OUTLOOK
Second quarter 2016
For professional investors

Emerging local debt: time to scale in

Fixed Income Outlook Q2 2016

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Summary

Main views

Main asset categories	Total	Valuation	Technicals	Fundamentals
German Bunds	0	--	+	0
US Treasuries	0	-	0	0
JGB's	--	--	+	-
IG Credits	0	0	0	-
High Yield	-	0	-	-
EMD local debt	+	+	+	-
EURO peripheral debt	-	-	0	-

Our key themes

- Growth depends on the consumer
  The global macro economic environment is fragile. Economic growth largely depends on the consumers' ability to spend as governments' and corporates' willingness to spend more is low and inventories are already high. However, without signs of wage increases and an increase in the savings ratio consumer spending is unlikely to pick up. We therefore stick with our low growth and low inflation scenario. In this environment an imminent bond market sell-off looks unlikely. The interest rate risk in the portfolios is biased towards longer dated bonds.
- Be selective within credits: focus remains on Europe and subordinated financials
  The US economy is in a more advanced stage than Europe, which also manifests itself in more balance sheet risks for US corporates. The picture for Europe still looks somewhat different, although corporates may take the benefit of the ECB buying program by issuing more debt. The subordinated financial sector remains our favorite. Increased regulation has improved transparency and reduced risk taking in the sector. From a bond holder perspective this is favorable. Issuer selection in the category remains key. We prefer banks that either have solid capital ratios or capital ratios that are clearly improving.
- Increasingly constructive on emerging local debt
  After years in the doldrums emerging market valuations have become quite compelling. Now that the Fed has turned less hawkish and emerging market debt (EMD) outflows have stalled or even turned the corner, it is time to benefit from the valuations and improvements in some fundamentals. One of the main risks to the position is China. China is doing an effective job managing the short-term challenges of the economic slowdown, but the long-term challenges remain unresolved.
- Increasingly cautious on peripheral government debt
  We expect peripheral government bonds to lag in performance. Valuation looks rich in the light of deteriorating fundamentals. Political uncertainty is on the rise. Spain and Ireland haven't been able to form new governments. Greek political leaders and the Portuguese minority government are publically challenging demands from official institutions. Market positioning is still biased to longs in these markets.

In focus

Emerging local debt: time to scale in

For many years now, emerging local debt markets have been in the eye of the storm. The impact of the Chinese growth slowdown was felt most in emerging economies which are often highly dependent on commodity prices. A looming string of rate hikes by the Fed also had a depressing effect on these markets, particularly on the exchange rates (versus the US dollar). Years of underperformance resulted in ever more appealing valuation levels for the asset class, but consistent outflows in combination with deteriorating fundamentals kept us from re-entering this market segment. So what has changed?

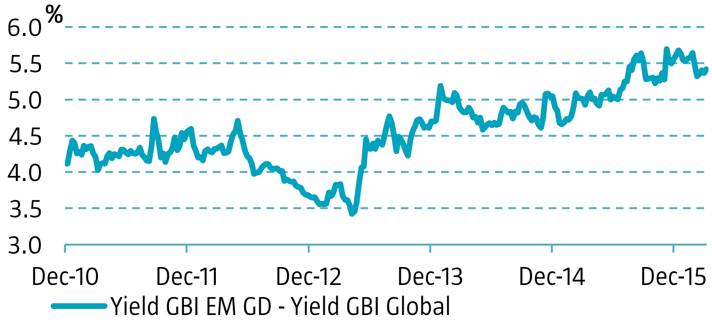
First of all, in recent months the Fed has turned much more dovish, adjusting its growth forecast downwards and stressing global risks to its growth and inflation outlook. This means further rate increases – if any - will likely take place only very gradually. This will halt the strong US dollar appreciation versus emerging currencies and potentially lure investors back into this market.

Secondly, fears of an imminent Chinese hard landing have receded as the country moved back from focusing on rebalancing the economy to reflating the economy. The approach has helped the local property market to recover dramatically (Shanghai house prices are up 20% this year) and demand for raw material is up on the back of it. Risks of a one-off large renminbi depreciation have abated as outflows continue, but at a more moderate pace. In effect the PBOC is pursuing a policy that has become known as "ease and squeeze", i.e. easing monetary policy conditions and squeezing the "speculators" who short the RMB.

We also see the first signs of prudent macro-economic policy by central banks (mainly in Latin American countries like Colombia, Peru and Mexico) as they hike interest rates to address the issue of increasing inflation due to rising import prices, despite this being a drag on economic growth. Finally, investor surveys highlight that emerging local debt is underowned after years of underperformance and fund outflows. At the same time, fund flow data show the first signs of net inflow into the asset class. So from a technical perspective this is encouraging.

Although these are positive signs that all support an allocation to the asset class, we do recognize that significant risks remain. First and foremost in China. The PBOC is doing an effective job in managing the short-term challenges of the economic slowdown, but China's twin problems of high corporate debt and continued excess capacity in the state-owned enterprises have not been resolved and the government's credit policy further increases the leverage in the economy. Tackling these problems will likely be accompanied by painful structural changes. Another source of risk is the vulnerability of emerging markets to external shocks, particularly to a sudden re-emergence of USD strength if the Fed is forced to hike sooner than what markets are pricing in. Stay tuned.

Yield difference emerging – developed rates markets



Source: Robeco, Bloomberg

Treasuries

Returns are driven by yield movements rather than yield levels.

Valuation: the bottom is not the bottom

In most developed markets around the globe yield levels are at historical lows. But market returns over the first quarter of this year clearly show it is not the level of yield, but the movement in yield that drives returns in bond markets. Supported by accommodative central bank policy markets with already near-zero or even negative yields (like Switzerland, Denmark, Japan and Germany) managed to show returns of 4-5% over the first three months of the year, thereby outperforming higher yielding markets like the US and Australia by a wide margin. So although on a valuation basis European yields hardly look attractive, valuation is perhaps not the key driver of returns in the current environment.

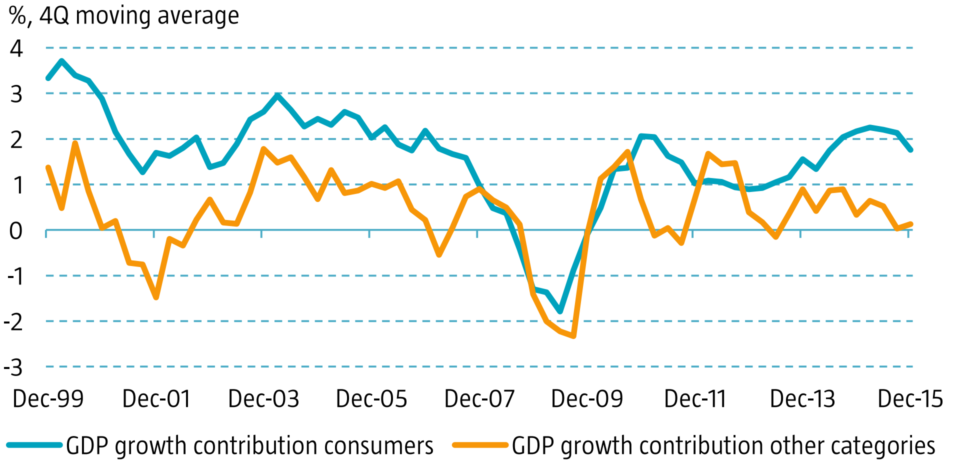
Technicals: central banks' growing impact on yield curve dynamics

The ECB surprised the markets by cutting the deposit rate by only 0.1% to -0.4%, while increasing the amount of monthly bond buying by 20 billion euros and adding corporate bonds to its universe. As liquidity in the corporate bond markets will constrain the uptake, we expect a large part of this additional 20 billion to be bought in government bonds. In the Japanese government bond market, the curve remained steep until the Bank of Japan introduced negative deposit rates and 10-year bond yields fell below 0%. With German 10-year Bund yields slowly approaching that same level, a similarly sharp curve movement might also occur in Europe.

Fundamentals: it is all about the consumer

GDP growth in the larger economies is declining slowly but steadily. Manufacturing has been weak for an extended period of time, but recently also services data started to come down. Over the past five years growth has primarily come from consumer spending. For consumer spending to remain at the current pace either income has to grow faster or debt has to increase. A strong increase in debt appears less likely given recent history, and despite low unemployment in countries like the US and UK there are no convincing signs of accelerating wage growth. Within Europe there is still so much slack in the economy that wage pressure is absent, even in strongly growing economies like Ireland. Without wage pressure it is difficult to envisage a significant uptick in inflation from current low levels.

US GDP growth relies solely on consumer spending currently



Source: Robeco, Bloomberg

Credits

Central banks can support demand, but not credit fundamentals.

Valuation: spreads are still elevated, but for good reason

After a very weak start of the year, corporate credits rallied and spreads are back at around year-end levels. This spread volatility may not abate soon. While credits compare favorably with ever lower yielding government bonds, the low growth environment and the focus on shareholder value call for a clear risk premium for credits. Spreads do not overly compensate for the heightened risk of more aggressive balance sheets either. Indeed, by looking at the compensation (spread) per turn of leverage, US investment grade spreads are just in the middle of the long-term range. When comparing US dollar with euro denomimated investment grade credits, spreads are more or less even. Although at first sight US credits look more attractive, the difference in spread levels is mitigated by cross currency swap costs.

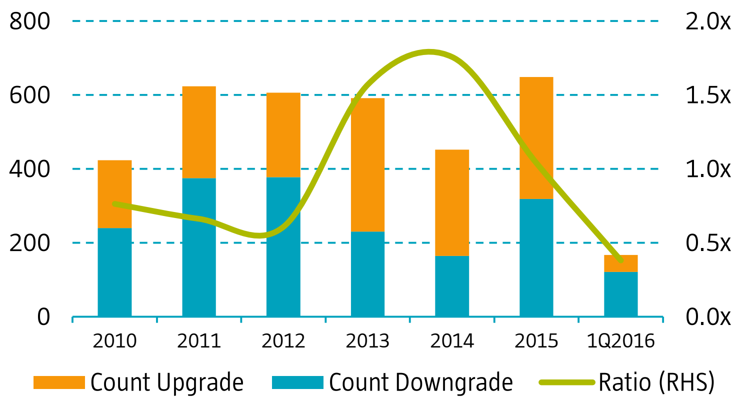
Technicals: is central bank enduced demand enough to absorb issuance?

The flow into investment grade credit has been declining since early 2015 and on a 12-month basis the cumulative inflow is close to zero in both the US and in Europe. The surprising announcement of the ECB to start buying euro denominated corporate bonds from European domiciled issuers resulted in an initial revival of demand for corporate bonds, but issuance picked up as well and the buying program so far lacks detailed information. Not only the ECB, but central banks in general, including a less hawkish Yellen, do their best not the derail the fragile economy and implicitly support risky assets. Demand for credit bonds may be less sticky though, with a greater portion flowing into liquid ETFs.

Fundamentals: deteriorating quality starts showing up in ratings

Also outside the battered commodity and energy sectors corporate fundamentals are not improving anymore. While US profit margins have remained strong so far, earnings growth is faltering and on average even declined in the last quarter of 2015. EBITDA is falling, and adjusted for the energy and commodity sectors only moderately increasing. Debt levels continue to grow, which already results in higher gross leverage ratios, and also makes corporates more sensitive when EBITDA growth continues its weakening trend and turns negative. An improving interest coverage ratio used to be a mitigating factor, but more recently the interest coverage has been declining as well. Given the prolonged period of low yields, the benefits of refinancing at lower coupons are fading. The deterioration in credit quality is starting to weigh on ratings. The upgrade versus downgrade ratio fell below 1 in the US in the second half of 2015 and in Europe early this year, while rating activity is increasing.

US Investment Grade corporates: number of downgrades is increasing



Source: Bloomberg, Robeco

Emerging debt

Fundamentals and technicals have improved sufficiently for us to scale in.

Valuation: currencies and yields have recently performed well but retain value

Most emerging currencies and yields have responded positively to the improving global external environment during the first quarter, but remain undervalued on longer term measures. The key components of this external improvement have been: a more dovish Federal Reserve Board, aggressive policy stimulus from the Chinese authorities, and firmer oil and other commodity prices on evidence of continuing supply reductions. The renminbi remains the exception as it remains overvalued on several measures, however the very limited openness of the Chinese capital account means that this is unlikely to adjust in the very short term.

Technicals: stronger on inflows and cautious positioning

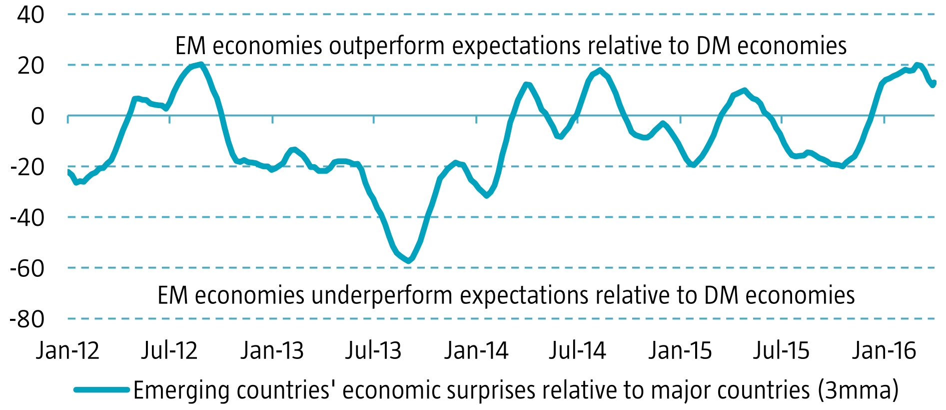
The short- and medium-term technical picture for local emerging debt and FX has improved significantly since the start of the year. Net inflows into the asset class are now evident and with core central banks continuing their monetary stimulus a search for yield is likely to continue unless fundamentals take a turn for the worse. Investor surveys and fund performance data suggest that institutional emerging debt investors are running underweight risk, which has probably contributed to the strong performance of local emerging markets this year. The increasing size of local savings pools, particularly in Asia, remains a longer term support for those markets.

Fundamentals: short-term relief from medium-term challenges

Emerging markets continue to diverge from a fundamental perspective, and making statements about the asset class as a whole is potentially misleading. The external impulse from core countries on emerging country economic activity has been mixed over the quarter, and will likely remain so over the coming quarter, as Chinese economic activity recovers and the US stabilizes.

The ability of some important emerging countries to engineer an improvement in aggregate demand via domestic policy action remains constrained. Both fiscal and monetary policy are constrained by rising inflation and deteriorating current accounts in several Latin countries. However, there are also countries which continue to benefit from continuing supply side reforms, which will grant them more domestic policy making flexibility to address the global growth slowdown. The chart below compares the extent to which recent economic data has surprised above market expectations in emerging versus core countries. Over the past two quarters positive surprises from emerging countries have exceeded those in core countries.

Emerging countries' economic surprise relative to core countries



Source: Bloomberg, Robeco

Portfolio Positioning

Highlights Robeco Global Total Return Bond Fund*

- Duration: The portfolio's duration is 5.6 years. The bulk of the interest rate exposure is concentrated in USD and EUR securities; smaller holdings are held in Canada and the UK.
- Yield curve: There is a clear preference for longer dated securities in both Europe and the US.
- Credits: The fund has a preference for European subordinated financial bonds. The exposure has been scaled down a bit to 8% of the portfolio. Most of these holdings are lower Tier 2 and investment grade. The overall exposure to the most deeply subordinated financial bonds, AT1s and/or Cocos, is below 2%. The overall credit risk is reduced by using European and US investment grade corporate credit derivative indices.
- EMD: The overall allocation to emerging local debt is increased to 6% of the portfolio. Half of the position is concentrated in Mexican and Indonesian local bonds.
- Euro peripheral government debt: The fund's peripheral sovereign bond holdings were brought back to zero by selling the remaining bonds in Ireland.
- FX: The exposure to emerging currencies (6%) is held against short positions in both euro and US dollar. More than 96% of the fund is denominated in the fund's base currency.

Highlights Robeco All Strategy Euro Bonds*

- Duration: The portfolio's duration is 6.9 years, against 6.7 years for the Barclays Euro Aggregate index.
- Credits: The exposure to cash credits is 26%. The overall credit risk is reduced by using European and US corporate credit derivative indices. The fund has a preference for European subordinated financial bonds. The overall exposure to this credit market segment amounts to 7%. The majority of these holdings is lower Tier 2 bank and dated subordinated insurance instruments and investment grade. The overall exposure to the most deeply subordinated financial bonds, AT1s and/or Cocos, is below 1%.
- Euro peripheral government debt: The overall exposure to peripheral government debt equals 9% of the portfolio, divided over exposure to Irish, Italian and Spanish government bonds. The allocation to peripheral government debt was reduced by 10% over the last three months. The positions in the periphery are skewed to maturities above 5 years.
- FX: There is no currency exposure other than to euros.

*Positions as of March 31, 2016

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