

OUTLOOK

For professional investors
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ROBECO
The Investment Engineers



Fixed Income Outlook Q3 2016

Yield drought & bond scarcity: Where to invest?

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Summary: Our key themes

- *Low growth, low inflation*

The world economy is characterized by sluggish growth and absent price pressures. Notwithstanding unprecedented stimulative monetary policy around the globe, inflation expectations as measured by market indicators have declined further. In this environment bond yields have set new historical lows and can continue to do so. Central bank buying programs add to the picture as bond scarcity in core government markets increases downward pressure on interest rates.

- *Preference for long dated bonds in US and Eurozone*

As prospects for (further) rate cuts in the US and the Eurozone are slim, long dated bonds remain our favorite. In the US the 30-year yield is approaching the 2% handle. The US money market curve no longer discounts any rate hike for the next two years. From a risk/reward perspective, most value is in long dated US Treasuries. In the Eurozone we expect the 30-year segment in Germany to benefit from further ECB policy measures (see our *In Focus* contribution below)

- *Brexit favors UK Gilts*

The surprise outcome of the Brexit referendum is bullish for UK Gilts. Business and consumer confidence in the UK will tumble. The Bank of England is expected to cut rates and potentially restart Quantitative Easing (QE). The UK Gilt market will converge to the

Eurozone bond market dynamics, having shown more parallels with the US Treasury market in recent years.

- *Be selective within credits: focus remains on Europe and subordinated financials*
 As the credit cycle is maturing, leverage is rising, especially for US companies. This calls for a cautious stance. We favor the European corporate bond market, more specifically subordinate financials. Brexit fears and worries about the Italian banking sector have pressured this segment year to date. We believe current valuations offer enough protection. The ECB corporate bond purchasing program will have positive spill-over effects also for this specific sector.
- *Constructive on emerging local debt*
 The star performer of the year has further to go. The imminent threat of a Fed rate hike has disappeared for now. This enables investors to focus more on the attractive yield differential compared with developed markets. Fund flow information underlines that appetite for this battered sector is gradually coming back.

Main views

Main asset categories	Total	Valuation	Technicals	Fundamentals
German Bunds	0	--	+	0
US Treasuries	0	-	0	0
JGBs	--	--	+	-
IG Credits	0	0	0	-
High Yield	-	0	-	-
EMD local debt	+	+	0	-
Euro peripheral debt	-	-	0	-

In focus

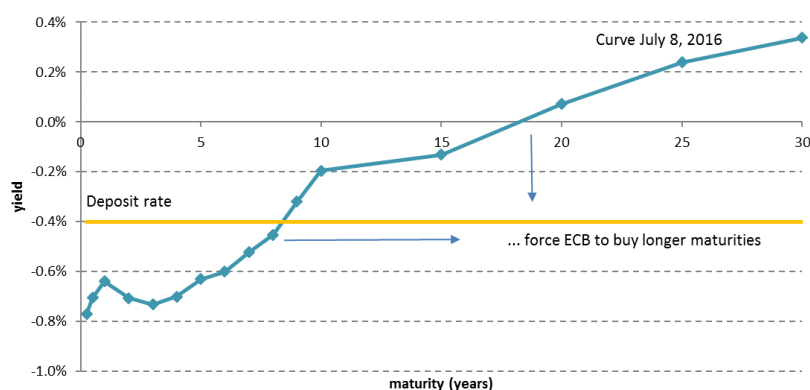
ECB bond buying drives long-end yield curve flattening

In the Eurozone, the rules of the ECB's QE program are forcing the ECB to buy long-end bonds only. The deposit rate rule only allows the ECB to buy bonds with a yield to maturity higher than the deposit rate, i.e. minus 0,4%. With declining interest rates, more and more bonds trade below the deposit rate, making them ineligible for the ECB to purchase. In practice it means that since the start of June, the minimum maturity that can be bought moved from 5 to 8 years in Germany (see picture below). This also has a second round effect: with a decreasing pool of purchasable bonds more needs to be bought per bond to get to the required monthly target of EUR 80 billion. As a result, one of the other rules of the program becomes increasingly pressing: the maximum percentage that may be purchased per outstanding bond. This limit, also known as the issue limit, is set at 33%.

Without changes in the parameters of the purchase programs, we think that the ECB will struggle to buy government bonds in both Germany and the Netherlands around year end. The ECB has options to increase the issue limit for bonds issued before 2013 to e.g. 50% or more. This will give the ECB leeway to continue buying for one or two more quarters. And since these older bonds are mostly concentrated in the long end of the curve, the ECB will again focus buying in that part of the curve.

An alternative 'nuclear' option to address the scarcity issue is for the ECB to give up on the capital key rule. Currently the government bond purchases are split across the Eurozone countries according to the capital key weights. The key is calculated according to the size of a member state in relation to the European Union as a whole, size being measured by population and gross domestic product in equal parts. Changing the purchasing basket according to e.g. debt outstanding (market capitalization) would hugely favor Italian bonds at the expense of German bonds. Italy's outstanding public debt is higher in nominal terms whereas the economy is smaller. We regard this option as politically highly controversial for now. It would be a step closer to Eurobonds. However, in the context of an existential threat to the euro system (Brexit, meltdown Italian banking sector) nothing can be excluded.

Figure 1 | German government bond curve: universe shrinks with decreasing yield



Source: Bloomberg, Robeco. Yield curve as per July 8, 2016

Treasuries

Valuation: the Japanification of the UK Gilt market is in the making

Money market curves have priced out any monetary tightening for all developed markets, including the US. In most countries further easing is now being discounted. Central banks of the UK, Norway, Australia and New Zealand are all expected to deliver one or more rate cuts this year. Forward curves analysis shows US and German bond yields rising only marginally, with 15 and 7 basis points respectively on a 12-month basis. Therefore, any buffer to compensate for capital losses due to interest rate rises is minimal. But then again, new lows in bond yield levels continue to be established around the globe. The Japanification of debt markets already reached the Eurozone and Switzerland. Currently the UK Gilt market looks to be next in line. And ultimately the US Treasury market might be a suitable candidate. In these uncharted waters traditional valuation metrics have to be treated carefully.

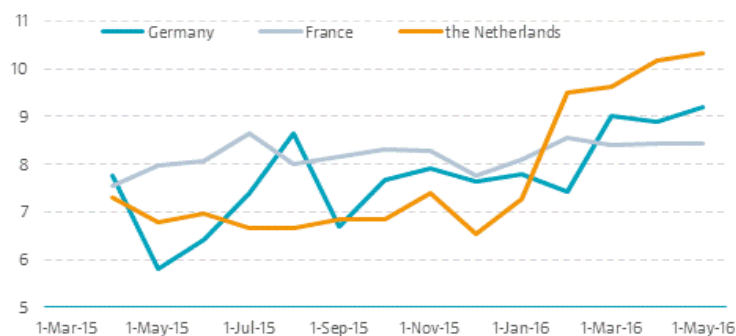
Technical: bond scarcity becoming an issue for central banks

Currently the Bank of Japan (BoJ) owns roughly 30% of all outstanding government debt. At the current purchasing pace, about 10% is added to the existing stock on a yearly basis. This clearly shows that the current program cannot continue indefinitely. Speculation about further stimulus by the BoJ faces practical constraints. The ECB faces similar challenges. Changing the rules might be the only way to make sure the pool of purchasing bonds for e.g. German government bonds remains sufficient. Already the ECB is forced to increase the weighted average maturity of purchases for selected countries (see picture below).

Fundamentals: watch US jobs market data

Will US payroll growth keep up to back consumer spending? Not much is expected from investment or export growth. As wages are rising and productivity growth is lagging, risks are that US companies will cut back on hiring at some stage to shore up corporate profitability. The July reading on payrolls growth showed a comeback after weakness in the months before. If the labor market turns, the recession risk for the US becomes real. For the eurozone economy assessing the Brexit impact will be key. Only 3% of Eurozone exports go to the UK. Indirect transmission channels are more important here; business confidence can take a hit. Meanwhile deflationary risks are still looming for the region. Even though the ECB crossed another Rubicon when starting buying corporate debt, the market's inflation expectations continue to fall.

Figure 2 | Weighted average maturity of purchases in years for selected countries



Source: ECB, Robeco

'Practical limitations of central bank buying programs are in sight.'

Credits

Valuation: average at best

Credit spreads were not immune to recent events like the UK EU referendum, but the overall spread change was moderate and mainly impacted banks. We keep our neutral assessment for valuation. Admittedly, with the ever lower or even negatively yielding government bonds, any yield pick-up may seem attractive. The yield on the European investment grade (IG) corporate credit index is now just below 1% and US corporates yield around 3%. US high yield (HY) is yielding close to 7%. Yield hungry investors might flee into these markets. Adjusted for leverage, spreads are at long-term averages at best though and leverage is increasing both for IG and HY. More than 10% of the euro corporate market, an equivalent of more than EUR 200 billion, already trades at negative yields and 50% has a yield of less than 0.5%.

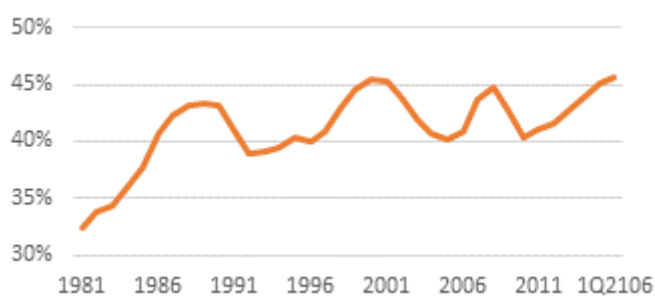
Technical: more buying, but more issuance as well

After a slow start of the year, demand for credits increased in the second quarter, bringing year-to-date fund flows into positive territory. On top of that the ECB started buying euro denominated senior non-bank bonds in June under its Corporate Sector Purchase Program. First indications show the ECB buying at the high end of expectations. Although not all bonds are eligible, the buying program remains a positive technical for now. The counterargument is the strong pick-up in issuance though, both in the US and in Europe. In Europe, about any non-bank can issue euro senior debt that is ECB eligible given its loose buying criteria. The average maturity of new issues is increasing in Europe, more bonds with 10+ years to maturity are issued.

Fundamentals: non-financial corporate debt at record high

One of the main fundamental concerns that makes us cautious towards credits is the strong increase in corporate debt. In the US the rise in leverage is broad based, in Europe it is still mainly concentrated in a few sectors, but the trend is also deteriorating. S&P reported that total debt for 2,000 rated corporates increased by roughly USD 850 billion in 2015 to USD 6.6 trillion. According to Fed data total non-financial corporate debt amounts to 45% of US GDP, the highest in history. The percentage of IG corporates with a year-on-year increase in leverage is 60%, within high yield 50%; both are near peak levels. The last time it surpassed this level was in 2009/2010, at that time mainly due to a strong drop in EBITDA. This time debt is growing and EBITDA is not, not a good combination!

Figure 3 | US corporate debt versus GDP



Source: US Federal Reserve, Bloomberg, Robeco

'US
Companies
are leveraging
up.'

Emerging (local) debt

Valuation: longer term undervaluation still in place

Compared with developed country bonds and foreign exchange rates, emerging local bonds and currencies continue to look relatively cheap. The renminbi remains the exception as it remains overvalued on several measures. However, the very limited openness of the Chinese capital account means that this is unlikely to adjust in the very short term. Yield levels for the universe as a whole compare favorably at around 6.5%. The improvement in external conditions identified last quarter has continued. The US Federal Reserve confirmed its more dovish stance and the market has subsequently priced out the chance of a rate hike this year. The Chinese authorities continue to inject policy stimulus as a means to achieving their 6.5% growth target for 2016, while at the same time keeping their capital account closed. This sustains their ability to manage the level of the renminbi and interest rates.

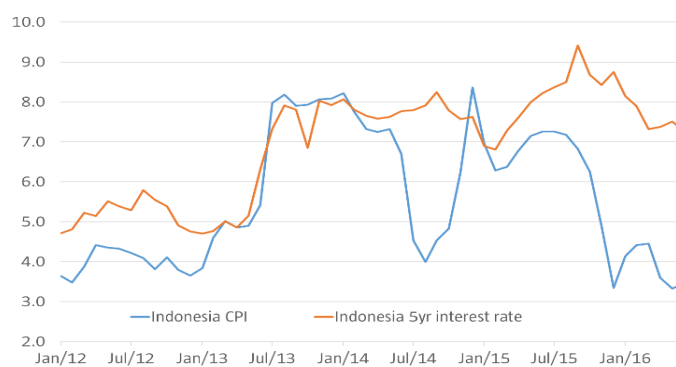
Technical: inflows continue, positioning is now more neutral than in early 2016

The outperformance of emerging local bonds over other fixed income asset classes over the last quarter has encouraged inflows from investors chasing returns. This in turn has encouraged fund managers to reduce cash and cover underweights in higher risk countries like Turkey and South Africa. Continued quantitative easing from the BoJ and ECB and the associated increase in the numbers of developed country bonds with yields below zero, underpin this flow of funds into emerging markets as investors reach for yield.

Fundamentals: signs of improvement, but medium-term challenges remain

Emerging markets continue to diverge from a fundamental perspective, and making statements about the asset class as a whole is potentially misleading. The external impulse from core countries for emerging economic activity has been mixed over the quarter, and will likely remain so over the coming quarter, as Chinese economic activity recovers and the US stabilizes. In aggregate emerging countries continue to show marginally stronger economic growth than developed countries. Inflation in the meantime declines. The overall firming in commodity prices during the past quarter has provided a tailwind for commodity exporters, whose current account positions are now in an improving trend.

Figure 4 | Indonesia's drop in inflation leaves room for more easing



Source: Bloomberg, Robeco

'Dovish turn
US Fed
supportive
for the asset
class.'

Portfolio positioning

Highlights Robeco Global Total Return Bond Fund*

- *Duration:* The portfolio's duration is 6.1 years. The bulk of the interest rate exposure is concentrated in USD and EUR securities; recently exposure was added in the UK Gilt market.
- *Yield curve:* There is a clear preference for longer dated securities in both Europe and the US. In the Eurozone the 30-year segment in Germany is our favorite bucket.
- *Credits:* The fund has a preference for European subordinated financial bonds. The exposure equals 8% of the portfolio. Most of these holdings are lower Tier 2 and investment grade. The overall exposure to the most deeply subordinated financial bonds, AT1s and/or Cocos, is below 2%. The overall credit risk is reduced by using European and US investment grade corporate credit derivative indices.
- *EMD:* The overall allocation to emerging local debt equals 5% of the portfolio. A position in Mexico was sold in the past quarter.
- *FX:* The exposure to emerging currencies (5%) is held against short positions in both euro and US dollar. More than 96% of the fund is denominated in the fund's base currency.

Highlights Robeco All Strategy Euro Bonds*

- *Duration:* The portfolio's duration is 7.3 years, of which 0.15pd is in the US and 0.3pd in the UK, against 6.8 years for the Barclays Euro Aggregate index.
- *Yield curve:* There is a clear preference for longer dated securities in Europe. In the Eurozone the 30-year segment in Germany is our favorite bucket.
- *Credits:* The exposure to cash credits is 27.6% with an additional 5.8% in European asset-backed securities (ABS). The overall credit risk is reduced by using European and US corporate credit derivative indices. The fund has a preference for European subordinated financial bonds. The overall exposure to this credit market segment amounts to close to 6%. The majority of these holdings is lower Tier 2 bank (3%) and dated subordinated insurance instruments (1.6%) and investment grade. The overall exposure to the most deeply subordinated financial bonds, AT1s and/or Cocos, is below 1%.
- *Euro peripheral government debt:* The overall exposure to peripheral government debt equals 9% of the portfolio, divided over exposure to Italian and Spanish government bonds. Recently the exposure to peripheral treasuries was increased. The positions in the periphery are skewed to maturities above 5 years.
- *FX:* There is no currency exposure other than to euros.

*Positions as of June 30, 2016

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