For professional investors

TURBULENCE AHEAD

INVESTMENT OUTLOOK 2019

CONTENTS

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TURBULENCE AHEAD

The bull market of the last few years has caused a number of noticeable differences within asset classes. We highlight some of them in this outlook, as we think that these will offer good investment opportunities in 2019.

Although 2018 has not yet ended, we feel confident that it will prove to have been a good year for the global economy. Developed economies have seen above-trend growth, while emerging markets outpaced developed markets, though growth has been below expectations. For the most part, this trend looks set to continue in 2019: we now expect to see sustained, above-trend growth in developed economies and somewhat stronger growth in emerging countries.

This sounds like good news for the financial markets. As growth remains strong, we could see above-average growth in earnings and so far there is no indication of extensive monetary tightening in 2019. However, next year we expect the markets to have two faces. The bright economic picture is expected to be overshadowed by concerns that this long bull market will soon end; think rising interest rates, protectionism, Italy, Brexit. Investors would be well-advised to prepare for these concerns becoming reality.

Economy

The US economy is set to continue its steady growth in 2019, supported by the increase in consumer spending thanks to the wage growth brought about by a tighter labor market. For the time being, the risk of a recession remains low; it's the risks to growth that are high. We think it's plausible that the US will introduce additional stimulus measures funded via the budget, with more tax cuts, this time aimed at the middle class, and the start of the long-awaited improvements to physical infrastructure. Given this procyclical budgetary policy, which is unusual at this stage of the economic cycle, the risk of overheating has risen. Although the Fed will continue its policy of gradual tightening, it is walking on eggshells now that it's on the president's radar. As a result, the central bank is more likely to do too little than too much, so as to avoid, wherever possible, the political fall-out. Trade tensions between the US and China are likely to persist, though without any significant escalation.

Growth in the EU will probably mirror that of 2018, and, as such, remain above trend. A key negative risk factor will be a thing of the past after 29 March 2019. This the date the UK is scheduled to leave the EU, but we expect to see a transition deal that will ensure little actually changes for the time being. The budget plan of Italy's new populist government is a second risk factor that is still looming over the market, as it violates prior budget agreements with the EU. Nevertheless, we believe that Italy will eventually back down – just because it's in their best interests. We do not consider the imminent departure of Chancellor Merkel a risk factor for European markets. With or without elections, the center in Germany will most likely continue to hold. The ECB is likely to implement an initial, modest interest rate hike just before Draghi steps down, allowing his successor to take office in 2020 with a deposit rate of 0.0%. In the meantime, inflation is showing a gradual rising trend, moving nicely towards ECB targets.

In Japan, growth is also expected to match 2018 rates. For the foreseeable future, macroeconomic policy will remain in the capable hands of Bank of Japan (BoJ) Governor Kuroda and Prime Minister Abe. Abe will follow through with the planned increase in sales tax, but pursue complementary policies to mitigate the negative effect on growth, wherever possible. The BoJ will not tighten monetary policy in 2019, either. The willingness of big businesses to make large investments, not only in replacement, but also in robotization and automation (partly in response to a tight labor market) will help boost growth.

In China, policy will be aimed at maintaining a relatively high growth rate, i.e. above 6.0%, although they will probably have no other choice than to accept a lower figure than in 2018. The devaluation of the renminbi is compensating to some extent for the effects of higher import duties in the US. This is placing pressure on countries throughout Southeast Asia, which will not be able to avoid a depreciation of their own currencies. Thanks to sustained growth in China and in developed markets, 2019 looks fairly good for emerging markets. We expect the growth differential between emerging and developed markets to widen, opening the door for investors with a somewhat bigger risk appetite to generate higher returns.

All in all, the macroeconomic environment will remain favorable, in spite of the mounting inflationary risks, particularly in the US where the procyclical budgetary policy could push rates over the top. Add this to a cautious Fed under political fire, and you have a recipe for an overheated economy.

Financial markets

We would not be surprised if the financial markets had two faces in 2019. Initially, riskier asset classes, primarily equities, could do well. Growth remains strong, the growth in earnings is above average and there is no indication of extensive monetary tightening. The trade war between the US and China is still an important factor, but the markets seem to have priced in the prospect of a protracted conflict without any significant escalation. Assuming that the economy does overheat, equity prices will probably move even higher before things really start to heat up.

However, as the year progresses, it will make sense to prepare, to some degree, for harder times. Then the likelihood of an overheated US economy will increase. Not just the Fed, but other central banks too, will slam on the brakes to slow down growth. But even if it doesn't overheat, there's a good chance that sentiment will dampen. And if it does, investors will wonder later in the year whether a recession is brewing.

	Relative attractiveness	Expected change during the year
Developed market equities	+	↓
Emerging market equities	=	↑
High yield bonds	-	=
Local currency emerging market debt	=	↑
Credits	=	↓
Government bonds	-	=

The symbols show the relative attractiveness of the different asset classes in a balanced portfolio

Equities

Under these circumstances, it's a good idea to focus more on equities with a more defensive profile. In addition to low-risk equities, we think equities with a low valuation, high quality and/or high dividend fall into this category. But despite our expectation that investors will reap long-term benefits from a more defensive equity portfolio, that doesn't mean we are overly positive about US equities. After nearly a decade of above-average returns, US equities are overvalued, not least compared to equities in other regions. We expect the tables to turn, generating new opportunities in 2019.

The widening growth differential between emerging and developed markets is a reassuring sign for emerging markets. Historically speaking, a larger growth differential goes hand in hand with relatively strong price performance in emerging markets. The fact that emerging market equities fell considerably this year will definitely help, too. For European equities, which have also come down a lot, subsiding concerns over Brexit and the Italian budget in particular could support an upturn. Over the last few years a rising political risk premium has had a significant impact on European equity valuations, and with good reason. That premium may come down next year as the risks subside, potentially leading to a window of opportunity on the European stock markets.

Bonds

As for bonds, it will remain hard to find decent returns in 2019. As we explain in our view on economic developments, we are now in a later stage of the economic cycle. Historically, this hasn't been the best time to invest in corporate and high yield bonds. Interest rates are rising, while spreads have narrowed significantly. As far as we're concerned, this cycle is no different. In fact, central banks' vast bond-buying programs have pushed both yields and spreads to artificially low levels. And there's not much of a buffer for even the slightest bit of normalization.

For high yield this is compounded by the fact that when the perceived risk of recession increases, it is accompanied by an expected rise in the number of defaults. That's why the outlook for this asset class is not particularly rosy. We're more positive about emerging market government bonds. Due to the huge depreciation of emerging currencies, this class is undervalued, while the yields are much higher than in developed markets.

So we don't expect a lot from euro government bonds in the coming year, either. Though yields have risen slightly, they are still remarkably low. With above-average economic growth likely in 2019 too, inflation moving closer to the ECB target and the central bank officially ending its bond-buying program, yields could rise even further. Incidentally, the ECB won't start gradually raising short-term rates to 0% until next autumn, so there is limited room for a rise in long-dated bond yields. Historically, the spread between short- and long-term government bonds can't widen too much.

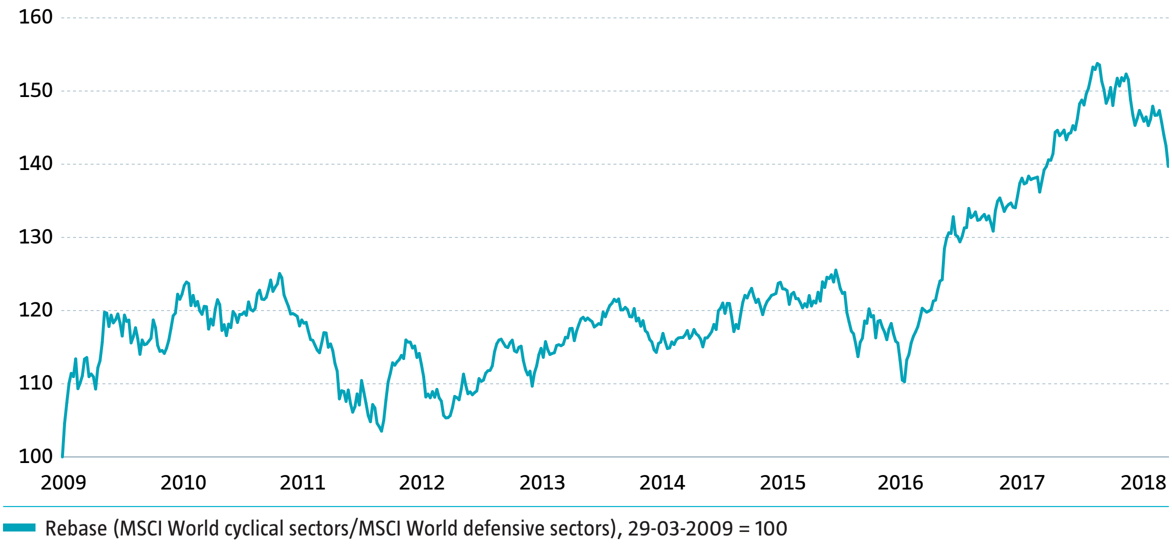
For Italy, the situation will probably have to get worse before it gets better. When the Italian government backs down, which we expect it to do, the spreads could narrow again, but they won't return to the levels we saw before the elections. US Treasuries will be the bright spot in this class – maybe not right away, as the Fed will continue hiking and the risk of overheating won't immediately be reflected in the yields, but with 10-year yields above 3% – and likely to rise further – US Treasuries are an interesting class to consider in preparation for harder times ahead for risky investments at a later stage in 2019.

In the next part of our Outlook 2019, we will take a closer look at a series of different themes that we expect to define the 2019 investment year. Several of these show noteworthy differences, and this is where we think the opportunities will lie for investors in 2019.

Investment Solutions
November 2018

1 Is it time for more defensive equity investing?

Global cyclical vs. defensive equities



Source: Thomson Reuters Datastream, Robeco

There are plenty of reasons to pursue a more defensive equity strategy, but paradoxically enough, this also carries several risks.

The worldwide stock market rally, which started in 2009 and set a new record last August as the longest ever, has certainly not been characterized by euphoria, with the 2011 Eurozone debt crisis, the Fed's unexpected announcement of plans to phase out quantitative easing in 2013 (the 'taper tantrum') and the unanticipated devaluation of the yuan in 2015.

More recently, we had the very recent sharp drop in the market in October 2018 brought about by a complex combination of factors: a fear of protectionism, rising interest rates, declining economic and earnings growth, and geopolitical quarrels. In short, unlike what we saw during the dot-com rally of the late 1990s, market sentiment has been far from festive – in fact, investors have had to climb a wall of worry.

In the period following the financial crisis, when the global economy struggled to recover, stocks of companies that still managed to offer solid earnings prospects proved to be very popular. In the last few years in particular we've indeed seen growth stocks deliver spectacular performance relative to value stocks.

Growth sectors include information technology, consumer discretionary, materials and industrials. The graph shows that these sectors have outperformed their defensive counterparts by 40% since the start of this bull market in 2009. Consumer staples, telecom, health care and utilities are examples of defensive sectors.

Past its peak

More recently, however, there has been a noticeable decline in the performance of cyclical stocks relative to defensive growth stocks: in March of this year, cyclical stocks were still outperforming defensive stocks by 53%. Does this mean, on closer consideration, that the cyclical stock rally is already past its peak?

There are several reasons why next year it might be wise for investors to position themselves for a more defensive approach to equity investing.

Now that we're in a late phase of the economic expansion, climbing the wall of worry seems to be getting increasingly difficult for the stock market; economic growth is at a turning point where acceleration will give way to stabilization and eventually, to deceleration.

Growth stocks under pressure

An environment of disappointing growth is usually bad news for growth stocks and goes some way to explaining why defensive stocks may gain further ground. The apprehension of the market amid rapidly rising interest rates is also a factor. Growth stocks typically deliver the expected profits later in the game than more defensive stocks, which already generate a continuous (and usually more steady) cash flow.

The fact that future cash flows have a longer duration means that growth stocks are more sensitive to an environment of rising interest rates. For next year, too, we predict a further rise in long-term interest rates. We also see that valuations in several cyclical sectors are much higher than in defensive sectors.

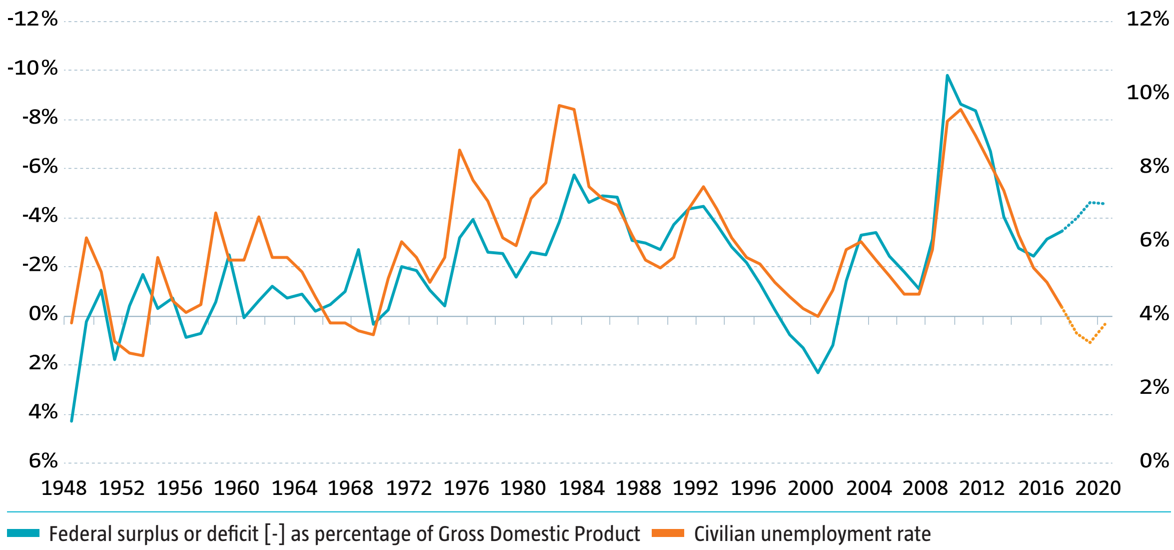
This higher valuation increases the downside risk of cyclical stocks in the long run, particularly in a market that is more volatile overall, as we expect to be the case in 2019. Amid greater market volatility, it may also be worthwhile to pursue a defensive strategy with increased exposure to value stocks, low-risk stocks and/or high dividend stocks.

Risk

Shifting to a more defensive profile also has risks. Positive economic growth surprises, central banks (including the Fed) hiking policy rates more gradually and/or diminishing geopolitical risks (e.g. Italy and Brexit) may in fact breathe new life into growth stocks.

2 An alternative after all

A new normal, or something special?



Source: Federal Reserve Bank, U.S. Bureau of Labor Statistics

After eight consecutive Fed rate hikes, investors finally have an alternative to risky assets: USD cash. Treasuries will follow.

TINA, the well-known acronym for 'there is no alternative', has been widely used to justify moving into risky assets. In other words: the only way to make decent returns is, it was thought, to take on additional risk. But these days, there is an alternative: USD cash. After eight consecutive Fed rate hikes in the past three years, US cash is emerging as an attractive asset class. The flipside, however, is downward pressure on bond returns. We see this downward pressure on bond returns as just a temporary setback which ultimately creates a good buying opportunity for US bonds.

In recent years, the Fed has carefully guided the market through quantitative tightening and multiple rate raises. This has taken place against a favorable backdrop of positive but not exceptional economic growth, improving but below target inflation, and quantitative easing programs by other central banks.

The Fed's 'better safe than sorry' approach and a market that continued to lag the central bank in pricing in rate hikes created a highly supportive environment for financial markets. But as things stand now, we think we are moving towards a different phase of the cycle. This is illustrated by US growth, which accelarated to an annualized rate of 4.2% in the second quarter of 2018.

Higher rates

Inflation is also currently above target, while unemployment is far below its natural rate. And if that isn't enough, the US administration is pursuing an extremely procyclical policy that includes substantial tax cuts and deregulation. As a consequence, the US is facing the exceptional situation of rising budget deficits and accelerating economic growth – something we normally only see when the country is at war.

From both a policy and an economic perspective, we think that higher rates are warranted. To make things worse, there are developments that could tip the balance of supply and demand for US bonds towards supply.

The policy of the US government is putting pressure on budget deficits. These deficits need to be funded, so bond issuance should increase. Unfortunately, this will happen at a time that the demand for these bonds is likely to waver. We will have passed the peak of quantitative easing by the ECB and the BoJ, and the Fed will accelerate the pace of its balance-sheet wind down. This will release the global bond market from the grip of the central banks.

Flat rate curve

Another compounding factor is the flat US yield curve. This makes it less appealing for non-US residents to buy US bonds on a hedged basis. Hedging the currency risk almost completely wipes out the advantage of higher US rates – unless, that is, investors believe that the positive difference in rates outweighs the higher volatility of their portfolios.

In the Trump era, everything is extremely politized – a factor that also needs to be taken into account. The US president has complicated the job of the Fed by publicly announcing that he was "not thrilled" and "should be given some help" by the central bank. "Every time we do something great, he raises the interest rates," said the president, adding that Mr. Powell "almost looks like he's happy raising interest rates."

This pressure, however, won't keep the Fed from hiking rates at a modest pace. But it will err on the side of caution. As a consequence, the bond market will tighten and the US yield curve will steepen – basically doing the job for the Fed. The bond market vigilantes will stage a comeback as the bond market awakes from its Fed-induced coma.

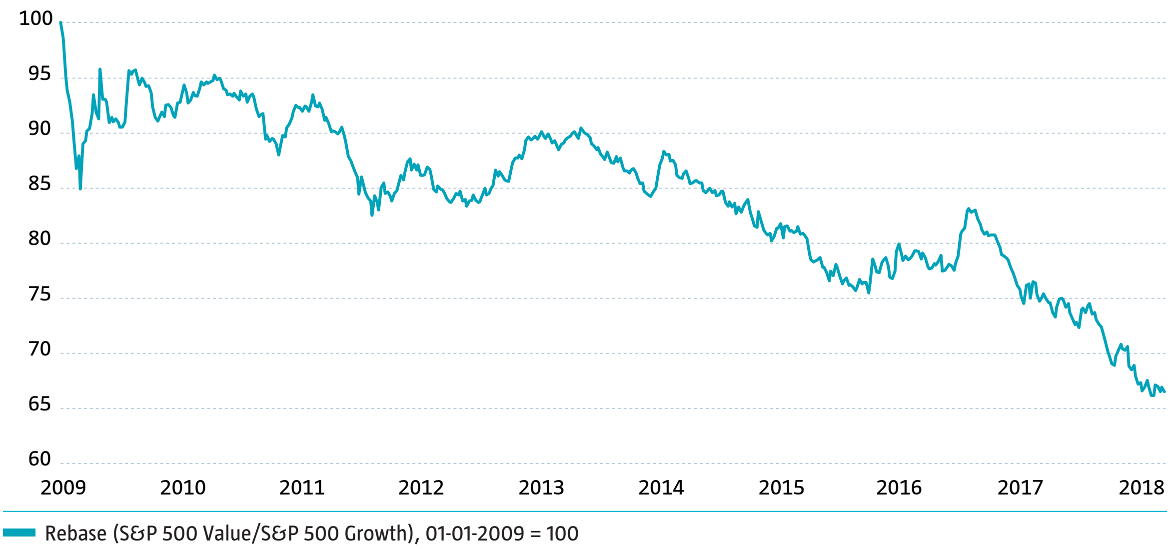
A move into Treasuries

We have yet to reach a peak in long-term yields. Throughout the cycle, central banks have been very transparent about their actions. This has enhanced the effectiveness of these actions as market participants have had time to adjust and stay ahead of the game. Given where we are in the cycle now and the steady ascent towards 3% of the federal funds rate, which is widely regarded as the neutral rate, we think that uncertainty will grow among market participants as forward guidance from the Fed recedes.

All of this means that US Treasuries are not yet a good alternative for risky assets. However, as we highlighted in our general view, we believe the market may have two faces in 2019. If this happens, market participants would do well to move into Treasuries at some time next year. Tightening at the middle and long end of the yield curve will be carried over to the short end: the Fed will hike rates above neutral. This could spark fears of a recession. In such an environment, we expect Treasuries do to well. Given their attractive starting yields, we can finally say that the TINA story is over.

3 | Positioning for a shift towards value stocks

S&P 500 Value vs. Growth index



Source: Thomson Reuters Datastream, Robeco

We think now is a very good time for investors to introduce value stocks to their portfolios. Investors adopting a more defensive investment strategy would be wise to gradually make space for value stocks in 2019.

Will 2019 mark the long-awaited revival of so-called value stocks? Value stocks are stocks of companies that are undervalued based on price-earnings ratios, mostly because of the boring, overly conservative business model these companies use. The lack of frills that characterizes these types of stocks is often why news about companies in this class elicits a tepid response from investors, in contrast to the way they devour news about growth stocks.

Value stocks have lost a staggering 35% against growth stocks in bull markets since 2009. Due to this long period of lagging returns, the relative performance of value versus growth stocks now seems completely out of balance. First, a similar performance in around 2000 heralded a rotation out of growth stocks into value stocks. This rotation also took place in a macroeconomic environment that, knowing what we know now, we can typify as 'late cycle' – a phase we also seem to have reached now.

Second, the price-earnings ratio of the MSCI Value Index is currently 21% below that of the MSCI World Index, which represents an above-average discount level. While value stocks should be cheap now too, based on other valuation criteria such as dividend, price-cash flow ratio and book value, they look even more attractive compared to their historical average discount. With both valuation and the phase of the economic cycle in mind, a return of value stocks seems very likely.

Rising interest rates will put the brakes on growth stocks

Another aspect is that relatively efficient financial markets look further ahead than just one calendar year. As we look further on the horizon, the economic picture slowly changes. If the US economy continues to fire on all cylinders, the Fed will have no choice but to gradually, but resolutely, continue hiking rates to a level that will put the brakes on the real economy. Historically, this transition to net tighter monetary policy has been a favorable environment for value stocks.

Rising rates will hurt the more rate-sensitive momentum and growth stocks and gradually more fine cracks will appear in this momentum-driven bull market, thereby increasing the downside risk. This environment will thus also set the stage for restoring more balance between the typical initial indifference of investors to value stocks and their corresponding disproportionate enthusiasm for growth and momentum stocks.

Rotation

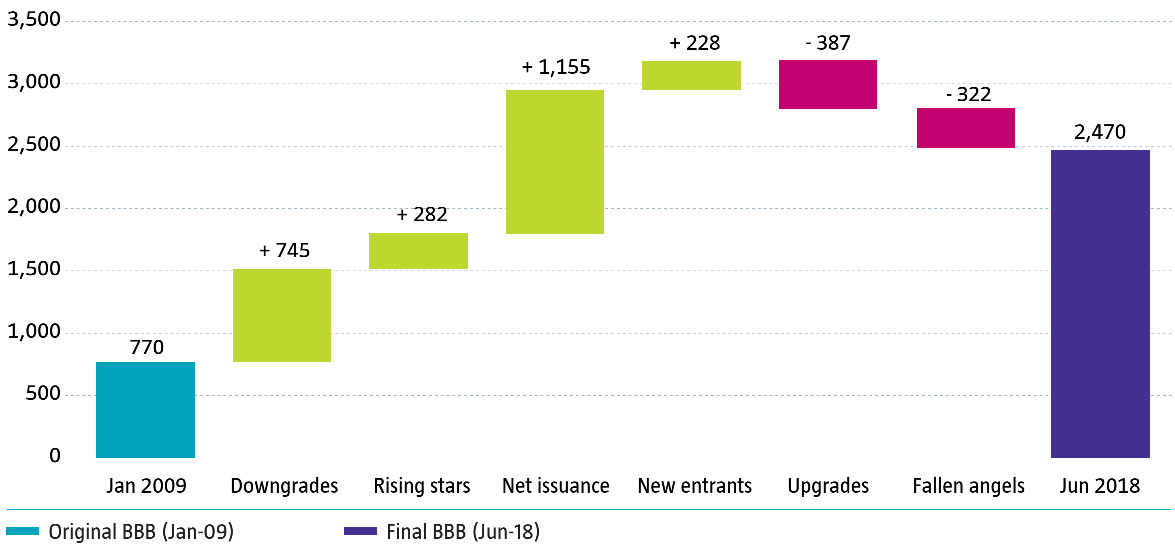
Nevertheless, there are also a number of risks that may hamper a comeback of value stocks. As long as momentum stocks continue to forge ahead, there are few gains to be made for value investors. The leadership of momentum-driven growth and technology stocks in this bull market could persist given the negligible variation in sector rotation that has so far characterized the current market. Second, short-term investing has become so commonplace in this market that there doesn't seem to be any place for an investment style – like value investing – that requires patience. Almost no one talks about these dull business models.

Third, discount rates for the future cash flows (that result from the current low interest rates) of companies are still so low that, despite the rise in interest rates we envisage, they continue to boost the more interest-rate sensitive growth and momentum stocks.

Given the developments we expect to see in 2019, now is still a very good time for investors to introduce value stocks to their portfolios. While there is no urgency for this rotation, investors adopting a more defensive investment strategy would be wise to gradually make space for value stocks in 2019. From a risk-return perspective, the opportunity costs of holding value stocks have now become very low – too low, perhaps.

4 Don't overshoot the exit

Evolution of the IG BBB Universe



Source: Morgan Stanley

As with most asset classes, specific segments always offer attractive opportunities. But if growth slows, the rest of 2019 will be an uphill slog for credits.

The credit markets are in a late stage of the cycle. Since the financial crisis and subsequent monetary easing, bond yields and spreads have fallen. As the central banks started to withdraw liquidity some time ago, this tailwind has subsided and the tide is actually turning. It now looks as though the spreads and yields seen in 2018 will be the lowest we are likely to see for some time.

Various signs of strain are evident in the credit markets, yet companies are still heavily dependent on them as a source of funding. Despite recent rises, interest rates are still low, making the bond market an attractive place for companies to arrange financing. Leverage levels are still very high and despite levelling off very slightly, there are certainly no signs of deleveraging. Companies are not incentivized to do so; it usually requires market pressures to set off this process – as was the case in the energy sector in 2016.

The overall quality of the credit market is a cause for concern. Since the financial crisis, the proportion of BBB-rated debt (S&P's lowest rating for investment grade bonds) in the credit segment has ballooned, mainly due to downgrades and the issuance of triple-B rated bonds.

Increase in the number of fallen angels

The BBB segment accounts for around half of the total credit market, but is two-and-a half times the size of the entire high yield market. In previous cycles, an average 10% of BBB-rated bonds were downgraded to high yield. If this happens again, these 'fallen angels' from the investment grade segment will make the high yield universe much larger.

Generally speaking, credit ratings lag the economic cycle. This move will therefore play a less significant role in 2019, but could subsequently have an impact on the high yield universe. In that case, it would also put pressure on returns in the investment grade universe, as investors would be forced to leave.

Economic growth in 2019 will to a large extent determine if and when the credit markets start to move and whether spreads really widen. In Europe, primarily, spreads have already widened in 2018, reaching median levels. As the ECB has been buying European credits in the context of its quantitative easing program, but will stop in 2019, there is still a possibility that they will widen further as the market's key buyer exits the stage.

Crowding-out effect

Although we think that Brexit and the discussions surrounding Italy's budget will be off the table in 2019, we always have to factor in political risk in Europe. If the situation sours, credit spreads will be in the firing line and the banking sector (which makes up almost 30% of the European credit market) will bear the brunt of it.

As stated above, we expect the US economy to continue to grow gradually in 2019 and there to be little risk of recession. Earnings growth will take the edge off the high leverage problem. Economic growth and the associated gradual tightening by the Fed will push up interest rates.

This is already having a 'crowding out' effect, as the question of why investors should still invest in credits when Treasuries offer lower risk and very similar yields, is becoming more and more relevant. In that respect, spreads need to widen. Absolute yields are quite a bit higher in the US than in Europe, but while – to all intents and purposes – this sounds attractive, euro investors are facing mounting hedging costs, wiping out most of the extra return.

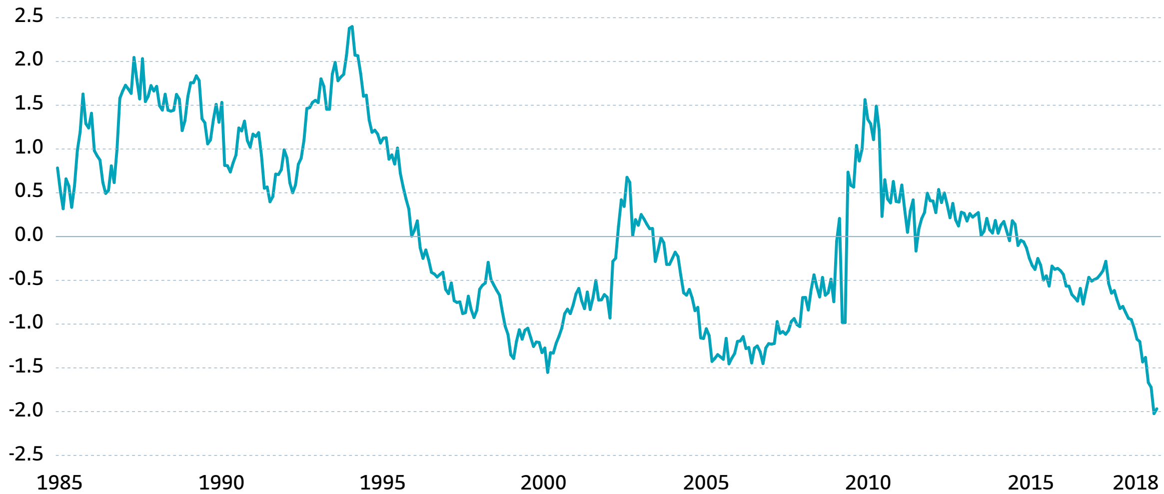
Turbulence in high yield

So, should investors shift into the riskier high yield bond segment? There could be even more turbulence on the horizon here. Quality is a cause for concern, too. The Moody's Loan Quality Index, which tracks the quality of covenants, is at a very low level, which is generally seen as a sign that we have reached an advanced stage in the cycle.

In addition, high yield bonds are sensitive to economic decline, which is often accompanied by an increase in bankruptcies, for example. The spread on high yield bonds is relatively low, which means they offer very little in the way of a buffer in the event of negative news. For the broader credit market, both in Europe and the US, most of the signals have been flashing amber for a while. And, as we know, amber is followed by red.

5 | A defensive market that is looking increasingly risky

The difference in equity risk premium in the US compared to the rest of the world (z-score)



Source: Thomson Reuters Datastream, Robeco

Historically, switching to the US is an obvious choice at a late stage of the bull market when a shift towards more defensive equity allocation is desired. However, this time may be different.

America first! It's hard to deny that the US stock markets have set the tone of President Trump's first term in office. The US finds itself in the exceptional situation that the economy is doing so well that monetary policy normalization is well underway, in contrast to what is happening in Europe and Japan. The US economy is now running at full throttle, spurred by a president who claims to be an expert in the rules of the economic game. Investors are pricing in uncertainty and seem to believe Trump's vow to put "America first".

Since he was elected in November 2016, it's remarkable how much the risk premium that investors demand for investing in equities in the US has fallen compared to the rest of the world. Large corporate tax cuts and a market with a sector bias towards growth and tech stocks which have so far performed well, also play a role.

Mind the gap

The risk premium* investors demand for investing in stocks in the US is now at a low compared to what they demand in other countries. This reflects the relatively high level of confidence of US investors. The rules of the economic 'game' in Trump's America seem more transparent than elsewhere in the world. Take Europe, for instance, where politicians quarrel about Italy and the future of the euro project still seems uncertain. However, this negative perception of risk about Europe is nothing new. Since the Eurozone crisis erupted in 2011, the gap between the equity risk premium investors demanded in Europe compared to the US has continued to widen.

The current, exceptionally large difference with the average risk premium in the US indicates that European investors may overestimate the risks, while US investors could be underestimating them.

First, the thorny Brexit situation must take a decisive turn before March 2019; regardless of the outcome, this will reduce uncertainty for European equity investors. Second, there are 'market forces' at work, i.e. yields on Italian government bonds are rising, which will eventually force Italian populists to compromise and submit a budget more in line with the EU's rules, thus providing temporary respite from the risks associated with Italy. Third, Trump's economic policy is losing clout.

The US versus the rest of the world

In other words, by now, the lingering, well-known European risks have been amply priced in, as the political playing field in the US grows increasingly complex. Although a higher risk premium on European equities is therefore still justifiable, looking ahead, the downside risk of European equities compared to their US counterparts is, in fact, more limited. This observation also applies more broadly, because in Japan, too, the political risks seem more limited, since Abe's re-election and the continuation of 'Abenomics'.

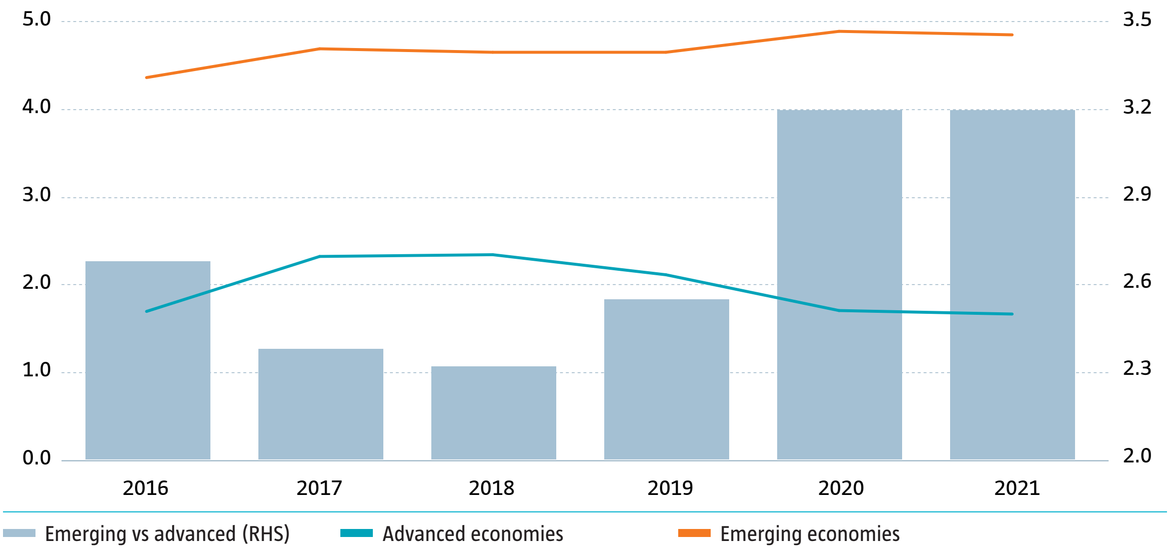
Our analysis demonstrates that with equity risk premiums in the US at their current, astonishingly low levels relative to the rest of the world, the returns on US equities have historically lagged. In other words: based on current valuations, the rest of the world has an edge on the United States when it comes to return potential.

Historically speaking, switching to the US, which has traditionally been a defensive market for equities, is an obvious choice at a late stage of the bull market. However, in this case, there are actually reasons to prepare for an increasing share of equities from other countries, so that one can gradually reduce the weight of US equities. Take, for example, the sustained global economic growth, the attractively priced European and Japanese markets and the expected decrease in political/geopolitical risks in Europe compared to the US.

*Determination of the z-score
We define the regional equity risk premium (ERP) as the earnings/price ratio of the regional equity index (the inverse of the price/earnings ratio, i.e. (1/K/W)) minus the return on the corresponding 10-year government bond. We calculate the US ERP as the S&P 500 earnings/price ratio minus the 10-year Treasury yield. For the global ERP, we subtract the yield on the Merrill Lynch global government bond (which has a comparable duration to the 10-year Treasury) from the MSCI World earnings/price ratio. Both data sets are denominated in dollars. Then monthly data from 1985 onwards was used to calculate a z-score using the absolute difference between the US ERP and the global ERP.

6 | Are emerging markets on the rebound?

GDP Growth



Source: IMF & Robeco

We expect emerging market equities to outperform developed market equities in 2019. There are three key reasons why we feel this will happen.

First, the gap between GDP growth in emerging and developed countries is likely to widen next year. It will be the first time that has occurred since 2016. In the latest IMF growth forecasts, shown in the graph, growth in emerging countries is expected to accelerate somewhat while growth in developed markets will ease over the next few years. By 2020 this gap is expected to widen by almost a whole percentage point. Historically, the gap between growth rates in emerging and developed markets is one of the strongest drivers of the emerging market equities relative to their developed market counterparts.

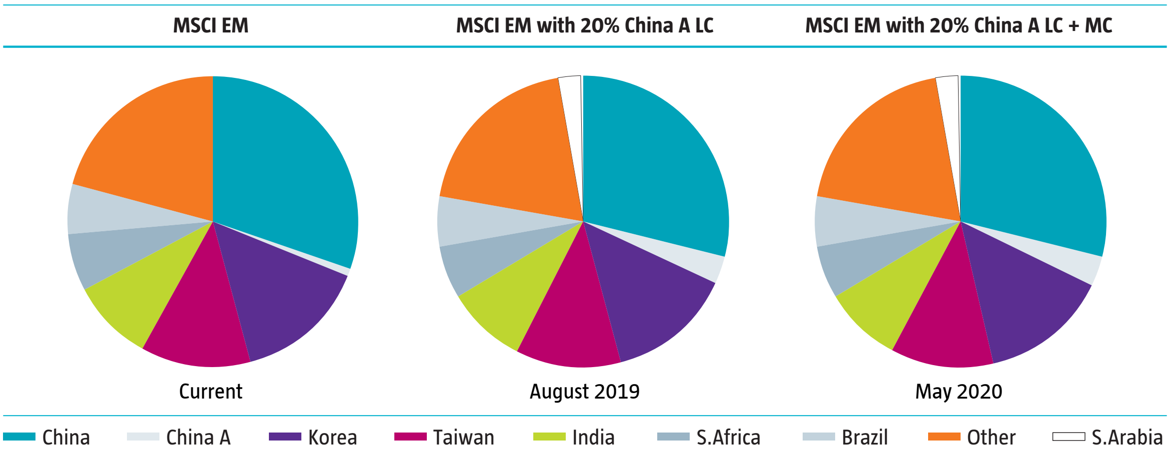
Second, while we expect the Federal Reserve to keep hiking rates, we also believe it will do so very gradually. In addition, investors could start to anticipate an end to the tightening cycle later next year. Assuming some normalization of monetary policy outside of the US, we expect the US dollar to weaken. A stronger US dollar often means tighter financial conditions. For example, a significant portion of emerging sovereign and company debt is denominated in dollars. Therefore, a weaker dollar implies looser financial conditions for emerging countries.

Third, emerging markets are cheap. The prolonged under-performance of emerging market equities has made valuations more attractive compared to other regions, especially the US. The trailing P/E ratio of the MSCI Emerging Markets Index has fallen from 16 earlier this year to its current level of 12. This is cheap in both absolute and relative terms. While valuation is seldom a trigger for a change in market leadership, we think it could be an important catalyst for emerging market relevance when the relative outlook starts to improve.

Risks

Obviously, what appears to be a bright future for emerging markets also comes with a number of significant risks. Some emerging economies like Argentina and Turkey look weak at best. These economies are particularly vulnerable to any adverse shock to global economic conditions or investor sentiment. At the same time, most of these economies are relatively small and unlikely to cause a widespread crisis across emerging markets.

If the US economy overheats, that would be bad news, as well. In that scenario, the Fed would tighten monetary policy more aggressively, causing liquidity to fall and the US dollar to rise. Finally, emerging markets remain relatively vulnerable to any escalation in the trade war between China and the US. While equity prices now reflect a long-term trade dispute with some resulting loss of economic momentum, bigger tensions could hurt emerging markets going forward.



Source: MSCI, Robeco

Note: LC = Large Caps, MC = Mid-Caps

In addition to emerging market equities, we also think there will be opportunities in Chinese A-shares. A key driver for this is that index providers are increasing the weight of Chinese A-shares. As a result, foreign investors will likely increase their exposures to A-shares. After this year's sell-off, fundamentals, especially valuations, look increasingly attractive, as we expect fundamentals to improve throughout the year.

Increasing the weight of A-shares

The announcement by FTSE to add A-shares to the FTSE Global Equity Index Series with a 25% inclusion factor and MSCI's proposal to increase the inclusion factor from 5% to 20%, reflect China's ongoing progress on capital market reforms. After the 25% inclusion, A-shares will account for 5.6% of the FTSE Emerging Index. In MSCI's case, the pro forma index weight of China A-shares in the MSCI EM Index would be 2.8% in August 2019. The addition of China A mid-cap securities with an inclusion factor of 20% in May 2020 would increase the pro forma weight further to 3.4%. At full inclusion, A-shares would take up nearly 15% of the emerging market index and all China stocks would account for over 40% of EM.

The China A-share market has already witnessed robust inflows this year. As a result, foreign ownership of China onshore equities had risen to 3.2% by Q2 of 2018. This is, however, still low compared to other major markets: Taiwan (26%), Korea (34%) and Japan (30%). Assuming full inclusion of A-shares in the MSCI and FTSE by 2025, this could generate an estimated USD 70 bln to USD 100 bln in annual inflows into the A-share market and bring the foreign ownership up to 8%.

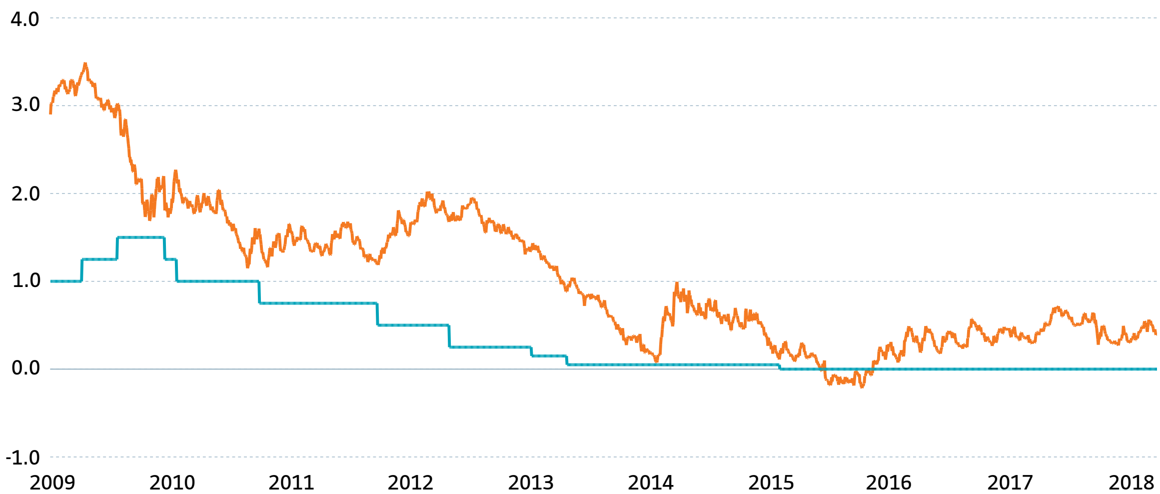
With China seeing more participation from foreign investors and a rising awareness of ESG, the corporate governance will gradually improve for Chinese companies. The focus of investors will also gradually shift towards more long-term fundamental drivers even though it could take time given the large proportion of retail investor participation. Despite the expected increase in foreign investment, the valuation of the A-share market is now at a level that is close to the historical minimum, with the P/E ratio trading at 9.8, compared to its historical average of 15.1. The price-to-book ratio has fallen to 1.5, below the historical average of 2.7. Valuation levels have become significantly more attractive this year.

Improving fundamentals

As mentioned, China's economy will face some challenges from the prolonged trade friction between China and the US and its already elevated debt levels, leaving it little room to stimulate the economy with credit growth. This is part of the reason why sentiment surrounding A-shares remains low, even though at the macro level, China is now shifting towards a looser monetary policy and more expansionary fiscal policy. We believe, however, that sentiment has become a bit too bearish and that fundamentals, such as profitability, will slowly improve, helped by the positive policies and reform measures introduced by the government.

7 | A first step towards normalization

The only way is up



EM Repo rate: Int. rate on short term repurchase agreements NADJ — Germany benchmark bond 10-year (Ds) - Red. yield

Source: Thomson Reuters Datastream, Robeco

The European Central Bank is ready to raise interest rates for the first time since Draghi took office. The question is whether it will happen before the end of his term.

Mario Draghi might go down in history as the only European Central Bank (ECB) president never to have raised interest rates. When he took office in November 2011, the lending rate stood at 1.5% and it gradually dropped to the current level of 0.0% during the course of his tenure. The ECB looks set to hike rates for the first time next year, but it will be a close call if it happens before Draghi steps down.

The ECB will, after all, be on automatic pilot until the fall of 2019: quantitative easing will end at the start of next year and interest rates will be kept at their current level at least until after the summer. As such, the ECB's meeting on 12 September 2019 could be the earliest opportunity to raise interest rates. After that, there will be one last chance for Draghi on 24 October, before his term ends a week later on 31 October.

Nonetheless, we think the ECB is likely to take a first modest step towards normalizing short-term interest rates in September, as the Eurozone economy continues to show strong growth. Over the last five years, unemployment showed an impressive drop from 12% to 8% and is continuing this downward trend. Additionally, more wage inflation is expected. This provides room to raise the abnormal and market-distorting negative deposit rate incrementally from minus 0.4% to 0.0% in December, with the lending rate moving back into positive territory.

Deflationary shocks

A rise in Germany's capital market interest rates is also expected. At around 0.4%, it is unnaturally low, while the Eurozone's core inflation rate is about 1.0%. The low rates are partly due to the ECB's bond-buying policy, which will be discontinued at the end of the year.

German Bunds are, after all, one of a select group of investments still considered to be a safe haven. This stability is particularly welcome in Europe, where political turmoil still abounds. A scarce commodity is simply more expensive and in the case of bonds, this equates not only to high prices but also to low yields. Their safe-haven status offers investors asymmetric protection against deflationary shocks.

A 'hard' Brexit could trigger a deflationary impulse. This risk will probably be a thing of the past after March 2019, when the UK officially leaves the European Union and a transition deal takes effect. For all intents and purposes, this deal will keep the UK in the internal market for years to come and have no economic effect compared to the current situation.

Collapse of the Eurozone

The collapse of the Eurozone would also have a strong deflationary effect on the region's economy. That risk is not entirely unrealistic and, over the last few years, it has continued to rear its ugly head, albeit in different forms. This time Italy is taking its turn in violating earlier budget agreements – risking getting stuck in a downward spiral of rising interest expenses, higher budget deficits, costly recapitalization of its shaky banking sector and a downgrading of its credit rating. The ECB can only assist the country once it starts to comply with EU agreements again.

But at the same time, that would obviate the need for assistance, as it would send the risk premium on Italian government bonds plummeting again. Under pressure from the bond market, we expect the Italian government to cut its losses at some point. This will give German capital market interest rates room to rise because the risk of collapse will be judged to be much lower.

Due to its flawed structure, the Eurozone is more vulnerable to deflation and default than inflation, unlike the United States, for instance. ECB policy must always take this into account.

The new Draghi

Deciding who replaces Draghi will be the outcome of a complex diplomatic chess game. A number of top European positions have to be filled (presidents of the European Commission, European Council and European Parliament), and the regional balance must be maintained. The importance of the individual should not be overestimated, either, as the ECB is the only key European body that decides by simple majority vote.

Furthermore, Italy's high debt burden is a factor that for the years to come will significantly limit the leeway of Draghi's successor. In an effort to support the weakest link, in this case Italy, with its relatively modest growth, the interest rate policy will retain a certain asymmetry.

8 Two European headaches: Brexit and Italy

Italian ten-year government bond yield

Spread of 10-year Italian government bond over Bunds

Source: Thomson Reuters Datastream, Robeco

The elimination of two key downside risk factors will give the ECB more room to start normalizing interest rates.

The dampened enthusiasm for European equities can be explained in part by varying, but persistent political risks. One such risk is that of a 'hard' Brexit. In this scenario, the United Kingdom would leave the European Union on 29 March 2019, without a transition deal, on the assumption that a new treaty will be agreed governing future trade relations between the two. It would, however, put an immediate end to the smooth trade between the UK and the continent. The implications would include import duties and inspections at the Irish border. Partly because of this, the movement of goods and people would take longer to process, potentially causing very long delays, and a physical border would have to be re-established between Northern Ireland and the Republic of Ireland.

A 'hard' Brexit would probably trigger a recession in the UK, which would hurt economic growth in the EU, too. It is much more likely, however, that the UK and the EU will reach a transition deal, thereby temporarily postponing key strategic decisions – theoretically until December 2020 or a few months thereafter, but in practice probably much later. The advantage of this scenario is that, economically speaking, nothing would actually change.

Italy's credit rating

So after 29 March 2019, European markets will no longer have the British sword of Damocles hanging over them. But the timing of a solution to the Italian crisis is a lot less certain. The Italian government decided unilaterally to renege on its pledge to reduce its budget deficit and is making very optimistic assumptions about future economic growth. The resulting conflict with the European Commission could drag on for a long time, eventually resulting in a modest fine. This will not have a preventative effect.

More importantly, the risk premium on Italian government bonds has risen considerably, which is undermining the financial position of Italian banks, as they hold large positions in these debt instruments. These banks may be forced to raise additional capital in the foreseeable future. But because they probably can't access the capital markets, the government will be forced to step in. In addition, Italy's credit rating has fallen to worrying levels. If it drops even slightly further, this could jeopardize the assistance provided by the European Central Bank.

There is speculation that the Italian government is pursuing a strategy aimed at helping populist parties secure a resounding victory in the 23 to 26 May 2019 European elections, in hopes of changing the rules of the Stability and Growth Pact. This doesn't seem like a promising approach, as these parties are not likely to garner the support needed from the left and right to achieve a majority. It's also doubtful whether the Italian government's current stance is going to win it many friends among the other populist parties, either.

Moreover, the European Parliament is basically toothless. It cannot change the pact. It can vote against a new Commission, but then the current one would stay on. The end of May 2019 also seems like a long way off given the stress on the financial markets. The Lega has close ties with the business community in Italy's affluent north, which probably isn't going to be too excited about a strategy that might lead to a costly Italexit.

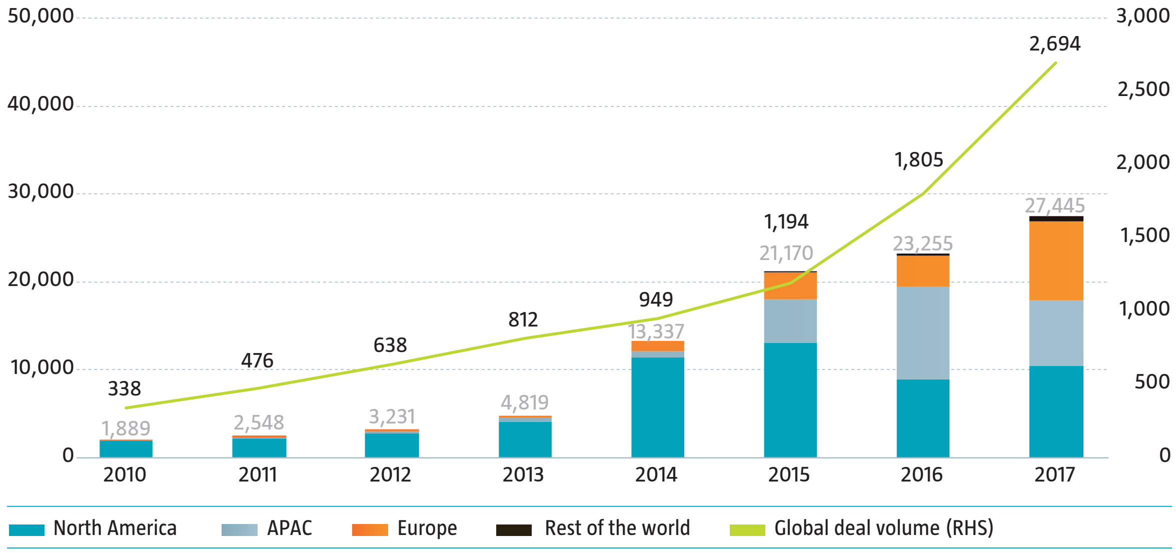
Good news for European banks

We think therefore that the Italian government will eventually give in and reach a compromise with the Eurogroup. This could cause the risk premium on Italian government bonds to fall, thus alleviating doubts about the sustainability of Italy's debt.

Drawing a line under both of these situations will help European equities deliver improved relative performance within a global equity portfolio, and banks will play a key role in this. The elimination of two key downside risk factors will give the ECB more room to start normalizing interest rates. Long-term German Bund yields will rise, once a high risk premium no longer needs to be priced in to compensate for the risk of a Eurozone collapse. And yield curve normalization is of course good news for the European banking sector.

9 | Leveraging new technologies in finance

Financing activity by region



Source: Robeco

While we believe in the long-term attractiveness of fintech, we also see several developments in the coming year that make it particularly interesting.

Fintech is maturing

But first we feel it is important to emphasize that fintech has changed dramatically over the past few years. What basically began as back-end payment service has transformed into an industry in its own right, leading to the unbundling of financial services now and in the future. Fintech solutions have now also been developed for areas such as consumer credit, foreign currency transactions, insurance and wealth management. And the number of fintech companies has grown significantly in recent years, with over 2,500 deals being completed in 2017 compared to just 330 in 2010.

More to come

The many new developments in fintech continue to reshape the financial sector. Some of these use emerging technologies to enhance financial services (fintech), while others are aimed at improving existing capabilities within the financial services industry (techfin). Together they will shape the fintech universe going forward. Two examples are artificial intelligence (AI) and big data. Electronic payment services involve the real-time analysis of huge amounts of data, increasing the risk of fraud. Neither this analysis nor the prevention of payment fraud are possible without both AI and big data.

Another growth area is core system replacement. Many financial institutions still run software from the 1970s and 1980s, developed and expanded in isolation. Connecting these outdated systems is an arduous task and many can't run new services and tools. Eventually they have to be replaced by more suitable, flexible systems offering opportunities for fintech-focused companies. The same goes for financial inclusion. In many countries, the economics of the traditional bank branch or insurance agency model do not work. Low density and relatively low GDP per capita mean it is not economically viable to open bank branches in rural areas. Basic financial services have to be provided by more electronically scalable solutions. Finally, the fact that payment services is the most mature part of fintech does not imply a lack of growth opportunities. The market share of digital payment solutions is still growing rapidly, a trend from which payment processors, networks and acquirers are benefitting.

So why now?

We currently see a number of specific developments that make fintech an interesting investment theme for next year. First, the investable universe is still growing. There will be many new IPOs in 2019, including some major US companies. Robeco has already identified more than 200 listed companies that fit the fintech theme. Liquidity is not a constraint, which means there is an increasing number of opportunities for active investors to both differentiate and diversify.

Second, the solid outlook for financials implies that these companies will have more cash to spend on replacing of systems and technology in general. With GDP growth set to continue, many companies are raising their budgets for capital expenditures. This is a positive trend for so-called technology enablers, many of which operate within the fintech universe.

Third, we could see more splits in the technology sector. Currently, technology segments like e-commerce, social media and fintech are mentioned in the same breath, despite having very different dynamics. Not all tech should be treated equally. More distinction will create more visibility on the strong earnings growth fintech offers. Now that the world has digested buzzwords like AI, blockchain and Robo advisors, we also expect the focus on the actual business and the strong fundamentals it represents to increase.

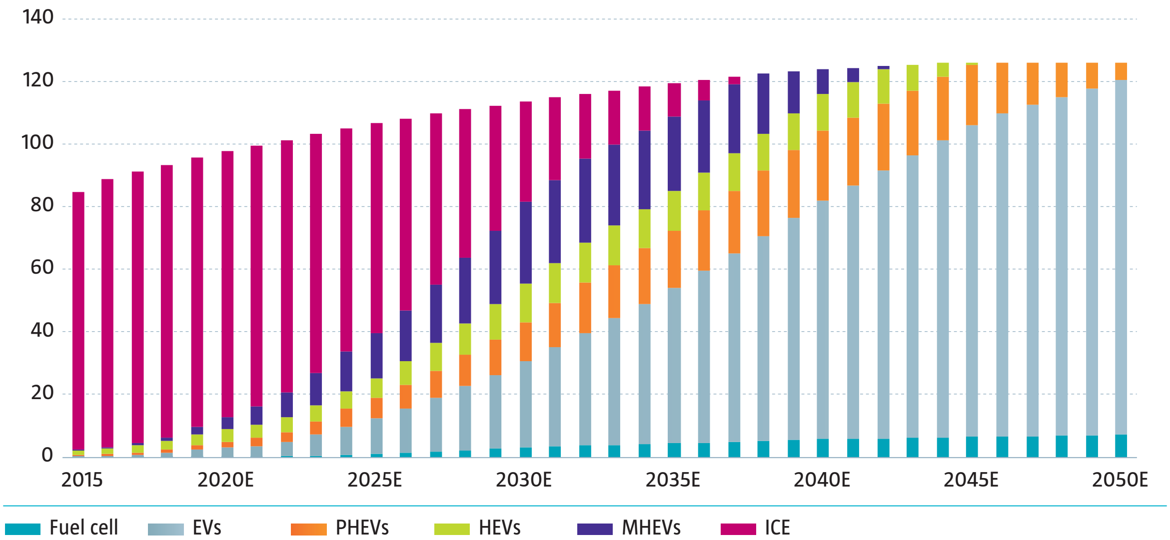
Finally, as this year's Outlook reflects, 2019 is expected to be a year of transition, at least for financial markets. As this transition is likely to be accompanied by more volatility, exchanges, market makers, trading platforms and so on look set to benefit. This is another example of the far-reaching impact that the rise of fintech is having on the financial markets.

Risks

Investing in a young, innovative and fast-growing sector like fintech is obviously not without risks. Many fintech companies can be defined as growth companies, which are more sensitive to rising interest rates. We also believe that regulation is a key area to watch in 2019. Many fintech solutions have been able to develop under a light-touch sandbox regime, which has boosted competition. But the big question remains whether these start-ups can keep growing fast enough and become profitable enough to deal with increased regulatory scrutiny, like their traditional financial peers.

10 Electric vehicles coming of age

Light vehicle sales forecast (in millions of units)



Source: RobecoSAM, 2017; EV = Pure Electric Vehicle, PHEV = Plugin Hybrid EV, HEV = Full Hybrid EV, MHEV = Mild Hybrid EV, ICE = Internal Combustion Engine

In the coming years, the global automotive industry will go through its most radical change as vehicle electrification and changing consumer preferences challenge existing business models.

While it may be too early to say goodbye to the combustion engine, 2019 looks set to become a milestone in the mass adoption of electric vehicles. We have known for some time that this was going to happen, as it is a transition that will help move us close to fulfilling a number of the Sustainable Development Goals formulated by the UN back in 2015[1]. However, the incentives required to get the ball rolling were only starting to emerge slowly. We now expect these to come thick and fast, offering interesting investment opportunities next year.

An example is the recent growing trend for governments to reveal their long-term ambitions for combatting air pollution and reducing CO2 emissions. Instrumental in achieving these targets is the introduction of stricter limits for vehicle emissions, an approach that is gaining momentum among governments worldwide. The EU, for instance, has set a CO2 reduction target of 27% by 2020. And environmental issues like 'dieselgate' have vastly increased awareness of a problem that desperately needs a solution. Electric vehicles are part of that solution. With new models expected to come off the production line this year and next, electric vehicles look set to become a real alternative to combustion-powered cars, providing an interesting investment opportunity into the bargain.

Electric vehicles at an inflection point

Investing in electric vehicles is a good example of impact investing, as it benefits the environment and offers an interesting investment case. Although stringent emissions regulations will continue to spur changes in the automotive industry, ongoing production-cost declines will be critical in driving electric vehicle sales.

Several factors are contributing to falling costs. The price of batteries has already come down a lot and should continue to fall over the next three to four years. In addition, the costs of electrified powertrains – including the power electronics and motors – are expected to fall significantly as well. Future electric vehicles will be based on optimized, scalable platforms, allowing a significant reduction in development and assembly costs. Once optimized, they are expected to require around 25% less assembly time (less than 30 hours compared with 40 hours for traditional cars).

With the total cost of owning an electric car marginally below that of owning a 'traditional' one, the electric vehicle market is already shifting from a subsidy-driven to purely economics-driven market. This transition will result in the electric vehicle market reaching the critical inflection point for mass adoption. Car manufacturers are investing heavily in electrifying their fleets and the results will become evident next year as a wide range of electric vehicles hits the market.

It is not, therefore, just about car manufacturers expanding their range; we also expect investment opportunities to materialize across the entire spectrum of sectors and industries that make up the electric vehicle value chain. These include component and sub-system suppliers focusing on the crucial elements of electrification, companies focusing on sensors and data processing, and suppliers of smart electrical grids and charging infrastructures.

Growth expectations

In the coming years, the global automotive industry will go through its most radical change as vehicle electrification and changing consumer preferences challenge existing business models. Around 1.1 million plug-in hybrid electric vehicles (PHEVs) and pure electric vehicles (EVs) were sold worldwide in 2017, which represents year-on-year growth of over 50%. Electric vehicle sales in 2018 are expected to increase to 1.7 million units; in other words, nearly 2% of all new cars sold. We expect this trend to accelerate in the coming years, with 3 million pure electric vehicles and 2 million plug-in hybrid electric vehicles estimated to be sold in 2020.

Investors that have embraced impact investing need to have a long-term view. Typically, such investment themes are accompanied by above-average volatility, as the corresponding strategies tend to have a growth bias. For the first half of 2019, we expect growth-oriented themes to fare well. But if the economy cools as we approach 2020, most investors will favor defensive stocks, which could hurt short-term performance. However, given the irreversibility of the mobility trend and the increasing quality and scope of connectivity and mobility services, entirely new markets will develop, further increasing the breadth of investment opportunities in 2019.

1. In particular: Sustainable Development Goal - Ensure access to affordable, reliable, sustainable and modern energy for all

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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 subject to limited regulation in the UK by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.

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 in 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.

Additional Information concerning RobecoSAM Collective Investment Schemes
The RobecoSAM collective investment schemes ("RobecoSAM Funds") in scope are sub funds under the Undertakings for Collective Investment in Transferable Securities (UCITS) of MULTIPARTNER SICAV, managed by GAM (Luxembourg) S.A., ("Multipartner"). Multipartner SICAV is incorporated as a Société d'Investissement à Capital Variable which is governed by Luxembourg law. The custodian is State Street Bank Luxembourg S.C.A., 49, Avenue J. F. Kennedy, L-1855 Luxembourg. The prospectus, the Key Investor Information Documents (KIIDs), the articles of association, the annual and semi-annual reports of the RobecoSAM Funds, as well as the list of the purchases and sales which the RobecoSAM Fund(s) has undertaken during the financial year, may be obtained, on simple request and free of charge, via the website www.robecosam.com or www.funds.gam.com.

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