CENTRAL BANK WATCHER

# One way or another

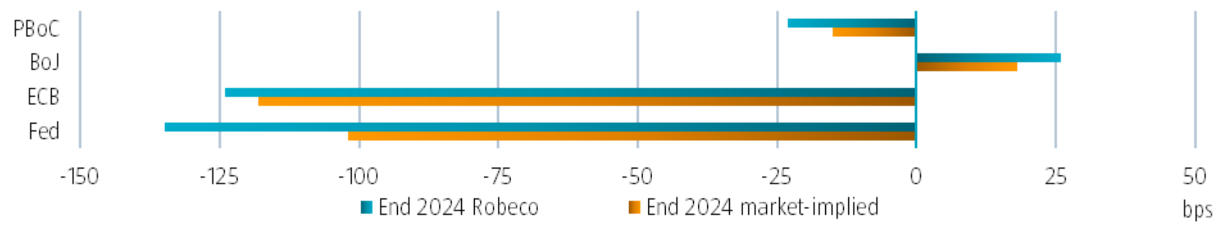
- Fed: rate cuts expected to blossom by spring's end
- ECB: last mile musings
- PBoC: under pressure
- BoJ: dovish hike

Behind the curve on the way up, DM central banks are understandably cautious in starting the descent from higher policy rates. This is particularly true given the challenges posed in the last mile of bringing down inflation, with labor markets remaining relatively tight and concerns about an impending (or deepening) economic malaise having shifted to the background. Nonetheless, in our view, rate cuts are coming – one way or another. They will come more quickly if a financial accident or sharp growth slowdown does occur, and more slowly if further disinflation, which we expect, allows central banks to trim the restrictiveness of their policy stance. On balance, we agree with the current market pricing for (late) Q2, when we expect the first Fed and ECB rate cut to be delivered.

In assessing bond market valuations, the exact timing of the first rate cut is less important than the trajectory of rates over the next few years. Although we agree that in a looser fiscal policy regime central bank rates are likely to settle at higher levels than before the pandemic, we have started to see markets overdoing it (as in Q3 last year). Specifically they have priced in terminal rate levels that are 'too high.'

Meanwhile, in China, the weak growth and low inflation backdrop piles pressure on the PBoC to ease further. Further rate cuts have indeed become more likely, though we expect balance sheet tools to continue to do the heavy lifting. In Japan, the BoJ remains on a gradual course towards tighter policy. Indeed, one way or another, negative policy rates look set to disappear this year.

Figure 1 – Outlook for central banks' policy rates




**Source**: Bloomberg, Robeco, change by end 2024, based on money market futures and forwards; 9 February 2024

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Marketing material for professional investors, not for onward distribution



Martin van Vliet
Global Macro Strategist


Rikkert Scholten
Global Macro Strategist


Bob Stoutjesdijk
Global Macro Strategist




Sustainable Investing Expertise by ROBECOSAM

## The Federal Reserve: rate cuts expected to blossom by spring's end

- Strong jobs growth reduces odds of quick rate cuts
- Inflation should allow the Fed to start cutting from June with gradual steps
- Valuation of curve belly more appealing after recent jump in yields

### Fed allowed rather than forced to cut rates

In our December Central Bank Watcher, we discussed two paths the Fed could take with interest rate cuts. One, the Fed is allowed to cut rates by moderating inflation, or two, the Fed is forced to do so because of deteriorating growth. Recent data, most notably the January payrolls report, suggests the 'allowed' trajectory is increasingly likely. This way the reduction will probably take place in small, predictable steps, initiated only after confirmation of several more months of modest inflation data. An important condition for rates to be cut is for inflation to remain well behaved. In his press conference at the 31 January FOMC meeting, Powell made clear that Fed officials do not necessarily need to see a further decline of inflation. However, they do desire a continued pattern of modest inflation prints visible since the summer. Over the past six months the average monthly gain in the core PCE index has been 0.15%, while core CPI rose by 0.27% on average. These numbers suggest that maximum 0.2% core PCE, and maximum 0.3% core CPI prints would be needed for the Fed to start cutting rates. In our projections this is doable, as we see a growing influence from declining rental inflation. The Fed is not immune to strong growth and jobs data. Still, judging from Powell's comments, it is mainly the impact on expected inflation that will matter for the direction of their policy. In the eyes of the Fed, there is ample room between the current Fed funds rate and the neutral rates level, which gives scope to cut. If inflation allows, the Fed would still prefer a soft landing, rather than engineering a hard landing. Recent US wage data should give some comfort. The Q4 employment cost index pointed to an annualized wage growth of 3.6%, at around their desired level of 3½%. Even the stubbornly high Atlanta Fed wage tracker fell significantly in January to 5.0% 3m annualized (4.7% y/y).

Table 1 - What is priced in for the Fed versus our expectations

| Fed funds rate (% upper bound) | 5.50 | Mar-24 | Jun-24 | Sep-24 | Dec-24 |
|---|---|---|---|---|---|
| Change implied by FF Futures (bps) | | -5 | -39 | -80 | -102 |
| Our probably-weighted expectation (bps) | | 0 | -30 | -75 | -135 |
| Our central scenario (bps) | | 0 | -25 | -75 | -125 |
| Fed funds rate central scenario (% upper bound) | | 5.5 | 5.25 | 4.75 | 4.25 |

Source: Bloomberg, Robeco; 12 February 2024

### Gradual cutting pace has benefits

Assuming that the FOMC members would want to see at least three more months of contained inflation, this would make the 1 May meeting the first realistic moment to cut rates. Our base case remains that the cutting cycle will start in June, which allows for some cautiousness by Fed officials. There is an important benefit for starting rate cuts before summer, though. US presidential elections are scheduled for 5 November and initiating policy changes close to elections could lead to accusations of the Fed intervening in the process. This same argument also firms the case for expecting a gradual and predictable rate path. As an additional benefit, a gradual approach also makes it easier to stop without having to reverse, if inflation were to unexpectedly rise again. As a base case we therefore assume a rate cutting pace of 25 bps per meeting. The Fed probably has the intention to keep rates neutral to modestly restrictive, suggesting rates should settle at the upper end of the neutral range. This would be a level of 3¼-3½% in our opinion, reached in June 2025. Rates could be cut more quickly and to lower levels if the labor market cooled significantly. However, structural shortages in non-cyclical sectors, such as healthcare and education, are likely to keep payroll growth in positive territory. We think there is a 25% probability of a 'forced' cutting cycle. A 15% probability is attached to our bear case, where renewed inflation pressures keep rates on hold until December.

### QT could be scaled down as soon as July

The debate among Fed officials about reducing the pace of the balance sheet rundown (USD 60 in Treasuries and 35 bln in MBS per month) has started earlier than we had anticipated. The current discussion suggests the balance sheet rundown could be slowed from July onwards. Around that time the balance in the reverse repo facility (which is used to park cash at the Fed) will probably be close to zero.

Table 2 - US Treasuries curve

| USTs | Spot yield | 12m fwd | Carry* | Hedged to EUR |
|---|---|---|---|---|
| 2yr | 4.48 | 3.96 | 218 | 132 |
| 5yr | 4.14 | 3.98 | 87 | 51 |
| 10yr | 4.18 | 4.14 | 50 | 29 |
| 30yr | 4.38 | 4.32 | 25 | 15 |

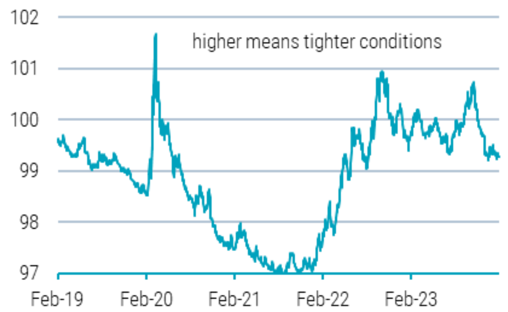
Source: Bloomberg, Robeco; 12 February 2024; *For a 1pd position over 12 months

### Valuation in especially belly has become more appealing

Treasury yields have recently surged, as enthusiastic rate cutting expectations were dialed back. This has brought market pricing of Fed cuts, from below our bullish case, closer towards our probability weighted view. Long term (5y5y) forward yields, at 4.1%, have now also moved back to levels which exceed our estimated range of neutral. The case for being overweight US Treasuries is thus improving, especially for the 5-year point. We are less convinced on the attractiveness of 10+ maturities, expecting more uncertainty on fiscal policy post the election to become a market theme. We expect a re-steepening of the US Treasury curve expressed in 5-30 and 5-10 maturities. These could be replaced by 2-10s positions when a first rate cut is circa a month away.

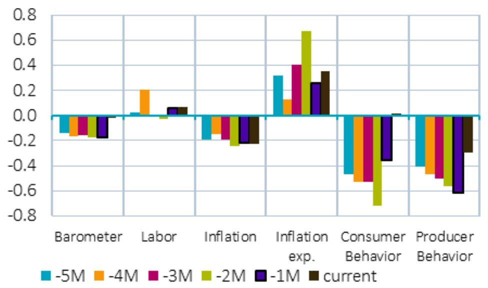
Jobs growth data has been strong, while recent data suggests inflation expectations have remained stable.

Figure 1 – Financial conditions have on net been stable recently



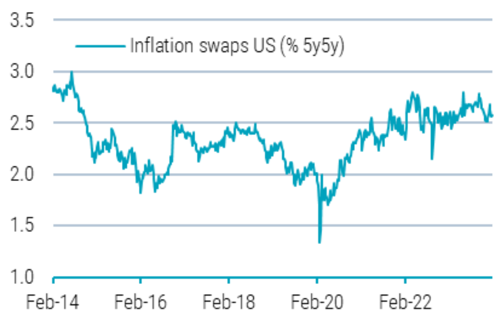

Source: Goldman Sachs, Bloomberg, Robeco; 12 February 2024

Figure 2 – Barometer rises on stronger producer data



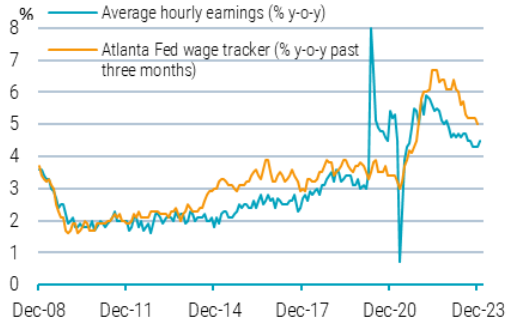

Source: Bloomberg, Robeco; 12 February 2024

Figure 3 – Inflation swaps in narrow range




Source: Bloomberg, Robeco; 12 February 2024

Figure 4 – Wage growth in a slowing trajectory




Source: Bloomberg, Robeco; 12 February 2024

## European Central Bank: last mile musings

- ECB to start reversing course in Q2; delay would imply faster cuts later
- Depo rate expected to land near 2% in 1H 2025, in line with ECB's latest r* estimate
- Further curve normalization amidst larger rally potential for 2- to 5-year yields

### The last mile to a first rate cut

For the third meeting in a row, the ECB Governing Council kept policy rates unchanged in January. Moreover, they refrained from endorsing the possibility of imminent rate cuts. Although the policy statement acknowledged that "the declining trend in underlying inflation has continued," and, in a dovish shift, no longer referenced "elevated domestic price pressures," ECB President Lagarde stressed that it was "premature to discuss rate cuts." She stood by what she said in Davos – i.e. that the ECB could start cutting interest rates "this summer."

It seems that wage growth in many Eurozone countries remains too high for the ECB's liking, and that they are afraid this might hinder the 'last mile' towards 2% inflation (Executive Board Member Schnable 's recent interview confirms this). They want to see further confirmation that wage pressures are indeed easing, as foreshadowed by wage growth in job postings and suggested by the decline in headline inflation (see Figure 1). As for QT (quantitative tightening), the ECB still intends to reduce the PEPP portfolio by €7.5 bln per month on average in H2 and discontinue reinvestments at the end of 2024 (APP reinvestments have already stopped).

Our central scenario is for the ECB to remain on hold at the next meeting in March, but we still envisage 50 bps of easing in Q2 (when two meetings will take place, i.e. in April and June). This premise is based on the assumption that economic stagnation in the Eurozone and disinflation (we assume that the annual rate of core inflation, which printed at 3.3% in January, will be around 2.5% in April) will be ongoing.

If the ECB prefers to await the wage settlements in Spring before starting to reverse course, the first cut may not come by April. This means that only 25 bps could be delivered in Q2. However, as we see a possibility of a first cut of 50 bps in June and we stick to our central scenario for the time being. We do agree with markets that – in the wake of signs of sticky wages, and better US growth data – the risk of the ECB cutting less than 50 bps by June has grown in recent weeks (see Table 1). A key rationale for delay seems to be that the ECB – being seen as behind the curve on the way up – is worried about starting the descent too early.

Table 1 - What is priced in for the ECB versus our expectations

| ECB deposit facility rate | 4.00 | Mar-24 | Jun-24 | Sep-24 | Dec-24 |
|---|---|---|---|---|---|
| Change implied by OIS (bps) | | -2 | -36 | -81 | -118 |
| Our probability-weighted expectation (bps) | | -2 | -38 | -76 | -124 |
| Our central scenario (bps) | | 0 | -50 | -75 | -125 |
| ECB depo rate in central scenario (%) | | 4.00 | 3.50 | 3.25 | 2.75 |

Source: Bloomberg, Robeco; 9 February 2024

In any case, for an assessment of 2-5-year bond valuations, the exact timing of the first cut in the end may not be that important. What matters is the trajectory of policy rates over the next few years. The cumulative amount of easing priced in the yield curve started to look somewhat aggressive in late December (see Figure 2). But currently, a trough in policy rates in 2025 is foreseen at the upper end of 'neutral' territory[1]. This implies there is scope for more cumulative easing to get discounted over the coming months.

[1] Our estimates for nominal neutral rate territory are in line with the ECB's latest (median) estimates of real r* topped up with their 2% inflation target

Table 2 - DBR curve

| | Spot yield | 12m fwd | Carry* (bps) |
|---|---|---|---|
| 2y | 2.68 | 2.05 | -98 |
| 5y | 2.30 | 2.10 | -41 |
| 10y | 2.36 | 2.33 | -14 |
| 30y | 2.56 | 2.54 | -8 |

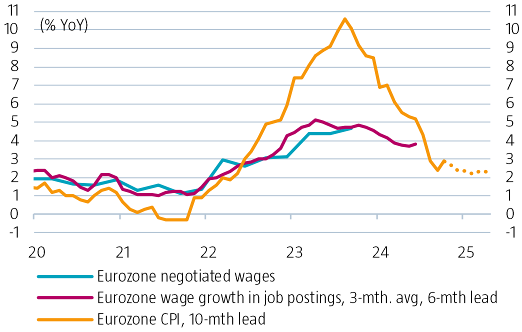
* for a 1pd position in cash bonds over 12 months

**Source**: Bloomberg, Robeco; 9 February 2024

### Further curve normalization beckons

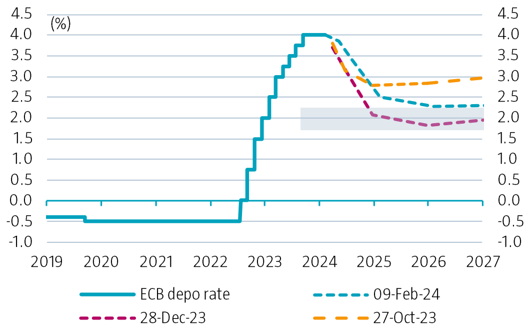
- The uptrend in German bond yields came to a sudden stop in Q4 last year, as a bond rally emerged in the wake of favourable signs of disinflation. 5-year yields fell all the way to 1.85% in late December – the intraday low reached in March 2023 at the height of the US regional banking turmoil. Since then yields have bounced higher, as central banks including the ECB have pushed back against imminent rate cuts.
- Markets now price in a return of the depo rate to around 2.3% by mid-2025 (Figure 2) which is slightly above our estimated long-term 'neutral' ECB depo rate range of 1.75%-2.25% – which is in line with the ECB's latest estimates. Even though we see scope for markets to price in lower terminal policy rates it seems too early to add to duration, given momentum and signs of resilient US economic growth. We would rather wait until the 5-year yield is above 2.40%. Selloff episodes after final rate hikes are not out of the ordinary (Figure 3).
- Curve-wise, we remain braced for further re-steepening, led by 5s10s and 5s30s, and 10s30s – which tend to out-steepen 2s10s at the end of tightening cycles (Figure 4). History suggests that 2s5s and 2s10s curves only start to meaningfully steepen once rate cuts are imminent. As for swap spreads over Germany, given the cheapening of repo rates, there is some potential remaining for further tightening, especially in 10-year tenors. However, risk-reward in setting front-end swap spread tighteners has turned less favorable, as such positions are (more) vulnerable to bouts of 'risk-off' in financial markets. We also think German swap spreads in 30-year space have little or no tightening potential left.

**Figure 1** – lead wage indicator has started to follow inflation lower



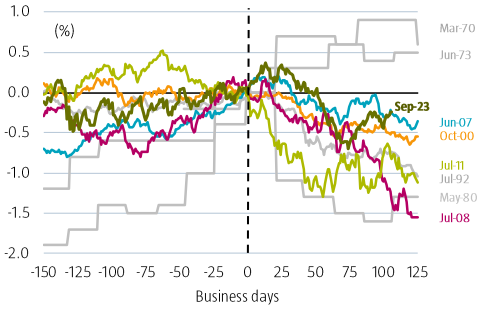

**Source**: ECB, Robeco; 9 February 2024

**Figure 2** –ECB depo rate and market-implied path on three dates



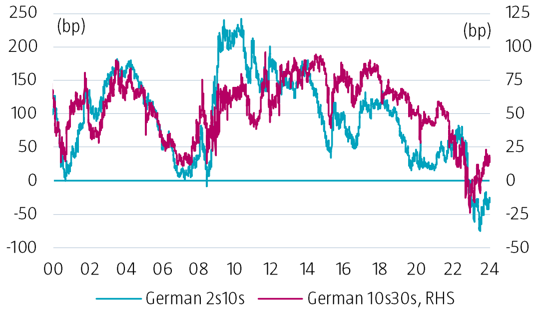

**Source**: ECB, Robeco; 9 February 2024 Note: grey shaded area marks our estimated range for the nominal neutral ECB depo rate

**Figure 3** – 10-yr yield changes around last ECB/Buba hike (t=0)




**Source**: ECB, Robeco; 9 February 2024

**Figure 4** – German 2s10s and 10s30s yield curve




**Source**: ECB, Robeco; 9 February 2024

## People's Bank of China: under pressure

- Weak growth and low inflation backdrop piles pressure on PBoC to ease further
- Further rate cuts have become more likely even if balance sheet tools do the heavy lifting
- Bounce in yields possibile if growth recovery ensues, though secular downtrend remains intact

### The crude art of balance sheet expansion

While growth in industrial production has been recovering, as foreshadowed by the pick-up in the OECD's leading indicator, overall economic conditions in China have remained lacklustre. This picture is corroborated by our Economic Barometer (see next page). Notably, forward looking components such as Lending Conditions suggest that somewhat better cyclical times might be ahead. But this probably requires at least some stabilization in the property market. So far, progress on this front has remained limited. Indeed, although home sales in the secondary market have improved, new home sales generally have remained depressed – despite the further loosening of property policies in recent months.

Meanwhile, in the wake of still-weak overall economic conditions, inflation pressures have remained very subdued, judging from the low level of core inflation (i.e. 0.4% YoY in January) and the negative rate of growth in the GDP deflator (-1% YoY in Q4 2023). As for the headline CPI rate, which fell further into negative territory (to -0.8% YoY) in January owing to the timing of Lunar New Year, we agree with the projection in the PBoC's Q4 Monetary Policy report that it will turn modestly positive later this year. Even so, this will do little to alleviate pressure on the PBoC to ease monetary policy further.

As we had expected, the PBoC refrained from cutting policy rates in January. Instead, it first resorted to another 50 bps cut in the reserve requirement ratio (RRR) of banks not yet facing a 5% RRR – to ensure a smooth issuance of government bonds and help steer money market rates lower (see Figure 1). In addition, the PBoC provided fresh loans under the pledged supplementary lending (PSL) facility – aimed at propping up property investment. However, it did also lower rates on the SME and agriculture relending and rediscounting facilities by 25 bps, effective January 25th.

Looking ahead, we expect PBoC balance sheet expansion (see Figure 2) to continue to do the heavy lifting in terms of supporting growth and addressing the debt woes of local governments. However, we agree with markets that a rate cut by mid-year is highly likely (see Table 1 below).

Table 1 - What is priced in for the PBoC versus our expectations

| PBoC 7-day reverse repo (%) | 1.80 | Mar-24 | Jun-24 | Sep-24 | Dec-24 |
|---|---|---|---|---|---|
| Change implied by forwards (bps) | | -4 | -11 | -17 | -15 |
| Our probability-weighted expectation (bps) | | -4 | -10 | -16 | -23 |
| Our central scenario (bps) | | 0 | -10 | -10 | -20 |
| PBoC 7-day reverse repo in central scenario (%) | | 1.80 | 1.70 | 1.70 | 1.60 |

Source: Bloomberg, Robeco; 9 February 2024

The 10-year CGB yield hovered in a narrow 10 bps range in the three months to mid-December. But the fresh PBoC balance sheet easing and weakness in Chinese equities subsequently triggered a bond rally and saw 10-year (and 5-year) yields hit fresh cycle lows ahead of the Lunar New Year. Further rate cuts are probably needed to push yields lower still, so we would opt to be tactically underweight CGBs cross-market against DM government bonds at the moment – in latter markets we see more downside for intermediate yields on a 3-6-month horizon.

If the 10-year CGB yield were to exceed the 1-year MLF rate (currently 2.50%) by around 20 bps, we would turn more constructive again, as we remain of the view that the secular downtrend in Chinese rates has further to run.

Table 2 - CGB curve

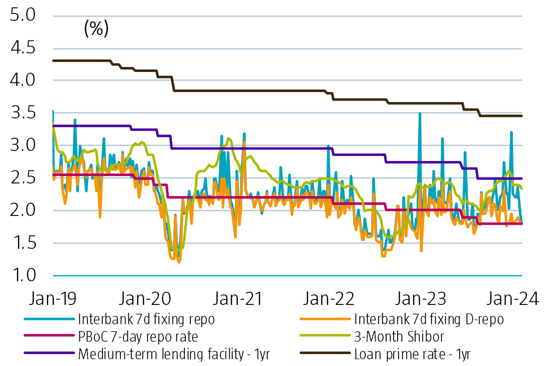
| | Spot | 12m fwd |
|---|---|---|
| 2yr | 2.15 | 2.35 |
| 5yr | 2.29 | 2.50 |
| 10yr | 2.43 | 2.52 |

**Source**: Bloomberg, Robeco; 9 February 2024

## Economic Barometer: no improvement yet, but…

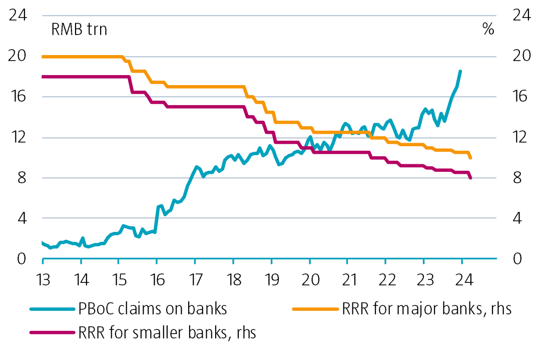
- Our Economic Barometer for China continues to be indicative of weak overall growth circumstances – which fits with the direction of travel in governemnt bond yields (Figure 4). However, the stability in the overall reading increasingly masks diverging developments across the components (Figure 3). Indeed, the Financial Health, Inflation and Consumer Behavior components slipped further in recent months, while the Z scores for Producer Behavior and Lending Conditions have been gradually improving.
- The latter component's Z score increased thanks to some easing in financial conditions and improving momentum in overall credit growth (from an impulse perspective), with the caveat that this is not yet reflected in better M2 money supply trends. The better Z-score for Producer Behavior reflects a pick-up in industrial production growth as well as perkier electricity usage and railway freight traffic.
- The signs of recovery discussed above point to some improvement in overall economic conditons in the coming months. However, the lingering weakness of the Z-score for Consumer Behavior demonstrates that consumer caution is unlikely to dissapate soon. Consumer Behavior continues to be held back by weak PMI employment and overall property sales data and the still subdued marginal-propensity-to-consume metric. This and would have been even weaker if not for the pick-up in car sales.

**Figure 1** – Selected policy and money market rates



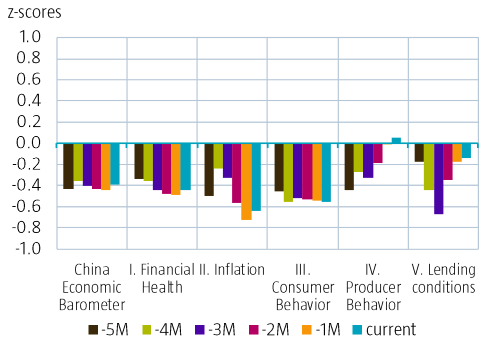

**Source**: Bloomberg, Robeco; 9 February 2024

**Figure 2** – PBoC balance sheet expansion in full swing



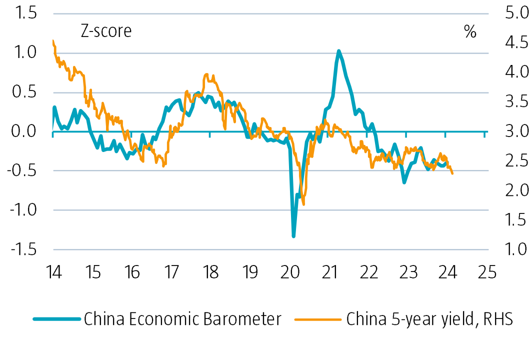

**Source**: Bloomberg, Robeco: 9 February 2024

**Figure 3** – Economic Barometer: stability masks divergence




**Source**: Bloomberg, Robeco; 9 February 2024

**Figure 4** – Economic barometer and 5-year CGB yields




**Source**: Bloomberg, Robeco; 9 February 2024

## Bank of Japan: dovish hike

- Weak consumption
- Dovish stance
- Stay short JGB but the window is closing

### Weak consumption

It is clear that the BoJ's policy will maintain a macro focus on the markets for the next three to six months. Importantly, from a long-term perspective, is if the Japanese economy has really exited deflation and whether it can grow meaningfully in nominal terms above rates seen over the past 30 years. We are not so sure. Without such a sustained rise in nominal growth it is difficult to see Japanese equities rising further. From this perspective, we worry about the weakness in household consumption and the recent data from the past two weeks has caused alarm bells to ring. We think the next GDP print will confirm that Japan's economy has grown with decent real growth, however, mainly driven by exports, while private consumption continues to add negatively to GDP. It seems that the re-opening effect of Japan post-pandemic is wearing off in terms of household consumption. This dynamic has been acknowledged to a certain extent by the BoJ and is perhaps one of the reasons why it keeps sounding quite dovish against expectations of more hawkish rhetoric. Nonetheless, weak consumption is important. At this moment it will not derail plans for further normalization, but it does pushes out the date and size.

As noted in previous Central Bank Watchers, we think that nominal wage growth will be key for the BoJ's next normalization steps. They expected nominal wage growth to pick up later this year amid slowing in CPI. We proceed with caution as we think the causality runs from high inflation to high wages and vice versa. Disinflation in headline and core inflation, will take the edge off very high demands. Secondly, corporates will hesitate to settle for higher nominal wage demands in excess of inflation rates and producer price developments (e.g. they face a sizeable profit margin squeeze). Still, we feel that wages are important. The next focus should be the spring wage negotiations (Shunto) between companies and labour unions that started a few weeks ago, with the first outcomes expected on March 15. Some initial guidance was already given in surveys and there is an expectation of roughly 3.5%, we feel that risks are skewed to the downside for reasons mentioned above. Furthermore, we would caveat that actual Shunto outcomes versus the broad wage numbers can diverge. The Shunto outcome last year was 3.6% while the broadest measure of wages only rose by a modest 2% due to differences in bonuses and overtime. So Shunto is important, but the number needs to be nuanced.

### Dovish stance

The BoJ has retained its current policy stance, and we expect the focus in the next meetings to turn to guidance on further policy normalization. Although with smaller steps, for the reasons mentioned above. Given the weak consumption numbers and disinflationary trends in headline and core inflation, we think that the BoJ will not be that eager to make changes to monetary policy in February and March, preferring to wait for the Shunto outcome. As a result, we expect the BoJ and Governor Ueda to keep sounding dovish. A significant risk to this view is the Yen. As the timing and size of rate cuts by other central banks is pushed out further, the risk of the Yen trading weaker will force the hand of the BoJ to move earlier. The BoJ remains a policy taker in that view and that is not without risks.

**Table 1** - What is priced in for the BoJ versus our expectations

| Policy balance rate (%) | -0.10 | Mar-24 | Jun-24 | Sep-24 | Dec-24 |
|---|---|---|---|---|---|
| Change implied by futures (bps) | | 2 | 4 | 11 | 18 |
| Our probability-weighted expectation (bps) | | 6 | 10 | 20 | 26 |
| Our central scenario (bps) | | 10 | 10 | 25 | 25 |
| Policy balance rate in central scenario (%) | | 0.00 | 0.00 | 0.15 | 0.15 |

**Source:** Bloomberg, Robeco; 12 February 2024

## Stay short JGB but the window is closing

We consider all meetings for the next quarter as live for changes in both the YCC and policy rate, simply due to the developments of the Yen and potential disorderly moves in the JGB markets. That said, the state of the domestic economy and the fact that inflation is now falling removes the need for the BoJ to make big and bold steps. We continue to think that the BoJ is eager to end negative interest rates and forecast their first hike in Q2 at the earliest, with the peak bank rate at 25 bps this hiking cycle. Further YCC steps are dependent on how the JGB market is behaving and how disorderly the Yen might trade. In case of further Yen weakness, we would not be surprised if the BoJ widens the YCC bandwidth another 50 bps to +/- 150 bps or shift from the 10yr to the 5yr point with similar bandwidth. This would allow front-end interest rates to rise a bit further which should help underpin the Yen.

With these potential YCC measures and policy changes, it is expected that the 7-year JGB yield will trade close to 1% by the end of Q2 2024, and the 10-year JGB yield close to 1.25%. In all scenarios we expect 10s30s to flatten further given the large upward pressure on 10-year JGBs. If JGB yields adjusted higher over the course of 2024 relative to other markets, and taking into account FX hedging costs, the 30yr JGB would be the superior investment for domestic Japanese investors compared to other global fixed income asset classes. We continue to look for a stronger yen versus other major currencies. As the BoJ begins to make changes to YCC, and other global central banks approach their respective terminal rates, we see value in taking long positions in the yen.

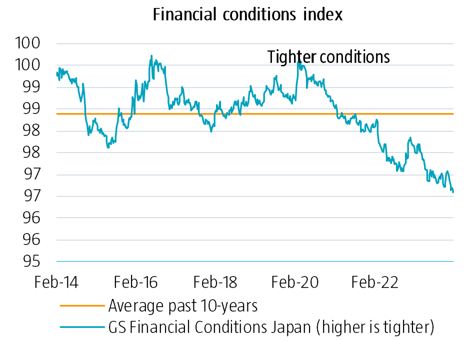
Table 2 - JGB curve

| JGB Curve | Spot yield | 12m Fw | Carry* | Hedged to EUR |
|---|---|---|---|---|
| 2yr | 0.11 | 0.20 | 11.5 | 13.2 |
| 5yr | 0.27 | 0.43 | 14.6 | 15.3 |
| 10yr | 0.72 | 0.94 | 16.6 | 17.0 |
| 30yr | 1.79 | 1.83 | 10.2 | 10.4 |

* for 1pd position over 12 months

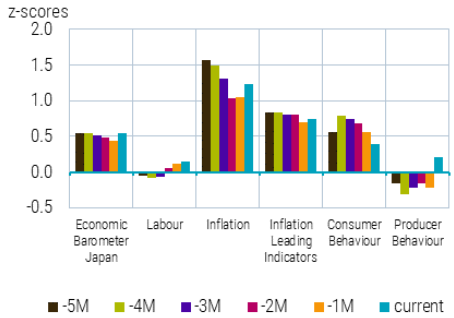
Source: Bloomberg, 12 February 2024

Figure 1 – Still loose financial conditions



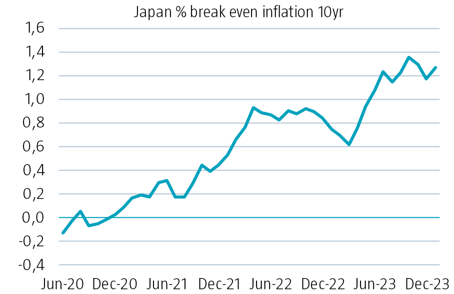

Source: Goldman Sachs, Bloomberg; 12 February 2024

Figure 2 – Economic Barometer: Less strong inflation momentum



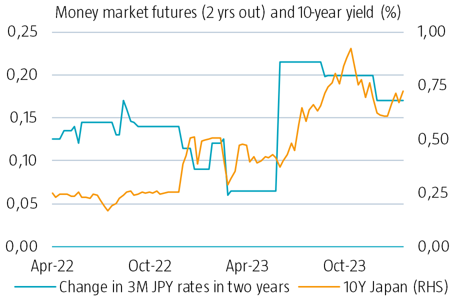

Source: Robeco, Bloomberg; 12 February 2024

Figure 3 – Strong improvement in breakevens




Source: Bloomberg; 12 February 2024

Figure 4 – Markets price in small amounts of tightening 2 years out




Source: Bloomberg; 12 February 2024

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