



Just how low can bond yields go?

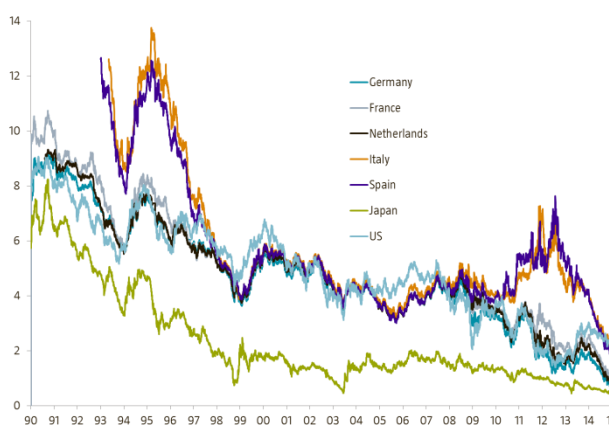
- ECB's vast program QE means there will be a net new buyer
- Why zero percent has not acted as the natural floor for bonds
- Economic outlook: Divergence continues between US and others
- Asset allocation: We expect the hunt for yield to continue in bonds

Topic of the month: Are we there yet?

You know that something out of the ordinary is going on when clients no longer appear to be primarily concerned about the remaining up- or downside for stock markets, but rather on how much lower yield in the 10-year government bond markets can go. For sure, we have seen these concerns more often during this decade-long drop in bond yields, but at those times yields were still at levels that were quite lofty, at least if we look back at it with hindsight.

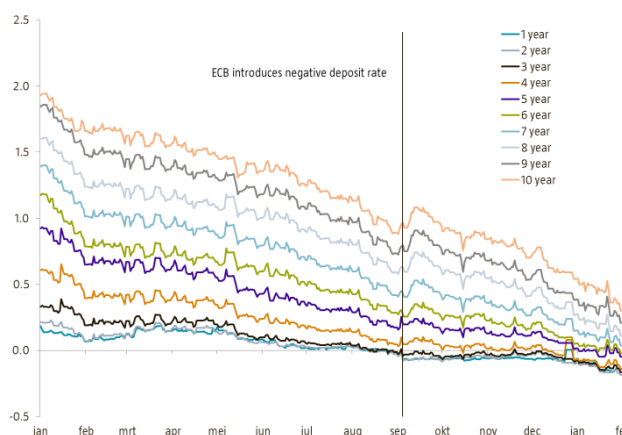
For example, just prior to the infamous bond market 'crash' of 1994, there was a lot of concern over whether bond yields had dropped below their equilibrium levels. Yields were trading at around 5½%, the lowest level in almost 30 years. Concerns turned out to be right, as the turn in the Fed's policy pushed yields back up to levels as high as 8% in the year that followed. Today, that 5½%, the 4% low in 1998-99, the 3% during the crisis of 2009) and even the 2% low of 2013 all sound like excellent

buying opportunities if we compare it to the 0.35% that you currently get when you invest in a 10-year German government bond. The expectation that the trend of ever-lower yields would finally be broken in 2014 once again turned out to be incorrect. Tapering or not, bond yields continued to trend lower, with especially European bonds moving in thus far uncharted territory. It was not just a European phenomenon though, as yields across the globe trended lower. Yields in almost all industrialized countries reached all-time lows, with even Japanese 10-year yields touching an unprecedented level of 0.3% at the end of the year. The only country bucking the trend with respect to all-time lows has been the US, which in itself is not surprising given the solid growth seen in 2014. But even there, yields have declined, defying strong growth as well as words of warning by the Fed about an upcoming change in monetary policy.



Just when you think the rally is done Source: Robeco/Bloomberg

Which brings us back to the million-euro question of how much lower can bond yields – and specifically 10-year bond yields- drop? With history as our guide, up until the middle of 2014 the answer would have been around 0.5%, as that appeared to be the natural low even the Japanese 10-year bond yield could not structurally break. Given the fact that Japan is a textbook example of a country with structural deflation, caught in a liquidity trap and with a central bank pushing through a massive QE program, this 0.5% felt like a good worst-case outcome. This low was reached in 2003, revisited in 2013, and appeared to again be the bottoming out level from which yields rebounded in 2014.



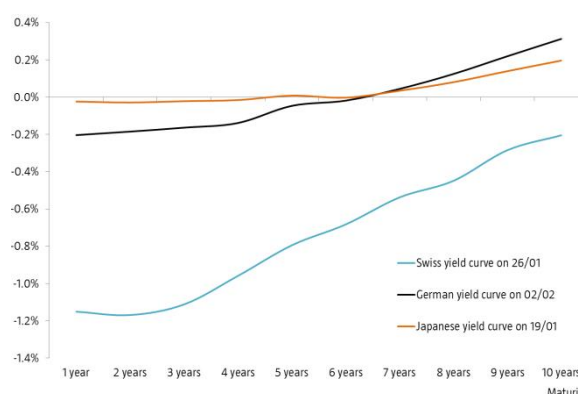
Boldly going where no yield curve has gone before. Source: Robeco/Bloomberg

The illusion of the worst-case outcome with respect to 10-year yields was rudely shattered during the last two months of 2014 though. The new open ended shock-and-awe QE measures announced by the Bank of Japan at the end of October gradually pushed Japanese bonds down in the months that followed, with 10-year yields posting a new low of 0.2% in the middle of January. As for Europe, thanks to the anticipation of QE measures by the ECB, German bonds never even paused at the assumed worst-case 0.5% level, with 10-year yields declining to a level of 0.3%. The real shocker however proved to be the Swiss bond market, where the whole yield curve with a maturity of up to 12 years was pushed into negative territory following the decision to let the peg with the euro go. Talk about a new worst case scenario... negative yields.

Negative yields are not new

In itself, negative yields for shorter-dated bonds are not a new phenomenon. Back in 2011, at the height of the euro crisis, yields on German 1-year bonds dipped below zero, as investors fled the peripheral bond markets. Paying a small negative yield felt like a much better deal than facing the odds of losing everything if the Eurozone broke up. This turned out to be a temporary situation, with German yields moving back to positive territory for most of

the time in 2013. Things changed again in the second half of 2014, however. This time the move was neither driven by panic nor a crisis, but it was triggered by the decision of the ECB to lower the deposit facility (the rate at which banks can put their surplus liquidity at the central bank) to minus 0.2%. The change in the markets that followed didn't happen overnight, but it did trigger the slow and steady decline in yields across the short end of the yield curve. This process was further enhanced by the quantitative easing measures that the ECB announced at the end of January, adding a net new buyer in the market. This pushed bond yields up to a maturity of five years into negative territory.



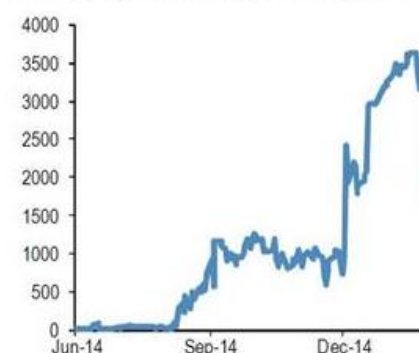
German yields are drifting lower. Source: Robeco/Bloomberg

According to the calculations of JP Morgan at the end of January, a total of USD 3.6 billion in government debt (16% of the total) was trading at a negative yield. As such, negative yields can hardly be called a big surprise. The fact that almost the whole Swiss yield curve is now in negative territory is unprecedented. And with zero not acting as a natural low, we get back to the question: how much lower can bond yields go?

Theoretically there is no good reason for yields to drop below zero. Why would you be willing to invest your money in an asset that will guarantee a loss? Taking the money and putting it under the mattress will yield you a better result (= zero percent), so why go through the hassle of buying a bond? There are a number of reasons why yields actually can drop below zero though. The first is that money under the mattress is not exactly a safe option either: theft or fire can result in a pretty big non-zero outcome after all. Storing it in a vault is the alternative, but this comes at a cost. Secondly, taking out a thousand euros as cash is an easy thing, but once you are talking millions, it might prove to be a different story. What might be a viable option for a private person is practically impossible to achieve for a bank or a pension fund. Even if you did go through to all the trouble of taking out the cash, it comes at a loss to quickly move funds in case they are needed.

In this modern world, and especially for financial institutions, electronic cash is much more convenient than actual bank notes. These three barriers - convenience, freedom to convert to cash and storage - are the reasons why bond yields can actually move into negative territory for longer periods of time without it leading to a run on cash. The cost of storage may be quantifiable (estimates range from 0.2% to 1.0%), but the price impact of the other two factors are far less easy to put a number to.

\$bn, aggregated at today's exchange rate



Source: Bloomberg, J.P. Morgan

The size of the market of government bonds trading at negative yields since June 2014.

Arguments for negative bond yields

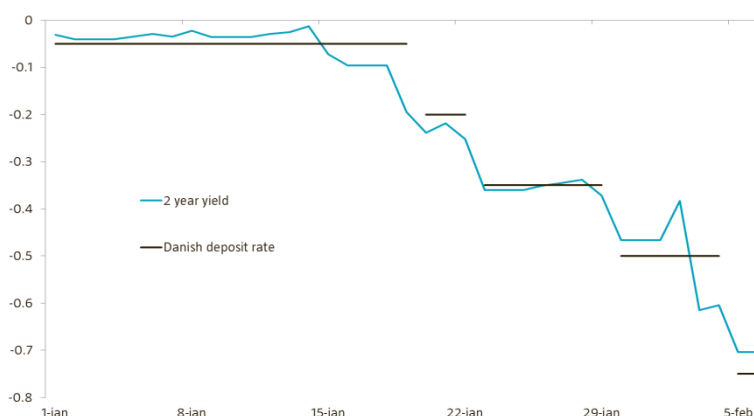
Apart from these practical reasons, there are a number of arguments why it even may make sense to invest in a negative yield environment. Some of these are speculative in nature, but some of them are logical given the economic and financial environment we are part of. We identify the following arguments:

- **Excess savings:** As a general observation, at the end of the day the yield of a bond is the outcome of supply and demand in the market. As long as demand continues to exceed supply, yields will move lower. All the underlying factors that have led to a high level of net savings (the so-called savings glut) have therefore been at the root of the trend of ever-lower yields. Factors like aging, excess savings by emerging markets, increased wealth, the increased preference for cash by companies (or the lack of investment opportunities) and QE by central banks can all be mentioned as factors that have contributed to the situation of depressed yields.
- **Central bank buying:** One special factor in the list mentioned above is the central bank buying activity under the various QE programs. In the specific case of the Eurozone it means that the balance between demand and supply has changed, as there is a net new buyer in the market. According to the rules stipulated by the ECB, bonds will be bought across the curve, with the aim of disturbing the 'normal market process' as little as possible. In theory this implies that this new buyer is also willing to buy bonds with a negative yield.
- **Deflation:** Given the earlier-mentioned constraints of not being able (or willing) to freely move to cash, investing in bonds with a negative yield makes perfect sense if you expect prices to fall even more. You may lose in nominal terms, but in real terms you still end up with a good result. In fact, bonds generally yield superior results to other asset classes in a deflationary environment, as a decline in prices is generally a result of weak overall demand, which is normally not too positive for risky assets. Although this may explain why shorter-dated bonds are bid up to offer negative yields, it is unlikely that this will be enough to push 10-year yields into the red. To quote *The Economist*: "You would have to be quite depressed to conclude that no asset on the planet would make any money at all over the next decade." To mark the point, even Japan, who has been flirting with deflation for decades, has never seen 10-year yields, or even 2-year yields move into negative territory.
- **Possible capital gains:** Even with a negative yield, it is still possible to get a positive result in bonds, although this notion is speculative. Sure, if you buy the bonds to hold until maturity, you are certain to lock in the negative starting yields, but as an active bond investor you can still make a profit from the running down the yield curve, or by speculating on a further decline in yields (as this equals a rise in the price of the underlying bond). This is of course not without risk and means that you will have to be active in the longer end of the curve.
- **Passive investors.** One argument put forward as to why investors may be willing to settle for negative yields is the rise of passive investors. These investors track the benchmark, irrespective the structure of the yield curve. Whereas an active manager is likely to shy away from the shorter-dated bonds in the current environment (see the previous point), trackers will do what they are supposed to do: simply buy the curve. Although this may play a role, it is not very likely that this is the reason for yield being driven below zero though.
- **Currency expectations.** Another reason why it makes sense to accept a loss up front is when you expect to be compensated for that loss from a positive currency movement. The Swiss situation is a simple example: if you had bought Swiss francs and invested it in negative yielding bonds at the beginning of this year, it would have resulted in a fair profit. As such, negative yields can be a sign of currency speculation. The pressure on yields in this case

depends on the amount of gains expected from the currency move. As a rule, these pressures will be higher in case of a peg (Swiss franc, Danish krone), but will probably be only limited in case of a floating currency. In case of European yields, the impact is probably even the reverse right now, as the consensus trade is that the euro will continue to weaken.

- **Negative deposit rate.** For banks with excess liquidity, there is the choice between the deposit rate at the central bank or a 'risk free' bond. The move by the ECB to lower deposit rates to minus 0.2% has thereby lowered the bar for shorter-dated bonds, as banks considered the trade-off between the two options. The fact that German yields have so far not dropped below the negative deposit rate of the ECB shows the importance of the deposit rate. In fact, the deposit rate is likely to be the lower bound for ECB buying as well, as it currently acts as the funding level for the ECB. The importance of the deposit rate can also be seen if we look at the recent developments in the Danish bond market, where the central bank has lowered the deposit rate to minus 0.75% in order to defend the peg with the euro. As can be seen, it is not a perfect match, as speculation of a further cut in the deposit rate can drive yields below the going rate.

Taking all the previous arguments together, barring situations of speculation, the answer to the question of how low bond yields can actually go very much depends on central bank policy. Given that banks cannot convert to cash on a large scale, the central bank deposit rate acts as the 'cash equivalent' alternative for banks. This means that in case of excess liquidity, in combination with the expectation that the current monetary policy is likely to be



Negative Danish deposit rates since the start of the year. Source: Robeco/Bloomberg

unchanged for a foreseeable time, the short end of the curve is tied to that negative starting point. So far, the ECB has been pretty vocal that it considers the current minus 0.2% rate to be the lower bound, which means that, for now, this appears to be the new worst-case outcome. Both Denmark and Switzerland show that there is no practical reason why deposits should not be moving lower, however.

Implications: The search for positive yield will continue

So where does this lead us? Given our central scenario of gradual normalization, it is clear that the current level of 10-year yields is way below what we would consider to be equilibrium levels. We expect nominal growth in the Eurozone to return to a 3% to 4% level on a five-year horizon, which means that yields will at some point move back towards those levels as well. The 'at some point' is an important addition though, as it is difficult to see this happen anytime during the next six months. The ECB has only just embarked on its new QE measures, with the policy clearly linked to the development of the (expected) inflation.

On a headline level, Europe will remain in a deflationary environment for another six months or so unless the oil price suddenly recovers. At a core level, we are not in deflationary situation, but the January headline inflation print of 0.6% is way below the ECB's target, and the trend is still down. In the current environment, the initial plan by the ECB to extend the QE measures to September 2016 is not going to be challenged. The same applies with respect to the negative deposit rate: rates will stay

unchanged for the foreseeable future, which means that the short end of the curve is likely to be fixed.

With short rates fixed and in negative territory, the first logical implication will be that the search for positive yield is going to continue. To put it differently, we are running out of options within bonds. Assuming that there will be no escalation and contagion from the current Greek situation, this means that spread compression in the peripheral countries is set to continue, while the very low 10-year yields are likely to trigger a further shift in the direction of longer maturities (30 years) in Europe. This search for yield within bonds is probably also the reason why the US bond market has continued to be this strong so far, despite healthy growth rates and the prospects of a rate hike by the Fed. The general trend in the current situation is that investors are being forced to move up the risk curve, yet again. This means that in absence of tail-risk events (such as a 'Grexit', Russian political deterioration or a slowdown in China), risky assets are likely to continue to drift higher, despite the fact that pricing of most of these assets is not exactly cheap.

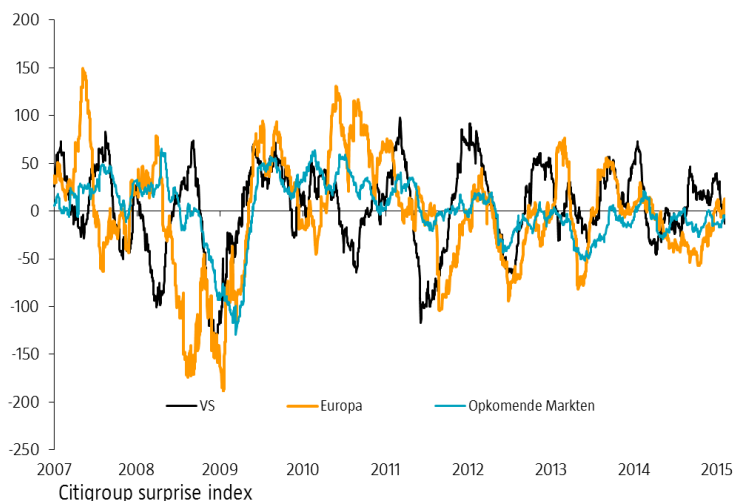
Asset allocation: Volatility is the name of the game

General overview: New geopolitical concerns offset rate cut benefits

Volatility was the name of the game in January, leading to wide divergence in the performance of the various broader asset classes. Commodities suffered, equities were on balance flat and bonds continued their unstoppable rally, while real estate once again topped the charts at the end of January. The rising concerns of a potential 'Grexit', the uncertainty with respect to the short-term negative implications of the drop in oil prices, Russia and the continued concerns about the strength of the Chinese economy acted as risk-off factors.

Countering this, financial markets were once again helped by monetary authorities worldwide, with rates being cut across the globe, not to mention the open-ended quantitative easing measures announced by the ECB. Divergence was also driven by the economic data published, with the latest US data disappointing somewhat, while Europe actually managed to surprise on the upside for once.

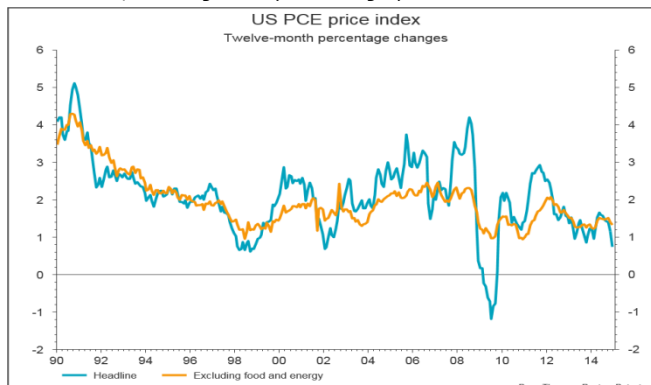
From a portfolio perspective, we have made two adjustments. The first is that we have moved to an overweight position in the longer dated bonds (10 years+). With the ECB now a net new buyer in the market, and with 10-year yields at unprecedented lows, we expect the search for yield to push longer-dated yields lower as well. Secondly, with the odds of a messy 'Grexit' lowered, we have increased our overall risk profile by adding to our equity exposure.



The US is switching sides with Europe with respect to economic surprises.
Source: Citigroup

World economies: A more subdued US growth rate is set to settle at 3%

The US economy slowed in the fourth quarter of 2014 from the unsustainably brisk 5% growth rate of the third quarter towards 2.6%, slightly worse than expected. Consumption was strong, buoyed by lower petrol prices and rising confidence due to the improving labor market. The strong US dollar left its mark on the trade balance, which deteriorated, shaving a full percentage point off the overall growth rate. Spending on new equipment by companies was also drag as a consequence of deep cuts by energy companies because of plunging oil prices. We expect capital expenditures in other sectors of the economy to strengthen in the course of 2015. The US economy is on course to settle at a growth rate around 3% for 2015.



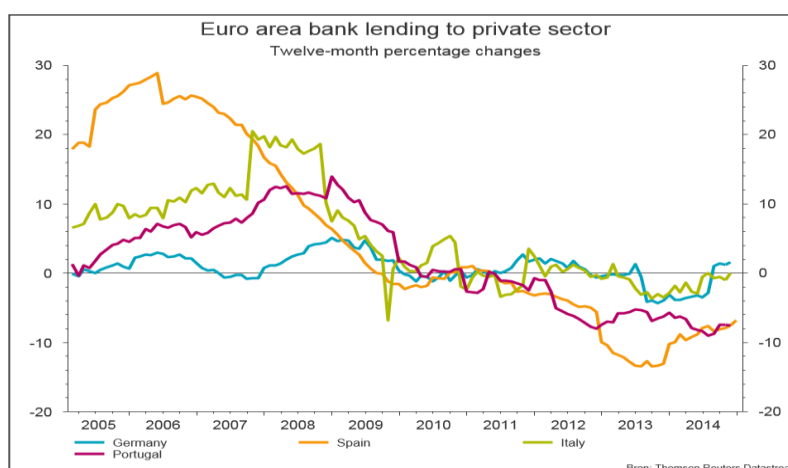
Inflation indicators preferred by the Fed are trending lower. Source: ThomsonReuters Datastream

The strong dollar and the collapse in oil prices have pushed inflation down. This is creating a dilemma for the Fed, which has called for “patience” amid increasing worries about foreign developments, but has also signaled its intention to hike rates in the course of 2015. A central bank worth its salt will of course create such an impression to persuade investors to look through the temporary effects of the windfall benefits of a collapse in oil prices. Nevertheless, an early hike remains a difficult “sell” in the current disinflationary environment. The likelihood of an early modest rate hike in June of 25 basis points has decreased. As the US appears to be the sole island of real strength in the world economy, caution by the Fed is warranted.

Europe: Collapse in inflation primarily caused by energy price falls

The collapse in European headline inflation primarily caused by the collapse in energy prices finally paved the way for the unleashing of quantitative easing (QE) in the Eurozone, resulting in a further weakening of the euro. Ironically, the controversial policy move towards QE coincides with generally improving business confidence indicators (with the exception of France) and a resumption in bank lending. Moreover, retail sales grew strongly in December.

We expect the Eurozone economy to improve further in the course of 2015, and a growth rate of 1.5% is in our opinion easily within reach, barring a severe political crisis. Such a crisis could be a consequence of a sharp deterioration in the relationship with Russia, which is, for



QE starts, just when bank lending is improving. Source: ThomsonReuters Datastream

example, stepping up its military intervention in Ukraine. Ongoing political uncertainty could dampen confidence and put pressure on investment in the Eurozone, as it did in 2014. Another crisis could be caused by a lack of agreement between the new Greek government and the EU, ultimately leading to an exit of Greece from the euro in the so-called ‘Grexit’. Although the EU should be able to take a

'Grexit', a severe damage of confidence - at least temporarily - is likely to ensue. A deal is in our opinion more likely in which the Greek government gets more flexibility on debt and deficit reduction in exchange for reform measures (including the tackling of tax evasion).

Japan: Oil price collapse is a boon for the Japanese economy

The collapse in the price of oil is a boon for the Japanese economy. As most of its nuclear reactors are still closed, Japan is almost completely dependent on imports to cover its energy demand. Exports are rising, a rather late reaction to the weakening of the Japanese yen. The trade balance will probably shift into surplus in the coming months. Capital expenditures have risen in the fourth quarter and will probably continue to do so in the current one. All in all, growth prospects have improved markedly for 2015.

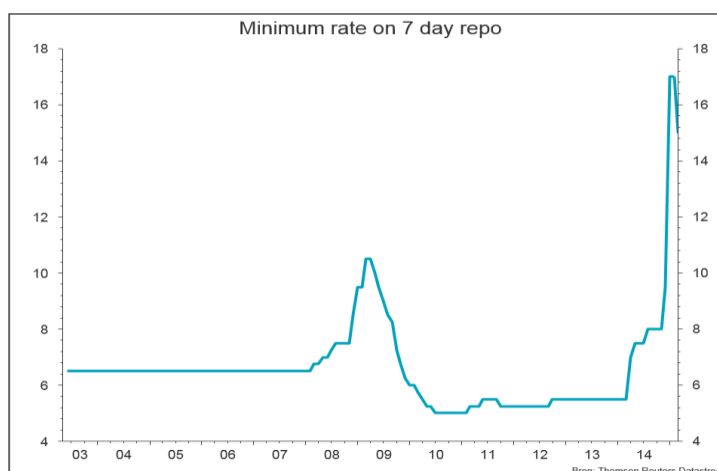
The other side of the coin of lower energy prices is disappointing inflation figures, at least when seen from the point of view of the Bank of Japan. It would like to see inflation expectations to rise consistently, driving up wages. But core inflation is trending downwards and inflation has outpaced wage growth in 2014. Fortunately, the labor market continues to tighten. The ratio of jobs to applicants has risen to the highest level in more than 20 years and the unemployment rate had fallen to 3.4%.

Pressure will be high on the BoJ to continue its unprecedented aggressive monetary policy which was supported by a narrow majority of 5-4 in October 2014. This year, two members of the board will be replaced with candidates approved by Japanese Prime Minister Shinzo Abe. A majority vote for aggressive monetary stimulus is therefore assured.

Our BRICS highlight this month: Russia, whose economy faces a severe recession

The collapse in oil prices will push the Russian economy into a severe recession this year, which is reason for us to put the spotlight on this member of the BRICS this month. In an unexpected U-turn, the Russian central bank recently lowered its benchmark interest rate from 17% to 15%, after hiking it a month earlier by an extraordinary 6.5 points. Apparently, the central bank no longer makes trying to defend the ruble a priority. Instead, it prefers to give some breathing space to the struggling banking sector. More rate cuts are to be expected in the coming months and the Russian ruble will probably weaken further. The escalation of the crisis in Ukraine makes a lifting of sanctions highly unlikely, nor is a hike in oil prices to more comfortable levels for Russia in sight.

Rating agency Standard & Poor's has lowered the foreign currency credit rating of Russia to junk (BB+). With public debt below 20% of GDP, this at first sight seems remarkable, but the sovereign will probably be forced to absorb a lot of rising debt problems in other sectors as the recession sets in. Inflation is on the rise and could hit 17% in March. The Russian government is contemplating price controls for essential food products (it lowered the vodka price). Capital controls are probably also under consideration. The Russian government expects the economy to shrink by 3% in 2015, which is too optimistic in our view. We reckon the shrinkage will be at least 5%.



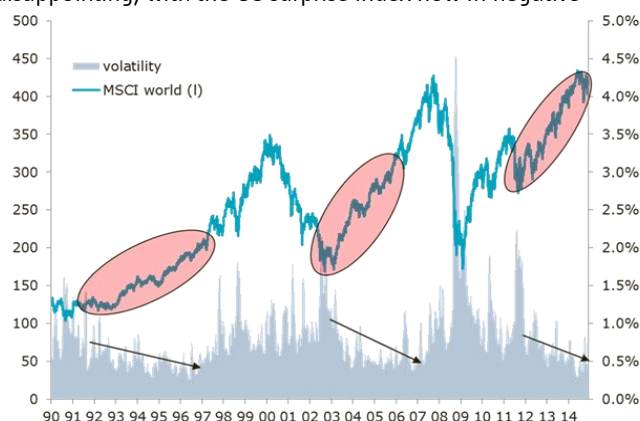
Unexpected cut in the Russian benchmark interest rate.
Source: ThomsonReuters Datastream

Equities: The year of increasing volatility is here

2015 picked up where 2014 ended: with an increased level of volatility. The collapse of the oil price, Greek elections, and weaker US macro data and reported earnings all played their part, with the MSCI world market on balance closing the month with a small loss. The most striking characteristic has been the strong divergence seen between the US markets (down) and the rest of the world (up): only twice during the past 28 years has such a clear split happened before. Normally it is the US that sets the tone, with the rest of the world following its lead.

Given the 'natural' leadership of the US in the equity markets, the logical question to ask is what has been the cause of this weakness, and whether it has broader implications for the markets as a whole. There are several reasons for the weak start to the year. Firstly, the US markets reacted a lot more nervously to the continued decline in oil prices, as this created uncertainty on the viability of the part of the economy which had acted as one of the engines behind the growth recovery thus far. Spreads in the High Yield market spiked to above 1000 basis points, with negative spillovers to sentiment in equities as well.

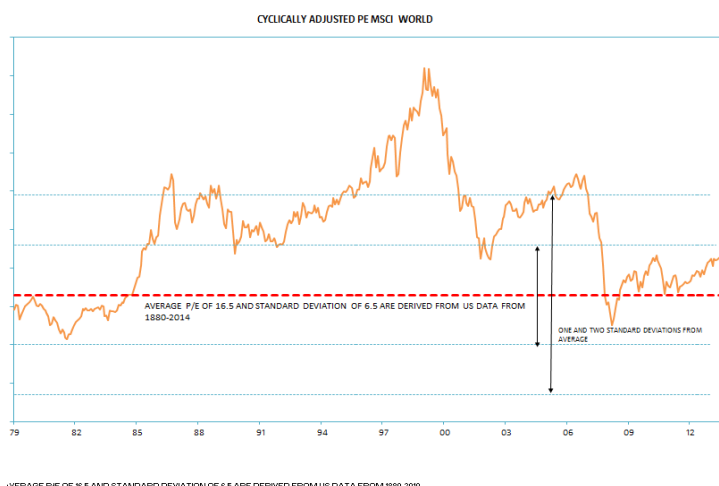
Secondly, the quarterly results published so far have indicated that the corporate sector is not immune to the strength of the dollar. Although the overall results are not bad - with roughly half of the companies reporting so far, earnings are up 5% - the dollar has been flagged as a negative by various internationally oriented companies in their guidance on future earnings. Thirdly, the latest economic releases have on balance been disappointing, with the US surprise index now in negative territory for the year, a factor that can also partly be attributed to oil prices and the dollar. The setback has been small however and there is no reason to expect this to turn into a fully fledged economic slowdown. This weaker sentiment, combined with the relatively high valuations in the US market, resulted in the negative start for US markets. As we expect the economic weakness to be only temporary, we see no reason for US markets to start acting as a drag on all the others as the year continues.



We expect 2015 to be a more volatile year, which is why we have a lowered our risk profile. Source: Robeco/Bloomberg

So much for the US, but what about the other risks out there? The political situation in Greece, the continuing conflict in Ukraine and uncertainty over growth prospects in China all have the potential to disrupt markets moving forward. In fact, the outcome of the Greek election as well as the aggressive drop in the price of oil were reasons for us to decrease our risk profile at the start of the month, reducing our exposure to stocks. Although both problems have not yet been settled, it is clear that both risks have become more contained. The oil price has stopped dropping like a knife, while the Greek Syriza party appears to be less outspoken now that they have won the elections. There are still some serious hurdles to be overcome in Greece, but the chances of a really messy outcome seems to have declined, now that Syriza has shown to be more political than radical.

As a general observation, we continue to expect 2015 to be a year of increased volatility. As can be seen from the chart on the left, the first part of the recovery in stocks is normally one that is characterized by declining levels in volatility. The second phase, which we think we have currently entered, is the phase in which stocks still go higher, but do so with a higher level of volatility. The period of cheap valuations has passed, and gains in stocks will be more linked to the underlying fundamentals, which



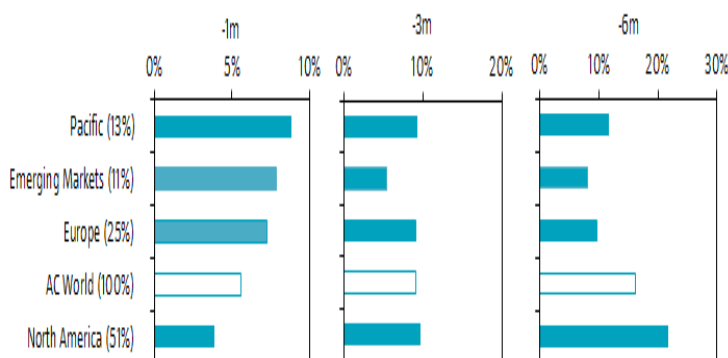
Stocks are not cheap. Then again, what is, these days?
Source: Robeco/Bloomberg/MSCI

typically is associated with higher volatility. This is particularly so for the US, where the Fed has ended its QE expansion program. Having said that, as we expect the decline in oil prices to have a net positive impact on underlying growth, and with liquidity still ample, on balance we expect equities to drift higher. The valuations of stocks are not too high to pose a real obstacle just yet, momentum (QAS models) are not negative, and quantitative models are mostly positive on stocks. In the face of reduced uncertainty, we have therefore cautiously increased our exposure to equity markets again.

Developed market equities: Strong dollar creates headwinds for US corporates

While the US leads the global cycle and has remained resilient to the slowing global growth momentum, the US equity market performance lagged other regional developed markets in January. At first sight this once again confirms the fact that the relationship between economic developments and equity returns is a rather loose one. However, a closer inspection suggests there are indeed several fundamental reasons for this relative underperformance. The strong dollar has created headwinds for US corporate competitiveness, which has led to a relative rerating of US earnings. However, it is not only a currency effect, as domestic factors also have played a role. Whereas retail sales in the Eurozone surprised to the upside, the latest consumer spending numbers in the US disappointed. US earnings growth declined somewhat as sales for the S&P 500 fell 1% (year-on-year) and the US energy sector showed it is coping with the slump in oil prices.

Diverging monetary policy sets the tone for regional equity perspectives as the BOJ and the ECB are clearly in QE mode, while the Fed is pondering the timing of its first rate hike. The effect of competitive devaluation on relative regional earnings is now turning in favor of Japan and Europe. Although the ECB says it does not target a lower euro, we think the exchange rate is the main transmission channel for reflation in the Eurozone.



US equities are underperforming the global benchmark.
Source: Robeco/Bloomberg

Apart from the earnings revisions, our cross-regional allocation is based on valuation and momentum. Valuations in the Pacific region and the Eurozone are attractive compared to the US and

to their own history, even when we have seen a strong rerating of European equities. Relative momentum is currently strongest for the Eurozone, as many investors buy the story that QE by the ECB will a) bring higher overseas earnings for European corporates through a lower euro; b) lower corporate funding costs; and c) boosts producer confidence. Although we tend to agree with this upbeat story, there are some pitfalls, as sentiment in the Eurozone remains particularly vulnerable to political developments. Tensions in Ukraine remain elevated after the Minsk 'truce' seems to have been abandoned, while both the left-wing Greek government and Germany have dug in hardline positions, although a compromise about Greek debt refinancing seems the most likely outcome.

A worsening in sentiment and a consequent risk-off mode could prevent the Eurozone from outperforming other developed regions. Also, a weakening momentum in dollar strength, probably as a result of the Fed showing more patience in returning to its conventional policy, could temper the benign prospects for European exporters. Recognizing these risks is why we prefer to stay neutral on Europe for now. On balance, we have an overweight position on Japan.

Emerging markets: Economic outlook has worsened

If anything, the economic outlook has worsened for emerging markets. The collapse in oil prices in combination with European sanctions are pushing the Russian economy into a severe recession this year and next. 2015 could see a 5% decline in Russian GDP. In China, the PMI Manufacturing index remained below the 50-threshold for a second month. In Brazil the growth outlook is also deteriorating as the central bank is clearly behind the curve. Inflation expectations look a bit unanchored at this point. The

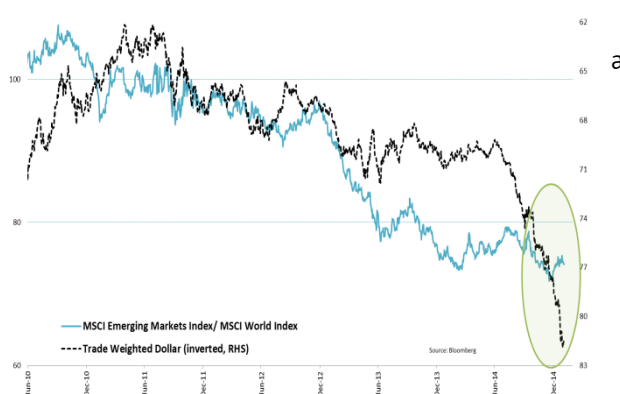
relationship between economic developments and equity returns is rather loose one. However the divergence between the Chinese PMI and the stock market does not look that bright. Stock markets have rallied as the Chinese rush to get money out of the cooling housing market and into equities. The number of new trading accounts has exploded, even though Chinese earnings have not risen all that

much in recent years. To keep a lid on excessive investor behavior, China aims to reduce margin lending. A

positive is looser monetary policy. Russian stocks are cheap, but for a reason. At this point it is far from certain that the recession is fully reflected in stock prices. Brazilian stocks could remain under pressure as the central bank restrains economic growth to keep inflation from getting out of hand.

Brazil, China and Russia, are, of course, only part of the emerging markets index. There are definitely countries where things look more upbeat. For the market as a whole, however, the strength of the US dollar, could be a headwind. Historically, a rising US dollar is often accompanied by underperformance in emerging markets.

There are three important factors that could prevent emerging markets from underperforming. Firstly, this time around the stronger USD is mostly a reflection of looser monetary policy outside the US. The increase in liquidity of central banks like the BoJ and ECB could potentially counterbalance the tightening stance of the Fed. Secondly, we invest in emerging markets with currencies that are unhedged against the euro. A massive sell-off of the euro, as was seen in January, can increase the returns of assets denominated in other currencies when converted into euros. In January a large part



Trade Weighted USD vs. Relative Performance Emerging Markets. Source: Robeco/Bloomberg

of the outperformance in emerging markets was explained by the rise of their currencies versus the euro. Thirdly, within time, the non-oil producing emerging markets will be helped by the decline in oil prices.

We remain underweight emerging market equities. At this point we find the negative risks outweigh the positives.

Real estate: ECB's QE is a major boost to property

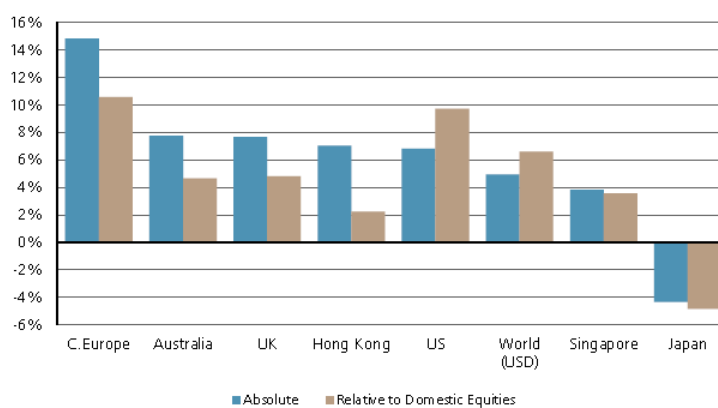
The bond buying program that ECB President Mario Draghi announced in January had a strong effect on interest rates worldwide. The result was that real estate was once again the asset class to which the investor community fled. Of course, European real estate profited the most from further declines in interest rates. On a global level, worldwide property gained around 12% when measured in euros, outperforming global equities in euros by 6%.

The correlation between interest rates and the performance of real estate is still very much alive, and on a global level is around 0.7. As interest rates move lower, the spread with the dividend yield for real estate widens. For investors looking for some kind of bond-like income, real estate provides a stable dividend. The fundamentals of real estate are less of an issue in that case.

In the US, the start of the earnings season confirmed that the real estate sector is doing well, with earnings as expected and positive guidance given by the majority of the sector. Real estate is expensive compared to equity in terms of the FFO multiple (comparable to the equity P/E) and to its history, but investors don't seem to mind. It's the dividend yield that counts.

To underline the relationship between real estate performance and interest rates we can also take a look at the Japanese real estate market. When Japanese interest rates rose in January and came close to European levels, the J-REIT market slipped away (-4%). J-REITs are being bought as part of the stimulus program by the Bank of Japan. That's one of the reasons why the J-REIT market is bigger than ever, with a record number of J-REITs and total market capitalization. The decline in real estate values in January doesn't make Japanese real estate cheap however: valuations are still stretched.

At this moment we have a neutral weight in real estate. We expect that there will be pressure on rates for the longer term (>20 years) in the coming months. Real estate is more vulnerable to shorter-term rates, so that would not be a reason to overweight real estate, as we expect that that part of the curve will not change very much. A further decline in interest rates however would give an extra boost to real estate performance. On the other hand, rising rates (and that's what we ultimately expect for the long term) would have a negative impact on real estate returns in the short term, as we have seen in Japan over recent weeks. So, with the rate uncertainty in mind we are comfortable with a neutral stance.



Note: As of 30 Jan 2015. Source: FTSE, EPRA, NAREIT, Thomson Reuters DataStream, UBS estimates. Regional real estate total return figures calculated using the FTSE EPRA/NAREIT (total return) real estate indices.

Performance of real estate YTD in different regions (local currency).

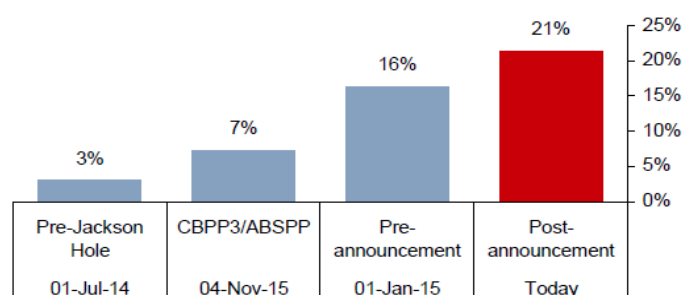
Fixed income: Bonds set new records yet again

AAA bonds: It's no longer newsworthy when a new low yield is reached

We have stopped mentioning that bond yields have yet again reached new lows, as the news value of a record dissipates when it is broken almost every week. So is there any sign that indicates that the tremendous bull run in bonds is over? To be honest, we find it increasingly difficult to find an answer to that question. It is difficult because of the massive control that central banks still exert on the bond market. This interference of central banks makes it difficult to interpret the movement in the bond market. With the recent actions of the ECB it is clear that we will have to keep dealing with this in the foreseeable future.

Although the ECB has purchased bonds before, up until now this has only been done in times of financial crises (like preventing the disintegration of Europe). This time around it is being used as a normal policy tool, where the goal is to fight deflation, or expectations for it. This essentially follows the policy path of the BOJ, Fed and BOE. An important difference though is that these banks were all engaged in purchases when their respective government faced substantial budget deficits, thereby increasing net supply. The ECB however is starting at a time when the Eurozone as a whole has a relatively small budget deficit. This is important as it the increased demand of the central bank will not be matched with an increase in supply. This may be one of the reasons why currently around 21% of the European bond market faces negative rates. When we divide the 10-year rate into 10 equal 1-year forward-rates slices, we get an idea of market expectations of short-term interest rates.

Currently the short-term rate is expected to stay below 1% for the coming seven years. This contrasts with our relatively optimistic view on growth. As mentioned before, we think that markets are putting too much weight on the negative short-term impact of declining oil prices and too little on the positive impact that this may have on growth, not just within the Eurozone. Furthermore, the Eurozone should profit from the low rates and the recent substantial depreciation of the euro. Having said that, these effects will not materialize overnight, so rates will remain low for the foreseeable future. With the ECB and de BoJ added as net buyers, and with governments scaling back on issuance, the hunt for scarce bonds is set to continue. This is most evident in the US where rates continue to be pressured lower, although this is an economy that has been announcing decent growth numbers for the past couple of quarters, and where inflation expectations still seem anchored.



(N.B. Using 2-30y central government debt > €1bn face value) Source: Bloomberg, RBS

The portion of the European Government bond market that has negative yields

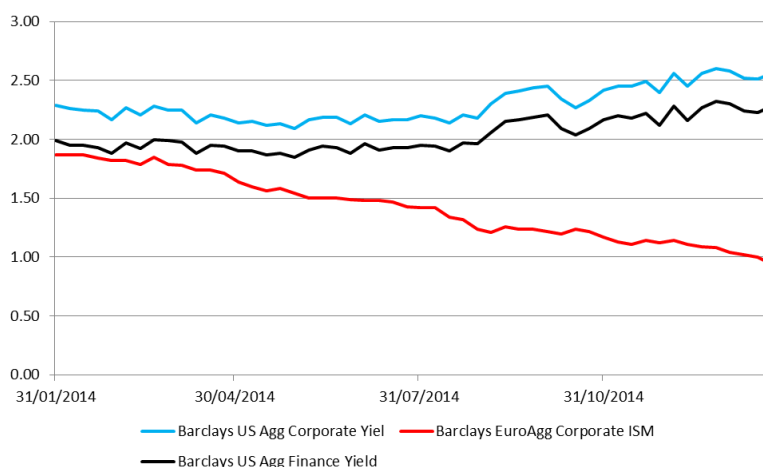
On balance, we have altered our view and recommend adding duration, preferably through longer-dated bonds. This is to capitalize on further downward pressure on rates due to purchases by the ECB.

Investment grade credits: Upside potential is limited in Europe

In January, the ECB decided that it would not include investment grade corporate bonds in the bond-buying program that it announced. However, the program is expected to have an indirect positive spin-off for European credits. As yields on government bonds turn more and more into negative territory, credits will be an alternative to gain at least *some* yield.

The spread above European government bonds yield was flat over the last half year, indicating that credits and government bond yields have moved downwards simultaneously. The spread

compression was most visible in the short end of the curve. The current yield on European credits is about 0.95%, and for European financial credits just above 1%. In the meantime, the first corporate credit has posted a negative yield. The Swiss multinational Nestlé is considered to be very creditworthy, and so it can borrow against a negative yield.



Yield on US corporates (measured in euros) compared to European yields. Source: Robeco/Bloomberg/Barclays

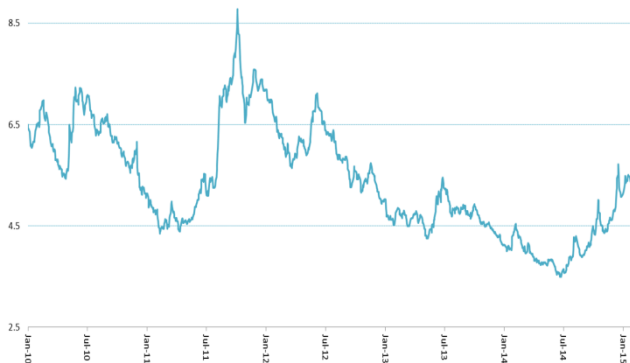
The upside potential for European credits is limited. A couple of factors provide an extra tailwind for credits and give a (limited) boost to the yields, such as the ECB program and a weakening euro. On the other hand, the situation in Greece might cause some spill-over effects in the banking sector and on the whole of investor sentiment in Europe.

High yield: Asset class recovers in January after a difficult December

After a difficult December, high yield recovered in January, albeit very modestly. From a multi-asset perspective, only commodity returns were worse. Spreads widened to an average of 546 basis points, compared to 506 basis points at the beginning of the year. Compared to the low of 2014, 350 basis points, high yield bonds trade about 2% wider.

A lot of the spread widening in recent months has to be attributed to falling oil prices. As discussed, oil sector high yield companies have grown to have a bigger weight in the high yield index. This is especially true in the US where

the shale gas 'revolution' significantly increased the number of energy companies. With the collapse in oil price, some but not all of these shale gas companies will run into difficulties. Production for these companies is not viable at these oil price levels. However, in recent months investors have not distinguished between the companies that will probably go out of business and the ones



High Yield spreads. Source: Robeco/Bloomberg

that won't. Also in recent days, oil prices have moved up a little higher, which should alleviate the pressure somewhat. At current spread levels, high yield energy companies offer some value.

Emerging Market Debt: Yields come down significantly as global easing restarts

As has been the case for more than a year now, the emerging market debt (EMD) spread changed marginally in January, tightening 14 bps to 4.68%. But that is just half the story. On the back of a restart of the global easing cycle, the yield on EMD came down significantly. Developed market central banks in particular have scaled up their measures to fight deflation, pulling down bond yields around the globe.

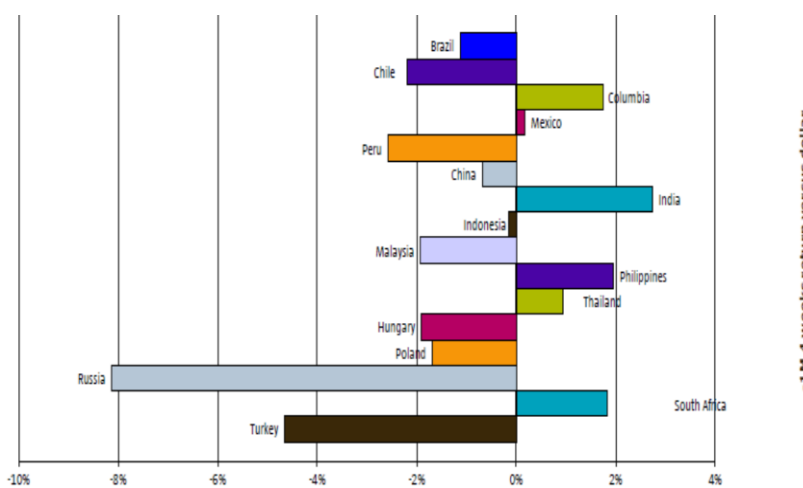
Although lower energy prices will push down headline inflation levels, the magnitude of the fall in CPI will be less outspoken than in developed markets. In fact, the IMF expects inflation for the whole of emerging markets (also including countries that are not in the EMD index) to rise in 2015. Countries like Brazil and Russia are two important examples of countries where inflation will rise. Poland, where consumer prices are down -1.0% year-on-year, should also see inflation go up.

Russia remains the most volatile and unpredictable part of the EMD universe. With the central bank intervening and oil prices rising of late, Russia’s government bonds prices have stabilized. There are still many risks though. The economy is collapsing, currency reserves are dwindling and a bold move by the central bank to lower short-term rates could backfire. Meanwhile, the weight of Russian bonds in the index fell to below 4%.

As with emerging market equities, currency movements have been a major factor in the strong performance of EMD, measured in euros. When measured against the US dollar, things look less impressive. It’s not so much emerging market currency strength, but euro weakness that had profound impact on the strong performance of EMD. Since the EMD benchmark is measured in US dollars, this is an important thing to keep in mind.

On a long-term horizon we expect emerging market currencies to fall against the dollar. Current accounts are improving slightly in this and next year, but remain negative for most countries. On top of that we expect that currency volatility can remain relatively high for a considerable time. Much of the effects and imbalances that are the result from the aggressive maneuvers by central bank around the globe are reflected through currencies.

We remain neutral on EMD. After high yield, EMD is the only fixed income asset class that provides a decent return. However, Russia remains a concern that could potentially spill over to other countries in Eastern Europe. We also expect higher volatility as central bank actions result in outright currency wars.



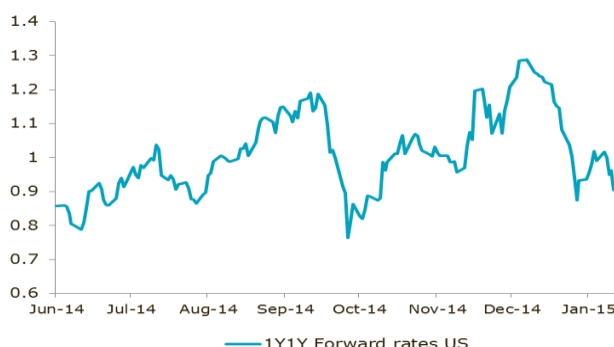
Currency movements in emerging markets. Source: Robeco/Bloomberg

Currencies: Another terrible month for the euro

January was again a terrible month for the euro, as it depreciated against all major developed market currencies except the Canadian dollar, whose central bank cut rates by 25 basis points. It was pretty obvious why the euro remained under pressure, as Draghi used every opportunity given to make sure the market got the message that another round of proper QE was coming to the Eurozone.

Following the old adage of ‘don’t fight the Fed’, or as it goes these days, ‘don’t fight any central bank’ has once again proven to be a profitable strategy, at least during the initial anticipation phase.

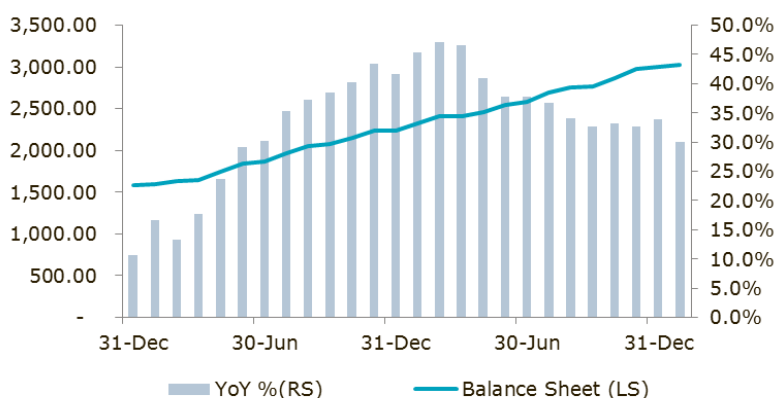
On 22 January came the long-awaited announcement about QE, and indeed the ECB didn’t disappoint. Not only was the size enough to please the market, Mario added a twist that will keep the market guessing on the duration of QE. By not binding QE to a targeted size of the ECB’s balance sheet, but making the duration dependent on the inflation returning to a moderate and stable path, Draghi made this round of easing essentially open ended.



US 1-year forwards have dropped 33 bps since the beginning of the year. Source: Robeco/Bloomberg

The market now needs to judge how likely it is that the ECB will continue easing after September 2016, when its balance sheet should have increased in size by around EUR 1 trillion. This basically comes down to making a call on growth. We maintain the view that growth will start to pick up. The massive drop in the oil price and the continuous decline in rates (German Bunds hitting 30 bps) will at some point be supportive. Economic surprises seem to back this view as the numbers are starting to come in better than expected. A risk remains Greece. We expect the Troika (or whatever replaces it) to come to some sort of agreement with the Greek government, but the risk remains that both sides fumble into a messy solution. We expect the euro to remain on the back foot, but a new trigger is needed to push it substantially lower.

A trigger for the euro/US dollar exchange rate might be the Fed. At the moment, Chairman Janet Yellen is keeping all options open, by on the one hand acknowledging the strength of the economy while on the other pointing to risks mostly stemming from international developments. The market is also a bit more uncertain about the timing of the first rate hike and expectations have been marked down. As for



The Bank of Japan - the gift that keeps on giving... Source: Robeco/Bloomberg

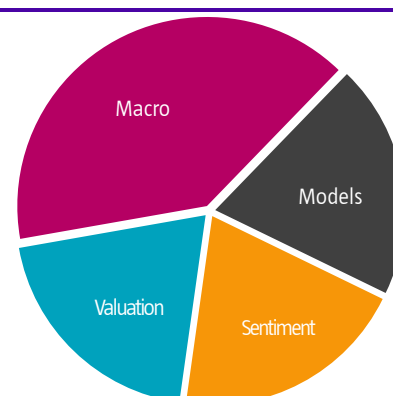
Japan, unlike the Swiss national bank the BOJ sees no technical limits on monetary easing. We therefore expect the BOJ to continue its aggressive bond-buying program, and so the bias for the yen remains down. We stick to our call to remain overweight the US dollar against the yen, and will look for an opportunity to reenter a short euro/dollar position.

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



Robeco Investment Solutions and Research

Jeroen Blokland: Emerging markets
 Léon Cornelissen: Chief Economist
 Lukas Daalder: Equities, special topic
 Ernesto Sanichar: Currencies
 Ruud van Suijdam: Real estate
 Peter van der Welle: Strategist

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