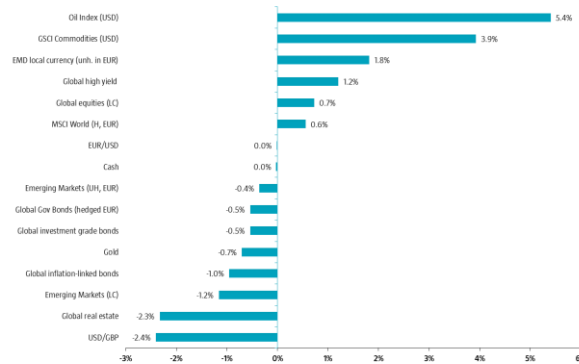


Multi-asset market outlook

For professional investors
October 2018

General overview

The oil price keeps rising



Source: Bloomberg, Robeco

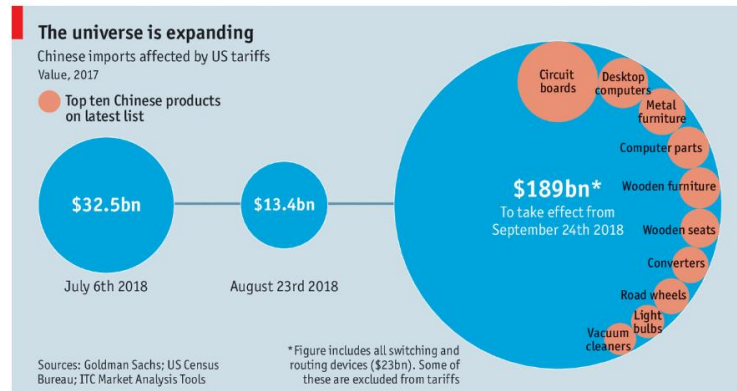
The number of tactical positions is limited at the moment

	Portfolio	BM	active
Equities Developed Markets	28.0%	25.0%	2.0%
Equities Emerging Markets	5.00%	5.0%	
Real Estate Equities	5.0%	5.0%	
Commodities	5.0%	5.0%	
Core Gov Bonds 1-10	20.0%	20.0%	
Core Gov Bonds 10+	7.50%	7.5%	
Investment Grade Corp Bonds	20.0%	20.0%	0.0%
High Yield Corp Bonds	2.0%	5.0%	-4.0%
Emerging Market Bonds LC	5.0%	5.0%	2.0%
Cash	2.5%	2.5%	0.0%
EUR/USD	0.0%	0.0%	
EUR/JPY	0.0%	0.0%	
EUR/GBP	0.0%	0.0%	
EUR CASH	0.0%	0.0%	

- > It was an exceptionally good month for commodities. The main driver of the positive return generated by the general commodity indexes was oil. In September, Brent increased 7.4% and WTI rose 4.9%. With Venezuela imploding and the almost certain loss of Iranian barrels due to the sanctions announced by the US, supply is getting tighter. The inability or the unwillingness of OPEC to ease the situation makes the market nervous, and is pushing up prices.
- > US equity markets took bit of a breather after the strong summer months, though the S&P500 still reached a new all-time high in September. Japanese equities were on fire this month: on the back of a weaker yen, the Nikkei index posted a gain of 6.2%. European equities were again the laggard. Investors continue to demand a higher risk premium to hold European equities, as political uncertainty remains. This month the market got spooked by the budget plan of the Italian government and yet another set back in the Brexit negotiations.
- > The Fed hiked rates once again and looks to be on a predetermined path of raising rates every quarter for the foreseeable future. The ECB is also sticking to its tapering plans and President Draghi expects inflation to progress towards the ECB target. After Turkey finally decided to implement more orthodox monetary policy, emerging markets started to show signs of stabilization. Emerging market debt benefitted and generated a decent return this month. For us it was a reason to close our underweight position in emerging markets and move to neutral. We remain overweight equities and have a short position in high yield.

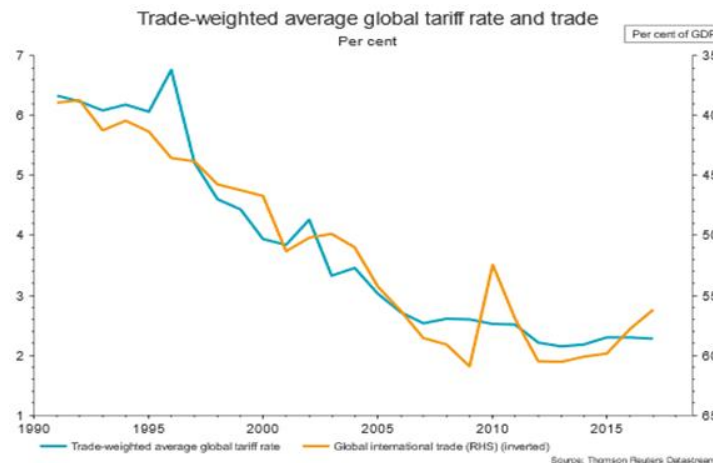
> Theme of the month: Oh! What a lovely trade war (I)

Tariffs on Chinese exports to the US



The Economist

Starting from a low level



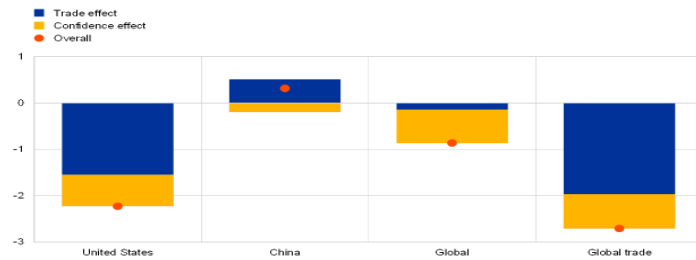
- > In recent surveys, investors consistently – you could say routinely – list trade wars as the biggest risk for financial markets. Apparently, they generally don’t share the view of the US president that “trade wars are good and easy to win”. But now that Trump is targeting half of China’s exports to the US with higher tariffs, markets seem to be shrugging it off. What can explain this paradox?
- > The wariness of investors is understandable. The world hasn’t forgotten the lessons of the Great Depression, in which gradually increasing protectionism contributed to the length and the depth of the downturn. That is the reason why after the Lehman collapse, the G20 countries agreed to refrain from protectionism, successfully as it turned out.
- > The latest round of US tariffs is a 10% levy on USD 200 billion worth of Chinese goods which came into effect in September, on top of the USD 50 billion that came into effect in August. Despite the slightly dizzying numbers, the products targeted so far still represent only a small part of world trade. It is therefore understandable that the tariffs have not yet significantly damaged producer and consumer confidence. This goes a long way to explain the muted financial market reaction so far.
- > However, further escalation is looming. The US has threatened to hike the 10% tariff rate on USD 200 billion of goods to 25% at the beginning of next year if China doesn’t “change its ways”. We use this rather vague sentence deliberately, as it is not entirely clear what the negotiation goal of the US vis-à-vis China is.

> Theme of the month: Oh! What a lovely trade war (II)

Estimated effects of a trade war in the first year

Estimated impact of an escalation in trade tensions – first year effects

(GDP response in 2018, deviation from baseline levels, percentages)



Source: ECB calculations.
 Note: The results are a combination of the direct trade effects from the GIMF model and the confidence effects modelled using the ECB-Global Model.

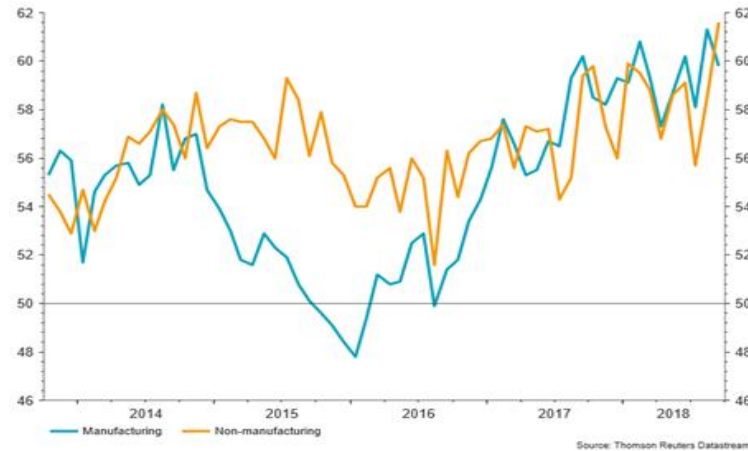
Avoiding protectionism after a crisis (source: Bank of England)



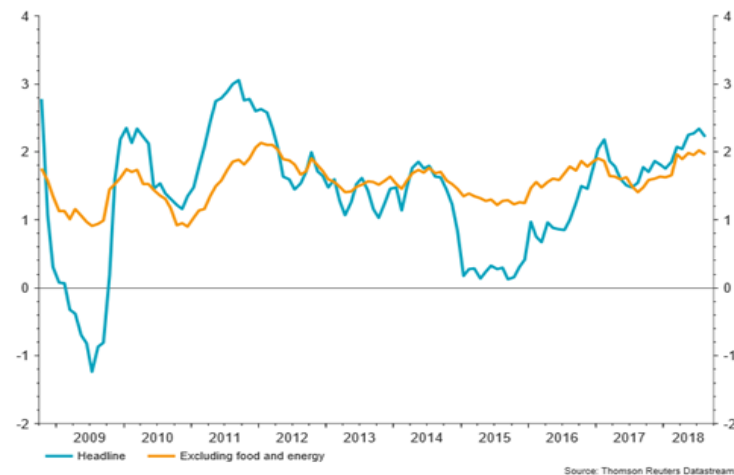
- > With an eye on the presidential elections of 2020, Trump could choose to keep political tensions high with China, in the hope that this will increase his re-election chances.
- > Moreover, although China could easily tone down its rhetoric on its Belt and Road initiative and its Made in China 2025 strategic plan, it will continue to wield increasingly more power in the South China Sea, central Asia and the Indian Ocean, if only to protect its commodity supply links with Africa and the Middle East. And it is unlikely to change its economic development model – which is considered inferior by mainstream US economists anyway – so what is exactly the problem?
- > Higher tariffs will thus become a permanent feature for the coming years. China will react with more monetary and fiscal stimulus to keep its growth rate at an acceptable level, to the detriment of its debt levels. A continuing gradual depreciation of the yuan is also likely, hampering the liberalization of its capital account, as it will have to continue to rely on stringent capital controls.
- > For investors, there is little upside in the escalating trade war. They can only hope that a more drastic escalation from current levels does not materialize. The threat of escalation is one of the reasons why we have downgraded our expected returns for emerging markets in our five-year outlook, and why we currently have only a limited overweight for equities in our multi-asset model portfolio.

> United States

The all-important US service sector is doing particularly well



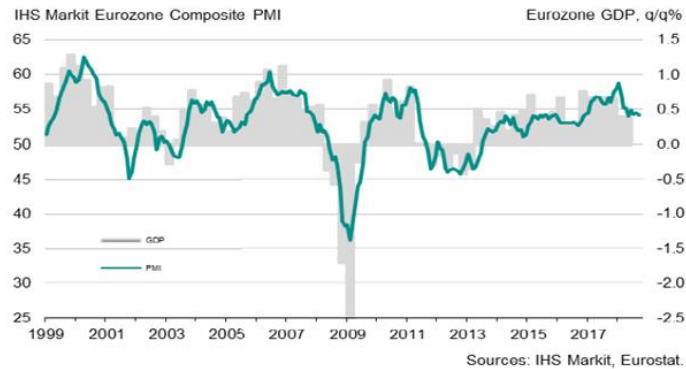
Core PCE is steady at 2.0%



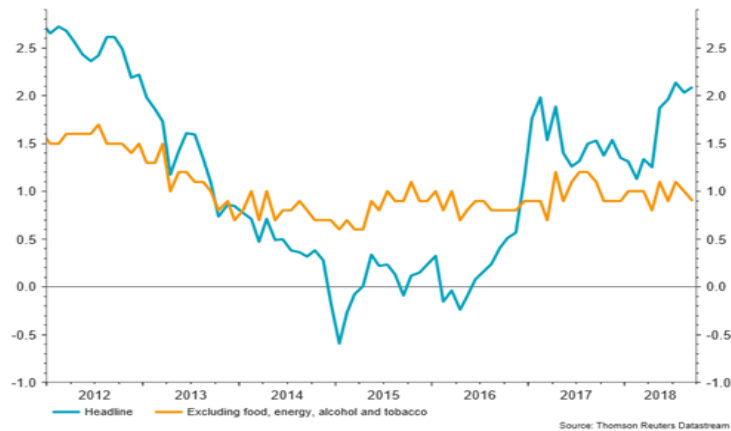
- > The US economy is doing fine, as illustrated by the ISM manufacturing index for September, although it came in a bit weaker at 59.8 after reaching 61.3 in August. By contrast, the ISM non-manufacturing index rose unexpectedly further to a strong 61.6 from 58.5 a month earlier, reaching its highest level on record. The US economy is roaring ahead, and so far appears to be immune to rising uncertainty due to increased trade tensions.
- > The core inflation indicator preferred by the Fed, the change in the underlying personal consumption expenditures index, continues to hover around 2.0%. The Fed is under no pressure to hike short-term interest rates more aggressively. But the impact of tariffs and the rise in the oil price will likely push up inflation in the months to come. This will allow FOMC policymakers to deliver further rate hikes at a modest pace; their now famous dot plot is signaling another rate hike this year, three more in 2019, and one rate rise in 2020.
- > The US mid-term elections will probably result in a Democratic majority in the House of Representatives (a change), and a continued Republican majority in the Senate. As the Democrats in general favor a tough approach against China on trade, and also favor ongoing fiscal stimulus, the outcome of the elections hardly matters from an economic policy perspective. The House could start impeachment proceedings against Trump, but the Senate can acquit him of any charges.

> Europe

The Eurozone economy slowed down in September



Another negative surprise for Eurozone core inflation



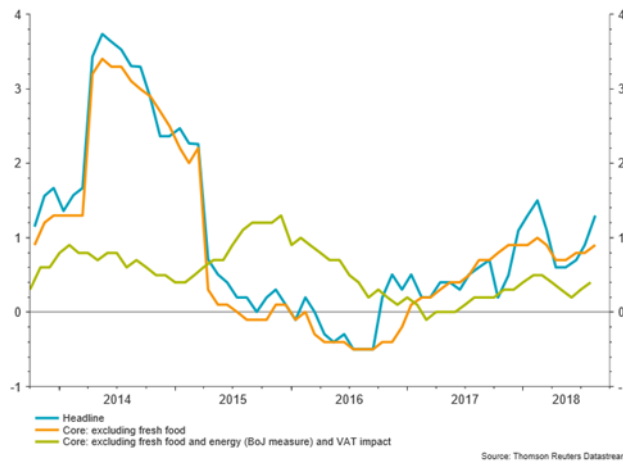
- > The Markit Eurozone Composite in August disappointed by slowing down somewhat to 54.1 from 54.5. Still, this level is compatible with GDP growth of 0.5% for the third quarter. Optimism about the fourth quarter has diminished, as momentum in output and new orders has slowed.
- > The eagerly awaited budget of the new populist government in Italy turned out to be an initial disappointment. Using rather rosy GDP projections, government deficits for the next three years were presented to amount to 2.4% of GDP. These were carefully crafted numbers, as they are within the 3.0% limit of the Lisbon Treaty, but still break European norms and earlier agreements. Italy has to run lower deficits in the light of its relatively high government debt ratio (130% of GDP). After negative reactions from Brussels, and more importantly, the 'bond vigilantes', the Italian government lowered its deficit projections somewhat. We expect the government to eventually back down further.
- > Core inflation in the Eurozone unexpectedly declined to 0.9% from 1.0%. This persistent lack of underlying inflationary pressures remains a concern for the ECB. Headline inflation is expected to rise as a consequence of the rising price of oil, but monetary policy will remain accommodative. The ECB feels no pressure to abandon its plans to end QE by the end of this year and keep interest rates unchanged at least until the summer of next year.

> Japan

Japanese earnings are on the rise



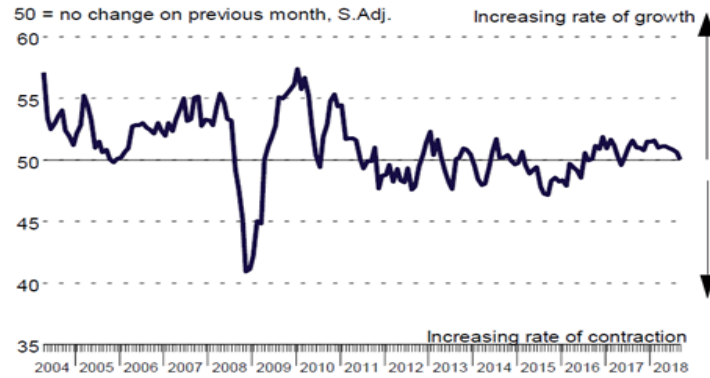
Japan's 'core core' inflation is rising further to 0.4% in August



- > Business confidence at big Japanese manufacturers as measured by the Tankan survey published on October 1 worsened unexpectedly to +19 from +21 three months ago. Natural disasters and looming US tariffs probably partly explain this weakening of sentiment. Japan dropped its earlier insistence on a multilateral approach to dealing with trade issues with the US after the US president threatened to impose stiff tariffs on automobiles and parts.
- > On a positive note, the latest Tankan survey underscored solid corporate capex plans. Big firms plan to raise their capital spending by 13.6% in the financial year starting April 2018, driven by the desire to update capacity and growing investment in robotics and automation to counter labor shortages due to the rapidly ageing population.
- > Prime Minister Shinzo Abe convincingly won the leadership ballot of the ruling Liberal Democratic Party, getting 553 votes out of 810. He is now on track to become Japan's longest-serving prime minister, staying beyond the Tokyo Olympic Games of 2020. Apart from continuing with Abenomics, Abe has promised to raise the retirement age.
- > The core-core inflation index excluding both energy and fresh food costs – the gauge preferred by the BoJ – rose 0.4% in August after rising 0.3% in July. The BoJ declared that it would keep monetary policy steady: Governor Haruhiko Kuroda stressed that the bank won't pull the plug on monetary easing until inflation hits its elusive target of 2.0%.

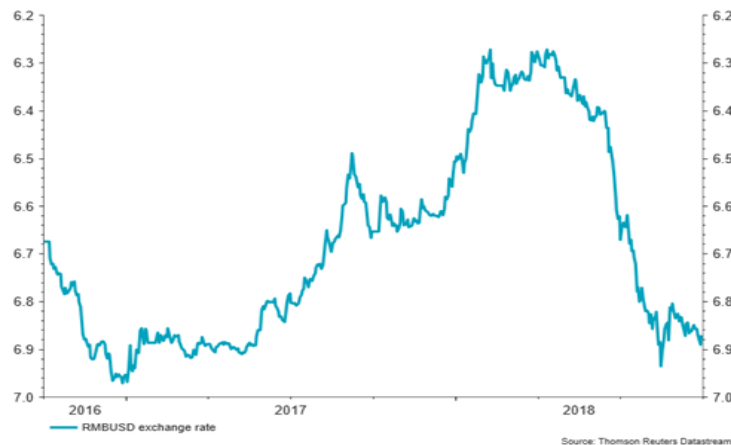
> China

September's Caixin China General Manufacturing PMI hits 50.0



Sources: IHS Markit, Caixin.

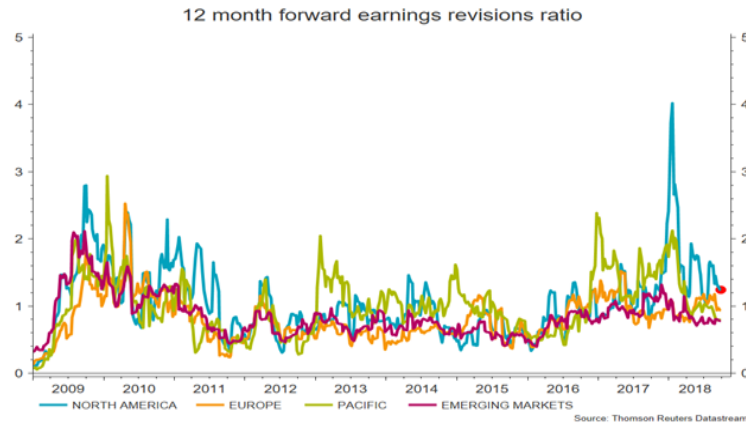
The Chinese yuan recently stabilized despite rising trade tensions



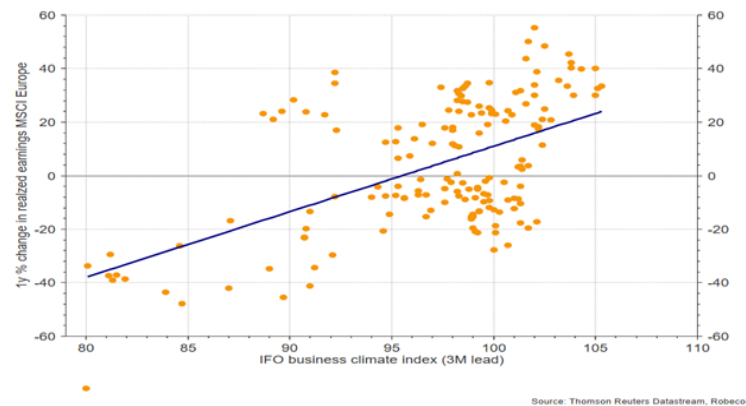
- > The Caixin/Markit General Manufacturing PMI for September fell more than expected to 50.0 from 50.6 in August. Tariffs are clearly taking a toll on the economy, as export orders are falling at the fastest rate for two years.
- > The US set 10% tariffs on USD 200 billion of Chinese exports effective from September 24, and China immediately retaliated by imposing tariffs on USD 60 billion of US goods. Chinese Premier Li Keqiang said at a speech at the World Economic Forum in Tianjin that a one-way devaluation of the yuan would do more harm than good to China's economy. China would therefore not try to stimulate exports by devaluing the yuan. Indeed, the yuan has recently stabilized vis-à-vis the US dollar. The 10% US tariffs will rise to 25% at the end of this year, pending a deal. The US president has declared it was too early to start a new round of negotiations with the Chinese government, and he is apparently comfortable with a further escalation of the trade war. We consider a further weakening of the yuan likely in that case, as it is a rather easy way to counteract the impact of higher tariffs.
- > The Chinese government said it will use other channels to stimulate the economy. It has promised to channel more funds to small firms and to cut corporate taxes and fees. It has also ordered banks to keep credit lines open to firms hit by the trade dispute.

> Equities (I)

Earnings revisions are trending lower, but the US still sees net upgrades



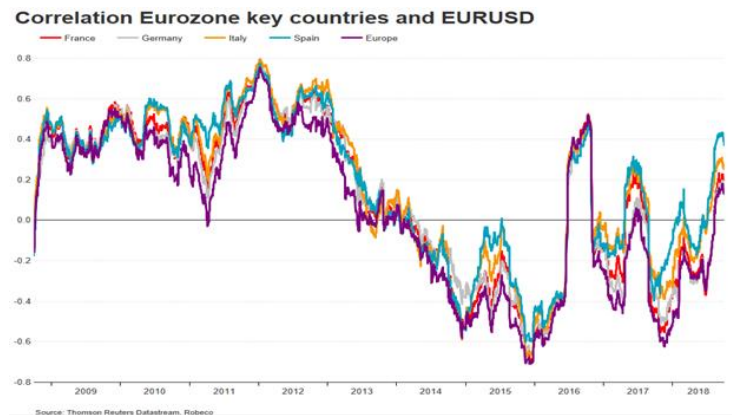
High-level German producer confidence suggests earnings remain solid



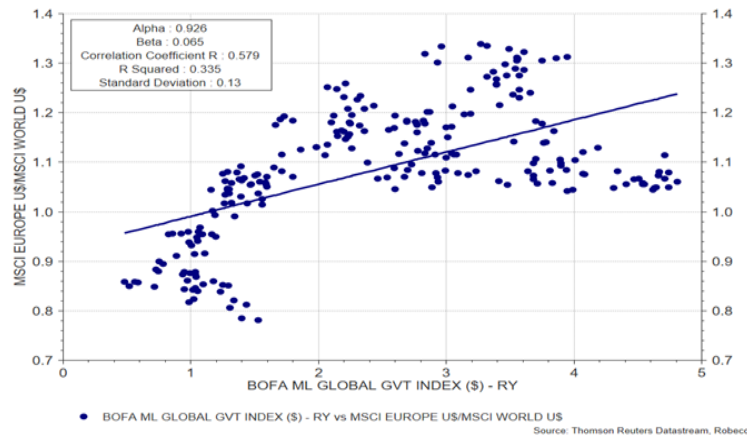
- > How healthy are listed corporate earnings? In general, reported earnings growth numbers have been solid through the summer. This has forced analysts to keep upgrading 12-month forward earnings for the US on the back of continuing economic expansion. However, not all corporates are created equal, as earnings revisions in other regions show net downgrades. Concerns about broadening US-China trade tensions and a frail truce on car tariffs have contributed to lower analyst optimism on forward earnings for Europe, China and the Asia-Pacific region. For Europe, worries are being aggravated by the renewed tension in the Eurozone following a clash between the EU and Italy on the Italian government budget.
- > Still, analyst estimates of European 12-month forward earnings growing by 9% look a bit too conservative. For instance, an IFO business confidence level of 103.7, which was seen in September, has in the past 20 years never been followed by year-on-year realized earnings growth that was less than 20% in the following quarter.
- > So, given where economic fundamentals stand for Italy, one of the key countries in the Eurozone, European earnings should be able to withstand a negative shock emanating from Italian debt markets. Or, phrased differently, a lot of additional bad news needs to emerge to derail the strong and stable earnings growth picture. A depreciating euro could provide additional earnings support for European exporters, although the 3-month correlation between equity performance and the euro is still positive.

> Equities (II)

3-month rolling correlation between daily MSCI index returns and the EUR/USD



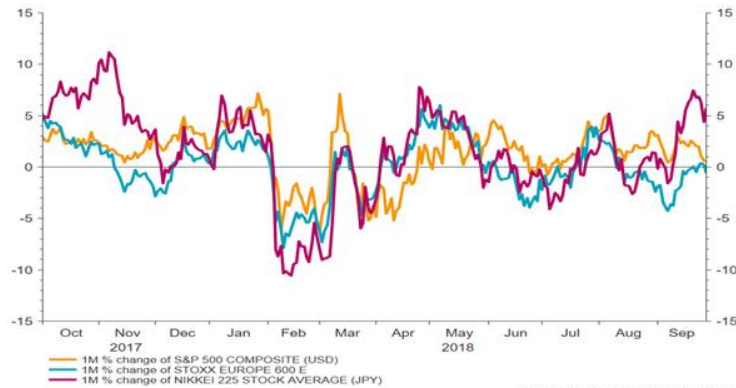
European equities tend to outperform global equities in higher bond yield regimes



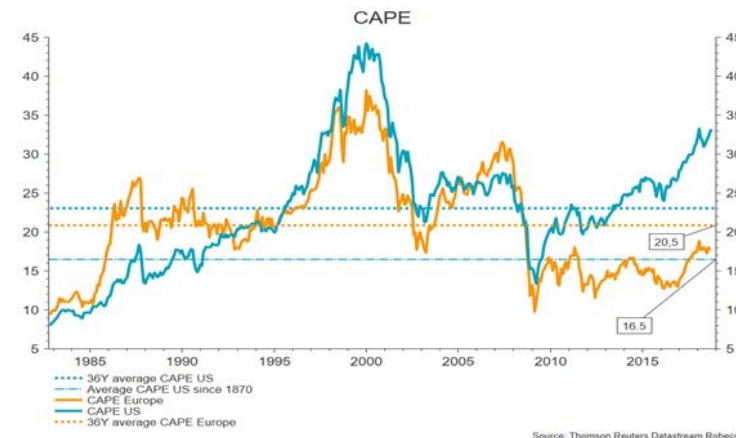
- > Despite trailing EPS growth of 16% and a dividend yield of 3.2%, Europe remains the sick man of the developed world from a performance perspective, with a YTD return in euros of -0.6%. Last month, momentum towards European equities remained negative, while US and Japanese returns were positive. Even rising global bond yields, which are normally consistent with European equity outperformance versus their global peers, failed to offer support last month.
- > Europe looks attractive on valuation compared to its own history and relative to the US. The discount that has emerged since 2011 versus the US remains, as the ghost of the European financial crisis hasn't been laid to rest yet. Besides, Brexit remains a problem, and we now face renewed doubts about debt sustainability in Italy. The Italian budget deficit proposal of 2.4% scared market participants. Given the defiant stance of the Italian government towards the EU, it cannot be ruled out that a vicious cycle reemerges between financial markets and the real Italian economy, where one spooks the other.
- > In summary, despite the global economy's 'steady-as-she-goes' stance, equity investors have yet another worry to overcome, even as trade tensions have eased due to a rebranded NAFTA deal. Downsizing equity risk has opportunity costs, given strong earnings expectations and the lack of available alternatives. As so often, patience is a virtue, especially for long European equity investors. We stick to our tactical overweight in developed equities.

> Developed Market Equities

The Japanese stock market catches up



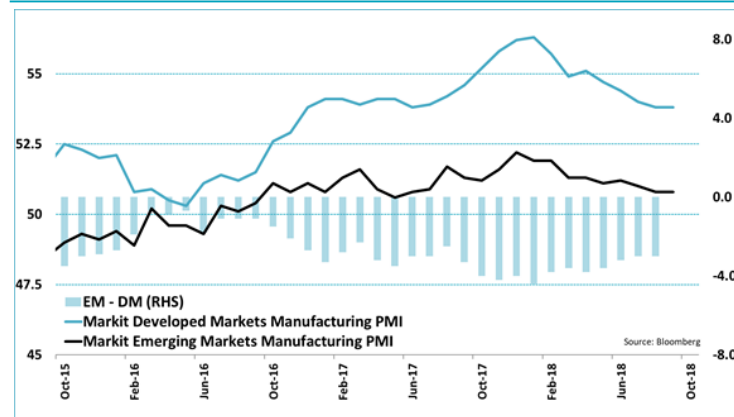
US stock market valuation on CAPE nears its January high



- > In September, global stocks maintained their positive momentum, even as trade tensions lingered between China and the US. Divergence in performance between developed regions was more outspoken, breaking away from the recent “America first” trend.
- > Based on monthly momentum of equity returns in local currency, Japanese equities were the clear winners, generating a return in yen of 6.2% for the Nikkei 225 stock index. US equities followed at a respectable distance, generating a dollar return of 0.6% in August. Tensions around Italy in the Eurozone flared up, denting European equity returns in euro, with banks particularly under pressure. Investors in the Eurostoxx 600 index saw a return of -0.6%. Long momentum (12M-1M) in local currency remains strongly in favor of US equities (12.9%) and Japanese stocks 9.5%. Long momentum for Eurozone equities has now become more negative, with a local return of -2.6%.
- > Equity valuations based on the Shiller CAPE US equity valuations remained on an uptrend, confirmed by other US stock market valuation metrics such as Tobin’s Q. The CAPE is now at 33.2, near the 17-year high of 33.2 reached in January 2018. With uncertainty over Brexit and increased tension surrounding Italy’s budget, European equity valuations de-rated based on CAPE, declining from 18.1 to 17.7. European equities remain in the doldrums, despite a weaker euro. We keep a neutral weighting for developed market equities.

> Equities: Emerging vs Developed (I)

Manufacturing PMI – emerging versus developed markets



Source: Bloomberg

Weight and characteristics of emerging countries



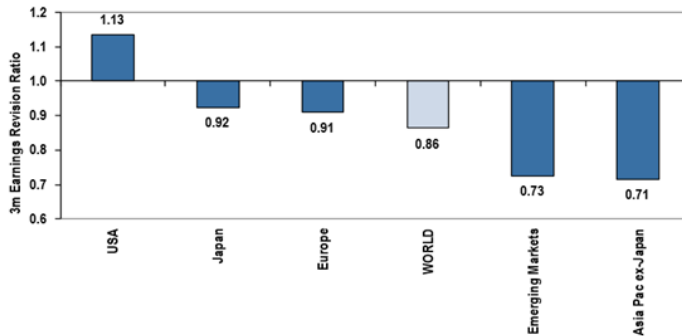
Source: Charles Schwab

- > After an ugly start to the month that continued a prolonged period of underperformance, emerging markets showed some signs of recovery as the month progressed. Still, the MSCI Emerging Markets Index in euros fell 0.4% in September against a positive return of 0.7% for the MSCI World Index.
- > During the month we decided to revise our view on emerging market equities from negative to neutral. While we expect the trade war between the US and China to continue for some time, we also feel that markets have started to price in this scenario. Unfortunately, this does not mean there won't be any unwelcome surprises, but investors seem to have discounted quite a bit of bad news.
- > In addition, some (but surely not all) of the anxiety surrounding Argentina and Turkey was removed. The IMF increased Argentina's already massive credit line to USD 57 billion, and also plans to transfer funds faster than before. Turkey's central bank finally took responsibility and hiked short-term rates by a massive 6.25% to 24% to stem the devaluation of the lira. Obviously these steps do not immediately solve the problems that these countries face, but they are steps in the right direction. In addition, the direct impact of Argentina and Turkey on global growth should not be exaggerated. Turkey represents less than 1% of global GDP, and less than 0.6% of the MSCI Emerging Markets index. Argentina carries even less weight. Their linkages with other economies are also relatively small suggesting that the chance of a broader emerging market crisis is limited.

> Equities: Emerging versus Developed (II)

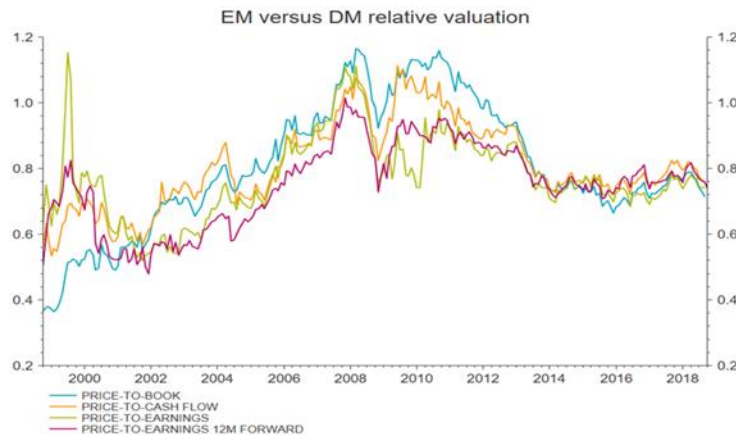
Earnings revisions in emerging markets are not the worst, but are still bad

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



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

Valuation : still cheap, but no trigger



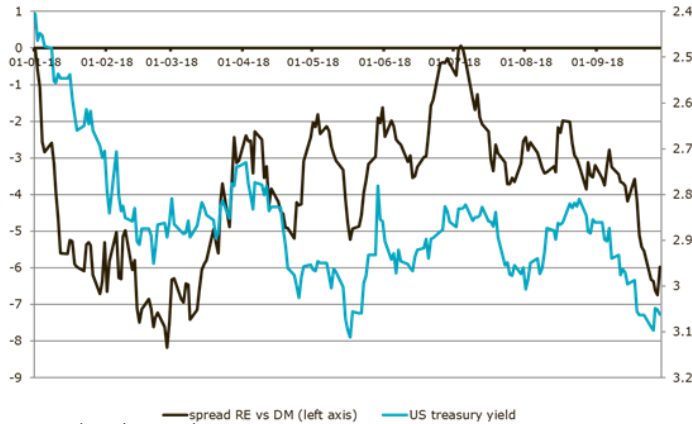
Source: Thomson Reuters Datastream, Robeco

Source: Thomson Reuters Datastream, Robeco

- > Another reason for a somewhat more constructive view on emerging markets is that the GDP growth differential with developed markets could widen a bit going forward. The Eurozone economy is slowing, while China is meticulously aiming to accelerate growth. As we have stressed many times before, China is unable to deliver debt-driven growth like it did in 2015, as corporate debt levels have risen to worrisome levels. Still, we expect some near-term improvement in China's growth outlook. Historically, the emerging versus developed market GDP growth differential is one of the most of significant factors that explains relative equity performance.
- > While we expect emerging market performance to keep up with developed markets for now, we remain cautious. The Fed has signaled more rate hikes, which could lead to a renewed period of US dollar strength. This is potentially damaging for emerging markets. In addition, earnings momentum looks far from great. Even though emerging markets no longer rank last on earnings revisions, the revision level has decreased again to just 0.73 upward revisions for every downward revision, showing that investors are getting more downbeat on emerging earnings.
- > We have lifted our stance on emerging market equities from negative to neutral. Trade tensions seem to be discounted to some extent, the relative growth differential should improve somewhat, and Fed transparency is pretty high. However, emerging markets remain vulnerable to escalating trade wars, a higher US dollar and country-specific events, all of which cannot be ruled out at this point.

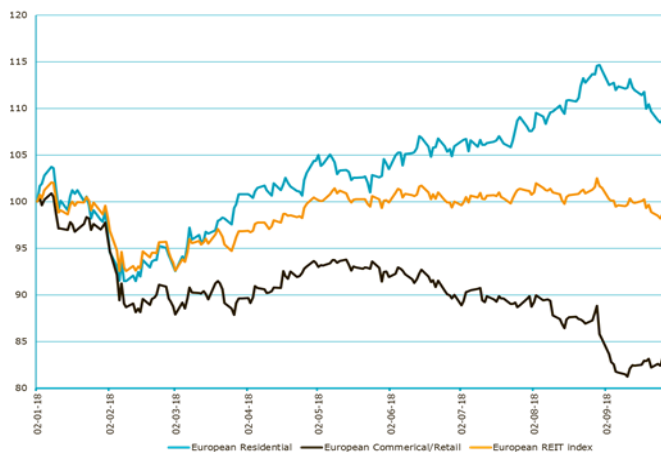
> Real estate

Real estate: falling of the relative cliff



Source: Bloomberg, Robeco

Divergence in European real estate

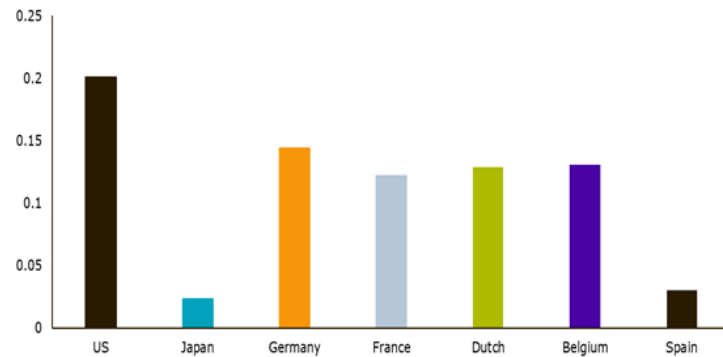


Source: Bloomberg, Robeco

- > In recent months we have mentioned that the tight correlation between the US Treasury yield and the relative performance of real estate against equities has loosened, but that this was probably a temporary phenomenon. In September, real estate investors were once again focused on the US Treasury yield, which rose from 2.86% to 3.06%. The impact on the S&P Global Developed Property Index (in US dollars) was negative, losing 2.2%. Global equities measured by the MSCI World Index, on the other hand, rose 0.7%. The underperformance of real estate is now back at the levels we saw at the beginning of the year.
- > In the US, the Fed lifted rates for the third time, while signaling more hikes in the foreseeable future. This triggered the underperformance of US real estate. We do not expect a change in Fed policy, so investors should expect continued downward pressure on real estate.
- > In Europe, rates moved in the same direction as in the US, and the performance of European REITs was even worse. The underlying trends in both regions are more or less the same. Just as in the US, commercial real estate faces structural challenges, due to the e-commerce threat. Residential real estate, however, is the best performing sub-class; in the year-to-date, the difference is about 25%! This sector benefits from the growing scarcity of residential space, fueled by low borrowing rates. The overall picture for real estate is mixed, so we prefer to remain neutral, within an overweight position in equities.

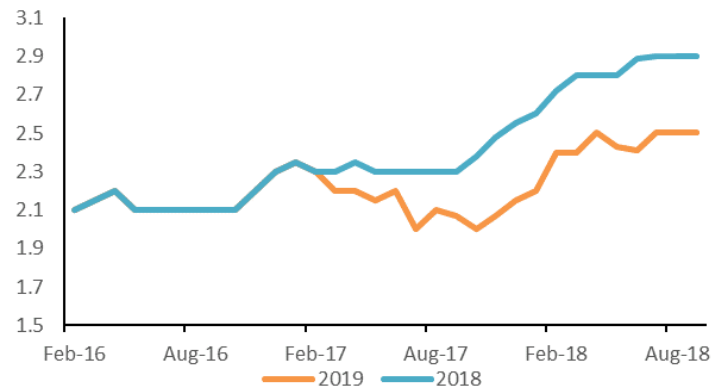
> AAA Bonds (I)

10-year rates in September: firmer rates across the major markets



Source: Bloomberg & Robeco

Consensus expects US growth to cool in 2019

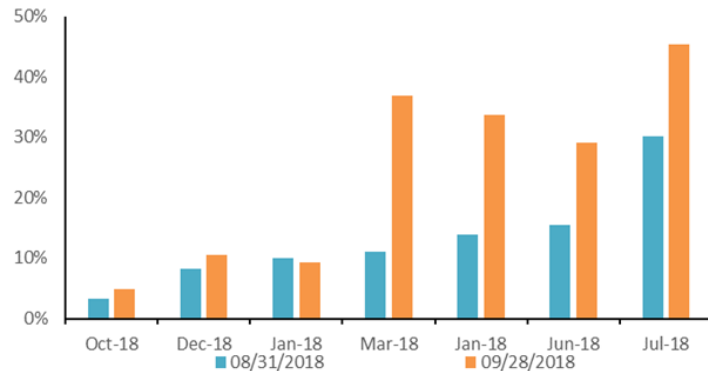


Source : Bloomberg & Robeco

- > Over the past couple of months, the major rates market has moved sideways to lower. This all changed in September. The 10-year US Treasury is back above 3%, and German rates increased by 14 basis points, or about one third of the level they were at the beginning of month. Again, most of the peripheral markets went against this trend.
- > In September we saw a substantial drop in Italian rates, as the markets started to warm up to the idea that the Italian government would abide by EU rules for its budgets. The drop almost completely reversed when the budget deficit presented was closer to the limit of 3% of GDP than the market had anticipated. We expect Italian rates to remain volatile.
- > As always, the increase in rates cannot be attributed to one specific factor, but a consequence of several developments. We do, however, think that central banks played a major part. There seems to be a clear change in tone coming from central banks: sometimes more explicitly, like the policy announcements of the ECB and Fed, and sometimes more implicitly, like actions taken by the Bank of Japan.
- > The message from the Fed is clear: the economy is doing just fine. This warrants a continuation of the rate-hiking cycle. Despite this clear message, there remains a discrepancy between what the market thinks the rate path will be, and how the Fed thinks rates should develop. Data wise, the onus is on the market, and not the Fed. We continue to witness a broad-base strengthening of the US economy.

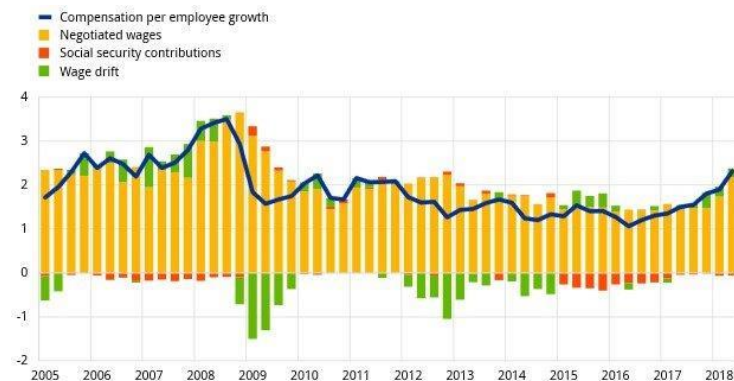
> AAA Bonds (II)

The Eurozone: compared to last month, rate hike expectations have increased



Source: Bloomberg & Robeco

ECB confidence about wage growth development remains positive

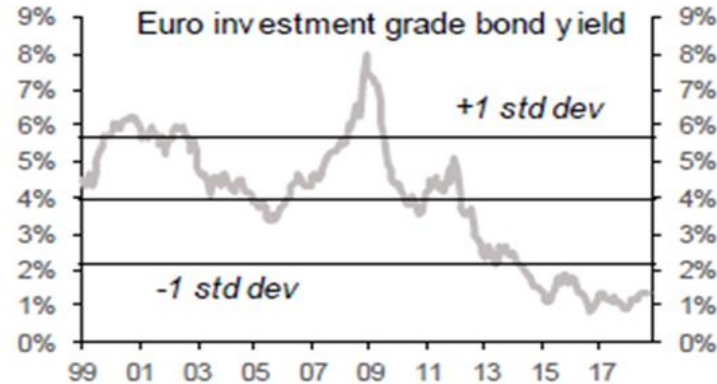


Source: Source: Eurostat and ECB

- > Confidence among US consumers and producers remains very strong, the labor market doesn't show any sign of weakening, and incomes keep increasing at a healthy clip. Basically, it all boils down to the sustainability of this upswing. The fact that confidence among small business remains solid is a strong indication that this might not be just a tax cut-driven sugar high. With consensus expecting 2019 growth to move lower towards more sustainable level, any indications that expectations are too low will probably trigger a substantial repricing.
- > We are getting strong indications from the ECB that an inflation print of around 1.7% meets its target. The conviction is growing at the ECB that its policy is working. The bank's president, Mario Draghi, seems to be firmly on board with this, as he recently stated that the ECB expects a relatively vigorous pick-up in underlying inflation. A major reason for the growing confidence is the continued improvement in wages for employees. In 2018, the increase in negotiated wages has been substantially higher than in 2017. Growing confidence that policy is working is a necessary requirement to exit the asset purchase program.
- > Compared to last month, we haven't changed our general view on rates. The US continues to hold the key to the future direction of rates. We continue to think that we haven't seen the highs in rates yet. but are unsure whether this is the right time to re-engage with the market.

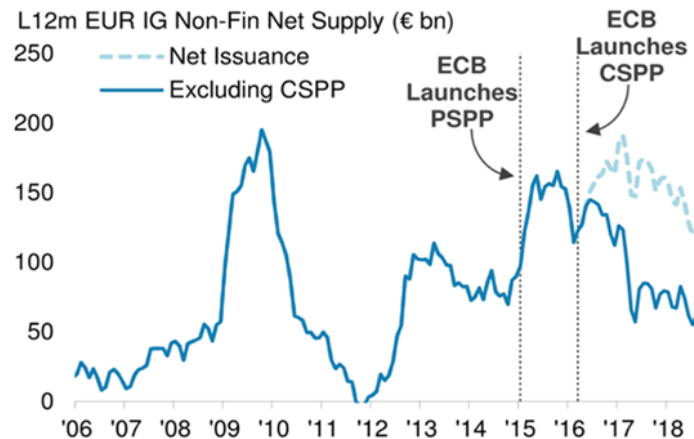
> Investment Grade Credits (I)

European yields are still extremely low in an historical perspective



Source: Societe Generale

The CSPP triggered a lot of extra issuance

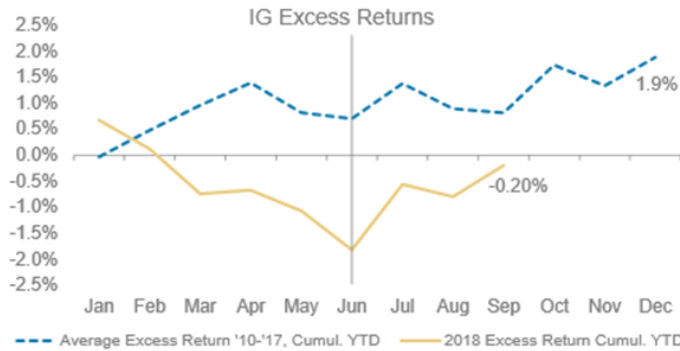


Source: Dealogic, ECB, Morgan Stanley Research

- > European spreads declined in the first half of September. The spread compression stalled towards the end of the month. Yields are experiencing upward pressure, but remain extremely low in an historical context. The European credit yield ended September at 1.08%.
- > After the summer, the ECB returned to the market to buy credits. As things now stand, this will be the last quarter of purchases within the CSPP program. From January onwards, only reinvestment purchases will be made. Sentiment on European markets was mainly determined by developments in Italy, although in the end, the reaction on the credit markets was relatively mild. As we don't think the last word has been said on the Italian budget plans, it remains a risk to credit spreads.
- > Technical factors were one of the main drivers of return this year. The CSPP, ultra-low yields and tight spreads resulted in heavy corporate issuance, as can be clearly see in the chart on the left. Increased supply and a retreating ECB as a marginal buyer is another reason why we expect the spreads on European credits to widen.
- > The European economy is doing fine and at its last meeting, the ECB confirmed the current policy setting. This has the potential to lead to rising sovereign yields. This could trigger some kind of crowding out effects, as sovereigns become more attractive from a risk/return perspective, and this is an extra reason why spreads could widen towards the end of the year.

> Investment Grade Credits (II)

US credits erase part of their losses



Source: Morgan Stanley Research, FTSE Fixed Income LLC

Foreign investors retreat from the US



Source: Morgan Stanley

- > In September, US credit yields rose above 4%, while spreads declined 9 basis points to 105 basis points. US credits have erased some of their losses of the first months of the year, but the total return remains negative. Much of this has to do with the tightening liquidity conditions this year, as the Fed shrinks its balance sheet and Treasury yields rise. We believe the relatively good performance in the third quarter was temporary, based on positive sentiment from strong macro data and fewer fears. The rally in Q3 made US credits even more expensive.
- > A range of potential headwinds remain. As the Fed hiked interest rates in September and is expected to do so again in December, liquidity has tightened again towards pre-summer levels. LIBOR is also rising again, increasing hedging costs for foreign investors. The retreat of foreign investors from the US market is already visible. On top of this, US corporates are still highly leveraged, and are thus vulnerable to rising yields.
- > We have a neutral stance on credits at the moment. Economic circumstances are still good, providing a solid base for credits. On the other hand, there are more than enough reasons to become cautious, such as rising yields and tightening liquidity in Europe and the US. Regionally, we prefer global to European credits, due to political risks in Europe.

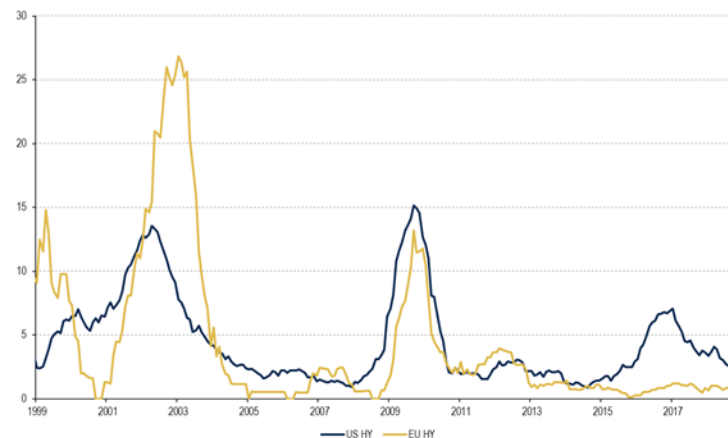
> High Yield (I)

High yield – spread



Source: Robeco & Bloomberg

High yield – defaults



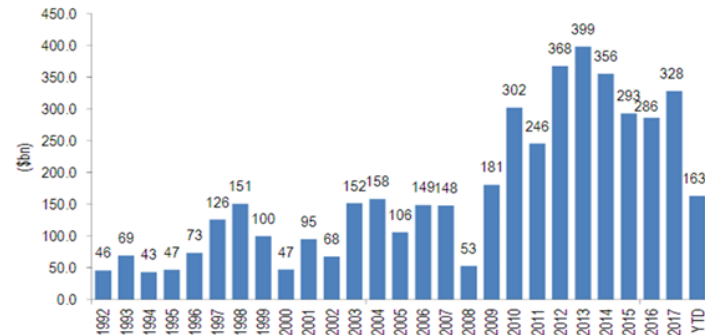
Source: BofA Merrill Lynch

- > September was one of the few months this year in which high yield bonds delivered a return. Global high yield bonds (hedged to euros) realized a return of 1.2%. At the end of September, the average spread on high yield bonds was 381 basis points, down an impressive 35 basis points from the end of August. We continue to be underweight high yield bonds, but have turned less negative on the asset class, as some technicals and fundamentals have improved.
- > The global economy continues to be healthy. This is especially the case in the US, representing more than 60% of the high yield bond universe, which enjoys annualized GDP growth of over 4%. This, in combination with still relatively low interest rates and strong earnings growth, resulted in a further decline in the US default rate. Defaults have now fallen to their lowest level since 2015. In Europe, where average high yield bond ratings are higher, the default rate remains close to zero.
- > It is normal in the current (late) phase of the economic cycle for high yield bonds to lag equities. With corporate debt levels increasing, this cycle is no exception. The average high yield company's leverage has increased in recent years. Interest rates remain relatively low, even in the US, and we do expect them to rise gradually over time. We don't think that this will cause a near-term spike in defaults, as the debt distribution (maturity wall) looks pretty benign. But, as is the case for most fixed income asset classes, rising rates do provide a headwind, especially with already pretty low spreads.

> High Yield (II)

High yield – issuance

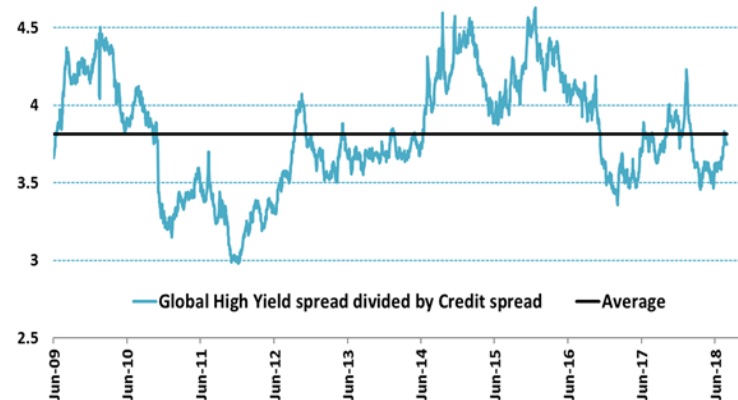
Annual high-yield new-issue volume



Source: J.P. Morgan

Source: J.P. Morgan

High yield – relative valuation against credits

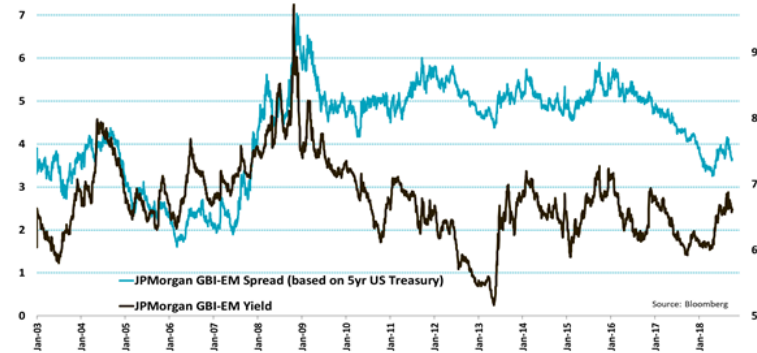


Source: Bloomberg

- > Something to keep an eye on is the rise in issuance of covenant-lite loans. Due to their low quality, they are highly vulnerable to adverse events or market circumstances. While there is no immediate trigger apart from an overall decline in sentiment, more attention paid to the quality of loans could lead to higher volatility for high yield bonds.
- > High yield bond issuance has slowed significantly this year and is expected to end the year substantially below the issuance volumes of previous years, somewhat shifting the balance of supply and demand (somewhat, because the issuance of leveraged loans has increased.)
- > As we emphasized last month, valuation has been an important reason for our negative stance on high yield bonds. However, things have somewhat improved. While the yield on local currency emerging debt also increased, this was accompanied by a massive surge in volatility. Compared to equities and credits, the valuation of high yield looks less stretched than a couple of months ago. In fact, the relative spread level of high yield over credits is now just below the long-term average. In Europe, however, equities are still convincingly more attractive.
- > We remain underweight high yield bonds, but have become less negative. From an economic viewpoint, things look OK, even though we are late cycle. Other risky assets, especially equities, tend to outperform during this phase. Technicals seem to have improved somewhat. Valuation is still a negative, but less so than a couple of months ago.

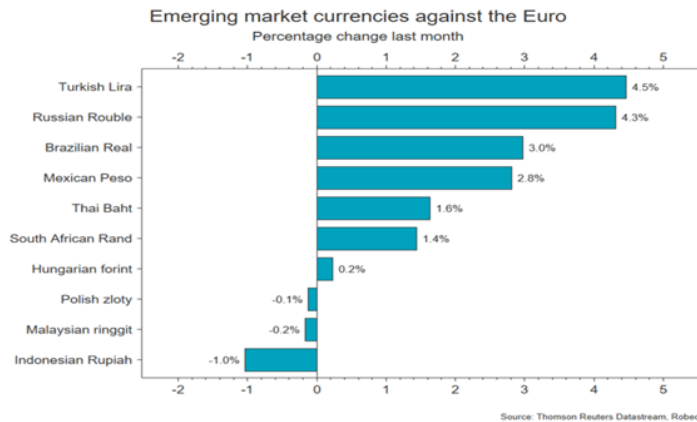
> Emerging Market Debt (I)

Emerging market debt in local currency – spread and yield



Source: Bloomberg

Emerging currencies



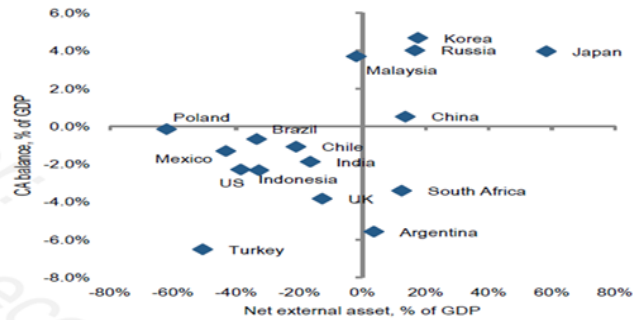
Source: Thomson Reuters

- > Local currency emerging market debt recovered from one of the worst months on record. The asset class returned 1.8% in September, beating high yield bonds and all other bond asset classes. For the year, however, emerging market debt is still down 3.6%, making it the worst-performing fixed income asset class.
- > A couple of factors attributed to the strong performance of local currency emerging debt in September. First, Turkey’s central bank did in the end decide to implement a more orthodox policy by raising short-term interest rates. As a result, the Turkish Lira halted its decline, but didn’t recoup much of its losses either. Bond yields also came down from elevated levels. We would emphasize that a renewed downturn of Turkish assets remains possible, as the impact on bank capital and GDP growth has yet to become visible.
- > Most other emerging currencies showed positive returns against the euro. To some extent, this had to do with the fact that basically none of the major emerging countries have the same characteristics as Turkey (see also next page). Also, emerging currencies have been under pressure for a long time, and some have become attractive in terms of valuation. We can’t rule out that some of the weakness of the euro was due to worries about Italy’s debt sustainability. We expect the value of emerging currencies to gradually increase over time, but emphasize that this will probably be accompanied by waves of very high volatility. This is an important reason that keeps us from becoming more upbeat.

> Emerging Market Debt (II)

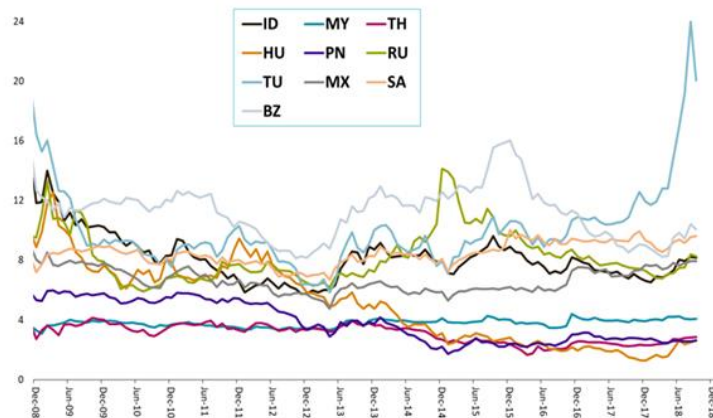
Turkey: terrible characteristics

Figure 2: Turkey has one of the highest net external debt and current account deficit (% of GDP)



Source: Thomson Reuters, Credit Suisse research

Yield to maturity – emerging countries

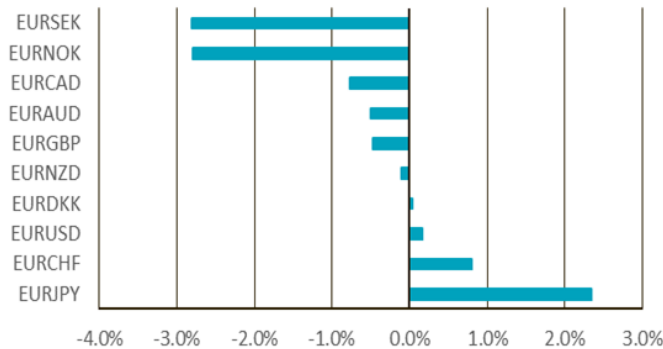


Source: Bloomberg

- > As mentioned last month, Turkey’s troubles are specific to that country. As the chart on the top left shows, Turkey has both a high percentage of external debt and a high current account deficit (meaning money has to flow in from abroad). Historically, this is a fruitful combination for currency crises. But the chart also shows that none of the major emerging market countries in the EMD index shares the same problematic combination of foreign debt and current account balance.
- > Finally, the combination of global GDP growth and inflation is mildly positive for emerging market debt. On average, emerging market GDP growth could pick up from here, even though the room for improvement is limited. Average inflation was very low until recently, but is now picking up as a result of earlier severe currency depreciation. Inflation in Turkey has risen to a massive 24.5%. The Fed will continue to draw down liquidity, but so far this has been reasonably gradual.
- > We remain neutral on emerging debt as we think downward and upward risks are more or less balanced. Some markets look attractively valued, where others like Turkey could see another leg down. Contagion seems to be limited at this point. The current yield of around 6.5% is substantially above the yield on Eurozone government bonds, but volatility is likely to stay high in the short-term.

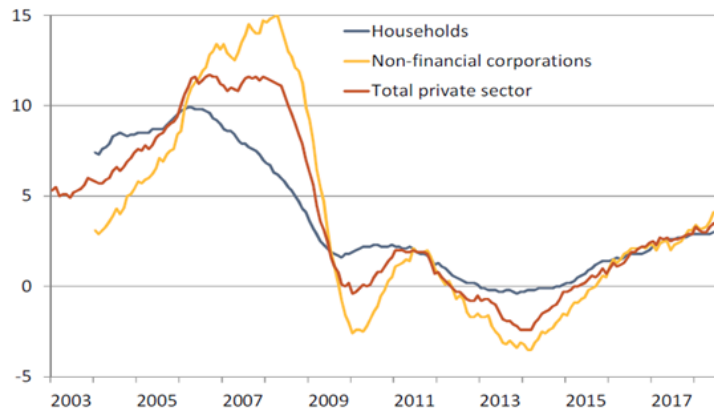
> FX (I)

G-10 currencies reverse the prior month's moves: safe currencies lose ground



Source: Bloomberg, Robeco

The credit cycle continues to improve in the Eurozone

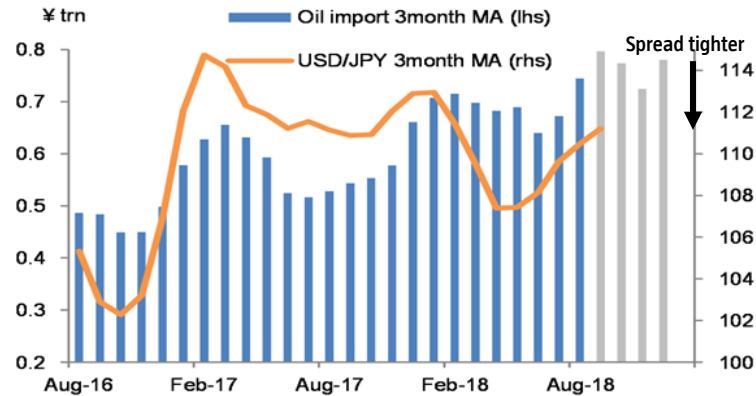


Source: Berenberg & ECB

- > In September, we saw a reverse of August's price action. The winners were the commodity/cyclical currencies, and the clear losers the safe have currencies. Besides growth issues and monetary policies, three major geopolitical issues continue to determine the path of the major currency pairs: Brexit, trade tension and Italian politics.
- > While the euro remained in a relatively tight range in September, what did catch our eye was the fact that since July, the gyrations of EUR/USD seem to have realigned with the ebbs and flow of Italian rates. This apparent recoupling of EUR/USD with European political risk is a worry.
- > It is a worry that we will be monitoring closely, but for now is not a trigger for us to pull out the euro crisis playbook, which is something that quite a few Anglo Saxon pundits are suggesting. We are well aware of the issues that Europe faces: politics, a trade war with the US, Brexit and immigration. What keeps us hopeful, however, is that there is still a clear counterbalance to all of this, and that is growth.
- > With a still-accommodative ECB policy, labor market/wage gains, an improving credit cycle, and still firmly positive economic sentiment, we find it hard to believe that growth will massively disappoint, and expect it to remain around trend. What is also encouraging is that although Italian risk has obviously increased, the euro still managed to hold its ground last month. So for now, it still looks to be a contained Italian political/economic issue.

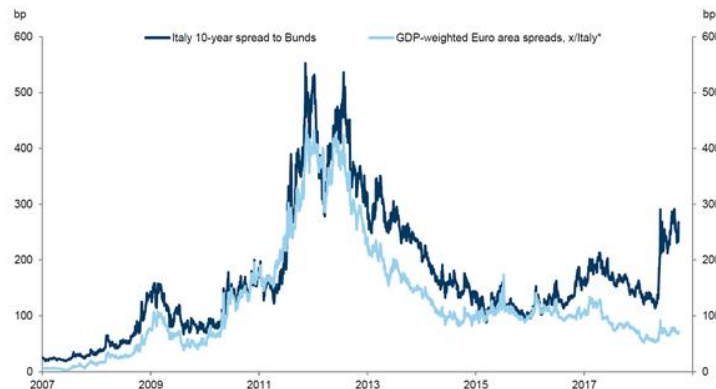
> FX (II)

Rising oil prices negatively impact Japan's current account



Source: Japan MOF, Bloomberg & Jp Morgan

Italy: still limited contagion



Source: Goldman Sachs Global Investment Research & Bloomberg

- > The weakest currency in September was the yen. The depreciation of the yen is a move we missed out on. With hindsight, there were signs that we should have picked up on. First, the increase in the oil price is not good for an oil importer like Japan. Second, the yen tends to do poorly during phases of deflation. And last but not least, we saw the return of the relationship between US and Japanese rate differentials. What also didn't help the yen is the market perception that the Bank of Japan is a laggard when it comes to monetary normalizations.
- > With Canada seemingly joining the trade agreement formerly known as NAFTA, we are getting an indication of which Trump we can expect going into the mid-term Congressional elections. Fortunately, it looks like being Trump the businessman/dealmaker, and not the anti-establishment Trump. This should be seen as a positive, and hopefully means less aggressive trade rhetoric.
- > Brexit risk remains high after last month's European summit, and it doesn't look like the tension will be alleviated any time soon, with the ruling Tories rallying their base at their annual party conference.
- > With geopolitics still a potential negative, we think the euro will find it hard to strengthen. However, any slowdown in the negative news flow will create a window for the euro to rise again, given the Eurozone's large current account surplus, a slowdown in growth that is already priced in, and as a consequence of rebalancing reserves.

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