Monthly Outlook

A steadily improving world economy

In this issue

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Highlights

• The world economy is recovering steadily, led by the advanced economies. Inflationary developments have in general been benign, so there is no need for central banks to reign in their ultra-loose monetary policy. Nevertheless, the ongoing strength of the US economy will make tapering likely in the next couple of months. The US budget crisis will be overcome without a default. The eurozone remains vulnerable to political risk. The picture for emerging markets is mixed. Geopolitical risks have come down markedly.

• We remain neutral on equities. Delayed withdrawal of excess liquidity by the Fed is sustaining expansion of equity market multiples, but risks remain. The market could become more uncertain about a struggling US government in the current debt ceiling debate. Earnings revisions are worsening, necessitating an uptake in growth.

• Real estate is not on solid ground yet, despite the recent rebound. We expect higher interest rates, which would mean lower returns in real estate due to its high interest rate sensitivity, and we remain negative on this asset class compared to equities. As we expect tapering to push capital market rates a tad higher, real estate is not in safe territory. Valuations have improved somewhat, but will not provide meaningful support for performance in the near term.

• High Yield remains our favorite asset class as we expect default rates to remain low in the near term and absolute return is still very decent. We remain neutral on commodities. Although we think that escalation risk from ongoing tensions in the Middle East has eased considerably, we think energy prices will move sideways. A steadily improving economy, notably in China, will improve demand for base metals. Seasonal demand for oil will be lower as the maintenance season is gathering steam.

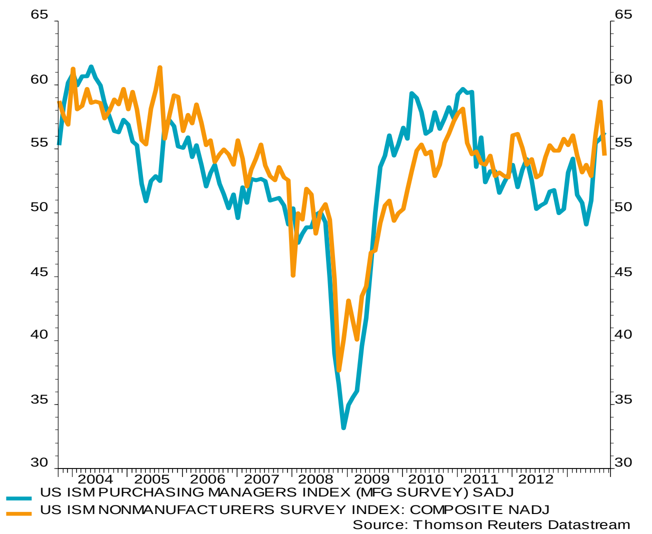
Macroeconomic view

Global economy

The world economy is recovering steadily, led by the advanced economies. Inflationary developments have in general been benign, so there is no need for central banks to reign in their ultra-loose monetary policy. Nevertheless, the ongoing strength of the US economy will make tapering likely in the next couple of months. The US budget crisis will be overcome without a default. The eurozone remains vulnerable to political risk. The picture for emerging markets is mixed. Geopolitical risks have come down markedly, after a compromise was reached to deal with the Syrian crisis and following an unprecedented charm offensive by the president of Iran.

North America

US: manufacturing and non-manufacturing ISM indices

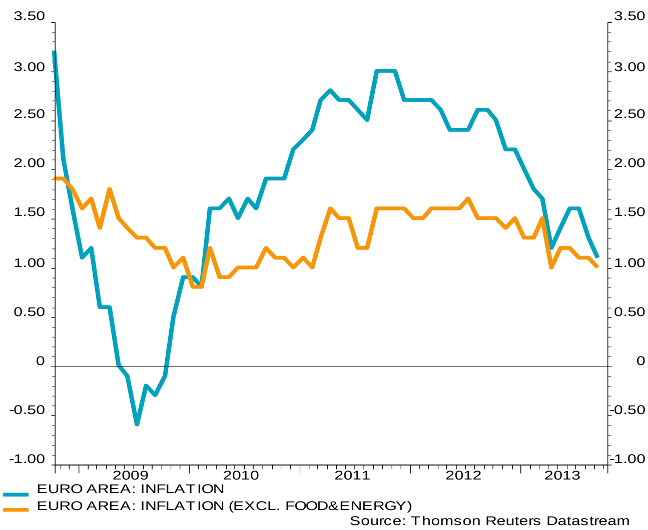


At the time of writing the US government has been partially shut down and it is still unclear if and when the debt ceiling will be raised. We think, however, that the shutdown will be short lived, as it is highly unpopular and could turn out to be very damaging to the Republican Party. Furthermore, in our opinion, no US president would allow the US to default. The most likely outcome is that the Republican front will break before a default is imminent, as was hinted by the Speaker of the House, John Boehner. Otherwise the US president would resort to emergency measures as a last resort, which would of course subject to legal challenges, all of which will be overcome eventually. We think the current political theatrics will temper growth only temporarily. The US economy is showing underlying strength, as demonstrated by the healthy developments of the ISM manufacturing and non-manufacturing indices. After preparing markets for two months to expect tapering to start in September, the FOMC suddenly left its policies unchanged. Probably this was a close call within the FOMC. Ten-year yields came down 35 basis points. But given the underlying strength of the US economy, the start of tapering is inevitable in the coming months. Due to limited market liquidity a policy change in December is unlikely. As markets are now completely left in the dark about future Fed policy, making a call on the precise moment that tapering will begin is very difficult, and it will be highly dependent on recent economic data. The situation is exacerbated by the change in Fed chairman/woman at the end of January 2014. President Obama's preferred successor to Ben Bernanke, Lawrence Summers, has withdrawn his candidacy due to lack of political support. Obama is hesitating to nominate the almost inevitable alternative candidate, Janet Yellen. Price developments are favorable, as headline inflation came down in August to 1.5% on an annualized basis. The core inflation figure rose slightly to 1.8%. The inflation indicators preferred by the Fed, the PCE headline and core figures, are both 1.2% on a yearly basis.

Europe

After a surprising uptake in economic activity in the UK in recent months, we expect the recovery may slow a little from its current heady pace. Real wage growth is not supportive enough yet to sustain the consumer-led recovery. However, leading indicators keep pointing towards expansion at an elevated pace, and investment activity should pick up. This will further lower the likelihood of additional monetary stimulus by the Bank of England.

EURO AREA: HEADLINE AND CORE INFLATION

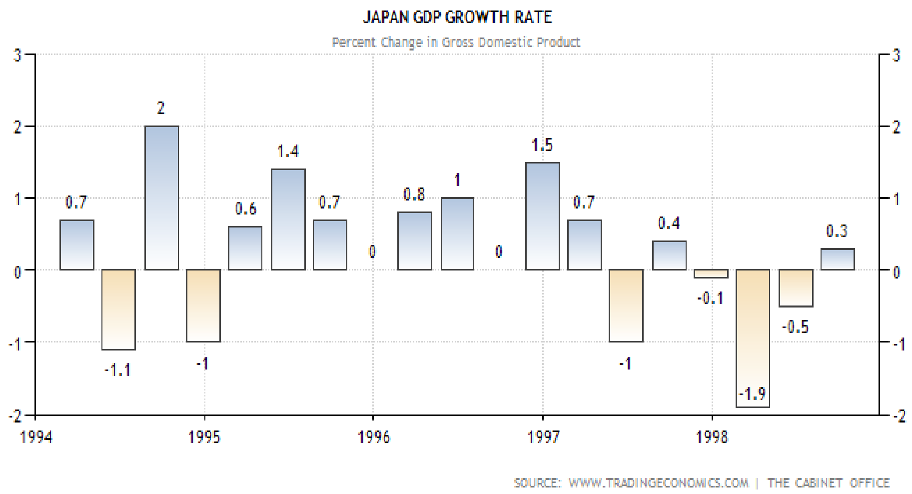


European PMI surveys for September confirmed that the eurozone recovery is gaining steam. The recovery is led by Germany, but France has also returned to growth. The figures for Italy were particularly upbeat, the Spanish economy is stabilizing. It should be kept in mind that growth so far is only modest. The short political crisis in Italy, which threatened to bring down the government of Enrico Letta, was a reminder to the markets that political risks remain high in Europe and the recovery can easily be derailed. The election victory of Angela Merkel in Germany has raised hopes in Europe of a strengthening European leadership that can handle the many problem dossiers within the region. But it is easy to get carried away by this idea. As Merkel's coalition partner, the FDP, failed to reach the 5% of votes hurdle needed to join the government, she needs another partner, most likely the SPD, the second-largest party within the Lower House. But even this so-called 'Grand Coalition' doesn't have a majority in the Upper House, just like the former government. With some exaggeration you could argue that Merkel entered the September elections as a lame duck, and will remain so for the foreseeable future. The opposition to current European policies is also on the rise, as the populist Eurosceptic AfD narrowly missed reaching the 5% hurdle. As a rule, coalition negotiations in Germany do not take very long, and this opens the way for the German Constitutional Court to give its verdict on the constitutional legality of the Outright Monetary Transactions (OMT) conducted by the ECB as part of bail-out measures. We do not expect that the Court will judge this new, so far untested, but very effective monetary instrument to be unconstitutional. The disinflationary trend in the eurozone is progressing further. Headline inflation fell in September to 1.1% on a yearly basis, and core inflation dropped to 1.0%. This gives the ECB some room for additional stimulus, although it won't be in a hurry to act, due to the current recovery. Worries about the broken monetary transmission mechanism within the eurozone could pave the way for a new Long-Term Refinancing Operation (LTRO). ECB Vice-President Vitor Constancio hinted that no large capital shortfalls are expected after the asset review and the stress tests that are being conducted before the ECB takes over banking supervision. This will certainly please European politicians, but it increases the risk that a golden opportunity to restore the international credibility of eurozone banks will be missed.

Pacific

The Australian economy is still struggling, but a China-driven rebound in the mining sector is likely in the months ahead. However, the non-mining sector remains lackluster, and a rise in unemployment could give the Australian central bank the incentive for a rate cut before the end of the year, as inflationary pressures remain subdued.

As expected, Japanese Prime Minister Shinzo Abe has decided to uphold the decision by the former government to hike the sales tax in April 2014 from 5% to 8%. The Japanese economy is currently clearly improving, as illustrated by the reading for the Tankan survey for large manufacturers which rose in the third quarter from 4 to 12. The Japanese government has a clear need to demonstrate its commitment to put government finances on a more solid footing. On the other hand the government is clearly aware of the dangers to economic growth of a sales tax hike. The last hike, from 3% to 5%, took place in April 1997, after which the economy sank into recession. The downturn lasted for over a year and a half and contributed to deflation taking root in Japan. Of course, it is hard to determine how much of this can be attributed to the tax hike, as 1997 was also the year of the Asian crisis and the subsequent banking crisis in Japan.

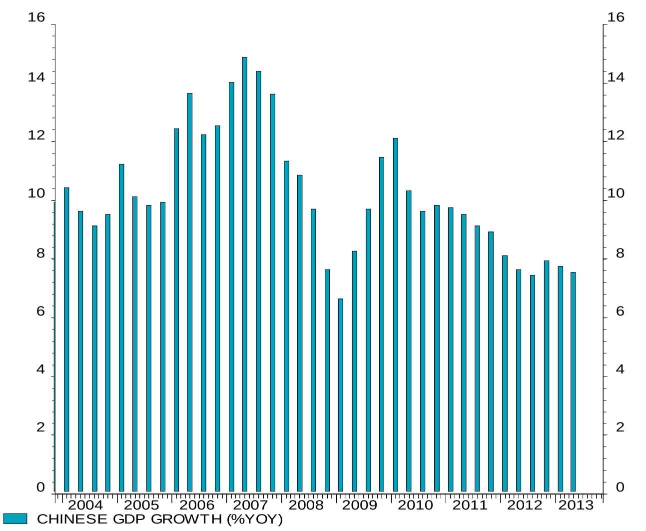


With 1997 in mind, the government will take fiscal stimulus measures to the extent of about 0.5% of GDP, watering down the impact on government finances of the tax hike as well. All in all, the tax hike remains a big gamble, but in the shorter term it will boost economic growth, as consumers will increase spending in the first quarter in anticipation of the higher tax. Inflation has picked up. Tokyo CPI, for instance, has been positive on a yearly basis for the last three months in a row. As wage growth hasn't picked up, consumers are getting squeezed, and this remains a challenge for the government. On the other hand, the Bank of Japan (BoJ) is clearly pleased with the tax hike decision and will be very supportive if needed. For the time being, the BoJ is leaving its current stimulus measures unchanged, partly in light of its upgraded view on capital expenditure.

BRICs

In the run-up to the Fed's decision to begin tapering from September, emerging markets were confronted by an outflow of capital, particularly in countries with a current account deficit. Of the BRIC countries, Brazil and India experienced difficulties. In China, the authorities are emphasizing growth again. The Russian economy is growing at a moderate pace.

Chinese GDP growth



The Chinese economy is showing acceleration and China is heading for a strong third quarter. The big question is whether this accelerated growth is sustainable. Presumably this is not the case, because the acceleration is mainly being driven by investment in sectors that already have excess capacity. Many economists have recommended rebalancing the Chinese economy towards more domestic consumption and fewer exports. The sharp depreciation of the Indian rupee has so far led to only a modest rise in inflation. However, a further acceleration in inflation is expected. The Indian central bank surprised markets with a quarter percent rate hike on 20 September. Markets are now expecting two more rate hikes in the coming months. As the rupee is stabilizing, a modest upturn in growth in the fourth quarter is likely. The general elections of May 2014 are beginning to loom, increasing fears that neither of the two major parties will win a convincing victory, and no reform agenda will be implemented.

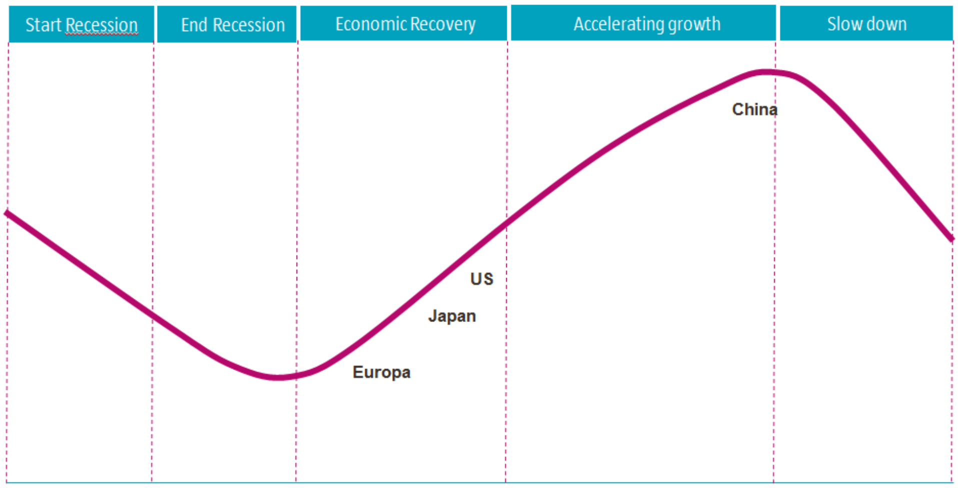
Upcoming elections also cast their shadows in Brazil, where President Dilma Vana Rousseff will seek reelection next year. Fiscal policy will consequently be expansionary (the proposed government spending increase amounts to 12%), making further rate hikes inevitable in October and November in our opinion in order to keep inflation in check. In August, inflation amounted to 6 %, against a target of 4.5%.

Russian inflation at around 6.5 % remains above the target zone of between 5 % and 6 %. The central bank has raised the target for 2014 from 4.5% to 5.0% in the light of the planned increase in government fees and indirect taxes by the Russian government. The Russian economy will stabilize the coming months at a growth rate of around 2.0%.

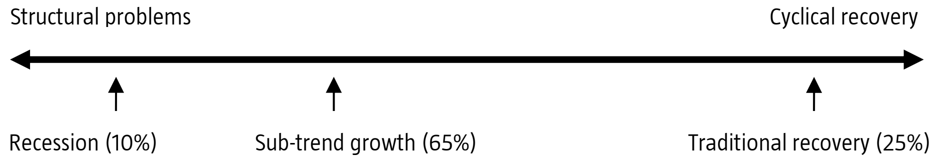
Position in the economic cycle, macroeconomic scenarios, and Robeco's view versus consensus

The world economy shows signs of ongoing recovery. 'Abenomics' is running according to plan, the Chinese authorities have been successful in accelerating their economy, and the eurozone economy continues to improve. For these three economies, the question is whether this recovery is sustainable over the long term of 12 months. But for the time being we have raised our estimate for the probability of a modest recovery from 20% to 25%. Our base case remains for below-trend growth, of which we have modestly reduced the probability from 70% to 65%. The probability of a global recession remains low in our opinion, at an unchanged 10%.

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	1.6	2.7	-0.5	+
Eurozone	-0.5	-0.4	0.9	0.0	=
UK	0.2	1.3	2.1	0.6	=
Japan	1.9	1.9	1.7	0.6	=
China	7.8	7.5	7.4	-0.6	+
India	5.0	4.9	5.9	-1.2	-
Brazil	0.9	2.2	2.7	-0.9	-
Russia	3.4	2.3	2.9	-1.0	=
World	2.2	2.0	2.9	0.0	=

* 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	-0.3	=
Eurozone	2.5	1.5	1.5	-0.2	-
UK	3.2	3.1	3.0	-0.3	=
Japan	0.0	0.1	2.2	0.1	=
China	2.6	2.6	3.0	-0.6	+
India	10.3	8.8	7.6	0.6	-
Brazil	5.8	5.8	5.6	0.2	=
Russia	6.6	6.0	5.5	0.1	=
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

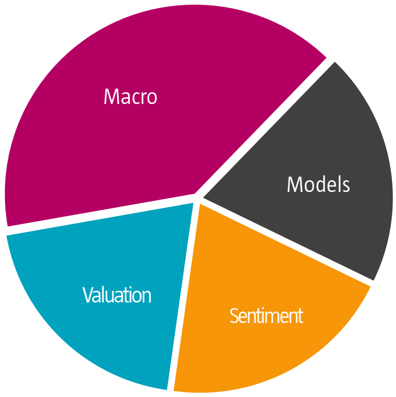
Source: Consensus Economics, Robeco

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.

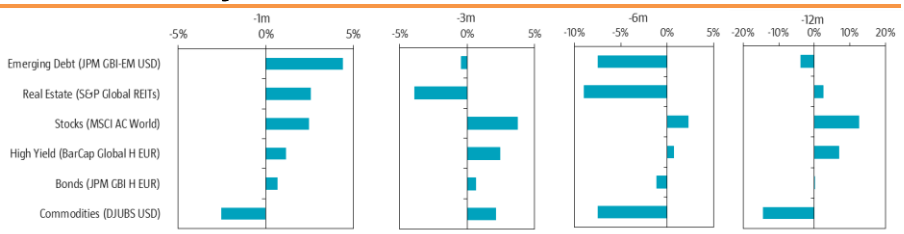
Next, we challenge our macro analysis with input from financial markets. Here, we take valuations into account as, at extreme levels, this might cause the performance of an asset class to change direction. Sentiment also plays a role, as markets tend to extrapolate shorter-term trends as investors put 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)

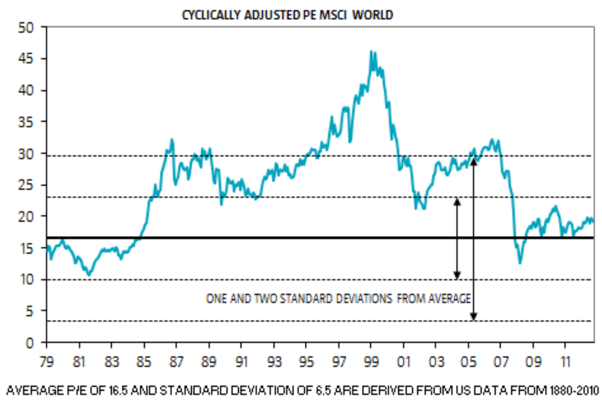


Source: ThomsonReuters DataStream, Bloomberg, Robeco

Equities

We are neutral on equities. We had taken a more cautious stance in the near term as several risk factors were present, notably volatility spurring from tapering, military intervention risk in Syria, and the German elections. Although some of these risk factors have eased, other sources of political risk have more clearly emerged, which could hamper economic expansion and lower earnings growth. The current US government shutdown and debt ceiling discussion could pose downside risks for equity markets, although the macroeconomic environment remains attractive. In addition, the delayed withdrawal of excess liquidity by the Fed is sustaining equity multiples expansion, but volatility in equity markets might increase later on if the Fed decides to taper before the end of this year.

Cyclically adjusted PE MSCI World



Source: ThomsonReuters DataStream, Robeco

Real estate

We remain negative on real estate, although lower capital market rates gave the asset class some relief. As we expect that the recovery in the developed world will continue, real estate is not on solid ground. Given its high interest rate sensitivity, higher rates would harm performance. Valuations have improved somewhat after the market decline, but they remain expensive compared to equities. The fundamentals of the real estate market are currently dominated by the rate implications from Fed tapering. As equities are relatively less sensitive to interest rates compared to real estate, we view equities as being more attractive. This difference has also become apparent in declining correlations between equities and real estate.

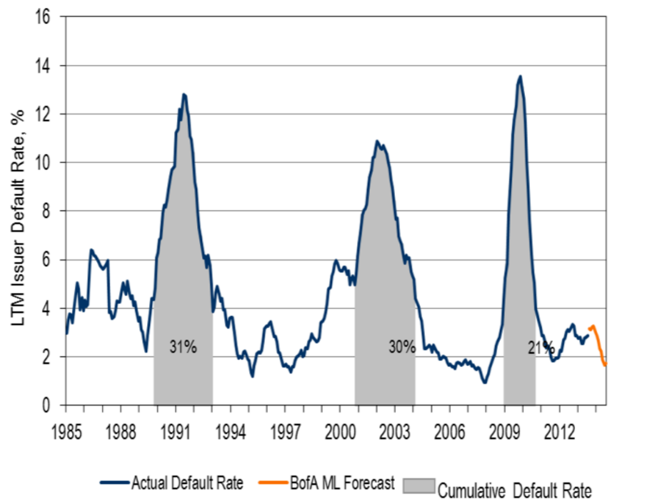
Performance of real estate versus equities (global)

Source: Bloomberg, Robeco

Investment grade credits and high yield

We retain our positive view on high yield. The global HY spread kept hovering around 493 basis points last month, which is somewhat below its long-term average. Nevertheless, the fundamentals remain solid as default rates are expected to remain low (around 2%) for 2013 and 2014. The absolute return perspective for HY remains attractive as well. High yield performs best in a macro environment of moderate growth and low inflation, which is currently the case. In this environment companies can generate ample cash flow to pay the interest on their debt. Interest coverage ratios remain healthy. Refinancing risk is mitigated for the medium term as corporates have had sufficient time to lock in artificially low rates. However, we remain alert to the increase in 'covenant lite' issuance as this has reached recent highs, which could cause problems if refinancing needs emerge in the medium term. For now, the risk is contained, thanks also to sufficiently strong balance sheets. 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. We have a neutral view on credits. Although interest rates declined last month, current low spread levels do not provide a sufficient buffer when, in our view, interest rates will pick up again. Also, their high correlation with country risk remains indicative of their higher volatility, which is more prevalent given the recent political turmoil in Italy.

HY default rates

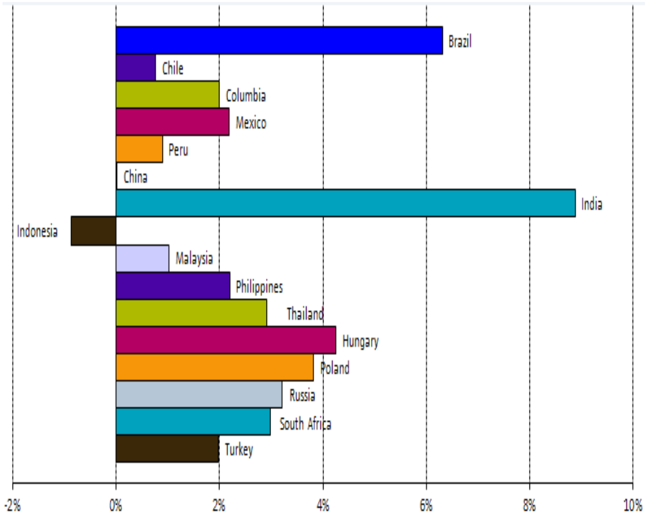


Source: BofA ML

Emerging market debt

We maintain our neutral position as high yield offers better risk-return perspectives, although emerging market debt (EMD) spreads have recently become relatively attractive. As the Fed surprised the markets with its decision not to taper in September, US interest rates declined, giving emerging market currencies more breathing space. Currency appreciation is a major contributor of EMD returns and the rebound in emerging market currencies has caused investor sentiment to turn less negative towards the asset class. However, as Fed tapering has only been postponed and not cancelled, this breathing space will likely be temporary. The vulnerability of emerging market economies remains an issue as they are no longer accelerating compared to developed markets, as was confirmed by recent leading producer manufacturing indices. In addition, the resilience of emerging markets to fend off capital flight has weakened somewhat, although their currency reserves remain ample on average. We expect more divergence within emerging markets according to differences in export orientation, current account balances and fiscal and monetary policies. Higher expected volatility in emerging market currencies keeps us cautious as capital restrictions and foreign exchange interventions will be used to mitigate renewed capital outflows.

One month dollar returns for emerging market currencies

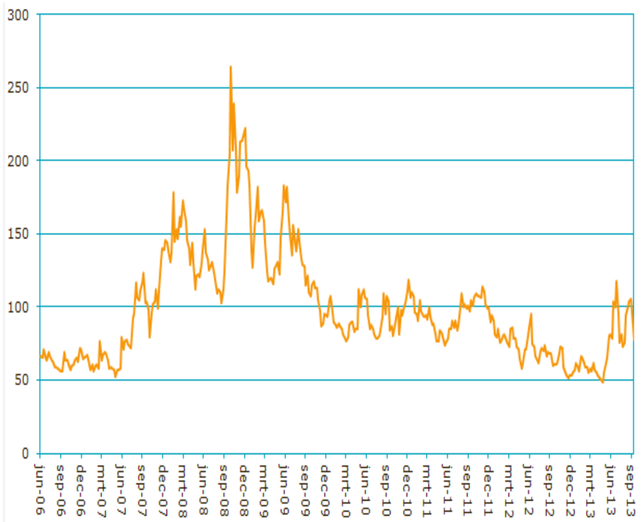


Source: Bloomberg, Robeco

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. Volatility in the bond market has decreased after the surprising Fed decision not to taper its monthly bond purchases in September, lowering capital market rates. However, the increased uncertainty about future Fed policy is keeping volatility elevated. We think that tapering has not been cancelled, but is the start of it has been shifted towards the end of the year, as incoming data remains supportive. Against this background, we expect global capital market rates to grind higher, as monetary policy normalization more closely reflects the improvement in the real economy. We therefore prefer higher-yielding fixed income classes to government bonds, as high yield provides a decent spread buffer against rising interest rates.

Treasury options volatility

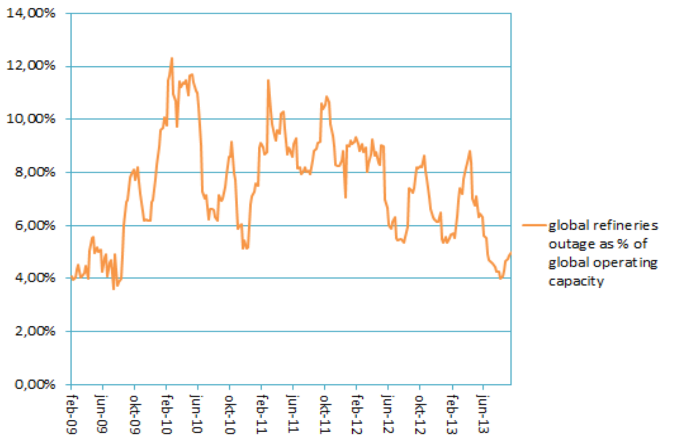


Source: Bloomberg, Robeco

Commodities

We remain neutral on commodities. Energy prices declined as political risk premiums within oil prices compressed. The immediate risk of military intervention in Syria has decreased as a political route has opened up. Meanwhile, Iran, a major oil producer, has surprisingly struck a more conciliatory tone towards the US. Nevertheless, geopolitical risks have not vanished, as supply disruptions in Libya and Iraq have not been solved. Refinery demand will ease somewhat as the maintenance season is gathering steam. This lower demand is balanced by the bottoming out of the Chinese economy and an uptake in manufacturing activity in the US. Although technical indicators point towards in improvement in roll returns, we remain cautious about a broad-based recovery in commodities.

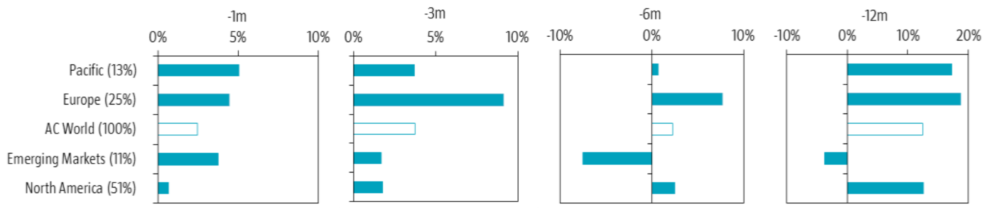
Global refineries outages as % of global capacity



Source: Bloomberg

Regional allocation

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



Source: ThomsonReuters DataStream, Robeco

We have become less constructive on North America as earnings revisions have deteriorated, necessitating strengthening economic growth, and valuations look relatively stretched. Higher political risk because of the gridlock about the US debt ceiling remains an obstacle for sentiment. Instead, Europe looks currently more favorable to us compared to North America, as the earnings outlook now looks more supportive because earnings growth has accelerated and valuations are relatively more favorable. We remain our positive view on the Pacific region. The weakening yen should help to improve the economic performance of Japan and earnings revisions are above average. We have become neutral on emerging markets as earnings growth and valuations are improving, although we do not anticipate a significant improvement in economic data as policy room to counter the current cyclical deceleration is limited. Earnings revisions also remain poor, though we believe the downward potential relative to other regions is increasingly limited.

Earnings and valuation data of regions (MSCI AC World)

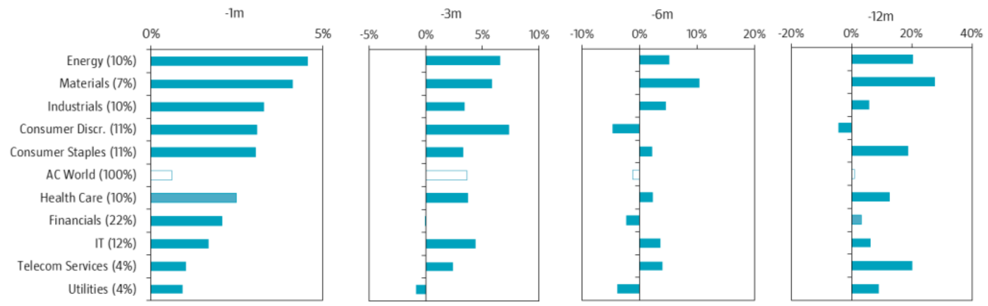
	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd earn.*	
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
North America	6,1	10,1	9,8	3,2	-16,5	14,4	14,2
Europe	-0,8	12,1	10,1	-33,5	-31,2	12,7	12,2
Pacific	34,8	9,3	19,1	-10,0	-5,1	14,3	15,4
Emerging Markets	8,7	11,3	10,9	-23,5	-16,5	10,4	10,7
AC World	7,3	10,7	11,1	-11,9	-19,3	13,4	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: ThomsonReuters DataStream, Robeco

Sector allocation

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



Source: ThomsonReuters DataStream, Robeco

We have a slight preference for cyclical versus defensive sectors this time. From a macroeconomic point of view, the recent delay in tapering should be positive for cyclicals, as well as for ongoing manufacturing expansion. A political solution for averting a US government debt default, as we expect will be agreed, could benefit cyclicals. Earnings revisions do not clearly favor cyclicals or defensives, but relative momentum favors cyclicals.

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	-2.3	8.5	6.7	-1.4	-2.5	10.8	11.0
Materials	-5.3	18.1	16.5	-39.7	-40.0	13.6	12.2
Industrials	9.0	13.9	14.0	-18.5	-21.6	14.5	14.3
Consumer Discr.	17.4	12.3	16.0	-2.7	-29.9	15.0	15.4
Consumer Staples	6.4	10.1	9.7	-58.1	-60.0	16.6	15.8
Health Care	0.5	9.2	7.8	-6.5	15.4	15.4	14.4
Financials	13.3	9.2	10.0	-0.1	-35.8	11.6	11.3
IT	9.3	12.4	13.1	1.5	18.8	13.5	16.3
Telecom Services	-1.0	7.5	6.2	-19.8	-44.0	13.5	14.7
Utilities	24.4	7.1	14.4	-16.1	27.3	13.8	13.7
AC World	7.3	10.7	11.1	-11.9	-19.3	13.4	13.3

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: ThomsonReuters DataStream, Robeco

Closing date text: 04 October 2013.
We refer to calendar months in all our data tables.