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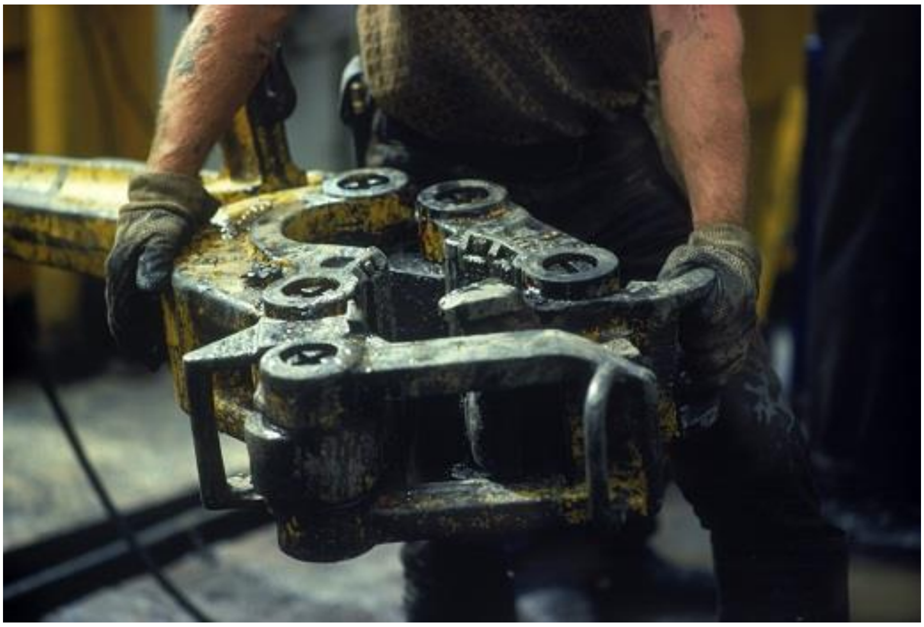


# Pouring oil on troubled waters

- Market has seen a 'perfect storm' from supply and demand sides
- OPEC may take action but not enough to rebalance the market
- Macro outlook: World economy is entering a more difficult phase
- Asset allocation: Equity rally continues but US remains overvalued

## Topic of the month: Dead calm from the Saudi desert

The oil price has been plunging this year, but what is causing it, and should investors worry? This month we analyze how the value of crude is likely to remain low.

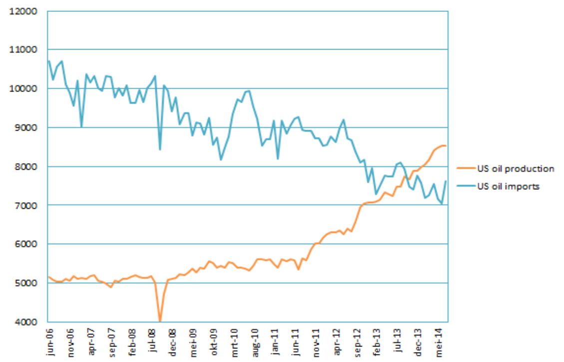
"Silence is the ultimate weapon of power" Charles de Gaulle once said. This insight is clearly understood by Ali al Naimi, the powerful Saudi oil minister, who has been mostly silent and was on vacation last month when the whole oil market was waiting for him. One of the burning questions in the oil markets right now is whether Saudi Arabia and OPEC will balance the oil market after the steep drop in Brent prices since last June. Brent prices have tumbled 21.6% in the year to date.

### A perfect storm has been brewing for oil

The oil market has experienced a 'perfect storm' from supply and demand side developments in recent months. On the one hand, the oil market is currently experiencing a supply boom. We expected to lower production by OPEC suppliers to try to raise prices, but the strong production volumes generated by the continuing oil revolution in the US has surprised both us and the oil market. US oil output is now running at the fastest pace since measurement began in 1983. OPEC production also kept its upward trend last month with an additional 53,000 barrels per day amounting to a total production of 30.97 million barrels per day.

At the same time the macro economic growth momentum of the global economy slowed down, leading to a less bright demand outlook for oil. The IEA cut its estimates for global oil demand growth by 250,000 barrels per day for 2014 and by 90,000 barrels per day for 2015. The question that is now prevalent is *whether* the oil market is going to rebalance next year and if so, in which way this rebalancing process is going to take shape.

**US oil production has surpassed the volume of imports**




*Source: Bloomberg, Robeco*

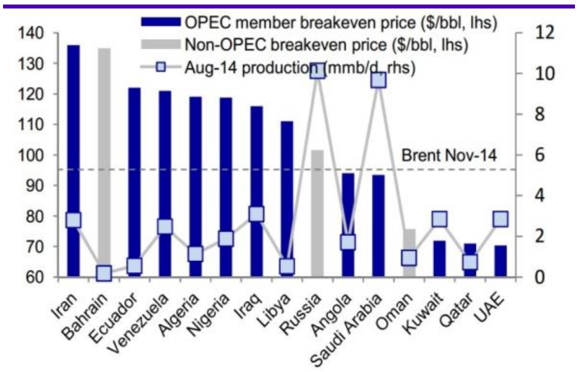
### OPEC may try to rebalance the oil market

A rebalancing of the oil market is needed for most key producers within OPEC (and for Russia as well), as they are now experiencing producer prices that are around or below fiscal breakeven levels, which makes current market prices unsustainable from a sovereign budget perspective. However, the silence from OPEC's largest member, Saudi Arabia, about future production cuts following the sharp drop in oil prices has raised uncertainty about OPEC's strategy. This uncertainty has only increased after Saudi Aramco lowered its prices to the US and the Saudis did not hint they might cut production after the sharp decline in oil prices. This could suggest a strategy to gain market share instead of retaining pricing power. The underlying reason for this strategy change could be to challenge the firming non-OPEC competition, especially the US oil producers. The reluctance to cut production by Saudi Arabia could also be aimed at bringing more alignment and discipline among OPEC producers for a more meaningful production cut later on. History (and game theory) has shown OPEC members to have an incentive to "cheat" on production levels that were agreed at OPEC meetings, and the Saudis could use the recent price drop to increase their leverage over non-abiding members. The discussion at the forthcoming OPEC meeting on 27 November will be as tense as it will be crucial, as Venezuela has been calling for a production cut.

### Game of chicken?

Although an OPEC cut seems a logical first step to balance the market, a risk to the above scenario is that the group remains reluctant to cut production meaningfully. First, OPEC could point to increasing oil demand in the future, as a drop of more than 20% in oil prices typically generates 0.4% in additional real GDP growth. Secondly, dissenting voices within OPEC to fight the current bearish market forces could prevent forceful action. Also, a more determined Saudi stance to push the US into the role of the global swing producer could play a motivating role in this scenario. Here, oil prices could even drop further from current levels, as the market would act as the rebalancing mechanism.

**Fiscal breakeven prices for leading oil producers**




*Source: Deutsche Bank*

But this scenario remains a tail risk in our view, because Saudi Arabia knows that the longer oil prices stay below fiscal breakeven prices, the more stressed the fiscal situation in oil-producing countries becomes, risking civil unrest and geopolitical repercussions. This would be a price too high to pay for triggering a cutback in US oil production.

In the US the dominant strategy is likely to be a continuing increase in production, although some marginal producers are heading for trouble given that market prices are below their breakeven levels. The lack of OPEC-like coordination mechanisms in the US industry and the history of maximizing output instead of cashflow leaves us with the view that the US oil revolution could have a temporary dent, but will not be brought down. We think the recent market developments have only provided the US oil producers with more incentives to focus on drilling efficiency to lower unit production costs through technological advances.

Although it is very difficult to see how this potential game of chicken between OPEC and the US oil producers will play out, a return of oil demand could come to the rescue later in 2015. Although the US is clearly advancing towards energy self-sufficiency, it still remains dependent on OPEC. The marginal barrel of oil - the barrel that is barely profitable to use in the economic process - will still be imported from OPEC countries. As stated above, academic research shows that a decline in oil prices of 20% generates 0.4% additional real growth for the global economy, and this increased economic activity will itself generate another leg of oil demand. Developments in China are also important in this respect. Although China will face increasing growth challenges in 2015, these challenges have thus far not translated into a structural break in China's oil imports, and are not likely to do so in the near term.

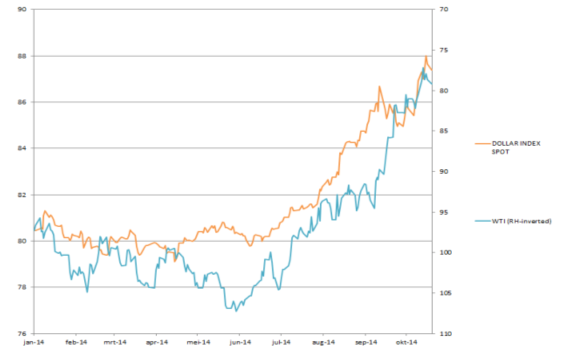
An even more complicating aspect in the current market dynamics are the US's deliberations with Iran. The US could grant concessions to Iran in exchange for Iran's support in the battle against their common enemy, ISIS. However, in a recent letter to Iran's supreme leader Khamenei, President Obama discouraged Iran from thinking that its leverage to demand concessions has increased because of their common goal to destroy ISIS. Therefore, a significant deal with Iran on 24 November, a few days before the crucial OPEC meeting, is not likely. The absence of a deal with the US also implies less bargaining power from Iran within OPEC and reduces the probability of a meaningful supply cut.

## No 'business as usual' if OPEC does cut production

It is likely that headwinds for a rebound in oil prices will remain strong in the near term. Even if there is a production cut by OPEC, non-OPEC supply will be encouraged to rise even further in reaction. Struggling emerging economies like Russia, Mexico and Brazil are clearly in need of additional oil revenues and will react with higher output if prices are propped up by OPEC.

Another headwind is the steadily appreciating dollar. A stronger dollar, as we expect for 2015, will be troublesome for the oil market as well, because this makes the oil bill for oil importers outside the US more expensive. Therefore, our modal view is that oil prices are going to stabilise, but a significant rebound back to the USD 100-115 per barrel bracket will not happen next year. Prices will likely drift higher, but remain below USD 90 for Brent.

**Oil price decline has coincided with a strong dollar**




*Source: Bloomberg, Robeco*

## Implications for financial markets

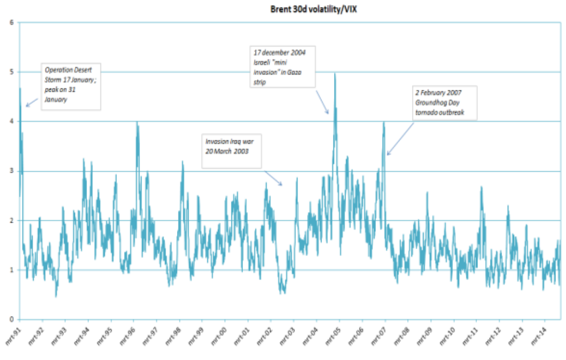
Depending on the scenario, the near and medium-term implications for financial markets may be quite significant. Below we review a few assets which have shown strong correlations with the fall in oil prices.

First of all, oil-specific volatility, taken as the 30-day volatility in Brent corrected for broader asset market volatility (as proxied by the VIX), has remain subdued. Thus, oil traders who wanted to sell could easily find buyers. This has been not the case in earlier supply side shocks such as the first Gulf war. Oil-specific volatility could increase in coming months if OPEC does not give a clear direction.

The drop in 5-year inflation expectations across the globe has almost coincided with the drop in oil prices since last June. If oil prices were to stabilize somewhat, as we expect in our base case, future inflation expectations would also rebound as import prices of oil consuming countries would rise again.

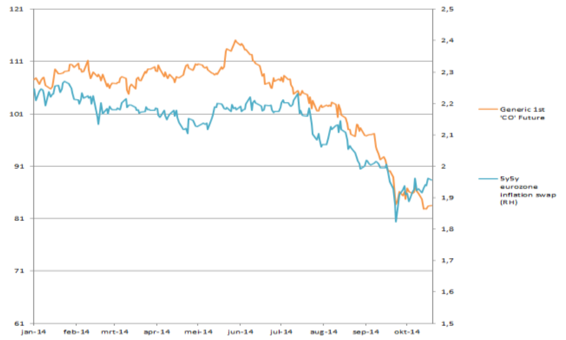
The issuance of high yield bonds in the energy sector of the US has increased in recent years. Energy companies make up more than 15% of the US high yield bond index. Since the drop in oil prices, spreads on these companies have widened considerably to 640 basis points from 375 in June when oil prices first started to collapse. Cashflows have not kept up with the increasing costs of operations, and this balance is likely to deteriorate if a significant rebound in the oil market fails to appear.

**Steady price direction; oil-specific volatility is still low**



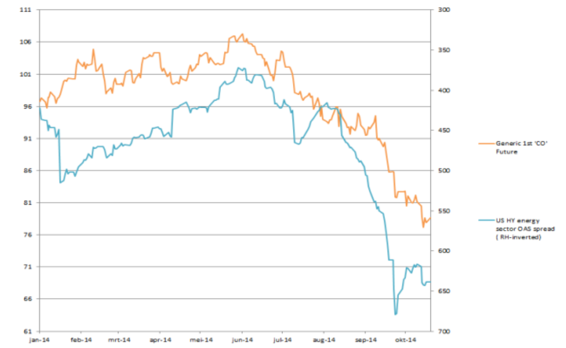

*Source: Bloomberg, Robeco*

**Significant repricing of forward inflation has taken place as the oil price has declined**




*Source: Bloomberg, Robeco*

**Spread widening has been seen in US high yield energy issuers as WTI came under pressure**

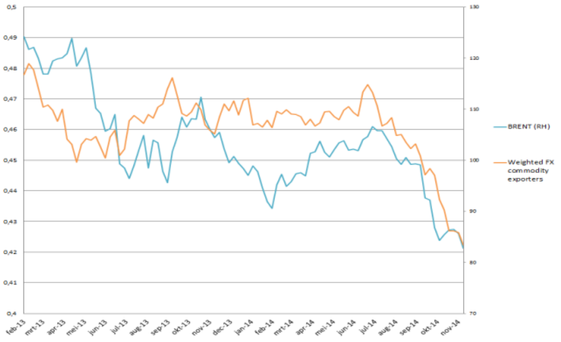



*Source: Bloomberg, BofaML, Robeco*

### Implications for commodity currencies

The Brent effect is also visible in the currencies of net commodity exporters. Countries which are net oil exporters like Russia, Brazil and Norway have seen their currencies depreciate against the US dollar. Although there are more forces at work besides the Brent effect here, stabilizing oil prices could mitigate depreciation pressure.

**Currencies of major oil exporters**




*Source: Bloomberg, Robeco*

# Macro outlook: World economy is entering a more difficult phase

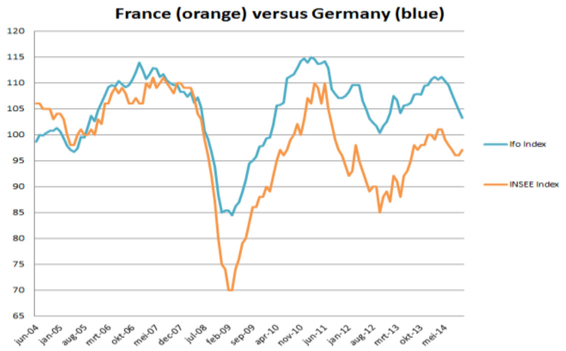
The world economy is entering a more difficult phase, with China probably doing less well than it has officially reported, the Japanese economy struggling, and increasing worries about the Eurozone economy. The weakness of the oil price is partly a symptom of lack of global demand. That said, reflationary efforts have been increased. The Bank of Japan has boldly stepped up its program of quantitative easing and in Europe, ECB President Mario Draghi is successfully (if judged by the EUR/USD trend) continuing his verbal quantitative easing.

**Increasing pessimism about the Eurozone economy**

The generally optimistic European Commission slashed its forecast for the Eurozone economy to grow by 1.1% in 2014, less than the 1.7% forecasted in the Spring. The main reasons are a lack of internal investment and political tensions in Ukraine and the Middle East. The conflict in Ukraine is currently showing signs of escalation which will continue to weigh on German producer confidence.

The ECB Governing Council apparently closed ranks by giving Draghi unanimous support for his earlier suggested plan to bring back the size of the ECB balance sheet to the level of March 2012, roughly EUR 1 trillion over a two-year period. As it is likely that the buying of asset-backed securities, covered bond and the Targeted Long-Term Refinancing Operation (TLTRO) will be insufficient to realize this ambition, corporate bonds may be next on the proposed buying list. Buying baskets of sovereign bonds (e.g. GDP-weighted or by the size of individual country contributions to the capital of the ECB) remains a weapon of last resort. This is highly unpopular in Germany, where the current Grand Coalition is increasingly feeling the heat of the Eurosceptic Alternative für Deutschland (AfD), which is doing consistently well in state elections.

**Ifo indicator points to decreasing expansion of production**




*Source: Bloomberg, Robeco*

In other words, the economic picture has to deteriorate markedly from current levels for generalized

QE to take place. The picture of internal harmony expressed by the ECB raised the hope of more aggressive actions in the future, which was positive for risky assets in the Eurozone and put downward pressure on the euro.

**Japan: Central bank  paves way for new sales tax hike**

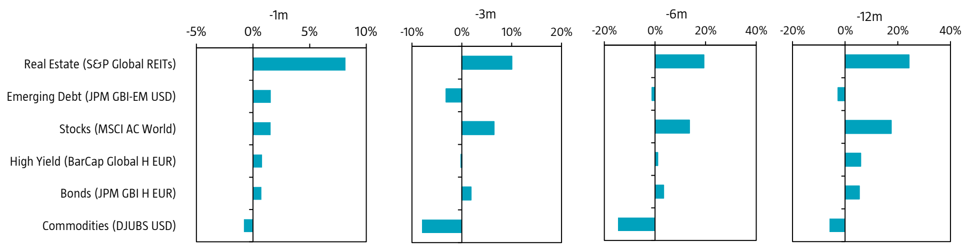
The sales tax hike in April led predictably led to a fall in Japanese consumer spending, though this fall was larger than initially expected. As a consequence, inflation fell back as well. Core inflation has declined from 1.5% in April to 1.0% in September, endangering the 2.0% target set for Spring 2015. Furthermore, an aide to Prime Minister Shinzo Abe, and later a cabinet minister, began to float the idea of postponing an additional sales tax hike planned for October 2015, on which a decision is expected by Abe in December. In our opinion, delaying the sales tax hike, an important cornerstone in Abe's attempts to regain fiscal credibility, would throw his whole commitment to 'Abenomics' into serious doubt. Delay is now less likely, as the Bank of Japan has made a bold, preemptive move (with a slim majority of 5 against 4) by promising to buy JPY 80 trillion of government bonds each year (15% of GDP) until the deflation  threat has been removed, essentially introducing a Japanese-style QE. As a percentage of GDP, the Bank of Japan's balance sheet would become much larger than that of the Fed and ECB. It would mean that the Japanese government could proceed with the tax hike according to plan. Not a lot is happening though on structural reform (the so-called third pillar of 'Abenomics') and this probably won't change. Rumors of a snap election will probably die down as well. The yen depreciation, made possible by the collapse in oil prices now that Japan's dependence on foreign energy is enormous, will put competitive pressure on South Asian economies and could easily start a round of depreciations and devaluations, including the Chinese yuan.

**US: Republican majority in both Houses of Congress raises the chances of pro-business reform**

Despite the ongoing recovery in the US (as illustrated by the steady decline in the unemployment rate, reaching 5.8% in October), Republicans gained a sweeping victory in the mid-term Congressional elections. The new Republican majority leader in the Senate, Mitch McConnell, struck a conciliatory tone: "We are not going to be shutting down the government or defaulting on our national debt" in the knowledge that President Barack Obama can strike down any proposed legislation with a veto which can only be overruled by a 2/3 majority (the Republicans have 54 of the 100 Senate seats). Progress can be expected in international trade, infrastructure spending and business tax reform.

# Asset allocation: Equity rally continues but US remains overvalued

**Performance of asset classes (gross total return) – real estate place outpaced other risky assets**

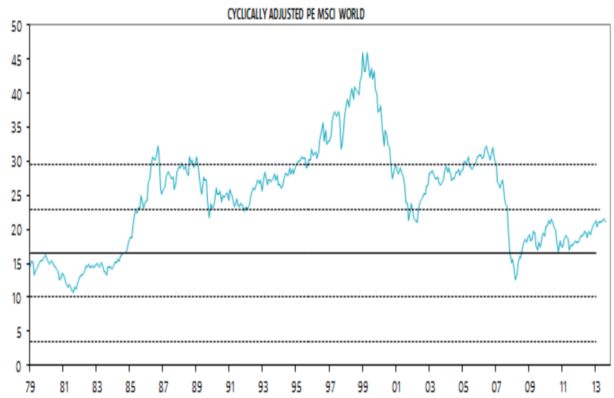



*Source: Thomson Reuters Datastream, Bloomberg, Robeco*

## Equities are still the place to be

We remain positive on equities. Global equities closed the month with positive returns of 1.5% month-on-month in EUR terms after by a swift and steep correction and an ensuing rebound within a month. At the start of last month, various triggers for higher volatility seemed to be in place, which led us to take some equity risk of the table. These included negative global economic growth surprises, fears about the spread of ebola, the surge of IS and the Fed ending its unconventional policy. Markets repriced equity risk upwards but changed their minds again as a non-voting member of the Fed, James Bullard, hinted at the continuation of easy money from the central bank. Indications of a resilient US economy, with the ISM showing increased expansion of manufacturing activity, gave the rebound an additional tailwind.

**Earnings revisions: Europe has shown some improvement**




*Source: Datastream, Robeco*

Whereas complacency seemed prevalent a few months ago, investors now have tuned in more to a more neutral stance towards equity risk. The recent correction can be seen as a healthy repricing, in line with historical patterns. The increased awareness that equities are risky will not ebb, but remain present as equity-specific volatility is on average still below the historical volatility of the asset class. Easy money is still around, but will be less easily available in the medium term, as central banks are taking different policy directions. After reigning in its unconventional policy, the Fed will likely hike its policy rate around mid-2015, while the BOJ and ECB still pursue balance sheet expansion. The BOJ surprised everyone last month with an unexpected additional expansion of its balance sheet by 50 trillion yen per annum, boosting equity prices in Japan. The intended balance sheet expansion now amounts to 15% of Japanese GDP. However, we think the Fed move will prevail in tilting the global easy money balance, and could cause a new pushback on the risk curve. Stronger fundamentals could mitigate increased risk perception as earnings growth has shown to be strong in the early stages of a hiking cycle.

Equity markets remain overvalued in the US. The current cyclically adjusted average PE ratio is 20% above its historical mean. The US market rebounded more sharply compared to Europe and emerging markets, even setting a new all-time high for the S&P 500. The reason for this is that equities are one of the few places that still offer a decent risk/return reward from a cross-asset perspective. In the near term, the search for yield will not disappear, but will become more critically focused on the first Fed hike and the corporate earnings perspective. We think the world economy will steer away from secular stagnation. Therefore, we expect both sustained pricing power for (US) corporates and increasing sales growth as the global economic cycle improves. Global earnings are still influenced by the gravity pull of slowed momentum in the global recovery. Earnings revisions were negative last month, especially in the US, where we have seen the negative impact of the stronger dollar coming through.

On balance, we remain positive on equities. Historically low capital market rates and still-benign wage growth will continue to support profit margins. Also, these subdued capital market rates are beneficial for sustaining current equity valuations. We will continue to watch interest rates and wage growth developments closely as we think these are key variables for the earnings story and the direction of Fed policy.

## High yield is rebounding nicely, but there is no time for complacency

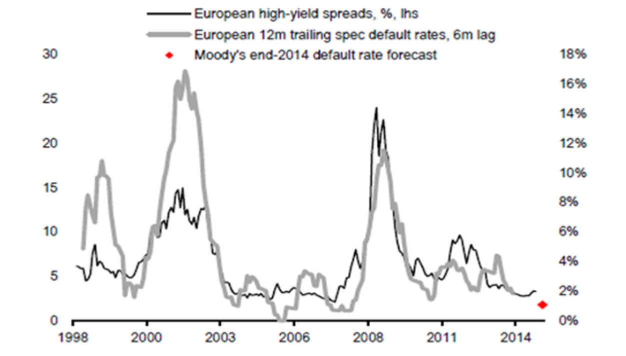
We have increased our overweight to high yield as we expect the global economic cycle to improve. Last month's performance was not overwhelming, with a return of 0.8%, behind that of most other risky asset classes. We have seen elevated uncertainty in financial markets and increased hedging demand from the start of last month. Spreads on global high yield widened and peaked in mid-October above 5%, creating more favourable entry points, and we have increased our overweight in the asset class again.

Just like cyclical stocks, high yield is susceptible to negative macroeconomic surprises, as we have seen in the last couple of months. In the US, default rate expectations appear to be on the rosy side, with defaults expected to decline further. Issuance in the US high yield energy sector has become an increasingly larger share of total US issuance. Spreads in the energy sector have widened to 643 basis points from 375 in June. Higher default rates in the US energy sector are likely to rise, as the steep decline in oil prices could negatively affect leveraged producers with relatively high breakeven prices. However, although defaults could rise in the medium term, the current environment of subdued growth and low inflation remains benign for the asset class.  European high yield has a better average credit rating than its US counterparts, although the composition is of rating quality is getting less balanced, as more CCC-rated firms have come to the market, especially in Europe. With the ECB now clearly in easing mode with its covered bond buying, we think this development could become more significant.

In the meantime, the search for yield will continue, albeit at a more measured pace, as the market is less assured of central bank easy money. Although risk perception is elevated, we think investors are still willing to pay a relatively high price for additional carry. Coupons are still relatively attractive, especially after the spread widening we have seen. We therefore think there is further room for spread compression. Looking ahead, we expect somewhat higher default rates in the US, as leverage in corporate balance sheets and risk in the energy sector has increased further, and the rising rates that we envisage will aggravate the leverage effect on cashflows and interest coverage ratios at lower-quality issuers. We therefore remain vigilant in the medium term.

## Investment grade credits have lost allure

**Corporate default rates are expected to remain low**




*Source: Thomson Reuters, Credit Suisse research*

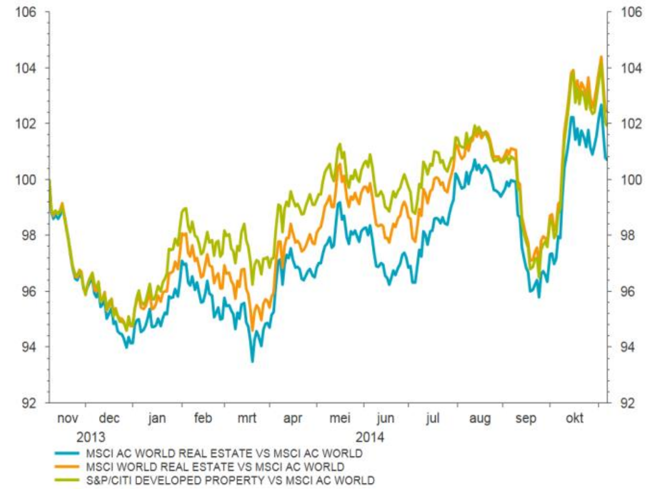
We maintain the view that, when corrected for risk, high yield remains more attractive than the ultra-low rates that investment grade credits offer. Investment grade withstood the recent market turmoil well and kept generating positive returns last month. But as many yields in the euro investment grade credit market are below those of a global government bond index, neither the yields nor the spreads are looking relatively attractive to us. The spread component for the average investment grade corporate is priced for perfection, although typically the better-rated companies have seen the largest spread compression. Downside risk has become more substantial as the ECB has hit the zero lower-bound level and the bond market has moved accordingly to ultra-low rate levels. Any reacceleration in the macroeconomic momentum or a pick-up in inflation in the Eurozone could lead to higher sovereign bonds rates, which will correspondingly lead to lower price returns on investment grade bonds.

The recovery in the periphery looks promising, but it still has a long way to go, and won't be without a glitch, as the recession in Italy has shown. The latest leading indicators for Italy did not point to a quick recovery. The unsurprising asset quality review by the ECB in October gave more clarity about the health of the European banking sector and did not cause upheaval in the financial credit market, although Italian banks weakness became apparent. We expect more confidence in the financial credit market, but do not expect a strong rally as these credits are not cheap. We are underweight credits.

## Real estate proves its defensive characteristics

We remain underweight to real estate compared to equities. Real estate emerged unharmed from the recent market turmoil with a return of 9.1%. The unexpected easing by the Bank of Japan has been positive for J-REITs while ECB easing action could benefit risky assets such as real estate. The asset class's correlation with fixed income has increased over the years, making real estate a substitute for sovereign bonds. Also, the dividend yield is either comparable to, or often exceeds, yields on government bonds. However, we are still not positive on the relative valuations of real estate compared to equities. The current forward earnings multiple is 27.3 compared to 14.2 for the MSCI World Index. Also, the recent bond-like behaviour of real estate does not bode well for future performance, as we expect interest rates to increase. In the near term, this will benefit equities more than real estate, in our view. The Chinese market is oversupplied and shows declining prices for real estate in the major cities, although new stimulus measures by the government could mitigate the price depreciation.

**Real estate outperformed equities in October**




*Source: Datastream, Robeco*

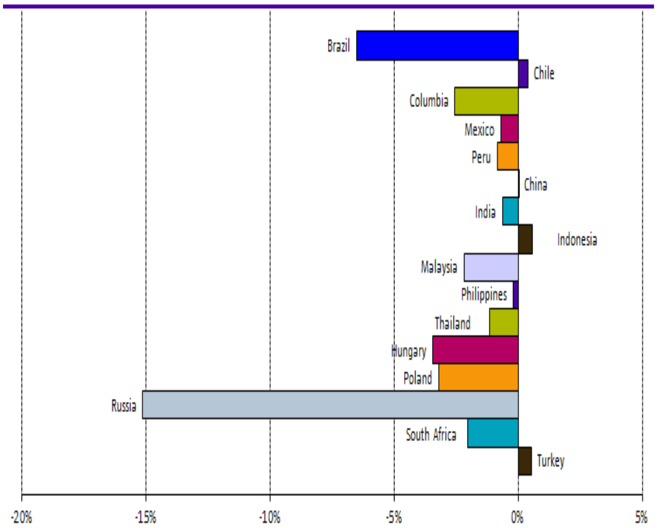
## Emerging market debt has tempting yields, but fearsome volatility

We remain neutral on emerging market debt (EMD). In local currency terms, the asset class returned 1.6% last month. The risks of an uneven recovery in emerging markets remains, although we see some signs of a pickup in activity in emerging debt-issuing countries. The spread of EMD local currency debt compressed by 15 basis points.

Political risk, one of the major factors behind spread movements, has not vanished. The Ukrainian-Russian conflict is negatively impacting economic performance in Hungary and Poland, both of which are EMD issuers. Both countries are now experiencing deflation. Russia has experienced large capital outflows and this has led to a surge in ruble volatility. The market is currently testing the willingness and ability of the central bank to stem the downfall.

Meanwhile in Brazil, President Dilma Rousseff narrowly won a second election round, which has scared the markets as her economic reform program lacks punch. This does not bode well for the much-needed supply side reforms as her previous successes on reforms have proven to be limited. We also observe that spreads are still lagging specific emerging market risks. We are not positive on the currency developments. Momentum for emerging market currencies remains negative. The decline in oil prices will challenge fiscal budgets in oil-exporting emerging market issuers.

**Emerging markets currencies were under pressure again last month**




*Source: Bloomberg, Robeco*

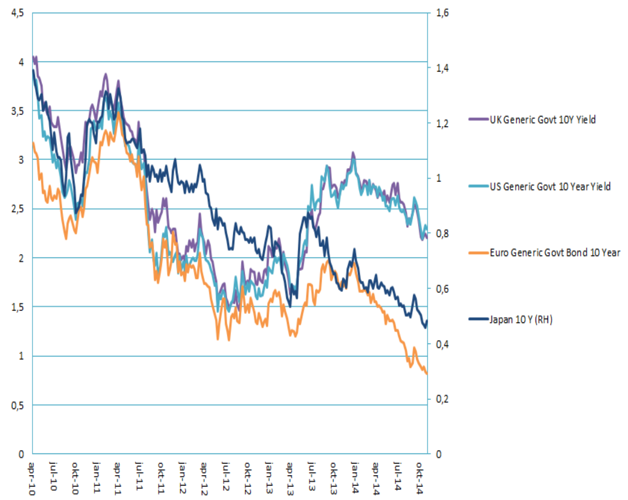
On the other hand, lower oil prices could help lower inflation in net oil-importing emerging countries, but is a burden for net oil exporters within EMD countries. Current accounts of commodity exporters are not likely to improve in the near term, putting downward pressure on their currencies. From the other side of the exchange rate cross, the strong performance of the US dollar has also negatively influenced EMD performance in local currency terms. The positive for emerging market currencies is that the correlation with the trade weighted dollar is declining. However, this correlation could increase again as the US economy keeps on track, despite faltering growth elsewhere, supporting the dollar. Higher volatility in the US Treasury market, which could stem from the increasing cyclical strength in the US, could also bring more volatility in emerging market currencies.

The current EMD yield of 6.41% stands in sharp contrast to the subdued yields of sovereign bonds in developed markets, keeping EMD in local currency terms relatively attractive, despite the currency volatility. So there are still reasons to remain selective and to err on the side of caution. We expect continuing divergence within emerging markets according to differences in export orientation, current account balances, fiscal and monetary policies, and political stability. We are not outrightly defensive as EMD yields are still above those of high yield, especially after the spread compression we have seen in the latter asset class.

## We are negative on government bonds

We remain negative on government bonds as we expect nominal rates in developed markets to rise. In the past quarter, German bond yields declined below 1% and stayed there in October, with yields now standing at 83 basis points. The correction in risky assets renewed safe haven flows and kept the government bond price rally going, despite worries about a sputtering Eurozone economy. As time progresses, these yields seem increasingly unsustainable from a valuation perspective. In the US, we expect higher bond yields because progress in the labour market has been consistent, changing the Fed's tone to become more hawkish. The recovery in the US has thus far shown to be resilient to slowing growth momentum elsewhere. But the latest ISM survey has shown that the US is not immune to the uneven recovery in other regions. The Fed will maintain its hawkish inclination, but will also stress that future policy steps towards a tightening stance will remain conditional upon further improvement in the labour market and the economy.

**German 10-year bond yields are now below 1%**




*Source: Bloomberg, Robeco*

In the Eurozone, a nominal 10-year bond yield of 0.83% and market inflation of 1.4% implies negative real yields, suggesting that the market is fully pricing in secular stagnation in the bloc. However, we expect the Eurozone to gradually normalize to pre-crisis growth levels. An impetus, both from the economic and a monetary side, is needed, and we see positive developments on both sides. Regarding growth, we expect that a depreciating euro and lower energy prices will pave the way to a turn in the slowing macro momentum we are currently experiencing.

Concerning monetary impetus, the ECB is now clearly determined to expand its balance sheet. In our last monthly outlook, we expressed doubts about the effectiveness of the ECB's announcements due to possible internal opposition. In his latest press conference, Draghi showed he was in charge and said the ECB board was 'unanimous' about the timely preparation of further easing measures to be implemented, if they become needed. We think the economy will just improve enough to prevent the ECB from taking the drastic step of sovereign bond buying. The ECB's balance sheet expansion will bring about a lower euro, regaining (German) export strength as China keeps its growth rate just above 7%. But the ECB needs to act decisively as it is in increasing competition with the BOJ, which also has reset its balance sheet targets. High yield bonds have better relative risk/return profiles. We therefore prefer non-investment grade corporate bonds to government bonds as high yield provides a decent spread buffer against rising interest rates.

### All eyes on OPEC

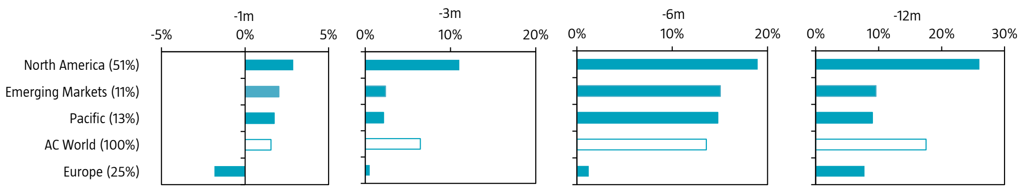
Commodity prices have continued to fall as the US dollar has strengthened since August. The weak and uneven recovery does not help commodity prices either, as it slows demand from emerging markets and the Eurozone. The decline in Brent prices since the second half of June has continued as Saudi Aramco lowered its selling prices to the US. All eyes are on OPEC now for the group to rebalance the oil market. The next OPEC meeting in November will therefore be tense as countries suffering the most from lower oil prices, such as Iran and Venezuela, will push for production cuts. Other OPEC countries are also seeing oil prices below or close to their fiscal breakeven levels. We think the next OPEC meeting could bring a modest production cut, although this will not set oil prices significantly higher against the background of slow macroeconomic momentum in the global economy.

**Strong dollar mitigated fall in Brent crude prices measured in euros**


*Source: Bloomberg, Robeco*

## Regional asset allocation: Unexpected tailwind for Japanese equities

**Positive momentum for Asia Pacific**




MSCI AC World unhedged EUR; index weights between brackets

*Source: Thomson Reuters Datastream, Robeco*

### Asia Pacific: Change in BOJ tone is positive for Japanese equities

We have been overweight on Asia Pacific, especially in Japan, predominantly because we were expecting additional policy action there. The eventual action still came as a surprise to us and the markets, however, after the BOJ announced plans last week to expand its balance sheet by an additional JPY 50 trillion per annum. The slowing in economic activity has brought forward action by the central bank to weaken the yen further and stimulate the export-dependent economy. In the past week the Nikkei returned 7.96% in yen terms. A stronger dollar will also help further yen weakening. Japanese earnings revisions have remained positive and will get an additional boost from the very recent yen weakening, which bodes well for future equity returns. Equity valuations for Asia Pacific are still comfortably below their 10-year averages.

## Europe: Reaffirmation of ECB action could lift European stocks

We are overweight to European stocks. Momentum has remained negative and European stocks have not experienced the rebound seen in US equities last month. Earnings revisions are still in negative territory, indicating more downgrades compared to upgrades of company earnings. On the positive side, we think that unconventional easing measures could improve earnings per share of European corporates through improved exports, although challenges remain. Although the truce between Ukraine and Russia seems to be holding, the illegal annexation of Crimea has damaged relationships with Europe, and Russia will continue to challenge the current status quo. Consequently, macroeconomic momentum in the Eurozone is still declining, but will improve as low oil prices could boost real spending power for consumers, and as the lower euro improves competitiveness for exporters, combined with internal devaluation (i.e. declining wages). Europe, as a net importer of oil, could experience 0.25% of additional real GDP growth as a result of the recent decline in oil prices by more than 20%. We think these factors, together with ECB action, will be a game changer for European equities, which are now clearly better valued compared to US equities.

**Earnings revisions are negative**

| | *Earnings growth (%)* | | | *Earn. rev. index* | | *P/E on 12m fwd earn.* | |
|---|---|---|---|---|---|---|---|
| | ***FY1*** | ***FY2*** | ***12m*** | ***3m*** | ***1m*** | ***Current*** | ***10y avg.*** |
| North America | 6.2 | 10.5 | 10.0 | -13.0 | -16.9 | 15.7 | 14.0 |
| Europe | 4.3 | 11.7 | 10.2 | -23.4 | -26.3 | 13.4 | 11.8 |
| Pacific | 6.2 | 10.4 | 9.1 | -7.7 | -6.6 | 13.6 | 15.0 |
| Emerging Markets | 3.7 | 11.6 | 10.4 | -20.5 | -26.9 | 10.6 | 10.8 |
| AC World | 5.4 | 10.9 | 10.0 | -5.8 | -20.5 | 14.2 | 13.1 |

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

## Emerging markets: We are neutral as the strong dollar weakens relative performance

We are neutral on emerging market equities. The hawkish tone of the Fed has implications for emerging countries with current account deficits, which are vulnerable to the decline in excess global liquidity, due to significant dollar funding and/or external portfolio outflows. Also, the stronger dollar has clearly been detrimental for the relative performance of emerging markets equities versus developed markets, and although dollar momentum could slow, its medium-term trend is pointing upwards given the diverging paths in policy by the major central banks. Given our expectation for a continuing strong dollar, we think emerging market currencies will remain under pressure in the near term. From the fundamental side, leading producer indicators are showing that emerging markets are expanding economic activity, but that this expansion is weak, especially in China, which has seen a broad decline in real estate prices in recent months.

Developments in Brazil and Russia – where both countries are experiencing high inflation and weakening currencies - are worrisome as well. With the decline in oil prices, export revenues for these commodity-exporting emerging markets are not likely to improve. As the macro figures of emerging markets are still surprising to the downside compared to developed markets, we think the growth deceleration in emerging markets versus developed markets will probably end in early 2015, though a more rigid decline in oil prices could delay an acceleration.  Although there are some bright spots (India), sentiment towards emerging markets remains vulnerable due to the discussion about the direction of Fed policy (end of Fed tapering), geopolitical developments (Ukraine, Russia, Iraq, Hong Kong) and political risk.

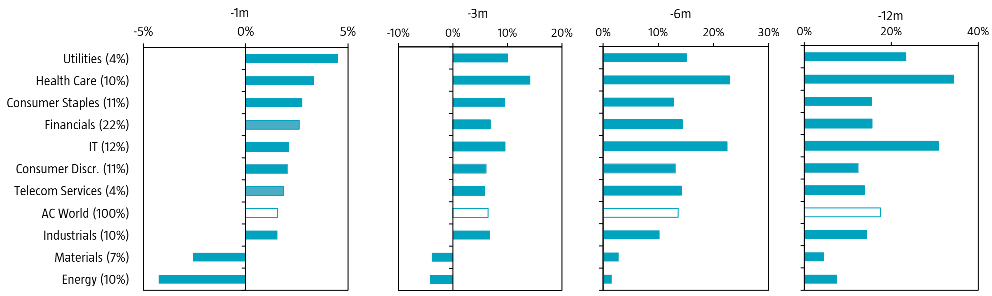
### US valuations are not attractive

We are underweight to North America. Although the US showed the strongest rebound after the market rout, we continue to expect a somewhat slowing momentum, as the focus of the equity market will be on future corporate earnings potential. On that front we have seen positive surprises, but analysts overall have downgraded more US corporates' future earnings than they have upgraded, given the recent strong (and negative) dollar effect on earnings.

Furthermore, the tone from the latest Fed meeting was slightly more hawkish, adding that "underutilization of labor resources is gradually diminishing". A higher probability of rising future interest rates makes currently overvalued US equities more vulnerable. Valuations suggest that investors have already anticipated a lot of the expected good news. Earnings growth prospects have somewhat lifted compared to the previous month as the consumer benefits from higher real spending power because of lower gasoline prices. The Republican victory in the Senate could improve consumer sentiment, although more cumbersome political manoeuvring in Washington is more likely as well. Positive sales surprises again surpassed negative ones for S&P 500 constituents during October, although a deceleration is now taking shape. Looking a bit further ahead, margin expansion is limited given our view of rising rates and, as the Fed notes, gradually higher bargaining power for labor. We now are a bit more constructive on US earnings, but valuations remain an obstacle.

## Sector allocation: We remain overweight cyclicals

**Negative momentum for energy as oil prices declined further**




MSCI AC World unhedged EUR; index weights between brackets

*Source: Thomson Reuters Datastream. Robeco*

Although we have taken some risk off the table overall, we still prefer cyclical sectors, as we think their performance has undershot the underlying macroeconomic picture. The gap between macroeconomic surprises in the US and the cyclical performance has widened further. We believe that this disconnect is due to the worsening sentiment both from the macroeconomic side, with slowing global momentum, and from the geopolitical side. We expect the US economy to accelerate further in the last quarter of this year and expect the (belated) catch-up of cyclical companies with the improved cyclical strength of the economy.

These developments, together with the continuing search for yield, keep us more positive on cyclicals relative to defensives. The anticipation of the first Fed hike will not pose a major threat for cyclical performance, as we find that growth companies' outperformance is positively correlated with a higher probability of a Fed hike at the next meeting.

**Cyclical versus defensive sectors – improved earnings revisions for the IT sector**

| | *Earnings growth (%)* | | | *Earn. rev. index* | | *P/E on 12m fwd earn.* | |
|---|---|---|---|---|---|---|---|
| | *FY1* | *FY2* | *12m* | *3m* | *1m* | *Current* | *10-yr avg.* |
| Energy | 3.6 | 2.7 | 2.8 | -46.6 | -58.6 | 11.7 | 10.8 |
| Materials | 2.8 | 13.7 | 12.2 | -20.8 | -25.6 | 13.6 | 12.2 |
| Industrials | 9.1 | 13.4 | 12.1 | -13.8 | -14.0 | 14.8 | 14.1 |
| Consumer Discr. | -1.6 | 16.3 | 13.2 | -18.2 | -24.7 | 14.9 | 15.2 |
| Consumer Staples | 2.7 | 8.8 | 8.1 | -44.1 | -42.2 | 18.1 | 15.9 |
| Health Care | 10.8 | 10.6 | 10.7 | 11.0 | 14.7 | 17.3 | 14.3 |
| Financials | 6.5 | 12.4 | 11.5 | -7.3 | -14.9 | 11.9 | 11.3 |
| IT | 12.1 | 10.6 | 11.2 | -5.2 | -8.8 | 15.1 | 15.5 |
| Telecom Services | -3.7 | 8.1 | 4.7 | -1.3 | -5.6 | 15.1 | 13.4 |
| Utilities | 0.5 | 9.7 | 7.2 | -7.9 | -6.9 | 14.8 | 13.9 |
| AC World | 5.4 | 10.9 | 10.0 | -16.6 | -20.5 | 14.2 | 13.1 |
| AC WORLD REITS | -7.8 | 9.3 | 7.5 | 0.0 | -0.1 | 27.3 | N.A. |

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

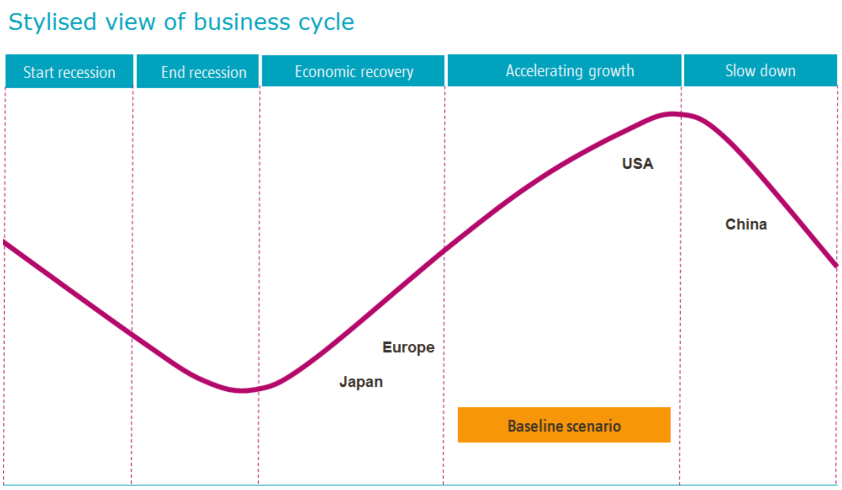
*Source: Thomson Reuters Datastream. Robeco*

# Position in the economic cycle: We continue to foresee a gradual recovery

### Macroeconomic scenarios and Robeco's view versus consensus

The world economy is entering a more difficult phase, with the exception of the US, which seems to be defying gravity. Our baseline scenario foresees a further gradual recovery. 'Abenomics' is running into difficulties now that the Japanese VAT hike has kicked in. The Japanese central bank has stepped up its reflationary efforts, paving the way for an additional sales tax hike in 2015 . The Chinese authorities have quietly implemented additional stimulus. The Eurozone economy continues to struggle, but we expect a resumption of a gradual, broad-based improvement thanks to the collapse in oil prices, the lower euro, continuing monetary easing by the ECB and the end of austerity. Our alternative, pessimistic scenario foresees a weaker global economy caused by slowing growth in Asia. In a positive scenario, the world economy is showing surprising strength, but central banks are unwilling to act correspondingly. As a result, inflationary risks will increase.

**Position in the economic cycle – US is the exception**



### Macroeconomic scenarios: A gradual normalization is the most likely outcome


*Source: Robeco*

### Robeco's expectations for growth are higher than consensus for the US and Brazil

| *GDP growth by region (%)* | *2013* | *2014* | *2015* | *Δ -1m 2014* | *Robeco** |
|---|---|---|---|---|---|
| US | 1.9 | 2.0 | 3.0 | 0.3 | + |
| Eurozone | -0.4 | 1.1 | 1.5 | 0.0 | = |
| UK | 1.8 | 3.1 | 2.6 | 0.1 | = |
| Japan | 1.7 | 1.2 | 1.2 | 0.0 | = |
| | | | | | |
| China | 7.7 | 7.4 | 7.2 | 0.0 | = |
| India | 4.6 | 5.0 | 5.4 | 0.7 | = |
| Brazil | 2.3 | 0.9 | 1.6 | -0.2 | + |
| Russia | 1.5 | 0.5 | 1.3 | -0.5 | - |

* indicates whether we expect a higher (+), matching (=) or lower (-) inflation rate than the current consensus estimate for 2014

*Source: Consensus Economics, Robeco*

### Robeco's expectations for inflation in the UK and Russia are higher than consensus

| *CPI by region (%)* | *2013* | *2014* | *2015* | *Δ -1m 2014* | *Robeco** |
|---|---|---|---|---|---|
| US | 1.5 | 2.0 | 2.2 | 0.1 | = |
| Eurozone | 1.3 | 0.6 | 1.2 | -0.1 | - |
| UK | 3.1 | 1.7 | 1.9 | -0.1 | + |
| | | | | | |
| Japan | 0.3 | 2.8 | 2.2 | 0.0 | - |
| | | | | | |
| China | 2.6 | 2.4 | 2.9 | 0.0 | = |
| India | 9.5 | 9.5 | 7.8 | 0.0 | - |
| Brazil | 5.9 | 6.4 | 6.3 | 0.0 | = |
| Russia | 6.5 | 6.8 | 7.2 | 0.0 | + |

* indicates whether we expect a higher (+). matching (=) or lower (-) growth rate than the current consensus estimate for 2014

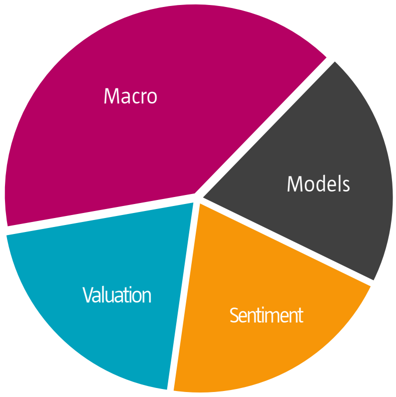
*Source: Consensus Economics. Robeco*

# Robeco's multi-asset management approach

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 macroeconomic 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 if investors put too much weight on recent developments. Finally, we use quantitative models to steer our expectations.

**Input factors for our investment policy**




The table below shows our current multi asset allocation table.

| | Portfolio | BM | active | previous | tracking error | risk budget |
|---|---|---|---|---|---|---|
| Equities Developed Markets | 29.0% | 25.0% | 4.0% | 4.0% | 0.48% | 75.5% |
| Equities Emerging Markets | 5.0% | 5.0% | | | 0.00% | 0.0% |
| Real Estate Equities | 2.5% | 5.0% | -2.5% | -2.5% | 0.33% | -17.9% |
| Commodities | 5.0% | 5.0% | | | 0.00% | 0.0% |
| Core Gov Bonds 1-10 | 15.0% | 20.0% | -5.0% | -3.0% | 0.12% | 12.1% |
| Core Gov Bonds 10+ | 7.5% | 7.5% | | | 0.00% | 0.0% |
| Investment Grade Corp Bonds | 19.0% | 20.0% | -1.0% | -1.0% | 0.03% | 0.2% |
| High Yield Corp Bonds | 10.0% | 5.0% | 5.0% | 3.0% | 0.19% | 19.8% |
| Emerging Market Bonds LC | 5.0% | 5.0% | | | 0.00% | 0.0% |
| Cash | 2.0% | 2.5% | -0.5% | -0.5% | 0.00% | 0.0% |
| EUR/USD | -2.0% | 0.0% | -2.0% | -2.0% | 0.15% | 0.0% |
| EUR/JPY | 1.0% | 0.0% | 1.0% | 1.0% | 0.11% | 10.2% |
| EUR/GBP | 0.0% | 0.0% | | | 0.00% | 0.0% |
| EUR CASH | 1.0% | 0.0% | 1.0% | 1.0% | | |
| Portfolio risk | 5.20% | 4.93% | | | | |
| Sum of individual tracking errors | 1.41% | | | | | |
| Portfolio tracking error | 0.50% | | | | | |

Closing date for text: 07 November 2014. We refer to calendar months in all our data tables.

# Robeco Investment Solutions and Research

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**Important information**