ROBECO

Monthly Outlook
Japan's stunning monetary experiment

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Highlights

- The world economy continues to expand at a below-trend rate. Japan has started a monetary revolution that will be closely monitored by the rest of the world. The eurozone is weakening and confidence has been damaged by clumsy policymaking and Italy's political stalemate. China's economy is slowing. The US is showing more resilience, thanks to the ongoing strengthening of the housing market.

- Equities remain attractive. Clearly, the Cyprus bail-in was a negative surprise. But 'money' continues to dominate 'macro' in its support for equity. We maintain our view that quantitative easing and low interest rates are the dominant forces at work for the time being. Accommodative central banks and a recovering global economy should keep sentiment positive. Valuations around neutral levels are not an obstacle for further gains.

- We remain positive on emerging markets debt even though the outlook has become less promising. Healthy inflows into emerging markets debt continue, but their pace is slowing. Credit spreads widened for a second month, as current accounts in emerging markets have weakened slightly and fiscal budgets are gradually leaving less room for economic stimulus. Emerging markets currencies depreciated against a strong dollar.

- We have turned slightly negative on commodities, as the economic recovery is not strong enough for a broad-based demand. Demand for oil has declined due to lower projected imports in the eurozone and China. US figures show the country is increasingly replacing imports with domestic production as a result of the tight oil revolution. Gold has lost its luster, although it remains a safe haven, given that geopolitical risks continue to be high.

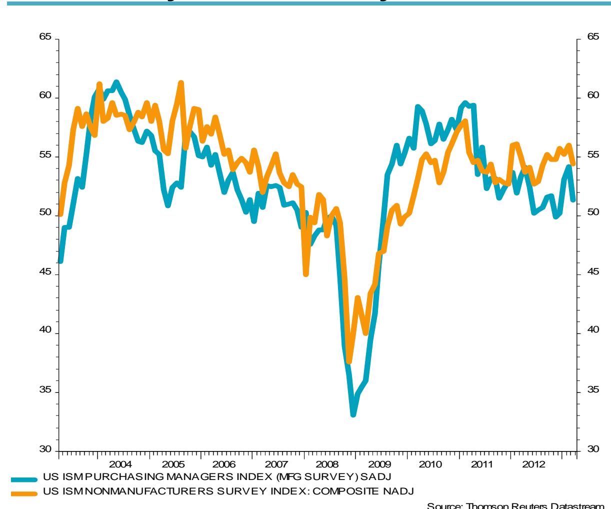
Macroeconomic view

Global economy

The world economy continues to expand at a below-trend pace. Japan has started a monetary revolution that will be closely monitored by the rest of the world. The eurozone is weakening and confidence has been damaged by clumsy policymaking and Italy's political stalemate. China's economy is slowing. The US is showing more resilience, thanks to the ongoing strengthening of the housing market.

North America

US: manufacturing and non-manufacturing ISM indices



Source: Thomson Reuters Datastream

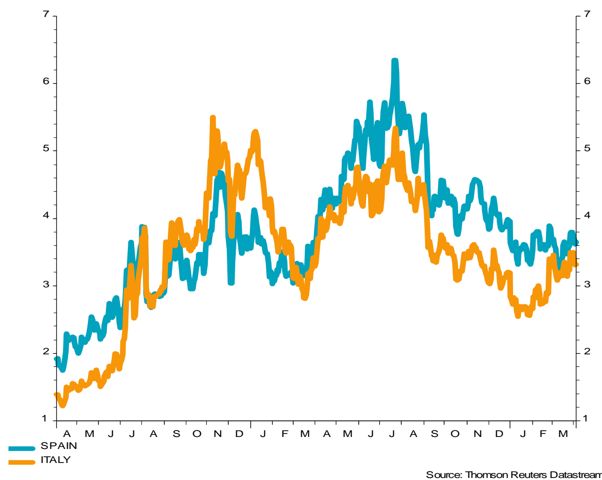
Momentum in the US economy remains positive as the recovery maintains its pace. Even so, jobs growth fell back sharply in March, though unemployment declined further to 7.6%. This still leaves a significant gap before the Federal Reserve's unemployment target of 6.5% is reached. This target is unlikely to be achieved in 2013 and, as a consequence, we expect the Fed to reduce its monthly Treasury purchases only in early 2014. The Fed will then end quantitative easing (QE) gradually, with explicit guidance about its policy steps. Investment activity that was put on ice due to the uncertainty surrounding the fiscal debate is expected to pick up now that a deal on the US budget is in place until 30 September. The spending bill enacted at the end of March has mitigated some of the effects of sequestration, which kicked in at the beginning of the month. Capacity utilization is rising and higher production levels—resulting from increased confidence—will eventually trigger investment. Housing market indicators, such as new home sales and Case-Shiller home prices, are continuing their upward trend and should sustain consumption through wealth effects. However, consumption could disappoint in the coming months as a result of the sequestration measures that have not been offset.

Europe

Activity in the UK economy remains subdued. Construction purchasing managers' indicators edged up this month to 47.2, indicating a continuing slowdown in construction. The depreciation of sterling has not yet translated into an improvement in the trade balance. Import prices are creeping up and inflation remains stubbornly high at 2.8%. Higher inflation is not only eroding UK consumers' purchasing power but is also affecting external competitiveness. The Bank of England has therefore been reluctant to increase QE to adhere to its inflation-fighting mandate. The bank is currently restricting itself to other unconventional measures, such as the FLS (the funding for lending scheme aimed at SME lending) and lower reserve-deposit rates. As the cyclical recovery is set to remain lackluster, we expect renewed QE later this year, as the initiatives now in place will not restore growth. SME lending demand even fell further in Q1, probably signaling low consumer end-demand.

Forward-looking indicators suggest that the German economy is stalling and that France is weakening. Although the ECB is contemplating a modest rate cut in May, we would not expect it to have a significant impact, as the transmission mechanism is clearly broken. In contrast to the other large central banks, the ECB is nevertheless refraining from a program of general quantitative easing, probably with the intention of keeping the pressure on governments to deliver on reform and fiscal consolidation. We believe that deflationary risks are on the rise, but the ECB stubbornly maintains that the risks to price stability in the eurozone remain "broadly balanced". Clumsy policymaking in the Cyprus crisis damaged confidence again, raising the risk of renewed capital flight from the periphery. The key variable to watch is the development of Target2 balances within the euro area. The political stalemate in Italy will probably result in new elections in July. It is far from certain that it will result in a government willing to implement eurozone-inspired austerity and reform along the lines of the policies of the former prime minister Mario Monti. The failure of a new Italian government to come back into line could easily lead to a higher risk premium on Italian government bonds versus Germany. The true extent of the conditionality of the ECB's OMT program could be tested and political tensions in the eurozone could rise sharply.

Ten-year yield spreads vs. Germany (%)

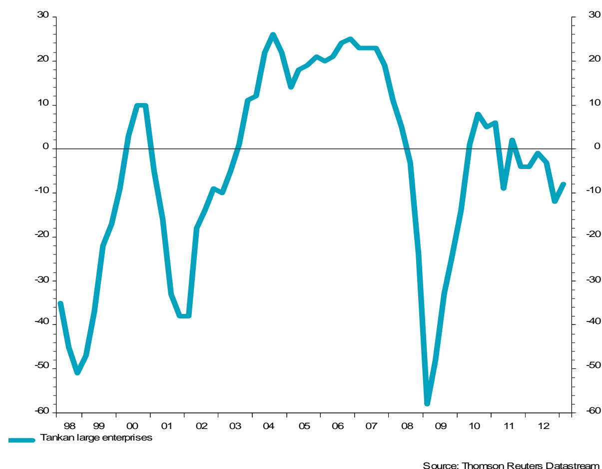


Source: Thomson Reuters Datastream

Pacific

Despite already-elevated expectations, the Bank of Japan (BoJ) was still able to surprise markets with the announcement of a stunning monetary stimulus program. It will expand its balance sheet by 1% of GDP per month (almost double the rate of the Fed), intending to push down the yen and generate an inflation level of 2% in two years' time. The main risk of this aggressive policy move is a hike in long-term interest rates, but this will probably be prevented by a combination of financial repression and BoJ buying of longer-term JGBs to keep yields down. Japan's government debt is almost completely held domestically. Though sentiment is on the rise and the stock market buoyant in local terms, the economy has yet to recover, as illustrated by the disappointing Tankan (see chart right).

Tankan



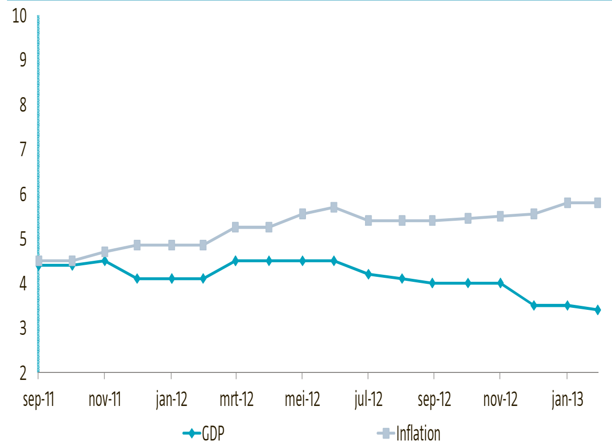
Source: Thomson Reuters Datastream

The Australian economy moved to a stronger footing in Q1 as December's interest-rate cut by the Reserve Bank of Australia fed through into the real economy. The trade balance, retail sales and dwelling approvals all surprised on the upside. But the outlook for mining companies is deteriorating due to high global inventory levels. Australian export growth will therefore probably experience some headwinds. Further easing in Q2 is likely if mining activity falters.

BRICs

It is difficult to assess the underlying trend in the Chinese economy due to the Chinese New Year. But anecdotal evidence suggests a loss of momentum. The expected rebound of the PMI after New Year did not materialize. Furthermore, the newly appointed leadership has signaled its resignation about a slower structural growth rate. Inflation remains a cause for concern and the Chinese authorities are allowing the yuan to resume its uptrend against the US dollar.

Brazil: Consensus GDP and inflation forecasts 2013 (%)



Source: Bloomberg

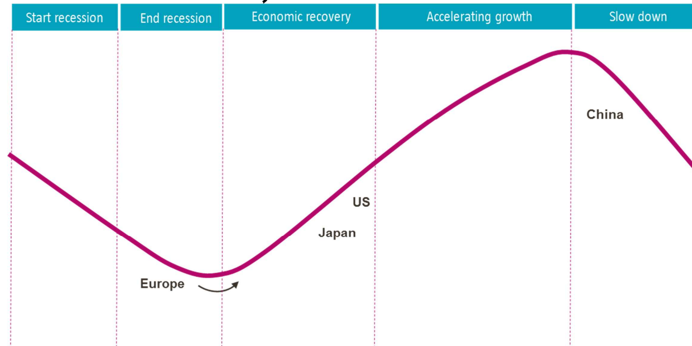
While the economy is cooling, the Brazilian government seems to be underestimating the risk of higher inflation in the medium term. Dilma Rousseff, Brazil's president, indicated that she was not in favor of rate hikes because of repercussions on the real economy. But neither a lax tax code nor the macroprudential measures that are on the table will re-anchor inflation expectations. Inflation has emerged as a result of a tighter labor market and resulting wage pressures. In addition, the country's outdated infrastructure is increasingly unable to sustain the Brazilian growth model and is imposing capacity constraints, driving up prices. Infrastructure investments are needed and sought after. The COPOM, the Brazilian central bank, will be forced to hike rates later this year if inflation expectations remain unanchored and CPI stays at the upper range of its inflation target range (2.5-6.5% for 2013).

Russia needs to deal with its vulnerability to commodity prices as the outlook for oil and base metals is deteriorating. The slowdown in growth has largely been countered by government spending. Despite ongoing inflationary pressures, Russia's central bank will likely leave rates unchanged, as combating inflation through monetary policy is not so effective in Russia. Furthermore, raising interest rates in a world of very low rates would harm export growth through the appreciation of the ruble.

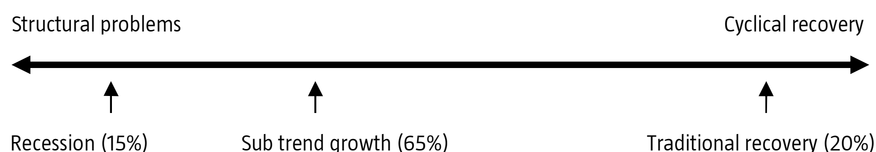
Position in the economic cycle, macroeconomic scenarios & Robeco's view versus consensus

Global economic growth will be lower than trend due to structural problems. Our baseline scenario remains below-trend growth, although we have lowered our estimate a little to 65%. We continue to consider the likelihood of a global recession to be 15%. We have raised our estimate of a traditional recovery from 15% to 20% 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	1.8	2.8	0.0	+
Eurozone	-0.5	-0.3	1.0	-0.1	-
UK	0.2	0.9	1.6	-0.1	-
Japan	2.0	1.2	1.2	0.0	=
China	7.8	8.2	8.0	-0.1	-
India	NA	5.2	6.3	-1.1	=
Brazil	1.0	3.2	3.8	-0.1	-
Russia	3.4	3.2	3.8	-0.1	-
World	1.9	2.0	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

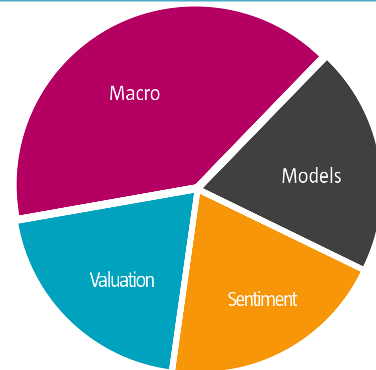
CPI by region (%)	*2012*	*2013*	*2014*	*Δ -1m 2013*	*Robeco**
US	2.1	1.8	2.1	0.0	-
Eurozone	2.5	1.7	1.7	-0.1	-
UK	3.2	3.2	3.0	0.1	+
Japan	0.0	0.0	1.8	0.1	+
China	2.6	3.2	3.5	0.0	-
India	NA	9.6	7.8	2.1	=
Brazil	5.8	5.6	5.5	0.1	=
Russia	6.6	5.9	5.6	0.0	=
World	2.3	2.3	2.6	0.1	-

* 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

Input factors for our investment policy

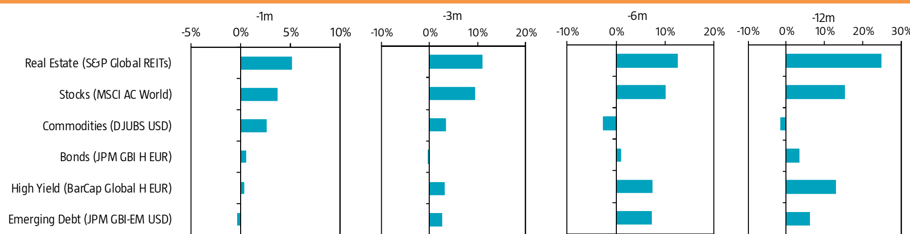


Our expectations are based on qualitative as well as quantitative analyses. As a starting point, we look at the long-term macroeconomic environment. We then determine our expectations for the economy for the next three- to six months to find out which developments could take the market by surprise, as this is a common factor for all asset classes. From this macroeconomic analysis follows our initial preference for assets.

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

Asset allocation

Performance of asset classes (gross total return in euros)



Source: Thomson Reuters Datastream, Bloomberg, Robeco

Equities

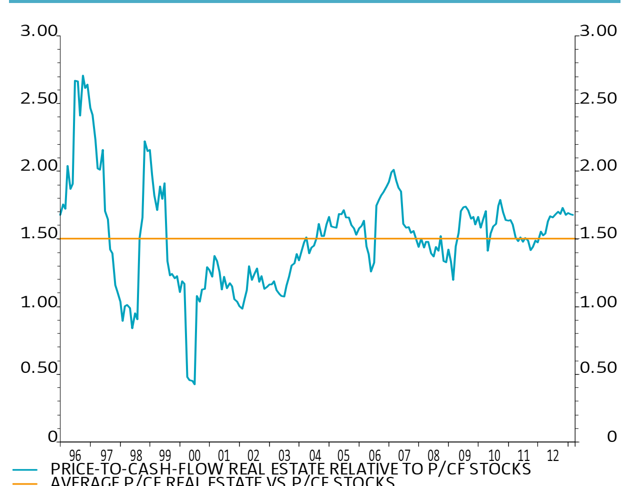
We maintain our positive view on equities. The upward trend continued in March, with a 4% gain in euros and 2% in local currencies. Year-to-date gains are approaching 10%. The Cyprus bail-out did not run smoothly. The initial plan to disregard the EUR 100k deposit guarantee has the potential to restart the silent bank run in Spain. But we think this is a small risk: Cyprus is a special case and—in the end—deposits up to EUR 100k appeared to be safe. We expect the focus to shift back to problems such as Italian politics and the economic performance of France. In the meantime, the global economy continues to grow at a 2% pace, quantitative easing is being stepped up and earnings are more or less stabilizing at—or close to—record-high margins. The first two of these three factors are the dominant forces at play. As a result, equities remain attractive. Among the risks factors that could materialize in the months ahead, the most prominent is a lack of support for economic reform in Italy, where we expect new elections in July. The conditionality of the ECB's OMT instrument could be tested. Moreover, the eurozone's economic performance remains a risk to positive sentiment. Even so, quantitative easing and moderate economic growth are the forces continuing to drive the positive stock market climate. As valuation is just above neutral, there is still room for further gains in stock prices.

Valuation ratios for MSCI World Index (x)

Real estate

Like equities, the outlook for real estate remains good. Thanks to low interest rates and a stock-market rally that is benefiting defensive sectors, real estate's returns continue to be satisfactory. The low-interest-rate environment is allowing refinancing at lower rates. The earnings outlook is more realistic for real estate than for equities. While improving, earnings revisions for equities are still mostly negative; in real estate, upward and downward earnings revisions are balanced. On the negative side, real estate's valuation is unattractive compared with equities. As the chart shows, the price-to-cash flow ratio for real estate is currently 1.7x the one for equities, against a historical average of 1.5x. This suggests an overvaluation of some 15%. Other indicators point to a higher overvaluation. As a result, we do not position real estate above equities.

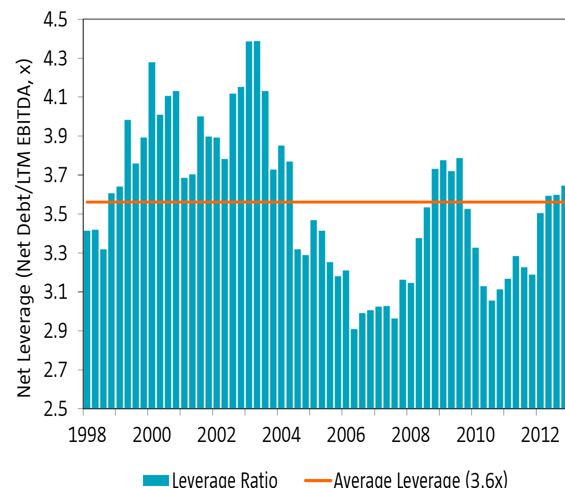
Price-to-cash flow ratio for global real estate versus equities' (x)



Credits and high yield

The outlook for both credits and high yield is positive. High yield has the best prospects, thanks to running yields that still offer decent absolute returns in the current low-interest-rate environment. For both asset classes, yield spreads are currently slightly below the historical median. Still, they could fall further due to financial repression. Global M&A has amounted to roughly USD 500-600 bln in most quarters in the last three years. We are not forecasting a wave of aggressive takeovers or leveraged buy-outs in this environment of moderate economic growth. But companies are becoming less bondholder friendly. Leverage for high yield is on the rise. However, this is no cause for major worries, as the global economy continues to grow at a moderate pace and central banks will act with more quantitative easing if growth falls back. In addition, default rates are low in all regions: 1.9% in the US, 1.1% in Europe and 1.8% in emerging markets, according to Bank of America estimates.

Spreads for credits and high yield in US market, and their medians

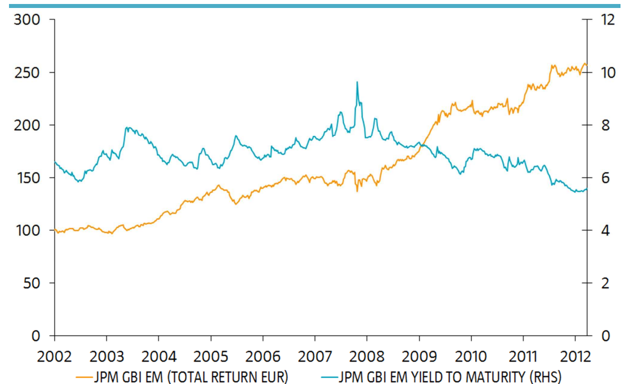


Source: Bank of America ML, Robeco

Emerging markets debt

Although some gloss has come off emerging markets economies, we remain positive on emerging market debt relative to developed government debt. For the second consecutive month, credit spreads widened due to increased macro volatility from ongoing events in Europe. In addition, current account balances and government budget balances are deteriorating against the backdrop of a disappointingly slow global recovery. The asset class continued to see positive net inflows, but at a slower pace. Emerging markets currencies generally depreciated in the last month, with only the Mexican and Thai currencies appreciating against a strong dollar. The emerging economies still remain vulnerable to movements of the dollar, although a partial decoupling

JPM GBI EM total return and YTM



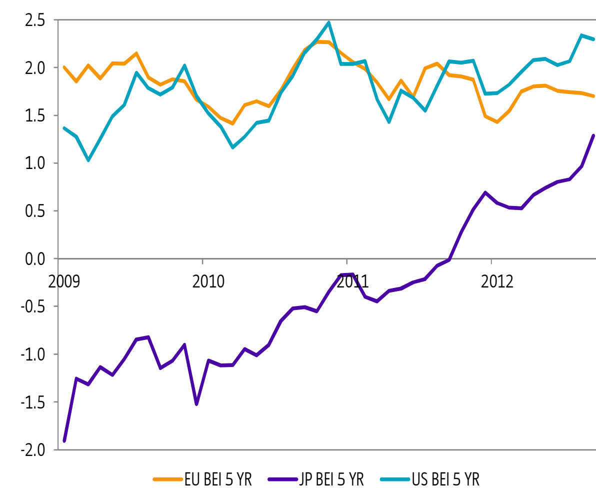
Source: Bloomberg, Robeco

towards country-specific factors is occurring. With inflation expectations on the rise in a number of countries, fewer emerging markets central banks will actively push for expansionary monetary policy going forward.

Government bonds

We hold on to our negative view on government bonds. Although we do not expect a significant rise in yields, they remain the least attractive asset category. Inflation expectations remain well contained. In the US and the eurozone, breakeven inflation rates have hovered around 2% for the last few years. Recently, the US rate has moved above 2%, while it is still below 2% in the eurozone. This reflects the contrasting economic performance. In addition, the Fed is acting more aggressively. The change in central bank policy in Japan is clearly visible in breakeven inflation rates. Over the past six months, inflation expectations have risen from 0.5% to 1.3%. Given that inflation expectations are well anchored and central banks continue their buying, rates are tending to stay too low. This is positive for bond investors but these low yields do not offer the opportunity for decent returns. We expect riskier assets to outperform government bonds.

Breakeven inflation rates in G3 (%)

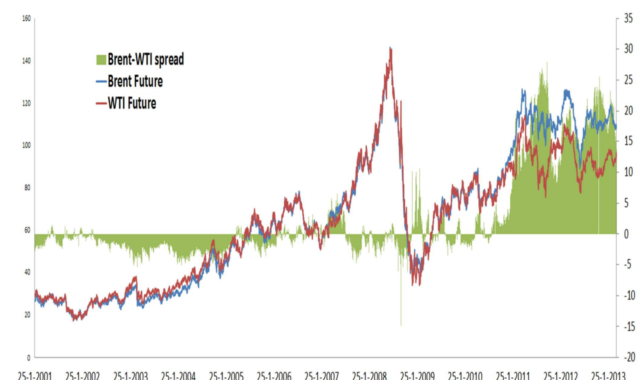


Source: Bloomberg, Robeco

Commodities

The outlook for commodities is slightly negative. We expect less demand for oil in the medium term. Major oil companies have downgraded their demand outlook for 2013 as China pursues a more modest growth trajectory. The ongoing deterioration in eurozone economic activity is exerting further downward pressure on oil prices. Moreover, emerging economies are expanding less rapidly. The supply boom in the US will cushion most of the uptick in oil demand there as the US recovery continues. With leading manufacturing purchasing managers' indicators pointing to a slow expansion of manufacturing activity, the outlook for base metals is negative, given the high inventory levels. Gold has lost its momentum. The safe-haven status of gold no longer seems strong enough to compensate for the ongoing outflows from gold ETPs. Lower inflation expectations in the US (higher real rates), decreased physical demand and reduced central bank hoarding of gold continue to put downward pressure on prices. We feel that only a significant geopolitical risk event or a sudden growth slowdown in the US would see gold prices trend upwards again.

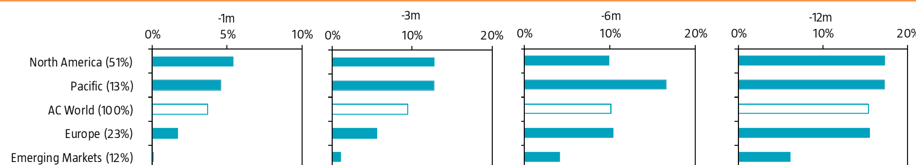
Brent–WTI spread



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. Despite weakness in the March confidence surveys among manufacturing and services companies, the general picture is that the US economy is doing relatively well. Quantitative easing will continue for at least this year. The US market is expensive but other regions offer a less-attractive economic outlook. In Europe, the eurozone debt crisis continues. The low levels of confidence among consumers and producers are having a huge effect on economic performance, with industrial production and retail sales both falling. We expect no positive surprises in this region: Slovenia and Malta are heading for financial assistance from the Troika, new Italian elections are expected for July and the budget-deficit targets for Spain and France are ambitious, given the weak economic data. We expect a relatively weak performance from European equities. The outlook for the Pacific is improving, as the weakening yen should boost Japanese exports. We still have a neutral view on the region, as we want to see more economic proof that the change in policy will benefit Japan. Economic data in emerging markets has been on the weak side and most currencies have come under some pressure. Momentum has been weak in the last few months. We do not believe that the economic data will improve and therefore expect the underperformance to continue.

Earnings and valuation data of regions (MSCI AC World)

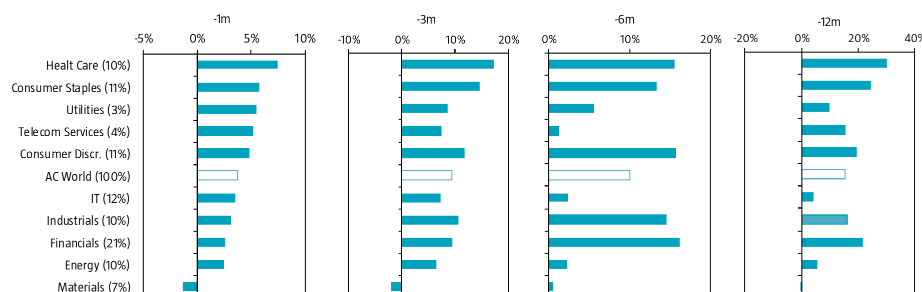
	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd earn.*	
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
North America	7.3	11.7	9.0	-10.8	-12.0	13.8	14.2
Europe	7.4	12.1	9.0	-18.2	-14.8	12.0	12.2
Pacific	27.2	11.8	29.0	19.6	16.3	14.2	15.4
Emerging Markets	16.0	10.8	14.6	-12.5	-7.6	10.4	10.8
AC World	10.6	11.7	11.9	-8.8	-8.1	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

Last month, defensive sectors outperformed the market without exception, leaving cyclical sectors with the weaker performance. This is a remarkable picture in a rising stock market. Before March, however, performance within defensive and cyclical equities was heterogeneous. Utilities and telecom were weak before then, and industrials and consumer discretionary beat the market. At present, we do not have an outspoken top-down view on sector positioning, given the mixed picture over the last few months. But as we expect moderate gains for the market as a whole, we maintain our view that low-volatility stocks are attractive. They tend to outperform when annual stock market gains are below 15%. As illustrated in the chart, low volatility stocks have outperformed the market on one- and three-year horizons, while they are also less risky.

MSCI AC World: low volatility index versus standard index

Source: Thomson Reuters Datastream

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	3.6	8.3	4.9	-23.0	-21.2	10.5	11.2
Materials	16.5	17.4	21.0	-28.9	-32.3	12.0	12.3
Industrials	11.7	13.1	12.8	-2.8	-8.6	13.8	14.4
Consumer Discr.	16.4	15.3	19.1	-8.2	-14.8	14.3	15.5
Consumer Staples	9.5	10.2	10.0	-14.4	-18.8	17.0	15.8
Health Care	1.4	8.8	3.3	-10.6	-20.8	14.6	14.6
Financials	14.5	10.9	13.7	10.8	15.0	11.3	11.4
IT	11.8	13.3	13.9	-1.6	-1.6	12.8	16.8
Telecom Services	6.5	9.0	7.2	-37.1	-18.2	13.0	15.4
Utilities	11.7	12.3	13.4	-7.1	15.3	14.4	13.6
AC World	10.6	11.7	11.9	-8.8	-8.1	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

Closing date text: 10 April 2013.
In our data tables, we do refer to calendar months.

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