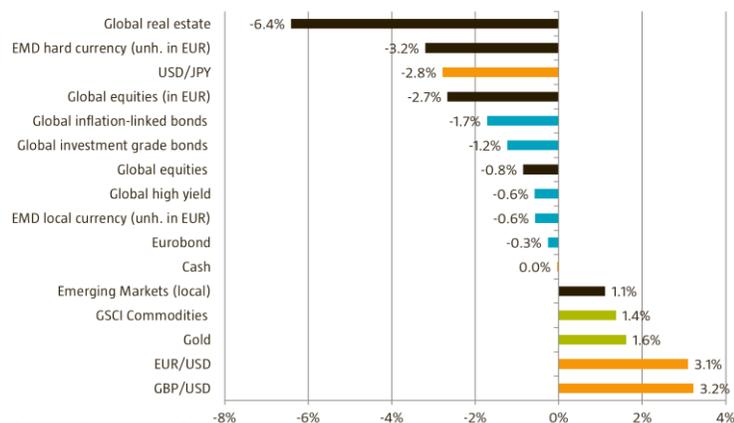


## Multi-asset markets outlook

For professional users  
February 2018

## General overview

### A correction at last



Source: Bloomberg, Robeco

### May the force be with us!

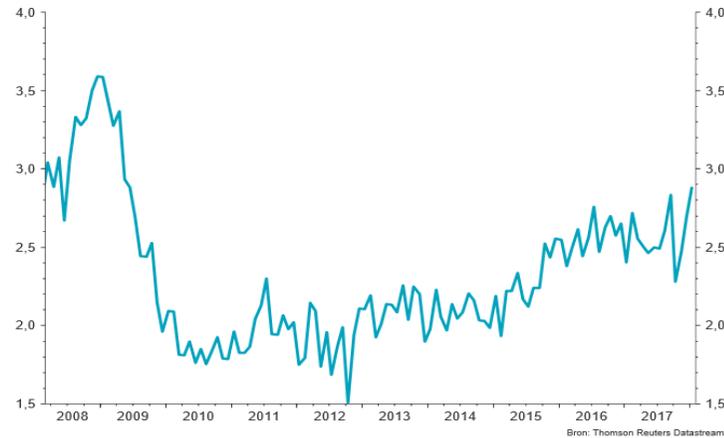
	Portfolio	BM	active	previous
Equities Developed Markets	25.0%	25.0%		6.0%
Equities Emerging Markets	5.0%	5.0%		
Real Estate Equities	5.0%	5.0%		
Commodities	5.0%	5.0%		
Core Gov Bonds 1-10	16.0%	20.0%	-4.0%	-8.0%
Core Gov Bonds 10+	6.90%	7.5%	-0.6%	0.0%
Investment Grade Corp Bonds	20.0%	20.0%	0.0%	0.0%
High Yield Corp Bonds	1.0%	5.0%	-4.0%	-2.0%
Emerging Market Bonds LC	9.0%	5.0%	4.0%	4.0%
Cash	7.10%	2.5%	4.6%	0.0%
EUR/USD	2.0%	0.0%	2.0%	-3.0%
EUR/JPY	0.0%	0.0%		3.0%
EUR/GBP	0.0%	0.0%		
EUR CASH	-2.0%	0.0%	-2.0%	0.0%

- Be careful what you wish for – that seems to be the theme of the year so far. It certainly applies to our own outlook, as our preferred outcome for 2018 was one of higher bond yields and more volatility in stock markets. We got what we wanted in the first five weeks of trading already: bond yield rose by between 30 to 50 basis points in January, while the 4.6% one-day correction in the US markets can certainly be qualified as being more volatile than anything that we saw in 2017. A rude, but necessary wake-up call is probably the best way to describe it. In the weeks ahead of the correction we had been lowering our overweight position in equities, so we cannot say it came as a complete surprise. We do not see it as a foreboding of the end of the rally, nor a sign that we are heading for a recession – nothing major like that. The world economy is humming along, and yes, wage pressures may be building up, but not to a threatening level just yet. Having said that, these kinds of wake-up calls tend to ‘stick’ with the market, as it changes the risk-awareness in the market.

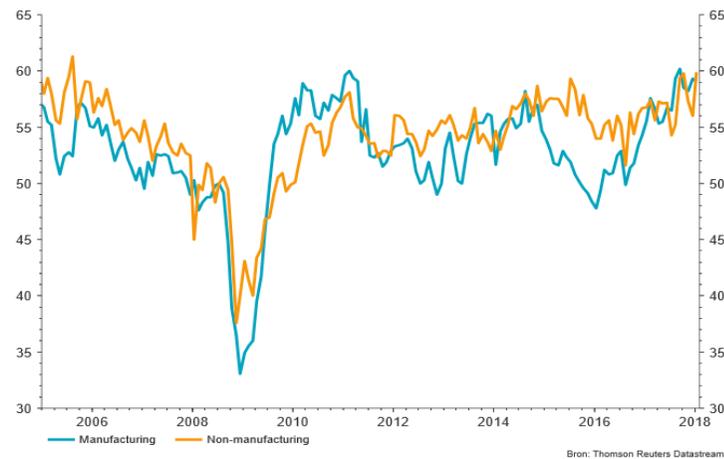
- Looking at the portfolio, we made a number of changes during the month. We lowered our overweight to equities to neutral. Keep in mind that the main reason for our overweight position was the momentum that was there at the time, and there is no denying that this argument has now taken a dent. We want to see this correction fully work through the market before re-entering it. We also de-risked by further increasing our short in high yield bonds, and kept our overweight in emerging market debt in place. Finally, we closed our short dollar-yen position and replaced it with a short dollar position versus the euro.

> United States

Average hourly earnings reaching a 12-year high



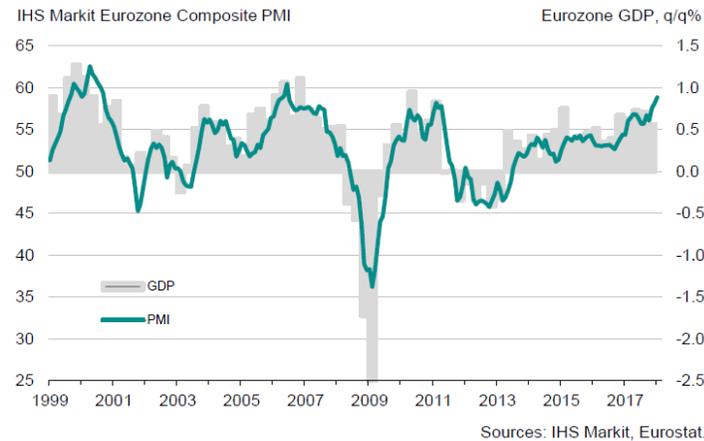
Very strong ISMs for manufacturing and non-manufacturing



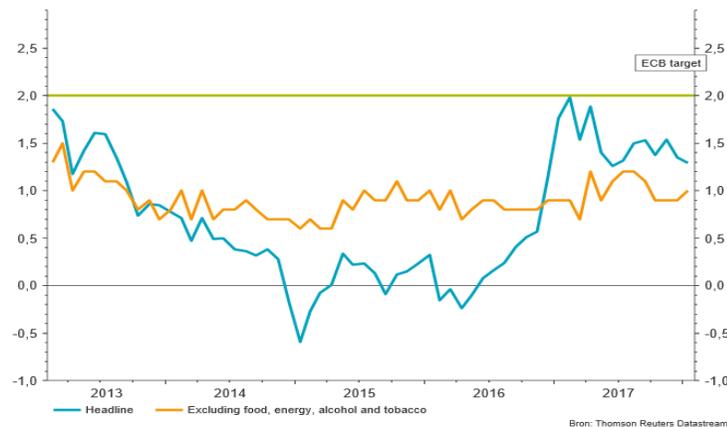
- > The US economy made a great start to 2018, with jobs growth exceeding expectations in January, as did wage growth, reaching 2.9% on a yearly basis. The ISM non-manufacturing index reached 59.9, while the manufacturing index was slightly lower compared to December, but still at 59.1, suggesting ongoing strong growth.
- > The new Fed chief Jerome Powell was sworn in on February 5. His views on future monetary policy will remain in the dark until the press conference after the FOMC meeting on March 20. We expect a 25 basis points rate hike, unless the current correction on equity markets gets out of hand, which we do not expect at this point. In March, the FOMC will present an update of its economic projections, while there are also the Humphrey-Hawkins hearings, for which no schedule is known yet. We consider a sudden hawkish stance unlikely as Powell is a pragmatic generalist, and with an eye on the mid-term elections will try his utmost to avoid displeasing Republican politicians including President Trump.
- > So far, the Fed has signaled that it plans three modest rate hikes this year. But higher wage growth – partly as a consequence of the massive corporate tax cut – and possibly increased infrastructure spending could increase the need for a more aggressive monetary policy. On the other hand, a severe equity crash could delay hikes. We expect the Fed in any case to prefer to err on the side of caution and to stay behind the curve.

## > Europe

### Eurozone business optimism continues to rise



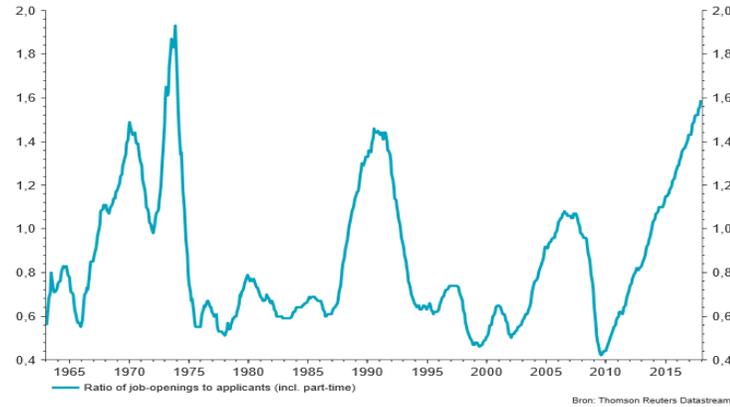
### Headline inflation is declining, but core inflation is picking up



- > At the start of 2018 the Eurozone economy continued its advance. According to Markit, output growth accelerated to a near 12-year high, underpinned by solid inflows of new business and accompanied by the strongest pace of job creation since late-2000.
- > Inflationary pressures are on the rise. Input costs and output charges both rose at their sharpest rates since mid-2011, with accelerations signaled in both the manufacturing and service sectors.
- > The strength of the recovery and rising inflationary pressures makes the current position of the ECB gradually untenable. It is therefore likely that ECB President Mario Draghi will change his rhetoric at the next monetary meeting of the Governing Council on March 8, probably calling for an end to QE in September, and possibly paving the way for a hike of the negative deposit rate in Q4 this year.
- > At the time of writing it is expected that the German CDU/CSU and the SPD will finalize a rather uninspiring coalition agreement. This has to be ratified by a majority of SPD members by March 4. It is far from certain that the SPD base will concur. If not, new elections seem inevitable. On the same date, general elections in Italy will be held, presumably resulting in a hung parliament. This will act as a barometer for the strength of populism in the Eurozone. Even Eurosceptic parties are no longer sure about giving up the euro, so the risk for the market is probably limited.

> Japan

Relentless rise in the job openings-to-applicants ratio



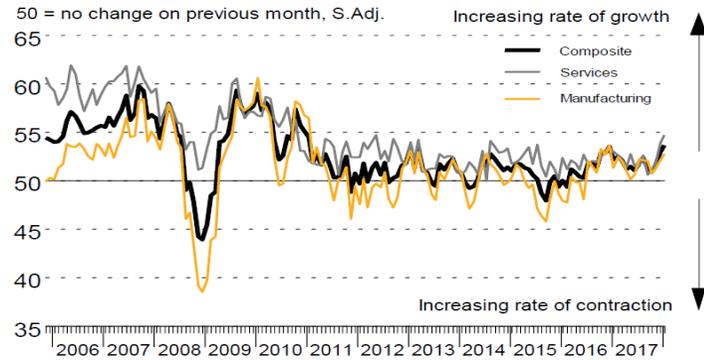
Japan's headline inflation is rising sharply, BoJ measure creeping up



- > The Japanese economy continues to expand, with the Japanese government raising its assessment of the economy in January for the first time in seven months. The government also raised its assessment of consumer spending for the first time since June after retail sales, household spending and new car sales gained momentum towards the end of 2017. Business investment is rising, exports are growing and the labor market is the tightest in decades, albeit partly as a consequence of a shrinking population. It is becoming tempting for Prime Minister Shinzo Abe to formally call 'the end to deflation', which would be a huge victory claim for 'Abenomics'.
- > The Bank of Japan's preferred measure of core CPI inflation (ex-fresh food and energy) has begun to creep upward, rising from a low of -0.1% in March last year to a still modest +0.3% in December. As another conventional core inflation yardstick has risen sharply over the last three months, a further rise in the BoJ measure is likely in the coming months. Moreover, wage negotiations in the Spring will probably contribute to higher inflation over the course of this year.
- > The bond market is reacting nervously to every sign of a possible shift in policy (like lower purchases of JGBs), testing the commitment of the BoJ to the 0.0% level of 10-year JGB's. The April policy meeting could be a convenient time to signal a modest rise in the target yield level in Q3 to 0.1% given the ongoing strength of the economy and rising inflation. The BoJ will probably consider it much too early to leave its policy of Yield Curve Control.

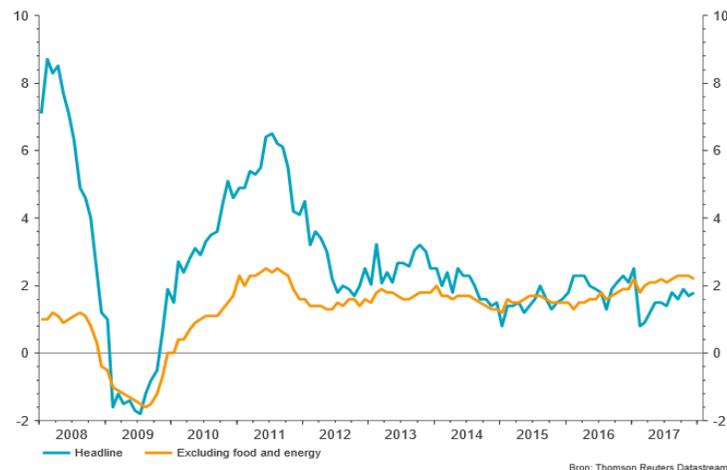
## > China

### Good start for the Chinese economy in 2018 according to Caixin/Markit



Sources: IHS Markit, Caixin

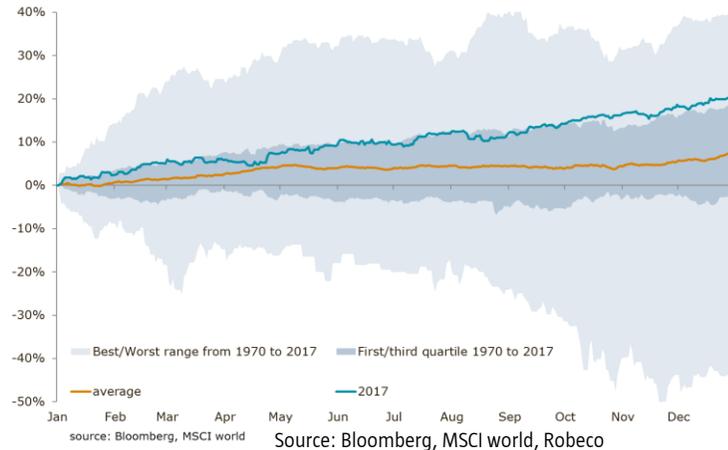
### Chinese inflation is well-behaved



- > The Caixin China Composite PMI (which covers both the manufacturing and the services sector) reached a seven-year high in January, signaling solid growth in the Chinese economy. It was the third month that this indicator has shown an upturn. New order growth particularly accelerated across the service sector.
- > In contrast, the official Chinese general manufacturing PMI figures for January showed a much less optimistic picture, with a dip from 51.6 to 51.3, an eight-month low. Output, new orders and imports all declined, reflecting a contraction in demand. Export orders fell the furthest, below the 50 average mark to 49.5, suggesting weaker foreign demand for Chinese goods.
- > At face value, the PMI figures looks more consistent with the Chinese government's tightening of financial and environmental regulations following the Communist Party's 19th Congress. On the other hand, the Caixin index differs from the official index around 40% of the time, and is considered to be a more accurate reflection of cyclical economic trends among leading analysts. On a positive note, overall inflationary pressures appear to remain low. The change in producer prices is showing a downward trend.
- > Predictably, China has launched an anti-dumping investigation into sorghum imports from the US, just weeks after the US government slapped its latest batch of tariffs on Chinese goods, spurring worries of a tit-for-tat trade war.

> Equities (I)

Another month, another new all-time high



It was not a sudden fear of rate hikes that triggered the sell-off

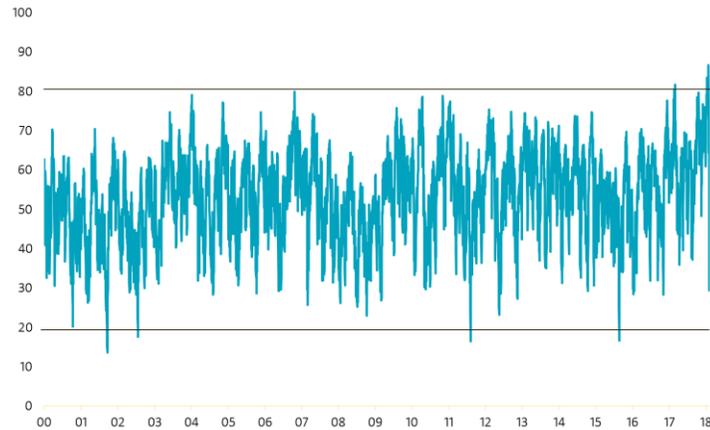


Source: Bloomberg, Robeco

- > Bond yields trending higher and volatility in risky assets returning; that was our preferred outcome, as we formulated it in our outlook for 2018. We had to wait just four weeks to get exactly that. Bond yields were on the up from the start of the year, while stocks started to show the first signs of strains at the end of January, culminating in the biggest ever one-day decline in the Dow Jones Industrial Average Index in the first week of February. This sounds a lot more ominous than it is though: the 1,175 points drop represents a 4.6% decline, barely enough to get it in the top 30 since the Second World War.
- > Numerous causes have been mentioned to explain the sell-off. These include the steady rise in (US) bond yields, rising concern about future US inflation on the back of higher wage growth in the latest payroll report, nervousness linked to the meltdown in the cryptocurrencies, and uncertainty about the new head of the Federal Reserve, as well as the highly extended and overbought nature of the US stock market. With the exception of the latter, neither of these arguments seem to be particularly compelling. Bond yields have risen, but can hardly be called threatening for stock markets at these levels. Rate hike expectations priced in the markets have drifted higher, but are still below the level indicated by the Fed's dot plot. No panic here. There has been panic in the cryptocurrencies of course, but that was long overdue given the bubble signals that accompanied last year's rally. Why this sell-off would have such a strong spillover in the stock markets is unclear to us. As for Jay Powell, we know little about him, but there is no reason to expect a radical change in Fed policy.

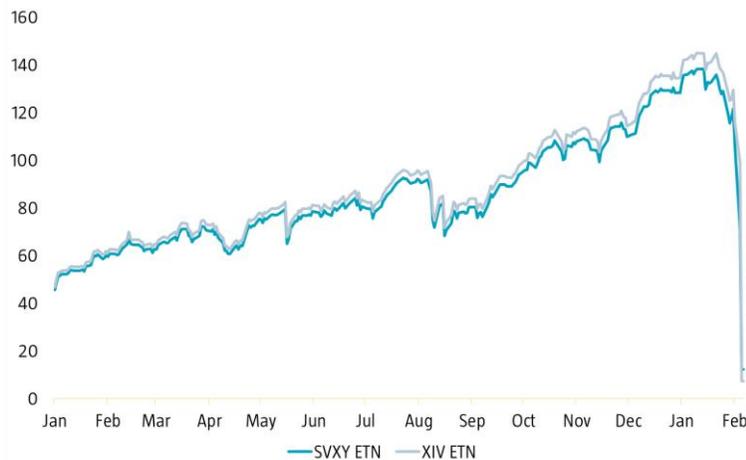
> Equities (II)

S&P 500 RSI was at its highest level for 18 years



Source: Bloomberg, Robeco

Now you have it, now you don't... \$ 2.5 billion market gap gone



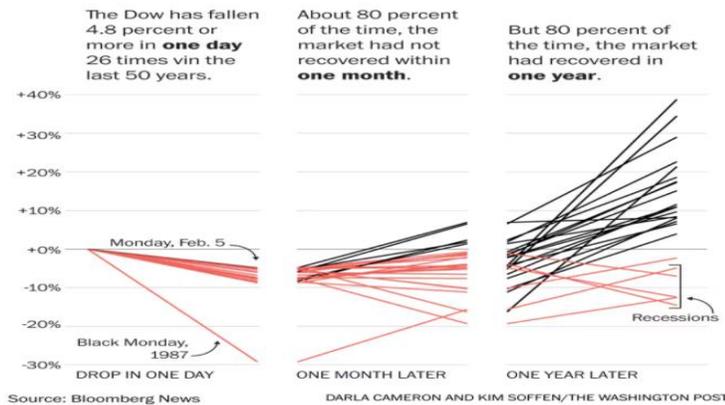
Source: Bloomberg, Robeco

- > So that narrows it down to the technicals of this market. Overbought, expensive and – due to the very low level of volatility seen recently – overleveraged. Looking at a technical indicator such as the Relative Strength Index (RSI), the S&P 500 was at the most overbought level of the current rally. In fact, you need to go back to 1961 to get to a market that was as overextended as this one. As such, a healthy correction was already on the cards, which was also the reason why we had been reducing our overweight equity position since the start of the year.
- > The real surprise is probably the ferocity of the correction. Again, technicals have played an important role here. Based on the extremely low trading volatility seen during the past 12 months, many market participants had increased their risk profile. The most obvious place to witness this was in the so-called short volatility traded funds – products that bet on volatility remaining low. The decline in share prices triggered a spike in the VIX, which led to technical covering of the VIX short positions (the demise of the XIV and SVXY exchange-traded notes), which thereby aggravated the selling pressures in the ordinary stock markets.
- > So what's next? Looking at the overall economic environment, there does not seem to be too much cause for concern. With the world economy still showing positive momentum, and with inflation still no big problem, the odds of this developing into a painful long drawn-out correction seem to be small. The fact that high yield bond or emerging market debt spreads hardly rose during the sell-off seems to >>

> Equities (III)

4% corrections are not normally recovered within a month

How long does it take the Dow to recover?



The US market has become expensive



Source: Shiller, Robeco

- > corroborate the idea that this sell-off is more technical than fundamental, and pretty much contained to the stock market. In itself, this bit of volatility is a blessing: we dubbed it as our preferred outcome for a reason after all. Low volatility breeds complacency and will ultimately lead to a much bigger correction further down the road. People should be aware of the risks involved with investing in stocks, and as such the sell-off has been a nice wake-up call.
- > Having said that, the experience with these kind of sharp sell-offs is that they normally should be treated with some caution in the short run. The short VIX positions may have been unwound, but the increased rise in recorded volatility is also going to have an impact on the positioning of the so-called risk-parity funds – those funds that reduce their risk when there is increased volatility in the market. And then there is the psychological effect of losing 4.6% in a single day; losing all the Trump tax plan signing gains in a single blow is something that leaves a mark on the willingness to simply buy any dip. The fact that US stocks are expensive does not help either. Based on historical data, in 80% of cases of a major single-day correction in US stocks, the losses were not completely recuperated within a month.
- > Given the technical nature of the sell-off, we prefer to stay on the sidelines for now to see how this shock is fully digested by the market. We have added to our cash position, as a clear indication that we expect this to be a temporary event.

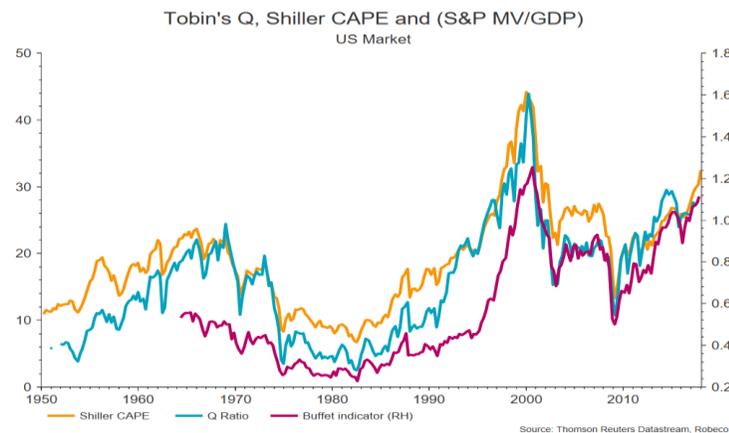
> **Developed Market Equities**

**Strong momentum was upheld in January**



Source: Thomson Reuters Datastream, Robeco

**The Shiller CAPE rises even further as earnings guidance improves**



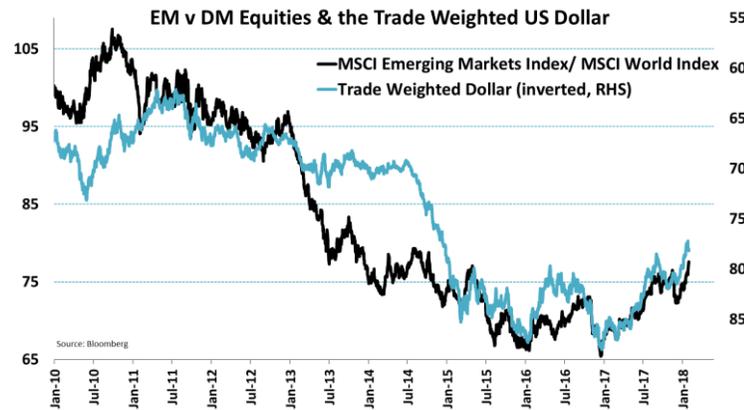
Source: Thomson Reuters Datastream, Robeco

Source: Thomson Reuters Datastream, Robeco

- > It was a solid start to the year for developed market equities as the ageing bull market marches on. The ranking on the basis of monthly momentum of equity returns in local currency showed the S&P 500 firmly in the lead with a gain of 5.6% over the month, outperforming Europe's return of 1.6% and Japan's 1.5% in local currency terms. A weak dollar, the approval of Trump's corporate tax cuts and confirmation of a continuing global cyclical upswing pushed US stock indices towards new records. Retail investors have returned to the US stock market, with investor sentiment running high. As a result of sustained positive momentum, technical indicators show the US equity market had entered overbought territory.
- > Looking ahead, the sell-off at the start of February and the recent narrative of rising capital market yields denting stock returns have weighed on equity momentum. With less return and more volatility likely to lie ahead, we are now neutral on developed equities. However, we expect global macro momentum to remain largely intact in the first half of 2018, likely underpinning further upward earnings revisions in developed markets. Earnings growth in Q4 has so far proved to be in double digits for the US, Eurozone and Japan, and corporate earnings are likely to remain supportive for equities in the near term, as wage growth remains subdued. The risk of a deepening sell-off in high beta markets, a strong euro and tapering fears in Japan make us now neutral from a regional perspective. From a relative valuation point of view, the story has remained unchanged, with the US becoming even more expensive at a CAPE of 32, a level observed only once since 1880.

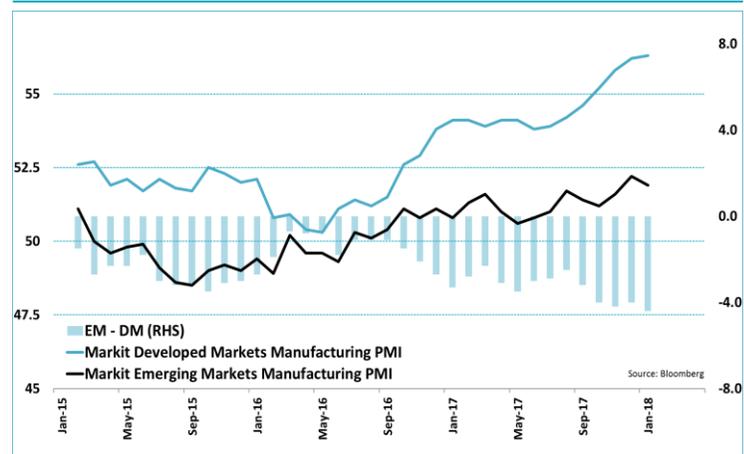
> Equities: Emerging vs Developed (I)

Emerging market equities – relative performance vs. USD



Source: Bloomberg

Manufacturing PMI – emerging vs. developed markets



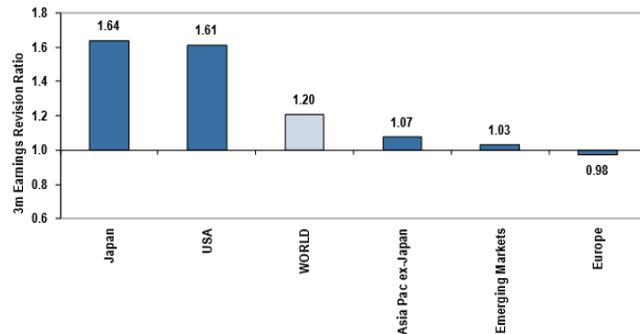
Source: Bloomberg

- > In line with worldwide equities, emerging market equity markets powered into 2018, rising 4.4% in January before giving back most of the gain as volatility spiked in early February.
- > Top down, things look pretty decent for emerging market equities. Global growth is increasing, and has been doing so for a while; commodity prices have recovered, and the US dollar is falling. As the chart on the top left shows, emerging market equities tend to outperform during periods of a weakening US dollar.
- > In most cases a depreciation of the dollar is accompanied by looser central bank policy and an increase in liquidity. This time around however, this is not the case. Central banks are – or will soon begin – reducing liquidity. It is the divergence and now convergence of central bank policy that can explain the bulk of the US dollar move.
- > Next to that, the improvement in growth momentum remains largely explained by better economic circumstances in developed markets. In fact, based on the most recent manufacturing PMI data, the gap between emerging and developed market growth momentum has widened. We believe China is an important factor here, as a continuous focus on reducing credit growth will put the country on a path of lower growth, despite the fact that Chinese macro numbers are higher than expected. From a more short-term view, South Africa’s economic outlook has deteriorated as political uncertainties have increased.

> **Equities: Emerging vs Developed (II)**

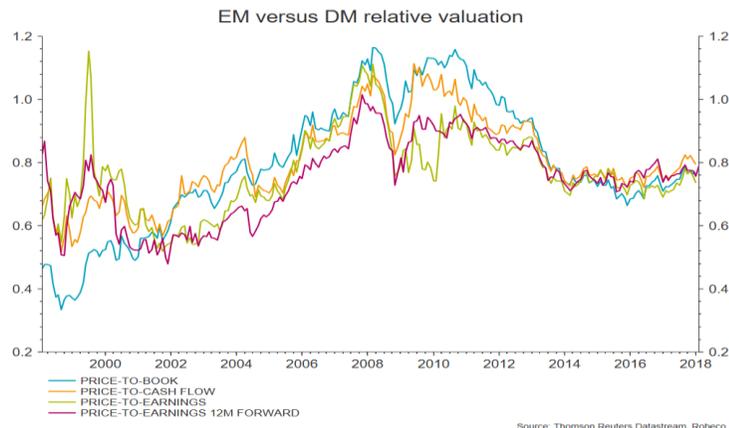
**Earnings revisions**

Chart 6: Earnings Revision Ratio by Region - Last 3 Months



Source: BofA Merrill Lynch Global Quantitative Strategy, MSCI, IBES

**Valuation**



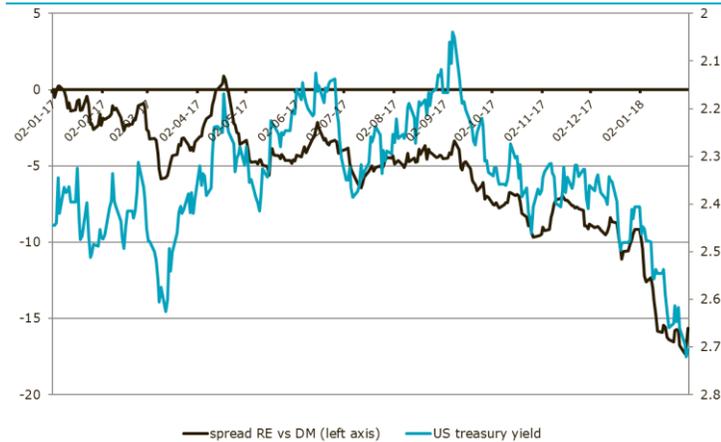
Source: Thomson Reuters Datastream, Robeco

Source: Thomson Reuters Datastream, Robeco

- > The development in earnings has improved, but still lags many other regions. The earnings revisions ratio has crept up in recent months, but so have the ratios in other regions. Currently, European equities score below emerging markets on earnings revisions.
- > On a more positive note, due to the improvement of the global economy, expected earnings growth looks less demanding than in previous years, reducing the probability of disappointments.
- > Despite the outperformance of emerging markets in recent months, valuation remains relatively attractive, although less so than in previous years. As mentioned above, price momentum is a positive, albeit less so against the MSCI World Index hedged to euros. We don't think the depreciation of the US dollar will continue at the current pace, but can imagine a bit of weakening going forward.
- > While we have become more constructive on emerging market equities, partly driven by a strong momentum, we are not fully committed to an overweight yet. First, historically the relative growth momentum between emerging and developed markets has been an important variable driving relative stock market performance. The outlook for earnings has improved, but it has for other regions as well. Emerging markets trade at a discount to developed markets, but are not outright cheap. The recent dip in investor sentiment makes us a bit cautious.

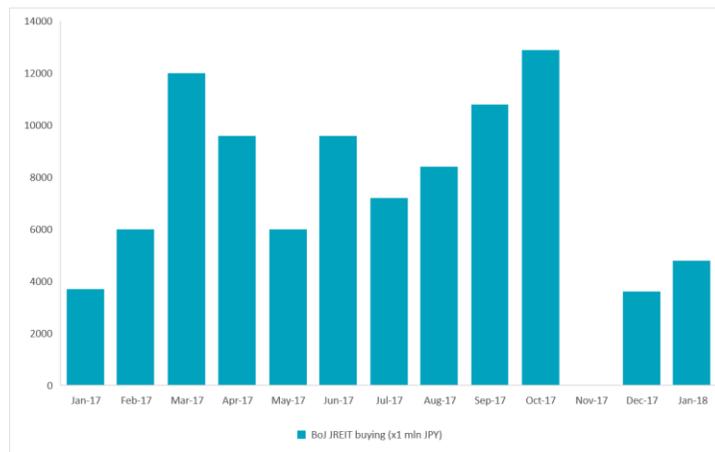
> Real estate

It's the US Treasury yield, stupid!



Source: Bloomberg, Robeco

Less BoJ activity in the Japanese REIT market

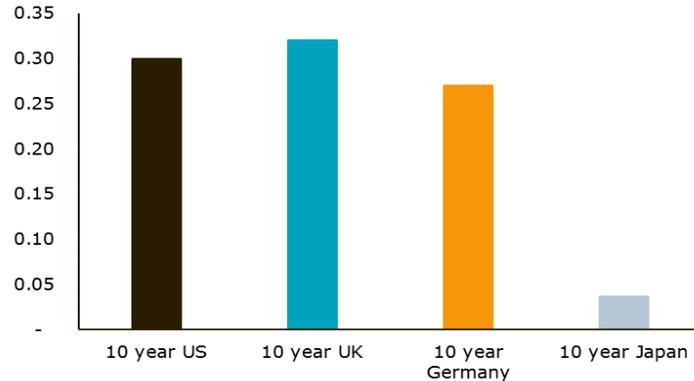


Source: BoJ, Robeco

- > The S&P Global Developed Property Index (in USD) had a flat performance in January, whereas global developed equities (in USD) rose 5.3%. The underperformance of real estate has now continued for almost a year, but January was the worst month of all. Rising bond yields as a result of strong economic data in the US is the most important reason for this. In addition, the Trump tax changes are better for equities than for real estate. As the US market is the dominant one in the real estate index, the global index suffered in line with US REITs.
- > In other regions the situation was different. In local currency, the Japanese market rose more than 5%. Valuations are relatively attractive after a year of a weakening of the J-REIT-index. The BoJ has reduced its J-REIT purchases significantly over the last three months. Compared to bond yields, the dividend yield on J-REITs of nearly 4% is still attractive, which helped performance. The rising Japanese (and European) real estate markets couldn't offset the negative impact of the US market decline last month.
- > The development in Treasury yields will be the main driver for the real estate sector for the coming period. We expect yields to continue to rise, putting pressure on the US and the global real estate sector. However, dividends and valuations don't look too bad. This mixed bag makes us cautious, but we remain neutral for real estate.

## > AAA Bonds (I)

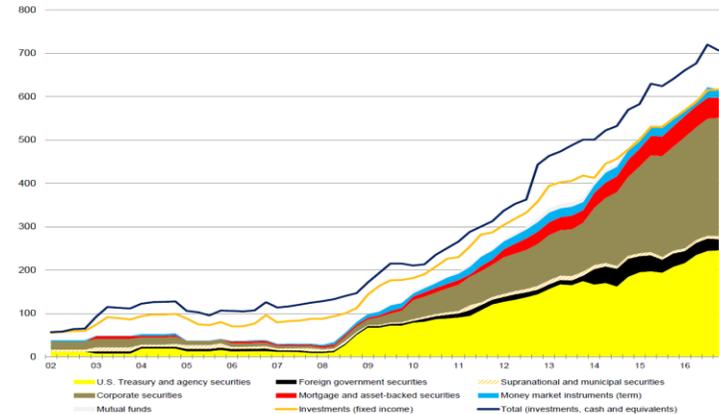
### Bad start to the year for bonds



Source: Bloomberg & Robeco

### The tax plan could trigger an unwinding of corporate bond portfolios

Breakdown of the top ten's bond portfolios by asset-class, \$ billions

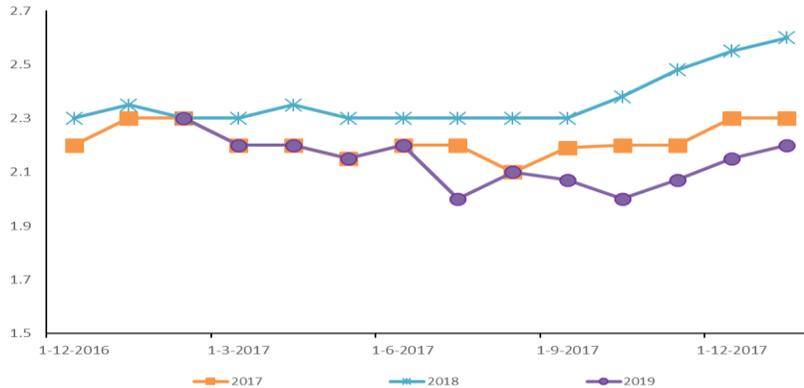


Source: Credit Suisse

- > Bonds started the year on a weak footing. Yields rose across almost all major developed markets. In Europe, yields in core countries increased more than in peripheral nations, causing spreads to compress.
- > While most yields moved more in January than they did all of last year, we have seen this before. One only has to look at last year, when 10-year German yields just meandered in a 35 basis point range following their initial rise at the start of the year. So will this year be different? While it's obviously too early to answer this question, we do think we currently have the perfect conditions for yields to move higher.
- > First of all we think that market technicals will become less supportive, as the supply-demand balance will move more in favor of supply. While the Fed has already started to unwind its balance sheet, so far this reduction has been completely overwhelmed by expansionary policies at the ECB and BoJ. This year, however, the unwinding of the Fed's balance sheet will gather pace, while the ECB is reducing its purchases and might even stop altogether by September.
- > The US tax plan adds to the demand/supply imbalance. On the one hand it creates massive deficits of around USD 1.5 trillion over a 10-year period. On the other hand it opens the door for US companies to repatriate overseas profits.

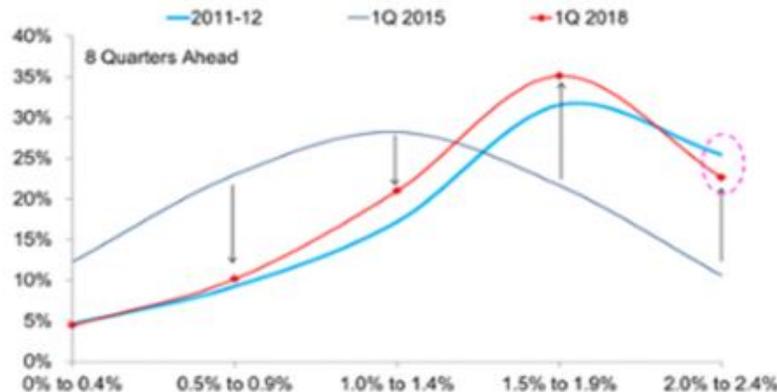
> AAA Bonds (II)

Expectations are for growth to remain firm in the US



Source: Robeco, Bloomberg

Survey of professional forecasters: expect further normalization of inflation

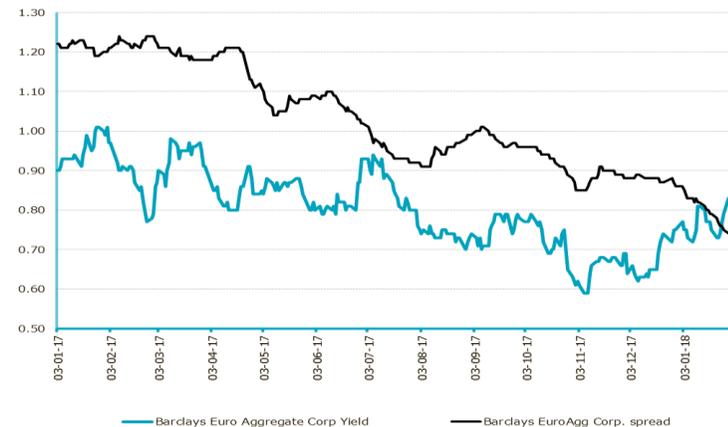


Source: Citi European economic research, ECB

- > While intuitively you would expect profit repatriation to have an impact on currencies, it is quite possible that it will impact bond markets. A large chunk of these overseas profits are kept in bond portfolios. Repatriation of offshore profits therefore could trigger an unwinding of these portfolios. Credit Suisse calculated that corporate savings are around USD 1.5 trillion. Of these, around 40% is held by just 10 companies, of which 90% represents offshore profits.
- > It has long been our assessment that monetary policy settings do not match economic conditions. However, as long as inflation remains soft, central banks have a viable excuse to remain very easy. In 2017, this is exactly what happened; while growth was very firm, inflation remained weak. We agree with the market that currently there is no reason to question the growth outlook, but we are noticing a change in the narrative regarding inflation. Normalization is slowly turning into becoming the base case of the market.
- > What matters is where inflation will be in the medium term. The latest ECB survey of professional forecasters puts average inflation expectations at 1.5%, 1.7% and 1.8% for 2018, 2019 and 2020 respectively. This fits quite nicely with the ECB's inflation target of close to but below 2%. We see no reason to change our long-standing view that rates are just too low given the current economic reality. The major risk to our call is that a sudden aggressive return of risk reversion will provoke the natural reflex of market participants to buy bonds.

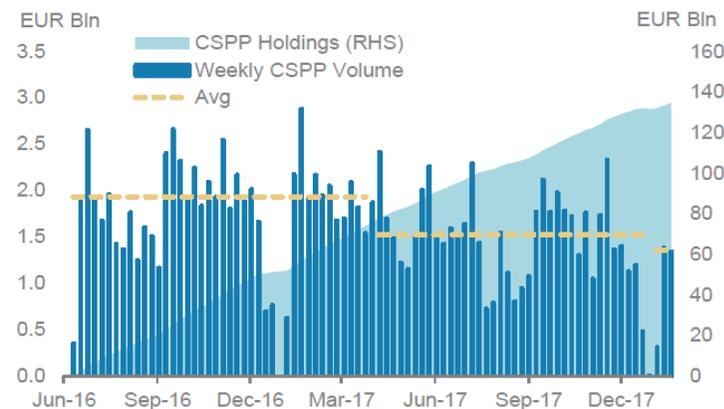
## > Investment Grade Credits (I)

### European credits: rising yields and lower spreads



Source: Bloomberg, Robeco

### CSPP volumes are lower, but still the most important demand factor

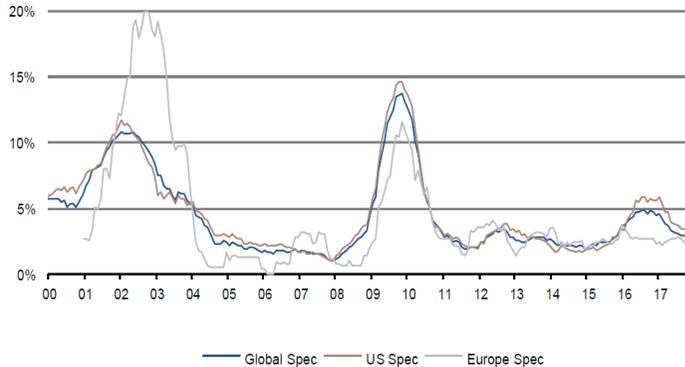


Source: ECB, Morgan Stanley Research

- > European corporate spreads fell another 13 basis points last month to 74 bps, a level we haven't seen since 2007. Whereas spreads are moving down, yields have been slowly moving up since early November. The spread tightening wasn't enough to offset the rise in the yields, so the total return last month was slightly negative. The European credit yield is now higher than the spread.
- > The spread compression in January was for the most part the result of a lack of supply in the investment grade issuance market in January: demand for investment grade was still there, which meant investors were forced to move to the secondary market. With a sharp rise in bond yields, the spread decline was a logical result. The demand is mainly coming from the ECB, as the CSPP program is still firmly in place. Although the ECB announced a tapering of the current stimulus program, the ECB keeps corporate bond buying at a relatively high pace at an estimated EUR 5.5 bln per month.
- > The current developments do not make European credits cheaper; the ECB assessed that the corporate debt market is trading 'at fair value'. Credit fundamentals in Europe are strong, European economic data is still good, and default rates are low. For the coming months, we don't expect the environment to change drastically. With rising yields, spreads may compress a little further, but total returns will be negative. However, a firm spread widening doesn't seem likely in the coming period. In the first days of February, the European credit market stayed remarkably stable.

> Investment Grade Credits (II)

Default rates remain low



Source: Moody's, SG Cross Asset Research/Credit

Rising volatility, but the US credit market hasn't reacted (yet!)

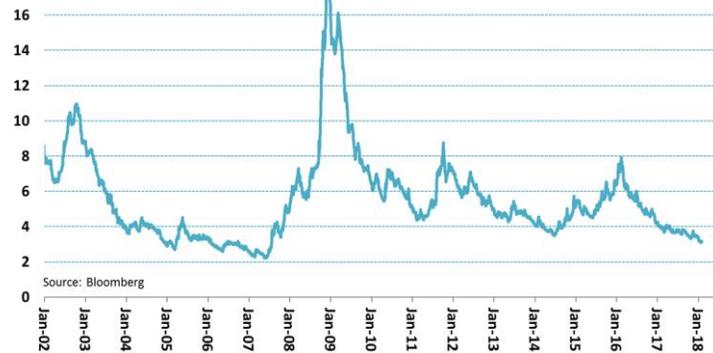


Source: Morgan Stanley Research, Citigroup Index LLC, Bloomberg

- > Spreads tightened also in the US last month, but not as sharply as in Europe. The yield on US corporates rose from 3.25% to 3.45%, while the spread came in by only 7 bps. Spread levels are at long-term lows and leave little room to tighten further. The US macro data is still very strong, so for the short term there are no real catalysts to spur a sell-off in the credit market. Defaults rates are still at low levels and not likely to rise. But warning signs are starting to appear.
- > Roughly one-third of US credits are owned by foreigners. If short-term yields in the US continue their way up and the dollar depreciates further, US credit investments (hedged back to euros or yen) will lose their attractiveness for foreign investors. This could lead to strong outflows in US credits.
- > There are more reasons to worry. Rising volatility in equity markets is an indicator to watch out for. The VIX index indicator for stock market volatility is rising while credit spreads have tightened in the last few months. These low spreads only make sense in a low-volatility environment. Markets are increasingly worried about inflation and rising interest rates, so it usually is only a matter of time before spreads react. In the early February market turmoil, the spread reaction was very limited.
- > The outlook for credits in 2018, especially in the US, is a bit gloomy. European credits could keep up longer. Overall, we are cautious, but we remain neutral and favor European credits over US credits.

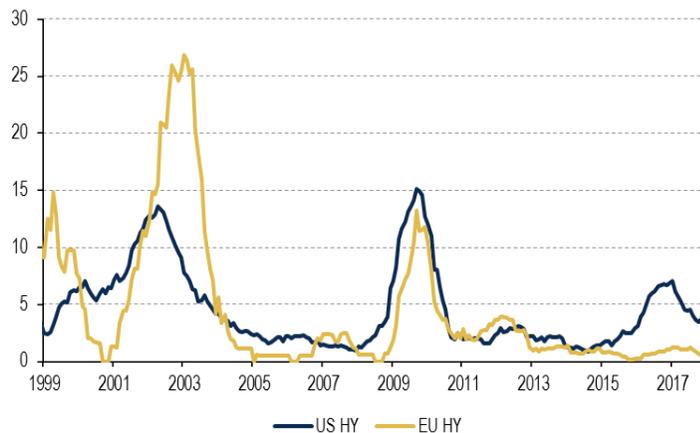
> High Yield (I)

High yield – spread



Source: Bloomberg

High yield - defaults

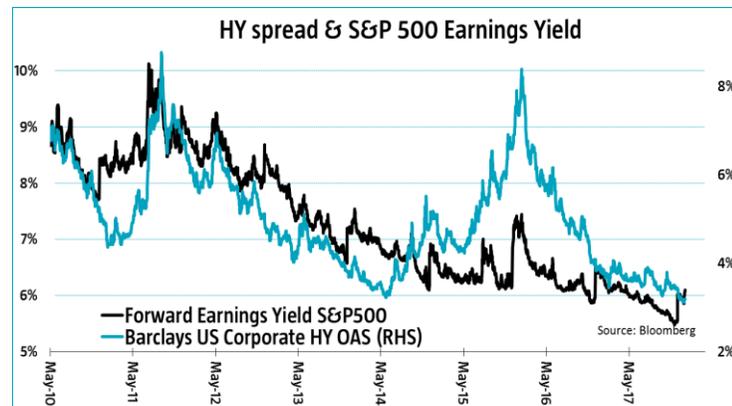


Source: BofA Merrill Lynch

- > Global high yield bonds were the best-performing fixed income-related asset class in January, realizing a positive return of 0.3%. Spread levels compressed even further on the back of the continuous risk-on mode in financial markets, cancelling out a rise in global government bond yields.
- > As the chart on the top left shows, spreads are down to levels not seen since the outbreak of the financial crisis. In 2007, spreads fell all the way down to a historical low of just above 200 basis points. At the end of January the spread stood at 316 bps. We could see even lower spreads going forward, but the odds of that happening are getting slimmer, particularly when you take into account the fact that spreads have been partially pushed down by the ongoing search for yield. As central banks start to unwind their massive balance sheets, we expect this factor to lose power as the year progresses. Spreads are already a bit too low given the level of the Global Financial Stress Indicator.
- > On the more positive side, global GDP growth – another important driver of spreads – is expected to remain solid. Global growth is expected to reach 3.9% this year and next, according to the IMF. Without a bond scare, we expect default rates to fall, or in the case of the Eurozone, remain low. Here too, however, valuations look stressed. For example, spreads on energy-related high yield bonds are at or below levels last seen when the oil prices was north of USD 100.

> High Yield (II)

High yield – relative valuation against equities



Source: Bloomberg

High yield – relative valuation against emerging debt



Source: Bloomberg

- > Over the course of 2017, the leverage of high yield companies crept up, especially in the US. This makes them more vulnerable to rising interest rates. At this point in time, however, the maturity wall doesn't look disturbing.
- > The most important reason for our underweight in global high yield bonds is valuation. As mentioned on the previous slide, spreads are tight, and the probability of even lower spreads should be low, given historical data.
- > But also compared to other asset classes, high yield bond valuations look elevated. Recently, even the forward earnings yield of US stocks – the most expensive of the major equity markets – has climbed above the US high yield spread level. In addition, the running yield on high yield bonds is also considerably less than on local currency emerging market debt. At current valuations, we think only Eurozone government bonds look less appealing within the fixed income space.
- > We hold on to our underweight in high yield bonds, based on elevated levels of valuation, both from an absolute and a relative view.

> Emerging Market Debt (I)

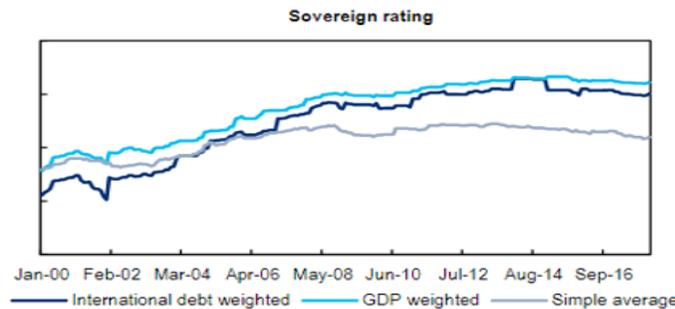
Emerging market debt in local currency – spread and yield



Source: Bloomberg

Emerging sovereigns – rating

Figure 4. ...and this has come at the expense of credit-ratings: EM's 'peak creditworthiness' was mid-2014



Source: Bloomberg, Fitch, Citi Research

Source: Bloomberg

- > Local currency emerging market debt realized a marginally negative return of 0.1% in January. However, the asset class comfortably beat developed market government bonds. A global rise in bond yields was offset by a significant tightening of the emerging debt spread. Unfortunately, the performance of emerging debt (as seen from the European investor) was again pushed down by a stronger euro.
- > Top down, current economic conditions are favorable for emerging market debt. Global growth continues to improve from already healthy levels. The IMF revised its global GDP growth forecast upwards to 3.9% for both 2018 and 2019. In combination with still relatively low inflation and ample liquidity due to the policy of central banks, this should benefit emerging market debt. In addition, commodity prices are also rising on the back of a stronger global economy, helping a significant number of emerging countries to reduce their imbalances.
- > That said, we have gone past the peak in emerging country creditability, as can be seen in the chart on the bottom left. After roughly a decade of improving sovereign debt ratings, things have reversed a bit since 2017. Brazil is one of the bigger countries that saw its credit rating lowered as debt builds up. Emerging debt levels are on the rise, but remain considerably lower than in developed markets. Stronger growth should allow governments of emerging countries to prevent debt levels from reaching unsustainable levels, but it is something we monitor closely.

> Emerging Market Debt (II)

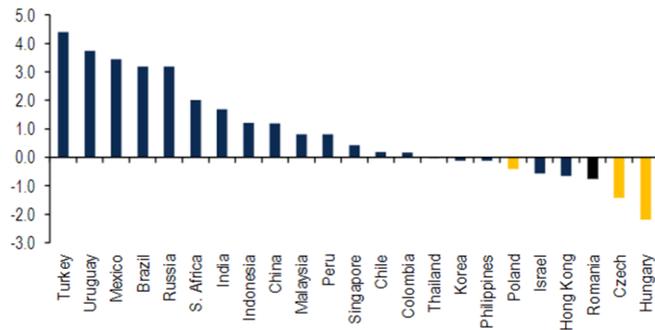
Emerging currencies



Source: Bloomberg

Emerging debt – real yields

Chart of the day: CE3 - still the lowest real rates in EM despite healthy growth/inflation mix



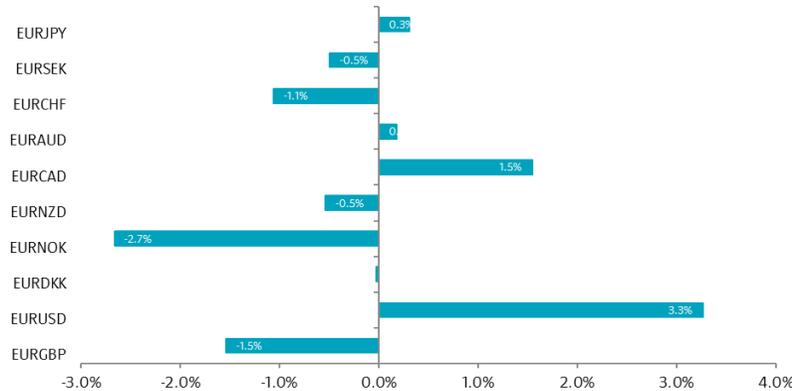
We define real rates as 1y rates minus 2018E inflation. Source: BofA Merrill Lynch Global Research.

Source: Bloomberg

- > As mentioned before, the performance of local currency debt has been negatively impacted by a strong euro. The graph on the top left shows that emerging currencies have gained more than 6% against the US dollar but lost almost 8% against the euro over the last 12 months.
- > The euro’s move has been pretty extreme from an historical point of view. However, with the unwinding of central bank policy this year, volatility is likely to stay. Hence, we have combined our overweight in local currency emerging debt with a short position in the US dollar against the euro. Basically, we now profit from an outperformance of local currency emerging debt both in US dollars and euros.
- > We think the valuation of local currency emerging debt remains relatively attractive. As the chart on the bottom left shows, most emerging countries offer a positive real yield – something that is not the case in areas like the Eurozone and Japan. As a result of the ECB stimulus, real yields in Eastern Europe are negative as well. Together the Czech Republic, Hungary and Poland represent 14% of the index.
- > The current yield on emerging debt remains roughly 1% higher than on high yield bonds, where spreads have come down significantly in the risk-on rally. Emerging debt spreads have also come down considerably when measured against the US 5-year Treasury, which is not the most straightforward measure for some countries. Overall, we believe emerging debt still offers relative value within the fixed income space.

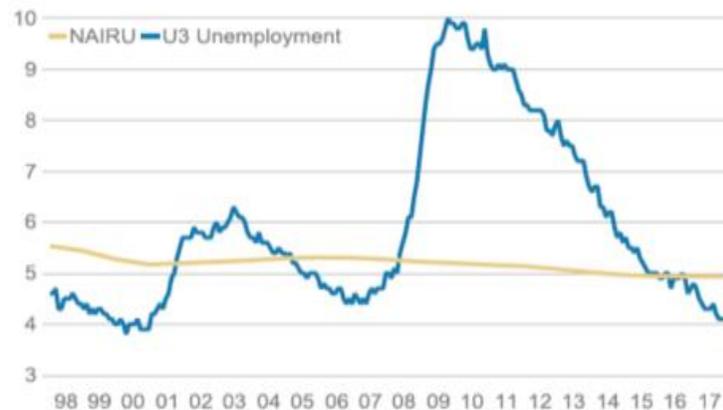
> FX (I)

**It was bad month for the dollar**



Source: Bloomberg, Robeco

**Unemployment continues to remain below NAIRU**

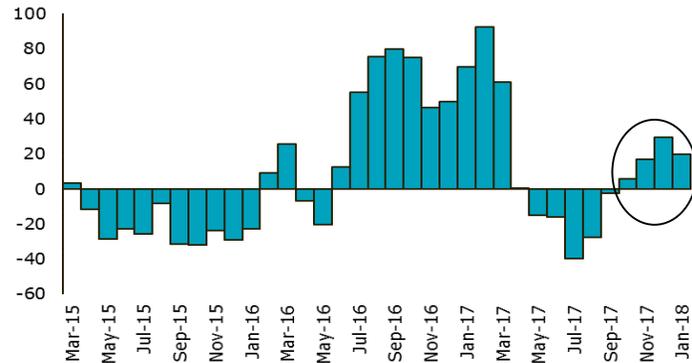


Source: Morgan Stanley, Macrobond, Bloomberg

- > The dollar has continued on the path it started last year and weakened further. In January, the dollar was the weakest currency within the G10. While normally this would indicate that the euro would be among the strongest, this time it was not. The euro is actually the fifth best, or fifth weakest currency in the G-10, depending on your preference. The Norwegian krona, Swiss franc and British pound take the top three spots. The negative momentum against the dollar is very broad, and reflects the fact that the rest of the world is catching up with US growth and normalization.
- > What definitely didn't help the dollar was the confusing remarks coming out of the White House. On the one hand, Treasury Secretary Mnuchin indicated that he is comfortable with a weak dollar, while on the other hand, President Trump declared his preference for a strong dollar.
- > So what can change this negative sentiment towards the dollar? We think higher rate expectations. The market expects the Fed to raise two to three times: for the dollar to regain momentum, this will probably need to be bumped up to four or five.
- > Based on the relatively subdued inflation momentum we saw last year, this is not what many anticipate, and we tend to agree. However, the latest employment numbers were very strong. Not only did job growth continue to increase at a healthy pace, while the unemployment level of 4.1% remained firmly below the natural rate of unemployment, >>

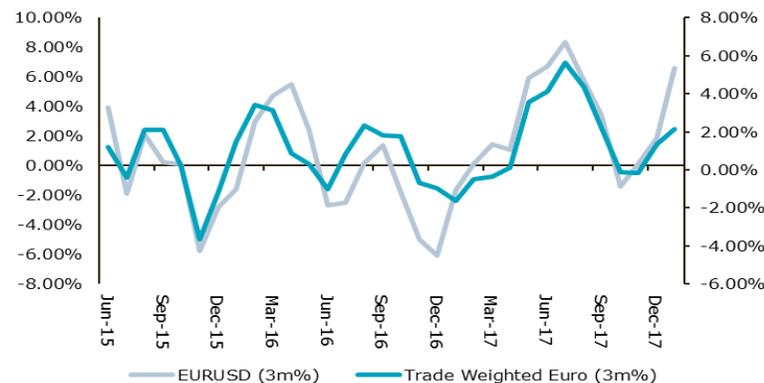
## > FX (II)

### Positive economic surprises supported sterling in the past period



Source: Robeco & Bloomberg i

### Euro trade-weighted increase was still modest



Source: Robeco & Bloomberg

- > but more importantly, the wage rise number was very strong. Average hourly earnings grew 2.9% year over year. Weak wage growth was seen as the main reason for the weak inflation environment that we have endured over the last few years, so any sustainable move in wage growth will therefore have major implications for Fed policy.
- > Sterling was one of the stronger currencies last month, which basically continued the trend of the last couple of months. Against the US dollar it is now back to pre-Brexit levels. Sterling strengthened on be back of better-than-expected economic numbers and greater visibility over Brexit. The UK's latest PMI numbers were not only lower than the previous ones, but also below expectations. We will closely monitor these developments to see if the time has come to short sterling again.
- > The latest ECB meeting didn't bring a lot of new insights. As expected, no direct comments were made about the strength of the euro, and concerns were only raised about its volatility. Given that up until now the rise in the trade-weighted euro hasn't been excessive, we think the ECB will just stand by and watch.
- > We closed our long US dollar position against the yen last month as the pair lost upwards momentum and we didn't see a catalyst to reignite it. We entered into a long euro position against the US dollar as we think Draghi currently lacks the will or reason to stop the euro rising further.

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