For professional investors

ROBECO
The Investment Engineers

A TALE OF 2 SCENARIOS

INVESTMENT OUTLOOK 2020

Sustainable Investing Expertise by
ROBECOSAM

A TALE OF 2 SCENARIOS

INVESTMENT OUTLOOK 2020

For professional investors

November 2019

CONTENTS

	Foreword	4
INTRODUCTION	**A Hand at Cards** Extending the economic cycle	6
OUTLOOK MULTI ASSET	**The Sea Still Rises** Extending the bull market	10
	A Knock at the Door The return of inflation	13
OUTLOOK GLOBAL EQUITIES	**Calm in Storm** Beyond the trade war	17
	Echoing Footsteps The return of the underdog	20
OUTLOOK FIXED INCOME	**The Night Shadows** Investing in fixed income if recession hits	25
	Recalled to Life Finding the right bonds for recovery	28

A Tale of Two Scenarios

The recurring theme of this outlook can be summarized in just two words: ‘what if?’. We expect the economic expansion to last a little longer, and the equity bull market to enter the last leg of a near decade-long climb. Based on expected global GDP growth, company earnings, and the relative value of equities compared to other assets, there is definitely a case for a prolonged period of tailwind for investors. We believe the things that made financial headlines in 2019 – Brexit and trade wars – to be less prominent in 2020. However, what if we’ve got it wrong? What if earnings and GDP growth stall earlier than we expect right now? What if the recession does hit us in 2020?

We think the odds are that we will see a best-of-times scenario for at least one more year, but we also believe the impact of a worst-of-times scenario (please excuse us for paraphrasing the opening sentence of Charles Dickens’ *A Tale of Two Cities*, we are aware you have seen this phrase in investment outlooks many times before) would be so big, that it would be unwise to ignore it completely. A >20% fall of the equity markets is not unthinkable if things do turn sour. In this outlook, we explore the potential futures that lie ahead, often directly comparing those two scenarios. We believe we will see another year of more than decent returns on investments, but... what if?

INTRODUCTION

A Hand at Cards

The lights inside were dim, and people were smoking pipes and playing games with worn decks of cards and yellow dominoes. One bare-chested, bare-armed workman was covered in soot and reading a journal out loud. Other people listened to him. People wore weapons on them, or had set them down nearby where they could be easily reached. Two or three customers had slumped forward, asleep.

(*A Tale of Two Cities*, Book 3 – Chapter 8)

Extending the economic cycle

The global economic cycle is likely to be extended just slightly more in 2020. Signs that manufacturing PMIs are stabilizing and will improve further out have increased, and financial conditions will remain favorable. This is mostly due to the continuous loose monetary policy by central banks around the globe.

We expect that the two major political headaches that dominated most of 2019 – the US-China trade war and Brexit – to have less impact in 2020. There will be no hard Brexit, and what happens in the meantime should be considered noise. There will be no comprehensive trade deal either, but any slimmed-down version is enough to bring back some business confidence and hence capital expenditures. This facilitates a return of corporate earnings growth, but only after a subdued final quarter of 2019.

US – no recession, room for further easing if necessary

The US economy is unlikely to slip into a recession next year as employment, consumer spending and services remain resilient. We expect the ISM manufacturing index to recover along the way, digesting the inventory overhang and moving back above 50. The yield curve has inverted, but based on historical data including lag times, a recession is more likely after 2020. Other recession indicators like building permits and initial jobless claims are not flashing red either. Contrary to the ECB and BoJ, the Federal Reserve has the ability to ease significantly, but will only do so if economic circumstances deteriorate. With monetary policy already pretty loose, however, this should not hamper growth. With 2020's slow start, US GDP growth will be lower (<2%) than in 2019. We expect Trump to remain US president after the elections because the incumbent party tends to win whenever the economy is improving. We acknowledge, however, that the way to that victory is likely to be volatile.

China – lower growth, no collapse

Unsurprisingly, China's GDP growth is set to slow further. Demographics, high levels of corporate debt and the transition from an investment-led economy to a consumer-led one make structurally lower growth rates inescapable. China has used the ongoing trade dispute with the US as an excuse for this lower growth, and without a significant trade deal on the horizon, this is likely to remain the case. Like the US, China has room to stimulate the economy further if needed, but will only do so reactively. Things need to get worse before the government steps in.

Europe – waiting in vain for fiscal stimulus

The outlook for GDP growth remains subdued. Germany is grappling with the global manufacturing slump and lower export growth, partly related to the US-China trade war. As a result, GDP growth in 2020 will be below 1%. Other major Eurozone economies, like France and Spain, will record better growth, albeit below trend as well. The ECB will not deliver any material additional monetary easing, unless economic circumstances turn ugly. It will look to governments to increase spending but based on current projections, fiscal stimulus will be minimal. Germany and the Netherlands are the two main contributors to additional government spending but will record another government budget surplus next year. There will be no hard Brexit, which should lift business sentiment for the whole of Europe, opening up room for some lost capex spending.

The alternative scenario

Our alternative scenario looks far bleaker because we believe the potential outcomes are binary. There is no middle road. In the alternative scenario, the path to a US recession is already irreversible as central banks are behind the curve. Manufacturing will not pick up and instead cause spillovers to other sectors like services. Corporate earnings weaken further, causing defaults, first among the lowest-quality companies, especially those with large amounts of debt, and will spread out from there. Unemployment will start to increase and consumer spending will drop, causing GDP to shrink. In this scenario, we expect central banks to ease as much as possible. As we see few major excesses in the economy, apart from the amount of corporate debt in some economies, the recession should be considerably less severe than in 2009.

Markets base case – extending the bull market, bond yields grind higher

We expect stock markets to reach new highs before struggling later. Equities tend to move up until very close to a recession, and improved economic growth should translate into renewed earnings growth. DM and EM stocks are expected to outperform other asset classes. High yield bonds look less impressive from a risk-return perspective compared to other risky asset classes, with spread widening often already starting in the later stages of the economic cycle. The same holds true for investment grade credits, but at least some of these have the ECB on their side. Government bond yields should grind higher as economic conditions improve, with central banks unwilling or unable to ease more. That said, we do not expect an end to extremely low or negative yields any time soon.

The alternative scenario for equity markets – equities down >20%

It is exactly the inability of central banks mentioned above that makes us expect a drop in equities of significantly more than 20% if a downturn hits. While the recession doesn't have to be that severe, several central banks like the ECB and the BoJ have already used up most of their ammunition, while others, like the Federal Reserve, will move reactively and reluctantly. Despite this, bond yields are likely to reach new lows, with other safe havens like gold rising as well.

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

Source: Robeco. The symbols show the relative attractiveness of the different asset classes from a multi-asset portfolio perspective, taking into account the risk-return impact of those asset classes.

OUTLOOK MULTI ASSET

Jeroen Blokland
Head of Multi Asset

The Sea Still Rises

Extending the bull market

It wasn't until nighttime that the men and women came back to their homes. Their children were crying and hungry, and the poor bakeries were filled with long lines of people who waited patiently to buy bad bread. While they waited hungrily, they passed the time by embracing and reliving the triumphs of the day. Eventually these lines of poor people broke up and they left. Then meager lights began to shine in the windows, and meager fires were made in the streets, where neighbors cooked together, then ate in their doorways afterward.

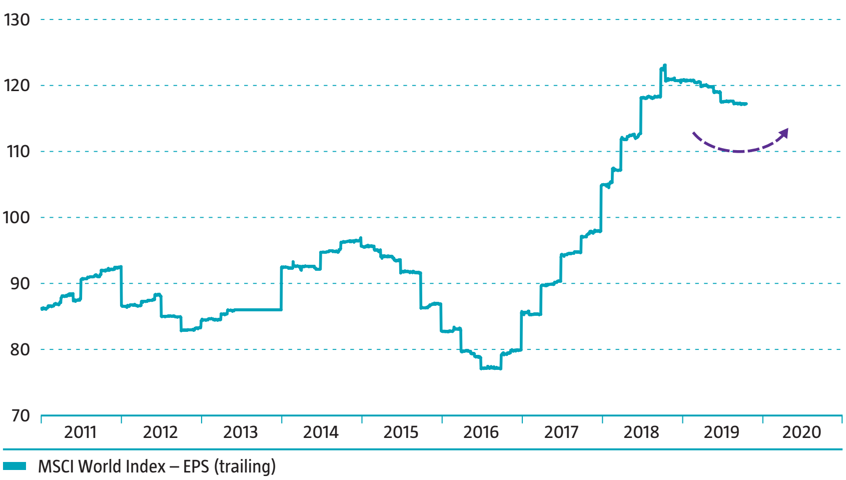
(*A Tale of Two Cities*, Book 2 – Chapter 22)

With a recession to be avoided and earnings growth to return, we believe global equities have further to go, with stock markets reaching new highs going forward.

First, a macro environment in which GDP growth is below but close to trend suits global equities just fine. In addition, financial conditions remain loose as a result of the very accommodative stance of central banks. Since the financial crisis in 2008, global markets have moved in tandem with central bank balance sheets, which will start rising again after a two-year break. With the US yield curve suggesting that a US recession is more likely after 2020, equities have room to extend the bull market. Historically, stock prices kept rising for an extended period of time of almost a year after every instance of the yield curve inverting (except for 1973). Prices peaked on average less than six months prior to a recession.

Second, earnings growth is set to return in the first half of next year. Diminishing uncertainty with regard to economic policy, as well as better manufacturing PMIs, will enable earnings-per-share growth to turn positive again.

Figure 1: MSCI World – Earnings per share



Source: Bloomberg

Earnings revisions, which remain at subdued levels today, could revert strongly once the cycle turns. Unit labor cost growth, which is negatively correlated to profit margins, will stay muted. Wage growth is still relatively benign and productivity growth is finally rising. The tailwind of buybacks on earnings per share will dwindle somewhat, partly because of stronger investment growth. We do not believe this will keep equities from rising, though. As long as bond yields stay low or negative, companies will be enticed to swap equity for debt.

Third, investor sentiment is far from exuberant. As John Templeton once put it, "Bull markets... die on euphoria". Currently, we are far away from a euphoric state of equity markets. Cash positions of global fund managers remain significantly above average, which is a contrarian bullish signal for stocks. In general, investor positioning is defensive. Credit spreads also remain well behaved, with the BBB-AAA spread just below average. If anything, exuberance seems to have skipped equities and moved to less liquid, alternative investments like leveraged loans and private equity.

Fourth, equities do not look expensive in a multi-asset world. The equity risk premium has been consistently high in recent years as global bond yields continued to fall. Today is no different, with the equity risk premium still firmly in the first quartile. Historically, on an annual basis, equities have realized the best returns when the equity risk premiums have been the highest. From an absolute level and based on realized P/E, valuation does not look demanding. The realized P/E ratio for the MSCI World Index is somewhat below its long-term average, driven by discounts in Europe and Japan.

The alternative scenario – recessionary bear market

Our alternative scenario features a US recession. Political uncertainty will not decrease or may even worsen and global manufacturing PMIs will not improve, pushing earnings down further. As a result, capital expenditures will not increase, but more importantly, a default cycle will begin as low-rated companies cannot pay off their debt. Unemployment will rise and consumer confidence will break down. Even though there are few excesses in the economy, corporate debt being the exception, the economy will slip into recession. With central banks having less room for recession-countering measures than in the past, stock markets are likely to decline more than 20% under this scenario.

Conclusion

We expect global GDP growth to continue at a pace that is below but close to trend. After a slow start of the year, growth will gradually pick up. Manufacturing PMIs will improve as the inventory overhang is left behind. Earnings growth will turn positive in the first half of the year, helping sentiment that is currently far from exuberant. Together with an attractive valuation relative to other asset classes, global equities are bound to make new highs before perhaps struggling towards the end of the year as recession fears start all over again.

A Knock at the Door

The return of inflation

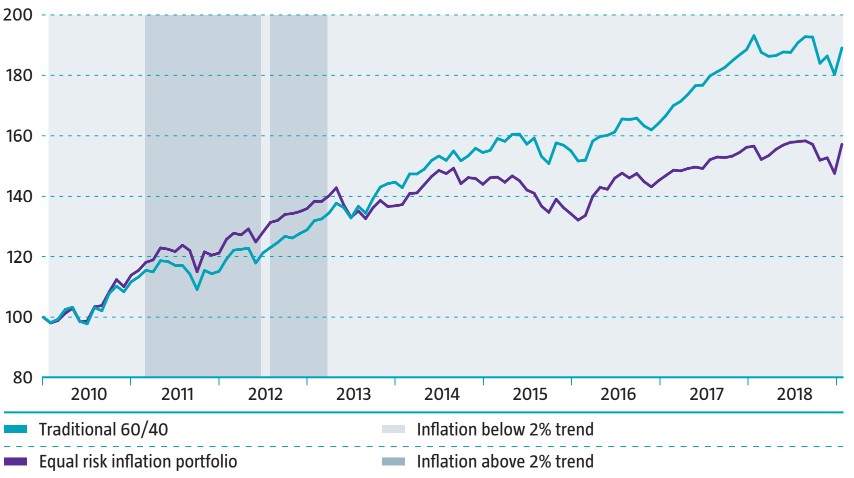
Everything was calm and quiet, and Lucie was calmer than she had been before. "What's that?" she yelled out suddenly. "My dear!" said the doctor, stopping his story and taking her hand. "Get a hold of yourself. You're so anxious! The smallest thing, even nothing, startles you!" "Father, I thought I heard strangers coming up the stairs," said Lucie, explaining herself. Her face was pale and her voice quavered. "Lucie, the staircase is as quiet as death." As he said the last word, someone knocked on the door.

(*A Tale of Two Cities*, Book 3 – Chapter 7)

Since the global financial crisis, one economic variable has stayed on our mind: inflation. In the aftermath of the crisis, it was experienced firsthand how destructive deflationary forces can be. Of course, financial markets have seen this before. The lessons drawn from the Great Depression and Japan have dictated the roadmap of central bankers over the last years. Now, 11 years after the Lehman default, it might be time to look for another course.

Declining inflation is not a new phenomenon; inflation has been on a downward trajectory for decades. During its decline from initially high levels, the move downwards was seen as welcome. Central banks were hailed as having policies that were effective in keeping down inflation. Inflation targeting, or a less explicit policy focus on inflation, was enshrined in most central bank mandates. Assets that tended to be more strongly linked to inflation massively underperformed traditional assets.

Figure 2: Inflationary assets massively lagged the market



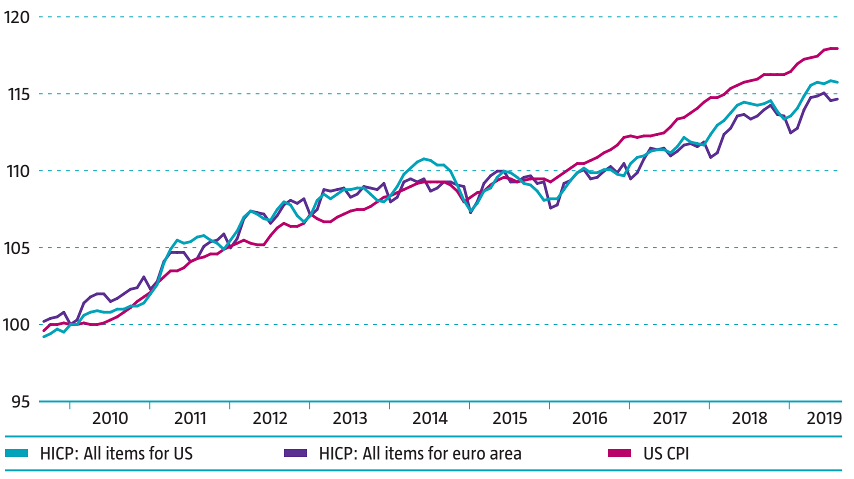
Source: Bloomberg. Calculations: Robeco. The traditional portfolio invests in the S&P 1200 global index and US treasuries 7-10 years. The equal risk inflation portfolio invests in the S&P real assets equity index, US ILBs 7-10 years, UBS commodity (CIC) index and cash.

In the beginning no one dared to question the success of central bank policy when it came to keeping inflation in check. However, looking back now, it is hard to deny that maybe a part of the success of central banks should be attributed to large powers that were working their way in the background.

One of the major forces that brought down inflation is globalization. To us, globalization is the coalescing of several major developments, such as the rise of technology, China joining the WTO and the liberalization of cross-border financing. All these developments created a fertile ground for companies to outsource labor and to tap into new consumer markets. As a consequence, global trade grew rapidly while inflation fell. Global developments steadily became an important driver for domestic economies. Of course, not every economy was affected in the same way and to the same extent. But even a relatively closed economy such as the US was impacted. This can be confirmed simply by looking at the share of imports in the GDP, which rose from 5% to 15% between 1970 and 2017.

Given our strong belief that globalization played a major role in inflation, why is it that the inflation numbers in the Eurozone and US differ so much? Shouldn't the readings be more in line with one another? In practice, there is only a general consensus on how inflation should be measured. To a certain degree, this is correct, as inflation needs to reflect regional and domestic preferences. For instance, in the US, healthcare has a much higher weight than in the Eurozone. Still, when we correct for these preferences, some odd variations remain. For instance, does it make sense for the US to include owner equivalent rents – which reflect the inflationary source of house prices – in its CPI when the Eurozone does not? If we calculated the US CPI based on the methodology used to calculate Eurozone inflation, the difference between Eurozone inflation numbers and US ones is considerably smaller than the official numbers suggest. Global drivers have indeed become an important driver for inflation.

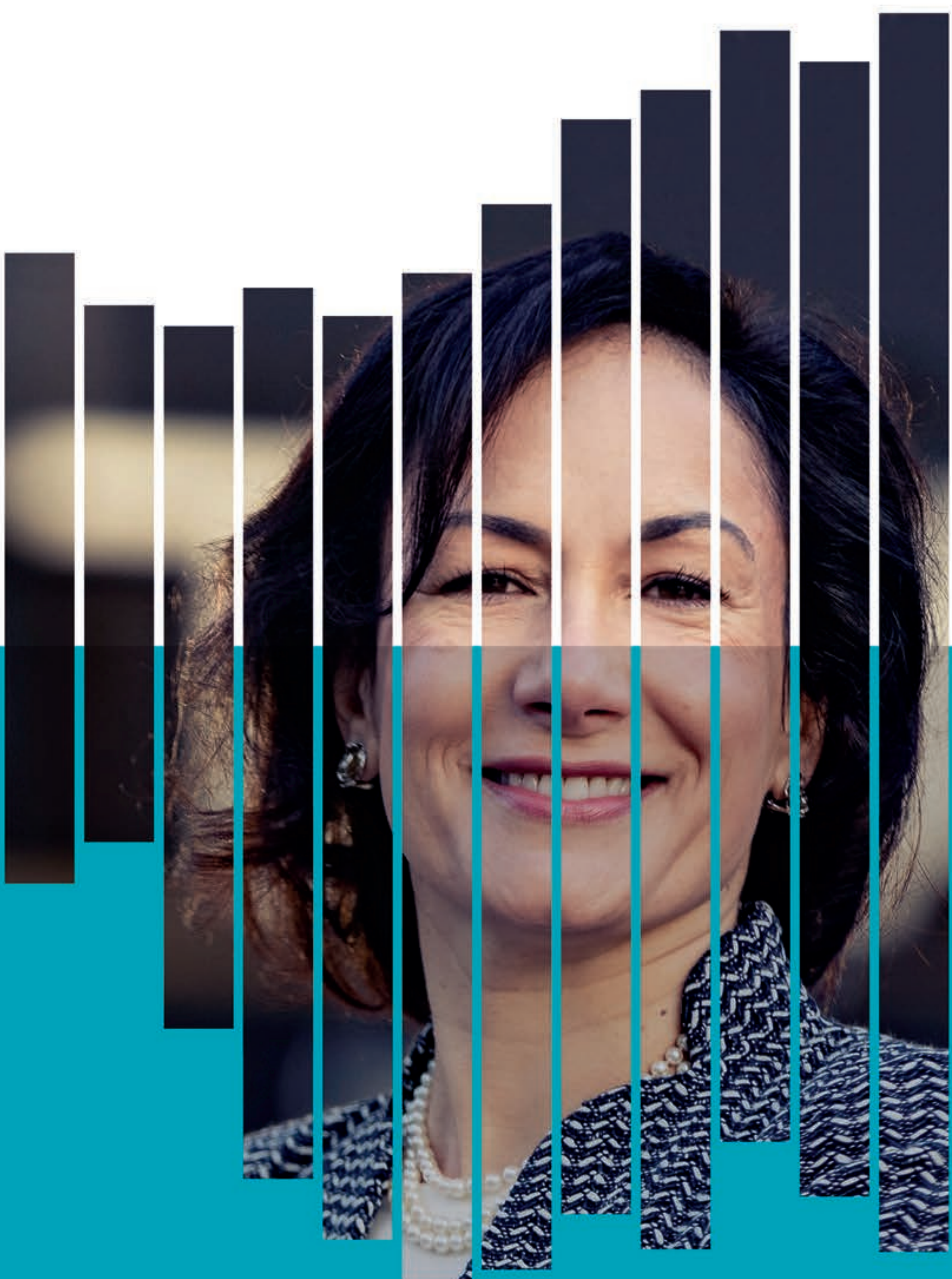
Figure 3: Definition matters: US and euro area CPI indices



Source: Federal Reserve Bank of St. Louis (FRED database). Calculations: Robeco. Indices are rebased to January 2010.

Over the past years, central banks have had difficulty turning deflationary forces around, fighting against forces outside of their control. We are at a turning point for globalization. The trade conflict between the US and China and of course Brexit demonstrate that globalization will no longer be a tailwind for deflation but more likely will turn into an inflationary breeze. Central bankers will need a new roadmap and will not be unsettled by a more than welcome increase in inflation. They will likely continue their dovish policy; an ounce of prevention is worth a pound of cure. If this plays out, 2020 may well mark the turnaround in the decade-long fall in inflation. This will have a pronounced impact on financial markets and the gap between the performance of inflationary assets and traditional assets may finally start to close.

OUTLOOK GLOBAL EQUITIES



Fabiana Fedeli
Global Head of Fundamental Equities

Calm in Storm

Beyond the trade war

They came from hills and plains, rock, gravel, and mud. They came from the South and the North, from fields and forests, from vineyards and olive fields. They came from the trimmed grass, cornfields, the lush farmland near the rivers, and the sandy beaches. What single person could compete with the storm rising? This storm was coming up from the ground instead of falling from the sky. Instead of a storm falling from Heaven, Heaven wanted nothing to do with this storm.

(*A Tale of Two Cities*, Book 3 – Chapter 4)

Over the past year, regional equity market allocation has been heavily influenced by investors' expectations on the outcome of the US-China trade war. We have nicknamed this 'pinball investing', where, in reaction to a world of binary outcomes, equity markets have been bouncing off tweets in whichever direction makes more sense at the time. The trade deal is on, equity markets are up and risk-on trades outperform; the trade deal is off, equity markets are down and turn more defensive.

This is not only due to the fact that investors are a temperamental bunch. The outcome of the trade disputes has a significant impact on corporate earnings, arguably a key determinant of equity allocation. There still remains uncertainty surrounding the trade conflict, not only between the US and China, but to a large degree between the US and the rest of the world. This, combined with the intellectual property disputes in information technology, is having an impact on economic activity and earnings across the globe: directly (through higher costs and lower revenues) or indirectly (as companies refrain from spending or investing more). Brexit has been the other topic at the forefront of equity investors' minds, although its impact is by and large contained to the UK and Continental European equity markets.

Depending on which one of our two scenarios (base case or alternative) develops over the next year, regional allocation in equity portfolios in our opinion should look very different.

Base case scenario: look outside of the US

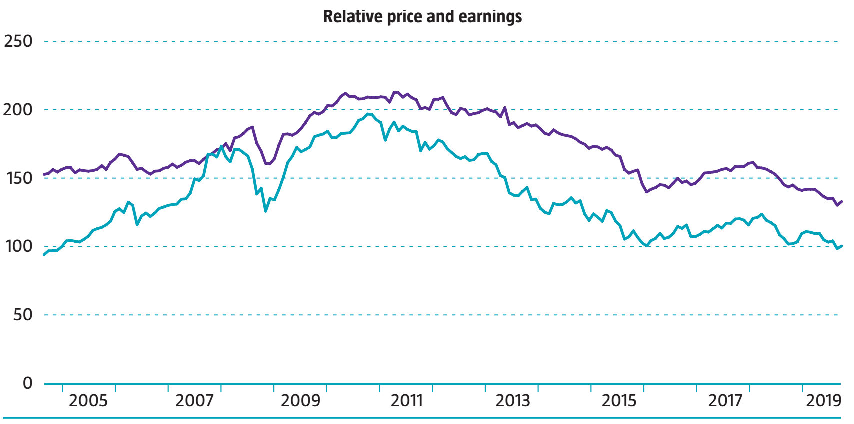
Our base case scenario – with no hard Brexit and a slimmed-down version of a US-China trade deal; sufficient to bring back some business confidence, capital expenditures and corporate earnings growth – makes the case for equities outside of the US compelling.

The current equity risk premium of US equities is at a 20 year low vis à vis Japan, Europe and emerging markets. Arguably, US equity markets are discounting a world where US corporates are not only firing on at least most of their cylinders, but also where the rest of the world's corporates remain far behind. However, a look at the current earnings expectations across major equity markets paints a very different picture.

Markets outside the US have already priced in a lot of uncertainty, and earnings growth (or lack thereof) is now at levels that do not justify the wide disparity in valuations. Take EM, with an expected earnings growth of 2.3% for 2019 and 13.4% for 2020, and a P/E of 13.2x and 11.4x, respectively. This compares with the US's 2.3% and 10.5% 2019 and 2020 earnings growth and 18.6x and 16.9x P/E, respectively. For Japan, earnings are expected to fall by 0.9% in 2019 and grow 5.8% in 2020, while P/E is at 13.7x and 12.8x, respectively. Europe's earnings expectations are for a 1.3% and 9.7% growth respectively, priced at a P/E of 14.8x and 13.4x.

The relative earnings outlook is a key driver for regional allocation in equity markets. This is most evident in emerging markets, where their relative performance to developed markets over the long term has coincided with the forward earnings gap (Figure 4).

Figure 4: EM-DM forward earnings gap and relative price performance

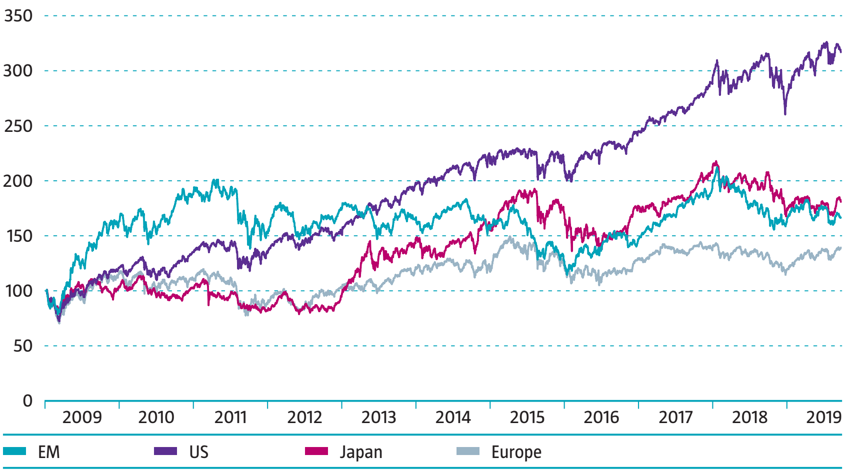


Source: IBES, as of September 2019. GEM vs MSCI World represents the ratio of the MSCI Emerging Markets Index to the MSCI World Index.

Of course, for equities outside of the US to outperform, we need their earnings expectations not to fall below their current levels. A poor earnings environment would set markets back on the defensive and quality-seeking path into the arms of US equities. That macro improvement, that is part of our base case scenario, is therefore a key prerequisite to support earnings.

The case for outperformance of non-US equity markets becomes even more compelling given the persistent underperformance that we have witnessed over the last ten years, as shown in Figure 5.

Figure 5: Global equity markets performance 2009-YTD



Source: MSCI (EM – MSCI EM Index; US – S&P; Japan – Topix; Europe – Euro Stoxx)
31 December 2008 – 30 September 2019

The alternative scenario: keep on hugging US equities

In our alternative scenario, which in our view is less likely, we have either no resolution or a meaningful setback in the US-China negotiations, the path to a US recession is already irreversible, and corporate earnings across the world weaken. Such a scenario would most likely bring back the risk-off stance, with global equity markets underperforming other asset classes and, within equities, the US market and more defensive bets most likely prevailing.

Conclusion

Depending on which one of our two scenarios develops over the next year, regional allocation in equity portfolios should look very different. In our base case scenario, the case for equities outside of the US is compelling, given relative earnings growth, valuations and prolonged underperformance. In this scenario, there is no hard Brexit and a slimmed-down version of a US-China trade deal, sufficient to bring back some business confidence, capital expenditures and a return of corporate earnings growth. Our alternative scenario would most likely bring back the risk-off stance. Within equities, the US market and more defensive bets would probably prevail. That said, we see the risk-reward between the two scenarios as asymmetric. Further degeneration in either the trade war or Brexit is likely to cause a negative price reaction, the latter limited to the UK and Europe. But the upside to non-US equities that would be triggered by positive news at this point looks far greater.

Echoing Footsteps

The return of the underdog

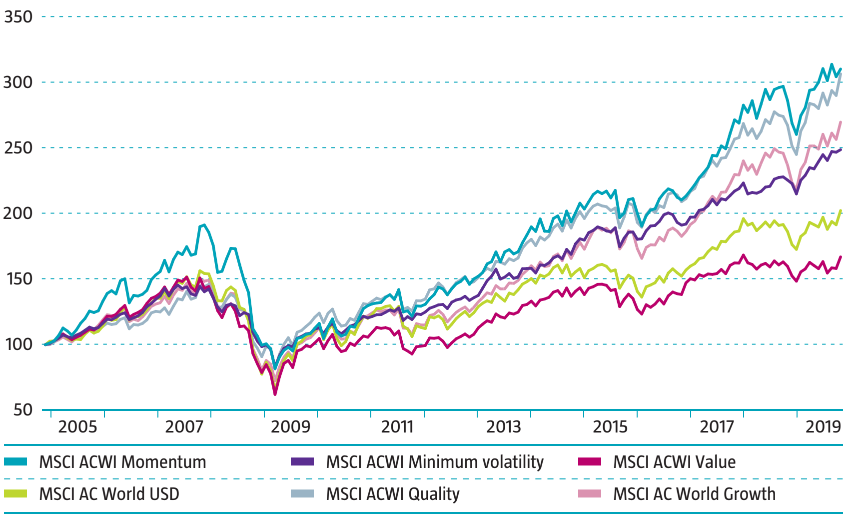
At first there were times when whatever she was working on would fall slowly out of her hands and she would look sad, even though overall she was a completely happy young wife. For there was something coming in the echoes, something far away and barely able to be heard, that upset her. She was caught between feelings of hope and doubt—hopes of a love still unknown to her and doubts that she would stay on earth long enough to enjoy that love.

(*A Tale of Two Cities*, Book 2 – Chapter 21)

It has been a while since we heard so much talk about value versus growth and momentum. After 15 years of value-style underperformance, interspersed with a few short-lived attempts to return to life, value has made a more consistent comeback since early September 2019.

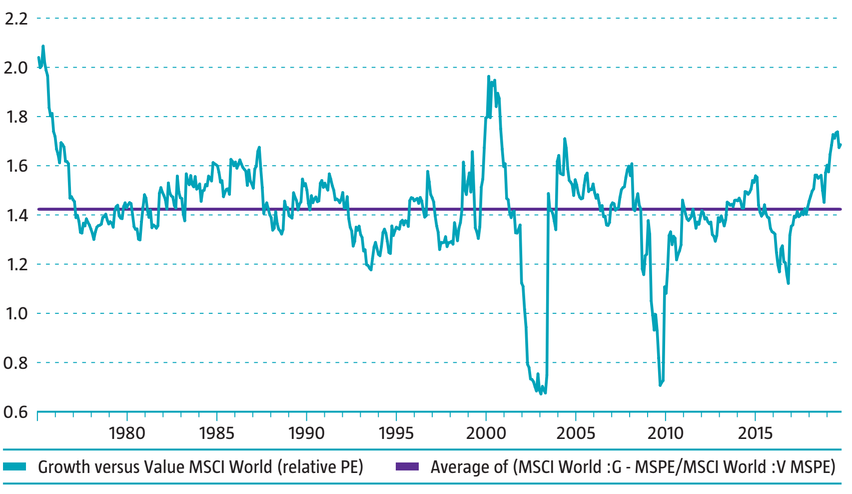
Not surprisingly, this coincided with hopes for an improved outlook, given the announcement that the US-China trade talks would resume. Admittedly, the outperformance of value was more convincing in September, but it has continued to defend itself in October as well. The value vs momentum reversal was particularly dramatic in the US in September, which is to be expected as the correlation between value and momentum is at near 30-year lows, i.e. value appears extremely oversold. Across the MSCI World, the P/E disparity between value and growth is back to levels last seen in 2004 and has just started rolling over (Figure 7).

Figure 6: Performance of value versus other styles 2005-2019



Source: Refinitiv Datastream, Robeco

Figure 7: Growth versus value



Source: Refinitiv Datastream, Robeco

The return of the underdog

Interestingly, the return of value has also coincided with the US equity market underperformance versus Japan, EM and Europe. The one common thread is that both value and non-US equities have been underdogs, significantly underperforming over the last ten years. This is understandable in a market that was shell-shocked by the global financial crisis. Moreover, just when it had started to see light at the end of the tunnel, with some positive macro signs outside of the US, in early 2018 it got struck down again when President Trump started waging his trade war. What the recent outperformance of value and non-US equities shows us is that equity investors are increasingly uncomfortable overpaying for arguably crowded trades, whether from a style or regional perspective, and are ready for a change. They just need a trigger.

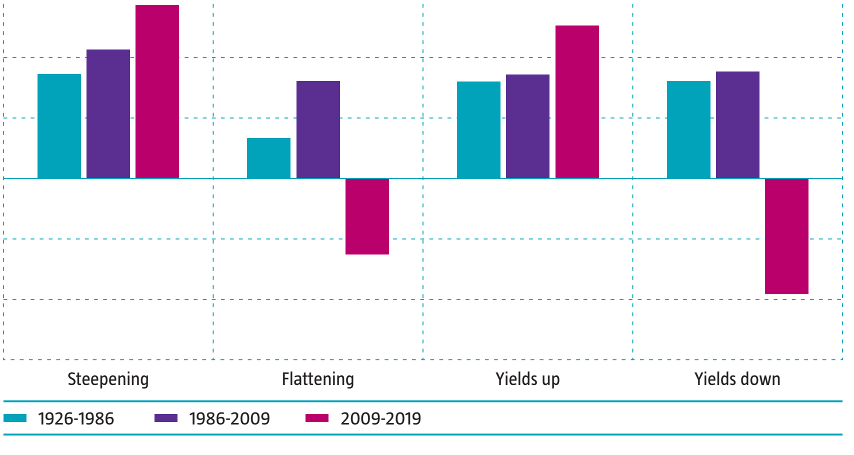
The resumption of the US-China trade negotiations and UK Parliament opposition to Prime Minister Johnson's no-deal Brexit rhetoric provided such a trigger in early September. For this return of the underdog to continue, we need that light at the end of the tunnel not to disappear. Our base case scenario, of no hard Brexit and a slimmed-down version of a US-China trade deal, would keep the light visible, offering hope of bringing back some business confidence, capital expenditures and corporate earnings growth.

Clearly, in our alternative (and less likely) scenario of either no resolution or a meaningful setback in the US-China negotiations, an irreversible path to a US recession and corporate earnings across the world set to weaken, investors would return to seeking what is likely to become even more scarce growth among equities, the more visible the better, and willing to pay a premium for it. Value would go back into the memory drawer until the next bout of hope.

The value versus yields conundrum

One pushback that we often get when talking about the future outperformance of value is the perceived correlation between yields and value. The mantra of value outperforming when yields rise and the yield curve steepens is common. So, how can value outperform in such a low-yield environment? Our quant team has looked at the correlation between value and yields from 1926 and has found that there is a positive correlation between value performance and the direction of yields over the last 10 years, but not over the preceding 83 years, as Figure 8 shows.

Figure 8: Simulated performance of the value factor for different interest rate regimes between 1926 and 2019



Source: Robeco research. Graph shows the performance of the Fama-French value factor from July 1926 to January 1986 and Robeco's Enhanced Indexing Value factor from January 1986 to January 2009 and from January 2009 to August 2019. Data is simulated. Results are gross of fees. The value of your investments may fluctuate. Past performance is not an indication of future results. Please refer to the appendix for other important disclosures.

This gives us confidence that it is not yields that determine value, but rather that value likes a healthy or improving earnings environment, as investors tend to focus on growth when the latter is scarce.

Redefining value

While we do believe that value is due a comeback, as fears in investors' mind settle, we do not believe that all traditionally defined value stocks are bound for a sustainable outperformance. We believe that the traditional mono-dimensional definition of value, based solely on a low P/B ratio, is outdated. In a world of technological breakthroughs, where economies around the globe are increasing their services and consumption content, retail and information flows have moved online, and production processes are more about software than hardware, we need to look at a far more multi-dimensional definition of value. The outlook and sustainability of earnings over the longer term is just one of the key elements that should be part of the definition of value of the future. And while every initial value upswing is likely to start with a dash for trash, our search for value needs to be smarter, taking into account that in a changing world, companies that do not keep up with innovation may well stay behind and become value traps.

OUTLOOK FIXED INCOME

Jamie Stuttard
Head Global Macro Fixed Income Team

The Night Shadows

Investing in fixed income if recession hits

The messenger rode slowly back, stopping often at alehouses along the way to drink, but keeping to himself, with his hat angled over his eyes. His eyes, which fit him well, were solid black and much too close together, as if each eye feared being caught at something if it were too far from the other. They peered out menacingly from under his old hat, which was pulled down low and looked like a three-sided spittoon. And they looked out over the large scarf that covered his chin and throat and went down nearly to his knees. When he stopped for a drink, he would remove the scarf with his left hand while he drank with his right, and as soon as he was done, he would cover his face again.

(*A Tale of Two Cities*, Book 1 – Chapter 3)

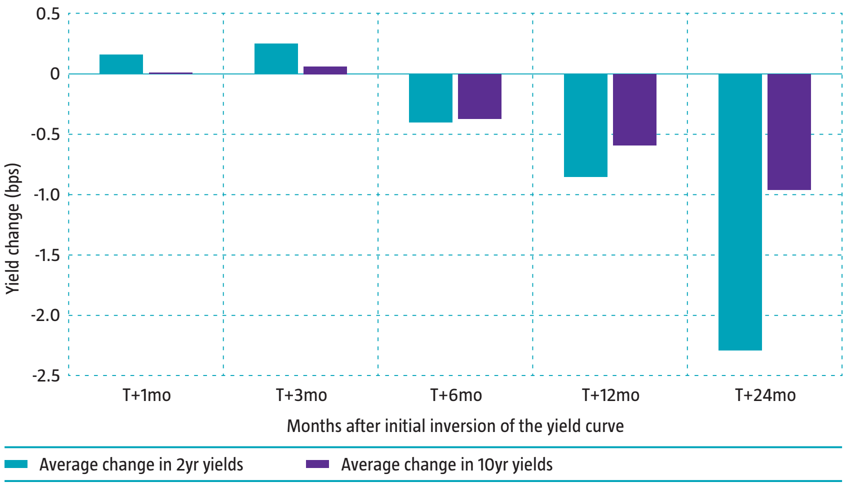
After more than ten years of expansion, the probability of a 2020 US recession has risen, amid inverted yield curves, contracting business surveys, global trade, and falling earnings and CEO confidence.

Fixed income is traditionally an excellent investment heading into downturns, as prevailing returns have demonstrated once again. Yet uneven prospects for different fixed income segments suggest an active manager's market in 2020, given rising corporate leverage and disparities in global government bond yield levels. We explore the opportunities, and risks, if the R word were to hit.

Global growth and many risky assets peaked this cycle in early 2018. Yet the data – and markets – have moved in slow motion since. While cracks appeared two years ago, they are still only just starting to spread. Rates markets have moved, but investment grade credit spreads have not. CCC spreads are now distressed, but the rest of high yield still looks priced to perfection. In EM, the hunt for yield is still on, despite the halving of bond prices in Argentina. Global growth has softened but there has been no sudden stop. Yet, if the US enters a recession, despite ample time to prepare, very few markets appear priced for it. Many fixed income sectors – be they governments, sovereigns, EM, credit or FX – have a large embedded cyclical component. If recession hits, investors should get ready for some big moves.

In government bonds, longer-dated treasuries initially perform well into slowdowns. But if the data keeps softening, the front end then starts to discount more aggressive Fed easing (Figure 9). Rising fiscal deficits during recessions and eventual expectations of recovery typically lead to curve steepening. So two-year bonds become the sweet spot.

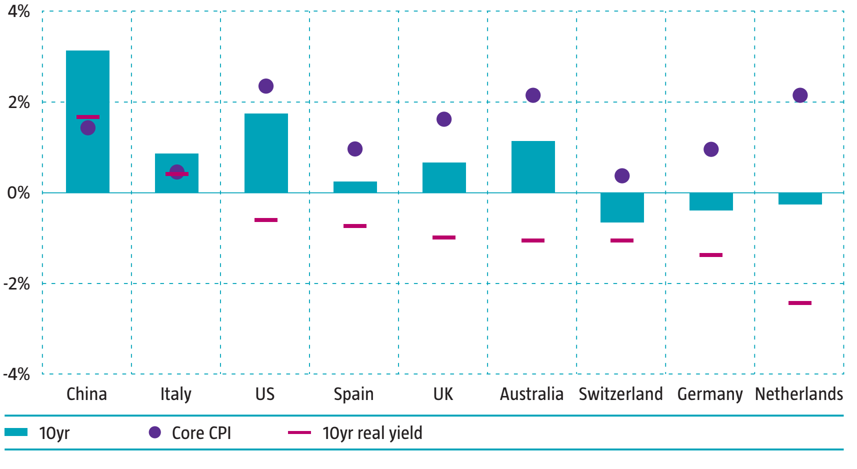
Figure 9: Average change in US 2yr and 10yr yields, last three recessions



Source: Bloomberg, Robeco calculations

Very few economists expect Fed Funds to fall from the current 1.75% upper bound to below 0.50% in 2020. Yet that would be our central scenario in case the US economy slips into a recession. While this is not our base case, it remains a meaningful risk. By contrast, in core Eurozone fixed income markets, the ECB may soon be running out of room to cut further, after years of falling yields. Policymakers are increasingly aware of the so-called 'reversal rate', the point beyond which further rate cuts into negative territory may become counter-productive. This limits returns in German, Dutch and Swiss government bonds, among others. Our rates universe seems divided into markets with scope for falling yields – and strong returns – versus those without (Figure 10).

Figure 10: Not all bond markets are equal: Nominal bond yields, real yields and core CPI (selected markets)



Source: Robeco calculations, Bloomberg

A focus on quality – throughout

While the seeping uncertainty since early 2018 has been gradual, the penalties for allocating capital too far down the quality spectrum have now begun to increase. Argentina's and Turkey's currencies delivered negative returns in 2018, but the August 2019 Argentina outcome was much more severe. Similarly, in US high yield, the CCC underperformance versus BBs continues as global default rates start to rise. There are risks ahead: S&P calculates so-called 'weakest links' (debt already rated at or heading into CCC territory) at a 10-year high; while the IMF estimates an unprecedented USD 19 trillion of corporate debt at risk of default in an adverse economic scenario.

Before running for the hills, bear in mind that even in severe recessions, the speculative grade default rate rarely rises above 15%, and for investment grade it is much less than that. But the lesson is that spread decompression is standard in bear markets as the deltas of different credit and emerging markets diverge, depending on their fundamental vulnerability. Should the much talked about downside risks finally materialize in 2020, a focus on quality – governments over credit, investment grade over high yield, BBs over CCCs and so on – will pay off.

Quality should receive extra support in European credit, where the ECB is reactivating quantitative easing. Geographically, we prefer to shelter 'under the umbrella' of the ECB: if volatility rises, euro-denominated IG credit will have a superior Sortino ratio to other global credit markets. (Unlike a Sharpe ratio, the Sortino only measures downside volatility – this measure is helpful in fixed income where investors prize stability, and becomes ever more relevant when downside risks increase.)

Conclusion

Fixed income returns are typically excellent on the way into recessions. But we see clear winners versus losers: government markets with the potential for over 100 bps of central bank cuts (the US), countries which have not yet imagined a world of negative rates (UK) and those with positive real yields (China) should outperform. Throughout fixed income, a focus on quality can both improve returns and reduce risk when heading into recessions. The alternative, in the weakest reaches of credit and emerging markets where cyclical vulnerabilities have built, can be treacherous. If we get a US recession in 2020, an active approach that discriminates will be critical.

Recalled to Life

Finding the right bonds for recovery

He lowered the window, and looked out at the rising sun. There was a ridge of ploughed land, with a plough upon it where it had been left last night when the horses were unyoked; beyond, a quiet coppice-wood, in which many leaves of burning red and golden yellow still remained upon the trees. Though the earth was cold and wet, the sky was clear, and the sun rose bright, placid, and beautiful.

(*A Tale of Two Cities*, Book 1 – Chapter 3)

Global growth has slowed for two years. At some point trends will bottom out. Markets, as we know, anticipate. While it might be too early, with or without recession, a recovery will eventually ensue.

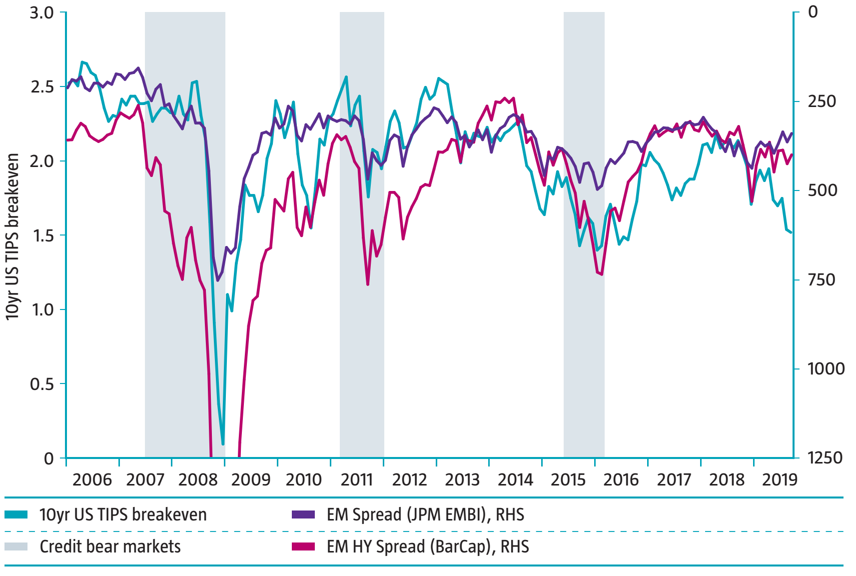
On the other hand, a US recession could still be averted in 2020 given central bank easing, more modest current account imbalances than in prior cycles, and a US election which logic suggests should focus White House minds on a more moderate approach to trade. Fixed income might not seem an obvious choice for a recovery phase. But within our USD 55 trillion global aggregate opportunity set, there are a surprisingly large and varied number of sectors that can outperform. We highlight three.

It's one thing to expect recovery, but another to find good prices

A key challenge for investors is that while many safe haven assets have begun to price for recession, many risky assets have not. Government bond prices and gold have appreciated, but their risky counterparts in the main haven't sold off – despite the softer economic backdrop. Be it years of easy monetary policy, the push of negative rates, a Pavlovian response from investors who have been conditioned for over a decade to buy every dip, downside risks are just not priced in, away from specific pockets such as CCCs and Argentine fixed income. Amid buoyant equity markets, aggregate HY spreads are close to their richest quartile versus history. EM spreads too. But we find three value exceptions.

First, inflation. The path of inflation implied by the difference between nominal bonds and real yields (the breakeven), has fallen to levels seen in prior soft patches, such as the Eurozone crisis and 2015-16 commodity downturn (Figure 11). There are both cyclical inflation trends (lower producer prices, softer survey data and a weaker oil price, for example) and secular trends (globalization trends as mentioned earlier, including falling goods prices amid technological advances in production and distribution). Should the secular dominate, then mean reversion to prior inflation norms may prove over-optimistic. Nevertheless, in a world where central banks have made valuations challenging almost across the board, breakevens have moved where other cyclical fixed income assets have not.

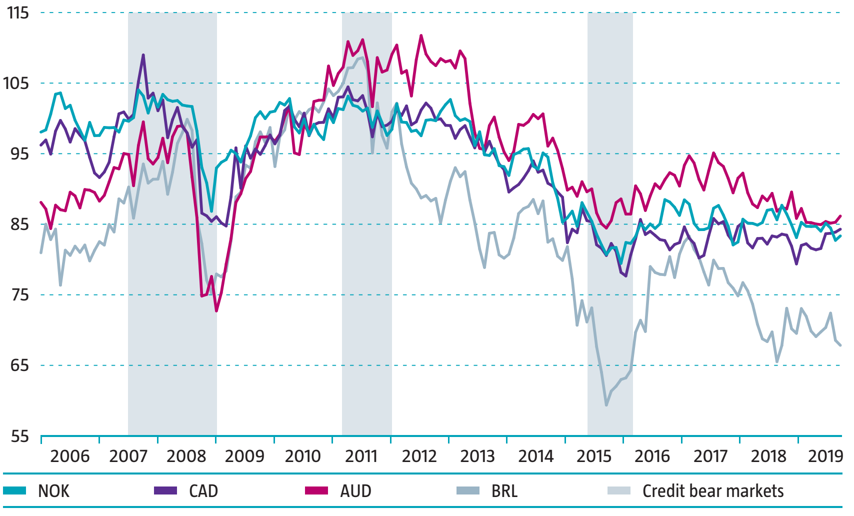
Figure 11: Recovery assets: HY, EM and US 10yr TIPS



Source: Robeco, JP Morgan, Bloomberg Intelligence

Second, several cyclical currencies have cheapened up materially (Figure 12), amid the weak commodity and strong dollar environment of recent years. Again, watch for the secular trends: take Australia where household debt and real estate prices suggest further downside first. But by using macro research to screen for macroprudential risks, a cleaner subset of opportunities can be created, should the recovery scenario come into fashion in 2020.

Figure 12: Selected real effective exchange rates



Source: Robeco, JP Morgan

Third, in the sovereign space, recovery should help Italian and other periphery bond markets push further versus the core Eurozone. Domestic political news flow will periodically hit the tape, but in general, there is a correlation between Eurozone growth and periphery spreads. While safe havens (German, Dutch and other AAA/AA sovereigns) are likely to underperform in a recovery, the flipside is that single-A and lower sovereigns should outperform.

Finally in credit, relief on global growth and trade concerns could see spreads retrace tighter. At the time of writing, the gains to be had are small. Yet that doesn't mean investors should ignore credit opportunities in 2020. The potential ranges in spreads can be broad. For example, at the start of Q4 2018, US high yield spreads were just 332, well into their richest quartile versus history. Yet on 1 January 2019, just three months later, they stood at 537 bps, more than 200 bps wider and pricing in a default rate of nearly 9%. That proved an attractive tactical entry point, not just in US HY but across DM credit. Given the uncertainties increasingly referenced by central bankers, investors should remain nimble and ready to execute if credit opportunities re-emerge, one of the key facets of a total return product.

Conclusion

Of course there isn't just one kind of recovery. Should the US economy avoid recession but growth remain sluggish, selected BBB and BB EM local government bonds should fare well. But in a more pronounced recovery scenario, we see three opportunities: global inflation-linked bonds, selected cyclical currencies and Eurozone periphery bonds. We think euro-denominated spread products enjoy additional protection given the ECB has only just recommenced its second ever quantitative easing program, with an open-ended nature this time round. In credit, as the last 12 months have shown, opportunities can appear and disappear rapidly. It's important to have a flexible approach, because the pendulum of market melodrama has a habit of swinging too far.

IMPORTANT INFORMATION

Robeco Institutional Asset Management B.V. has a license as manager of Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs) (“Fund(s)”) from The Netherlands Authority for the Financial Markets in Amsterdam. This document is solely intended for professional investors. Robeco Institutional Asset Management B.V and/or its related, affiliated and subsidiary companies, (“Robeco”), will not be liable for any damages arising out of the use of this document.

The content of this document is based upon sources of information believed to be reliable and comes without warranties of any kind. Without further explanation this document cannot be considered complete. Any opinions, estimates or forecasts may be changed at any time without prior warning. If in doubt, please seek independent advice. It is intended to provide the professional investor with general information on Robeco’s specific capabilities, but has not been prepared by Robeco as investment research and does not constitute an investment recommendation or advice to buy or sell certain securities or investment products and/or to adopt any investment strategy and/or legal, accounting or tax advice.

All rights relating to the information in this document are and will remain the property of Robeco. This material may not be copied or used with the public. No part of this document may be reproduced, or published in any form or by any means without Robeco’s prior written permission.

ROBECO
The Investment Engineers

Contact

Robeco
P.O. Box 973
3000 AZ Rotterdam
The Netherlands

T +31 10 224 1224
I www.robeco.com