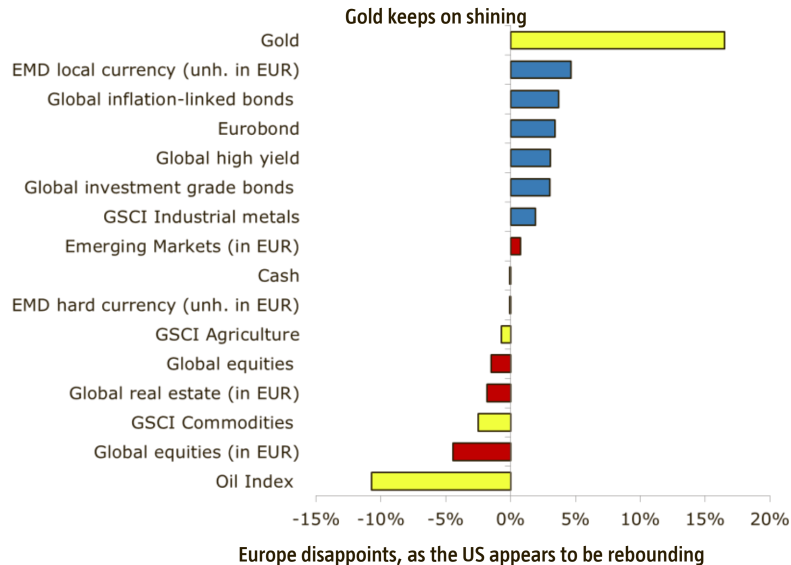
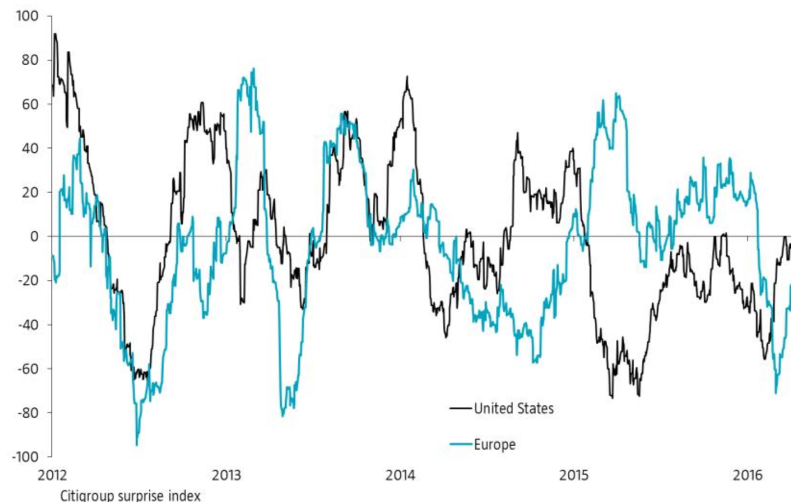
ROBECO

Multi-asset markets outlook

April 2016

General overview



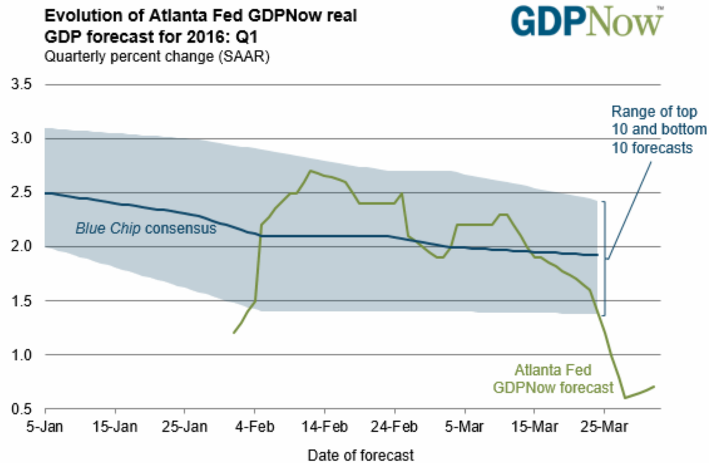


- Whether you think the first quarter of 2016 was a horror story or rather an interesting experience mostly depends on two factors: on timing and on whether you were active in the bond markets. Let's start with the latter, in the overview of returns over the quarter, the difference between bonds and almost all other risky-assets was very significant. If it hadn't been for the rebound in gold, fixed income would have led the top five of best performing asset classes by an impressive margin, with even the very expensive Eurobonds yielding an attractive 3.4% absolute return in Q1. As for the second factor –timing, it is clear that the chart on the left doesn't really do justice to the underlying volatility seen during the quarter. Being overweight risky assets from 11 February onwards would have produced double digit returns for all of these assets. As we were overweight risky assets, it is clear that Q1 was a bumpy ride, but as we were willing to stay overweight, we recovered most of our losses.

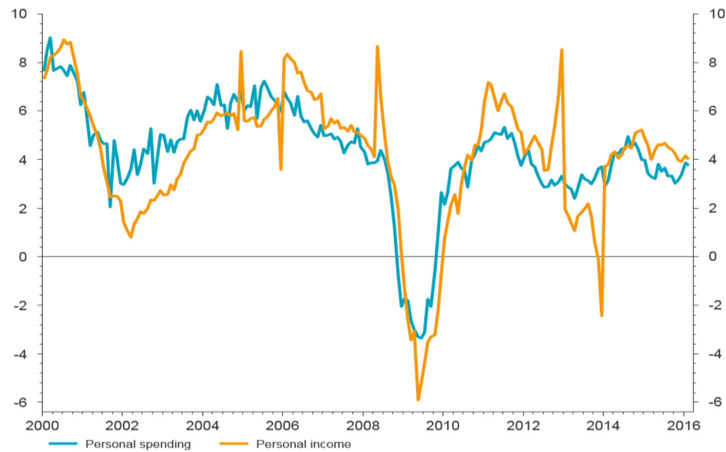
- Although we continue to expect risky assets to deliver better returns than the safe assets of the world, we think that high yield offers a better risk-return tradeoff to equities right now. Therefore, we have lowered our position in equities to neutral, in favor of an overweight in high yield.

United States

Atlanta Fed's GDPNow model predicts just 0.7% QoQ annualized growth 2016Q1



US personal spending will probably increase as labor market continues to strengthen

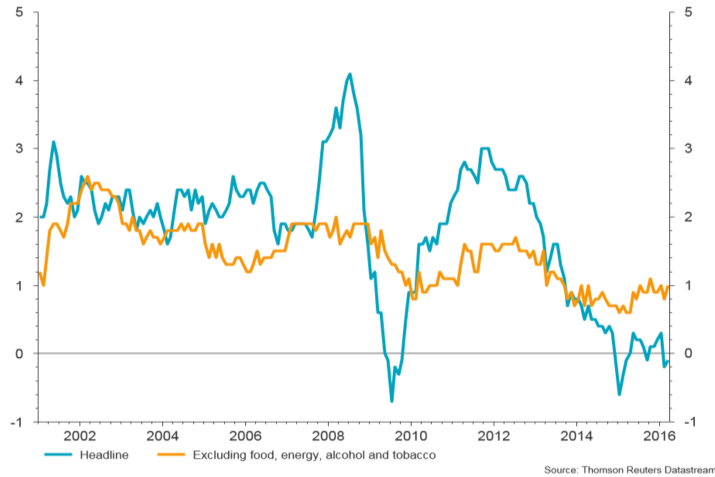


- According to the final print of the fourth quarter GDP number, the US economy expanded twice as fast (1.4%) as was originally reported (0.7%). Nevertheless, pessimism is on the rise for the first quarter, as demonstrated by the collapse in the Atlanta Fed GDPNow forecast to a meager 0.7%. The main factor is the external sector, as a consequence of dollar strength and disappointing personal spending and income figures. The latter points to a missing link in the US recovery: timid wage growth. Nevertheless, as the labor market continues to improve (as illustrated by the non-farm payrolls increase of 215K for March), and with sentiment in the manufacturing sector rebounding (ISM 51.8) we expect the US economy to expand steadily .

- Fed Chief Yellen reiterated the very dovish stance at a recent speech in New York. Weakness overseas was one argument, the other the cloudy outlook for US domestic inflation. As inflation will probably rise in the coming months due to base effects (making the outlook in our opinion a bit less cloudy), it is clear that Yellen would prefer to stay firmly behind the curve. The market is now pricing in a first full 25 basis point rate hike for March 2017. It remains to be seen whether the Fed doesn't succumb to increasing pressure to hike due to unfavorable inflationary developments (i.e. by hiking as early as June), but it is clear it prefers to err on the side of caution.

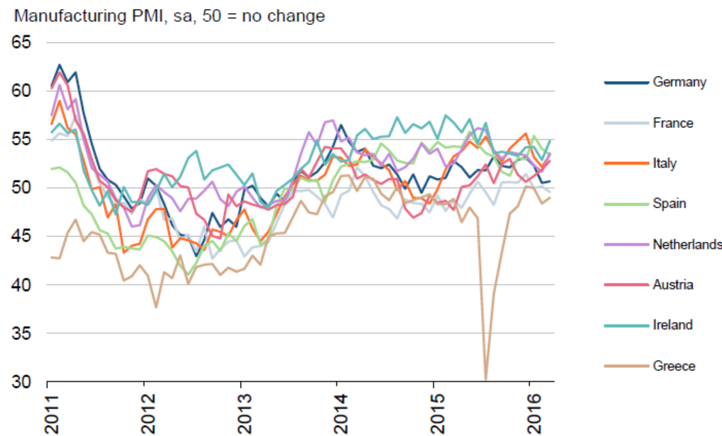
Europe

Modest uptick Euro area inflation



France, Germany hovering around stagnation, solid growth elsewhere

Manufacturing PMI, sa, 50 = no change



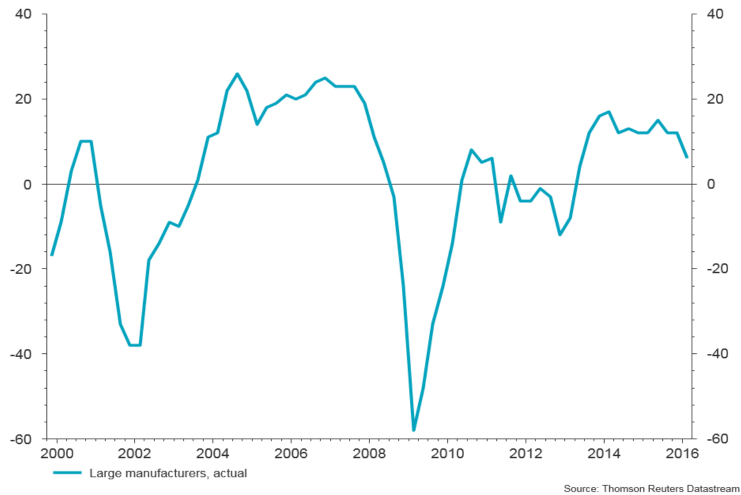
Source: Markit.

- The ECB's Mario Draghi succeeded in surprising markets with a comprehensive package to stimulate growth and to mitigate the impact of negative rates on the business models of banks which went further than expected. In the accompanying press conference Draghi suggested that the -0.4% deposit rate would be the true zero lower bound. Questioned on helicopter money, he stoically responded that it was a very interesting concept currently being debated in academic circles. Although this has to be considered as a desperate measure of last resort, it is clear the ECB wants to signal that its monetary arsenal is far from exhausted. The latest inflation data showed somewhat less headline deflation in the Eurozone and a rebound in core inflation, making it unlikely that the ECB will increase stimulus in the coming months.

- The rate of expansion in the Eurozone manufacturing sector showed a slight uptick for March (51.6 vis-à-vis 51.2 in February). Greece remained at the bottom of PMI rankings, but France and Germany also showed weakness. In both countries this was largely due to disappointing export trends, which in the case of France were exacerbated by weak domestic demand. In contrast, Spain, Italy and the Netherlands showed robust rates of expansion.
- All in all, we consider the Eurozone upswing to be intact, but slow and vulnerable.

Japan

Tankan is heading lower again



Unwelcome yen strengthening despite NIRP

- The unwelcome strengthening of the yen (almost 7% against the US dollar since the beginning of this year), despite the Bank of Japan initiated negative rate policy (NIRP), damaged sentiment among Japan's large manufacturers. The Tankan in March dropped to 6 and was weaker than expected. Spring wage increases have been weak again too. It is therefore likely that the Bank of Japan, initially taken aback by the outspoken market's reaction to its negative rate policy, will expand stimulus at its scheduled meeting of April 28. A lowering of the IOER is likely, as is increased buying of ETFs and J-REITs.

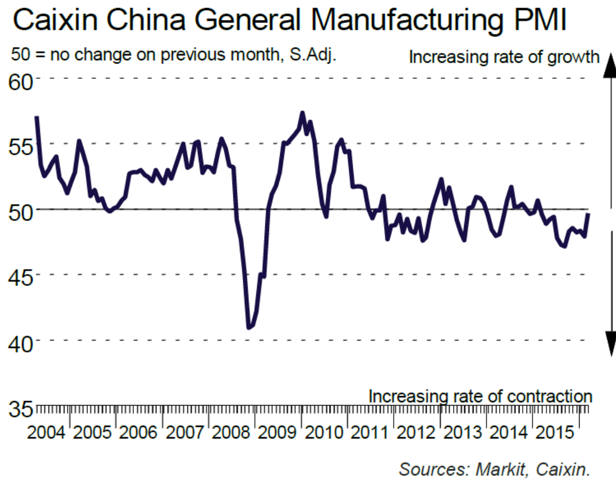
- The Japanese Prime Minister Shinzo Abe has recently insisted that he will proceed with the planned VAT-hike in April 2017. Nevertheless, we do not accept this statement at face value and think it likely that the next G-7 meeting on 26-27 May, hosted by Japan, will be chosen as an excellent opportunity to announce a delay to the VAT hike and that lower and upper house elections will be held together in July. These elections are a risky bet due to the worsening sentiment on the economy and thus on the success of Abenomics, but do offer Abe the chance of a lifetime to consolidate power for years to come.

- It is likely that the Japanese government will announce a new fiscal stimulus package in the light of what will all-important July elections for Shinzo Abe.

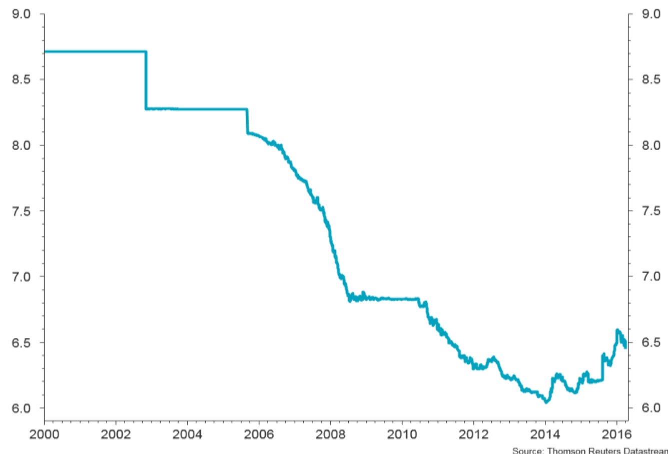
Economy

Our highlight this month: China

Government stimulus begins to take hold



Yuan/USD calmer

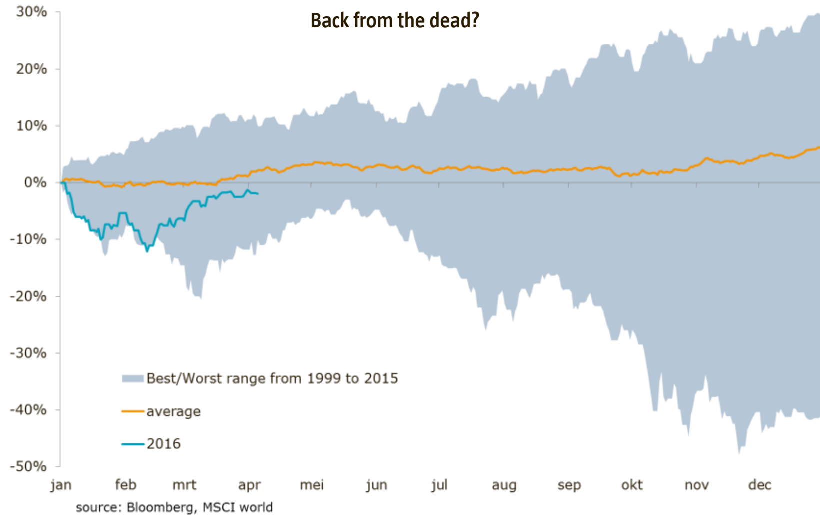


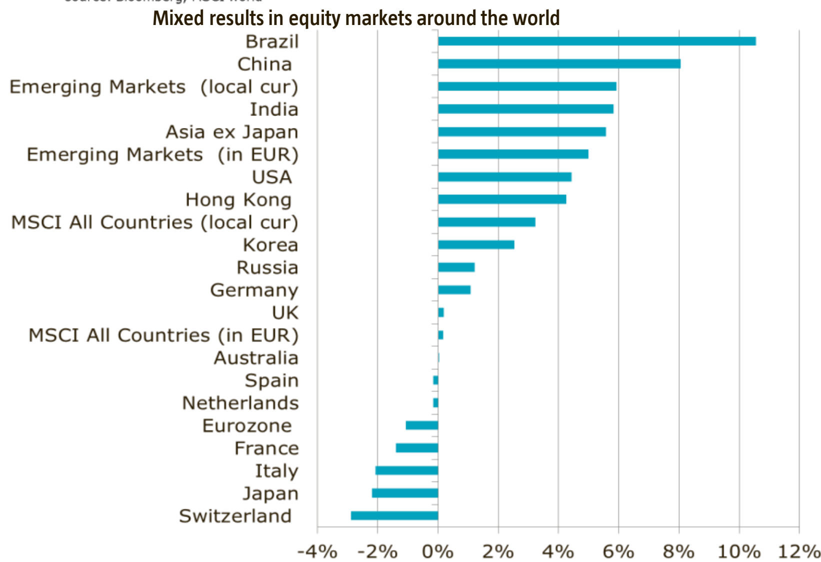
- Finally some good news from China: the China General Manufacturing PMI index for March rose 1.7 towards 49.7. All categories of the index have improved. The stimulus policies of the Chinese government are clearly starting to work. Capital outflows from China came down markedly in February as the yuan stabilized and fears of an intended aggressive depreciation policy from the People's Bank of China diminished. Strengthened capital restrictions were probably also helping. The fact that unrest about exchange rate policy has died down somewhat paves the way for more monetary stimulus in the coming months.

- Inflation rose in February from 1.8% to 2.3% but this is largely the consequence of higher food prices and therefore likely to be temporary. Producer prices are firmly in deflationary territory, suggesting there is ample room for more monetary stimulus.

- Following an earlier move by rating agency Moody's early March, Standard &Poor's also cut its outlook for China's sovereign credit rating on March 31 from stable to negative, saying the government's reform agenda is on track but likely to proceed more slowly than expected. This move illustrates growing worries about the risks of the increased leverage in the Chinese economy. But we do not expect this to get out of hand for the time being.

Equities (I)

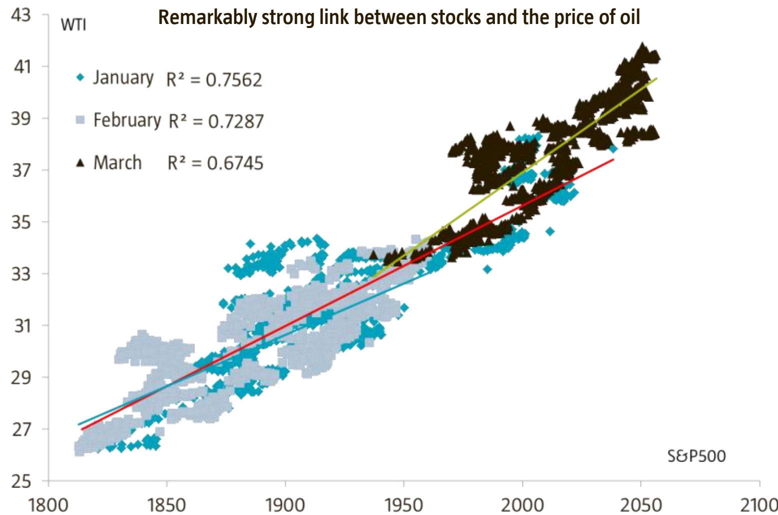


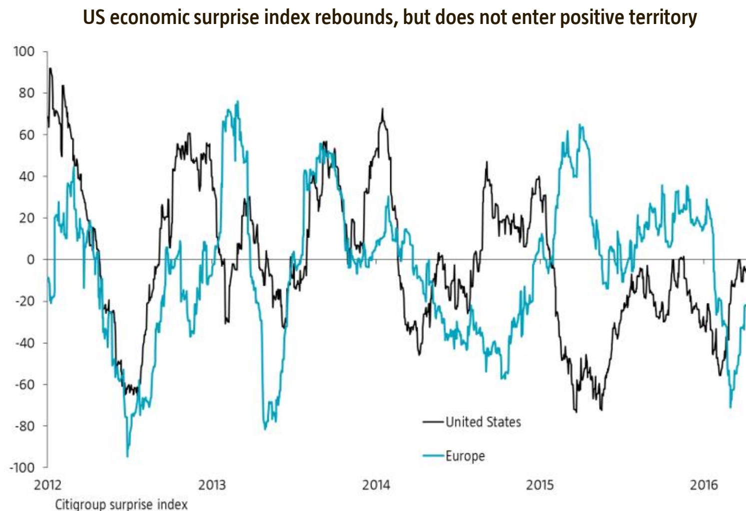


- Stock markets continued to recover lost territory during the month of March, even though global stocks are still down year to date (-1.8%). However, the recovery was not evenly distributed, with (strong) gains in emerging markets and the US and flat to negative results in the European and Japanese markets. Not surprisingly, this relative underperformance came on the back of a strengthening of the yen and the euro versus the dollar, with the yen up by more than 7% since the start of the year.

- Of course, we are happy that the markets have bounced back: we stayed overweight equities throughout the entire sell-off that took place during the first six weeks of the year, as we felt the markets were far too panicky about a number of underlying uncertainties (oil, China, US slowdown). Our main premise was that as long as the US economy was doing fine, the sell-off would prove to be a temporary phenomenon. The markets seemed to be pricing in a US recession, which we thought unlikely at this stage. It would be nice to claim that the recovery that we have seen since the middle of February was indeed linked to the ongoing strength of the US economy, but that would probably be oversimplifying things. Sure, the US economy has continued to expand, with the labor market expanding at a remarkably steady pace, and even the US industrial sector rebounding into positive territory (US manufacturing

Equities (II)





- producer confidence rose to 51.8 for March). However, looking at either the movement in the US Citi Surprise Index (still in negative territory) or the Atlanta Fed estimates for Q1 growth (0.6%), it is difficult to claim that developments relating to the US economy have been very impressive.

- The rebound in oil prices seems to have been far more important. Stocks have been at the mercy of oil since the start of the year, with the correlation of intraday moves in oil and stocks rising to remarkably high levels this year. The rule of thumb seems to have been that a USD 1 move in the oil price coincided with a 1% move in the same direction in stock prices. With oil rebounding by more than 10 USD per barrel, this seems to explain most of the rebound. As we have stated before, we think this low-oil-is-bad-for-stocks theory is an oversimplification, as low oil prices increase purchasing power for consumers around the world. The difference is that this positive effect takes a lot longer to materialize than the negative effects, which is why this trade has been so dominant. We expect stocks to steadily become less preoccupied with oil as time progresses, but in the short term we expect oil to continue to play a role in the underlying volatility in stocks.

- So what's next? On balance, we have become somewhat more cautious on the short term risk environment moving forward. It's true, the US

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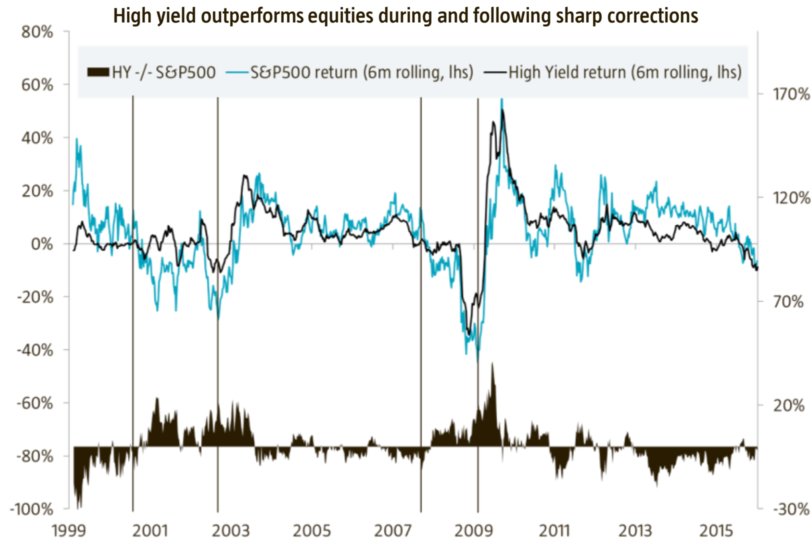
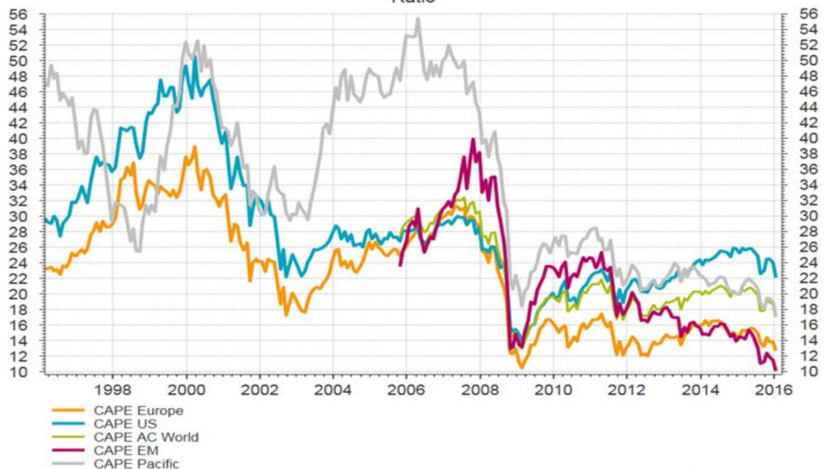
Equities (III)

High yield outperforms equities during and following sharp corrections



Stocks in Emerging Markets and Europe are cheap by now

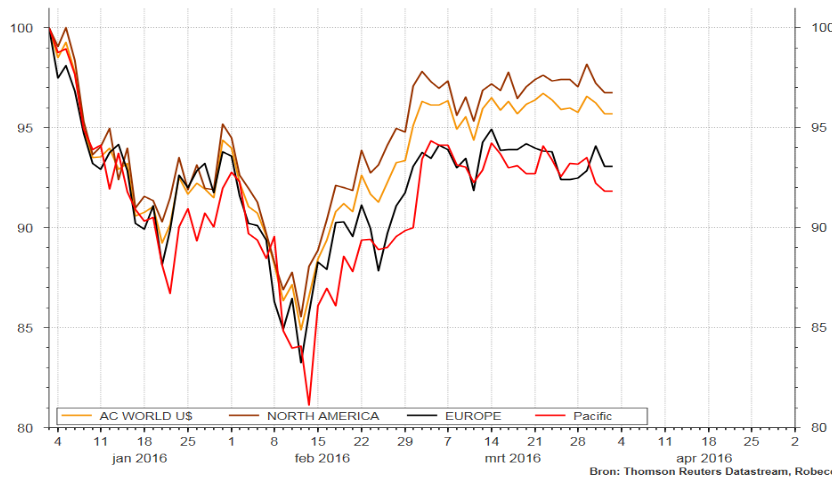


- economy has managed to stay the course, but growth has not been impressive, with the consumer acting as the sole engine flying the plane. The dollar's reversal seen since the start of the year, may add some support to the external sector in the second half of the year, but the US's gain will be Europe's and Japan's pain, as we already have seen this year. Added to this is increased uncertainty regarding the perceived power of central banks to move the markets. This is particularly the case for the Bank of Japan, where the decision to move to a negative deposit rate has (indirectly) triggered the sharp yen appreciation. Luckily, the BoJ is always a bit of an outlier and the Fed has so far been less affected by this diminished-returns-of-monetary-policy virus. Additional sources of uncertainty moving forward are of course Brexit, Grexit (yes, it is back), the general cohesion in the European Union and the US elections.

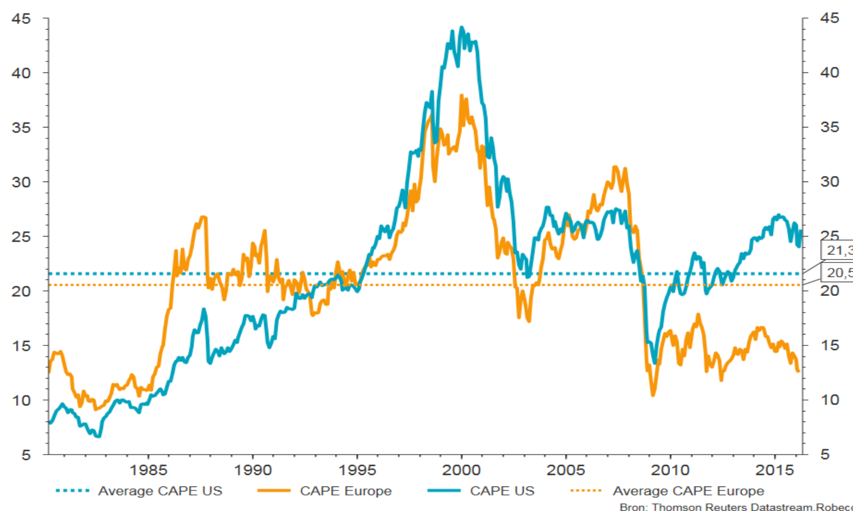
- Although we continue to expect risky assets to deliver better returns than the safe assets of the world, we think that high yield offers a better risk-return tradeoff to equities right now. If history is anything to go by, high yield should show a better performance to stocks in times of turmoil, as rising credit spreads offer a better buffer for corrections than dividend yields do. All in all, we are lowering our weight for equities to neutral, in favor of our overweight in high yield..

Developed Market Equities

Momentum did not improve materially in March



US still expensive compared to Europe

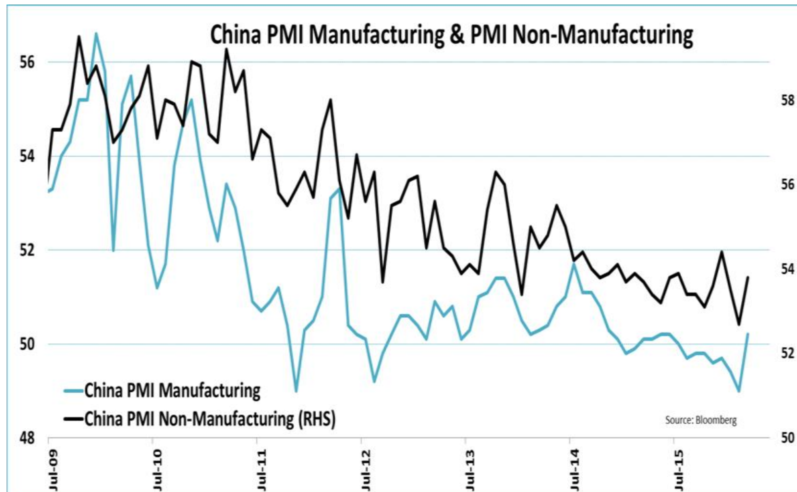


- Global equity momentum on a 1 month basis in euro terms has stayed positive, with Pacific equity performance gaining 2.1%. However, the performance of regional developed equity markets is showing increasing dispersion after the trough of 11 February, with the more defensive US equity market still leading YTD performance. The rally in the US has been broad based, with the full breadth of the market underpinning the improvement in momentum. In euros, the US declined -0.4 % in March, while performance of the MSCI Europe stayed flat. Short- term momentum for global equities remains moderately positive as we enter April, while longer term (12M-1M) momentum is still strong.

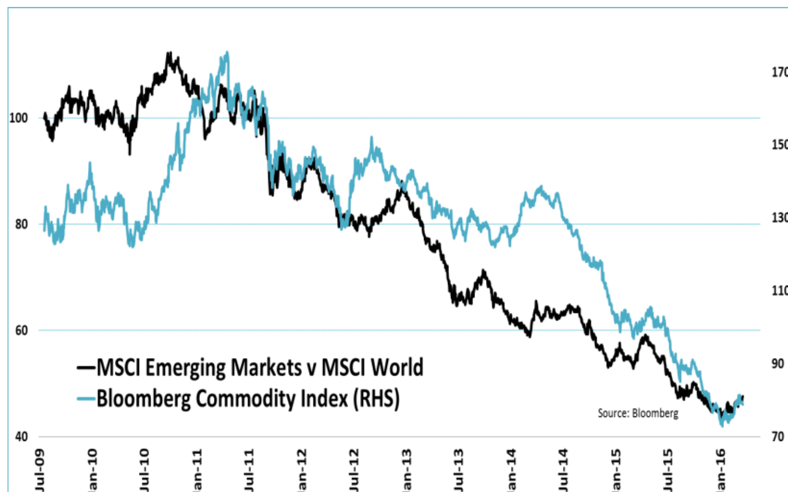
- Looking ahead for developed market equities, we do not think a US recession this year is very likely, especially as the confidence in the manufacturing sector improved in March, showing a renewed expansion in activity. The significant decline in earnings expectations, has also lowered the bar for upward surprises. However, past dollar strength and the still troubled energy sector hamper earnings capacity, especially as wage growth steadily improves. We continue to favor Europe and Japan to the US, as the upside there in terms of earnings seems higher. From a valuation point of view, CAPE metrics favor Europe and Japan compared to the US, which is clearly the most expensive region at the moment.

Equities: Emerging vs Developed (I)

China Manufacturing & Services PMI



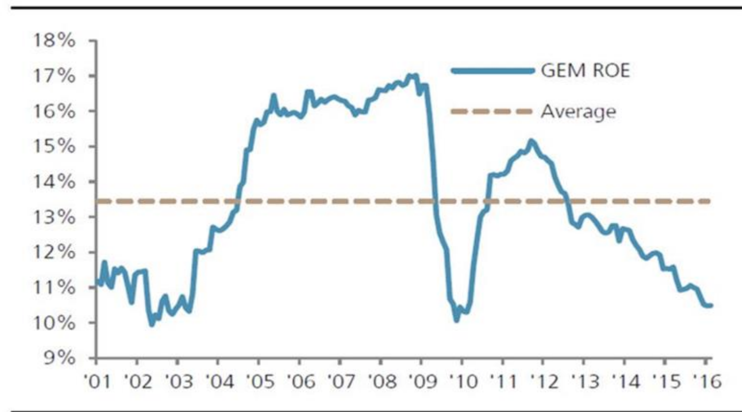
EM Manufacturing PMI lags developed



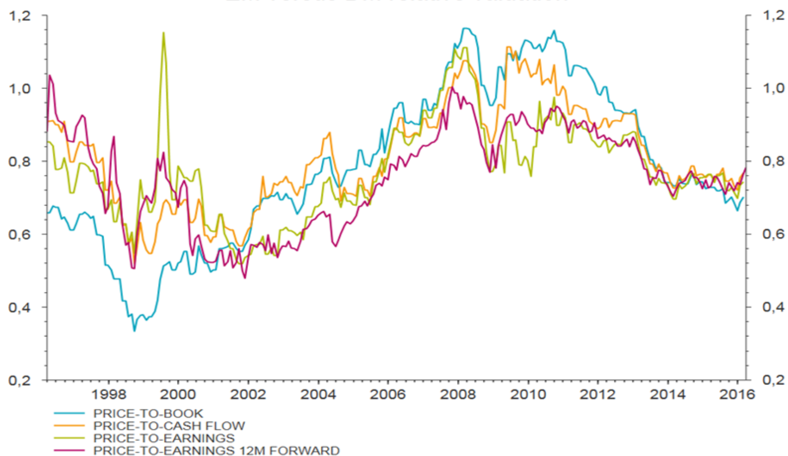
- Emerging market equities had a very good March, as they benefited from a combination of higher commodity prices, a lower US dollar and more central bank easing. As a result, emerging markets leapfrogged developed markets and our now up for the year to date.
- Unless it was an 1 April joke, Chinese PMI numbers published then showed an uptick in March. Both the manufacturing and non-manufacturing PMI went up, with the former breaking above 50 for the first time in eight months. This looks encouraging and could be an early sign that the Chinese economy is stabilizing after the government boosted stimulus. However, as always, data is even less reliable during this period of the year due to Chinese New Year.
- Commodities prices continued to rise in March. As the graph on the bottom left shows, the correlation between emerging markets and commodity prices remains strong. Despite the major differences in commodity exposure of the different countries, emerging markets as a group tend to benefit from higher commodity prices. In addition, emerging markets also tend to profit from a weaker USD, something that also occurred as Yellen ensured investors she will take things very, very slowly.

Equities: Emerging vs Developed (II)

EM and commodity prices



Valuation discount



- These developments have triggered us to significantly reduce the underweight in emerging markets. However, for now we still retain a small underweight. First, although Yellen's statement was dovish, the Fed will slowly raise rates. This means the divergence with other central banks, especially the ECB, remains. So we don't think this downtrend in the US dollar will continue, and certainly not at this pace. Second, while we may have seen the bottom in commodity prices, they could still fall further again. Oil inventories are still building, OPEC has not decided on any cuts yet, and the rebalancing between demand and supply will only start later this year.

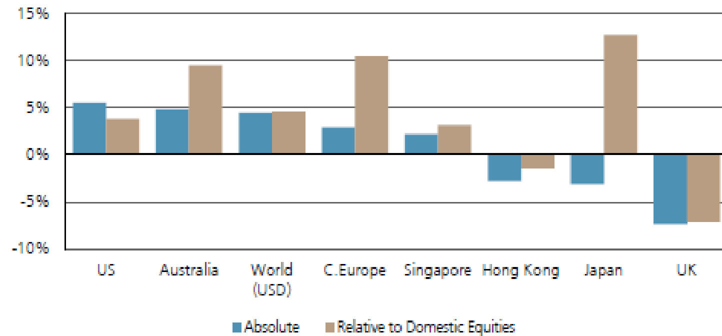
- Third, and these tends to be overlooked from time to time, bottom up fundamentals are not helping the situation. Corporate debt levels are rising, especially in China, and profitability is weak. If some of these bottom up fundamentals were also to improve that would really make us more bullish. Some of these elements could improve as the massive depreciation of emerging currencies starts to positively impact profits.

- We maintain a small underweight in emerging markets as the US dollar and commodities could reverse and bottom-up fundamentals have yet to improve.

Real estate

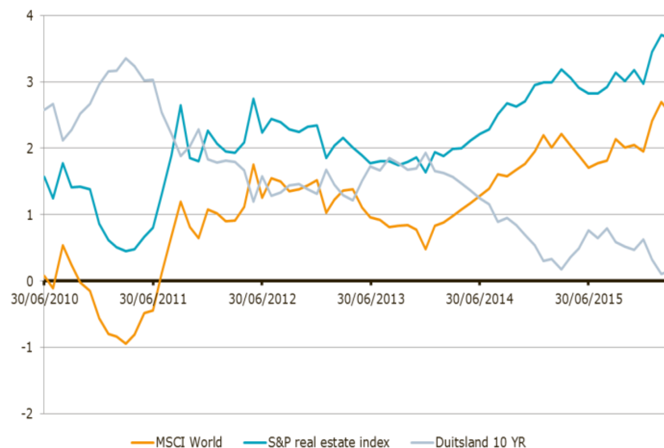
Outperformance of real estate

Figure 3: Total Returns Calendar YTD as of 01 April 2016 (Local Currency)



Note: As of 01 April 2016. 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. World shows USD return.

Dividend spread to bonds attractive



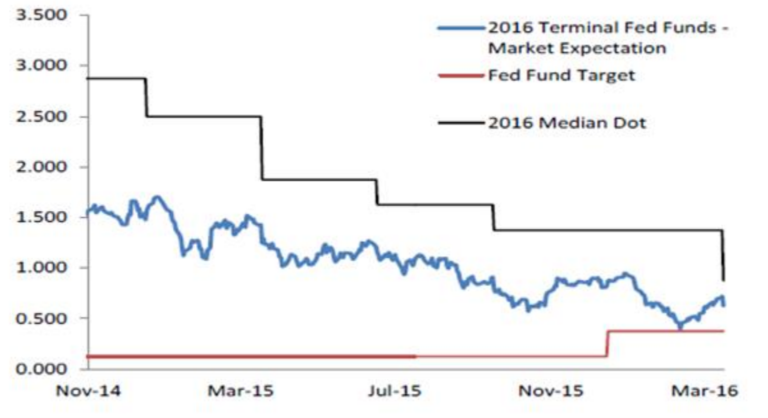
- March was a strong month for listed real estate, which rose 9.5% (S&P Developed, in USD), outperforming global equities by 2.7%.

- European and Japanese real estate were clearly ahead of the rest of the market, extending their year-to-date performance. In both regions the central banks are stimulating the markets. The ECB lowered interest rates and extended its bond-buying program, while the BoJ continued its buying, and this included J-REITS. This resulted in outperformance as investors continue to look for yield and the dividends for real estate are still attractive, around 3% in Japan and above 4% in Europe. The correlation with interest rates is on the rise. As prices in Europe and Japan have risen sharply, so have valuations. J-REITs in particular are once again expensive from a historical perspective.

- The US is a different story. The Fed has made clear that, albeit cautiously, rates will rise in the coming period. Nevertheless, US REITs responded rather positively, as this more moderate Fed approach came as a surprise. However, the strong correlation between real estate and US Treasuries, is fading away. US Real Estate also is expensive.
- For now, we maintain our neutral view on real estate.

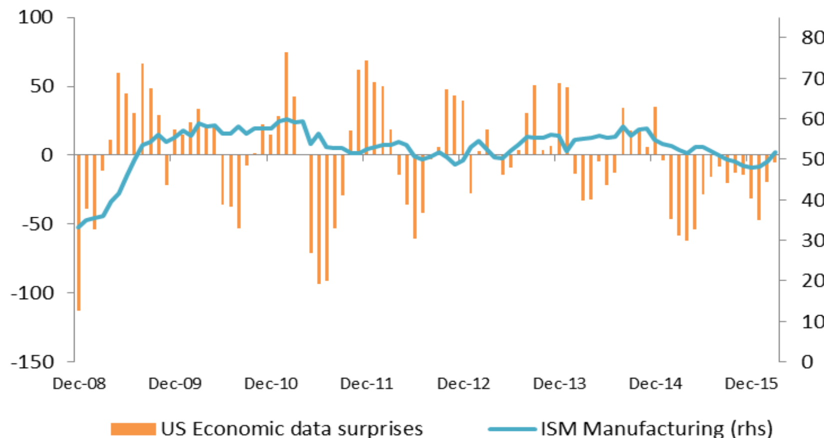
AAA Bonds (I)

Fed moved towards the market: market has no faith in the US economy



Source: Nomura, Federal Reserve

Data is improving in the US



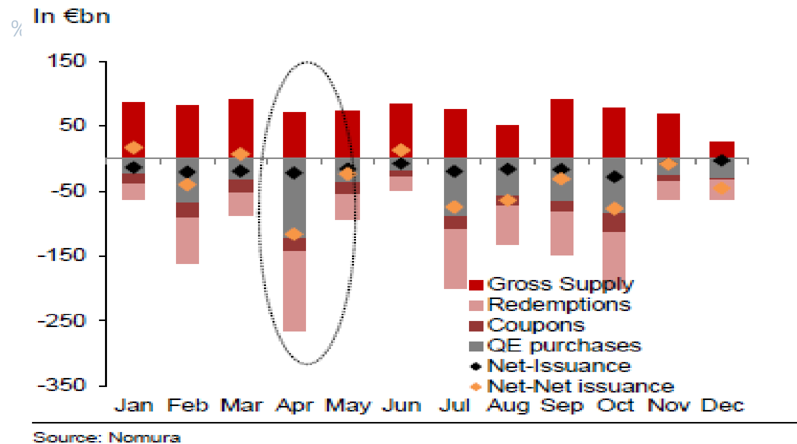
Source Bloomberg, Citi

- If you wanted to summarize 2016 up to this point: if in doubt, go for easier monetary policy. While markets were pretty much expecting this from the ECB and the BoJ, the fact that even the Fed was willing to play according to these rules came as rather a surprise. It is now clear that the Fed Chair has chosen to take an incredibly dovish view of the world. What Yellen also highlighted was that the Fed is not just looking at the US to determine its policy stance. The international angle is now firmly back as an important determinant of US monetary policy. The Fed seems to have moved from being data dependent to being more market dependent. Whether this will ultimately be good or bad, remains to be seen. If financial markets are used as a measure to judge policy success, however, Yellen is getting a double thumbs up. Markets that are sensitive to US reflationary policy are benefiting and, in general, risky assets had a pretty good month.

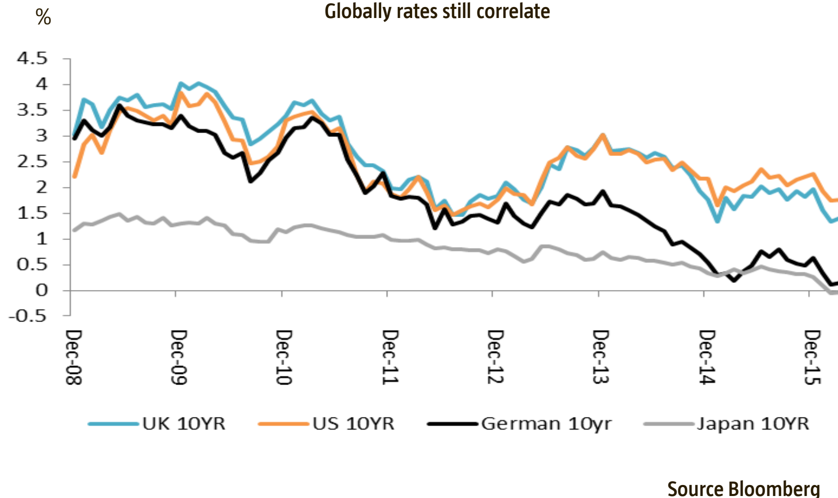
- Over the past period we have had quite a difficult time in correctly calling movements in the bond markets and we admit we are still struggling. One of the reasons for this is that central bank policies have become increasingly important for judging the attractiveness of bonds. People tend to care less about valuation when central banks get involved in the market.

AAA Bonds(II)

Market technical may start exerting a bigger influence on rates once more



Globally rates still correlate



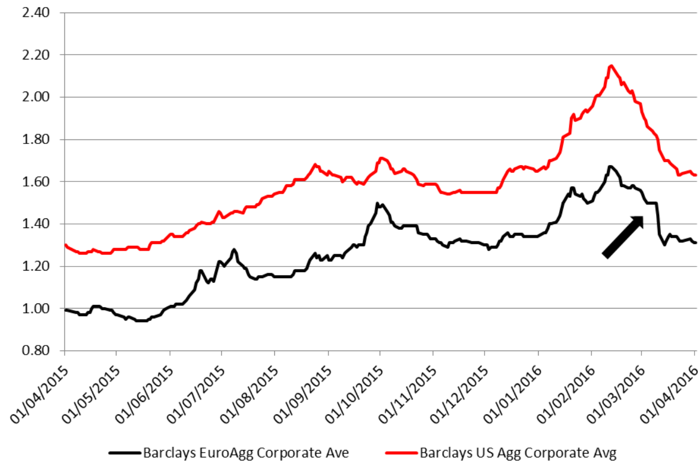
Source Bloomberg

- With the ECB once again increasing its purchasing program and offering liquidity via various programs, market technicals are back. Based on current expectations we will be faced with negative supply in Europe, as the further increase of the ECB's buying program in combination with coupon payments and redemptions overwhelms the expected supply of bonds. The biggest impact will be on German bonds. Bond yield levels will determine how pressing the supply and demand issue will be, as it tends to be either self defeating (if rates rise) or self enforcing (if rates drop). As correlations between global rates are still high, European rates will exert downward pressure globally. The impact might be a bit bigger, as there is little to offset this effect now that Yellen has turned extremely dovish and has raised the bar in terms of US data influencing monetary policy. Given that the market, like the Fed, still doubts the strength of the US economy, it remains reluctant to demand a premium for US bonds. As we believe the cue for higher rates globally will come from the US, current policy setting will delay this.

- We continue to think that bonds offer no value, and remain on the sidelines as the current sentiment could continue for the coming period. The market and the Fed will need proof that the current improvement in US data is sustainable. Until this happens the natural tendency for the markets will be to go after yield.

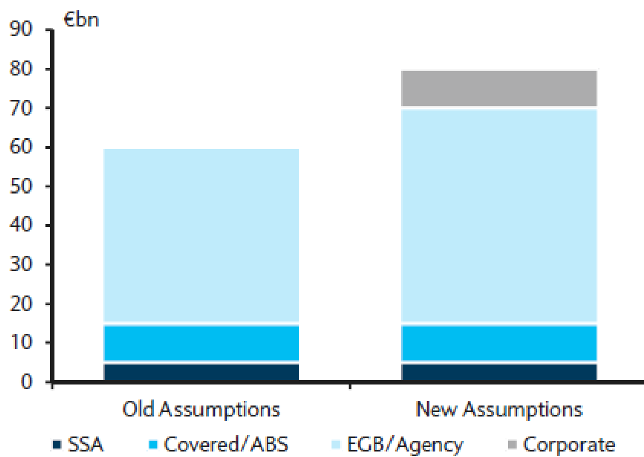
Investment Grade Credits

European spreads dropped sharply after ECB announcement



Source: Bloomberg, Robeco

Monthly ECB bond buying program in buckets: extension of EGB and Corprates on top of it.



Note: Average monthly pace of purchases. Source: Barclays Research

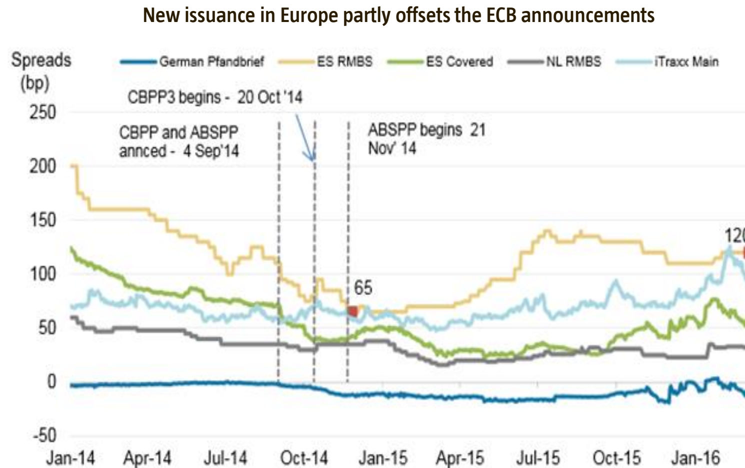
- Credit markets responded instantly to the words of ECB President Draghi at the latest ECB meeting. Draghi announced he would add EUR 20 bln to the current bond-buying program, but the main message for the credit market was that credits are part of the program – albeit under certain restrictions. The ECB will start buying at the end of Q2, 2016. European credit spreads went sharply down on the news, from 1.50 to 1.35 in two days. This rally was – at least temporarily – halted by the dovish Fed meeting and terrorist attacks in Brussels.

- The constraints of the program are to be announced at a later date, but based on previous ECB programs, we can assume some of the possible restrictions. These are likely to include that the corporates must be investment grade, euro-denominated, the issuer must be established in the euro-area and the bond must be issued by a non-bank corporation.

- The ECB is expected tol buy an estimated maximum of EUR 10 bln of corporate securities per month, in both the primary and secondary markets. This means there is a universe of eligible corporate bonds of around 400 bln, but also a lot of question marks. For instance, what happens and what will the ECB's policy response be if a bond's credit rating falls to high yield levels?

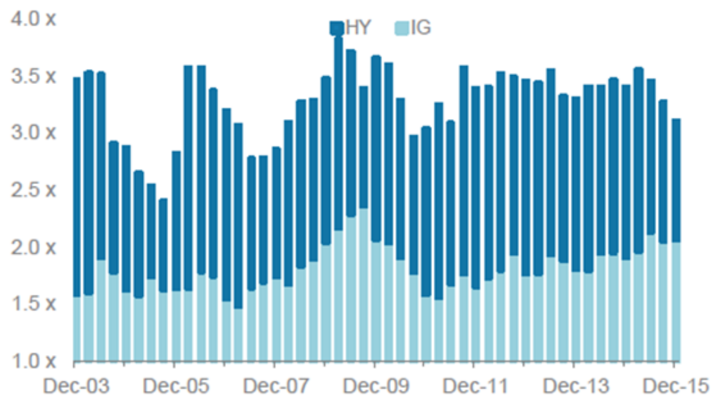
Investment Grade Credits

New issuance in Europe partly offsets the ECB announcements



Source: Morgan Stanley Research, Markit, Bloomberg

Net Leverage for US investment grade still moving higher



Note: Data is of 4Q15. Source: Morgan Stanley Research, Bloomberg, Company data

- If we take earlier buying programs as an example, spread impact is most pronounced in the period between the announcement and the actual start of purchasing. So we expect most spread compression to have taken place by the end of June. Currently, spreads are moving slowly lower, which is also a result of the large amount of new issuance in the last weeks of March, especially in the industrials sector.

- From the top in Mid-February, US credit spreads had declined in a straight line to 1.63% by the end of March, which is still significantly higher than European spreads. However, if we make a correction for the overall lower credit quality in the US and the relative high commodity exposure in the US credit universe, this makes good sense. In addition, leverage in the US is also at a high level. So, the spread level looks attractive, but a cautious approach is necessary.

- European credits are more attractive in our opinion. As the ECB is in the market as a buyer for the coming period, we expect the credit spreads to continue to decline. So we have raised credits to an overweight position. We still bear in mind what we have seen in earlier ECB buying programs , which is that most of the yield compression takes place in the period before the actual buying.

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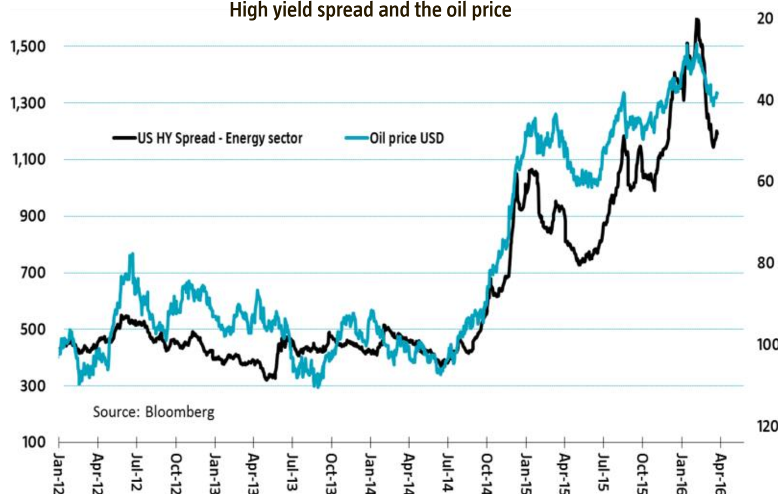
High Yield (I)



- High yield bonds continued their stellar performance, which started in the second part of February. As the oil prices recovered and recession fears abated somewhat, the global high yield spread tightened by 74 basis points. Together with continued downward pressure on government bond yields, this resulted in a strong performance for high yield bonds.

- As mentioned many times before, the correlation between oil prices and high yield spreads has increased significantly. This is not just the case for energy related bonds (as shown in the bottom graph), but for the asset class as a whole. Hence, as oil prices went up again in March, high yield bond prices went up as well.

- We would like to emphasize, however, that in our opinion this co-movement between the oil and high yield has gone too far. The oil price collapse also partly reflected investor uncertainty concerning the US economy. In recent weeks the probability of a recession has come down which has helped the prices of risky assets to recover. Recession fears were overdone.

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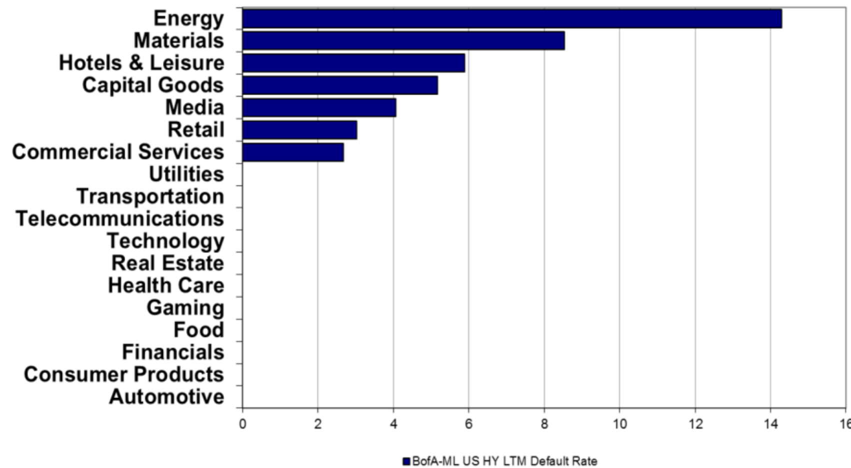
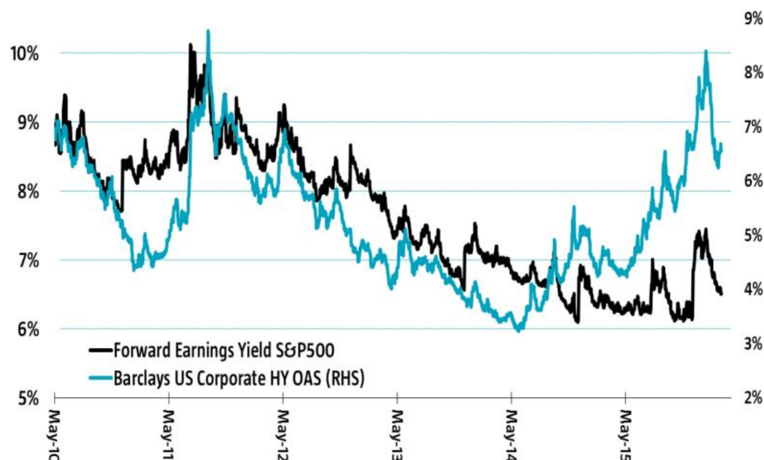
High Yield (II)

Spread on high yield energy companies



HY default rates



- As a result default fears were also overdone. The chart to the left shows this year's defaults in the US. It is no surprise that these defaults are concentrated within the materials and especially the energy sector. The energy default rate has increased to a lofty 14%. While that's certainly a big number, investors were pricing in defaults of more than 50%. Unless oil sets new lows, that is just not going the happen. In addition, defaults are mostly an American thing. The European default rate is practically zero.

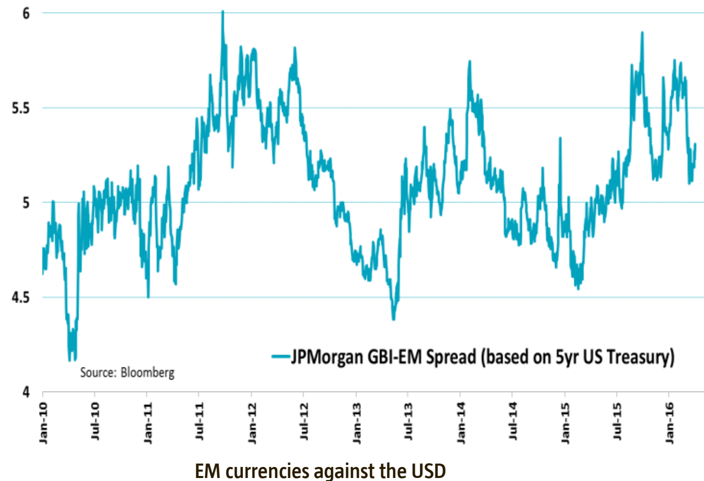
- While US balance sheets look less healthy (debt and profitability ratios have declined materially) it's here that high yield offers more value relative to equities. The is shown in the bottom graph on the left. Even after the recent tightening of high yield spreads we continue to see value in this asset class.

- That said, compared to last month two factors are now less positive. First, as the gap between oil supply and demand has yet to close, the upward potential for oil remains muted after the recent rise. Given the strong correlation between the two asset classes this poses a risk. Second, volatility is rising in high yield. After a period where volatility practically matched that of government bonds, a gap has opened up in favor of governments bonds.

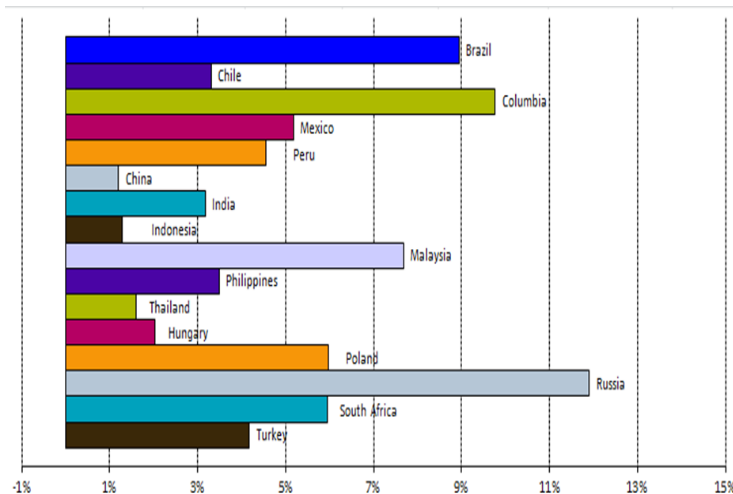
Fixed Income

Emerging Market Debt (I)

Emerging Market Debt spread based on the 5-year US Treasury yield



EM currencies against the USD



- Emerging Market Local Currency Debt (EMD) experienced one of the strongest months on record as emerging currencies posted their biggest monthly gains since 1999. Against the US dollar that is. Since the euro strengthened against the dollar, euro returns were somewhat less extreme.

- As the graph at the bottom low shows EM FX appreciation was especially strong in commodity-exporting countries like Brazil and Russia. Commodity prices continued to rise in March benefitting these countries. Other currencies appreciated as well, as the Fed Chair, Yellen, comforted markets by signaling that rates will only go up very gradually.

- A weaker US dollar and bottoming commodity prices proved to be a cheerful mix for emerging assets. However, as we expressed in our view on emerging market equities, we are not sure if these developments will continue. First, although Yellen has done a convincing job in striking a dovish tone, the Fed remains the only major central bank that has a tightening bias. This will limit the scope for further US dollar weakening. Although we no longer expect EM FX to weaken to previous lows, we remain cautious on further EM strengthening as economic conditions still remain shaky.

Fixed Income

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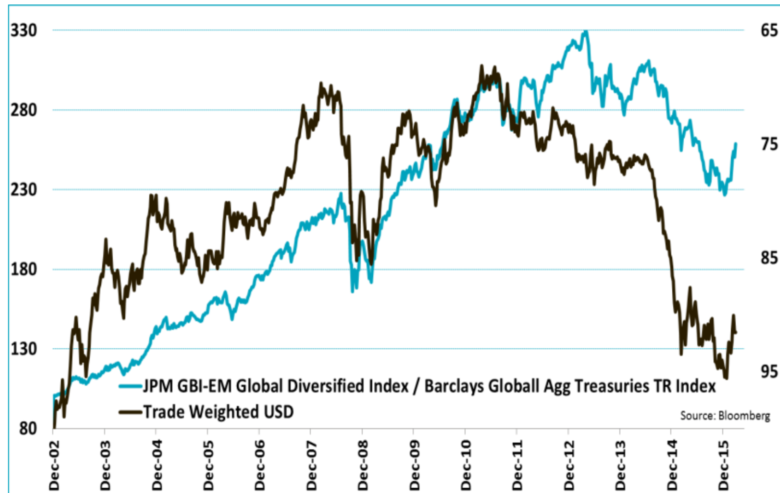
Emerging Market Debt (II)

South Africa – Yield to Maturity



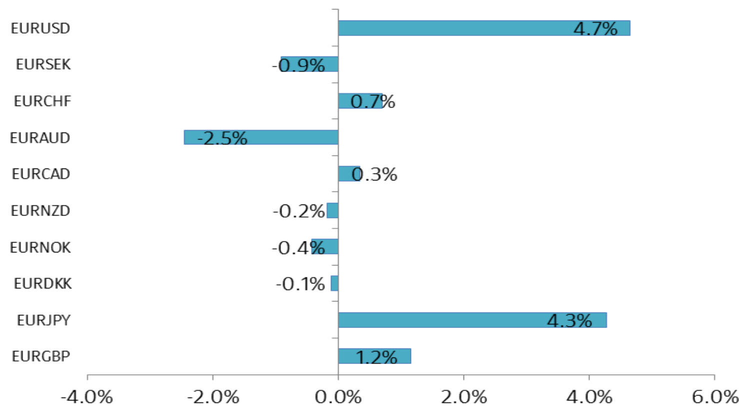
Yield EMD vs High Yield

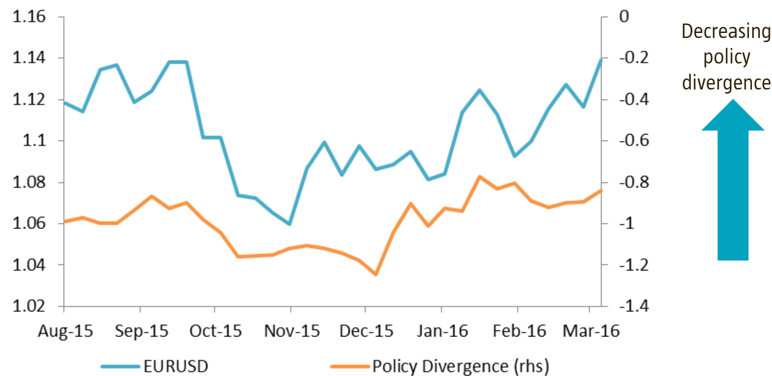
- Second, although we do think some commodities have bottomed, the upside may be limited as well. Oil is down 13% from its 22 March peak and prices of other commodities have come down too. OPEC is moving, but has, so far, refrained from implementing an actual output cut. Companies have delayed or cancelled future commodity capacity investment on a massive scale, but it could take a while for these decisions to filter through into the balance between supply and demand. The future certainly looks brighter, but high volatility means things could go in both directions from here.

- China's currency remains a risk. It showed a willingness to depreciate its currency at the beginning of the year, and pressure could remain as the economy tries to regain traction. In the event that China opts to weaken its currency again this would we bad news for EM FX.

- So, while we like the yield on EMD, especially against the almost zero-yielding European government bonds, we prefer high yield. EM FX risk, high volatility and China event risk make EMD less attractive, while the risk for high yield (energy and defaults) is more transparent at this point.

FX (I)





Source: Bloomberg

- Within the G-10, the Australian dollar was the clear winner in March. Most commodity currencies performed quite well. In line with cyclical assets such as emerging markets assets (equity and bonds), high yield and stocks, commodity currencies benefited massively from the better risk environment of the last period as deflation fears slowly started to dissipate.

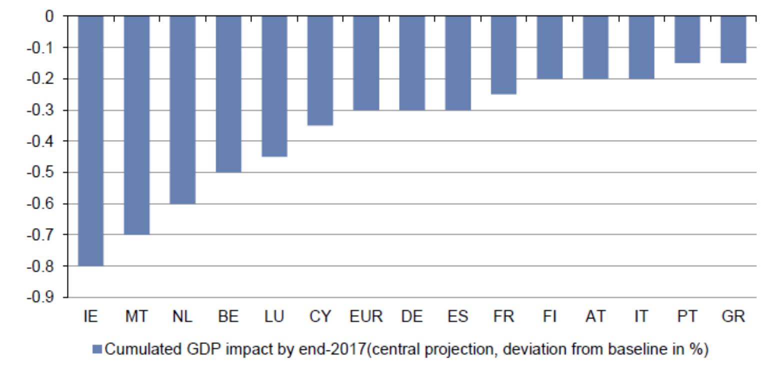
- Among the major currencies, the euro was the strongest, with both the yen and US dollar contending for the weakest spot within G-10. Given that the ECB was the only central bank that actually committed itself to further easing in March, the recent strength of the euro is a bit odd. The assumption that the central bank that 'out-eases' the others ends up with the weakest currency doesn't seem to apply anymore.

- The easy thing would be to simply conclude that this is just another sign of central bankers running out of ammunition. Although we do not think central banks will ever really run out of ammunition (not as long as there is no hyperinflation that is), this does not mean that the markets can't disagree with us at times. What is also surprising is the limited impact that the Brexit debate seems to have on the euro.

FX (II)

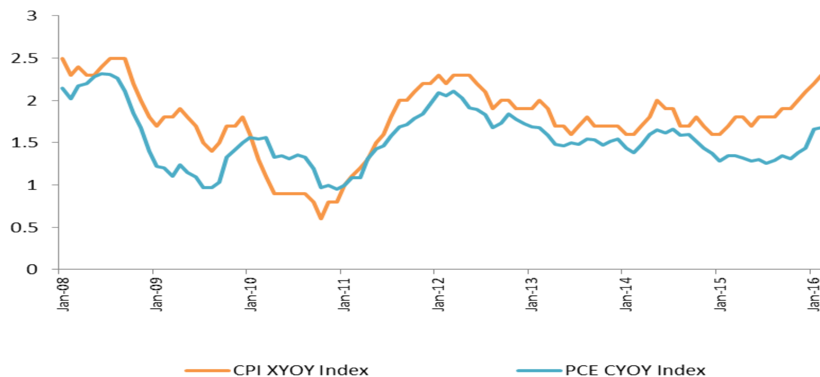
Brexit comes at cost for Euopes

The cost of Brexit for Europe (cumulative impact on GDP by end-2017)



Source: ING estimates

Inflation continues to grind higher in the US



Source: Bloomberg

- It is clear that Brexit is negative for the pound sterling, but it would also have a negative affect on the Eurozone: not just economically, but also politically. A clear 'out' vote would bring the whole Eurozone break-up debate back into the spotlight.

- So why is the euro so strong? Well, while it takes two to tango only one can lead. The one leading is the US or more specifically the Fed. What we are witnessing is a U-turn by the Fed. While the Fed was bold enough to hike in December, it has since become incredibly dovish. The awkward thing is that this is happening at a time when US data seems to be picking up. Not only is the manufacturing PMI back above the 50 threshold but inflation is also steadily picking up (for both goods and services). The Fed has definitely raised the bar for moving policy back to a more neutral stance.

- With this new asymmetric policy reaction function, the dollar will struggle to strengthen. We continue to believe that the US economy is strong and that this will ultimately be reflected in the monetary policy. So, policy divergence is not dead but is just taking a breather. For now we maintain a neutral stance on the US dollar, but still look to set up a long position.

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