



Why 'Abenomics' is running out of steam

- Third arrow of structural reforms faces a logjam
- Trade deal failure symptomatic of problems
- Japan still over-reliant on monetary stimulus
- After VAT hike, Abe is now running out of options

Topic of the month: Japan's economic miracle in doubt

'Abenomics' is running out of steam, and more monetary stimulus may be inevitable. That is our verdict as the all-important 'third arrow' of economic stimulus by Japanese Prime Minister Shinzo Abe – structural reform to an entrenched economy – appears to falter. Following the sales tax hike last month, Abe is now running out of options.

The recent visit by US President Barack Obama to Japan did not result in a bilateral trade agreement, despite a last minute 'sushi summit' with Abe. An agreement was a necessary condition to rekindle negotiations over the 12-nation Trans Pacific Partnership. But Abe didn't dare to put too-heavy burdens on Japan's highly protected farmers: he wants to retain import tariffs on farm products. This is symptomatic for the lack of progress on the so-called third arrow of 'Abenomics' - supply side reform to increase Japan's structural growth rate.

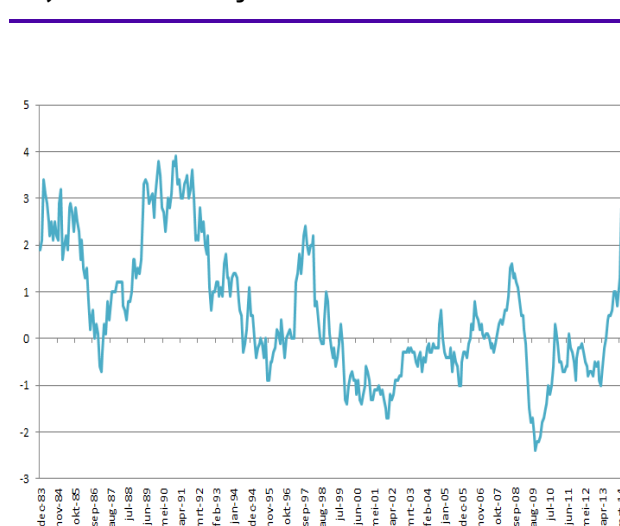
Abe did succeed in getting a reconfirmation from Obama that the Senkaku/Diaoyu islands whose sovereignty is disputed with China were covered by US security guarantees. However, Obama did not take a position on the question where ultimate sovereignty of the disputed islands lies; he just

stressed the need for a peaceful solution. Obama made it clear he does not want China to be provoked unnecessarily. Under these circumstances it is unlikely that Abe will be able to distract himself from Abenomics by switching to a nationalist political agenda.

Lack of reform makes yen weakening difficult

It could be argued that the third arrow of Abenomics is a long-term issue and therefore not relevant for the short-term growth prospects of the Japanese economy. But lack of reform could mean that the world would have much more difficulty in accepting a further weakening of the yen. Japan's position has been dubbed by the International Monetary Fund (IMF) as an "over-reliance on monetary stimulus" which could also hinder a rebound of investment by Japanese companies in their country, a necessary condition for self-sustaining growth and the ultimate success of Abenomics. Few concrete measures have been announced to support the third arrow, including the legislation needed to create special economic zones. Tax reforms, labor market deregulation and corporate governance reform could support investments. An increase in the female labor participation rate and a relaxation of immigration requirements would also be welcome. So far, progress has been limited, raising fears that Japan could fall back again into deflation.

Tokyo CPI: VAT hike weighs on inflation



Source: Bloomberg, Robeco

Initially, Japan's GDP accelerated after the introduction of Abenomics one and a half years ago on the back of stronger exports, thanks to the weaker yen and strong private consumption growth which was caused mainly by the boost to national wealth from higher equity prices. But share prices have weakened so far this year (the Nikkei is down 8%), the yen is stabilizing at around 102 to the US dollar, and the hike in the sales tax rate (from 5% to 8% on 1 April) will be a drag on growth. The IMF in April lowered its growth forecast for Japan for 2014 from 1.7% to 1.4%. The Bank of Japan (BoJ) also cut its growth forecast for the current fiscal year in its semi-annual report in April, now predicting that GDP will grow by 1.1% in the fiscal year to March 2015 instead of the 1.4% forecast in January. The central bank blamed "sluggishness" in emerging economies as the main reason for Japan's muted export performance, though it admitted that the steady shift of production overseas has also been a factor.

Sales tax hike is still an important step

The sales tax hike is an important step towards fiscal consolidation. That is why it is backed by the BoJ, despite its negative impact on growth. In October 2015 an additional hike is envisaged - from 8% to 10% - which would result in the government debt ratio stabilizing at a staggering 250% of GDP.

Abenomics has so far been very successful in raising inflation and inflationary expectations, due to the dramatic monetary loosening by the BoJ. The Tokyo CPI inflation rate rose to 2.9% year-on-year in April, including the effect of the VAT hike. Inflation expectations also rose, but now seem to have leveled off. This could be a reflection of continuing doubts that Abenomics will not be more than a temporary stimulus to the Japanese economy. In contrast to recent price developments, wage rises have been disappointing. Average monthly cash earnings rose only a meagre 0.7% on a yearly basis in March (still much better than the expected 0.1%). But in real terms they are declining. The sluggish wage growth is partly due to structural developments such as the shift from full-time to part-time workers. However, it also suggests caution by employers who in general apparently remain unconvinced that Abenomics is having more than a temporary impact, and are therefore reluctant to

raise fixed personnel costs. The outcome of the current wage bargaining round is critically important. Despite lowering its growth forecast, the BoJ remains pretty upbeat about inflation. The bank expects it to exceed 2% in 2016, and so remains confident that its price target will be reached. This projection is consistent with earlier remarks in March by BoJ Governor Haruhiko Kuroda that he saw no immediate need to expand stimulus for the time being. With this belief he ruled out a preemptive strike by the BoJ to counter the effects of fiscal contraction due to the sales tax hike on 1 April. Market expectations are now that the BoJ will continue to stand pat on policy until July at the earliest. The BoJ's projections are much more bullish than market (and consensus) expectations and are not credible in our view. At some point, probably in July, the BoJ will be forced to act by pushing for a lower yen. Without additional stimulus, the Japanese government could moreover be tempted to postpone the envisaged sales tax hike for 2015, weakening long-term debt sustainability.

In conclusion, the eventual success of 'Abenomics' at this stage remains in doubt. Key variables to watch are wage developments and investments. We believe that the overly optimistic BoJ will be forced into additional monetary stimulus, probably in July, leading to a weaker yen vs. the US dollar.

Macroeconomic outlook

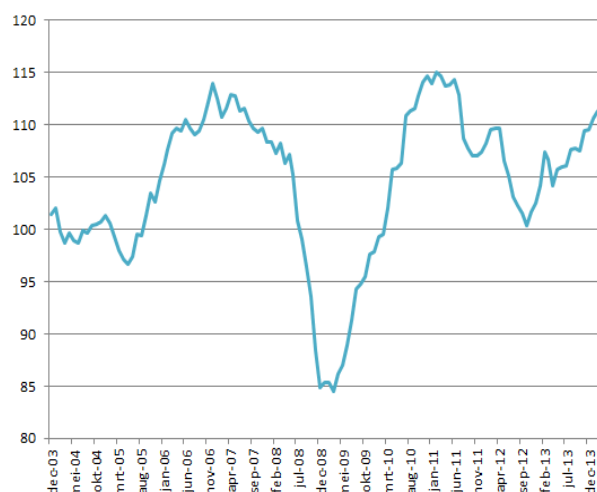
Disinflation in the US and the Eurozone gives central banks more room to keep rates low for longer. Geopolitical tensions have eased after the relatively bloodless annexation of Crimea by Russia and limited sanctions by the West. With no signs of a significant pull-back of Russian troops on the Russian/Ukrainian border, tensions remain elevated however, and little progress can be expected to be made in the run-up to the Ukrainian presidential elections, scheduled for 25 May. In China, the authorities are quietly stepping up efforts to stimulate the economy, initially promising more railroads and more loans for affordable housing. More stimulus will be added if it becomes necessary.

Europe: no need for the ECB to act

The European economy is showing a broad-based recovery, illustrated by the fact that manufacturing PMIs for April showed readings above 50 for all economies for the first time since November 2007. France is still lagging its peers because of rather mediocre export growth in contrast to Italy and Spain, highlighting its competitiveness problem, but it is still showing expansion. Spain is doing particularly well. It showed a GDP growth of 0.4% in the first quarter, the fastest rate in six years. Due to low capacity utilization rates and high unemployment rates in many countries, inflation remains low. The flash estimate for April rose by 0.2 percentage points to 0.7%, a level which is still far below the European Central Bank

(ECB) target rate of below but close to 2.0%. Deflation is currently a much discussed theme in the Eurozone but will lose its relevance in the course of the economic upswing. Though ECB policymakers apparently have closed ranks now that Bundesbank President Jens Weidmann has at least theoretically accepted quantitative easing (QE) as a potential monetary instrument, our baseline scenario remains that the ECB will be on hold for the foreseeable future. Who cares about disinflationary/deflationary tendencies during a broadening economic recovery? ECB policy makers appear to be fretting about the strength of the euro, but the solid start to the second quarter by the Eurozone economy and the coming upswing in the US will lessen this problem. If the ECB does feel forced to act, its instruments of choice would be lowering the refinancing rate to 0% and cutting the

German leading indicator shows business confidence improving



Source: Bloomberg, Robeco

deposit rate to negative territory. Generalized QE remains a measure of last resort.

In the European elections of 22-25 May, we will likely see a strong showing of Eurosceptic parties who may raise their vote from one fifth to nearly one third. They will, however, not be strong enough to block European decision making and partly due to low voter turnout, the relevance of the election results at a national level will be limited. In an economic sense, no material impact is to be expected.

Ukrainian crisis will not hinder recovery in Europe

The main risk to the current economic upswing would be a severe deterioration of EU relations with Russia, resulting in a full energy embargo. As the Russian economy, which probably has already drifted into recession, would be severely hit by such an embargo as well, the chances of this scenario materializing are low in our opinion. Nevertheless, an invasion of Ukraine by Russian forces cannot be ruled out, and this would force Western powers to materially step up sanctions against Russia. Russia in turn would probably feel forced to retaliate. Even then it remains to be seen if it would dare cut off energy supplies to the West. Our baseline scenario for the foreseeable future is that Russia will be satisfied with destabilizing Eastern Ukraine from the outside, preventing full elections and thereby undermining the legitimacy of the future Ukrainian president. It will refrain from an invasion. Under these circumstances, the Ukrainian crisis will not hinder the ongoing recovery in Europe.

US: after a severe winter, it is bouncing back nicely

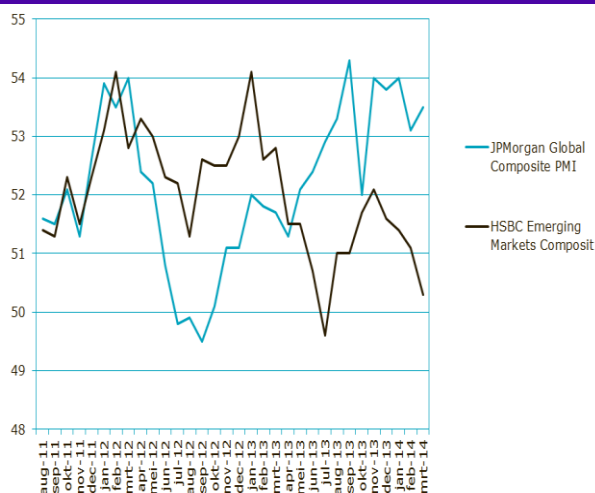
The first estimate of US GDP growth in the first quarter showed hardly any growth at all: an unexpected and disappointing 0.1%. But the first estimate is primarily based on the first two months in which economic activity suffered from unusually severe winter weather, so the figure will most likely be revised upwards. Although investments and exports were weak, consumption grew 3.0%.

The GDP figure is clearly understating the underlying strength of the US recovery, which in our view is still on track to show a healthy growth rate around 3.0% this year. The labor market figures for April confirmed the gradual improvement, while showing no inflationary pressure. Under these circumstances the US Federal Reserve (Fed) will continue to taper in a measured pace and finish this policy in October this year. We do not expect the first rate hike before the third quarter of 2015.

China: stabilization of growth is likely

Industrial activity in China rose marginally in April, raising hopes that economic growth will stabilize. Government measures to speed up railroad construction and public housing have led to a higher rate of growth of infrastructure spending compensating for a weakening real estate sector. Taxes for small firms have been cut as well. Chinese policymakers have stressed recently that employment growth is more important than GDP growth, though Prime Minister Li Keqiang has admitted a growth rate of 7.2% is necessary to reach the 10 million urban jobs goal, close to the official GDP target growth rate of 7.5%. In addition he has pledged to step up support for the trade sector. In our view, the Chinese authorities are currently clearly worried over the loss of economic momentum. If a further stabilization of growth fails to materialize, they will arrange for additional stimulus, e.g. by lowering reserve requirements for banks.

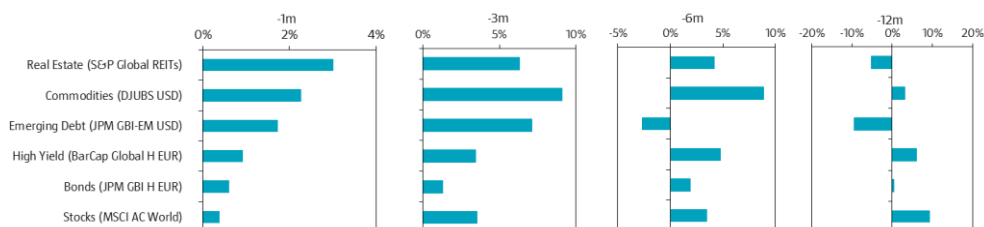
The emerging market producer confidence indicator is less positive than its global counterpart



Source: Bloomberg, Robeco

Asset allocation – we are positive on risky assets

Performance of asset classes (gross total return) – real estate assets were the flavor of the month



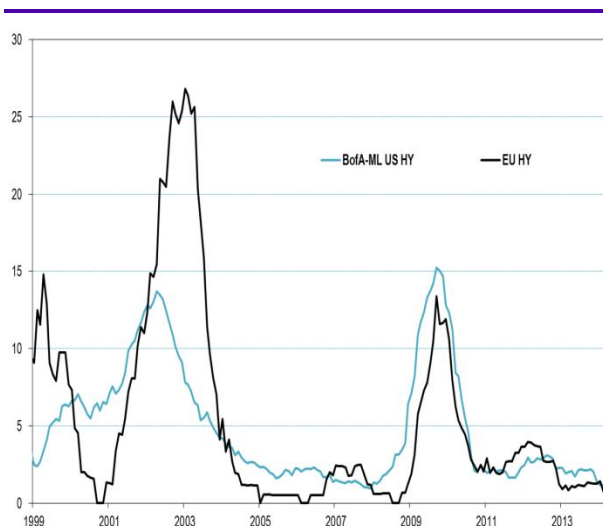
Source: Thomson Reuters Datastream, Bloomberg, Robeco

High yield remains our favorite asset class, but vigilance is increasingly needed

We retain our positive view on high yield compared to government bonds, as the search for yield continues and the stronger developed market economies and benign inflation environment are positive for the asset class. Inflows into high yield funds are still strong, and the return since the start of the year is almost 4%. Given the healthy appetite for the asset class, valuations have increased as spreads at 400 basis points are now well below historical averages. Nevertheless, lower spreads seem justified by historically low default rates expectations in combination with high recovery rates. Still, we think the one-way direction of the high yield market neglects the fact that risk is two sided and requires us to remain vigilant. Investors are willing (and increasingly so) to pay a relatively high price for additional carry. The high coupon payments keep high yield attractive. Although a trigger for a turn in the market is not imminent, rollover risk in the lowest grade segment of the market could in the longer term provide distress and spillover to the market as a whole, causing liquidity pressures. Covenant lite high yield issuance has surged and issuance is increasingly being used for M&A purposes, replacing leveraged loans.

For investment grade credits, we maintain our view that, when corrected for risk, the yield on high yield remains more attractive than the ultra-low rates that investment grade offers. Spreads in the euro-denominated investment grade market compressed further in April by 10 basis points, and are now at 94 basis points. Neither the yield nor the spread are looking relatively attractive to us. First, non-financial and financial credits yields have dropped significantly in recent years and are now moving in tandem with European government bond yields. Second, the remaining spreads in the credit market have converged with their respective country spreads, and are sometimes at levels even below those of sovereigns. Third, the credit fundamentals of European credits and financial bonds still look healthy thanks to strong balance sheets, conservative corporate behavior and low refinancing risk. However, we hold the view the positive story is fully priced in and may be in danger of becoming overpriced, given the continuing spread compression. Downside risk has become more substantial, as the recovery in the periphery looks promising, but it has still a long way to go and won't be without a glitch. Higher credit spreads if banking stress test results disappoint later this year could also shift market pricing.

Low default rates for HY



Source: Bloomberg, Robeco

We remain optimistic about equities

The recent performance of equities shows that the market does not seem to be too worried about risks, although price gains since the start of the year lag those of the first four months of 2013. The traditional 'Sell in May and go away' effect, which on average has manifested itself in two out of every three years, does leave insufficient upside to compensate for volatility for the markets in the coming months. Although in our view the US economy will accelerate further later this year and US monetary policy poses no threat for equity markets at the moment (unless forward guidance fails significantly), the Ukrainian crisis and especially the latest economic figures in China are reasons to remain cautious.

Regional Shiller PE: Stocks expensive but not overvalued



Source: Bloomberg, Robeco

The Ukrainian conflict has not escalated as many feared, but at the same time its sting has not been entirely removed, and tensions are rising. Increased Western sanctions on Russia could backfire economically and provoke bolder military steps by Russian President Vladimir Putin. The worry about China is less a question about lacking ambition - Chinese leaders have reiterated the 7.5% growth target for 2014 and announced another stimulus package - but more about the government's ability to do the tricky balancing act of preventing a hard landing while deflating the credit bubble. Analyst earnings expectations have in general been too optimistic for the year, although recent earnings revisions on a 3-month basis for the US have shown more earnings upgrades compared to downgrades.

No end to the search for yield

The reason we remain positive about equities despite the uncertainties is that we see no end yet to the search for yield. The spread for credit risk on fixed income remains comparatively low compared to the risk premium in equities, even on a risk-adjusted basis, especially given the increasing volatility risk in the lower investment grade fixed income classes. Low interest rates, sluggish wage growth and increasing aggregate demand also keep supporting earnings. Profit margins for the S&P 500, which has passed its peak levels of 2007, still remain strong at 9.5%.

Given our view of an ongoing recovery in developed markets, we doubt whether current profit margins are sustainable in the near term. Although there is still ample slack in the labor markets of developed economies, wage growth could pick up more notably in the near term as the US economy strengthens further. Rising interest rates, which we expect this year, do pose a lesser threat for margins as companies have managed to lock in low rates and are less leveraged, but they will no longer be a boon for profits. We therefore continue to expect profit margins to move sideways as accelerating economic growth leads to higher capital expenditure, while low refinancing risk and the virtual absence of labor pricing power should sustain high margins for longer.

Real estate shows strong performance

Real estate performance has had a very strong start this year and has continued to perform well in April, generating a strong return of 3.4% last month. There are several factors behind the strong real estate performance. As investors shifted last month from growth stocks to more value driven stocks, real estate also profited from this shift in market sentiment towards assets with a more defensive nature. Also, the most recent statements made by Fed President Janet Yellen and greater safe haven flows given heightened geopolitical tensions have kept rates low.

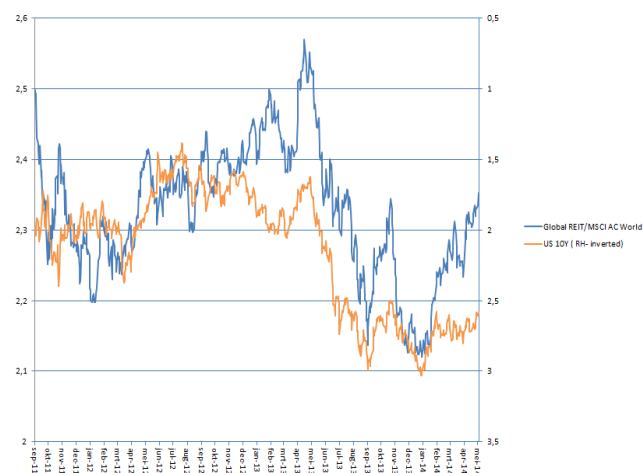
The rebound in economic activity after the cold winter in the US has not translated into rising rates and US 10-year Treasury rates have remained in a 20 basis point-range between 2.6% and 2.8% since February. The stronger appetite for fixed income streams has thus sustained real estate. However, we believe that the sensitivity of real estate to interest rates remains a key factor in the short to medium term. Given our view of a rebound in interest rates as the economic recovery in developed markets picks up, we remain underweight in real estate compared to equities. Although a rise in real rates, as we envisage, would signal increasing economic strength and potentially higher rental income, equities are better positioned to profit from such an economic rebound.

From a valuation perspective, real estate remains expensive compared to equities, especially in the US. This valuation gap is compensated to some extent by higher dividend yields. There remain substantial differences in regional valuations, with the US and Japanese markets more expensive than Europe, although some parts of the UK market are heating up as well. Given the still high valuations of real estate compared to equities and its relatively high interest rate sensitivity, we remain underweight real estate compared to equities.

Emerging market debt fundamentals still weak

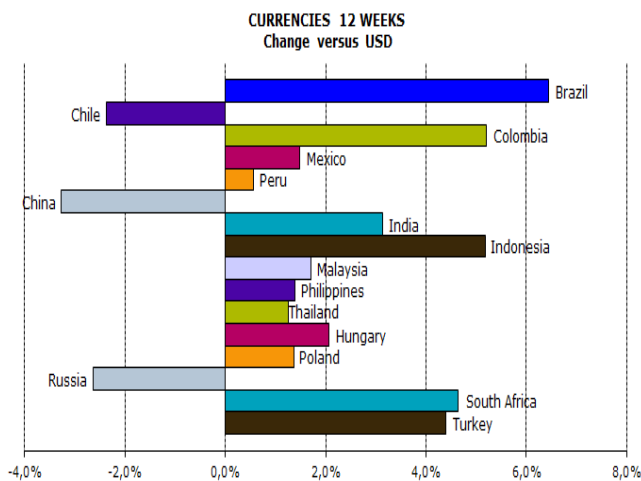
We remain underweight in emerging market debt (EMD). EMD again generated a very decent monthly return, helped by improving investor sentiment towards the asset class, improved currency volatility and momentum for emerging market currencies. Lower rates in the US in combination with the recent rate hikes in major emerging countries have also improved the carry component. However, we are not convinced of a structural improvement in EMD. From the fundamentals side, current account deficits are not expected to improve this year, putting downward pressure on currencies. We also still see no end to the deceleration in growth in emerging markets, as evidenced by the surprising return of macroeconomic indices to negative territory this month. Although recent rate hikes have defended some currencies from depreciating further, it will likely put downward pressure on domestic economic activity in Brazil, Russia, South Africa and Turkey.

REIT's outperform equities as interest rates increase slows



Source: Bloomberg, Robeco

Currencies have rebounded for emerging currencies



Source: Bloomberg, Robeco

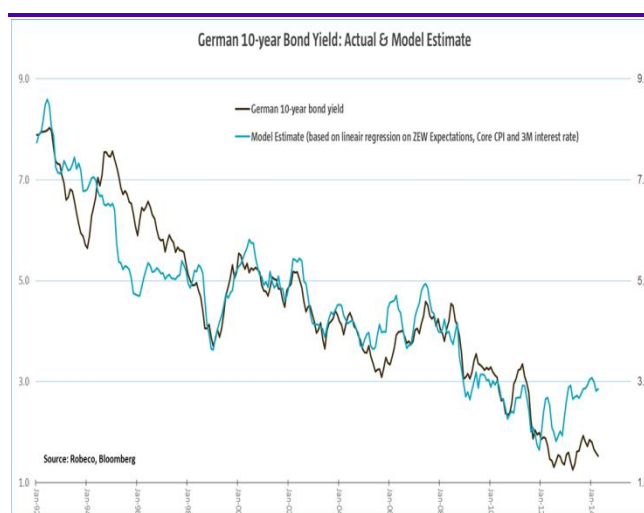
Also, despite the recent rate hikes, inflation does not seem to be under control. For instance, Turkey's core inflation rate surprised to the upside in April at 9.74%. The developments in Ukraine are also reasons for concern. Russia's implied ruble-dollar volatility has edged up since the start of the unrest, although we do not detect spillover to other emerging currencies yet. Elections are being held in major emerging countries like Brazil and Indonesia which could also pose a risk as investors are possibly pricing in the best case scenarios. We see that current credit spreads are below those suggested by country-specific risks on political, economic and financial markets dimensions.

Thus, although sentiment and momentum currently do favor EMD, we hold these driving factors to be vulnerable for deteriorating news on the geopolitical and macroeconomic fronts. The latest (leading) producer confidence indicators in May showed very modest economic expansion in the major emerging debt issuers, although there are underlying differences. However, we do not expect an escalation within emerging markets from this point. The increasing differences in emerging market currency performances illustrate that investors are differentiating more between countries, according to each one's policy mix and cyclical situation. Emerging market policy makers have the complex task of managing a tricky balancing act between achieving external and internal stability. We expect continuing divergence within emerging markets according to differences in export orientation, current account balances, fiscal and monetary policies, and political stability.

Government bond market will face headwinds

We remain negative on government bonds as we expect nominal rates in developed markets to rise in the coming months. Inflation numbers have been too benign in developed markets, with consumer price inflation well below the mandates of central banks in the Eurozone and US. However, we expect inflation to bottom out given the reacceleration in growth in developed markets. Inflation expectations have remained firmly anchored in the US, although some slippage has been seen in the Eurozone. While this should concern the ECB, we have seen inflation in April moving to the less threatening part of President Mario Draghi's 'danger zone' of inflation below 1%. A further rate cut is therefore not likely in our view. Conventional policy tools will be exhausted first before moving into QE-related policies. To the extent that the market has discounted QE by the ECB, this will leave upside risk for rates in the Eurozone in our view.

The German 10-year bond yield is still well below fair value



Source: Bloomberg, Robeco

Government bonds also have rallied because markets have repositioned on the risk curve as the long rally in stocks has caused some investors to take risk off the table into fixed income. This sentiment was encouraged by the continuing unrest around Ukraine, which seems to affect safe haven Eurozone government bonds more than US Treasuries. Although sentiment and momentum are positive for government bonds, we think valuation is still a clear negative, and improved macro momentum will eventually translate into higher nominal rates. The "lower rates for longer" forward guidance from Yellen will be harder to communicate in an environment which increasingly sees confirmation of strengthening growth and a (modest) pickup in inflation because of higher commodity prices and a weakened dollar. However, the rise in nominal rates will mainly be driven by real growth expectations and not by inflation. For the latter we need to see demand-pull inflation by wage growth exceeding productivity gains, a phenomenon which is still virtually absent. We expect US growth to be predominantly consumer driven. US consumer spending has increased in the first quarter by 3%, despite the cold winter. Personal incomes rose last month and wealth effects through strong rising stock markets and house prices is adding spending power. With more upbeat economic data

expected, we expect rates to rise above 3% towards the end of 2014. Higher rates in the US will likely spill over to the Eurozone. The Fed is unlikely to change the pace of tapering from the current level of USD 10 bln/month. On the one hand, the slack in the labor market is still too substantial to trigger an increase in the pace of tapering, while on the other, the economic rebound we expect will prevent a slowdown from the current pace. 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.

Emerging market commodity demand slows

We remain neutral on commodities. The three main drivers behind the upturn in commodities - extreme weather, geopolitical risk and worries about the Chinese growth path - remain largely intact and have led to another strong month for commodities. These factors have had different impacts on different commodities in different regions. Upward pressures from developments in Ukraine remain for geopolitically sensitive commodities such as Brent oil and gold. Wheat markets have also been affected as Ukraine is the fifth-largest wheat exporter in the world. Brazil has been hit with the worst drought in decades and its impact on agricultural commodities is still material.

US paves the way towards energy self sufficiency

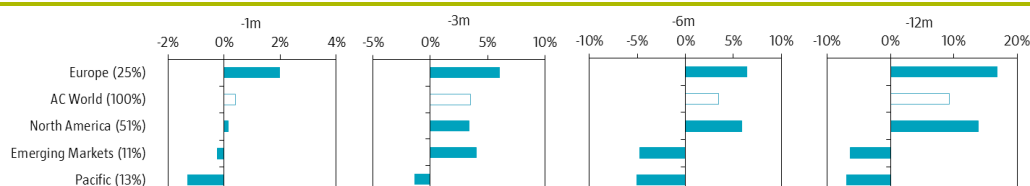


Source: Bloomberg, Robeco

Although geopolitical risk and the weather will put upward pressure on several commodities, we remain cautious about the medium-term outlook for the asset class as a whole, as the deceleration in China is slowing commodity demand. Given the sluggish improvement in emerging markets producer confidence indicators, we do not expect a strong pick-up in commodity demand from emerging markets, which are an increasingly important global buyer. The International Energy Agency adjusted emerging market oil demand downwards in April and we expect it to do so next month, given the overall weak recovery in the developing manufacturing sector. Meanwhile, the US reconfirmed that it is firmly on the road towards energy self-sufficiency as domestic oil production increased while oil imports decreased. The oil price is likely to drift downwards as supply outpaces demand, but is expected to do so more gradually than we expected previously, as non-OPEC production disappointed. Shale gas drilling in the US is increasingly focused on maximizing profit growth instead of maximizing output. On the demand side, the refinery maintenance season is past its peak and will trigger seasonal demand again in the near term.

Regional asset allocation – we are more constructive on US equities

More modest returns from equity markets have been achieved in recent months



MSCI AC World unhedged EUR; index weights between brackets

Source: Thomson Reuters Datastream, Robeco

We have become more constructive on North America, as improving macroeconomic momentum and brightening earnings revisions now indicate a pick-up in earnings growth. US non-farm payroll numbers surprised on the upside, as 288,000 new jobs were added last month. Earnings growth will be firmed by improving retail sales, positive feedback effects from lower capital market rates in the US since the start of the year, and declining hourly wages last month. Profit margins remain around peak levels of 9.5% for S&P 500 companies, although further expansion seems unlikely. Volatility has remained low as the search for yield keeps sentiment towards risky assets positive, with the Fed still buying US Treasuries, albeit at a diminished pace. At the same time, multiples expansion in the US, as measured by the Shiller variant, has slowed down as price momentum is not particularly strong while cyclical corrected earnings have improved further. However, a further multiples contraction in the US will be difficult given overall positive risk sentiment and diminished room for further expansion of profit margins from historical peak levels. Capital expenditure is likely to increase depreciation costs, wage growth is gradually gaining traction, and higher real interest rates over the year will not improve interest costs for corporates. In addition, momentum has not favored US stocks.

Overweight on emerging markets

We are overweight on emerging markets as we believe that relative valuations are favorable, thanks to a discount of almost 30% relative to developed markets. We do not believe that emerging markets are already experiencing a structural recovery, as economic activity is still subdued and fundamentals remain vulnerable. However, the country composition of emerging market equities is less sensitive to the recent currency-driven sell-off in the broader asset class. Equities are to some extent hedged for a decline in currency values, in the sense that a weaker exchange rate boosts the earnings outlook for the relevant country, as recent yen weakening in Japan has demonstrated.

European equities are less attractive

Equity valuations in Europe have become less favorable and we have become less positive about the region despite improving macroeconomic data. Earnings revisions in Europe on a 3-month horizon, which have some predictive power for equity returns in the near term, are also the least favorable of all regions. A further risk we see for Eurozone equity exposure is the toughness of the ECB stress test for banks and the possible contagion risks stemming from any defaults. Europe is also relatively more vulnerable to a negative supply- and demand shock from increased sanctions if Russia remains its aggressive stance towards Ukraine.

Few signs of growth in Asia Pacific

We retain our neutral stance on Asia Pacific as we see few signs of the necessary improvement in real wages in Japan, restraining the spending power of Japanese consumers as inflation picks up. Also, a meaningful improvement in corporate business confidence is still absent. The impact of the sales tax hike will suppress economic activity in the second quarter, but we expect the BoJ to step in with

additional QE in July. This could result in further yen weakening, although upward corporate earnings revisions for Japanese exporters will eventually diminish. Asia Pacific saw negative earnings revisions this month, possibly due to the stronger yen which hampers profit growth at Japanese exporters. Valuations are still comfortably below their 10-year averages.

North America has shown notable improvement in earnings revisions

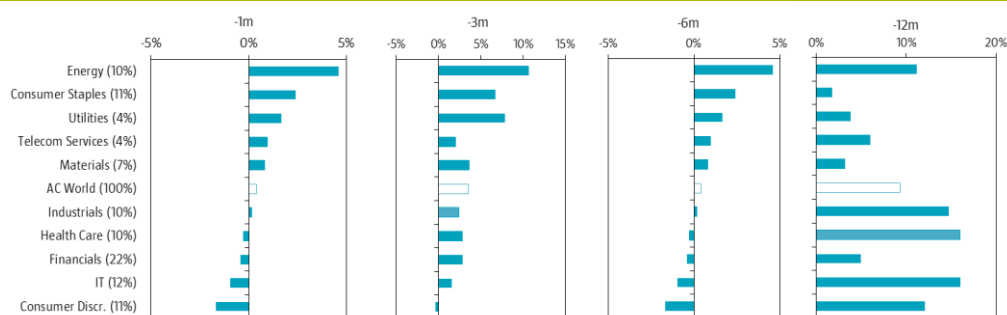
	<u>Earnings growth (%)</u>			<u>Earn. rev. index</u>		<u>P/E on 12m fwd earn.</u>	
	<i>FY1</i>	<i>FY2</i>	<i>12m</i>	<i>3m</i>	<i>1m</i>	<i>Current</i>	<i>10y avg.</i>
North America	8.4	11.7	9.7	5.0	18.8	15.5	14.0
Europe	8.0	12.3	9.3	-30.9	-34.2	14.1	11.9
Pacific	8.7	9.5	8.7	-0.5	0.8	13.5	15.1
Emerging Markets	11.5	10.4	11.0	-14.7	-3.2	10.5	10.8
AC World	8.8	11.4	9.6	-8.5	4.0	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

Sector allocation – counteracting forces make us neutral

Energy stocks have shown strong momentum



MSCI AC World unhedged EUR; index weights between brackets

Source: Thomson Reuters Datastream. Robeco

We maintain our neutral stance on sectors, as we see various counteracting forces at work. First, expected cyclical outperformance is highly correlated with macroeconomic surprises. Although we expect moderate surprises in the remainder of the year due to above-consensus growth in the US, this effect will be moderately positive for cyclicals. Second, value stocks have gained momentum compared to more cyclical, growth-biased stocks. Earnings growth has still not surprised within cyclical sectors and the multiples expansion that was seen in cyclical sectors such as IT last year is now reverting. Third, momentum does not clearly favor cyclical stocks. Uncertainties remain elevated, following indications of slowing growth in China and the continuing Russia/Ukraine crisis. Earnings revisions have also proven to be negative overall, which is a reason to remain cautious about cyclical outperformance, despite our expectations for a rebound in developed market growth.

Cyclical versus defensive sectors – improved earnings revisions for industrials and energy

	Earnings growth (%)			Earn. rev. index		P/E on 12m fwd earn.	
	FY1	FY2	12m	3m	1m	Current	10-yr avg.
Energy	9.0	6.4	8.0	-6.1	10.8	12.3	10.9
Materials	13.9	13.9	11.9	-19.5	-6.2	14.2	12.1
Industrials	12.9	12.9	12.9	-8.3	7.1	15.3	14.1
Consumer Discr.	8.5	15.6	11.6	-18.2	-8.6	15.1	15.2
Consumer Staples	5.5	9.7	8.2	-32.0	-14.3	17.7	15.8
Health Care	8.6	10.9	9.5	-6.9	0.0	16.6	14.3
Financials	7.3	12.5	8.8	-4.5	6.4	11.9	11.3
IT	13.1	11.2	12.5	18.7	22.0	14.4	15.6
Telecom Services	2.6	7.4	3.2	-29.4	-33.3	14.4	13.9
Utilities	1.9	8.2	3.1	3.2	-3.7	14.9	13.8
AC World	8.8	11.4	9.6	-8.5	4.0	14.2	13.1
AC WORLD REITS	-6.5	7.6	-2.1	0.0	-0.1	25.8	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.

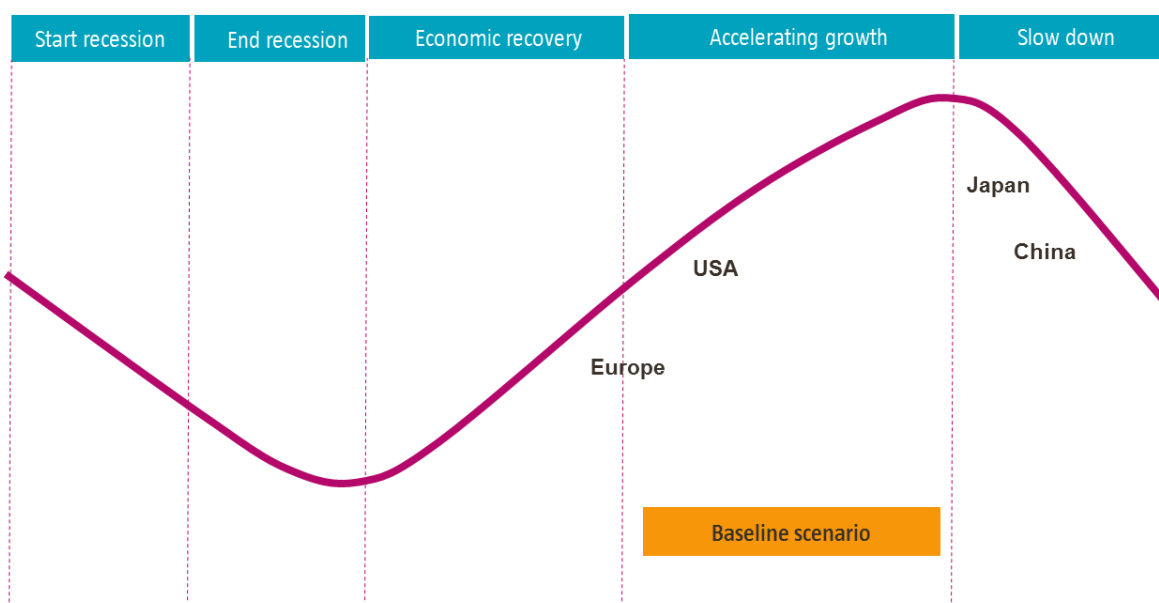
Source: Thomson Reuters Datastream. Robeco

Position in the economic cycle – a gradual recovery

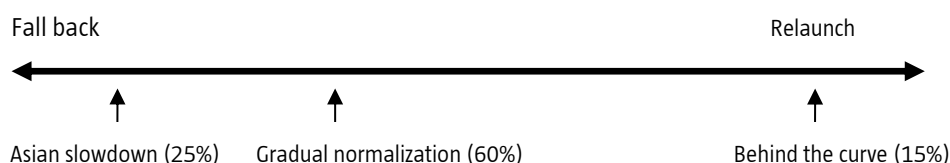
Macroeconomic scenarios and Robeco’s view versus consensus

The world economy is developing positively, led by the US. Our baseline scenario envisages a further gradual recovery. 'Abenomics' is running into difficulties now the VAT hike has kicked in. The Japanese central bank will eventually act energetically to weaken the yen. The Chinese authorities will prevent an excessive cooling of their economy and are in no hurry to implement ambitious reforms. The Eurozone continues to show a gradual, broadening improvement. 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 – Europe lags the other major economies



Macroeconomic scenarios: a gradual normalization is the most likely outcome



Source: Robeco

Robeco's expectations for growth are higher than consensus for the US, Eurozone and UK

GDP growth by region (%)	2013	2014	2015	Δ -1m 2014	Robeco*
US	1.9	2.7	3.0	-0.2	+
Eurozone	-0.4	1.1	1.5	0.0	+
UK	1.7	2.7	2.4	0.0	+
Japan	1.7	1.5	1.2	0.0	=
China	7.7	7.5	7.3	-0.2	=
India	4.6	4.8	5.3	-0.1	-
Brazil	2.3	1.9	2.5	-0.1	-
Russia	1.5	2.0	2.5	-0.8	-

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

Source: Consensus Economics, Robeco

Robeco's expectations for inflation are lower than consensus for the US and Japan

CPI by region (%)	2013	2014	2015	Δ -1m 2014	Robeco*
US	1.5	1.7	2.0	0.1	-
Eurozone	1.3	1.0	1.4	-0.1	+
UK	3.1	2.0	2.1	0.1	=
Japan	0.3	2.6	1.7	0.1	-
China	2.6	2.7	3.2	-0.3	=
India	9.5	9.5	8.2	-0.1	=
Brazil	5.9	6.0	5.7	0.1	+
Russia	6.5	6.0	5.0	0.4	+

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

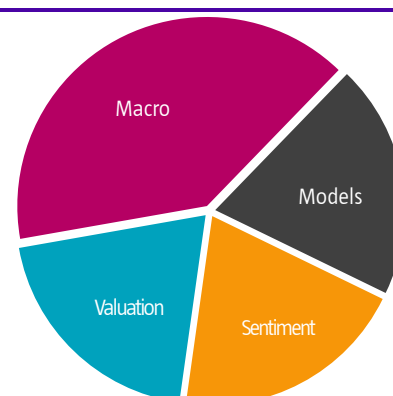
Source: Consensus Economics, Robeco

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. We recently switched funds from investment grade corporate bonds into high yield credits by reducing our allocation to the former by 1% and used the money to raise our exposure to the latter by 1%.

	Portfolio	BM	active	previous	tracking error	risk budget
Equities Developed Markets	29.0%	25.0%	4.0%	2.5%	0.60%	68.4%
Equities Emerging Markets	6.0%	5.0%	1.0%	1.0%	0.18%	16.6%
Real Estate Equities	2.5%	5.0%	-2.5%	-1.0%	0.40%	-32.2%
Commodities	5.0%	5.0%			0.00%	0.0%
Core Gov Bonds 1-10	15.0%	20.0%	-5.0%	-6.0%	0.15%	11.2%
Core Gov Bonds 10+	7.5%	7.5%			0.00%	0.0%
Investment Grade Corp Bonds	19.0%	20.0%	-1.0%		0.03%	-0.3%
High Yield Corp Bonds	11.0%	5.0%	6.0%	5.0%	0.35%	31.5%
Emerging Market Bonds LC	3.0%	5.0%	-2.0%	-1.0%	0.17%	-5.2%
Cash	2.0%	2.5%	-0.5%	-0.5%	0.00%	0.0%
EUR/USD	-4.0%	0.0%	-4.0%	-4.0%	0.36%	-5.5%
EUR/JPY	2.0%	0.0%	2.0%	2.0%	0.25%	15.4%
EUR/GBP	0.0%	0.0%			0.00%	0.0%
EUR CASH	2.0%	0.0%	2.0%	2.0%		
Portfolio risk	6.54%	6.05%				

Closing date for text: 07 May 2014.

We refer to calendar months in all our data tables.

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