

Multi Asset Monthly

Global Strategy



Digest and rebalance

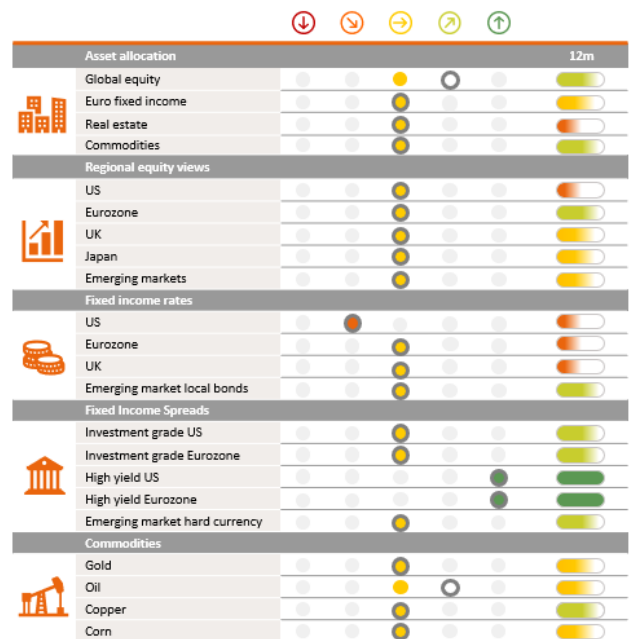
Economic outlook

Macro data are increasingly heralding the start of the economic normalization process in regions where the vaccine roll-out has been smooth. In the US more infrastructure spending has been announced. Inflation numbers and expectations have risen, but we see this as a temporary phenomenon that will not lead to tighter monetary policy in the short term. In the medium term, the sustainability of the recovery will depend on how long it takes to attain herd immunity, how willing policymakers are to continue providing stimulus, and how much permanent damage the economy has suffered.

Market outlook

Over the past months, investors have fully embraced the reflation story. Economic support, improving macro data and strong earnings drove equity markets higher. The cyclical commodity markets also benefited from this trend. On the other hand, the rise in government bond yields put pressure on fixed income returns. We think that monetary policy support and further economic progress will contain the impact. We expect this market strength to continue over the coming months but as the economy enters a more mature state, a different, more balanced portfolio approach might be warranted.

Model portfolio



Current active views are shown by coloured circles; circles with thick grey edges represent previous views. The five rankings for the views are (from left to right): strong underweight, moderate underweight, neutral, moderate overweight, strong overweight.

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Asset allocation and scenario update

- Risky assets have thrived on positive news
- The business cycle will transition from the recovery towards the midcycle phase
- We adopt a more balanced stance by reducing our cyclical growth exposure

Asset allocation

Our strong preference for cyclically sensitive assets in our portfolio this year was fully justified by the prevailing environment. In the US, the Democratic majority in Congress gave President Joe Biden room to manoeuvre to implement his vast and ambitious economic plans for the US economy. The “Build Back Better” programme is a package aimed at helping the US to regain or even surpass previous trend growth. This package encompasses broad infrastructure spending and support for the welfare state. In Europe, the European Recovery Fund is expected to start allocating money this summer.

Second, the vaccination programs gained further traction in the Western economies, including Europe. As restrictions loosen, the normalization of the economy is becoming more discernible. In emerging markets and Japan, however, the vaccination roll-out is clearly lagging.

A third factor is monetary policy support. Central banks in developed markets will remain accommodative, even in the wake of rising inflation data. Inflation rates are indeed rising because of soaring commodity prices, base effects and supply disruptions, but this should be a temporary phenomenon in our view.

Finally, the corporate side has shown its robustness. First-quarter results beat expectations by a wide margin and corporate executives expressed their confidence in the future. This led to a further rise in earnings expectations. The 2021 consensus numbers currently stand at +35%.

In this environment, risky assets like equities, real estate, commodities and high yield bonds have all performed very well. Safe government bonds, on the other hand, printed negative returns. With all this good news largely priced in, the obvious question is: What now?

Recently we saw some hesitation creeping into the market. Inflation surprised on the upside, Fed minutes revealed taper discussions, earnings growth is peaking and economic normalization has become the base case. The rise in bond yields came to a pause. Stock markets rotated from value into growth and overall the pace of progress in equities moderated.

At the same time, the economic cycle is progressing unusually rapidly and it will morph from the recovery phase into the midcycle phase in the coming months. This is not necessarily negative for risky assets but warrants a more balanced approach away from pure cyclical

growth exposure towards stable growth.

As a consequence we scaled back cyclical risk in our model portfolio. We reduced equities from a moderate overweight to neutral; in commodities we cut our exposure in oil.

In the rates market we maintain a moderate underweight in US Treasuries. On a longer time horizon, Treasury yields are on a rising trend, given the strong macro data and the Fed’s likely next steps.

Fixed income

Along with our moderate underweight in US Treasuries, we remain neutral in German Bunds. With this trade we seek to capture the different macro and supply dynamics between the two regions, although at a lower conviction level than before. In spreads we have large overweights in euro and US dollar high yield. High yield offers an asymmetric return profile, outperforming when government bond yields drop and stabilizing when they rise.

Equities

We reduced our equity exposure back to neutral as the risk/reward trade-off started to deteriorate. Our equity allocation is still tilted to benefit from rising bond yields and commodity prices. In sectors, we maintain a cyclical preference for industrials, materials and financials at the expense of healthcare and real estate.

We nevertheless moderated our pro-cyclical exposure somewhat by cutting the overweight in materials from large to moderate and upgrading consumer staples to neutral. Our other overweight is IT. The technology sector offers superior long-term profitability and growth and is well-placed to benefit from structural economic changes. As we move towards the next phase of the business cycle, investor preference may start to shift from cyclical towards secular growth, and from weak balance sheets to strong balance sheets. The tech sector scores well on both metrics.

Real estate

We are neutral on global real estate. Rising yields as a result of US fiscal support and economic normalization represent a medium-term headwind. Nevertheless, real estate has outperformed equities so far this year, regaining ground following Covid-led underperformance. Banks in the Eurozone have once again started easing housing credit standards in the second quarter, while US credit standards have also eased during the same period.

In the US, housing and labour data are on the mend, but supply bottlenecks, rising office vacancy rates and high mortgage delinquencies are headwinds. Investor positioning in global, US and European real estate is strongly underweight, with small inflows in US RE and outflows in Europe.

Valuation of the asset class, both absolute and relative, provides support. However, real estate is undergoing structural change amplified by the Covid-19 crisis. The trend towards e-commerce is limiting demand for retail real estate while strengthening logistics real estate. Increased working from home will continue to affect office demand. These themes will continue to weigh on the asset class in 2021 and beyond.

Commodities

We are neutral on commodities. Volatility has been high as of late, with supply bottlenecks acting as a speed bump on the global trend towards economic recovery. The Chinese authorities have announced a willingness to rein in excessive commodity price rises. High investor positioning almost across the board continued to be unwound in May, while precious metals got a bid amid rising uncertainty. The agricultural segment fell sharply following increased US planting and yield forecasts for soybeans, wheat and corn, coupled with lowered exports.

In oil, the US-Iran talks on the revival of the nuclear deal are in focus. We expect a new nuclear deal to materialize over the coming months with a gradual return of Iranian barrels. This should not fundamentally alter a tightening oil market in the near term, given developed market re-openings, refineries returning from maintenance and OPEC+'s gradual production increase for June and July. Nevertheless, the theme of returning Iranian barrels could lead to position unwinding weighing on prices in the near term. We have therefore closed our overweight in Brent. We maintain an overweight in WTI crude oil.

In industrial metals, we expect restocking amid solid end-use demand. We prefer aluminium, as environmental production curbs are coinciding with rising green demand. We moved platinum to overweight on renewed investment demand, rising demand for car catalysts and jewellery, and medium-term support from hydrogenation.

Table 1: Equity market forecasts

Index	Current	+3m	+6m	+12m
S&P 500	4201	4300	4400	4500
Stoxx 600	449	455	465	475
TOPIX	1947	2000	2025	2075
FTSE 100	7039	7100	7200	7350
MSCI EM Free	1354	1370	1400	1425

Source: NN Investment Partners, 31 May

Patrick Moonen
Principal strategist

Background: Spring scenarios update

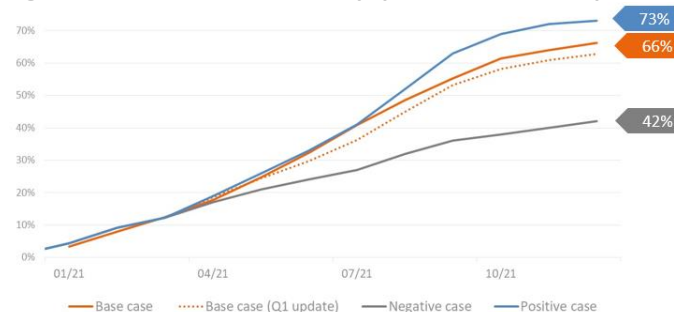
The views embedded in our *New Future* scenarios are based on the idea that after the pandemic, the world will strive to "return" to some sort of normality. The political and economic environment has

already changed in many ways, so the post-pandemic world will be different from the pre-pandemic one and we are heading "back" to a new future.

Our investment scenarios are designed to describe the context in which various possible market environments might evolve. The base scenario describes what we see as the most likely outcome. The alternative scenarios are meant to explore a wide range of possible futures. They are not meant as forecasts.

The scenarios are organized in terms of a few critical *unknowns* that span the space of possible outcomes. Our spring update features four unknowns: the global vaccine roll-out, fiscal stimulus, inflation expectations and animal spirits. We discuss them in turn. First, our assumptions about the global vaccine rollout are captured in Figure 1, which shows the portion of the fully vaccinated population in the US, EU, Japan and the UK in various cases. According to our base-case analysis, we expect about 66% of the population to be vaccinated by the end of the year.

Figure 1: Vaccination scenarios for population of US, EU, Japan, UK



Source: NN Investment Partners

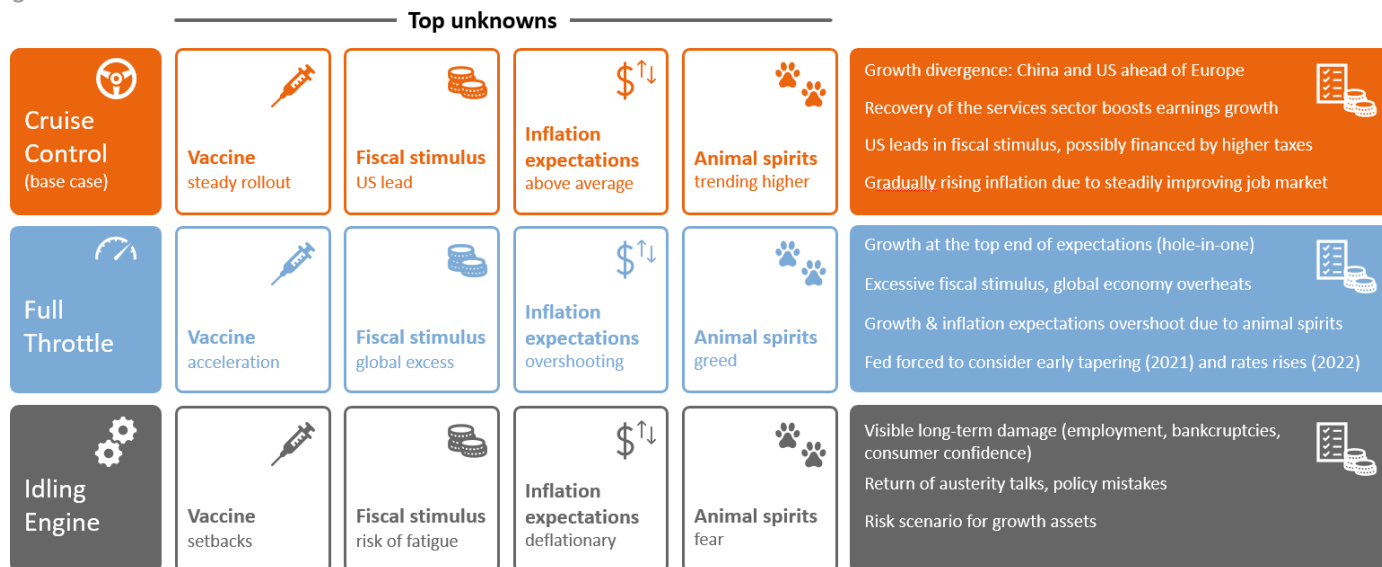
The expected strong growth of the global economy depends on continued fiscal support as well as the reopening of businesses. This is certainly the case in the US, where fiscal policy is moving from relief support to a debate on investments and social reforms. Further fiscal support is also needed in Europe, where the rollout of the recovery plan is slow, and in emerging markets, where fiscal headroom is limited.

We need to look at two more unknowns: inflation expectations and animal spirits. These unknowns allow us to explore how market participants will respond to the US Federal Reserve's new strategy, and to better capture potential deviations from market fundamentals.

New Future scenarios in detail

We maintain our three scenarios: cruise control (base case), full throttle, and idling engine. They are summarized in Figure 2.

Figure 2: Overview of the New Future scenarios



Source: NN Investment Partners

Cruise control

The cruise control scenario describes a world in which the aforementioned advances in the US on the fiscal and vaccination side warrant an upgrade of the economic outlook. We now expect the US economy to grow by 6.6% in 2021, compared with 4.3% for the Eurozone. This goes hand in hand with a gradual labour market recovery in both regions. Similarly, core inflation improves only gradually in the base scenario. This is also a positive backdrop for the Chinese economy, which is expected to grow by 9.4% in 2021.

In this environment, financial markets price in reflation and the comeback of the affected parts of the service sector. US yields have some room to edge higher, but the actual inflation trajectory should limit the rise. The Fed continues to anchor inflation expectations reasonably well. The European Central Bank, meanwhile, finds it more difficult to create room to manoeuvre, given the institutional setting and the lack of further fiscal response.

The strong increase in global earnings that analysts anticipate is materializing and might even exceed expectations. This should lead to decent equity returns in 2021.

Full throttle

The full throttle scenario offers an alternative future in which global growth surprises on the upside. Various factors are at play: significant pent-up demand, strong capex growth and excessive fiscal stimulus.

The high growth comes at a price. The global economy shows signs of overheating and labour markets recover so quickly that the actual inflation numbers overshoot the Fed’s 2% target. The Fed might be forced to taper early and raise rates prematurely, or they might be tested repeatedly by the market. In either case, the FOMC might face

problems anchoring inflation expectations. This conflict paves the way for higher yields in the US.

In this scenario, equity markets perform well, at least initially, due to strong earnings growth. The crucial point is that equity valuations and rates might rise sharply, because animal spirits detach valuations from fundamentals.

Idling engine

The idling engine scenario is one in which various factors become a drag on growth and undermine the recovery assumption that is crucial for global growth in 2021. Major setbacks for the vaccine roll-out in the G3 region may trigger such a negative spiral.

Policy mistakes are another possible trigger. For example, a premature tightening of monetary policy by the Fed or the ECB might derail the current rally. On the political side, any return to the austerity policies of 2011 might worsen the economic outlook in the European Union. For example, the September general elections in Germany and the French presidential elections next April might create opportunities for right-wing parties to force a debate about austerity. This scenario is clearly a drag on equities and creates deflationary pressures on bond yields.

We maintain this relatively pessimistic scenario not because we deem it probable, but because it highlights the importance of the sustained stimulus and the economic recovery of the sectors most affected by the pandemic.

The scenarios are updated on a quarterly basis. The next update will be at the end of the second quarter.

Marco Willner
Head of investment Strategy

Market review

- Positive but volatile month for risky assets
- Bond yields are stabilizing
- Dominant market narrative is changing

Stay in May

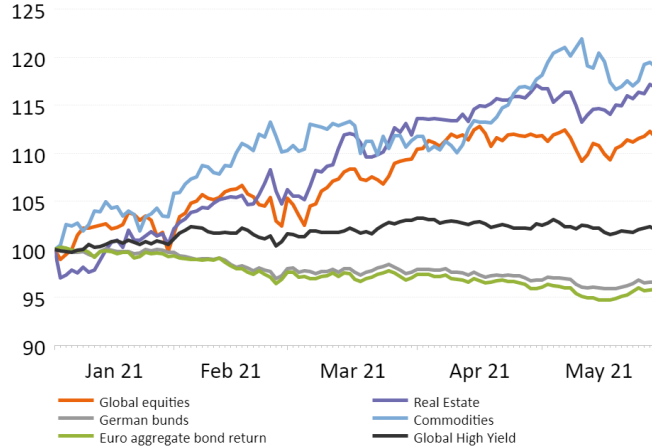
Risky assets continued to rise in May. Equities, real estate and most non-agriculture commodities posted positive returns. Credit spreads stabilized. In government bonds, the German Bund and US Treasury yields moved closer together. Yields rose during May in Euroland while declining in the US.

The main drivers of this bull market have not changed: fiscal support, accommodative monetary policy, strong earnings growth with positive guidance and the successful vaccination programmes in the Western hemisphere. These all support the current V-shaped recovery and make the path towards economic and social normalization this summer more credible.

The underlying narrative has however changed somewhat. Inflation data came in well above expectations and the recovery in US jobs market data stalled. At the same time, the Fed meeting minutes revealed that tapering was already discussed during the April meeting. These news flows created some short-term nervousness among investors, but this didn't last long and risky assets eventually grinded higher to end the month in positive territory. The changing sentiment was also illustrated by the rise and subsequent fall in volatility, with the VIX rising to 27 and then falling back to 16.

The corporate earnings season started in April and the numbers again beat expectations by a wide margin, in Europe and in the US and across all sectors. Profit guidance was also positive, acting as an additional driver for equities.

Figure 1: Year-to-date asset class performance (EUR)



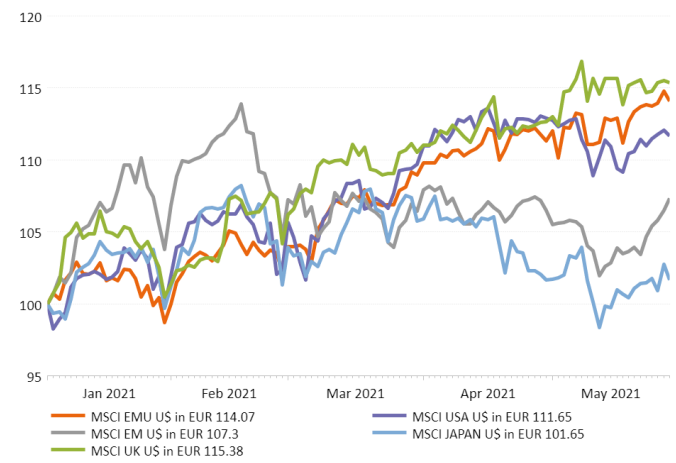
Source: Refinitiv Datastream, NN Investment Partners

Equities

Regions

Regional performance was mixed. Cyclical and value markets benefiting from a global growth recovery did relatively well. This caused the European and the Japanese markets to outperform the US and emerging markets in local currency terms. Several Asian EMs continue to struggle with the pandemic, particularly Taiwan and Malaysia. This is denting their growth outlook. The reduction in the positive growth gap compared to DMs is not helping either. In the final week of the month, EMs experienced some relief from a weaker US dollar and somewhat lower US bond yields. Chinese growth worries also look overdone and trade growth is picking up.

Figure 2: Regional equity performance (EUR)

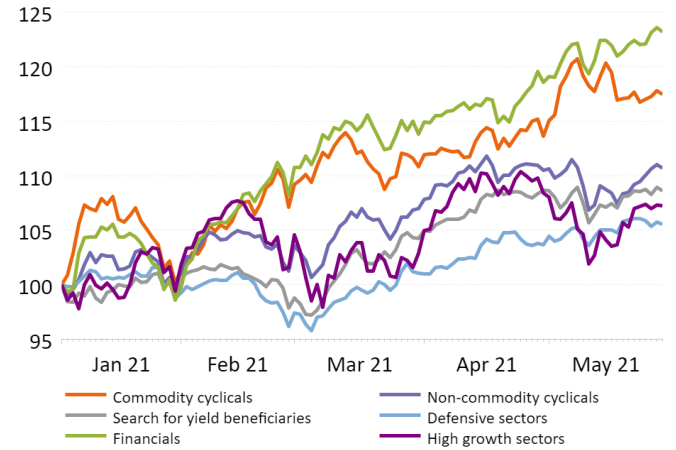


Source: Refinitiv Datastream, NN Investment Partners

Sectors

Those sectors exposed to the twin themes of higher commodity prices and higher bond yields continued to outperform the broader market. Materials, financials, industrials and energy beat the market by a decent margin. Technology, consumer discretionary and communication services, on the other hand, underperformed. In reality it was less straightforward and, during the month, there were several shifts in the week-to-week performance rankings, linked to doubts regarding the dominant market narrative.

Figure 3: Equity performance by sector (local currency)

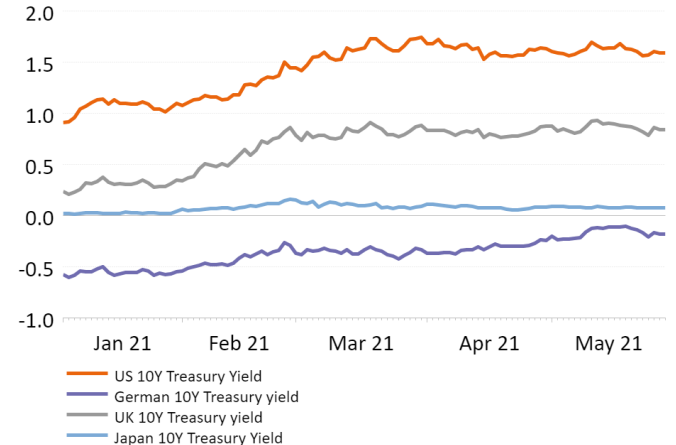


Source: Refinitiv Datastream, NN Investment Partners

Fixed income

In fixed income, there was a narrowing of the spread between US and German yields, a move we consider to be temporary.

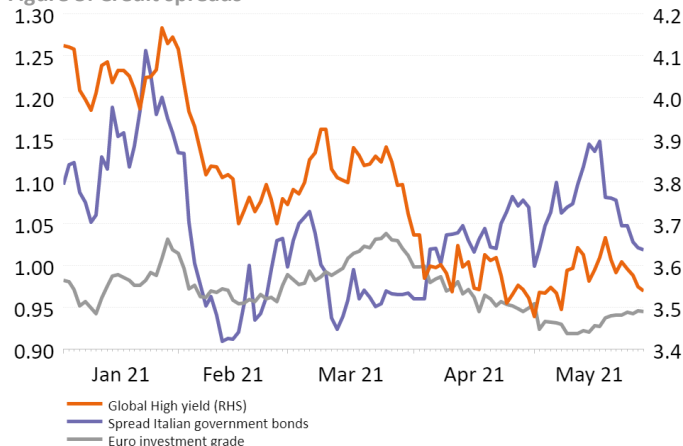
Figure 4: Long-term government bond yield trends



Source: Refinitiv Datastream, NN Investment Partners

In fixed income spreads, global high yield spreads were stable. Lower US yields were a tailwind here, in addition to the rapid improvement in corporate profitability.

Figure 5: Credit spreads

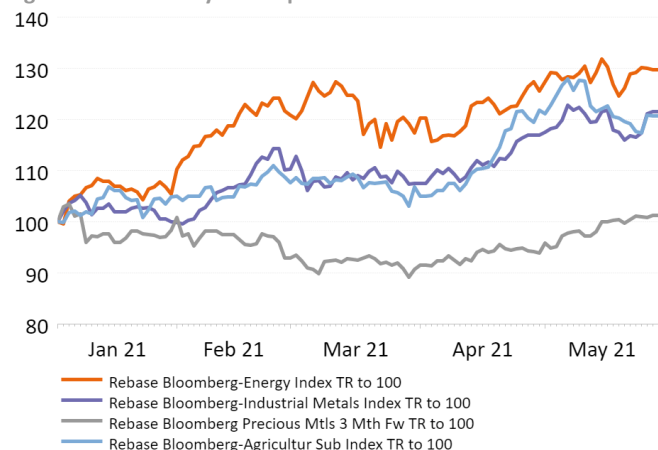


Source: Refinitiv Datastream, NN Investment Partners

Commodities

Commodities posted a very strong month in May. The industrial metal and energy segments both did very well, helped by high OPEC+ output compliance and expectations of rising demand as the economy normalizes. Precious metals also recovered on the back of lower real yields, probably supported by investors switching back from cryptocurrencies into “real gold”. Agriculture on the other hand lagged.

Figure 6: Commodity sector performance in USD



Source: Refinitiv Datastream, NN Investment Partners

Performance overview main indices

	Euro		Local Currency	
	MTD	YTD	MTD	YTD
MSCI WORLD - TOT RETURN IND	-0.07%	11.71%	1.09%	11.81%
MSCI EM - TOT RETURN IND	0.76%	7.44%	1.37%	7.15%
MSCI USA - TOT RETURN IND	-1.07%	11.84%	0.48%	11.76%
MSCI JAPAN - TOT RETURN IND	0.00%	1.80%	1.65%	7.79%
MSCI EMU - TOT RETURN IND	2.70%	14.51%	2.70%	14.51%
MSCI EUROPE - TOT RETURN IND	2.70%	13.87%	2.47%	13.13%
MSCI UK - TOT RETURN IND	2.41%	15.39%	1.31%	10.88%
MSCI PACIFIC EX JP E TOT RETURN IND	0.57%	11.47%	1.90%	11.17%
MSCI WORLD HEALTH CARE - TOT RETURN IND	0.54%	7.07%		
MSCI WORLD FINANCIALS - TOT RETURN IND	3.30%	25.45%		
MSCI WORLD UTILITIES - TOT RETURN IND	-2.16%	3.22%		
MSCI WORLD IT - TOT RETURN IND	-2.53%	6.00%		
MSCI WORLD ENERGY - TOT RETURN IND	3.69%	29.28%		
MSCI WORLD MATERIALS - TOT RETURN IND	2.76%	16.41%		
MSCI WORLD INDUSTRIALS - TOT RETURN IND	1.41%	14.35%		
MSCI WORLD CONS DISCR - TOT RETURN IND	-2.57%	7.96%		
MSCI WORLD CONS STAPLES - TOT RETURN IND	1.45%	5.90%		
MSCI WORLD T/CM SVS - TOT RETURN IND	-1.72%	14.22%		
GPR 250 REIT WORLD - TOT RETURN IND	-0.10%	17.00%	1.17%	17.21%
Gold Bullion LBM \$/t oz DELAY			7.66%	0.43%
Crude Oil BFO M1 Europe FOB \$/BBL			3.50%	34.34%
LME-LMEX Index - PRICE INDEX			4.10%	27.39%
Bloomberg-Agricultur Sub Index TR - RETURN IND. (OFCL)			-0.94%	20.67%
Bloomberg-Commodity TR - RETURN IND. (OFCL)			2.73%	18.94%
EBF EURIBOR 1M - OFFERED RATE	-0.563%	-0.554%		
US GVT BMK BID YLD 10Y (US) - RED. YIELD	1.593%	0.912%		
GERMANY GVT BMK BID YLD 10Y (E) - RED. YIELD	-0.183%	-0.575%		
JAPAN GVT BMK BID YLD 10Y (Y) - RED. YIELD	0.079%	0.021%		
UK GVT BMK BID YLD 10Y (E) - RED. YIELD	0.797%	0.196%		
JPM EMBI Global Diversified - Blended YTM	NA	NA		
JPM EMBI Global Diversified - Blended Spread (bp)	NA	NA		
JPM EMBI Global Diversified - Return	NA	NA		
Barclays Euro-Aggregate EUR - Yield to worst	0.11%	-0.14%		
Barclays Euro-Aggregate: Corporates EUR - Yield to worst	0.38%	0.24%		
Barclays Global High Yield USD - Yield to worst	4.32%	4.47%		
Barclays US Aggregate ex Government USD - Yield to worst	1.87%	1.47%		
US \$ TO ECU/EURO (WMR) - EXCHANGE RATE	1.22265	1.22355		
JAPANESE YEN TO EURO (WMR) - EXCHANGE RATE	133.752	126.326		
GBP TO EUR (BOE) - EXCHANGE RATE	0.8602	0.904		

Source: Refinitiv Datastream, 31 May 2021

Patrick Moonen
Principal Strategist Multi-Asset

Economic outlook

- To taper or not to taper... that is the question
- For the Fed, early guidance on any policy change remains crucial
- ECB remains hesitant to reduce pace of PEPP purchases for fear of causing a tantrum

The tapering issue has reappeared on investors' radar screens over the past month. Seven years ago, the infamous taper tantrum shook the nerves of investors and of Fed policymakers. It is unsurprising that the Powell-led Fed wants to avoid a repeat of this experience. On the other hand, the prospect of a continuing strong recovery suggests that the criterion of "substantial further progress" towards Fed goals will likely be met later this year. In addition, the Fed wants to signal its readiness to react if inflation expectations should break out on the upside. Talking about tapering is a useful component of this effort.

A potential taper is also an upcoming issue for the ECB, which promised in March to significantly increase the pace of purchases under the Pandemic Emergency Purchase Programme to dampen the upward pressure that US reflation hopes were exerting on EMU yields. If the PEPP existed purely to support the functioning of markets, a reduction in the pace of purchases in response to decreased upward pressure on yields would not be a problem. However, the PEPP is also focused on price stability because one of its key functions is to ensure an equal transmission of the easy monetary policy stance across all EMU countries. What's more, the ECB is in the midst of its strategic review, which will involve a great deal of political horse-trading between the hawks and the doves. As such, the market may take a significant tapering of PEPP purchases as a hawkish signal. For this reason, several ECB decision-makers have signalled that PEPP tapering may be postponed until the strategic review is completed.

The nature of tapering and why it could cause a tantrum

Tapering is simply a reduction in the monthly pace of net asset purchases, with a view to reducing these to zero over a specified horizon. As such, tapering does not constitute a tightening of policy, but rather a deceleration in the pace of easing. When the central bank engages in net asset purchases, it takes duration out of the market and onto its balance sheet. All else equal, this should spark a lower term premium and hence lower long-term yields. Yet, when Fed Chair Ben Bernanke announced in 2013 that the Fed would reduce the pace of its net purchases at some future date, this caused an effect akin to a sharp and unexpected hike in the policy rate: Treasury yields surged and risky assets sold off. This was because the market interpreted Bernanke's speech as a hawkish shift in the Fed's reaction function.

First, at least in theory, the term premium should be influenced by the expected cumulative stock of Treasuries that the Fed will take on its balance sheet, rather than the current pace of purchases. The pace can of course matter, especially in times when market liquidity dries up, but it can also act as a signal of how much more duration the Fed is likely to remove from the market. During the taper tantrum, the market made its own large downward adjustment to offset the expected cumulative stock of Fed Treasury purchases, which caused a rise in the term premium. It also made a hawkish adjustment to the expected future path of the policy rate – in other words, talking about tapering was interpreted as a signal that the Fed would start the hiking cycle earlier and/or at a faster speed than expected. The Fed responded to these developments by clarifying that tapering would be conditional on further improvement in the

economic outlook and that a decision about tapering was distinct from the decision about when to start hiking rates. In this way, the Fed provided the market with an anchor for expectations about future policy by tying the guidance for QE and rates to changes in the economic outlook.

The Fed is inching towards tapering

This time around, the Fed provided the market with a much stronger anchor for two reasons. First, it has adopted a strategically dovish reaction function in response to the constraints imposed by the combination of a low equilibrium real policy rate (r -star) and the zero bound on the actual (nominal) policy rate. During a downturn it will be difficult to push the real policy rate sufficiently below r -star to bring inflation back to target as soon as possible. Therefore, these constraints could cause inflation expectations to drift lower over time. To compensate, the Fed effectively commits to maintaining a structurally more accommodative policy stance during the expansion, which will result in inflation moderately overshooting the target for some time. Second, the Fed now ties its guidance to economic outcomes rather than economic forecasts. In particular, it is focused on the gap between the current level of employment and inflation and their respective targets. The Fed was systematically overpredicting inflation even before 2020, and the Covid-19 shock only increased the degree of uncertainty. As a result, the Fed now wants to see the "whites of the eyes of inflation" before raising rates.

The current inflation spike is no reason for the Fed to deviate from its dovish reaction function. The most plausible explanation for higher inflation rates is that they are caused by base effects and temporary supply/demand imbalances in various sectors as the economy reopens. As such, the increase in inflation should be transitory and should not cause inflation expectations to break out on the upside of the mandate-consistent range. There is of course a tail risk that this will happen anyway; in this case, the Fed will quickly turn more hawkish, which could well trigger a "super taper tantrum". To avoid this scenario, the Fed is paying more attention to risk management by clearly signalling its readiness to act if inflation expectations rise too much and by using the leeway in its existing QE and rate guidance to sound a bit more hawkish. Various Fed speakers, most importantly Vice-Chair Richard Clarida, have signalled over the past month that it may be appropriate to start a discussion about tapering during one of the upcoming meetings. This is not in itself shocking because the release of pent-up demand and excess savings make it very likely that the economy will indeed make "substantial further progress" in the next few months. In addition, the taper tantrum has taught us the important lesson that the Fed should gradually dial up the volume on tapering for some time before actually starting.

ECB hesitant to reduce pace of PEPP purchases

While the Fed made the switch from emergency instruments back to regular QE and rate guidance last year, the ECB is still firmly stuck in emergency mode. The PEPP QE program is part of this. It was set up to counter the effects of a panic-driven liquidity drought in several EMU sovereign bond markets. Arguably, therefore, the pace of PEPP purchases can be safely scaled back once the panic subsides. However, in practice things are a lot more complicated. First of all, the market's awareness of the ECB liquidity backstop is probably why the panic will subside and remain under control. Secondly, and related to this, price stability is only attainable if the ECB's policy stance is transmitted in equal strength to all jurisdictions. This requires an instrument to prevent excessive peripheral spread widening. Hence, the PEPP incorporates a strong monetary policy element. The market could therefore interpret tapering as a hawkish signal.

An added complication is that the ECB is in the midst of its strategy review, the outcome of which may have profound implications on its goals and instruments. With regard to its goals, the inflation target will likely be changed from "below 2% but close to it" to a symmetric

2% target. The former gives the impression that 2% is a ceiling, while the latter conveys the message that the ECB dislikes inflation that is X percentage points below the target just as much as inflation that is X percentage points above it. The big question is to what extent it will explicitly aim for a moderate temporary overshoot to compensate for years of undershooting. In relation to the ECB's instruments, it remains uncertain to what extent some of the flexibility embedded in the PEPP, such as the ability to temporarily deviate from the capital key, will be transferred to the ECB's regular QE programme. There is substantial disagreement between the hawks and the doves on these issues.

In March, the ECB promised a significant increase in the pace of PEPP purchases to dampen the upward effect on EMU yields exerted by US reflation. The big question is how much the central bank will scale back purchases in the third quarter. EMU yields have risen further on balance over the past two months, but this was mostly driven by domestic EMU reflation expectations. The ECB has largely remained silent in the face of rising bond yields, but several Governing Council members have recently commented on the rise. The doves would like to dampen upward pressure on nominal yield curves as much as possible and would thus not favour a scaling-back of PEPP purchases. Meanwhile, the hawks argue that increases in nominal yields that are driven by a better growth outlook are desirable and they would like to end the PEPP at the earliest possible opportunity.

Predicting the outcome of this difference of opinion is very difficult. Nevertheless, centrist and moderately hawkish GC members have started to signal a willingness to maintain the current pace of PEPP purchases into the next quarter. Perhaps they have studied the Fed's experience last year. In March 2020, the Fed started a market functioning QE programme aimed at relieving a liquidity drought in the Treasury market. When the Treasury market had calmed down, the Fed signalled that it would maintain a monthly injection of USD 120 billion until its strategic review was complete and its regular instruments could be recalibrated accordingly. This was partly because tapering before the strategic review might be construed as a hawkish signal about its outcome, which would trigger an unwarranted tightening of financial conditions. In much the same way, the ECB is not yet in a position to recalibrate its rate and QE guidance and give the market a more solid anchor for expectations about its future policy stance. The optimal course of action is therefore arguably to maintain the current pace of PEPP purchases until the strategic review is completed, in order to avoid an EMU version of the taper tantrum.

Willem Verhagen
Senior Economist

Emerging markets

- Emerging market recovery still lags developed world
- Rising regulatory uncertainty, mostly in Latin America

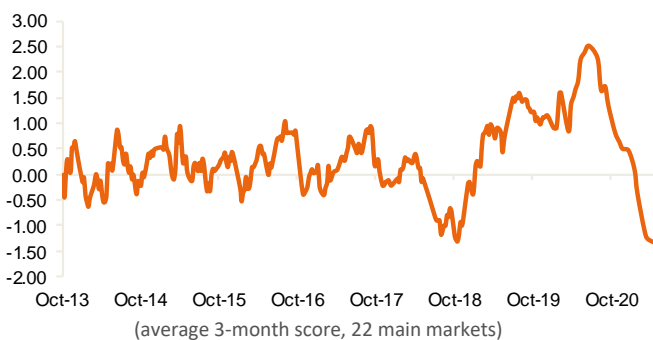
Slow vaccinations, monetary tightening, weak business climate

The economic recovery in the US and Europe continues to outpace that in emerging markets. The main explanation is the much slower vaccination speed in EM, which is preventing a rapid decline in coronavirus infections. As a result, health concerns for businesses and households remain higher than in DM, and mobility restrictions are only gradually being lifted. New infection waves have also interrupted the recovery in countries such as Taiwan and Malaysia. Another important factor that is likely to prevent the EM recovery from catching up with DM in the coming period is the limited room for fiscal stimulus and the gradual tightening of monetary policy.

The increasing EM macro imbalances, the related shift towards more unorthodox economic policies, the narrowing EM-DM growth differential, and the still-high sensitivity of EM capital flows to changes in US monetary policy expectations explain why broad capital flows to EM have been negative in most months since the coronavirus crisis began. The high currency risk originating from fears of more capital outflows is a key reason why inflation expectations in emerging markets have been rising. This is forcing EM policymakers to tighten monetary policy.

After the unprecedented monetary easing during the first months of the pandemic, the policy normalization has clearly started, with most EM central banks either hiking rates or assuming a tightening bias. This is nicely reflected in our proprietary EM monetary policy stance indicator moving further into negative territory (see figure). A negative reading of this indicator means that on balance more central banks are tightening policy than easing.

Figure 1: EM monetary policy stance



Source: NN Investment Partners

As stated above, negative capital flows and pressure on currencies are the key factors that push EM central banks into policy tightening. More directly, it is actual inflation and rising inflation expectations that explain the more hawkish policy stance. Due to the rise in inflation since last summer and the dramatic easing of monetary policy in the first months of the pandemic, real policy rates have often ended up in negative territory. Most EM policymakers are not comfortable with having negative or very low real rates in an environment in which DM bond yields are rising and market participants are becoming nervous about the approaching start of policy tapering in the US.

We believe that EM monetary policy tightening will continue in the coming months, given the combination of sticky or rising EM inflation

(due to supply bottlenecks, expectations of rising taxes and the steady rise in global food and energy prices) and the prospect of higher US bond yields keeping pressure on EM capital flows.

Rising interest rates will make it difficult for EM credit growth to start rising again. The historically low EM interest rates in the past year have not led to a rise in credit growth. On the contrary, the high uncertainty linked to the pandemic caused a sharp decline in private-sector credit demand. The lower price of credit failed to make a difference. The current level of EM private-sector credit growth (corporates and households together) is 7.8%, which is very close to our estimate of Q2 EM nominal GDP growth.

The prospects of continuously high public-sector borrowing needs, due to large fiscal imbalances and rising interest rates, will make it difficult for private-sector credit growth to pick up. This is one of the reasons why we think the EM-DM growth differential will remain low in the coming years. EM domestic demand growth will also be held back by the trend of more state interventionism in the economy and a less favourable business climate. Regulatory uncertainty as an obstacle for corporate investment is an increasingly relevant theme throughout the emerging world, but particularly in Latin America.

Policy uncertainty in Latin America

The Latin American country that has changed most in this context is Mexico. Here, corporate investment growth has been negative for most of the time since President López Obrador came to power in 2018. The reversal of decisions made by earlier administrations, such as the construction of the new Mexico City airport and the energy reforms, has led to uncertainty and has seriously affected the business climate. The upcoming mid-term elections on June 6 will determine how much room the president will have to carry out more of his nationalist and interventionist agenda.

Also on June 6, the second round of Peru's presidential elections will take place. The front-runner in the polls, Pedro Castillo, has a radical programme that includes much higher royalties for mining companies and even outright nationalization of assets in the natural resources sector.

In Chile, a constitutional convention was elected in May. The result was negative for the centrist parties, both on the left and right side of the political spectrum. The good results for the more radical parties and independent candidates will likely not only make the writing of the new constitution difficult but also increase the likelihood of a more market-unfriendly end result. The new constitution should be ready within 12 months. Before that, in November, Chile will have presidential and congressional elections that will likely put more pressure on the political status quo.

Finally, in Brazil, where the popular discontent has reached new highs due to the mismanagement of the corona crisis by the Bolsonaro government, the next elections will be held in October 2022. Also here, polarization is likely to increase further. For now, former president Lula da Silva is the favourite to win. As in 2001, when Lula won the elections, the campaign will probably be characterized by large ideological differences. After more than a decade of economic crises and with an average annual GDP growth of only 0.3%, fundamental changes in Brazil's economic model might be at stake. Until then, policy uncertainty will likely increase further.

M.J. Bakkum

Senior Emerging Markets Strategist

Fixed income outlook

- Growth and inflation expectations could push Bund yields higher, but ECB is a strong anchor
- US Treasuries include a taper premium that could rise further when Fed turns hawkish

Growth expectations will dominate Bund inflation expectations

European rates have exhibited relatively high volatility as of late. Various reasons have been posited to explain the recent sell-off and the subsequent sharp rebound. Growth, inflation, and fiscal and monetary policy are key contributors to yield developments, but within a complex system and a behaviourally biased market, these factors dominate narratives interchangeably.

In this section of the Multi Asset Monthly, we break down the key components of German Bund and US Treasury yields to better understand how growth, inflation and policy expectations have dominated bond yields since the beginning of the year. This exercise helps us to cut through the noise of various narratives that are trying to explain yield moves, and to look at what the actual data is telling us. By understanding how the key factors contribute to yield developments, we can sharpen our narrative for global rates markets.

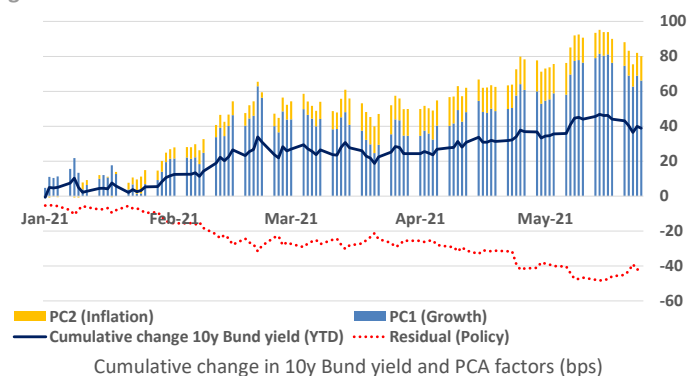
We break down bond yields using principal component analysis (PCA), which indicates the largest uncorrelated factors that determine yield curve movements. We find that two factors – the first and second principal components – explain around 99% of all variance in German yield curve movements over the past year.

These principal components, or factors, do not themselves have a clear macroeconomic meaning. However, by running regressions on the different principal components using macroeconomic variables, we find that macroeconomic variables associated with growth have a strong relationship with absolute yield levels, which is the first principal component. We also find that various market-based measures of inflation expectations are closely related to the second principal component and have been driving the steepening in European yield curves.

Figure 1 shows the cumulative yield changes in 10y Bunds since the beginning of the year. The contributions of the first two principal components associated with growth and inflation have steadily risen over the past year, with the inflation component steadily gaining importance in Bund yields since the end of March. Along with higher growth expectations, this fuelled the recent sharp rise in yields. ECB executive board member Isabel Schnabel recently stated that it's important to understand the drivers behind the recent rise in yields. "Rising yields are a natural development at a turning point in the recovery," she said. "Investors become more optimistic, inflation expectations rise and as a result, nominal yields go up." She added that this is what the ECB wants to see, indicating that a rise in yields for the right reasons does not negatively impact financial conditions.

Figure 1 shows just that: a rise in Bund yields that mainly stems from higher growth and inflation expectations, rather than the anticipation of a more hawkish-sounding ECB. Therefore, the recent rise in yields shouldn't overly concern the ECB with respect to financial conditions, especially as real yields still remain relatively well-anchored at low levels. So, the ECB is more in the game of mitigating upside volatility than pushing yields lower.

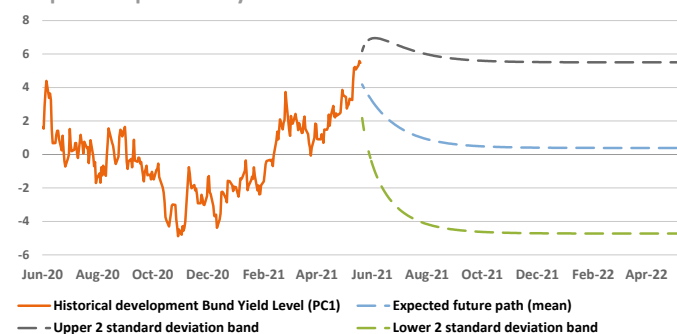
Figure 1: PCA bond yield decomposition shows ECB's impact versus growth and inflation



Source: NN Investment Partners

Bund yields are currently around 40 bps too low, given macroeconomic fundamentals. This is because the ongoing ECB asset purchase programs are dampening volatility in European interest rates. Growth and inflation are pushing yields higher, but asset purchases are mitigating the rise. This is captured by the third principal component, which we have taken as part of the residuals in our analysis. Figure 1 shows that these residuals have kept the rise in Bund yields relatively limited. Even though these PCA residuals show a strong correlation with inflation break-evens, equity and even oil markets, we believe this is because monetary policy is keeping real yields depressed. Higher nominal rates in the current economic recovery phase, at a time of depressed real yields, are not necessarily negative for risky assets.

Figure 2: Mean reversion of principal component shows potential for quick drop in Bund yields



Source: NN Investment Partners

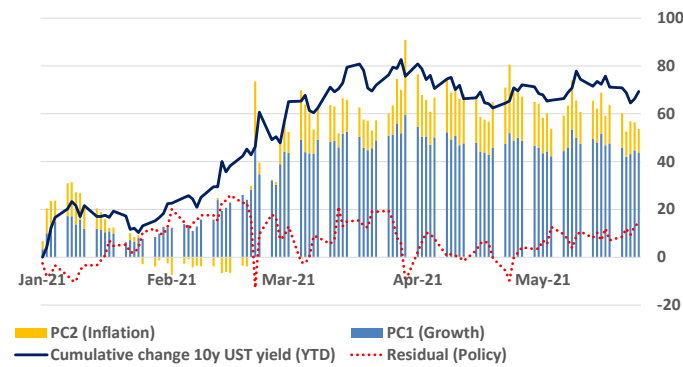
These principal components also have mean-reverting tendencies (Figure 2). The first principal component (level) is the most important driver for outright 10y Bund yields and should mean-revert to approximately the deposit rate over the coming months, according to our mean reversion model. However, this pure statistical analysis doesn't include our positive narrative for medium-term growth. Growth is an important driver for yield levels and should gradually push yields higher still.

Even with a step-up in the pace of the ECB's weekly asset purchases, nominal Bund yields have moved steadily higher this year due to higher growth and inflation expectations. For now, we think the upward trend in yields is not yet over and the recent drop in yields should be viewed as a temporary pullback. We remain neutral in Bunds and prefer to position for an increase in European government bond yields via an underweight in Italian government bonds, which should allow for more yield volatility to the upside.

Fiscal policy, QE taper premium priced into Treasury yields

We have conducted a similar bond yield breakdown for US Treasuries (Figure 3). In this case we find that the inflation component has had a larger impact on yields, with growth expectations recently stabilizing.

Figure 3: Policy-dominated PCA residual adds premium to 10y UST yields

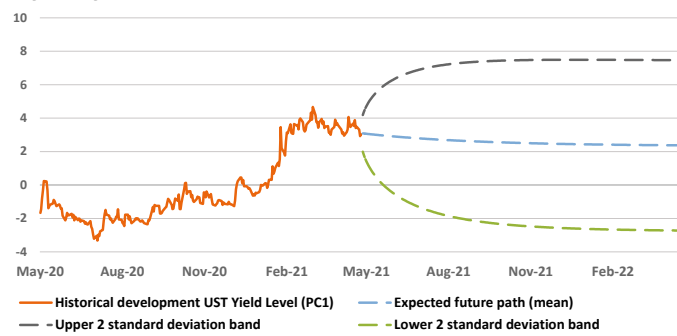


Cumulative change in 10y UST yield and PCA factors (bps)

Source: NN Investment Partners

Whereas Bund yields were pushed lower by the policy component – a PCA residual that includes the third principal component associated with monetary policy – US Treasury yields are being pushed up beyond their macroeconomic fundamentals. The PCA residual has been volatile, but overall adds a premium to US Treasury yields commensurate with a repricing of rate hike expectations and tapering of asset purchases.

Figure 4: Very slow mean reversion, no clear statistical direction in 10y UST yields



Source: NN Investment Partners

In addition to our more qualitative narrative on higher growth and inflation for the US, we look more closely at what the underlying data are telling us. Figure 4 shows that from a statistical perspective, the 10y US Treasury yield won't experience strong mean-reverting tendencies, which creates broadly balanced potential for upside and downside yield moves.

All in all, US Treasury yields have stabilized somewhere in the range of 1.50–1.70%, as the inflation component declined a bit. We expect yields to continue moving higher as the Federal Reserve becomes more explicit about reducing stimulus in the form of asset purchases amid elevated economic growth and a continued decline in unemployment figures in second-half 2021. We maintain our moderate underweight in US Treasuries. On balance, we believe the risk is tilted to more upside in interest rates.

Fouad Mehadi, CFA
Senior Investment Strategist Fixed Income

Equity outlook

- Normalization is increasingly priced in
- The risk/reward outlook looks less favourable
- We have taken a neutral stance on equity and a more balanced sector approach

Digest and rebalance

In local currency terms, global equity markets continued to move higher in May. We witnessed some rotation in the sector performance. The month started with a cyclical tilt, but during the final weeks this gave way to a different, more growth-oriented tilt. This was linked to more moderate cyclical commodity prices and a pause in US bond yields' upward trend. Emerging markets in Asia continued to struggle. So where do we stand today?

The news on the pandemic front is encouraging. The vaccination roll-out is gaining momentum across most developed markets and the journey towards economic and social normalization has begun. In Europe, although some delivery issues remain, the rate of inoculation is accelerating. A gradual re-opening of the economy, including for Mediterranean countries that are heavily dependent on holiday travel, looks to be on the cards. Elsewhere, the road remains bumpy. Emerging markets like India and Brazil are failing to get the virus under control, while Taiwan faces rising infections and Japan's vaccination roll-out remains slow.

Fiscal policy will continue to provide support. The Biden administration has announced a huge investment plan in both physical and "human" infrastructure via the USD 2.3 trillion American Jobs Plan and USD 1.8 trillion American Families Plan. But the debate is also focusing on the revenue side and on who will pay for this. A corporate tax increase and higher capital gains tax are in the pipeline. Although a headwind, equity markets have not yet reacted much to the prospect of higher taxes. This might be because the tax plans may be moderated during the approval process and the positive growth impact of fiscal policy still has to be taken into account. Hence, the net earnings impact should be less than 5%, which looks manageable.

In Europe, after some delay the recovery fund may start the disbursement of the funds sometime in the summer. If all these stimulus plans are well executed and also trigger more private investment, this could turn out to be a once-in-a-decade opportunity to lift the economy out of its secular stagnation. For equities this would mean lower risk premiums and structurally higher earnings growth.

Easy monetary policy remains the baseline. However, the developments of previous weeks have illustrated that the monetary policy path can no longer be taken for granted. Investors will need to deal with more inflation uncertainty over the coming period. This could lead to heated debates and speculation on the future monetary policy path, possibly leading to more market volatility. In May we also observed inflation data that came in well above expectations. In our base case, these upticks are temporary, driven by base effects and one-off items such as the partial spending of excess savings and rising commodity prices.

First-quarter corporate results were strong. In the US, 85% of companies did better than expected, with an average earnings beat of over 25%. The absolute earnings growth number was well above 50%. In the Eurozone the results are equally positive. The guidance was also optimistic and is reflected in an upward revision of the next quarters' earnings consensus. The second quarter will show the biggest YoY growth and then the numbers will start to normalize

rapidly, from 50%+ in Q2 down to less than 10% for FY 2022. This slowdown is linked not only to base effects but also to upward cost pressure stemming from rising commodity prices, higher transportation costs, supply chain disruptions, sub-optimal use of capacity, higher taxes and potentially higher wages. Companies will either allow their margins to absorb these costs or try to reflect them in higher selling prices, impacting inflation. Equity markets could react negatively to both possibilities.

In the past few months, equity markets have also been driven by the volatility in the bond market. Rising yields led to strong performance of value stocks and cyclical sectors. As this upward momentum faded in the second half of May, a partial reversion of the value-versus-growth trade occurred. The technology sector rebounded and commodity cyclicals together with financials hit a speed bump.

It is clear that yields matter for certain sectors, but we can make two observations about the risk that rising yields pose for equity markets. First, the correlation between yields and equity markets is not stable. In the recovery phase, both often move in tandem as higher yields are compensated by a better growth outlook. In the more mature phase of the cycle, the correlation turns negative. Secondly, the cause of the rate rise is important. Is it linked to a shift in monetary policy expectations or to rising inflation expectations?

Figure 1: Risk premium proxy: earnings yield minus bond yield



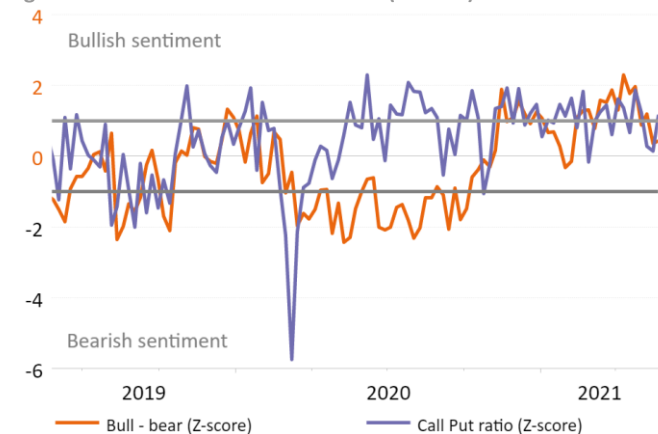
Source: Refinitiv Datastream, NN Investment Partners

The net market impact will ultimately depend on two factors: expected earnings growth and the speed at which yields rise. Based on this metric, the risk/return trade-off for the US market has deteriorated rapidly since year-end. It fell dangerously close to levels that, since the global financial crisis, have produced negative results three months ahead. However, these periods of negative returns often coincided with tighter monetary policy (2017-2018), which is not yet on the cards today. This makes us believe that if yields rise in an orderly way, justified by improving macro data and accompanied by strong earnings growth, they will not derail the bull market. Taking into account 2021 (+35%) and 2022 (<10%) consensus earnings estimates, US 10-year bond yields could gradually rise to 185 bps by the end of this year.

Investor behaviour

Investor sentiment has cooled over the past weeks. We can no longer define the market as (rationally) exuberant. Pockets of the market where signs of over-optimism were visible earlier in the year, like cryptocurrencies and special-purpose acquisition companies, have also experienced significant corrections recently.

Figure 2: Investor sentiment indicator (Z-score)



Source: Refinitiv Datastream, NN Investment Partners

Moreover, equity inflows are accelerating and equity buybacks will jump this year, following the strong increase in expected cash flow generation by companies. Still, the net impact will be smaller, given a high level of new IPOs and secondary transactions.

Positioning

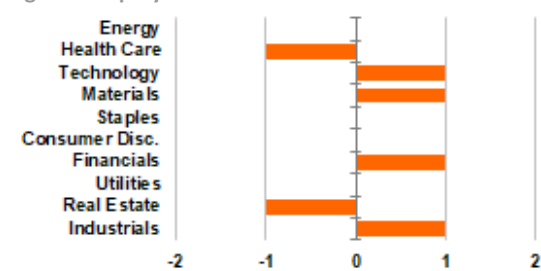
After the strong rally since the beginning of the year, a lot of the positive fundamental news on the earnings outlook and the pandemic looks to be priced in. The balance between risk and return has deteriorated and we expect earnings to normalize rapidly in 2022. The pandemic has taken a backseat as a market driver in developed markets and consensus expectations are for the economy and people’s social lives to normalize from this summer. At the same time, we can no longer take the existing monetary policy framework for granted. The April Fed meeting minutes revealed the growing unease on inflation risks amongst participants. This might lead to a sooner-than-expected announcement on tapering. The combination of all these factors together with a reduction in economic surprises (mainly in the US so far) makes equity investments less attractive. Still, less attractive does not mean unattractive. Investor sentiment has cooled and should act as a buffer against a large correction.

To summarize, we maintain a constructive long-term view on equity markets, but the short-term risk/reward trade-off has deteriorated, leading us to take some risk off the table for the time being.

One area of focus in the coming months will be the gradual shift from a pure reflation and cyclical trade towards a better-balanced trade. History shows that as the economy moves from the recovery phase to the mid-cycle phase, sector performance starts to shift from cyclical-growth sectors towards secular/stable growth and quality.

We are not mid-cycle yet, but this cycle is advancing very quickly due to the event-driven nature of the preceding downturn and the unprecedented policy support that followed. With this pattern in mind, we have already been making some changes in recent months. We have downgraded energy to neutral and upgraded technology to a moderate overweight and consumer staples to neutral. Materials was cut back a notch but still remains one of our preferred sectors, as it is a beneficiary of higher commodity prices and more infrastructure spending. We also like financials as a beneficiary of higher interest rates.

Figure 3: Equity sector allocation



Source: NN Investment Partners

From a regional perspective we closed our moderate overweight in the UK and our moderate underweight in Switzerland, moving both regions back to neutral.

In May we closed our overweight in US small caps. The trade had already lost momentum and the strong earnings season was not able to turn this trend. The vulnerability of small caps to a shift towards quality and secular/stable growth was another factor that we took into account. Hence, we opted to close this trade.

Finally, we maintain our value-versus-growth overweight. We have entered the phase in the cycle where earnings growth is not a scarce asset. Low valuations are much harder to find, however, hence our value overweight.

Patrick Moonen
Principal Strategist Multi Asset

Commodity outlook

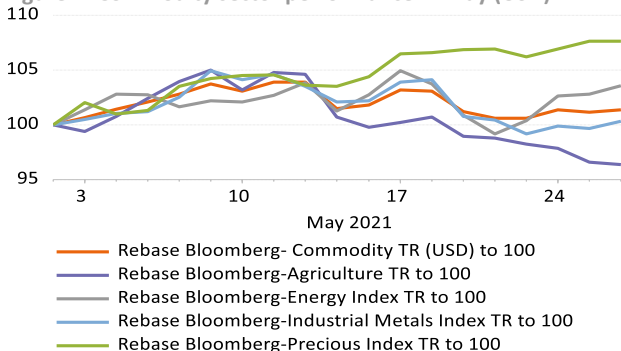
- Volatility reigns as cyclical segments tighten
- We close our Brent overweight on return of Iranian barrels

Volatility reigns, with cyclical segments still tightening

Volatility has been high in commodities as of late. In the first half of May, commodity prices continued the rise that began in April. A mid-month reversal coincided with the softening of global macroeconomic surprise indicators, most notably in the US and China. In the US, a weak reading on employment and sharply rising inflation data spooked markets, while in China, credit data, industrial production, fixed asset investments and retail sales all softened in April. All these are largely attributable to supply bottlenecks impeding the global trend towards economic recovery.

Moreover, the Chinese authorities have announced their willingness to rein in excessive commodity price rises and speculative activity. Their desire to avoid pass-through of rising commodity (metal) prices to consumers may dent sentiment to the asset class in the very near term. However, it is unlikely to derail the tightening physical market that we expect to continue in industrial metals over the next several months. We foresee a restocking phase amid pent-up demand in developed markets. When the Covid-19 crisis erupted last year, destocking occurred in anticipation of collapsing demand. The subsequent rise in demand for manufactured goods defied expectations and led to the current supply disruptions. Covid containment measures – including port congestion, lack of vessels, rising freight costs, labour shortages, shortage of building materials, rising lumber prices, and mine disruptions due to health and safety measures – amplified these disruptions. Manufacturing clients' inventories remain low, and pent-up demand makes a restocking phase likely, which will support industrial metal prices.

Figure 1: Commodity sector performance in May (USD)



Source: Refinitiv Datastream, NN Investment Partners

In this volatile environment, the high investor positioning almost across the board continued to be unwound in May. Precious metals nevertheless got a bid amid rising uncertainty. The agricultural segment was the most notable underperformer. Agricultural prices fell sharply after May 12 when the USDA raised US planting and yield forecasts for soybeans, wheat and corn and lowered export estimates.

Closing Brent overweight on expected return of Iranian barrels

Oil prices have become volatile once more. On the one hand, US-Iran talks on the revival of the nuclear deal created the outlook for rising supply and weighed on prices. On the other hand, strong reopening-led oil demand is pushing prices higher. We expect a new nuclear deal in the coming months. The timing is difficult, as the Iranian presidential elections will take place in June, with a new government

to be formed in August. Ultraconservative candidates seem to have the upper hand. A deal would probably lead to a gradual return of Iranian barrels, to the tune of some 500 thousand barrels per day. We would expect this to rise later on, with Iranian oil production increasing to around 3 million barrels per day in first-half 2022 (from 2.5 mbd currently) and towards estimated capacity at some 3.8 mbd thereafter. This should not fundamentally alter a tightening oil market in the near term, given developed market re-openings and refineries returning from maintenance. The latter should lead to an increase in incremental crude demand of about 4 mbd until August. In particular, Q3 2021 should remain tight, as OPEC+ is expected to stick to its agreed-on gradual ramp-up of production during June and July.

OPEC+ remains disciplined in bringing back supply. On 1 April, the group decided to gradually bring back production in May, June and July, with a ramp-up of 350 kbd in May, 350 kbd in June and 441 kbd in July. Saudi Arabia also announced that it would phase out its 1 mbd voluntary cut with increases of 250 kbd in May, 350 kbd in June and 400 kbd in July. We expect OPEC+ and Saudi Arabia to stick to this plan. Moreover, they will likely adapt their strategy if needed in the event of a nuclear deal with Iran. Nevertheless, the potential return of Iranian production could lead to position unwinding weighing on prices in the near term. Towards year-end and going into 2022, the theme of returning US barrels in addition to Iranian ones will likely become a headwind for oil prices. In line with this outlook, we locked in profit by closing our Brent overweight. We maintain a moderate overweight in US WTI crude oil.

We also moved platinum to overweight in May. Platinum has safe-haven demand components, and much like gold and silver should benefit from the recovery in jewellery demand already visible in China. The platinum/gold price ratio is also still below its long-term average. The key support for platinum is investment demand, aided by easy monetary policy and low real yields. Platinum should also benefit in this respect. Non-commercial net long positioning in platinum is below average and ETF holdings have room to rise after recent unwinding. On the supply side, last year's South African production are expected to normalize, but production outages in platinum group metals (PGM) in Russia make a market deficit likely this year. On the demand side, other than jewellery and safe-haven demand, exposure to the car industry is important. Platinum is exposed to the diesel car catalyst market, where a recovery in global car sales is visible, with Chinese commercial diesel vehicle sales rising strongly. China will tighten its truck emission regulations in the second half of 2021, further supporting platinum demand, as tighter regulation leads to higher PGM loadings (the amount of PGM used per vehicle). Further, loadings in hydrogen fuel cell cars are 4 times higher than for diesel cars, while those for trucks are 10 times higher than for diesel cars. Platinum should additionally benefit from the hydrogenation of the economy and its use in electrolyzers (EU Green Deal). In the medium term, platinum may also benefit from substitution for palladium in gasoline car catalysts.

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