Multi Asset Monthly

Global Strategy

Economy and markets on the mend

Highlights

Economic Outlook

With economies gradually reopening, real activity and confidence data are both well off their lows. Now we have moved into a new, more uncertain phase of the pandemic. Much will depend on developments related to Covid-19 itself and the impact it has on economic activity. In the meantime, the race to find a vaccine or treatment continues unabated. The effectiveness of policy measures in preventing permanent damage to the economy will be another determining factor. The US and Europe are taking very different approaches to this. Finally, over the coming period, political uncertainty will increase.

Market Outlook

Markets have taken relief from all the policy measures and the encouraging developments in macro and corporate data. The gloom has made way for optimism. However, investors have already gone quite a long way in discounting a V-shaped recovery in growth and earnings, and have temporarily turned a blind eye to the virus. This leaves the market vulnerable to any disappointment on the macro, corporate, pandemic or political front.

Allocation

Last month, we maintained our existing overweights in US and Euro investment grade and added to EMD. Central bank support and a positive carry in an otherwise sideways-moving market are the key drivers. The macroeconomic backdrop, strong earnings, fiscal policy support, encouraging vaccine developments and generally cautious investor positioning still warrant a constructive view on risky assets. We also upgraded commodities to a moderate overweight.

Contents

Market Review

- Strong macro and earnings data steer risky assets higher in August
- Safe yields rise and credit spreads tighten

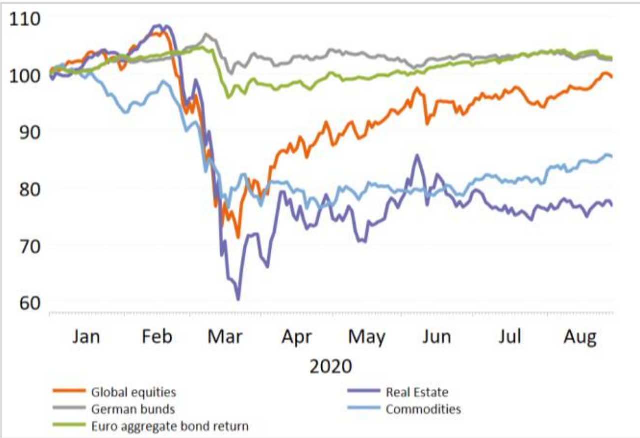
Strong macro and earnings data steer risky assets higher

Equity and commodity prices rose in August. This rise occurred against a background of improving macroeconomic data, supportive earnings releases and constructive outlooks, most notably from cyclical companies. Euro investment grade and high yield credit spreads tightened in this environment, as did EMD HC sovereign spreads. US dollar credit spreads meanwhile lagged slightly. Safe yields increased moderately with real estate as a yield-sensitive asset class underperforming equities. In commodities, the gold price reached an all-time high early in the month, after which profit-taking occurred and the more cyclical segments were favoured.

Economic surprises in developed markets remained in positive territory although to a lesser degree in the Eurozone on a resurgence of virus cases. Meanwhile emerging market macroeconomic surprises moved into positive territory on ex-China data releases. The gap between EM and DM macro surprises in favour of DM diminished accordingly.

Investors are hopeful that progress is being made on developing a vaccine and that in the meantime a renewed hard lockdown on a broad scale can be avoided or be limited locally to regions or cities. As such, with ample monetary stimulus and more fiscal impulse to come, a continued economic recovery is still considered to be likely.

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



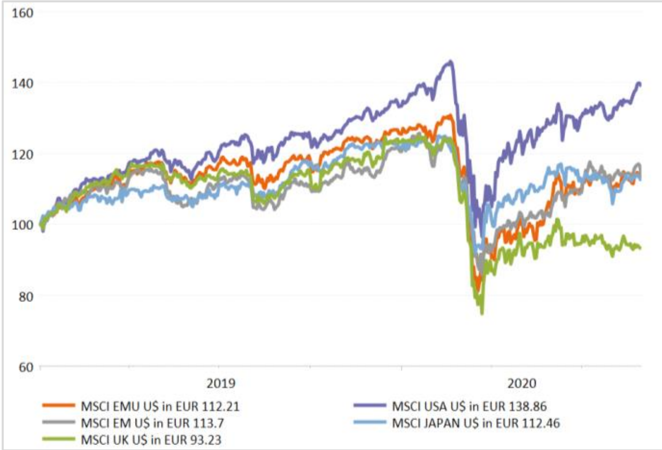
Source: Refinitiv Datastream, NN Investment Partners

Equities

Equity regions

Despite the difficulties in reaching an agreement on a fourth fiscal package, the US equity market was once again the lead performer in August, driven by strong earnings reports, an improvement in the virus data and better high-frequency data. Japan also did well, although around month-end it faced the news of Prime Minister Abe's resignation for health reasons. Europe and emerging markets were both up but nevertheless lagged the broader index.

Figure 2: Regional equity performance (EUR)

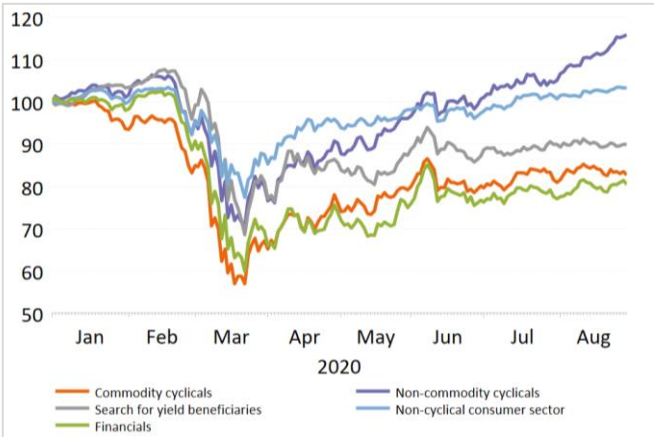


Source: Refinitiv Datastream, NN Investment Partners

Equity sectors

The technology sector outperformed the broader market in August. The more traditional cyclical sectors like industrials and consumer discretionary also performed strongly. Defensive sectors like healthcare, utilities and consumer staples lagged. This is an illustration of the impact that the continued improvement in fundamental data can have on market performance.

Figure 3: Equity performance by sector (local currency)

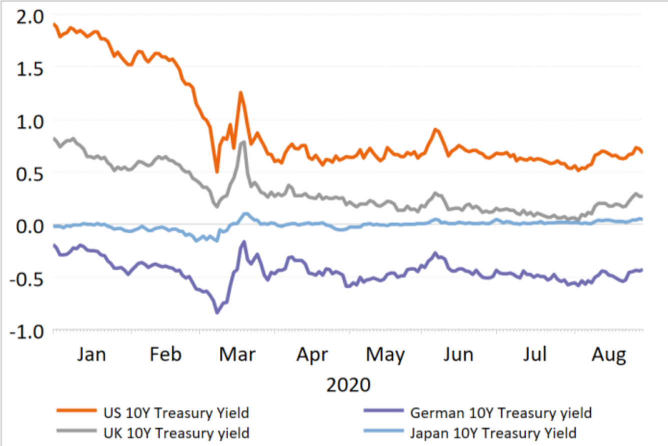


Source: Refinitiv Datastream, NN Investment Partners

Fixed income

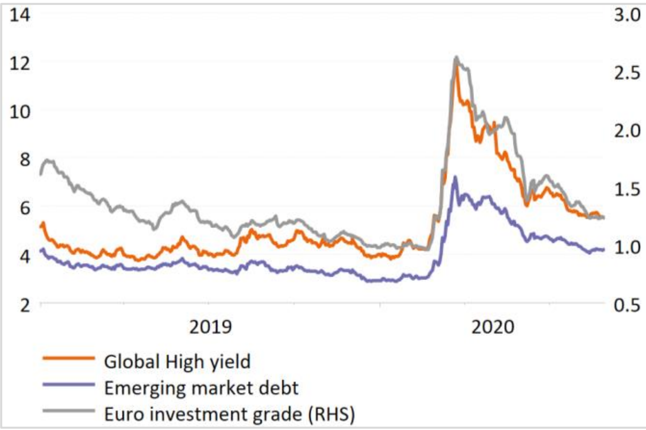
Global fixed income markets delivered a mixed performance in August with treasury yields up and spreads tighter. This was driven by monetary and fiscal policy events, including supportive monetary policy decisions and dovish comments by central banks. The Jackson Hole speech of Fed Chair Powell was an important message that may lead to higher nominal yields driven by higher inflation expectations. Fiscal stimulus continues to play an important role in large parts of the world. With all eyes on pandemic developments, one thing is for sure: policymakers have demonstrated their resolve.

Figure 4: Long-term government bond yield trends



Source: Refinitiv Datastream, NN Investment Partners

Figure 5: Credit spreads

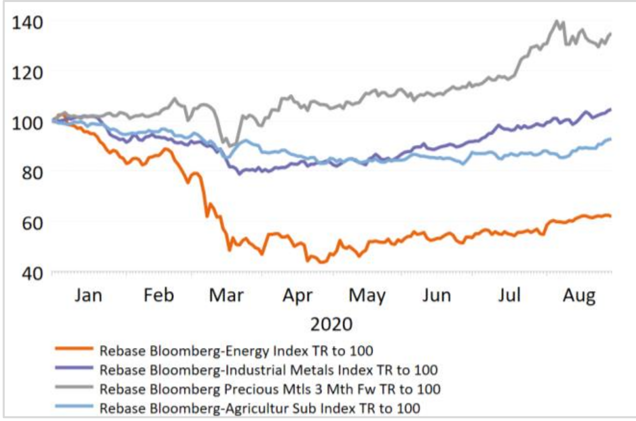


Source: Refinitiv Datastream, NN Investment Partners

Commodities

Commodity prices continued their recovery in August. Energy stood out positively with US natural gas prices in particular rising strongly on favourable weather-related demand and production restraint. After gold prices rose to a record high, they witnessed some profit-taking on the back of rising US real yields. Agricultural prices lagged after the US Department of Agriculture raised the forecast for the US grains and beans crop.

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	5.52%	-0.76%	6.31%	4.39%
MSCI EM - TOT RETURN IND	1.09%	-5.50%	2.20%	4.63%
MSCI USA - TOT RETURN IND	6.30%	4.58%	7.51%	11.42%
MSCI JAPAN - TOT RETURN IND	6.41%	-7.48%	7.94%	-3.81%
MSCI EMU - TOT RETURN IND	3.54%	-10.13%	3.54%	-10.11%
MSCI EUROPE - TOT RETURN IND	2.96%	-11.09%	2.75%	-10.06%
MSCI UK - TOT RETURN IND	2.39%	-24.35%	1.51%	-20.25%
MSCI PACIFIC EX JP E TOT RETURN IND	4.59%	-11.35%	3.77%	-8.37%
MSCI WORLD HEALTH CARE- TOT RETURN IND	0.94%	1.52%		
MSCI WORLD FINANCIALS - TOT RETURN IND	4.19%	-21.76%		
MSCI WORLD UTILITIES - TOT RETURN IND	-2.49%	-8.99%		
MSCI WORLD IT - TOT RETURN IND	9.42%	25.49%		
MSCI WORLD ENERGY - TOT RETURN IND	0.52%	-40.50%		
MSCI WORLD MATERIALS - TOT RETURN IND	3.75%	-1.68%		
MSCI WORLD INDUSTRIALS - TOT RETURN IND	7.52%	-8.25%		
MSCI WORLD CONS DISCR - TOT RETURN IND	10.94%	14.65%		
MSCI WORLD CONS STAPLES - TOT RETURN IND	1.84%	-3.26%		
MSCI WORLD T/CM SVS - TOT RETURN IND	6.57%	5.82%		
GPR 250 REIT WORLD - TOT RETURN IND	1.73%	-21.12%	1.95%	-16.87%
Gold Bullion LBM $/t oz DELAY			-0.36%	29.43%
Crude Oil BFO M1 Europe FOB $/BBl			4.59%	-31.96%
LME-LMEX Index - PRICE INDEX			5.03%	6.12%
Bloomberg-Agricultur Sub Index TR - RETURN IND. (OFCL)			5.50%	-7.22%
Bloomberg- Commodity TR - RETURN IND. (OFCL)			6.76%	-9.04%
EBF EURIBOR 1M - OFFERED RATE	-0.522%	-0.438%		
US GVT BMK BID YLD 10Y (U$) - RED. YIELD	0.693%	1.910%		
GERMANY GVT BMK BID YLD 10Y (E) - RED. YIELD	-0.396%	-0.187%		
JAPAN GVT BMK BID YLD 10Y (Y) - RED. YIELD	0.047%	-0.022%		
UK GVT BMK BID YLD 10Y (£) - RED. YIELD	0.313%	0.825%		
JPM EMBI Global Diversified - Blended YTM	5.06%	4.93%		
JPM EMBI Global Diversified - Blended Spread (bp)	427.7	297.1		
JPM EMBI Global Diversified - Return	-0.15%	1.37%		
Barclays Euro-Aggregate EUR - Yield to worst	0.10%	0.23%		
Barclays Euro-Aggregate: Corporates EUR - Yield to worst	0.58%	0.51%		
Barclays Global High Yield USD - Yield to worst	5.73%	5.68%		
Barclays US Aggregate ex Government USD - Yield to worst	1.57%	2.66%		
US $ TO ECU/EURO (WMR) - EXCHANGE RATE	1.19595	1.1225		
JAPANESE YEN TO EURO (WMR) - EXCHANGE RATE	126.825	121.988		
GBP TO EUR (BOE) - EXCHANGE RATE	0.8939	0.85		

Source: Refinitiv Datastream, August 31, 2020

Patrick Moonen
Principal Strategist Multi-Asset

Economic Outlook

- Global recovery surprises on upside but uncertainties remain
- Two major forces will dictate how the recovery evolves from here

Global recovery surprises on upside but uncertainties remain

As the third quarter progresses, it is becoming clearer that we are moving into the third phase of the corona crisis, which is also the most difficult to forecast. The first stage was the rapid downturn, and the second the technical rebound, which was fuelled by the easing of restrictions and the substantial support given to household incomes. The accompanying boost to consumer spending is starting to level off, and the big question is what will happen next.

At the most basic level this will depend on two major forces. The first concerns the extent to which virus flare-ups restrict economic activity through renewed restrictions and increased voluntary social distancing. The second force is the tug of war between permanent damage and the fear factor, on the one hand, and the policy response on the other. There is still a great deal of uncertainty surrounding both forces. It is very difficult to get a grip on the link between the virus situation and the effects on the economy. We simply do not have that much experience with how people will react, certainly not on a global scale in a world as interconnected as ours. As far as the second force is concerned, one of the main sources of uncertainty stems from the political arena, where populism and political polarization have been around for some time and in many (but not all) cases are strengthening.

An uneven recovery with plenty of uncertainties

Despite all this, the global economy is recovering somewhat more strongly than many observers anticipated a few months ago. Global goods spending has surpassed the pre-Covid high, but global industrial production is still well below its previous peak. Part of this discrepancy can be explained by an inventory drawdown. Inventories are now at very low levels relative to sales, so they might well serve as a boost for global growth in the second half. The other reason for the lag in industrial production stems from the large drop in global capex last quarter.

Service-sector spending is likely to remain well below pre-Covid levels for some time, owing to social distancing and other factors. Thus, the service sector will likely suffer more permanent damage than the manufacturing sector. For the latter, the capex outlook remains the main wildcard. Given that financing costs are already pretty low, the main constraint for capex will be profit expectations. These are largely driven by the final demand outlook, which brings us back to the two aforementioned forces: the virus situation and the tug of war between the fear factor/permanent damage and the policy response. As for the latter, the long-run outlook seems more favourable in Europe than in the US, given that EMU fiscal policymakers are engaged in a marathon while their US counterparts are caught up in a series of stop-go sprints.

Still, we should mention one caveat to the aforementioned low financing costs. These certainly apply to credit and equity markets, but the latest G4 bank lending surveys reveal a tightening of bank lending standards. This tightening is most pronounced in the US, where lending standards were tightened severely across all categories in the second quarter. In contrast, business lending standards were tightened only modestly in Europe in the second quarter, but banks expect some serious tightening in the third quarter. The main drivers of this expected tightening are an increase in the expected share of nonperforming loans as well as a decrease in banks' tolerance for taking risk on their books. On the other side of the credit equation, loan demand for businesses soared in Europe and Japan last quarter while it fell in the US. This difference is attributable to the different approaches to ensuring business liquidity. The US is a market-based financial system, so the Fed has concentrated much of its effort on its credit easing programmes. In contrast, in Europe and Japan efforts were concentrated on providing loan guarantees and on giving banks a fiscal subsidy for extending more credit.

The main message from all this is that the quality of business balance sheets has deteriorated because of rising debts as well as a big hit to profits. Loan guarantees in Europe and Fed credit market interventions can certainly help businesses to stay liquid at a low cost and keep near-term default risks low. However, in both cases businesses are forced to increase leverage, which reduces their balance sheet strength unless they benefit from a strong and persistent rebound in profits in the not-too-distant future. This makes the quality of business balance sheets crucially dependent on the strength of final demand and thus the fiscal policy response. This is what Powell means when he says that the Fed is in the business of lending, not spending.

The past will offer limited guidance

When gauging the future path of the economy, we should be careful not to extrapolate too much from past experience. This crisis is totally different. For instance, in the average recession there is a collapse in durable goods spending as a share of GDP. This makes sense because in the face of falling income growth and increased uncertainty, business and consumers will postpone the purchase of big-ticket items. In this recession, US durable goods spending has increased as a share of GDP. Obviously the consumer is the main driver here, as capex declined substantially. This may be partly because of diversion of spending away from services (for example, buying a new car to go on holiday if you cannot take a plane). Another reason could be that consumers invested massively in equipment which better enables them to work from home. At any rate, the implications of this increase in durable goods spending are unclear. Normally, the durable goods cycle adds additional impetus to the recovery once incomes and confidence start rising again. This impetus may well be smaller this time around.

Meanwhile, service-sector spending usually remains pretty much intact during a recession. In other words, it typically maintains a positive growth rate, and any decline in the growth rate tends to be very modest. This time around, service spending is likely to have dropped twice as much as goods spending. What's more, because of social distancing it is likely to experience only a gradual recovery, which will depend largely on the virus situation. It is very possible that some parts of the service sector will see a permanent decline in activity if, for instance, people permanently change their social behaviour in response to the Covid crisis. In other words, social distancing may become a permanent feature of our lives to some degree. After all, the coronavirus is not the only (potential) threat out there.

Labour markets remain key to the outlook but are also pretty difficult to forecast. This is because aggregate demand and labour demand are strongly interdependent. Aggregate demand is the main driver of labour demand, while employment growth is one of the key drivers of household income growth as well as consumer confidence. The two forces – the virus situation and the tug of war fear factor/permanent damage and the policy response – thus also apply fully to the labour market. At any rate, the global PMI suggests that employment growth is lagging overall activity.

The US provides the perfect example of how difficult it is to forecast employment growth and the unemployment rate. The latter is even more difficult because it also depends on changes in labour supply, where we have seen big swings in some countries. Still, looking through all the noise, the pace of labour market improvement, which started in May, seems to be coming down. This is consistent with the notion that growth rebounded very quickly as lockdown restrictions were eased and that most of this technical rebound is now behind us. In July, the US unemployment rate stood at 10.3%. This is still above the high seen during the global financial crisis, but is much lower than the circa 25% that many experts forecast back in April. The participation rate is still well below pre-Covid levels, which suggests there is somewhat more slack than the headline unemployment rate suggests. Meanwhile in Europe the unemployment rate has increased by only 0.6 percentage points to 7.8% on balance, but this is of course due to the widespread application of furloughing schemes. Correcting for that, the extent of labour market damage is probably comparable to the US.

Inflation expected to remain subdued

In many regions we observe a rise in core inflation following a decline in previous months. This is essentially just volatility caused by relative price changes. During the depth of the GDP decline, prices in the worst-hit sectors tended to fall, and now that demand is resurging, prices are rising again. Moreover, commodity prices are recovering from their steep fall in the spring, which is pushing up headline inflation and probably also explains the small tick-up in inflation expectations in some consumer surveys.

Core inflation rates are likely to fall in the medium term, owing both to the large degree of slack and to slipping inflation expectations. Having said that, especially in the US, inflation expectations have received support from the recent change in Fed strategy. The Fed now explicitly wants inflation to be equal to the target on average in the long run. Given the persistent undershoot over the past few years, this means the Fed is aiming for a moderate overshoot for some time. In addition, the Fed has a more expansive view of its employment mandate: Policy will no longer be tightened if the unemployment rate approaches the Fed's estimate of its long-run equilibrium value, unless inflation is accelerating.

Conclusion

Adding it all up, consumer spending growth seems to be decelerating after a very strong three-month run. However, the baton is probably being picked up by inventory accumulation as well as a resurgence in trade. With respect to the latter, the bellwether economies in EM Asia are showing robust positive export growth. Finally, even though consumer spending growth is slowing down in the medium term, it will remain the main demand-side driver for the recovery. The good news is that there is ample fuel in the tank to power spending, as G4 savings rates all rose above 20% in the second quarter. As such, there is no need to be overly worried about the tightening of lending standards for consumers and the decline in consumer loan demand.

Still, if the savings rate is to decline through higher spending, consumers must have some degree of confidence in their prospects for decent income growth. In the next few months, this confidence can only come from substantial ongoing fiscal support. In this area the Eurozone has much better cards than the US: Its policy response is calibrated for the long run, with national fiscal programmes providing immediate support and the recovery fund expected to kick in when these programmes are wound down. By contrast, the US has gone over several fiscal cliffs and its political establishment has so far been unable to find a compromise to fix this. We still expect this to happen in September, but the risks are skewed towards a later date, in which case there will be negative repercussions for household income and employment.

Willem Verhagen
Senior Economist

Emerging markets

- Tailwinds for EM assets from global search for yield
- Rising EM inflation momentum despite output gaps
- Monetisation of widening fiscal deficits is main risk for EM capital flows

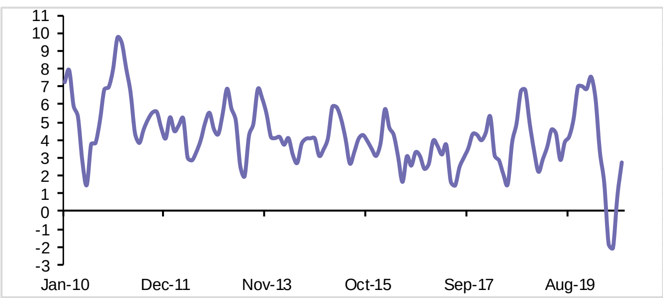
On inflation and the sustainability of easy economic policies

In the past month, emerging market assets have struggled to keep up with developed markets. The underperformance has been largest in equities, where EM has lagged DM by some 3 percentage points. In the debt space, the differences are smaller. Possible explanations are the still-major pandemic problems in Latin America and South Asia, which are preventing a speedy economic recovery, and indications that Chinese monetary stimulus has already started to moderate. Inflation has also picked up in several key countries, most prominently in India, Brazil, Mexico, South Africa and Turkey, which has pushed overall EM inflation momentum back into positive territory.

In the current environment of declining real yields in DMs and the Fed and ECB's ongoing strong commitment to keep interest rates very low, EM assets remain well sustained by the global search for yield. Another important positive factor is the strong demand growth for IT-related products, which has been a key factor in the swift recovery in East Asian trade volumes. In our view, these two factors explain why the recent EM underperformance has only been modest.

We do not think that DM monetary policy will be tightened in the coming quarters. The strong IT demand is also likely to continue, due to structural changes linked to working from home and e-commerce. But we should not assume that these factors will be strong enough to offset negative developments elsewhere. Currently, we are most vigilant about the rising inflation in combination with the still-deteriorating fiscal accounts in a growing group of emerging countries. EM governments need interest rates to stay low so that they can finance their rising fiscal deficits. But if inflation momentum continues to deteriorate, EM central banks will no longer be able to maintain such easy monetary policy.

Figure 1: EM inflation momentum



3m/3m, % change annualised, GDP-weighted average of 17 main EMs

Source: NN Investment Partners

So what has happened to inflation? Figure 1 shows GDP-weighted inflation momentum in EM. In the first months of the corona crisis, inflation collapsed in most countries due to the demand shock. Encouraged by the aggressive policy easing in developed markets and the rapid decline in inflation at home, EM central banks have seen room to reduce interest rates to historic lows and in some cases even to start quantitative easing.

Since July, average inflation momentum has started to rise, quickly moving back into positive territory, despite the slow economic recovery and still large output gaps. However, it is early days and the level of inflation is not alarming, apart from the countries with structurally high inflation, such as Argentina and Turkey. Also, one of the drivers of higher inflation, supply constraints linked to the pandemic, should only be temporary. As economic activity gradually normalizes, these constraints, particularly in food production and logistics, should fade.

More worrying is the rise in inflation due to shifting inflation expectations. It is always difficult to say exactly why these change. In EM countries where there is generally less trust in policymakers and financial institutions, the exchange rate is a key driver of inflation expectations. The depreciation of EM currencies in the first months of the corona crisis has pushed inflation expectations higher in countries such as Turkey, Brazil and Argentina.

Monetisation of widening fiscal deficits is main risk

It will be important to watch the EM policy mix in the coming quarters. The widening of fiscal deficits, to an average of 9.5% in 2020, and the likelihood of structurally higher deficits in the following years, is pushing central banks into outright monetisation of deficits. In Indonesia, the central bank will fund all of the corona-related fiscal stimulus this year (around 4% of GDP). In Turkey, the central bank and the unemployment insurance fund are increasingly absorbing new public debt issuance. And in Brazil, it is quite clear that without central bank help, the fiscal deficit, set to reach at least 16% of GDP this year, cannot be financed.

This shift towards a much more unorthodox policy mix should at some point lead to more currency weakness and more elevated inflation expectations. In our view, this is the main risk in EM for the coming years: how will EM policymakers sustain structurally higher fiscal deficits without much weaker currencies, higher inflation and eventually higher interest rates?

Until now, the strong search for yield has prevented meaningful capital outflows. As long as investors believe that higher EM inflation is the result of corona-related supply constraints and the currency depreciation of the first phase of the crisis, investor confidence should not deteriorate too much. But once doubts start to emerge about the sustainability of the current policy mix, possibly triggered by a continuous rise in inflation expectations, the global search for yield will probably not be enough to sustain positive capital flows. In this context it is important to realise that real interest rates in EM have fallen to below 1% on average, with several countries in negative territory already.

M.J. Bakkum
Senior Emerging Markets Strategist

Asset Allocation

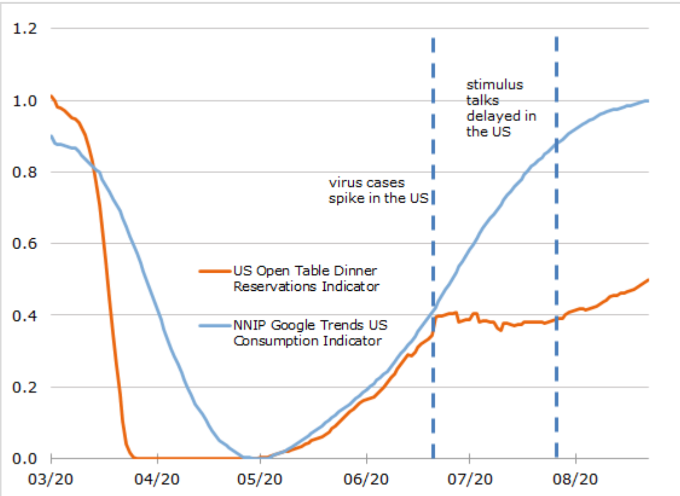
- Risky assets up amid mixed news flow
- Virus control crucial to prevent second waves
- We still prefer credits over equities

Economy and markets on the mend

Although risky assets continued their upward move in August, the news flow during the month was mixed. In the US, the political stalemate around the fourth fiscal package continued throughout August as Congress went into recess without a deal. President Trump did sign an executive order to mitigate some of the immediate effects of the delay. However, with Congress controlling the power to allocate funds, these temporary arrangements do not reduce the need for a sizeable fiscal stimulus to keep the nascent recovery going. We continue to believe that both sides will reach a compromise eventually, as does the market.

Despite a spike in Covid-19 cases and delay in fiscal stimulus, the expectation that the latter will eventually arrive, coupled with the resilient consumption and mobility trends reflected in the high-frequency data in the US, gave further support to the rally in risky assets. Virus data also showed improvement across the US, and the spikes in parts of Europe led to local lockdowns and mask mandates instead of a second complete lockdown, as was initially feared. In some parts of Asia and Australia, the virus outbreak worsened but the overall picture gave markets confidence that governments across the board are getting better at dealing with the virus without instituting full lockdowns. This is a view we also share.

Figure 1: High-frequency data in US showed resilience despite political stalemate and spike in virus cases



Source: OpenTable, Google, NN Investment Partners

Having said that, for a complete return to normality and the expected V-shaped recovery to materialize, the development of a Covid-19 vaccine will be essential. Preliminary results offer reason for optimism, but it will probably be several months into 2021 before a vaccine is widely available. Until then, fiscal and monetary support will have to be continued to keep the recovery going and limit downside risks for the market.

From a tactical asset allocation perspective, our focus remains on those market segments where the policy measures have most impact. In our view this is still the fixed income spread universe. We have added emerging market hard currency sovereign debt to our existing maximum overweights in US and Euro investment grade. These segments offer positive carry and so benefit from a search for yield as main central banks keep their policies loose. Towards month-end we moved commodities to overweight, triggered by Powell's announcement at Jackson Hole on the new Fed inflation make-up strategy, which we expect to support both cyclical commodities and precious metals.

Fixed Income

We maintain our constructive stance on developed market investment grade credit. We still expect a general tightening in credit spreads. For now, we prefer to position in investment grade paper as it has shown resilience during times of deteriorating risk sentiment. It also provides a decent volatility-adjusted carry. Finally, within the emerging markets complex, we still see some room for further spread tightening in hard currency debt, mainly due to the continued weakness in the US dollar, declining US real yields and the relatively long duration exposure. Good reasons for caution include the macroeconomic backdrop, virus developments and the US-China trade war rhetoric, but these concerns are to a large extent reflected in valuations and carry, particularly for the high yield segments.

Equities

In the equity sectors, our preference for structural growth stories is reflected in an overweight in technology, but we maintain a cyclical tilt through industrials and materials at the expense of consumer staples and real estate. This month, we introduced a moderate overweight in utilities and financed it through a moderate underweight in healthcare. Our preference for utilities is a bet on the search-for-yield theme while the healthcare underweight stems from the imminent political focus on pharma sector regulations. With political stalemate continuing in the US, we maintain our neutral exposure to the region and play the Asian story through our emerging markets overweight, with China, South Korea and Taiwan together representing more than 60% of the benchmark. We maintain our moderate underweight in Japan as it lags on macro and earnings fundamentals and is being hurt by the yen's appreciation. The resignation of Prime Minister Abe due to health reasons may add political uncertainty.

Real Estate

We are neutral on global real estate. Our quantitative scorecard for real estate improved in August on both macro fundamentals and market dynamics. We saw improvements in global cycle indicators, US unemployment, sentiment and momentum. However, banks are also tightening credit standards and investor capital has been moving out of the asset class.

A high level of uncertainty is defying the search for yield that typically favours real estate, as attention shifts to financial leverage and resilience of rents and dividends. Dividend cuts are likely. The earnings buffer in real estate is limited by the high payouts. Investor positioning in global real estate is strongly underweight. European real estate positioning however remains strongly overweight. Virus-related demand fallout and the rise of e-commerce are weighing on the retail segment, while the increasing trend towards working from home is affecting the office segment.

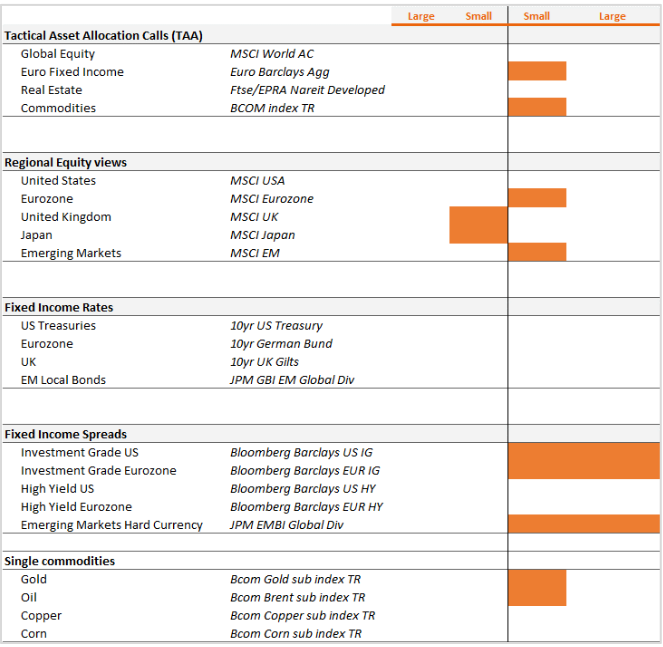
Commodities

We moved commodities to overweight. The improvement in the overall quantitative scorecard for commodities in August was led by the macro component, while market dynamics deteriorated. Commodity demand has recovered on the back of China's V-shaped economic recovery, but demand there is expected to level off. Meanwhile, in the rest of the world, we are less confident about a further boost to demand, given the lingering virus cases. Nevertheless, full broad-based lockdowns are unlikely and with strengthened monetary policy support by the Fed (make-up inflation strategy) and more fiscal policy easing, further normalisation in commodity demand can be expected.

Oil prices are supported by credible OPEC+ production restraint amid an expected very gradual return of US shale oil production in the face of an ongoing demand recovery. Oil inventories are expected to draw in the second half of the year.

During August we took profit on our overweight in coffee and moved platinum and palladium to an overweight. The latter two are expected to benefit from both safe-haven demand as well as from a recovery in global car sales (as they are used in car catalysts). Towards month-end we moved gold and Brent to overweight.

Model portfolio



Market Forecast Table

Equity	Current	+3m	+6m	+12m
Countries				
S&P 500	3508	3550	3600	3650
Stoxx 600	369	375	380	385
TOPIX	1618	1625	1650	1675
FTSE 100	5964	6000	6100	6200
MSCI EM Free	1122	1150	1175	1200

Source: NN Investment Partners, 31 August 2020

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Fixed Income Outlook

- Bond yields stay in trading range
- A closer look at break-even inflation
- Still positive on investment grade credits

Bond yields stay in trading range

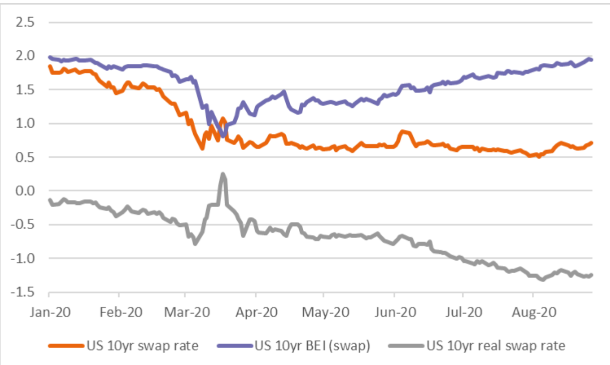
A month ago, yields for Bunds and US Treasuries seemed to break out of the trading range to the downside. This was related to the increased virus worries, geopolitics and the stalling rebound in economic activity. During August, however, yields drifted higher again as risk sentiment improved (see the Asset Allocation section for more on this). All in all, US and German 10-yr bond yields continued to trade around the 0.2%-point trading range that has been their trading level since mid-April.

We expect nominal yields to continue to show limited directionality. The signals are indicating higher yields, but cyclical signals in particular might be overstating the importance of the change in economic activity and ignoring the still low level of activity. In addition, the strong forward guidance by central banks combined with their bond purchases is bringing a lot of stability to bond markets.

A closer look at break-even inflation

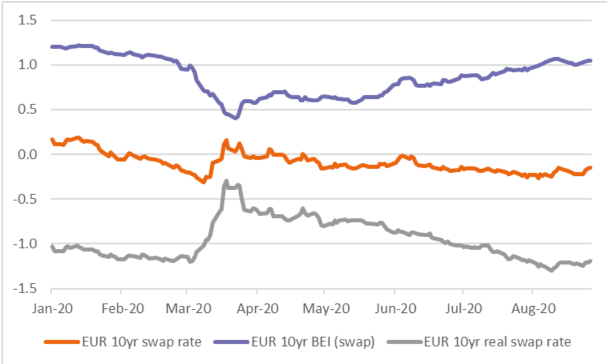
This stability in bond yields is hiding some interesting developments, however. Figures 1 and 2 show that while nominal yields moved sideways, break-even inflation (BEI) moved up and real yields declined. As the BEI is by definition the difference between the yield on a nominal bond and the yield on an inflation-linked bond (ILB), a stable nominal yield and rising BEI must imply lower real yields. Especially in the current environment of forward guidance by central banks, it's our view that markets are pricing the nominal yield (based on expectations for the short-term rate) and the BEI, and that the real yield is the result.

Figure 1: US BEI back to pre-Covid levels



Source: Bloomberg, NN Investment Partners

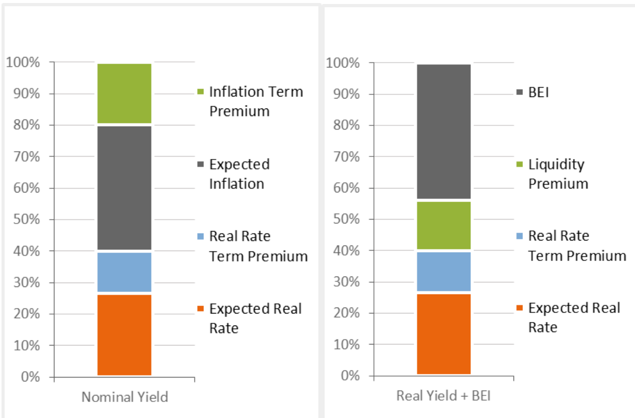
Figure 2: EUR BEI almost back to pre-Covid levels



Source: Bloomberg, NN Investment Partners

Furthermore, we need to address the relationship between BEI and market inflation expectations. As shown in Figure 3, a nominal yield can be seen as the sum of the expectations for the short rate and the inflation during the life of the bond, plus the term premiums for both, as these expectations are uncertain. The real yield on an inflation-linked bond (ILB) does not include an inflation term premium, but does contain a liquidity premium as ILBs are significantly less liquid than nominal bonds (so, to be precise, we should really call it a "relative liquidity premium"). Hence, the BEI can either overstate or understate expected inflation, depending on the size of the inflation term premium relative to the liquidity premium.

Figure 3: BEI can differ from expected inflation



Source: NN Investment Partners

Finding the inflation risk premium has always been something of an academic "holy grail", and the same is true for the liquidity premium. It's beyond the scope of this article to tackle all the difficulties related to estimating this premium, but our key observation is that 'true' expected inflation can deviate from the BEI.

Going back to Figures 1 and 2, perhaps the most interesting question is why BEI has gone up over the last few months. Firstly, this is probably explained by a decline in the liquidity premium on ILBs. At times of market panic, the BEI declines sharply as relatively illiquid ILBs underperform, which almost certainly played a role in March. The subsequent recovery in risk appetite in the last few months has resulted in a decline in the liquidity premium, pushing up BEI.

Secondly, the increase in oil prices since end April might have played a role. Although the impact of oil price shocks on inflation is not straightforward, and price fluctuations tend to be highly correlated with risk appetite and economic activity data, the recent rise might have contributed to the increase in BEI.

Thirdly, the policy response to the Covid crisis has been unprecedented. Monetary and fiscal easing has been timely, sizeable and coordinated. One could argue that the roles of fiscal and monetary authorities have switched. Fiscal policy easing should now contribute to stable (i.e., not too low) inflation expectations, while monetary policy easing should contribute to sustainable government finances by keeping rates low. In this new environment, inflation might well move to higher levels than we have seen in recent years.

Finally, even before the Covid crisis, central banks were already in the process of strategically reviewing their policy. A clear example of this occurred on 27 August, when Fed Chair Powell announced that the Federal Open Market Committee has adopted a flexible form of average inflation targeting as the key outcome of its monetary policy framework review. The FOMC simultaneously released an updated Statement on Longer-Run Goals and Monetary Policy Strategy. The new statement includes dovish revisions to the FOMC's approach to both its employment and inflation objectives.

On the inflation side, the statement notes that the FOMC "seeks to achieve inflation that averages 2 percent over time," and that "following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time."

On the employment side, the statement now says that policy will be informed by its assessment of "shortfalls of employment from its maximum level" rather than "deviations," the language previously used. This change represents a shift towards an asymmetric response to the employment gap, under which an unemployment rate below the estimated natural rate of unemployment is not sufficient reason alone to tighten policy. The new statement also now describes the maximum level of employment as a "broad-based and inclusive goal."

Overall, these developments can be seen as a significant dovish long-term shift for the Fed, but one roughly in line with expectations. The new policy introduces an element of make-up inflation, but the lack of an explicit averaging window, or degree of overshoot, also gives the new target some flexibility. Indeed, it implies that the Committee will retain a substantial amount of discretion in applying it to policy.

Based on the four topics discussed above, we still see room for somewhat higher BEI. The liquidity premium has probably normalised to a significant extent already, but a further improvement in economic data might still push the BEI higher. More importantly, the new monetary/fiscal policy mix and the strategic review by the Fed (and maybe later by the ECB) also raise the probability of higher inflation going forward. In the Eurozone the BEI is still at historically low levels and well below the current ECB target of "close to but below 2%". In the US, the BEI is trading around 2%, but it should be noted that the 2% inflation target refers to the PCE deflator, which is around 30-40 bps below the Consumer Price Index that is relevant for US inflation-linked bonds.

Still positive on IG Credits

The stability in nominal yields combined with some further upside in BEI implies that real rates will remain low or might even drift somewhat lower. This low real yield environment is supportive for risky assets in general. In particular, investment grade corporates are likely to do well in a low and stable yield environment.

In addition, euro investment grade corporate downgrades are currently at around 2%, significantly lower than the 5% markets were expecting a few months ago. There are several reasons for this lower downgrade percentage. Firstly, the economic recovery has been better than expected so far. Secondly, a lot of corporate issuance (also equity) has been well absorbed, and liquidity and capital ratios have improved. It should be noted that a large proportion of issuance is being used for cash hoarding, implying that leverage ratios are not deteriorating. Thirdly, many corporates are reducing capex, equity buybacks and dividend payments. Fourthly, central banks are facilitating refinancing. Finally, the Fed is buying fallen angels and the ECB might do so as well.

All in all, although corporate spreads have already tightened significantly, we still see some value left. Combined with strong corporate fundamentals and a constructive risk environment, we remain positive on investment grade credits.

Jaco Rouw
Senior FI Portfolio Manager

Equity Outlook

- Rally fuelled by new-technology names with some cyclical secondary support
- We maintain a balanced approach between structural and cyclical growth

The technology train looks unstoppable

Global equities continued their upward march in August. The continued improvement in macro data, a better-than-expected earnings season, particularly in the US, and continued monetary policy support from expanding central bank balance sheets more than offset the spike in virus cases in some parts of Europe and Asia, as well as the political stalemate around the fourth stimulus package in the US.

The virus situation remains a cause for concern, with global cases reaching around 24 million and global deaths crossing the 800,000 mark and still increasing. However, August did offer some silver linings. Without instituting a full-scale lockdown, the Sun Belt states in the US decreased the average number of new cases over the course of the month. These states successfully employed strategies like mask mandates and selective, localized scaling-back of re-openings to reduce the case numbers.

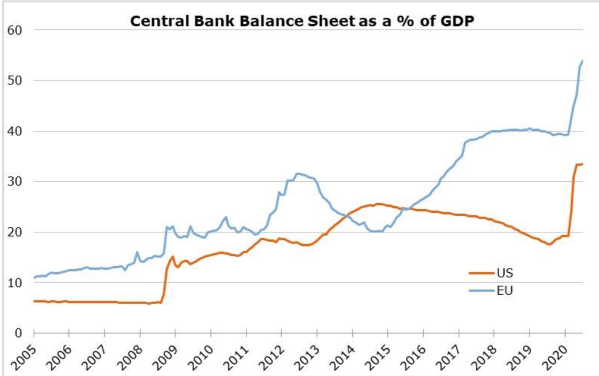
Europe seems to have learned from this experience and is following the same strategy. This gives us some confidence that full-fledged second lockdowns can be avoided. Nevertheless, there remains some uncertainty about the ability of authorities to manage the ongoing health crisis with limited measures as we head into flu season. However, given the experience of southern-hemisphere countries, particularly Australia, we remain cautiously optimistic that governments can manage the crisis even in winter without imposing a full lockdown.

In the meantime, the race for a vaccine continues unabated, with preliminary test results offering some encouragement. However, the earliest we can expect any vaccine to be widely available is several months into 2021. For now, the central bank “liquidity vaccine” is keeping the equity bears at bay, but fiscal stimulus is essential for the nascent economic recovery to continue.

The second-quarter earnings season concluded with companies posting their best quarter relative to expectations since the global financial crisis. In the US, around 80% of companies beat expectations, while their earnings exceeded expectations by 22.1% on average. This high number reflects the level of investor uncertainty regarding the impact of the virus and the subsequent policy response on the economic and earnings outlook.

The improvement in earnings sentiment is also noteworthy, with the ratio of upgrades to downgrades currently at its highest level in several years. Especially for the more cyclical sectors, this positive shift has been strong. This has further raised hopes for a V-shaped profit recovery in which US earnings surpass end-2019 levels by end-2021, with Eurozone earnings only 5% below end-2019 levels. These high expectations seem to suggest that the equity market is vulnerable to a setback if the news flow does not confirm the positive scenario. For the market to continue moving higher, it will need constantly positive news on the virus, the economy and policy. This seems likely in the short term, but medium-term uncertainties remain high.

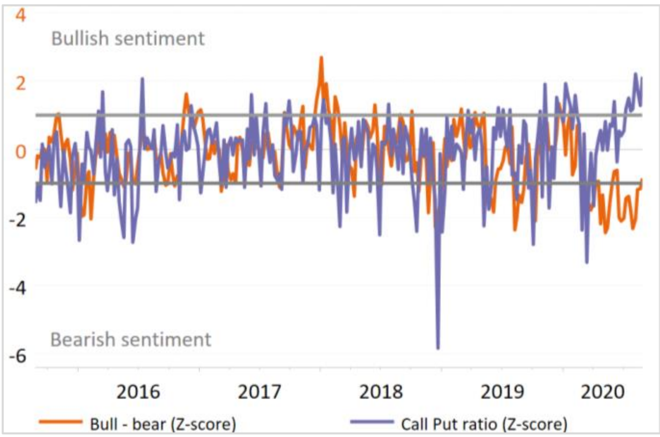
Figure 1: Unprecedented monetary policy support is bolstering markets



Source: Bloomberg, NN Investment Partners

With the market rebound, valuations have also moved sharply higher. The global 12-month forward price-earnings ratio is at its highest level of the past 20 years. Also, the equity risk premium has fallen below its average since the global financial crisis, despite extremely low risk-free rates. This drop is linked to the reduction in downside tail risks achieved by monetary and fiscal authorities. There is a loose positive correlation between the trend in money supply and equity valuations, but central banks alone cannot keep pushing markets higher. Continued and sizeable fiscal support is necessary to sustain the upward trend. It is therefore essential for lawmakers in the US to deliver the fourth stimulus package. The political climate is not conducive to a quick compromise, with campaigning for the November election already having begun and given the very polarized political landcape. However, like the market, we believe that policymakers will eventually strike a deal that prolongs the recovery and supports markets.

Figure 2: Investor sentiment indicator (Z-score)



Source: Refinitiv Datastream, NN Investment Partners

Investment sentiment data remain supportive overall. The big data sentiment indicators we track to gauge equity market sentiment remain supportive and have shown resilience despite the spike in coronavirus cases and delayed fiscal stimulus. The bull-to-bear ratio, which measures expectations six months ahead, has moved higher and is no longer in contrarian buy territory. On the other hand, the put/call ratio indicates very bullish investors. Our risk aversion indicator, which is based on market factors, shows a rapid increase in risk appetite from bearish levels to neutral levels. This leads to the conclusion that investor sentiment is still supportive but not as supportive as it was a couple of months ago.

Most institutional equity investors, both systematic and discretionary, increased their equity positioning during August. However, their overall positioning remains cautious. In other words, institutional investors are sitting on a cash pile and positioning is still supportive for the continuation of the market rally. Institutional investors have increased their equity allocation but their exposure is still tilted towards a defensive positioning, with a focus on Covid-19 winners at the expense of banks and value sectors. This has stretched the relative valuation of structural Covid-19 winners relative to the rest of the market. A correction in these large-cap growth names remains a risk to the broader market. Given the stellar earnings that these companies delivered in the second quarter and the structural trends that favour them, we believe such an event looks unlikely in the near future.

On the flip side, the biggest buyers of stocks over the past few years – the companies themselves – must significantly scale back their purchases. Corporate share buybacks are likely to fall by at least half. Companies want to preserve cash or protect their balance sheets, or are simply not allowed to carry out buybacks from a regulatory perspective, as with the banking sector.

To sum up, supportive investor sentiment and positioning, combined with the continued monetary and fiscal stimulus, could keep pushing markets higher. Along the way, however, news and macro data will have to keep reaffirming the V-shaped recovery consensus, or else stretched valuations will inevitably lead to mean reversion. We therefore maintain a neutral stance this month on global equities.

Figure 3: Our Support Resistance Indicator gives a neutral verdict

Indicators	Conclusion
What are people buying in equity Markets	Resistance
Traditional Sentiment Indicators	Neutral
TRMI Sentiment Indicators	Support
Valuations	Resistance
Central Bank Policy	Support
Draw downs	Resistance
High Frequency Economic Activity Data	Support
Investor Positioning	Neutral
Final Verdict	Neutral

Source: Bloomberg, Thomson Reuters MarketPsych, Google, OpenTable, IHS Markit and NN Investment Partners

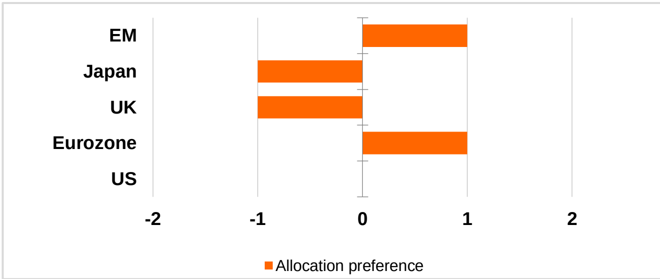
Positioning

From a regional perspective we maintain a small preference for the Eurozone over the US, mainly because of a more coherent economic policy. This stands in contrast with the struggle in the US to approve a fourth package and avoid fiscal cliffs.

We maintain a small overweight in emerging markets. It is important to remember that China, South Korea and Taiwan together represent more than 60% of the EM benchmark. These three countries managed the Covid-19 virus well and have sizeable new-economy exposure. The improvement in the Chinese data, especially in the industrial sector, is an additional support because of its positive impact on commodity prices. This in turn benefits the commodity exporters. Valuations are also attractive. Finally, a weaker US dollar and easy monetary conditions are tailwinds for emerging markets. Risks are linked to the US-China frictions.

We also maintain a small underweight in Japan. Macro and earnings fundamentals are lagging. Also, the political framework looks less stable with Prime Minister Shinzo Abe's resignation due to health problems.

Figure 4: Equity region allocation



In sectors we opted for a more balanced approach between structural and cyclical growth. We maintained our overweight in technology, which benefits from structural trends and a low interest rate environment, while retaining our small overweight on basic materials and industrials, which stand to benefit from a global economic recovery.

As we came closer to US elections and both the Democrats and Republicans held their conventions, the healthcare sector continued to underperform and we maintained our underweight. As previously highlighted, this sector generally underperforms in the run-up to elections. This time, both parties seem to be focused on regulation of the pharmaceutical sector, making the argument even more relevant. On the other side, we kept our small overweight on utilities. This sector benefits from the drive towards more sustainable investing in the long term as well as from the "search for yield" theme.

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Multi asset strategist

Commodity Outlook

- A so-far-credible OPEC+ strategy
- Record high gold prices lead to profit taking
- The hybrid nature of platinum and palladium is attractive

A so-far-credible OPEC+ strategy

OPEC+ is very responsive to any new developments in the oil markets at its monthly monitoring committee meetings and is capable of adjusting its production target when deemed necessary. This strategy has so far been credible and is perceived to be working well. Not only does it allow for flexibility in setting the production targets of its members according to its aggregate output, it simultaneously establishes a mechanism to enforce individual countries to comply with the set targets. This monitoring and enforcement mechanism is currently viewed as credible. As such, overall compliance within OPEC+ was estimated at about 97% in July. Moreover, make-up strategies for previous non-compliers are being developed. It is estimated that oversupply from May to July at OPEC+ level represented some 2 mbd with the main non-compliers being Iraq, Nigeria, Russia and Kazakhstan. Meanwhile the non-compliers have pledged to compensate for this slippage during August and September.

With oil demand continuing its fragile recovery, OPEC+ decided to stick to the plan in September, which represents production restraint of -7.7 mbd versus October 2018 levels. These levels are in principle expected until year-end but that will ultimately depend on a further pick-up in oil demand and the pace of recovery in US oil production, which is an important factor. As far as the latter is concerned, US oil producers so far seem reluctant to re-engage, despite prices being in the low 40s and close to estimated break-even levels. In fact, US oil rigs declined from 683 in mid-March to 172 in mid-August before rising again to 183 on 21 August. US oil production has fallen by some 2 mbd since March. According to the US Energy Information Administration, based on weekly data, US oil production was still down by some 1.6 mbd on an annual basis on 19 August and is expected to be down by close to 1 mbd this year. A very gradual return of US shale oil production appears likely, after which natural declines will dent the outlook.

As for the demand outlook for oil, this is expected to level off somewhat after the V-shaped trajectory of the economic recovery's first leg. China has been opportunistically buying oil, also for strategic reserve purposes. It also did so when prices tanked in April. Its purchases exceeded domestic needs by an estimated 2 mbd. With oil inventories high, Chinese oil demand and imports are expected to level off. A similar pattern can be expected for the US, where plateauing virus cases and the end of the driving season make the outlook more fragile. Nevertheless, with ample monetary and fiscal policy support a further normalisation in global oil demand is expected. All in all, in the current environment, oil demand is expected to outpace supply, causing a draw in oil inventories in the second half of the year.

Profit-taking in gold prices but medium-term outlook is positive

Gold prices reached an all-time high in early August before some profit taking set in. Positions in gold futures and options were unwound on the back of a combination of a small upward move in US real yields amid macro data strength, stimulus and vaccine hopes. Increasing long-term Treasury issuance and an uptick in the US dollar further amplified the move. Comparisons were made to the gold sell-off in March. However, to put these in perspective, during the March correction US 10-year real yields on TIPS (US inflation-linked bonds) rose by over 120 bps whereas this time the rise was limited to some 10 bps. In addition, while US inflation expectations fell in March, these and inflation break-evens actually rose in August. As such, while we acknowledge that investment demand is currently the sole driver of gold demand, we expect it to remain a support for some time to come. This is all the more the case with the new Fed inflation make-up strategy. We remain constructive on gold in the medium term due to unabating central bank easing policies that are expected to keep real yields lower for longer. Simultaneously, as the economy recovers we expect jewellery demand to start to recover as well (as already seen in China) after a weak first half of 2020.

The hybrid nature of platinum and palladium is attractive

We moved platinum and palladium to an overweight. Both have safe-haven-like demand components (platinum more than palladium, which is more cyclical) and as such could undergo a catch-up price rally relative to gold and silver. As is also the case for gold and silver, jewellery demand has remained weak and is struggling to recover. Seasonality may nevertheless become more favorable from now on, with Chinese jewellery demand turning positive on an annual basis in July. The key support for precious metals is investment demand aided by lower real yields due to easy monetary policies and ongoing uncertainty as to the strength of the economic recovery with lingering virus waves. Platinum and palladium should also benefit in this respect. This is already happening in platinum, where ETF holdings are high and rising. ETF palladium holdings are still low and have recovery potential. Non-commercial net long positioning in both platinum and palladium meanwhile is still low with substantial pent-up demand remaining.

On the supply side, South African production shut-ins between March and May were substantial, at 12% and 6% of refined supply for platinum and palladium respectively. A gradual recovery is expected from here, however, with an ongoing focus on supply discipline. On the demand side, other than jewellery and safe-haven demand, exposure to the car industry is important. Platinum is more exposed to the currently weak European diesel car catalyst market, while palladium is used in gasoline car catalysts. In this respect, palladium has a better outlook with Chinese and US car sales recovering, both of which have more gasoline exposure. Nevertheless, a recovery in global car sales will also support platinum if Chinese commercial diesel vehicle sales rise strongly. In the more medium term, platinum may benefit from substitution for palladium in gasoline car catalysts and from the expansion of the hydrogen economy and its use in electrolysers (EU Green Deal).

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