ROBECO
The Investment Engineers

Fixed Income Outlook Q3 2016

Yield drought & bond scarcity: Where to invest?

Kommer van Trigt
Head Global Fixed Income Macro team
Stephan van IJzendoorn
Portfolio Manager
Paul van der Worp
Portfolio Manager

Summary: Our key themes

- *Low growth, low inflation*
  The world economy is characterized by sluggish growth and absent price pressures. Notwithstanding unprecedented stimulative monetary policy around the globe, inflation expectations as measured by market indicators have declined further. In this environment bond yields have set new historical lows and can continue to do so. Central bank buying programs add to the picture as bond scarcity in core government markets increases downward pressure on interest rates.

- *Preference for long dated bonds in US and Eurozone*
  As prospects for (further) rate cuts in the US and the Eurozone are slim, long dated bonds remain our favorite. In the US the 30-year yield is approaching the 2% handle. The US money market curve no longer discounts any rate hike for the next two years. From a risk/reward perspective, most value is in long dated US Treasuries. In the Eurozone we expect the 30-year segment in Germany to benefit from further ECB policy measures (see our *In Focus* contribution below)

- *Brexit favors UK Gilts*
  The surprise outcome of the Brexit referendum is bullish for UK Gilts. Business and consumer confidence in the UK will tumble. The Bank of England is expected to cut rates and potentially restart Quantitative Easing (QE). The UK Gilt market will converge to the

Eurozone bond market dynamics, having shown more parallels with the US Treasury market in recent years.

- *Be selective within credits: focus remains on Europe and subordinated financials*
  As the credit cycle is maturing, leverage is rising, especially for US companies. This calls for a cautious stance. We favor the European corporate bond market, more specifically subordinate financials. Brexit fears and worries about the Italian banking sector have pressured this segment year to date. We believe current valuations offer enough protection. The ECB corporate bond purchasing program will have positive spill-over effects also for this specific sector.

- *Constructive on emerging local debt*
  The star performer of the year has further to go. The imminent threat of a Fed rate hike has disappeared for now. This enables investors to focus more on the attractive yield differential compared with developed markets. Fund flow information underlines that appetite for this battered sector is gradually coming back.

Main views

Main asset categories	Total	Valuation	Technicals	Fundamentals
German Bunds	0	- -	+	0
US Treasuries	0	-	0	0
JGBs	- -	- -	+	-
IG Credits	0	0	0	-
High Yield	-	0	-	-
EMD local debt	+	+	0	-
Euro peripheral debt	-	-	0	-

ROBECO
The Investment Engineers

In focus

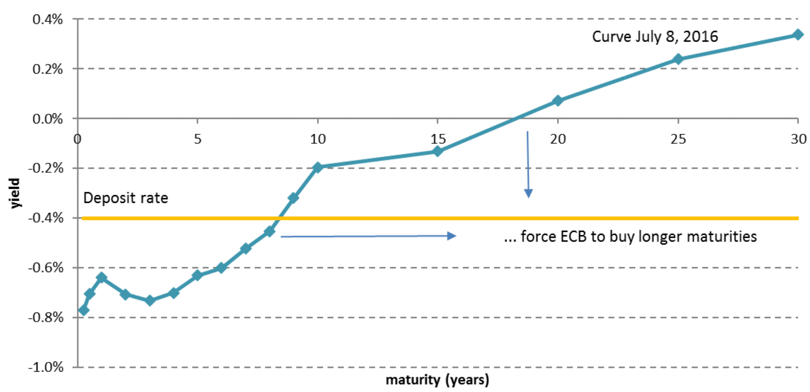
ECB bond buying drives long-end yield curve flattening

In the Eurozone, the rules of the ECB's QE program are forcing the ECB to buy long-end bonds only. The deposit rate rule only allows the ECB to buy bonds with a yield to maturity higher than the deposit rate, i.e. minus 0,4%. With declining interest rates, more and more bonds trade below the deposit rate, making them ineligible for the ECB to purchase. In practice it means that since the start of June, the minimum maturity that can be bought moved from 5 to 8 years in Germany (see picture below). This also has a second round effect: with a decreasing pool of purchasable bonds more needs to be bought per bond to get to the required monthly target of EUR 80 billion. As a result, one of the other rules of the program becomes increasingly pressing: the maximum percentage that may be purchased per outstanding bond. This limit, also known as the issue limit, is set at 33%.

Without changes in the parameters of the purchase programs, we think that the ECB will struggle to buy government bonds in both Germany and the Netherlands around year end. The ECB has options to increase the issue limit for bonds issued before 2013 to e.g. 50% or more. This will give the ECB leeway to continue buying for one or two more quarters. And since these older bonds are mostly concentrated in the long end of the curve, the ECB will again focus buying in that part of the curve.

An alternative 'nuclear' option to address the scarcity issue is for the ECB to give up on the capital key rule. Currently the government bond purchases are split across the Eurozone countries according to the capital key weights. The key is calculated according to the size of a member state in relation to the European Union as a whole, size being measured by population and gross domestic product in equal parts. Changing the purchasing basket according to e.g. debt outstanding (market capitalization) would hugely favor Italian bonds at the expense of German bonds. Italy's outstanding public debt is higher in nominal terms whereas the economy is smaller. We regard this option as politically highly controversial for now. It would be a step closer to Eurobonds. However, in the context of an existential threat to the euro system (Brexit, meltdown Italian banking sector) nothing can be excluded.

Figure 1 | German government bond curve: universe shrinks with decreasing yield



Source: Bloomberg, Robeco. Yield curve as per July 8, 2016

ROBECO
The Investment Engineers

Treasuries

Valuation: the Japanification of the UK Gilt market is in the making

Money market curves have priced out any monetary tightening for all developed markets, including the US. In most countries further easing is now being discounted. Central banks of the UK, Norway, Australia and New Zealand are all expected to deliver one or more rate cuts this year. Forward curves analysis shows US and German bond yields rising only marginally, with 15 and 7 basis points respectively on a 12-month basis. Therefore, any buffer to compensate for capital losses due to interest rate rises is minimal. But then again, new lows in bond yield levels continue to be established around the globe. The Japanification of debt markets already reached the Eurozone and Switzerland. Currently the UK Gilt market looks to be next in line. And ultimately the US Treasury market might be a suitable candidate. In these unchartered waters traditional valuation metrics have to be treated carefully.

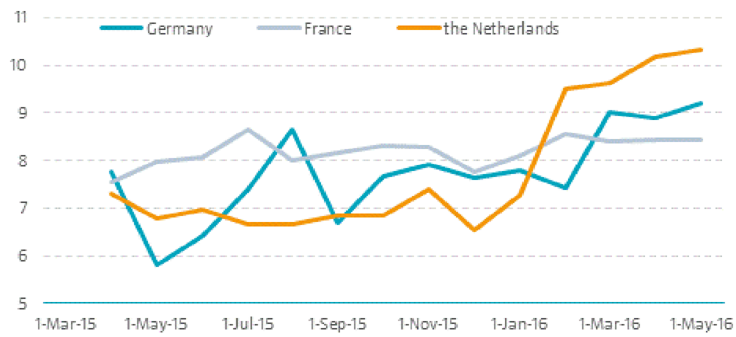
Technicals: bond scarcity becoming an issue for central banks

Currently the Bank of Japan (BoJ) owns roughly 30% of all outstanding government debt. At the current purchasing pace, about 10% is added to the existing stock on a yearly basis. This clearly shows that the current program cannot continue indefinitely. Speculation about further stimulus by the BoJ faces practical constraints. The ECB faces similar challenges. Changing the rules might be the only way to make sure the pool of purchasing bonds for e.g. German government bonds remains sufficient. Already the ECB is forced to increase the weighted average maturity of purchases for selected countries (see picture below).

Fundamentals: watch US jobs market data

Will US payroll growth keep up to back consumer spending? Not much is expected from investment or export growth. As wages are rising and productivity growth is lagging, risks are that US companies will cut back on hiring at some stage to shore up corporate profitability. The July reading on payrolls growth showed a comeback after weakness in the months before. If the labor market turns, the recession risk for the US becomes real. For the eurozone economy assessing the Brexit impact will be key. Only 3% of Eurozone exports go to the UK. Indirect transmission channels are more important here; business confidence can take a hit. Meanwhile deflationary risks are still looming for the region. Even though the ECB crossed another Rubicon when starting buying corporate debt, the market's inflation expectations continue to fall.

Figure 2 | Weighted average maturity of purchases in years for selected countries



Source: ECB, Robeco

> 'Practical limitations of central bank buying programs are in sight.'

Credits

Valuation: average at best

Credit spreads were not immune to recent events like the UK EU referendum, but the overall spread change was moderate and mainly impacted banks. We keep our neutral assessment for valuation. Admittedly, with the ever lower or even negatively yielding government bonds, any yield pick-up may seem attractive. The yield on the European investment grade (IG) corporate credit index is now just below 1% and US corporates yield around 3%. US high yield (HY) is yielding close to 7%. Yield hungry investors might flee into these markets. Adjusted for leverage, spreads are at long-term averages at best though and leverage is increasing both for IG and HY. More than 10% of the euro corporate market, an equivalent of more than EUR 200 billion, already trades at negative yields and 50% has a yield of less than 0.5%.

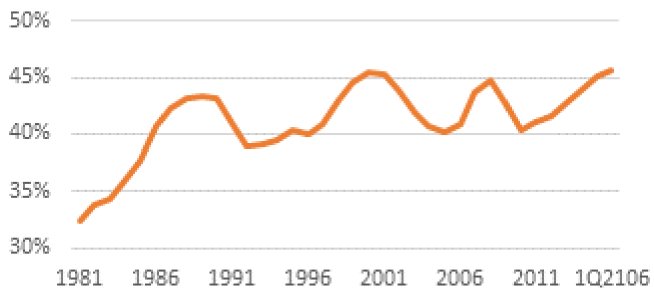
Technicals: more buying, but more issuance as well

After a slow start of the year, demand for credits increased in the second quarter, bringing year-to-date fund flows into positive territory. On top of that the ECB started buying euro denominated senior non-bank bonds in June under its Corporate Sector Purchase Program. First indications show the ECB buying at the high end of expectations. Although not all bonds are eligible, the buying program remains a positive technical for now. The counterargument is the strong pick-up in issuance though, both in the US and in Europe. In Europe, about any non-bank can issue euro senior debt that is ECB eligible given its loose buying criteria. The average maturity of new issues is increasing in Europe, more bonds with 10+ years to maturity are issued.

Fundamentals: non-financial corporate debt at record high

One of the main fundamental concerns that makes us cautious towards credits is the strong increase in corporate debt. In the US the rise in leverage is broad based, in Europe it is still mainly concentrated in a few sectors, but the trend is also deteriorating. S&P reported that total debt for 2,000 rated corporates increased by roughly USD 850 billion in 2015 to USD 6.6 trillion. According to Fed data total non-financial corporate debt amounts to 45% of US GDP, the highest in history. The percentage of IG corporates with a year-on-year increase in leverage is 60%, within high yield 50%; both are near peak levels. The last time it surpassed this level was in 2009/2010, at that time mainly due to a strong drop in EBITDA. This time debt is growing and EBITDA is not, not a good combination!

Figure 3 | US corporate debt versus GDP



Source: US Federal Reserve, Bloomberg, Robeco

'US Companies are levering up.'

Emerging (local) debt

Valuation: longer term undervaluation still in place

Compared with developed country bonds and foreign exchange rates, emerging local bonds and currencies continue to look relatively cheap. The renminbi remains the exception as it remains overvalued on several measures. However, the very limited openness of the Chinese capital account means that this is unlikely to adjust in the very short term. Yield levels for the universe as a whole compare favorably at around 6.5%. The improvement in external conditions identified last quarter has continued. The US Federal Reserve confirmed its more dovish stance and the market has subsequently priced out the chance of a rate hike this year. The Chinese authorities continue to inject policy stimulus as a means to achieving their 6.5% growth target for 2016, while at the same time keeping their capital account closed. This sustains their ability to manage the level of the renminbi and interest rates.

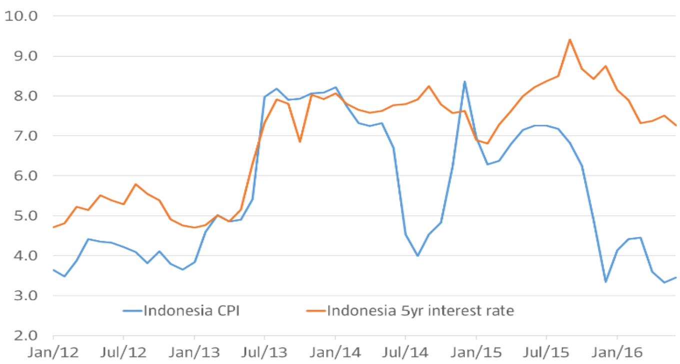
Technicals: inflows continue, positioning is now more neutral than in early 2016

The outperformance of emerging local bonds over other fixed income asset classes over the last quarter has encouraged inflows from investors chasing returns. This in turn has encouraged fund managers to reduce cash and cover underweights in higher risk countries like Turkey and South Africa. Continued quantitative easing from the BoJ and ECB and the associated increase in the numbers of developed country bonds with yields below zero, underpin this flow of funds into emerging markets as investors reach for yield.

Fundamentals: signs of improvement, but medium-term challenges remain

Emerging markets continue to diverge from a fundamental perspective, and making statements about the asset class as a whole is potentially misleading. The external impulse from core countries for emerging economic activity has been mixed over the quarter, and will likely remain so over the coming quarter, as Chinese economic activity recovers and the US stabilizes. In aggregate emerging countries continue to show marginally stronger economic growth than developed countries. Inflation in the meantime declines. The overall firming in commodity prices during the past quarter has provided a tailwind for commodity exporters, whose current account positions are now in an improving trend.

Figure 4 | Indonesia's drop in inflation leaves room for more easing



Source: Bloomberg, Robeco

> 'Dovish turn US Fed supportive for the asset class.'

ROBECO
The Investment Engineers

Portfolio positioning

Highlights Robeco Global Total Return Bond Fund*

- *Duration*: The portfolio's duration is 6.1 years. The bulk of the interest rate exposure is concentrated in USD and EUR securities; recently exposure was added in the UK Gilt market.
- *Yield curve*: There is a clear preference for longer dated securities in both Europe and the US. In the Eurozone the 30-year segment in Germany is our favorite bucket.
- *Credits*: The fund has a preference for European subordinated financial bonds. The exposure equals 8% of the portfolio. Most of these holdings are lower Tier 2 and investment grade. The overall exposure to the most deeply subordinated financial bonds, AT1s and/or Cocos, is below 2%. The overall credit risk is reduced by using European and US investment grade corporate credit derivative indices.
- *EMD*: The overall allocation to emerging local debt equals 5% of the portfolio. A position in Mexico was sold in the past quarter.
- *FX*: The exposure to emerging currencies (5%) is held against short positions in both euro and US dollar. More than 96% of the fund is denominated in the fund's base currency.

Highlights Robeco All Strategy Euro Bonds*

- *Duration*: The portfolio's duration is 7.3 years, of which 0.15pd is in the US and 0.3pd in the UK, against 6.8 years for the Barclays Euro Aggregate index.
- *Yield curve*: There is a clear preference for longer dated securities in Europe. In the Eurozone the 30-year segment in Germany is our favorite bucket.
- *Credits*: The exposure to cash credits is 27.6% with an additional 5.8% in European asset-backed securities (ABS). The overall credit risk is reduced by using European and US corporate credit derivative indices. The fund has a preference for European subordinated financial bonds. The overall exposure to this credit market segment amounts to close to 6%. The majority of these holdings is lower Tier 2 bank (3%) and dated subordinated insurance instruments (1.6%) and investment grade. The overall exposure to the most deeply subordinated financial bonds, AT1s and/or Cocos, is below 1%.
- *Euro peripheral government debt*: The overall exposure to peripheral government debt equals 9% of the portfolio, divided over exposure to Italian and Spanish government bonds. Recently the exposure to peripheral treasuries was increased. The positions in the periphery are skewed to maturities above 5 years.
- *FX*: There is no currency exposure other than to euros.

*Positions as of June 30, 2016

Important Information

Robeco Institutional Asset Management B.V., hereafter Robeco, has a license as manager of UCITS and AIFs from the Netherlands Authority for the Financial Markets in Amsterdam. Without further explanation this publication cannot be considered complete. It is intended to provide the professional investor with general information on Robeco's specific capabilities, but does not constitute a recommendation or an advice to buy or sell certain securities or investment products. All rights relating to the information in this publication are and will remain the property of Robeco. No part of this publication may be reproduced, saved in an automated data file or published in any form or by any means, either electronically, mechanically, by photocopy, recording or in any other way, without Robeco's prior written permission. The information contained in this publication is not intended for users from other countries, such as US citizens and residents, where the offering of foreign financial services is not permitted, or where Robeco's services are not available. The prospectus and the Key Investor Information Document for the Robeco Funds can all be obtained free of charge at www.robeco.com.

Additional Information for investors with residence or seat in Germany

This information is solely intended for professional investors or eligible counterparties in the meaning of the German Securities Trading Act

Additional Information for investors with residence or seat in Hong Kong

This document has been distributed by Robeco Hong Kong Limited ('Robeco'). Robeco is licensed and regulated by the Securities and Futures Commission in Hong Kong. The contents of this document have not been reviewed by any regulatory authority in Hong Kong. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Additional Information for investors with residence or seat in Singapore

This document has not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this document and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of Shares may not be circulated or distributed, nor may Shares be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 304 of the Securities and Futures Act, Chapter 289 of Singapore (the "SFA") or (ii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

Additional Information for investors with residence or seat in Australia

This document is distributed in Australia by Robeco Hong Kong Limited (ARBN 156 512 659) ('Robeco') which is exempt from the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth) pursuant to ASIC Class Order 03/1103. Robeco is regulated by the Securities and Futures Commission under the laws of Hong Kong and those laws may differ from Australian laws. This document is distributed only to wholesale clients as that term is defined under the Corporations Act 2001 (Cth). This document is not for distribution or dissemination, directly or indirectly, to any other class of persons. It is being supplied to you solely for your information and may not be reproduced, forwarded to any other person or published, in whole or in part, for any purpose

Additional Information for investors with residence or seat in the United Arab Emirates

Robeco Institutional Asset Management B.V. (Dubai Office), Office 209, Level 2, Gate Village Building 7, Dubai International Financial Centre, Dubai, PO Box 482060, UAE. Robeco Institutional Asset Management B.V. (Dubai office) is regulated by the Dubai Financial Services Authority ("DFSA") and only deals with Professional Clients and does not deal with Retail Clients as defined by the DFSA

Additional Information for investors with residence or seat in France

RIAM is a Dutch asset management company approved by the AFM (Netherlands financial markets authority), having the freedom to provide services in France. Robeco France has been approved by the French prudential control and resolution authority (formerly ACP, now the ACPR) as an investment firm since 28 September 2012.

Additional Information for investors with residence or seat in Spain

The Spanish branch Robeco Institutional Asset Management BV, Sucursal en España, having its registered office at Paseo de la Castellana 42, 28046 Madrid, is registered with the Spanish Authority for the Financial Markets (CNMV) in Spain under registry number 24.

Additional Information for investors with residence or seat in Switzerland

RobecoSAM AG has been authorized by the FINMA as Swiss representative of the Fund, and UBS AG as paying agent. The prospectus, the articles, the annual and semi-annual reports of the Fund, as well as the list of the purchases and sales which the Fund has undertaken during the financial year, may be obtained, on simple request and free of charge, at the head office of the Swiss representative RobecoSAM AG, Josefstrasse 218, CH-8005 Zurich. If the currency in which the past performance is displayed differs from the currency of the country in which you reside, then you should be aware that due to exchange rate fluctuations the performance shown may increase or decrease if converted into your local currency. The value of the investments may fluctuate. Past performance is no guarantee of future results. The prices used for the performance figures of the Luxembourg-based funds are the end-of-month transaction prices net of fees up to 4 August 2010. From 4 August 2010, the transaction prices net of fees will be those of the first business day of the month. Return figures versus the benchmark show the investment management result before management and/or performance fees; the fund returns are with dividends reinvested and based on net asset values with prices and exchange rates of the valuation moment of the benchmark. Please refer to the prospectus of the funds for further details. The prospectus is available at the company's offices or via the www.robeco.ch website. Performance is quoted net of investment management fees. The ongoing charges mentioned in this publication is the one stated in the fund's latest annual report at closing date of the last calendar year.

Additional Information for investors with residence or seat in the United Kingdom

This statement is intended for professional investors only. Robeco Institutional Asset Management B.V. has a license as manager of UCITS and AIFs from the Netherlands Authority for the Financial Markets in Amsterdam and is subject to limited regulation in the UK by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.