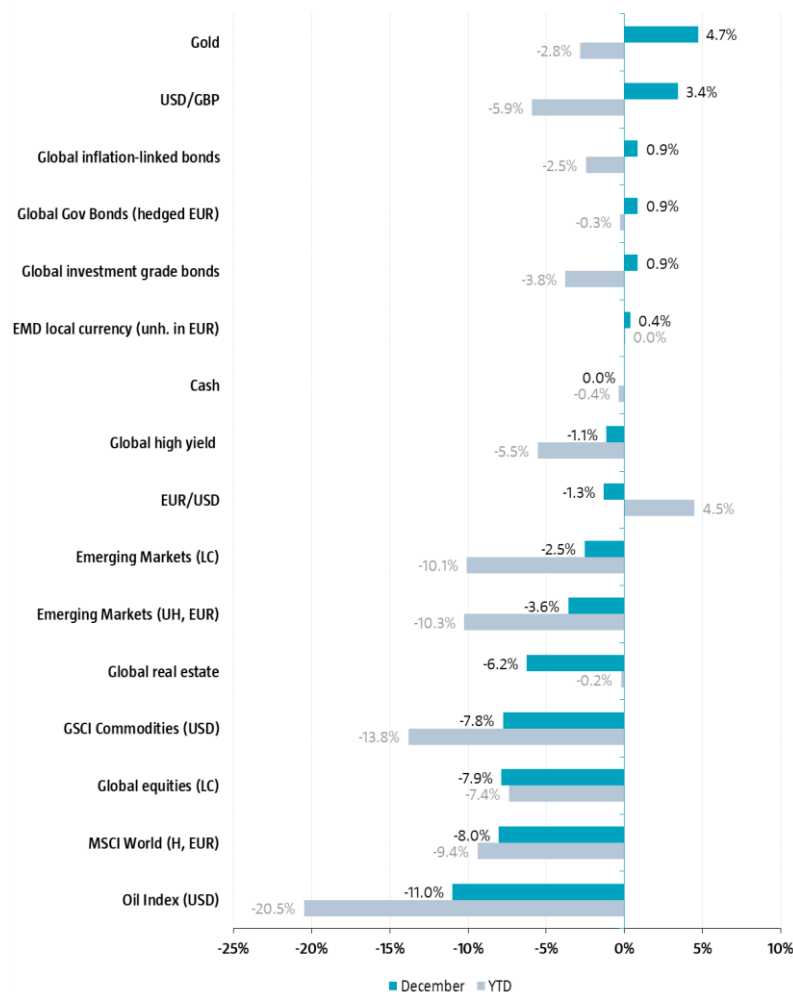


Multi-asset market outlook

For professional investors
January 2019

General overview

2018: some positive returns please...

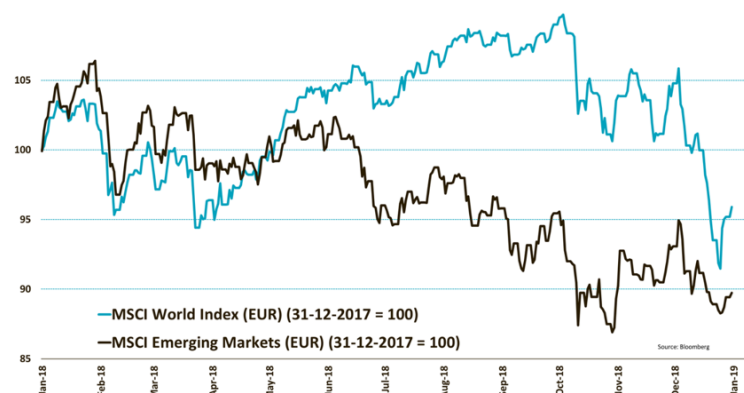


Source: Bloomberg, Robeco

- > Those who hoped for a December equity market rally were massively disappointed. Not only did the markets take a hit in the first days of the month, but losses rapidly accumulated going into the new year. The gains realized by equity markets in the first three quarters had already been erased before December had even begun. Global equity markets ended 2018 with 7.4% loss.
- > While only a couple of months ago we were talking about a possible overheating, fear prevailed towards the end of the year. Confidence was eroded by a number of issues. The US economy started to show signs of weakness, while the trade war with China and the weakening Chinese economy began to weigh on US corporates profits. The market also started to lose hope that tariffs would either be lifted or frozen, and the Fed refrained from making changes to its pre-determined hiking path. Amid all the headwinds, emerging markets outperformed developed markets in the last quarter.
- > The two major bond markets moved in opposite directions in 2018 – the US rose while Europe fell – although during the equity sell-off, US Treasury and German Bund yields both declined.
- > Despite the turmoil, we only made small changes to our positioning. We remain overweight equities, but have tilted our exposure more towards emerging markets. This came at the expense of US equities. We remain negative on most bond categories.

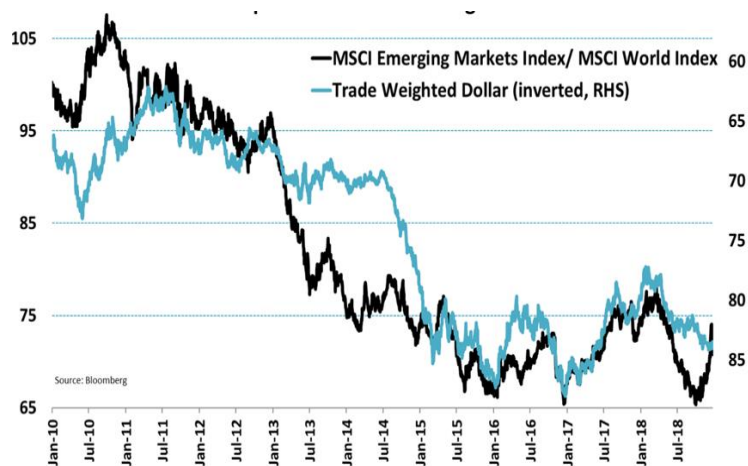
> Theme of the month: Will emerging markets make a comeback this year? (I)

Developed and emerging stock market performance in 2018



Source: Bloomberg, Robeco

EM and DM equities and the trade-weighted US dollar

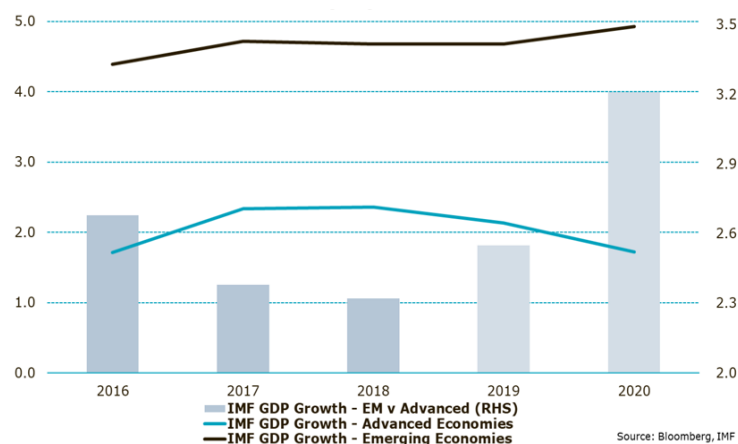


Source: Bloomberg, Robeco

- > 2018 wasn't a pretty year for equity markets in general, and for emerging markets in particular. Global stocks fell 4.1% (in euros), whereas emerging market equities realized a negative return of more than 10% (also in euros). But what about the outlook for 2019? Given recent developments in markets, the odds for a solid emerging market performance from here on are pretty decent.
- > Contrary to the messages of just a few months ago, the end of, or at least a pause in, US monetary tightening is now on the table. This means that the difference between interest rates in the US and, for example, the Eurozone will not widen further, even though the ECB probably won't get very far with its own rate hike plans before the next recession hits. And that means the US dollar – which is already overvalued – won't necessarily strengthen, as the attractiveness of a currency largely depends on interest rate differences between two regions.
- > This is an important development for emerging markets, as a stronger US dollar often coincides with lackluster emerging market performance, as can be seen in the graph. As emerging market economies are more open than the US economy, Fed tightening measures often hit these countries harder. Generally speaking, this tends to have a greater impact on asset classes at the end of the risk spectrum, such as emerging market stocks.

> Theme of the month: Will emerging markets make a comeback this year? (II)

GDP growth – emerging and advanced economies



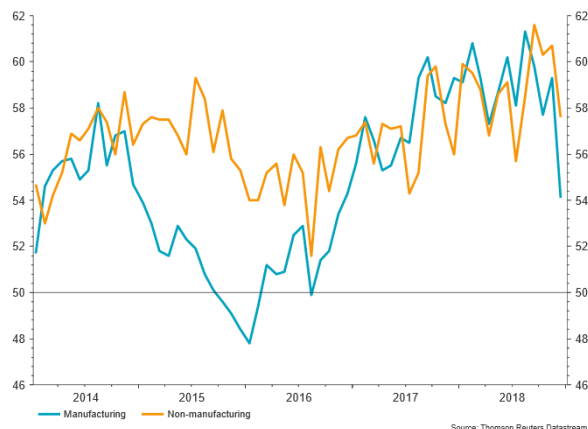
MSCI Emerging Markets Index – P/E ratio



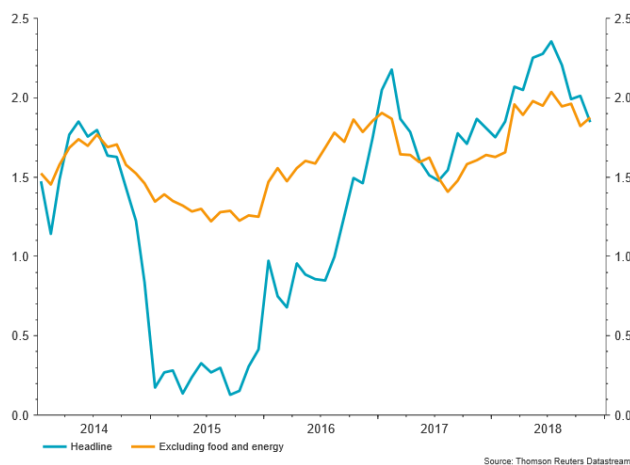
- > Next to a pause in Fed tightening, we also expect the gap between GDP growth in emerging and developed countries to widen this year for the first time since 2016. Historically, the gap has been one of the strongest drivers of emerging market equity performance relative to developed market equities.
- > In the latest IMF growth forecasts, as shown in the chart, growth in emerging countries is expected to accelerate somewhat, while growth in developed markets is seen easing in the coming years. While the divergence will be slow at first, the gap will likely widen to above 3% in 2020, the biggest differential since 2013.
- > So, what about the trade war between China and the US? In recent months, a temporary truce was declared: China lowered tariffs on some US imports, and President Trump offered some willingness to come to an agreement. While the dispute is not yet solved, the marginal effect on trade and GDP growth will decrease. When this happens, we expect emerging stocks to be among the main beneficiaries.
- > Finally, valuation could provide a catalyst: the average P/E ratio of emerging equities has dropped by as much as 30% as a result of the sell-off last year. Although it is rarely the trigger for market reversals, we believe that the current level of valuation can become an important tailwind when things start to turn around.

> United States

Sharp decline in headline ISM indices



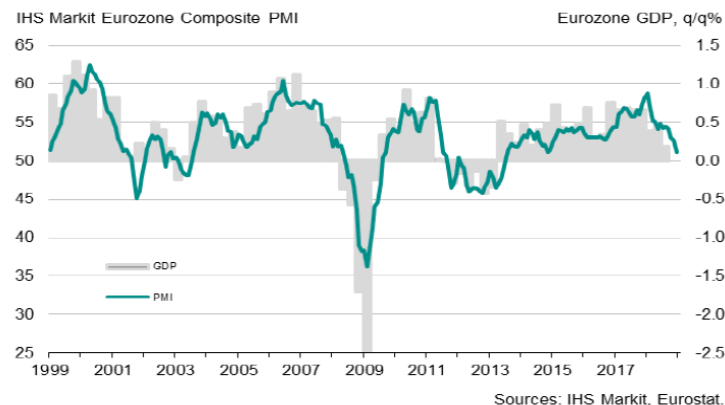
Core and headline PCE are below 2.0%



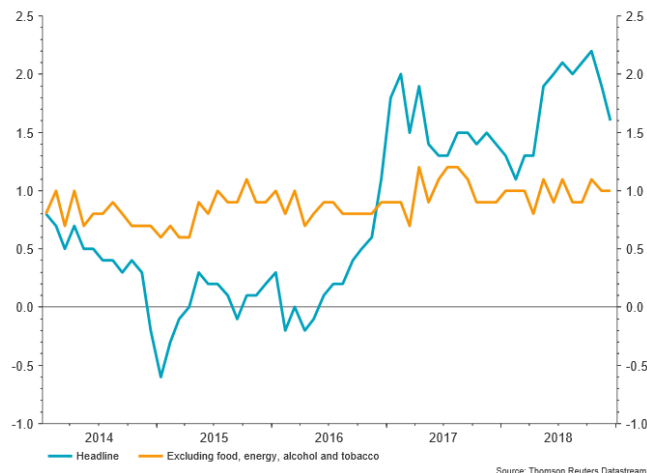
- > Powered by unfunded tax reductions for corporates, the US economy had a good 2018, growing around 3.0%. In this climate, the Fed was able to continue to hike interest rates at a modest pace. For December, forward-looking indicators have come down sharply however, suggesting an economic cooling.
- > Drifting into a recession remains unlikely. The labor market continues to be strong, as illustrated by the increase in non-farm payrolls by 312,000 in December. The unemployment rate admittedly rose to 3.9%, but this because more workers entered the labor force, a sign of health. Average hourly earnings rose to 3.2% on an annual basis, the highest increase since 2009, which bodes well for personal consumption.
- > As 2019 is a pre-election year, there is every reason for the US president to seek a compromise with Congress on additional fiscal stimulus, such as by increasing much-needed public investment in infrastructure, and tax relief for the middle class. The current partial shutdown of the US government is temporary and is of limited economic significance.
- > With the headline rate of inflation as well as the core PCE – the inflation indicator preferred by the Fed – both hovering below 2.0%, the Fed has room to take it easy. Chairman Jerome Powell has signaled that the Fed is no longer on autopilot, and interest rate decisions will be data-dependent, suggesting a pause for the time being. Presumably, the Fed will resume tightening at a modest pace in the second half of 2019.

> Europe

Eurozone composite PMI weakens further in December



Eurozone core inflation: steady as she goes



- > The Eurozone economy made a promising start to 2018, but the growth picture deteriorated during the course of the year, due to a range of negative factors. The important German car industry wrestled with new and more severe emission norms (probably temporarily). The export-driven European economy was an indirect victim of rising trade tensions between the US and China. The confrontation between the populist Italian government and the European Commission about European budget norms damaged confidence. French consumer spending suffered from repeated demonstrations by the 'yellow jackets'.
- > Fortunately, partly under pressure from events in France, the European Commission has reached a compromise with the Italian government on the government budget, which also gives the French government more budgetary room for maneuver.
- > Ongoing Brexit issues didn't help either. Uncertainty around the Brexit process is still high, despite the looming deadline of March 29. Chances of a no-deal, so-called hard Brexit have in our opinion diminished markedly though. The European Court of Justice has ruled that the UK government has the right to unilaterally withdraw its invocation of Article 50. In that case, probably only to be used as a last resort, the UK would stay as a member of the EU on current terms. More likely is the UK entering a transitory regime after leaving the EU in March, which would mean a 'Brexit in name only' for the time being. The road to this solution is at the time of writing still unclear.

> Japan

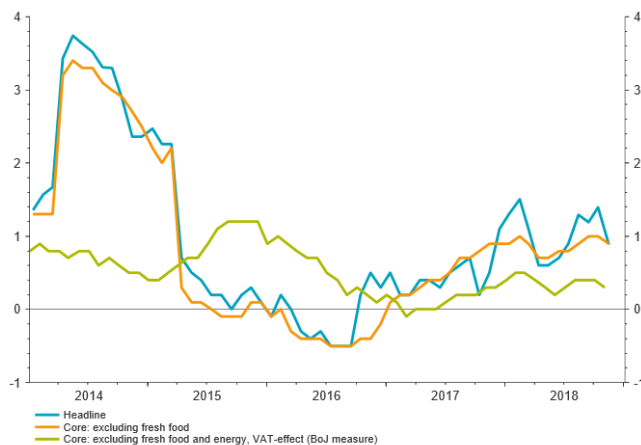
Solid expansion for the industrial sector in Japan

Nikkei Japan Manufacturing PMI



Sources: Nikkei, IHS Markit

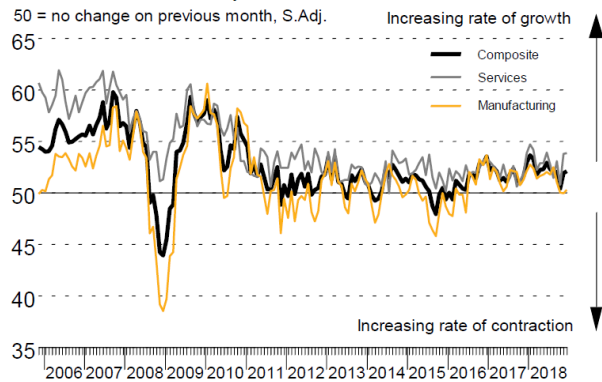
Inflation is falling back again



Source: Thomson Reuters Datastream

- > On balance the Japanese economy did well in 2018, growing at a solid rate of almost 1.0%. After a very weak third quarter due to a succession of earthquakes and typhoons, the economy rebounded strongly in the fourth quarter. The current expansion will reach its 74th month in a row in January 2019, becoming the longest post-war expansion by overtaking the 73-month so-called 'Izanami boom' which lasted from February 2002 to February 2008.
- > Japanese manufacturers remain positive on growth prospects, partly because of the coming 2020 Olympic Games. But the mood is tempered by worries about the impact of China-US trade tensions. More importantly perhaps is the impact of the VAT hike from 8% to 10% scheduled for October. Well aware of the contractionary risk posed by this tax increase, the Japanese government has introduced tax relief for households in its budget for fiscal year 2019. Tax on food will be reduced and the government is taking initiatives for the provision of free education and childcare.
- > The core-core inflation index excluding both energy and fresh food – the gauge preferred by the Bank of Japan – slowed to a disappointing 0.3% in November from 0.4%. As the rise in producer prices was flat in November, more weakness in the core-core is to be expected, increasing pressure on the BoJ to maintain its huge stimulus program.

> China

The Caixin Composite China PMI rose further in December

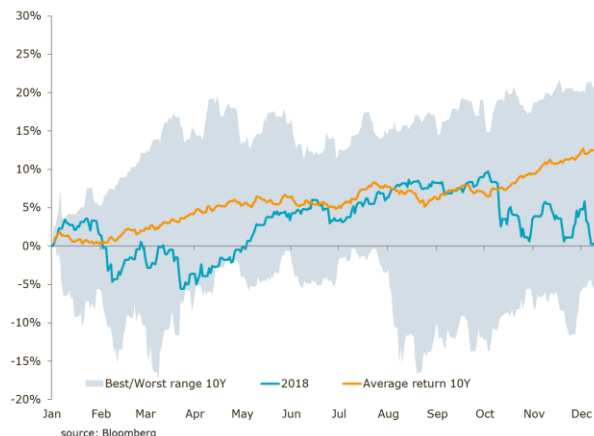
Sources: IHS Markit, Caixin.

The Chinese yuan is stabilizing at under 6.9 to the dollar

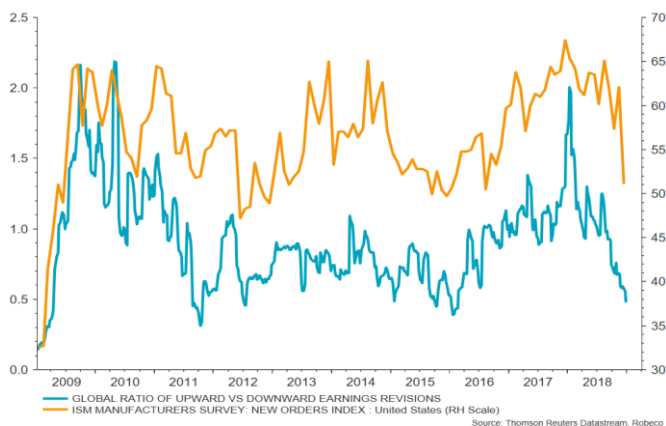
- > The Chinese economy weakened in 2018. The trade war with the US damaged Chinese exports and producer confidence. Still, the Chinese economy probably was able to reach a growth rate in excess of 6.5%. The Chinese government has stepped up efforts to stimulate the economy. Recently, it has cut the reserve requirement ratio for banks by an additional 100 basis points. Moreover, the central bank has increased credit supply to small and medium-sized businesses. Once again, local governments have been allowed to invest in infrastructure. Tax relief for households is probably also on the agenda.
- > The slowdown in the Chinese economy should not be exaggerated, as illustrated by the Caixin China Composite PMI, which covers both manufacturing and services. It rose in December to a five-month high of 52.2 from 51.9. Not only did services companies register a solid rate of activity growth, manufacturing output expanded as well, albeit slightly, after two months of stagnation.
- > Trade negotiations between the US and China have begun, but a comprehensive deal is unlikely in the short term. Both sides have an incentive, however, to extend the truce. The popularity of the US president is threatened by nervous financial markets, partly as a result of the impact of the trade war. The Chinese economy and financial markets seem to be the main casualties of the current tensions, spreading to the rest of the world as well. Some kind of minor, but face-saving compromise allowing Trump to claim a victory of sorts seems likely.

> Equities (I)

Developed equity – 2018 performance



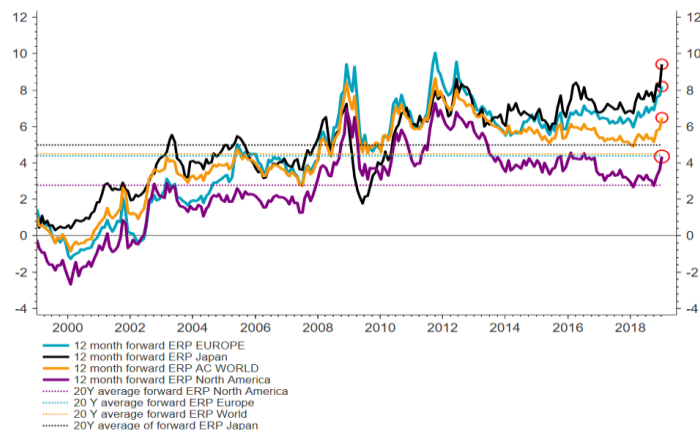
Leading indicators roll over, earnings revisions turn net negative



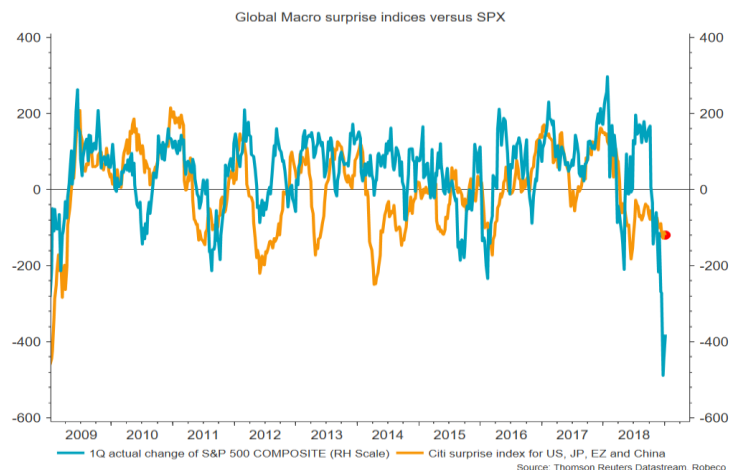
- > For equity investors, 2018 is a year they would rather forget, as the MSCI World Index generated a loss of 4.1% in euros. The sting of 2018 trading was in its tail, with a steady drip of bad market news in the fourth quarter. December ended with the largest monthly December loss for the S&P in 50 years. With a decline of around 20% from peak to trough, equities hovered around bear market territory.
- > Clearly, those investors eagerly setting sail for an end-of-year rally in September based on strong earnings growth (still 25% y-o-y for the S&P in Q3) and seasonality turning positive were wrongfooted. Some blame machine traders for the recent market rout by exacerbating volatility. But the magnitude of the sell-off was not matched by extreme volatility levels, both realized and implied. Though the VIX spiked to 36 in the last trading days of December, average volatility this year has remained below the average historical implied stock market volatility level of 19.
- > It is still unclear whether this was just a technical sell-off, or whether we were confronted with a more fundamental shift in expectations and risk perception. In 2018, leading indicators such as earnings revisions have rolled over.
- > The market has now largely priced in a recession in the coming year. But one should remember that the stock market isn't a very good predictor of future recessions. Only with the benefit of hindsight will we know whether the market was right this time.

> Equities (II)

Equity risk premiums have shot up, now above long-term averages



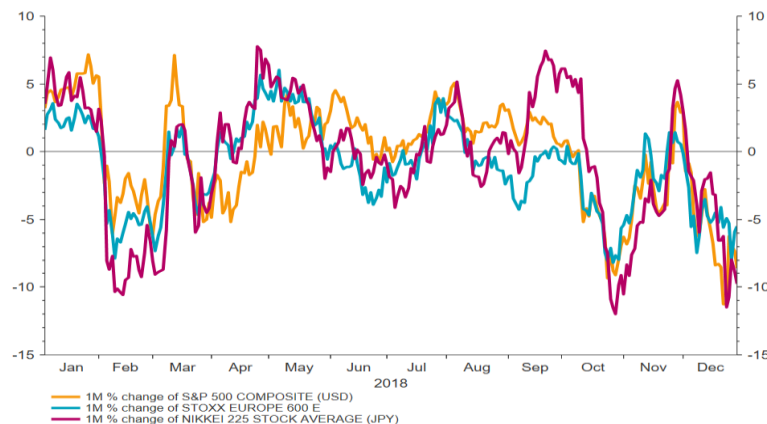
The S&P 500 downturn undershot the extent of bad macro news releases



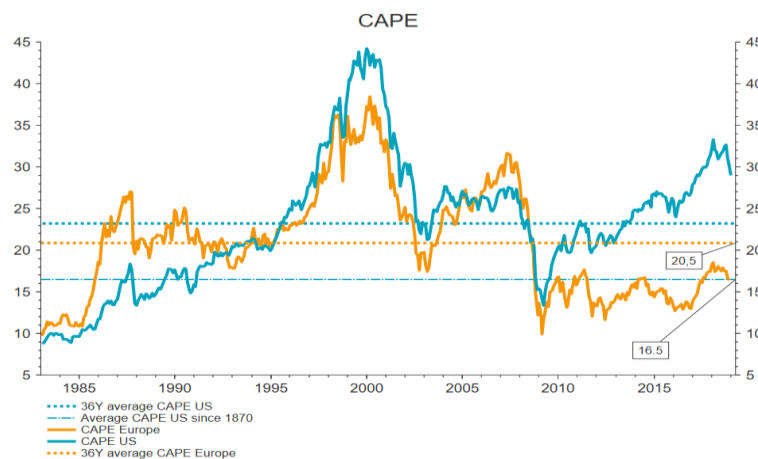
- > The equity risk premium for the MSCI World index is now at 6.4%, which is comfortably above its historical average and represents 75% of the peak equity risk premium (8.4%) seen during the great financial crisis. We do not think that a drifting down into a US recession in 2019 is likely, which implies risk premiums have probably overshot, suggesting there is limited upside for equity markets.
- > Excessively bearish investor sentiment relative to fundamentals is also illustrated by equity market moves far undershooting the extent of negative macroeconomic surprises in the last quarter. This underlying market fear can create negative wealth effects, and thus negative feedback loops into the real economy. This is a short-term market risk. However, investors will gradually start to recognize that the transition from accelerating to decelerating expansion is not synonymous with an imminent slump in global activity growth, but is a more gradual process most of the time.
- > There are further glimmers of hope, and we think the equity market has overshot. The Fed is no longer on autopilot towards rate decisions. Positive surprises could come from geopolitical events like the China-US trade negotiations. As we think a recession in 2019 is unlikely; we added equities in the downturn of the last quarter of 2018, and have entered 2019 with an overweight in global equities.

> Developed Market Equities

It was an exceptionally bad December for developed equities



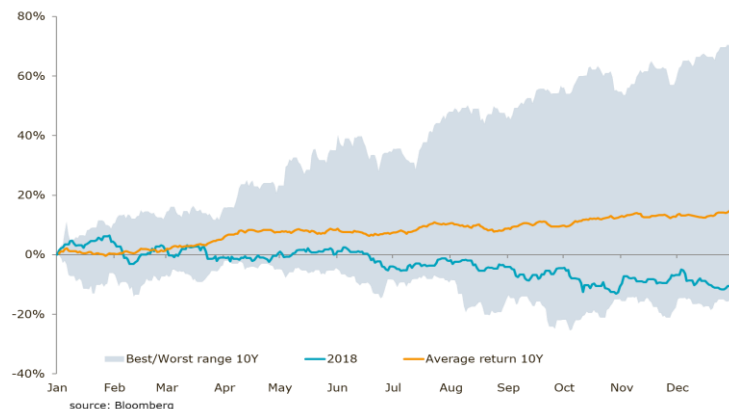
US CAPE has probably peaked in this expansion



- > In December, after failing already for two months to regain positive momentum, developed market equities slid into an aggravated, broad-based downturn amounting to the worst December sell-off for US equities in 50 years. While equities usually do well in December, mounting worries about an imminent global growth slowdown clearly overruled seasonality last month.
- > Based on monthly momentum of equity returns in local currency, US equities were not spared in the global sell-off, with S&P 500 investors losing 8.4% in US dollars. Japanese equity investors were even worse off, with a loss of 10.1% for the Nikkei 225 index. Interestingly, a high beta market like Europe outperformed other developed regions. European equity investors faced a more modest loss of 5.7% in euros. Long momentum has now turned negative for developed market equities. The (12M-1M) signal in local currency has become negative for US equities (-11.4%), followed by the Japanese market (-14.1% in yen). Long momentum for Eurozone equities is now -14.7% in euros.
- > Equity valuations based on the Shiller CAPE declined in the last quarter. US CAPE is now at 29, still a relatively high level with respect to medium-term expected returns and volatility. European CAPE-based equity valuations declined and are now at a level of 16.4. A more patient Fed, steeper yield curves and European growth catching up with US growth rates could be beneficial for European equities. We remain overweight in developed market equities, slightly biased to US stocks.

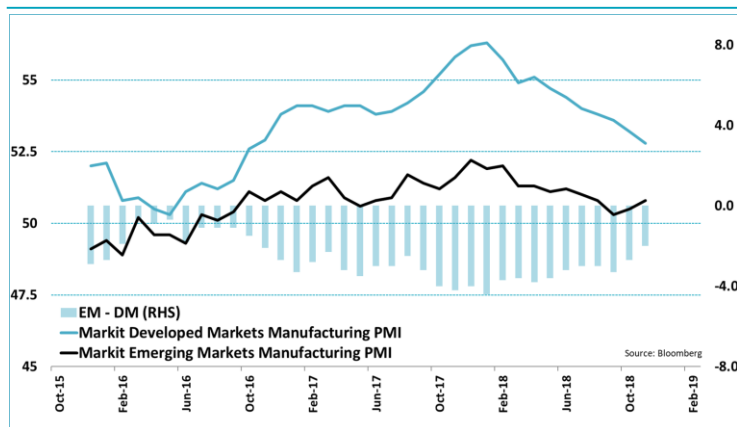
> Equities: Emerging vs Developed (I)

Emerging market equities – 2018 Performance



Source: Bloomberg

EM v DM: Manufacturing PMI



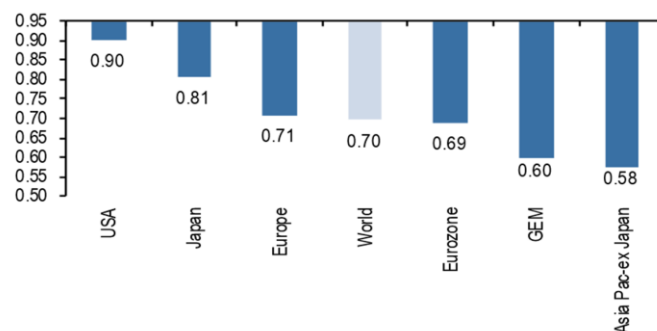
Source: Charles Schwab

- > As for most equity markets around the globe, 2018 was pretty awful for emerging markets. Measured in euros, the MSCI Emerging Markets Index fell more than 10%, significantly lagging the MSCI World Index. The underperformance was realized in the first three quarters of the year. After that, emerging markets recouped some of their (relative) losses, with an outperformance of almost 5% in a very volatile December.
- > In 2018, a vast number of risks took hold of emerging market performance. Among them were a tighter monetary policy by the Fed, slower growth in China that was exacerbated by the trade war with the US, relatively poor earnings growth and idiosyncratic factors that characterize the asset class, such as the currency crises in Argentina and Turkey.
- > As the year progressed however, some of these risks abated, improving the outlook for emerging market equities compared to developed market stocks. For example, after the latest comments by the Fed, a pause in the Fed hiking cycle is now likely. Even if the Fed decides to make a couple more rate hikes, the end of the cycle has become much more visible. It is likely that this will coincide with a peak in US dollar strength, which is positive for emerging markets.
- > Next to that we believe that, while the trade dispute between China and the US is far from over, it has peaked. This means that the impact on trade and growth will not increase that much from here on.

> Equities: Emerging versus Developed (II)

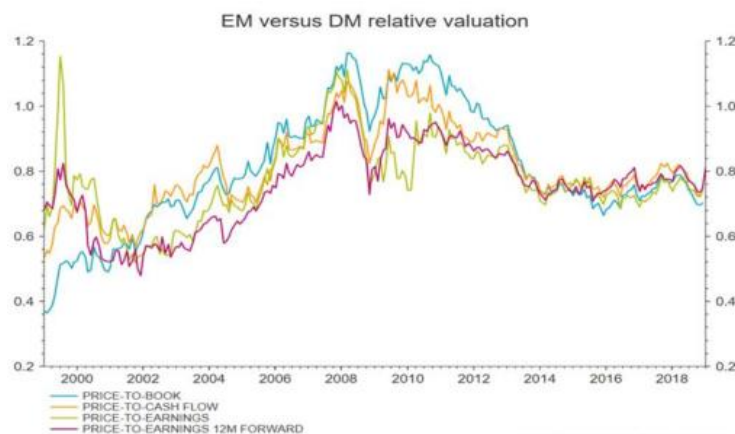
Earnings revisions are downbeat globally, not just in EM

Chart 5: 3 month Earnings Revision Ratio by region



Source: BofA Merrill Lynch European Equity & Quant Strategy, MSCI, IBES

Valuation – the discount is close to neutral



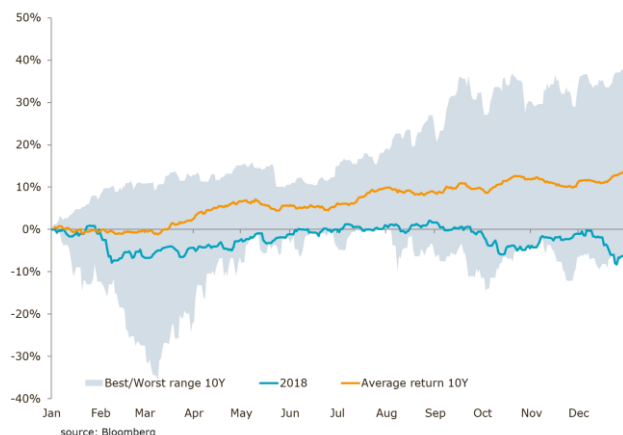
Source: Thomson Reuters Datastream, Robeco

Source: Thomson Reuters Datastream, Robeco

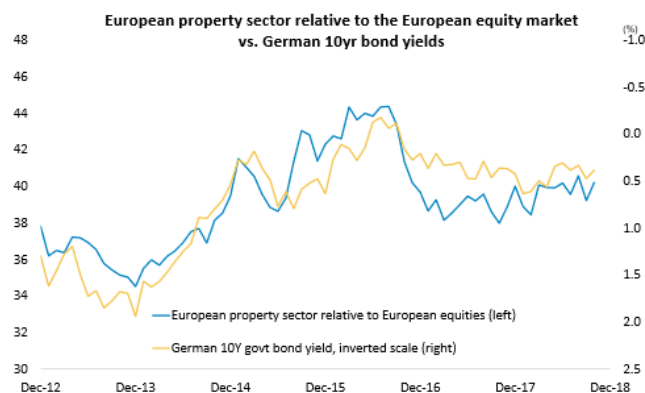
- > Since global trade has a relatively large effect on emerging countries, any form of stabilization or improvement in the dispute is a positive for emerging market equities.
- > That said, not all risks have abated. China's Manufacturing PMI fell below the threshold of 50, suggesting that GDP growth has yet to pick up. While signs of improvement can take longer to become visible, as the Chinese government has opted to stimulate growth selectively in order to deal with a large corporate debt-to-GDP ratio, investor worries about the health of the Chinese economy are understandably rising.
- > From the bottom up, things don't look that great. As a result of the global sell-off, earnings revisions have dropped massively and are now below 1 in every major region. Emerging markets experienced the smallest decrease in December, but that probably also has something to do with the fact that levels were already relatively depressed.
- > We stick to our marginal overweight in emerging markets for now. We think the Fed will indeed pause and go on the 'data dependency' pilot from here. Also, China is more likely to further stimulate its economy than not, offering some relief on the global growth outlook. Earnings expectations are down a lot, especially taking into account the fact that we are at the beginning of the year, a period in which investors tend to be too optimistic.

> Real estate

2018: A below average year



European real estate is Bund sensitive



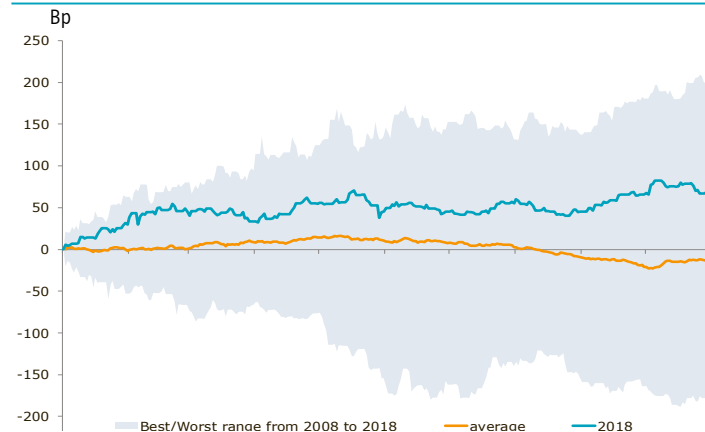
Source: Datastream Morgan Stanley Research (Note: Blue line shows FTSE/EPRA Developed Europe index vs. MSCI Europe)

- > Global real estate measured by the S&P Global Developed Property Index (USD) turned out to be the best-performing asset class over the last 10 years, outperforming the MSCI World index (USD) by 1.2%. Part of this result came from 2018, when real estate outperformed global equities by 2.6%. That said, the absolute return of real estate was a disappointing at 6.0%, well below the 10-year average return.
- > As we have noted before, regional differences in the performance of real estate are significant. The US market, which accounts for more than 50% of the Global Property Index (just like equities), lost 8.1% in December. European real estate remains a clear underperformer, losing 20.4% of its value in 2018. Negative influences included Brexit, Italian budget discussions, lower growth prospects in Europe and expected higher interest rates. German Bunds were the safe haven in December, which also explains the bad performance of European real estate, since the correlation between European real estate and German Bund yields is traditionally relatively strong. On a global level, the correlation with US Treasuries is falling, which makes real estate a more equity-like investment category.
- > Compared to equity, real estate is relatively cheap, has an attractive dividend yield (also compared to bond yields), and has proven to be some kind of safe haven during the market turmoil. For now, we have a neutral position in real estate.

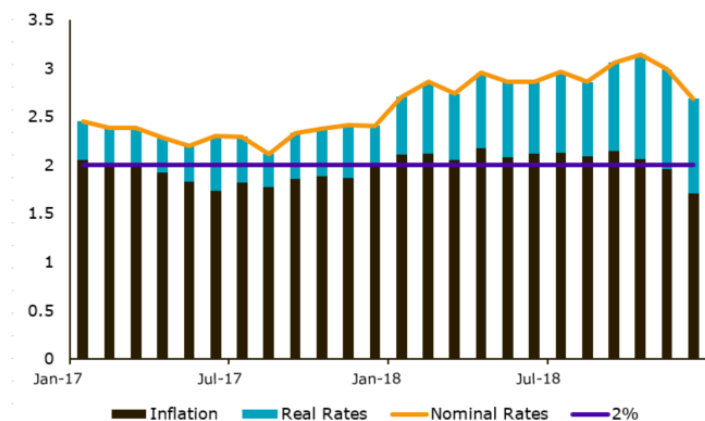
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> AAA Bonds (I)

2018: the 10-year US Treasury had an exceptional year



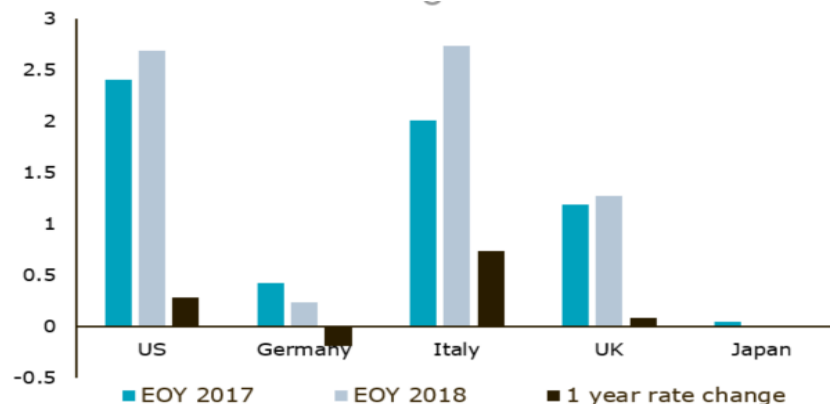
Tighter conditions: real rates were the driver of 10-year US yields



- > 2018 was the year of the rise in US yields. When you compare the gyrations of 10-year US yields with the past 10 years, it becomes pretty clear that it has been an extraordinary year. In every month in 2018, the 10-year yield was higher than the level at which it started the year. The normal pattern for the 10-year yield is to rise in the first part of the year and then to fall in the second part.
- > The Fed remained in tightening mode in 2018 and hiked rates four times. It also continued its withdrawal from the bond market. In the first part of the year, this was seen as a positive signal by markets: tightening was a confirmation of economic strength. This view, however, slowly started to change during the year, as the market started to take notice of developments outside of the US. Not only was growth slowing in Europe, but stress levels were starting to rise in emerging markets. These developments put into question the synchronized global growth theme. Markets started to believe that growth was in fact not synchronized, but was mainly a US phenomenon, turbocharged by Trump policies.
- > The strength of US assets sucked capital away from the rest of the world, which further exacerbated the weakness outside the US. While rising rates might have been appropriate for the US, it was definitely not for the rest of the world. In that light, the Fed's tightening path suddenly wasn't a reflection of strength, but unwarranted tightening for the rest of the world.

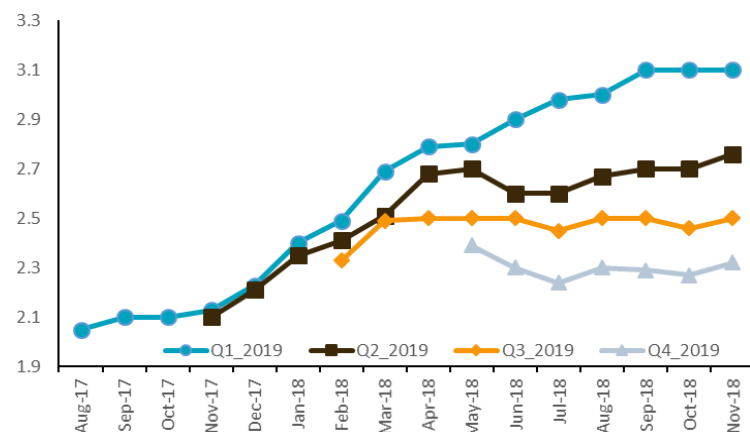
> AAA Bonds (II)

Diverging performance of global 10-year yields in 2018



Source: Bloomberg & Robeco

The US: positive but decelerating growth expected in 2019

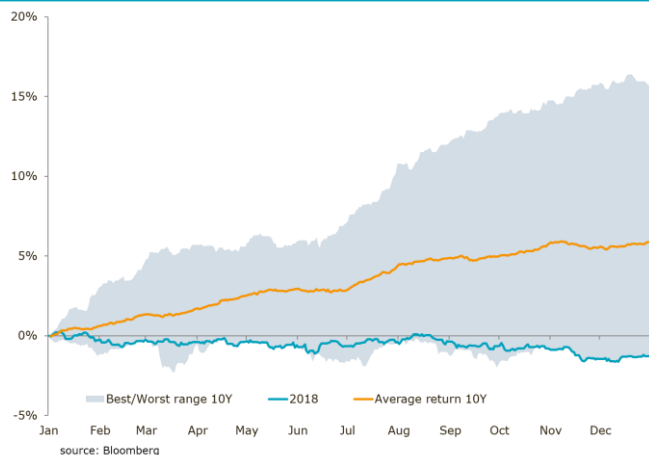


Source: Bloomberg & Robeco

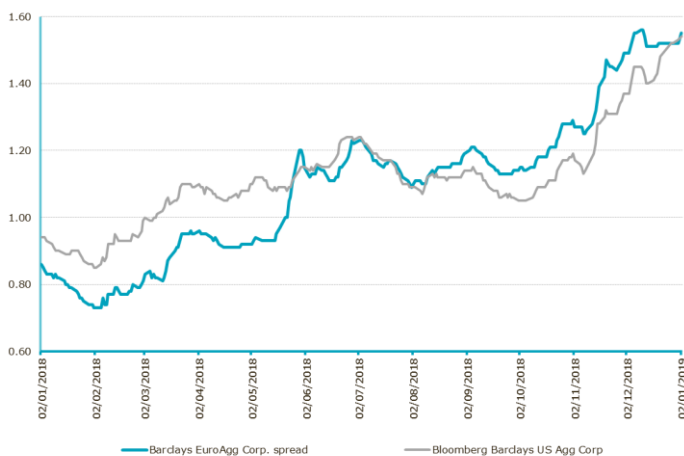
- > In the slipstream of Fed policy, US yields also continued to rise, setting the tone for other bond markets. However, as growth became less synchronized, idiosyncratic risk (political risk, etc.) started to dominate, causing divergence between markets. The most striking divergence in 2018 was US yields moving up while German 10-year yields moved down. After moving in tandem at the beginning of the year, political developments in Italy pressured German 10-years lower, and they didn't manage to recover lost ground. The increase in political risk had the opposite effect on the Italian 10-year yield, which rose by 50 basis points and at one point during the year even reached 4%.
- > In the last quarter of the year, yields and stocks started to move down in tandem – a clear sign that the market had started to reprice growth expectations lower. We understand the worry, but think markets are getting ahead of themselves. The theme for the coming year will be the convergence of growth levels, and that overall, growth will be a bit lower in 2019 than it was in 2018. The slowdown in inflation is just a temporary phenomenon, which might be with us a bit longer due to the drop in oil prices.
- > The Fed has reacted to the latest data weakness by moving to a less hawkish stance. We think that this might be just a temporary change of position. We continue to think that we haven't yet reached the peak in yields in this cycle, although we do think that we are getting closer to that point. Our preference remains to be underweight bonds.

> Investment Grade Credits (I)

European investment grade performance



The year of the rising spreads

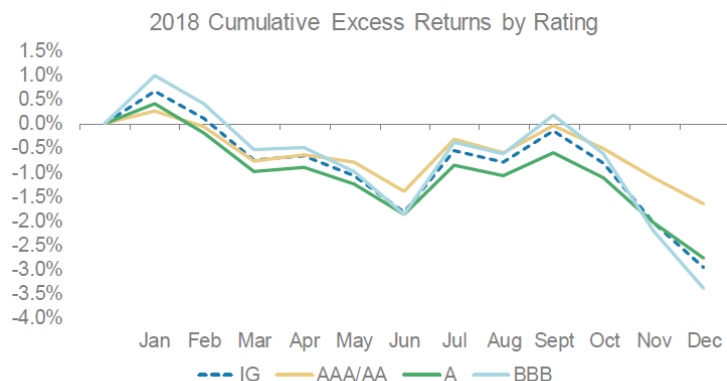


Source: Bloomberg, Robeco

- > European credits had a difficult year. Spreads ended 2018 much wider than at the start of the year. The widening occurred in two phases: in a rally before the summer, after which spreads stabilized for a couple of months before widening further in the last quarter of the year. The European spread ended 2018 at 1.52%. Yields also increased, but a yield of 1.30% at December 31 is still low in an historical context. The fact that the spread is actually higher than the yield is above all a sign that the government bond yield is extremely low. The total return, as can be seen in the graph, was also disappointing in 2018 at -1.2%.
- > The rise in European credit spreads during the year was due to a mixed bag of mostly known risks that worried investors in 2018: Brexit and the Italian budget discussions. Some extra elements were added in the fourth quarter, such as increasing pessimism about economic growth, which also sent equity markets firmly down. The Fed hike in December and the 'Trump factor' added to the deteriorating sentiment.
- > Going into 2019, all these risks aren't off the table. We think the European-specific problems like Italy and Brexit could be solved in 2019. But we have to wait to see how the absence of the ECB in the credit market will work out, along with what the effects of the trade war will be. Europe is an important trade partner for China, and if its economy slows down, this will certainly have a knock-on effect in Europe. That said, the downturn in 2018 at least caused more attractive valuations for European credits, for instance in the financial sector.

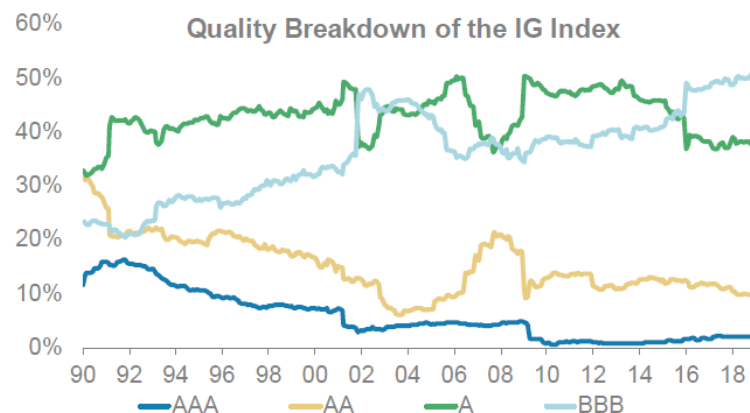
> Investment Grade Credits (II)

US credits



Source: Morgan Stanley Research, FTSE Fixed Income

US investment grade credit yields hedged into foreign currency

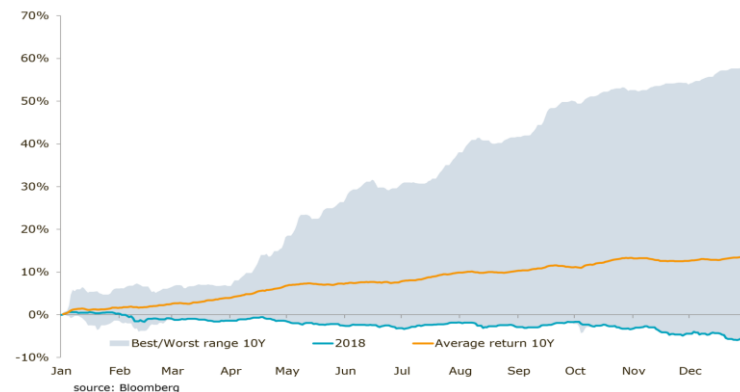


Source: Morgan Stanley, FTSE Fixed Income LLC

- > US credit markets performed worse than their European counterparts. The total return for US credit was -2.5% (in US dollars, -5.3% when hedged into EUR), caused by a spread widening over the year from 0.93% to 1.53%. Yields closed the year at 4.20%.
- > Until the last quarter of 2018, lower-quality credits outperformed the other rating buckets, but this reversed in the final months of the year. Increasing worries about the future state of the US economy sent the riskier buckets down and erased the outperformance of the BBB segment, which now forms the majority of the investment grade universe of the index. Losses in the higher-rated AAA/AA bucket were limited. Besides the Fed rate hike and US politics, the spread widening was also fed by the oil price declining further. The US credit index is more vulnerable to oil-related issues than the European index, as energy-related companies are mostly BBB-rated.
- > The BBB segment is what markets worry the most about, given its relative size and the credit quality within the segment. Corporate leverage is high, which is not a problem at the moment, but could become one with seriously slowing growth. Downgrades to high yield are imminent, which will enlarge the high yield segment significantly.
- > Recently, we have reduced our weight in credits, as we expect the spread widening in volatile markets will continue. We prefer European credits over US credits, as we assess the risks of the latter as higher.

> High Yield (I)

High yield – 2018 performance



Source: Robeco & Bloomberg

High yield – spread

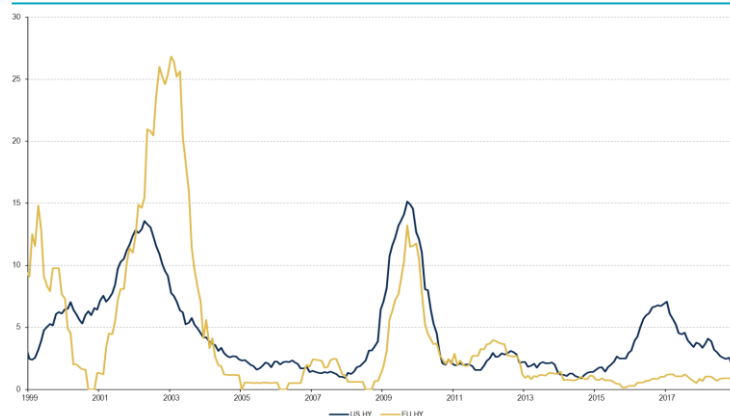


Source: Bloomberg

- > As for most risky asset classes, 2018 was a pretty bad year for high yield bonds as well. On average, global high yield bonds fell 5.5% in 2018, marking the worst calendar year in 10 years. In 2018, we were underweight high yield bonds for most of the time, which had a favorable effect on the return of the multi-asset portfolio.
- > Many of the arguments that substantiated our underweight in high yield bonds still apply. While we do not believe we have reached the end of this economic cycle, we do believe we are late cycle. Typically, this is a phase in which high yield bonds (and credits) struggle. Corporate leverage has slowly crept up in recent years, and this means higher borrowing costs when yields go up. Also, investors have been increasingly pre-occupied with the question of whether a recession is coming any time soon.
- > At the time of writing, the average spread on global high yield measured 557 basis points. While this is almost 200 basis points higher than in early October, marking the start of increased market turmoil, the current spread remains significantly lower than in previous periods of elevated market volatility (2011 and 2015/2016). For other risky assets, and for equities in particular, some valuation metrics are actually below the levels seen during those previous periods. Hence, while the valuation of high yields bonds has certainly become more attractive in recent months, it's not enough to compete with other risky assets given the current phase of the economic cycle.

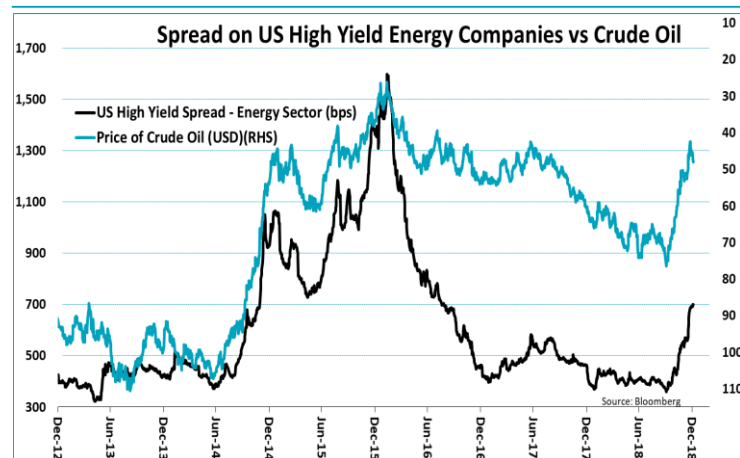
> High Yield (II)

High yield – default rates



Source: BofA Merrill Lynch & Bloomberg

High yield – energy companies and oil price

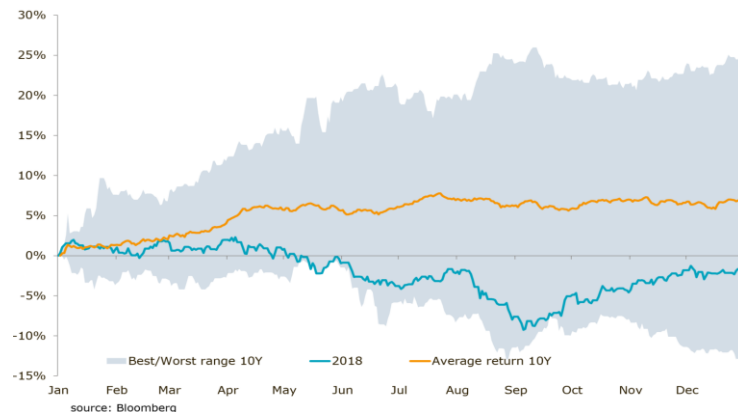


Source: Bloomberg & Bloomberg

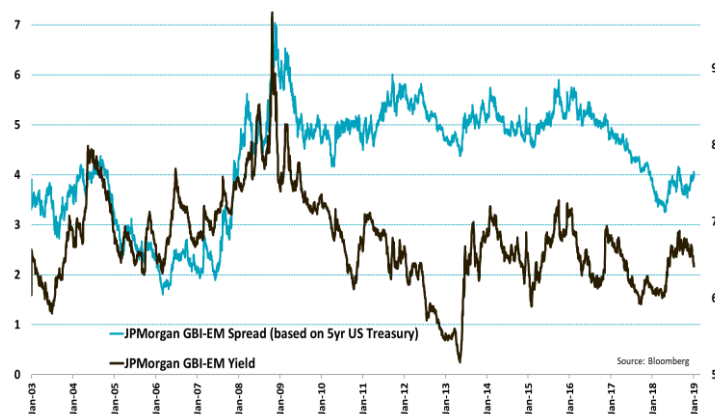
- > On a more positive note, we continue to believe that the odds of a US recession are relatively low. This implies that default rates are also likely to stay low. As the chart on the top left shows, the default rate in Europe remains close to zero, while defaults in the US continue to come down. Also, the recent drop in bond yields means that interest costs have stopped increasing. Interest coverage ratios remain pretty decent, although this obviously depends on forward earnings as well. Slower growth will likely translate into lower earnings forecasts, as we have witnessed in recent weeks.
- > What's also different from the 2015/2016 turmoil is the fact that the landscape of energy-related high yield companies has changed quite a bit. Many shale gas producers have either gone out of business, or were promoted to the investment grade index as oil prices rose. In addition, the breakeven oil price for shale gas producers has fallen to around USD 40 a barrel. Taken together, these factors help explain why spread widening within energy, but also to a certain extent within the overall index, has been relatively muted compared to earlier volatile episodes.
- > Therefore, we do not believe high yield is heading for a major default wave because of a recession, and/or fast-rising interest costs. However, being this late cycle probably means that the room for spread tightening is also limited. Equities seem to have priced in a much bigger slowdown in growth, which looks a bit overdone. We subsequently remain underweight high yield bonds.

> Emerging Market Debt (I)

Emerging market debt – 2018 performance



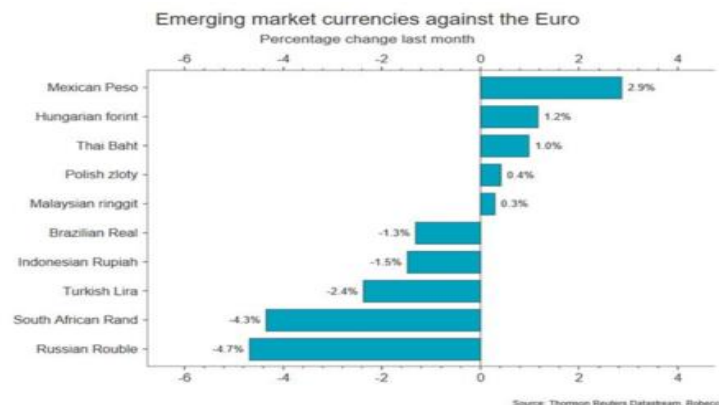
Emerging market debt in local currency – spread and yield



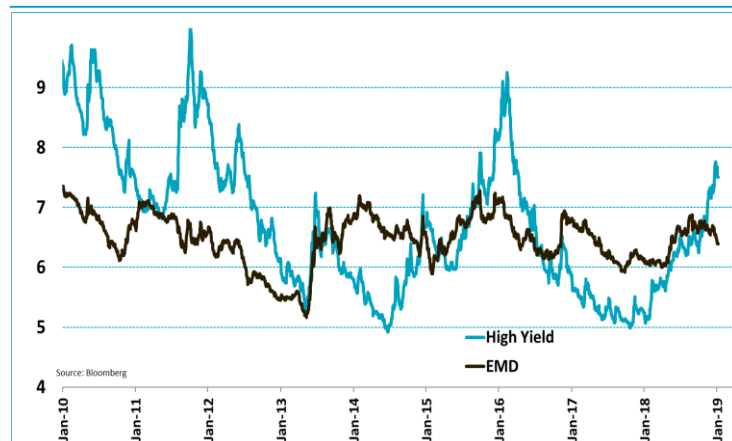
- > Local currency emerging market debt realized a return of around zero in 2018. This number looks far less extraordinary than it really is. First, local currency emerging market debt experienced a particularly volatile 2018. Prices plummeted in the first part of the year, as they were dragged down by a severe depreciation of emerging currencies, before staging an impressive rally that continued even as volatility spiked on equity markets. Second, the zero return means local currency emerging market debt was actually the best performing fixed income asset class within our multi-asset portfolio.
- > Despite the recent momentum, we are sticking to our neutral stance on local currency emerging market debt. Macroeconomic data has disappointed in recent months, and while we do not expect a US recession any time soon, global growth is set to slow significantly. It is especially during phases of slower growth that investors start to differentiate between those emerging countries with healthy government balances and those without. As we have stressed in recent months, this could mean that countries like Turkey, and to a lesser extent, South Africa are increasingly scrutinized by investors.
- > In addition, while we believe it is likely that the Fed will take a break from raising interest rates, markets are already pricing in 'half a rate cut' for next year. Despite the weaker-than-expected growth, we don't think this will materialize. An adjustment in Fed expectations poses something of a risk to emerging markets.

> Emerging Market Debt (II)

Emerging currencies versus the euro



High yield bonds versus emerging market debt

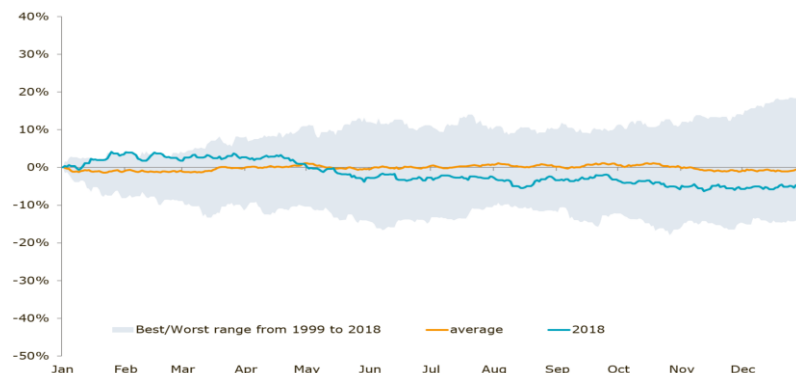


Source: Bloomberg, Robeco

- > That said, the recent statements of Fed Chairman Jerome Powell clearly show the Fed's willingness to take market circumstances into account.
- > With inflation in emerging countries still relatively muted, and many emerging central banks reluctant to hike rates, we don't see a general turn in sentiment towards local currency emerging debt in the short term.
- > China remains an important factor. In recent weeks, the renminbi has strengthened on the back of more stimulus from the government. This has helped emerging debt outperform. Some pressure on the renminbi is likely to remain however, as GDP growth continues to slow. Also, a lack of progress in trade talks with the US could trigger a weakening of other emerging currencies, especially those in Asia.
- > Finally, because of the strong performance of emerging debt, relative valuation has increased. For example, the yield differential between global high yield and emerging debt (as shown on the bottom left) has widened considerably.
- > We remain neutral for now on local currency emerging market debt. Fundamentals have improved, but a massive change in Fed policy expectations could provide a short-term headwind. Relative valuation has also become less attractive.

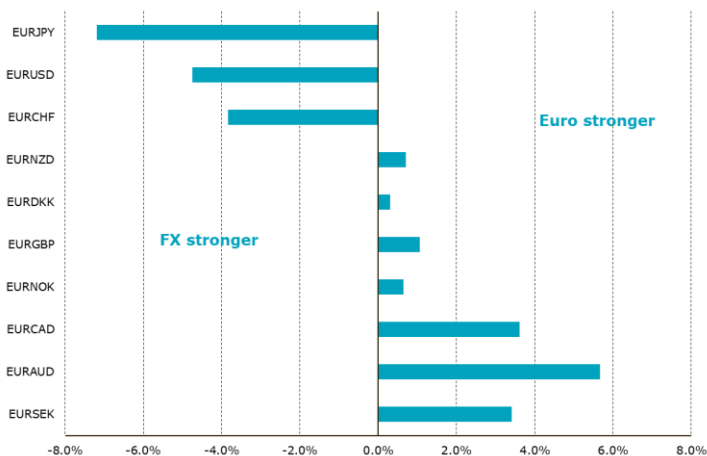
> FX (I)

EUR/USD – 2018 performance



Source: Bloomberg, Robeco

2018 was a good year for safe havens

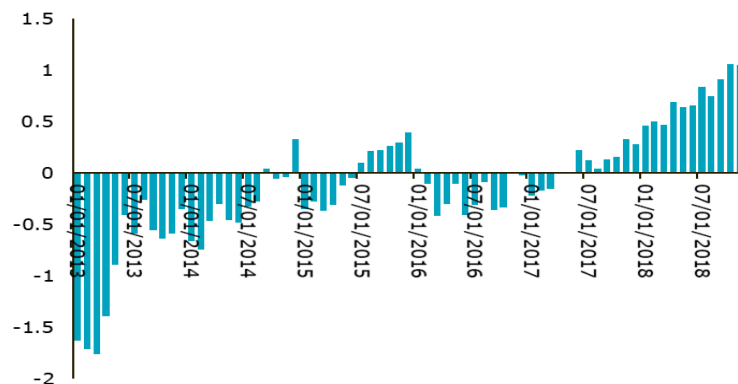


Source Bloomberg, Robeco

- > 2018 was not a typical year for EUR/USD. In the first months of the year, the euro was substantially stronger against the dollar than its historical average, while in the latter part of the year, it was substantially softer.
- > Within G-10 currencies, the euro actually didn't do too badly this year. Based on the performance of the past year, the euro ranked in the middle of the G-10 pack in 2018.
- > When you look at the one-year returns of the G-10 currencies, the conclusion can only be that it was year in which there was a clear preference for safety. The top three performing currencies against the euro (the euro depreciated, so this is a negative sign) are all considered to be safe haven currencies that investors normally buy when they seek protection. The three worst performing currencies can all be characterized as cyclical currencies that tend to do well during upswings and when optimism prevails.
- > Another thing that stands out that in 2018 is that buying currencies with a high interest rate and selling those with a low one wasn't a successful strategy. While both the Swiss franc and the euro offered the lowest carry in 2018, they both outperformed high yielders like the Norwegian krone and Australian dollar. It is also interesting that the currency that offered the highest interest rate, the US dollar, wasn't the best performer: this was the yen, which offers a substantially lower rate than the greenback.

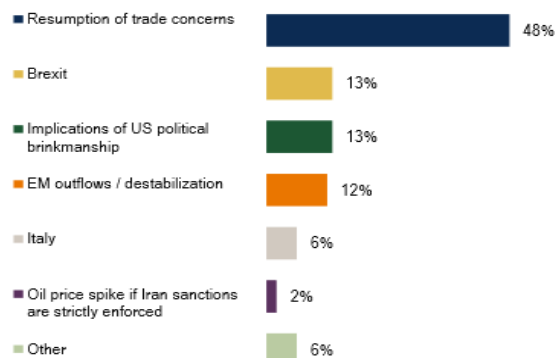
> FX (II)

The US: 5-year real rates are at a 5-year high



Source: Bloomberg, Robeco

2019's biggest concerns include Brexit and Italy



Source: BofA Merrill Lynch FX and Rate Sentiment Survey

- > Our base case is that in 2019 the US dollar will weaken against other major currencies. The growth differential between the US and the rest of world will begin to narrow and this will weigh on the greenback. The caveat to this though is that if financial markets continue to trade softly, it will be difficult for the US dollar to weaken.
- > If financial markets do indeed remain weak, then the preferred currency should be the yen. Not only is it a proven safe haven currency, but it currently has an edge over the US dollar. An important driver of USD/JPY is the real rates, which for the US is currently pretty high. As we expect US growth to decelerate, we also expect US real rates to soften, and this would be a drag on USD/JPY.
- > The euro not only suffered due to weaker growth, but also from self-inflicted wounds. These were, as always, created by the still relatively unstable political situation in the Eurozone. This political uncertainty demands a higher risk premium, and this weighs on the single currency. With Brexit still ahead and the ongoing 'yellow jacket' protests in France, a relatively high risk premium remains warranted.
- > We currently don't hold any active currency positions in our portfolio. We do, however, expect a stronger EUR/USD in the coming year. An important trigger for this will be a turn in European growth data and an easing of the political risk premium.

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