

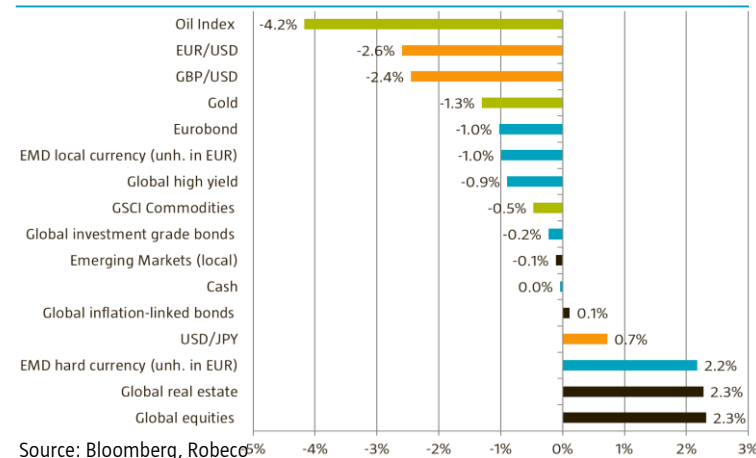
## Multi-asset market outlook

For professional investors

June 2018

## General overview

### A mixed picture



### May the force be with us!

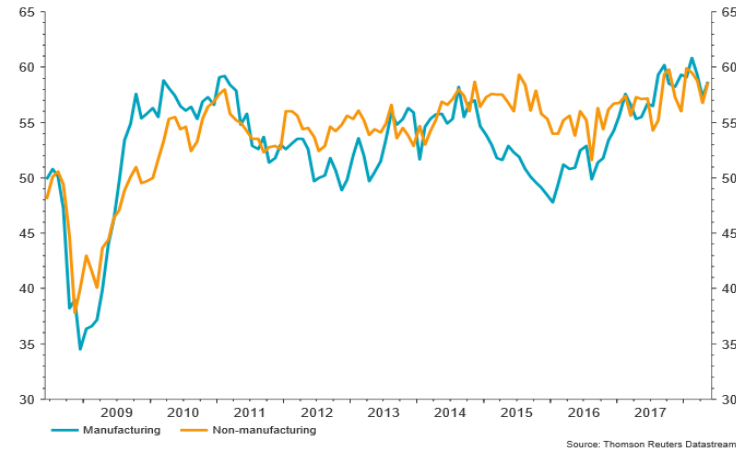
	Portfolio	BM	active	previous
Equities Developed Markets	29.0%	25.0%	4.0%	4.5%
Equities Emerging Markets	3.5%	5.0%	-1.5%	-1.5%
Real Estate Equities	5.0%	5.0%		
Commodities	5.0%	5.0%		
Core Gov Bonds 1-10	17.5%	20.0%	-2.5%	-2.5%
Core Gov Bonds 10+	7.50%	7.5%		-0.6%
Investment Grade Corp Bonds	23.5%	20.0%	3.5%	3.5%
High Yield Corp Bonds	1.0%	5.0%	-4.0%	-4.0%
Emerging Market Bonds LC	5.0%	5.0%		
Cash	3.0%	2.5%	0.5%	0.6%
EUR/USD	-4.0%	0.0%	-4.0%	-2.0%
EUR/JPY	0.0%	0.0%		
EUR/GBP	2.0%	0.0%	2.0%	2.0%
EUR CASH	2.0%	0.0%	2.0%	
Portfolio risk	5.56%	5.39%		

> Another month, another source of volatility. Back in February the rise in volatility was almost exclusively limited to equities, but this time the effects spread over a number of markets. The Italian bond market was the epicenter of the volatility, with ripple effects in both currencies (most notably the euro) and equities (most notably Europe). As is the case with a real earthquake, the ripples declined with geographical distance, which explains why for example the Nasdaq managed to post a new all-time record at the start of the new month. And as shocking as the news headlines may have been, the impact on the broader asset classes overall has been relatively muted. The same applies to the other geopolitical development, the escalating trade dispute triggered by the US. Equities have continued to be driven by the extremely strong earnings reported in the US, as well as the ongoing strong economic momentum there.

> Have we made any changes to our portfolio as a result of these developments? Not really. In the run up to the Italian political crisis, we took a short position in the euro as a potential hedge. This hedge worked well, but was not enough to compensate for the losses incurred on our short position in bonds (the German 10-year yield dropped from around 60 basis points to 20 in less than two weeks) and our overweight in developed market equities. We have only made marginal adjustments to our portfolio since. Whether Italy will develop into a new (bigger) euro crisis will ultimately depend on the stability of the new Italian government.

## > United States

### ISM manufacturing and non-manufacturing rebound



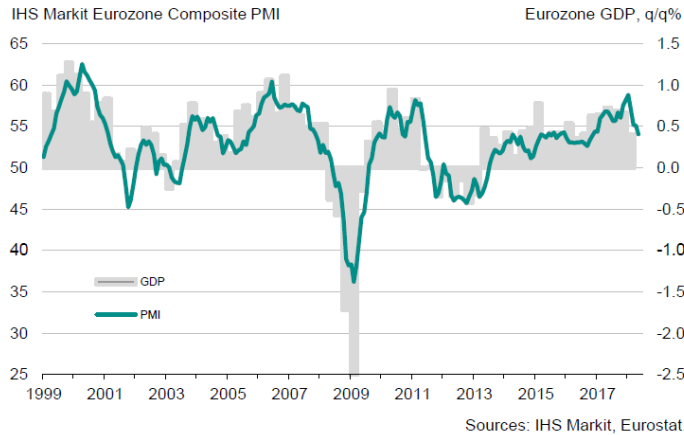
### Inflation indicator preferred by the Fed stable in April, core declines



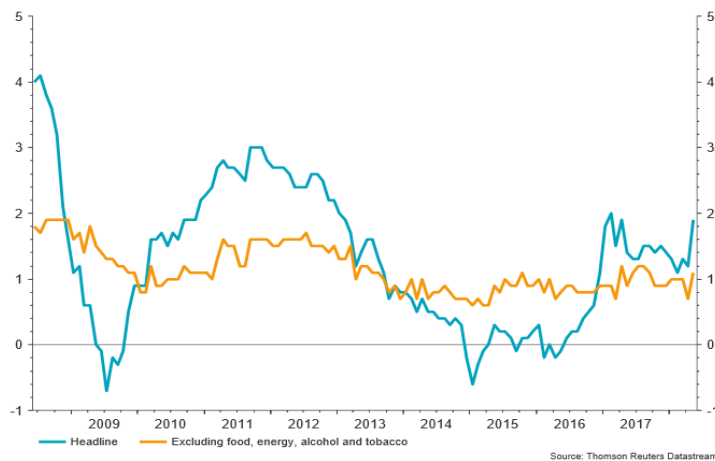
- > Both the US manufacturing and the non-manufacturing ISM readings rebounded in May despite rising trade tensions. The US economy is thus still in solid expansionary territory as demonstrated by the strong non-farm pay rolls. The Fed's preferred inflation indicator was unchanged for April, the core figure even declined slightly. The Fed is therefore not under pressure to speed things up, but will keep to its gradual tightening pace of 25 basis points per quarter. A June 12 hike is almost certain.
- > As expected President Trump announced tariffs on steel and aluminum from Canada, Mexico and the European Union on May 31 after two delays of a month. These tariffs have been justified on dubious national security grounds. Retaliation is likely, but even after that the macroeconomic consequences will be very limited. Nevertheless, a further escalation remains a serious risk. Mexico has presidential elections on July 1 and meaningful concessions towards the US can be ruled out for the time being. This could provoke a frustrated President Trump to step out of NAFTA, which would have more serious economic consequences. In the meantime, Europe is being threatened with tariffs on cars.
- > President Trump renewed his earlier threat to China to impose a 25 percent tariff on USD 50 billion of Chinese goods as a penalty for theft of American intellectual property. China has warned that all Chinese commitments made in earlier talks will be withdrawn if these tariffs are imposed. Risks of a prolonged trade war remain high as a consequence.

## > Europe

### Eurozone growth slowing to an 18-month low



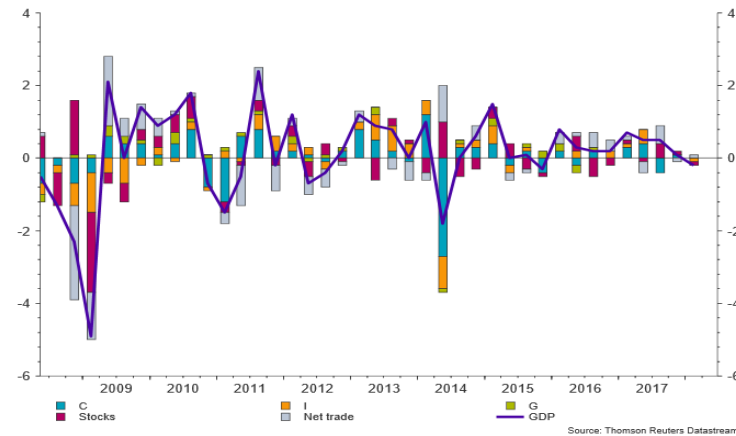
### Energy prices push up Eurozone headline inflation rate



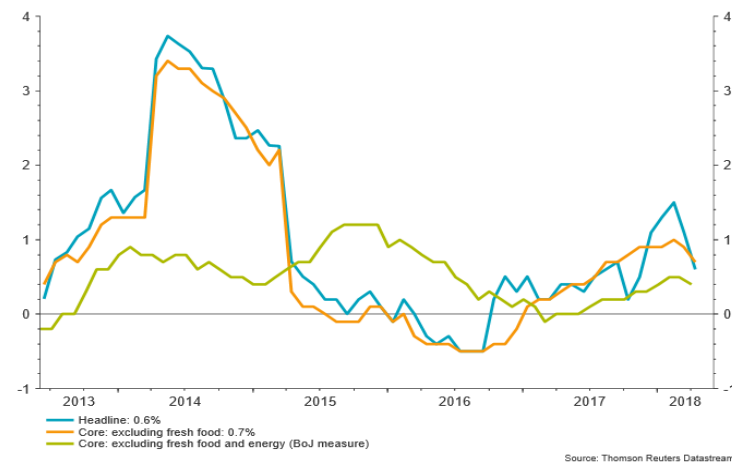
- > The Markit Eurozone Composite PMI disappointed again in May hitting a one-and-a-half year low. Italy's Composite PMI was unchanged but is still at the lowest level of the four largest Eurozone economies. The Eurozone economy remains, of course, in expansion territory but it will be difficult for it to reach a growth rate materially above 2.0% for 2018.
- > Headline inflation on the other hand rose strongly, partly as a consequence of higher energy prices. But core inflation picked up too, now rising by a still timid 1.1% on a yearly basis. Given the heightened economic and political uncertainty, it is still unlikely the ECB will terminate its QE program in September. It will probably further limit the size of its monthly bond purchases and extend the program until December.
- > The new populist government in Italy has expensive fiscal plans: the introduction of a flat tax in the form of a two-tier system that ranges between a mere 15 and 20 percent and a Universal Basic Income. As a consequence the budget deficit for next year will rise dramatically, breaching Eurozone limits. If these plans are not watered down, Italy will be on a collision course with its European partners. Rising risk premiums in the bond markets will probably force the Italian government to back down at some point, as a solvency crisis is not in the interest of the governing parties. But ongoing uncertainty could last for the most of 2018 dampening economic confidence and growth. The wobbly minority cabinet in Spain will probably not last long, but in contrast to Italy, no majority for populist parties is likely after elections.

## > Japan

### Japan's GDP unexpectedly contracting in Q1



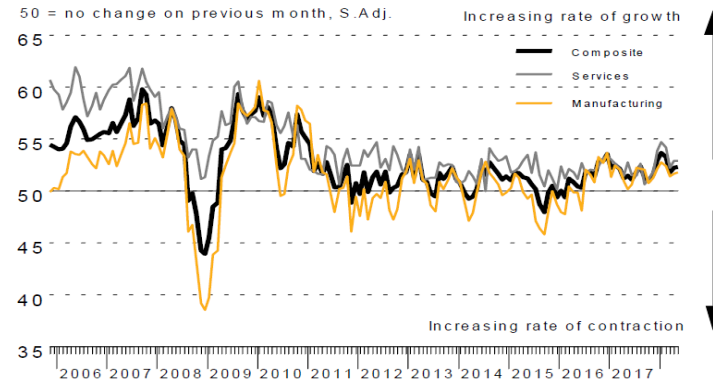
### Japan's inflation weakening again



- > The notoriously unreliable first estimate of Japan's GDP showed an unexpected contraction. Increasing fears of a technical recession, however, diminished after strong retail figures for April, showing an impressive 1.6% growth on a yearly basis after a couple of weak months. Moreover, the labor market remained tight. The unemployment rate stayed unchanged in April at 2.5%. The job-offers-to-applicants ratio, was unchanged at 1.59.
- > Nevertheless, confidence in the economy has been shaken. As a consequence, the Japanese government is planning fresh fiscal stimulus to counter the negative economic effects of the planned increase in the national consumption tax to 10% in October 2019. Measures contemplated are extending tax breaks or introducing some form of subsidies for durable goods such as car and home purchases. The 2020 deadline to reach a primary budget surplus will also be postponed by up to five years to 2025. It is unlikely that fiscal discipline will be reinstated.
- > Inflation is coming down again. Headline inflation collapsed to 0.6% on a yearly basis and is now 0.9% lower than its recent February peak of 1.5%. The so-called 'core core' preferred by the Bank of Japan (excluding fresh food and energy) declined to 0.4%. The Bank of Japan's 2.0% target remains way off and any tightening of monetary policy is unlikely for the foreseeable future. Like the government, the Japanese central bank feels trapped in its current policies.

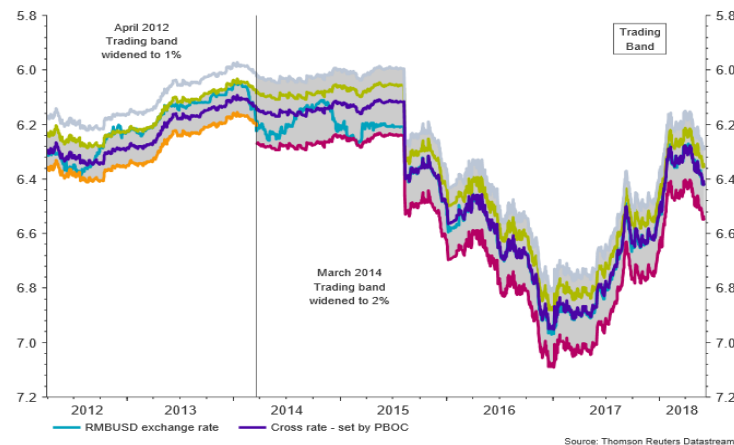
## > China

### May's Caixin China Composite PMI stable



Sources: IHS Markit, Caixin.

### China's yuan weakening against the dollar

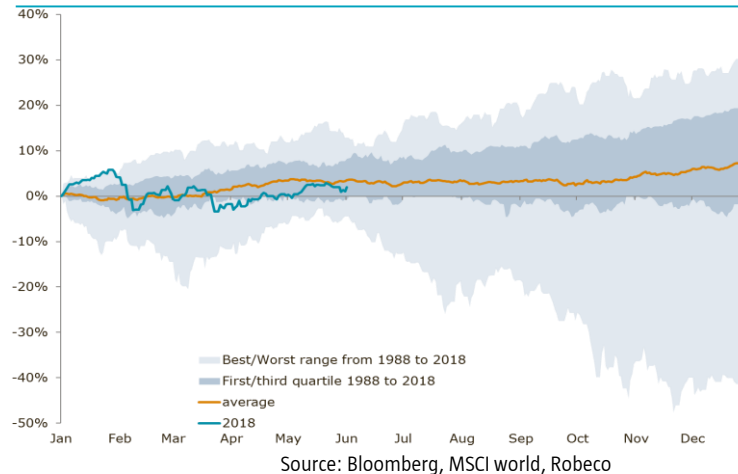


Source: Thomson Reuters Datastream

- > The Caixin China Composite PMI, which covers both the manufacturing and the services sector, was unchanged in May after the unexpected rise in April from 51.8 to 52.3. The growth environment remains therefore stable on the basis of this indicator.
- > After concluding its regular article IV consultation on China at the beginning of June, the IMF marginally raised its growth projection to 6.7% for this year (compared to its earlier April outlook projection of 6.6%). The IMF therefore remains pretty upbeat about Chinese growth signaling that some near-term risks have receded, but is still of the opinion that significant reform is needed for China to break away from debt-fueled expansion.
- > In the first quarter the Chinese yuan rallied sharply vis-à-vis the US dollar which offered policymakers the room to reduce curbs on currency outflows. Recently, the yuan has fallen somewhat from its March high. But there is little concern this will turn into a rout. There are signs that Chinese policymakers are once again increasing efforts to promote the yuan's status in global finance, after letting this subject rest for the last two years.
- > Regarding trade relations with China, White House economic advisor Larry Kudlow recently took a defiant stance on Fox News: "Blame China, blame Europe, blame NAFTA, blame those who don't want reciprocal trading, tariff rates and protectionism." Trade tensions remain high.

> Equities (I)

So, where has the bad news gone?



The Nasdaq closed the first trading day of June with a new all-time high



- > *Gevoelstemperatuur*. We know that this is not the easiest of Dutch words to get used to - especially as it starts with the typical Dutch G - but this is a word that is clearly missing from the English language. It is a word that is usually used in the winter to indicate that the temperature that you feel may be a lot colder than the one that is shown on the thermometer. Wind, the level of humidity, the lack of a sun; all these factors can lead to a temperature experience that deviates from the actual measured temperature. As a rule, *gevoelstemperatuur* is only mentioned when things feel more chilly than they officially are.
- > Why go through the trouble of introducing this word? The reason is simple: it is a best way to describe what has been happening in the equity markets so far this year. *De gevoelstemperatuur* is telling us that we have been experiencing pretty harsh weather conditions in the equity markets. Not only have we been hit with the strong and unexpected February sell-off and the escalation of the US trade dispute. Not only has the rise in US bond yields created a headache for equities, but we have now also been impacted by the re-emergence of the Eurocrisis as well. If we add all these elements together, one could be forgiven for thinking that 2018 has been a pretty horrific year for equities so far, that we are freezing our butts off out here. If on the other hand, we simply look at the MSCI All Country Total Return Index (gross dividends) in local currency - a sort of thermometer for a global equity investor, if you like - equities have yielded a positive return of 1.9% year to date. Better still, the Nasdaq closed at a new all-time high on June the first. So, so much for winter: it has not come yet.

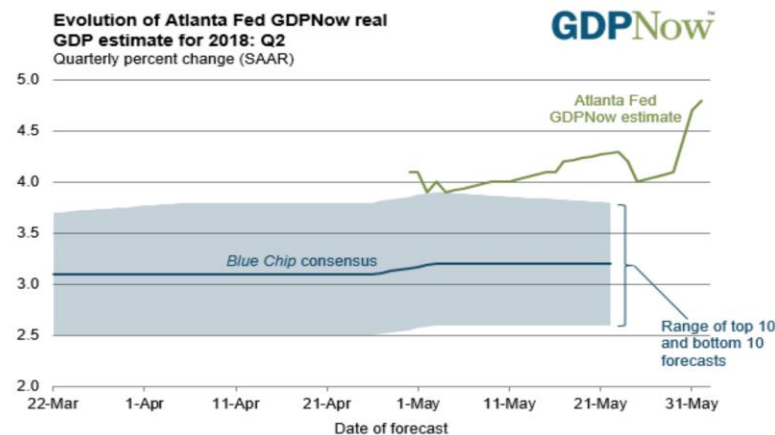
## > Equities (II)

### Tax cuts have helped, but it is not the whole story

A large portion – 43 percent – of corporate America’s income growth in the first three months of 2018 came from the change in the tax law



### Is the US on track to grow by 4.5% in Q2?



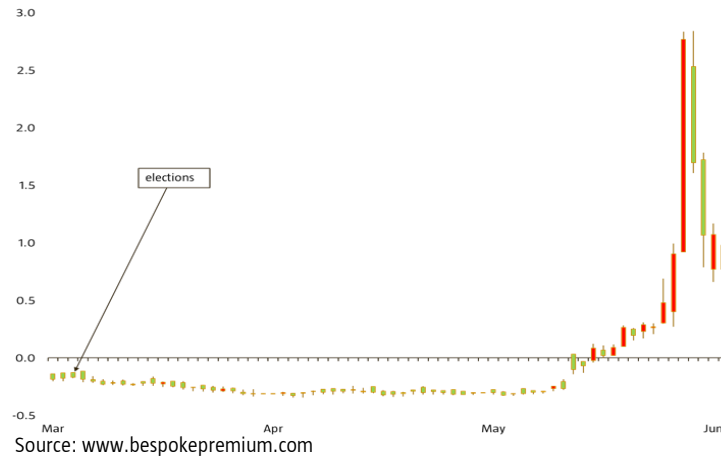
Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts  
Note: The top (bottom) 10 forecast is an average of the highest (lowest) 10 forecasts in the Blue Chip survey.

- > The fact that markets have not reflected the same sort of panic we have seen in the headlines is of course nothing new: we have already mentioned it a number of times in recent years and we might have to flag it another couple of times before this bull market is officially over. It is probably an integral part of a bull market, with commentators eager to find reasons to warn, while equity markets are eager to find reasons to move higher. And let’s face it, those reasons are still easy to find. First-quarter earnings in the US have been pretty solid, with EPS growth for the S&P 500 now forecasted to rise by 24% for the year as a whole. Part of this boost is of course related to the Trump tax cut, but according to Bloomberg, 57% of this increase is not related to the cuts, indicating that underlying growth has been positive. What’s more, if we are to believe the Atlanta Fed’s GDP tracker, the US economy is now on track to expand by more than 4.5% in the second quarter, which will give earnings another boost. For sure, the escalation of the US trade dispute may pose a threat to growth in the second half of the year, but the announced measures (by the US) and assumed counter measures (promised by the impacted trade partners) are so far relatively small.
- > At the same time, Europe and Japan are still going through a soft patch –the Citi Surprise Index for the Eurozone has been stubbornly low at the minus 90 level - but even here, economic momentum also appears to still be strong enough to push earnings higher. Consensus expects European earnings of around 16%, while Japan is forecast to produce 5% growth.

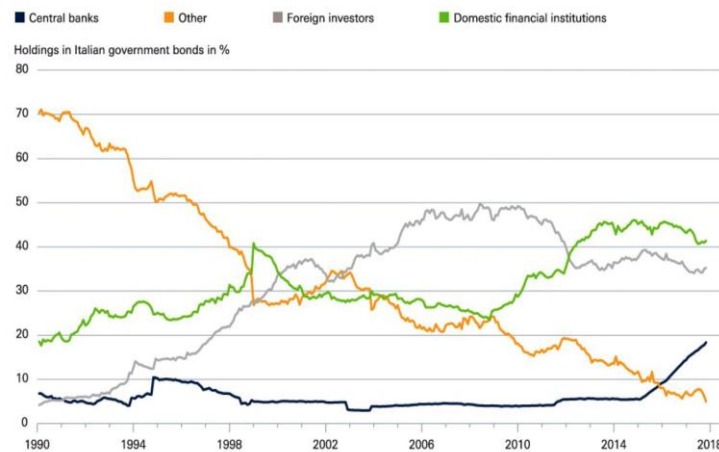


> Equities (III)

The slow response to the Italian elections



US stocks have lost their mojo

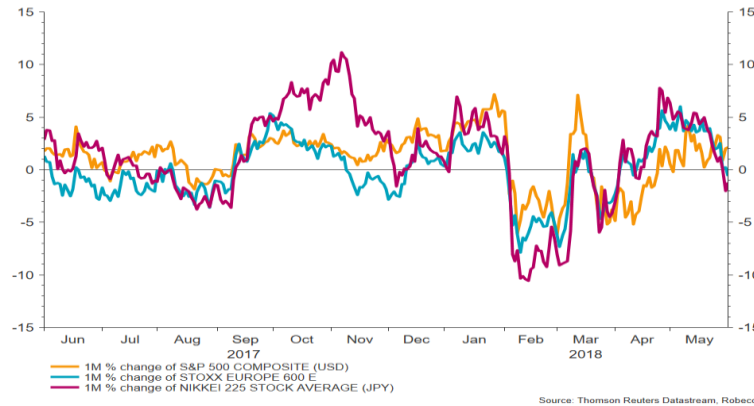


Sources: Bloomberg Finance L.P., Deutsche Asset Management Investment GmbH, as of 3/8/18

- > But let's not completely disregard the alarming headlines either. The biggest theme last month clearly was the return of the Eurozone worries, with Spain's political turmoil playing second fiddle to the much more important Italian political developments. The crisis was slow in coming. The Italian parliamentary elections that took place in early March were initially regarded as a non-event in financial markets. Things took a sudden turn for the worse, when it became clear that negotiations between the Five Star Movement and the Lega – the two big winners in the election – appeared, against all the odds, to be moving towards a successful outcome. Given that the only common ground between the two parties appears to be their anti-immigrant and anti-Brussels feelings, it is clear the prospects of this unlikely union spooked markets. Leaving the euro does not appear to be their main goal, but stimulating the economy by running a higher deficit will put them on a firm collision course with the rules of the Stability Pact.
- > This is not Greece. The Italian economy is almost ten times bigger, with Italy comprising roughly 15% of recorded economic activity in the Eurozone. Furthermore, due to the high level of debt (130% of GDP), Italy is the third largest debtor in the world, after the US and Japan. According to Deutsche Bank calculations, roughly 40% of this debt is domestically owned, with foreign investors (around 35%) and the Eurosystem (around 18%) the other major owners. If things go sour, this will be the major theme in financial markets for some time to come. Whether it comes to that will ultimately depend on the stability of the new government: but this coalition is unlikely to remain intact for long.

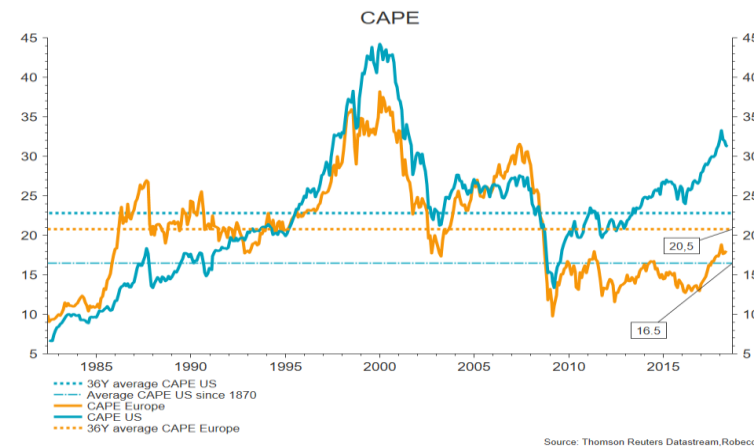
> **Developed Market Equities**

**Developed market equities: sell in May?**



Source: Thomson Reuters Datastream, Robeco

**CAPE shows improving equity valuations**



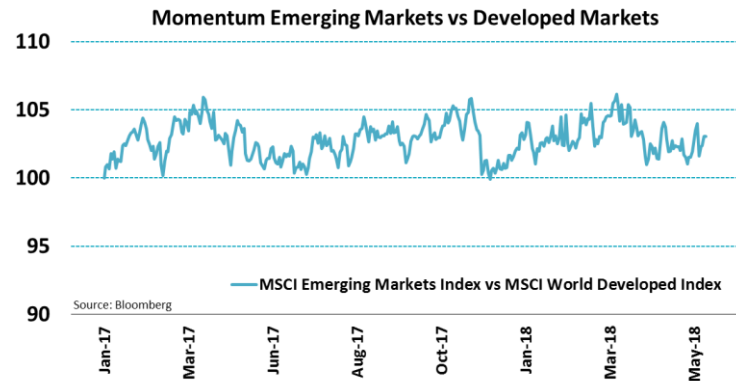
Source: Thomson Reuters Datastream, Robeco

- > In May, a soft patch in the growth of advanced economies, lingering worries about global trade disruptions and geopolitical concerns, ranging from North Korea to Italy, put a hold on the stock market rally in developed markets. The ranking on the basis of the monthly momentum of equity returns in local currency showed US equities regaining strength towards the end of the month, rising 2.9% in dollar terms, with other markets ending the month lower with the Eurostoxx 600 losing 0.4% in euros and the Nikkei ending 1.2% lower in yen. The S&P 500 lagged and ended the month 0.2% higher in dollars. Considering the longer trend in developed equities, long momentum (12M-1M) in local currency is positive for both US and Japanese equity markets (11.6% versus 10.8% respectively) with Eurozone equities now finally also registering positive long momentum with 0.97%.

- > Strong earnings and sales growth for developed market corporates in combination with an equity sell-off in Q1 have led to improved valuations for equities year to date. The US CAPE is now at 31.2, down from 33.3 in January. Looking ahead, macro-related risks for developed market equities now look tilted to the upside as leading indicators last month pointed to a stabilization in producer confidence while strong employment suggest healthy consumer spending ahead. There is no immediate threat of recession. Global earnings revisions have rebounded and show net upgrades. Negative seasonality, geopolitics and rising real interest rates could however limit upside. We stick to our modest overweight in global equities, with a neutral regional weighting within developed equities.

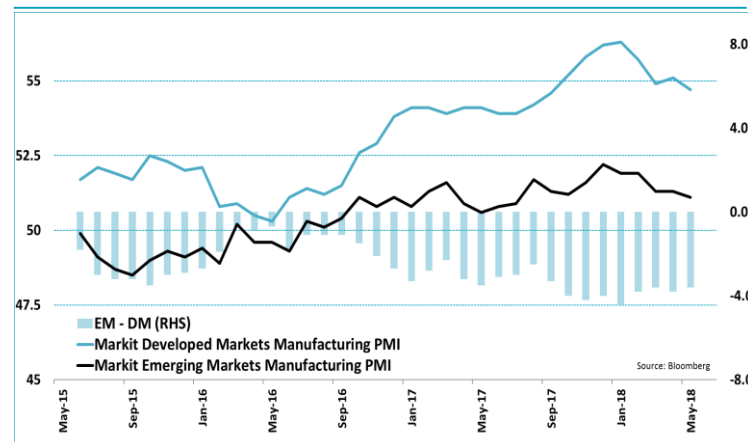
> Equities: Emerging vs Developed (I)

Emerging market equities – momentum



Source: Bloomberg

Manufacturing PMI – emerging versus developed markets



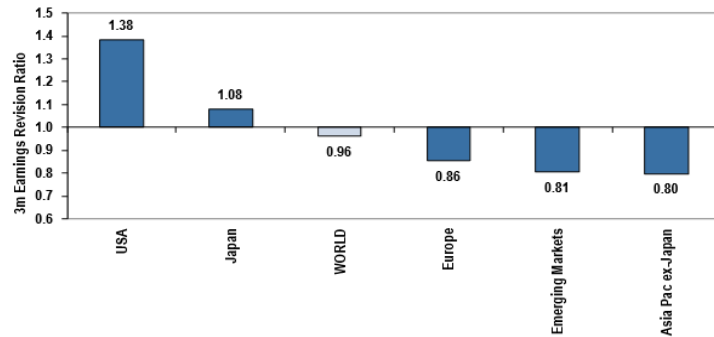
Source: Bloomberg

- > Emerging market equities underperformed global equities in May. The MSCI Emerging Markets Index in euros fell 0.2% versus a gain of 1.1% for the MSCI World Index hedged to euro. However, as the chart on the top left reveals, the difference between emerging and developed market equities (hedged that is) has been relatively muted. This is not the case for the MSCI World Index in euro. Emerging markets have trailed developed market equities by about 7% since March, mostly due to the appreciation of the US dollar, .
- > It briefly looked as if trade tensions would abate pretty quickly after China agreed to reduce its trade balance with the US. But, as we have seen in the past. Mr. Trump decided to double down, suggesting more tariffs could be on the table. So far, China has maintained its composure, but at the same time it has shown willingness to retaliate, as have other US trade partners. We continue to believe that emerging markets will be among the asset classes hardest hit if trade tensions do escalate.
- > After a series of weaker economic numbers, the US economy is improving again. As a group, emerging countries are hobbling along without showing any signs of taking over the growth momentum. Obviously, the poor outlook for some emerging countries has something to do with this. Especially Turkey continues to show weakness. Rating agency Fitch has cut both the outlook for Turkey’s sovereign debt and its banking sector. Meanwhile the pressure on the Turkish lire remains, resulting in very high inflation levels. We do not

> Equities: Emerging vs Developed (II)

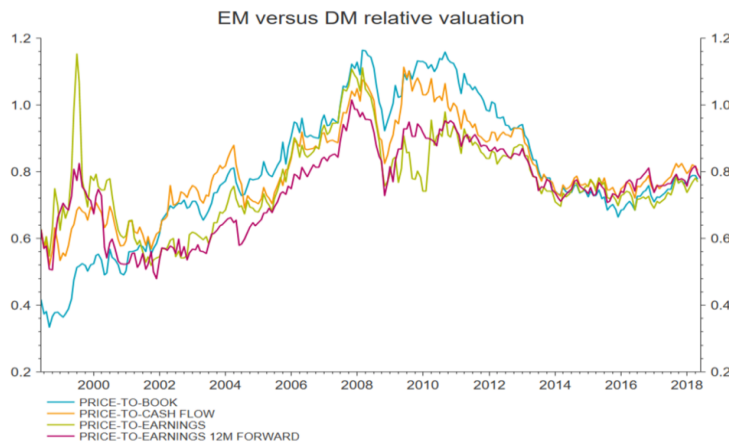
Earnings revisions

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



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

Valuation



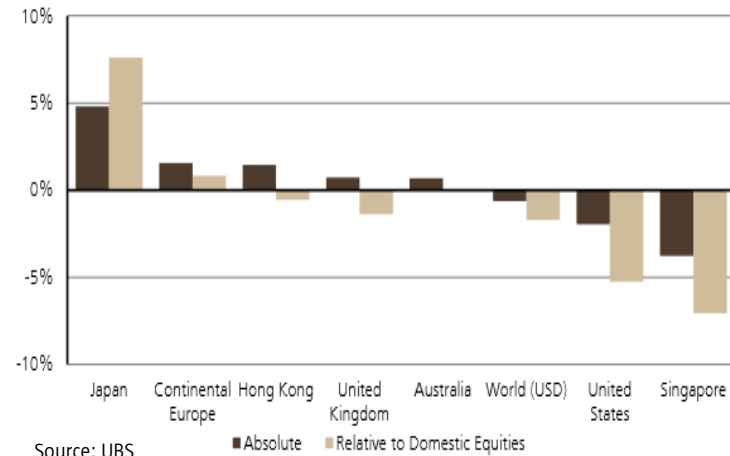
Source: Thomson Reuters Datastream, Robeco

Source: Thomson Reuters Datastream, Robeco

- > expect the situation in Turkey to materially improve any time soon. Russia and South Africa also look rather vulnerable, even though circumstances in the latter have improved somewhat.
- > Italian politics and a Federal Reserve message that could, not should, be interpreted as dovish, made the market doubt future Fed rate hikes. But we don't think the Fed will deviate from its path that easily as it already seems to anticipate some degree of overshooting. Higher Fed rates with the end of the ECB's QE program on the horizon reduces liquidity, something emerging markets don't tend to like.
- > Emerging market earnings revisions continue to struggle, with downgrades exceeding upgrades. As we stated at the beginning of the year the expectations for emerging market earnings growth, which looks pretty healthy, were a bit too high. Valuations looks reasonable, over a longer-term horizon, a 20% discount to developed market equities is still sizeable, but it also implies that emerging equities are no longer outright cheap.
- > We remain underweight emerging market equities. Trade tensions could flare up, which is a negative for the asset class. The same holds for a gradual reduction in liquidity. At this point, momentum, earnings growth and valuation do not make up for these less attractive factors.

> Real estate

Regional differences year to date



Discount of global real estate to NAV widens

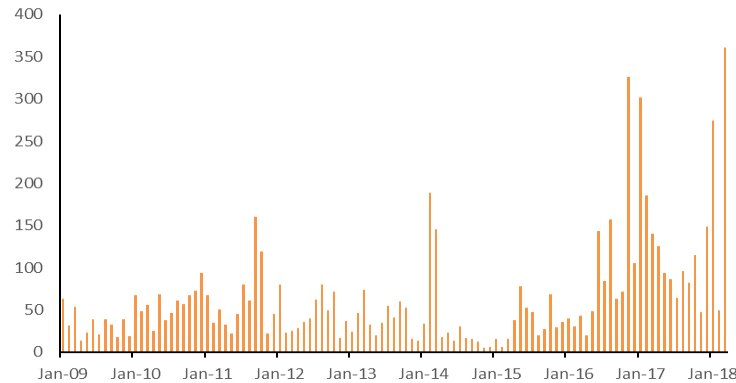


Source: Worldscope, I/B/E/S, DataStream, UBS estimates, as of 30 May 2018.

- > In May, the S&P Global Developed Property Index (in US dollars) rose 1.5%, while global equities (also measured in dollars) rose by 0.6%, reducing the year-to-date underperformance for real estate to 1.7%. The underperformance of global real estate is mainly due to the underperformance of US real estate. Year-to-date, Japanese real estate is outperforming the other regions, but overall real estate performance is still in negative territory.
- > As mentioned several times here, the US market dominates the index, while it has a high correlation with the US bond market. The Treasury yield had a roller coaster ride last month. Economic data in and outside the US are strong, so yields rose above 3%, but as the Southern European troubles flared up, markets switched to risk-off mode, with lower yields the result. The relative performance of real estate more or less followed the same (inverse) path: outperforming with falling yields.
- > Economic developments favor of real estate, with economic momentum in most parts of the world leading to higher rental income. In most regions the dividend yield is attractive, although the spread against bond yields in the US is tightening. Valuation metrics look attractive as global real estate trades at a discount to NAV.
- > The fundamentals look pretty good at the moment, but the US Treasury yield remains a key driver of real estate performance. And although the Fed was less hawkish last meeting, our base scenario is that yields will move higher. So, neutral seems the best position for now.

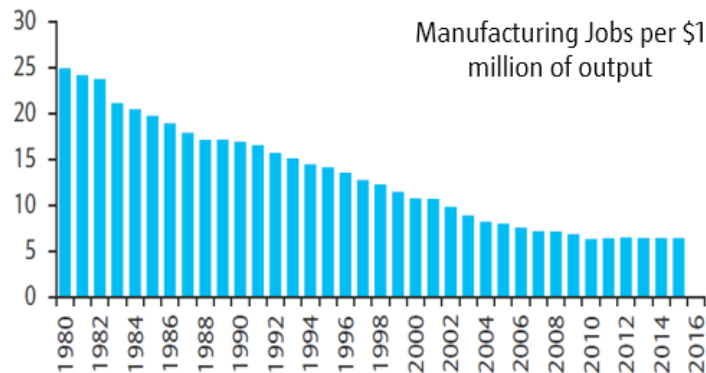
> AAA Bonds (I)

**US trade policy uncertainty index at a record high**



Source: Bloomberg & Robeco

**Trump trade policy: fighting a lost war to safe manufacturing jobs**

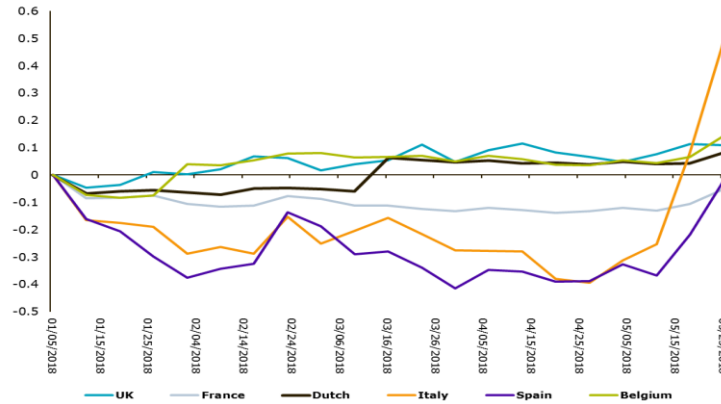


Source: The brooking Institution and Moody's Analytics

- > The ten year US Treasury yield continued to hover around the 3% level in June. Half way through the month it looked as if we were finally making a decisive move above the 3% level, but unfortunately - after reaching the 3.11% level - yields succumbed to downward pressure and fell firmly below 3% again.
- > While it was a combination of factors that pushed yields below 3%, the trigger was probably the release of the Fed Minutes. The main takeaway was that the Fed was less hawkish then generally expected. The explicit willingness to let inflation run above the target level raised some eyebrows and made it pretty clear that 2% is not the ceiling for inflation. The market took this as a cue to lower hiking expectations, but refused to also add risk to compensate for the probability that this may ultimately lead to a Fed that is falling behind the curve.
- > Trade, politics and geopolitical developments all played their part in eroding confidence and triggering a shift to safe havens, in which US Treasuries and German bonds were once again the assets of choice.
- > The reemergence of trade and geopolitical risks was triggered by President Trump. First he pulled the US out of the nuclear agreement between Iran and P5+1. Subsequently the US moved its embassy to Jerusalem and then Trump started to flip flop on whether the meeting with North Korea's Kim would indeed take place.

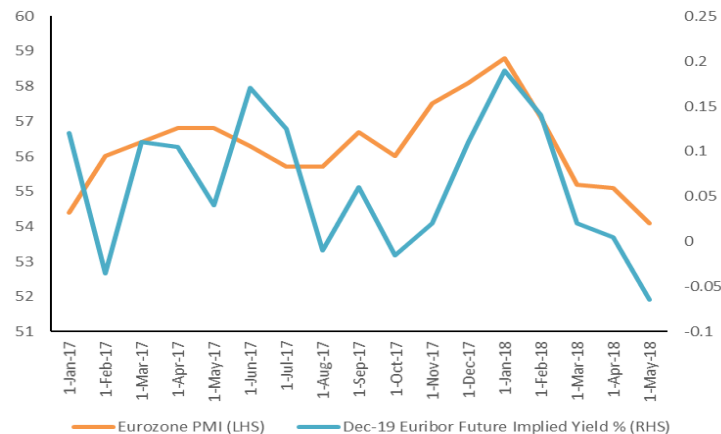
> AAA Bonds (II)

Spread versus German Bunds: Bunds remain the safe haven of choice



Source: Bloomberg & Robeco

Weakness in Eurozone data is taking its toll on rate expectations

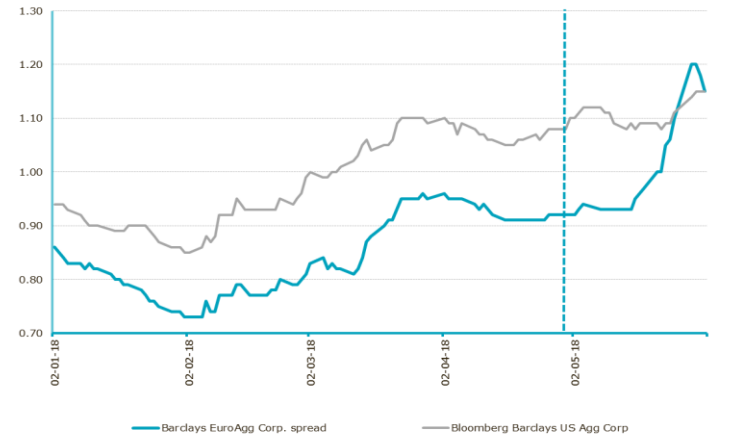


Source: Bloomberg & Robeco

- > On top of this, Italian political risk started to resurface. While the outcome of the Italian election always had the potential to disrupt, most market participants initially remained sanguine about the outcome. This quickly unraveled when the market started to worry about the euro sceptic credentials of the two parties that were looking to form a government. The decision of Italy’s president to reject the candidate that was put forward to become finance minister triggered a massive sell-off that was not restricted to Italian assets, as fears for an unraveling of the Eurozone started to resurface.
- > With politics and geopolitical risk rising and causing financial conditions to tighten, we need to figure out if this will have a lasting impact on global growth. The initial signals are not good, the latest economic numbers out of the Eurozone failed to confirm that the weakness in the first quarter was indeed just temporary.
- > The combination of continued data weakness and stability issues in Italy could opens the door for the ECB to stay put for longer. The market has already pushed forward the date for the first rate hike. While we tend to agree with this, it should be noted that inflation numbers came in much firmer. It will be interesting to see if the ECB just dismisses these. It’s clear that growth has pivoted towards the US and this puts the fate of government bonds in the hands of the Fed. For now we continue to stick to our view that growth will continue and that there is still room for yields to move higher.

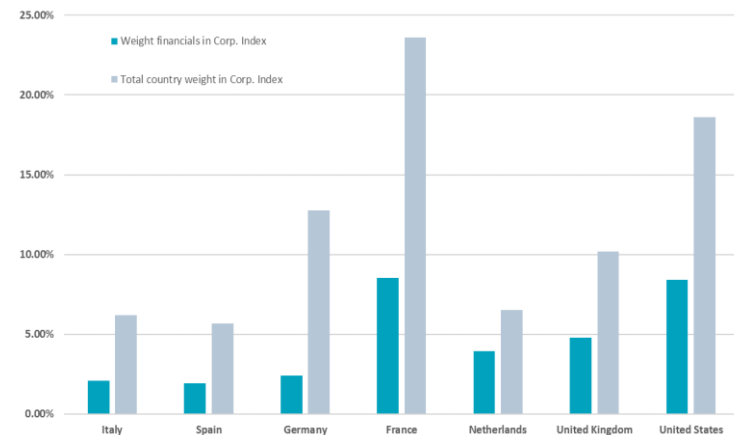
> Investment Grade Credits (I)

Italian political turmoil and the European credit spread



Source: Bloomberg, Robeco

Exposure Italian and Spanish financials vs the European Corp. Index



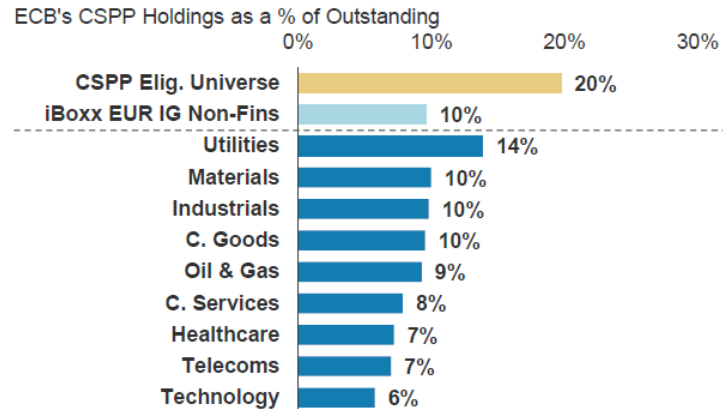
Source: Bloomberg, Robeco

- > In the second half of the month, the political turmoil in Italy gripped the European sovereign bond markets. As a result, government bond yields in the Southern European countries rose sharply, while German Bunds were sought as a safe haven. Credit spreads widened sharply as a consequence, but that was mainly related to the declining European government bond yields. On a standalone basis European credit yields rose by a maximum of just 8 bps, compared to the 28bps spread widening in the same period.
- > On balance, the European credit market also acted as a sort of safe haven, which can partially be explained by its relatively low exposure to Southern European countries and more specifically European financials, which are most vulnerable when panic erupts on the financial markets and yields rise. The European credit market is dominated by France, followed by US issuers of euro-denominated credit and Germany. Even Dutch (financial) credits have a larger weight in the index than Italy or Spain. That said, there will always be at least some contagion if the situation in Italy escalates.
- > Another factor that helps the relatively stable European credit market is the ECB’s ongoing CSPP program, although the intensity of corporate bond buying has diminished since the start of the year. The ECB holds about 10% of the corporate bond market, half of the eligible universe (see graph next page). The credit market is focused on the ECB meeting of 14 June, which might give some clarity on when the CSPP program is likely to end. The ECB is reinvesting the proceeds of the



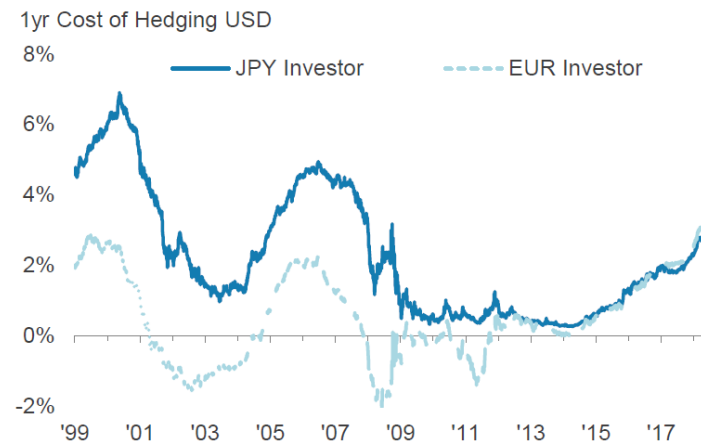
## > Investment Grade Credits (II)

### Unwinding CSPP: distribution of the outstanding corporates



Source: Morgan Stanley

### Hedging costs make US credits unattractive for Europe and Japan



Source: Bloomberg, Morgan Stanley Research

- > holdings, which still amount to for almost EUR 3 bln. Given the duration of the holdings, these reinvestments will continue at least until 2020. But, as the ECB withdraws, we expect the credit market to become more volatile in the coming period.
- > The US credit market wasn't immune to the Italian issues, but also had to deal with a next phase in the US trade conflict with China (and Canada, and Mexico and Europe...). In the longer run, these tariffs will probably start to hurt corporate profits. Besides that, a stronger US dollar, in combination with increased currency hedging costs, make US credits unattractive for both European and Japanese investors, which is also reflected in the fund flow data. The risks are already reflected in movements in US credit yields, which keep rising. Since January, the US credit yield has already risen by more than 50 bps to 3.32.
- > We still have an overweight position in credits, which is based on a technical view rather than from the convincing outlook for credits. The main reason why we are still interested in this asset class is that it offers more than the negative yield on cash. From a fundamental point of view, risks associated with credit investments are still rising, especially in the US. As long as the music continues to play, we will remain invested in European credits in preference to cash, but we are cautiously watching what the ECB's next steps will be.

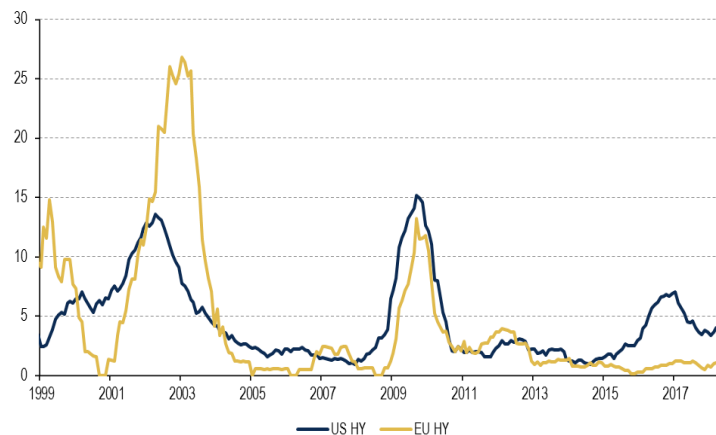
> High Yield (I)

High yield – spread



Source: Bloomberg

High yield – defaults

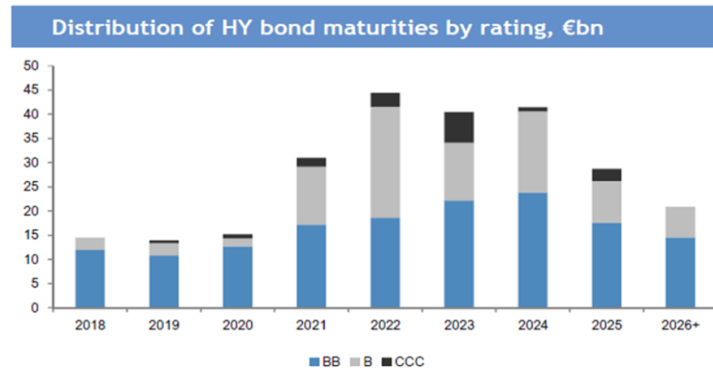


Source: BofA Merrill Lynch

- > Another month, another negative return for global high yield bonds (hedged into euro). High yield bond prices fell by an average of 1.1% in May, marking the fourth consecutive month in which the asset class has realized a negative return. Global high yield bonds also underperformed other fixed income asset classes. At the end of May, High yield bonds were down 2.5% for the year, with the average spread at 399 basis points versus 350 basis points at the end of April.
- > Despite the slight improvement in valuation as a result of the recent underperformance, we remain cautious on the outlook for high yield bonds. Yields and spread levels still offer little protection against less favorable market circumstances. While we remain marginally overweight risky assets in a portfolio context, high yield bonds offer the least attractive risk-return profile.
- > For now we maintain our base case that economic fundamentals will ultimately prevail, even though recent events related to trade tensions and political turmoil in Italy should not be taken too lightly. This means that government bond yields will rise, especially now that inflation is showing signs of life. This is also a negative for high yield bonds given their relatively narrow buffers as described above.
- > However, decent economic growth, which we expect, also implies that defaults could stay low for some time to come. From this perspective we do not expect a significant widening in high yield spreads.

> High Yield (II)

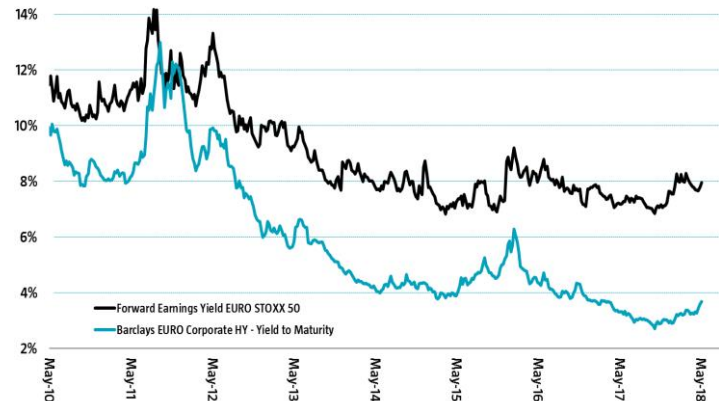
High yield – energy spread



Source: J.P. Morgan  
Source: Bloomberg

J.P.Morgan CAZENOVE

High yield – relative valuation against equities

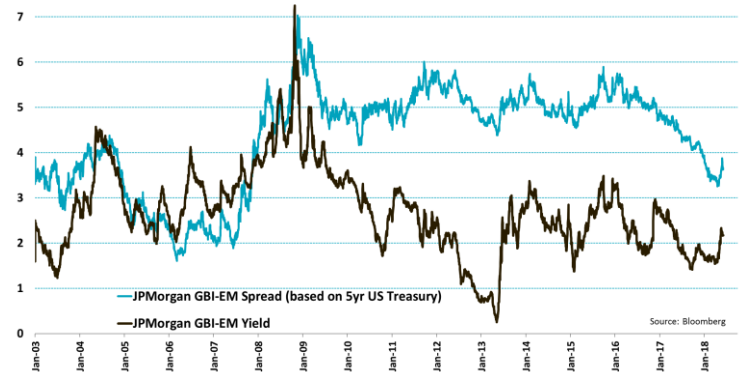


Source: Bloomberg

- > In the Eurozone, where average high yield credit ratings are higher, the default rate remains close to zero, while default rates have fallen below 5% in the US.
- > In addition, strong earnings growth and bond yields at still low levels, should prevent many companies from running into trouble any time soon. Higher oil prices also make it less likely that defaults will spike. Since the increase in the number of US shale producers, many of which are US high yield companies, the weight of the energy sector in this segment has steadily increased. Finally, the so-called maturity wall, the scheduled amount of debt that has to be refinanced, looks manageable.
- > High yield bonds look expensive compared with most other asset classes, especially in the Eurozone. The chart on the bottom left shows the relative valuation of Eurozone high yield compared to equities. Artificially low interest rates, as a result of the ECB’s ongoing QE program, have pushed high yield bond yields far below the earnings yield of Eurozone equities. At current valuations, we think only Eurozone government bonds look less appealing within the fixed income space.
- > We maintain our underweight in high yield bonds, based on negative momentum and elevated valuation levels. Equities offer a more attractive risk-return profile.

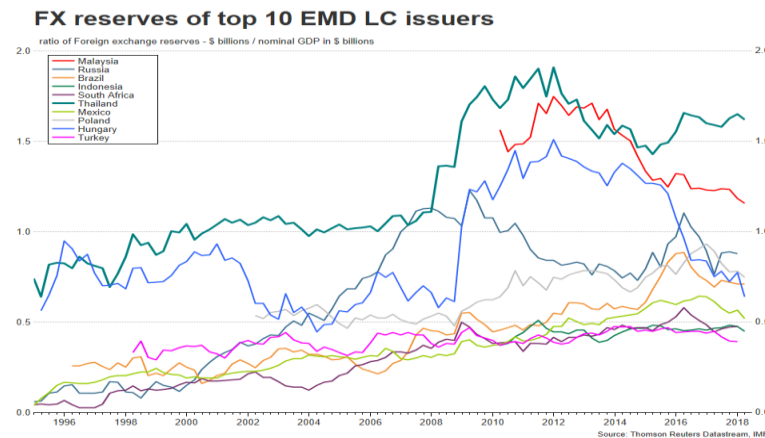
> Emerging Market Debt (I)

Emerging market debt in local currency – spread and yield



Source: Bloomberg

Turkey has the lowest FX reserves as % of GDP of EMD LC universe

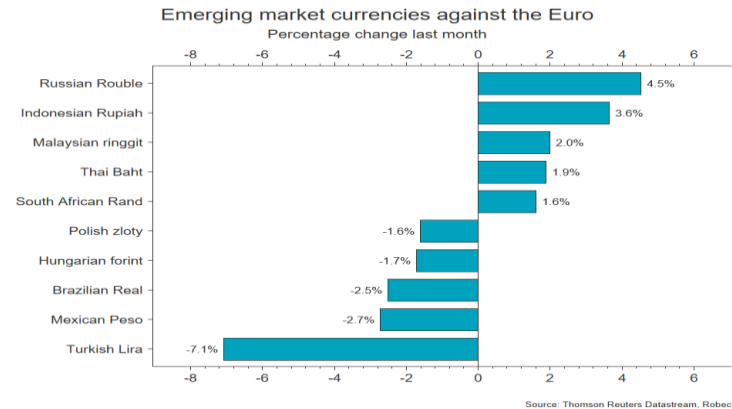


Source: Thomson Reuters

- > Local currency emerging market debt (EMD) unhedged in euros lost 0.7% in May and continued to show negative momentum. Sentiment among EM investors soured as the dollar strengthened, US bond yields edged up while fears of a hard landing in Turkey rose after a sharp sell-off in the Turkish lira. The uptick in global bond volatility shows that the environment for EMD in local currency has become more challenging and volatile.
- > Solid macro data from the US suggested the Fed could continue on its path to raise policy rates at least three times in the remainder of this year. In response, US 10-year yields had risen to 3.1% by mid May for the first time in seven years, making yields on emerging market debt in local currency look less attractive, especially for US investors. Nevertheless, yields on local currency emerging market debt at 6.4% at the end of the month still compares favorably with other fixed income categories such as high yield (6.2%), although yield gaps have narrowed.
- > In response to slipping currencies and a worsening external environment, EM central banks have refrained from further easing. The Turkish central bank was forced to raise policy rates by 300 bps to 16.5% to stem the fall of the lira. In the case of Indonesia, the central bank raised policy rates twice last month amid concerns of a capital flight. In Brazil, the COPOM remained on hold, not easing policy further despite steady growth and still low inflation. In short, the more dovish monetary policy outlook for EM central banks has become questionable, especially against a backdrop of rising oil prices.

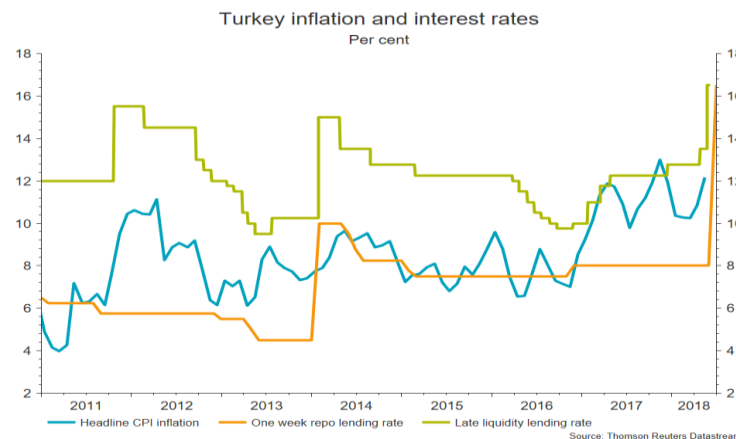
## > Emerging Market Debt (II)

### Emerging currencies



Source: Thomson Reuters

### Turkish central bank ramps up policy rates to stem lira downfall

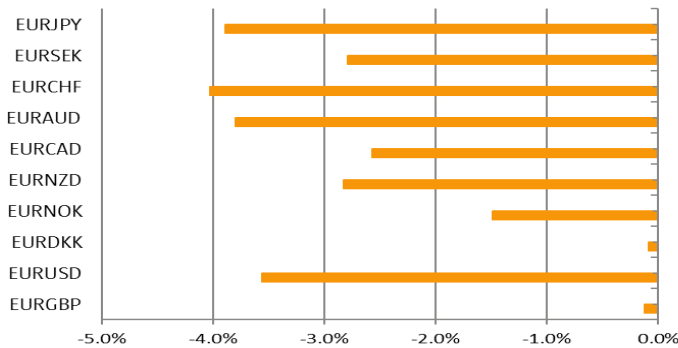


Source: Thomson Reuters

- > The currency of the month in the EMD universe has undoubtedly been the Turkish lira, which lost 7.1% against the euro in May. A mixture of a high level of dollar denominated debt, a current account deficit of 6.5% and elevated leverage can explain a lot. Last month, Turkish president Erdogan called high interest rates “the mother and father of all evil”, hinting on limiting the central bank’s powers. It was this threat to central bank independence that scared investors and led to the subsequent dramatic fall in the lira. With inflation now running in double digits, higher interest rates are needed to curb inflation and capital outflows. The Turkish central bank did finally intervene in the second half of May, calming markets to some extent.
- > A positive development for oil exporters within the EMD universe was the increase in Brent Crude by 4.4%, particularly benefitting Russia. The Russian energy industry has been recently benefiting from the weaker ruble and the surge in oil prices last year. The divergent FX performance within the top 10 EMD issuers shows that even during this ‘EM rout’ investors were still discriminating according to underlying specific country fundamentals.
- > Yields in local currency EMD still look attractive. However, with long term US yields unlikely to remain below 3% for long, the pressure on emerging market debt could continue if the valuation discount in EMD currencies is lackluster, increasing spillover risks if sentiment worsens. We remain tactically neutral in EMD local currency, as we think the current positive carry is barely sufficient to shield us from the expected negative currency impact.

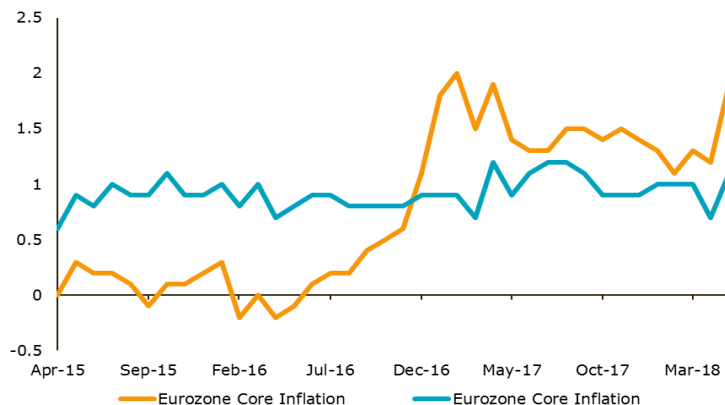
> FX (I)

**G-10 currencies: the Canadian dollar is the winner**



Source: Bloomberg, Robeco

**Inflation picked up firmly in the Eurozone**

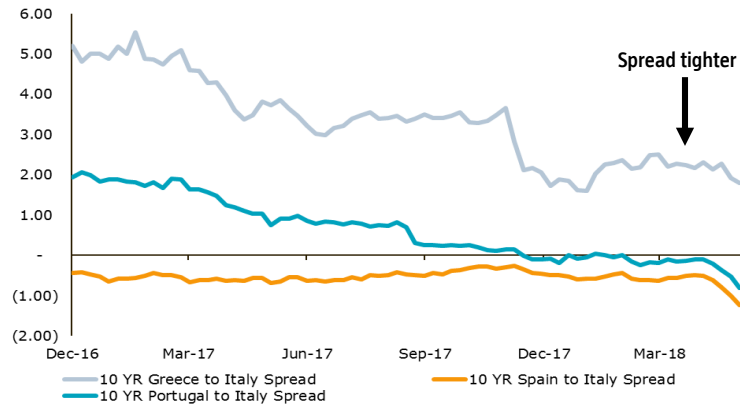


Source: Bloomberg, Robeco

- > Political uncertainty is back in the Eurozone and the single currency is once again feeling the consequences of this. Rightfully or not, developments in Italy have put Eurozone break-up risk firmly back onto the radar screen of investors. The top three best performing currencies were the natural safe havens in such circumstance, Swiss franc, Japanese yen and the US dollar.
- > It is interesting to see that EURCHF was the strongest within G-10. It should be pointed out that the Swiss national bank is not happy to see this development, while they continue to have a relatively low bar for stepping into the market.
- > It cannot be denied that rising political premiums weighed on the euro, however the depreciation started long before Italian politics became a major issue. As we noted last month the realignment of currencies with rate differentials reoccurred for the first time in quite a while. This rate differential is a reflection of the cyclical divergence between the Eurozone and the US. This triggered the euro's initial move lower, as market participants started to weigh the favorable cyclical conditions more heavily than the structural problems (twin deficits) of the US.
- > This dynamic is still playing out, as European data failed to rebound in the second quarter. The euro will find it difficult to find a firm footing as long as its economic numbers lag those being released by the US.

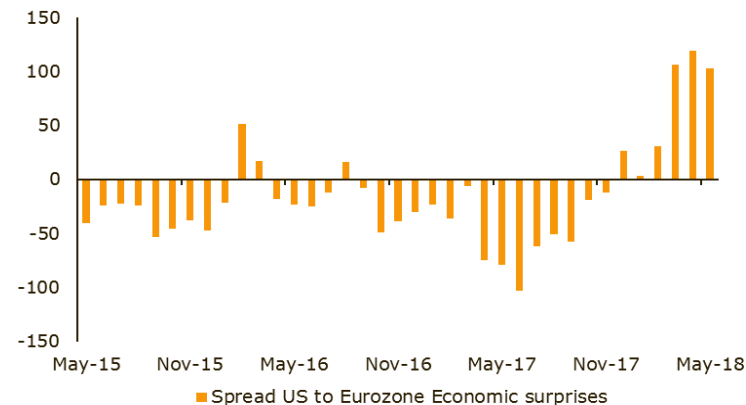
> FX (II)

**Contagion benign: lower-rated peripherals tightened relative to Italy**



Source: Bloomberg & Robeco

**Cyclical support EURUSD: US massively outperforms Eurozone Surprises**



Source: Robeco & Bloomberg

- > The strength of the latest job numbers is another confirmation that the US economy is continuing to do just fine.
- > For the euro to strengthen an additional condition is required and that is that political risk premiums need to decrease. While things seem to have started to calm down in Italy now that a government has been formed, questions remain about the budgetary plans of the new administration. An important test for the government will be the budget approval process that will start around summer.
- > The ECB has been very reserved in its response to developments in Italy and the weaker data. The stronger-than-expected inflation numbers may have complicated things a little more for the bank. We continue to think that the ECB has limited room to maneuver. If the contagion remains limited, the purchasing plan will end this year. But we do think the market is right to push the likely date for an initial rate hike further into the future.
- > During last month we closed the final leg of our US dollar underweight position and moved to an overweight position. Initially we only went underweight pound sterling in favor of the dollar. This was done as we thought it was highly likely that Brexit risks would start to resurface. Later we also added an underweight in euros against the dollar, to reduce the sensitivity of our portfolio to Italian political risk.

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