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The Investment Engineers

Euro area: a frozen economy

Fixed Income Outlook Q1 2015

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Summary

Main views and changes since last quarter

Main asset categories	Total	Valuation	Technicals	Fundamentals
German Bunds	0 ▲	–	+	+
US Treasuries	0 ▲	–	0	0
JGB's	–	–	+	-
IG Credits	0	0	+	0
High Yield	-	0	-	0
EMD local debt	-	+	0	-
EURO peripheral debt	+	+	+	0

Our key themes

- Interest rate exposure increased
  In recent months we increased the interest rate exposure of the portfolio via targeted purchases in the US, Australian and UK bond markets. These markets can be regarded as 'high yielders' in the advanced government bond markets. We can envisage that the Fed will postpone its first rate hike given the weak global economic backdrop and the lack of domestic wage pressure. For Australia we expect the RBA to resume cutting its official target rate from the current 'elevated' level of 2.5%. We also added exposure to long dated German bonds as we expect the search for yield will attract new buyers in this part of the curve.
- European peripheral debt has further to go
  We remain positive on peripheral bond markets. The coming elections in Greece will bring more uncertainty, but we regard contagion risk for other peripheral bonds as manageable. ECB sovereign Quantitative Easing (QE) is likely to be with us this quarter, which should be a positive. It is the only plausible route to shore up the ECB's balance sheet significantly. The devil will be in the details where it comes down to risk sharing between the Eurosystem and the private sector and between the central banks of the euro countries.
- Subordinate financial bonds our favorite pick within credits
  Within the credit universe we stick with our preference for subordinated bonds issued by financials. The sector is undergoing a structural change driven by regulation. It will make the industry less risky and better capitalized. Superior issuer selection should eliminate bail-in risk within this category.
- Anticipate further weakness for the euro and the Australian dollar versus the US dollar
  We expect that the coming balance sheet extension of the ECB will put further pressure on the euro. This is welcomed by the ECB as it would support exports and ease deflationary pressures somewhat. In Australia we expect the RBA to resume its easing path as the non-mining economy is struggling. Capital expenditures in the commodity sector are petering out and other sectors of the economy have become less competitive. A weaker Australian dollar could be a welcome impulse for the country's exporters.

In focus

Dispersion of global fixed income markets returns to continue

European fixed income markets were last year's clear winner. Peripheral government bond markets posted impressive returns. Former love babies like high yield and emerging debt lagged expectations. We expect dispersion between the different market segments to continue. Divergence in economic activity and monetary policies across the globe underpin this conviction. Dynamic cross asset class strategies are ideally suited to exploit these differences.

We have rebalanced between interest rate exposure and spread exposure . We have increased the fund's duration by adding exposure in the US, UK, Australia and Germany. We have lowered the credit spread exposure by scaling down our holdings in corporate credits. We have also increased our weight in European peripheral government bonds at the expense of corporate credits. Subordinated bonds issued by financials are our favorite pick in the credit universe. We remain light on exposure to emerging debt and regard corporate high yield as unattractive.

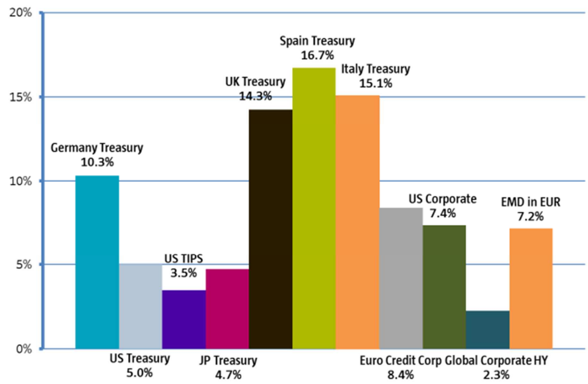
The large decline in energy prices will dampen global inflationary pressures. Chinese economic growth will slow further and aggregate demand in the euro area is not likely to recover. The Bank of Japan and the ECB will provide financial markets with ample liquidity this year. Appetite for liquid safe haven debt will remain high. 'Higher' yielding government bond markets can benefit from this trend. In the US we do not rule out that the Fed will postpone normalizing official policy rates given the weakish international economic backdrop. In Australia the RBA is expected to lower its target rate to broaden economic growth to sectors outside commodities.

Secular stagnation in the euro area not a bad thing for bonds

The euro area is again at the center stage. This economic heavyweight, which represents around a third of the global economy – is facing a fall-out of aggregate demand. Political events deserve investors' attention with early elections in Greece late January and later in the year general elections in Spain, Portugal and presidential elections in Italy.

Chances are high that the ECB will engage in government bond purchases. This seems the only viable option left to shore up the size of its balance sheet. The region is heading for a long period of very low or zero growth, hampered by disinflation and high savings. Poor demographics and deleveraging households, governments and banks are taking their toll on the economy. A frozen economy. For fixed income securities this isn't necessarily a bad thing. The bond market has traded already on this theme – the German yield curve is almost a copy of the yield curve in Japan by now. Euro area yields have more than halved in just one year. The German 5-year yield has dropped to zero. Permafrost discounted by markets. More ECB stimulus will support investment strategies that performed last year already: anticipate the German yield curve to flatten, peripheral markets to outperform and the euro to decline further.

2014 total return fixed income asset classes*



*Index returns as of 31 December 2014, hedged to euro except EMD
Source: Barclays, Robeco

Treasuries

Long-term inflation expectations are gapping lower, partly triggered by the energy price slump. Valuations look stretched, but technical and fundamental factors are still supportive and dominate market forces for now.

Valuation negative: japanification of European debt market is a fact

The graphs below highlight the speed at which German bond yields have converged to Japanese levels. Up to 5-year German bonds now trade below their Japanese counterparts and are in negative territory. Long-term US bond yields also look stretched. The US 30-year yield is trading at 2.60%, only 0.2% above its all time low. Valuation indicators are clearly not in favor of treasuries accros the advanced economies. But as we know, valuation indicators are bad at timing investment decisions. The technical and fundamental analysis are more supportive and for now clearly drive markets.

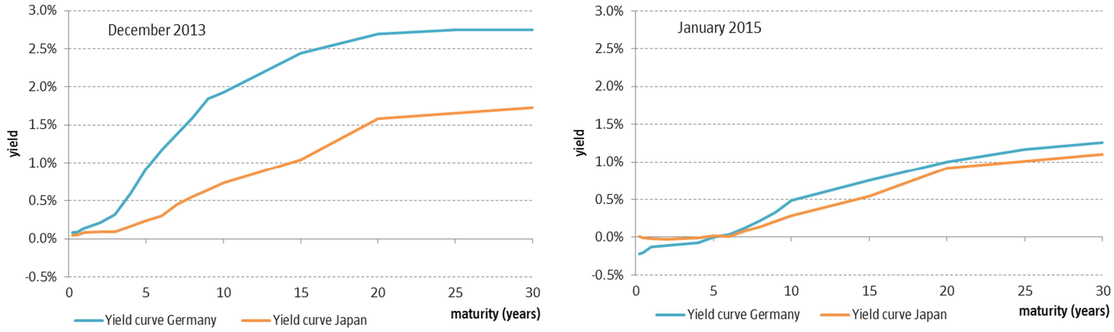
Technicals: global supply of liquid safe haven debt is becoming insufficient

Major central banks are front-running market needs for liquid safe haven debt, which increasingly leads to market distorsions and shortages. The Japanese government bond market is a clear example with the 10-year yield falling to a fresh low of 0.25%. But also take a look at the Swiss 10-year yield, now at 0.15%, making JGB and German Bund equivalents look like high yielders! Scarcity of high rated sovereign risk-free assets is also driven by the rating migration that occurred since the start of the crisis. Also the composition of fixed income issuance is changing - more spread product, fewer treasuries – which leads to further shortages. Perhaps an unexpected observation at times of high public debt loads.

Fundamentals: long-term inflation expectations drifting lower

Mr Market is smelling something. In recent months bond yields came down significantly in many parts of the world. Negative rates in the euro area, QE and near zero rates in the UK and zero rates and five years of QE in the US have given us…deflation in the euro zone and well-below mandate inflation in the US and the UK. Global deflationary pressures are a strong force to keep bond yields low for longer. Long-term inflation expectations are declining sharply, partly driven by the slump in energy prices. The Fed's five-year forward breakeven inflation rate fell from 2.5% to 1.8% over summer. Financial markets clearly question central banks' ability to turn things around.

The Japanification of the euro debt market



Source: Bloomberg, Robeco

Credits

Recent developments in the energy sector may be indicators of more volatility in different parts of the credits market. US Corporate credits already posted negative excess returns over US Treasuries in 2014.

Credit spread risk on the upside

The tumble in oil prices, in itself positive for the economy, raised concerns about the credibility of the energy sector and indirectly highlights the skewed risks inherent to credits. Even with a moderation of capital expenditures, currently at around 80% of EBITDA and even higher for high yield companies, debt restructurings within the oil related sectors are set to rise if oil prices stay at current levels. The significance of the energy sector in the US corporate credit market, making up around 10% of the Barclays US Corporate index (mostly BBB rated) and 15% of the high yield index, and the highly capital-intensive nature of this industry will contribute to market volatility and potentially broader based spread widening.

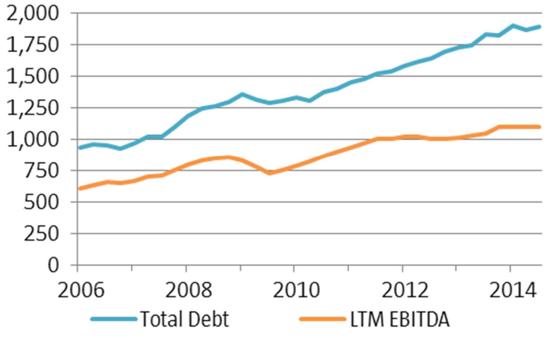
Flows a dominant factor for performance

The flow in credits continues to be a very dominant market force. In Europe, the European Central Bank is expected to announce further stimulus measures which will implicitly or even explicitly support corporate bonds. And while issuance in Europe and the US is expected to remain strong in the coming year net issuance is not expected to pick up substantially. Market liquidity remains a major concern; especially as the US Fed is moving closer to interest rate normalization. Also, while investment grade fund flows have been supportive over the last couple of years, the sensitivity to outflow was shown in the sudden spike in volatility in October last year. Moreover, a flurry of, for example, deeply subordinated bank debt issuance (AT1), needed to increase capital ratios, may take some time to be digested.

Industrials increase debt, bank fundamentals to improve

From a fundamental viewpoint the general storyline is still positive for credits. Apart from the oil-related and mining companies, credit fundamentals are supported by lower commodity costs. The outlook is not improving anymore though. The record issuance in 2014 contributed to higher corporate debt levels while corporate profitability was lagging. While low interest rates improved debt affordability as measured by the interest coverage, the leverage has passed its nadir. The emphasis on equity valuation is increasing with share buy-backs and increased Merger & Aquisition activity. European subordinated financial debt offers most value as credit metrics are improved by amongst others regulatory requirements. As an illustration, very recently Banco Santander, one of the largest financial institutions in Europe, announced a capital increase of as much as 7.5 billion euros.

Non-financial US corporate debt growth



Source: Deutsche Bank

Emerging debt

Despite the global downfall in yields in 2014 local emerging market bond yields have not followed. Fundamental weakness is one reason; declining appetite for investments in emerging markets is another. Despite attractive yield levels we prefer other fixed income categories.

Valuation is appealing, especially against other fixed income markets

Last year emerging *bond* returns have been modestly positive, except for Russia, but taking into account the currencies most of the *total* returns were in negative territory. This however has been mainly a USD phenomenon. When calculating returns in EUR, returns have been positive, but lagging other markets. Yield levels in most emerging debt markets have hardly fallen though. This should raise question marks as we had a year during which bond yields dropped significantly in developed markets. Volatility in the underlying emerging currencies is very high (twice that of bond volatility) and will remain high in our view. The running yield of EM hard currency debt currently equals 5% and for local emerging debt it equals more than 6%. This in itself looks appealing.

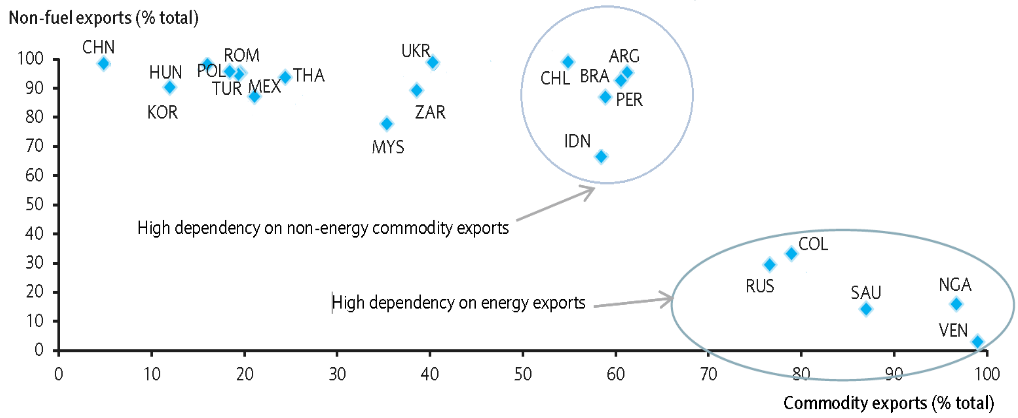
Technicals unlikely to turn positive

Fund flows into emerging markets were negative in 2014. Hard currency debt kept up pretty well, but by the end of the year also this asset class experienced outflows. Eventual US monetary tightening (in 2015 or 2016) will not be a positive. A number of key emerging market countries are at risk of losing their investment grade status, i.e.: Russia, Brazil, South Africa, and Turkey. This could provoke additional selling pressure for specific countries.

Fundamentals are not very strong

In the previous quarters many factors were negative for emerging markets: Fed tapering and potential Fed tightening, deteriorating current account and budget deficits (fragile five), postponement of necessary reforms due to elections in many emerging markets and potential downgrades. Most of these issues are still a reason for concern, but the issue of low and declining commodity prices currently draws most attention. Many emerging economies have strongly benefited from the emerging market boom from 2000-2012(BRICs). With the current drop in oil, silver, soybean, coal or sugar prices, countries that leverage on these commodities suffer. And will suffer going forward as it is not likely that these prices will rise at short notice. Some emerging economies are commodity importers like Turkey, Thailand and Korea and should benefit. But all in all we assess the drop in commodity prices as a negative for the asset class.

EM universe shows large divide between commodity exporters and importers



Source: Barclays, Robeco

Rorento's positioning

In our global total return fixed income fund Rorento we have translated our main views into the following positions*:

- Duration: The portfolio's duration equals 6.2 years. The interest rate exposure is concentrated in USD and EUR securities. For German bonds we prefer the long end of the yield curve. We also built up a position in the Australian bond market.
- Credits: The fund has a preference for European subordinate financial bonds. The overall exposure to this credit market segment is 12%.
- EMD: Allocation to local currency emerging debt is kept low.
- Euro peripheral government debt: The overall exposure to peripheral government debt equals 26% of the portfolio divided over Spain, Italy, Ireland and Portugal. For the latter market, the exposure is concentrated in 3-year bonds. For the other countries, the focus is on 5-10 year bonds.
- FX: We anticipate further US dollar strength versus both the euro and the Australian dollar.

*Positions as of January 2015