ROBECO

Monthly Outlook
Markets hesitant as economy struggles

In this issue

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Highlights

- The world economy continues to grow at a moderate pace. Uncertainty remains high, however. The main risk to the moderately benign outlook for the global macro picture is a renewed escalation of the eurozone debt crisis, which could easily be triggered by financial-sector problems in Spain, political troubles in Greece or a number of other potential catalysts. In the end, however, European policymakers have no choice but to get systemically important sovereigns back on track, one way or another.

- We believe the rebound in equity markets has come to an end. First, we are not expecting positive economic surprises. The global economy remains on a muddling-through trajectory. Second, first-quarter earnings figures are unlikely to drive up earnings revisions further. Third, the time of the year has started that has not, on average, delivered a risk premium in the past.

- We remain positive on equities in North America. The self-reinforcing process of job creation and consumption growth is at work. US earnings revisions continue to be the best of all four regions, with many US companies having beaten analysts' estimates. Momentum is higher than the market average. From both fundamental and quantitative points of view there are reasons to maintain an upbeat view on North American equities.

- While we also have a positive view on emerging markets equities, this view increasingly lacks quantitative support. Growth is not such a concern, but economic governance certainly is. Emerging markets' long-term fundamental outlook, which is less affected by aging than developed markets' and is supported by decent government finances, remains good.

Special: There is an interaction between the 'Sell in May' effect and the US presidential cycle. In election years, the seasonal effect weakens in the US but is stronger elsewhere. On balance, the US elections have almost no impact on the 'Sell in May' effect on the MSCI AC World index.

Macroeconomic view

The world economy continues to grow at a moderate pace. Uncertainty remains high, however. The US macro picture is mixed but on balance points towards reasonable growth. The Chinese economy has shown some signs of weakness. The eurozone debt crisis is far from solved and the ECB is implicitly increasing the pressure on European sovereigns by refusing to ease further. We believe that the US economy will continue to grow and that China will rebound. As a result, we are not too worried about Japan. The main risk to the moderately benign outlook for the world economy is a renewed escalation of the eurozone debt crisis, which could easily be triggered by financial-sector problems in Spain, political troubles in Greece or a number of other potential catalysts. In the end, however, European policymakers have no choice but to get systemically important sovereigns (those that are too big to be allowed to fail, such as Spain), back on track, one way or another.

North America

The US economy is doing rather well. Forward-looking indicators are pointing towards moderate, slightly-below-trend growth. The housing market is probably past the bottom now; indeed, it is beginning to show signs of recovery. The manufacturing purchasing managers' index (PMI) is trending upwards. And although the non-manufacturing index fell in April, at a level of 53.5 it still showed expansion. As a consequence, additional simulative measures by the Federal Reserve have become less likely. While fiscal tightening after the presidential elections in November looks unavoidable, no monetary tightening measures are likely for the foreseeable future.

Europe

Unexpectedly, the UK economy has slipped back into recession thanks to two successive quarters of negative growth. The PMI index in April for the services sector, which is relatively important in the UK economy, also suffered a worse-than-expected decline, falling from 55.3 to 53.3. Still, remaining above the 50.0 level points to at least a modest expansion. It is likely that the Bank of England will remain on hold for the foreseeable future after completing the additional quantitative easing decided in February. Harmonized CPI is in a clear downtrend.

Eurozone PMI and GDP (% change qoq)

Sources: Markit, Eurostat.

April's PMI indices for the eurozone suggest that the region will slide deeper into recession in the coming months. The four largest economies in the shared-currency area all suffered a decline in production. Weak demand and falling trade within the eurozone are taking their toll. Even Germany, which is benefiting from extremely low interest rates, experienced an unexpected deterioration in unemployment, signaling that even the largest economy in the eurozone is taking a hit. The relatively sharp declines in output in Italy and Spain were worrying, as they point to further divergence from the rest of the region. As a consequence, the risk premiums on these countries' long-term bonds have risen again. Some kind of bail-out for Spain seems inevitable, as its financial sector is in dire need of recapitalization. The ECB is unlikely to ride to rescue. Its instrument of intervention in the secondary bond market has been damaged after its Greek sovereign holdings received preferential treatment during the Greek restructuring. Meanwhile, the ECB will probably view an additional LTRO as premature at this stage. A more likely scenario is that the ECB will let Europe's politicians handle the Spanish problems, which will probably lead to rising tensions within the eurozone. The likelihood of Spain losing market access in the coming months and being pushed into the safety net is increasing. If Italy suffers from contagion, some kind of ECB action is inevitable, as it doubtful whether the current EFSF/ESM safety net could handle even Spain.

François Hollande's victory in the French presidential elections makes a shift in eurozone policy towards less austerity likely. The German Chancellor, Angela Merkel, is probably already anticipating the need to shift the CDU to a coalition with the SPD (a so-called "Grand Coalition") after the elections slated for 2013 (though they could take place earlier if her current coalition partners, the FDP, perform badly in the upcoming regional elections).

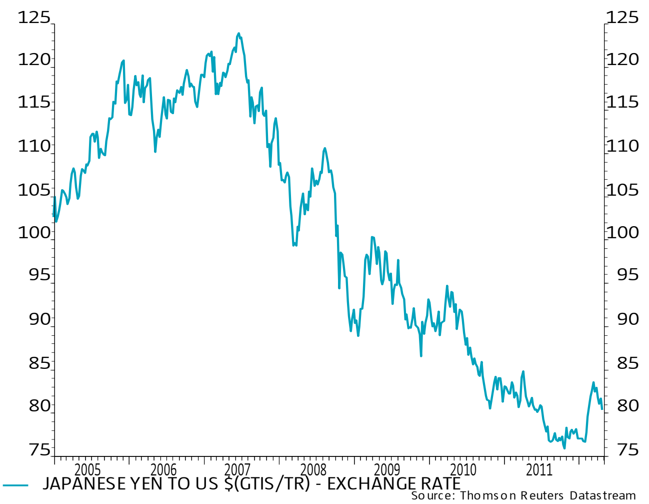
Other potential catalysts for renewed tension in the eurozone are the strategy chosen by the new Greek government for the EU and the Irish referendum on the new stability treaty at the end of May (though this treaty now has little practical importance after the Hollande victory and will have to be watered down and/or supplemented).

Eurozone inflation has declined slightly, with the flash estimate for April coming down a notch to 2.6%. Although the ECB will tone down its hawkish rhetoric, with inflation at this level the ECB is unlikely to implement any significant additional easing in the coming months.

Pacific

The Japanese economy continues to struggle. The manufacturing PMI for April was slightly lower than March, but the picture is generally flattish. CPI has moved into positive territory on a yearly basis, with a 0.5% reading in March. The central bank deliberately surprised markets with a larger-than-expected expansion of its asset-purchase & loan program, but it failed to quell doubts about its real commitment to stoking inflation, as it offered few clues about longer-term monetary policy. The yen has appreciated against the US dollar since mid-March, a move generally considered to be unwelcome. More limited easing measures by the Bank of Japan are likely in July. The Japanese economy should benefit from a stronger China in the second half of this year.

Yen versus USD



As a consequence of a positive surprise in the Australian inflation rate (headline CPI collapsed to 1.6% in the first quarter from 3.1% previously), the Reserve Bank of Australia (RBA) was able to cut interest rates aggressively, reducing its short-term rate by 50 basis points to 3.75%. In doing so, the Australian central bank is probably anticipating weaker demand from China, its largest export market. As we believe that the Chinese government has a lot of leeway to boost growth if necessary, the RBA's move looks panicky. We expect the RBA to be on hold for the foreseeable future. Economic growth should be stronger in the second half of this year.

Emerging markets

In emerging markets, much attention is given to developments in China. The Chinese economy has cooled down, but policymakers are loosening the monetary reins. If necessary, more will be done to re-ignite growth. We expect inflation to continue to drift downwards.

Confidence in India's macroeconomic management has deteriorated, prompting Standard & Poor's to lower its outlook to negative. India's investment-grade status is thus under threat, as its current BBB- rating is the lowest non-junk rating.

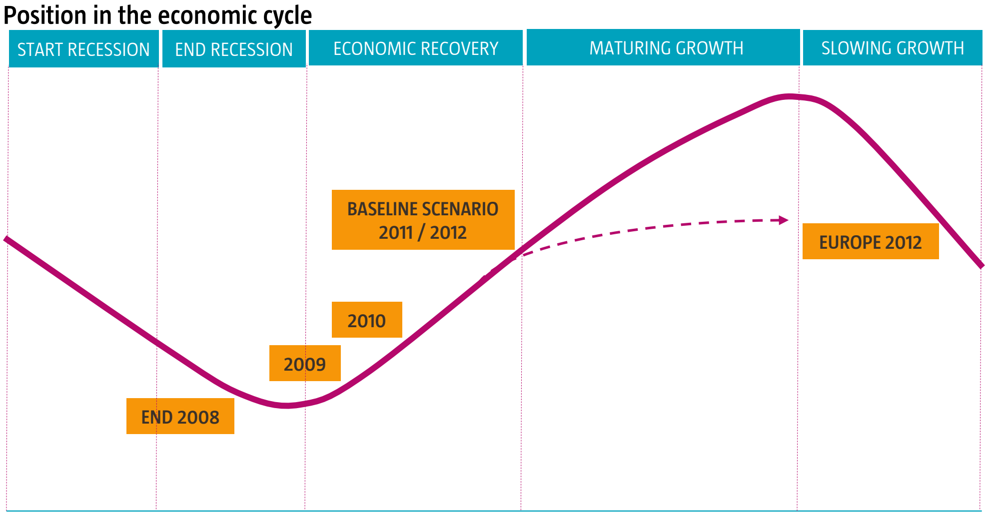
The Brazilian government is determined to cut interest rates further and weaken the real in order to spur economic growth and is thus neglecting inflationary risks. Protectionism and economic populism are on the rise in Latin America.

After the Putin victory in Russia's presidential elections, there is still no clarity about the configuration of the new administration or the policy initiatives it will pursue. In the meantime, the weakening of the price of oil is unwelcome news for the Russian economy.

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 will continue to be major themes this year. But whether this is cause for gloominess remains a pertinent question. The corporate sector is in a relatively strong position. While the Japanese economy is still in a recovery phase following the earthquake of March 2011, emerging markets as a group are contributing to economic growth, though doubts about economic governance are on the rise. Only in Europe is the current weakness more than a mid-cycle correction; the region is slipping deeper in recession, the extent of which will largely depend on further developments in the euro crisis.

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 the trend growth of the past. Our baseline scenario is therefore one of sub-trend growth (probability 70%), while we feel that there is currently a slightly increased 15% likelihood of a recession occurring. Due to relatively weaker economic data in April, we believe the probability of a traditional recovery has fallen from 20% to 15%.

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	2.3	2.5	0.1	+
Eurozone	1.5	-0.4	0.9	0.0	=
UK	0.7	0.7	1.8	0.1	=
Japan	-0.7	2.0	1.5	0.0	-
China	9.2	8.4	8.5	0.0	-
India	6.8	7.2	7.7	0.3	=
Brazil	2.7	3.3	4.4	0.1	=
Russia	4.3	3.7	3.8	0.2	+
World	2.4	2.3	2.9	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	2.3	2.1	0.1	=
Eurozone	2.7	2.3	1.7	0.1	=
UK	5.3	3.2	2.6	0.1	=
Japan	-0.3	-0.2	0.0	0.1	=
China	5.4	3.3	3.6	0.0	=
India	8.2	7.0	6.6	-1.4	+
Brazil	6.5	5.4	5.3	0.1	+
Russia	6.1	6.4	5.9	-0.2	=
World	3.3	2.6	2.3	0.0	=

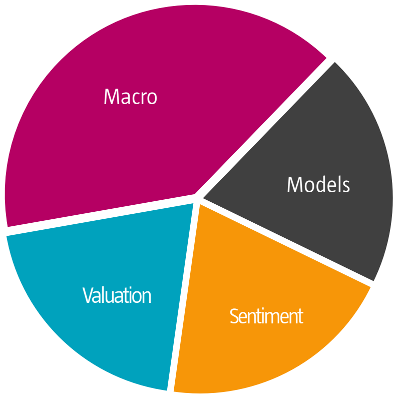
* indicates whether we expect a higher (+), matching (=) or lower (-) inflation rate than the current consensus estimate for 2012

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.

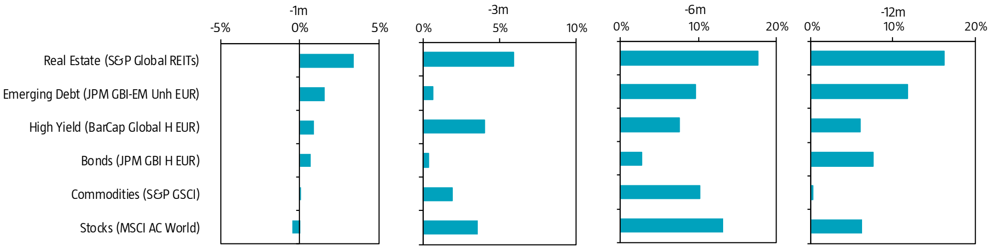
Input factors for our investment policy



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 they put too much weight on recent developments. Finally, we use quantitative models to steer our expectations.

Asset allocation

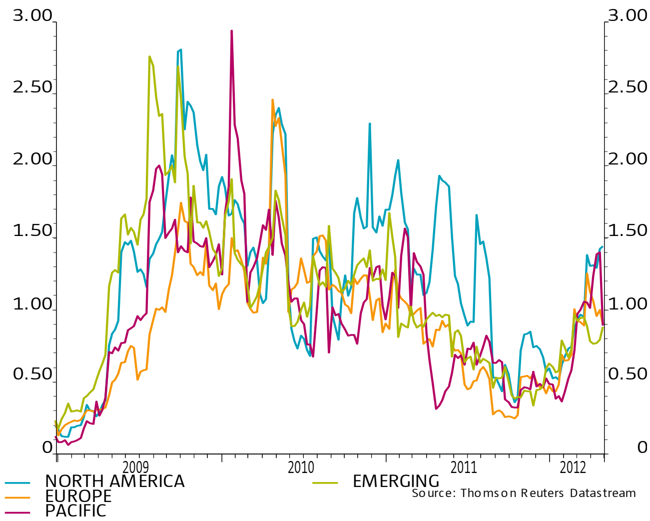
Performance of asset classes (gross total return in euros)



Source: Thomson Reuters Datastream, Bloomberg, Robeco

Equities

Earnings revisions MSCI AC World by region

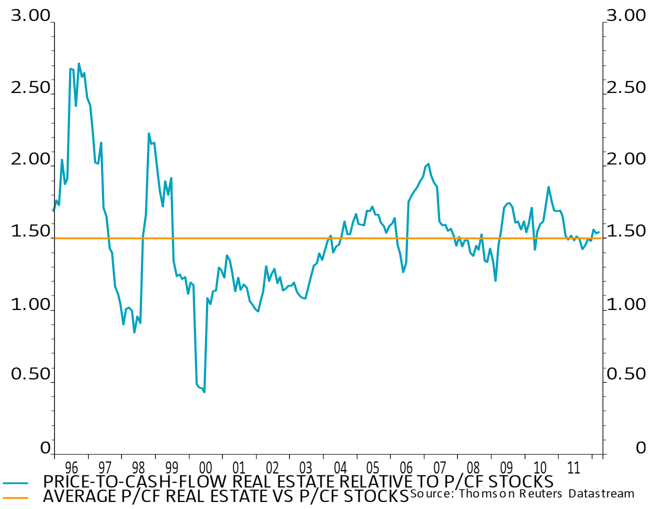


We believe that the rebound in equity markets that started in November has come to an end. The MSCI AC World index in euros is no longer in an uptrend. Last month, stocks fell by 0.5% and were the worst performing asset class, as shown in the chart above. We are not forecasting a renewed rise in the short term for three reasons. First, we are not expecting positive economic surprises. The US economy is doing fine, with continuing job creation and rising producer confidence. However, most recent producer-confidence data in Spain and Italy point to a recession, which in itself could re-ignite the debt crisis in the eurozone once again. Other regions continue to grow, but in the end the global economy remains on a muddling-through trajectory. Second, earnings figures for the first quarter are unlikely to drive up earnings revisions further. The exception is the US, where positive earnings surprises are outnumbering negative surprises. Third, the time of the year has started that has not, on average, delivered a risk premium in the past.

Real estate

Real estate and equities have a similar outlook. Last month, real estate had a surprisingly strong return of 3.4%, given the flat performance of equities. We attribute this difference to the fall of longer-term interest rates. With its relatively stable cash flows, real estate is a kind of long-duration equities class. As long as the global economy continues to grow at a moderate pace, low interest rates should benefit real estate. The price-to-cash flow valuation metric shows that real estate's valuation relative to stocks is in line with the historical average, as shown in the chart right. Based on a neutral valuation for the asset class and our belief that long rates will not fall further, we expect real estate to perform in line with equities.

Valuation metrics real estate relative to equities (x)



Credits and high yield

We expect the outperformance by investment-grade credits over government bonds to continue. As shown in the table to the right, investment-grade spreads (we focus here on the US due to its extensive historical data) are currently in their ninth decile. High yield spreads are in their seventh decile. We think valuation remains attractive for investment grade. Although high yield also offers high spreads in a historical perspective, many high yield bonds (half the US market) are close to price levels at which it is logical for the issuers to call their bonds, thus leaving limited potential for spread compression.

US historical interest rate spreads by decile (1987-2012)

Deciles	US credits	US high yield
1	0.67%	3.0%
2	0.77%	3.3%
3	0.88%	3.8%
4	0.94%	4.6%
5	1.02%	5.1%
6	1.25%	5.6%
7	1.56%	6.4%
8	1.75%	7.1%
9	2.06%	8.4%
10	6.07%	18.3%
Current	1.85%	5.74%
Average	1.34%	5.52%
Median	1.02%	5.07%

Source: Barclays, Robeco

Default rates are low and—in our baseline economic scenario—should stay low, given the ongoing growth in the global economy and the recession in the eurozone only being a mild one. Demand for credits is overwhelming. Allotment on new issuance in the credits arena is limited. Negative real yields on government bonds are driving this strong demand. We expect credits to outperform government bonds. This should also be the case for high yield, but the risk/reward ratio for high yield is less attractive than for investment-grade credits. High yield also has less room for spread compression.

Emerging debt

We prefer emerging markets debt to government bonds from developed markets, but our enthusiasm remains muted. We thus prefer investment-grade credits to emerging markets debt. The emerging debt asset class is benefiting from low government bond yields in the major developed countries and the moderate growth of the world economy. Inflation rates are coming down. In addition, in countries such as Brazil and Thailand, which have a significant weight in the emerging debt universe, most recent economic data points to decelerating inflation. The currency picture is mixed. The Brazilian real and the Indian rupee fell by 2-4% over the last four weeks as the central banks lowered interest rates by more than expected. India was also hurt by a warning from S&P that its sovereign rating could be downgraded. The market seems to have some doubts about the policy mix in emerging markets. In general, we expect currencies to play a neutral role. On the one hand, emerging countries might implement policy that is too loose in a bid to stimulate economic growth. On the other, developed countries are suffering from a debt crisis that has the potential to undermine their currencies relative to emerging currencies. In short, we continue to see local yields of 6.3% as attractive, but we prefer investment-grade credits, as the latter offer a better risk/reward pay-off.

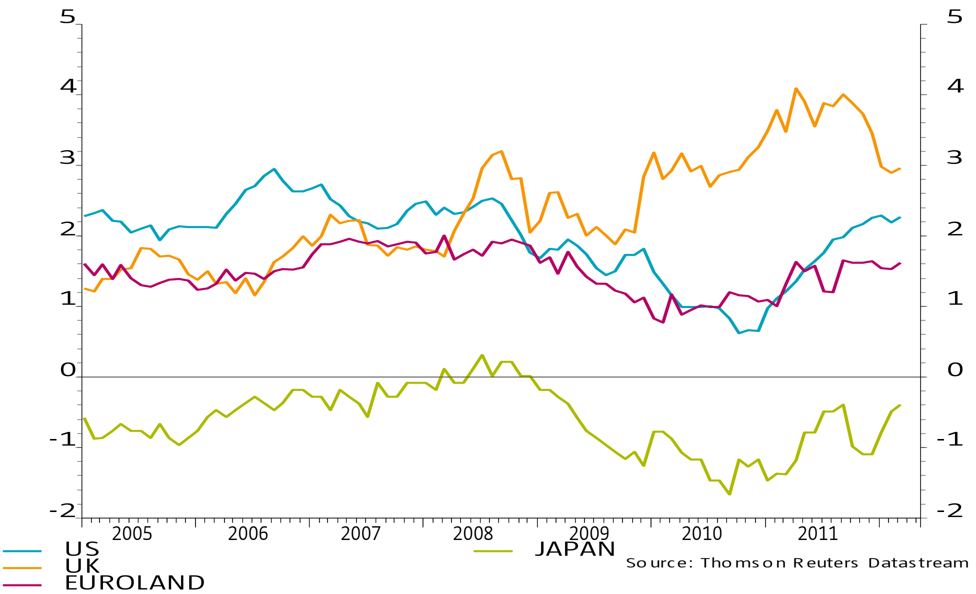
JPM GBI EM total return index and average yield to maturity

Source: Bloomberg, Robeco

Government bonds

Primarily based on valuation, we remain negative on government bonds. Sub-trend economic growth demands low interest rates, but sovereign bonds yields are at extremely low levels. We expect a normalization of bond yields in the years ahead. Given the attractive spreads for investment-grade credits, high yield bonds and emerging debt, compared with these asset categories the outlook for government bonds is weak. The negative real yields on sovereign bonds are driving demand for other bond categories.

Core inflation rates (%)



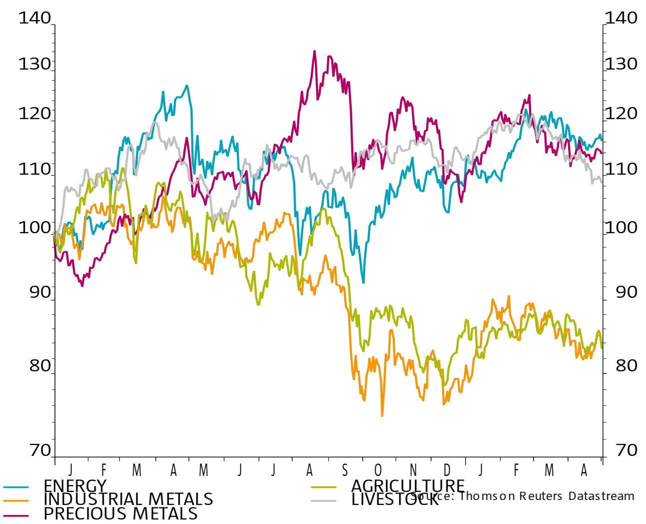
Source: Bloomberg, Robeco

Headline inflation in major markets has declined over recent months. On the other hand, core inflation remains in a two-year uptrend. Moreover, there are three reasons why inflation risks are on the upside in the medium term: quantitative easing, the aging of the population and the swift rise of the emerging middle class are factors that could well drive consumer prices higher a few years down the road.

Commodities

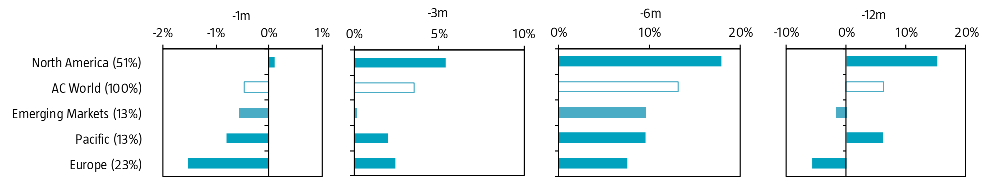
The spot prices of all five commodity categories have generally been drifting downwards over the last two months. Investors probably lost their appetite for commodities due to cracks appearing in sentiment regarding the emerging markets economic picture, especially China. Commodity prices are experiencing some pressure but we do not expect a significant correction, given the continuing moderate growth of the global economy. Oil stocks in the US are high, as are copper stocks in China, limiting the upside as well. A unilateral strike from Israel against Iran remains an unlikely threat. Our baseline scenario is that the world will learn to live with a nuclear Iran. Combined with the muddling-through scenario, we do not expect much from commodities in the months ahead.

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 offer the best investment prospects. The US economy is performing relatively well. According to consensus, economic growth is expected to come in at 2.3% in 2012. This seems to be a reasonable estimate. The self-reinforcing process of job creation and consumption growth is at work. US earnings revisions continue to be the best of all four regions, with many US companies having beaten analysts' estimates. Momentum is higher than the market average. From both fundamental and quantitative points of view there are reasons to maintain an upbeat view on North American equities.

While we have a positive view on emerging markets equities, this view increasingly lacks quantitative support. Growth is not such a concern, but economic governance certainly is. Emerging markets' long-term fundamental outlook, which is less affected by aging than developed markets' and is supported by decent government finances, remains good. Valuation should support the market. In addition, there is room for monetary easing, as seen in Brazil and India. But emerging markets are struggling to keep up with the return of the MSCI AC World index. Moreover, earnings revisions have disappointed for another month.

Equities in Europe and the Pacific region are unattractive compared with North America and emerging markets. The eurozone's mild recession is increasingly problematic for the southern periphery, as witnessed by the very low—and falling—producer confidence in Spain and Italy. We do not think that Europe is dirt cheap. Relative to North America, valuation indicators are some 10% below their historical averages. That is a positive for Europe, but it is not so cheap that it will set a floor for relative performance in the event that negative news flow continues. We remain cautious on the Pacific because of Japan. The country's economy is not particularly impressive, while the long-term outlook is being depressed by the sovereign-debt mountain.

Earnings and valuation data of regions (MSCI AC World)

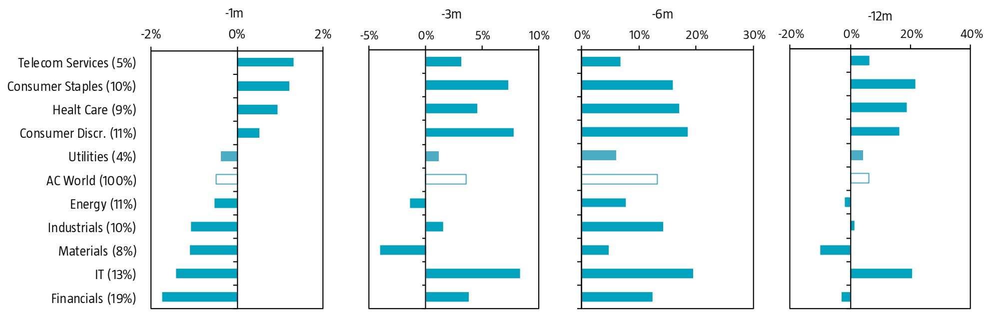
	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd earn.*	
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
North America	9.8	12.8	11.0	12.4	17.2	12.6	14.6
Europe	4.9	11.8	7.7	1.3	-0.2	10.3	12.7
Pacific	36.2	15.3	36.0	5.4	16.5	12.2	16.1
Emerging Markets	14.0	11.6	13.0	-11.1	-11.8	10.0	10.7
AC World	11.6	12.6	12.8	2.4	5.2	11.5	13.8

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 still have a slight preference for cyclical stocks above financials. In general, defensive sectors are becoming stronger than cyclicals. Last month, telecom, consumer staples and health care were the best performers. Industrials and materials join IT and financials at the bottom of the ranking over the last month. For financials, we find it hard to judge valuation due to changing business models and rising capital requirements. Given the lack of convincing relative momentum, we remain hesitant on the sector. Cyclical sectors are losing their appeal, although consumer cyclicals and IT seem to be an exception, based on their strong earnings revisions and their three-month performance. As a result, we have not altered our sector view at this stage.

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	2.5	8.6	4.4	-18.8	-23.1	9.2	11.7
Materials	5.5	16.2	11.5	-25.0	-23.1	10.4	12.7
Industrials	12.5	13.5	13.9	6.5	11.0	12.2	14.8
Consumer Discr.	35.5	17.5	34.1	30.0	31.8	13.1	16.0
Consumer Staples	8.0	10.4	9.4	-6.1	-3.1	15.3	15.9
Health Care	3.0	8.0	4.8	-3.3	9.9	12.1	15.1
Financials	14.7	12.4	14.2	13.4	20.0	10.0	11.5
IT	17.8	16.1	17.1	21.1	21.1	12.7	18.1
Telecom Services	3.6	8.8	5.4	-38.9	-37.7	11.5	17.8
Utilities	17.2	16.7	18.2	-24.5	-23.7	14.3	13.4
AC World	11.6	12.6	12.8	2.4	5.2	11.5	13.8

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

Special: ´Sell in May´ and the US elections

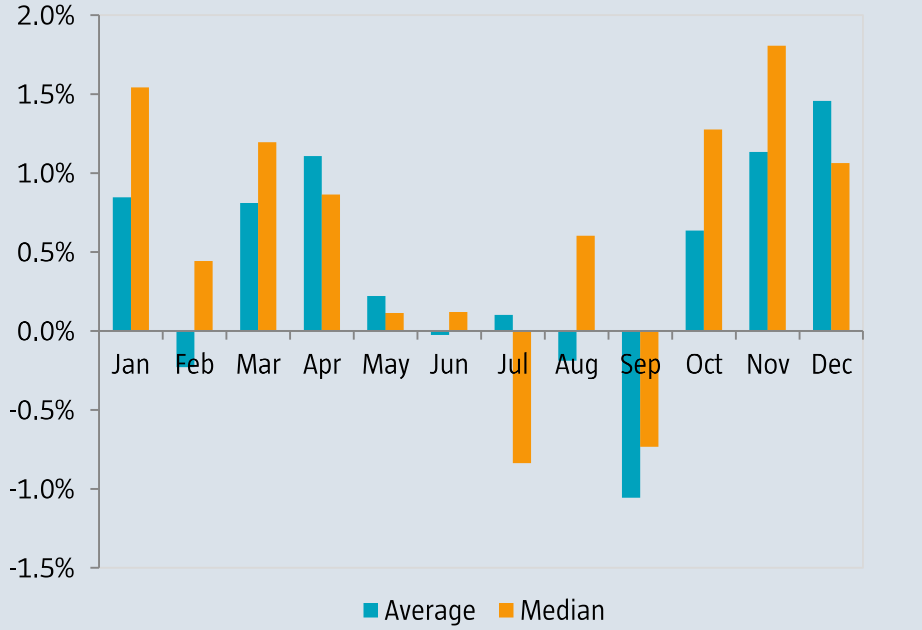
Thanks to a tweet from @IEXProfs, our attention was drawn to a contribution on the blogsite www.ritholtz.com which quoted research from Bianco Research. The conclusion was ´Sell in May, except in election years´.

We decided to dig into this for two reasons. First, there is academic support for the 'Sell in May' effect, as well as for the impact of the US presidential cycle. Second, we believe the 'Sell in May' effect has to do with a cycle in investors' optimism. Approaching the last months of the year, investors shift their attention to the following year, which gives room for an optimistic view of stock markets. As the following year progresses, it typically becomes apparent that such optimism was unjustified. This results in weak sentiment in the stock market in the summer. This explanation also gives scope for earlier optimism in election years, due to appealing campaign promises. That would explain a weaker seasonal effect in election years.

We have taken a look at total return data from 1970 for the US, the MSCI AC World index excluding the US, and the MSCI AC World index. All data are calculated as excess returns over cash. So we are actually examining risk premiums.

In all three series, there is a clear 'Sell in May' effect. As an illustration, the figure below shows the seasonal pattern for the US. The difference in risk premiums for the first four months and the two last months of the year on one side, and the months May through October on the other, amounts to 6.5%. For the World ex-US this is 12.1% and for the World it is 8.9%.

Monthly returns MSCI US (excess returns over cash)

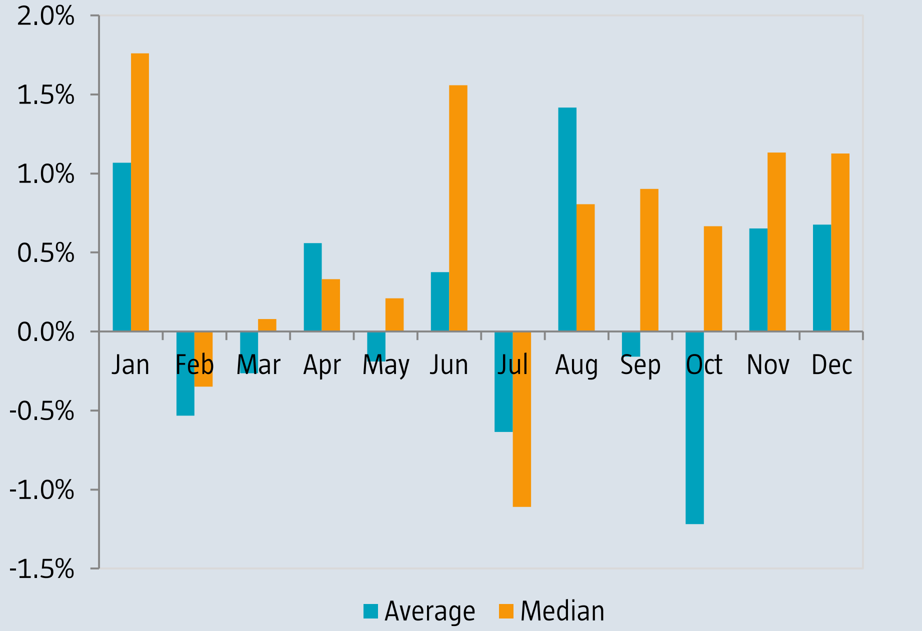


Source: Thomson Reuters, Robeco

Indeed, during the ten US election years, the difference in the US shrinks to 3.2% (see chart below for the monthly returns), while in the other 32 years in our sample the difference amounts to 7.6%. This suggests that the seasonal effect is itself affected by the

US elections. For the World ex-US these figures are 15.8% and 10.9%. Outside the US, then, the seasonal effect is extra strong in election years. For the World, there is no significant impact, with figures of 9.4% and 8.7%.

Monthly returns MSCI US in election years (excess returns over cash)



Source: Thomson Reuters, Robeco

These results suggest that there is a regional effect from US elections. During election years, the US is the place to be and the seasonal effect is weakened. This is in line with the presidential cycle, which shows that the first year after the elections is the worst one.

The probability that the US presidential cycle has an impact on the 'Sell in May' effect by coincidence is 18%. For an academic, this is rather high; 5% is the usual mark. However, the number of observations in our sample is limited. As such, practitioners should not be put off by that 18%. These results suggest that North America will continue to outperform other regions. In addition, for the world as a whole the 'Sell in May' effect is hardly affected by the US elections. So from a seasonal point of view, one should expect weak stock-market returns in US election summers.

Closing date text: 04 May 2012.
In our data tables, we do refer to calendar months.

Important information