Financial Markets Research

# Outside the eurozone, the world economy is doing OK

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## Highlights

- The eurozone debt crisis may make Europeans feel miserable about the state of the global economy, but from other vantage points the picture is not so gloomy. The world economy remains on a path of moderate growth. The debt crisis could still blow up the euro, but it is more likely that the ECB will do whatever is needed to ensure that Spain and Italy can refinance their debts at affordable interest rates.

- Given the weak economic growth, inflationary risks are limited this year, even though both overall inflation and inflation excluding volatile food and energy prices have increased. In the medium term, however, we continue to see inflation risks.

- We are not forecasting strong returns for equities over the next few months. Positive surprises are unlikely in the period ahead. With a fresh all-time high for global earnings and a neutral valuation as the starting point, we do not expect stocks to stage a strong rebound.

- We expect both investment grade and high yield bonds to outperform their government counterparts over the coming months. Worries about the debt crisis remain, but low economic growth should be enough to generate compelling returns relative to government bonds. Investment grade and high yield bonds have priced in a recession.

- Government bonds are heavily overvalued. US and German yields are hovering around multi-century lows, generating negative real yields. Core inflation around the globe is generally on the rise, Japan being an exception within developed markets. But the Robeco Inflation Monitor indicates that short-term inflation risks are falling. Short-term rates should remain low during 2012, meaning it could take some time before long-term interest rates start to normalize.

- Within equities, we remain positive on emerging markets, despite the disappointing performance in 2011, which we ascribe to inflation risks and risk aversion. Now, inflationary risks are falling and there is room to relax monetary policy. Investor risk aversion has probably peaked.

## Summary

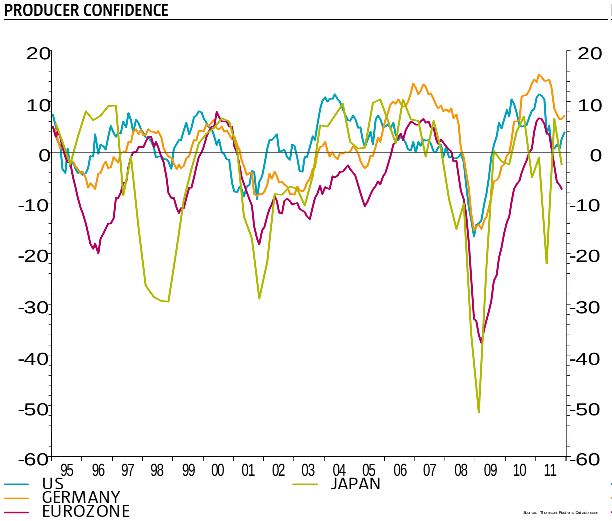
**The eurozone debt crisis may make Europeans feel miserable about the state of the global economy, but from other vantage points the picture is not so gloomy. The world economy remains on a path of moderate growth. The debt crisis still has the potential to blow up the euro, but it is more likely that the ECB will do whatever is needed to ensure that Spain and Italy can refinance their debts at affordable interest rates. We are not forecasting strong returns for equities in the next few months. Currently, we believe the most attractive trade is to be long corporate bonds (both investment grade and high yield) versus government bonds, due to their high spreads.**

## Macroeconomic view

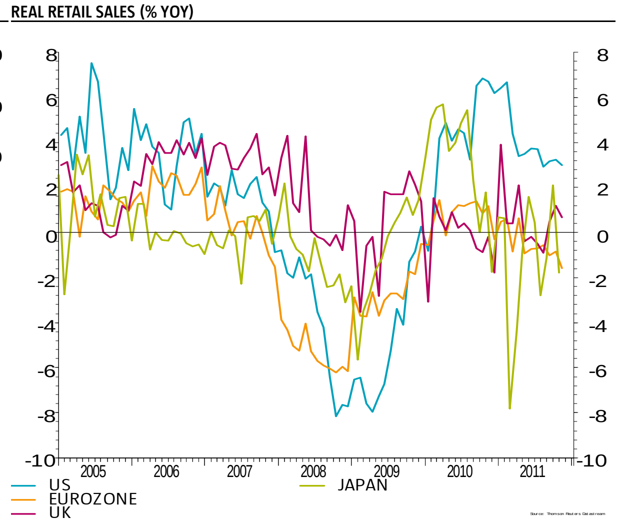
The eurozone debt crisis may make Europeans feel miserable about the state of the global economy, but from other vantage points the picture is not so gloomy. Last year was actually a year of moderate economic growth, even though the eurozone slid into recession. The debt crisis has brought uncertainty that is making companies reluctant to invest, while consumers are hesitant to spend. Indeed, the debt crisis still has the potential to push the eurozone into a depression and to drag the global economy into a recession. But it is more likely that the ECB will do whatever is needed to ensure that Spain and Italy can refinance their debts at affordable interest rates. The collapse of the euro, a consequence of a Spanish or Italian default, would entail huge costs. That means that the euro is here to stay, although it is possible that Greece will not only default on its bonds but also leave the eurozone.

Producer confidence in developed markets suggests that moderate economic growth will continue. During 2011, confidence gradually declined (see chart below left), and the current levels usually coincide with below-trend growth. One positive surprise has been the cautious rise in confidence in the US and in Germany in recent months. Retail sales data (see chart below right) also points to continuing moderate economic growth. Real retail sales in the US and the UK are increasing, while consumers in the eurozone are spending somewhat less than a year ago. In Japan, where the data is volatile, growth is fluctuating around zero.

**PRODUCER CONFIDENCE**

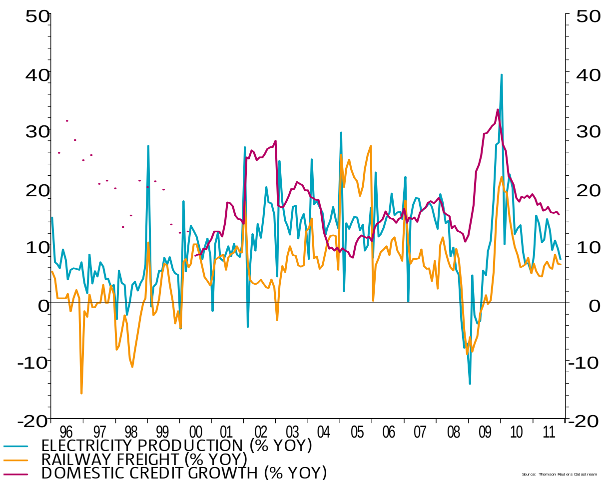



**REAL RETAIL SALES (% YOY)**

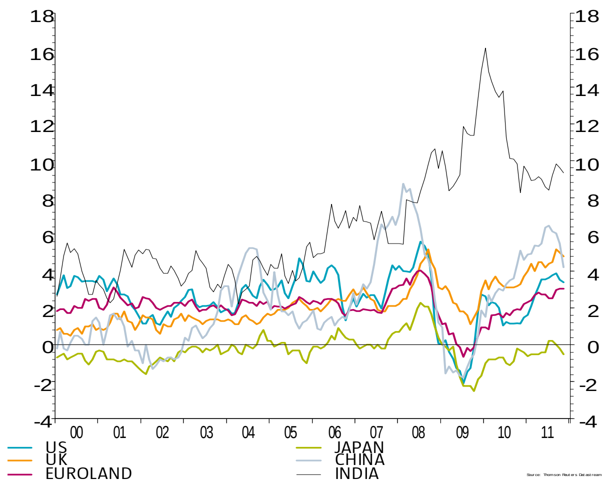



In emerging markets, economic growth in China, India and Brazil declined last year. That was actually good news, given the acceleration of inflation. The threat of inflation has subsequently fallen sharply, and some relaxation of monetary policy has already occurred. We expect the brake on the economy to be released gradually. For China, fears about a hard landing for the economy have not disappeared. But it does seem unlikely. The three indicators favored by vice premier Li Keqiang (see the chart below left) point to a controlled slowdown. As for the debt in China, we do not believe this is excessive, considering that the economy is growing at a nominal rate of 12-15%. Moreover, the central bank's large reserves can be used in the case of an emergency.

**CHINA: LI KEQIANG ECONOMIC GROWTH INDICATORS**




**HEADLINE INFLATION (% YOY)**




In short, the world economy continues on its path of moderate growth. Given the weak economic growth that is expected this year, inflationary risks are limited, although both overall inflation and inflation excluding volatile food and energy prices have already increased. In the medium term, by contrast, we do see inflation risks. After a debt crisis, the threat of inflation is always present. In addition, the rise of the middle class in emerging markets is increasing the demand for commodities. Finally, aging might eventually lead to wage inflation.

**GDP GROWTH BY REGION (%)**

| | 2011 | 2012 | Δ -1M 2012 | ROBECO* |
|---|---|---|---|---|
| US | 1.7 | 2.1 | 0.1 | = |
| EUROZONE | 1.6 | -0.1 | -0.5 | - |
| UK | 0.9 | 0.7 | -0.4 | - |
| JAPAN | -0.6 | 2.0 | -0.2 | = |
| CHINA | 9.2 | 8.3 | -0.1 | = |
| INDIA | 7.2 | 7.5 | -0.2 | - |
| BRAZIL | 3.2 | 3.5 | 0.0 | - |
| RUSSIA | 4.1 | 3.5 | 0.0 | = |
| WORLD | 2.5 | 2.4 | -0.2 | = |

* INDICATES WHETHER WE EXPECT A HIGHER (+), MATCHING (=) OR LOWER (-) GROWTH RATE THAN THE CURRENT CONSENSUS ESTIMATE FOR 2012
*SOURCE: CONSENSUS ECONOMICS, ROBECO*

**CPI BY REGION (%)**

| | 2011 | 2012 | Δ -1M 2012 | ROBECO* |
|---|---|---|---|---|
| US | 3.2 | 2.1 | 0.0 | = |
| EUROZONE | 2.7 | 1.8 | 0.0 | = |
| UK | 5.3 | 3.2 | -0.2 | = |
| JAPAN | -0.2 | -0.2 | 0.0 | = |
| CHINA | 5.4 | 3.5 | -0.3 | = |
| INDIA | 8.2 | 7.1 | -0.1 | + |
| BRAZIL | 6.5 | 5.5 | 0.0 | + |
| RUSSIA | 7.1 | 6.8 | 0.0 | = |
| WORLD | 3.4 | 2.4 | 0.0 | = |

* INDICATES WHETHER WE EXPECT A HIGHER (+), MATCHING (=) OR LOWER (-) CPI THAN THE CURRENT CONSENSUS ESTIMATE FOR 2012
*SOURCE: CONSENSUS ECONOMICS, ROBECO*

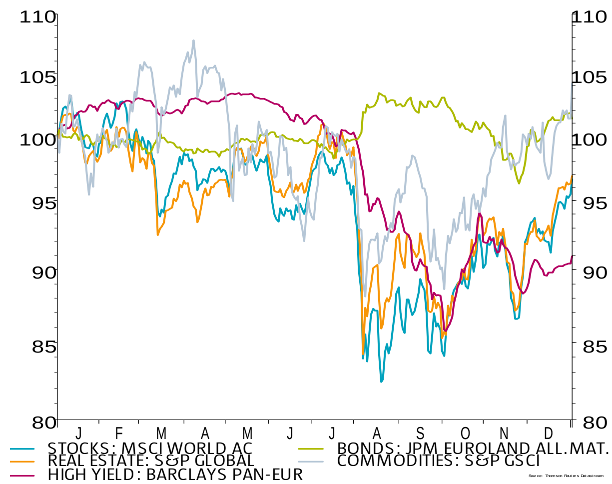
## Outlook financial markets

### Asset mix

*Last month's review*

Positive sentiment was maintained through December for two reasons. First, macro data suggests that the global economy remains on a path of moderate growth, despite the eurozone entering a recession. Second, with European leaders agreeing to more budget discipline, it seems likely that the ECB will maintain its support for the euro. Equities, real estate and commodities all gained 4-5%. European high yield matched eurobonds' performance of 2.1%. The main driver for sovereign debt's solid performance was a drop in the ten-year German interest rate from 2.1% to 1.9%. Interest-rate spreads on peripheral countries in the eurozone remain high, while the euro fell from USD 1.34 to USD 1.29. Both developments point to ongoing stress in the eurozone. The oil price edged up from USD 110/bbl to USD 113/bbl, while gold slumped by USD 140 to USD 1,610/oz. The VIX is trading around 25, close to its lowest level since August. This is still high in long-term perspective, however.

**PERFORMANCE OF ASSET CLASSES (TOTAL RETURN EUR)**




**PERFORMANCE OF ASSET CLASSES (TOTAL RETURN IN EUROS)**

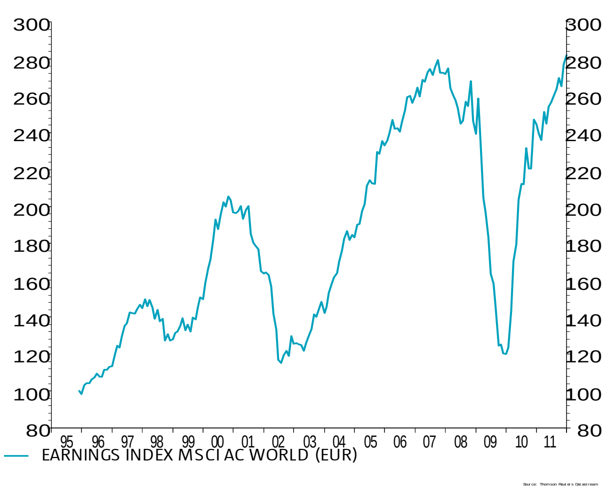
| | -1M | -3M | -6M | -12M | -3Y | -5Y |
|---|---|---|---|---|---|---|
| STOCKS (MSCI AC WORLD) | 4.1% | 14.5% | -0.5% | -3.3% | 51.4% | -4.3% |
| REAL ESTATE (S&P GLOBAL REITS) | 4.9% | 13.6% | -0.8% | -3.1% | 69.6% | -21.5% |
| HIGH YIELD (BARCLAYS PAN-EUR) | 2.1% | 3.9% | -10.3% | -9.0% | 60.9% | -16.8% |
| BONDS (JPM EUROLAND ALL MAT.) | 2.1% | -1.7% | 1.7% | 1.3% | 6.7% | 19.0% |
| COMMODITIES (S&P GSCI) | 4.1% | 15.6% | 11.1% | 4.2% | 31.2% | -5.8% |

*SOURCE: THOMSON FINANCIAL DATASTREAM*

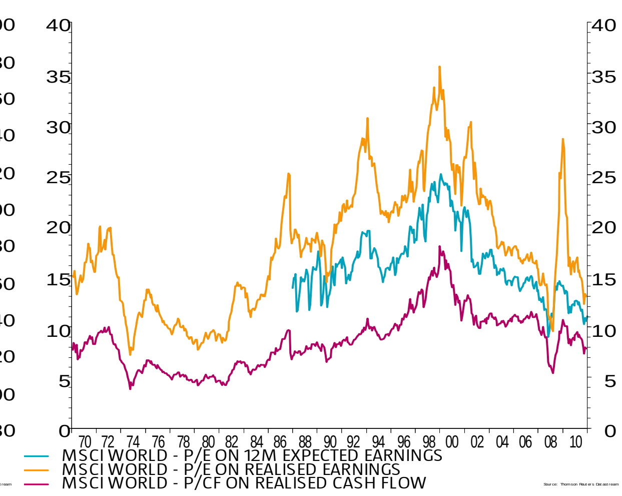
*Equities*

Although we upgraded the outlook for equities from negative to neutral in November, we are not forecasting strong returns for the asset class. Earnings have staged an impressive rebound and—thanks to record earnings margins—have reached new all-time highs, as illustrated in the chart below left.

**EARNINGS INDEX MSCI AC WORLD (EUR)**




**VALUATION METRICS**



Given our baseline scenario—which features ongoing moderate economic growth and the ECB doing whatever is needed to make sure Italy and Spain can refinance their debt at reasonable interest rates—we feel that the current earnings estimates are too optimistic. But as analysts are—on average—overly optimistic, the current estimate is not unusually high. We expect low single-digit earnings growth at best. At this stage, we believe that positive surprises in the months ahead are unlikely. As a result, from a starting point where valuation is neutral, we do not expect equities to stage a strong rebound.

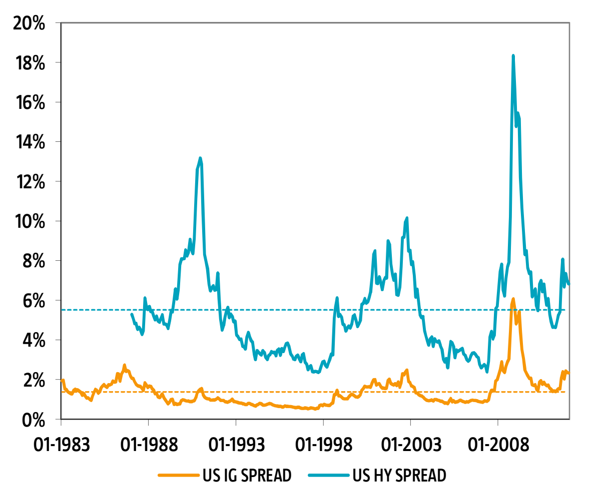
*Real estate*

The outlook for real estate closely resembles the one for equities. We expect both to deliver moderate returns in our economic "muddling-through" scenario. The ratio of net debt to total assets is decreasing, but it is still high from a historical perspective. Access to funding will remain an important issue for the foreseeable future. From a valuation perspective, we believe there is no significant difference between equities and real estate. The asset classes are highly correlated and, based on the price/cash flow ratio, their valuations hardly differ. The current price/cash flow ratio for real estate is 1.5x the one for stocks. That is in line with the historical average.

*Corporate bonds*

We expect both investment grade and high yield bonds to outperform government bonds over the coming months. Worries about the debt crisis remain, but the low economic growth that we expect should be enough to generate compelling returns relative to government bonds. Investment grade and high yield bonds have priced in a recession. Spreads in the US market are high in a historical context. On the one hand, one could argue that spreads have risen too far, given that corporate balance sheets are healthy and loaded with cash. On the other, the graph to the right shows what happens when the market becomes really worried about a credit crunch, as happened in 2008. But a situation like 2008 is an extreme and unusual one.

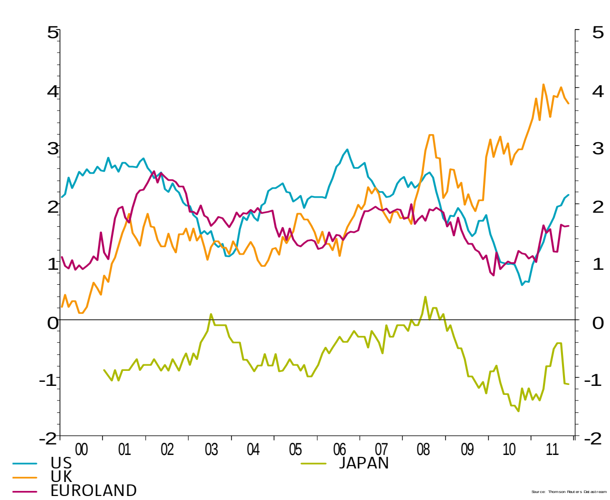
**US INVESTMENT GRADE AND HIGH YIELD SPREADS (SOURCE: BARCLAYS)**




*Government bonds*

Government bonds are heavily overvalued. US and German yields are hovering around multi-century lows, generating negative real yields. Core inflation around the globe is generally on the rise, Japan being an exception within developed markets. But the Robeco Inflation Monitor indicates that short-term inflation risks are falling. While we believe that inflation will materialize in the medium to long term, inflation risks this year are limited. Moreover, short-term interest rates should remain low during 2012, and possibly also in 2013. That means it could take some time before long-term interest rates start to normalize. Nevertheless, we do not like government bonds, as we expect them to be outperformed by corporate bonds.

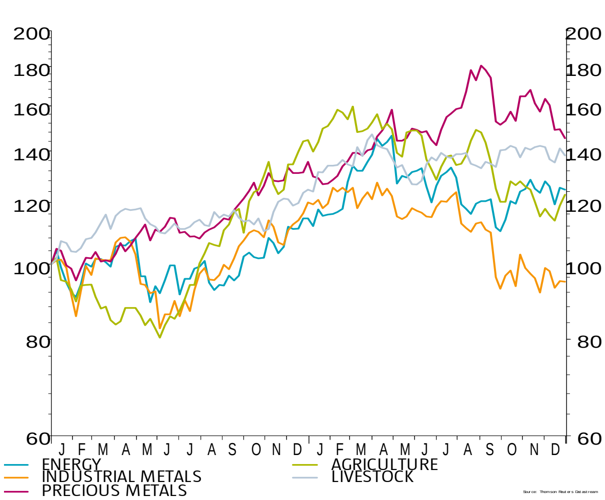
**CORE INFLATION RATES (%)**



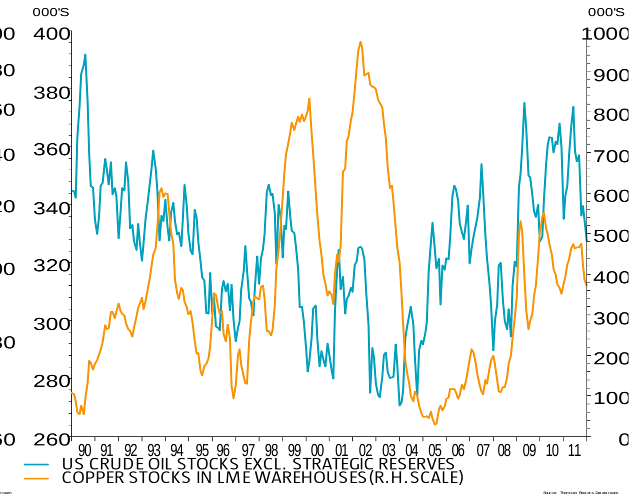
*Commodities*

We expect the long-term uptrend in commodity prices, which began at the start of this century, to continue. At present, the eurozone debt crisis, a slowing down of emerging markets economies and tensions around Iran are playing a role. As we believe that emerging markets will not slow down significantly from here on, the risks are primarily centered on the eurozone debt crisis. There, we believe that the ECB will do what is needed. For now, we regard commodities as a high-risk bet that we do not wish to make in the short term. We retain our neutral stance on the asset class.

**GSCI COMMODITY SPOT PRICES (USD)**




**OIL AND COPPER STOCKS**



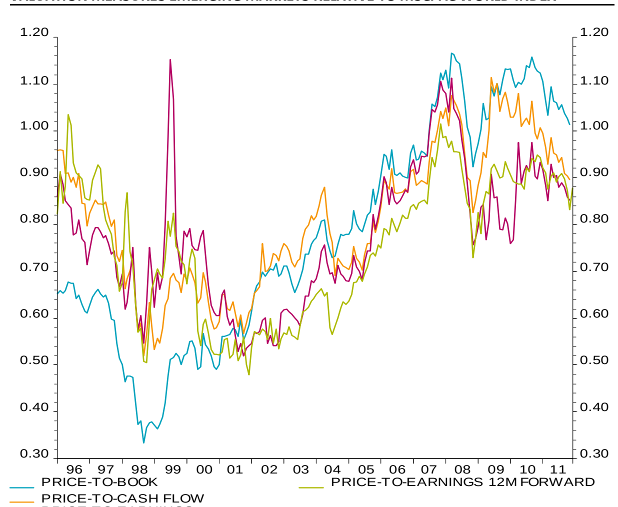

## Regional mix

**PERFORMANCE OF REGIONS (MSCI AC WORLD; UNHEDGED TOTAL RETURNS IN EUROS)**

| | -1M | -3M | -6M | -12M | -3Y | -5Y |
|---|---|---|---|---|---|---|
| NORTH AMERICA (50%) | 5.6% | 18.5% | 5.8% | 3.6% | 58.6% | 4.1% |
| EUROPE (24%) | 4.5% | 13.2% | -7.1% | -5.8% | 36.3% | -18.8% |
| PACIFIC (13%) | 1.4% | 4.7% | -1.5% | -10.4% | 34.2% | -14.2% |
| EMERGING MARKETS (13%) | 0.8% | 12.6% | -8.6% | -15.0% | 86.6% | 17.4% |
| AC WORLD (100%) | 4.1% | 14.5% | -0.5% | -3.3% | 51.4% | -4.3% |

*SOURCE: THOMSON FINANCIAL DATASTREAM*

**VALUATION MEASURES EMERGING MARKETS RELATIVE TO MSCI AC WORLD INDEX**




Within equities, we remain positive on emerging markets, despite the disappointing performance in 2011, which we put down to inflation risks and risk aversion. Now, the inflation risks are falling and there is room to relax monetary policy. Economic growth in emerging markets decelerated in 2011. This year, growth in China might fall a bit further. In general, however, the deceleration should cease. Meanwhile, investor risk aversion has probably peaked. Looking at fundamentals, emerging markets are a relatively cheap segment compared with developed markets, and have relatively sound fundamentals. Europe is also cheap compared with the market, but we expect more debt crisis-related volatility in the eurozone in the months ahead. Moreover, the eurozone is in a recession, a development that is reflected in earnings growth and in earnings revisions, which are low compared with other regions'. We are also negative on the Pacific region. Index heavyweight Japan has negative long-term fundamentals and there is no short-term reason to change that view.

**EARNINGS AND VALUATION DATA OF REGIONS (MSCI AC WORLD)**

| | EARNINGS GROWTH (%) | | | ST.DEV. ESTIMATES (%) | | EARN. REV. INDEX | | P/E ON 12M FWD EARN. | |
|---|---|---|---|---|---|---|---|---|---|
| | FY1 | FY2 | 12M | CURRENT | 10Y AVG. | 3M | 1M | CURRENT | 10Y AVG. |
| NORTH AMERICA | 16.1 | 10.1 | 10.4 | 7.3 | 5.6 | -13.6 | -25.9 | 11.7 | 14.9 |
| EUROPE | 1.9 | 8.2 | 8.2 | 13.9 | 13.0 | -32.5 | -36.5 | 9.6 | 13.0 |
| PACIFIC | 6.3 | 18.1 | 14.4 | 1.1 | 0.8 | -36.8 | -35.2 | 11.5 | 16.4 |
| EMERGING MARKETS | 10.8 | 9.9 | 9.7 | 14.8 | 10.2 | -37.5 | -24.2 | 9.2 | 10.7 |
| AC WORLD | 10.0 | 10.5 | 10.1 | 2.7 | 2.1 | -26.3 | -29.1 | 10.8 | 14.1 |

THE EARNINGS REVISIONS INDEX IS CALCULATED AS THE DIFFERENCE BETWEEN THE NUMBER OF UP- AND DOWNWARD REVISIONS RELATIVE TO THE NUMBER OF TOTAL REVISIONS.
*SOURCE: THOMSON FINANCIAL DATASTREAM*

## Sector mix

**PERFORMANCE OF SECTORS (MSCI AC WORLD; UNHEDGED TOTAL RETURNS IN EUROS)**

| | -1M | -3M | -6M | -12M | -3Y | -5Y |
|---|---|---|---|---|---|---|
| ENERGY (12%) | 4.3% | 24.7% | 2.7% | 2.2% | 53.5% | 21.1% |
| MATERIALS (8%) | 1.6% | 14.2% | -10.8% | -16.5% | 75.4% | 16.0% |
| INDUSTRIALS (10%) | 4.6% | 17.5% | -4.4% | -6.2% | 54.1% | -1.3% |
| CONSUMER DISCRETIONARY (10%) | 3.0% | 13.5% | -1.1% | -1.9% | 81.5% | 0.3% |
| CONSUMER STAPLES (11%) | 5.7% | 12.3% | 11.9% | 11.8% | 64.8% | 44.1% |
| HEALTH CARE (9%) | 8.6% | 14.0% | 8.4% | 13.4% | 45.7% | 15.3% |
| FINANCIALS (19%) | 3.5% | 13.1% | -10.4% | -15.8% | 27.6% | -46.0% |
| IT (12%) | 2.7% | 13.3% | 6.5% | -1.1% | 78.9% | 9.9% |
| TELECOM SERVICES (5%) | 4.4% | 8.5% | 4.6% | 3.7% | 40.1% | 12.1% |
| UTILITIES (4%) | 4.0% | 6.6% | 2.7% | -1.1% | 13.6% | -5.7% |
| AC WORLD (100%) | 4.1% | 14.5% | -0.5% | -3.3% | 51.4% | -4.3% |

*SOURCE: THOMSON FINANCIAL DATASTREAM*

The strong differences in the performance of defensives, cyclicals and financials in 2011 do not show up over the last three months. We continue to take a wait-and-see approach before retreating from our positive view on defensive sectors. There is no strong fundamental or quantitative signal calling for a change. The debt crisis has not disappeared and the eurozone has fallen into a recession, while momentum and earnings revisions are no longer so clear cut. For now, we hold on to our positive view on defensives versus financials, although our conviction about this call is weakening.

**EARNINGS AND VALUATION DATA OF SECTORS (MSCI AC WORLD)**

| | EARNINGS GROWTH (%) | | | ST.DEV. ESTIMATES (%) | | EARN. REV. INDEX | | P/E ON 12M FWD EARN. | |
|---|---|---|---|---|---|---|---|---|---|
| | FY1 | FY2 | 12M | CURRENT | 10Y AVG. | 3M | 1M | CURRENT | 10Y AVG. |
| ENERGY | 24.2 | 3.0 | 2.8 | 3.2 | 2.7 | -14.0 | -13.4 | 9.3 | 11.9 |
| MATERIALS | 26.9 | 10.2 | 10.1 | 4.1 | 2.7 | -50.6 | -47.0 | 9.1 | 12.8 |
| INDUSTRIALS | 11.5 | 10.9 | 10.8 | 1.1 | 0.7 | -27.9 | -20.2 | 11.3 | 15.0 |
| CONSUMER DISCRETIONARY | 10.2 | 20.0 | 16.8 | 0.9 | 0.7 | -16.3 | -32.1 | 12.2 | 16.3 |
| CONSUMER STAPLES | 7.5 | 9.3 | 9.6 | 0.4 | 0.3 | -24.0 | -34.4 | 14.6 | 16.0 |
| HEALTH CARE | 5.4 | 4.6 | 4.5 | 0.5 | 0.3 | -3.0 | -17.9 | 11.5 | 15.5 |
| FINANCIALS | 3.7 | 14.1 | 14.5 | 0.9 | 0.9 | -36.4 | -27.8 | 8.9 | 11.6 |
| IT | 8.1 | 10.7 | 10.5 | 0.6 | 0.4 | -24.6 | -38.4 | 11.9 | 19.0 |
| TELECOM SERVICES | -0.3 | 7.2 | 7.0 | 0.5 | 0.5 | -27.1 | -36.9 | 11.5 | 18.8 |
| UTILITIES | -8.7 | 20.3 | 17.2 | 1.1 | 0.8 | -26.6 | -33.3 | 14.0 | 13.3 |
| AC WORLD | 10.0 | 10.5 | 10.1 | 2.7 | 2.1 | -26.3 | -29.1 | 10.8 | 14.1 |
| AC WORLD REITS | 10.0 | 2.0 | 2.6 | 3.7 | N.A. | -0.1 | 0.1 | 22.5 | N.A. |

THE EARNINGS REVISIONS INDEX IS CALCULATED AS THE DIFFERENCE BETWEEN THE NUMBER OF UP- AND DOWNWARD REVISIONS RELATIVE TO THE NUMBER OF TOTAL REVISIONS.
*SOURCE: THOMSON FINANCIAL DATASTREAM*

Closing date text: 05 January 2012.
In our text and data tables, we do not refer to calendar months but look back from this closing date.

## Important information