For professional investors

ROBECO
The Investment Engineers

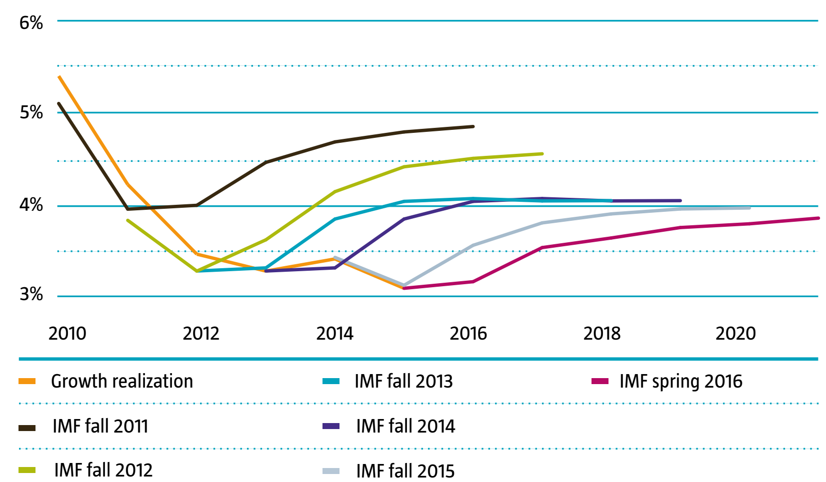
TIME FOR PLAN B

OUTLOOK 2017

CONTENTS

BRING ON PLAN B

IMF world real GDP growth forecast, 2010-2020

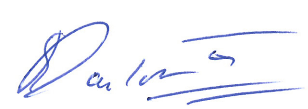


Source: International Monetary Fund (IMF), World Economic Outlook

In the aftermath of the Great Recession, the International Monetary Fund – and with it most economic analysts – forecasted the usual quick recovery and subsequently had to lower their over-optimistic forecasts. The crucial question is whether the IMF was too slow in acknowledging that structural headwinds had increased, or whether there was just an unfortunate sequence of cyclical items leading to a prolonged period of disappointing growth. The answer is probably both. Structural factors like aging, rising debt, the disruptive impact of digitalization and increasing inequality have had a negative impact on underlying growth dynamics. Having said that, a number of temporary factors have not helped either. The unusually severe recession caused the banking sector's transmission mechanism to break down.

This was followed by the Eurozone crisis, the meltdown in the commodity markets and disappointing growth in the emerging markets bloc. This has been compounded by an overreliance on a single stimulus engine – monetary policy – which has not helped. As we indicated in last year's outlook, monetary policy has entered the phase of diminishing returns and is no longer able to kick-start the economy on its own.

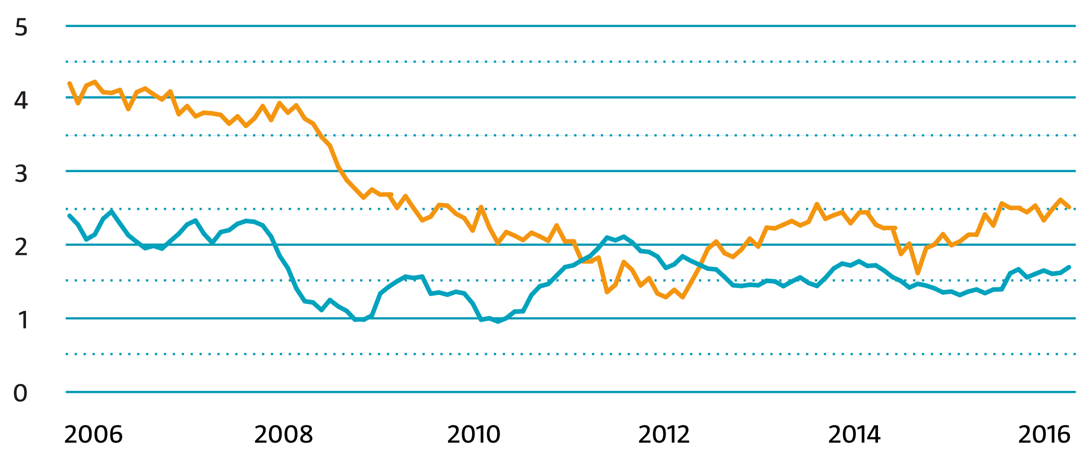
So... time for Plan B. But is there one? The US electorate certainly seemed to think so when they surprisingly elected Donald Trump as their new president. It is currently too early to assess the broader impact of his plans, but one thing seems to be clear: he will push for fiscal stimulus, replacing the current overreliance on monetary policy. One could simply shrug this off as just Trump, but with even the ECB now insisting that governments should take their role seriously, it is clear that sentiment on this subject has shifted. This in conjunction with the generally tight labor markets in most of the leading economies may mean that inflation is set to make a comeback. Given the current low growth expectations, there is considerably more scope for surprises on the upside, with everyone apparently expecting the slowdown to be permanent. If there are positive growth surprises, this could lead to a much needed improvement in underlying sentiment, also rekindling investment as an additional growth engine. The clear risk to this scenario, is that Trump could also opt for Plan C: a return to protectionism...



Lukas Daalder, Chief Investment Officer Investment Solutions
November 2016

US: THE TIGHT SPOT MAY BE THE RIGHT SPOT FOR ONCE

Great again? United States, % increase on a year earlier



Core inflation (personal consumption expenditures excluding food and energy)

Wages (median increase)

Source: BEA, Federal Reserve Bank of Atlanta

Whereas official GDP growth has been disappointing in recent years, this has not been the case for the labor markets. The current level of unemployment in most of the leading economies is well below the longer-term average and job growth has remained remarkably stable given the low GDP growth numbers. Of course, the official numbers may be inflated by a number of discouraged workers who no longer register as unemployed, but that does not alter the fact that labor markets in the leading economies – the US, the UK, Germany and even Japan – have tightened. These workers may now return to the labor markets as the situation has improved, but their skillsets seldom fit requirements, so this will have little effect on the tightness in the broader parts of the labor market.

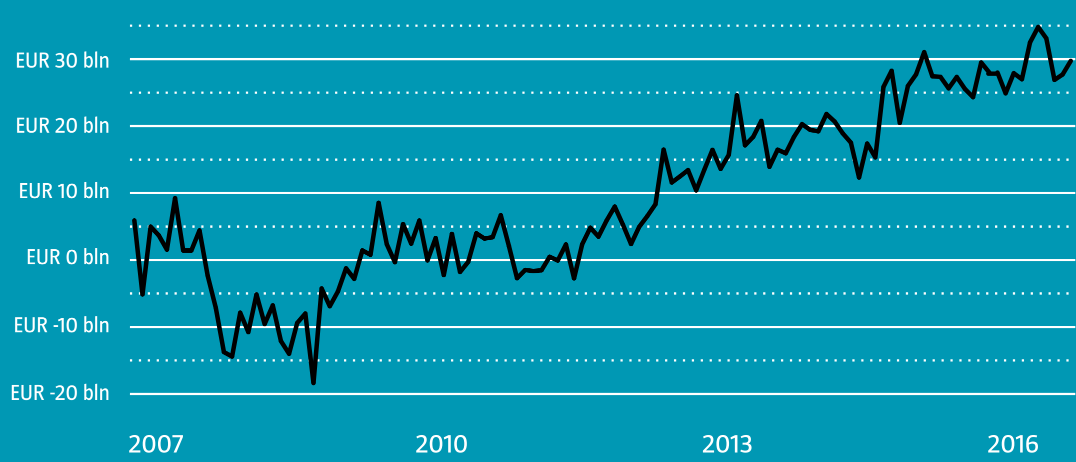
The consequences of these tighter labor markets become clear if we look at the US, for example. The economy has finally reached full employment and wage growth has steadily improved. As inflation is still pretty subdued at the moment, this wage growth has been a real factor, not just a nominal one. This means wage growth can drive personal consumption and facilitate a rebound in investment. An additional factor is the US consumer who has been deleveraging in recent years, brightening the outlook for US consumption. However, Trumpanomics – leading to a further sharp rise in inequality, the killing off of Obamacare and the possible negative impact of trade tariffs – could dampen overall consumer demand. Although it is too early to make that call just yet. All in all, we do expect US growth to exceed the level forecast for 2016.

Will this lead to a much more aggressive policy from the Federal Reserve? Fed Chair Janet Yellen has indicated several times that she considers wage growth between 3% and 4% as healthy and that this is a necessary condition for a gradual tightening of monetary policy. As a majority of the Fed decision makers will probably continue to err on the side of caution, we reckon there will be two modest rate hikes at most in the course of 2017.

‘The economy has finally reached full employment and wage growth has steadily improved’

CURRENT ACCOUNT SURPLUSES CUT BOTH WAYS

Account surplus: Sign of strength?



Source: Bloomberg, Robeco

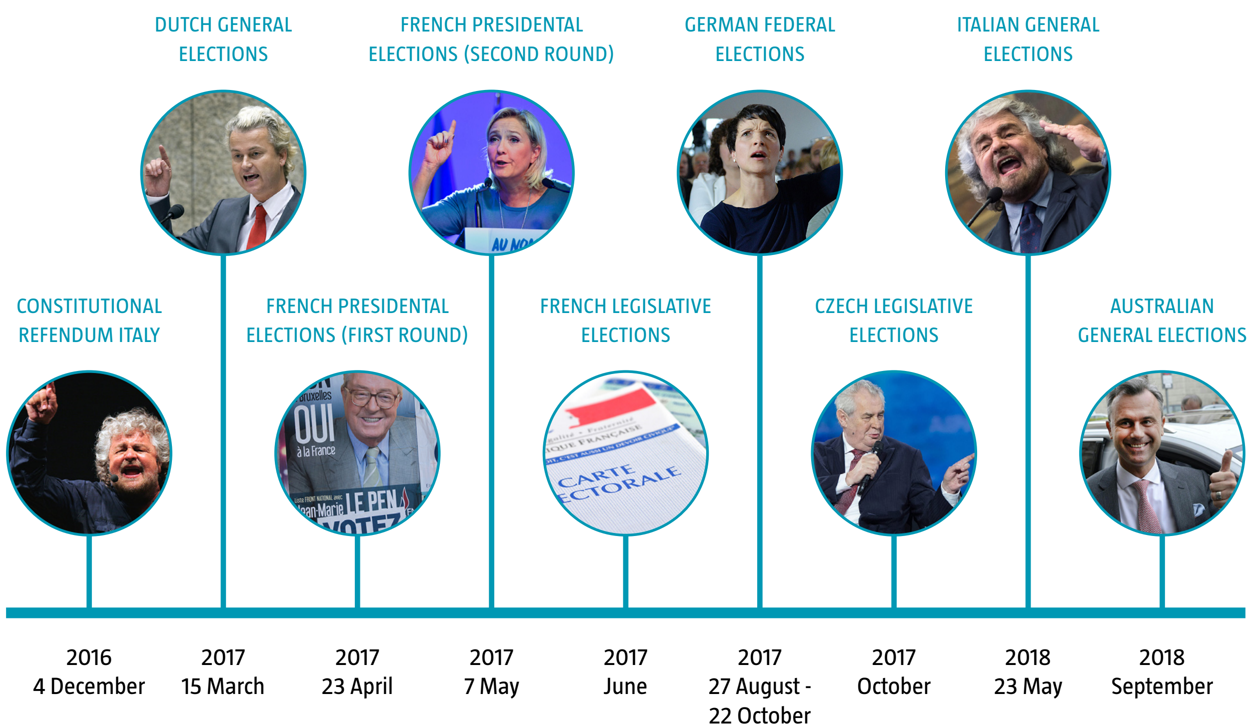
If we listen to the economists, there appear to be two distinctly different schools of thought in the case of current account surpluses. One sees a surplus as a sign of the strength in the underlying economy; a surplus means that goods and services are produced more competitively than elsewhere. This school regards the deficit countries as the problem area: they should toughen up, reduce costs and become more competitive. However, the other takes a different approach, regarding a current account surplus as a sign of insufficient domestic demand. The current account surplus is either a reflection of a government surplus, or a saving surplus (more savings than investments), or both. According to this interpretation, it is the surplus countries that have the solution for current account imbalances. The logical step is for them to take measures to boost domestic demand.

This also implies that the Eurozone has acted as a deflationary force in the world economy, as austerity policies in the periphery combined with a lack of countervailing fiscal action in the core have led to this growing imbalance in the world economy. So far, the German government has resisted demands for more economic stimulus. We expect some change in the current trend, with 2017 autumn elections on the horizon and Angela Merkel likely to promise some sort of tax relief to keep the electorate happy. In addition, the German economy – running a 9% surplus on its current account – will be vulnerable to protectionist calls by the new US administration, as it is relatively easy for the US to accuse the Eurozone of manipulating its currency.

Furthermore, although aging is generally seen as a cause for the rise in savings, there is a natural tipping point: once you retire, dissaving takes over. And maybe this is why German consumption has managed to surprise on the upside over the past two years. As in the US, labor markets have tightened in recent years, which should help to support consumer spending into 2017 as well. This combined with the fact that the pressure on the periphery to continue austerity policies has also diminished, means we have probably seen the high in the German current account surplus.

> 'Although aging is generally seen as a cause for the rise in savings, there is a natural tipping point'

P IS FOR POPULISM



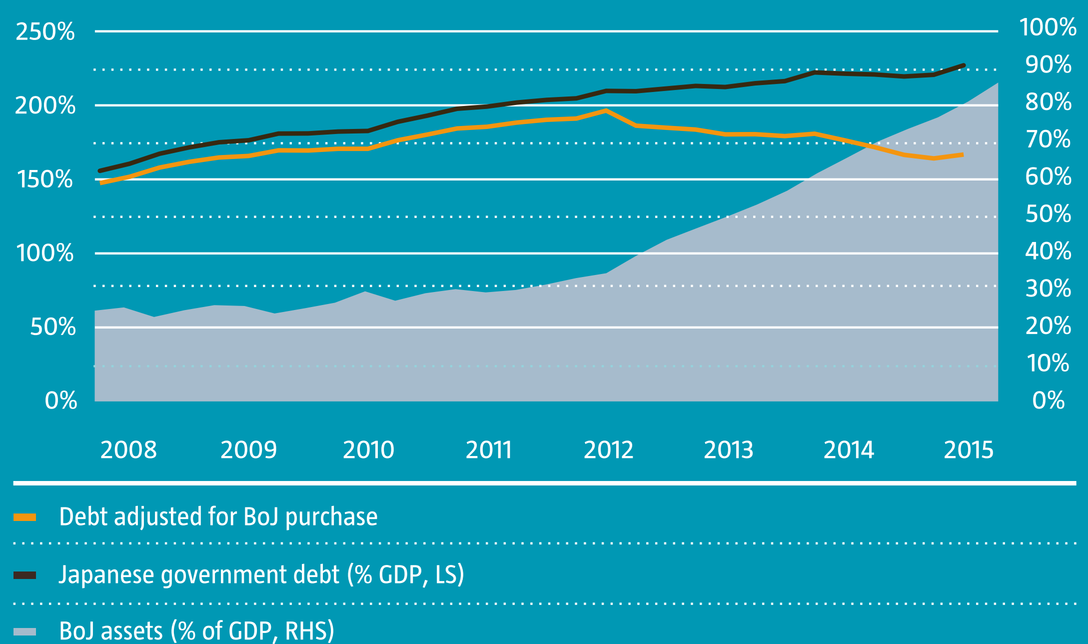
There is a heavy political agenda for 2017, which could be further aggravated by the early scheduling of the Italian election. Apart from Italy (referendum in December 2016, possible elections following the outcome), France poses the largest risk (April-May 2017). It is likely that the self-proclaimed 'Madame Frexit' and candidate for the ultra-right Front National, Marine Le Pen, will reach the second round of the presidential elections. It is generally assumed she will be beaten by a mainstream candidate (e.g. Alain Juppé from the popular center-right), but let's not forget Brexit and Trump... A Le Pen victory would unleash a devastating political and economic crisis in the EU. There will be a German general election in the autumn, which will probably show the heightened popularity of the ultra-right AfD (Alternative for Deutschland). Political stability will probably not be seriously endangered, with Merkel possibly becoming Chancellor again. But a year is a long time in politics. The rise of the AfD could cause other German politicians to press for more hardline austerity in Europe, threatening the political climate in the Eurozone.

The success of Donald Trump shows that the rise of the populist vote is not just a European phenomenon, but a more widespread sign of the times. The degree of discontent among the broader electorate has been linked to the disappointing growth recovery, increasing inequality and a general feeling of disenfranchisement with current politicians. Given the extent of this dissatisfaction, if ignored much longer, it could even start resulting in unwelcome election results. The most logical response to this trend is for those politicians currently in office to try to regain popularity with the broader electorate by introducing policies such as an increase in the minimum wage, more progressive tax regulations and austerity measures. As we have already indicated, this is part of the reason why we are not that negative on the growth outlook for 2017 as a whole.

'A Le Pen victory would unleash a devastating political and economic crisis in the EU'

BOJ'S BOX OF TRICKS

BoJ ever-expanding balance sheet



Source: Bloomberg, BIS, Robeco

Just when you think we have must have reached the end of the line after a decade of 'financial innovation' in terms of monetary policy, the Bank of Japan (BoJ) announces yet another change in its policy approach. Rather than just quantifying a fixed amount of bond purchases, the central bank has now moved to yield curve targeting, effectively fixing not only short rates, but also the ten-year yield, which it has currently set at a level of around 0%. As the experience of the US in 1942-1951 has shown, the fact that the market knows the target level means that a central bank has to do very little actual buying to reach that target. The knowledge that there is a buyer out there that will buy bonds no matter what, is enough to keep the market from actually testing the limit.

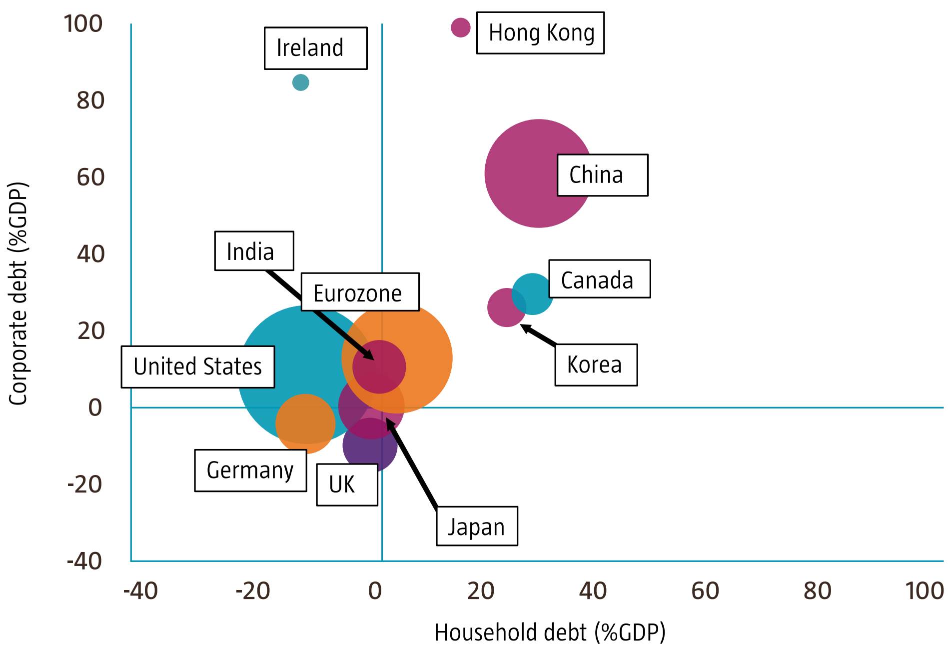
However, what is true for rising yields is not necessarily true for falling yields, as the BoJ would then also have to act as a sort of 'seller of last resort'. Having said that, following the massive QE programs of the last few years, the BoJ holds more than 27% of outstanding government bonds, which means that there is plenty of room for it to act as a seller, should the market so wish. So is this the long awaited improvement that will save Japan after all? From a monetary policy perspective, little has actually changed. Pushing yields lower has not managed to kickstart the economy, so fixing them can hardly be seen as a game changer.

Of course, the slightly upward sloping yield curve and the decline in underlying bond volatility will be welcomed by the financial sector, but it is hard to see how this will make a difference. More importantly, price fixing long-term bonds can be considered as an open invitation to the fiscal authorities to step up stimulus. Monetary policy alone is not enough, the government also needs to step in. The extent to which Prime Minister Abe uses this room to maneuver will be an important issue in 2017. The Japanese track record on fiscal spending has unfortunately not been very convincing to date, but raising the minimum wage or increasing pay-outs are also some of the options available to Abe. The Japanese unemployment rate has dropped to the lowest level in over 20 years, with job availability at its highest level since 1990. The aging population has resulted in tight labor markets, which should at lead to higher wage growth at some point. One thing is clear though: any reflation of the economy that occurs will no longer be reflected in the government bond market.

'Monetary policy alone is not enough, the government also needs to step in'

DEBT THREAT

Debt has been stable on aggregate, but underlying changes have been substantial



Source: BIS, Robeco

Debt: is it really as big a problem as everybody appears to think it is? Although it is easy to find alarming headlines on this subject, it may come as a surprise to hear that if we look at overall debt levels, the picture isn't actually all that bad. In the US, total private sector debt as a percentage of GDP has remained stable at a level of 150% since 2008. The increase in corporate debt (up 8% as a percentage of GDP since 2008) has been almost completely offset by the decline in household debt. This reduction in US household debt is something that is seldom mentioned by all the debt scaremongers. Having said that, there are certainly problem areas out there, the most obvious one being the Chinese debt explosion. As the growth cycle of the Chinese economy has matured, more and more emphasis has been put on credit expansion. Since the start of 2008, Chinese private sector debt as a percentage of GDP has expanded by over 90% (now 210% of GDP), with the corporate sector acting as the main driver for this credit expansion.

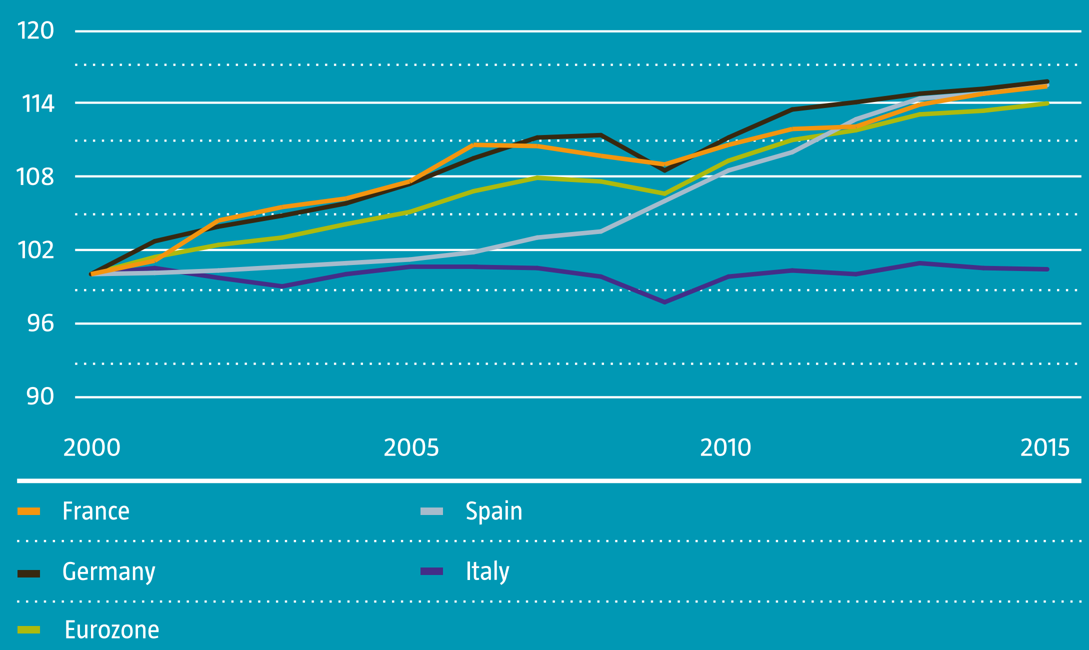
Centrally directed growth targets have taken precedence over sensible investment policy, which has led to overcapacity in, for example, manufacturing and housing. This is clearly reflected in the increase in non-performing loans: according to official numbers they now make up 5% of the total, but IMF estimates indicate they could be as much as three times as high.

A sensible policy would be to tackle this problem head on. Initiate debt write-downs, reduce existing overcapacity and share the burden across the economy so that it does not lead to disruptions in certain sectors. Although China, as a centralized economy, has the option to take this route, it would mean having to abandon its medium-term growth target of 6.5%, something we do not think is likely to happen. Current leader Xi Jinping probably doesn't want to see bleak economic headlines before the 19th Communist Party congress in Autumn 2017, when the leadership at the top could change for the first time since 2012. All in all, we assume that China will be kicking the can down the road for a little longer. Although this is negative from a longer-term perspective, it will limit growth disappointments in 2017.

'China will be kicking the can down the road for a little longer'

ITALY – THE EU'S PROBLEM CHILD

Real labor productivity per hour worked, Index (2000=100)



Source: OECD, Robeco

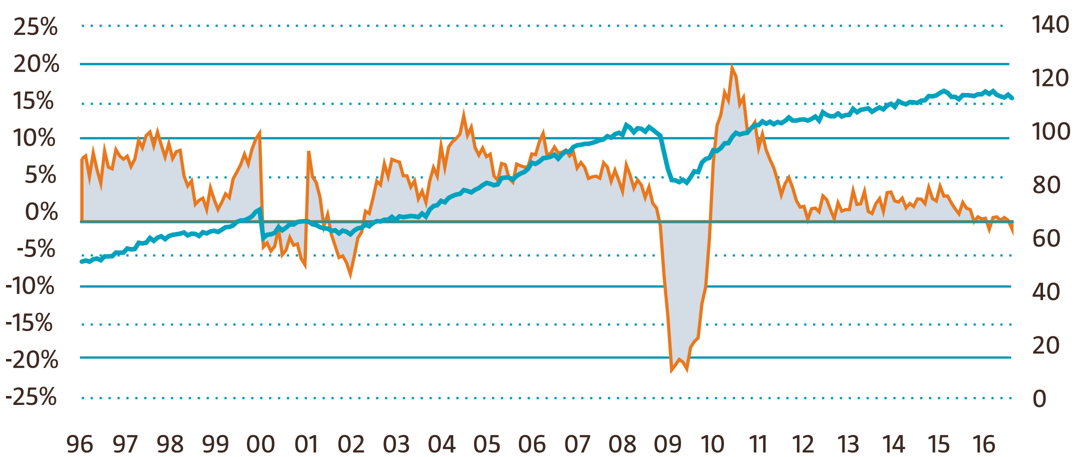
Developments in real labor productivity within the Eurozone show a striking contrast between Italy, the third largest economy, and the rest. The Italian economy has barely grown in the last ten years, which is understandably making the electorate more and more restless. Growth-enhancing reform measures have been limited and Italy, with its uncompetitive labor force, seems to be trapped in the Eurozone. With the ECB effectively capping long-term bond yields, risks have now shifted to the social and the political sphere. Opposition party Northern League has rejected the euro outright and the Five Star Movement has called for a referendum on the euro, a somewhat doubtful proposal from a constitutional perspective, although if they are elected, there is nothing to prevent them from holding a consultative referendum.

As long as the Italian government, with whoever is at the helm, nominally adheres to European rules, the ECB will remain the effective guardian of the bond market. But a rebellious Italian administration contemplating to leave the euro would throw the Eurozone economy and financial system into disarray and likely provoke a severe recession and a huge political crisis in Europe. Although this is possible, we do not think it is the most likely scenario. Italian elections are scheduled for May 2018 at the latest.

'The Italian economy has barely grown in the last ten years'

TRADE. OR ELSE...

World trade on the verge of collapse?



World trade volume yoy

S&P 500 Earnings per share

Source: Bloomberg, Robeco

As global trade is cooling down, the debate about its apparent demise is warming up. In a recent Reuters poll, 75% of the 200 plus economists who responded saw reviving international trade as more important for the world economy than boosting inflation. The IMF recently shared economists' worries in its World Economic Outlook, stating that the uptick in protectionism is 'not innocuous' and is partly responsible for the decline in global trade in recent years. But is this recent slowdown so exceptional or have we experienced extremely strong trade growth in the past? A closer look at the factors affecting global trade shows that we are actually experiencing a gradual normalization in trade rather than a meltdown. However, a Trump presidency poses a risk to this view.

The high pre-financial crisis global GDP growth rates boosted global trade far above its long-term trend in the years 2003-2007. A Chinese economy at full throttle, a commodity boom and an expanding global supply chain were key factors. This benign environment was overturned as a result of the financial crisis. The IMF estimates that a sluggish post-crisis global cyclical recovery is responsible for 75% of the slowdown in global goods trade. Only 25% is due to weaker trade policies (antidumping, countervailing duties, temporary trade barriers etc.), largely inspired by rising protectionism.

Given this assessment, according to many observers, the best medicine to revive global trade at this point should be a cyclical pick-up in economic activity. But even if global economic growth improves in 2017, as we expect it to, the pick-up in global trade could still be underwhelming. First, after decades of improvement, the contribution of logistics and further financial integration has diminished. Second, a certain proportion of trade has moved into the digital space, where prices and margins are much lower.

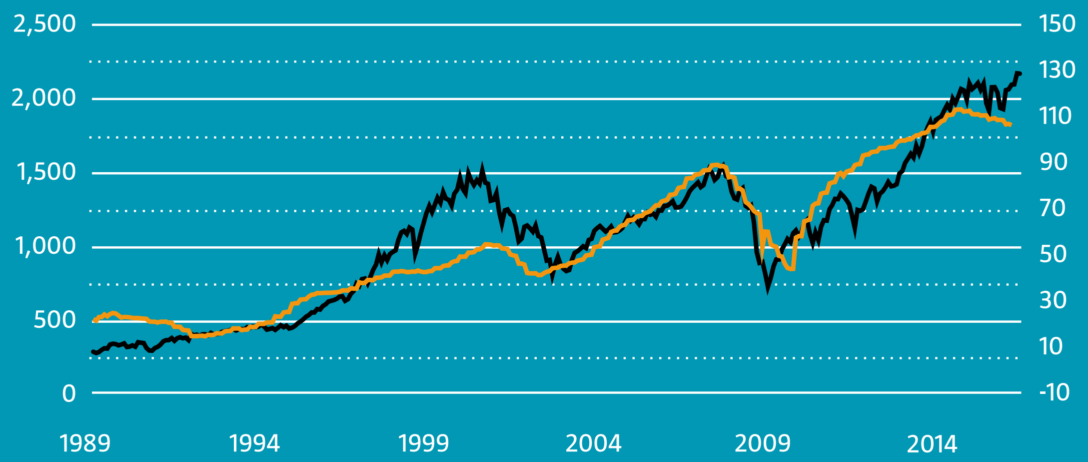
By far the most important issue, however, is the possible rise of protectionism, with Trump as the new US President. He has been quite vocal on Mexico and China, but given the Eurozone's high current account surplus, things could turn nasty quite rapidly. The main problem is that we do not yet know what the priorities of the new Trump administration are. But let's not get too pessimistic here. Emerging markets are still far behind the technological frontier of developed markets. Global trade remains a powerful catalyst for aspiring emerging countries to accelerate technological catch-up. Now that investor sentiment and capital flows towards emerging market are improving, global trade could show a subdued recovery. The recent uptick in global trade to 1.5% annual growth bodes well in this respect. Like 'peak oil', 'peak trade' could also prove to be a call one may come to regret.

This view on trade also underpins our constructive long-term view on emerging markets, see our five-year Expected Returns.

'The best medicine to revive global trade at this point should be a cyclical pick-up in economic activity'

IT'S ALL ABOUT VALUATIONS

Stock price appreciation outpaced earnings growth



Source: Bloomberg

Since Q2 2015, earnings per share growth for the US stock market has started to decline, triggering an earnings recession. This has coincided with a drop in profitability at US corporates and a deterioration in sales volume growth. Historically, an ongoing decline in profit margins has been a good predictor of recession and spells trouble for equities. At the start of 2016, recession fears gripped the market, with many thinking that it was just a matter of time before the US would fall into recession, after the seven-year recovery. However, expansion phases do not die of old age, as proven by the continuous ten years of economic expansion the US experienced from 1991-2001, which ended as a result of irrational exuberance. Nowadays, irrational exuberance is a rare commodity in the equity market.

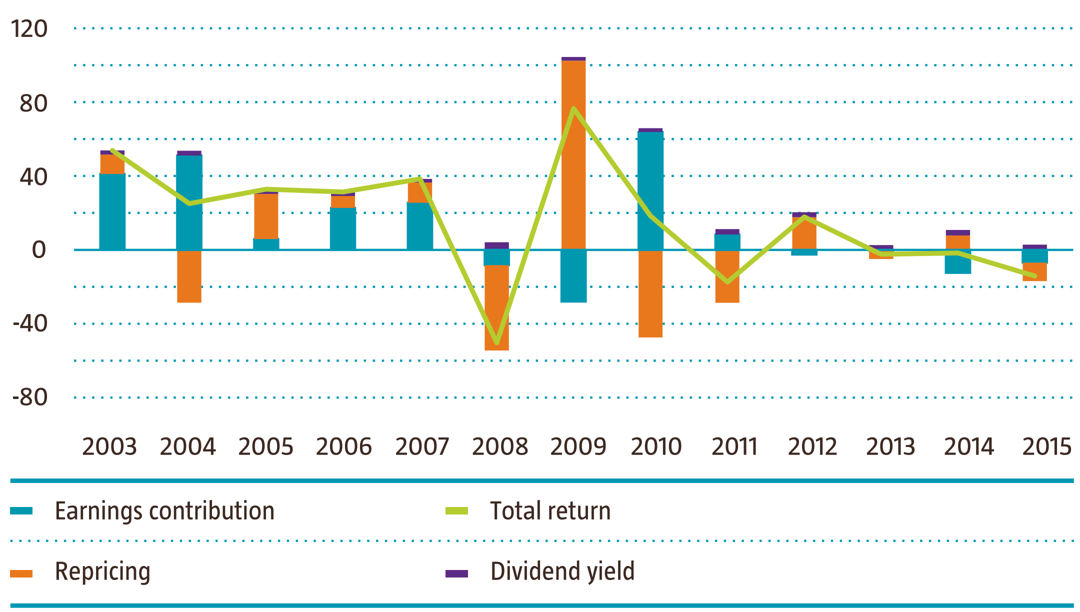
We think there could be further pressure on overall profit margins with annual wage growth around 3.5%, but we expect the main victim of the recent decline, the energy sector, to recover some lost pricing power. On balance, a more modest drop in profit margins is expected, while sales volumes are expected to improve, pushing overall earnings growth back into positive territory in 2017. These developments could validate elevated US equity valuations. Yellen hinted recently on running a 'high-pressure' economy. Higher inflation expectations, which we expect, would nuance the secular stagnation thesis and be constructive for equity sentiment as marginal investor preference might shift from nominal bonds to equities as the latter has proven to be a better inflation hedge.

The recovery of earnings in the US removes one of the bigger concerns holding back equity markets around the world. The US market is relatively expensive, something which can be justified only if there is a prospect of future earnings growth. The dynamics of stock markets outside the US are clearly different, as both European and emerging markets are cheap. One would be inclined to think that this means that 2017 has the potential to become a great year for those stock markets. Indeed it has, but the fates of these markets will be closely linked to the outcome of the various European elections, Brexit, Trump's protectionism and – most significantly for the emerging markets – China.

'The recovery of earnings in the US removes one of the bigger concerns holding back equity markets '

EMERGING FROM RECESSION

Emerging markets return decomposition – many moving parts



Source: Bloomberg, Robeco

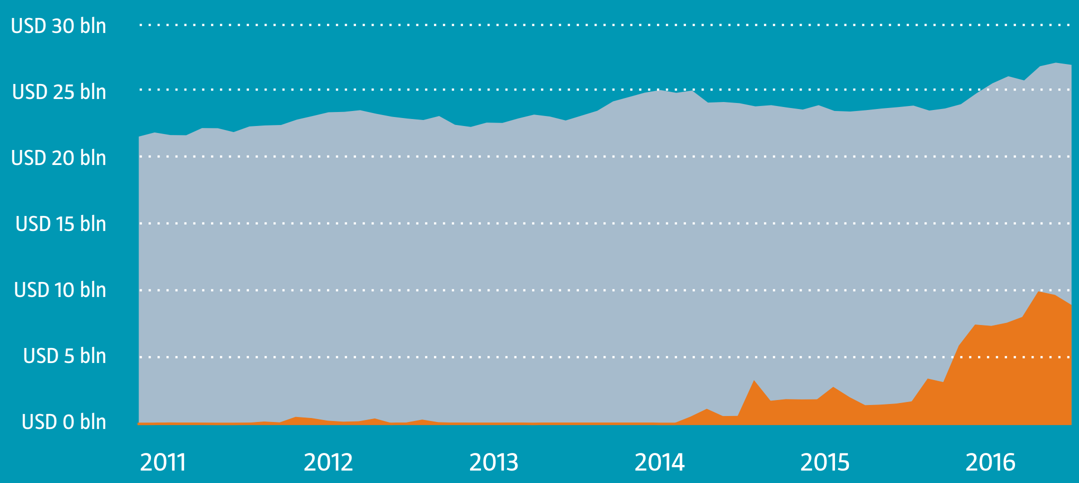
So far 2016 has turned out to be the year that emerging markets managed to buck the trend, after a five-year period of underperformance. From an unloved and underowned asset class at the start of the year, the emerging market trade rapidly became the consensus bull trade of 2016. Is this set to continue into 2017? Emerging markets are still trading at a significant discount to their developed peers, but there will probably be a pause in the rally, after which the focus will shift towards fundamentals. And here too there is reason to remain positive on the asset class. Major emerging market countries like Brazil and Russia are coming out of recession, with declining inflation rates allowing easier monetary policy. India and Indonesia have implemented reforms and will likely experience healthy growth rates.

A further catch-up in productivity growth will keep earnings growth attractive compared to that of developed markets. However, we should still expect the occasional bout of volatility; dollar strength, volatile oil prices, the threat of Trump ripping up trade agreements and (geo)political turmoil. Furthermore, China remains pivotal when it comes to emerging market sentiment. In 2017, we expect China to achieve growth that is slightly below, but close to its projected Five Year Plan growth rate of 6.5%. However, the positive effect of recent monetary stimulus will vanish in the course of 2017, while the resulting boost to credit growth in the manufacturing sector will ultimately come at the expense of future stability, a theme to which we think the market will become increasingly susceptible.

'Major emerging market countries like Brazil and Russia are coming out of recession'

YIELDS SET TO RISE... SOMEWHAT

Share of negative yielding bonds has expanded rapidly



Source: Barclays POINT, Bloomberg

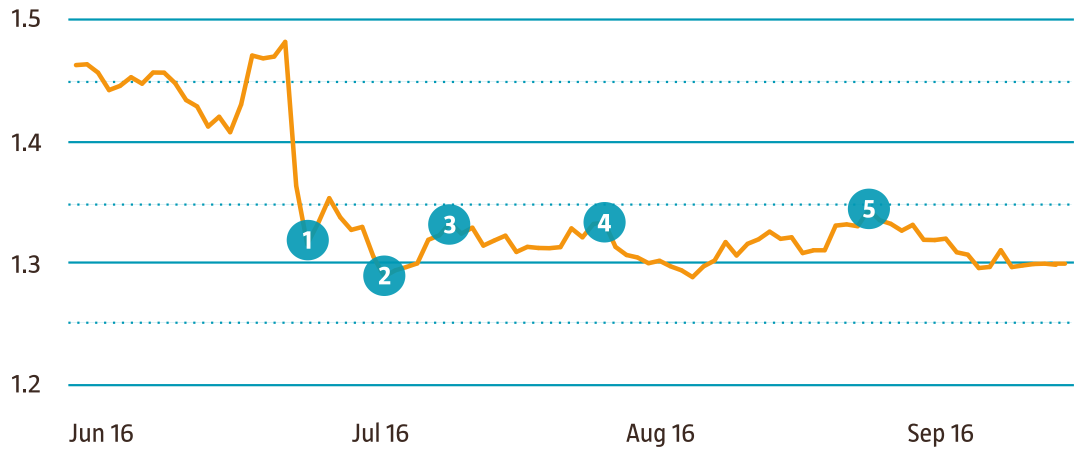
As a result of central bank quantitative easing (QE), an increasing proportion of outstanding government bonds have negative yields. Buying a bond with a negative yield suggests investors are willing to pay a premium to park their money somewhere, instead of demanding a premium as compensation for risk. This behavior may seem to imply that negative yielding government bonds are riskless. Far from it, in fact. They may provide insurance against a near-term deflation scenario, but if held to maturity, a loss is guaranteed. The interest rate sensitivity of these bonds has also increased recently as governments extend the duration of their outstanding debt. All else being equal, this means that bond prices will now react more strongly to any change in yields than they did in the past. And a warning for index-focused bond investors – lack of return does not imply absence of volatility.

So do we expect the long awaited correction in bond markets to take place next year? Much, if not all depends on central bank policy, which rests in turn on the return of inflation. As we have seen in 2016, the Bank of Japan has moved to yield curve targeting, while the ECB is still in full QE mode. Based on our cautiously optimistic outlook for the European economy, somewhat higher headline inflation around the start of 2017, and assuming that the various European elections go smoothly, speculation may soon arise as to when the ECB will initiate tapering. Although this could lead to a temporary increase in volatility as we experienced in 2015, we think that the ECB will not simply stand by and do nothing if the markets become too volatile or respond too violently, especially given the lingering geopolitical risks. European yields will therefore be limited by (potential) ECB intervention. The biggest uncertainty is what will happen in the US. If Trump succeeds in implementing a reflationary package pushing debt levels higher, US Treasuries look vulnerable. At this point in time, it is hard to judge how successful such a strategy might be. On balance, we expect yields to rise and volatility to pick up, but we think it is still too early to start talking about normalization yet.

> 'Bond prices will now react more strongly to any change in yields than they did in the past'

‘OUR CURRENCY, YOUR PROBLEM’

Sharp fall in the pound as Brexit unfolds



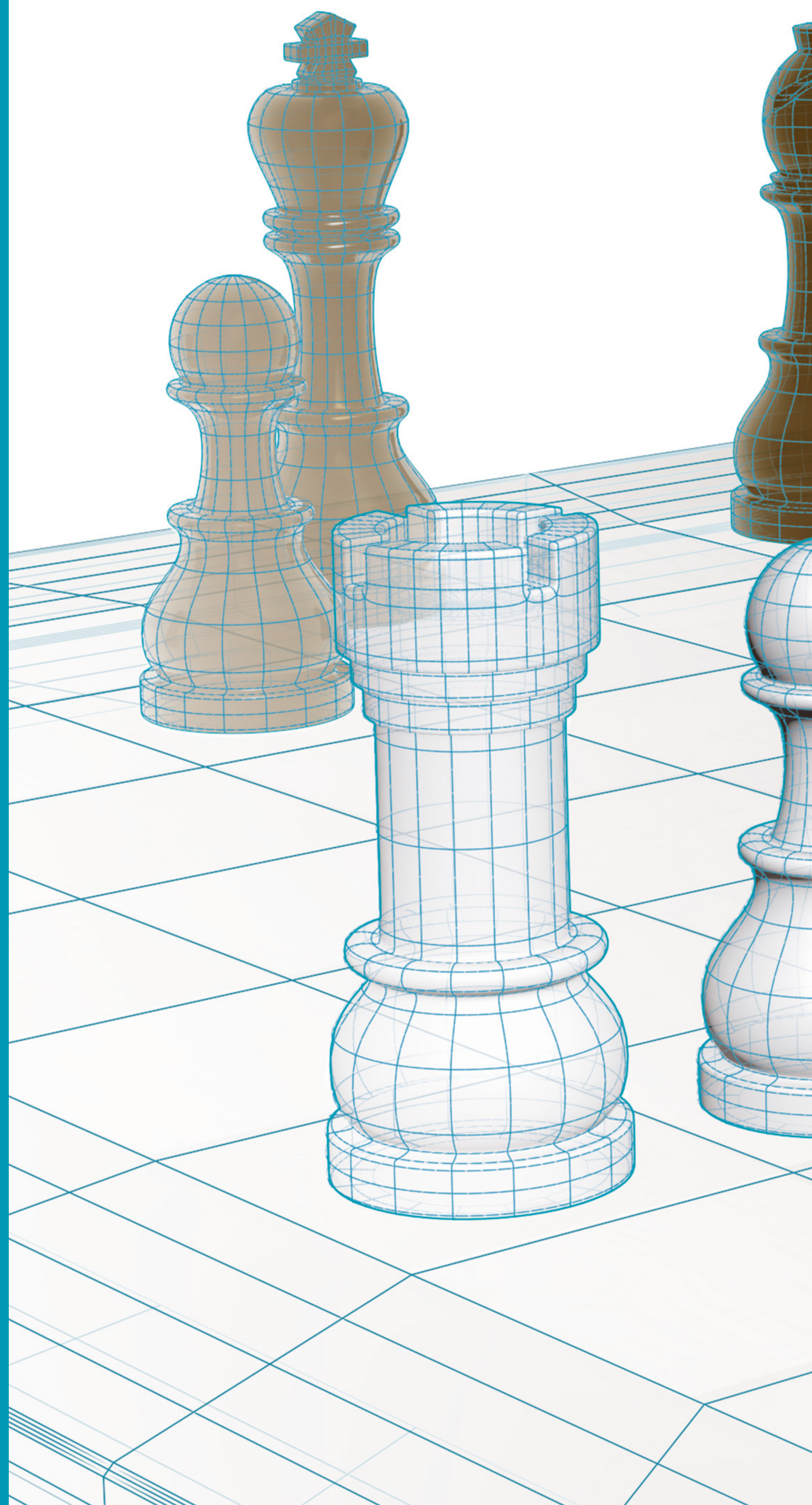
Source: Bloomberg, Robeco

1. Brexit result downs David Cameron as UK prime minister. Sterling falls 8.3%, the S&P 500 falls 3.6%, the dollar index rises 2.1% and oil falls 4.9%.
2. Pound falls to 31-year low of USD 1.2796 amid fears of financial instability, as property funds suspend customer withdrawals.
3. Theresa May becomes prime minister. Two days later, sterling rallies to USD 1.3480.
4. Bank of England cuts rates, reintroduces quantitative easing.
5. Surprise economic data damp recession fears and push sterling higher.

After the Brexit referendum the British pound weakened by about 18%, reflecting the increased risk to the economy of a possible secession from the largest internal market in the world. The British prime minister has expressed the government’s intention of triggering Article 50 of the Lisbon Treaty by March 2017, setting a two-year horizon for divorce negotiations. This is not a clear-cut step, as it may require parliamentary approval and a majority vote in favor is certainly not a given. Furthermore, it is unclear if certain parts of the UK (like Scotland) will be able to veto. The situation will remain highly uncertain, which will dampen foreign investment in the UK. Given the very sizable current account deficit, it is clear that this lower level of foreign investment will continue to keep pressure on the British pound.

A more direct impact is expected to come in the form of an expected rise in inflation, linked to the sharp depreciation of the pound. It looks as if the UK will become the only major economy in the world with inflation exceeding its target for 2017. Workers won’t generally be fully compensated, with companies citing ongoing uncertainty as the reason. Rising inflation limits the Bank of England’s room to maneuver. All in all, even though the UK economy hasn’t fallen off a cliff – as some seemed to expect it would – it is clear that we have yet to face the real pain of a Brexit. The UK economy will show markedly lower growth in 2017. Will there be spillovers to the rest of Europe? Apart from the fall-out due to a decline in domestic demand, the more direct impact will be via the exchange rate: UK exporters will be able to compete more aggressively. To compensate for this, European investment may be diverted towards other countries, which should help to partially compensate for the softer UK growth outlook.

‘It is clear that we have yet to face the real pain of a Brexit’



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