
Preferring Europe to the US

Fixed Income Outlook Q4 2014



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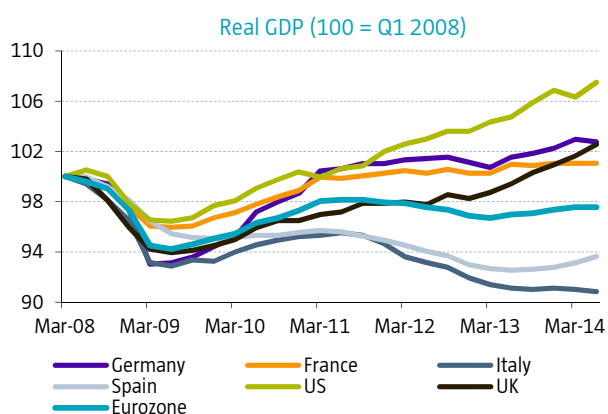
Summary

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
High Yield	- ▼	0	- ▼	0
EMD local debt	-	+	0	-
EURO peripheral debt	+	+	+	0

Our key themes

- European fixed income remains our favorite**
 As the Fed is almost done with its purchase program of US Treasuries and MBS, the ECB will initiate a fresh campaign of open market purchases in both ABS and covered bond markets. It illustrates the different phases the economic blocs are in. The US economy is on track for a gradual recovery whereas the euro area economy looks stagnant. The picture below illustrates the difference in economic dynamics. We run a short duration position at the front end of the US yield curve: in our view markets are too complacent with regards to future Fed policy. We are much more comfortable maintaining interest rate exposure in the euro area although short dated bonds offer no value with yields close to zero.



Source: Bloomberg, Robeco

- Prefer subordinate financial bonds to global high yield**
 Related to our regional preference we switched out of global high yield as roughly 80% of this category is dominated by US issues. Valuation is stretched and the asset class looks vulnerable to a more hawkish Fed further down the road. Subordinated bonds issued by financials are dominated by European issuers. The euro denominated bonds are less sensitive to US rates. Furthermore the universe is undergoing a structural change driven by regulation. It will make the industry less risky and better capitalized. Superior issuer selection should eliminate bail-in risk.
- European peripheral debt has further to go**
 We remain positive on peripheral bond markets. The ECB's policy remains very supportive for peripheral bond markets. The ABS purchase program will likely benefit Spain and Italy most. The expansion of the ECB balance sheet will continue to spur the search for yield. Peripheral bonds remain attractive in this environment.

In focus

Banking on banks

In the aftermath of the financial crisis banks are becoming more what they used to be, i.e. more stable and more predictable. While change in the European banking landscape is still in full swing, the outlook for the sector from a credit perspective has improved, or at least the confidence in the sector has returned. There is more transparency on reduced balance sheets, more clarity on capital structures, capital positions have greatly improved, and regulations are more stringent on a European level. The results of EU bank stress tests, due to be released in the coming weeks, should give further comfort that the largest European banks have become more sound and better able to handle potential future economic headwinds. Some may fail the stress test, but the additional capital needs will be manageable. Several banks have already increased their common equity capital substantially and the market has witnessed a revival of the subordinated bond issues that fit the new capital requirements and strengthen capital positions.

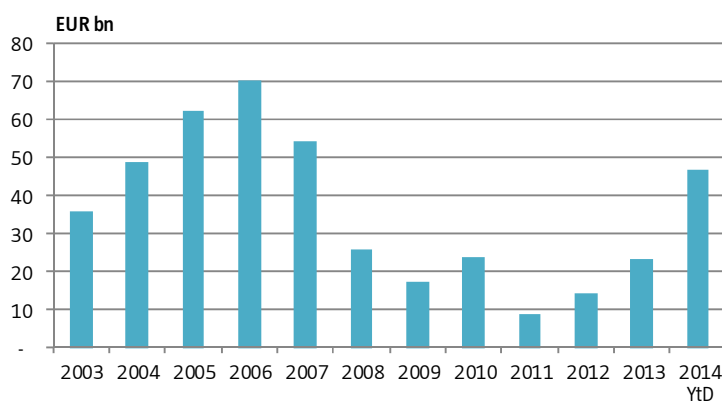
New-style subordinated bank debt creates opportunities

This introduction of new-style subordinated bank debt has created an interesting investment opportunity. Yields and spreads are more than double those for senior credits and by buying selectively into this market severe downside risks can be mitigated. Indeed, these instruments carry bail-in language and more than ever regulators want to include bond investors in any burden sharing if the thresholds are breached. The recent problems with the second largest Portuguese bank show the importance of being selective. However the resolution of this specific case took place without contagion to the whole market segment. While issuance has been subdued in the run-up to the regulatory treatment, it has started to grow more recently. More banks are expected to use this type of instrument to further improve their capital ratios and more investors will embrace them once they become used to the characteristics.

Switch from high yield to subordinated financials

In the current environment it may not pay off to add additional credit risk to the portfolio. Spreads have already experienced a substantial tightening run, the bias to monetary tightening is increasing in the US and also the improvement in credit fundamentals may have run its course. Switching from high yield to subordinated financials on a risk adjusted basis addresses these issues. Whereas high yield is more skewed to the US, subordinated financials have a bias to Europe. The embedded risk characteristics, elevated yields and expected volatility also make a comparison to corporate high yield more appropriate than investment grade senior credits. Given these factors, exposure to subordinated instruments issued by investment grade financial institutions is expected to generate better returns if market circumstances turn more adverse.

Revival of euro sub financials issuance



Source: Société Générale, Robeco

Treasuries

As capex and wage growth still look lackluster in many parts of the world, bond yields are kept low for now by financial repression and central bank balance sheets. Valuation does not look appealing.

Valuation negative: bond yields trading well below nominal GDP

Economic theory tells that in the long run there should be a close relationship between Treasury yields and nominal GDP. Both series tend to be volatile and as a result in practice they rarely coincide. Nominal GDP is the sum of real GDP and inflation. The first is itself an aggregate of both productivity and employment growth. For the US real GDP is projected to lie close to 2.5%. The demographic outlook for the US compares favorably with e.g. Germany and Japan. This lifts potential growth. Even without taking into account the inflation component, US bond yield levels look expensive. Currently bond yields are well below realized averages of nominal GDP for both the US and Germany. Financial repression in the years to come suggests this situation can continue to exist for long.

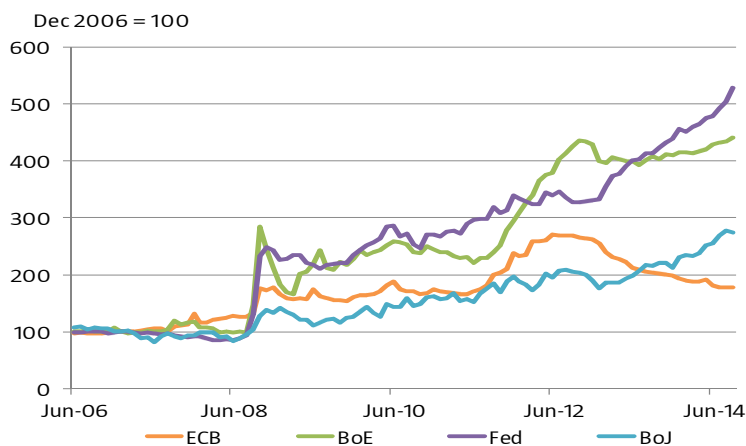
Technical: central bank balance sheets at center stage

Central bank balance sheets are still at the center stage of bond market dynamics. The ECB recently made clear that it has opted for a more active and controlled management of its balance sheet as opposed to passive provision of central bank credit. Be it via TLTROs, ABS & covered bond purchases or, at some stage, outright government bond purchases, it seems highly likely that the ECB's balance sheet will rise significantly. This is a strong positive for (European) fixed income securities. For the Bank of Japan the jury is still out whether or not the current QQE program will be upsized. The Fed will first normalize the Fed funds rate before reducing its balance sheet by halting reinvestments in Treasuries and MBS. Liquidity in the system will not dry up any time soon, but technicals look more favorable for the euro area compared to the US.

Fundamentals: animal spirits please!

Animal spirits amongst corporates are as of today obsolete in many parts of the world. Capex plans and wage growth still find it difficult to lift off. This helps to explain why e.g. the Fed and the Bank of England are so hesitant in making a start with normalizing monetary policy seven years after the Great Recession started. The US economy does show encouraging developments, but there is still a long way to go to seduce CEOs to go for more aggressive growth strategies. Labor market slack is coming down, but no material impact is visible yet in terms of solid wage increases. It all confirms the gradual nature of a recovery after a big banking crisis.

Central Bank balance sheets



Source: Bloomberg, Robeco

Credits

While further ECB stimulus and abundant liquidity may be supportive for credits, investor concentrations and single name developments are indicators of more volatility in different parts of the credits market.

Break-even spread levels grinding lower for credits

The tightening trend of corporate credit spreads seems to have stalled for now at levels that are clearly below the median. This is a fairly consistent picture across all sub-categories. An exception is the European covered bond market that received a big impuls in recent months from the ECB's intention to buy into this market again. Spread levels here contracted by almost 50% compared with year end levels. As government bond yields for both German Bunds and US Treasuries continued to decline, break-even levels for both European and US credits declined as well. The break-even spread level highlights the extent of spread widening you can bear to maintain a positive excess return versus government bonds. So current spread levels now offer less protection in more adverse market conditions than at the beginning of the year.

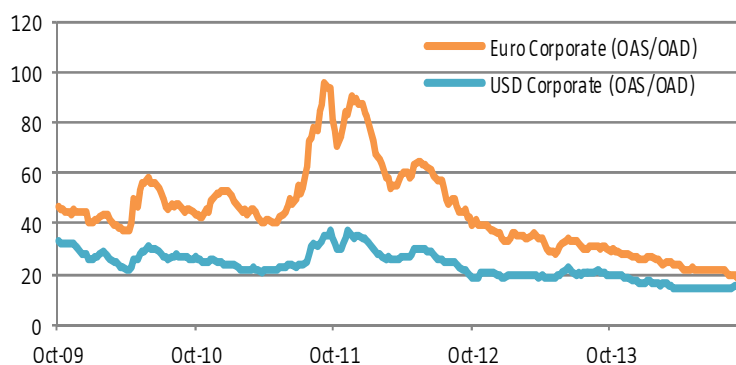
Concentration risk among end investors adds to the liquidity challenge

Technical continue to be a very dominant market force. The ECB's intention to increase its balance sheet by buying into ABS and covered bond paper is a credit positive. Central bank liquidity continues to fuel the 'search for yield' market theme. Fund flows confirm that the demand for investment grade corporate credit remains high. Over summer though we got a quick reminder of the poor liquidity conditions credit markets are in when especially high yield bonds came under pressure. Banks that are no longer prepared to hold sizable inventories are part of the story here. Another reason for concern is the high degree of concentration among end investors. The top-ten money managers have grown so big that investor concentration adds to the liquidity challenge. It is estimated that the 10 largest investors hold more than 20% of the individual high yield issues in Europe and for the US this percentage is even higher.

Fundamentals: Rising idiosyncratic risk underlines importance of issuer selection

While from a fundamental viewpoint the general story line is still positive for credits, recently there were gentle reminders of the importance of fundamentals. Issuers running into trouble following the loss of key clients or margin pressures due to falling commodity prices resulted in double digit price drops on individual bonds. No reason for broad-based concern yet, but this shows that good company research matters. Financial institutions are moving into a more predictable environment, with higher required capital levels and increased regulation. With at least double the spread of the investment grade credits, subordinated financial debt from well capitalized banks offers an attractive investment opportunity.

Break-even spreads (bps) are low



Source: Barclays

Emerging debt

Weak fundamentals and technicals refrain us from chasing attractive yield levels in emerging local debt.

Valuation is appealing, especially against other fixed income markets

In the current low yield environment investors are obviously attracted by the still elevated yields levels in emerging local debt. The universe as a whole carries a running yield of close to 7% with individual countries like Indonesia (>11%) and Brasil (>8.5%) offering even higher yields. However, these yields are only attainable when leaving open the currency exposure. Year-to-date the positive bond return for the asset class is almost fully watered down by the negative currency returns (in USD terms). The graph below underlines the impact forex movements can have on the overall return profile. For most of the individual markets, FX volatility is responsible for the bulk of the overall volatility. With the US dollar likely to appreciate further, prospects for positive currency returns look grim.

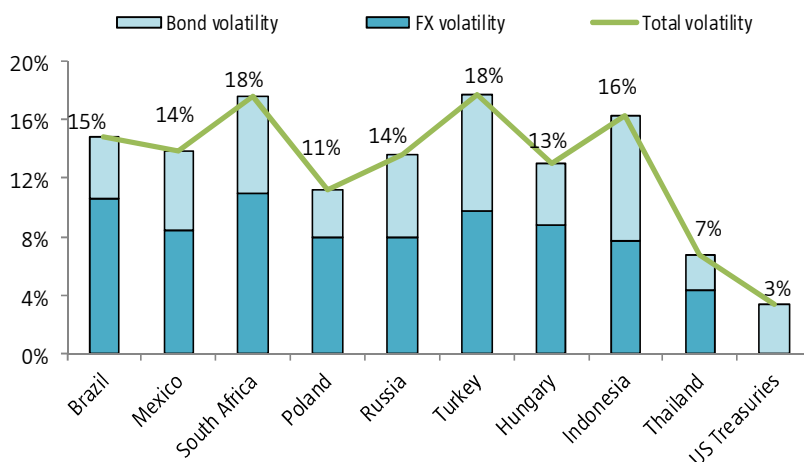
Technicals unlikely to turn positive

The share of non-resident holdings in emerging local currency debt has increased strongly over the last decade. Typically, exposures were built up via the primary market. It is highly questionable whether the secondary market can offer enough liquidity once flows are to turn decisively. Reason for the IMF to talk about a 'systemic liquidity mismatch'. This is clearly a negative. Overall, flows into emerging markets have been positive this year albeit almost fully concentrated in equity markets. Disappointing total returns on emerging local debt so far could trigger further outflows, especially with significant 'tourist money' involved in this market. A Fed turning more hawkish somewhere in the future could be the catalyst for such a move.

Fundamentals are not very strong

Economic activity looks lackluster in most countries in the universe. Various factors are behind this sobering picture after years of buoyant growth. Deleveraging of private balance sheets is dampening domestic spending in many economies. As a result corporates shy away from capex and hiring. Many commodity exporting countries are faced with price declines. Monetary tightening, implemented to underpin pressured currencies of several current account countries, is also putting a lid on economic activity. Finally when looking at economic reforms, it is difficult to be impressed. Only a few countries stand out, among which Mexico and India.

Annualized FX and bond return volatility emerging markets versus US Treasuries



Source: Robeco, Bloomberg

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 hovers around 4,5 years. The overall exposure to euro denominated fixed income securities equals close to 2 years. US duration exposure is concentrated in longer dated bonds. Exposure to the 5-year area in US Treasuries is kept low in favor of exposure to German Bunds in the same maturity.
- **Credits:** The fund has built up a significant portfolio of European subordinate financial bonds. The overall size equals 20% of the fund.
- **EMD:** Allocation to local currency emerging debt is kept low.
- **Euro peripheral debt:** The overall exposure to the periphery equals 25% of the portfolio divided over Spain, Italy, Ireland and Portugal. For the latter market, the exposure is concentrated in 3-year bonds. For the other countries, the focus is on 5-10 year bonds.
- **FX:** We recently took profit on our short Japanese yen versus the US dollar, and our short position in the euro versus the US dollar and the British pound. Medium term we still anticipate a further depreciation of the euro.

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