ROBECO

Monthly Outlook
Expect less nail-biting

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Highlights

- The prospects for the world economy are mediocre. But a number of 2012's problem issues are no longer such a concern, at least for the time being. Japan and the US have avoided their fiscal cliffs, though the latter has done so only temporarily. In the eurozone, policymakers are trying to delay major decision making until after the German elections in the autumn.

- The ECB continues to hold in reserve a powerful weapon, its outright monetary transactions (OMT). The risk of a Grexit has declined significantly. The Chinese economy is rebounding. Our baseline scenario is a continuing muddling through of the world economy. The risk of a global recession has lessened. Tensions in the Middle East remain high.

- We maintain our positive view on credits and high yield bonds. Running yields may be low but spreads can still be characterized as normal. Spreads could thus continue to decline, given that companies are still cautious on capital expenditure and are benefiting from strong cash flows and have healthy balance sheets. As real yields on government bonds are in negative territory, we expect the outperformance of credits and high yield relative to government bonds to continue.

- Inflows into emerging markets debt are set to continue due to the attractive yields and the healthy economic fundamentals. Government debt ratios are generally stable and the external balance of emerging markets against the rest of world remains positive.

- We are not very enthusiastic about the outlook for equities. On the positive side, the US fiscal cliff has been averted—for the time being—and there remains ample liquidity in the markets that could deliver a positive surprise. On the negative side, earnings growth appears to be limited to a few percentage points and valuation is normal.

- We rank real estate in line with equities due to its unattractive valuation. With a return of 22% in 2012, listed real estate was the top asset class of the year. We expect large and

well-positioned real estate players to continue to enjoy lower refinancing costs. Vacancy rates are falling and quantitative easing has increased demand for real estate.

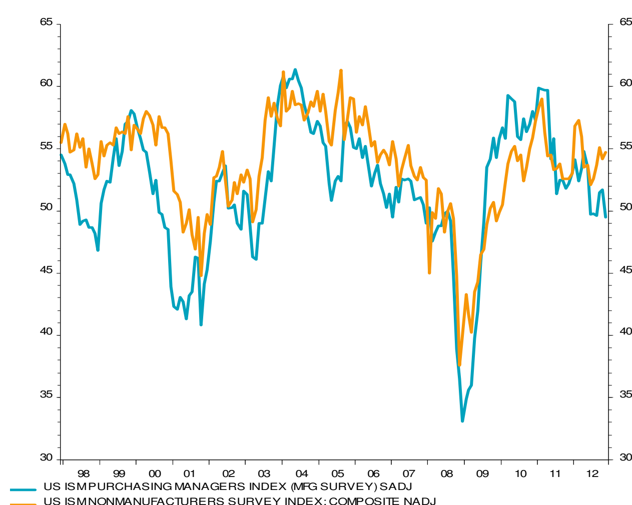
Macroeconomic view

Global economy

The prospects for the world economy are mediocre. But a number of 2012's problem issues are no longer such a concern, at least for the time being. Japan and the US have avoided their fiscal cliffs, though the latter has done so only temporarily. In the eurozone, policymakers are trying to delay major decision making until after the German elections in the autumn. The ECB continues to hold in reserve a powerful weapon, its outright monetary transactions (OMT). The risk of a Grexit has declined significantly. The Chinese economy is rebounding. Our baseline scenario is a continuing muddling through of the world economy. The risk of a global recession has lessened and, as a result, we expect less nail-biting from market participants. One concern is that tensions in the Middle East remain high.

North America

US PMI manufacturing and non-manufacturing



Source: Thomson Reuters Datastream

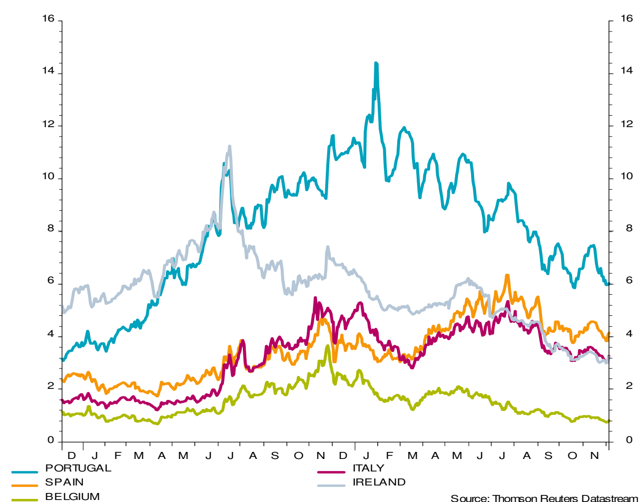
In the US, the unexpected weakness of the manufacturing purchasing managers' index proved to be a temporary phenomenon, and was probably mainly due to Hurricane Sandy. The underlying economic growth trend is moderately positive. The housing market continues to recover. But continuing uncertainty about fiscal policy is delaying investment. As both major political parties are gearing up for another showdown on the debt ceiling at the end of February, uncertainty will remain for the time being. In the end, we expect some sort of compromise, as it is unlikely that the debt ceiling will not be raised. No major party will want to be held responsible for that. As such, not much has changed since the fiscal cliff was avoided around year-end. We feel it is unlikely that a credible medium-term path for fiscal policy will be negotiated. Politicians will probably follow the path of least resistance, leaving it up to both parties to sort things out at a later stage. Promises of medium-term fiscal consolidation are thus not very convincing, increasing the risk that the US's credit rating will be lowered in 2013. Still, the impact of such a move would probably be limited. The Federal Reserve looks certain to remain in its aggressive easing mode. As expected, the US central bank terminated Operation Twist at year-end. Instead, the central bank is now simply buying USD 85 billion of Treasuries and mortgage-backed securities each month. A new development is the quantification of its unemployment target (at 6.5%, vs. the current level of 7.7%) and a maximum level for inflation (2.5%). At some point, a conflict could arise between these two targets, but probably not in 2013. All in all, the US central bank has an explicit preference of remaining behind the curve. It is still a long way before it will be necessary of take away the punch bowl in a timely fashion just as the party gets going. Of course, future FOMC decision making is in no way bound by the current approach. At worst, it would lose credibility if it decided to formulate a new policy stance.

If Iran crosses the nuclear threshold in 2013, the risk of a military escalation in the Middle East is high. But the US wants to avoid a war against Iran at almost any cost, given what happened in Afghanistan and Iraq. Economic sanctions are undermining the Iranian economy quite effectively. A last-minute deal between the US and Iran is conceivable.

Europe

UK's economy surprised this month with UK's manufacturing purchasing managers' index coming in at 51.4, the highest number in 15 months. A figure above 50 indicates an expansion in economic activity. Further quantitative easing is likely in 2013, although it is currently on ice due to the stubbornly high level of inflation. The governor-elect of the Bank of England, Mark Carney, who will succeed Mervyn King on 1 July, has spoken positively about nominal GDP targeting in the event that policy rates approach zero. Targeting nominal GDP could be an effective way of obtaining debt sustainability. The pressure is mounting for significant steps regarding the UK's fiscal situation. Last month, S&P gave the UK's AAA rating a negative outlook due to the insufficient progress in tackling the country's public finances. If fiscal policy is unchanged, a downgrade for the UK within the next two years is becoming more likely. Further unconventional monetary policy will be necessary down the road. As well as a change in style, a change in substance also seems more likely now.

Ten-year yield spreads vs. Germany



The eurozone economy is experiencing a deepening recession. The latest purchasing managers' index pointed to a further contraction in economic activity. In particular, French new orders dropped sharply, highlighting the ongoing erosion in the country's competitive power. President Hollande's pursuit of the 3% fiscal-deficit target has suffered a further setback, as the French constitutional court rejected his proposed 75% tax rate on annual earnings over EUR 1 million. Inflation in Germany crept up a little and now stands at 2%. Inflation risks in the eurozone remain broadly balanced, with energy costs expected to ease further. Despite the adverse economic developments, conditions in debt markets remain stable, with the ECB keeping its OMT weapon in reserve. With German elections approaching, policymakers have done their best to contain the eurozone crisis, at least for the time being. As part of this process, Brussels is taking a more accommodating stance towards France's deficits. Negative surprises from the periphery, forcing Germany to act ahead of the elections, could negatively affect German sentiment towards Europe and weaken Angela Merkel's stance of moving the eurozone project forward after the elections. Italian yields have returned to 2010's low levels, dropping below prime minister Mario Monti's target spread over German paper of 287 basis points (bps). But calm in eurozone markets is not assured, not least because of tail risks stemming from a bad outcome in Italy's election in February. At present, though, the situation looks promising. It is likely that Pierluigi Bersani's center-left coalition, which is well ahead in the polls at 42%, would keep Monti's austerity policy largely intact. Inflation pressures in Germany will fade, while inflation in the eurozone looks set to continue on its downward path. We expect the ECB to provide some additional monetary stimulus by lowering the refi rate by an additional 25 bps in the first quarter of 2013.

Pacific

A further weakening of the Tankan highlighted the deterioration of economic conditions in Japan. The opposition achieved a decisive victory in the 16 December elections. The center-right LDP/NKD coalition gained a qualified majority in the lower house, meaning that it can now overrule the upper house. The new prime minister, Shinzo Abe, has raised pressure on the Bank of Japan (BoJ) to loosen policy further. Furthermore, the new government has announced a new fiscal stimulus package. The yen has weakened significantly against the major currencies, improving Japan's competitiveness. So far, the negative impact on long-term rates has been limited. All in all, Japan's growth and inflation prospects should improve, as China strengthens. Given the nationalistic make-up of Abe's new cabinet, the risk that relations with China will worsen has certainly risen. However, Abe's cautious approach so far gives room for optimism that enlightened self-interest will prevail and tensions will be kept in check.

BRICs

Thanks to a broad range of easing measures, the Chinese economy is gradually recovering. As a consequence, industrial profits are on the rise, which bodes well for fixed-investment growth.

The Indian economy is showing signs of recovery. Recent PMIs point to rising orders, while exports are improving. Inflation remains stubbornly high, however. While the Indian recovery should continue, not much progress on inflation is to be expected.

Brazil's economy appears to be improving somewhat as a result of the government's stimulus. This is allowing the authorities to put more emphasis on controlling inflation. The central bank will therefore be on hold for the foreseeable future.

The Russian economy is weakening slightly as a consequence of the lower oil price. The Russian government has reduced its growth forecast for 2013 to 3.6%, which we consider to be reasonable. Inflation is set to be a tad lower in 2013 than in 2012.

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 (70%). The likelihood of a global recession has declined to 15% due to growing optimism about growth in China and the US, at least temporarily diminishing tensions in the eurozone and the political revolution in Japan. Geopolitical risks in the Middle-East remain high. We feel the probability of a traditional recovery has increased to 15%.

Position in the economic cycle

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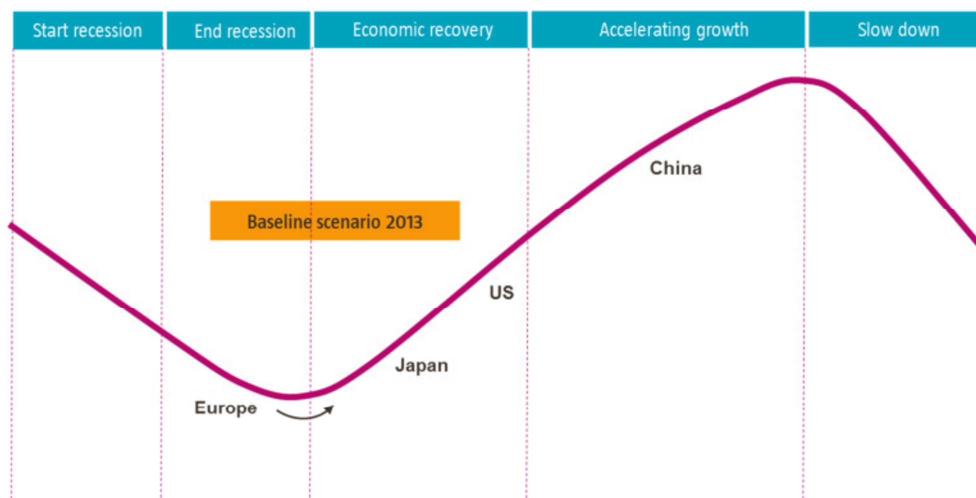


Macroeconomic scenarios

Source: Robeco

Consensus estimates of economic growth and Robeco's expectations

GDP growth by region (%)	*2011*	*2012*	*2013*	*Δ -1m 2013*	*Robeco**
US	1.8	2.2	1.9	0.0	+
Eurozone	1.5	-0.5	-0.1	-0.1	-
UK	0.9	-0.1	1.1	-0.1	-
Japan	-0.5	1.8	0.6	-0.3	=
China	9.3	7.7	8.1	0.1	=
India	6.5	5.5	6.5	-0.1	-
Brazil	2.7	1.5	3.8	-0.1	+
Russia	4.3	3.7	3.5	-0.1	=
World	2.5	2.0	2.1	-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 (%)	*2011*	*2012*	*2013*	*Δ -1m 2013*	*Robeco**
US	3.1	2.1	2.0	0.0	-
Eurozone	2.7	2.5	1.9	-0.1	-
UK	5.3	3.2	2.9	0.2	=
Japan	-0.3	0.0	-0.2	0.0	+
China	5.4	2.7	3.2	-0.1	-
India	8.3	9.4	7.7	0.1	+
Brazil	6.5	5.4	5.3	0.0	=

Russia	6.1	6.7	5.9	-0.1	=
World	3.3	2.6	2.3	0.0	-

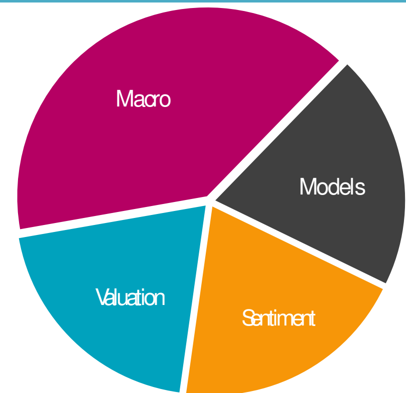
* indicates whether we expect a higher (+), matching (=) or lower (-) inflation rate than the current consensus estimate for 2013

Source: Consensus Economics, Robeco

Financial markets outlook

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

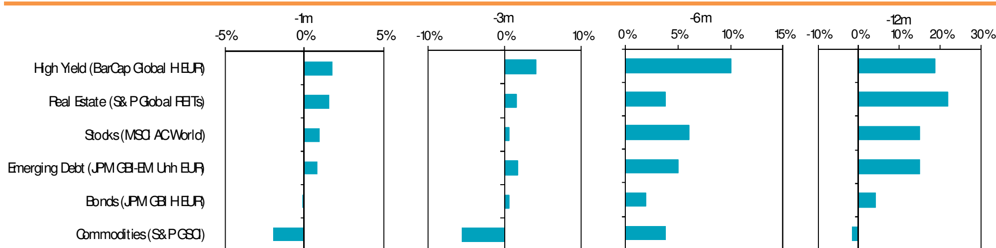
Input factors for our investment policy



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

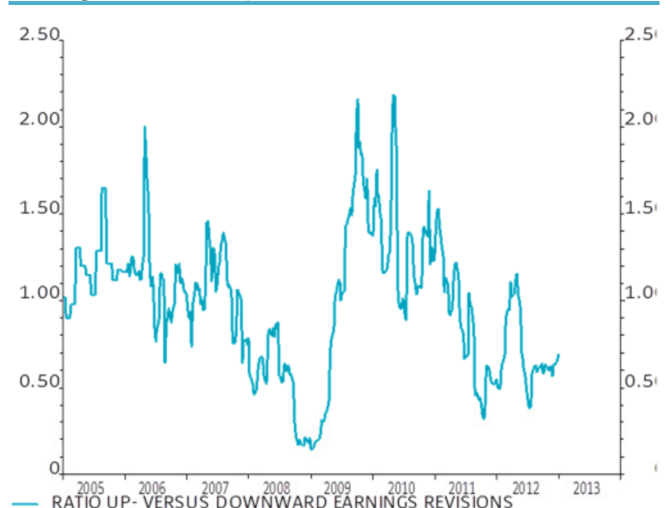


Source: Thomson Reuters Datastream, Bloomberg, Robeco

Equities

Our stance on equities is somewhat cautious. On the positive side, the US fiscal cliff has been averted—at least for the time being—and there remains sufficient liquidity in markets to keep the search for yield going. Risky assets such as equities should benefit from this. Moreover, equity volatility remained relatively low in the uncertainty surrounding the cliff, certainly when compared with the period when the debt ceiling was under discussion in the summer of 2011. Given the self-reinforcing nature of the US recovery, the fiscal tightening exercised in the fiscal deal should not be a significant drag on stock prices. On the negative side, earnings growth looks set to be limited to a few percentage points, as further margin expansion is unlikely. The limited upside for earnings growth is shown by the earnings-revisions ratio, where earnings downgrades still outnumber upgrades. With valuation at historically normal levels and with only limited earnings-growth surprises to be expected, we maintain a neutral view on equities.

Earnings revisions (# up minus # down/# total revisions)

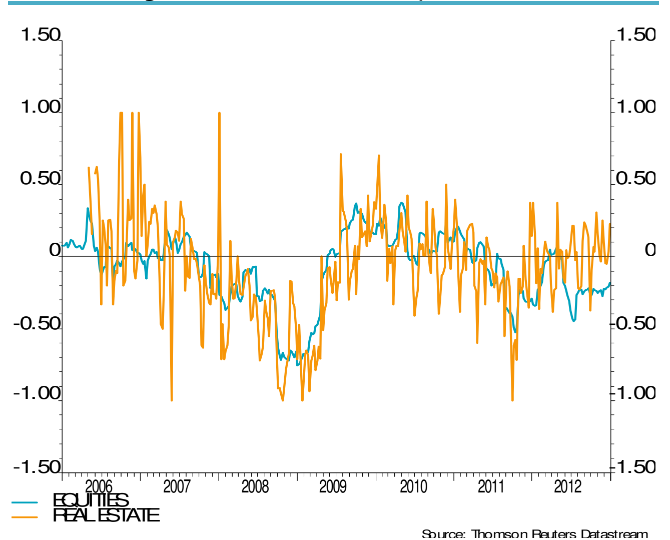


Source: Thomson Reuters Datastream

Real estate

With a 22% return in 2012, listed real estate was the year's top asset class, beating equities by 7 percentage points. Earnings projections for real estate have been more robust than equities': downward and upward earnings revisions in real estate have counterbalanced each other for four months in a row, while earnings downgrades for equities outnumbered upgrades for most of 2012. That's not all. We expect large real estate players to continue to enjoy lower refinancing costs; vacancy rates are falling; and quantitative easing has increased demand for real estate due to its perceived inflation protection. We expect the search for the next-best alternative to low-yielding government bonds to go on. If these were the only factors at play, real estate would rank above equities. But unattractive valuation means we rank real estate in line with equities.

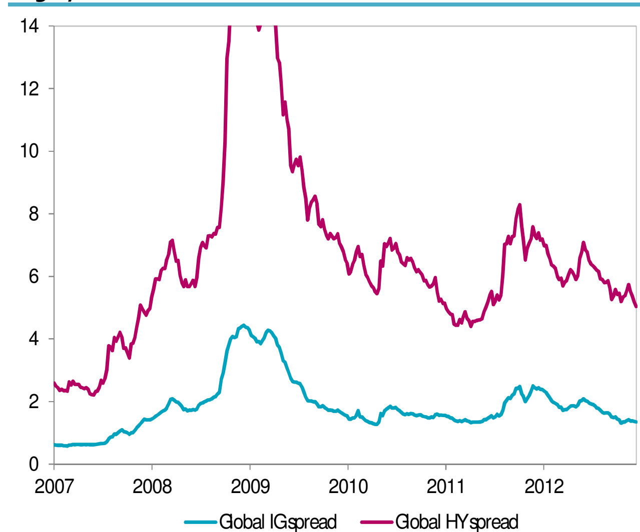
Valuation of global real estate versus equities



Credits and high yield

We maintain our positive view on credits and high yield. For credits, the global interest-rate spread declined to 1.3%, comparable to the first half of 2010. For high yield, spreads are now at 5.0%, the lowest since March 2011. Running yields may be low but spreads can still be characterized as normal. Spreads could thus continue to decline, as companies are still cautious regarding capital expenditure and are benefiting from strong cash flows and healthy balance sheets. We expect the global default rate for high yield to average 3.5% over the next 12 months. There is room for positive surprises in the US and negative surprises in Europe. As real yields on government bonds are in negative territory, we expect the outperformance of credits and high yield to continue, with running yields clearly above those on government bonds.

High yield default rates

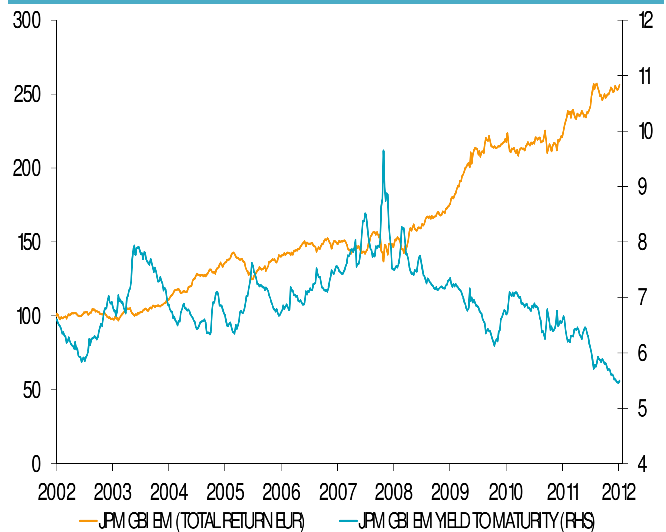


Source: Barclays, Robeco

Emerging debt

Inflows into emerging debt should continue due to the attractive yields and healthy fundamentals. Central banks in developed markets have eased monetary policy aggressively, putting downward pressure on interest rates. Emerging yields further compressed in December to 5.5%. Tail risks for emerging rates would stem from a promising US fiscal deal and further stabilization of the eurozone crisis, which could put upward pressure on nominal rates. Given our preference for overweighting emerging debt against developed government bonds, the key issue is the effect on emerging currencies. This should be limited, as emerging markets benefit from economic strength elsewhere. Currency exposure adds risk, but currency gains are more likely than losses due to the healthy fundamentals. Government debt ratios are stable and emerging markets' external balance against the rest of world is positive.

Sovereign debt levels of various emerging market countries



Source: Bloomberg, Robeco

Government bonds

Despite a 20-30 bps jump in ten-year yields in many government bond markets, yields are still close to historical lows. The outlook continues to be negative, given the moderate outlook for the global economy and the small chance of inflation manifesting itself in the short term. The consensus expectation for global growth in 2013 is 2.1%, slightly above the 2.0% for 2012. Global inflation is expected to fall from 2.6% to 2.3%. Against this economic backdrop and with major central banks active on the buy side, we expect interest rates to stay close to their historical lows. In itself, this is not a negative for government bonds. But we expect the negative real yields to spur on the continuing outperformance of investment-grade credits, high yield and emerging debt relative to government bonds.

Inflation in developed markets

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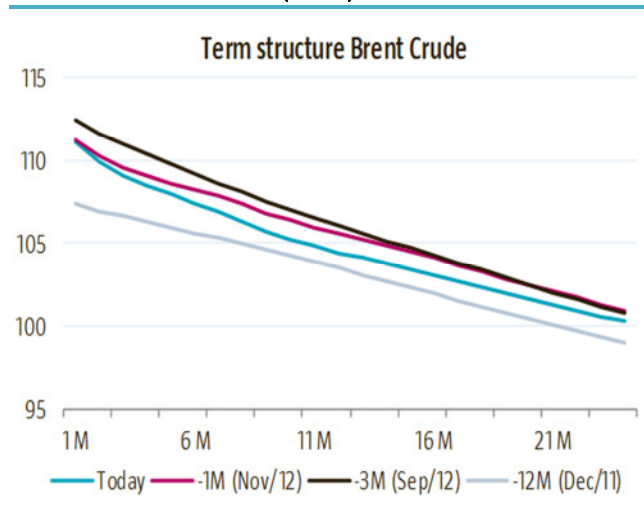
Commodities

We have a neutral view on commodities. For oil, futures point to a Brent price of around USD 105/bbl in 2013. Supply is being impacted by Saudi Arabia, which has been reducing supply for months to support prices. Demand for oil from China is on the rise, but not strongly enough to compensate for the fall in demand from Europe. Ongoing tensions in the Middle East will continue to affect the oil price, but without an escalation, we expect oil to trade sideways, given that global economic growth remains muted. Industrial metals prices seem to be picking up due to the acceleration of economic growth in China. But China has large stocks of copper, its most important metal. We doubt whether the pick-up will gather much steam.

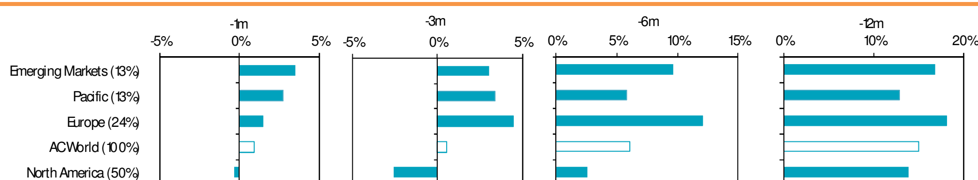
Term structure oil market (Brent)



Source: Bloomberg

Regional allocation

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



Source: Thomson Reuters Datastream, Robeco

North America and emerging markets are our favorite regions. Uncertainty remains over the US budget cuts and debt ceiling, but in the end we expect the US to maintain its 2% growth rate. Rising employment and increasing income, together with an improving housing market, have resulted in a self-sustaining economic recovery. Downside risk is limited compared with other regions. Our preference for emerging markets is based primarily on the slight acceleration in economic growth combined with low inflation risks, while valuation is a small positive. Due to the risk of ongoing economic disappointments, we still have a somewhat negative view on Europe. The region is also characterized by a huge number of downward earnings revisions. The outlook For the Pacific has brightened, with increasing pressure being put on the BoJ to inflate Japan's economy. The weakening yen is hurting the unhedged performance of Japanese stocks, but it should also drive exports. For now, we remain negative: the recent outperformance may well turn out to be another short-term blip, as the economy—still—continues to be weak.

Earnings and valuation data of regions (MSCI AC World)

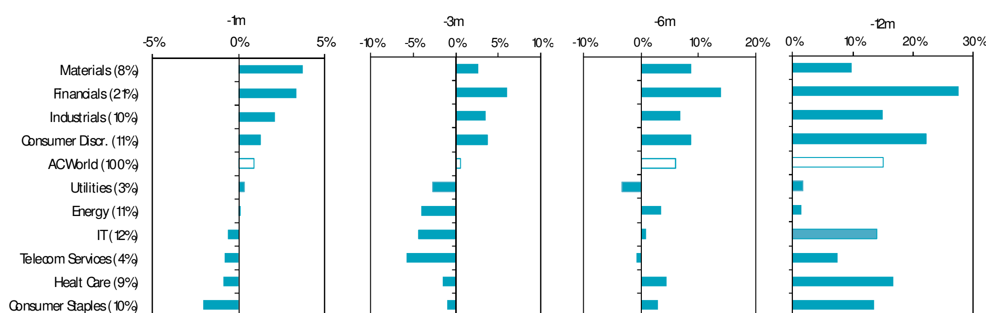
	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd*	
earn.	*FY1*	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
North America	5.6	9.4	9.6	-22.0	-20.0	12.8	14.3
Europe	-3.5	9.1	9.5	-26.0	-35.9	11.4	12.3
Pacific	15.1	21.3	22.2	-23.7	-10.5	13.4	15.5
Emerging Markets	2.7	13.8	13.8	-18.5	-7.4	10.5	10.7
AC World	3.5	11.2	11.5	-22.5	-18.2	12.2	13.5

The earnings revisions index is calculated as the difference between the number of upward 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

Sector performance within the cyclical and defensive groups has been mixed. Over recent months, consumer discretionary has continued to perform relatively well within the cyclical segment, while telecom and utilities have been weak within defensives. We do not expect the economic backdrop to change too much. This could mean that bottom-up developments remain relatively important. Currently, we do not have an outspoken top-down view on sector positioning. But as we do expect moderate gains for the market as a whole, we think low-volatility stocks are attractive. As a rule of thumb, they outperform when stock market gains are below 15%.

Earnings and valuation data of regions (MSCI AC World)

earn.	*Earnings growth (%)*			*Earn. rev. index*		*P/E on 12m fwd*	
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
Energy	-9.3	5.2	5.0	-24.8	-20.0	10.0	11.3
Materials	-22.5	21.9	23.3	-45.3	-44.1	12.3	12.4
Industrials	4.1	10.8	10.8	-40.6	-33.8	12.8	14.4
Consumer Discr.	29.9	16.6	17.1	-16.4	3.4	13.4	15.5
Consumer staples	5.3	9.7	9.9	-12.8	-8.2	15.5	15.7
Health Care	3.1	6.6	6.7	-7.5	-2.6	13.0	14.6
Financials	8.1	12.2	12.4	-7.8	-11.1	10.9	11.4
IT	11.5	12.3	13.1	-24.3	-34.3	12.3	17.2
Telecom Services	0.3	8.5	8.3	-15.8	-4.3	12.1	16.0
Utilities	17.4	9.2	10.0	-15.5	13.3	14.1	13.5
AC World	3.5	11.2	11.5	-22.5	-18.2	12.2	13.5

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: 04 January 2013.
In our data tables, we do refer to calendar months.

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