Robeco Investment Outlook 2019

Turbulence ahead

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Summary

2019 – a year with two faces

	Relative attractiveness	Expected change during the year
Developed market equities	+	↓
Emerging market equities	=	↑
High yield bonds	-	=
Local currency emerging market debt	=	↑
Credits	=	↓
Government bonds	-	=

Symbols show the relative attractiveness of the different asset classes within a balanced portfolio

- Bull market in equities continues, sustained by solid earnings growth while monetary policy is not outright restrictive.
- Probability of US overheating increases while sentiment could turn if recession worries flare up in the second half of 2019.
- Emerging markets are set for a rebound against developed markets given a widening economic growth differential, sizeable valuation discount and fading dollar strength. However, lingering protectionism will prevent a full unlocking of the value of EM.
- Outlook for credits & high yield lacklustre; late in the credit cycle, exceptionally low covenant quality, low spread buffers to mitigate shocks, central bank policy normalization.
- It will be hard to earn decent returns in (European) sovereign bond markets given the expected normalization of artificially low yields.

Turbulence ahead
Macro outlook 2019

US: firing on all cylinders

- Strong performance US economy
- More (funded) fiscal stimulus likely
- ‘High pressure’ economy
- Recession risk in 2019 remains modest

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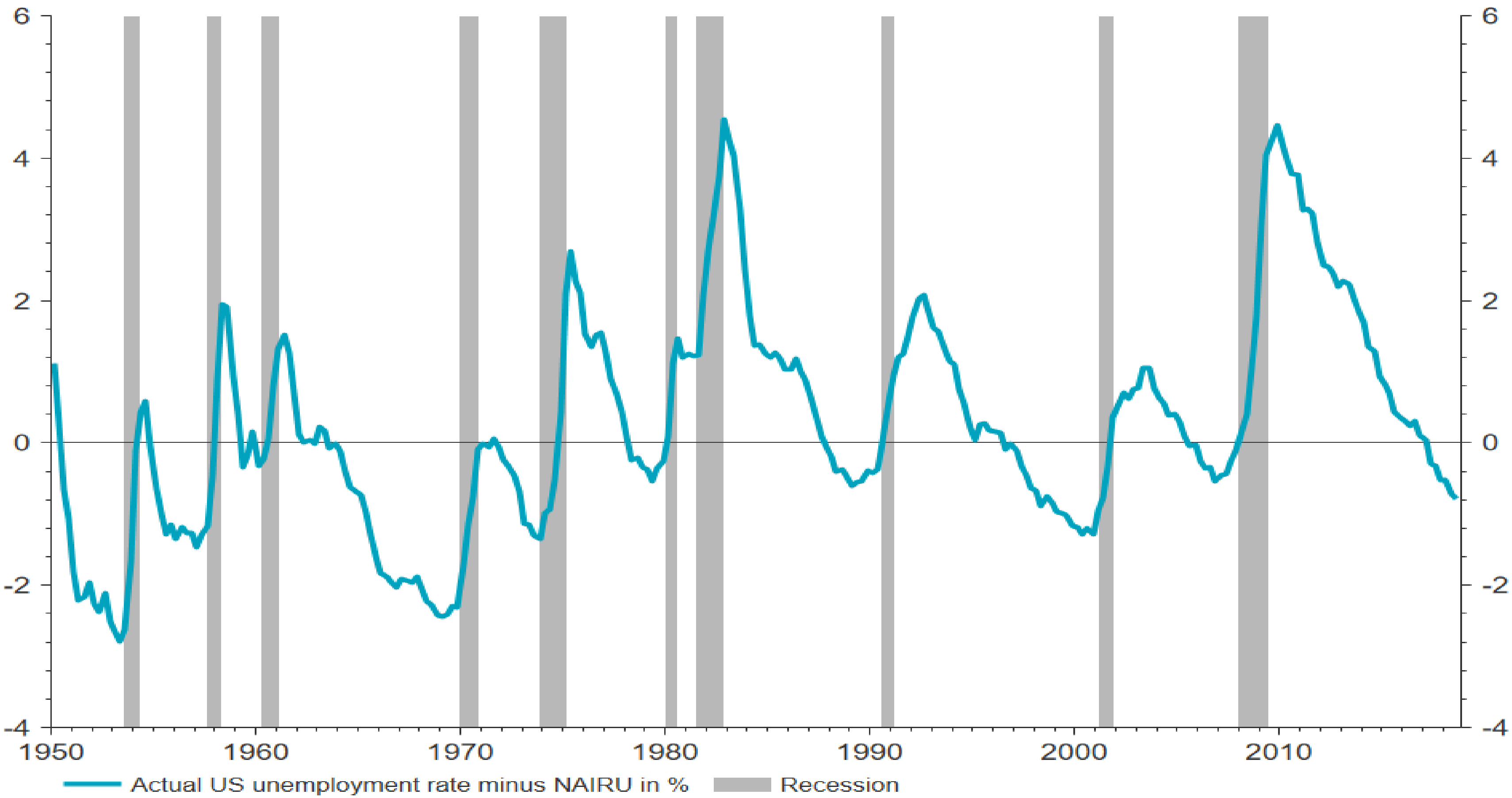
US: unemployment below natural rate of unemployment



Source: Thomson Reuters Datastream, Robeco

- Tight labor market
- Could experience even further tightening (see 1967/68)
- Wage inflation picks up if unemployment drops below NAIRU (Phillips curve steepens)

US: TINA? Alternative in the making?

Source: Thomson Reuters Datastream

- Equities perceived to be the only way forward to achieve decent absolute return
- With rising yields on Treasuries an alternative is emerging

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China: depreciation yuan response to US tariffs

- Policymakers vigilant, prevent capital flight
- Broad policy stimulus to counteract negative trade impact
- Trade conflict will not be fully resolved, major escalation unlikely as it is counterproductive

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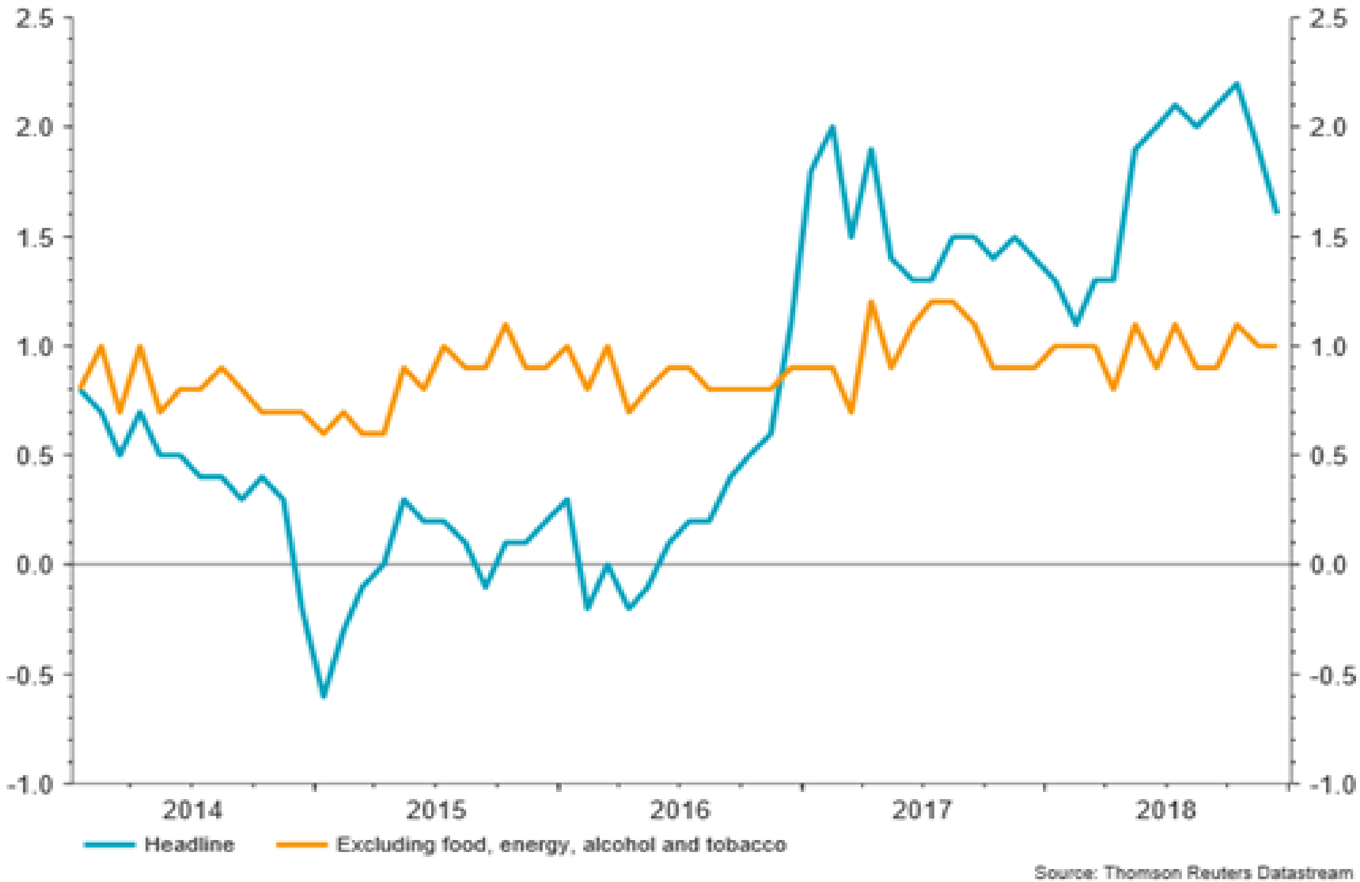
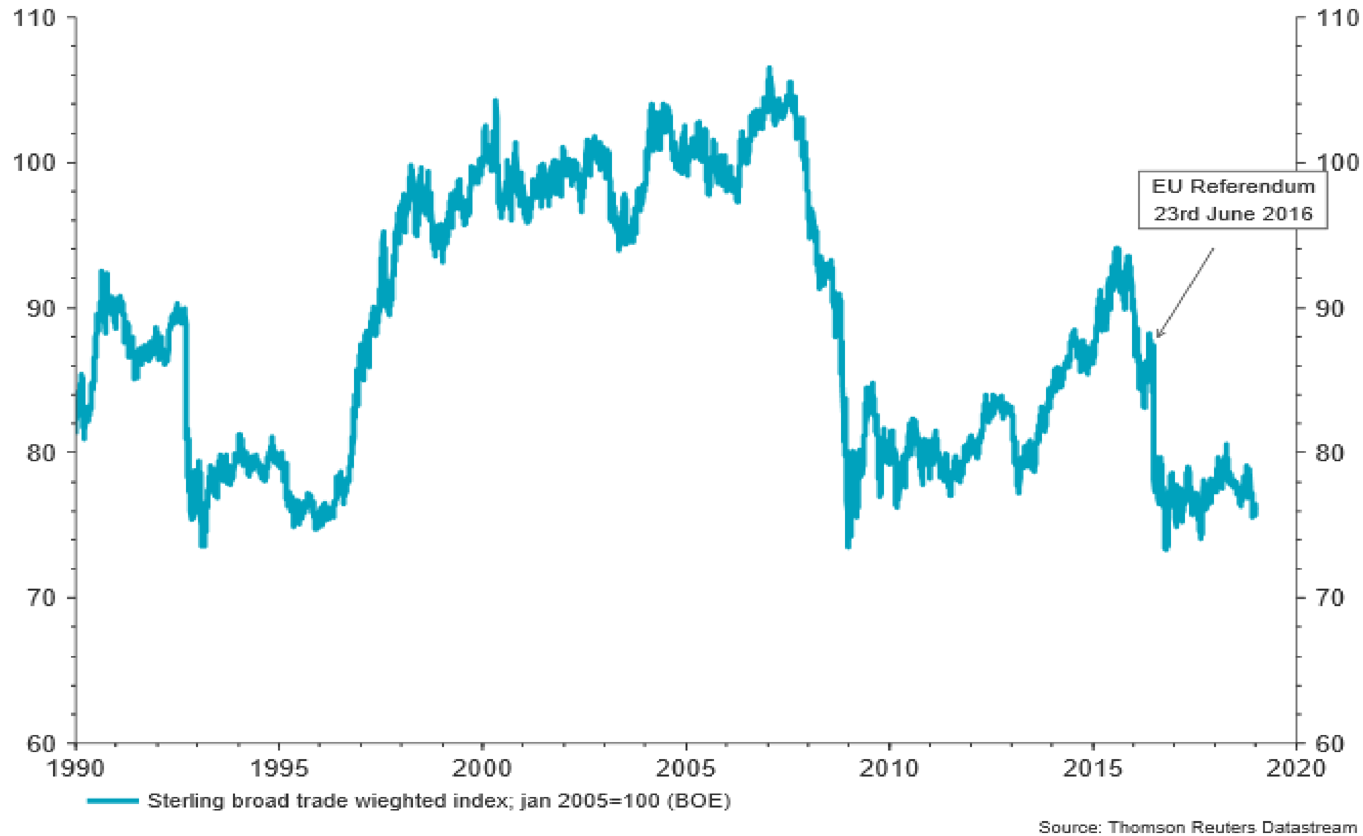
Eurozone: the end of the Draghi era



- Core inflation still subdued but expected to rise gradually; ECB's forward guidance remains unchanged for now
- Tough call for Draghi to raise policy rates before his term ends
- ECB only European institution with a common majority vote

Europe: Brexit pain



- GBP trading sideways
- ‘No deal Brexit’ would be huge GBP sell signal
- Base case is a transitional deal with no material change afterwards (BRINO)
- BoE ahead of ECB in tightening cycle

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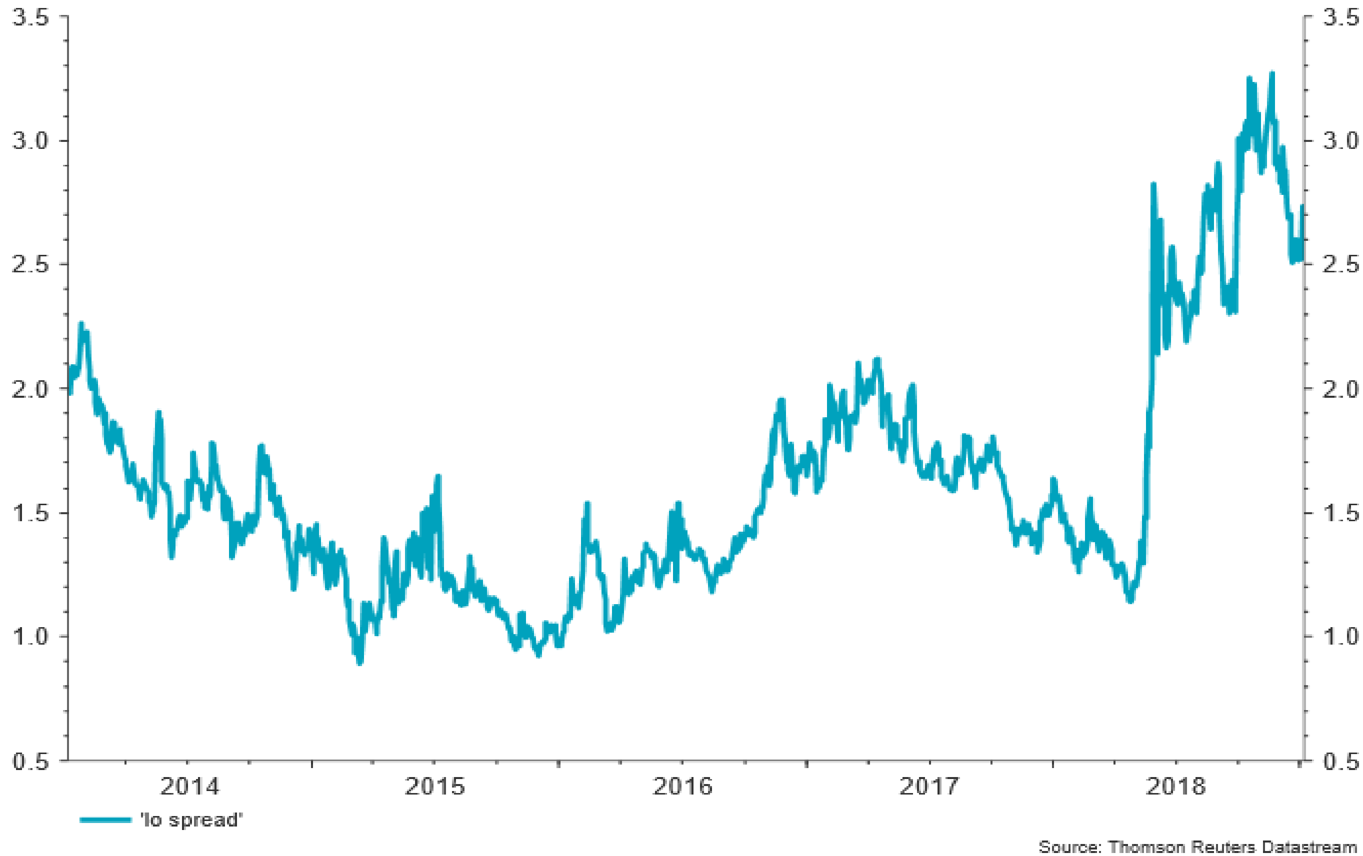
Europe: Italian budget pain



- Pressure on Italian bond market (and indirectly on Italian banks)
- More capital to Italian banks?
- Capitulation likely, timing uncertain
- European banks attractive again

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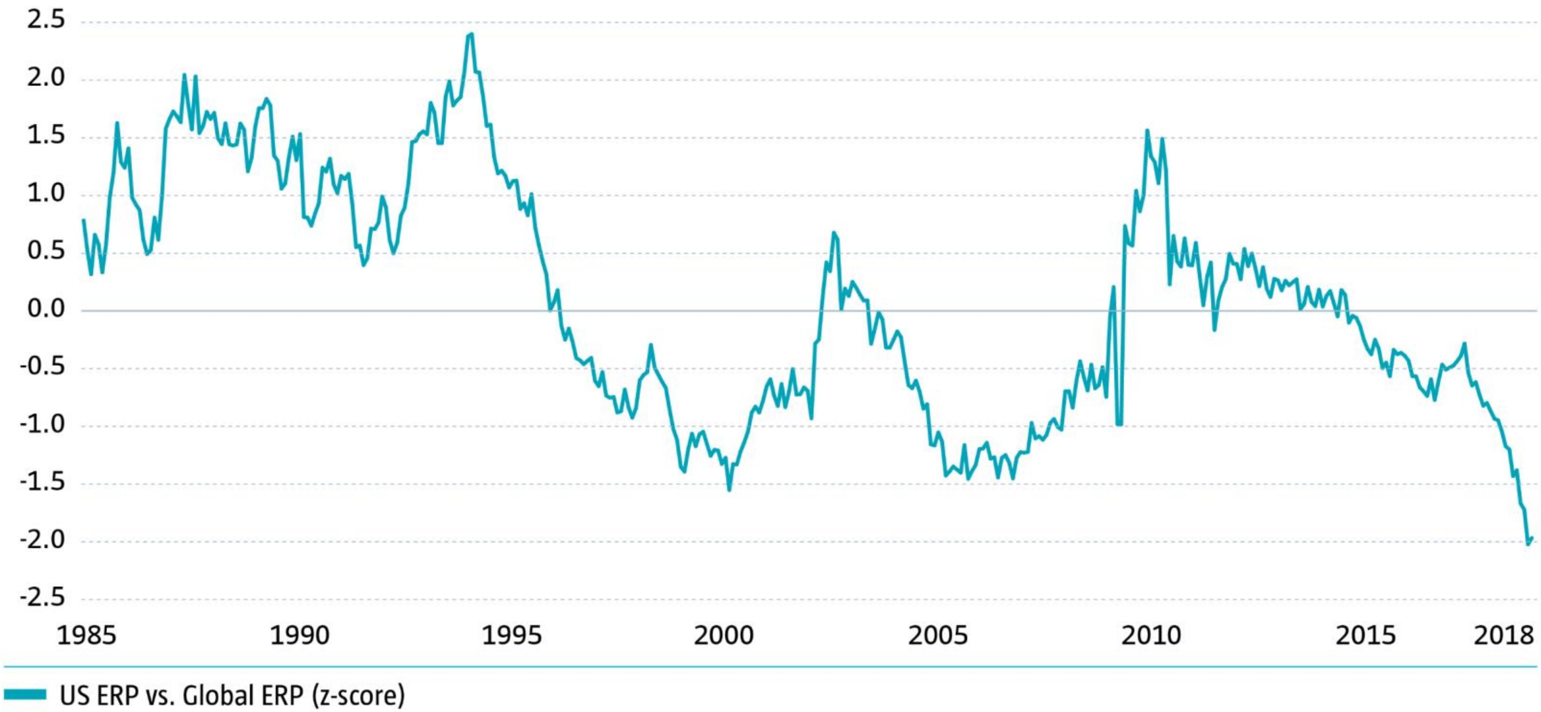
Turbulence ahead
Investment themes 2019

US: risks priced out versus RoW

Relative ERP US versus RoW

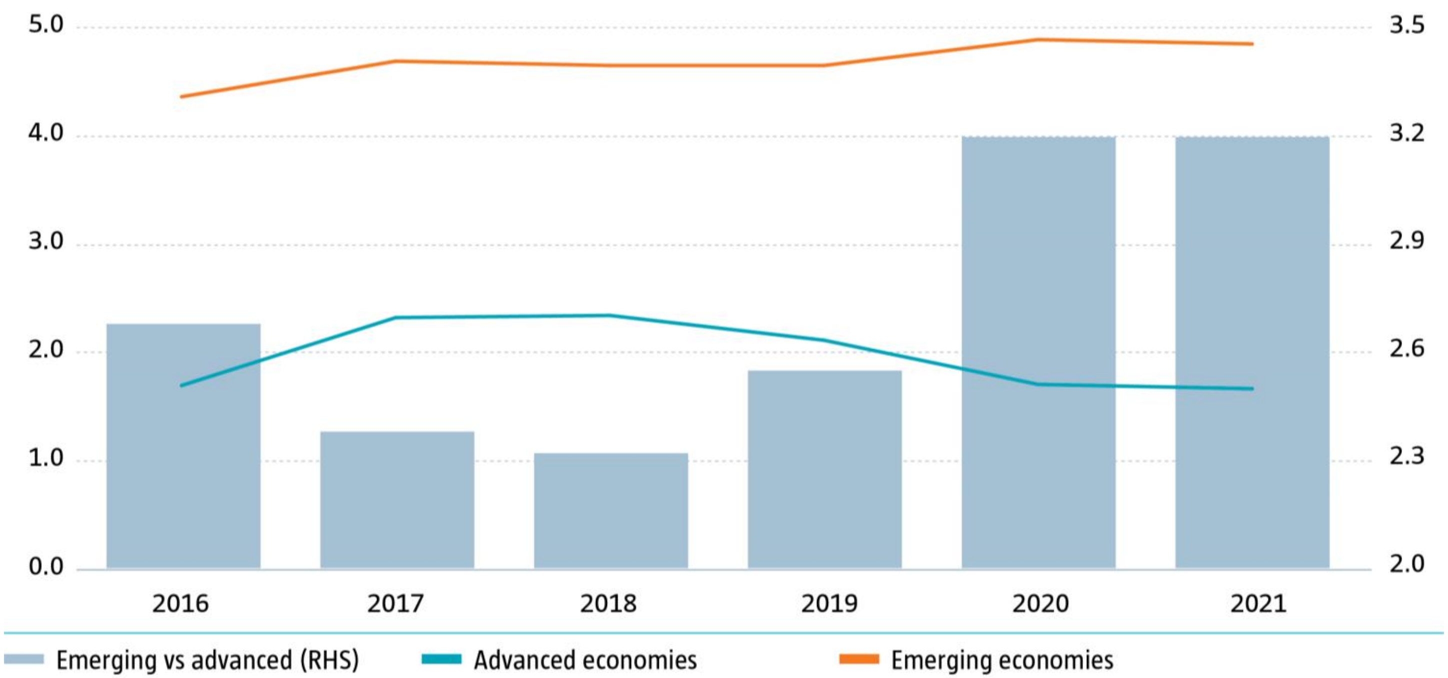


Source: Thomson Reuters Datastream, Robeco

- Low (macro) volatility and belief in a "Trump put" has led to decline in US risk premia.
- Never in the past 33 years have demand risk premia in US been so low compared to RoW, little buffer for shocks.
- Result; a traditionally defensive market has become more risky.

Emerging opportunities

Widening growth gap EM versus DM



Source: IMF & Robeco

- After three years of deceleration, EM-DM growth gap set to widen again.
- Fed will continue hiking, but in measured pace, end of dollar bull market approaching.
- Significant discount on P/E, P/B valuation metrics
- As protectionism lingers, not all value recently created in EM will be unlocked however

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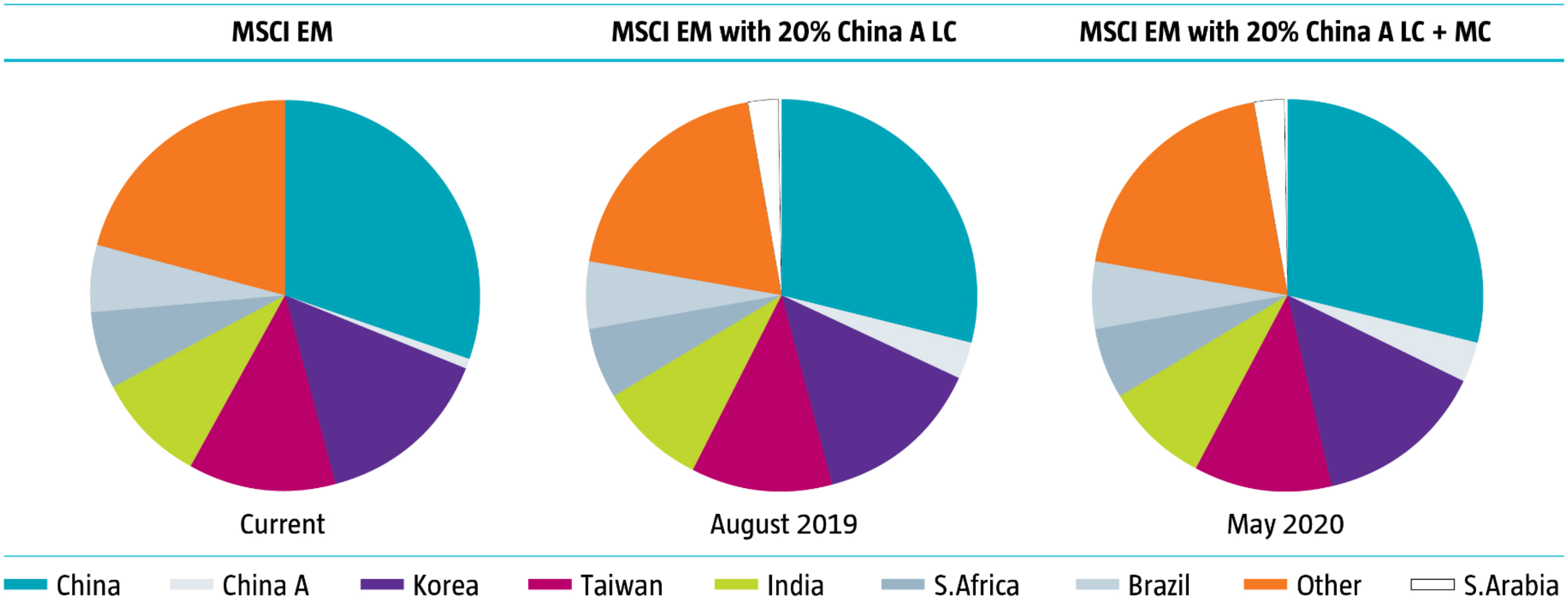
A-shares

Country exposure MSCI EM Index



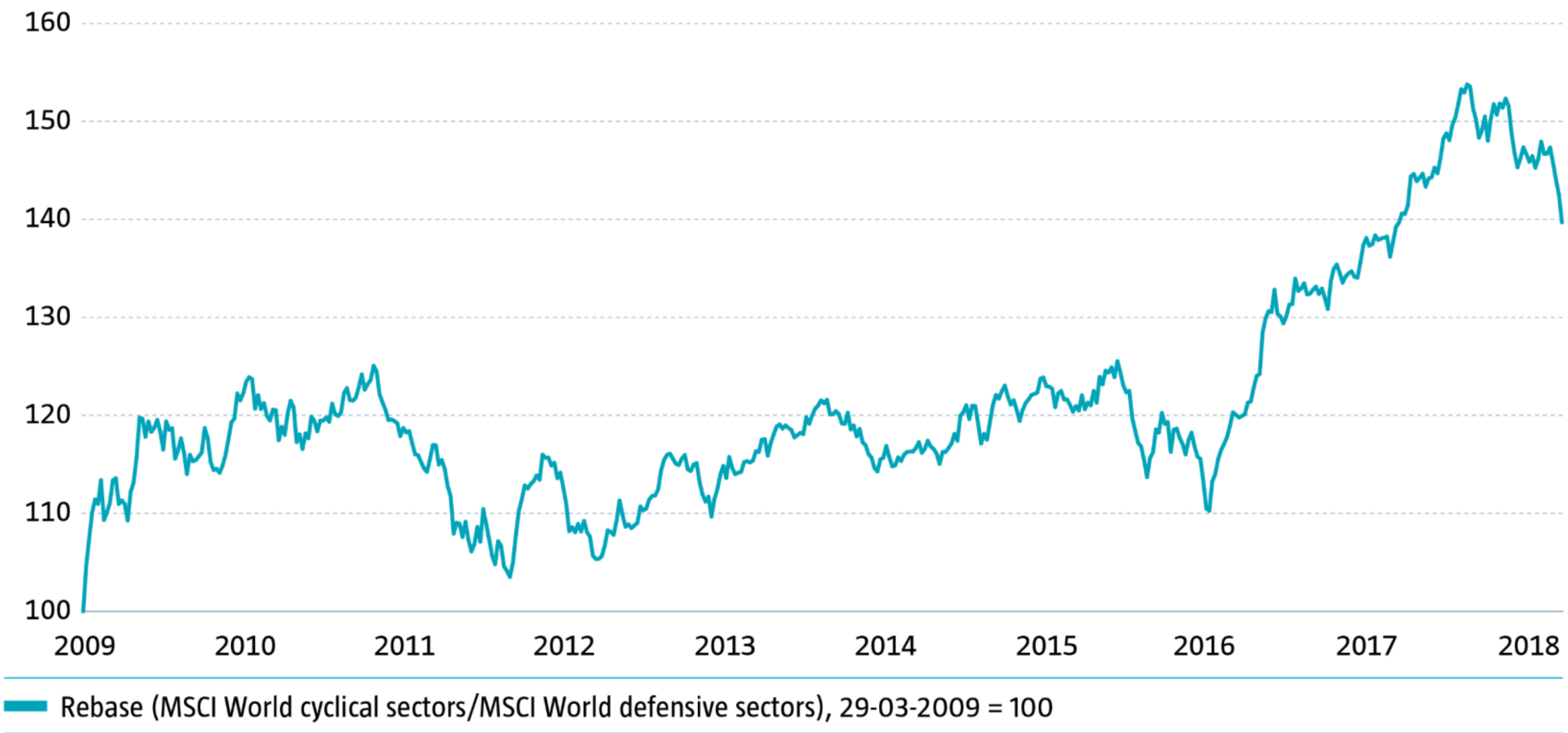
Source: MSCI, Robeco

Note: LC = Large Caps, MC = Mid-Caps

- FTSE en MSCI gradually include A-shares in indices, triggering foreign capital inflows to China
- Offers opportunities to exploit ongoing transition to domestically driven growth model China
- Targeted policy stimulus, profitability improves, valuations have become more attractive

Time to go defensive?

Cyclical stocks outperformer in this post GFC bull market

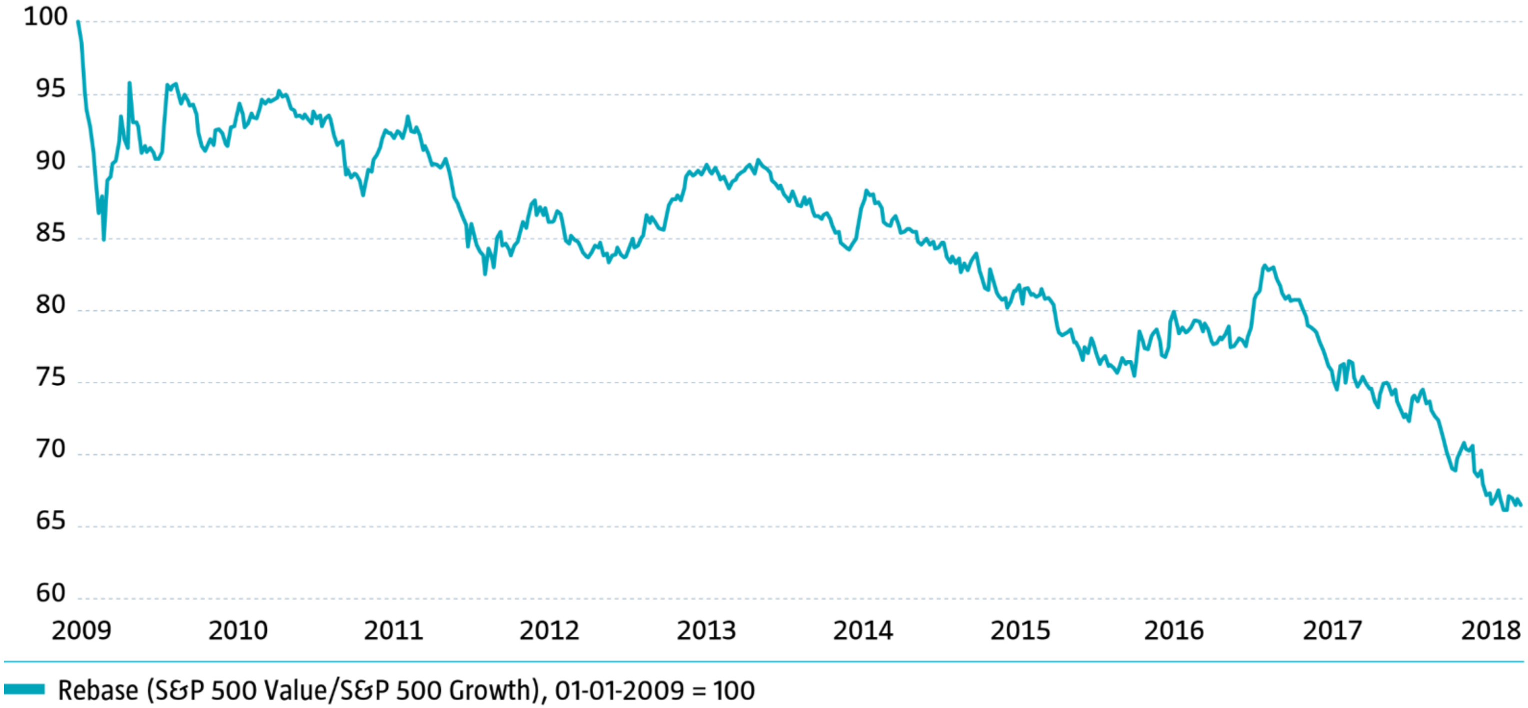


Source: Thomson Reuters Datastream, Robeco

- As the cycle matures, the hurdle for cyclical stocks to outperform increases
- Rising interest rates imply higher discount rates for future cashflows, impacting higher duration equities like cyclicals
- Defensive stocks (low volatility, quality, high dividend) have room to catch-up in 2019.

The return of value?

Value v Growth Index

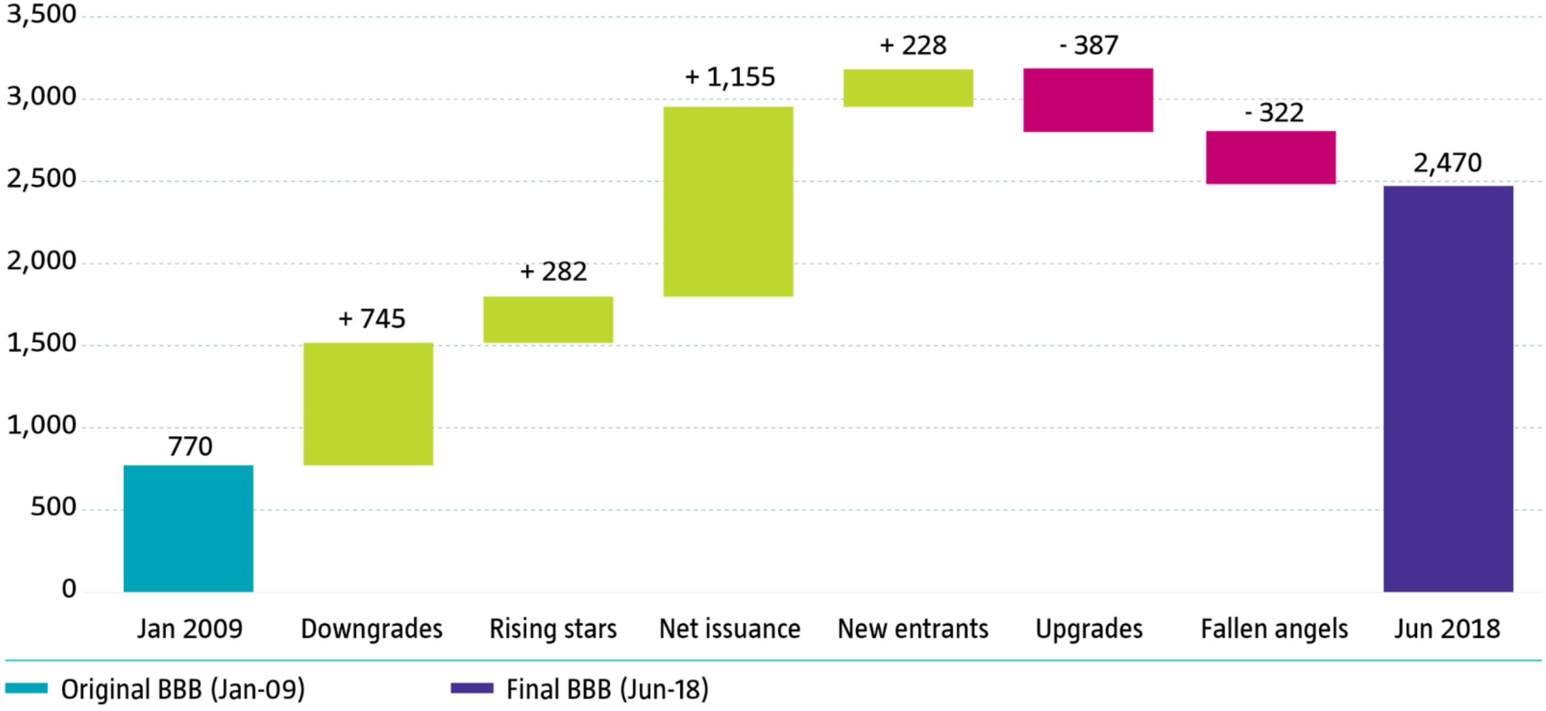


Source: Thomson Reuters Datastream, Robeco

- Like our defensive theme, value stocks tend to rebound in a late phase of economic expansion
- Valuation compared to growth stocks is attractive
- ‘Stocks with ’boring’ business models require more patience to pay off (at the same time a risk)

Credits & High Yield

Evolution of the BBB-segment investment grade credits

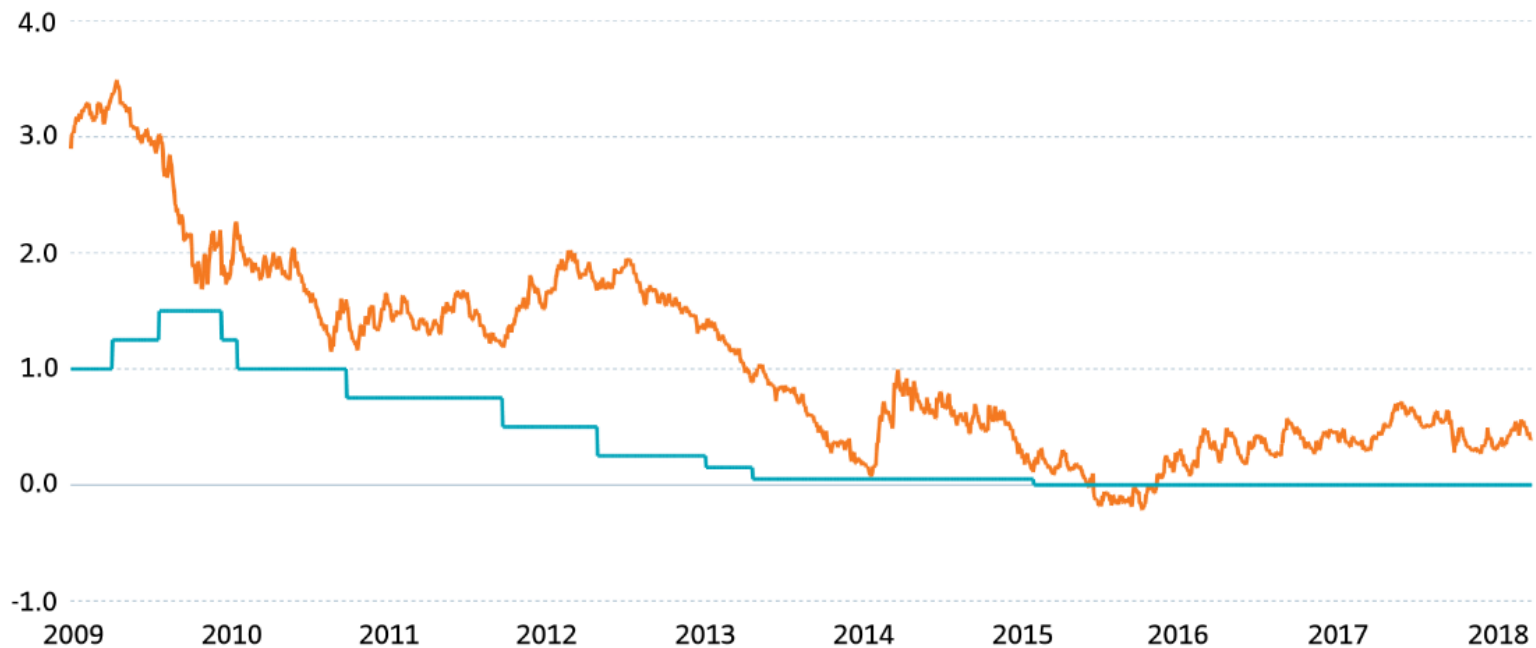


Source: Morgan Stanley

- Average rating of credits has declined in past 10 years, asset class more sensitive to negative shocks
- Yields and spreads in Europe very low, do not expect ECB policy normalization to be neutral factor for the asset class
- Prospects for HY lackluster given low starting yields, weak covenant quality and susceptibility to turn in earnings cycle and financial conditions

Policy normalization will hurt sovereign bonds

The only way is up



Source: Thomson Reuters Datastream, Robeco

- ECB (and other CB's) seize the opportunity of inflation returning to target, transitioning towards conventional rate setting policies
- Centrale banks have distorted fixed income markets, reducing their presence in these market will increase yields
- Sovereign bonds have a skewed 'risk-reward' distribution. A lot has to go wrong in markets to generate decent sovereign bond returns in 2019.

Questions about the Outlook?

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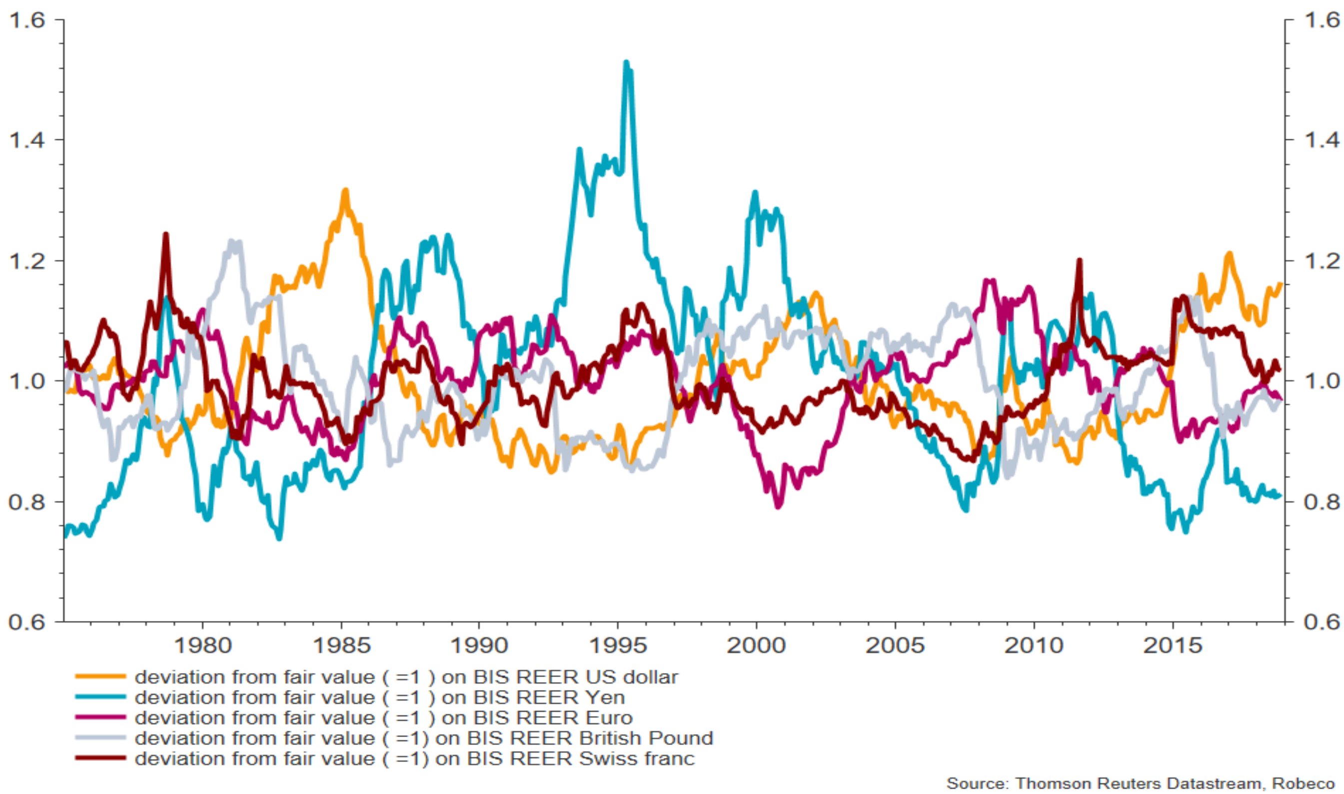
Dollar overvalued



- Dollar overvalued
- Markets starting to anticipate end of US tightening cycle will weaken US dollar
- Sterling will benefit from disappearing hard Brexit risk

Important Information