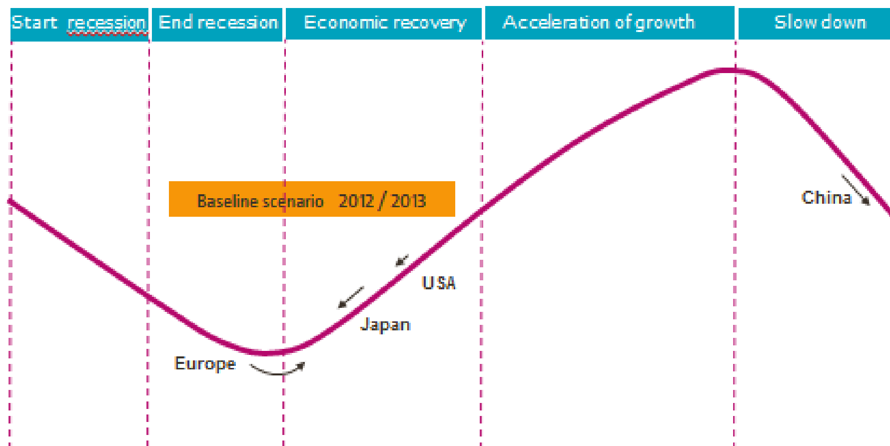
The Brazilian economy is gaining speed thanks to the monetary and fiscal authorities' stimulative policy mix. In a reaction to the Fed's new QE measures, the Brazilian government has threatened to enhance its capital restrictions to prevent the upward pressure on the real.

The Russian economy is doing fine, thanks to the current high oil price. The apparently confident central bank has unexpectedly raised its main interest rate in order to combat inflation. Another modest tightening move is possible in the coming months.

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

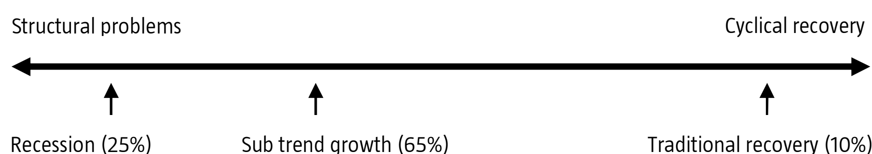
The current environment can be characterized as a generally weakening cyclical recovery with the exception of the US. Deleveraging, austerity measures, the ongoing euro crisis and a lack of political decisiveness continue to be major themes. International divergence is rising. The corporate sector is relatively strong.

Position in the economic cycle



As a result of structural problems and a lack of political resolve, economic growth is set to be lower than historical trend growth. Our baseline scenario is one of sub-trend growth (probability 65%), while we feel that there is currently a 25% chance of a renewed worldwide 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	1.8	2.2	2.1	0.0	=
Eurozone	1.5	-0.5	0.2	0.0	-
UK	0.8	-0.3	1.3	-0.1	-
Japan	-0.7	2.4	1.3	-0.1	=
China	9.2	7.7	8.1	-0.2	=
India	6.5	5.9	6.9	-0.2	=
Brazil	2.7	1.6	4.0	-0.3	+
Russia	4.3	3.8	3.7	0.0	+
World	2.5	2.1	2.4	0.0	=

* 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	2.0	2.0	0.0	=
Eurozone	2.7	2.4	1.8	0.1	=
UK	5.3	3.1	2.6	0.1	-
Japan	-0.3	0.1	0.0	0.0	-
China	5.4	2.8	3.4	0.0	=
India	8.3	8.9	7.4	0.2	+
Brazil	6.5	5.2	5.3	0.3	+
Russia	6.1	6.6	5.9	0.3	=
World	3.3	2.5	2.3	0.1	=

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

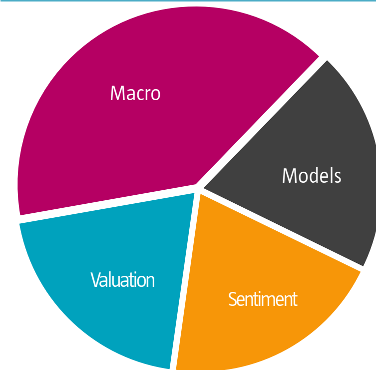
Source: Consensus Economics, Robeco

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.

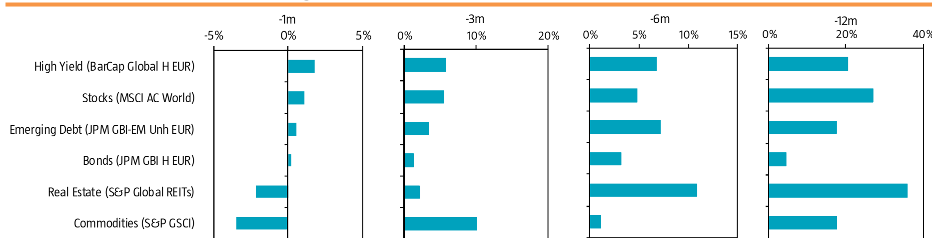
Next, we challenge our macro analysis with input from financial markets. Here, we take valuation into account as, at extreme levels, this might induce a turn in the performance of an asset class. Sentiment also plays a role, as markets tend to extrapolate shorter-term trends as investors put too much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

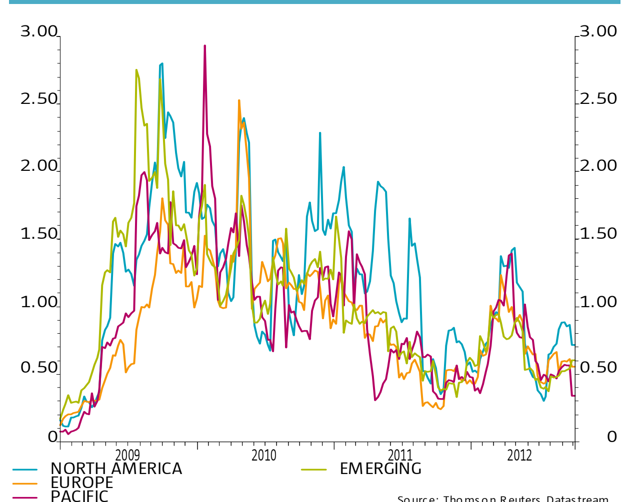


Source: Thomson Reuters Datastream, Bloomberg, Robeco

Equities

We maintain our neutral stance on equities. Stocks have continued to be relatively robust, despite some weak economic data. In addition, downward earnings revisions are outnumbering upward revisions in all four regions (see chart right). As a result, expected earnings growth for 2012 has now fallen to 6%. This is probably still a bit too optimistic, but at least unrealistic fantasies of double-digit growth have vanished. In the face of all of these negatives, the driving force behind the decent performance has been the growing conviction that central banks, including the ECB, will continue to act aggressively. Investors might start to worry about the deteriorating earnings outlook, however. Third-quarter earnings data will shed more light on the sustainability of the record-high earnings margins. Given this uncertainty on earnings, we prefer to remain neutral on equities, despite central banks' aggressive behavior.

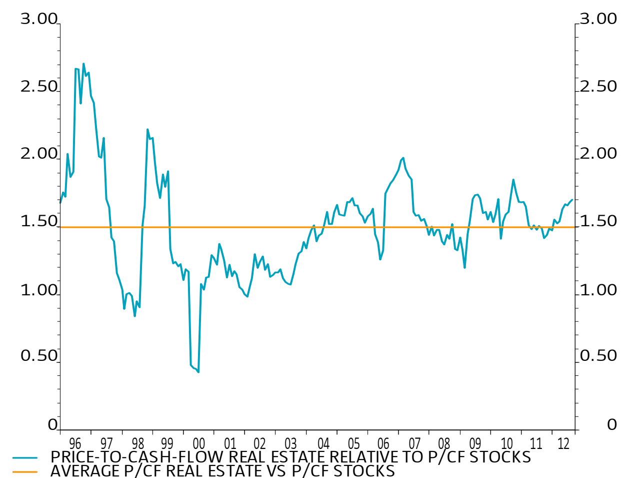
Earnings revisions index (#up minus #down/#total revisions)



Real estate

The outlook for real estate is neutral. Real estate lagged equities in the last two months, but we believe its defensive characteristics (provided by stable cash flows) will benefit the asset class in a world where investors are searching for yield. The valuation of real estate is somewhat high compared with equities. The price-to-cash flow ratio relative to equities' is 1.7x, above the historical average of 1.5x (see chart right). Other valuation indicators point to a larger overvaluation. Still, the sector should benefit from low interest rates and the scope for a further decline in credit spreads. In addition, the asset class is less prone to downward earnings revisions. On balance, we expect real estate to perform in line with equities.

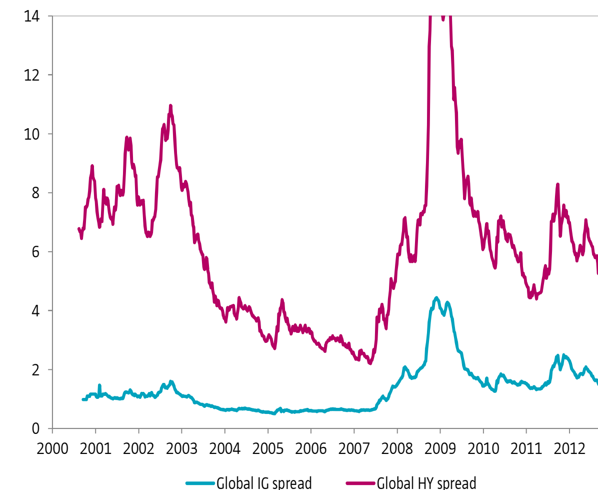
Valuation of global real estate versus equities



Credits and high yield

Credits and high yield continue to benefit from a high yield pick-up compared with government bonds. Moreover, there is room for spreads on investment-grade credits to fall further. Corporate fundamentals are strong, while companies remain conservative and have high cash balances. These are positives for bondholders. As for European financial credits, there is negative net issuance due to LTROs and the issuance of covered bonds, while higher capital requirements are reducing the risk for bondholders. These positives outweigh negatives such as asset encumbrance (where fewer assets are available to unsecured bondholders in the event of default because collateral has been pledged elsewhere, as with covered bonds) and bail-in measures. As a result, we keep our positive view, particularly on investment-grade credits.

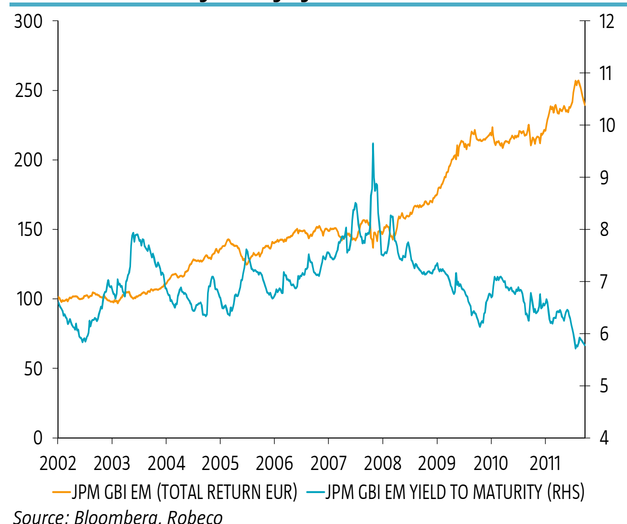
Global spreads for investment grade and high yield bonds



Emerging debt

As with credits and high yield, the prospects for emerging debt are better than those for government debt. Across the globe, economic growth is declining in 2012. This is reducing inflationary risks. The consensus for next year is a moderate increase in growth. In a bid to stimulate growth, some emerging countries are implementing policies that are too loose. Although we are positive on the long-term outlook for emerging currencies, such policy steps are likely to delay further strengthening. That said, the low fiscal deficits and debt-to-GDP ratios bode well for the future performance of emerging debt. Local-currency government bond yields of 5.8% are attractive compared with government debt from developed markets. But we still prefer investment-grade credits to emerging debt, given their better risk/reward pay-off.

Yield on local sovereign emerging markets debt

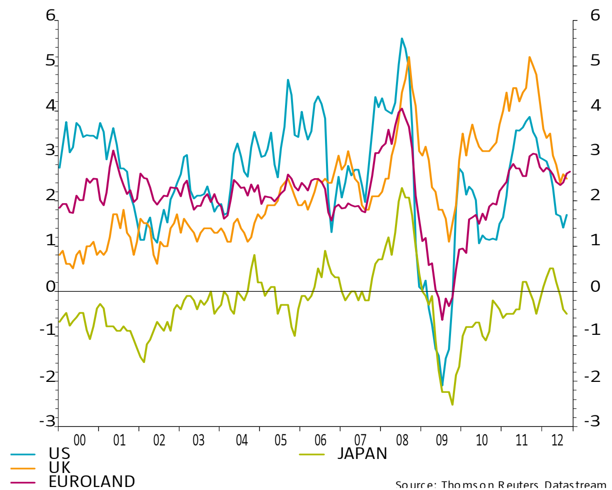


Source: Bloomberg, Robeco

Government bonds

We are negative on the outlook for government bonds. But we do not expect a serious correction in long-term interest rates. They are set to remain extremely low, even though safe-haven demand is being negatively affected by the ECB's assumption of the role as lender of last resort. However, inflationary pressures are likely to stay low for the foreseeable future. Economic data is weak, with risks on the downside. A structural issue is the increasing scarcity of safe bonds. The supply of safe assets is shrinking because of downgrades, while regulatory changes (Solvency II, central clearing) are increasing demand for them. Although we do not foresee a significant rise of long-term interest rates, we firmly hold on to our view that government bonds will lag investment-grade credits, as the latter offer a higher running yield and the opportunity to benefit from falling spreads.

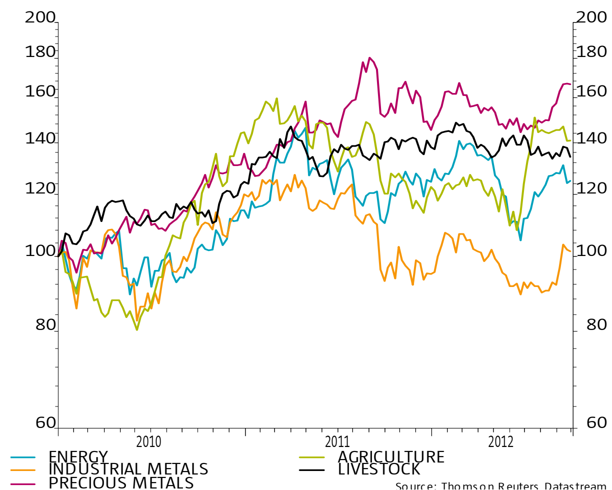
Headline inflation in major developed economies (%)



Commodities

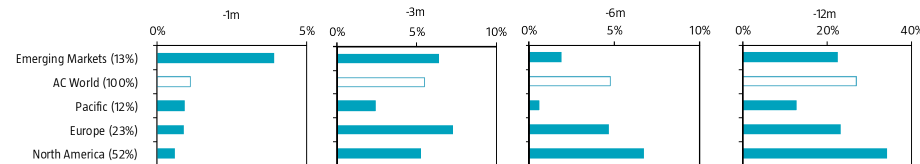
We expect commodities to move sideways. The macroeconomic environment is set to stay sluggish. China-related commodities, such as iron ore, continue to be vulnerable to disappointing growth. Even accelerating growth in China in the fourth quarter might not help, as stockpiles are high. Tensions concerning Iran and Syria, as well as tight OPEC oil supply, have driven up the oil price. With limited spare capacity, price risks seem to be on the upside. But a release from US strategic oil reserves just before the election should also be taken into account. For the commodities asset class as a whole, we do not forecast any major moves.

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 is our favorite. We consider it unlikely that the next president will take decisive measures to tackle the US's long-term budget problems. Both candidates lack a convincing plan. Moreover, they will not dare to undermine the weak recovery. We think it is too early to make a definite call on Europe. We became less negative on Europe a few months ago, but we currently lack conviction for a further upgrade of our view. Austerity will negatively affect growth and economic weakness brings the risk that the euro will again come under pressure.

Our faith in emerging markets continues to weaken, thanks to disappointing performance and weak earnings revisions. In China, however, we expect a moderate strengthening of the economy due to government spending. This is a positive for emerging markets. Given the weak growth and mild inflation in Japan, we expect the trend of underperformance by the Pacific region to continue.

Earnings and valuation data of regions (MSCI AC World)

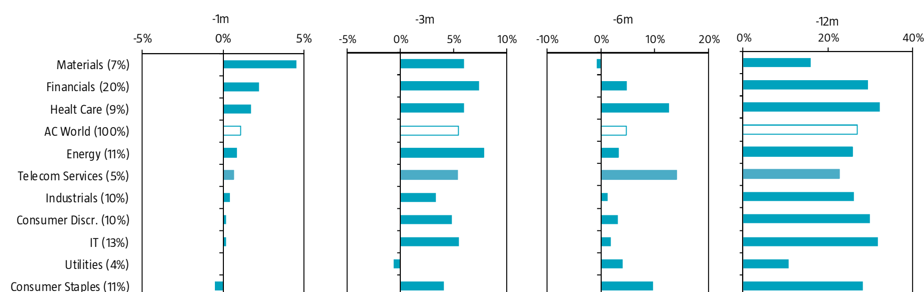
	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd earn.*	
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
North America	6.1	11.4	10.1	-16.9	-16.7	13.0	14.4
Europe	-2.7	12.5	9.1	-25.9	-28.5	11.0	12.4
Pacific	27.5	16.1	23.0	-33.2	-49.5	12.1	15.6
Emerging Markets	5.3	12.5	10.7	-33.8	-24.7	10.2	10.7
AC World	5.6	12.4	11.3	-25.4	-26.0	11.9	13.5

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 have a preference for defensive sectors. Cyclical sectors are still suffering the greatest number of earnings downgrades and once again it has become clear that moderate economic growth is the best we can hope for, both this year and next.

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.*
Energy	-8.9	8.2	3.7	-26.1	-43.0	10.1	11.4
Materials	-14.8	20.4	12.1	-54.2	-34.1	11.5	12.4
Industrials	8.9	12.1	12.2	-40.4	-57.6	11.9	14.5
Consumer Discr.	36.4	16.0	23.8	-14.4	-14.0	12.7	15.6
Consumer Staples	6.1	9.8	9.3	-16.8	-10.5	15.7	15.8
Health Care	3.0	7.9	6.8	-10.0	9.4	13.0	14.8
Financials	9.9	11.6	11.4	-9.4	5.6	10.3	11.4
IT	11.9	16.7	14.7	-36.5	-35.5	12.5	17.4
Telecom Services	0.8	9.2	7.3	-9.8	-15.4	12.6	16.7
Utilities	14.9	15.6	15.4	-2.8	1.9	14.9	13.5
AC World	5.6	12.4	11.3	-25.4	-26.0	11.9	13.5

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 October 2012.
In our data tables, we do refer to calendar months.

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