Multi Asset Monthly

Global Strategy

When consensus becomes a pain trade

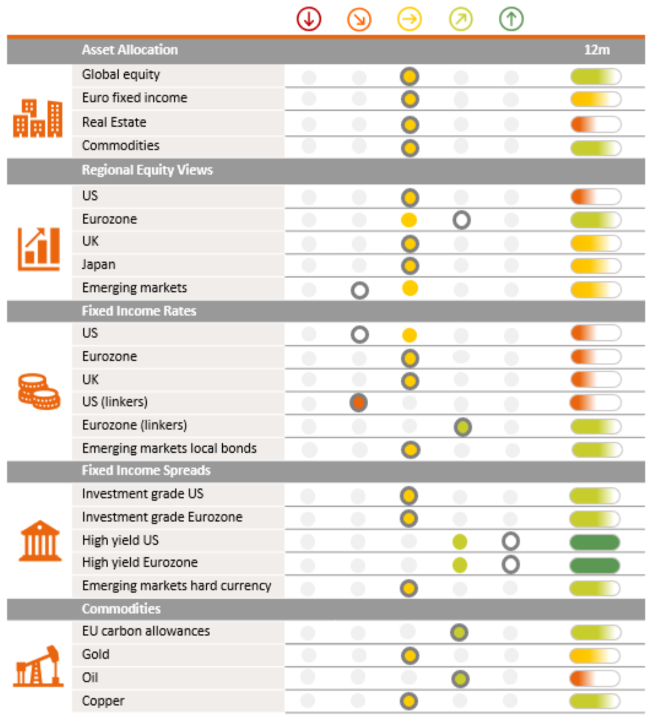
Economic outlook

The economic normalization process is well under way, notwithstanding a flare-up in new coronavirus cases. The return to normality is most evident in regions where the vaccine roll-out has been smooth. Inflation numbers have risen sharply, but we see this as transitory. In July the ECB sent a dovish message, while the Fed signalled it is on track to announce tapering in the fourth quarter. In the medium term, the sustainability of the recovery will depend on virus developments, policymakers' continued willingness to provide stimulus, the release of excess savings, and private investment.

Market outlook

The reflation narrative of the first six months of 2021 has stalled. In the first half, cyclical assets outperformed defensive ones as investors embraced the reflation story, encouraged by economic policy support, improving macro data, the roll-out of vaccines and strong earnings. Now, rate markets in particular appear to have started pricing in a slowdown. This seems premature to us. We expect higher rates and a bounce in cyclical assets towards year-end. However, we also believe that as the economy moves away from the recovery phase, a more balanced portfolio approach may be warranted.

Model portfolio



Coloured circles represent active views; thick grey edges around the circles indicate previous views. The five rankings for the views are, from left to right: strong and moderate underweight, neutral, moderate and strong overweight.

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Asset allocation

- Consensus trades cause investor pain
- Market overreaction creates opportunities
- We are neutral on top-level TAA, with specific views within each asset class

The importance of flexibility

This year's financial market dynamics highlight the importance of being flexible and adaptive. Recent moves in the rates markets in particular seem to defy economic fundamentals. The market's swings also show that positions that initially looked like no-brainers, at least on paper, turned out to be extremely challenging.

Earlier this year, the reflation trade enjoyed broad consensus among investors. Our own model portfolio reflected a strong preference for cyclically sensitive assets, with an overweight in equities and spreads and an underweight in government bonds. The prevailing environment fully justified this stance. Fiscal policymakers rolled out vast and ambitious spending plans, vaccination programs gained traction, and economic normalization in the Western hemisphere was under way. Central banks were in no hurry to shift policy and companies generated robust cash flow.

Much has happened since then. Inflation figures made unexpected jumps while other economic surprises dissipated. The Fed made a hawkish pivot and year-on-year earnings growth is peaking. The Delta variant of the coronavirus is spreading rapidly, which poses a risk in regions were the vaccination process is lagging. In other regions, such as the UK, the link between new cases and hospitalizations has weakened.

As a consequence, the market has become less straightforward in its preferences. To many investors' surprise, the rise in bond yields reversed and real yields fell to their lowest levels of the year. We also witnessed a rotation from value into growth stocks; more generally, the pace of progress in equities moderated somewhat.

Central banks in developed markets will probably remain accommodative, even in the face of accelerating inflation. The rising numbers are the result of soaring commodity prices, base effects, and supply disruptions, all of which we view as temporary factors. The Fed's hawkish shift was somewhat surprising but can be interpreted as a way to manage inflation expectations.

Rates market has overshot the cycle's progress

The economic cycle is progressing unusually rapidly and is morphing from the recovery phase into the mid-cycle phase. The rates market seems to have overshot and is behaving as if the economy is already entering a late-cycle slowdown phase; equities, in turn, are taking their cues from the bond market's moves. This should create opportunities later in the year.

We scaled back top-down cyclical risk in our model portfolio. Equites remain neutral; we reduced our exposure to cyclical commodities. In the rates market, we closed the underweight in US Treasuries and will wait for a better opportunity to re-install a short position. On a longer time horizon, Treasury yields seem to be on a rising trend, given the strong macro data and the Fed's likely next steps.

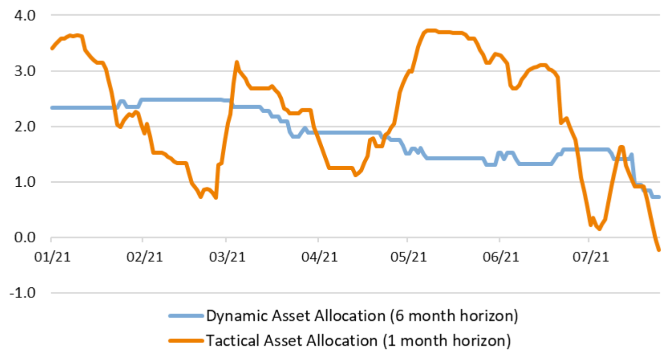
Fixed income

In addition to closing the underweight in US Treasuries, we remain neutral in German Bunds. Rates still look likely to be higher by year-end, given the macro fundamentals and policy outlook. We will wait until rates-market sentiment improves before re-initializing active trades. In spreads, we cut our overweights from large to moderate both in euro and US dollar high yield. We remain positive on high yield, which outperforms when government bond yields drop and stabilizes when they rise, creating an asymmetric return profile.

Equities

We maintain a neutral equity positioning. The markets have had an exceptionally strong run, and the risk/reward trade-off has started to deteriorate. The Delta variant, the peak in earnings growth and macro indicators, the rising inflation numbers and the Fed's hawkish message all made the environment more uncertain. Our quantitative signals confirm this assessment (see Figure 1). They have gradually declined to a neutral position, driven mainly by peaking macro data and deteriorating sentiment regarding the macroeconomic outlook.

Figure 1: Peaking macro data, fading sentiment weaken conviction



Global equity quantitative signals (-4 to +4)
Source: Bloomberg, Refinitiv Datastream, Marketpsych, State Street PriceStats, NN Investment Partners

Our equity allocation remains tilted to benefit from the twin themes of rising bond yields and increasing commodity prices. We also introduced more focus on secular growth with an overweight in IT and communication services. Following the sharp drop in emerging market equities, we closed the underweight in EM and the overweight in Eurozone equities.

Real estate

We are neutral on global real estate. Real estate has outperformed equities this year, catching up from its Covid-driven underperformance. Banks in the Eurozone started to relax housing credit standards in Q2. Credit standards also eased in the US, where housing and labor data are on the mend, but supply bottlenecks, rising office vacancy rates and high mortgage delinquencies form headwinds. Valuation of the asset class, both absolute and relative, provides support. Investor positioning in global, US and European real estate is neutral to underweight.

Real estate is undergoing structural changes that have been amplified by the Covid crisis. The growing e-commerce trend reduces demand for retail properties while strengthening demand for logistics-related real estate. Increased work-from-home will continue to affect office demand. These themes will continue to weigh on the asset class in 2021 and beyond.

Commodities

Commodity prices rose slightly last month. Energy and industrial metals outperformed. China's cut in the reserve requirement ratio for banks should provide short-term support to commodities. Nevertheless, Chinese authorities remain willing to rein in speculative activity, mostly in industrial metals. China released strategic reserves of copper, aluminium, and zinc via public auctioning. Volumes are limited so far. Year-on-year growth in China's June industrial production, fixed asset investment and retail sales slowed from May but came in above expectations. Seasonal summer demand for metals is also softening. Chinese authorities want to avoid passthrough of rising metal prices to consumers. This may dent sentiment to the sector in the near term, but it is unlikely to derail the physical tightening of the market that will continue in the next several months on restocking amid pent-up demand in developed markets. This may also create an opportunity to add to metals over the summer. Aluminium may find price support from the Carbon Border Adjustment Mechanism (CBAM) announcement by the European Commission.

Equity market forecasts

Index	Current	+3m	+6m	+12m
S&P 500	4395	4400	4500	4600
Stoxx 600	462	470	480	490
TOPIX	1940	1975	2000	2075
FTSE 100	7032	7100	7200	7350
MSCI EM Free	1278	1325	1380	1400

Source: NN Investment Partners, 31 July

Patrick Moonen
Principal strategist

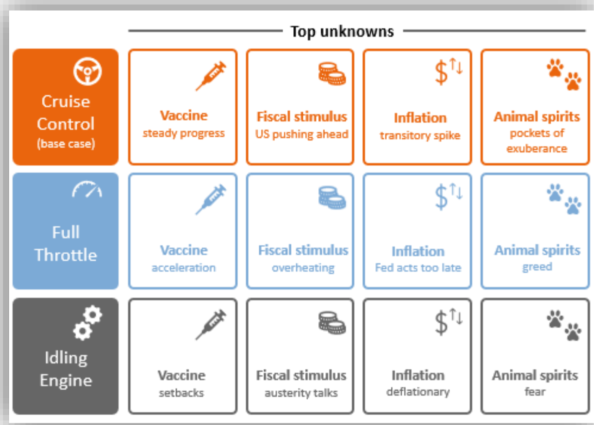
Aviral Utkarsh
Multi-Asset Strategist

Our three scenarios for this quarter

Cruise control
In our base case, the **"Cruise Control"** scenario, we presuppose that the strong recovery of the developed economies remains intact. We assume it will take a few months before we see signs that inflation is in transition, and that the Fed is moving towards tapering. This should create an environment in which equities have some moderate upside left and rates should then rise gradually. And while this overall trend might be gradual, markets may be volatile along the way due to the strong macroeconomic dynamics and the nervousness always attached to monetary tightening.

Full throttle
In our **"Full Throttle"** scenario, we describe an alternative future in which the global economy overheats. Inflation lasts well into next year and forces the Fed to tighten prematurely.

Idling engine
The third scenario, "**Idling Engine**", takes us into a different market environment, in which the current strong stimulus is followed by a push back from fiscal hawks. In this case, consumers decide to hoard their saving and new virus mutations could lead to an increasing number of smaller setbacks.



Market review

- The market is sending mixed messages
- Assets that protect against inflation outperformed, but so did safe treasuries
- Emerging market assets feel pressure from Chinese government's crackdown

Mixed market messages

No single theme completely captures July's asset class performance. On the one hand, assets such as real estate, commodities, and developed market equities, which provide some degree of protection against inflation, posted flat to positive performances. On the other hand, fixed income assets seemed to reflect a peak in economic indicators and a firm belief in the transitory nature of the higher inflation data. Safe treasury yields declined further, with real yields reaching year-to-date lows and global high yield spreads widening.

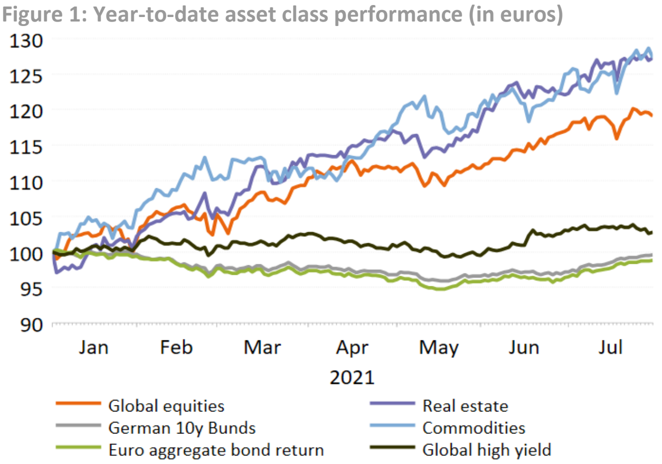
Emerging market assets struggled in July as Chinese authorities' crackdown on the technology and education sectors sent Chinese equities into a tailspin; at the same time, spreads on hard-currency EM debt widened.

The data flow was also inconsistent from a fundamental point of view. The earnings season was very strong and most companies gave positive guidance, but economic surprises have clearly peaked and are even turning negative in the US.

Virus data were also more mixed. The Delta variant is spreading rapidly and is leading to a sharp rise in new cases. However, the vaccination roll-out has weakened the link between new cases and hospitalizations, especially in the Western hemisphere. The normalization process remains on track.

Central bank news confirmed monetary policymakers' willingness to look through the latest rise in inflation data. The ECB message can be interpreted as "lower for longer" and the Fed is notifying the market well in advance that tapering will start, but only if sufficient progress is made towards its goals.

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



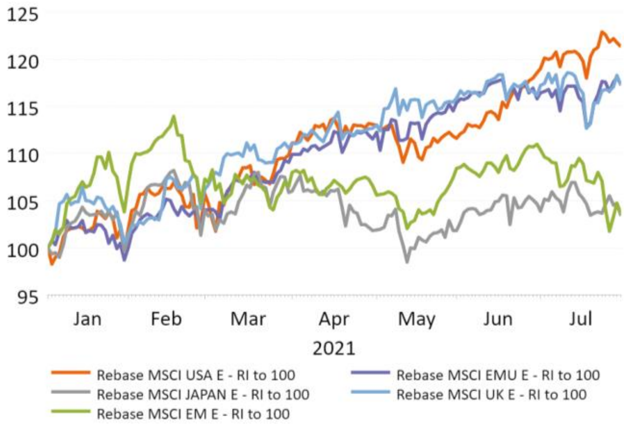
Source: Refinitiv Datastream, NN Investment Partners

Equities

Regional equity performance was split between emerging markets and developed markets, and between Japan and the other developed markets. Emerging market equities dropped by 6% in July, despite lower US yields, a prudent Fed, a cut in China's bank reserve requirement ratio, and higher cyclical commodity prices. This was mainly due to the regulatory pressure in China, which hit the technology and educational services sectors. More broadly, the pandemic poses more threats to growth in EM than in developed markets. Overall EM economic policy is on a tightening path.

Japan remained a laggard despite its sensitivity to the global recovery. The stalled vaccination process probably played a big part in the underperformance; other factors may include the sharp drop in Japanese economic surprises and Prime Minister Yoshihide Suga's waning popularity. The US was again the best-performing region, thanks to continued demand for large-cap growth names.

Figure 2: Equity performance by region (in euros)

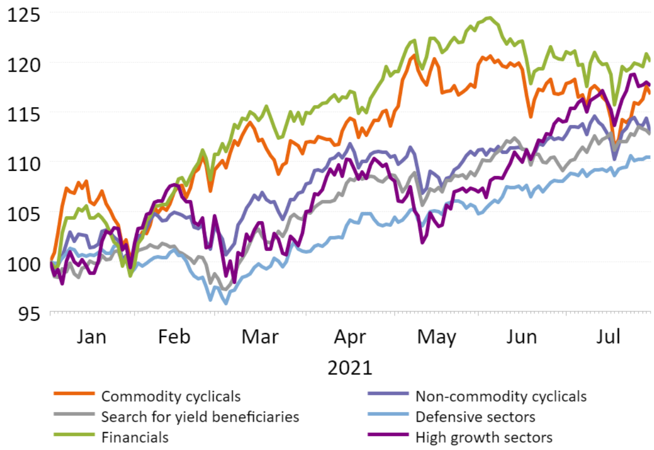


Source: Refinitiv Datastream, NN Investment Partners

Among sectors, the previous months' trend persisted. Defensive sectors (health care) and bond proxies (utilities, real estate) outperformed financials and other cyclicals. The energy sector was particularly weak (-6.2%) despite higher oil prices. This decline is especially noteworthy in comparison with materials, which rose 3% in July. Style-wise, growth out-performed value and large caps did better than small caps.

The drivers behind this trend were the further drop in bond yields, signs of a peak in macro data, and perhaps higher risk aversion following China's crackdown and the spread of the virus's Delta variant. In July the VIX rose by almost 20%, while some investor sentiment measures cooled.

Figure 3: Equity performance by sector (in local currency)

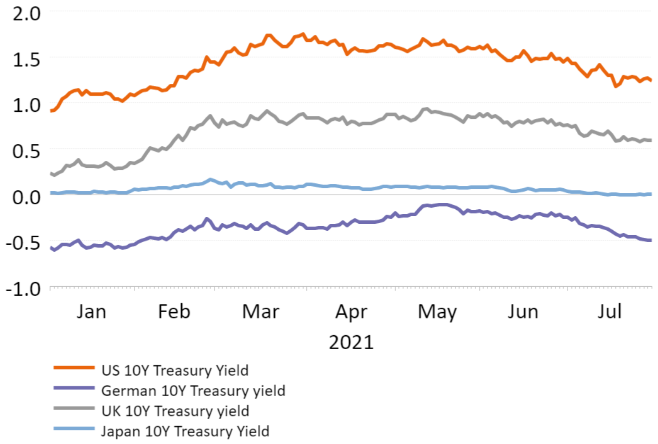


Source: Refinitiv Datastream, NN Investment Partners

Fixed income

In fixed income, the drop in nominal yields continued unabated. Real yields have fallen to their lowest levels this year. We attribute this more to positioning and momentum than to a shift in the underlying fundamental outlook.

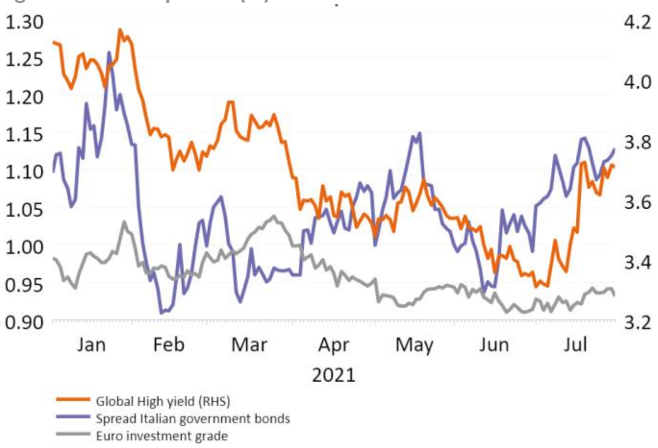
Figure 4: Ten-year government bond yields (%)



Source: Refinitiv Datastream, NN Investment Partners

Spreads widened over the month. High yield was particularly weak. In the Eurozone, Italian bond spreads also widened.

Figure 5: Credit spreads (%)

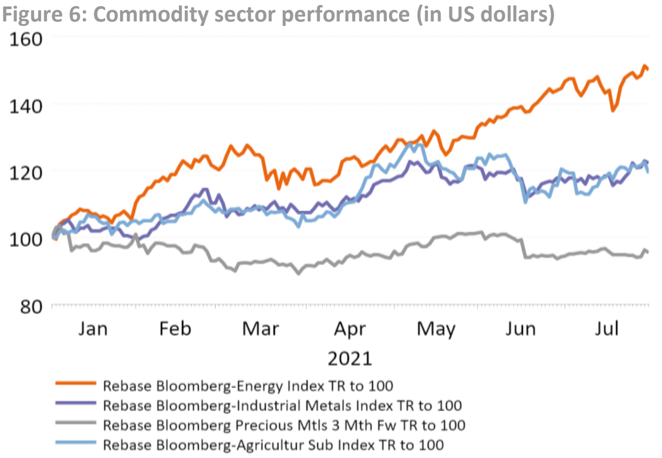


Source: Refinitiv Datastream, NN Investment Partners

Commodities

Commodities added another 1.8% in July, supported by the normalization of the economy, higher inflation numbers and an OPEC+ agreement on production. The agricultural segment was the exception, losing around 1%.

Figure 6: Commodity sector performance (in US dollars)



Source: Refinitiv Datastream, NN Investment Partners

Performance overview main indices

	Euro		Local Currency	
	MTD	YTD	MTD	YTD
MSCI WORLD - TOT RETURN IND	1.82%	19.06%	1.74%	16.46%
MSCI EM - TOT RETURN IND	-6.66%	3.60%	-6.05%	1.55%
MSCI USA - TOT RETURN IND	2.37%	21.33%	2.36%	17.59%
MSCI JAPAN - TOT RETURN IND	-1.26%	3.36%	-2.37%	6.48%
MSCI EMU - TOT RETURN IND	1.34%	17.32%	1.34%	17.32%
MSCI EUROPE - TOT RETURN IND	1.87%	18.01%	1.48%	16.69%
MSCI UK - TOT RETURN IND	0.92%	17.18%	0.26%	11.66%
MSCI PACIFIC EX JP E TOT RETURN IND	-1.48%	11.45%	-0.13%	11.66%
MSCI WORLD HEALTH CARE- TOT RETURN IND	3.76%	18.01%		
MSCI WORLD FINANCIALS - TOT RETURN IND	-0.11%	24.85%		
MSCI WORLD UTILITIES - TOT RETURN IND	3.18%	6.71%		
MSCI WORLD IT - TOT RETURN IND	3.58%	20.98%		
MSCI WORLD ENERGY - TOT RETURN IND	-6.17%	28.91%		
MSCI WORLD MATERIALS - TOT RETURN IND	3.01%	18.57%		
MSCI WORLD INDUSTRIALS - TOT RETURN IND	1.31%	17.59%		
MSCI WORLD CONS DISCR - TOT RETURN IND	0.32%	14.21%		
MSCI WORLD CONS STAPLES - TOT RETURN IND	1.30%	10.33%		
MSCI WORLD T/CM SVS - TOT RETURN IND	1.99%	22.96%		
GPR 250 REIT WORLD - TOT RETURN IND	4.49%	28.02%	4.62%	25.39%
Gold Bullion LBM $/t oz DELAY			3.27%	-3.93%
Crude Oil BFO M1 Europe FOB $/BBl			1.62%	47.37%
LME-LMEX Index - PRICE INDEX			4.07%	26.54%
Bloomberg-Agricultur Sub Index TR - RETURN IND. (OFCL)			-0.98%	19.27%
Bloomberg- Commodity TR - RETURN IND. (OFCL)			1.84%	23.37%
EBF EURIBOR 1M - OFFERED RATE	-0.556%	-0.554%		
US GVT BMK BID YLD 10Y (U$) - RED. YIELD	1.239%	0.912%		
GERMANY GVT BMK BID YLD 10Y (E) - RED. YIELD	-0.458%	-0.575%		
JAPAN GVT BMK BID YLD 10Y (Y) - RED. YIELD	0.019%	0.021%		
UK GVT BMK BID YLD 10Y (£) - RED. YIELD	0.567%	0.196%		
Barclays Euro-Aggregate EUR - Yield to worst	-0.08%	-0.14%		
Barclays Euro-Aggregate: Corporates EUR - Yield to worst	0.16%	0.24%		
Barclays Global High Yield USD - Yield to worst	4.40%	4.47%		
Barclays US Aggregate ex Government USD - Yield to worst	1.72%	1.47%		
US $ TO ECU/EURO (WMR) - EXCHANGE RATE	1.1858	1.22355		
JAPANESE YEN TO EURO (WMR) - EXCHANGE RATE	130.142	126.326		
GBP TO EUR (BOE) - EXCHANGE RATE	0.8504	0.904		

Source: Refinitiv Datastream, 31 July 2021

Patrick Moonen
Principal Strategist Multi-Asset

Economic outlook

- The delta of growth remains unclear
- Inflation spike may last into next year

Crosscurrents are converging

Markets continue to face an unusually uncertain environment. Even before the pandemic started, uncertainty had been on the rise due to the strengthening of secular stagnation forces and increasing political polarization which reinforced each other. Secular stagnation has caused productivity growth, underlying inflation and equilibrium yields to drift lower. This raises the question whether developed economies will shift further towards a Japan scenario – where the level of nominal GDP has on balance drifted sideways over the past 25 years – or whether the robust and fairly stable real growth rates of the Great Moderation can be restored with well anchored inflation expectations. Meanwhile, political polarization can cast doubts on the stability of the institutions governing domestic economic activity, international trade, and international finance. Prime examples of this were the threat of an EMU break-up 10 years ago and the trade war started by former US President Donald Trump. Needless to say, such doubts corrode business and consumer confidence and thus enhance secular stagnation.

The pandemic added considerable insult to this injury by putting part of the economy in a coma; that is, supply and demand curves in the affected sectors rapidly shifted inwards. On the other hand, the pandemic also acted as a catalyst, significantly accelerating the change in policymakers' underlying philosophy that had begun before the winter of 2020. This resulted in a commitment to keep fiscal and monetary policy easy for a long time. Over the past 18 months, this commitment has substantially limited the damage to private sector incomes and balance sheets. What's more, if this policy mix is sustained for long enough – a big "if" in some regions –the economy could move out of secular stagnation towards an equilibrium with higher productivity growth, inflation, and equilibrium yields.

Over the past few months, the various crosscurrents described here have converged and reinforced each other. This makes it much more challenging than usual to interpret the data flow and to gauge which of the many possible paths the economy will follow in the coming months and years. These paths all lie somewhere between the tail risk of a breakout of inflation expectations and the tail risk of a return to strengthening secular stagnation forces.

In this environment, it is very difficult for businesses, consumers, and markets to find a stable anchor for their expectations about the future state of the economy. Policymakers can make this task easier by clearly spelling out their reaction function and communicating how they would change policy in response to a change in the economy. Or they can make it more difficult, if internal or external political constraints cloud their reaction functions; an example is the vast difference of opinion between the hawks and doves within the ECB's Governing Council.

A major market theme recently has been whether or not growth in the developed world has peaked. During the lockdown period, a significant pile of excess savings as well as demand for services built up, which started to be released during the spring. The resulting surge in demand was supercharged by further fiscal stimulus and ran into a wall of supply bottlenecks in various sectors. These bottlenecks were largely the result of massive underestimations of future demand combined with lean inventories. At some point the surge in demand will fade and some of these supply bottlenecks may prove to be pretty persistent. In that scenario, the peak in growth may already be behind us.

The rise of the Delta variant probably added to these considerations. The considerable increase in consumer and business confidence over the past six months may have been partly driven by the expectation that life would return to something close to the pre-pandemic situation in the course of this year. The Delta variant could cast doubts on this; consumers' propensity to save could rise and companies' willingness to invest may decline. Also, investors may shift their allocation towards safe assets. This would push the economy back in the direction of a secular stagnation equilibrium. None of this is certain, however. The most recent virus data show a decline in the number of infections again and additional pressure on health care systems has so far been considerably less than in the past autumn and winter.

Hence, we could well remain in a situation where economic life continues to converge to something close to the pre-Covid situation. In that case, it is far from certain that growth in the developed markets has already peaked. The US is ahead of Europe and Japan in this cycle because it reopened sooner and implemented far more fiscal stimulus. However, this does not necessarily mean that US growth will slow from the around 6.4% average pace seen in the first half of 2021. For instance, the savings rate in June was still some 2 percentage points above the pre-pandemic level, which arguably means that consumers were still adding to the pile of excess savings. It is uncertain how much of these savings will eventually be spent but there is clearly still a lot of "fuel in the tank". What's more, there are good reasons to believe that this spending may well be smoothed out over a longer period than generally assumed. Service spending is still nearly 4% below the pre-Covid peak, which leaves considerable room for catch-up. This process may well be spread out over quite some time as supply restrictions in the service sector could well be gradually eased further.

On the goods side of the equation, we observe that consumer durable goods spending is well above its long-term trend so there may not be much room for further gains here. However, business's investment intentions remain strong, and given the fact that investment has been very sluggish over the past decade, there may be quite a bit of room for strong capex growth, provided business confidence remains robust. What's more, given the fact the inventories are very lean, one can expect inventory rebuilding to provide a substantial boost to growth once supply bottlenecks start to ease.

The export-dependent economies of Europe and Japan will undoubtedly benefit substantially from robust global capex growth and inventory rebuilding. There is also considerable room for rebound in these economies as reopenings stimulate service spending. In this respect, Q2 GDP growth in Euroland (8.3% qoq annualized) surprised significantly on the upside, thanks to a surge in household spending. Most of Japan's growth bounce will take place in the second half of this year due to recently renewed restrictions.

Inflation spike still looks transitory but may last into next year

As we have been arguing, the increase in inflation is first and foremost the result of price and wage increases in several sectors where a surge in demand has run into supply bottlenecks. Because demand will normalize at some point and supply constraints are likely to be eased, these increases are to a first approximation one-off events which actually help to resolve supply/demand imbalances. There are tentative signs that supply bottlenecks are already easing somewhat as price increases for several goods have begun to stabilize or even reverse. In addition, surveys suggest that delivery times are no longer lengthening while the ratio of new orders to inventories in the global manufacturing PMI has come off its highs. Despite this, supply bottlenecks may well continue to make themselves felt into next year as it takes time to expand capacity and rebuild inventories. Meanwhile, the Delta variant could slow down the easing of US labour supply restrictions as potential workers decide to remain out of the labour market longer because of health risks or the need to take care of children.

The big question for central banks, and the Fed in particular, is whether these one-off price increases will start to feed on themselves. For that to happen, we need to see enhanced distributional conflict between wage earners and profit owners or a breakout of inflation expectations to the upside. So far, measures of longer-term inflation expectations remain well-behaved so there is little reason to an upside breakout. In addition, US productivity growth has been running well ahead of the pre-Covid average since the second quarter of last year.

If this trend persists, which may well happen if business investment remains strong, robust growth in real wages and real profits could coexist peacefully. Also, the continued historically high level of the profit share of GDP suggests worker bargaining power is still low. Europe and Japan are behind the US in this cycle; their inflation spikes are less pronounced so far. We expect this to remain the case, as these economies have implemented less fiscal stimulus and are starting out with inflation expectations that have drifted further below target than in the US.

Willem Verhagen
Senior Economist

Emerging markets

- EM economic underperformance is due to the pandemic and lack of policy support
- Monetary tightening results from the combination of macro imbalances and capital outflows
- US tapering prospects likely to keep pressure on EM policymakers to reduce imbalances

EM continues to recover but lags US, Europe

Growth momentum in the emerging world is positive but unimpressive. The recovery in the developing economies continues to lag that in the US and Europe due to economic policy tightening and the ongoing struggle with the coronavirus pandemic. The pandemic is also causing a wide divergence between the countries where infection growth is accelerating or still high and those that have clearly passed their last infection wave. The main problems are in several East Asian countries, including Malaysia and Vietnam, where lockdowns are having a big impact on economic activity. The most positive recovery momentum is in India and Brazil, where economic re-openings have caused a swift recovery in domestic demand growth.

The slow vaccination roll-out in most emerging countries means they will not attain herd immunity to the virus in the coming quarters. A large part of the emerging world will remain vulnerable to new infection waves, and the resulting uncertainty is likely to prevent consumer and particularly business confidence from fully recovering to pre-corona levels. At the same time, the economic impact of mobility restrictions has softened over time in several countries, including Mexico and Indonesia. This suggests that even in a scenario of new infection waves, the recovery can continue, albeit at a slower pace than anticipated.

Emerging market GDP growth is likely to average 7%, about the same as in the US. But the US will have returned to its pre-pandemic growth path by the end of this year, while EM will have recovered only half of the lost terrain. And when we consider that China, like the US, will be fully back to its pre-crisis growth path before year-end, the economic underperformance of the rest of the emerging world looks even more dramatic.

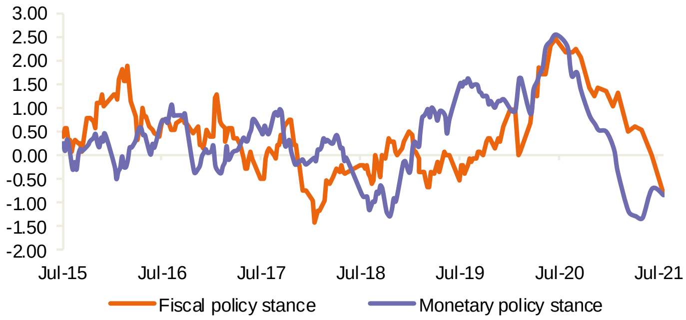
The pandemic's brutal impact explains most of the EM ex-China economic underperformance. Weak governments and institutions, highly informal economies, and structural social and health vulnerabilities are the main reasons why the spread of the virus has been so difficult to contain.

Lack of policy support is also hampering EM recovery

What has also held back most emerging economies, both in the early stage of the pandemic and now in the recovery phase, is the lack of economic policy support. In the first quarters of the crisis, we saw unprecedented monetary easing, but since the third quarter of 2020, EM central banks have been forced to withdraw the stimulus.

Sharply increased fiscal imbalances, rising inflation, currency weakness, and the threat of larger capital outflows made the easy EM monetary policy stance short-lived. Our proprietary EM fiscal policy stance indicator plainly reflects this policy shift (see Figure 1). This indicator, which measures the average policy direction for the 22 main emerging nations, has been declining since last August. Since then, the number of countries easing has been falling. And since February, when the indicator turned negative, more countries have been tightening than easing. We expect this to remain the case in the coming quarters, as the theme of Fed policy tapering gains strength in financial markets and puts more pressure on EM capital flows.

Figure 1: EM monetary and fiscal policy stance

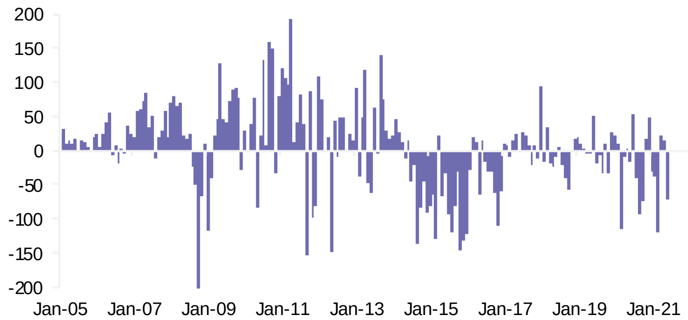


Average 3-month momentum scores in 22 main emerging markets
Source: NN Investment Partners

Fiscal policy has also made a rapid turnaround. In the first phase of the pandemic, most EM governments allowed deficits to widen dramatically. On average, the 2020 EM fiscal imbalance doubled from 4% of GDP to 8%; we expect the average 2021 deficit to narrow to 6% of GDP. Apart from China and South Korea, where we expect a positive fiscal pulse in the coming quarters, all emerging countries will proactively choose or be pressured by financial markets to reduce their fiscal imbalance.

Our fiscal policy stance indicator (Figure 1, orange line) shows that the tightening countries are outpacing those that are still easing. The prospects of the Fed starting its policy tapering in the coming quarters is likely to put more pressure on the EM/DM carry trade. That will leave little room for the countries with large macro imbalances to postpone reduction of their deficits. We have seen in the past months that when US yields rise, EM capital flows turn more negative. And when US yields fall again, EM flows improve. On average, though, EM capital flows have remained in negative territory since the beginning of the pandemic (see Figure 2).

Figure 2: Global emerging market capital flows (monthly basis)



Current account deficit + changes in FX reserves (USD bln), 20 main markets
Source: Refinitiv Datastream, NN Investment Partners

We think most emerging countries will have to deal with fiscal and monetary policy tightening, which will keep the pace of the economic recovery slower than it has been in the US and Europe. The EM/DM growth differential, a key driver of relative performance of EM vs DM equities that has been on a declining trend since 2010, will probably not improve in the coming quarters.

Maarten-Jan Bakkum
Senior Emerging Markets Strategist

Fixed income outlook

- Growth repricing has pushed Bund yields materially lower
- Treasuries have been driven by downward revisions of growth and inflation expectations
- We keep an overweight in high yield, but remain vigilant

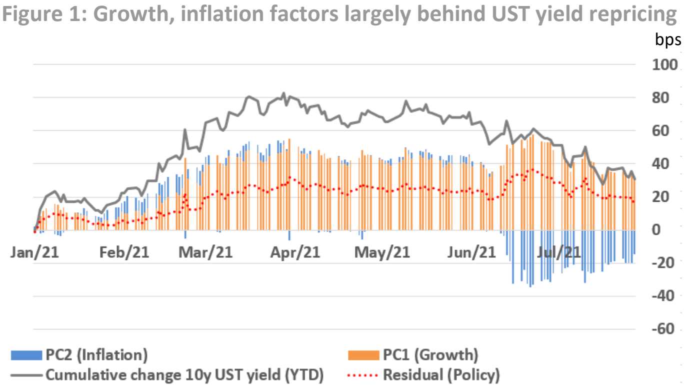
Stay patient; the market will come to its senses

Global interest rates continued their downward trend over the past month. Treasuries and Bunds had a particularly strong rally, although expected growth, inflation and monetary policy dynamics are different in the two regions. The past month was also characterized by increased uncertainty regarding the spread of the Delta variant of the coronavirus, and by market speculation on the implications for growth and inflation in developed markets. With the recovery still robust and strong demand leading to supply-side constraints, the global economy isn't yet firing on all cylinders. This has raised a lot of questions on whether the business cycle has reached peak growth, whether inflationary pressures are transitory, and whether central banks might reduce their accommodative stance prematurely, which could hamper growth and inflation over the medium term.

Even with these uncertainties in the background, global credit spreads have remained resilient. Developed market high yields are still backed by strong macroeconomic fundamentals, supportive fiscal policy, and strong commodity markets. The low interest rate environment has helped high yield companies to focus on balance sheet repair. However, we question how much spreads could tighten further from current levels. All in all, there are some discrepancies between our assessment of the future state of the world and current pricing on global rates markets.

Momentum-driven investors, summertime illiquidity or peak growth? The US Treasury yield conundrum of the past month has resulted in different narratives and no clear consensus.

Figure 1: Growth, inflation factors largely behind UST yield repricing



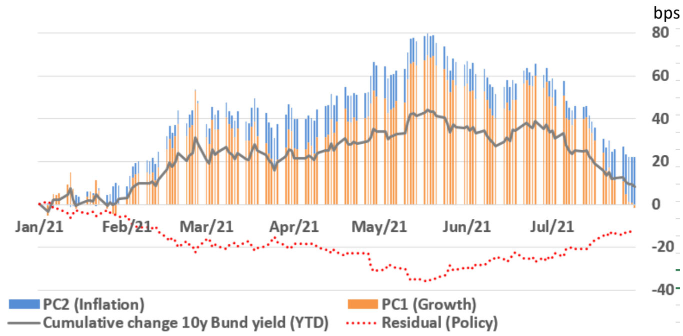
Source: NN Investment Partners

The current yield-curve dynamics are not what we would normally expect in the current stage of the business cycle, particularly at a moment when the Fed is poised to scale back its easy monetary policy. For example, recent releases of strong US inflation, growth and labour market releases were followed by declines in longer-dated US Treasury yields. These types of moves – where the yield curve bull flattens – signal anticipation of a growth slowdown.

Figure 1 revisits an analysis we discussed in the June edition of the Multi Asset Monthly. We have broken down the key drivers for bond yields using a statistical technique called principal component analysis, which enables us to assess the most important uncorrelated statistical drivers. Interestingly, we find that the sharp drop in US Treasury yields since June wasn't only due to lower growth expectations, but also a significant repricing in the inflation component as well. Around 40bps in the cumulative decline in US Treasury yields during the month of July could be equally attributed to downward revisions of the growth and inflation components. At the same time, a slightly more hawkish-sounding Fed has offset this drop, as reflected in the 20bps increase in the policy component in our analysis over the same period.

This repricing of growth and inflation appears overdone. As we noted in last month's Multi Asset Quarterly, there is ample evidence that recent inflationary pressures are transitory, while growth over the medium term still looks robust. The degree to which market participants are revising inflation lower is greater than the upward revisions we saw earlier in the year. Given the continued strong demand as economies reopen and the easier fiscal and monetary policies that have been implemented, it seems odd to revise growth and inflation lower down to this extent. The positive level effect of growth – regardless of a somewhat lower growth rate – should still allow the fundamental drivers for US Treasury yields to move higher. For now we prefer to remain neutral and wait for the appropriate time to initiate an underweight. The momentum to the downside in US Treasury yields is still too strong. At the same time, there's a clear asymmetry in favour of higher yields.

Figure 2: Growth factor almost fully priced out in 10y German Bunds



Source: NN Investment Partners

German Bund yields present a somewhat similar picture, although for 10y Bunds, the growth component has even made a "round trip" this year. This suggests that market participants are completely pricing out recent higher growth, putting implied growth expectations back at levels seen in the beginning of the year.

This dynamic doesn't resonate with us. Given the ongoing reopening and still-ample fiscal and monetary policy stimulus, market participants seem to have assigned too much weight to the Covid Delta variant in their future growth assessments. Based on fundamentals in combination with several statistical and sentiment indicators, we think the recent Bund rally is overdone. We will wait for a stabilization in interest rates and a turn in momentum to initiate a moderate underweight in Bunds.

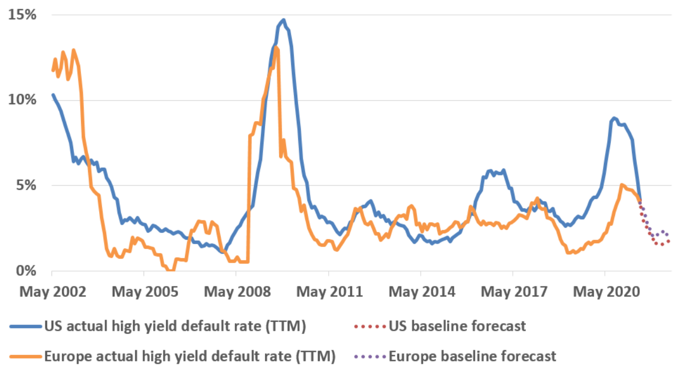
High yield credit is in a good place … maybe too good

We recently reduced our large overweight in US and European high yield credit following the uncertainty that crept into the market. Though the correction in global equities turned out to be limited and the risk-off stance across financial markets seemed contained, we decided to take profit and maintain a smaller overall position.

Fundamentally, the global macro and policy backdrop still looks very supportive for credit. The widening in credit spreads seems relatively small in historical context, though we don't necessarily expect a continuation of the strong credit spread tightening trend we have seen since the height of the pandemic last year.

Figure 3 shows the monthly high yield default rates, both for the US and for Europe, continuing their decline from last year's highs. The forecasted path of default rates for developed market high yield is pointing towards a continued decline this year, but a rise is to be expected by the end of the first quarter next year, according to estimates by Moody's.

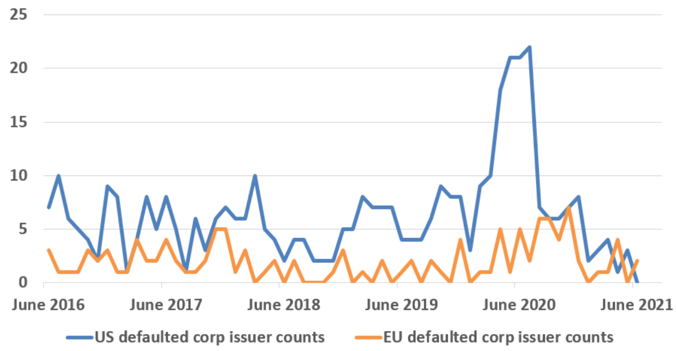
Figure 3: Developed market HY default rates close to historical lows



Source: Moody's Analytics, NN Investment Partners

The actual number of defaults in the month of June was zero for the US high yield universe and only two for European high yield issuers. US default numbers in the first half of the year were significantly lower than the 5-year monthly average of six defaults. This shows that the global economy, commodity markets, and the ample fiscal and monetary policy stimulus have helped high yield issuers to weather the storm, refinance at even more favourable levels, and focus on balance sheet repair.

Figure 4: Monthly HY default numbers have fallen significantly



Source: Moody's Analytics, NN Investment Partners

Credit spreads in general and high yield in particular are likely to stay close to current levels, perhaps with a slight tightening going into the final quarter of the year. But we are keeping in mind that high valuations are peaking and that the default rates are signalling that most of the credit spread tightening is behind us. For now, the risk of a significant widening of spreads is limited in our view, unless a more broad-based risk-off sentiment develops in global financial markets. For now, we prefer to maintain our moderate overweight, mainly for carry purposes.

Fouad Mehadi, CFA
Senior Investment Strategist Fixed Income

Equity outlook

- Pandemic news is encouraging
- Strong earnings growth confirmed
- We combine secular and cyclical growth

Broken records

We're not yet sure what the Olympic games in Tokyo will bring, but equity markets have broken records. The S&P500, Nasdaq, and MSCI World indices reached record highs in July. Growth sectors and beneficiaries of low bond yields led the pack. The main reason was the relentless decline in safe government bond yields in an environment of soaring inflation figures accompanied by peaks in macro surprises and year-on-year earnings growth. Emerging markets in Asia continued to struggle, as the Chinese government's regulatory crackdown on the technology and educational services sector created yet another factor hurting sentiment. So where do we stand today and what is our outlook for equities?

The news on the pandemic front is encouraging, although it would be premature to sound the all-clear. The highly transmissible Delta variant is rapidly becoming the dominant strain. Fortunately, the increasing vaccination rates have weakened the link between new cases and hospitalizations/deaths. This should reduce the likelihood of new lockdown measures, which implies a diminishing negative impact on the growth outlook. The journey towards economic and social normalization has begun, but at an unsteady pace. Most European countries have still restrictions in place. One exception is the UK, which removed most restrictions in July and has become a live experiment for the rest of the vaccinated world. Currently the growth in new cases in the UK is declining, which is positive news. The emerging world remains worrisome, however, also because of the low efficacy of the Chinese vaccine against the variant.

In the US, more fiscal support is under way. Congress is working on a bipartisan infrastructure bill of USD 550 billion in new spending. Senate Democrats on the Budget Committee also announced an agreement on a USD 3.5 trillion spending plan. This partisan bill would bring the total amount to more than USD 4 trillion over the next 10 years but will be watered down. An outcome in the USD 3.0-3.5 trillion range looks more likely. A vote is expected in the autumn. The debate is also focusing on the revenue side: who will pay for all this? A corporate tax increase and higher capital gains tax are in the pipeline; so far, equity markets have not reacted much to the possibility of this headwind. The European recovery fund has received less attention than the US's fiscal bazookas, but it is a political game-changer. Disbursement of the funds to finance projects is set to begin.

If all these US and European stimulus plans are well executed and trigger more private investment, they could create a once-in-a-decade opportunity to lift the economy out of secular stagnation. For equities, this would mean lower risk premiums and structurally higher earnings growth. For the time being, though, financial markets are telling a different story. Real bond yields fell to historic lows and yield curves flattened. In equities, the beneficiaries of a low nominal growth environment outperformed the reflation beneficiaries. Value has given up all its outperformance relative to growth and small caps have underperformed large caps.

Easy monetary policy remains the baseline but we may have reached the point of maximum support. The Fed made a hawkish pivot at its June meeting in an attempt to manage inflation expectations. Tapering is on the table and rate hikes have been pulled forward in the dot plot. Strong macro data and surprisingly high inflation numbers have created more uncertainty and market volatility.

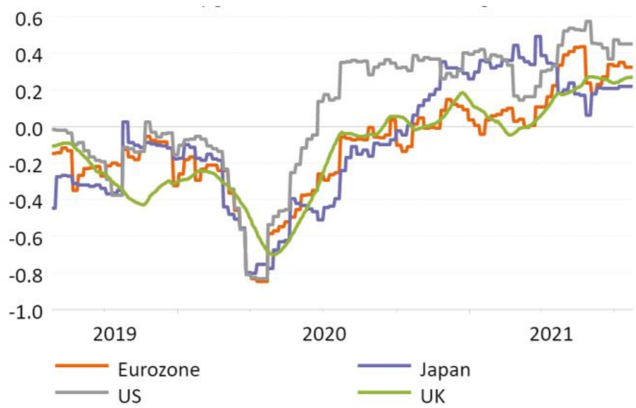
However, in the central banks' base case as well as our own, these inflation upticks are temporary, driven by base effects and one-off items related to the re-opening of the economy. These factors include partial spending of excess savings, supply-side constraints, and rising commodity prices.

The corporate sector is in excellent shape. So far, Q2 earnings reports have been strong. Almost 9 out of 10 companies beat expectations and the average beat is 20% on earnings and 4% on revenue. The absolute year-on-year growth is expected to be above 80%. Not surprisingly, the biggest bounces are in the cyclical sectors, which are highly leveraged to the rebound in economic growth.

Earnings momentum, defined as net upgrades versus total estimate changes, has remained positive across all regions. Full-year numbers are still being revised higher. The second quarter will mark the peak of the current cycle. Starting in Q3, the growth rate will normalize rapidly as base effects become less pronounced.

Supply chain disruptions, higher transportation costs, higher wages and even higher taxes may also start to bite. Depending on their pricing power, companies will either absorb these costs in their profit margins or try to cover them by raising their selling prices. The market has been rewarding strong earnings less than in the past, which may be a sign that the earnings "surprises" were not really that surprising.

Figure 1: Regional 12-month forward earnings momentum



Net upgrades to total estimate changes
Source: Refinitiv Datastream, NN Investment Partners

The very high earnings growth has helped bring absolute equity valuations below their levels of the beginning of the year. The picture relative to bonds has also improved, due to the decline in long-term bond yields. The global equity risk premium has risen almost 40bp since mid-April to close to 4%.

Figure 2: Price to 12-month forward earnings

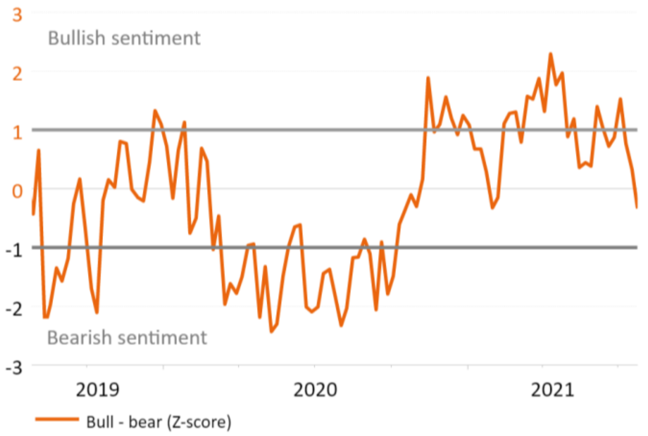
Source: Refinitiv Datastream, NN Investment Partners

The gyrations of bond yields have been driving equity market themes in the past few months. In Q1, rising yields led to a strong performance of value stocks and cyclical sectors. In Q2, this picture was turned upside down with a sharp reversion of the value-versus-growth trade. July was no different; the continued fall in bond yields put further pressure on value versus growth.

Investor behaviour: more caution

Investor sentiment became more cautious in July. The bull-to-bear ratio reached its lowest level of the year, perhaps because of the Delta variant, the Fed's pivot, or the lack of progress on the US fiscal front. Other possible explanations are Chinese regulation, higher volatility, and weaker macro data. Futures positioning has stalled but remains high.

Figure 3: Investor sentiment indicator (Z-score)



Source: Refinitiv Datastream, NN Investment Partners

Thanks to the strong corporate cash-flow generation, equity buybacks are likely to surge this year. More than USD 500 billion was already authorized in early May. The loosening of bank restrictions by the Fed, the BoE and the ECB will boost the total by several tens of billions of dollars, although the net impact will be less, given a high level of new IPOs and secondary placements. Full-year estimates for new US issuance are in the range of USD 250-300 billion.

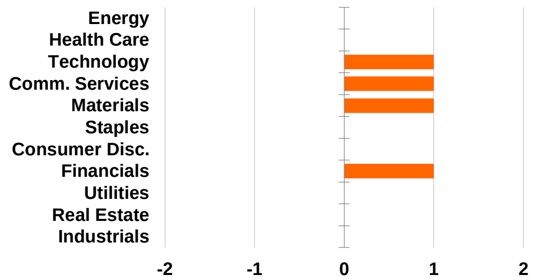
Following the strong rally that has been in progress for much of this year, markets seem to have priced in much of the positive fundamental news regarding the economic normalization path, the earnings outlook, and the pandemic. Uncertainties remain, including the inflation outlook and its policy implications, as well as the possibility of new, more contagious coronavirus strains.

Consequently, the balance of risk and returns has deteriorated, making equities less attractive than in the first half. But "less attractive" does not mean "unattractive". There are few signs of market exuberance and fundamentals remain strong.
We maintain a constructive long-term view on equity markets, although the short-term risk/reward trade-off has deteriorated, which explains our neutral stance on equities versus cash.

The economy has moved from the recovery phase to the mid-cycle phase. The cycle is advancing very quickly due to the event-driven nature of the preceding downturn and the unprecedented policy support that followed. In sectors, we combine secular growth (technology and communication services) with cyclical growth (materials and financials). We also maintain a slight style preference for value over growth. We think the market has gone too far in discounting an imminent growth slowdown or a return to the secular stagnation of the past decade.

Regionally, we closed the relative value trade consisting of a Eurozone overweight versus an underweight in emerging markets. Our only reason for doing so is that emerging market equities have underperformed to such an extent that a technical rebound looks likely. Fundamentally the Eurozone is in good shape. Relative earnings growth is high, as is the 5% equity risk premium.

Figure 4: Equity sector allocation



Source: NN Investment Partners

The European recovery fund may revive foreign investor interest in the region and the Fed's hawkish pivot may lead to further dollar appreciation and higher bond yields, both of which would benefit the Eurozone. The emerging world faces the headwinds of a stronger US dollar, higher bond yields, a worsening pandemic situation and a diminishing growth differential with developed nations. China's economic and regulatory policies are another big source of uncertainty.

Patrick Moonen
Principal Strategist Multi Asset

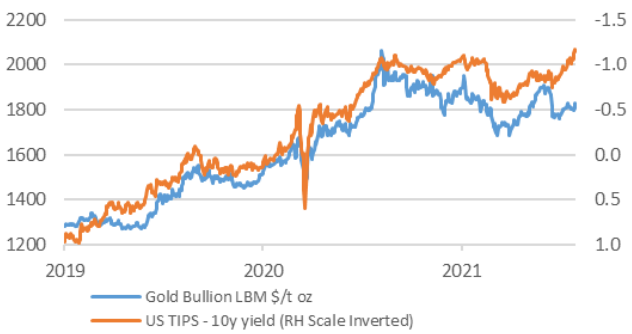
Commodity outlook

- Gold is likely to remain rangebound
- We reduce our overweight in aluminium and close our overweight in platinum

A look at gold's correlation with yields and exchange rates

Following our discussion of correlations in our May edition, we focus this month on gold's correlation with real yields and exchange rates. Investors normally expect a negative relationship between the price of gold and US real yield, since real yield, defined as nominal yield minus inflation, is essentially the opportunity cost of holding gold. Movements in gold prices and real yields since 2019 demonstrate how these two instruments comove. Being denominated in dollars, gold also tends to move against US dollar exchange rates.

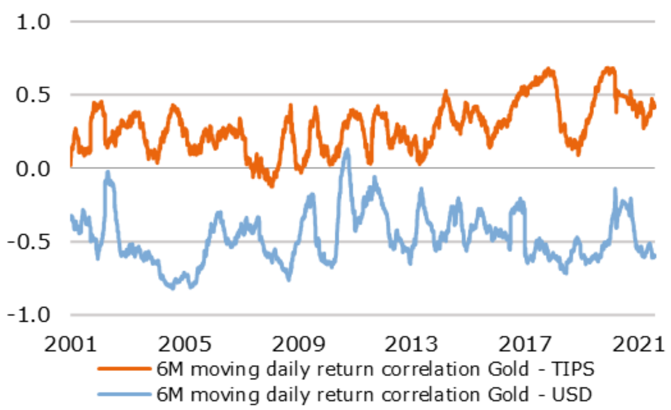
Figure 1: Correlation gold vs US real yield



Source: Bloomberg, NN Investment Partners

Gold and the dollar are usually interchangeable safe instruments, and investment flows will chase whichever is stronger. By calculating correlations among returns of gold, the dollar, and US inflation-linked bonds on a rolling 6-month basis, we found that the relationship between gold and real yield can be as high as 0.7 when a common risk driver such as the recent pandemic is in play. In contrast, the substitution effects of gold and dollar appeared more often in calmer markets.

Figure 2: Correlation gold vs US dollar



Source: Bloomberg, NN Investment Partners

These relationships may not always hold. Since the beginning of 2009, for instance, the correlation even flipped to positive territory due to hedging against inflation, economic risk, and political risk. In July, the price of gold oscillated in a narrow range around USD 1,800 per ounce. When the yield of 10-year US Treasury inflation-protected securities (TIPS) dropped to -1.18%, gold was far from responsive, which supports the correlation analysis.

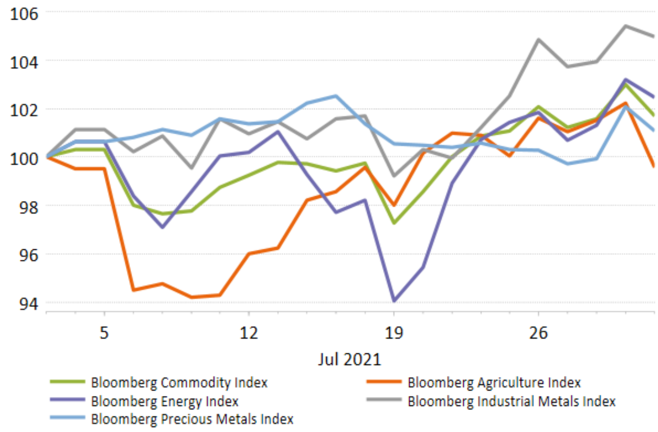
Normalization is still the main theme supporting investor risk appetite, despite recent increases in coronavirus infection numbers. Given the oversupply of liquidity and the strength of stock and bond markets, gold's appeal to investors is fairly limited.

The dollar's weakening trend might play a bigger role in this current market environment, thus providing a support level for gold. In conclusion, we think gold will remain rangebound in the short term, assuming monetary policy takes no sharp turns and a major economic recession does not break out.

We reduce our positioning in aluminium and platinum

Commodity prices edged higher in July, led by energy and industrial metals. We expect the physical market for metals to continue tightening in the coming months due to restocking and the release of pent-up demand.

Figure 3: Commodity sector performance (total return, US dollars)



Source: Refinitiv Datastream, NN Investment Partners

Aluminium prices may get a boost from the Carbon Border Adjustment Mechanism (CBAM) announced by the European Commission last month. This system imposes a tax on imports of aluminium and certain other goods into the EU to help reduce the risk of carbon "leakage", according to the Commission.

We reduced the cyclicality of our allocation by partially locking in profit on aluminium, moving it to moderate from strong overweight. Weaker seasonality, China's clampdown on rising commodity prices, including the release of strategic reserves, and high investor positioning are short-term headwinds.

Among precious metals, platinum is suffering from weak momentum. Chip shortages are slowing the recovery in automobile sales, and the substitution of platinum for palladium in gasoline-powered cars faces delays. Supply at platinum mines is meanwhile recovering. In view of the lost momentum and the outlook for higher real yields that could impact safe-haven investment demand, we closed our overweight position. Nevertheless, platinum is likely to benefit in the medium term from the transition to a hydrogen economy.

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