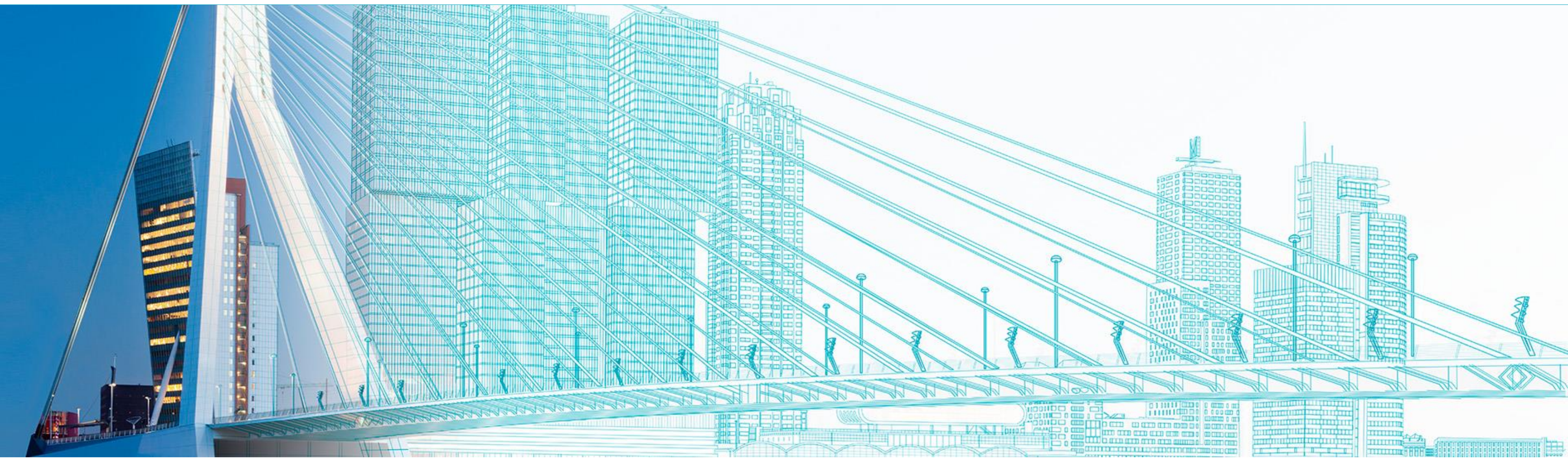
ROBECO



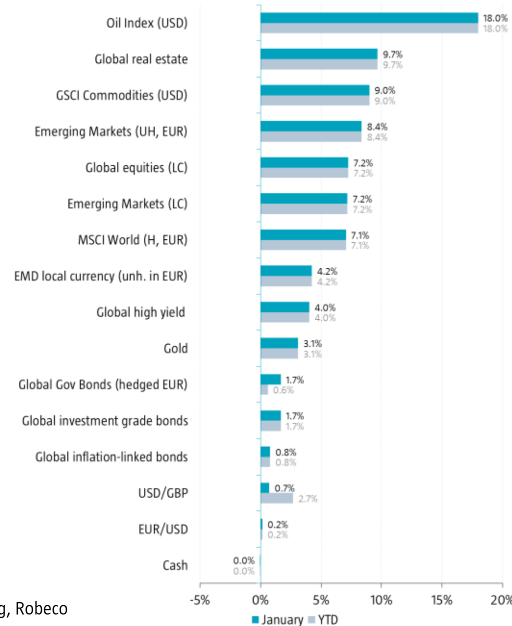
Multi-asset market outlook

For professional investors

February 2019

General overview

2019 starts with a strong reversal on the financial markets



Source: Bloomberg, Robeco

We are overweight equities and underweight bonds

	Portfolio	BM	active
Equities Developed Markets	29.0%	25.0%	4.0%
Equities Emerging Markets	7.00%	5.0%	2.0%
Real Estate Equities	5.0%	5.0%	
Commodities	5.0%	5.0%	
Core Gov Bonds 1-10	19.0%	20.0%	-1.0%
Core Gov Bonds 10+	7.50%	7.5%	
Investment Grade Corp Bonds	19.0%	20.0%	-1.0%
High Yield Corp Bonds	2.0%	5.0%	-3.0%
Emerging Market Bonds LC	5.0%	5.0%	
Cash	1.5%	2.5%	-1.0%

- In January, markets reversed full speed into a risk-on mode, after a disastrous fourth quarter of 2018, culminating in a 7.2% return on global equities (local currency) in January. The reversal in the oil prices was even more striking: -20% in December versus +18% last month.

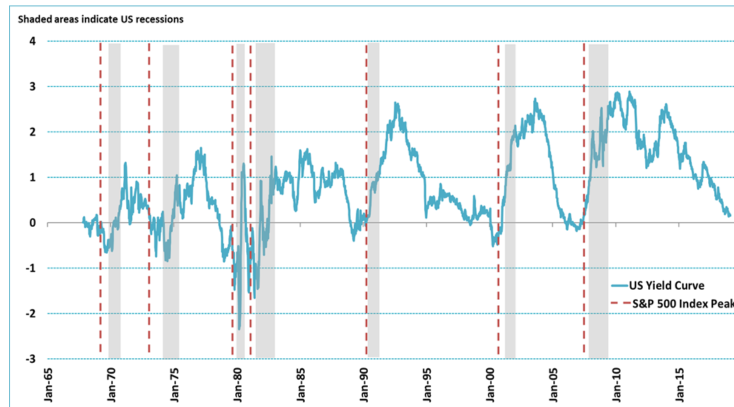
- It was a sort of ‘game of chicken’ between the markets and the Fed. From October onwards, markets gave a strong signal to the US central bank that they disagreed with the more hawkish tone the Fed had adopted. While the Fed tried to soften its stance, it took until January until it finally capitulated. The Fed is back in data-dependent mode, and for now it means we at least have a pause in this rate hike cycle. And that’s also good news for emerging markets, which outperformed developed markets last month. It looks like tension between the US and China is easing as trade talks have resumed. Europe is the region where worries remain as the Brexit saga drags on and economic growth keeps disappointing, notably in Germany and Italy.

- The ‘risk-on’ mode was also felt in the bond markets. Spreads tightened in both investment grade and high yield bonds, and government bonds yields declined further. So there were positive returns everywhere.

- In our portfolios, we increased our exposure to emerging market equities. We remain firmly overweight developed market equities and are underweight most bond categories.

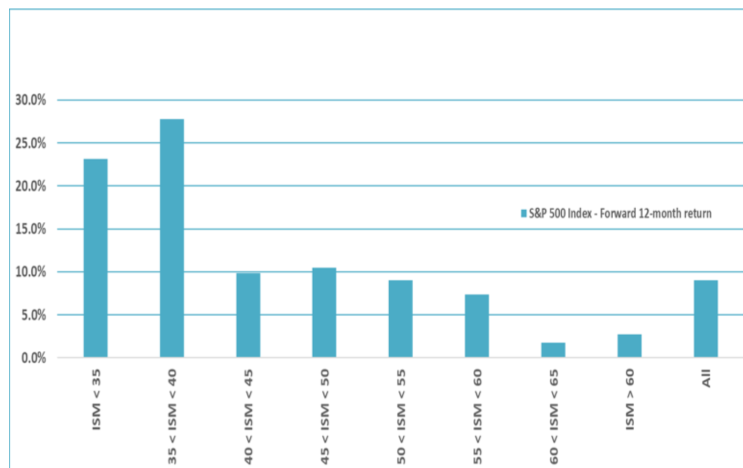
Theme of the month: On recessions and stock markets (I)

Yield curve inversion versus S&P 500 peaks



Source: Bloomberg, Robeco

ISM Manufacturing Index versus average S&P 500 Index returns



Source: Bloomberg, Robeco

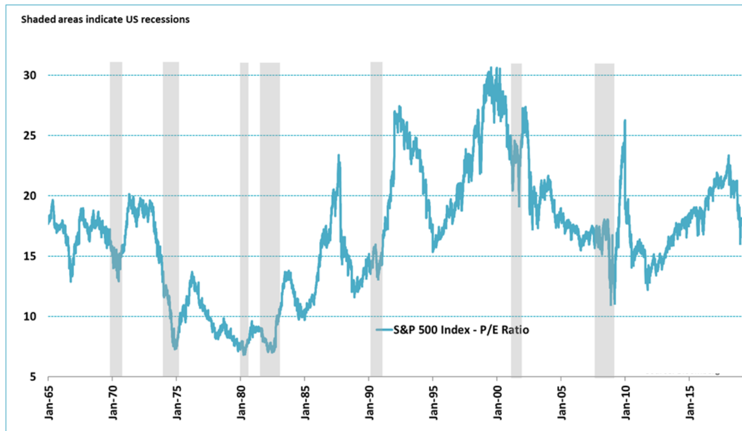
- Equity investors are always looking for signs of the next recession, continuously scrutinizing macroeconomic data, earnings numbers, valuations and sentiment levels, among other indicators, to assess whether another downturn is coming. Unfortunately, the relationship between these indicators, recessions and stock market prices is far from straightforward. As it turns out, equity markets are far less forward-looking than one might expect.

- The US yield curve showing the difference between long-term and short-term bond yields is one of the best – if not *the* best – recession indicators out there. The yield curve correctly predicted all the last seven US recessions since December 1969. As a rule of thumb: whenever the yield curve inverses, meaning when short-term rates move above long-term rates, a recession will occur somewhere within the next year or two.

- However, an inverted yield curve has not stopped the S&P 500 Index from rising, as shown in the chart to the left. It shows that stock prices kept rising after each time the yield curve inverted, except in 1973. In fact, the S&P 500 Index continued to grind higher for another 11 months on average before it reached its peak. So, while the yield curve is perhaps the ultimate the recession indicator, it does a poor job in predicting stock market peaks. You would have missed a significant amount of return if you had based your investment strategy on the yield curve.

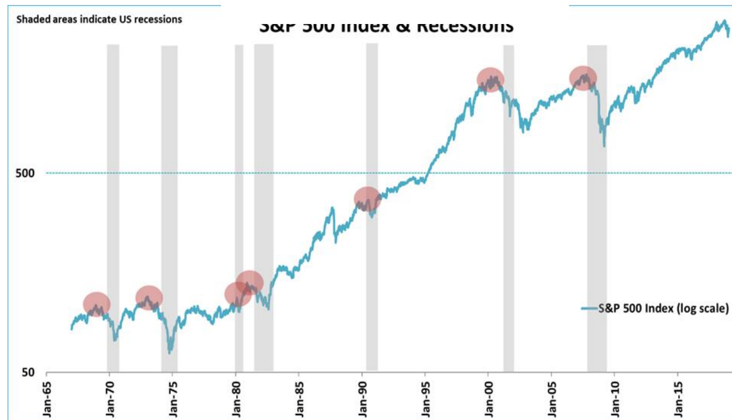
Theme of the month: On recessions and stock markets (II)

S&P 500 Index – P/E ratio



Source: Bloomberg, Robeco

S&P 500 Index and recessions



Source: Bloomberg, Robeco

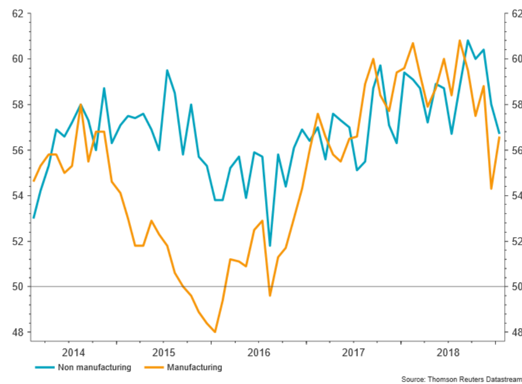
- So, what about valuation? Some investors believe that high valuations precede recessions, and that stocks fall during them as normal valuation levels are restored. But as the chart on the left shows, price/earnings ratios of the S&P 500 Index have varied greatly just before the start of past recessions. If anything, P/E ratios were somewhat below the long-term average ahead of a recession.

- If we look at the last seven US recessions, the S&P 500 Index recorded a peak just six months before the official start of the recession, on average. This is shown in the chart to the left. On two occasions, in 1980 and 1990, the peak in the equity market actually coincided with the start of the recession. In general, equity markets tend to perform solidly up to 12 months before a recession, then show a mixed but positive picture 12 to 6 months before a recession, and then tend to turn south within six months of the next recession.

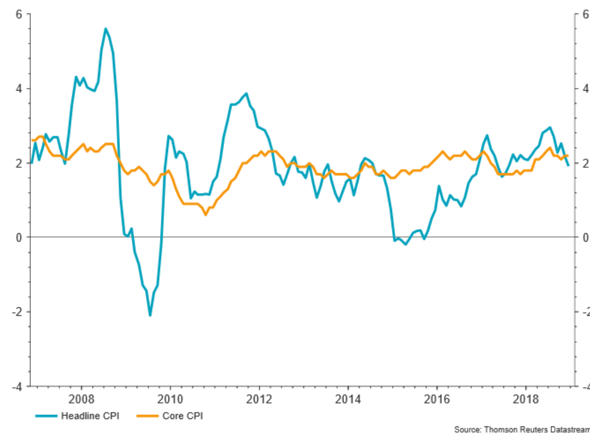
- Remember though that recessions are often defined months or sometimes even years after they occur. At the time of a market peak, investors did not know yet when the recession would officially start. Yet, this does not take away from the fact that equity markets tend to peak long after renowned recession indicators signal one. This in turn explains why these indicators have little forecasting power when it comes to stock market prices.

United States

Strong rebound in the ISM manufacturing index



US headline inflation is coming off



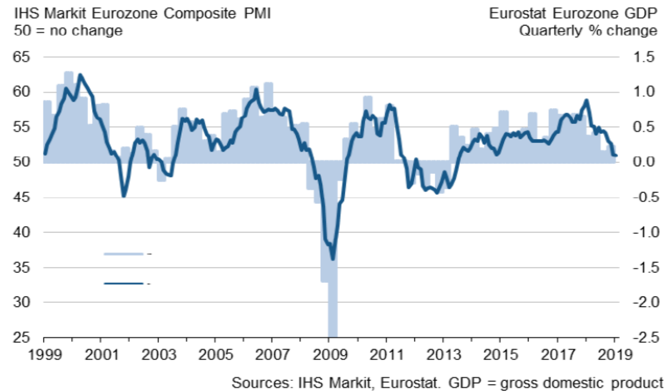
- After the sharp decline of both ISM indices in December, the ISM manufacturing index showed a strong rebound in January. Combined with the strong non-farm payrolls figure of 300,000, which was achieved despite the record-long closure of the US government, recession fears for the US economy lessened markedly. The ISM non-manufacturing index declined further, albeit modestly from 58.0 to 57.6, and with both indices still above 55 – which is considered to be exceptional – the US economy will continue to show a healthy growth level.

- Before the strong economic numbers for January, the Fed made an unexpected sharp U-turn in its forward guidance. Instead of signaling at least two interest rate hikes for 2019, Fed Chairman Jay Powell hinted that the direction of the next rate move could equally be down or up. Patience is now the order of the day, as he said: "We believe we can best support the economy by being patient in evaluating the outlook before making any future adjustment to policy."

- Continuing worries about the effects of ongoing trade tensions, the surprising weakness in Europe, the slowdown in China, the risk of a no-deal Brexit, the tightening in US financial conditions and the concurring sell-off in equities probably provoked the sharp about-turn. Nevertheless it is hard to escape the impression that the Fed overreacted again, just like it did last December. The modest decline in headline inflation due to falling energy prices and the steady core inflation rate of 2.2% didn't in any case prevent the Fed from taking a dovish stand.

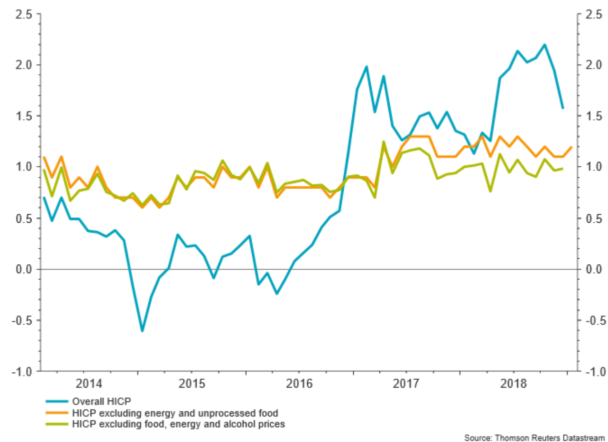
Europe

The Eurozone composite PMI was a tad lower in January



Sources: IHS Markit, Eurostat. GDP = gross domestic product

Eurozone headline inflation is collapsing



- The Markit Eurozone Composite PMI in January was a tad lower than in December: 51.0 versus 51.1. But by staying above 50.0, it continues to signal continuing expansion. The Italian PMI was particularly low, declining for the third time in four months, to its lowest level (48.8) in more than five years. The Italian economy is now in a technical recession.

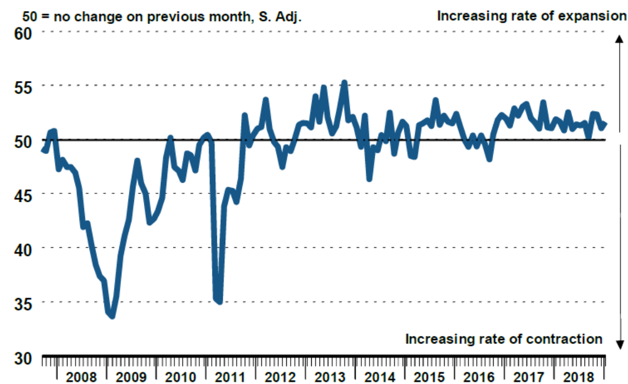
- The most important Eurozone economy, Germany, was remarkably weak in the fourth quarter. Weakness in Chinese car demand is probably partly an explanation, but more important is the difficulty in adjustment to new European emission standards in the car sector, and the logistical problems created by the low water level in the Rhine, which also led to a rationing of water intake for factories. Both problems are expected to be temporary, and a rebound in GDP in the current and the next quarter is to be expected.

- The ECB has not adjusted its forward guidance for 2019 yet, but a new TLTRO is to be expected shortly, partly to alleviate pressures on the southern periphery, especially Italy. Headline inflation collapsed due to energy prices, and core inflation is stable at around 1.0%, so there is no argument for monetary tightening for the foreseeable future.

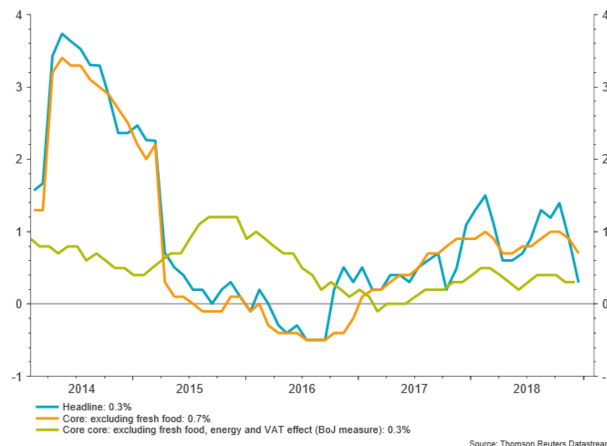
- The multiple games of chicken around Brexit continue to proceed. There appears to be no parliamentary majority for a hard Brexit, a general election or a second referendum. So, an eventual majority of the possibly slightly adjusted May deal remains the most likely outcome.

Japan

The Nikkei Japan Services PMI expanded in January



The BoJ's December 'core core' was stable at 0.3% (YoY)



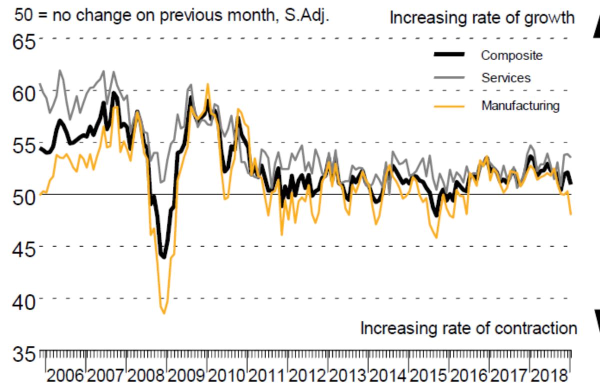
- The currently rare good news for the Japanese economy was provided by the services sector. The Nikkei Japan Services PMI rose in January from 51.0 to 51.6. The manufacturing sector, however, underperformed due to worries over the coming VAT tax hike and the ongoing trade tensions between China and the US.

- In January, the labor ministry admitted that it had secretly revised the statistical method to calculate the monthly wage survey from January 2018. Due to this revision, sudden spikes in nominal wages showed up in the data throughout 2018, with real wages flat on balance. In reality, real wages probably declined in 2018, despite reaching a 30-year low in unemployment at 2.5%, placing the success of Abenomics into doubt.

- The core-core inflation index excluding both energy and fresh food – the gauge preferred by the Bank of Japan (BoJ) – was unchanged at 0.3% in December. The headline inflation rate collapsed to 0.3% as well as a consequence of lower energy prices. Though inflation remains far from the target rate of 2.0% after six years of ultra-loose monetary policy under the leadership of Haruhiko Kuroda, Prime Minister Abe strongly supported the BoJ in parliament, declaring that he accepted the explanations given by the central bank, while stressing that the economy would otherwise have been in a much worse state. The BoJ decided to keep monetary policy steady in January, but cut its inflation forecasts again, warning of growing risks to the economy due to rising protectionism and weak external demand.

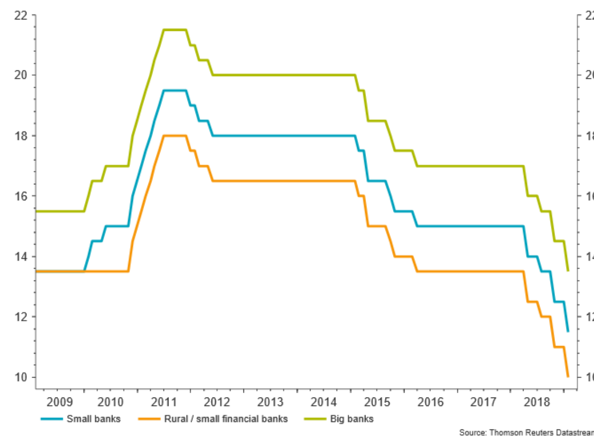
China

The Caixin China Composite PMI signals softening expansion in January



Sources: IHS Markit, Caixin.

China continues to cut the reserve requirement ratios for banks



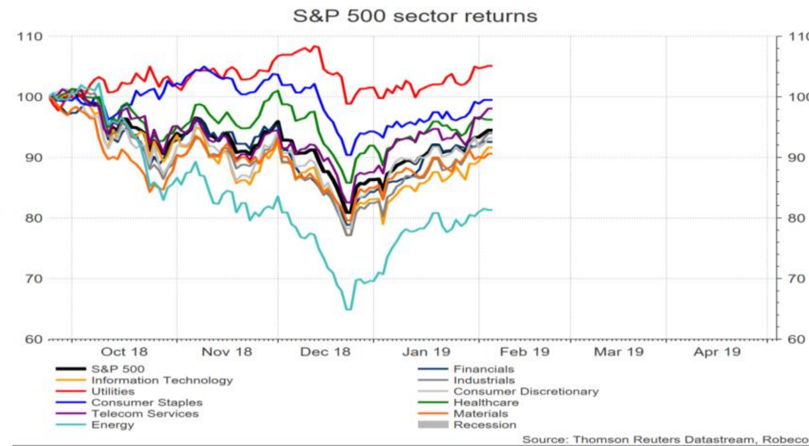
- The Caixin China Composite PMI (which covers both manufacturing and services) declined in January from 52.2 to 50.9, still signaling expansion on average, though manufacturing crossed the neutral level of 50.0, signaling contraction. Exports improved somewhat, probably helped by signs that the negotiations between the US and China were developing favorably. President Trump recently tweeted that "Meetings are going well, with good intent and spirit on both sides." He added that he believed the US and China could reach a deal before the March 1 deadline for tariff hikes on Chinese goods.

- Though a comprehensive deal is unlikely, both countries have an interest in avoiding a further escalation. New or higher tariffs are therefore unlikely as well. It seems safe to assume that the March 1 deadline will be postponed for another couple of months. China will probably promise to increase imports from the US, and vaguely commit to initiate reforms, but a substantial overhaul of its economic growth model remains out of the question. Tensions will therefore continue to simmer.

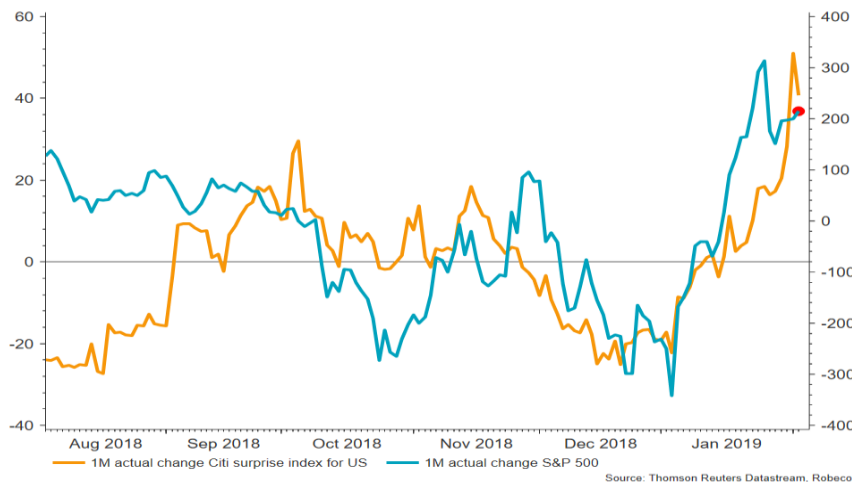
- The Chinese authorities have avoided overly aggressive strong stimulus, but have gradually stepped up their efforts to stimulate domestic demand over a broad front, including tax cuts and infrastructure investment. They will continue to do so, until they see sufficient evidence of a renewed strengthening of the economy. Monetary policy will have to contribute as well: another 100 basis point cut in the reserve rate ratio for banks in April is to be expected, for example.

Equities (I)

A broad-based recovery in January



A major upward move in US macro surprises contributed to the rebound



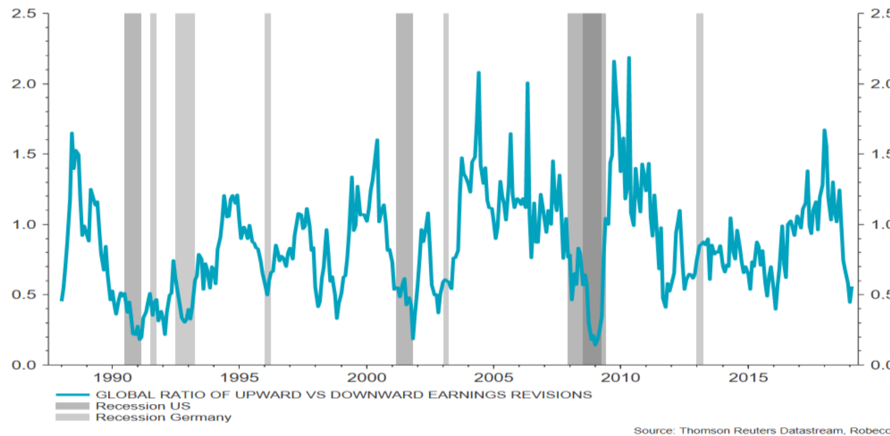
- Equity market investors experienced a V-shaped recovery in January. It can be seen as a clear case of 'staircase down' during Q4 2018,and 'elevator up' since the end of December. For global stocks, it has even been the best January since 1987, with the MSCI World (UH, EUR) generating 7.4%. The recovery is broad based, as all major S&P 500 sectors contributed positively.

- The swift recovery of risky assets begs the question as to whether this is a dead cat bounce or a sustainable rally that has further to run. Last month we said that this sell-off was unlikely to be one of a purely technical, quant-driven nature, but a more fundamental one, driven by coinciding inflection points in the business cycle and in monetary policy. However, we concluded at the same time that the bar for positive surprises was low from a macro perspective.

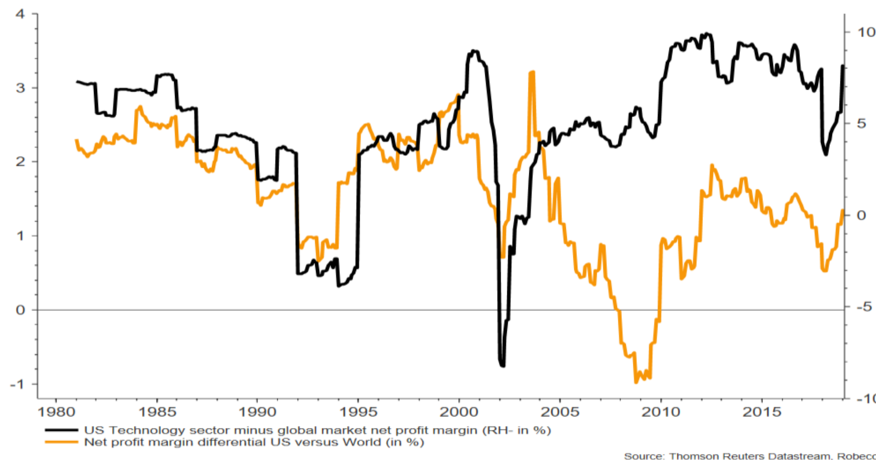
- And that bar for positive macro economic surprises did indeed prove to be low. The US Citi macro surprises index made a jump only seen in 5.9% of the historical cases on a monthly basis. With investors adjusting overly bearish economic expectations, the S&P made a similar move (see the bottom chart). Therefore, the January market move can not be solely attributed to a U-turn in Fed guidance. Yes, Chairman Jerome Powell made a remarkable twist by stating that the Fed would pursue a 'patient' approach to monetary policy instead of the earlier steady 25 bps hikes each quarter. This cleared a major obstacle for a rally. Powell also shared his view that he thought markets had moved "well ahead of the data" in Q4, implying markets had overpriced recession risk.

Equities (II)

Earnings revisions have rarely been this downbeat outside of recessions



The rebound in US tech profitability is reflected in overall US-RoW margin divergence



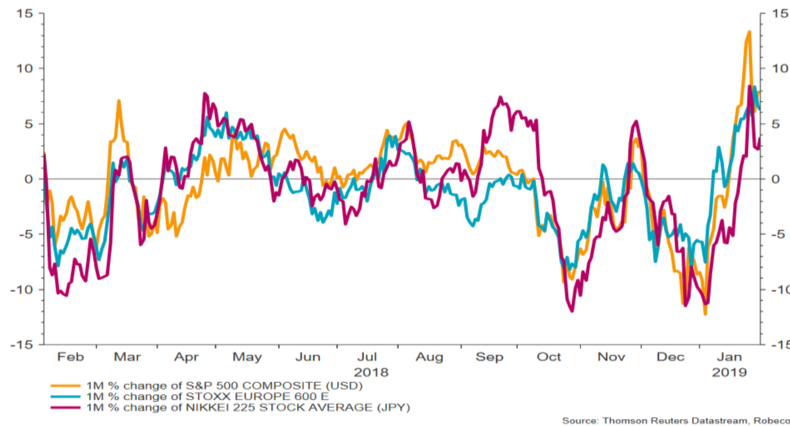
- With markets undoing a lot of the damage done since early October, the overshoot in recession pricing seen in the last quarter has been largely eliminated. Implied equity risk premiums rolled over and have moved lower in tandem across regions.

- In short, we had an exceptionally bullish start to the year, with a monthly equity return that (admittedly mildly) even overshot our steady-state equity return of 7% on an annualized basis.

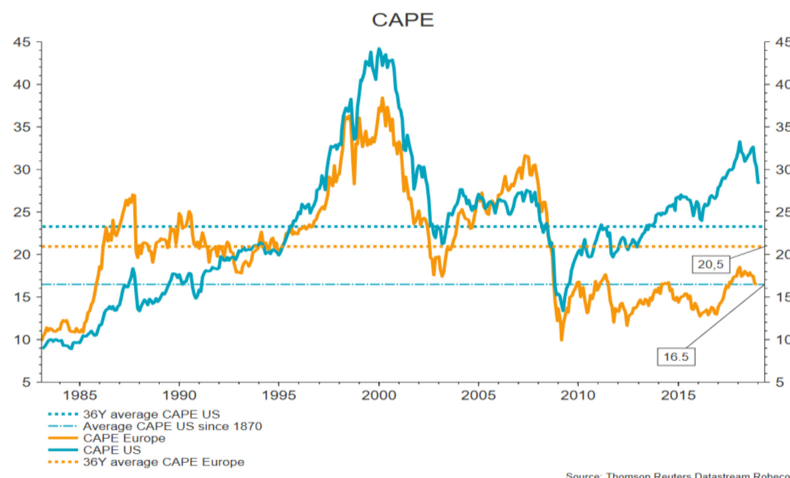
- Should we close our overweight position on equities given a late-cycle economy and a deteriorating corporate earnings perspective? We did ponder this, but there are several elements that keep us overweight on equities for now. The first is that from a valuation perspective, overall equity risk premiums are still elevated, and they do compensate for underlying macro risks. The rebounds in the US ISM and Chinese PMI indicate that global growth is finding a stronger footing. Geopolitical risk as reflected by some measures remains exceptionally high, but in some regions (China), a rollover in economic uncertainty is detectable. The second reason is that a patient Fed will no longer stifle growth outside of the US in the near term. This could trigger a catch-up of rest-of-the-world (RoW) growth differentials versus the US, though profit margins in the US have outpaced RoW margins (see chart), as tech dominance in the US keeps its overall profitability robust. Lastly, imminent recession risk remains low, paving the way for further gains.

Developed Market Equities

A strong reversal in momentum in January



US equities have become somewhat less expensive



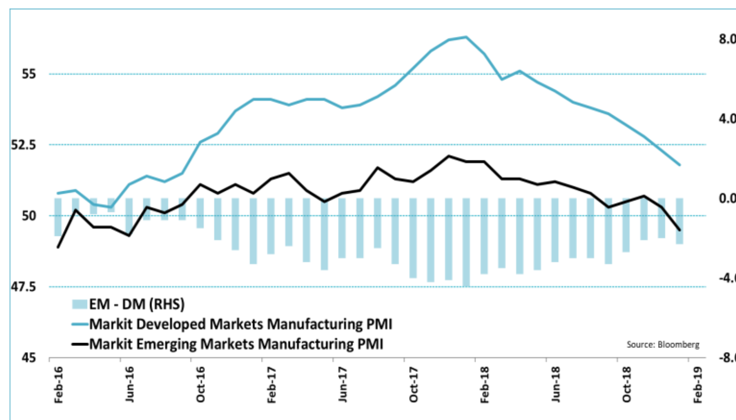
- In January, stocks made a momentum U-turn after a dismal December, and went into recovery mode after a dovish turn by the Fed. This change in forward guidance removed a major obstacle for a rebound in stock prices. For the US equity market, this was the strongest performance in January since 1987, as negative momentum swiftly morphed into positive momentum.

- Based on monthly momentum of equity returns in local currency, US equities clearly lead the rebound in developed markets, with S&P 500 investors gaining 7.9% in dollar terms. European equity investors followed with a monthly gain of 6.2% in euros. Japanese equity investors closed the ranks within developed equities with a gain of 3.8% for the Nikkei 225. After turning negative in the fourth quarter of last year, the (12M-1M) signal in local currency has become positive again for US equities (+0.9%). Long momentum for both Japan and Europe remains negative in local currency, coming in at -4.3% in their respective currencies.

- Equity valuations based on the Shiller CAPE stabilized in January, with the CAPE remaining at 28.8, a notch higher from the December level. Underlying earnings growth within developed markets remain the strongest in the US. European equities have not shown a revaluation against their US counterparts, as the European CAPE remains at 16.4. With Eurozone growth still in the doldrums versus the US, the current discount in CAPE is a necessary, but insufficient condition for Eurozone outperformance versus the US.

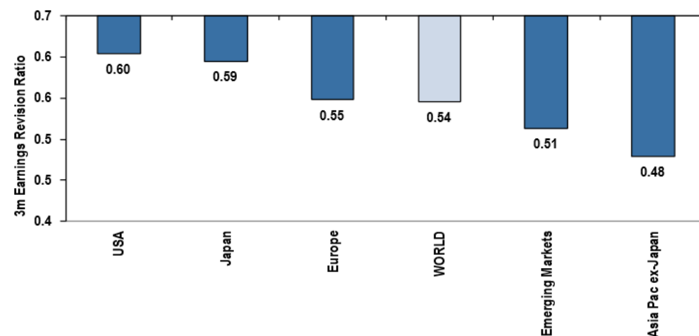
Equities: Emerging versus Developed (I)

Emerging versus developed markets: Manufacturing PMIs



Source: Bloomberg & Robeco

Earnings revisions are downbeat globally, not just in emerging markets



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

- Emerging market equities continued their strong performance relative to developed market equities. After beating the MSCI World Index by 5% in December, emerging markets added another 1% of relative performance after a stellar 8.4% return in January. As a result, our overweight in emerging markets added positively to the multi-asset portfolio's return.

- Despite the strong (relative) performance recently, the global slowdown is also being felt in emerging markets. The average emerging market Manufacturing PMI has fallen below 50 for the first time since July 2016. In addition, the gap with the developed market Manufacturing PMI widened for the first time in four months, mostly because of the strong PMI numbers out of the US. China's PMI data was mixed, with the non-Manufacturing PMI showing a sharp rebound, whereas the Manufacturing PMI stabilized below 50. We can expect little guidance on China in the near term, apart from anecdotal evidence, as the country celebrates the Chinese New Year.

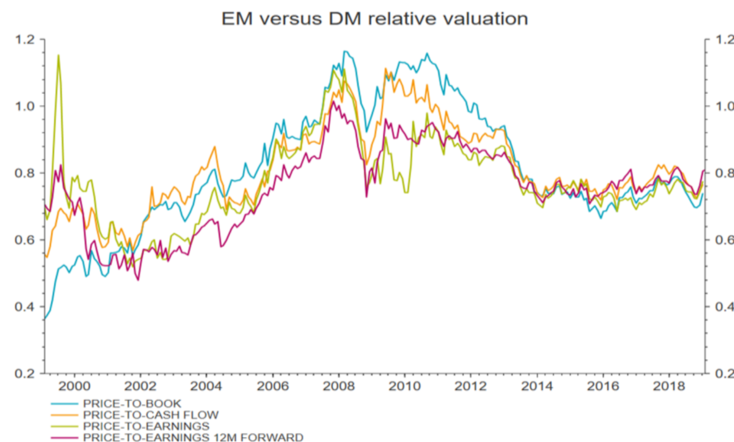
- Earnings expectations are being revised sharply lower as economic growth has cooled significantly in recent months. The earnings revisions ratio is well below 1, which reflects a balance between the number of up- and downgrades for every major equity region. These kind of revisions ratios when compared to previous growth-related market corrections are only just above levels seen during recessions. Interestingly, on a one-month basis, the ratio is now the highest for emerging markets and the lowest for the US.

Equities: Emerging versus Developed (II)

China: Earnings versus stock prices

Source: Bloomberg & Robeco

Valuation – the discount is close to neutral



Source: Thomson Reuters Datastream, Robeco

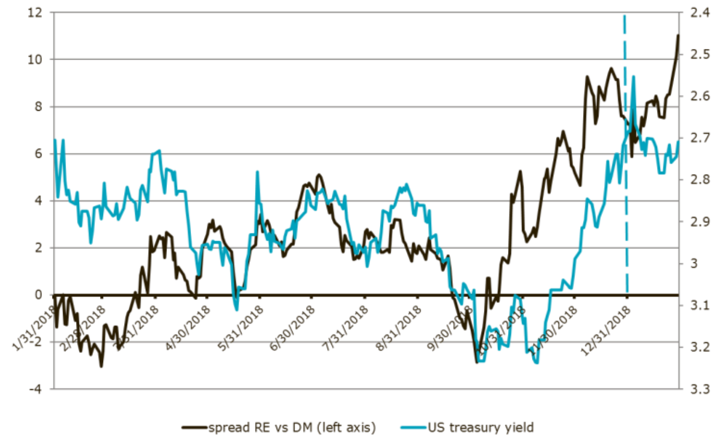
- In a relatively short time, investors have become incredibly negative about future earnings. To some extent, this can be explained by the significant slowdown in global growth, the uncertainties related to the ongoing US-China trade war, and the health of the Chinese economy. However, as we said last month, investors may have become too bearish on earnings. This applies to China as well. A large number of companies have significantly lowered their guidance in recent weeks. Yet, as the chart on the top left shows, investors have already priced in an even bigger fall in company earnings.

- The official pause in the Federal Reserve's tightening cycle is a positive for emerging markets. As we have mentioned before, the prospect of a more dovish Fed was an important reason for going overweight on the asset class. This should reduce the upward pressure on the US dollar, especially as global growth can start to stabilize from here.

- We remain overweight on emerging market equities in the multi-asset portfolio. The positives that lie ahead are faster growth in the second half of the year, the Fed pausing, a potential peak in the US dollar, and improving earnings on a relative basis. Earnings expectations are down massively, especially taking into account the fact that we are at the beginning of the year, a period in which investors tend to be more optimistic. China remains the biggest risk, but as the country has increased stimulus in recent months, we should expect some improvement later this year. Valuation is attractive from an absolute stance, but close to neutral on a relative basis.

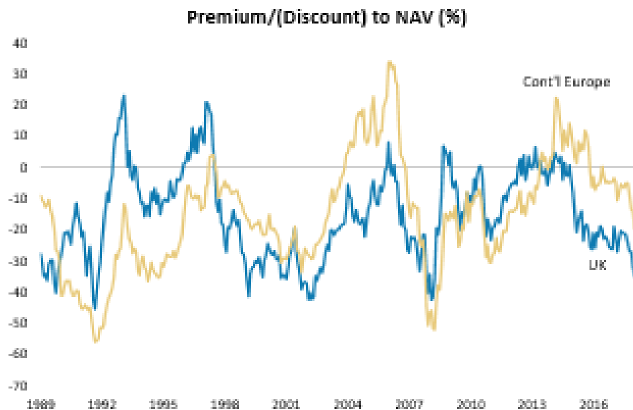
Real estate

A strong start to 2019



Source: Bloomberg, Robeco

European real estate is still cheap, despite rebound last month



Source: Company data, Datastream, Morgan Stanley Research

- Global real estate, measured by the S&P Global Developed Property Index (USD) had a very strong start to the year, generating a return of 10.7%. Compared to the broad MSCI World index (+7.8%, in USD), real estate outperformed by 2.9%.

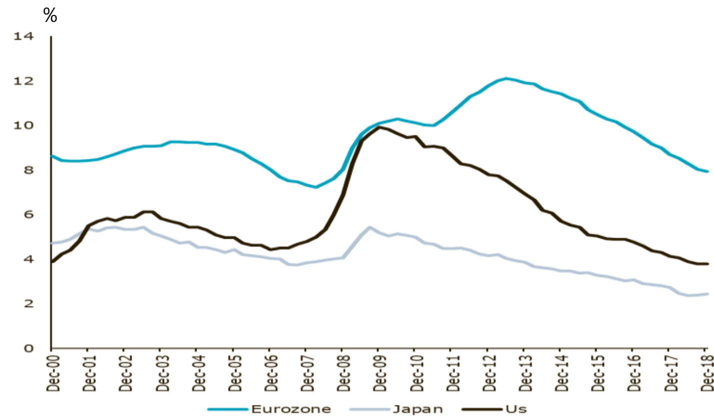
- The dovish words of Fed Chairman Powell had a positive impact on the real estate markets in both the US and in Europe. Although US Treasury yields were relatively stable in January, a dovish Fed is always good news for the sector, as real estate markets are still interest yield-driven.

- The rebound in real estate started back in early 2018, but nevertheless, real estate still trades at a discount to NAV. This is especially the case in Europe. It is obvious that the valuation for UK real estate looks even more attractive. That could be an opportunity for investors. But, as long as the Brexit jury is still out, we think the risks outweigh the possible opportunities. The European economy remains weak, and although a recession is unlikely, this keeps pressure on the rental income of real estate companies. In the US, the picture is the same.

- Dividend yields have come down a bit, but are still relatively more attractive than bond yields. As the risk of rate hikes have diminished for now, and economic data isn't deteriorating rapidly, don't be surprised if real estate catches up with equities following a long period of underperformance. For now, we have a neutral position in real estate.

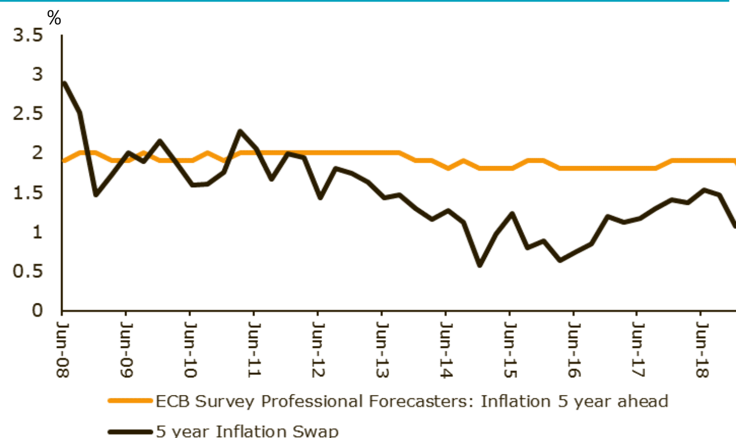
AAA Bonds (I)

Unemployment rates continues to grind lower



Source: Bloomberg & Robeco

Disappointing economic data is weighing on inflation expectations



Source : Bloomberg & Robeco

- While economic data has been decelerating for a while now, economic surprises in general have continued to fall. This points to a market that still hasn't fully caught up with the weakening economic pulse. This weakness had a big impact on yields, and in January the general trend amongst bond yields was lower.

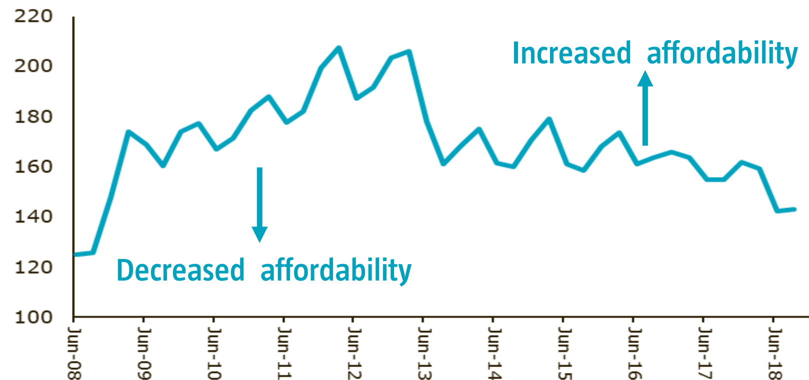
- This softening has not gone unnoticed and central banks are starting to change their tone accordingly. Both the ECB and the Fed have moved to a more dovish stand lately.

- We are disappointed about the continuous weakness in European data. Unfortunately, we still don't think that we have reached the end of the down cycle. The purchasing manager's index slid once again; its latest print was barely above the 50 threshold. Italy reported another set of negative GDP numbers and is now officially in recession. A new worry came from the latest bank lending survey which indicated that the easing of credit conditions is slowing. On top of all of this, we are also witnessing a drop in inflation expectations. This is not only the case in market-based indicators, but is also slowly starting to become visible in the survey of professional forecasters, whose inflation expectations have dropped to 1.8%, having being steady at 1.9% for a very long time.

- It isn't all doom and gloom, however. For one thing, Eurozone employment numbers are holding up pretty well. The latest unemployment rate came in below 8%, something we last witnessed in 2008. And wages are also holding up nicely.

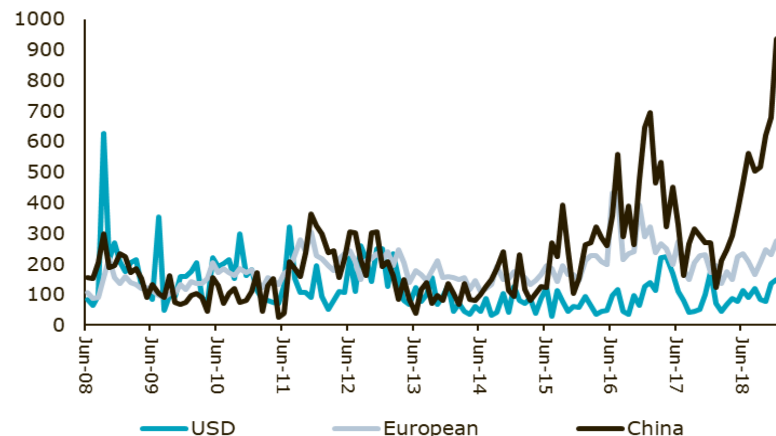
AAA Bonds (II)

Housing affordability is still sliding lower



Source: Bloomberg & Robeco

The economic policy uncertainty index is finally coming down in China

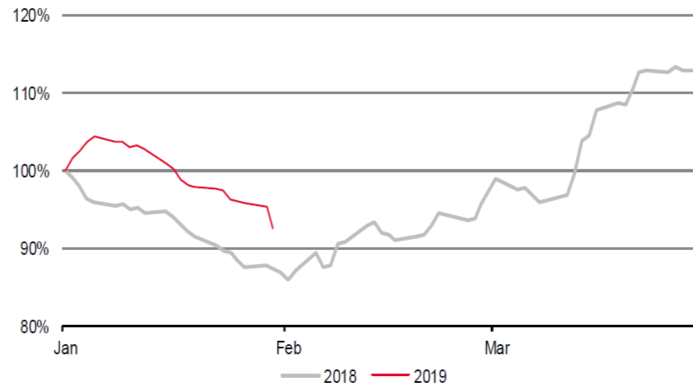


Source: Bloomberg & Robeco

- All in all, domestic drivers seem to be hanging in there. The weakness is driven by developments outside the Eurozone: the China slowdown and the continued trade rows between China and the US. The market has pushed out its expectation for the first ECB rate hike, and the ECB doesn't seem to disagree with that.
- In line with Europe, labor markets in both the US and Japan continue to tighten. What is also comforting is that wages are holding up nicely in the US. The latest employment cost index number continues to indicate that wages are growing at a healthy clip.
- There are, however, some cracks appearing in the US growth story – nothing dramatic, but they are still there. Consumer confidence is cooling down and housing remains on the weak side. The good news is that the Fed is on alert and continues to move to a more dovish stands.
- So, what does it all mean for bonds? Well our base case is that although economic momentum is decelerating, we are not heading for a recession. We see the current weakness as temporary. What is comforting for us is that the Chinese are stepping up stimulus. 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.

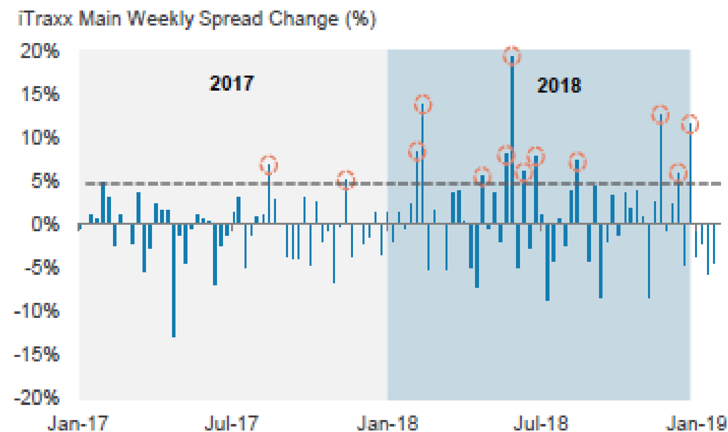
Investment Grade Credits (I)

European investment grade had a better start in 2018, but after that...



Source: Markit, SG Cross Asset Research/Credit

Weekly spread changes: volatility has increased



Note: red circles show 5%+ weekly move; Source: Bloomberg, Morgan Stanley Research

- European credits had a good start to the year. The European credit spread declined 10 basis points to 1.42. Although it was a decent start to 2019, in 2018 the markets began the year even better. However, spreads widened significantly after that, something that we also foresee for this year. The widening was less pronounced than in the US, as can be seen on the next slide.

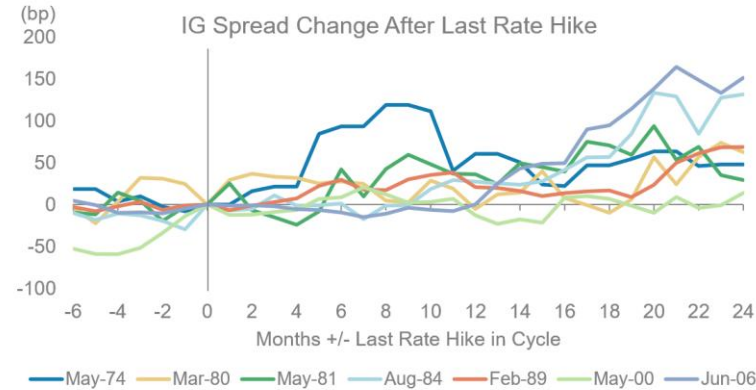
- The dovish remarks from Fed Chairman Powell were positive for the markets. Now that the ECB has formally retreated from the credit market, other investors will need to pick-up the slack. This month, there were plenty of investors who needed to invest their cash. It seems that the discontinuation of CSPP could be sufficiently countered by other market participants. A consequence of the absence of a 'certain buyer' is an increased in volatility, as can be seen in the second chart.

- That said, developments in Europe aren't very encouraging. Italy is in recession. The German economy suffers indirectly from the trade war between the US and China, as trade from and to the latter has diminished, such as in the automobile industry. And Brexit is still on the agenda, causing a lot of uncertainty. The ECB also noticed that economic data has been weakening, but sees no recession in the foreseeable future.

- Given the modest outlook for the economy, a spread widening in 2019 is the most likely scenario. Therefore, we currently have a slightly underweight position in credits.

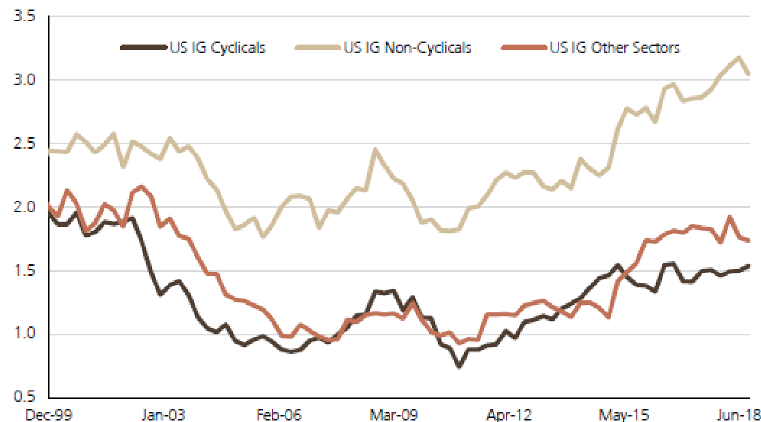
Investment Grade Credits (II)

US credit spread widens in the period of the last rate hike



Source: Morgan Stanley Research, FTSE Fixed Income, Moody's
Note: Uses average of AAA and BBB corporate bond spread to 10Y Treasury before 1980; uses IG index G-spread after 1980

US investment grade net leverage for sub-sectors



Source: UBS

- The US credit markets reacted – as might be expected – positively to the dovish statements of Fed Chairman Powell. The US corporate spread fell 25 bps from 1.53 to 1.28 at the end of January, which resulted in a (hedged to euro) return of 2.1% for US corporates.

- We're not sure whether this is just a Fed hike pause, or if we now have reached the end of the cycle. The fact is that we are late in the economic cycle. This is normally a part of the cycle where credits tend to struggle. The tightening we witnessed over the past month might therefore be seen as a bit unusual. However, given the change in the Fed stance that we witnessed, it is not so unusual. For the short term, a pausing Fed is fine for the markets.

- So, as we expect global growth to slow a bit further, it is normal to expect wider spreads. Besides the expected slower pace of growth, other risk factors for US credits remain in place. As we have mentioned before, the biggest risk is leverage, which is still at (too) high levels. Leverage in cyclical sectors is still rising, and these cyclicals are the most vulnerable to slower economic growth.

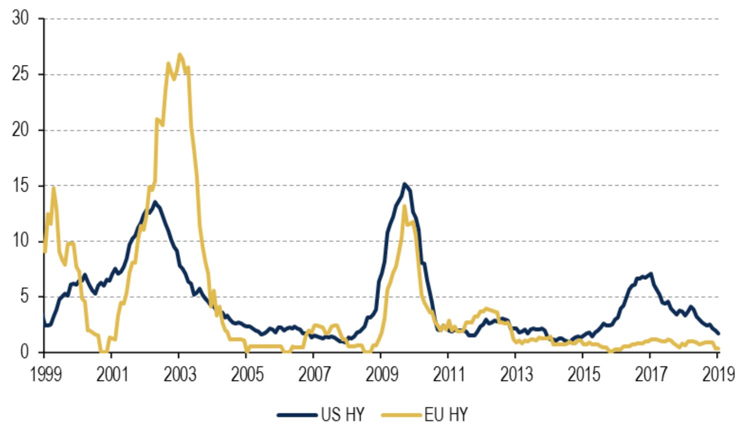
- We recently reduced our weight in credits to underweight, as we expect the spread widening in volatile markets will continue, due to slower economic growth.

High Yield (I)

High yield – spread

Source: Robeco & Bloomberg

High yield – defaults



Source: BofA Merrill Lynch & Bloomberg

- As the first month of 2019 was characterized by a big reversal in the performance of risky assets, global high yield bonds experienced a very solid month. The average spread tightened by an impressive 110 basis points and the asset class returned 4% in January. However, despite the healthy return, global high yield bonds lagged the performance of other risky asset classes, including local currency emerging market debt.

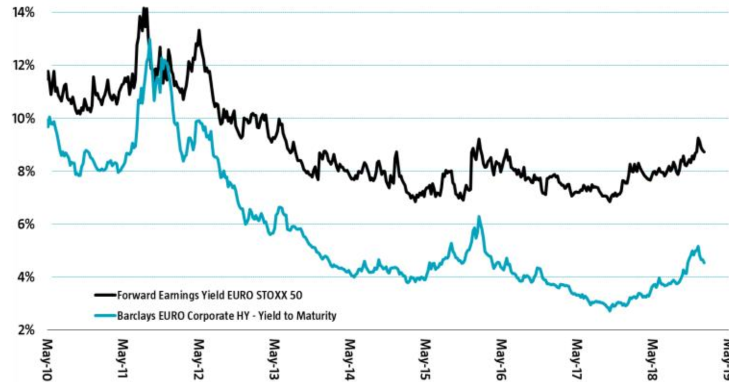
- Macro economic developments have confirmed in recent months that the global economy has entered the later stages of this economic cycle. To be sure, late cycle does not equal end cycle, yet late cycle is a phase in which high yield bonds (and credits) tend to struggle. Leverage has risen significantly in recent years and this means higher borrowing costs when yields go up.

- Also, even if we don't expect a US recession any time soon, earnings growth will come down and may even turn negative for some regions. We expect this will shift investor focus to debt sustainability, especially when bonds yields move gradually higher, which remains our base case for now.

- A relatively low probability of a US recessions implies default rates are also likely to stay low. As the chart on the bottom left shows, the default rate in Europe remains close to zero, while defaults in the US continue to come down. Interest coverage ratios remain pretty decent, but slower earnings growth are likely to negatively impact these numbers in the coming months.

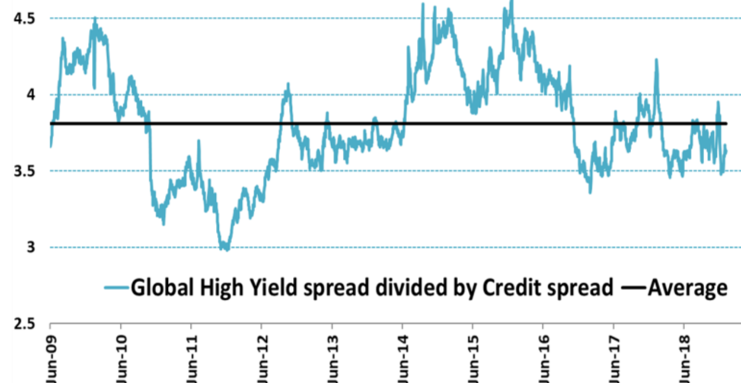
High Yield (II)

High yield – relative valuation versus equities



Source: Bloomberg & Robeco

High yield – relative valuations versus credits



Source: Bloomberg & Robeco

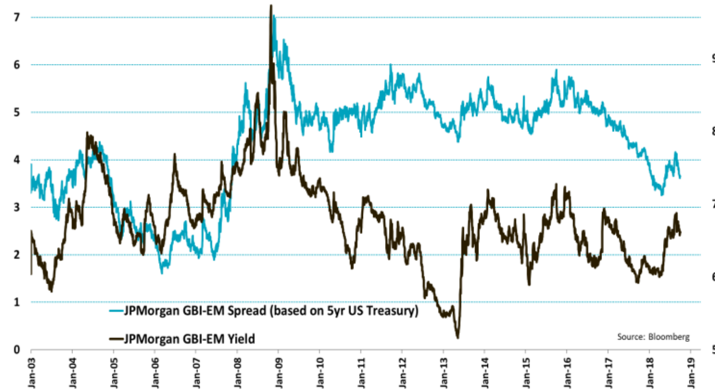
- High yield has seen relatively few downgrades so far, as they are lagging indicators most of the time. Within global high yield, the risks for the US and Europe look roughly balanced. US companies have increased their leverage ratios more aggressively, making them more vulnerable to high borrowing costs. However, with a data-dependent and patient Fed, the leverage-related risks have actually abated somewhat. In addition, the outlook for US GDP growth is more robust than it is in Europe.

- Recent GDP growth numbers have been disappointing in Europe. Poor growth in the last two quarters have pushed the region closer to a (shallow) recession. Ongoing uncertainty about Brexit and Italy are not helping sentiment, but credit quality tends to be higher here, and overall yields remain extremely low. This reduces the odds of a spike in defaults. Low yields also mean, however, that the buffer against adverse market circumstances is extremely low.

- This brings us to our most important reason for staying underweight in high yield bonds: valuation. Despite the massive turn in sentiment in the final months of 2018, the spread widening was relatively muted compared to the valuation adjustment in other asset classes, predominantly equities. But also compared to credits, average spread levels remain below average. We remain underweight in high yield for now as other risky assets, especially equities, look more attractive.

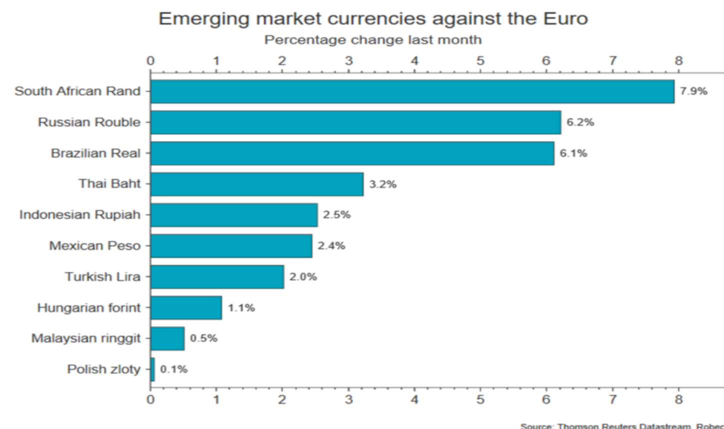
Emerging Market Debt (I)

Emerging market debt in local currency – spread and yield



Source: Bloomberg, Robeco

Emerging currencies



Source: Robeco

- Local currency emerging market debt realized a positive return of 4.2% in January, extending what was already a strong period for the asset class, especially from a relative perspective. Local currency emerging debt also beat high yield bonds, in which we are underweight in the multi-asset portfolio.

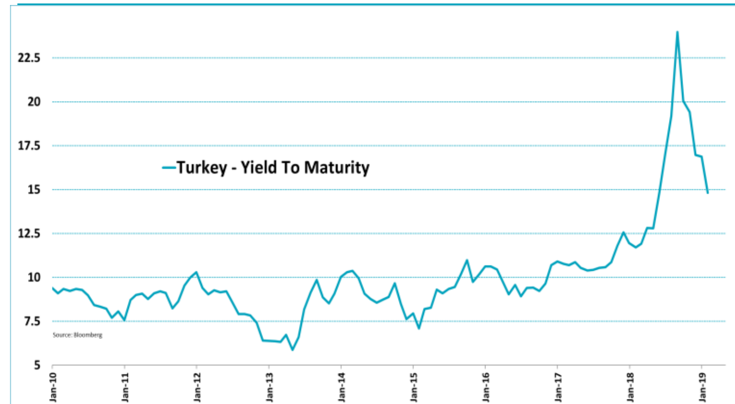
- As the chart on the top left shows, the spread and yield to maturity tightened somewhat, but the yield remains close to the average level of the last six years, unlike the yield on Eurozone government bonds and credits, which remain extremely low.

- Macroeconomic data has disappointed in recent months, and while we do not expect a US recession any time soon, global growth is slowing. 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 stressed in recent months, this could mean that countries like Turkey, and to a lesser extent, South Africa are increasingly scrutinized by investors.

- That said, emerging currencies can provide a tailwind for emerging debt, as valuations have become attractive after the sell-off last year. This can lead to substantial currency gains from time to time, as the chart on the bottom left shows. All major emerging currencies gained against the euro, driving the strong return in January. While we expect some volatility down the road, currencies could appreciate a bit more over the course of 2019.

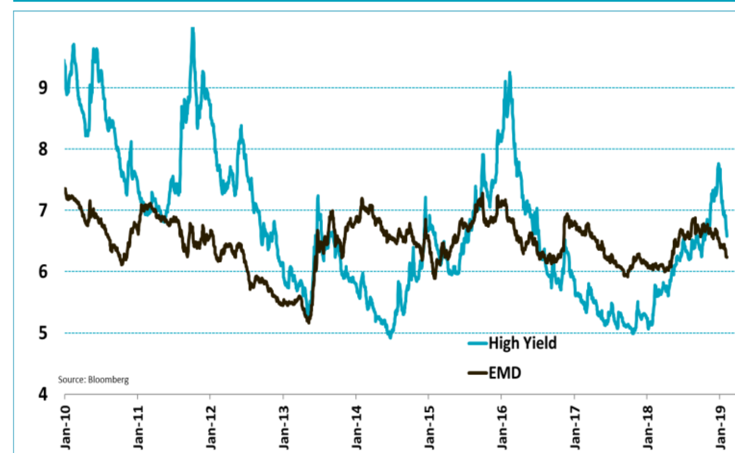
Emerging Market Debt (II)

Turkish yield to maturity continues to decrease



Source: Thomson Reuters Datastream, Robeco

High yield versus emerging market debt

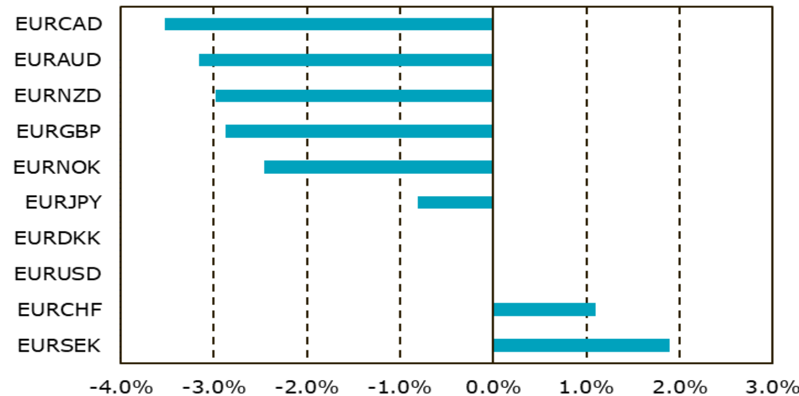


Source: Bloomberg, Robeco

- In Turkey, things seem to have stabilized for now. The currency has strengthened and bond yields have come down, as the peak in inflation is probably behind us. Yet, political and economic uncertainty and the relative large amount of foreign debt of Turkish companies could spark another wave of volatility at any time.
- In general, inflation in emerging countries remains muted, reducing the odds of interest rate hikes. Now that the Fed has paused its tightening cycle, these odds have further decreased. A more dovish Fed is a positive for asset classes that depend more heavily on liquidity, such as emerging debt.
- China remains an important factor. In recent months, the Chinese renminbi has strengthened on the back on more stimulus from the government. This has helped emerging debt outperform. Some pressure on the renminbi is likely to remain, however, as GDP growth has yet to pick up. Also, no clear improvement in the China-US trade war could trigger a weakening of other emerging currencies, especially those in Asia.
- We remain neutral on local currency emerging market debt. Momentum is solid as the asset class escaped a strong downturn in November and December. However, the rise in emerging currencies was pretty extreme in January, and we do not expect it to continue at this pace. Also, from a relative perspective, valuation looks slightly less attractive.

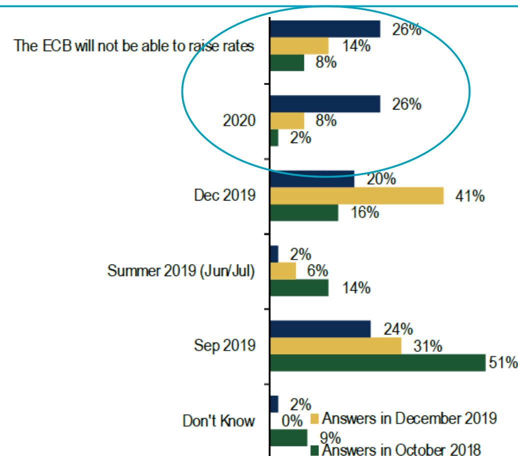
FX (I)

EUR/USD : January was not a good month for the euro or the US dollar



Source: Bloomberg, Robeco

ECB rate expectations have pushed back substantially compared to previous months



Source : BofA Merill Lynch FX and Rates Sentiment Survey

- January wasn't a good month for the euro. It held its ground against the US dollar but depreciated against six currencies pairs within G-10. The winners this month were the so-called commodity currencies, which benefitted from improving risk sentiment, resilient commodity prices and the continued fiscal and monetary easing of Chinese policy makers. Sterling also appreciated as optimism grew that a hard Brexit was off the table. The two currencies against which the euro appreciated are both closely linked to the Eurozone's economic growth prospects, which continue to decelerate. Politically, things were relatively quiet in Europe this month.

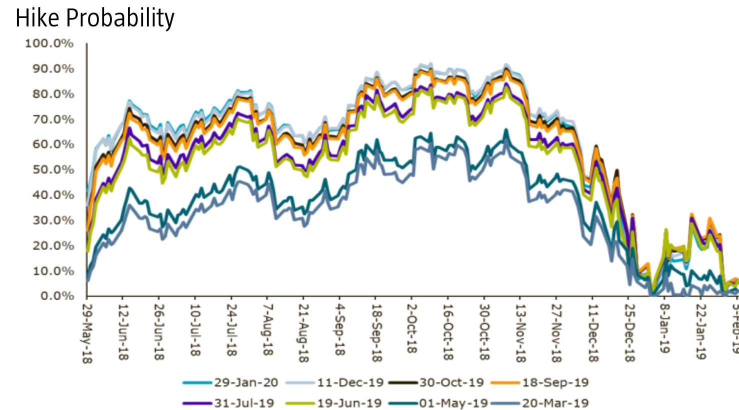
- Economic data in Europe keeps on disappointing. We were expecting at least some stabilization in the data, but this has unfortunately not materialized. The ECB is starting to take notice of the softness and is monitoring developments closely. The probability has increased that the ECB will need to act in some form to ensure that its policy still has traction across the zone.

- While politics has been less of a front page issue this month, risks remain as we are heading for European parliamentary elections in May. Also, the EU exit day for the UK is getting closer.

- Sterling has been following the ebbs and flows of British politics. In January, the odds of a Brexit no-deal outcome started to come down, and this was a massive support for sterling.

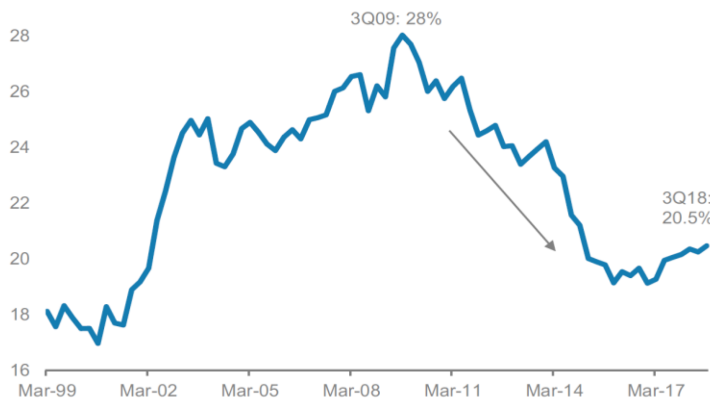
FX (II)

The Fed: no rate hike expected for the upcoming 8 Fed meetings



Source: Bloomberg, Robeco

The euro's share in global FX reserves is still low historically



Source: Macrobond, Morgan Stanley research

- As parliament has given UK Prime Minister Theresa May the assignment of renegotiating parts of the Brexit deal, and the EU up until now has been unwilling to do so, markets will continue to have to deal with an increasingly unstable situation. This will weigh on sterling.

- January was not only a terrible month for the euro, but was just as bad for the US dollar. Everything that went the right way for the greenback last year is looking to go against it now. While the US remains one of the stronger economies, we are starting to see some signs that economic momentum is decelerating.

- The Fed, however, is on the ball. The first FOMC statement of the year was very dovish, and it is clear that the Fed will take its time to assess developments before deciding in which direction it will ultimately take rates. The big surprise was the update on balance sheet normalization. It is now clear that the end of the rundown of the balance sheet is closer than was earlier thought. So, not only is the US dollar losing support from growth and fewer rate hikes, the prospects of tighter liquidity conditions are now also fleeing.

- We currently don't hold any active currency positions in our portfolio. We expect that the dollar will start coming under pressure as it loses the tailwinds that provided substantial support last year. The euro looks a good candidate to outperform the dollar, though the prospect of future political risks keeps acting as a headwind.

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The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except in circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.

Additional Information concerning RobecoSAM Collective Investment Schemes
The RobecoSAM collective investment schemes ("RobecoSAM Funds") in scope are sub funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) of MULTIPARTNER SICAV, managed by GAM (Luxembourg) S.A., ("Multipartner"). Multipartner SICAV is incorporated as a Société d'Investissement à Capital Variable which is governed by Luxembourg law. The custodian is State Street Bank Luxembourg S.C.A., 49, Avenue J. F. Kennedy, L-1855 Luxembourg. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the RobecoSAM Funds, as well as the list of the purchases and sales which the RobecoSAM Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, via the website www.robecosam.com or www.funds.gam.com.