



Global Fixed Income Macro Outlook

The inflation game

- Central banks are increasingly prioritizing the control of inflation
- Q1's energy and food price shock has evolved into a rate and VaR shock...
- ...meaning cheaper valuations before H2 opportunities in credit and rates

Summary

From the unenviable...

Last quarter, we discussed in "[Czech Mate](#)" that central banks faced an unenviable dilemma amid higher and more persistent inflation, following the Russian invasion of Ukraine. We used the chess phrase "Zugzwang" (a situation where the obligation to make a move in one's turn is a serious and often decisive disadvantage) to describe their fix. Yield curves had begun to invert, beginning in countries where central banks grasped the inflation problem faster, such as Czechia, moving across CEE curves, to the UK and even the Korean swaps curves. Since then, the US Treasury curve has joined the inversion club (as the 2s10s spot curve followed inversions already seen in Eurodollar and swap curves). After brief relief in May, US 2s10s has now inverted once again amid rising bond market volatility in June.

...to the inescapable

As for chess, it seems that many central banks have now resigned on the question of growth, prioritizing the need to bring inflation down to target. Increasingly, many accept that a process of demand destruction – with its inescapable recessionary risks – is a price that needs to be paid for the

Outlook

For professional investors
June 2022

Robeco Global Macro team

Jamie Stuttard, Michiel de Bruin, Bob Stoutjesdijk, Rikkert Scholten, Martin van Vliet, Regina Borromeo, Stephan van IJendoorn, Rogier Hoogeveen, Philip McNicholas

sake of future consumer prices we will all pay. They are now determined to win the inflation game.

3D games

Some games, however, are simpler than others. Whereas the Fed face a two-dimensional challenge of sacrificing growth on the Volcker-esque altar of inflation control, for other central banks, the challenge appears in 3D. The ECB for instance also have to play the anti-fragmentation game, as the stresses of tighter monetary policy reawaken concerns over periphery debt sustainability, bringing back the ghost of crises past from 2020, 2018 and 2011-12. The ECB now have five weeks to design a legally compliant, market-effective crisis tool to once again save an ever-more indebted periphery. For the PBoC, there is the macroprudential game, given the extreme level of corporate sector debt and large and growing cracks over the past year in real estate, besides lingering Covid challenges. The BoJ face a unique mix of macroprudential risk and JGB market liquidity, amid the traditional face-off between central bank market pegs (in this case the peg of yield curve control) and market forces, as their prevailing policy is now openly questioned.

‘In only one week, the Fed has delivered the largest rate hike since 1994, the Swiss National Bank have hiked 50 bps, and the ECB have felt compelled to hold emergency meetings before even executing their first rate hike in eleven years’

A prolonged taper regime

With inflation broadening – across CPI basket items, and countries – and with the year-on-year peak still elusive despite favorable base effects, relief from aggressive rate rises, and the associated market volatility, still seems far off. In only one week, the Fed has delivered the largest rate hike since 1994, the Swiss National Bank have hiked 50 bps, and the ECB have felt compelled to hold emergency meetings before even executing their first rate hike in eleven years.

For bond markets, this means we remain in the ‘taper regime’ that has dominated H1 2022, whereby real yields rise at the same time that credit spreads widen, and with a stronger dollar to boot. In recent times, a positive correlation between government yields and credit (i.e. yields higher, spreads wider) was previously only seen for a matter of one or two months (the taper tantrum of May-June 2013, the Bund tantrum in April 2015, or the brief but sharp US credit sell-off in Q4 2018). 2022 has offered a much more prolonged period of taper regime, not seen

since the 1970s. We noted in late 2021, in “[Pricing sigma](#)”, that volatility was picking up, “after nearly a year and a half of an expensive and generally dull landscape in fixed income, with opportunities mainly on the short side”. Well, say that again. This means still few places to find shelter in bond markets on the long side, other than perhaps Chinese government bonds, amid deeply negative benchmark, passive and ETF returns. It also means a need in our view to remain patient and judicious about when to get long each of rates and credit. The good news is we think we will see nominal bond coupons at among their highest for more than a decade before the year is out and, with each week of abrupt moves, the necessary repricing is underway.

For the Fed, 75 is the new 25

At the start of 2022, the Fed dot plot anticipated just 4x25 rate hikes for a total of 100 bps for the year. As of 20 June, we have already had 150 bps delivered and, with a potential 1x75 and 1x50 at the next two Fed meetings, Fed funds could easily be at 3% by the end of September. Once Fed funds rates are higher than 2-year Treasury yields, another current red light for duration longs could – in due course – be turning amber to green.

Recession is now odds on

We discussed rising recession probabilities three months ago already, noting the [timely work](#) of Larry Summers and Alex Domash of the Harvard Kennedy School of Government in being among the first we know of in this cycle to point out the high probability of recession when inflation is way above central bank targets at the same time that unemployment is below the NAIRU. At our quarterly we heard from Deutsche Bank’s Peter Hooper and HSBC’s Stephen King, among others. Hooper in particular concurs with Summers’ compelling historical evidence that the space for a soft landing for the Fed is slim indeed (as an aside, we liked the experience of all our guest speakers this quarter and particularly enjoyed listening to someone that worked at the Fed under Arthur Burns in the early 1970s).

Who can keep dancing?

One view that seems prevalent in markets currently is the idea that recession is still a few years out, based on the lags of monetary policy, strong prevailing growth, high household cash savings, low unemployment and the traditional time lags from yield curve inversion to NBER recessions – and as such, to quote Chuck Prince, the music is still playing and risk takers should still dance. While appreciating different scenarios, we would make eleven points:

1. Monetary policy indeed has lags but the interest rate-sensitive housing market in the US is already starting to crumble given that higher mortgage rates for marginal new buyers are immediately impactful (and as a market

rate, they do not have to wait for the central bank to move).

2. 2022's food and energy price shock, which is of historical proportions, is already hitting consumer wallets. Record crack spreads, a distillate shortage in Europe and a terms of trade shock in EM, the Far East and much of Europe mean the reality is far worse than a crude Bloomberg WTI chart.
3. While new orders were robust earlier in 2022 after two years of Covid disruption, these can evaporate fast, should business confidence start to turn.
4. The help from high household cash savings is, we think, an illusion from the Fed Z1 aggregates, and the true picture is better gleaned from income cohort analysis. Relatively few households have very high cash savings; many have a lot of debt. A majority of households therefore do not enjoy substantial savings, as the Pew Research Center studies [show](#).
5. From a credit strategy perspective, low unemployment rates, below the NAIRU, are a very-late-cycle indicator, auguring short positions in anticipation of wider spreads.
6. Be careful on timing: NBER recessions are determined by the Business Cycle Dating Committee long after they begin (quarters or even over a year after). Reality occurs before confirmation.
7. Equities fall before recessions occur: our job is to position ahead of market prices, not GDP.
8. Credit spreads often widen before equities fall.
9. Those still dancing, as Chuck Prince infamously intoned in July 2007, may find that when the proverbial music stops, so does liquidity. Abruptly. This means prepositioning rather than reaction is necessary, before the crowd consider the same, given most clients, managers and business models tend to run structural overweight credit and risk positions.
10. The UK may already be in a quarter of growth contraction as we speak.
11. The continued drop in the Atlanta Fed's GDP Nowcast towards zero, suggests that even the US may be in technical recession this year (albeit with some inventory funnies and trade data making for lower GDP outturns than underlying demand).

Market price action in early June, besides the year to date, suggests the pendulum of opinion is starting to move, with many market participants now scrambling to wake up to the above eleven risks – and others. For too long, amid too much cheap money, many investors have blindly chased returns in cryptocurrencies, SPACs and all manner of the latest bull market synthetic product creations, reminiscent of investment trusts of the late 1920s, profitless dotcom stocks of the late 1990s or CDOs of the pre-2008 era. The profitless and questionable were awarded extraordinary,

but historically all-too-familiar, valuations. That is now changing. But it does not yet mean that recession is priced.

Recession gameplans

We do not yet think recession is priced into high yield spreads, for example. At a US high yield OAS of just over +500 (from only +300 OAS as recently as December), a still-insufficient amount is priced in terms of potential default rates and liquidity premia, compared to prior recessions. Similarly, US investment grade spreads of +150 suggest something closer to a mid-cycle hiccup, not the fallout of the sharpest hiking cycle and highest inflation shock in the past forty years.

As for duration, a recession would bring opportunities from the long side, as markets eventually price out rate hikes and central banks start to cut. However, what may transpire into 2023 may be different to the post-1982 period, when as investors we could rely in each recession on the Fed cutting rates by 500 bps to zero, creating massive and highly rewarding bull-steepening home-runs in fixed income. This time round, yield curve inversions may be deeper first as central banks grapple with record-low real rates. Should inflation not ease immediately at the same time that growth contracts (the UK, for example, may well see growth contraction amid double-digit inflation), the path for falling yields is more compromised. In the meantime, patience is required. Premature attempts to get long duration can run into aggressive mark-to-market losses.

From zugzwang to the inflation game

As we wrote in March, "Critically, from current levels of inflation, the Fed has never tightened just enough to make inflation come back down to target without causing a recession. Commodity strategists already talk of 'demand destruction' as the central scenario for wheat and energy prices to come back down in due course. For the likes of Fed Chair Powell and the BoE's Governor Andrew Bailey, who are facing an unwelcome policy version of *zugzwang*, the path shown by CEE curves and the historically unlikely challenge of pulling off the feat of dampening inflation without causing recession, it might just be Czech mate."

Fast forward to June, we stand by our words. We note the Fed, the BoE and a growing number of central banks have now given up on the game of trying to save growth. Controlling second-round effects and inflation expectations is the priority now, while growth is the casualty: the next chapter of 2022 is the inflation game.

Contents

Macroeconomic and policy outlook	5
Rates strategy	7
Fixed income asset allocation	8

Macroeconomic and policy outlook

- Consensus view of soft landing over the next 12 months seems too optimistic
- G3 inflation may peak later this summer but uncertainty on where it will settle
- Monetary tightening dominates for now – until recession or a retreat in inflation

Growth outlook: R you ready?

The effects on supply chains, commodity markets and inflation resulting from the tragic war in Ukraine continue to adversely impact the global economy. First and foremost are lower-income countries, where food and energy prices account for a large share of household expenditures, as the World Bank recently warned. But even in developed economies, the shock to real incomes (almost) matches that seen in the early 1970s. This, coupled with the sharp tightening in financial conditions ensuing from expectations for further central bank tightening in the face of inflation pressures, all besides the fragile China macro backdrop, implies a real risk of recession in our view.

Economic activity, in particular in services, is still being propped up by the post-Covid-19 reopening across many countries. Moreover, replenishment of low inventories in segments of the European manufacturing sector, could provide some near-term support to industrial production, supply bottlenecks permitting. On top of that, fresh fiscal stimulus has been unleashed in China, while in Europe talk about additional fiscal measures to curb household energy bills is gaining traction. The UK's attempts to recoup fiscal receipts via higher national insurance contributions this year has dissolved amid help for poorer households via energy subsidies. Even in the US, our understanding is that the fiscal stance by local and state governments could loosen somewhat.

'We can't help but suspect that the consensus view for subdued recession probabilities over the next 12 months is too optimistic'

Yet, we can't help but suspect that the consensus view for subdued recession probabilities over the next 12 months is too optimistic. To be sure, despite the noticeable slowdown in US housing – which tends to be early cyclical – we see a bigger recession risk in parts of Europe, where the tail risk of possible (further) disruptions to imports of Russian gas still

lingers. In China, where most of the fiscal stimulus has focused on boosting production, we still see little sign of improvement in underlying consumer spending and housing demand amid lingering Covid-19 uncertainty. It seems the rest of the world cannot rely on Chinese growth to the extent they have been accustomed to since 2009.

Obviously, aside from the *odds* of recession, one needs to factor in the *severity* and *length* of any downturn as well. Here there are reasons to be less worried than in 2007 (e.g., less-fragile banking system and household finances – outside of lower-income cohorts). That said, the room for maneuver for central banks to provide easing in case of recession seems smaller – and may not fully open up until inflation meaningfully retreats. Moreover, after many years of QE, the impact through a repricing of financial market assets could be more substantial than 'normal'. For markets, with high inflation and interest rate volatility, it may not even really matter: year-on-year changes in nominal GDP stayed positive for all of the 1970s, yet that decade saw far more severe credit bear markets than the 50s, 60s, late 80s or 90s.

Inflation: descent may matter more than peak

With food price inflation surging and many commodity prices showing little sign of real retreat, financial markets have once again pushed back the anticipated peak in headline inflation to later this summer, be it in the US, the Eurozone or the UK. In Europe, the subsequent descent may be slow and initially look more like plateauing, keeping central bankers fretful about inflation expectations becoming unanchored from inflation targets.

We drew the latter conclusion recently at the second annual edition of our *Inflation Day*. Further takeaways from the various sessions, which focused on (i) supply chain disruptions, (ii) the interaction between wages and inflation, (iii) the inflationary effects from globalization and de-globalization, and (iv) the impact from the energy transition, can be found [here](#) and [here](#). We also concluded that uncertainty about where inflation will settle is likely to remain elevated in the coming quarters – hence supporting

inflation risk premia embedded in bond yields for the time being. We think wage pressures in the Eurozone, albeit catching up, are likely to remain relatively more contained than in the US and the UK. But it's also clear that the national origin of inflation (be it overly easy US fiscal policy in 2020, or food and energy shocks from Russia/Ukraine) doesn't matter much. In global markets for goods and commodities, and with central bank hikes leading currency moves (creating imported inflation for those on the receiving end of terms of trade shocks), the misery of inflation is quickly and broadly shared by many channels, as the Bank of England's Catherine Mann recently [concluded](#).

In parts of EM, the challenge for central banks to get inflation under control still seems at least as sizeable as in DM, especially in CEE. Meanwhile, in China and parts of Asia, inflation pressures have remained much more subdued, due to, among others, cyclical reasons, a smaller price impact from logistics disruptions, and stronger government price intervention. However, surging food price inflation implies that many Asian central banks (bar the PBoC) might soon be forced to spring into action or step up action.

Underlying inflation pressure has remained subdued in Japan. But yen weakness is amplifying imported inflation, suggesting that over time even Japan may not fully escape the global inflation wave.

Fiscal & monetary policy: tightening dominance

Even as fiscal policy easing initiatives have been taken across many DMs to curb soaring food and energy costs, the fiscal *impulse* – which measures the change in incremental support – generally remains in negative territory. This is notable in the US and the UK, but less so in the Eurozone – due to ongoing support from the NextGenerationEU recovery fund. In China, the impulse has turned positive, even though the stimulus seems more beneficial for production than consumer spending. Looking ahead, if recession would indeed hit, we suspect that calls for fiscal policy loosening would generally grow quickly.

Central bank *balance sheet* policies, by contrast, might struggle to turn supportive again anytime soon. With inflation closer to 10% than 0%, markets may need to unlearn much of the past decade of easy QE responses to needy market tantrums. Many G10 central banks, including the RBNZ, BoC, BoE and the Fed, have embarked on a path of quantitative tightening (QT), i.e. starting to reduce their bond holdings. According to the Fed's own calculations, the current QT trajectory will equate to around a cumulative 50 bps of policy rate tightening. Even the SNB recently surprised markets by suggesting it could sell some of its FX

reserves if needed to help tame inflation pressures. Highlighting its outlier western status, the ECB is only now about to end the expansion of its QE bond portfolio. And it does not seem intent on following other banks into QT anytime soon.

Rate hikes are the main channel through which central banks across DM and EM are now trying to rein in inflation pressures. Some early movers such as the BoE have managed to stick to 25 bps moves (for now). But some like the RBNZ and BoC have been forced to resort to the larger-sized moves currently taken by central banks that started hiking later, such as the RBA and the Fed – with the latter having embraced the jumbo, 75 moves seen in the EM space. While the ECB is intent on kicking off its hiking campaign in July with a 25 bps move, it does seem likely that by end September, the ECB depo rate (which is currently at -0.50%) will be back in positive territory. A rate hike by the BoJ does not yet seem to be on the horizon – a first step later this year will likely be to widen the band at which it allows the 10-year yield to move around its 0% target under its yield-curve control (YCC) policy, from 25 bps to 50 bps.

With the lingering threat of inflation expectations becoming unanchored from central bank inflation targets, we understand why front ends price in a series of >25 bps-sized steps across many markets. Still, we do see a risk of hiking cycles getting pausing or aborted further out, especially in Europe, as recession risks mount or materialize and as signs emerge of a long-awaited inflation retreat.

Rates strategy

- Investigating long duration signals, after the jump higher in rates
- History suggests second-to-last hike is a powerful signal
- Still in some flatteners, but bias less pronounced now

Investigating signals to buy duration

Yields of 10-year developed market government bonds have risen anywhere between 150 bps (UK) and 250 bps (Australia) since the start of the year. This obviously raises the question whether now is the time to go overweight duration. Analyzing a set of indicators that potentially could flag a cyclical peak in yields, led us to the following six conclusions:

1. The peak in headline inflation is far from being a perfect indicator for a peak in yields. It worked to some degree in the 1970s, but in general the lead-lag times can be substantial, making it too imprecise as a micro-timing signal.
2. The peak in core inflation is an equally unreliable indicator, with similar lead-lags.
3. The interest rate sensitivity of economies – the point at which market interest rates bite and cause slowdown and recession – is contingent on the size of the debt stock in the economy across households, corporates and governments. We find that the US and China already seem close to the danger zone.
4. The second-to-last Fed rate hike is a more reliable indicator. US 10-year yields often peak very close to this point in the tightening cycle. This response has been consistent for at least five decades. The snag is that it is only truly known ex post.
5. German 10-year yields often peak closely after the cyclical high in US Treasury yields.
6. Across a range of markets, 2s10s curve inversion has been a powerful signal for an outperformance of 2-year notes. Note that, for this particular analysis, we looked at 2-year yield levels versus their respective forwards 12 months earlier, rather than a peak in yields. We find that the outperformance of 2s did not necessarily materialize in the first three months after the 2s10s inversion. For the US, where we have a long history of data, this strategy worked well in both the post-1985 interest rate regime, as well as the regime of the 1970s (albeit after deeper curve inversions). The two days of US 2s10s curve inversion in early April are for now the main signal suggesting we could start considering long positions in the front end of the US curve. But we are aware that other cash government bond markets have

not reached that point yet and, as mentioned, results from this signal can be more mixed in the first months after inversion.

7. The level of 2-year yields falling below their respective official central bank rates could be an indicator to watch. Initial analysis suggests this could be an important confirmation of other, possibly earlier signals, once a rally in 2s is already underway.

Most developed market central banks have started hiking rates and many are increasingly front loading their tightening steps. This suggests that in some markets we could well be approaching the second-to-last hike toward the end of Q3. Still, we do acknowledge that sustained heightened inflation risks could continue to extend hiking cycles.

In global rates markets we hold on to our preference for Chinese government bonds, with the PBoC being an exception in a central bank landscape that is dominated by rapid tightening. Japanese government bonds are our most preferred overweight, as we expect the BoJ ultimately to give in to pressures to loosen their control over the yield curve and we view pricing as asymmetric. (Put another way, the target band for the 10-year yield doesn't look like it will be *lowered*.) On curves, we continue to prefer flatteners in German Bunds and Australian government bonds. On the US curve, we have closed flatteners and opened a butterfly strategy, being long the 5-year point and short 2s and 10s.

Fixed income asset allocation

- Investment grade and high yield spreads wider but not yet fully pricing recession
- EUR swap spreads still the most attractive fixed income spread product
- All eyes on the ECB's attempt to design a new tool for the periphery

Credit markets – nothing else matters

One of the features of credit markets is having to wait for months, quarters and even years when credit spreads are tight and unappetizing, and volatility is low. This involves the personal discipline of leaving the office day after day without making money, as spreads grind tighter from expensive to very expensive, or merely languish at close to cyclical tightness. It also involves a contract or understanding with clients that return targets from cyclical strategy are best measured over a market cycle, rather than in the artificial divisions of time into monthly, quarterly or annual chunks. As the boring and expensive credit markets of 2021 have morphed into exciting, volatile and soon-to-be cheap markets in 2022, the nature of sustained slow concave spread tightening, followed by an abrupt unravelling, has once again been revealed. Cyclical patterns remain.

We discussed earlier that neither IG nor HY credit spreads are priced for recession. In EUR IG, the OAS is optically cheaper at nearly +190 for a 5-year spread-duration market, versus the US at only +150, which has to compensate for 7 years of spread duration. Yet the EUR IG ASW is still only +108 versus over +160 in the US. Credit risk is thus underpriced in Europe versus the US, even before considering Europe's energy import challenges, the shocking policy mistake of being dependent on Russia for energy, or the lack of planning for refining capacity amid the climate energy transition. The difference in valuations is of course the swap spread, and EUR swap spreads over Germany once again remain the most attractive part of the global spread product set-up from a relative-value perspective.

Collateralized counterparty risk can still be volatile into a recession, but it is far higher up the capital structure than credit risk. Further, with new ECB tools potentially involving reallocation from core sovereigns to the periphery (the ECB cannot turn QE back on with inflation above 8%), there are now additional reasons that might help unlock the outsized relative value and cause swaps to outperform Bunds over the medium to longer term. Still, be prepared for a rocky

ride as volatility in June 2022 has risen above anything seen since the initial Covid shock two years ago.

While we do not think credit spreads price in recession, we recognize they have shifted materially from the tightness. We are therefore closer to benchmark-neutral levels in investment grade. While this neutral stance may be premature, we have higher confidence in the excess gains that would then follow from a tightening back in from wide levels, than in the precise levels that IG and HY spreads would reach in a sustained widening. Should IG credit spreads move materially above +200 and high yield head to +900, the abundant portfolio opportunities this brings would dwarf any other strategy consideration, in our view.

If recession transpires, we have good visibility on where the basis points will come from, as returns from those stressed levels are cyclically very attractive – see 1991, 2003, 2009 or the remainder of 2020 after the 23 March wades. In the meantime, those managers who have already spent the year overweight credit, may well face outflows, VaR and tracking error challenges, leading to forced selling at back bids amid poor liquidity, taking spreads to their usual recessionary levels. With prospective returns extremely attractive once recession is priced, then in the big picture for strategy, nothing else matters.

Peripheral bonds: cautious for now

Drama is back

The ECB Governing Council's (GC) announcement at its June press conference of its intention to end all net asset purchases in early July and start raising rates later in the month, immediately started to weigh on periphery spreads. President Lagarde's emphasis that the ECB would deploy existing or new tools, if necessary, to address any fragmentation in bond markets, clearly was not sufficiently convincing, as the 10-year BTP-Bund spread widened from 200 bps to 240 bps in a matter of days. Some governors were seemingly deeply worried, and it was less than a week before the GC had to meet in an emergency session to

discuss the possibility of launching yet another tool to fight fragmentation. In case you've missed them, market drama and sudden emergency meetings are back.

'Market drama and sudden emergency meetings are back'

The press release after the emergency meeting, as expected, indicated that the first line of defense to fight fragmentation would be to use the flexibility of PEPP redemptions. This would involve channeling redemptions towards countries where spreads are under pressure, essentially meaning QE for some countries (where holdings would increase) at the expense of QT for others (where holdings would decline), at least temporarily.

The press release also indicated that relevant Eurosystem committees had been formally tasked with designing a new anti-fragmentation tool. Apart from the announcement, there were no details given about the modalities of the instrument and what would trigger its deployment. The ECB's back-room monetary ballistics experts now have five weeks to put the specifications together and come up with the goods. Recalling the language of the Eurozone crisis, a 'bazooka' is needed or, at the very least, a legally compliant tool that convinces the market of the ECB's firepower to tackle market fragmentation in a way that placates the northern Eurozone governors, perhaps via a quid pro quo on the commitment to tackling inflation. So what might they design?

A Bloomberg story, citing 'ECB sources', suggested that the ECB could implement a so-called 'operation switch', i.e., actively buying bonds from countries where spreads are under pressure versus selling other bonds. This indeed could be a powerful tool, but for now many things are unclear and there could be serious legal challenges to such an approach. In order to make a new tool legally feasible, some conditionality will likely need to be assigned to it, involving quid pro quos for compliance with structural reforms or fiscal stipulations. Moreover, we believe that it would be most powerful if there are no ex ante limits attached to it (as with the OMT program launched under Mario Draghi's presidency).

Thinking about fair value and fragmentation puts

It seemed that a 10-year BTP-Bund spread of 200 bps, the level at which the spread traded at the time of the GC meeting, is not a concern for the GC. As the emergency meeting was called when the spread traded at 240 bps, we assume that levels around or above 240 bps will likely trigger action. In addition, it is also very likely that the speed

of the move, the shape of the curve, and the degree of contagion to semi-core countries such as France, matters. In the wake of the initial GC meeting it took only a short time for the spread to spike higher – and this is what seems to have got the GC worried as well.

As many things remain unclear for now, we believe that a sustained tightening of the 10-year Italy-Bund spread below 200 bps will be challenging. As the ECB has no choice but to be firm on its tightening path given inflation, we continue to hold a cautious view on peripheral spreads and would not be surprised by further market attempts to test the ECB's resolve in the weeks ahead. Additional considerations are the prospect of elections in Italy by spring next year, the elevated BTP supply outlook and the notion that even if spreads stay contained, and the ECB proceeds with rate hikes, the monetary policy stance will turn more restrictive in Southern Europe than in Northern Europe due to a lower 'neutral' rate. Bear in mind that back in 2011, many non-centrist domestic political parties were yet to be founded and that the Italian government debt-to-GDP ratio was 120%; post-Covid, it is over 150%. In Greece, it is now over 200%.

EM debt: too early still to step in

We remain cautious on EM fundamentals. The outlook remains challenging given higher commodity and food/agricultural prices along with the already sticky inflation, strong US dollar, general risk aversion, accelerated tightening from the Fed and inescapable implications for growth. Many EM central banks have been proactively ahead of the curve and raised policy rates well in advance of DM central banks, but we note that many Asian central banks have been the exception by not raising rates. In China, the PBoC is expected to remain accommodative to offset the weak property dynamics and ramifications of the rolling lockdowns spurred by China's zero-Covid policy.

The prolonged supply chain constraints across Asia and tapering of global demand, as well as even higher food and energy prices, look set to dampen growth and corporate profitability. So, the outlook could well be weak throughout the year. Whilst EM rates have corrected and spreads are at wider historical – and more attractive – ranges, there is still a fundamental reason for this repricing. In our opinion it is yet too early to be overweight EM bonds and spreads at the asset class level. Looking forward and being more specific, opportunities appear to be building in Latam and Eastern European local bond markets. Do note, however, that patience is required before entering those trades as the Fed is still accelerating monetary tightening as we speak. A rise in market volatility, EM fund outflows and general risk

aversion can of course lead to overshoots versus fundamental sense.

Asian local bonds seem vulnerable to us as those central banks have lagged the tightening elsewhere across EM. Furthermore, we expect inflation in many of those Asian EM countries to become more problematic in H2 given that many rely on energy and food imports. Selected Southeast Asian markets look to be potential candidates for additional underweight positions. We are still long China rates given our view of the skew towards further monetary easing to offset property market restructuring and the potential of a hard landing. We continue to expect China growth to disappoint both official and consensus forecasts.

FX: Underweight selected EM currencies

With the exception of the BoJ and the ECB, all G10 central banks have started hiking rates. Many are also starting QT, or have at least flagged their intentions. In contrast, the BoJ is the only G10 central bank that remains on hold through July, keeping rates negative and sticking with yield targeting backed by asset purchases. The ECB is only now about to end QE, will not start QT anytime soon, has the lowest policy rate in G10 and has pre-announced that it would hike by only 25 bps in July.

As currencies are a relative concept, what matters most now for the strength of currencies vis-à-vis the USD is the differential in central bank policy versus the Fed. Keep in mind that just few weeks ago, the market was expecting the Fed to pause potentially after September, because of weak data and the tightening of financial conditions. Since then, high inflation and inflation expectation prints have pushed the Fed into more front-loaded tightening, supporting the USD. Within the G10, perhaps the only exception is the Bank of Canada, which is signaling faster and bolder rate hike steps versus the Fed, keeping the CAD relatively strong.

With the Fed delivering bolder hikes, many EM central banks have also shown an urgency to act. The combination of FX weakness and rising global commodity prices have cornered even the most dovish central banks in the EM space (like the Bank of Thailand) to focus on anchoring inflation expectations by indicating a start of their rate hiking cycle at the next meeting.

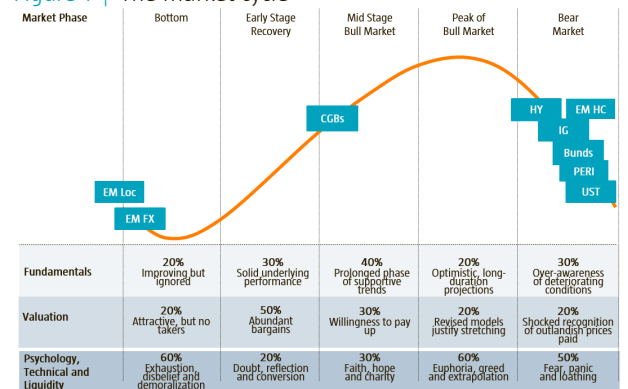
From an FX perspective, the most important question now is how individual EM central banks are positioned versus the

Fed in tightening monetary conditions. We think it is important to distinguish between regions here. Latam is clearly ahead of the Fed and EM peers, as some tightening was already implemented during the pandemic. Eastern Europe is now in a catch-up phase. While large tightening steps have been implemented, more needs to come, as that region struggles with a wage-price spiral. Africa and EM Asia excl. China have been the clear monetary policy laggards. Indeed, the pandemic entailed a big hit to Asia, with prolonged lockdowns and resulting adverse economic implications keeping central banks dovish. Nonetheless, policy needs to adjust there as well.

Many Asian countries rely on food and energy imports, which is pushing up inflation, while the dollar is strong in a global economy that is clearly cooling down. Hence, we remain underweight Asia FX via IDR and PHP, and are keen on finding attractive levels to underweight KRW as well. We are still underweight the ZAR for secular reasons, including the rising risk of political instability, but also note the sensitivity of the currency to weaker global growth while having sizeable external USD liabilities. So, overall, we are overweight USD versus a basket of selected EM names that are vulnerable from a perspective of food and energy imports and external liabilities (USD sensitive).

Asset class positioning

Figure 1 | The market cycle



Source: Robeco, June 2022

We wish to thank Stephen King (HSBC), Peter Hooper (DB), Ralf Preusser (BAML) and Bhanu Baweja (UBS) for contributing to a productive and insightful quarterly outlook session.

Important Information

Robeco Institutional Asset Management B.V. has a license as manager of Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs) ("Fund(s)") from the Netherlands Authority for the Financial Markets in Amsterdam. This marketing document is intended solely for professional investors, defined as investors qualifying as professional clients, who have requested to be treated as professional clients or are authorized to receive such information under any applicable laws. Robeco Institutional Asset Management B.V. and/or its related, affiliated and subsidiary companies, ("Robeco"), will not be liable for any damages arising out of the use of this document. Users of this information who provide investment services in the European Union have their own responsibility to assess whether they are allowed to receive the information in accordance with MiFID II regulations. To the extent this information qualifies as a reasonable and appropriate minor non-monetary benefit under MiFID II, users that provide investment services in the European Union are responsible for complying with applicable recordkeeping and disclosure requirements. The content of this document is based upon sources of information believed to be reliable and comes without warranties of any kind. Without further explanation this document cannot be considered complete. Any opinions, estimates or forecasts may be changed at any time without prior warning. If in doubt, please seek independent advice. This document is intended to provide the professional investor with general information about Robeco's specific capabilities but has not been prepared by Robeco as investment research and does not constitute an investment recommendation or advice to buy or sell certain securities or investment products or to adopt any investment strategy or legal, accounting or tax advice. All rights relating to the information in this document are and will remain the property of Robeco. This material may not be copied or shared with the public. No part of this document may be reproduced or published in any form or by any means without Robeco's prior written permission. Investment involves risks. Before investing, please note the initial capital is not guaranteed. Investors should ensure they fully understand the risk associated with any Robeco product or service offered in their country of domicile. Investors should also consider their own investment objective and risk tolerance level. Historical returns are provided for illustrative purposes only. The price of units may go down as well as up and past performance is no guarantee of future results. If the currency in which the past performance is displayed differs from the currency of the country in which you reside, then you should be aware that due to exchange rate fluctuations the performance shown may increase or decrease if converted into your local currency. The performance data do not take account of the commissions and costs incurred when trading securities in client portfolios or for the issue and redemption of units. Unless otherwise stated, the prices used for the performance figures of the Luxembourg-based Funds are the end-of-month transaction prices net of fees up to 4 August 2010. From 4 August 2010, the transaction prices net of fees will be those of the first business day of the month. Return figures versus the benchmark show the investment management result before management and/or performance fees; the Fund returns are with dividends reinvested and based on net asset values with prices and exchange rates as at the valuation moment of the benchmark. Please refer to the prospectus of the Funds for further details. Performance is quoted net of investment management fees. The ongoing charges mentioned in this document are the ones stated in the Fund's latest annual report at closing date of the last calendar year. This document is not directed to or intended for distribution to or for use by any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, document, availability or use would be contrary to law or regulation or which would subject any Fund or Robeco Institutional Asset Management B.V. to any registration or licensing requirement within such jurisdiction. Any decision to subscribe for interests in a Fund offered in a particular jurisdiction must be made solely on the basis of information contained in the prospectus, which information may be different from the information contained in this document. Prospective applicants for shares should inform themselves as to legal requirements which may also apply and any applicable exchange control regulations and taxes in the countries of their respective citizenship, residence or domicile. The Fund information, if any, contained in this document is qualified in its entirety by reference to the prospectus, and this document should, at all times, be read in conjunction with the prospectus. Detailed information on the Fund and associated risks is contained in the prospectus. The prospectus and the Key Investor Information Document for the Robeco Funds can all be obtained free of charge from Robeco's websites.

Additional Information for US investors

Robeco is considered "participating affiliated" and some of their employees are "associated persons" of Robeco Institutional Asset Management US Inc. ("RIAM US") as per relevant SEC no-action guidance. Employees identified as associated persons of RIAM US perform activities directly or indirectly related to the investment advisory services provided by RIAM US. In those situations these individuals are deemed to be acting on behalf of RIAM US, a US SEC registered investment adviser. SEC regulations are applicable only to clients, prospects and investors of RIAM US. RIAM US is a wholly owned subsidiary of ORIX Corporation Europe N.V. and offers investment advisory services to institutional clients in the US.

Additional Information for investors with residence or seat in Australia and New Zealand

This document is distributed in Australia by Robeco Hong Kong Limited (ARBN 156 512 659) ("RIAM BV"), which is exempt from the requirement to hold an Australian financial services license under the Corporations Act 2001 (Cth) pursuant to ASIC Class Order 03/1103. Robeco is regulated by the Securities and Futures Commission under the laws of Hong Kong and those laws may differ from Australian laws. This document is distributed only to "wholesale clients" as that term is defined under the Corporations Act 2001 (Cth). This document is not intended for distribution or dissemination, directly or indirectly, to any other class of persons. In New Zealand, this document is only available to wholesale investors within the meaning of clause 3(2) of Schedule 1 of the Financial Markets Conduct Act 2013 (FMCA). This document is not intended for public distribution in Australia and New Zealand.

Additional Information for investors with residence or seat in Austria

This information is solely intended for professional investors or eligible counterparties in the meaning of the Austrian Securities Oversight Act.

Additional Information for investors with residence or seat in Brazil

The Fund may not be offered or sold to the public in Brazil. Accordingly, the Fund has not been nor will be registered with the Brazilian Securities Commission (CVM), nor has it been submitted to the foregoing agency for approval. Documents relating to the Fund, as well as the information contained therein, may not be supplied to the public in Brazil, as the offering of the Fund is not a public offering of securities in Brazil, nor may they be used in connection with any offer for subscription or sale of securities to the public in Brazil.

Additional Information for investors with residence or seat in Brunei

The Prospectus relates to a private collective investment scheme which is not subject to any form of domestic regulations by the Autoriti Monetari Brunei Darussalam ("Authority"). The Prospectus is intended for distribution only to specific classes of investors as specified in section 20 of the Securities Market Order, 2013, and must not, therefore, be delivered to, or relied on by, a retail client. The Authority is not responsible for reviewing or verifying any prospectus or other documents in connection with this collective investment scheme. The Authority has not approved the Prospectus or any other associated documents nor taken any steps to verify the information set out in the Prospectus and has no responsibility for it. The units to which the Prospectus relates may be illiquid or subject to restrictions on their resale. Prospective purchasers of the units offered should conduct their own due diligence on the units.

Additional Information for investors with residence or seat in Canada

No securities commission or similar authority in Canada has reviewed or in any way passed upon this document or the merits of the securities described herein, and any representation to the contrary is an offence. Robeco Institutional Asset Management B.V. relies on the international dealer and international adviser exemption in Quebec and has appointed McCarthy Tétrault LLP as its agent for service in Quebec.

Additional information for investors with residence or seat in the Republic of Chile

Neither Robeco nor the Funds have been registered with the *Comisión para el Mercado Financiero* pursuant to Law no. 18.045, the *Ley de Mercado de Valores* and regulations thereunder. This document does not constitute an offer of or an invitation to subscribe for or purchase shares of the Funds in the Republic of Chile, other than to the specific person who individually requested this information on their own initiative. This may therefore be treated as a "private offering" within the meaning of article 4 of the *Ley de Mercado de Valores* (an offer that is not addressed to the public at large or to a certain sector or specific group of the public).

Additional Information for investors with residence or seat in Colombia

This document does not constitute a public offer in the Republic of Colombia. The offer of the Fund is addressed to fewer than one hundred specifically identified investors. The Fund may not be promoted or marketed in Colombia or to Colombian residents, unless such promotion and marketing is made in compliance with Decree 2555 of 2010 and other applicable rules and regulations related to the promotion of foreign Funds in Colombia.

Additional Information for investors with residence or seat in the Dubai International Financial Centre (DIFC), United Arab Emirates

This material is distributed by Robeco Institutional Asset Management B.V. (DIFC Branch) located at Office 209, Level 2, Gate Village Building 7, Dubai International Financial Centre, Dubai, PO Box 482060, UAE. Robeco Institutional Asset Management B.V. (DIFC Branch) is regulated by the Dubai Financial Services Authority ("DFSA") and only deals with Professional Clients or Market Counterparties and does not deal with Retail Clients as defined by the DFSA.

Additional Information for investors with residence or seat in France

Robeco Institutional Asset Management B.V. is at liberty to provide services in France. Robeco France is a subsidiary of Robeco whose business is based on the promotion and distribution of the group's funds to professional investors in France.

Additional Information for investors with residence or seat in Germany

This information is solely intended for professional investors or eligible counterparties in the meaning of the German Securities Trading Act.

Additional Information for investors with residence or seat in Hong Kong

The contents of this document have not been reviewed by the Securities and Futures Commission ("SFC") in Hong Kong. If there is in any doubt about any of the contents of this document, independent professional advice should be obtained. This document has been distributed by Robeco Hong Kong Limited ("Robeco"). Robeco is regulated by the SFC in Hong Kong.

Additional Information for investors with residence or seat in Indonesia

The Prospectus does not constitute an offer to sell nor a solicitation to buy securities in Indonesia.

Additional Information for investors with residence or seat in Italy

This document is considered for use solely by qualified investors and private professional clients (as defined in Article 26 (1) (b) and (d) of Consob Regulation No. 16190 dated 29 October 2007). If made available to Distributors and individuals authorized by Distributors to conduct promotion and marketing activity, it may only be used for the purpose for

which it was conceived. The data and information contained in this document may not be used for communications with Supervisory Authorities. This document does not include any information to determine, in concrete terms, the investment inclination and, therefore, this document cannot and should not be the basis for making any investment decisions.

Additional Information for investors with residence or seat in Japan

This document is considered for use solely by qualified investors and is distributed by Robeco Japan Company Limited, registered in Japan as a Financial Instruments Business Operator, [registered No. the Director of Kanto Local Financial Bureau (Financial Instruments Business Operator), No, 2780, Member of Japan Investment Advisors Association].

Additional Information for investors with residence or seat in South Korea

The Management Company is not making any representation with respect to the eligibility of any recipients of the Prospectus to acquire the Shares therein under the laws of South Korea, including but not limited to the Foreign Exchange Transaction Act and Regulations thereunder. The Shares have not been registered under the Financial Investment Services and Capital Markets Act of Korea, and none of the Shares may be offered, sold or delivered, or offered or sold to any person for re-offering or resale, directly or indirectly, in South Korea or to any resident of South Korea except pursuant to applicable laws and regulations of South Korea.

Additional Information for investors with residence or seat in Liechtenstein

This document is exclusively distributed to Liechtenstein-based, duly licensed financial intermediaries (such as banks, discretionary portfolio managers, insurance companies, fund of funds) which do not intend to invest on their own account into Fund(s) displayed in the document. This material is distributed by Robeco Switzerland Ltd, postal address: Josefstrasse 218, 8005 Zurich, Switzerland. LGT Bank Ltd., Herrengasse 12, FL-9490 Vaduz, Liechtenstein acts as the representative and paying agent in Liechtenstein. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the Fund(s) may be obtained from the representative or via the website.

Additional Information for investors with residence or seat in Malaysia

Generally, no offer or sale of the Shares is permitted in Malaysia unless where a Recognition Exemption or the Prospectus Exemption applies: NO ACTION HAS BEEN, OR WILL BE, TAKEN TO COMPLY WITH MALAYSIAN LAWS FOR MAKING AVAILABLE, OFFERING FOR SUBSCRIPTION OR PURCHASE, OR ISSUING ANY INVITATION TO SUBSCRIBE FOR OR PURCHASE OR SALE OF THE SHARES IN MALAYSIA OR TO PERSONS IN MALAYSIA AS THE SHARES ARE NOT INTENDED BY THE ISSUER TO BE MADE AVAILABLE, OR MADE THE SUBJECT OF ANY OFFER OR INVITATION TO SUBSCRIBE OR PURCHASE, IN MALAYSIA. NEITHER THIS DOCUMENT NOR ANY DOCUMENT OR OTHER MATERIAL IN CONNECTION WITH THE SHARES SHOULD BE DISTRIBUTED, CAUSED TO BE DISTRIBUTED OR CIRCULATED IN MALAYSIA. NO PERSON SHOULD MAKE AVAILABLE OR MAKE ANY INVITATION OR OFFER OR INVITATION TO SELL OR PURCHASE THE SHARES IN MALAYSIA UNLESS SUCH PERSON TAKES THE NECESSARY ACTION TO COMPLY WITH MALAYSIAN LAWS.

Additional Information for investors with residence or seat in Mexico

The funds have not been and will not be registered with the National Registry of Securities, maintained by the Mexican National Banking and Securities Commission and, as a result, may not be offered or sold publicly in Mexico. Robeco and any underwriter or purchaser may offer and sell the funds in Mexico on a private placement basis to Institutional and Accredited Investors, pursuant to Article 8 of the Mexican Securities Market Law.

Additional Information for investors with residence or seat in Peru

The Fund has not been registered with the Superintendencia del Mercado de Valores (SMV) and is being placed by means of a private offer. SMV has not reviewed the information provided to the investor. This document is only for the exclusive use of institutional investors in Peru and is not for public distribution.

Additional Information for investors with residence or seat in Singapore

This document has not been registered with the Monetary Authority of Singapore ("MAS"). Accordingly, this document may not be circulated or distributed directly or indirectly to persons in Singapore other than (i) to an institutional investor under Section 304 of the SFA, (ii) to a relevant person pursuant to Section 305(1), or any person pursuant to Section 305(2), and in accordance with the conditions specified in Section 305, of the SFA, or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA. The contents of this document have not been reviewed by the MAS. Any decision to participate in the Fund should be made only after reviewing the sections regarding investment considerations, conflicts of interest, risk factors and the relevant Singapore selling restrictions (as described in the section entitled "Important Information for Singapore Investors") contained in the prospectus. Investors should consult your professional adviser if you are in doubt about the stringent restrictions applicable to the use of this document, regulatory status of the Fund, applicable regulatory protection, associated risks and suitability of the Fund to your objectives. Investors should note that only the Sub-Funds listed in the appendix to the section entitled "Important Information for Singapore Investors" of the prospectus ("Sub-Funds") are available to Singapore investors. The Sub-Funds are notified as restricted foreign schemes under the Securities and Futures Act, Chapter 289 of Singapore ("SFA") and invoke the exemptions from compliance with prospectus registration requirements pursuant to the exemptions under Section 304 and Section 305 of the SFA. The Sub-Funds are not authorized or recognized by the MAS and shares in the Sub-Funds are not allowed to be offered to the retail public in Singapore. The prospectus of the Fund is not a prospectus as defined in the SFA. Accordingly, statutory liability under the SFA in relation to the content of prospectuses does not apply. The Sub-Funds may only be promoted exclusively to persons who are sufficiently experienced and sophisticated to understand the risks involved in investing in such schemes, and who satisfy certain other criteria provided under Section 304, Section 305 or any other applicable provision of the SFA and the subsidiary legislation enacted thereunder. You should consider carefully whether the investment is suitable for you. Robeco Singapore Private Limited holds a capital markets services license for fund management issued by the MAS and is subject to certain clientele restrictions under such license.

Additional Information for investors with residence or seat in Spain

Robeco Institutional Asset Management B.V., Sucursal en España with identification number W0032687F and having its registered office in Madrid at Calle Serrano 47-14^º, is registered with the Spanish Commercial Registry in Madrid, in volume 19.957, page 190, section 8, sheet M-351927 and with the National Securities Market Commission (CNMV) in the Official Register of branches of European investment services companies, under number 24. The investment funds or SICAV mentioned in this document are regulated by the corresponding authorities of their country of origin and are registered in the Special Registry of the CNMV of Foreign Collective Investment Institutions marketed in Spain.

Additional Information for investors with residence or seat in South Africa

Robeco Institutional Asset Management B.V. is registered and regulated by the Financial Sector Conduct Authority in South Africa.

Additional Information for investors with residence or seat in Switzerland

The Fund(s) are domiciled in Luxembourg. This document is exclusively distributed in Switzerland to qualified investors as defined in the Swiss Collective Investment Schemes Act (CISA). This material is distributed by Robeco Switzerland Ltd, postal address: Josefstrasse 218, 8005 Zurich. ACOLIN Fund Services AG, postal address: Affolternstrasse 56, 8050 Zürich, acts as the Swiss representative of the Fund(s). UBS Switzerland AG, Bahnhofstrasse 45, 8001 Zurich, postal address: Europastrasse 2, P.O. Box, CH-8152 Opfikon, acts as the Swiss paying agent. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the Fund(s), as well as the list of the purchases and sales which the Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, at the office of the Swiss representative ACOLIN Fund Services AG. The prospectuses are also available via the website.

Additional Information relating to RobecoSAM-branded funds/services

Robeco Switzerland Ltd, postal address Josefstrasse 218, 8005 Zurich, Switzerland has a license as asset manager of collective assets from the Swiss Financial Market Supervisory Authority FINMA. RobecoSAM-branded financial instruments and investment strategies referring to such financial instruments are generally managed by Robeco Switzerland Ltd. The RobecoSAM brand is a registered trademark of Robeco Holding B.V. The brand RobecoSAM is used to market services and products which entail Robeco's expertise on Sustainable Investing (SI). The brand RobecoSAM is not to be considered as a separate legal entity.

Additional Information for investors with residence or seat in Taiwan

The contents of this document have not been reviewed by any regulatory authority in Hong Kong. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. This document has been distributed by Robeco Hong Kong Limited ("Robeco"). Robeco is regulated by the Securities and Futures Commission in Hong Kong.

Additional Information for investors with residence or seat in Thailand

The Prospectus has not been approved by the Securities and Exchange Commission which takes no responsibility for its contents. No offer to the public to purchase the Shares will be made in Thailand and the Prospectus is intended to be read by the addressee only and must not be passed to, issued to, or shown to the public generally.

Additional Information for investors with residence or seat in the United Arab Emirates

Some Funds referred to in this marketing material have been registered with the UAE Securities and Commodities Authority (the Authority). Details of all Registered Funds can be found on the Authority's website. The Authority assumes no liability for the accuracy of the information set out in this material/document, nor for the failure of any persons engaged in the investment Fund in performing their duties and responsibilities.

Additional Information for investors with residence or seat in the United Kingdom

Robeco is temporarily deemed authorized and regulated by the Financial Conduct Authority. Details of the Temporary Permissions Regime, which allows EEA-based firms to operate in the UK for a limited period while seeking full authorization, are available on the Financial Conduct Authority's website.

Additional Information for investors with residence or seat in Uruguay

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 under 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.