ROBECO
The Investment Engineers

Don't worry about Eurozone deflation

- Three reasons why falling prices aren't a problem
- Roaring equities remain our favourite asset class
- Cyclical stocks preferred to defensives as US growth accelerates

Topic of the month: will falling prices pose problems?

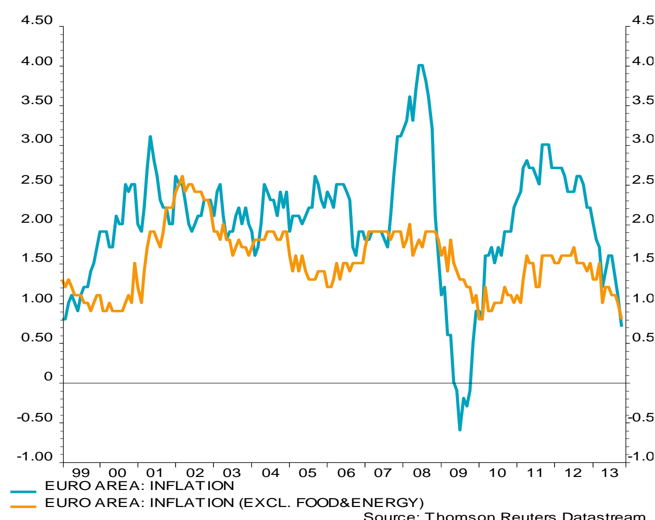
The strength of the euro combined with generally falling prices in a low-growth environment has raised investors' fears that deflation could take hold in the Eurozone. However, these fears are misplaced, as there are three clear reasons why deflation is unlikely to take hold. And there is little danger of a Japanese-style deflation ushering in a 'lost decade' due to the very different economic environment and culture in the euro area.

A striking development in 2013 was that after years of underperformance as the Eurozone lurched from one crisis to another, the euro appreciated against all major currencies. On a trade-weighted basis the euro has risen by almost 13% against its peers since mid-2012. The Japanese experience was that a strong yen markedly contributed to the country's slide into deflation in the 1990s.

The ongoing strengthening of the euro therefore increases the risk of deflation for the Eurozone, where inflation was already heading downwards. Headline inflation fell to 0.8% on an annualized basis in December 2013 from 0.9% in November. Core inflation – which strips out more volatile food and energy prices – fell to a record low of 0.7% in December. Other indicators also indicate a long-term trend of disinflation. Producer prices fell 1.3% in November, private sector loans shrunk a dismal 2.3% in November versus -2.2% in October, and M3 money supply fell 1.7% in November.

The Eurozone has been here before, as shown in the graph. In 2008/2009 a dramatic drop in inflation ended in a five-month period of mild deflation. Such a short-term period of mild deflation is not a disaster, so long as deflationary expectations do not become entrenched. If the latter scenario happens, the economy stalls as consumers postpone buying goods because everything gets cheaper all the time, thereby exacerbating the deflationary process. We are still far from such a development in the Eurozone.

The Eurozone survived a brief period of post-crash deflation



Three reasons why deflation will not take hold

We see three arguments for optimism that deflation will not take hold in the euro area. Firstly, the Eurozone is experiencing a recovery, and the southern periphery in particular is enjoying an upswing. Bond yields in Italy and Spain have come down to comfortable levels, supporting the recovery. It is hard to see how an accelerating European economy can fall into a deflationary trap. Of course, some argue that the European recovery isn't self-sustaining, and due to ongoing austerity measures, a fall back into a recession is likely. We disagree. We consider it more likely that budget deficit and debt targets will be postponed once again. France, for one, will probably also fail to meet its targets. The EU and Germany have very little leverage over France and subsequently over austerity policies within the periphery, whose cause is often championed by the French.

France, the second-largest economy in the Eurozone, has recently become some kind of puzzle. On the face of it, recent PMI figures seem to confirm that France is the real sick man of Europe. But other indicators like December manufacturing from Insee, the French national statistics institute, have shown a two-point improvement, with output rising to hit the long-term average of 100 points on its scale. Figures for new car sales in France also showed a marked uptick in December of 9.4 per cent over the same month a year ago. It is likely that the French PMI is overstating France's competitiveness problem.

Mario Draghi

Secondly, the European Central Bank (ECB) is well aware of the deflationary risks and its president, Mario Draghi, showed in November 2013 that he was prepared to act against the will of a significant minority on the ECB Governing Council to combat deflationary trends. Recently, Draghi has stressed there is a risk that inflation, which is already clearly below the ECB's 2% target, might fall further. Interestingly, he has emphasized that the ECB has to be very careful that inflation does not permanently fall below 1% - "and thus into the danger zone". As interest rates in the Eurozone head towards zero, this is a clear signal that the ECB is prepared to resort to unconventional monetary measures if the need arises, putting pressure on the euro exchange rate and limiting deflationary risks.

Thirdly, the prospect of a Japanese-style deflationary environment is politically unacceptable within the Eurozone. The long stagnation period in Japan can be partly explained by the unusually

consensus-driven and mono-ethnic nature of Japanese society, which was prepared to suffer for the national good. Such stoicism is unlikely within the Eurozone. A fall into a deflationary trap would put the existence of the current composition of the Eurozone into great danger, provoking the ECB to act. Policy makers within the area including the Germans would in our opinion go to unprecedented lengths to avoid a partial breakup and thus a deflationary scenario.

Robeco's inflation estimates concur with consensus everywhere except India

CPI by region (%)	*2012*	*2013*	*2014*	*Δ -1m 2013*	*Robeco**
US	2.1	1.5	1.7	-0.2	=
Eurozone	2.5	1.4	1.2	-0.1	=
UK	3.2	3.1	3.0	-0.3	=
Japan	0.0	0.3	2.4	0.1	=
China	2.6	2.7	3.1	-0.1	=
India	7.5	6.1	9.1	0.0	-
Brazil	5.4	6.1	5.8	0.2	=
Russia	6.6	6.0	5.5	0.0	=
World	2.6	1.9	2.6	-0.1	=

* indicates whether we expect a higher (+), matching (=) or lower (-) inflation rate than the current consensus estimate for 2013

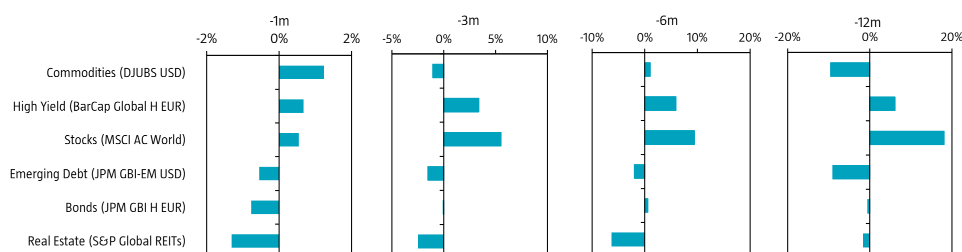
Source: Consensus Economics, Robeco

It could be argued that the slow, insufficient, unsatisfying progress towards a true banking union within the Eurozone is a recipe for slow growth. Such a scenario fails to break the link between weak banks and weak states, and reminds observers of the Japanese-style 'convoy system' which keeps afloat the zombie banks that keep alive zombie companies, preventing creative destruction and a reset. That is, of course, partly true for the Eurozone.

However, the general health of the European banking sector is better than that of the Japanese. As such, the unhealthy tolerance of weak banks and sovereigns within the Eurozone is in our opinion more of a long-term problem for the bloc. This issue will be obscured by the ongoing recovery and therefore is insufficient to push the zone into Japanese-style deflation.

Asset allocation – stock market rally is set to continue

Performance of asset classes (gross total return) – stocks ruled in 2013



Source: Thomson Reuters Datastream, Bloomberg, Robeco

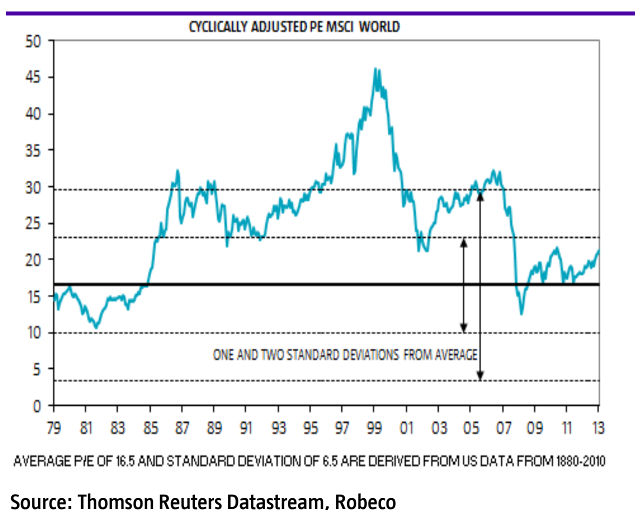
Roaring equities remain our favorite asset class

With returns exceeding 25%, developed market equities had an outstanding year in 2013. As we enter 2014, equities remain our favorite asset class. The rally has been driven by multiples expansion and as a result valuations have drifted higher into more questionable territory. However, we do not believe that valuation will become a major obstacle for the equity market in 2014. Experience shows that the current levels of multiples do not create significant near-term downside risk, although a correction remains a possibility.

Sentiment remains positive as major risks in the economic and political spheres have eased and the US Federal Reserve (Fed) will proceed cautiously with its withdrawal of excess liquidity. It will give with one hand (i.e. forward guidance, low interest rates for a considerable time) what it takes with the other hand (less bond purchases). Momentum is also good.

However, there are several factors that we watch closely besides valuation. Earnings revisions have not been improving overall, although they are stabilizing in the US. Profit margins seem stretched in the developed world, now at almost 9% for the S&P 500 companies. We expect a more sideways movement in profit margins as accelerating economic growth will lead to higher capital expenditure, while low refinancing risk and the virtual absence of labor pricing power will sustain high margins for longer.

Cyclically adjusted PE MSCI World shows multiples expansion



Source: Thomson Reuters Datastream, Robeco

Real estate is too interest rate sensitive

We remain negative on real estate compared to equities as the asset class continues to show its vulnerability to rising interest rates, behaving more like bonds. In our view interest rates in the US will rise towards 3.5% this year and this implies that real estate will continue to underperform. However, we expect this impact to become less prevalent as vacancy rates will decline as the economy improves further, while increased rental income and higher asset values will also be positive.

From a valuation perspective, real estate is still expensive compared to equities, although this valuation gap is compensated to some extent through higher dividend yields. There remain substantial differences in regional valuations, with the US and Japanese market more expensive compared to European markets.

Real estate has underperformed equities

Source: Bloomberg, Robeco

High yield still attractive thanks to low defaults

We retain our positive view on high yield. In a low but increasing interest rate environment, high yield retains its attractiveness compared to other asset classes. Strong interest coverage ratios, low refinancing risk and accelerating growth in developed markets will keep default rates low. As a result of these developments, high yield spreads compressed considerably in the last few months, although the return impact was dampened by the increase in interest rates.

High yield spreads between US and Europe have widened

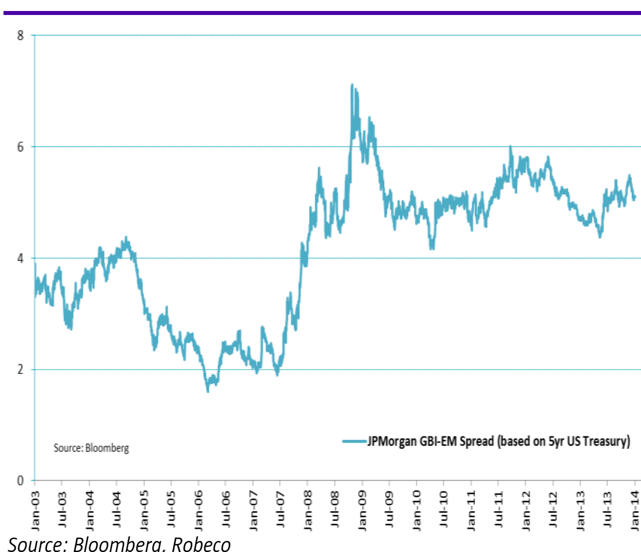
Source: Bloomberg

The growing difference in spreads between European and US high yield is partly due to a higher rated European market (BB/BB-) versus BB-/B+ for the US. The fundamentals for both markets remain positive, although we remain alert on increased 'covenant lite' issuance as well as the more volatile character of the high yield market in general. Broker liquidity for this asset class is relatively modest, creating more potential for price swings. We have a neutral view on credits. Spread levels in European high yield have dropped to 104 basis points. Although this is still a decent spread, it leaves the credit market increasingly vulnerable to rising interest rates. The high correlation with core government bond markets further enhances this risk. We prefer equities and high yield compared to credits.

Currency factors dominate emerging market debt

We maintain our neutral position on emerging market debt (EMD) against high yield as the latter offers a better risk/return perspective. High yield volatility is considerably lower compared to EMD and the higher EMD spread is outweighed by high currency volatility. Although EMD saw some spread compression last month, the main contributing factor for local currency EMD remains the relevant currency's performance against the USD. Emerging market currencies have experienced significant depreciation against the USD after the tapering talk began in the market. The consequent capital outflows also revealed the economic weaknesses of emerging markets as current account deficits grew and fiscal balances deteriorated. Structural reforms are under way, but this long-term gain will cause short-term economic pain.

JPMorgan GBI-EM spread also widened in 2013



Source: Bloomberg, Robeco

The structural reforms themselves could be hampered in a year that will see several elections in key countries. Market fears for further significant capital outflows in the wake of the tapering of Fed bond purchases might be exaggerated, but the susceptibility of emerging markets to capital outflows certainly remains high, especially in those with higher market liquidity. Differentiation in economic performance within emerging markets could be substantial in the near term as last year already showed. We expect continuing divergence within emerging markets according to differences in export orientation, current account balances, fiscal- and monetary policies and political stability.

Government bonds set to fall in value

We remain negative on core government bonds as we enter 2014. These bonds generally profit from political uncertainty which has been abating in recent months in the core economies, notably the US and the Eurozone. We think that the US political gridlock is resolved for now with a two-year Congressional deal on the federal budget in place. Meanwhile, the Eurozone has seen progress on the institutional reforms side and safe haven flows to core government bonds have diminished. From a fair value perspective, interest rates in the current low or negative yield environment should trend higher, causing downside for bond prices.

US 10-year bond yield is still well below fair value

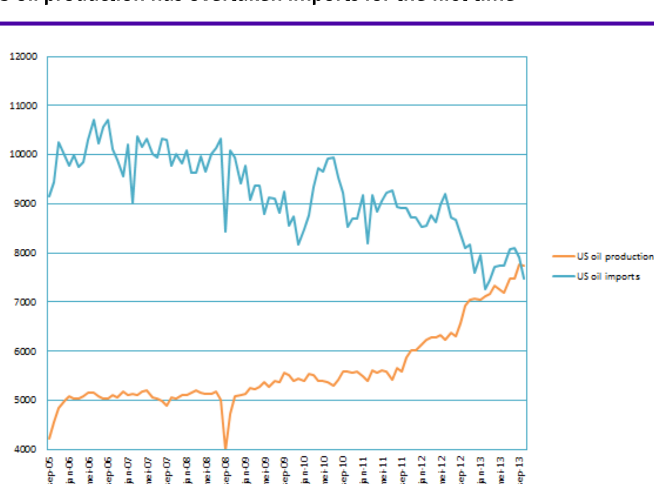
Source: Bloomberg, Robeco

The steadily improving world economy will translate into higher nominal interest rates despite the disinflationary trend observed in some developed countries, notably within the Eurozone. The Fed decision in December to start tapering its Treasury purchases from January 2014 onwards will sustain the gradual normalization in interest rates. The decision to start with a 'little taper ' of USD 10bn/month has kept bond market volatility and market stress subdued, and US bond volatility even declined last month. Although this development is in principle favorable for core government bonds, other fixed income classes like credit and high yield have better relative risk/return prospects in this rising rate environment. We therefore prefer corporate bonds compared to government bonds as high yield provides a decent spread buffer against rising interest rates.

Commodities are 'stuck in the mud'

We remain neutral on commodities, as the asset class remains 'stuck in the mud' and is not profiting from the accelerated expansion of economic activity in developed countries to the extent that other risky assets have done. Over the past year the asset class has experienced decreased sensitivity to macro developments while supply/demand fundamentals had more influence on price behavior. This especially holds true for the energy sector, where supply on the oil market has been ample due to record non-OPEC production levels, driven by the shale oil revolution in the US. We expect this development to be counterbalanced by OPEC to stabilize oil output at profitable levels for Saudi Arabia. Also, strikes in Libya and increasing sectarian violence in Iraq are keeping production levels erratic and below capacity.

US oil production has overtaken imports for the first time

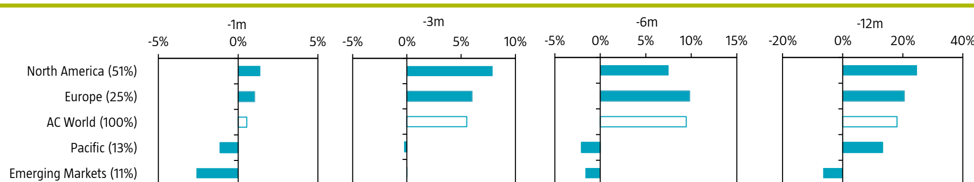


Source: Bloomberg

Commodity demand from emerging markets will not be a major driver as industrial production remains lackluster. The Chinese authorities increasingly show a tightening bias in their monetary policy and we expect Chinese oil demand to moderate somewhat in the near term. Newly opened Chinese refineries will sustain physical demand. Also, countercyclical policies will be put in place in a timely manner if policymakers fear a hard landing for the Chinese economy. These factors will sustain demand in the medium term and it is therefore too early to say the super-cycle in commodities is over.

Regional asset allocation – Europe preferred to US

Europe has been the best performer over past six months



MSCI AC World unhedged EUR; index weights between brackets

Source: Thomson Reuters Datastream, Robeco

We remain less constructive on North America, although earnings revisions there have recently improved. We want to see accelerating economic growth translate into earnings growth to compensate for the relatively stretched valuations before becoming more positive again. Europe currently looks more favorable to us as the improved competitiveness in the periphery and increasing consumer confidence at the core bode well for demand-led growth. Also, the recent interest rate cut by the ECB is supportive for economic activity, possibly increasing investment.

With deflationary forces becoming more entrenched in the Eurozone, the ECB is relatively more pressurized compared to other central banks to provide more liquidity, which could fuel regional asset markets. We retain our positive view on the Pacific region. An accommodating Bank of Japan will push for further yen weakening which should help the country's economic performance, despite the negative impact of the proposed VAT hike in April. Earnings revisions are decent from a historical perspective and valuations are still below their 10-year averages. We remain neutral on emerging markets as we do not expect a significant improvement in earnings growth, despite favorable valuations.

The Pacific region has the highest earnings growth

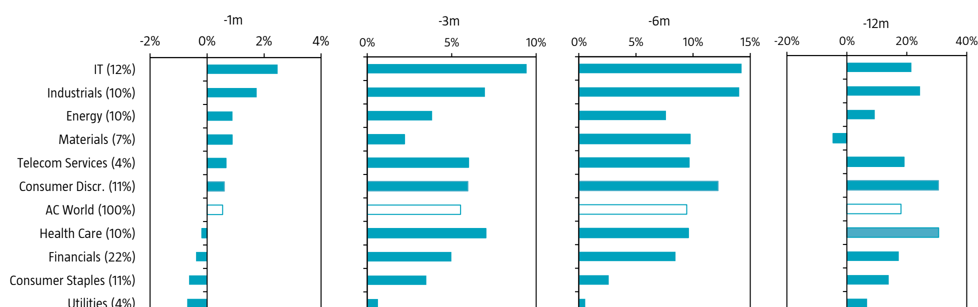
	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd earn.*	
	FY1	*FY2*	*12m*	*3m*	*1m*	*Current*	*10y avg.*
North America	5.8	9.6	9.8	-5.4	-11.4	15.5	14.1
Europe	-2.2	12.7	12.5	-32.1	-44.3	13.4	11.9
Pacific	35.7	9.7	15.4	-5.9	-5.7	14.4	15.2
Emerging Markets	6.9	11.8	11.6	-12.6	-22.5	10.3	10.8
AC World	6.5	10.7	11.4	-12.8	-17.9	14.1	13.2

Earnings and valuation data of regions (MSCI AC World). The earnings revisions index is calculated by using the difference between the number of up- and downward revisions relative to the number of total revisions.

Source: Thomson Reuters Datastream, Robeco

Sector allocation – cyclicals preferred to defensives

Cyclical sectors such as IT have been the best performers



MSCI AC World unhedged EUR; index weights between brackets

Source: Thomson Reuters Datastream, Robeco

We prefer cyclical to defensive sectors. From a macroeconomic point of view, we expect an acceleration in US economic growth above consensus in 2014, and this clearly favors cyclical stocks. Earnings revisions also do more clearly favor cyclicals, notably the IT sector.

Cyclical sectors also have the best earnings growth potential

	Earnings growth (%)			*Earn. rev. index*		*P/E on 12m fwd earn.*	
	FY1	***FY2***	***12m***	***3m***	***1m***	***Current***	***10-yr avg.***
Energy	-7.0	10.4	10.4	-22.4	-5.3	11.3	11.0
Materials	17.2	17.2	17.4	-15.2	-33.3	13.8	12.2
Industrials	13.8	13.8	14.6	-16.9	-17.4	15.5	14.2
Consumer Discr.	19.0	10.4	13.5	-10.1	-31.2	15.8	15.3
Consumer Staples	5.2	9.1	9.3	-36.0	-52.9	17.1	15.8
Health Care	0.5	8.2	8.2	-5.6	-31.0	16.5	14.4
Financials	14.8	10.1	10.5	2.1	-17.3	12.0	11.3
IT	9.5	12.5	12.8	-8.3	23.1	14.7	16.0
Telecom Services	-3.5	5.7	5.9	-21.3	-38.5	14.7	14.4
Utilities	20.9	7.6	10.9	-10.2	-15.4	13.8	13.7
AC World	6.5	10.7	11.4	-12.8	-17.9	14.1	13.2

Earnings and valuation data of sectors (MSCI AC World). The earnings revisions index is calculated by using the difference between the number of up- and downward revisions relative to the number of total revisions.

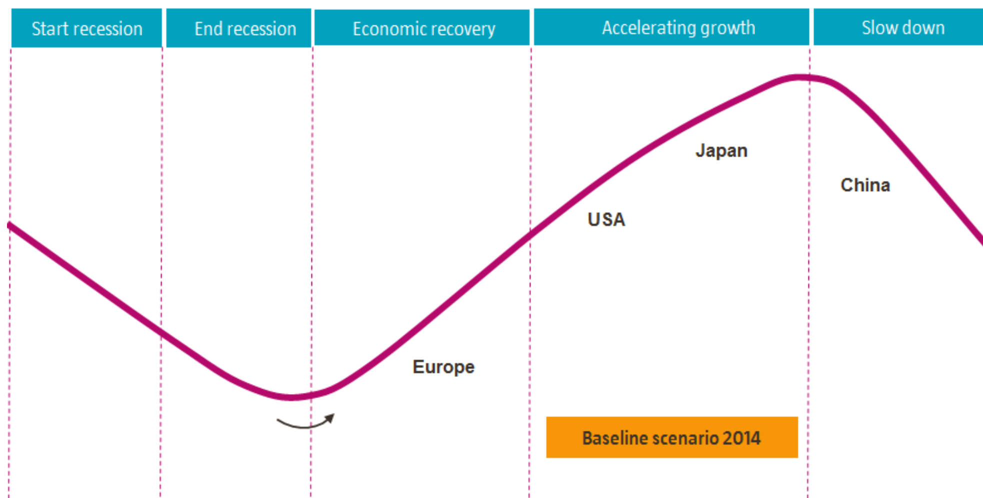
Source: Thomson Reuters Datastream, Robeco

Position in the economic cycle

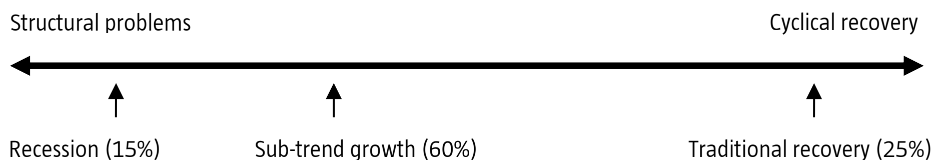
Macroeconomic scenarios, and Robeco's view versus consensus

The world economy is showing signs of ongoing recovery. 'Abenomics' is running according to plan, the Chinese authorities have been successful in accelerating the Chinese economy, and the Eurozone economy continues to improve. For these three economies, the question is whether this recovery is sustainable in the long term of 12 months. But for the time being we have raised our estimate for a modest recovery from 20% to 25%. Our base case remains below-trend growth, of which we have modestly reduced the probability from 65% to 60%. The probability of a global recession remains low in our opinion, at around 15%.

Position in the economic cycle – Europe lags the other major economies



Macroeconomic scenarios



Recession (15%) Sub-trend growth (60%) Traditional recovery (25%)

Source: Robeco

Robeco's expectations for growth are higher than consensus for US, Eurozone and UK

GDP growth by region (%)	*2012*	*2013*	*2014*	*Δ -1m 2014*	*Robeco**
US	2.8	1.7	2.6	0.0	+
Eurozone	-0.6	-0.4	1.0	0.0	+
UK	0.2	1.4	2.4	0.1	+
Japan	1.9	1.8	1.6	0.0	=
China	7.8	7.6	7.5	0.0	-
India	5.2	5.0	4.8	0.1	-
Brazil	0.9	2.3	2.3	-0.2	-
Russia	3.4	1.5	2.4	-0.1	=
World	2.2	3.1	3.8	0.0	=

* indicates whether we expect a higher (+), matching (=) or lower (-) growth rate than the current consensus estimate for 2013

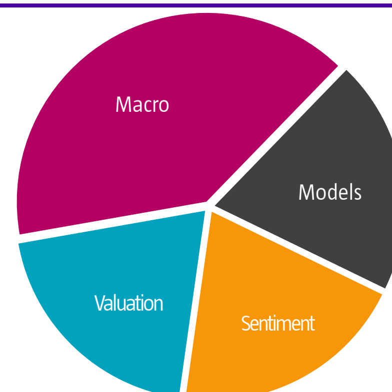
Source: Consensus Economics, Robeco

Robeco’s multi-asset management approach

Our expectations are based on qualitative and quantitative analyses. Our starting point is to look at the long-term macroeconomic environment. We then determine our expectations for the economy for the next three to six months to find out which developments could take the market by surprise, as this is a common factor for all asset classes. This macroeconomic analysis determines our initial preference in terms of assets.

Next, we challenge our macro analysis with input from financial markets. Here, we take valuations into account as, at extreme levels, these might cause the performance of an asset class to change direction. Sentiment also plays a role, as markets tend to extrapolate shorter-term trends if investors put too much weight on recent developments. Finally, we use quantitative models to steer our expectations.

Input factors for our investment policy



The table below shows our current multi asset allocation.

	Portfolio	BM	active	previous	tracking error	risk budget
Equities Developed Markets	27,5%	25,0%	2,5%	1,0%	0,40%	56,0%
Equities Emerging Markets	5,0%	5,0%		-1,0%	0,00%	0,0%
Real Estate Equities	4,0%	5,0%	-1,0%	-1,0%	0,18%	-20,4%
Commodities	5,0%	5,0%		-1,0%	0,00%	0,0%
Core Gov Bonds 1-10	14,0%	20,0%	-6,0%	-4,5%	0,19%	17,5%
Core Gov Bonds 10+	7,5%	7,5%			0,00%	0,0%
Investment Grade Corp Bonds	20,0%	20,0%	0,0%	0,0%	0,00%	0,0%
High Yield Corp Bonds	10,0%	5,0%	5,0%	5,0%	0,27%	31,4%
Emerging Market Bonds LC	5,0%	5,0%			0,00%	0,0%
Cash	2,0%	2,5%	-0,5%	-0,5%	0,00%	0,0%
EUR/USD	-4,0%	0,0%	-4,0%	-2,0%	0,37%	-6,2%
EUR/JPY	2,0%	0,0%	2,0%	2,0%	0,26%	21,7%
EUR/GBP	0,0%	0,0%	0,0%		0,00%	0,0%
EUR CASH	2,0%	0,0%	2,0%	0,0%		
Portfolio risk	6,53%	6,18%				
Sum of individual tracking errors	1,66%					
Portfolio tracking error	0,54%					

Closing date for text: 07 January 2014.
We refer to calendar months in all our data tables.

Robeco Investment Solutions & Research

Financial Markets Research:
Léon Cornelissen
Ronald Doeswijk
Peter van der Welle

Portfolio Management:
Jeroen Blokland
Lukas Daalder
Artino Janssen
Jan Sytze Mosselaar
Ernesto Sanichar
Ruud van Suijdam
Shengsheng Zhang

Important Information
This presentation has been carefully prepared by Robeco Institutional Asset Management B.V. (Robeco)
It is intended to provide the reader with information on Robeco's specific capabilities, but does not constitute a recommendation to buy or sell certain securities or investment products.
Any investment is always subject to risk. Investment decisions should therefore only be based on the relevant prospectus and on thorough financial, fiscal and legal advice.
The information contained in this document is solely intended for professional investors under the Dutch Act on the Financial Supervision (Wet financieel toezicht) or persons who are authorized to receive such information under any other applicable laws.
The content of this document is based upon sources of information believed to be reliable, but no warranty or declaration, either explicit or implicit, is given as to their accuracy or completeness.
This document is not intended for distribution to or use by any person or entity in any jurisdiction or country where such distribution or use would be contrary to local law or regulation.
All copyrights, patents and other property in the information contained in this document are held by Robeco. No rights whatsoever are licensed or assigned or shall otherwise pass to persons accessing this information.
The information contained in this publication is not intended for users from other countries, such as US citizens and residents, where the offering of foreign financial services is not permitted, or where Robeco's services are not available.
Robeco Institutional Asset Management B.V. (trade register number: 24123167) has a license of the Netherlands Authority for the Financial Markets in Amsterdam.