Monthly Outlook

ECB action to offset global economic decline

In this issue

Financial Markets Research:
Léon Cornelissen
Ronald Doeswijk

Highlights

- The world economy is struggling. Across the globe, manufacturing is showing weakness. China is slowing, negatively affecting the global economy. The European recession is widening. The ECB has brought down sovereign debt yields and—once again—the eurozone has bought some time. We expect central banks in developed markets to increase their use of unconventional measures.

- Emerging economies have plenty of room for conventional stimulus. Chinese policymakers have stepped up their stimulus measures and a rebound of the country's economy is likely in the second half of this year. We view the slowdown of the Chinese economy as primarily cyclical.

- We maintain our neutral stance on equities. The driving force behind the decent recent performance has been the growing conviction that the ECB would do whatever it took to save the euro. What the ECB delivered is very positive. But while liquidity issues have been addressed, solvency issues remain. Moreover, investors might start to worry about the deterioration of the economic outlook.

- In August, after a five-month winning streak, real estate lagged equities. The defensive characteristics provided by stable cash flows were less in-demand than in previous months. Real estate's valuation is a bit on the high side. 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.

- Credits and high yield continue to benefit from a high yield pick-up compared with government bonds. Moreover, we still believe there is room for spreads to fall further, especially for investment-grade credits. 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. Safe-haven demand is being negatively affected by the ECB's gradual assumption of its role as lender of last resort. However, economic data is weak, with risks on the downside. There is also a structural issue in the increasing scarcity of safe bonds.

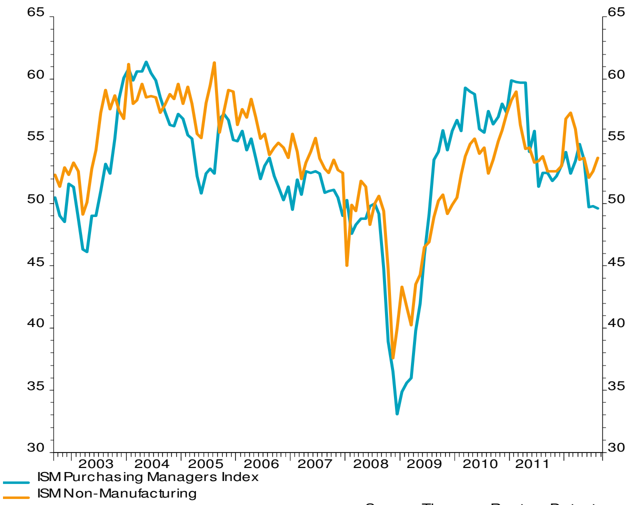
Macroeconomic view

Global economy

The world economy is struggling. Across the globe, manufacturing is showing weakness. Contrary to our expectations, the oil price has risen. China is slowing, negatively affecting the global economy: Japan and Australia are also declerating, for instance. The European economy is drifting into recession. The ECB has succeeded into bringing down peripheral sovereign debt yields and—once again—the eurozone has bought some time. We expect central banks in developed markets to increase their use of unconventional measures. Emerging economies have plenty of room for conventional stimulus. Chinese policymakers have stepped up their stimulus measures and a rebound of the country's economy is likely in the second half of this year. We consider the slowdown of the Chinese economy to be primarily cyclical.

North America

US ISM Manufacturing and Non-Manufacturing



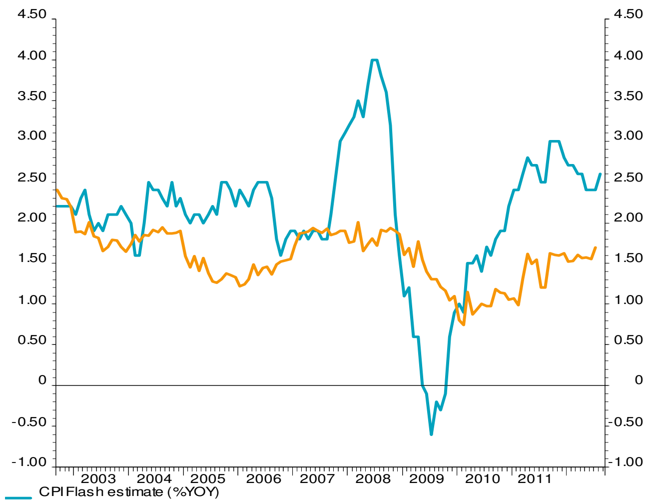
Source: Thomson Reuters Datastream

The overall US economy continues to expand at a slow pace, but the manufacturing sector has contracted slightly over the past three months (the ISM manufacturing gauge is still just below 50). The housing market is recovering. For the coming months, we expect positive, albeit very moderate, growth. The elevated oil price is hampering the economy. We expect the stalemate with Iran to linger, though no short-term escalation is expected, as a unilateral strike by Israel remains unlikely for both strategic and tactical reasons. At the Jackson Hole conference, Ben Bernanke, the chairman of the Federal Reserve, expressed his firm belief in quantitative easing. And the latest, disappointing non-farms payroll data means that the Fed looks more or less certain to resume quantitative easing (QE3) at its 13 September meeting. But the economic impact will probably be limited. The main 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 and will—eventually—become unsustainable. Neither presidential candidate has—as yet—come up with a convincing plan to address this issue. After the election, this theme will undoubtedly pop up.

Europe

The UK economy is struggling. The latest services PMI index was much higher than expected (53.7 for August), but data from the labor market and the retail sector were much less comforting. UK economic data is difficult to interpret due to the Olympics. Given this uncertainty, the Bank of England is expected to be on hold for the foreseeable future.

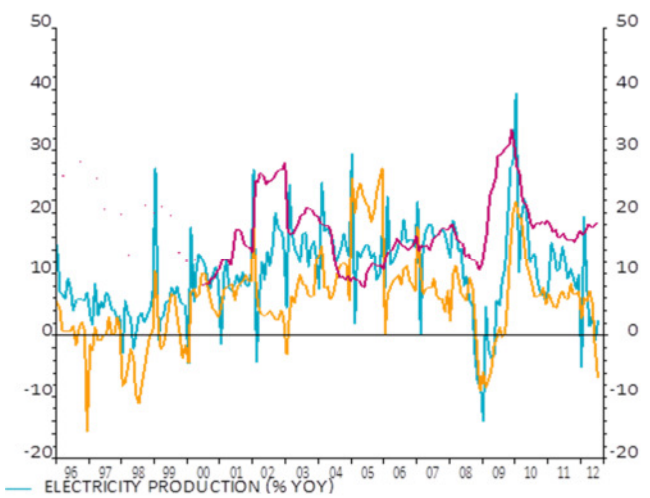
Eurozone headline and core inflation



The recession in the eurozone economy has broadened to reach the core. In the coming months, the ECB will probably lower the refi rate further. It is unlikely that the discount rate will be taken below the current 0.0%. A more important development, however, is the program of buying shorter-term sovereign debt to lower peripheral interest rates (involving potentially unlimited, sterilized purchases at the short end of the curve, though with no yield caps; buying will be on the basis of conditionality and the ECB will not claim seniority as a creditor). It remains to be seen if longer-term rates will be brought down sufficiently to bring Italy and Spain onto a sustainable path. Longer-term doubts about the solvency of Spain and political stability in Italy remain. But the eurozone has bought time, once again. Greece's continuing membership of the eurozone will be discussed by European leaders at the 18-19 October European Council meeting. A Grexit would be highly destabilizing, but could be unavoidable, due to Greece's weak compliance with its bail-out terms and a potential uncoupling by the IMF. We give Greece's exit a 50/50 chance.

Pacific

Li Keqiang's preferred indicators for the Chinese economy



Spreading economic weakness in the eurozone and China has led to a deterioration of the Japanese economy. Industrial production unexpectedly declined in July. Deflation remains firmly embedded, with CPI excluding food and energy stuck at -0.6% on a yearly basis for three months in a row. The bold move by prime minister Yoshihiko Noda to plan for a future VAT hike has backfired due to defections from his party and an unwilling opposition. The country faces ongoing political gridlock, limiting the government's room for maneuver. A general election in the coming months is becoming likely. The Bank of Japan has stalled its program of quantitative easing but will presumably resume in October. The Japanese economy will have a weak second half of 2012, possibly even sliding back into a mild recession.

The deceleration of the Chinese economy is also taking its toll on the second-largest developed economy in Asia, Australia. In this respect, BHP Billiton's decision to suspend its Olympic Dam mine expansion is illuminating. In Q2, Australian GDP growth slowed from 1.4% (QoQ) to 0.6%. The Reserve Bank of

Australia has plenty of scope for conventional monetary easing. Inflation has declined from 1.6% to 1.2% in the second quarter.

Emerging markets

The Chinese economy is slowing, as clearly indicated by the weakening of two of Li Keqiang's three preferred indicators. Anecdotal evidence suggests inventories are piling up. The government is stepping up its stimulus measures as expected. The central government is increasing investments in railways. Some local governments have announced large-scale investment programs, as newly appointed local leaders striving to make their mark. Inflation is in a clear downtrend, reaching 1.8% in July on a yearly basis. Some additional monetary stimulus should be expected in the coming months. All in all, the government is trying to increase the momentum of the Chinese economy over a broad front in a measured style, not a desperate one.

Though India's forward-looking PMI service industry index was upbeat in August (55 versus 54.2 in July), there is little question that the country's growth prospects are weakening. The monsoon has been disappointing, industrial production is declining and no policy initiatives are to be expected from the government. Inflation as measured by the benchmark wholesale price index is stubbornly high (6.9% for July), limiting the Reserve Bank's room for maneuver in cutting rates, but reductions will come through eventually. It is unlikely that overall GDP growth in 2013 will be less than 5%.

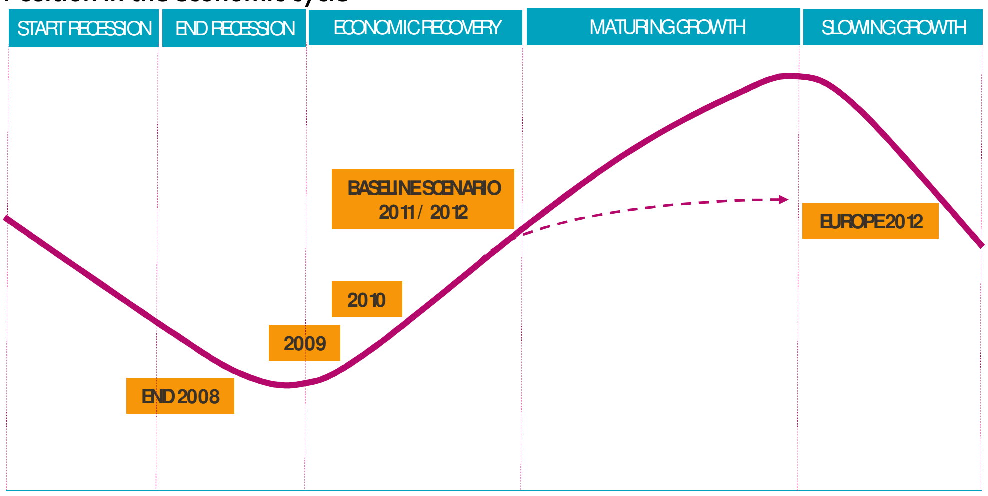
By cutting taxes and interest rates aggressively, Brazil's policymakers will probably succeed in speeding up growth. Inflation is on the rise, however, reaching 5.2%, making it likely that the central bank will remain on hold for the foreseeable future.

The Russian economy is also suffering from inflationary tensions, with CPI reaching 5.9% on a yearly basis. This is partly weather-related, due to the severe drought pushing up food prices. It is therefore not very likely that the central bank will hike rates. The oil-dependent economy will continue to grow at a reasonable rate.

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

Structural problems ←→ Cyclical

Recession (25%) | Sub trend growth (65%) | Traditional

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	2.1	0.1	=
Eurozone	1.5	-0.5	0.3	0.0	-
UK	0.8	-0.2	1.4	-0.3	-
Japan	-0.7	2.5	1.4	0.0	=
China	9.2	7.9	8.3	-0.1	=
India	6.5	6.1	7.1	-0.3	-
Brazil	2.7	1.9	4.0	0.0	=
Russia	4.3	3.8	3.7	0.0	+
World	2.4	2.2	2.5	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	2.3	1.7	0.0	=
UK	5.3	3.0	2.4	-0.1	=
Japan	-0.3	0.1	0.0	-0.1	=
China	5.4	2.8	3.4	-0.2	=
India	8.3	8.7	7.6	0.3	+
Brazil	6.5	4.9	5.4	0.0	+
Russia	6.1	6.3	5.7	0.0	=
World	3.3	2.5	2.3	0.0	=

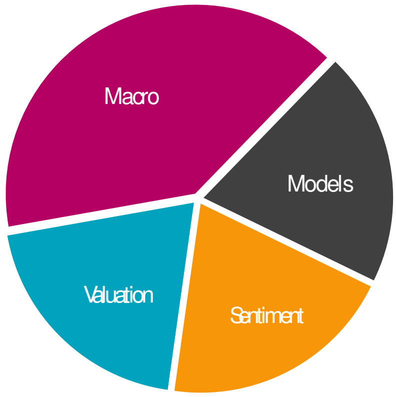
* indicates whether we expect a higher (+), matching (=) or lower (-) inflation rate than the current consensus estimate for 2012

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.

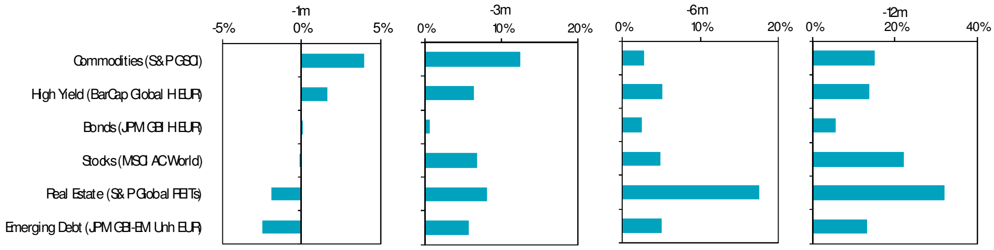
Input factors for our investment policy



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)

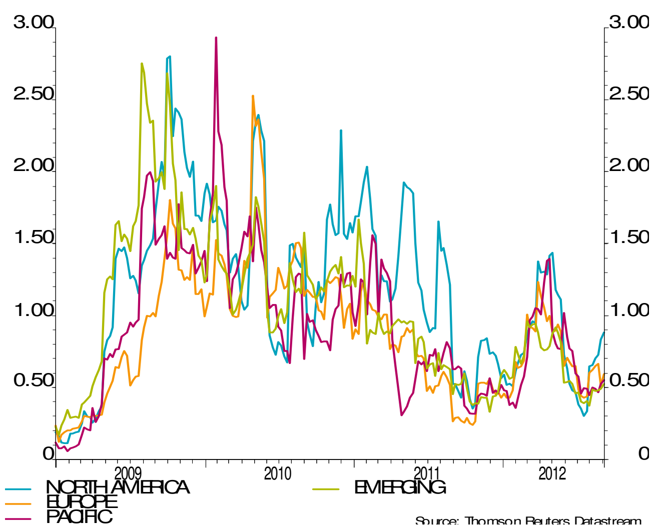


Source: Thomson Reuters Datastream, Bloomberg, Robeco

Equities

We maintain our neutral stance on equities. Stocks have performed strongly despite the ongoing flow of 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 double-digit growth dreams have vanished. In the face of all of these negatives, the driving force behind the decent performance has been the growing conviction that the ECB would do whatever it took to save the euro. What the ECB has delivered is very positive. But even though liquidity issues have been addressed, solvency issues remain. Moreover, investors might start to worry about the deterioration of the economic outlook. To illustrate this decline, as recently as June economists were forecasting economic growth of 0.8% for the eurozone in 2013; now, they expect 0.3%. Furthermore, worries about China are on the rise

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

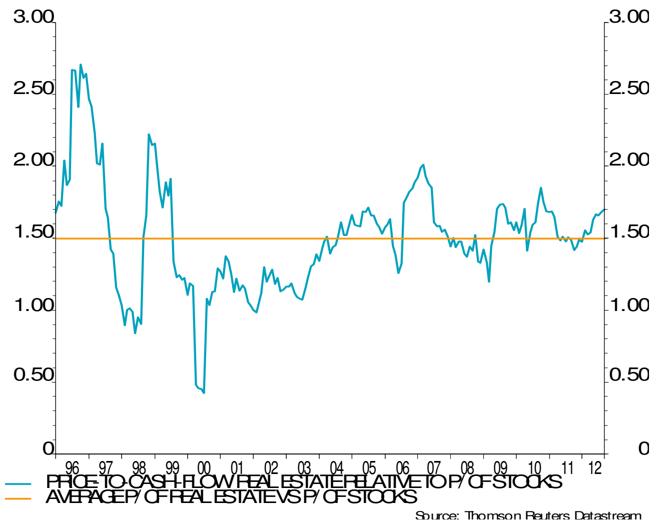


and the US economy is not doing particularly well. So although the ECB is acting like a true lender of last resort, we doubt whether this will be enough for an ongoing rally in equity markets. We thus remain neutral on equities.

Real estate

We rate the outlook for real estate as neutral. After a five-month winning streak, real estate lagged equities in August. The defensive characteristics provided by stable cash flows were less in-demand than in previous months, as investors became more positive on the back of Mario Draghi's promises to do everything necessary to save the euro. 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.

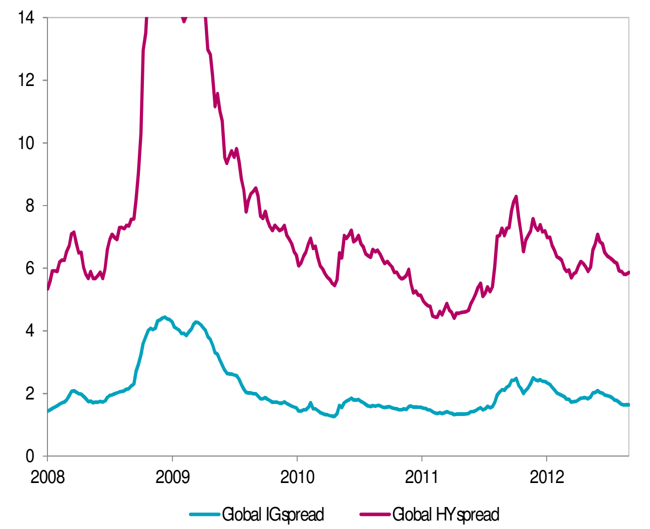
Valuation of global real estate versus equities



Credits and high yield

Credits and high yield continue to benefit from a high yield pick-up compared with government bonds. Moreover, we still believe there is room for spreads to fall further, especially for investment-grade credits. Corporate fundamentals are strong, while companies remain conservative and have high cash balances. These are positives for bondholders. As for 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. We think these positives outweigh negatives such as so-called "asset encumbrance" (where there are fewer assets available to unsecured bond holders in the event of default because collateral has been pledged elsewhere, as with covered bonds, for instance) and bail-in measures. As a result, we keep our positive view, particularly on investment-grade credits.

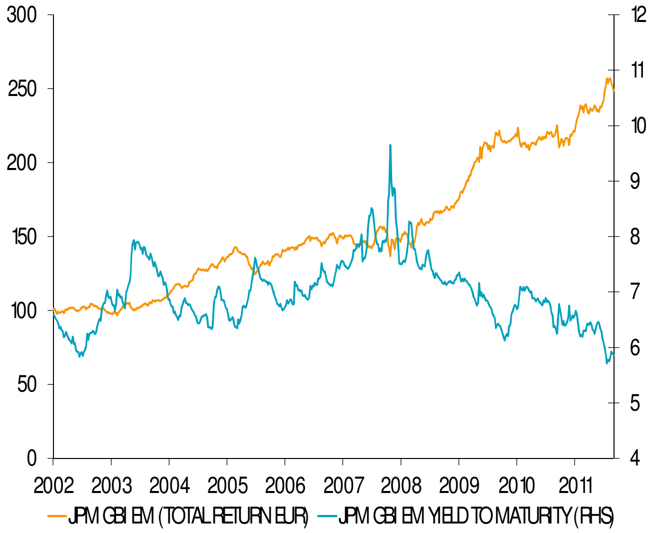
Global spreads for investment grade and high yield bonds



Emerging debt

Like credits and high yield, the prospects for emerging debt are better than those for government debt. Across the globe, economic growth will decline in 2012. This is reducing inflationary risks. For next year, the consensus is for a moderate increase in economic growth. In a bid to stimulate economic growth, some emerging countries are 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. That said, fiscal deficits and debt-to-GDP ratios are low, which bode well for the future performance of emerging debt. Local-currency government bond yields of 5.9% are attractive compared with government debt from developed markets. However, we continue to prefer investment grade credits to emerging markets debt, as they offer a better risk/reward pay-off.

Yield on local sovereign emerging markets debt

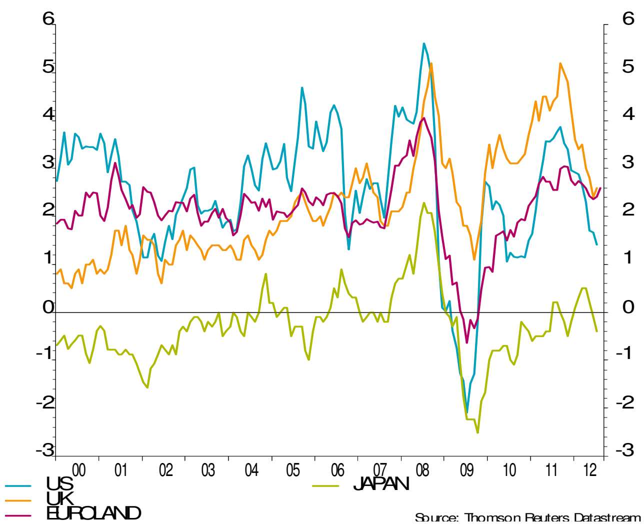


Source: Bloomberg, Robeco

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.

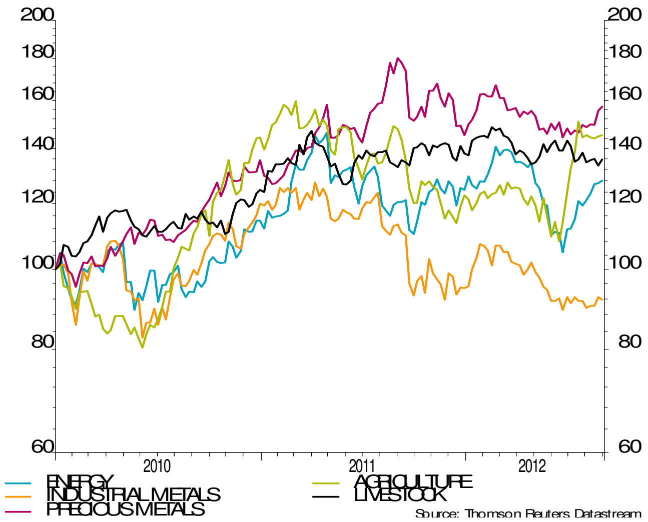
Headline inflation for major developed economies



Commodities

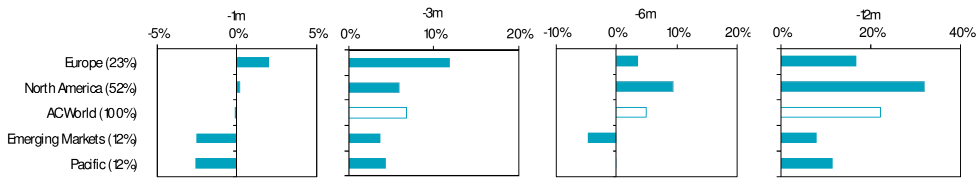
We expect commodities to move sideways. The macroeconomic environment is set to stay sluggish. China-related commodities, such as iron ore, continue to be vulnerable to disappointing growth. Even accelerating growth in China in the fourth quarter might not help, as stockpiles are high. Tensions concerning 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, our regional views became less outspoken in June, as our conviction concerning the ongoing underperformance of Europe was declining and we felt less comfortable with our positive view on emerging markets. Europe still trades at discount of close to 20% more than usual versus North America. Greece will probably be the next issue to come to a head, although negative surprises in Spain could also occur, given that the economy is weak and a bank-run is taking place. However, the ECB is doing whatever is needed to keep the euro together and we expect the eurozone central bank to continue this strategy. As a result, we are becoming less pessimistic on Europe. At the same time, our faith in emerging markets continues to weaken, thanks to disappointing performance and weak earnings revisions. We have fewer doubts about North America, while we remain hesitant towards the Pacific region.

Earnings and valuation data of regions (MSCI AC World)

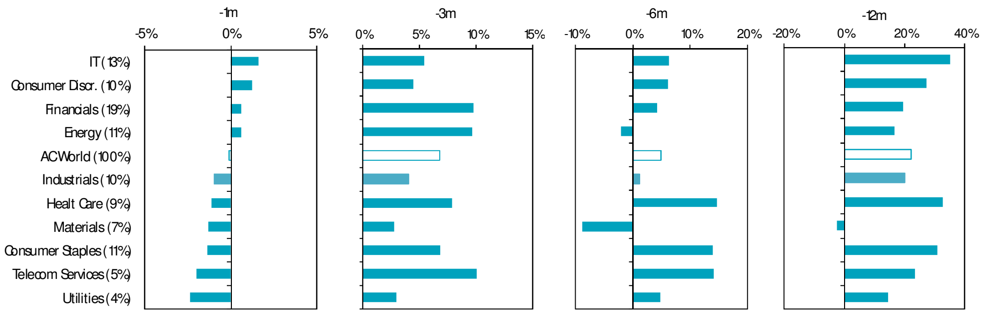
	Earnings growth (%)			*Earn. rev. index*			
	P/E on 12m fwd earn.						
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
North America	5.8	11.6	9.8	-27.6	-9.2	12.9	14.4
Europe	-1.7	12.5	8.2	-30.3	-32.1	10.8	12.4
Pacific	31.2	15.1	25.5	-30.6	-31.4	12.1	15.7
Emerging Markets	6.8	12.8	10.7	-38.6	-34.2	9.9	10.7
AC World	6.4	12.4	11.2	-30.9	-26.0	11.8	13.6

The earnings revisions index is calculated as the difference between the number of up- and downward revisions relative to the number of total revisions.

Source: Thomson Reuters Datastream, Robeco

Sector allocation

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



Source: Thomson Reuters Datastream, Robeco

We continue to have a slight 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 sectors (MSCI AC World)

	Earnings growth (%)			*Earn. rev. index*			
	P/E on 12m fwd earn.						
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
Energy	-9.0	7.7	3.4	-33.1	-13.8	9.9	11.4
Materials	-12.2	21.0	13.7	-60.8	-61.6	10.6	12.4
Industrials	10.2	12.4	12.8	-38.4	-49.5	11.6	14.5
Consumer Discr.	36.0	16.4	24.1	-16.5	-8.6	12.5	15.7
Consumer Staples	6.2	9.6	9.1	-21.4	-17.8	15.6	15.8
Health Care	2.9	7.8	6.8	-13.3	-16.9	12.6	14.8
Financials	10.3	11.6	11.5	-18.8	-5.6	9.9	11.4
IT	12.7	16.9	15.0	-38.3	-37.3	12.3	17.5
Telecom Services	1.4	9.1	7.4	-8.1	-19.0	12.5	16.9
Utilities	18.1	14.8	16.7	-8.5	3.6	14.4	13.4
AC World	6.2	12.4	11.5	-29.1	-24.2	11.6	13.6

The earnings revisions index is calculated as the difference between the number of up- and downward revisions relative to the number of total revisions.

Source: Thomson Reuters Datastream, Robeco

Closing date text: 06 September 2012.
In our data tables, we do refer to calendar months.

Important information