ROBECO
The Investment Engineers

Taking some risk off the table

- Higher market volatility likely in near term as risk factors re-emerge
- Divergence in monetary policy poses challenge for investors
- Macro outlook: We see an uneven and mediocre recovery
- Asset allocation: Positive on equities, but positions less aggressive

Topic of the month: The bull run faces headwinds

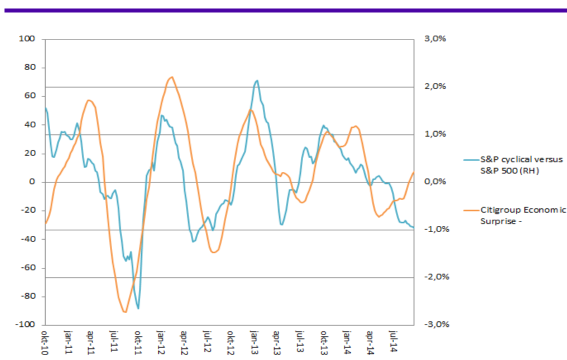
This month we have taken some risk of the table by reducing our overweight to equities, as we think that risks (and thus volatility) are becoming more prevalent in an uneven global recovery. We believe we are at an inflection point where different regional growth trajectories/events combined with lower levels of available liquidity will also lead to different policy reactions, with different market implications, raising market uncertainty. Although we do not expect major market events, there are several reasons that make us more cautious in the near term on risky assets.

This week, researchers at the Federal Reserve Bank of New York published an article about the drivers behind the recent period of low volatility (as proxied by the VIX). They observe that over the last two decades there have been only two other periods of similar low volatility; in May 2013 and prior to the financial crisis in 2007.

They conclude that the current climate resembles the May 2013 episode. Although the authors refrain from making predictive statements about volatility, we can remind investors that it occurred just before the then-Fed Chairman Ben Bernanke gave a first hint to markets of the possible end of the Fed's Treasury purchases. This prompted an uptick in Treasury volatility after his pronouncement on 22 May 2013, marking the start of several months of higher volatility in the US Treasury market and emerging market currencies. Likewise, the recent low volatility episode could turn into an environment where it is less plain sailing for investors. Running stepwise regressions on potential determinants of volatility, the New York Fed's researchers ended up with variables that also underpinned our reasoning for a less aggressive tactical risk profile.

First, we see a decreasing momentum in risky assets and an increasing divergence within equity markets. Small caps (which are perceived as more risky by investors) have lagged the performance of large caps. This observation has been confirmed in the US, as cyclical stocks have lagged the performance of defensives, although the macroeconomic environment suggests cyclicals should outperform. This decoupling of cyclicals from a strengthening macro picture indicates an increased risk perception in the market.

Relative cyclical performance has decoupled from economic performance

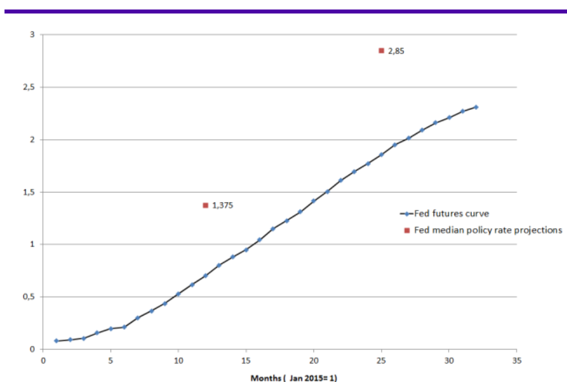


Source: Bloomberg, Citi, Robeco

Second, the divergence in monetary policy is more apparent than it was a couple of months ago. The US Federal Reserve (Fed) has hinted that it sees higher median policy rates in 2015, and new Fed Chairwoman Janet Yellen's more hawkish tone has increased uncertainty about the Fed hiking path. After the Federal Open Markets Committee (FOMC) meeting on 17 September 2014, futures market expectations about the number of basis points that the Fed will hike its policy rate in the next 12 months has clearly become more volatile.

Volatility could remain elevated if the Fed drops the phrase that rates 'will remain low for a considerable time' at its next meeting on policy rates on 29 October. This would suggest an increased probability of an earlier hike while the US inflation environment is still benign. Given the progress in the US labor market, with unemployment falling further to 5.9%, the Fed has reason to remain hawkish. On the other hand, the stronger dollar creates disinflation through lower import prices, decreasing the need for the Fed to tighten monetary policy.

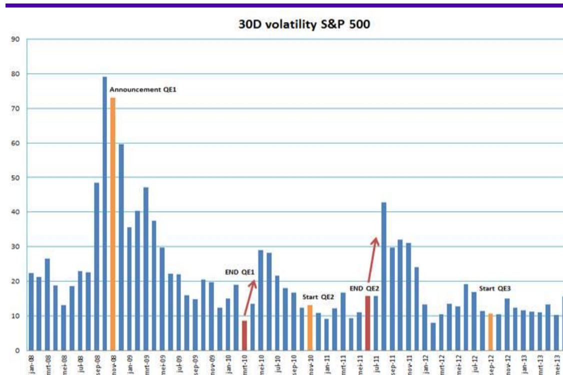
Market expectations for Fed projections on policy rates



Source: Bloomberg, Robeco

Furthermore, the Fed will no longer expand its balance sheet from November onwards with unconventional policy instruments as it will end the additional buying of Treasuries. The recent history of quantitative easing (QE) shows that the ending of unconventional policies has typically brought elevated volatility in the surrounding months.

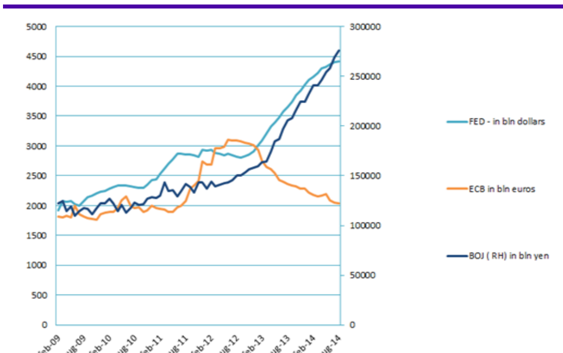
Volatility was elevated around the ending of QE1 and QE2



Source: Bloomberg, Robeco

Meanwhile, divergence in monetary policy has increased as the European Central Bank (ECB) has now made its intention clear to increase its balance sheet over a period of two years by EUR 1 trillion through acquiring asset backed securities (ABS) and covered bonds. Furthermore, cheap funding will be provided to banks via the so-called TLTRO's (targeted long-term refinancing operations). Internal opposition on the ECB board, as evidenced by the latest pronouncements from German policy makers against ABS purchases, could also limit the scope of the credit easing and increase uncertainty about the success of the ECB. Generalized QE (e.g. the buying of GDP-weighted baskets of Eurozone sovereign debt) remains an option if the Eurozone economy weakens considerably more from this point.

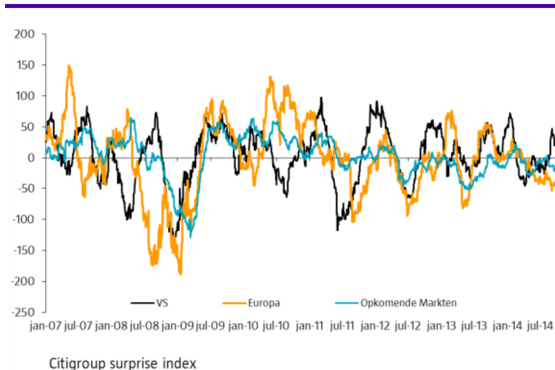
Central bank balance sheets show policy divergence



Source: Bloomberg, Robeco

Third, the global economy recovery remains uneven as the International Monetary Fund (IMF), ECB, World Bank and Organization for Economic Cooperation and Development (OECD) have reiterated in recent months. Although the US is performing well, other regions continue to disappoint, as the Citi surprise indices show.

Macro surprises indicate regional growth divergence



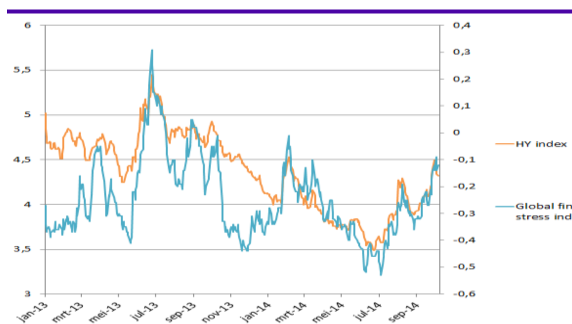
Citigroup surprise index

Source: Bloomberg, Citi, Robeco

Macro momentum in Europe has slowed as consumer and producer sentiment has worsened considerably. Although we think the slowdown in Europe is temporary, it remains nonetheless an additional risk factor. One of the explanations for the decrease in macroeconomic momentum is that sentiment and expectations in the European manufacturing sector have been dragged down by the lingering unrest in Ukraine. But a rebound in sentiment is possible as the truce between separatists and the Ukrainian government has avoided a future escalation of hostilities. The economy in Japan has disappointed as Abenomics needs to reignite its third pillar of structural reforms.

Fourth, the prospect of financial stress in the system - one of the variables the authors of the New York Fed found significant in explaining volatility - has increased again. One metric for financial stress is estimated by Bank of America Merrill Lynch using a cross-market index comprising risk, hedging demand and investor flows in the global financial system. This metric has gone up. This is also reflected in higher spreads in the corporate high yield market as they tend to correlate closely with financial stress. Spread widening seen in the high yield market is also a reason to take a more cautious stance towards equities.

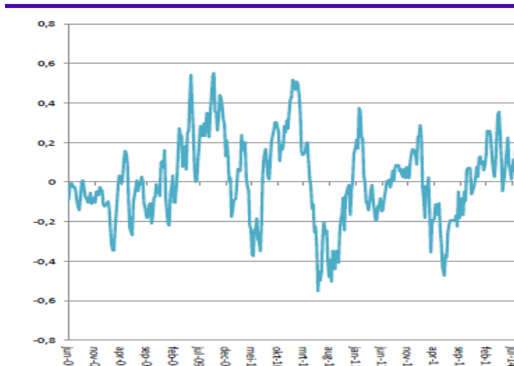
Financial market stress increased together with credit spread widening



Source: Bloomberg, BofaML, Robeco

Fifth, several conflicts are currently drawing the attention of financial markets and have possibly negatively influenced sentiment. References to uncertainty in the press - another of the other variables that were found to be significant in explaining volatility by the New York Fed study - have also increased. The Citi news-implied sentiment indicator is a reflection of investor uncertainty using the tone of news stories published on Bloomberg. The indicator turned negative last month. The ongoing student protests for more democracy in Hong Kong are closely followed as being relevant for China and the broader Asian region. Although the protest has scaled down in size, a peaceful resolution is not a given, as the Hong Kong governor has threatened the remaining protesters with force. Also, the march of Islamic State in northern Syria and Iraq could further raise tensions in the oil-rich Middle East.

News implied sentiment indicator turned negative



Source: Bloomberg, Citi, Robeco

To conclude, we find that several variables that historically explain volatility are re-emerging again, making us more cautious in our positions within risky assets in the near term. With market risk around the corner, we prefer a less aggressive tactical profile.

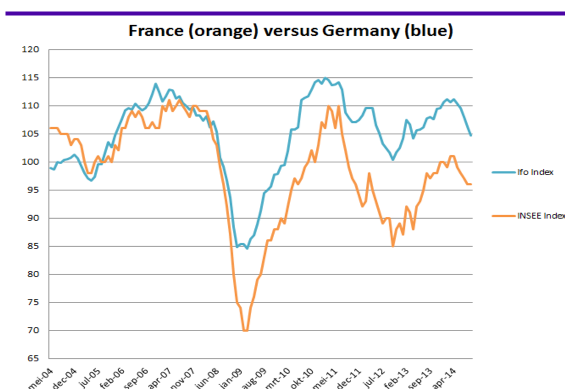
Macro outlook: Recovery is still mediocre and uneven

Although the world economy is still recovering, progress has been uneven and mediocre. The strongest economy is the US, though the latest confidence indicators have come down a bit from very high levels. With the strengthening of the dollar, pressure on the Fed is diminishing, and we do not expect a first rate hike before the summer of 2015.

The Chinese economy is switching to a growth path of around 7%, slightly lower than the target rate of 7.5%. Recently, the Chinese authorities have quietly stepped up stimulus by injecting roughly USD 80 bln into the five largest banks, the equivalent of an interest rate cut of 50 basis points. The Chinese authorities probably won't accept a target growth rate lower than 7.0% for next year and will accept a larger debt build-up to be able to reach this target.

The Japanese economy shows signs of stabilizing after the slowdown caused by the sales tax rate hike. Large manufacturers are signaling more optimism and have raised their investment plans. This makes it more likely that Japanese Prime Minister Shinzo Abe this autumn will decide to increase the sales tax rate once again in October 2015, as originally planned. Furthermore, the Bank of Japan won't go into additional quantitative easing any time soon, though this will in the end become inevitable in our opinion to push inflation structurally to a level of 2%.

Ifo indicator points to decreasing expansion of production



Source: Bloomberg, Robeco

In Europe the most striking development has been the ongoing weakening of the German economy, with Ifo business expectations even dipping below 100. The dropdown in investment is probably the most important explanation. There are some worries about German competitiveness due to the current Grand Coalition turning back some modest reform measures and implementing a costly energy policy ('Energiewende', out of nuclear power). But the most important factor is probably the Ukraine crisis. Now that the ceasefire seems to hold, the crisis could develop into a 'frozen conflict' and German producers could bounce back. There is a risk that the Russian Federation will increase pressure again this winter, threating natural gas supplies, perhaps also choosing another theatre than Ukraine, such as the Baltics. We consider this to be less likely, as the Russian economy is weak and the government is facing increasing budgetary difficulties due to the relative low price of oil, which is another boon for the Eurozone economy. Russian inflation is also picking up as a consequence of sanctions. It should be kept in mind that Russian behavior in Ukraine has been relatively cautious. It hasn't allowed the destruction of separatists by changing the military balance decisively. But it has refrained from an aggressive expansionary push, such as by volunteers taking Odessa. All in all, a stabilization of the conflict is likely, which means it would no longer hamper a rebound in confidence.

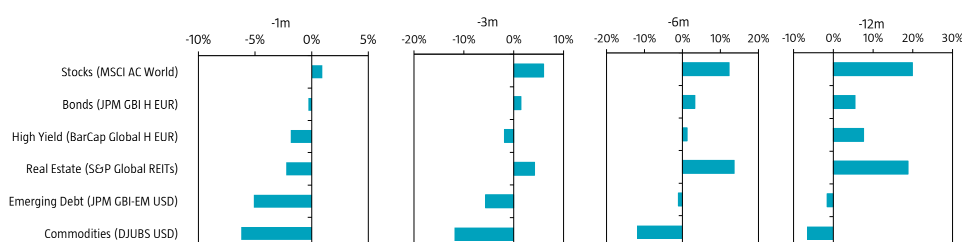
Another factor supporting the recovery is the ongoing monetary stimulus provided by the ECB, which contributes to a weaker euro, as the US is already in the early stages of a mild tightening cycle. The ECB has made clear its intention to increase its balance sheet over a period of two years by EUR 1 trillion by acquiring asset-backed securities and covered bonds. Furthermore, cheap funding will be provided to banks via the so-called TLTRO's (targeted long term refinancing operation). Generalized QE (e.g. the buying of GDP-weighted baskets of Eurozone sovereign debt) remains an option if the Eurozone economy weakens considerably more from this point. Given the already very low long rates in the Eurozone it is by the way doubtful that this form of QE would have a material additional impact. We are clearly reaching the limits of the power of monetary policy. Nevertheless, the ECB, primarily worried about the weak performance of the Eurozone economy, and not so much about disinflation in which energy is an important factor, will act if the need arises. As other major central banks have earlier engaged into this kind of QE (Japan, UK, US) the ECB could justify this instrument as being a nowadays 'standard' monetary policy instrument. Its legality is therefore not in doubt, although it will be undoubtedly challenged by the German Constitutional Court. For political reasons the ECB is keeping this option - probably wisely - as a weapon of the last resort.

At Jackson Hole, ECB President Mario Draghi called for a 'Grand Bargain' consisting of additional fiscal stimulus (pan-European infrastructure projects, German stimulus), structural reform (France, Italy) and additional monetary stimulus. Fortunately, the ECB, the only major European institution which decides policy by simple majority vote, did not wait to keep its part of the proposed bargain.

The chances on the Grand Bargain being successful are low. Nevertheless, self-defeating austerity is no longer on the European agenda. France has unilaterally declared that it needs more time to reach its deficit targets. Italy has followed France. Though the results thus far hardly inspire confidence, an end to attempts to tighten the fiscal stance is a positive factor at least in the short term for growth in the Eurozone.

Asset allocation – with market risk around the corner, we prefer a less aggressive tactical profile

Performance of asset classes (gross total return) – stocks continue to be monthly winners



Source: Thomson Reuters Datastream, Bloomberg, Robeco

High yield is still valuable, but downsizing exposure seems prudent

We remain overweight on high yield, but we are getting less enthusiastic about the asset class. In previous months we have downsized our overweight to high yield. High yield bond values have not fully recovered from the correction that occurred after a July speech by Fed Chairwoman Janet Yellen about 'stretched valuations' in pockets of the credit market. Instead, spreads have widened again as a signal that the correction has a more fundamental nature then just the worry of a central banker. This month, other market participants joined the pronouncements made by the Bank of England about the lack of liquidity in the corporate bond market. The liquidity theme is especially important against the background of the expansion of excess liquidity coming to an end, as the Fed halts its buying of additional Treasuries in the market, and the ongoing Fed discussion about when it will raise policy rates for the first time since the financial crisis. Another worry remains the gradual deterioration of the underlying credit quality of this asset class.

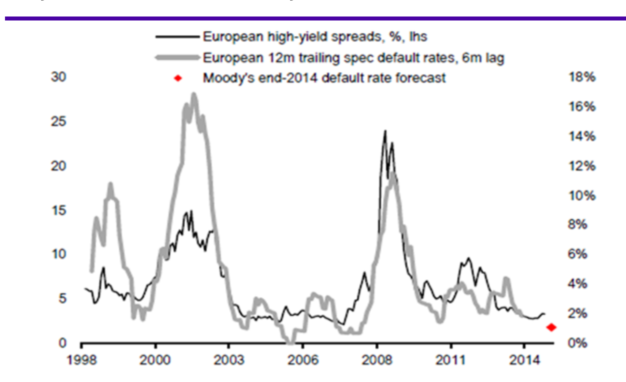
However, the broader environment of still-subdued growth and benign inflation remains favorable, and the recent ECB easing measures are an additional boost for risky assets. In the meantime, the search for yield will continue, albeit at a more measured pace, as the market is less assured of central bank easy money. Although risk perception is currently strong, 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.

Looking ahead, we expect somewhat higher default rates in the US, as leverage in corporate balance sheets has increased further, and the rising rates that we envisage will aggravate the leverage effect on cashflows and interest coverage ratios on lower-quality issuers. We therefore remain vigilant in the medium term.

Investment grade credits are unattractive

We maintain the view that, when corrected for risk, high yield remains more attractive than the ultra-low rates that investment grade credits offer. But as yields in the euro investment grade credit market are now even below those of a global government bond index, neither the yields nor the spreads are looking relatively attractive to us. The spread component is priced for perfection. 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. Current credit yields are now just above the German government bond yields. 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. Higher credit spreads may ensue if banking stress test results disappoint later this year, but we find the probability for this to be quite low. The bottoming out of disinflation in the Eurozone, stimulated by a lower euro and more stable energy prices, could push nominal capital market rates higher, eating into the remaining spread buffer of investment grade bonds.

Corporate default rates are expected to remain low

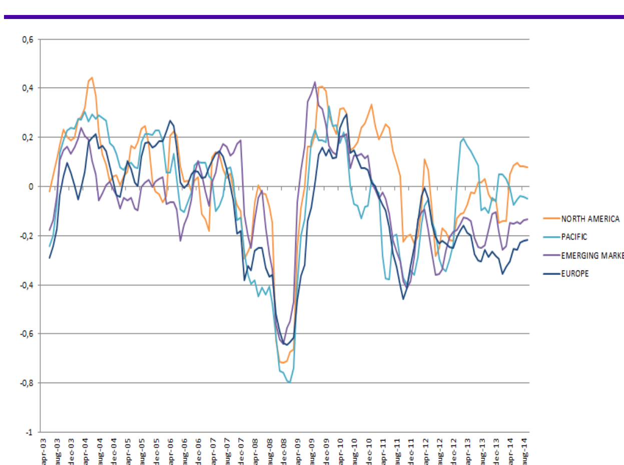


Source: Thomson Reuters, Credit Suisse research

We remain optimistic about equities, but take some risk off the table

Global equities showed positive returns in dollar terms last month with a 0.9% month-on-month return, topping other risky assets. However, solely from an asset class perspective, the rally seems to be losing some steam. Whereas complacency seems prevalent a few months ago, investors now have tuned in more to the risk side of the equity story. Cyclical equities in the US have lagged performance-wise compared to the positive macroeconomic surprises we have seen in the US. Also, small caps (which are perceived as being riskier) have underperformed large cap companies in the US. A slowing global macroeconomic momentum and a rise in geopolitical tensions have not helped to improve sentiment. Tensions around the Russia-Ukraine conflict remain elevated, although a truce has now been struck. Western sanctions have triggered counter-sanctions from Russia. Although not at the forefront of market interest, the possible geopolitical impact of the Ukrainian conflict, the outbreak (and spreading of) ebola in Africa and the insurgency of the Islamic State in Iraq and Syria (ISIS) group have not been negligible. Also, other risky assets such as corporate high yield bonds, which tend to move in tandem with financial market stress, have shown widening spreads to reflect the increased awareness of financial market risk. This financial market risk will likely remain elevated as the major central banks show increasing divergence on monetary policy, bringing higher volatility. The latest Fed meeting triggered a market discussion about the 'Fed dots', which showed higher median policy rates for 2015, indicating that the Fed could be more hawkish than anticipated by the market, hiking earlier. However, uncertainty about the timing of the first Fed rate

Earnings revisions: Europe has shown some improvement



Source: Datastream, Robeco

hike remains high, given that there is benign inflation in the US and still some slack in the labor market. Meanwhile, the ECB has shifted gear in the opposite direction with its intended balance sheet expansion to early-2012 levels. With more risks around , we decided to take some equity risk off the table but to remain overweight equities overall compared to government bonds.

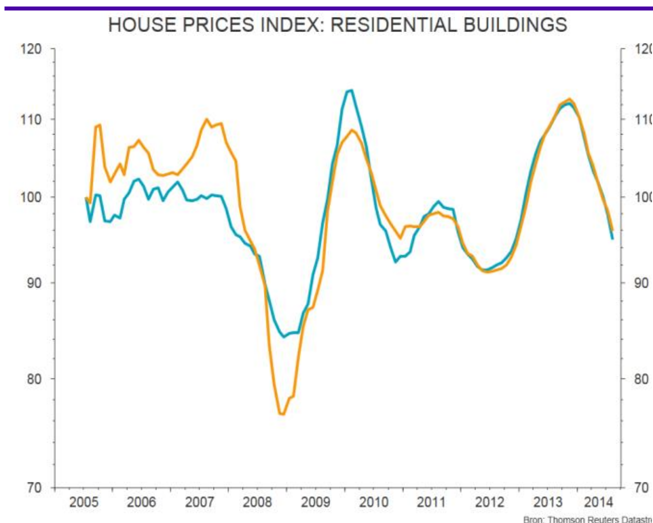
The reason for this is that equities are one of the few places that still offer a decent risk-return reward. The search for yield will not disappear as the Fed prepares for the first rate hike since the financial crisis, but will become more critically focused on the corporate earnings perspective. From a forward-looking macroeconomic perspective, developments have been benign for equities, as capital markets rates have declined and the US consumer is getting more upbeat, which should lead to increased sales. For the US, this story has already translated into positive earnings surprises. Earnings revisions are still upward for US corporates and revisions elsewhere are improving. The equity market thus could remain supported even as central bank support decreases when the Fed ends its buying of additional Treasuries next month. This will also put less emphasis on worries about elevated valuations as earnings growth will likely keep pace with price appreciation in developed countries. Recently, valuations on a cyclically adjusted basis have declined somewhat in developed world markets.

The recent decline in capital market rates and still-benign wage growth will continue to support profit margins. Also, 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.

We are underweight in real estate as we expect rates to rise

We remain underweight in real estate compared to equities. Real estate underperformed global equities in September as the discussion about the direction of Fed policy took a new turn, with the Fed hinting on higher median policy rates in 2015. We expect interest rates to increase, which will benefit equities more than real estate in our view. Overall, real estate valuations compared to equities remain high. The US is most vulnerable to higher rates, also because from a cross- regional view, US valuations are high. The Eurozone real estate market seems less sensitive to rate developments in the US, especially as the ECB took further easing measures last month. The Japanese real estate market could benefit from further easing by the Bank of Japan, increasing J-REIT returns. The Chinese market is oversupplied and shows declining prices for real estate in the major cities, although new stimulus measures by the Chinese government could mitigate the price depreciation.

Chinese housing market is oversupplied



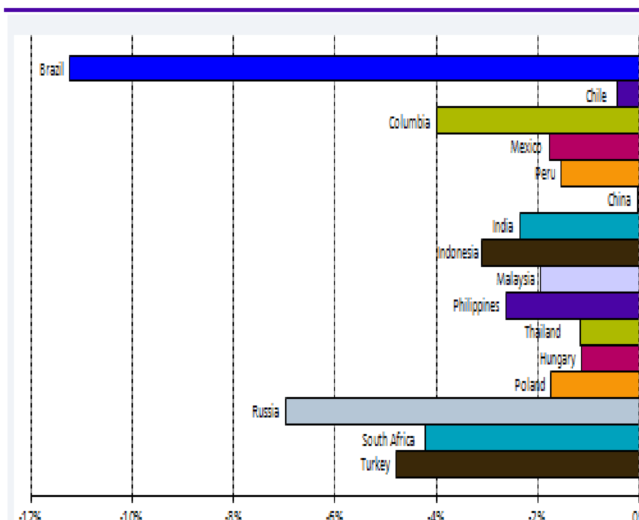
Source: Bloomberg, Robeco

Emerging market debt faces challenges from Fed policy and an uneven recovery

We remain underweight emerging market debt (EMD) versus high yield. Recent EMD spread compression has not moved in line with the underlying fundamentals. Leading indicators o for emerging market economies are turning more positive, indicating that the macroeconomic picture overall is improving. However, risks of an uneven recovery in emerging markets become apparent while vulnerability to Fed policy remains.

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. In the Brazilian presidential election, current President Dilma Rousseff is leading the polls, which does not bode well for the much needed supply side reforms as her previous successes on reforms have proven to be limited.

Emerging markets currencies were under pressure last month



Source: Bloombera. Robeco

The decline in the oil price has continued in tandem with emerging market currencies. 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, putting downward pressure on currencies. From the other side of the cross, the strong performance of the dollar has also negatively influenced EMD performance in local currency terms. Although there is reason to suggest that the recent dollar appreciation may have overshot, dollar momentum is expected to remain strong.

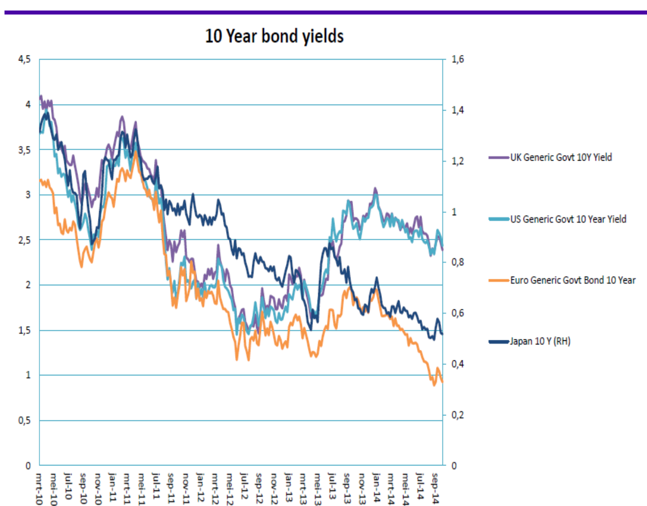
Traditionally the ending of unconventional central bank policies is surrounded by higher market volatility as the market has to stand on its own legs again. The end of tapering of US Treasury purchases by the Fed next month could therefore bring more volatility for Treasuries as the market will subsequently fully focus on the next move by the Fed. Higher Treasury market volatility would induce higher volatility in emerging markets currencies.

Thus, there is reason 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. However, we are not outrightly defensive as EMD spreads are still above those of high yield , even after the spread widening 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%. From a valuation and macroeconomic perspective, these yields seem unsustainable. A nominal 10-year bond yield of 1.1% and market inflation of 1.6% implies negative real yields, suggesting the market is fully pricing in secular stagnation in the Eurozone. However, we expect the Eurozone to gradually normalize to pre-crisis growth levels. In the near term, a depreciating euro and lower energy prices will pave the way to a turn in the slowing macro momentum we are currently experiencing. After ECB President Mario Draghi hinted at the Jackson Hole summit of more easing because of declining inflation expectations, he delivered by promising to bring the ECB balance sheet level back to the early-2012 levels, hinting at a 1 trillion euro balance sheet expansion.

German 10-year bond yields are now below 1%



Source: Bloomberg, Robeco

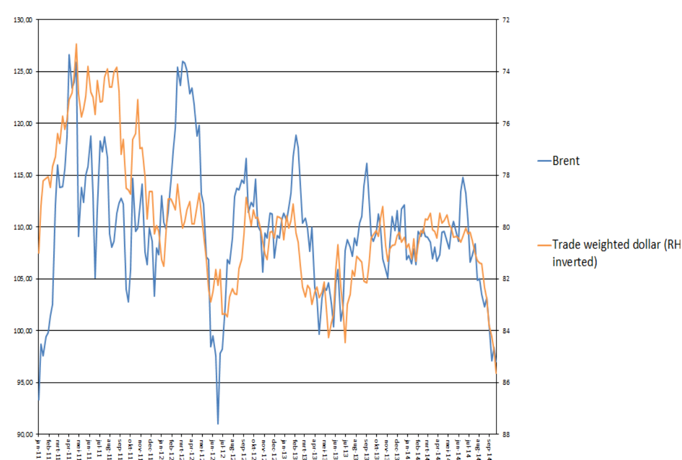
Several reasons for the impressive rally that followed Draghi's announcements could abate in the remainder of the year. First, the market has clearly anticipated easing in the form of ABS purchases and QE, but internal opposition against ABS could limit the scope of the ECB program. Second, safe haven flows have lowered yields in Germany even further, but the tensions around Russia and Ukraine have eased somewhat compared to a few months ago. Third, more stable oil prices in combination with higher import inflation could change the inflation picture towards the end of the year. A lower euro, regaining German export strength as China keeps its growth rate just above 7%, and lower energy bills in the Eurozone could cause the strong momentum in bonds to reverse.

Also, strong macroeconomic momentum from the US as evidenced for instance by the further decline in unemployment, could spill over through higher Treasury rates into the Eurozone market. Correlation between Bunds and Treasuries have declined somewhat recently as the two major central banks seem to head in opposite directions, but remain high nonetheless. Although the Fed has kept its phrasing that rates will remain low for a 'considerable time', the improving labor market and higher inflation numbers will make this message from Yellen harder to maintain. 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.

Oil prices are likely to stabilize

The decline in Brent prices since the second half of June has been a quite remarkable 19%. Several factors have contributed to this. The latest downward move in oil was triggered when Saudi Aramco, the world's largest oil exporter, lowered its prices to customers. This hints at a change in the long-standing strategy of OPEC to maintain price stability. With the return of supply from Libya and a more reluctant stance from Saudi Arabia than we expected, supply remained ample against a background of uneven growth in demand from emerging and developing markets. Both the OPEC and International Energy Authority lowered demand projections for next year. The next OPEC meeting in November will therefore be tense as countries suffering the most from lower oil prices, such as Iran, 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 will 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. The recent move of Saudi Arabia to lower its oil prices is more likely a reflection of exploiting regional pricing differences than a strategic shift. Thus, oil prices are now more likely to stabilize.

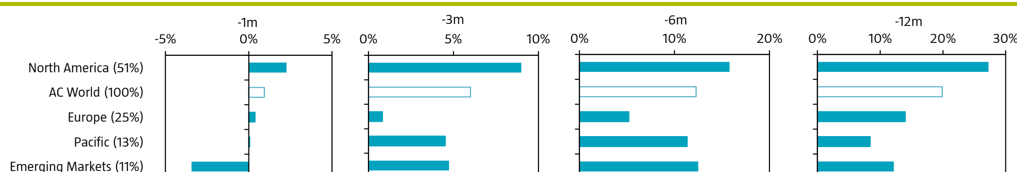
Strong dollar contributed to the fall in Brent crude prices



Source: Bloomberg, Robeco

Regional asset allocation – we are positive on Japanese equities

Momentum has turned negative for emerging markets



MSCI AC World unhedged EUR; index weights between brackets

Source: Thomson Reuters Datastream, Robeco

A near-term catalyst is lacking for accelerating earnings growth in the US

We are underweight on North America. Although the US outperformed the global equity index last month, we expect a somewhat slowing momentum as the focus of the equity market will be on future corporate earnings potential, given the more hawkish tone from the Fed, elevated US valuations and the decline in risk sentiment. Valuations suggest that investors have already anticipated a lot of the expected good news. Earnings growth could remain healthy as the consumer gradually returns thanks to higher real spending power, but we doubt whether it will be strong enough to provide a new trigger for the US equity rally in the near term. Earnings revisions by analysts have been positive since April, but did not accelerate last month. This could indicate that earnings need a new impetus in the near term, but accelerating sales growth seems difficult given the slowing momentum in US retail sales, while the strong dollar is hampering overseas revenues. Positive sales surprises have surpassed negative ones for S&P 500 constituents during September, but a deceleration is also visible here. Margin expansion is limited given our view of rising rates and gradually higher bargaining power for labor. In the absence of a clear catalyst to propel earnings further in the near term, we take a more neutral stance. The US economy is gradually firing on more cylinders: US non-farm payroll numbers have showed continuing improvement in the labor market, with around 248,000 new jobs added in September and declining unemployment. The end of Fed tapering in November could bring more volatility into the US market.

European forward earnings improve

	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd earn.*	
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
North America	6.7	12.2	11.0	7.7	-18.7	15.7	14.0
Europe	5.5	12.9	10.8	-21.6	-19.1	13.8	11.8
Pacific	7.0	9.9	8.6	-4.8	-4.0	14.2	15.0
Emerging Markets	5.4	11.9	10.4	-13.3	-14.9	10.9	10.8
AC World	6.3	12.1	10.6	-5.8	-15.8	14.4	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

Europe: ECB action could lift European stocks

We have raised our allocation to European stocks. Momentum has remained negative despite the recent easing measures by the ECB, in which it hit the zero lower-bound range in policy interest rates. We think that unconventional easing measures will have a positive impact on the earnings per share of European corporates, 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 has declined, 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). We think these factors, together with ECB action, will be a game changer for European equities, which are cheap compared to US equities.

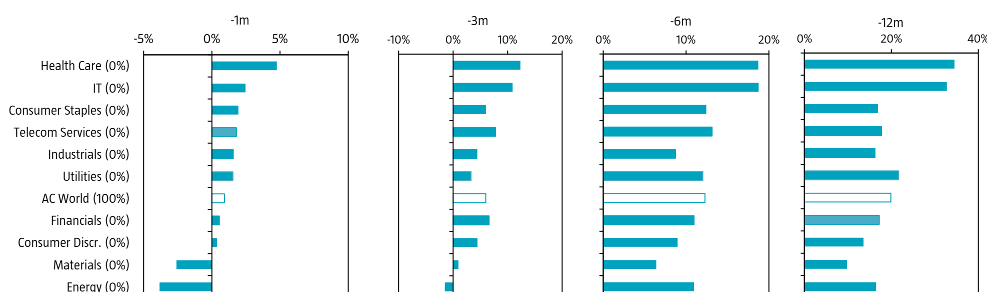
Asia Pacific: expected change in BoJ tone would be positive for Japanese equities

We are overweight on Asia Pacific, predominantly because we are positive about additional policy action in Japan. The slowing in real activity will likely bring forward action by the Bank of Japan (BoJ) to weaken the yen further and stimulate the export-dependent economy. A stronger dollar could also help further yen weakening. Japanese earnings revisions have remained positive, which bodes well for equity returns. Also, the Nikkei has lagged the yen depreciation, which gives upward potential for Japanese stocks, although this could partly be the result of diminishing return prospects from yen weakening for Japanese exporters. Equity valuations for Asia Pacific are still comfortably below their 10-year averages.

We are neutral on emerging market equities as we have seen a clear reversal in price momentum. This reversal has partly been caused by the latest Fed guidance, showing higher median Fed policy rate projections for 2015. 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. 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, although commodity-exporting emerging markets are likely to see declining current accounts because of weak commodity prices. 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 end in early 2015. 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 (elections in Brazil).

Sector allocation – we remain overweight cyclicals

Strong momentum for health care, cyclicals lag improved economy



MSCI AC World unhedged EUR; index weights between brackets

Source: Thomson Reuters Datastream. Robeco

Although we have taken some risk of 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	7.7	6.9	7.0	-12.3	-38.7	11.9	10.8
Materials	16.7	16.7	13.5	-10.3	-9.8	14.1	12.2
Industrials	13.4	13.4	12.7	-8.3	-12.0	15.1	14.1
Consumer Discr.	-0.5	16.7	12.3	-13.5	-21.1	15.2	15.2
Consumer Staples	3.4	9.6	8.5	-31.2	-47.0	18.0	15.9
Health Care	10.7	10.9	11.0	22.1	14.6	17.5	14.3
Financials	6.2	13.3	11.6	-2.0	-14.3	12.1	11.3
IT	12.5	11.2	11.6	7.2	-9.9	15.5	15.5
Telecom Services	-3.0	8.7	4.1	2.1	19.1	15.3	13.5
Utilities	0.4	9.9	6.6	-6.0	3.8	14.6	13.8
AC World	8.2	12.1	10.6	-5.8	-15.8	14.4	13.1
AC WORLD REITS	-10.4	12.3	8.4	0.0	-0.6	26.1	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.

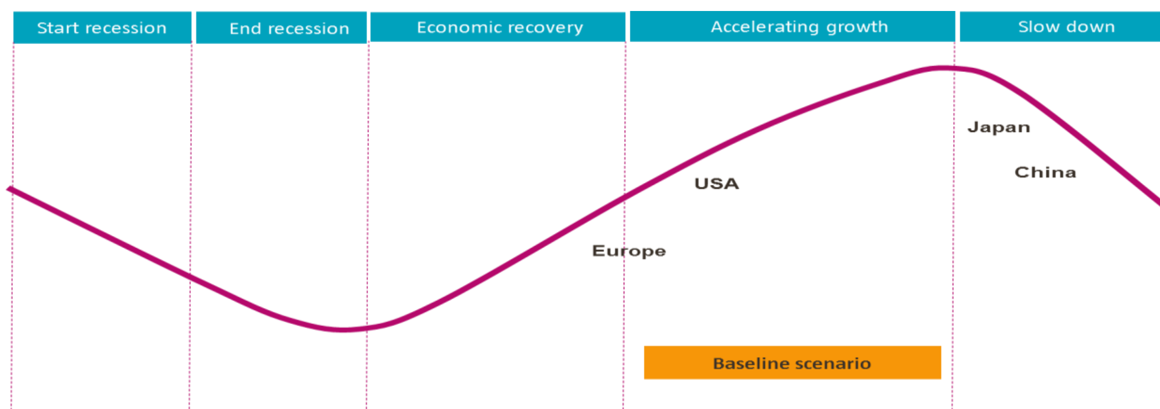
Source: Thomson Reuters Datastream. Robeco

Position in the economic cycle – we continue to foresee a gradual recovery

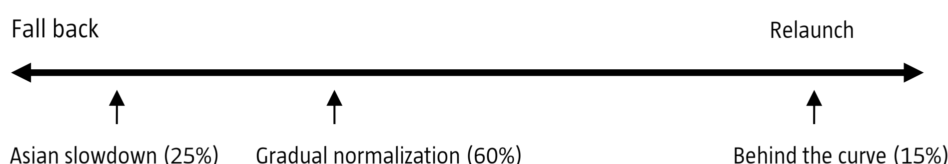
Macroeconomic scenarios and Robeco's view versus consensus

The world economy is developing positively, led by the US and the UK. 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 will eventually act energetically to weaken the yen. The Chinese authorities have quietly implemented additional stimulus. The Eurozone economy came to a standstill in the second quarter, but we expect a resumption of the earlier gradual, broad-based 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 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, India 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	+

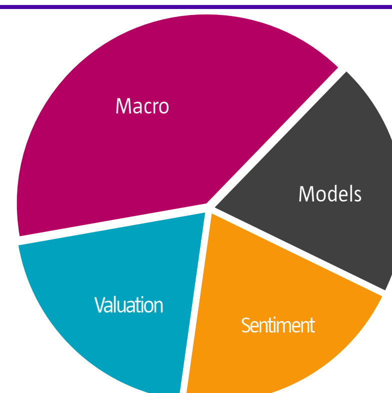
* indicates whether we expect a higher (+). matching (=) or lower (-) growth rate than the current consensus estimate for 2014

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.

Input factors for our investment policy



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.

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%	6.0%	0.52%	97.4%
Equities Emerging Markets	5.0%	5.0%		1.0%	0.00%	0.0%
Real Estate Equities	2.5%	5.0%	-2.5%	-2.5%	0.34%	-32.8%
Commodities	5.0%	5.0%			0.00%	0.0%
Core Gov Bonds 1-10	17.0%	20.0%	-3.0%	-4.0%	0.08%	9.5%
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%	0.4%
High Yield Corp Bonds	8.0%	5.0%	3.0%	3.0%	0.15%	16.9%
Emerging Market Bonds LC	5.0%	5.0%			0.00%	0.0%
Cash	2.0%	2.5%	-0.5%	-2.5%	0.00%	0.0%
EUR/USD	-2.0%	0.0%	-2.0%	-2.0%	0.16%	-3.8%
EUR/JPY	1.0%	0.0%	1.0%	1.0%	0.12%	12.4%
EUR/GBP	0.0%	0.0%			0.00%	0.0%
EUR CASH	1.0%	0.0%	1.0%	1.0%		
Portfolio risk	5.55%	5.29%				

Closing date for text: 06 October 2014. We refer to calendar months in all our data tables.

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