

Monthly Outlook

World economy is strengthening; tapering, Middle East dampen spirits

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Highlights

- The world economy is showing strength. The European economy is no longer in recession. The US is showing mediocre but stable growth and tapering will be announced shortly by the US central bank. In Japan, growth is moderate. China is showing some resilience, probably as a consequence of earlier conventional stimulus measures. But some major emerging markets are struggling. The risk of policy mistakes in selected emerging markets is increasing. An important risk factor for the global economy is rising tensions in the Middle East, though we do not expect a major escalation.
- We have lowered our view on equities and are now neutral. As we expect moderate economic growth and artificially low rates to continue, the macroeconomic environment remains attractive. However, there are several reasons why we are less optimistic for the near term. Firstly, the withdrawal of excess liquidity by the Federal Reserve may heighten volatility. Secondly, political escalation risks in the Middle East and Europe remain high. Thirdly, multiple expansion instead of earnings growth has lately driven equity markets, leaving less upside from a risk/return perspective.
- We have become negative on real estate, as higher interest rates mean lower returns in this asset class due to its high interest rate sensitivity. As we expect tapering will push capital market rates a tad higher, real estate is not in safe territory. Valuations do not provide support either, and although the recent market correction did not increase them, valuations remain high, especially in the US and Japan.
- We have become neutral on commodities. We worry about escalation risk from the ongoing tensions in the Middle East, which feeds into energy prices. Moreover, the perceived slowdown in China seems temporary.

Macroeconomic view

Global economy

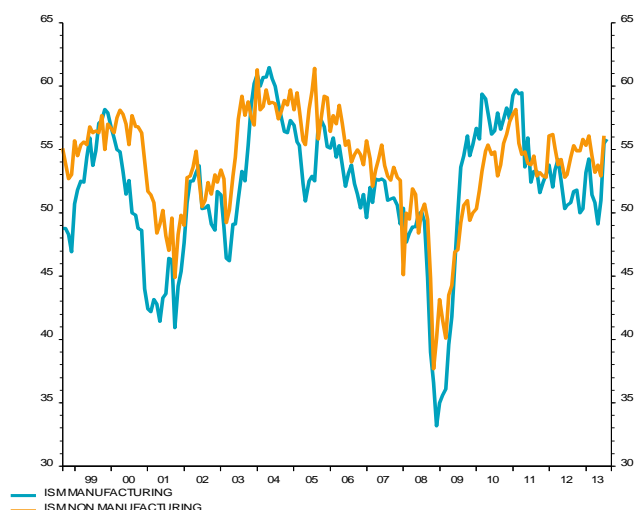
The world economy is showing strength. The European economy is no longer in recession. The US is doing fine and tapering will be announced shortly by the US central bank. In Japan, growth is moderate. China is showing signs of unexpected strength, probably as a consequence once again of earlier conventional stimulus measures. But some major emerging markets are struggling. The risk of policy mistakes in selected emerging markets is rising. An important risk factor for the global economy is rising tensions in the Middle East, though we do not expect a major escalation.

The oil price has risen in recent months, mainly as a consequence of Middle East tensions, to a level of USD 115/barrel. At the time of writing the US government was pushing for a short-term punitive strike against Syria, but it is unclear if it will be backed by the House of Representatives. In any case we expect only limited hostilities, if any, and no broader escalation of the conflict. The inflationary impact of the recent oil price hike, if sustained, will be limited to the order of a couple of tenths of a percent. That said, tensions have risen and escalation risks are not negligible.

North America

The US economy grew at an annualized rate of 2.5% in the second quarter after a large upward revision from the initially reported figure of 1.7%. A large revision to trade figures was the main source of the change. Overall, the revision confirms that the US is still stuck in a pattern of mediocre but stable growth of around 2% a year, but is showing a lot of resilience given big cuts to government spending. The revision is unlikely to make much difference to the Federal Reserve's decision on when to slow its asset purchases. The Fed probably will consider the US economy to be strong enough to announce during its September 18/19 meeting that it will start tapering its monthly purchases of USD 85 bln. Within the Federal Open Market Committee there is growing skepticism about the effectiveness of unconventional policy measures and worries about their unintended consequences. The Fed will probably repeat its intention to end its program of quantitative easing by mid-2014. But the underlying strength of the US economy should not be exaggerated. Higher interest rates will dampen consumer expenditures and negatively affect the recovering housing market. Investment spending remains unimpressive. Budget cuts by the government will continue, as will the continuing political bickering over government funding and the debt ceiling, and in our opinion there remain outside risks of a temporary shutdown of some government offices and/or a temporary default. The issue continues to hamper the long-awaited surge in corporate investments. Inflation remains well behaved, with the PCE index, closely watched by the Fed, hovering around the 1.2% mark.

US: manufacturing and non-manufacturing ISM indices



Source: Thomson Reuters Datastream

Europe

The UK economy is showing surprising strength. Producer confidence in the services sector rose to 60.5 in August from 60.2 in July, reaching its highest level since December 2006. This puts an end to any idea of additional monetary stimulus by the Bank of England. Although the new governor, Mark Carney, has been stressing that a rise in the Bank Rate is very far off, markets are not taking him too seriously. It is clear that the instrument of ‘forward guidance’ is still only a prototype.

Growth in European economies is improving and this strength is broadly based. Even the periphery is stabilizing. Loan growth is disappointing.

Unemployment is stabilizing at around 12.1% on a seasonally adjusted basis. The euro zone is girding itself towards a positive GDP growth figure for 2014, probably slightly above 1.0%. We do not expect the German Constitutional Court to declare the Outright Monetary Transactions (OMT) illegal - the conditional guarantee against a break-up of European Monetary Union (EMU) by the European Central Bank (ECB). Nor do we consider the German elections to be a risk factor. But there is room for disappointment in financial markets if the new German government does not meaningfully alter its stance on the architecture of the euro. Tensions over the proposed banking union can easily flare up as a consequence.

Worrisome is the lack of genuine reform in France. The recently announced modest overhaul of the country’s pension systems is symptomatic. It relies heavily on an increase in pension contributions by employers and employees. Fortunately the system overhaul does not represent a total failure to act, but neither is it a real supply-side policy. The current cyclical recovery in Europe, which is being felt in France, is clearly not an incentive for French politicians to act. Peripheral risks remain high. In Italy, the recent cancellation of the property tax on first homes was a welcome development in Italian politics, but tensions over former Prime Minister Silvio Berlusconi’s Senate seat are likely to return shortly. Moreover, Italy and Spain will continue to struggle to reach their weakened budgetary targets. For Greece, a new rescue package is inevitable, probably shortly after the German elections. All is furthermore not well in other smaller peripherals like Cyprus, Portugal and Slovenia.

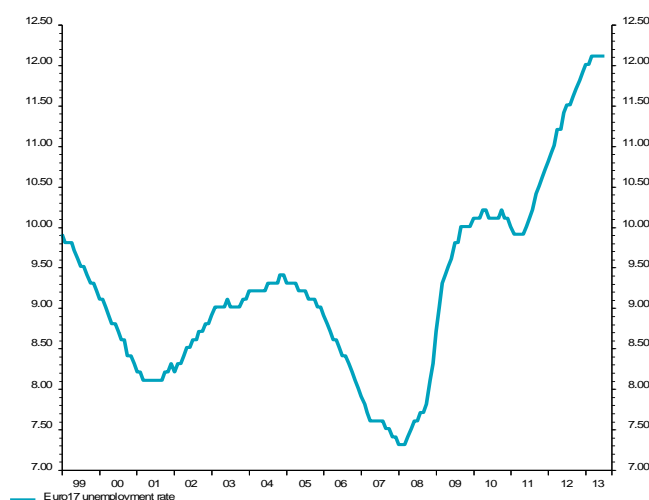
Inflation is below target. Headline inflation came down to 1.3% on a yearly basis in August. Underlying inflation has even hit 1.1%. Some upward pressure due to energy prices is to be expected, but most likely inflation will remain below target for the foreseeable future, now that EU member states generally also have stopped hiking VAT rates.

Pacific

The Australian economy is weakening, but a China-driven rebound is likely in the months ahead. After a further rate cut in August, we expect the Australian central bank to hold rates for the time being, but a rate cut in the fourth quarter cannot be ruled out as inflation remains subdued.

The Japanese economy is recovering at a moderate pace and inflationary expectations are on the rise as well. Exports have risen along with public and corporate investment in fixed assets. The benchmark consumer price inflation index (excluding fresh food) rose 0.7% in July on a

EU17 UNEMPLOYMENT RATE(%)



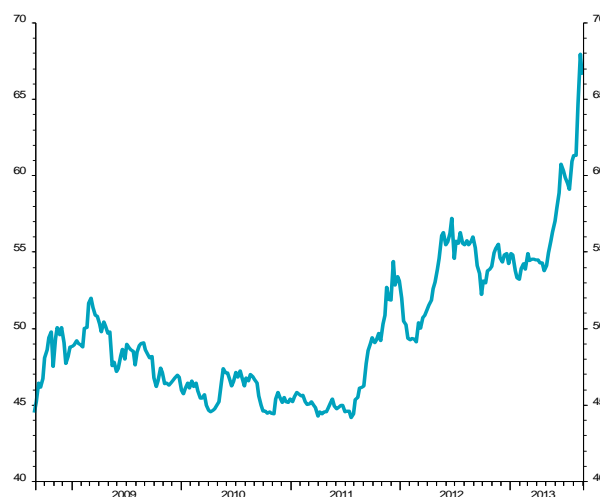
Source: Thomson Reuters Datastream

yearly basis, the highest rate since 2008. Price developments are roughly in line with the forecasts of the Bank of Japan (BoJ), so the pressure is off. We expect the BoJ to push for a lower yen if necessary. Attention now shifts to the Japanese government. Will it present convincing supply-side measures? Although these measures will only have a long-term impact, they are crucial to keep international confidence in the current Japanese administration. The macroeconomic environment seems just good enough to allow Prime Minister Shinzo Abe to positively decide on the consumption tax hike scheduled for April next year.

BRICs

Chinese policymakers have given up their complacency regarding the slowdown in GDP. Rhetoric has shifted towards confirming the 7.5% growth target for 2013. Investment is rising again in selected sectors. Forward indicators suggest modest resilience of the Chinese economy. This is most welcome, as the other Asian giant, India, continues to weaken. But the rupee's depreciation has unleashed a severe deflationary shock. Room for fiscal and monetary stimulus is very limited. The appointment of Raghuram Rajan as the governor of India's central bank won't make much difference, as India's problems are not predominantly of a monetary nature. The Brazilian economy is weakening as well, but despite this development the central bank will continue to raise interest rates to keep inflation in check. Russia is profiting somewhat from the higher oil price. Inflation in August was unchanged at 6.5%, which makes it unlikely that the central bank will lower interest rates soon.

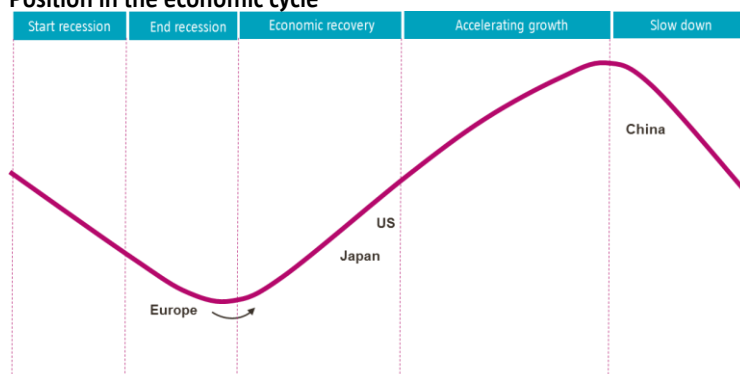
Indian rupee vis-à-vis US dollar



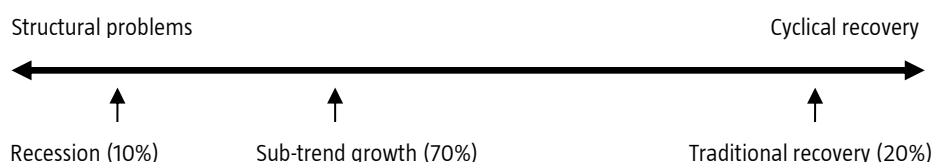
Position in the economic cycle, macroeconomic scenarios, and Robeco's view versus consensus

Generally, positive figures have dominated the macroeconomic picture in the past couple of months. The largest positive surprises were seen in Europe, and the most disappointing figures in emerging markets. Currently, we do not see the need to change our view of ongoing moderate growth. Deleveraging by consumers and banks (Europe), austerity from governments (US, Europe), relatively low investment levels (US and Europe) and moderate growth in emerging markets are a drag on underlying growth. Moreover, an escalation in the Middle East and a flaring up of the European debt crisis remain major risks. Our baseline scenario therefore remains one of below-trend growth, to which we attach a likelihood of 70%. The likelihood of a global recession remains 10%. We maintain our forecast of 20% for the likelihood of a traditional recovery because of positive developments in the US economy, a strengthening Europe and a modestly improving 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	1.5	2.6	-0.3	+
Euro zone	-0.5	-0.6	0.9	0.1	=
UK	0.2	1.2	1.9	0.2	=
Japan	1.9	1.9	1.5	0.0	=
China	7.8	7.5	7.5	0.0	=
India	5.0	5.5	6.3	-0.3	-
Brazil	0.9	2.5	3.2	0.0	-
Russia	3.4	2.6	3.2	0.0	=
World	2.0	1.8	2.7	-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	1.5	1.9	0.0	=
Euro zone	2.5	1.5	1.5	0.0	-
UK	3.2	3.1	3.0	-0.1	=
Japan	0.0	0.0	2.1	0.0	=
China	2.6	2.6	3.1	0.0	=
India	10.3	8.5	7.3	0.4	-
Brazil	5.8	5.8	5.6	0.0	=
Russia	6.6	6.0	5.6	0.0	-
World	2.6	2.0	2.4	0.0	-

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

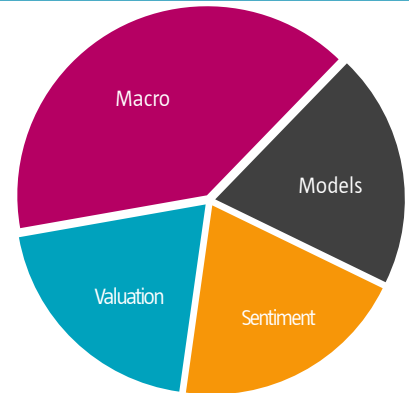
Source: Consensus Economics, Robeco

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.

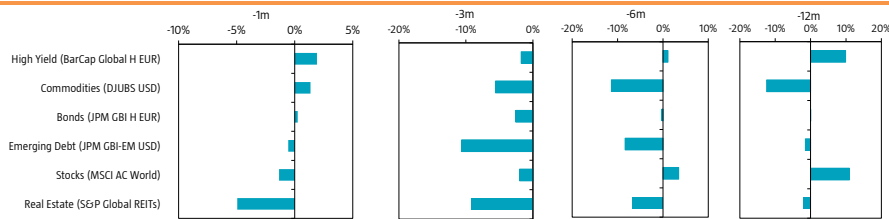
Next, we challenge our macro analysis with input from financial markets. Here, we take valuations into account as, at extreme levels, this might cause the performance of an asset class to change direction. Sentiment also plays a role, as markets tend to extrapolate shorter-term trends as investors put too much weight on recent developments. Finally, we use quantitative models to steer our expectations.

Input factors for our investment policy



Asset allocation

Performance of asset classes (gross total return)

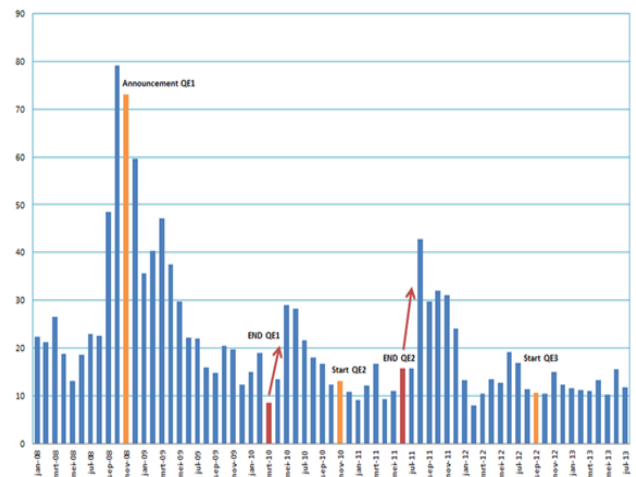


Source: Thomson Reuters Datastream, Bloomberg, Robeco

Equities

We are now neutral on equities. We take a more cautious stance in the near term. As we expect moderate economic growth and artificially low rates to continue, the macroeconomic environment remains attractive. However, there are several reasons why we are less optimistic for the near term. Firstly, the withdrawal of excess liquidity by the Fed is approaching, and therefore volatility in equity markets might increase, as we have seen in earlier episodes of quantitative easing. More volatility will put returns under pressure. Secondly, political unrest is elevated due to conflicts in Syria and Egypt. Although these conflicts are stand-alone cases which have no significant global economic impact, escalation risk remains, especially in case of a military intervention in Syria. In Europe, the government of Prime Minister Enrico Letta in Italy is less stable after Berlusconi's conviction for fraud. Thirdly, the good returns we have seen in the equity market thus far have been generated for a large part by multiple expansion instead of earnings growth, leaving less upside from a risk/return perspective.

Monthly volatility S&P 500

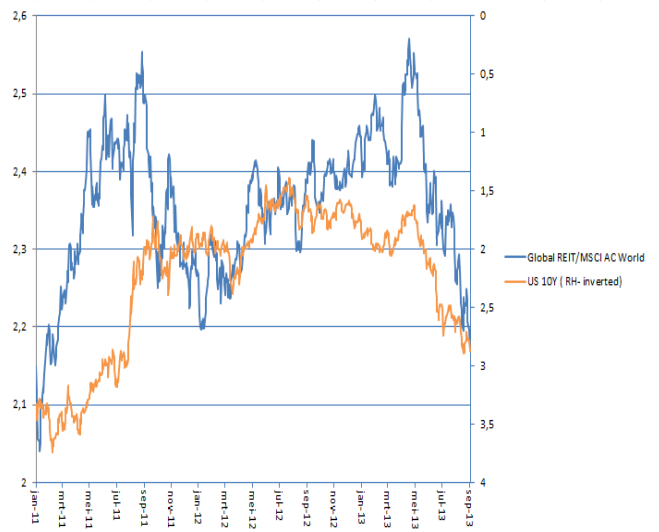


Source: Bloomberg, Robeco

Real estate

We have become negative on real estate, as higher interest rates lower returns in the this asset class due to its high rate sensitivity. As we expect tapering will push capital market rates a tad higher, real estate is not in safe territory. Valuations do not provide support either, and although the recent market correction did not increase them, valuations remain high, especially in the US and Japan. Dividend yields for real estate are above those of equities, but we think the worsening interest rate environment is currently the dominant factor for real estate performance. As equities are relative less sensitive to interest rates compared to real estate, we view equities as being more attractive.

Performance of real estate versus equities (global)

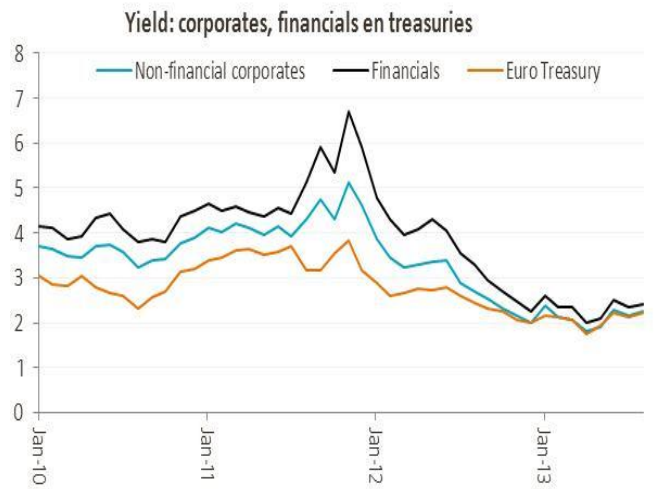


Source: Bloomberg, Robeco

Investment grade credits and high yield

We retain our positive view on high yield. Its performance recuperated from the disruption in June as investors fled from risky assets. As emerging market debt (EMD) and credit have disappointed more in the past months, we expect investors to return again to the high yield market. The global HY spread increased somewhat last month, but the fundamentals remain very decent as default rates are expected to remain low (around 2%) for 2013 and 2014. With a current yield of 6.63%, the absolute return perspective for HY remains attractive. There are some factors that could hamper the performance of high yield. First, 'covenant lite' issuance has reached an all-time high. However, as we move from below-trend growth to trend or above-trend in the years ahead, we expect low default rates. This factor is likely to come into play at a later stage. Another factor is relatively high leverage, but as most companies took the opportunity to lock in low interest rates, the negative effect on corporate cash flows is limited. Interest coverage ratios look healthy. In the meantime, spreads remain attractive and still offer the potential for a decent absolute return. We have a neutral view on credits. Although interest rate coverage ratios improved last month, current low spread levels do not provide a sufficient buffer against rising interest rates. Also, their high correlation with country risk remains indicative of their higher volatility, especially with European governments in imposed-austerity mode.

Yield on corporate credits, financials versus treasuries

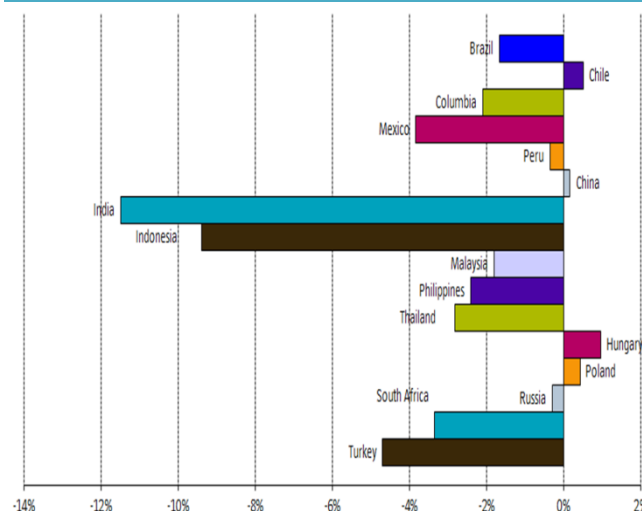


Source: Bloomberg, Robeco

Emerging market debt

We maintain our neutral position as high yield offers better risk-return perspectives. The prices of local currency EMD have declined as tapering fears led to higher US Treasury rates, which fed into the interest rates of emerging market economies. Also, volatility around emerging market currencies has increased, as investors are spending more time scrutinizing local economic developments in the wake of a reduction in global excess liquidity. Emerging market economies are decelerating compared to developed markets, as has been shown by leading producer manufacturing indices. In addition, as we expect deterioration of current account balances, this does not bode well for their currencies. High volatility in emerging market FX keeps us cautious on the asset class as currency performance is the largest return contributor for local EMD. Last month saw a significant sell-off in emerging market currencies as worries about the deceleration of their economies coincided with rising rates in developed markets. Several countries tried to counteract capital outflows through interest rate hikes, but this could hurt economic growth in the near term. We therefore expect a sideways pattern for EM countries, and more divergence with financial markets placing more attention on countries' resilience levels to withstand capital outflows, notably FX reserves.

One month dollar returns for emerging market currencies



Source: Bloomberg, Robeco

Government bonds

We remain negative on government bonds. The current environment of low or negative real interest rates makes sovereign debt unattractive relative to higher-yielding fixed income classes. Although the Fed has indicated that it will maintain an accommodative interest rate policy for some time (at least until 2014), the market is already pricing in policy normalization in reaction to the upcoming tapering of Fed bond buying. This can be observed from the significant rise in term premia in the bond market from the low levels of early 2013. This uptake in term premia has reduced the overvaluation in bonds, but we think the bond market remains too expensive based on economic fundamentals. Looking ahead, we expect global capital market rates to creep higher as monetary policy normalization more closely reflects the improvement in the real economy. We prefer higher-yielding fixed income classes to government bonds as high yield provides a decent spread buffer against rising interest rates.

Ten year interest rates

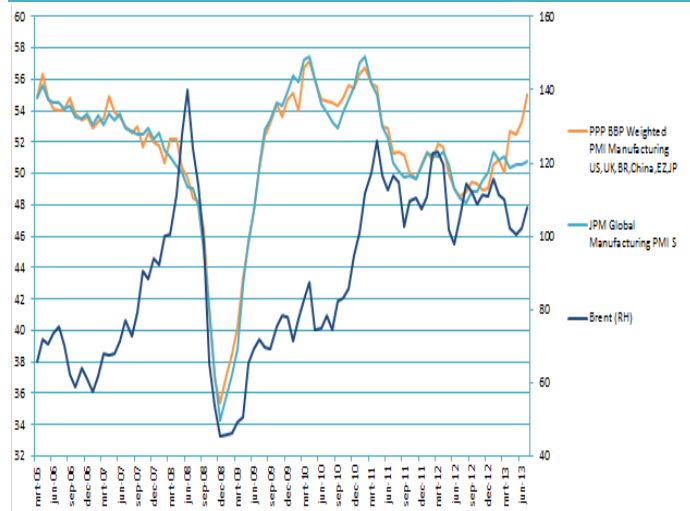


Source: Thomson Reuters Datastream, Robeco

Commodities

We have become neutral on commodities. The slowdown in China has bottomed out as the Chinese economy has shown signs of improvement, with the official producer manufacturing confidence index pointing to expansion of the economy. Moreover, we worry about escalation risk from the ongoing tensions in the Middle East. As military intervention in Syria becomes more likely, the potential for escalation of geopolitical tensions increases. Although Syria and Egypt are not significant oil market suppliers, the surrounding countries contribute about 30% of the world's oil. Strategic reserves are able to prevent oil price spikes, but the current situation triggers a lot of uncertainty, indicating the potential for oil prices to increase further. As oil has to cope with rising geopolitical risk, we have a more neutral stance on commodities. In the longer term, sluggish global growth still does not provide for a broad-based recovery in commodities prices, although technical indicators point towards improvement in roll returns.

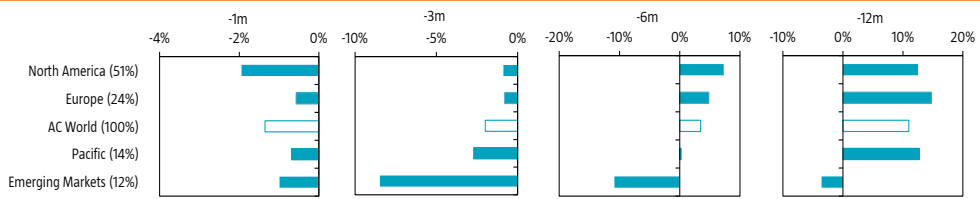
Brent versus PMI



Source: Bloomberg

Regional allocation

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



Source: Thomson Reuters Datastream, Robeco

We still favor North America. Its economic performance remains strong compared to other regions; earnings revisions underline this. These two positive factors have brought a higher valuation, but this should not hinder short-term performance. We have a slightly positive view on the Pacific region. The weakening yen should help to improve the economic performance of Japan and earnings revisions are above average. For Europe we are still negative. Economic data have continued to surprise on the upside, but the earnings outlook is not supportive. We remain negative on emerging markets despite their relatively favorable valuations. We do not anticipate an improvement in economic data, as policy room to counter the current deceleration is limited. Earnings revisions are also poor, though we believe the downward potential relative to other regions is limited.

Earnings and valuation data of regions (MSCI AC World)

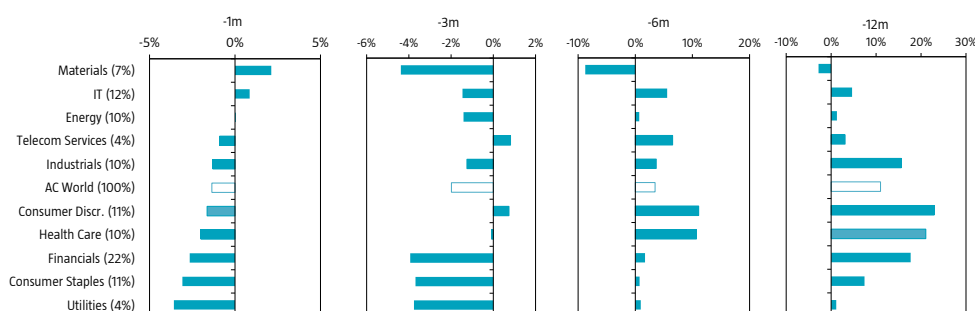
	Earnings growth (%)			Earn. rev. index		P/E on 12m fwd earn.	
	FY1	FY2	12m	3m	1m	Current	10y avg.
North America	6.5	10.2	9.5	0.3	-4.5	14.1	14.2
Europe	-0.5	12.5	8.5	-41.7	-40.7	12.5	12.2
Pacific	34.9	9.6	23.9	-8.3	-11.9	13.6	15.4
Emerging Markets	9.0	11.3	10.8	-27.4	-23.8	9.9	10.7
AC World	7.7	10.9	11.0	-15.5	-17.4	13.0	13.4

The earnings revisions index is calculated by using 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 do not have a strong view on cyclical versus defensive sectors at this time. From a macroeconomic point of view, the recent positive surprises in manufacturing should underpin cyclical sectors. However, global economic growth will likely remain modest, and higher volatility around tapering, as we expect, could benefit defensives. Moreover, relative momentum and earnings revisions do not clearly favor cyclicals or defensives.

Earnings and valuation data of sectors (MSCI AC World)

	<u>Earnings growth (%)</u>			<u>Earn. rev. index</u>		<u>P/E on 12m fwd earn.</u>	
	<u>FY1</u>	<u>FY2</u>	<u>12m</u>	<u>3m</u>	<u>1m</u>	<u>Current</u>	<u>10y avg.</u>
Energy	-2.7	9.7	5.5	-7.4	-7.7	10.5	11.1
Materials	-3.6	17.6	14.4	-45.3	-34.5	13.1	12.3
Industrials	9.3	14.2	13.7	-18.6	-20.0	13.9	14.4
Consumer Discr.	17.9	12.5	17.1	-1.1	-4.4	14.5	15.5
Consumer Staples	6.7	10.2	9.3	-61.2	-60.8	16.5	15.8
Health Care	0.6	9.0	6.2	-5.7	-26.9	15.4	14.6
Financials	13.5	9.2	10.8	-2.2	-6.8	11.3	11.4
IT	9.4	12.2	13.1	-4.8	-20.9	13.1	16.6
Telecom Services	1.0	7.5	5.2	-15.6	-34.7	12.8	15.2
Utilities	24.8	6.7	17.6	-19.1	-4.2	13.5	13.6
AC World	7.7	10.9	11.0	-15.5	-17.4	13.0	13.4

The earnings revisions index is calculated by using 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 2013.

We refer to calendar months in all our data tables.

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