ROBECO

Monthly Outlook

The world economy is in better shape

In this issue

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Highlights

- The world economy is doing better. The downturn in China is showing tentative signs of bottoming out. The US economy is stronger than expected. But the US is still facing a fiscal cliff, as is Japan. Calm has been restored in the eurozone but much work remains to be done. Political tensions in the Middle East and the South China Sea have eased, at least temporarily.

- Early indications of renewed strength in the Chinese economy have appeared. In October, manufacturing expanded for the first time in three months, while retail sales rose the most in six months. The new Chinese leadership is likely to step up stimulus.

- We expect equities to trade more or less sideways. In the third-quarter earnings season, sales tended to disappoint while earnings lived up to expectations, albeit lowered ones. But companies' forward-looking statements were cautious. With valuation in neutral territory and growth continuing to be moderate, we do not expect spectacular returns for equities.

- Credits and high yield have rallied firmly in recent months. Given our muddling-through macroeconomic outlook, we are still positive on the corporate bond market. We are not expecting strong additional gains from falling spreads. Rather, we believe the spreads themselves are enough to support a positive view. Government bond yields are negative in real terms, while corporate fundamentals are strong. Companies continue to behave in a conservative fashion and they have high cash balances.

- On a relative basis, credits have benefitted from spread compression in recent months. As a result, their prospects have deteriorated a little. We now rank credits equal to high yield and emerging markets debt.

- We hold on to our negative view on government bonds. Economic data is no longer surprising negatively. Still, we do not expect a serious correction in long-term interest rates: economic growth is weak and inflation risks are absent at this stage of the economic cycle. Rates are thus set to remain extremely low.

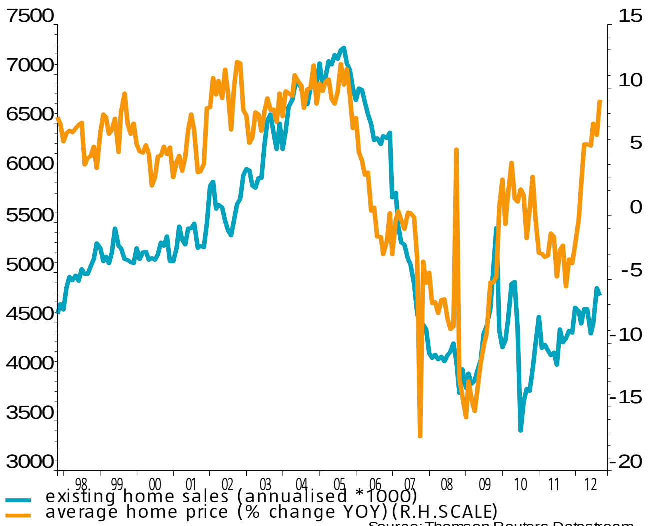
Macroeconomic view

Global economy

The world economy is doing better. The downturn in China is showing tentative signs of bottoming out. The US economy is stronger than expected. The US is still facing a fiscal cliff, as is Japan. Calm has been restored in the eurozone, but much work remains to be done. Political tensions in the Middle East and the South China Sea have eased, at least temporarily.

North America

US: existing home sales and average home price



Source: Thomson Reuters Datastream

In the post-election period, we expect a deal regarding the fiscal cliff to be arranged so the recessionary impact on the US economy will be limited. With most of the fiscal cliff's negative impact thus removed, with export and private-sector demand picking up and with the Federal Reserve determined to stay behind the curve, we do not expect the US economy's fragile recovery to stall going into 2013, especially given the likely rebuilding demand in the aftermath of hurricane Sandy. GDP grew at a 2% annualized rate in the third quarter, which is still below the trend growth required for full employment. The figure was less impressive when adjusted for the erratic jump in defense spending (+13%), which flattered the GDP figure by almost 0.7%. The US economy thus continues to expand at a slow pace. Unemployment rose from 7.8% to 7.9% in October as companies, fearing reduced demand thanks to the fiscal cliff, increased layoffs. An increased participation rate also contributed to the higher unemployment rate. Yet people re-entering the labor force may be signaling increased confidence in the strength of the economy. The housing market also showed signs of improvement and activity in the construction sector strengthened, contributing to a somewhat less unfavorable picture for the coming months. The re-elected US president, Barack Obama, has some things to worry about, though. Congress's lack of decisive political action on the fiscal cliff is creating uncertainty among corporates. US companies therefore cut investment expenditure further in the third quarter against the background of weak global growth. Despite the fall of the dollar against other major currencies, US exports fell by 1.6% in the third quarter, reflecting the weaker demand from China and Europe. As China's latest PMI figures were better, we expect US exports to strengthen again in the coming months. Hurricane Sandy severely hampered economic activity along the eastern coast, with an expected negative contribution to Q4 GDP growth of 0.2 percentage points.

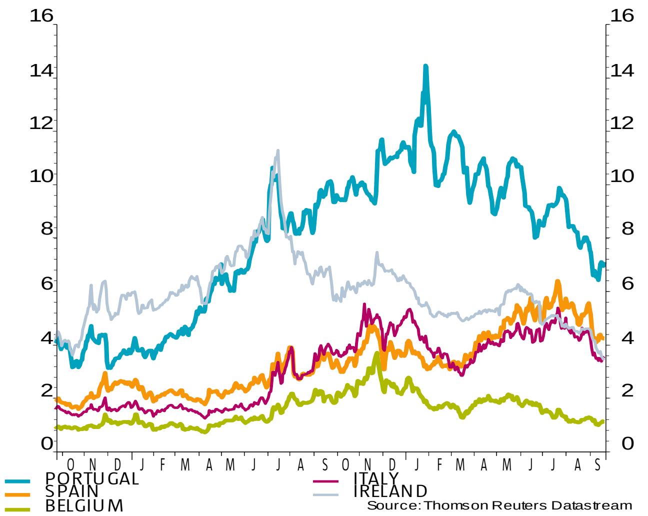
After avoiding the fiscal cliff, investment activity will likely rebound in the first half of 2013. The steady improvement in private household consumption even as the fiscal cliff looms closer indicates the US consumer's regained confidence.

Europe

The UK economy reported remarkably strong Q3 GDP growth of 1.0%. The figure was flattered by two one-offs: a rebound effect from a missing working day due to the Queen's Diamond Jubilee in Q2 and additional growth from the Olympic Games. The underlying growth trend is still negative, however. Construction is still weakening and the manufacturing sector is suffering from a potent cocktail of declining exports, depressed demand from the eurozone and rising cost pressures. More asset-buying by the Bank of England is expected before year-end.

The eurozone continues to muddle through. Economic activity remains subdued, as most recent PMI figures confirmed that the recession has not left the region. Unemployment increased to 11.6%, as austerity measures continued to destroy demand and caused employers to lay off workers. Social and political tensions in the periphery are rising.

Ten year yield spreads vs Germany



Greece presented its budget for 2013. It estimated a further contraction in economic growth from the previously estimated -3.8% to -4.5%. To comply with the conditions imposed by the Troika for the emergency package, Greece now has to cut expenditures even further to stabilize the debt level, with a EUR 13.5 bln austerity package. As this will erode the Greek economy's productive capacity, the IMF has pressed creditors to forego some of the outstanding debt to bring Greek debt levels back onto a sustainable track. The core members of the eurozone firmly opposed this measure, as it would not only remove the incentive for Athens to restore competitiveness but it would also result in losses for taxpayers at home. With the 2013 elections approaching, German chancellor Angela Merkel is unwilling to tell her electorate that Greece is permanently insolvent. The ECB wants to avoid official sector involvement (OSI) as well, regarding the cancellation of Greek debt on its balance sheet as monetary financing. Several ideas have been floated to circumvent painful debt write-downs, but they lack substance. Putting Greece back on a sustainable path will require renewed political will and further commitments from the core countries at some stage. Meanwhile, the Greek coalition is looking wobbly, shaken by the tax-evasion scandal among Pasok's leaders. This will make parliamentary approval of the 2013 budget increasingly difficult. Intensified political gridlock leaves the probability of a Grexit on a 12-month horizon unchanged at 50/50.

Italy, infamous for its numerous political scandals, had a new one. Former prime minister Silvio Berlusconi was sentenced for fraud and publicly attacked the austerity program of his technocrat successor, Mario Monti. This is feeding the political instability, with the anti-austerity Five Star movement of Beppe Grillo now clearly on the rise.

Spain's prime minister, Mariano Rajoy, continues to put off the country's long-awaited bail-out request to the ESM, defending his indecisiveness as being part of his strategy. Spain's passive stance is a roadblock for the conditional bond buying that the ECB has announced, even now that the central bank's president, Mario Draghi, has been given the green light to implement this unconventional measure by the Bundestag. Although financial markets seem to be giving Rajoy the benefit of the doubt, we believe his dithering will have a negative pay-off. That is because the Spanish situation is likely to deteriorate, given that unemployment is still rising and a pile of bad housing loans has yet to be dealt with.

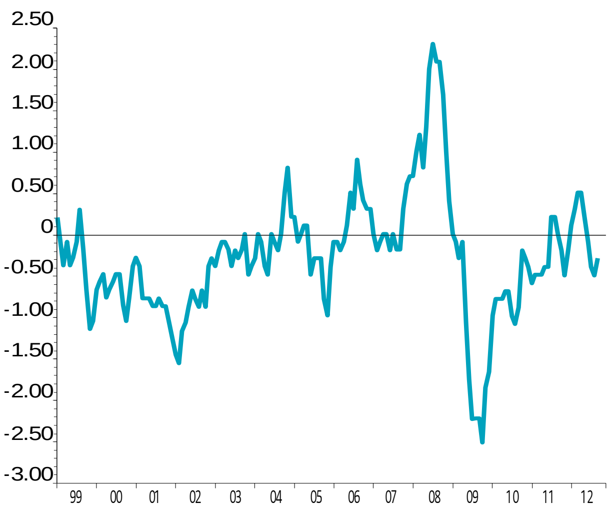
In France, the declining competitiveness of the country's industry is becoming the subject of political debate, pressuring the president, François Hollande, to implement structural reforms in the labor market. Last month, the prime minister, Jean-Marc Ayrault, referred to the possible abolition of the 35-hour working week. But his attempt to open up the debate on labor reform was rapidly quashed by intense union opposition. Given the strength of the unions in France, we expect falling productivity to erode debt sustainability, leading—eventually—to a wake-up call from financial markets. This should incentivize Hollande to stick to his pro-EU/pro-growth agenda and push on with reform.

With overall economic activity slowing, the risks to price stability in the eurozone are becoming increasingly downward-skewed. An indication of the deflationary pressures was the contraction in credit growth in the eurozone. With downward risks to price stability now dominating, the ECB will have more ammunition to justify lowering the policy rate by 25 basis points. It is probably too early for a negative deposit rate or for unconventional quantitative easing.

Pacific

The Japanese economy is weakening. September saw the largest fall in industrial production since the 2011 earthquake (-4.1% mom). At the same time, the country's political impasse continues. Opposition lawmakers refused to authorize additional borrowing; the prime minister, Yoshihiko Noda, refused to call elections, which he had earlier promised would be held "soon" in return for opposition support for the hike in sales tax. The stalemate is a threat to Japan's credit rating. As Noda would suffer heavy losses in an election, he has every incentive to avoid going to the polls. As expected, the Bank of Japan has taken additional easing measures. It even participated in an unprecedented joint statement with the government, pledging to cooperate to end deflation. This signals that the government is seeking greater influence over BoJ policy. More quantitative easing is to be expected, now that several BoJ board members have expressed the view that Japan is in a recessionary phase and that political pressure will intensify.

Japanese inflation (%)



Source: Thomson Reuters Datastream

As a consequence of the weakening of the Chinese economy, Australia is also slowing. Further monetary easing is likely in the coming months.

BRICs

The Chinese economy is showing tentative signs of renewed strength. In October, manufacturing expanded for the first time in three months, while retail sales rose by the most in six months. In order to defuse trade tensions with the US before the latter's elections, the Chinese authorities have apparently resumed their policy of gradual strengthening the yuan against the US dollar. It remains to be seen whether this policy will be continued now that the elections are over. The new Chinese leadership is likely to introduce more stimulus into the Chinese economy.

India's manufacturing growth also accelerated in October. The country's central bank is resisting calls from the government to cut rates. Inflation remains high. The trade deficit is worsening. But the renewed resolve of the Indian government for reform is—so far—keeping investor sentiment upbeat.

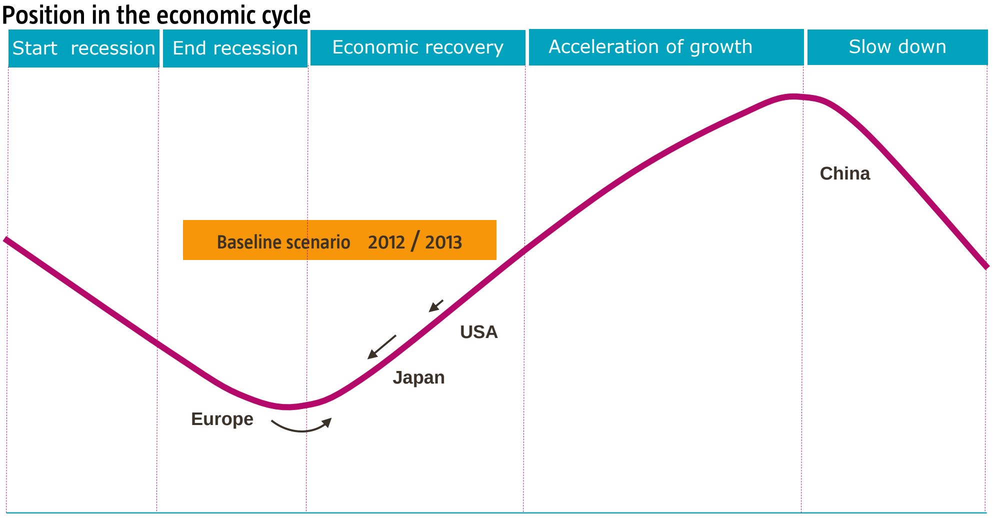
In Brazil, monetary easing is probably coming to an end; the economy has accelerated to an annualized growth rate of 4%.

The Russian economy is losing momentum. Inflation is still above the central bank's year-end target (6.6% in September, against the original target range for the year of 5-6%). But the Russian central bank will probably remain on hold for the foreseeable future.

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

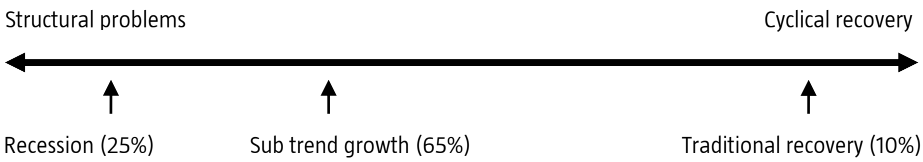
The current environment can be characterized as a generally weakening cyclical recovery with the exception of the US. Deleveraging, austerity measures, the ongoing euro crisis and a lack of political decisiveness continue to be major themes. International divergence is rising. The corporate sector is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

Position in the economic cycle



As a result of structural problems and the 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 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 2013*	*Robeco**
US	1.8	2.1	2.0	-0.1	+
Eurozone	1.5	-0.5	0.2	0.0	-
UK	0.9	-0.2	1.2	-0.1	=
Japan	-0.7	2.3	1.3	0.0	-
China	9.3	7.7	8.1	0.0	=
India	6.5	5.8	6.8	-0.1	-
Brazil	2.7	1.6	3.9	-0.1	+
Russia	4.3	3.7	3.6	-0.1	=
World	2.5	2.1	2.3	-0.1	=

* indicates whether we expect a higher (+), matching (=) or lower (-) growth rate than the current consensus estimate for 2013

Source: Consensus Economics, Robeco

Consensus estimates of inflation and Robeco's expectations

CPI by region (%)	*2011*	*2012*	*2013*	*Δ -1m 2013*	*Robeco**
US	3.1	2.1	2.0	-0.1	=
Eurozone	2.7	2.5	1.9	0.1	=
UK	5.3	3.1	2.7	0.1	=
Japan	-0.3	0.0	-0.1	-0.1	=
China	5.4	2.8	3.4	0.0	-
India	8.3	9.1	7.5	0.1	+
Brazil	6.5	5.3	5.3	0.0	=
Russia	6.1	6.7	6.0	0.1	=
World	3.3	2.5	2.3	0.0	=

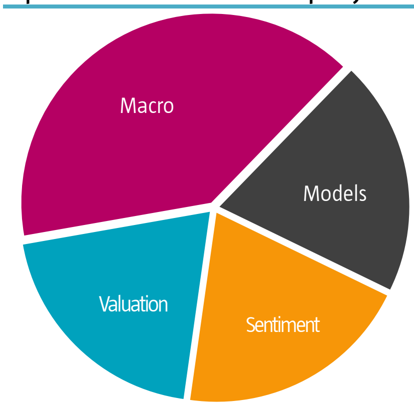
* indicates whether we expect a higher (+), matching (=) or lower (-) inflation rate than the current consensus estimate for 2013

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.

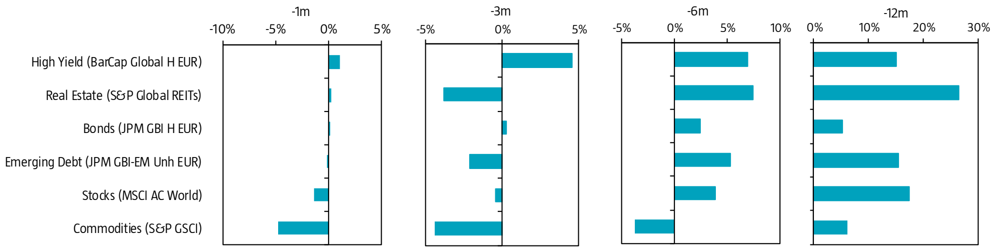
Input factors for our investment policy



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.

Asset allocation

Performance of asset classes (gross total return in euros)

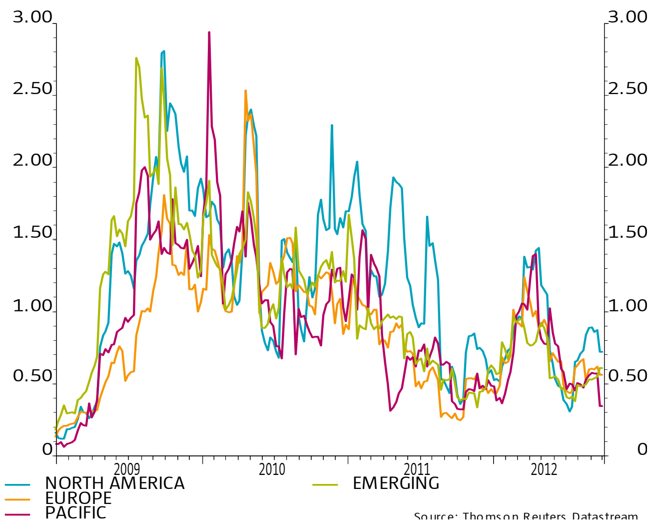


Source: Thomson Reuters Datastream, Bloomberg, Robeco

Equities

We expect equities to trade more or less sideways. In the third-quarter earnings season, sales tended to disappoint, while earnings lived up to expectations, albeit lowered ones. But companies' forward-looking statements were cautious. That was no surprise, as we believe there is no upward potential for earnings margins. This will limit earnings growth. In the meantime, aggressive monetary policies remain a positive factor for equities, as they discourage consumers and investors from saving. Moreover, companies have huge cash piles and they may take the opportunity to raise their stock buy-back programs. Currently, S&P 500 companies have a stock buy-back run rate of USD 100 bln a quarter; on an annualized basis, this represents roughly 3% of market capitalization. Still, with growth continuing to be moderate and with the valuation of equities at neutral, we do not expect spectacular returns for the asset class.

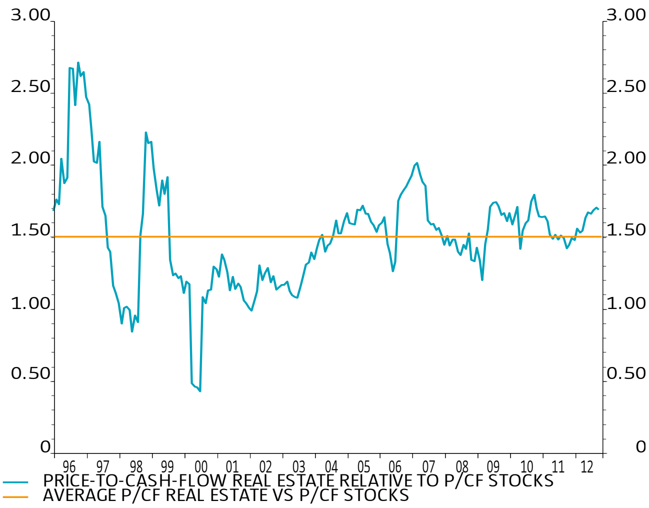
Earnings revisions index (# up minus # down/# total revisions)



Real estate

The outlook for real estate remains neutral. The defensive characteristics of real estate were apparent in the latest round of earnings figures. Analysts continue to downgrade their earnings estimates for equities, but for real estate earnings upgrades and downgrades are in balance. Real estate is likely to benefit from low interest rates and the scope for a further small decline in credit spreads. Nevertheless, we expect real estate to perform in line with equities; valuation has been creeping up in 2012. The price-to-cash flow ratio relative to equities' is 1.7x (see chart right), above the historical average of 1.5x.

Valuation of global real estate versus equities

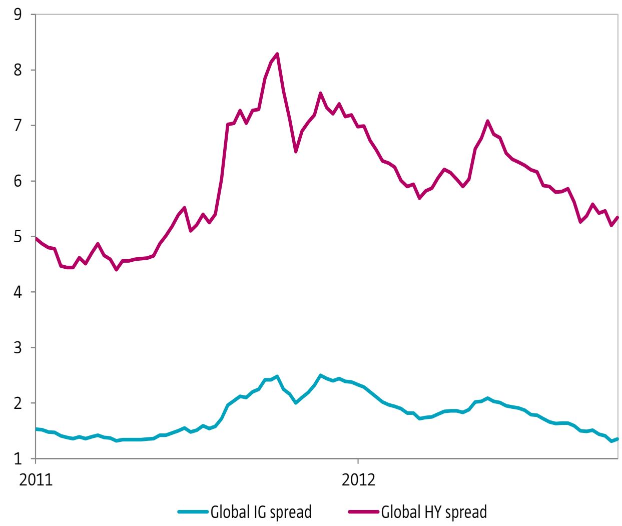


Source: Thomson Reuters Datastream

Credits and high yield

Credits and high yield have rallied firmly in recent months. Given our muddling-through macro outlook, we remain positive on corporate bonds. We do not expect strong additional gains from falling spreads. Rather, we feel that the spreads themselves are enough to support a positive view. Moreover, government bond yields are negative in real terms, while corporate fundamentals are strong: companies continue to behave conservatively and have high cash balances. After the recent rally, we no longer favor credits over high yield, as credits have benefitted the most on a relative basis. As a result, we now feel that the prospects for credits and high yield are similar. Within credits, spreads on European financial credits are still attractive: tail risk has declined, net issuance of bonds is negative and higher capital requirements are reducing risk.

Global spreads for investment grade and high yield bonds



Source: Bloomberg, Robeco

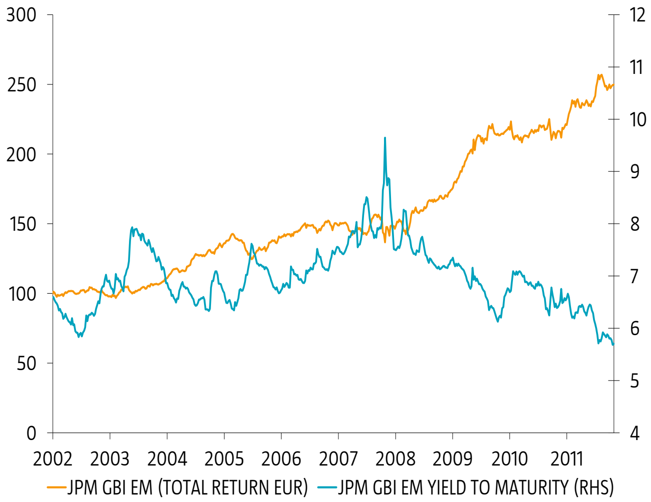
Emerging debt

We believe that the current return drivers for emerging markets debt—mainly the search for yield and the healthy economic fundamentals in these markets—remain firmly anchored. Central banks in developed markets have been more aggressive in their easing of monetary policy in recent months, putting downward pressure on interest rates. We believe this low ceiling on nominal and real yields in developed economies will continue to trigger steady inflows into emerging debt, as the absolute yield there—currently 5.7%—is comparatively high. Fundamentals for emerging debt look solid, even against a backdrop of weak global demand. Inflation risks are low, government-debt ratios remain stable and the external balance of emerging markets against the rest of world is positive. Currency exposure will add to volatility in the short run, but we expect a positive return contribution in the long term.

Government bonds

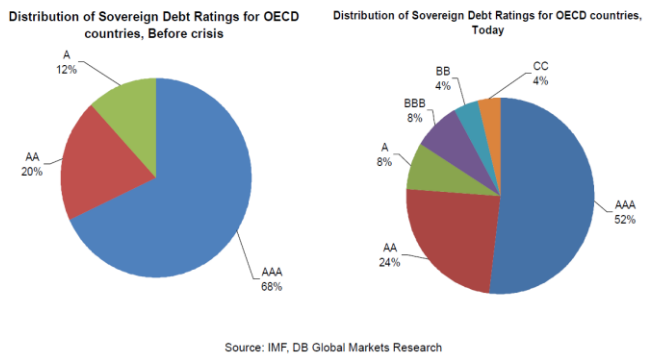
We maintain our negative view on government bonds. For one thing, economic data no is longer surprising negatively. Still, we do not expect a serious correction in long-term interest rates. Economic growth will be weak and inflation risks are absent at this stage of the economic cycle. Rates are thus set to remain extremely low. Although safe-haven demand is being negatively affected by the ECB's assumption of the role as lender of last resort, major central banks continue to operate on the buy side. The increasing scarcity of safe bonds is a positive structural development for high-quality government bonds (see chart right). The supply of safe assets is shrinking because of downgrades, while regulatory changes (Solvency II, central clearing) are increasing demand for them. In short, we expect government bonds to lag investment-grade credits, high yield and emerging markets debt.

Yield on local sovereign emerging markets debt



Source: Bloomberg, Robeco

The increasing scarcity of safe bonds



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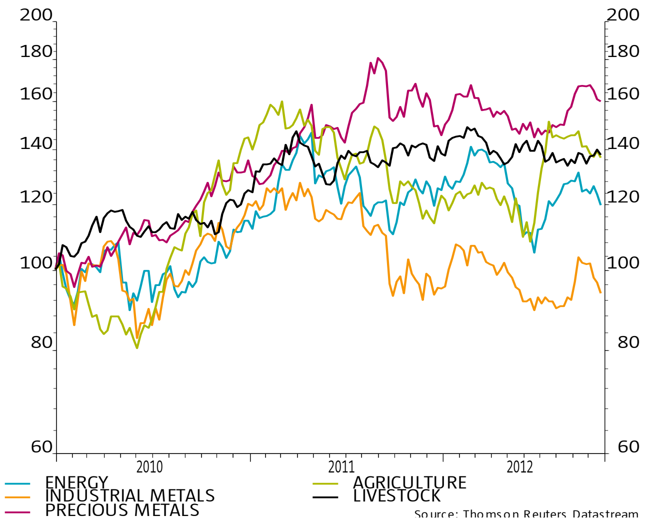
Commodities

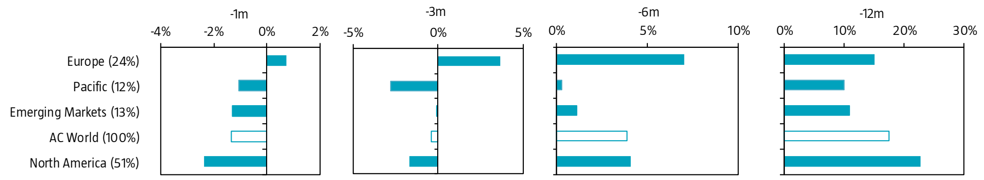
We rate commodities at neutral. Last month, most commodities experienced a mild correction. Waning political risk in the Middle East affected the oil price. We do not expect the correction to continue, given the minor positive surprises in producer confidence around the globe, particularly in the US and China. Such mildly positive economic surprises also make us think that the decline in industrial metals prices will not continue. Moreover, after the appointment of the next generation of leaders, China's economy is likely to accelerate. This would support commodity prices, given China's major role in the commodity markets. For commodities in general, we expect the flattish trading—as has occurred over the last 12 months—to continue.

Commodity spot prices (USD)



Regional allocation

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



Source: Thomson Reuters Datastream, Robeco

North America is our favorite region within equities. Our view is based on the macroeconomic situation, as valuation is high compared with the other regions and relative momentum is weakening. Earnings revisions are in line with the market. But there have been positive surprises in the US economy lately, which confirm our view that the US is performing better than Europe or Japan. Our conviction on emerging markets has been undermined by disappointing returns and weak earnings revisions. Still, we expect sentiment to turn. Economic growth in China should accelerate after the power change. Recent producer confidence data is already pointing to such an up-tick. Moreover, we believe that emerging markets are 10-15% undervalued compared with developed markets. As a result, we are giving emerging markets the benefit of the doubt. We are still a bit hesitant towards Europe. Austerity will negatively affect growth and economic weakness brings the risk that the euro will come under pressure again. Finally, we are negative on the Pacific due to economic weakness in regional heavyweight Japan.

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	5.8	10.7	9.9	-18.4	-24.0	12.7	14.4
Europe	-2.5	10.7	8.9	-25.9	-25.1	10.8	12.3
Pacific	24.3	16.0	21.0	-34.3	-43.9	12.3	15.6
Emerging Markets	3.9	12.9	11.4	-26.0	-11.0	10.2	10.7
AC World	5.0	11.6	11.1	-24.3	-23.7	11.8	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

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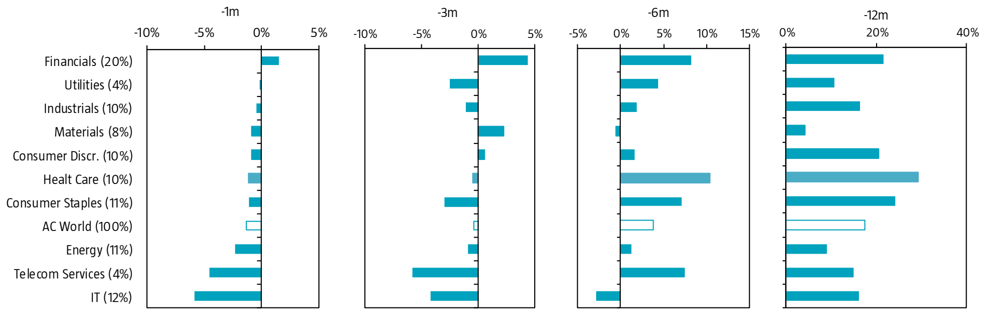
Performance of sectors (MSCI AC World unhedged EUR; index weights between brackets)



Source: Thomson Reuters Datastream, Robeco

We have a preference for defensive sectors, which is based on our baseline scenario of a muddling-through global economy. In the third-quarter earnings season, defensive equities have again suffered fewer downward earnings revisions than cyclicals.

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	7.4	4.5	-24.1	-26.1	9.9	11.3
Materials	-18.7	20.8	14.1	-50.4	-45.7	11.6	12.4
Industrials	7.1	11.3	11.2	-48.2	-43.6	12.0	14.5
Consumer Discr.	38.2	12.6	19.4	-18.1	-30.7	12.5	15.6
Consumer Staples	5.6	9.9	9.7	-14.9	-11.5	15.5	15.8
Health care	3.1	7.2	6.7	-10.0	-7.1	12.9	14.7
Financials	9.7	11.9	11.7	-2.6	-0.7	10.3	11.4
IT	10.7	14.9	13.6	-30.4	-24.5	12.1	17.3
Telecom Services	0.7	9.2	8.0	-11.6	-5.1	12.2	16.5
Utilities	14.6	14.7	14.7	-3.0	-18.6	14.6	13.5
AC World	5.0	11.6	11.1	-24.3	-23.7	11.8	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: 07 November 2012.
In our data tables, we do refer to calendar months.