NN investment partners

Reflation theme more pronounced in global equities

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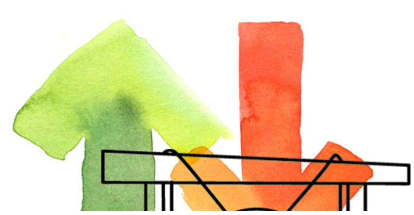
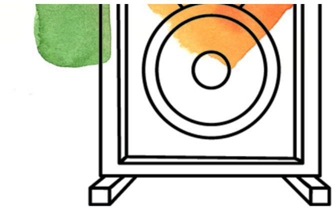
- Bond yields continue to rise amid higher inflation expectations and growing confidence in a strong global recovery
- Improving pandemic-related news and continued fiscal stimulus should further accelerate growth momentum
- We doubled our oil overweight and introduced an overweight in value versus growth stocks

Increasing confidence in a strong global recovery continues to push bond yields higher. Recent economic data reflect decent growth momentum, which can only improve if the positive trend in coronavirus vaccinations continues. Policymakers, especially in the US, will continue to provide new stimulus that should further boost growth in the activity normalization phase. So far, higher inflation expectations are



the primary driver behind the rise in bond yields. Monetary policy expectations have also moved, but remain well anchored for the coming years. Risky assets have held up well on aggregate. The most pronounced moves have been in equities, where cyclical sectors are outperforming defensives and value stocks are outpacing growth stocks.



In our multi-asset model portfolio, we retain our pro-cyclical, risk-on stance with overweights in equities and high-yield credit and a large underweight in US Treasuries. We increased our cyclical exposure by doubling the size of our oil overweight.

Global growth momentum continues to surprise on the upside. Key data such as the global PMIs and Asian exports were strong again in February, despite continued lockdowns and mobility restrictions. In the countries where vaccination programmes have progressed most, such as Israel and the United Kingdom, a positive impact on infection growth and hospitalizations is already materializing. In contrast, in large parts of Latin America, where the vaccination process remains slow and government action has been erratic, there is a new surge in corona infections. In these countries, the economic recovery is faltering, as reflected by a deterioration in mobility and economic activity.

On a global scale, pandemic-related news has been positive on balance, with infection growth moderating and vaccinations accelerating. In the context of the latter, we still expect most of the developed world to have attained herd immunity by the end of the third quarter. This remains consistent with our base-case "cruise control" scenario. In this scenario, a swift normalization of public life and large fiscal stimulus will be the key factors driving the services-led economic recovery back to 2019 levels before year-end.

Such a recovery is consistent with a rise in actual inflation in the short term and with the increase in market inflation expectations, as reflected by the 0.5-percentage-point rise in US break-even inflation since the election of President Joe Biden. However, given still-low worker bargaining power and the temporary nature of the current fiscal stimulus, medium-term inflation expectations still look well anchored. The Fed is likely to look through a short-term spike in inflation. As a result, policy tapering is unlikely to start this year and a first rate hike should not be expected before 2023.

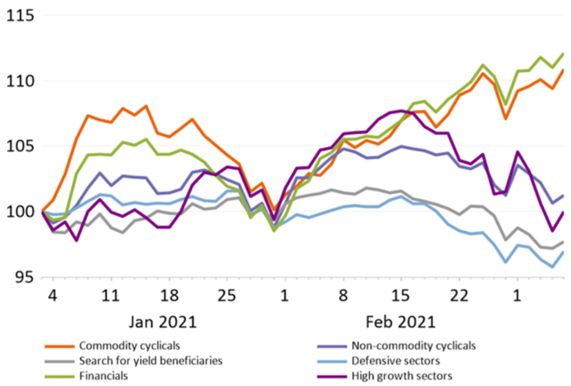
Oil market should remain tight

In the short term, the rising oil price presents a risk factor for our base-case scenario. In last week's OPEC+ meeting, the main oil-producing countries surprised with more production restraint than anticipated. Saudi Arabia agreed to extend its voluntary production cut of 1 million barrels per day by one month, while Russia was allowed to step up its production by 130 thousand barrels per day. On a net basis, the agreed production targets were lower than the market had expected, triggering another 10% spike in the oil price. We expect the market to remain tight. On the supply side, the return of OPEC+ to pre-crisis production levels is very gradual, and there are indications that US shale oil production will continue to decline until the summer. On the demand side, we think oil demand will continue to normalize at a steady pace. On this basis we increased our long-held overweight in oil from moderate to large.

Overweighting value versus growth

The oil theme is also reflected in the energy sector's solid outperformance within equities. Global equities moved largely sideways over the past week, digesting the rise in US Treasury yields fairly well. Below the surface, however, the drivers have completely changed in recent months. Equity markets are adapting to three macro themes: higher interest rates, higher commodity prices and the gradual normalization of economic growth. This new environment has put an end to the long period of strong outperformance of the growth theme. Instead, cyclicals are outperforming defensive sectors, technology is clearly lagging, financials are beating the market by a big margin and the energy sector is up by more than 30% since the beginning of the year (see figure).

Sector performance (local currency)



Source: Refinitiv Datastream, NN Investment Partners

The question at the forefront of investor minds is whether equity markets can defy a further rise in bond yields. Bond yields and equities often move in tandem in the early stages of an economic recovery, as the rise in yields is caused by better growth prospects and higher inflation expectations. This is exactly the phase we are in today. We believe the equity market can cope with a gradual rise in US bond yields to around 1.85% by year-end, whereby earnings growth absorbs the yield pick-up. However, if yields rise too quickly, as they did in the last weeks of February, the equity risk premium will rapidly contract. This will result in the market either consolidating over an extended period or experiencing a short-term correction to bring the risk premium back up.

In our top-down allocation we maintain our moderate overweight in equities. We added an overweight in value versus growth, for the first time in years. Rising yields, strong earnings growth, a large valuation discount and a turn in momentum are all supportive for this trade. Our sector preferences still have a clear cyclical tilt, with overweights in energy, materials, industrials and financials. We are underweight technology and we prefer small caps over large caps in the US.

We stay overweight in high yield, remain cautious in EMD

In fixed income, we have continued to benefit from our large underweight in US Treasuries. The divergence in growth and inflation prospects between the US and the Eurozone is driven by differences in fiscal and monetary policy and should be reflected in a wider yield differential. This is why we combine our large US Treasury underweight with a moderate Bund overweight. The net short between the two reflects our expectations for a continuously positive yield trend that is consistent with our recovery scenario. The main near-term risk is the large and crowded short positioning in US Treasuries. This could lead to more volatility and push yields sharply lower if risk appetite were to deteriorate for whatever reason and investors were to flock back to safe assets.

We are also holding on to our large overweights in US and Eurozone high yield credit. Some weakness has filtered through from equity markets in recent weeks, but the high-yield segments have remained relatively resilient. We expect more spread tightening, but at a slower pace than we have seen over the past quarters. The gradual lifting of lockdown restrictions and the associated strong global recovery should continue to positively impact credit spreads.

We remain more cautious in emerging market debt (EMD), which is struggling with rising developed-market yields and a stronger US dollar. Endogenous factors in emerging markets remain weak, due to the slow pace of vaccinations limiting room for a fast economic recovery and the sharply increased fiscal imbalances that will be difficult to narrow again. At the same time, EMs' average external imbalances are much smaller than during the taper tantrum episode in 2013. This is the main reason why we do not expect similar pressure to develop for the broad EMD category for now. We maintain a neutral position in both hard currency and local currency EMD.

Tactical Asset Allocation	
Global Equity	•
Euro Fixed Income	•
Global Real Estate	•
Commodities	•

Equity Regions	
United States	•
Eurozone	•
United Kingdom	•
Japan	•
Emerging Markets	•

Fixed Income Rates	
US Treasuries	• ●
German Bunds	•
UK Gilts	•
Emerging Markets Local Bonds	•

Fixed Income Spreads	
Investment Grade US	•
Investment Grade Eurozone	•
High Yield US	• ●
High Yield Eurozone	• ●
Emerging Markets Hard Currency	•

Commodities	
Gold	•
↗ Oil	• ●
Copper	•
Corn	•

↗ Upgrade ↙ Downgrade • Moderate overweight • ● Large overweight • Neutral
• Moderate underweight • ● Large underweight

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