ROBECO

# Monthly Outlook
# World economy inching forward

**In this issue**

Highlights 1
Macroeconomic view 2
Financial markets outlook 6

Financial Markets Research:
Léon Cornelissen
Ronald Doeswijk
Peter van der Welle

## Highlights

- The world economy is showing a loss of momentum, but forward indicators are generally still pointing towards a modest expansion. Inflation is coming down unexpectedly fast, pushing central banks towards further easing.

- We maintain our positive view on equities. Earnings have been more or less flat for a year now. This supports our view that artificially low interest rates are the main driving force behind the rally in risky assets. We do not anticipate quantitative easing to moderate in 2013. As equity valuations are still in neutral territory, this bodes well for performance.

- The investment perspectives for real estate also remain good. Last month, global REITS added 3% and over the last three months this figure is as high as 14%. This strong performance is primarily driven by low interest rates, which enables refinancing at lower cost and encourages investors to pick up yield in asset classes other than government bonds. The earnings outlook is more realistic for real estate than for equities, but valuation is less attractive.

- We maintain our positive view on emerging market debt relative to developed market debt. Emerging market debt will remain vulnerable to a further deterioration in the global macro environment, but the global search for yield and risk appetite will remain factors that dominate activity in emerging market debt as the carry remains high.

- All defensive sectors have outperformed the market over one- and three-month periods as artificially low interest rates remain the main factor behind the equity market rally. Earnings revisions are more favorable in defensive sectors than cyclical sectors. Finally, the relative performance of defensive sectors tends to be strong in the May through October period. In short, we expect the outperformance of defensive stocks to continue.

Special: The chance of a negative return is 44% during the summer (May-October), and 26% during the winter (November-April). Investors should think about the 'Sell in May'-effect as a series of months with an increased likelihood of (un)attractive returns.

# Macroeconomic view

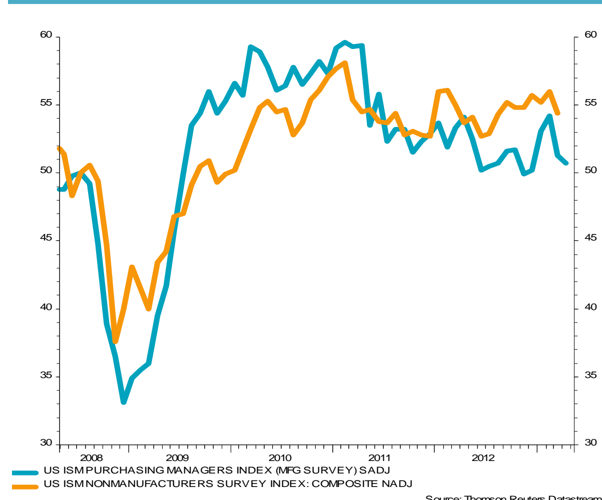
### Global economy

The world economy is showing a loss of momentum, but on balance forward indicators are generally still pointing towards modest expansion. Inflation is falling unexpectedly fast, pushing central banks towards more easing.

### North America

The US economy has been expanding at a slower pace this month. The leading ISM manufacturing index declined from 51.3 in March to 50.7 in April, but the underlying movement is more favorable than the headline figure suggests. The inventory component continued to decline, indicating higher demand. Manufacturing input prices also declined as commodity prices fell further this month. Inflation expectations in the US eased accordingly and inflation came out at 1.5%, well below the central banks 2.0 percent target. Labor market data now more convincingly point to an ongoing recovery, with positive adjustments to job creation in March and 165,000 new jobs created in April. US unemployment declined to 7.5%. The private payroll tax that formed part of the sequester deal earlier this year is still restraining economic growth in Q2. The Fed has expressed concern about belt-tightening in Washington and sees fiscal drag hampering the ongoing labor market recovery. In response, Bernanke stated that the Fed is 'prepared to reduce or increase the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes '. This opens the door to further QE and represents a nod to the doves within the Federal Open Market Committee, but also demonstrates a remarkable degree of flexibility in the recent forward guidance policy. Although the statement sounded balanced with regard to the pace of QE, in fact it was skewed towards a more adverse economic scenario. We therefore think that a reduction in QE is effectively being further postponed to sustain the US recovery and will only occur later in 2014.

**US: manufacturing and non-manufacturing ISM indices**



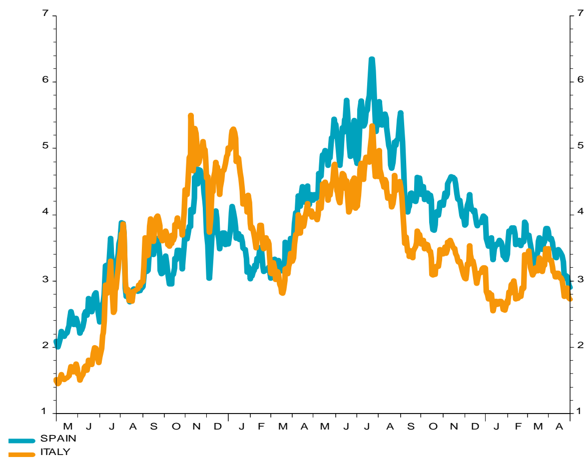

Source: Thomson Reuters Datastream

### Europe

First quarter GDP growth in the UK surprised on the upside with 0.3% q-o-q, but business surveys imply that growth remains weak. The latest producer manufacturing index came in at 49.8, pointing to a slight contraction in economic activity. The BOE is increasingly shifting its policy focus away from QE towards other more unconventional measures in an effort to stimulate lending to the real economy. This month the bank increased the scope and duration of its Funding for Lending Scheme, a program intended to increase lending to SMEs. The results have been disappointing, although there is evidence of some credit easing for small companies. As Mark Carney replaces Mervyn King as BOE Governor in July, we see a greater likelihood of a policy shift towards other easing options like cutting the remuneration rate on central bank reserves coupled with more explicit guidance.

In Euroland the most striking development is the weakening of the German economy. Since February, German producer confidence has fallen rapidly. The periphery remains stuck in a recession, but so far the economy there is not weakening further, although unemployment, a lagging indicator, is still on the rise. The political consensus is shifting towards placing less emphasis on austerity measures and more on structural reform. Selected countries have been given an extension to reach the 3% budget deficit target. The problem with this inevitable policy change is the lack of desire for true reform (France) and large implementation risks (Italy). But the Eurozone has once again bought itself more time. The new prime minister of Italy, Enrico Letta, leader of a probably feeble grand coalition, has pledged to keep his budgetary promises, while scrapping the unpopular property tax and refraining from an earlier planned VAT-hike, but has not indicated how this will be funded. This uncomfortable balancing act could easily go on for some time and will postpone a test of just how conditional the ECB's OMT program really is.

**Ten-year yield spreads vs. Germany (%)**




Inflation is falling rapidly. The flash estimate in April reached a level of 1.2% on a yearly basis, significantly lower than the ECB's target. On 2 May, the ECB lowered its refinancing rate by a modest 25 basis points, while leaving its deposit rate unchanged at 0%. The overall impact of this measure will be limited. The ECB prefers to remain behind the curve and to refrain from drastic, unconventional measures. It continues to predict an economic recovery later this year, although conceding that the risks are mainly on the downside. We expect the Eurozone economy to deteriorate further in the coming months and deflationary risks to increase. At some point, it is inevitable that the ECB will implement additional modest easing measures, possibly including a negative deposit rate, as hinted at by Mario Draghi.

Although risk premiums on peripheral bonds have come down vis-à-vis Germany, we consider it likely that the European debt crisis will flare up again later this year as a consequence of disappointing budgetary developments, lack of convincing structural reform and rising social and political tensions. Institutional progress in Europe is slowing, with Germany taking an ambiguous approach towards the creation of a full banking union, hinting on earlier proposals about time-consuming treaty changes.

## Pacific

On April 4, the Bank of Japan (BoJ) announced its stunning plans for a monetary boost. So far, this policy is working well and the BoJ has succeeded in increasing the monetary base. The yen has weakened against the US dollar to around the 100 level. The G20 has been supportive of the BoJ's measures. Household spending jumped 5.2% in March on a yearly basis, indicating the increased optimism among consumers Abenomics has created, and demonstrating the wealth effect resulting from the sharp rise in domestic stock prices. We expect the BoJ and Japanese authorities to pursue further yen weakening to push the country into inflationary territory. The main risk of these drastic policy measures are capital flight (which so far shows no signs of materializing, quite the reverse, in fact) and an increase in long term interest rates (ten year yields are currently hovering around a reassuring 0.55% level).

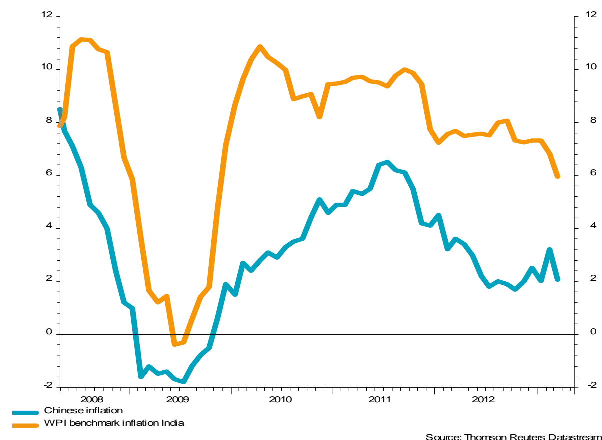
Australian CPI declined to 2.5% last month. The RBA has already cut its benchmark interest rate with 25 bps and  we stick to our view that further easing in Q2/Q3 is likely to stimulate growth.

Although the housing market is recovering (new home sales rose 4.2% m-o-m in March) with the exception of the mining sector, the economy is still struggling. This sector is also coming under more pressure as a result of a resilient Australian dollar and a slowdown in growth in Asia (China in particular). The resulting lower commodity prices depress input manufacturing prices and directly reduce the nominal pressure on the economy, opening the door for rate cuts.

## BRICs

In China, forward looking indicators point to slower economic growth. The Chinese authorities may lower their growth target for next year further from 7.5% to 7.0%, showing their acceptance of a lower structural economic growth path. Despite the slowdown, China is allowing the yuan to appreciate modestly against the US dollar. Inflation has been behaving itself, declining to 2.1% in March on a yearly basis.

**China and India: CPI (%)**




The growth momentum in India is slowing as well, but is still indicating economic expansion. Inflation is finally coming down, with the benchmark WPI breaching 6.0% on a yearly basis in March. Some further modest monetary easing is on the cards, following the May 3 rate cut of 25 bps. Room for policy easing remains modest however, partly due to the current account deficit.

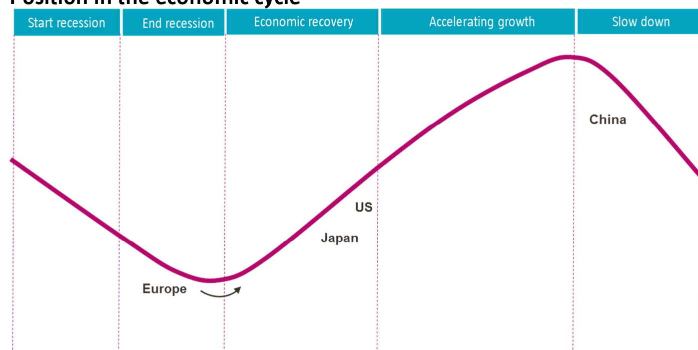
The Brazilian central bank raised its target interest rate by 25 basis points last month to mitigate the pressure of rising inflation. The breadth of price increases in the CPI basket caused some concern for the central bankers. On the fiscal side, the central government budget surplus came in below expectations in March, at 1.99% of GDP. Despite a lower surplus, government investment spending remains constrained. The government seems too complacent to invest in the infrastructure required to ease capacity constraints and thereby raise potential growth. Part of the underlying inflation pressure stems from capacity constraints. Further rate hikes later this year and healthy (infrastructure) investment, will be required to bring inflation under control.

The current backdrop of falling commodity prices and the ongoing shale gas revolution in the US do not bode well for Russia, which is dependent on oil exports. The latest trade balance figures for February showed a decline in exports. The ruble declined as export prospects for oil and gas later this year worsened against slowing global oil demand, especially from Europe, Russia's main export market.

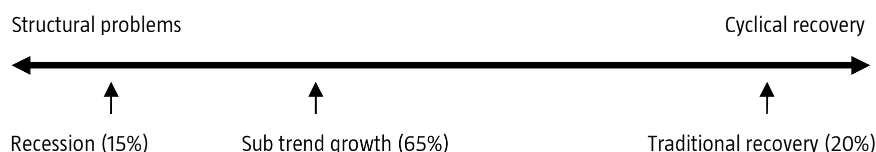
## Position in the economic cycle, macroeconomic scenarios & Robeco's view versus consensus

Global economic growth will be lower than trend due to structural problems. Currently we see a slowdown in global growth momentum. Our baseline scenario therefore remains one of below-trend growth, and we estimate its likelihood to be 65%. We continue to consider the likelihood of a global recession to be 15%. However, we maintain our forecast of 20% for the likelihood of a traditional recovery because of positive developments in the US economy and increasing optimism about Japan.

### Position in the economic cycle




### Macroeconomic scenarios




*Source: Robeco*

### Consensus estimates of economic growth and Robeco's expectations

| *GDP growth by region (%)* | *2012* | *2013* | *2014* | *Δ-1m 2013* | *Robeco** |
|---|---|---|---|---|---|
| US | 2.2 | 2.1 | 2.7 | 0.2 | = |
| Eurozone | -0.5 | -0.4 | 0.9 | -0.1 | - |
| UK | 0.3 | 0.7 | 1.6 | -0.1 | - |
| Japan | 2.0 | 1.3 | 1.3 | 0.1 | = |
| | | | | | |
| China | 7.8 | 8.2 | 8.0 | 0.0 | - |
| India | 5.1 | 6.1 | 6.8 | 0.9 | = |
| Brazil | 1.0 | 3.1 | 3.7 | -0.1 | - |
| Russia | 3.4 | 3.3 | 3.8 | 0.1 | - |
| | | | | | |
| World | 2.0 | 2.1 | 2.8 | 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 (%)* | *2012* | *2013* | *2014* | *Δ-1m 2013* | *Robeco** |
|---|---|---|---|---|---|
| US | 2.1 | 1.9 | 2.1 | 0.1 | - |
| Eurozone | 2.5 | 1.7 | 1.6 | -0.1 | - |
| UK | 3.2 | 3.4 | 3.1 | 0.1 | + |
| Japan | 0.0 | 0.1 | 1.9 | 0.0 | + |
| | | | | | |
| China | 2.6 | 3.2 | 3.5 | 0.1 | - |
| India | 9.8 | 8.2 | 7.4 | -1.5 | = |
| Brazil | 5.8 | 5.6 | 5.5 | 0.0 | = |
| Russia | 6.6 | 5.9 | 5.5 | 0.0 | = |
| | | | | | |
| World | 2.6 | 2.3 | 2.5 | 0.0 | - |

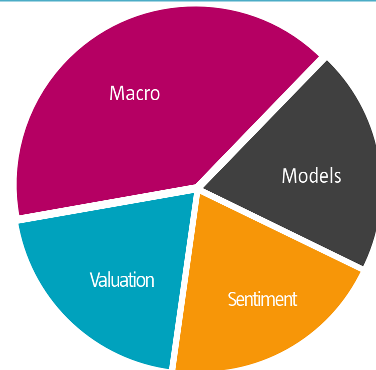
* indicates whether we expect a higher (+), matching (=) or lower (-) inflation rate than the current consensus estimate for 2013

*Source: Consensus Economics, Robeco*

# Financial markets outlook

Our expectations are based on qualitative and quantitative analyses. Our starting point is to 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. This macroeconomic analysis determines our initial preference in terms of assets.

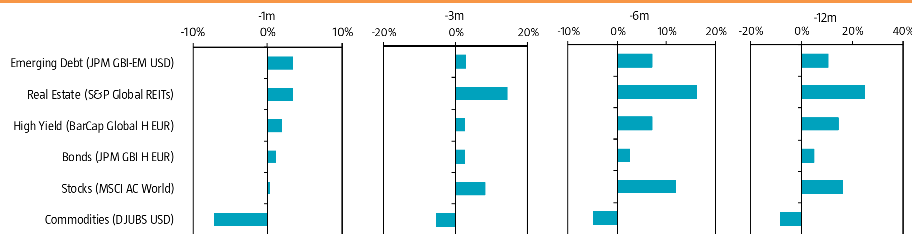
**Input factors for our investment policy**




Next, we challenge our macro analysis with input from financial markets. Here, we take valuation into account as, at extreme levels, this might cause the performance of an asset class to change direction. 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)**

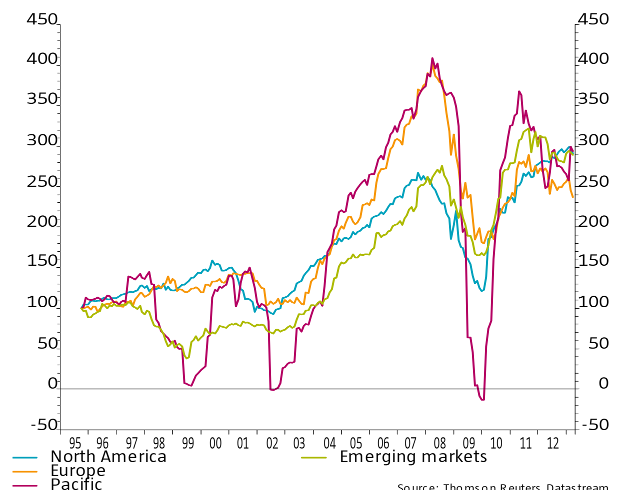



*Source: Thomson Reuters Datastream, Bloomberg, Robeco*

### Equities

We maintain our positive view on equities. So far, the earnings season is not very different to that of the past few years. Earnings tend to beat consensus estimates, while sales have trouble beating analysts' expectations. This is probably the result of companies providing more guidance on earnings than on sales estimates; perhaps they care less about sales as these are less important. Meanwhile, earnings have been more or less flat for a year now, as illustrated in the chart. This strongly supports our view that artificially low interest rates are the main driving force behind the ongoing rally in risky assets. We do not anticipate quantitative easing to moderate in 2013. As the valuation of equities can still be characterized as being in neutral territory, this bodes well for their performance in the near future. However, investors should be aware that returns in summer tend to be low. The main risk factors for the positive sentiment are European politics and economic data in the Eurozone.

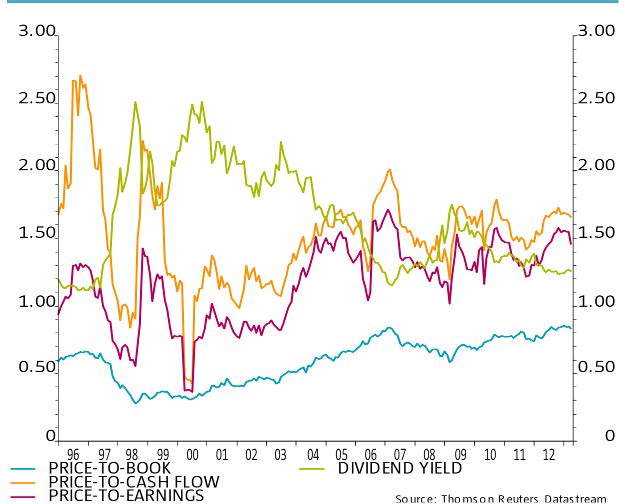
**Earnings indices by MSCI regions (USD)**



## Real estate

The investment perspectives for real estate also remain good. Last month, global REITS added 3% and over the last three months this figure is as high as 14%. This strong performance is primarily driven by low interest rates, which allows refinancing at lower rates and encourages investors to pick up yield in asset classes other than government bonds. The earnings outlook is more realistic for real estate than for equities. Therefore, earnings revisions for equities remain negative while they are well balanced for real estate. There is one clearly negative factor. Real estate's valuation is unattractive compared to that of equities. To illustrate, Japanese REITs rose 48% in the first quarter. This means that prices are now 50% above their net asset value. A wide range of indicators point to overvaluation of global real estate relative to equities.

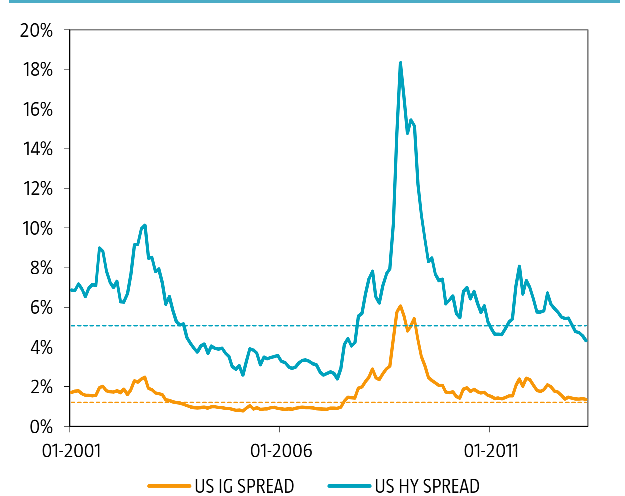
**Valuation of global real estate versus equities' (x)**




## Credits and high yield

The outlook for both credits and high yield is positive, but we have a preference for high yield as running yields there still offer decent absolute returns in the current low-interest-rate environment. For both asset classes, yield spreads are currently close to the historical median. We expect spreads to tighten further as a result of financial repression. We are not overly concerned about a possible wave of aggressive takeovers or leveraged buy-outs in this environment of moderate economic growth. When one compares high yield to local currency emerging market debt, it appears that spreads for high yield have come close to those for emerging market debt which mostly has an investment grade rating. So, one could summarize the difference as a choice between a lower rating (HY) and currency risk (EMD). We like both asset classes.

**Spreads for US credits and high yield, and their long term medians**

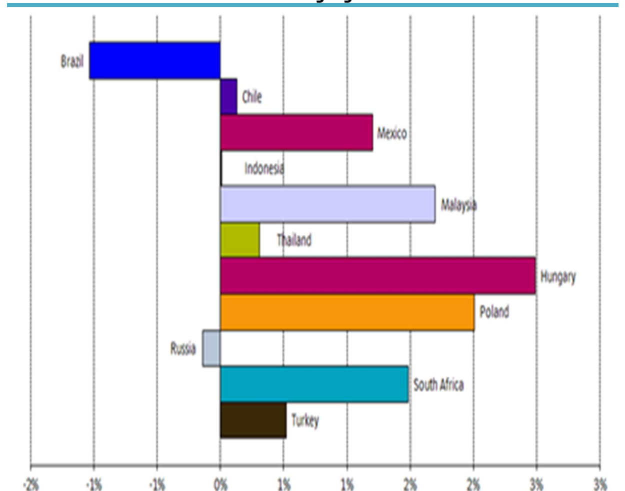



*Source: Bank of America ML, Robeco*

## Emerging market debt

We remain positive on emerging market debt relative to developed market debt. Emerging market currencies appreciated last month after disappointing returns over the past months. Inflation fears in EM have eased as commodity – and food prices, an important item in EM consumption baskets, have fallen. The decline in inflation provides central banks with an incentive to use the remaining room at their disposal to lower interest rates as the end of an easing cycle comes to an end. EMD spreads compressed by around 20 bps, but the growth slowdown in China and lower commodity prices will keep further spread compression moderate in the near term. Emerging market debt will remain vulnerable to a further deterioration in the global macro environment, but the global search for yield and risk appetite will remain factors that dominate activity in emerging market debt as the carry remains high.

**One month dollar returns for emerging market currencies**

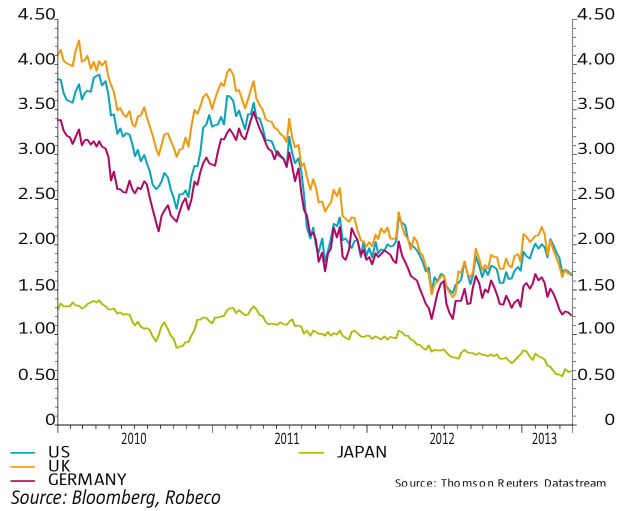



*Source: Bloomberg, Robeco*

## Government bonds

We firmly stick to our negative view on government bonds. On the back of moderate economic growth around the globe, an environment without short term inflationary threats and ongoing quantitative easing, bond yields continue to hover around record lows. In Japan inflation expectations have risen, but at 1.33% they remain below 2% on a five year horizon. As, in general, inflation expectations are well anchored and central banks are continuing to buy, rates will tend to remain at very low levels. This is positive for bond investors but these low yields do not offer the opportunity for decent returns. Although we do not expect a significant rise in yields, government bonds remain the least attractive asset category. We expect riskier assets to outperform government bonds.

**Ten year interest rates**

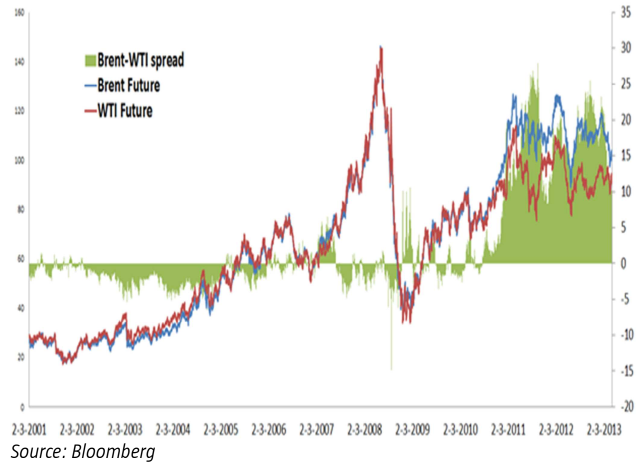



*Source: Bloomberg, Robeco*

## Commodities

We remain negative on commodities as the slowdown in the global recovery seems more persistent. China's leading manufacturing indices pointed to a further weakening in economic activity and consequently lower commodity imports. This does not bode well for basic metals, especially given the still high inventory levels. The outlook for energy in the near term is also less optimistic as the global demand outlook is deteriorating. The slowdown in demand from the Eurozone and China has caused Brent to fall, although this drop in demand carries a seasonal component. Upside surprises for oil prices could originate from geopolitical risk, e.g. further civil unrest in Iraq that could lead to a reduction in the oil supply from this increasingly important OPEC member. Natural gas prices increased as a result of exceptionally cold weather in March and stable production levels. Gold experienced a remarkable market correction of -14.7% on April 15. The outflows from gold ETFs that underpinned this correction will continue.

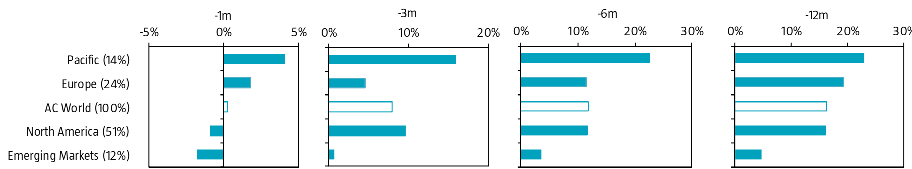
**Brent–WTI spread**




*Source: Bloomberg*

## Regional allocation

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




*Source: Thomson Reuters Datastream, Robeco*

North America continues to be our favorite region for equities as the economy is doing relatively well. An ongoing labor market recovery and an improving housing market are resulting in a self-

reinforcing economic recovery, despite some weakness in recent data and a disappointing first quarter GDP growth of 2.5%. In addition, we expect the Fed not to moderate its quantitative easing in 2013 and earnings revisions are above average following the first quarter reporting season for most companies. For the Pacific we have a neutral view. For Japan, the weaker yen is positive for exports and the prospect of quantitative easing has sent equities and REITs up sharply. At this stage we expect the yen to weaken further, but we refrain from taking a positive view on equities yet as we would like to see more evidence of an economic rebound to support the stock price rises. We are negative on Europe. The debt crisis in the Eurozone is the most important factor. Despite a new Italian government, Italy remains a political risk. Reforms will hardly come through. Moreover, economic data in the Eurozone continue to be weak. This is also reflected in poor earnings revisions. Economic data in emerging markets has been weak. Momentum has been lagging in the last few months. We do not anticipate an improvement of economic data and therefore we expect that the underperformance there could continue.

**Earnings and valuation data of regions (MSCI AC World)**

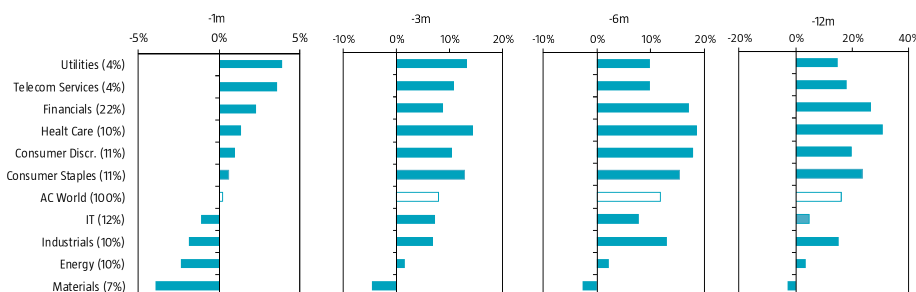
| | *Earnings growth (%)* | | | *Earn. rev. index* | | *P/E on 12m fwd earn.* | |
|---|---|---|---|---|---|---|---|
| | *FY1* | *FY2* | *12m* | *3m* | *1m* | *Current* | *10y avg.* |
| North America | 6.7 | 11.4 | 8.9 | -7.7 | -0.1 | 13.9 | 14.2 |
| Europe | 6.5 | 12.1 | 8.8 | -21.2 | -32.0 | 12.0 | 12.2 |
| Pacific | 27.8 | 11.9 | 28.1 | 16.7 | 10.3 | 14.8 | 15.4 |
| Emerging Markets | 16.7 | 11.0 | 14.6 | -12.9 | -16.3 | 10.1 | 10.8 |
| AC World | 10.2 | 11.6 | 11.7 | -9.0 | -10.0 | 12.9 | 13.4 |

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*

All four defensive sectors, consumer staples, health care, telecom and utilities, have outperformed the market over one and three month(s). This illustrates that the main factor behind the equity market rally is artificially low interest rates. Surprisingly strong economic data could reverse the outperformance of defensive sectors, but this seems unlikely to us. Also, earnings revisions favor defensive sectors above cyclical sectors. Finally, the relative performance of defensive sectors tends to be strong in the May through October period. In short, we expect the outperformance of defensive stocks to continue.

## Earnings and valuation data of sectors (MSCI AC World)

| | *Earnings growth (%)* | | | *Earn. rev. index* | | *P/E on 12m fwd earn.* | |
|---|---|---|---|---|---|---|---|
| | ***FY1*** | ***FY2*** | ***12m*** | ***3m*** | ***1m*** | ***Current*** | ***10y avg.*** |
| Energy | 3.0 | 8.2 | 4.8 | -17.3 | -1.5 | 10.1 | 11.2 |
| Materials | 10.9 | 18.0 | 17.8 | -36.0 | -50.1 | 11.9 | 12.3 |
| Industrials | 11.4 | 13.4 | 12.9 | -10.7 | -24.8 | 13.6 | 14.4 |
| Consumer Discr. | 16.3 | 15.5 | 18.7 | -9.1 | 0.7 | 14.3 | 15.5 |
| Consumer Staples | 8.8 | 10.2 | 9.5 | -14.2 | -9.0 | 17.3 | 15.8 |
| Health Care | 1.1 | 8.9 | 3.7 | -11.7 | -14.2 | 15.1 | 14.5 |
| Financials | 15.3 | 10.6 | 13.8 | 14.2 | 18.6 | 11.4 | 11.4 |
| IT | 10.6 | 12.7 | 13.5 | 0.1 | -9.3 | 12.6 | 16.8 |
| Telecom Services | 6.2 | 8.8 | 7.2 | -31.6 | -0.9 | 13.3 | 15.3 |
| Utilities | 15.6 | 11.7 | 15.6 | 0.5 | 18.6 | 14.6 | 13.6 |
| AC World | 10.2 | 11.6 | 11.7 | -9.0 | -10.0 | 12.9 | 13.4 |

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*

ROBECO

## Special: Sell in May, global statistics 1970-2012

Since 1970, in two out of every three years the MSCI World index has delivered higher returns in the winter period (November through April) than in the summer period (May through October). The risk of a negative six-month return is 44% during the summer, and 26% during the winter.

The arithmetic mean total return, measured in euros (guilders), has been 9.0% in winter and 0.0% in summer. The equity risk premium over cash has averaged 6.4% in winter and -2.4% in summer.

The month of May comes in with an average return when measured in euros, but in US dollar terms it is a weak month. However, we are reluctant to draw conclusions on any particular month. We think that investors should think about the 'Sell in May'-effect as a series of months with an increased likelihood of (un)attractive returns, without attaching too much value to the historical pattern of monthly returns.

**Average equity risk premium over cash for MSCI World Index (EUR)**

*Source: Thomson Reuters Datastream, Robeco*

Closing date text: 07 May 2013.
In our data tables, we do refer to calendar months.

**Important information**
This document has been carefully prepared by Robeco Institutional Asset Management B.V. (Robeco). It is intended to provide the reader with information on Robeco's specific capabilities, but does not constitute a recommendation to buy or sell certain securities or investment products. Any investment is always subject to risk. Investment decisions should therefore only be based on the relevant prospectus and on thorough financial, fiscal and legal advice.

The content of this document is based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness. This document is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation. The information contained in this document is solely intended for professional investors under the Dutch Act on the Financial Supervision (Wet financieel toezicht) or persons who are authorized to receive such information under any other applicable laws.

Historical returns are provided for illustrative purposes only and do not necessarily reflect Robeco's expectations for the future. Past performances may not be representative for future results and actual returns may differ significantly from expectations expressed in this document. The value of your investments may fluctuate. Results obtained in the past are no guarantee for the future.

All copyrights, patents and other property in the information contained in this document are held by Robeco Institutional Asset Management B.V. No rights whatsoever are licensed or assigned or shall otherwise pass to persons accessing this information.

The information contained in this publication is not intended for users from other countries, such as US citizens and residents, where the offering of foreign financial services is not permitted, or where Robeco's services are not available.

Robeco Institutional Asset Management B.V., Rotterdam (Trade Register no. 24123167) is registered with the Netherlands Authority for the Financial Markets in Amsterdam.