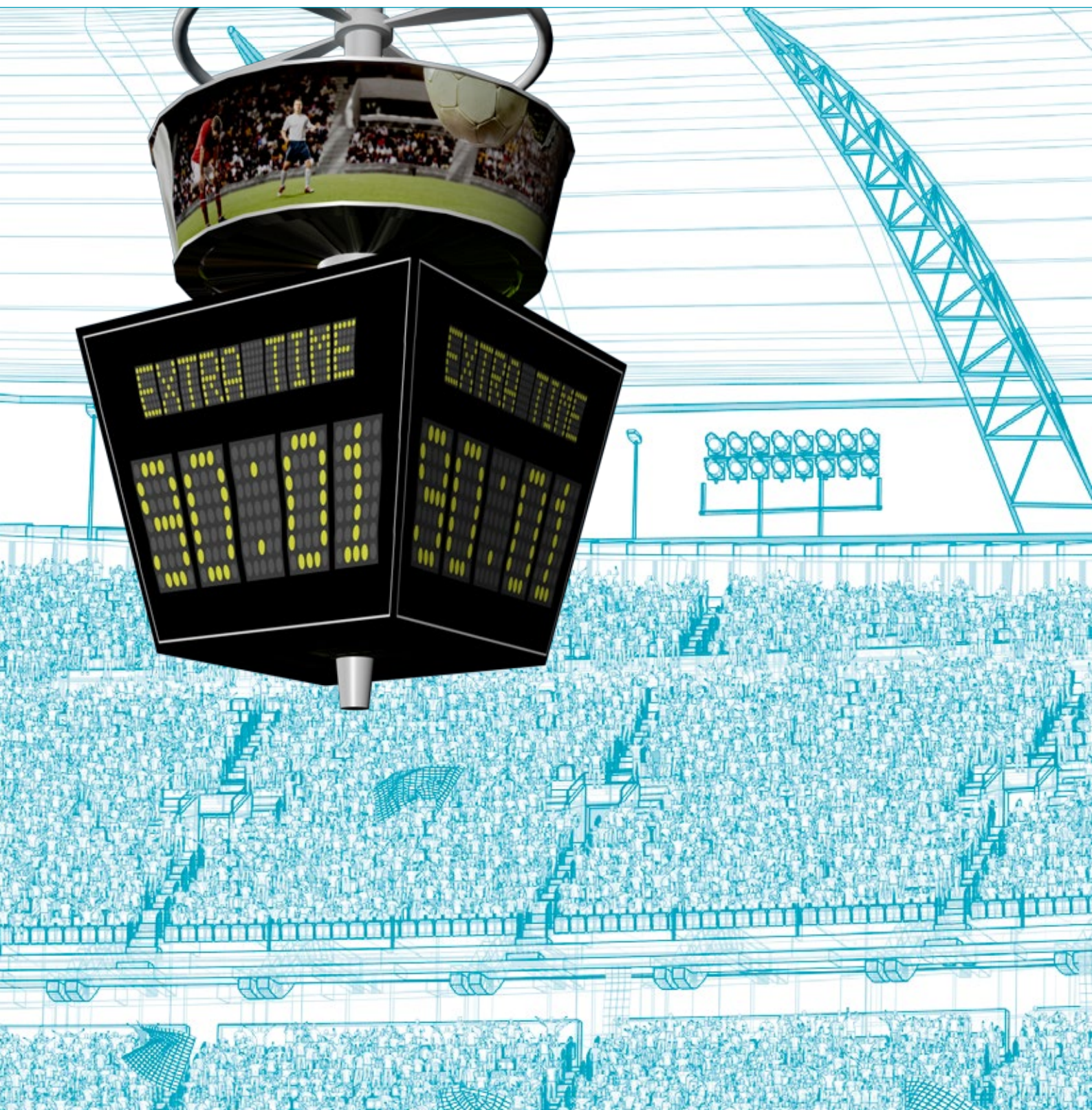


PLAYING IN EXTRA TIME

INVESTMENT OUTLOOK 2018



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PLAYING IN EXTRA TIME



Living on borrowed time. Enjoy it while it lasts. Into the third half. How much porridge is still left in Goldilocks' bowl? It ain't over till the fat lady sings.

We struggled a lot to come up with the right description of the 2018 outlook. We were looking for a phrase that would warn that the current bliss in the financial markets is not sustainable, but that this is not necessarily an ominous sign for 2018. Financial markets tend to overshoot, and with growth momentum picking up and inflation nowhere in sight, why should markets suddenly come to their senses? We eventually settled for 'Playing in extra time'. The best part of the game is over, but the outcome is still undecided. The players are tired, the game is looking less dynamic, but that does not exclude the possibility of there being some surprising last minute goals and 'plot twists'.

Looking at the state of the world economy and financial markets, there is no denying that we are now in a late stage cycle, with all the associated signs of wear and tear. For one thing, the quality of the global credit market has steadily weakened. The overall creditworthiness is declining and covenant-lite financing is on the rise, while the number of so-called zombie companies – whose very survival depends on receiving even more credit – has steadily risen. We have not yet reached critical levels, but the outlook has clearly weakened. The same applies to China's private sector debt, which has risen to more than 220% of GDP. That's almost twice the level of ten years ago. Granted, China probably holds the world record when it comes to 'kicking the can down the road' and it may be capable of adding another year or two to its record, but it is clearly approaching an inflection point. A third factor that confirms we are in the late stage of the cycle is the steady decline in unemployment rates around the world.

Mind you, we are not complaining. Low unemployment is always a welcome development. However, historically, tight labor markets are not normally conducive to economic stability. Wages start to rise, the economy starts to overheat, and central banks react. And, yes, we have seen the obituaries of the Phillips curve as well and heard the rumors regarding the death of the link between unemployment and wages, so maybe the economy will take longer to overheat this time. To simply expect that we can continue going down the current path for another eight years, however, is not realistic. The final, and probably most important, sign that we are currently into extra time is the fact that almost all financial markets have become so expensive. The S&P 500 is now trading at a Shiller PE of 30.7 times, a level only ever seen before in 1929 and 2000; global high yield spreads are at the 15% richest levels on record; while the German ten-year yield (0.4%) is still completely out of line with the nominal trend growth of the German economy (2.5% over the past five years). To make the situation with the S&P 500 a bit more tangible: over the past six years, reported earnings per share have risen by 30%, while the S&P 500 has risen four times as much (120%). We freely admit that we have carefully chosen this timeframe to maximize the gap, but even so, there is no denying that during the past years the S&P 500 has structurally outpaced the underlying economy, pushing valuations up.

So how much longer can this party last? The honest answer is that valuation plays an important role in the longer run (a five- to ten-year timeframe), but it is pretty useless for predicting for the near future. The classic example is the dot-com rally. Greenspan gave his "irrational exuberance" speech at the end of 1996, which was followed by another three years of additional stock market gains. Not that we think that the current situation is comparable to the 1996-2000 era – the current stock market rally has been dubbed "the most hated rally ever" for a reason, but it does serve as a clear example that momentum-driven rallies can last a long time. The same applies to high yield spreads: the last time we saw these levels of tight spreads was in early 2006; it took another year and a half for problems to arise.

Extra time can still be pretty fun to watch. As a general rule though, the longer the party lasts, the bigger the crash once the normalization process sets in. As such, we would prefer to see the dancers take a break in 2018. That would mean a bit more volatility in equities, higher bond yields and a return of credit risk premiums. While this might not make for a brilliant investment year, it would be a logical effect of the overly positive returns we have seen over the past five years. *Reculer pour mieux sauter*, as the French saying goes.

If we have learned anything over the years, it is that financial markets do not follow the 'preferred' scenario. Growth momentum is picking up, earnings momentum is strengthening and, notably, a rise in inflation is nowhere in sight. Central banks are not acting like party poopers just yet. Sure, debt is too high and credit is too loose, but as long as sentiment stays high, financial markets can easily ignore such concerns.

Keep an eye on the clock though.



Lukas Daalder, Chief Investment Officer Investment Solutions
November 2017

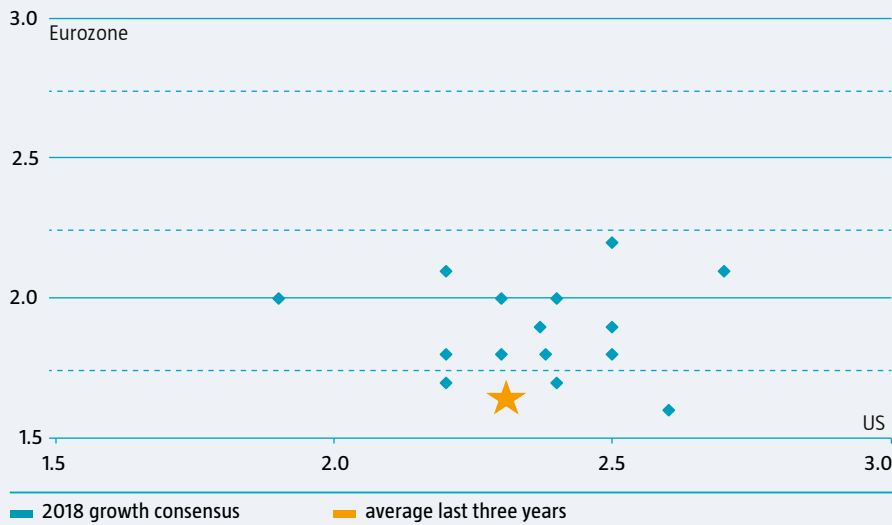
1

Risks to US growth
in 2018
are on the upside



US growth

2018 growth consensus



Source: Bloomberg, Robeco

The US economy is doing fine at the moment. It is tempting for forecasters to predict a slowdown in 2018 to a 'more sustainable' growth path of around 2.0%, given general pessimism about the potential growth rate of the US economy due to aging, dismal productivity growth and zombie firms, as well as the headwinds resulting from gradual Fed tightening. Consensus estimates of the leading forecasters currently predict growth of 2.3%, which is exactly what we have seen over the past three years. Given this rather bland steady-as-she-goes outlook, we are tempted to say that the risks are actually on the upside right now. Economic momentum has continued to strengthen throughout the year and labor markets are tight, while tax reform is likely to boost effective demand, which looks inevitable given that the US president has had so little legislative success so far.

Are there risks? Of course, there always are. One might be that a new and improved Fed will prove more hawkish than it is now. No fewer than three FOMC monetary policy committee positions are currently vacant, with Chair Janet Yellen's term ending in February 2018. President Trump has announced his intention to appoint the centrist Jerome H. Powell as the new Fed chair, but this still leaves open the other positions to be filled. In general, monetary policy is decided by majority vote, which makes any radical change unlikely. What's more, the fact that inflationary developments continue to be favorable mean there is little reason as yet to implement monetary tightening in 2018, at a point no more than two steps after the modest rate hike of December 2017. Another risk specific to the US, is that the threat of impeachment could dampen 'animal spirits'. This risk will

likely only become critical after the 2018 Congressional elections, if the Republicans lose their majority in the House of Representatives. In that sense, the main risk to the growth outlook is the rise of protectionism as illustrated by the difficult negotiations surrounding NAFTA.

All in all, in 2018, US economic growth could easily surprise on the upside.

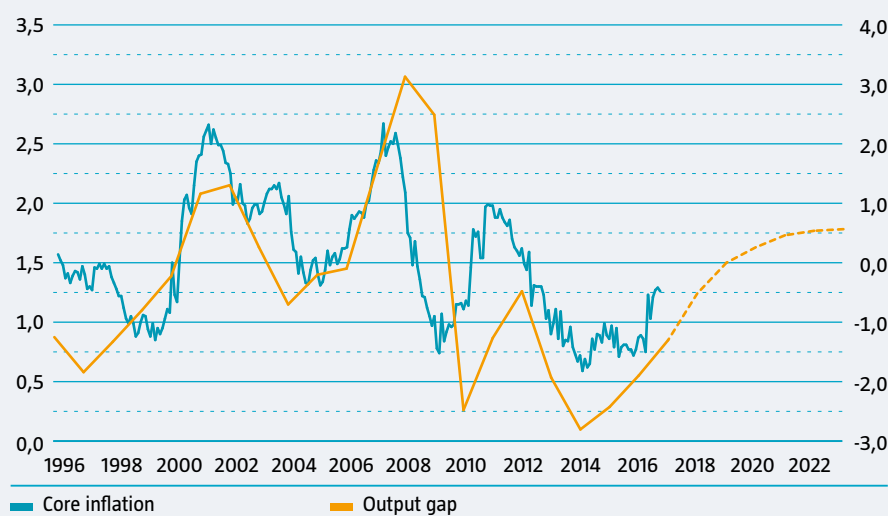
2

Eurozone outperforming
the US, monetary policy
too loose



Core inflation vs output gap

Eurozone



Source: Thomson Reuters Datastream, IMF

With the growing popularity of the term of 'secular stagnation', the talk about the Japanification of the Eurozone economy and increasing worries about an aging population, it may come as some surprise that the world economy is currently on the upswing. Another surprise is that underlying growth in the Eurozone is currently stronger than in the US. In 2016, the economy grew 1.8% in the Eurozone compared to 1.5% in the US. In 2017, we expect these figures to reach 2.25% and 2.0%, respectively. This is exceptional given that the US is generally assumed to have a higher potential growth rate than the Eurozone due to more favorable demographics. Based solely on population growth and thus disregarding changes in participation rates, the US rate would be around 0.5% higher. Other factors that contribute to potential growth are total factor productivity and capital investment. Total factor productivity cannot be measured directly, and is therefore usually estimated in the form of a residual by stripping away the estimated impact of capital investment from the economy's average output per hour.

Most of the declines in output observed since the Great Recession are now attributed to declines in potential GDP. Pessimism about productivity growth has become rampant, but there is no reason to believe there is much of a difference between the two economic blocks. Current estimates hover around 1.0%, which is far below the 1.5% to 1.75% range observed over the longer term. As US output is assumed to grow more or less in line with potential growth, according to these estimates, the Eurozone is growing above its estimated potential. By contrast, the monetary policies in the two blocks are diametrically opposed: in the US, the Fed has started

normalizing interest rates and reducing its balance sheet, while in the Eurozone, the European Central Bank is only just beginning to phase out quantitative easing. The ECB deposit rate is still negative and any rate hikes are a long way off.

The solution to this apparent mismatch is of course linked to the fact that the Eurozone is not a single economy. This is best illustrated by the development of the output gap, the difference between actual and potential growth in the participating countries. According to the OECD, in Germany, this gap already closed in 2015, so its economy is facing increasing inflationary risks, while France and Italy are still showing huge gaps (above 2%).

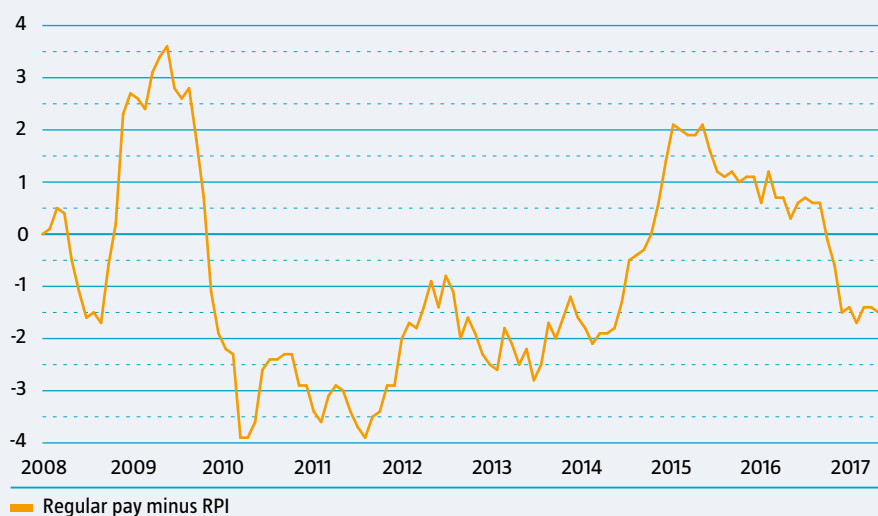
Of course, these potential growth estimates must be treated with caution. Not long ago, and well after the over-optimistic 'new economy' debate, the ECB estimated the potential growth of the euro area in 2005 at 2.0%-2.5%. But it seems fair to say that the Eurozone's current monetary policy is extremely accommodative, which will allow the region to boom for a while longer. We are playing in extra time. Due to the huge differences in output gaps, Germany will probably have to accept an above-target inflation rate (> 2.0%), as the ECB allows France and Italy to catch up.

3

Brexit negotiations
will first go to the brink



UK real earnings
Twelve-month percentage change



Source: Thomson Reuters Datastream / Fathom Consulting

“No deal is better than a bad deal”. The UK government keeps repeating this mantra, probably for negotiating purposes, though in economic terms, “no deal” would be highly detrimental. First of all, the absence of a deal does not automatically mean the UK can trade with the EU on World Trade Organization (WTO) terms. To be able to do this, a great many deals on new administrative procedures governing certification of regulatory standards, customs processes and so forth will be required. The agreements must be reached well before Friday 29 March 2019. In fact, it is hard to see how trade can continue if these deals are not made by the summer of 2018. The problem is that so far, the UK has done nothing, nothing at all, to prepare itself for a ‘hard’ Brexit. No arrangements have been made with regard to customs, new agencies or residency rights. Moreover, even if it were possible to trade on WTO terms almost immediately after leaving, a recent World Bank study suggests that trade in goods with the EU would halve, and trade in services would fall 60%. It would be highly irresponsible not to make a deal and therefore unlikely. So “no deal” is nothing more than an empty threat. The recent US Bombardier tariffs are a reminder that life is cold outside the largest internal market in the world.

In the meantime, the clock is ticking. The EU is demanding sufficient progress on three issues: the size of the divorce bill, the citizens’ rights for EU-27 citizens in the UK and UK citizens in the EU-27, and the future of the current, ultra-soft border between Northern Ireland and the Irish Republic, before negotiations on future trading relations can start. As the UK government intends to leave both the customs union and the internal market, solving the Irish border problem looks a

lot like an attempt to square the circle. Furthermore, the UK government is in no hurry to settle the divorce bill, as it is one of the few trump cards in its hands. What we can expect is that businesses will start to panic more and more, the longer it takes to conclude a preliminary deal. At some point, the UK government will probably surrender to the fact that “no deal” is not a viable option. Nobody is under the illusion that the upcoming negotiations on the future trade relationship between the UK and the EU will be finished quickly. In the meantime, the transitional relationship will be more or less the same as it is now: the UK will still be subject to new EU rules and to the jurisdiction of the European Court of Justice, and will still contribute to the EU budget, etc. In Florence, Prime Minister Theresa May indicated the transitional period would last for two years. However, it is doubtful that will be long enough. The negotiations regarding the recent EU/ Canada deal, for instance, took seven years to complete.

Initially, the Brexit saga will continue to be a substantial drag on the economy. Only if the UK ends up remaining a de facto member of the EU for the years to come, will the drag subside. An additional benefit would be that the Irish border could remain soft for the foreseeable future.

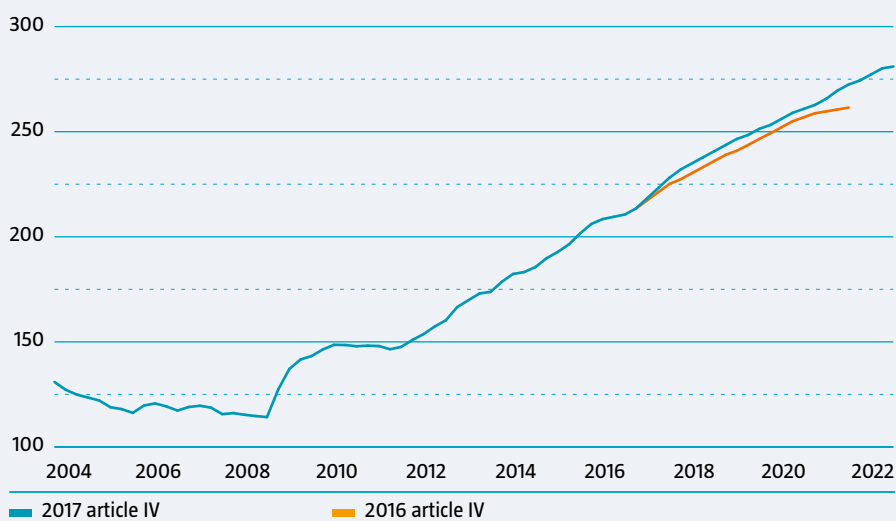
4

China: more can-kicking but the inflexion point is nearing



Debt: trending up

China's non-financial debt is now projected to rise even more strongly



Source: Haver analytics and IMF staff estimates

In 2017, the Chinese economy will grow at an unexpectedly high rate of 6.8%. This relatively strong growth has come at a price: it has been fueled by a further increase in the debt ratio. The total debt of the non-financial sectors (government, household and corporates) is estimated to have reached a staggering level of about 270% GDP in 2016. The reasons for allowing China to continue growing for such a long time at such a high rate (too high for its own good) may have been politically motivated, as President Xi Jinping aimed to increase and solidify his power base for the next five years or more in October at the all-important five-yearly Congress of the Communist Party. The rise in debt is, however, clearly unsustainable and increases the vulnerability of the Chinese economy. On 21 September, the rating agency Standard & Poor's highlighted this problem, firing a well-timed warning shot by downgrading China's credit rating for the first time since 1999. These warnings were in line with those uttered earlier by the Bank for International Settlements (BIS) and the International Monetary Fund (IMF).

The question is if Xi Jinping, now firmly in power, will change course and, like a modern Hercules, choose the narrow, difficult path of virtue, full of potholes or, alternatively, the wide, straight and easy path, effectively kicking the can further down the road for a couple of years (if at all possible). Of course, it's not possible to precisely define the level of debt that would inevitably trigger a crisis, but a long-lasting rapid build-up of leverage will eventually lead to a crash.

Nothing in Xi Jinping's past suggests he is a reformer, so the IMF is probably right to adjust its growth projections for

China upwards in the coming years, while at the same time highlighting the risk of an abrupt slowdown at some point in the future.

For 2018, the upward adjustment of 0.3 of a percentage point to nearly 6.5% mainly reflects the expectation that the authorities will maintain a sufficiently expansionary policy mix, especially through large public investments, to achieve their target of doubling real GDP between 2010 and 2020.

China's intended rebalancing of economic activity toward services and consumption seems to have slowed. It consequently faces higher debts and therefore diminished fiscal means to address an abrupt slowdown. What could trigger such a slowdown? The IMF has mentioned the possibility of a funding shock, which could take place in the short-term interbank market or in the funding market for wealth management products, for instance, the imposition of trade barriers by trading partners (especially given the unpredictability of the current US administration), or a return of capital outflow pressures now that US interest rates are normalizing.

To be fair, the Chinese authorities are fully aware of the current debt risks, and have recently increased their efforts to curb the expansion of credit. However, if history is any indication, this debt curbing will take a back seat to the all-important growth target. So more can-kicking, which will eventually lead to a bigger crash, seems to be the option of choice.

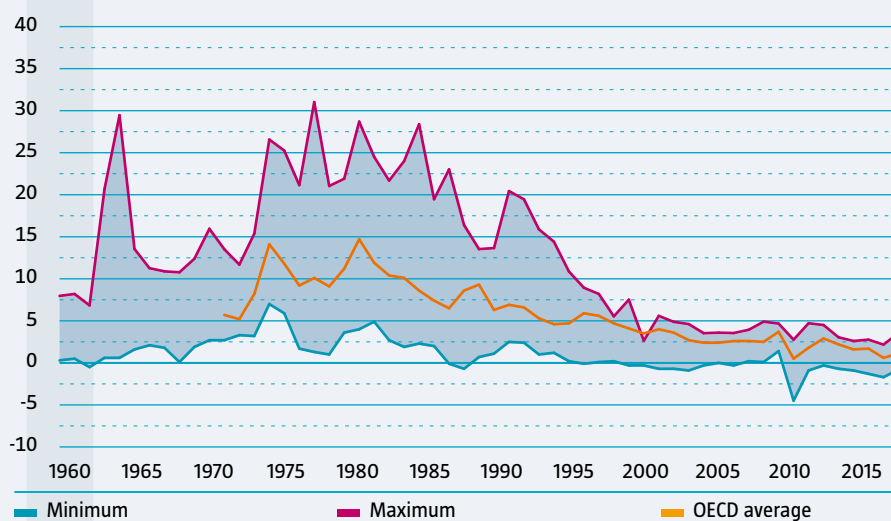
5

Are the reports on the death of inflation highly exaggerated?



Inflation

Disinflation has been with us for a longer time already



Source: OECD, Robeco

Earlier this year the Financial Times called the remarkable lack of inflation in the US “A fly in the Fed’s ointment”. Despite the current expansion entering its ninth year, producer confidence hitting a 15-year high in September and unemployment dropping to one of its lowest levels in over 50 years, this has not stopped core inflation from falling to 1.3% in August. One might be tempted to look for temporary factors that led to this drop, but it is hard to escape the impression that this so-called ‘lowflation’ is anything more than just a temporary phenomenon, or one that is limited to the US. Given the inflation distribution in developed economies over the past 20 years, it is clear that the trend of ever-declining inflation rates has been going on for quite some time now.

There are many factors at play that explain this downward trend. Everything from de-unionization to greater efficiency (due to Big Data), from improved transparency (Amazon, the Internet) to globalization, and from digitization to aging populations, have all been mentioned as causes of this worldwide phenomenon. Added to this is the anchoring effect of the inflation expectations themselves: just as higher inflation expectations can lead to higher wage demands and, in turn, higher inflation, the same also applies to the downside.

It is this latter effect that explains the ECB’s current tenacity in its decision to continue pursuing an (overly) accommodative monetary policy: with inflation expected to be 2%, you can still push real interest rates to -2%, by cutting policy rates to 0%. That’s a lot harder to do if inflation is expected to drop to 0%. For this reason, economists like Paul Krugman and Olivier

Blanchard are actually advocating raising inflation targets to 3% from the current 2% norm, in order to stay clear of the lowflation vortex. This line of thinking is strongly opposed by another group of economists who believe that inflation will be structurally lower from now on, and that it is crucial that central banks adjust their policy accordingly. Ultra-loose monetary policy may not have led to regular inflation as defined by the CPI calculations, but it certainly did have some impact: it may have greatly destabilized asset price inflation. Over the past five years, many assets (housing, US equities, most bonds) have become expensive, which raises the odds of another boom-bust outcome. Central banks should therefore either pay less attention to traditional inflation, or even lower the inflation targets.

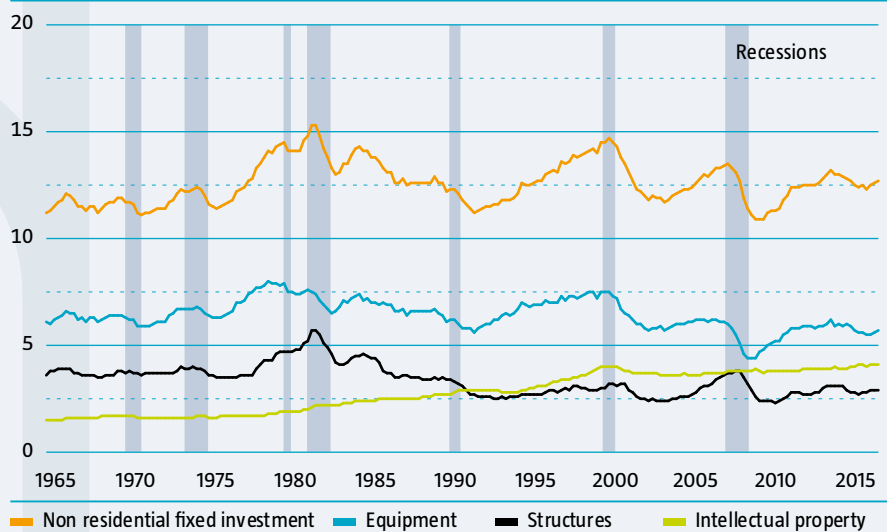
So where does this leave us? With two options. The first is that inflation is indeed a thing of the past, but as long as central banks refuse to recognize this, financial markets bubbles will be a permanent fixture. In this scenario, most assets may have become expensive already, but as long as central banks maintain the loose liquidity, there is no reason why they should not become even more expensive in 2018. This game will be a joyful one, right up until the next crash happens, that is. The second option is that inflation is not dead. Declining commodity prices, disinflation linked to cheap labor in China, a drop in the natural unemployment rate: all of these factors have had an only temporary impact. In this scenario, wages are the main variable to keep an eye on, as they determine the fate of central banks and bonds, alike. Given the current benign inflation expectations, in this scenario, the bond markets appear to be the most vulnerable.

6

Does underinvestment threaten growth?



US investments Percent of GDP



Source: FRED database

The notion that investments by the private sector are lacking is popular nowadays. This is one factor explaining the dismal productivity growth figures and the sluggish economic recovery. Cash-rich companies with boards motivated by the wrong incentives are more interested in pushing up the share price with share buy backs than anything else, and due to weak sales prospects, they are reluctant to invest for the longer term. Over-indebted governments are taking the political path of the least resistance and cutting back on public investment. Sounds convincing, doesn't it? When it comes to the public sector, there is certainly some truth to this idea.

As highlighted by IMF in its recent World Economic Outlook, public investment in infrastructure in advanced economies has dropped to near historic lows as a percentage of GDP after decades of almost continuous decline. The low interest rate environment does offer excellent opportunities to improve the quality of the existing infrastructure stock. According to the IMF, countries with deficits in infrastructure spending include Australia, Canada, Germany, the UK and the US. The fund suggests that upgrading surface transportation and improving infrastructure technologies (in high-speed rail, ports, telecommunications, broadband), as well as green investments should be given priority. Probably not much can be expected from the Anglo-Saxon countries in the short term, but the new German government will most likely increase infrastructure investment for the next year.

In terms of gross fixed capital formation in advanced economies, 2016 wasn't such a bad year, with a growth rate of 1.7% compared to an average of only 1.1% from 2009

to 2018 (which includes the 11% drop in 2009). It was also only slightly worse than the average of 2.3% from 1999 to 2008. The differences between the countries were relatively large, with the UK and the US figures being particularly weak (0.6% and 0.5%, respectively). Global investment has picked up since the third quarter of 2016 and the IMF expects (conventionally) that growth of gross fixed capital formation in advanced economies will rise to a strong 3.4% next year. The composition is of course important as the worst investment binges are generally linked to the property sector. Fortunately, so far, residential investment has not been a key contributor to the growth rate.

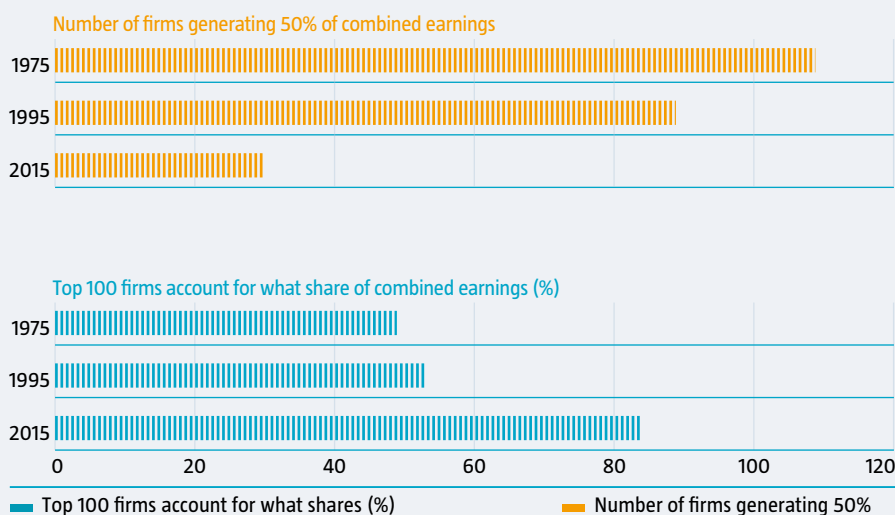
Another way to assess investment is to look at the figures for Research and Development spending as a percentage of GDP. For the OECD as a whole, the ratio of gross domestic spending on R&D (total expenditure (current and capital) on R&D carried out by all resident companies, research institutes, university and government laboratories, etc., in a given country has been pretty stable since 2000 (starting at 2.1%), showing a slightly upward trend reaching 2.4% of GDP in 2015. The Financial Times recently pointed out that US companies are now spending 1.73% of GDP on R&D compared to the then all-time high of 1.67% in Q1 2000 during the dot-com bubble. This does not seem to suggest that the reluctance to invest is in fact as extreme as some make it out to be.

7

The winner
takes all!



Among public companies, the big guys now dominate
Combined earnings



Source: "Is the US Public Corporation in Trouble?" Kahle & Stulz

'This time is different'. We are well aware of the fact that these four words have been called the most dangerous words in investment by Sir John Templeton. Dangerous, as they have been used regularly to identify a paradigm shift that warranted higher stock prices just prior to the painful correction back to the not-so-different normal. Still, these words seem to be the best way to characterize the remarkable shift that has been underway in the US corporate sector: fewer and fewer companies are producing an ever-increasing share of the total earnings pie. Back in 1975 it took the top 109 companies to produce 50% of all earnings, whereas in 2015, this was achieved by just 30, according to economists Kathleen Kahle & René Stulz. The winner may not take all, but it is getting closer and closer to the truth, it seems.

One popular notion is that this is a reflection of the new business model ushered in by the likes of Facebook, Airbnb and Amazon. For these platform-based companies, the size of the customer base has been a critical factor to their success. As the match between supply and demand is most effective on a platform with the biggest customer base, the winner-takes-all principle seems to be more prevalent among these web-based businesses than brick and mortar companies. Additionally, these new companies have set up their businesses according to the spec of the modern world and are therefore not burdened by high overheads and legacy costs. As such, they can also be considered to be a disruption. Research also shows that concentration has been on the rise due to a continuous process of mergers and acquisitions, which has led to a steady decline in the number of listed companies.

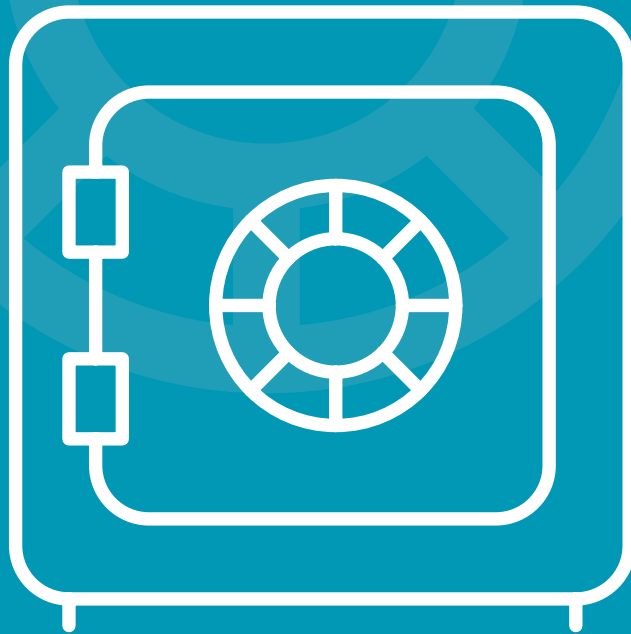
Whatever the cause may be, there is a clear concern about the trend. Concentration may ultimately lead to monopolies, with all the associated negative consequences of higher prices and the reduced flexibility. This fear of a world ruled by monopolistic companies is of course hardly new, nor does it seem particularly relevant at this time. For one thing, the world is not a closed system, which means that there is always competition from China or Europe. Complacency is the kiss of death, especially now. Additionally, a company like Apple may currently be one of the top earners, but that is hardly because of its monopolistic hold on the smartphone market. There are plenty of cheaper options on the market and even the mighty Apple may be punished if its iPhones are overpriced.

Maybe the real risk is of a completely different nature, however. The rise of the number of top earners seems to have coincided with that of the so-called zombie companies, whose survival depends completely on creditors overextending financing to keep them afloat¹. The risk in this case is not to monopolistic pricing, but rather to the productivity dynamism of the broader economy. To quote a study by the Organization for Economic Cooperation and Development (OECD), "a 3.5% rise in the share of zombie firms is associated with a 1.2% decline in the level of labor productivity across industries." If this is indeed the main cause of the rise of top earners, the solution may be simple: central banks should end the current period of lax monetary policy to weed out those zombie firms. With the current growth momentum in place, now is as good a time as ever, but much depends on how central banks will deal with the sticky issue of the lowinflation environment seen in much of the world.

¹ Using the BIS definition, these are firms whose interest payments exceed earnings before interest and taxes.

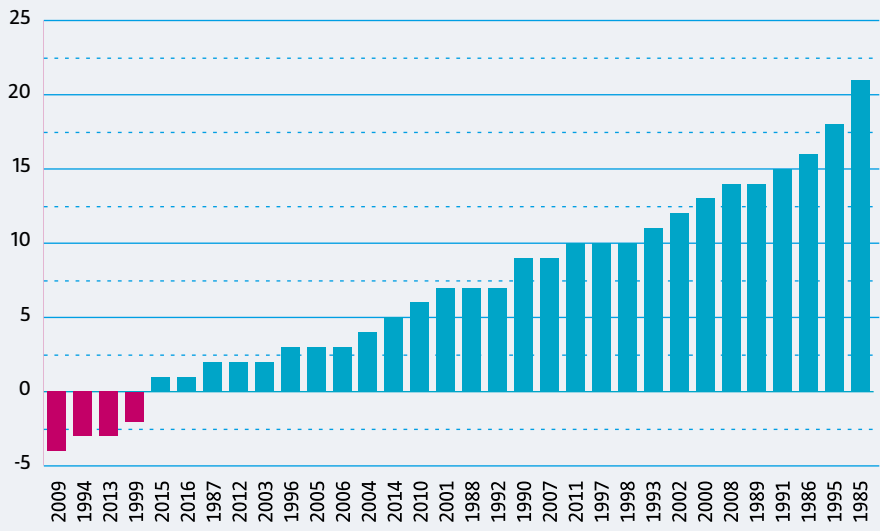
8

Bonds are not
as safe as
previously assumed



Annual return bond index

How risk-free is your risk-free asset?



Source: Citi Global Bond Index

“Tell me how you look, then I will tell you what you are looking for”, the philosopher Ludwig Wittgenstein once wrote. The fact that this chart of bond market returns over the past 40 years is mostly green seems to make it the ideal marketing material for bond investors: in just four out of the past 40 years did bonds yield negative returns!

Alas, there is a powerful framing effect at work here: we are looking at one of the largest bull markets in history. If the analysis is expanded to include data going back to 1900, we see that bonds yielded negative returns in 18% of the cases². Perhaps the bond bulls should be grateful to Paul Volcker. When Volcker took office as Fed chair in 1979, he curbed inflation with his infamous cold turkey approach by aggressively raising policy rates to bring inflation back under control. Although this was an economically costly approach, it proved effective to topple inflation. Content with receding inflation, but cognizant of the economic costs of Volcker’s approach, central banks then moved on to a more a rules-based monetary policy framework in the 1980s and 1990s that targeted inflation and was considered credible and transparent.

Although many other factors were at play, this bond-friendly evolution in monetary policy has certainly contributed to the great bond bull market of the past decades. In hindsight, central banks’ measures targeting inflation may have been even more beneficial for bonds than the ‘Greenspan put’ has been for stocks. After the Great Financial Crisis, the bond market entered a new phase with the market itself becoming instrumental in achieving central bank inflation targets as QE was implemented.

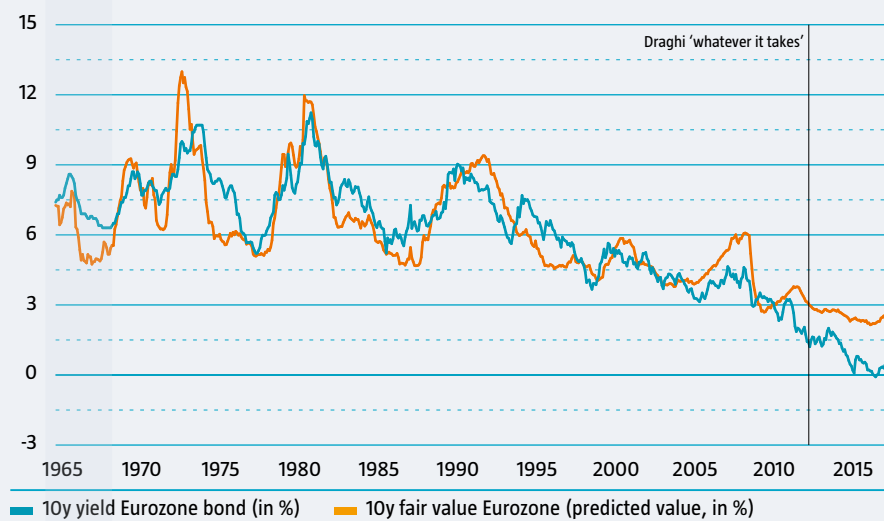
Looking ahead, it is quite likely that bond bulls will be challenged if the global cyclical upswing continues in 2018. The German bond market has not shown such a disconnect with fundamental pricing factors like real GDP growth and inflation for over 50 years, foreboding negative returns in the medium term. The culprit: the bond-buying policies pursued by central banks in recent years, which have artificially suppressed yields below fair value.

>> *Continues on next page*

² Calculations based on DMS data from 1900-2016 for 21 countries

German sovereign bonds look very expensive from a historical perspective

A widening gap



Source: Thomson Reuters Datastream, Robeco

Central banks are now looking to change their policies in 2018. Sustained macroeconomic momentum and reflation are giving central banks the confidence they need to transition from quantitative easing to quantitative tightening and shrink their balance sheets. With inflation close to the target, but still just below it, a cold turkey approach is out of the question. Instead, central banks will prefer to take the punchbowl away only gradually, and bond markets will be given the time to adapt. However, amid record low levels of volatility, a market could easily fall prey to a sell-off if forward guidance about this transition somehow fails. That bond markets do not like to be surprised by hawkish central bankers is all the more evident from the graph: the few instances of negative returns in previous decades were in years in which central banks upset markets with unanticipated announcements regarding their policies. All in all, there is certainly risk involved in what is commonly known as the 'risk-free asset class'.

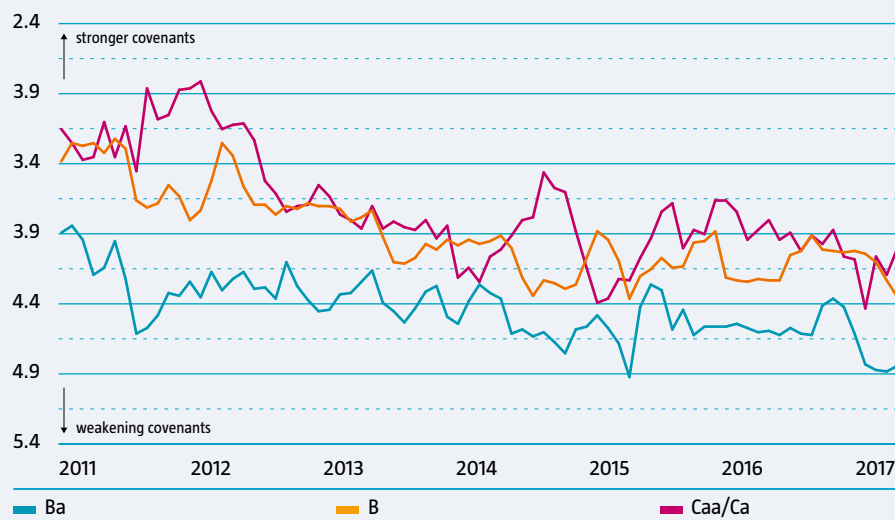
9

Rising risks,
falling spreads



Covenant Quality Index by Rating Category

Credit quality has been steadily declining



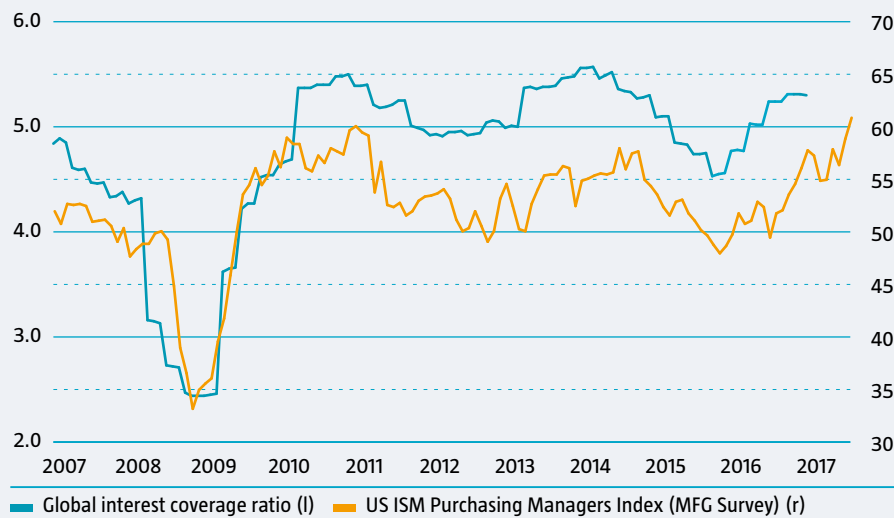
Source: Moody's

The credit markets are starting to look like a driver who puts the pedal to the metal when passing a sign warning of a slippery road ahead. Credit spreads have compressed to cycle lows, while covenant quality erosion has hit cycle highs. The rise in covenant-lite bonds exemplifies how much the credit market has shifted bargaining power to the borrowers instead of the creditors in this mature phase of the credit cycle. Functioning like traction control in modern cars, covenants are aimed at keeping the issuers' creditworthiness on track by limiting (or preferably reducing) net debt to EBITDA, capital expenditures or interest expenses as a proportion of income. These safety measures for credit investors are now becoming scarcer in parts of the junk bond market as shown in the graph.

On the face of it, the road ahead does not seem to be getting slippery at all. After all, the global recovery has firmly taken root, producer confidence metrics have surged recently and overall market sentiment is upbeat. It is logical that positive economic data has partly taken away investor concerns about the future of the business cycle as EBITDA and interest coverage are trending up, requiring less compensation for taking on credit risk. Who needs traction control anyway?

>> *Continues on next page*

Interest coverage levels look resilient near term
 Ability to service corporate debt follows leading ISM indicator



Source: Thomson Reuters Datastream, Robeco

So investors have decided to keep the traction control mostly switched off. According to Moody's, 40% of the global high yield market now consists of covenant-lite issuers. It has happened far too often this cycle that investors have been burned by betting on a crashing credit market. Betting against beta has become too painful. This 'go with the flow' behavior is not uncommon in a late phase in the credit cycle, perhaps out of fear of missing out.

A closer inspection of the credit market shows that there are risks on the horizon, despite a favorable outlook for corporate earnings. Central banks in developed markets are gradually moving away from quantitative easing to quantitative tightening. This brings about a landmark shift in orientation as market participants will have to start guessing what central banks will sell instead of what they will buy. Of course, central banks will have no incentive to unsettle markets and will prepare market participants for this new episode to the best of their ability, but even if forward guidance is executed flawlessly, there's no guarantee it will have the desired effect. Moreover, the impact of misfiring central bankers is aggravated in a low credit spread world. Another credit-unfriendly development could be brought about by increased capital expenditure spending now that capacity utilization rates in the global economy have increased and CAPEX intentions are rising.

It is not unthinkable that the global cyclical upswing will sustain spreads and cause them to grind even lower well into 2018. Sustained profitability in an environment of rising rates would then still favor high yields compared to investment grade bonds. But with yield-hungry investors gearing up to harvest every last bit of credit risk premium in a market that is already tilting towards covenant lite, the impact of an accident in the junk bond market could very well be rising. Mounting risks and falling spreads indicate we are already playing into extra time. This period of extra time could end up being less rewarding from a risk-reward perspective than the enjoyable start would suggest. Yes, initially, the road ahead will be clear, but what will happen miles down the road is unknown.

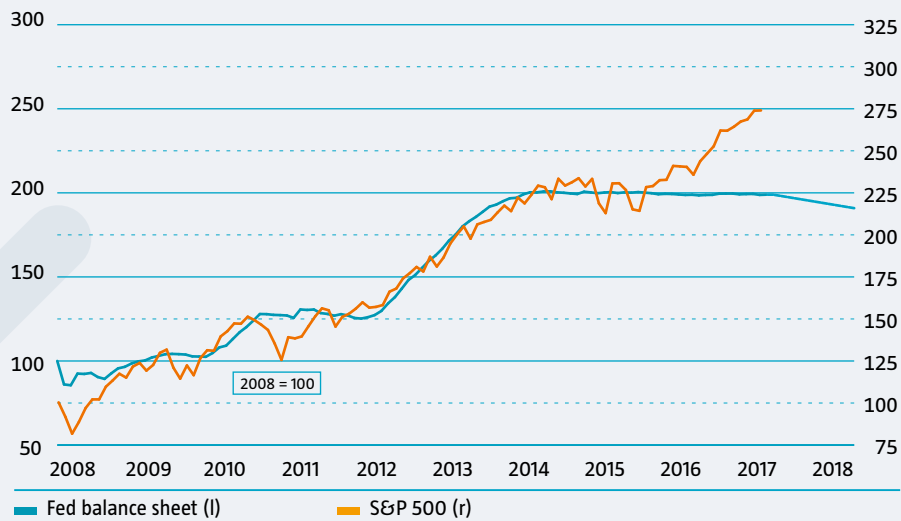
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Will QT hurt?



Will QT weigh on stocks?

US stock market has reached escape velocity from QT



Source: Bloomberg, Robeco

So here we are. The S&P, Nasdaq, Dow and many other major stock market indices have hit all-time highs. Stock market volatility had dropped to record lows. To date, the year's maximum drawdown on the S&P has been 2.8%, one of the lowest levels in history. The old bull market that used to be referred to as "climbing the wall of worry" seems to have morphed into a more exuberant version of itself, which is typical for a mature phase of a bull market. Judging by market action year-to-date, we are now in extra time. The wall (consisting of high stock market valuations, leverage and geopolitical uncertainty, to name but a few) still very much exists, but people just worry about it less. For instance, the record low VIX has recently shown an unusual divergence from measured levels of geopolitical risk. The prospect of missing out on price action has captured the imagination more than the fear of shaky fundamentals, a phenomenon also seen in current cryptocurrency markets. At first glance, this appears to be a momentum-driven market, where every dip is steamrolled by new demand for risky assets.

As in physics, momentum for any system is only conserved in the absence of an external shock. Upon closer examination of the very high SKEW (which measures the price of tail risk on the S&P 500) compared to the VIX, market participants do not appear to be naïve about external shocks, and are willing to pay up to hedge tail risks while joining in the positive momentum. Though equity investors in this phase of the bull market may exhibit signs of exuberance, it does not yet seem to be the type of irrational exuberance that could spell the imminent demise of a bull market.

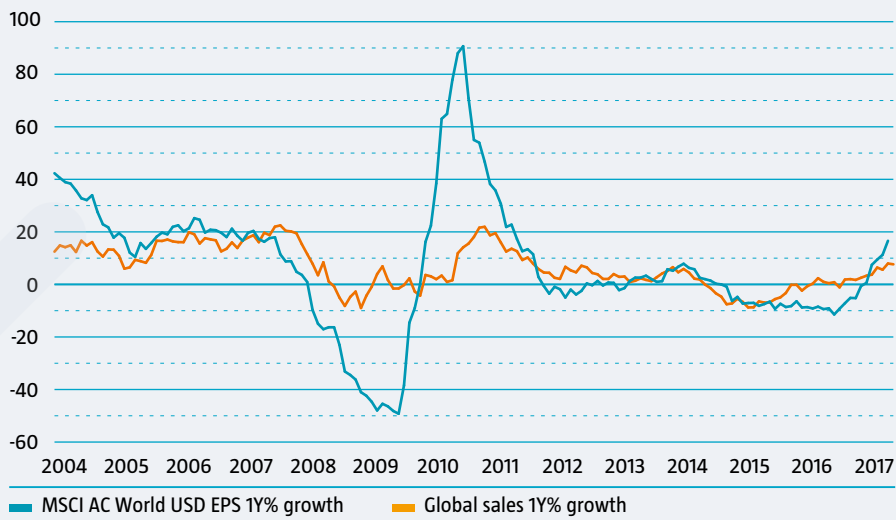
Indeed, this stock market is still about much more than 'close your eyes and buy'. Stock market indices may have surged (with emerging markets in the lead with a 30% gain year-to-date), but so have numerous consumer – and producer – confidence indices, indicating a resilient global expansion that is accelerating and broadening. Very solid reported corporate earnings growth in major equity markets over the year also provide evidence of sustained macro-momentum.

According to analysts' forward earnings projections, forward 12-month earnings growth will be around double digits in the US and Europe. This is not unrealistic in our view, as we expect the Eurozone and US economic expansions to power ahead at a solid pace in 2018, with the Eurozone even boasting above-trend growth. In the earlier stages of this bull market, profit margins rebounding to record highs have led to a recovery in earnings. With labor markets strengthening and the peak in monetary easing behind us, this earnings driver will be gradually losing strength. In the third half, we see earnings growth becoming more reliant on rebounding sales growth on the back of an optimistic consumer. Rebounding global sales activity year-to-date reflects global consumers (especially those in the US, which are leading the global cycle) who are confident of improvements in future disposable income driven by wage growth, housing wealth and lower tax rates.

>> *Continues on next page*

EPS growth

Earnings growth gaining importance as a total return driver



Source: Thomson Reuters Datastream

Of course, confidence in the rise of future incomes would quickly erode if the global economy hits an obstacle that triggers a recession. Since 1854, recessions in the US have occurred on average once every five years. With this expansion now in its eighth year, we are overdue for a recession, which begs the question; how long can this period of extra time last for the equities bull market? Equity markets typically start to decline four months prior to a recession.

Judging by the ISM manufacturing survey, the risk of recession still seems fairly low. Based on the past ten US recessions, it takes an average of 35 (median 31) months after a cyclical peak in the ISM manufacturing survey for a recession to develop in the US. This suggests that even if the recent ISM (at 60.8 at its the highest level since 2009) has marked the peak of the US economic expansion since the financial crisis, a recession remains a pretty remote risk, and the current growth in trade can continue for the time being.

With earnings growth now largely underpinning stock market returns instead of easy money, it comes as no surprise the S&P 500 has recently decoupled from the Fed's balance sheet evolution, as shown in the graph. This chart should reassure Fed board members that their balance sheet reduction, of which they have given extensive warning, will probably not bring the stock market to its knees. Still, the rising interest rates that will result from balance sheet reduction and further conventional tightening could limit multiple expansion further down the road, especially as US stocks have already moved up considerably in the expensive phase. It seems more likely, however, that the current positive momentum will push stocks even higher.

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