ROBECO
The Investment Engineers

No Gilts, just pounds

Fixed Income Outlook Q3 2014

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Summary

Main views and changes since last quarter

Main asset categories	Total	Valuation	Technicals	Fundamentals
German Bunds	-	-	0	0
US Treasuries	--	-- ▼	-	-
JGB's	--	--	+	-
IG Credits	0	0	0	0
High Yield	0	0	0	0
EMD local debt	-	+	0 ▲	-
EURO peripheral debt	+	+	+	0

Our key themes

- US economy set for growth
  One of the surprises so far this year has been the lackluster overall growth picture in the US, partly due to the weather conditions. When looking at underlying trends in labor market indicators (e.g. private payroll growth) and producer confidence series, we maintain our view that the US economy is in the midst of a recovery. At the same time inflation indicators have bottomed and are expected to rise further this year. For the euro area disinflationary pressures are ample thereby fueling the decoupling theme between the US (and UK) and the euro area.
- Strong preference for Continental European fixed income
  The UK and the US have taken the lead on the road to recovery, Europe is clearly lagging. This resulted in diverging monetary policy trends and yield outlook in the respective markets. This argues for reduced interest sensitivity in the US and UK markets in favor of continental European markets. Especially for bonds with a maturity of around five years, we anticipate the interest rate spread between US Treasuries and Bunds to widen further. We shy away from the UK Gilt market and focus on an outright sterling position instead.
- The credit bull market on its last legs?
  Credit may continue to perform well in a moderate economic growth environment, but the reward has become less appealing. After a strong performance, credit spreads offer limited protection against market risks like poor liquidity and potentially rising yields.
- Don't just chase yields in emerging debt
  Emerging debt is one of the few places where yields can still be elevated, which triggers investor appetite in the current low yield and low volatility environment. The higher yields are not without a reason though and especially currencies look vulnerable on the road to rate normalization in the US.
- European peripheral debt has further to go
  We see further upside in European peripheral government bonds. The new policy measures announced by the ECB at its June meeting have re-energized the liquidity driven rally of this segment. After the impressive rally in especially the short dated securities, the upward potential here has diminished. We now rather focus on the bonds with a maturity between five and ten years.

In focus

No Gilts, just pounds

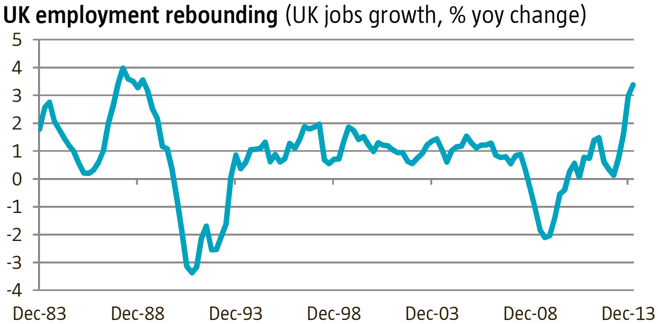
For a bond investor the UK is a very interesting case to follow. Not so much because of the impact of its economy on the world economy. Measured by nominal GDP, the UK ranks sixth, far behind countries like the US, China and Japan. It has more to do with the monetary policy issues currently being discussed, which give us a sneak preview of what we may be heading for in the US later in the year.

The UK economy has done surprisingly well over the last few quarters and the outlook is positive. GDP growth north of 3% for 2014 is in the making. This is still a rather unique phenomenon in advanced economies in the aftermath of the crisis. The UK housing market is booming again. London's house prices are 30% above their pre-crisis peak; national prices are back at their 2007 peak. The labor market is improving rapidly. Unemployment is likely to fall to 6% by year end from a peak close to 8.5% in 2011. Jobs growth between January and March rose strongly. However, the recovery of total employment since the crisis has been partly driven by a rise in self-employment. Not per se a sign of underlying strength. This is probably also a good explanation of the lagging productivity growth. Furthermore while labor market slack is shrinking fast it is still unclear when this will lift household wages and salaries.

The Bank of England is well aware of these uncertainties and is of the opinion that the tightening cycle should be "gradual and limited". It has indicated that if it plans to raise rates gradually, it might be prudent to start doing so sooner rather than later. The BOE's balance sheet doubled since the start of the crisis. Unlike the Fed's still growing balance sheet, the BOE's balance sheet has been stable since the end of 2012. The BOE so far reinvests maturing debt though and owns nearly one third of all UK Gilts, representing a value of more than 20% of British GDP. These statistics show that the road to a change in policy is a true balancing act; this delicacy was only recently confirmed by BOE's Carney comments in June. In his Mansion house speech, the Governor surprised the market by stating that rate hikes may come sooner than the market expects, but he later also elaborated on the economic imbalances and slack in the economy.

The pick-up in activity and the BOE trying to push the brakes gently in the not too distant future confirms our view that there is more upside for the pound than for Gilts. Rorento's exposure to Gilts has been limited for more than a year now, but the pound exposure was increased this year. The confusion created by the communication serves as an example of the challenges the US Fed faces in choosing its wording when the time is right for rate normalization. While current market volatility is low, the road to normality can easily trigger a more nervous market reaction. This will create new opportunities.

UK employment rebounding (UK jobs growth, % yoy change)



Source: Bloomberg, Robeco

Treasuries

US Treasury yields are artificially low due to a dovish Fed, lagging economic activity so far and renewed buying interest of foreign public entities. We fail to see further return upside. The outlook for European sovereigns is less meager due to disinflationary pressures.

Valuation negative: getting even more expensive

The US money market strip (see picture below) highlights the market's complacency as to when and how fast the FED will normalize monetary policy. The market expects the Feds fund rate to equal 0.65% at the end of 2015 whereas the FOMC anticipates twice that level. Longer dated forwards also point to a benign rate outlook. The US 10-year yield is expected to remain below 3% for the coming 16 months. The German 10-year yield is expected to stay below 2% for the coming 38 months! In the US headline PCE rose to 1.8% and headline CPI to 2.1%, which is the highest level in 1½ years. Real yields are now in negative territory for US Treasuries up to 7 years. For German Bunds the picture is similar albeit with a much lower inflation rate. Headline inflation in the euro area is currently hovering around 0.5%.

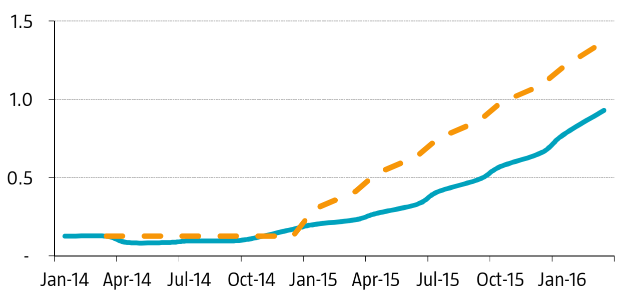
Technicals: flows that matter

The rally in government bond markets over the first half of 2014 underlines healthy demand for the category. US Treasuries were in demand among foreign investors. European government bonds flourish helped by the flush of liquidity offered by the ECB. The TLTRO, cheap four-year loans targeted at reviving bank lending, will also filter through to the sovereign bond market. This also applies to the impact of the ABS purchase program which will most likely start at the end of this year. Core European treasuries also continue to see good appetite from Asian investors. In Japan the planned rebalancing of the world's largest pension fund (GPIF), will lead to a shift out of Japanese government bonds (JGBs) into higher-yielding assets including foreign government bonds. We expect no distortion in JGBs as the BoJ buying program easily absorbs the extra supply.

Fundamentals: inflation diverging

After a weak start of the year the world economy is gaining traction again. Inflation in the US is expected to rise further while remaining much lower in the euro area. In the autumn the Fed is likely to end its purchase program which will open the debate on when the first rate hike will come. In the second half of 2014 the ECB will execute its announced measures (TLTROs, ABS purchase program) after which the question will be how much more is in the pipeline. Is full scale QE to follow?

FED interest rate expectations implied by money market strip versus FOMC (dotted line)



Source: Bloomberg, Robeco

Credits

While the fundamental picture for credits still is favorable, the current reward seems insufficient for the lingering risk of poor market liquidity. The Bull Run for credits may have come to an end, although it may take time for the risks to disturb market sentiment.

From a valuation perspective credits have become less attractive

Over the first half of 2014 the corporate credit market continued the positive trend of the last few years. The question marks for future performance are increasing though. Spreads have not reached record low levels yet, but are clearly getting closer and, apart from senior financials, are through the long-term median levels. This makes credits less attractive from a valuation point of view. Dispersion among credits is also low, for both investment grade and high yield. About 75% of the IG issue in the euro area trades at a spread of below 100bps and it only takes about 10-15bps widening on average for credits to underperform government bonds. While investment grade performance may be more subject to rising Treasury yields, high yield trades at close to record prices. The average price for bonds from BB and B rated credits is around 107, offering little price upside; even the average price for CCC rated bonds is now above par. This leaves little more than a moderate spread return at best for the coming period.

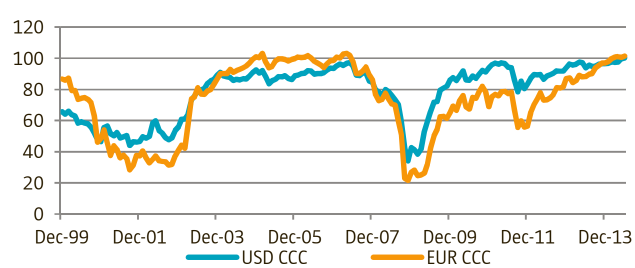
Demand for credits remains solid whereas the market is not growing in size

While demand for credit has remained strong, market liquidity is poor. Even in a more bearish environment it proved difficult to source bonds in the secondary market. This limited liquidity may have helped a very active primary market, e.g. with many small first time issuers in high yield, and pushed spreads lower over the past years, but it may cause problems once investors start scaling down their positions. And that point may be getting closer as especially US yields may be set to rise now that the economy continues to improve and the first Fed rate hike is getting closer. Both in the US and in Europe the mutual fund market for credits has grown substantially, while increased regulation has led to lower dealer inventory. Experience with previous periods with increased volatility show that this is not the best combination to warrant a solid credit performance.

The fundamental picture has changed little, but we remain cautious

The fundamentals are still solid. Although leverage is off the lows and there is an increase shareholder focus, corporate balance sheets are still strong with ample cash. The shareholder focus is reflected in higher dividends, more share buy-backs and increased M&A. Not too concerning yet and no revival of the M&A boom in the 2005-2007 periods, but something to clearly monitor.

Average price CCC rated debt



Source: Barclays POINT

Emerging debt

Low volatility, lower US treasury yields and a global search for yield have supported the asset class. The question is how sustainable this is given the Fed's preparation for monetary policy normalization.

Valuation positive compared with other asset classes

Yield levels on the different emerging markets (EM) are widespread (see chart below). Some strong EM countries like Poland and Malaysia carry yields that are comparable with developed markets. Levels for countries like Brazil and Turkey are much higher. In a low yield environment where interest rates for other fixed income asset classes equal 5% at a maximum, yields for riskier EM appear attractive. Low volatility and low and declining (US) bond yields in the second quarter guided many investors back into EM, in search of yield pickup. Brazil and Turkey already returned 14% and 11% respectively this year. However we consider the current low volatility environment to be an underestimation of medium term risks. A more hostile bond market environment driven by speculation on policy normalization by the Fed can put emerging local debt under renewed pressure. High yielding EM like Brazil and Turkey are particularly vulnerable in such an environment.

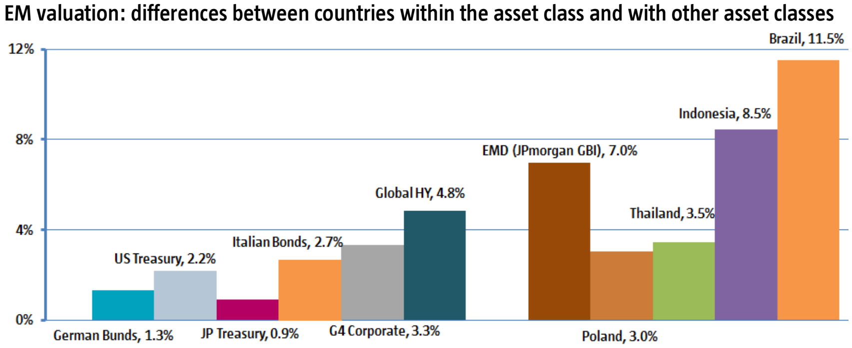
Technicals are moderately positive but very fragile

Technicals of emerging debt markets stabilized during 2014. Since February, flows have in fact been modestly positive for the asset class as a whole. It is striking though that most of this net inflow has been into hard currency (HC) emerging debt. On a net basis flows into HC have been positive since the beginning of the year (HC spreads approaching one year lows), whereas flows into local currency debt are still negative. This illustrates the fragile state most local emerging debt markets are still in. The possibility of US dollar strength further out the road is definitely part of the story here.

EM fundamentals not deteriorating anymore

Global economic growth is expected to be picking up with developed markets being in the lead. EM with leverage on the global economy are likely to profit. Manufacturing countries and trade hubs from South East Asia and commodity rich EM are well positioned. However, this will not be enough for a sustained economic upturn. Structural reforms should be initiated as well. Current account deficits in many countries illustrate the need for more structural changes. With the exception of Mexico, we are not impressed by the efforts in this area so far. In some countries election outcomes could give reason for more optimism. Stay tuned.

EM valuation: differences between countries within the asset class and with other asset classes



Source: Barclays, Robeco

Rorento's positioning

In our global total return fixed income fund Rorento we have translated our main views into the following positions:

- Duration: The portfolio's duration equals 3.8 years. More than 50% of the duration exposure origins from the euro area. Not more than 25% relates to US securities. The remaining exposure to Japanese bonds is small and fully concentrated in the 20-year area.
- Treasuries: Exposure to the 5-year area in US Treasuries is kept very low in favor of exposure to German Bunds in the same maturity.
- Credits: The allocation to pure investment grade credits and high yield equals 24% and 12% respectively.
- EMD: Allocation to local currency emerging debt is kept low.
- Euro peripheral debt: The exposure to the European periphery was moved further out the curve and is now concentrated in 5-10 year maturities. Overall exposure equals just below 20% and is fully invested in Italy, Spain and Ireland.
- FX: We anticipate further strengthening of the British pound versus the euro. We also run a long position in the US dollar versus both the euro and the Japanese yen.

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