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Multi Asset Monthly

Global Strategy

Reducing risk

Highlights

Economic Outlook

At the start of May, the global economy seemed to be on course for a renewed global growth acceleration. Since then, however, trade risks have flared up again and there is considerable risk that the concomitant uncertainty will continue to dampen business confidence and capex spending. To the extent that this occurs, global growth will be weaker and more vulnerable to negative income and confidence shocks. Nevertheless, the prospect of additional policy easing should prevent global growth from entering recession territory.

Market Outlook

The escalation of the trade war is starting to affect the growth outlook. This has led to an increase in the risk premium for equities and spreads. Earnings estimates, which had recovered nicely after the strong Q1 earnings season, look prone to renewed downside revisions if the trade uncertainty lasts much longer. We expect policy support to only partially offset this headwind. Given this environment, safe treasuries will continue to receive support.

Allocation

We reduced risk in May and are currently defensively positioned in cyclical assets. We underweight equities, spreads and commodities and are neutral real estate and safe treasuries.

Contents

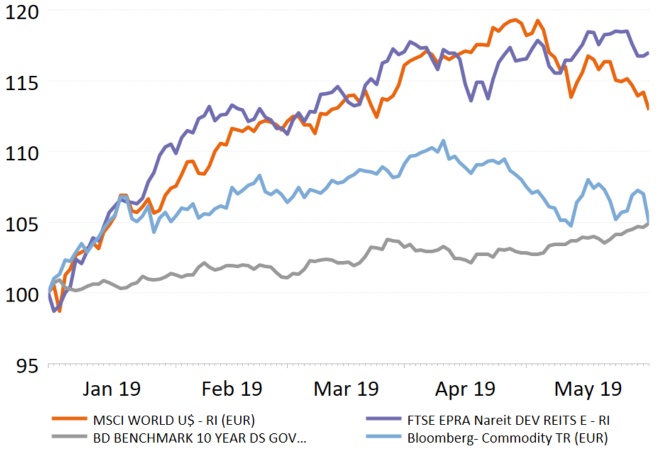
Market Review

- **Trade worries led to sell-off in risky assets**
- **German bond yields dropped to record low**
- **Only real estate realized a small positive return**

Asset class performance

The escalation of the US-China trade war threw a bucket of cold water on the "Goldilocks light" scenario. Fears regarding the impact of an escalating conflict on the growth outlook led to a sharp repricing of risky assets. Global equities dropped more than 5% and credit spreads rose across the board. Commodities suffered from weakness in the cyclical commodities and the drop in the oil price. There were few places to hide. One such place was government bonds, with the yield on German bunds falling to a record low -20 bps. The other was global real estate, which as a bond proxy benefited from this drop in yields.

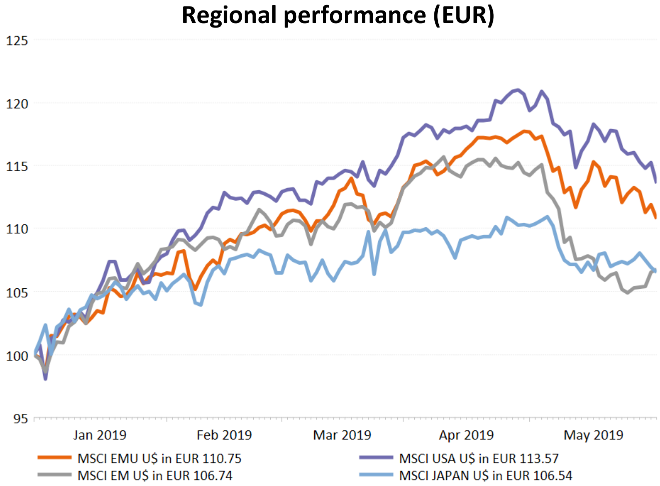
YTD asset class performance (EUR)



Source: Thomson Reuters Datastream, NN Investment Partners

Equities

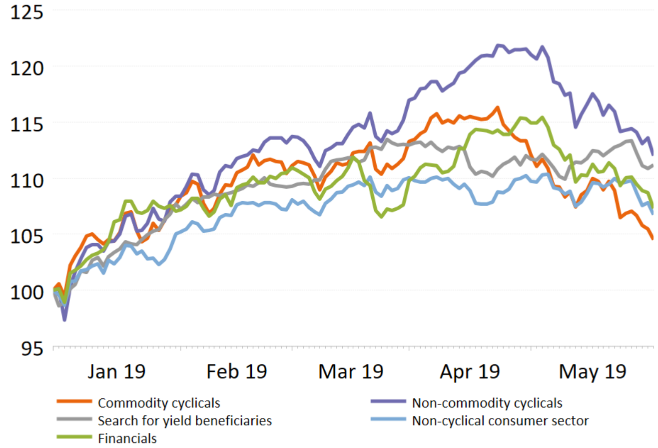
Regional performance (EUR)



Source: Thomson Reuters Datastream, NN Investment Partners

Regionally, all markets were down sharply. Emerging markets were the worst-performing region. Chinese data have thus far disappointed and the escalation of the trade war also weighed on export-sensitive markets. However, the region has recently recovered, helped by monetary policy, lower oil and the observation that emerging markets may already be pricing in many of the trade risks. In euro terms, Japan limited the drop to 3.5% but this was helped by a 3.5% appreciation of the Japanese yen versus the euro.

Sector performance (LC)

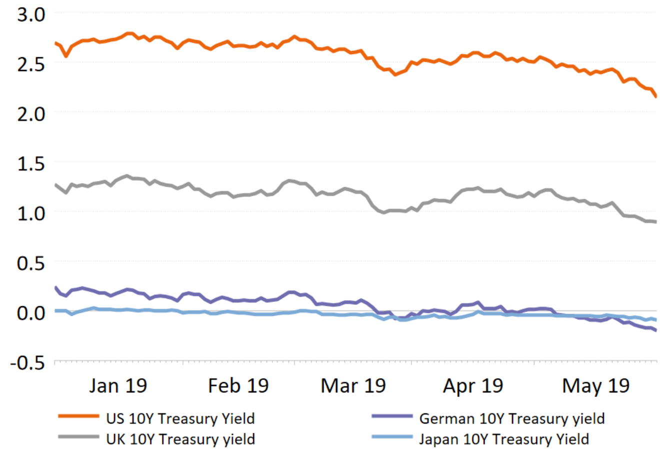


Source: Thomson Reuters Datastream, NN Investment Partners

From a sector point of view, the relative performance of cyclicals versus defensives continues to flip-flop. In May, cyclicals underperformed defensives. The technology sector suffered from the US ban of Huawei and the commodity sectors declined in sympathy with the drop in industrial metal prices and oil prices. Defensive sectors resisted better. The big relative gainers were the bond proxies: utilities and real estate. The latter even showed a small positive performance.

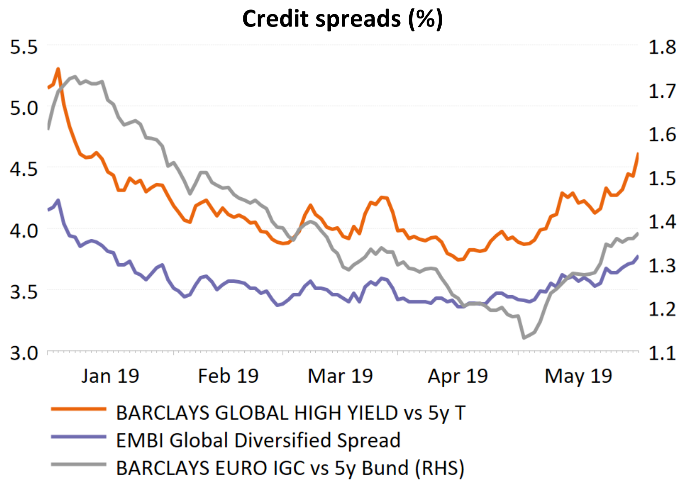
Fixed income

Long-term government bond yields (%)



Source: Thomson Reuters Datastream, NN Investment Partners

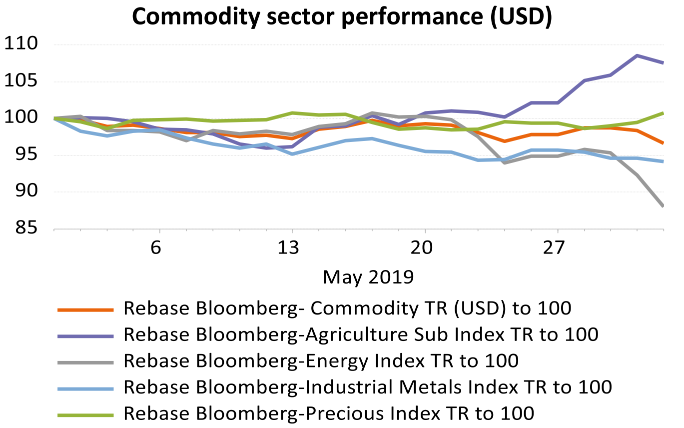
The escalation of the trade war and the increasing worries about its impact on the growth outlook have led to a surge in risk aversion, pushing the yield on safe assets further down. The German 10-year even fell to a record low of -20 bps. US Treasuries also dropped 35 bps to their lowest level since September 2017. In this environment, central banks will remain accommodative and the odds are increasing that the Fed will even make insurance rate cuts later in the year, perhaps in September, should the outlook worsen.



Source: Thomson Reuters Datastream, NN Investment Partners

The risk-off environment that prevailed in May pushed spreads on all fixed income spread products higher.

Commodities



Source: Thomson Reuters Datastream, NN Investment Partners

As trade tensions intensified, commodity markets declined, particularly cyclical commodities like industrial metals and energy. Agriculture was the positive outlier, as cold and wet weather in the US led to crucial delays in planting, underpinning prices.

Performance overview main indices

	Euro		Local Currency	
	MTD	YTD	MTD	YTD
MSCI WORLD - TOT RETURN IND	-5.14%	12.92%	-5.61%	10.52%
MSCI EM - TOT RETURN IND	-6.70%	6.87%	-6.57%	5.29%
MSCI USA - TOT RETURN IND	-5.79%	13.86%	-6.32%	10.99%
MSCI JAPAN - TOT RETURN IND	-3.41%	6.74%	-6.37%	2.97%
MSCI EMU - TOT RETURN IND	-5.51%	11.47%	-5.52%	11.44%
MSCI EUROPE - TOT RETURN IND	-4.72%	11.91%	-4.26%	11.55%
MSCI UK - TOT RETURN IND	-5.46%	10.36%	-2.77%	8.70%
MSCI PACIFIC EX JP E TOT RETURN IND	-2.21%	13.91%	-1.78%	12.23%
MSCI WORLD HEALTH CARE- TOT RETURN IND	-1.77%	5.81%		
MSCI WORLD FINANCIALS - TOT RETURN IND	-5.92%	11.76%		
MSCI WORLD UTILITIES - TOT RETURN IND	-0.29%	12.01%		
MSCI WORLD IT - TOT RETURN IND	-7.84%	19.76%		
MSCI WORLD ENERGY - TOT RETURN IND	-7.67%	8.47%		
MSCI WORLD MATERIALS - TOT RETURN IND	-6.77%	9.08%		
MSCI WORLD INDUSTRIALS - TOT RETURN IND	-6.03%	14.86%		
MSCI WORLD CONS DISCR - TOT RETURN IND	-6.69%	12.72%		
MSCI WORLD CONS STAPLES - TOT RETURN IND	-2.55%	13.58%		
MSCI WORLD T/CM SVS - TOT RETURN IND	-4.24%	15.15%		
GPR 250 REIT WORLD - TOT RETURN IND	0.72%	17.21%	0.24%	14.44%
Gold Bullion LBM $/t oz DELAY			1.33%	1.46%
Crude Oil BFO M1 Europe FOB $/BBl			-10.93%	22.21%
LME-LMEX Index - PRICE INDEX			-6.36%	-1.10%
Bloomberg-Agricultur Sub Index TR - RETURN IND. (OFCL)			7.57%	0.67%
Bloomberg- Commodity TR - RETURN IND. (OFCL)			-3.36%	2.31%
EBF EURIBOR 1M - OFFERED RATE	-0.378%	-0.363%		
US GVT BMK BID YLD 10Y (U$) - RED. YIELD	2.142%	2.691%		
GERMANY GVT BMK BID YLD 10Y (E) - RED. YIELD	-0.201%	0.246%		
JAPAN GVT BMK BID YLD 10Y (Y) - RED. YIELD	-0.098%	0.002%		
UK GVT BMK BID YLD 10Y (£) - RED. YIELD	0.887%	1.269%		
JPM EMBI Global Diversified - Blended YTM	5.99%	6.86%		
JPM EMBI Global Diversified - Blended Spread (bp)	382.2	416.4		
JPM EMBI Global Diversified - Return	0.41%	7.65%		
Barclays Euro-Aggregate EUR - Yield to worst	0.44%	0.77%		
Barclays Euro-Aggregate: Corporates EUR - Yield to worst	0.79%	1.30%		
Barclays Global High Yield USD - Yield to worst	6.56%	7.66%		
Barclays US Aggregate ex Government USD - Yield to worst	3.09%	3.73%		
US $ TO ECU/EURO (WMR) - EXCHANGE RATE	1.11435	1.14315		
JAPANESE YEN TO EURO (WMR) - EXCHANGE RATE	120.991	125.421		
GBP TO EUR (BOE) - EXCHANGE RATE	0.8839	0.8969		

Source: Thomson Reuters Datastream

Economic Outlook

- **Trade risks could translate into negative shocks**
- **Policy easing should prevent global recession**

A look at trade

At the start of May the global economy seemed to be on course for a scenario where the green shoots would mature into renewed moderate global growth acceleration. Combined with dovish central banks and some assorted fiscal easing, this should have exerted mild downward pressure on equity and credit risk premia and caused Treasury yields to rise.

Since then trade risks have flared up again, and there is a considerable chance that the concomitant uncertainty will continue to dampen business confidence and capex spending. To the extent that this occurs, global growth will be weaker and more vulnerable to negative income and confidence shocks. Nevertheless, the prospect of additional policy easing in various regions should prevent global growth from entering recession territory.

An assessment of the risks attached to trade warrants a thorough understanding of the issues at hand. In this respect, we would like to highlight four issues.

A move towards more free trade has benefits but also costs. The benefits are similar to those which accrue from technological progress. A country can get more consumption out of a given set of resource inputs. This benefit can come from comparative advantage, focusing on products that make intensive use of a relatively abundant input, such as low-skilled labour. Or it can come from being able to take more advantage from economies of scale, for example, because of a large and fixed cost of product development, such as in the case of Apple or Microsoft.

Either way, production costs will be lower than in the absence of trade, which benefits consumers in both countries involved. As such the benefits from trade are a win-win situation. The costs can be divided into two categories. First of all, more trade causes some sectors to shrink and others to expand. Those with a big stake in shrinking sectors will be confronted with a loss of income. In theory, the winners could fully compensate the losers, but in practice this usually does not happen, certainly not if the winners also gain political power. Secondly, more trade requires that a country submits to a larger and more invasive set of common rules that may well clash with domestic voter preferences.

Both cost categories can thus give rise to more voter unrest and political uncertainty. The political risks that have flared up over the past few years suggest that the marginal cost of more global integration could well exceed the marginal benefit.

In a world of free capital flows, the trade balance is essentially a residual of the action taking place on the capital account. Just as the current account balance of an individual household in a given month is determined by the difference between income and spending, the national current account balance is the excess of national income over national spending. Hence, countries with a current account deficit live beyond their means and are dependent on net foreign funding. Conceptually it is easiest to think of all countries as having some desired or planned current account balance. These plans will generally not be consistent with each other. Hence, when these countries meet in the international capital market, changes in asset prices, exchange rates and income will ensure that all current account balances around the world add up to zero. For instance, if Country X has a desired current account deficit that is bigger than the one which the rest of the world is willing to finance at currently prevailing asset prices, then financial conditions in Country X will tighten, raising national savings and reducing investment.

The special position of the US in this game ensures that it usually gets what it wants, to a considerable degree. Hence, if the US wants a bigger current account deficit, it is likely to get it, for the simple reason that there is persistent excess demand for the assets the US produces to finance the deficit (dollars of safe Treasuries). The immediate implication is that there is only one way to reduce the US current account deficit (a stated Trump policy objective), which is to reduce US spending relative to its income.

Tariffs introduce a micro inefficiency that does not necessarily count for much at the macro level – until non-linearities kick in. A tariff is simply a tax on a relatively small part of the economy. Most of the time, this tax is to a large extent borne by the consumer, who effectively transfers real income to the government. Hence, raising tariffs is essentially a form of fiscal tightening. A 10% tax on USD 200 billion of Chinese imports in a USD 20 trillion economy amounts to a tax increase of 0.1% of GDP, or even less if US importers switch to other countries. That does not sound like something to lose much sleep over.

This will change if Trump taxes all Chinese imports (more than USD 500 billion) at a 25% rate, because then it becomes the kind of fiscal tightening that can have a meaningful effect on GDP growth. Even then, though, it is important to remark that a tariff imposed by a large country triggers an effect that partly reduces the contractionary effects of the tax hike; that is, it will lead to an improvement in the terms of trade. By lowering global demand for the import goods targeted and/or by moving resources away from domestic export industries towards domestic industries that produce the import good, the relative price of exports in terms of imports will rise. This is a real income gain because the country can buy the same amount of imports by giving up less in the way of exports.

This mechanism is also the reason why the most aggressive country in a trade war will tend to see its currency appreciate. This currency appreciation is also part and parcel of the mechanism that ensures that the trade balance does not change after the imposition of tariffs. The US may import less from China, but the dollar appreciation will increase its imports from other countries and reduce its exports.

The upshot is that tariffs introduce micro inefficiencies that need not be very visible on the macro scale, especially if domestic and foreign policy easing attempts to mitigate their effects. So why do markets worry so much about them, and are these worries justified? This is when we come to the second part: the non-linearities. As more or higher tariffs are introduced, their cumulative effect will increasingly exceed the sum of the parts, because a tariff in one sector will cause ripple effects towards other sectors (e.g., suppliers). As more of these ripple effects are introduced, they can start to reinforce each other.

This is very clear in the case of global value chains. The degree of integration of production chains across borders has risen exponentially over the past two decades. Hence, the distortion introduced by taxes on a small part of such a chain can have substantial knock-on effects on other parts of the chain and beyond. As such tariffs could have a magnified effect on the value of the assets of some corporates and hence on their stock prices.

Another related possible non-linearity is the effect on confidence and financial conditions, which often goes beyond the direct effect of tariffs described so far. Investors may see the imposition of tariffs as the thin end of the wedge – that is, a signal of more trouble to come.

The importance of solid and credible global institutions (rules of the game) governing trade and finance was often overlooked until recently. High-quality institutions may well be taken for granted by many actors, especially if they have been in place for a long time. In that case, they are no longer actively taken into account when making investment decisions because there is no reason to believe this factor will change.

In this respect, Trump's trade war is symptomatic of his general approach towards the rules-based world order where the US acts in the spirit of enlightened self-interest. This approach is characterized by deliberate attempts to weaken these institutions. For corporates that operate internationally, this means they now face considerable uncertainty about the global rules of the game going forward, which will make them naturally more cautious with respect to investment decisions that require a large start-up cost.

This is an important reason why increased trade risks should cause markets to price structurally higher equity and credit risk premiums. This is true especially because this political/institutional uncertainty comes on top of myriad factors that have made DM space structurally vulnerable in the past 10-15 years. These factors can be summed up as the causes of secular stagnation, which expresses itself in multiple lows: low r-star, lowflation and low productivity growth.

To the extent that trade uncertainty pushes all of these lower, central banks will find it more difficult to fight a recession. This in turn will be a reason to increase equity and credit risk premiums further, and so on. On top of that, the concomitant deterioration in macro performance is likely to bleed into further political uncertainty, which will push the lows further down. Viewed from this angle, the worries currently in the market are to some extent justified.

The objective functions of trade policy makers are pretty complex. With the benefit of hindsight, many market players were probably too much focused on the purely economic benefits of a trade deal and therefore too optimistic about it becoming a reality. Both sides severely burnt their fingers when the trade war was heating up in H2'18 in terms of a slowdown in economic growth and a tightening of financial conditions. Having learned from this experience, it was assumed that both Xi and Trump would judge it to be in their advantage to come to a deal.

Of course everyone realized that there is a huge issue of strategic competition between the US and China lurking in the background. This holds both for the position of global hegemon and the related question of which economic model (market- or state-led) works best. The latter question is important because trade requires a common rulebook.

Nevertheless, many believed that this strategic issue would remain in the background for now because Trump would be focused on getting re-elected in 2020, in which case he needs a strong economy, strong employment growth and a strong stock market. Meanwhile it was believed that Xi would be focused on cultivating the green shoots in the Chinese economy in order to reduce unemployment and enhance social stability.

In addition, Xi probably wants to increase China's credibility with respect to being a responsible player on the global stage. This would enable him to steer the production structure of the economy further in the direction of high-tech and high-value-added production.

The big issue we all underestimated is that the aggregate preferences of the elites in the US and in China will change with shifts in the underlying domestic and foreign balances of power.

Both sides always face a substantial degree of uncertainty about the preferences of the other player. Successive rounds of retaliation can be seen as a device to learn more about these preferences. Because national pride (an identity issue) plays a considerable role in both players' preferences, the risk is that this process escalates beyond the point where both players would judge beforehand that the economic costs of escalating have become too big. In other words, it is comparable to a game of chicken. Before the race starts, both drivers strongly feel that it is not worth driving themselves over the cliff, but once the race is going their pride may cause them to do just that.

If the amount of economic and/or market pain endured by a player increases, he will be more willing to reach a compromise. Behind the scenes, this increased pain will probably enhance the political power of the trade doves. By the same token, the willingness to compromise will decline if the pain eases again. In that case, the trade hawks will feel more confident in asserting themselves.

The trade hawks on both sides are very much focused on the strategic economic and trade differences between the US and China. On the US side, this strategic perspective essentially views China a threat to US power on the geopolitical stage. Translated into economic terms, this boils down to the notion that China uses a set of policies to gain an unfair economic advantage by shielding some sectors from global competition, insufficient protection of intellectual property rights, forced technology transfers, a large involvement of the state (including subsidies) in certain key sectors, and so on.

The probably correct assumption of US trade hawks is that once China feels it has accumulated sufficient economic power, it will assert itself more strongly in other areas as well, for example, military and geopolitics. Hence the objective of US trade hawks is essentially to force China to change its economic model from its current state-led focus towards more focus on market-led development.

The Chinese strategic perspective is more or less the flipside of the US one, which already strongly suggests that the two are irreconcilable. The Chinese trade hawks probably feel emboldened in this respect by the view that China's strong economic rise has largely resulted from activist state intervention. In this respect, there are a number of powerful institutions in China which occupy themselves with state intervention, and of course they seek to maintain or expand their power base.

Both presidents will have a big say in the negotiation tactics. Xi and Trump also have their own personal considerations which feed into this. Trump knows he will once again need the votes of blue-collar workers in the rust-belt states to win the next election. If Biden wins the Democrat nomination, these votes will be under considerable threat. Because Biden was more dovish on trade during his tenure as vice president, Trump has an incentive to remain hawkish towards China. The risk is that this will weaken the economy.

Meanwhile, Xi's personal ambition is to extend his own term beyond 2023. To do so, he will need to show continued progress on the project of making China a bigger player on the global stage. State-led capitalism, in the form of such projects as Made in China 2025 and the Belt & Road Initiative, is part and parcel of this objective.

National pride will make agreement difficult

During the negotiations it appears there were three sticking points. First of all, the US refused to remove existing tariffs up front as part of the deal. For the US, maintaining these tariffs acts as an enforcement device. Secondly, US requirements for Chinese purchases of some commodities were perceived as too high. Last but not least, the Chinese perceived the draft agreement as not "balanced" enough to ensure that both sides could present the deal as a win. This is very likely related to the US requirement that China makes far-reaching changes to its laws that would ensure it becomes a more market-driven economy. There is a clear red line for the Chinese, which the US demands crossed.

In short: on the US side, the deal-breaker was a lack of trust that China would live up to the commitments already made. On the Chinese side, the hawks probably saw the result of the negotiation so far as too humiliating.

Given that both sides have increased the stakes in this respect and that national pride is an important consideration, it will be more difficult to reach a trade deal in the near future. This holds all the more so now that the trade conflict has spread into the tech sector. As the case of Mexico shows, Trump is clearly willing to use tariffs to gain leverage over other countries in US foreign policy. On the other hand, this may just be a last-minute attempt by Trump to extract as many concessions as possible, and there is an outside chance that he may succeed. Neither US policy makers nor the market really know the status of the balance of power in the Chinese political elite. In any case, Trump and Xi are still scheduled to meet in late June at the G20 summit.

Willem Verhagen
Senior Economist

NN IP Global Economic Outlook

	2018	2019	2020	2018	2019	2020	2018	2019	2020
US									
NN IP	2,9	2,3	1,5	2,4	2.2	2.3	2,50	2,00	2,00
consensus	2,9	2,5	1,8	2,4	1,9	2,1	2,50	2,75	2,75
Euro									
NN IP	1,9	1,1	1,0	1,8	1,3	1,4	0,00	0,00	0,00
consensus	1,9	1,3	1,4	1,8	1,4	1,5	0,00	0,00	0,50
Japan									
NN IP	0,9	0,4	0,4	0,9	0,8	0,8	0,00	0,00	0,00
consensus	0,9	0,5	0,6	0,9	0,7	0,7	0,00	0,00	0,00
UK									
NN IP	1,2	1.0	1,0	2,5	2,1	2,0	0,75	0,75	1,00
consensus	1,3	1,3	1,0	2,5	2,1	2,0	0,75	1,00	1,50
Emerging markets									
NN IP	5,1	4,6	4,8	3,6	3,9	3,8			
consensus	5,1	4,7	4,9	n.a.	n.a.	n.a.			
China									
NN IP	6,6	6,2	6,0	2,0	2,5	2,7			
consensus	6,6	6,2	6,1	2,1	2,1	2,1			

Consensus forecasts are taken from the Reuters Poll survey

Emerging Markets

- **EM torn between trade uncertainty and policy stimulus**
- **Divergence grows between trade- and capital-sensitive markets**

EM domestic demand growth recovery

So far this year, EM growth has been weaker than we anticipated. The main problem has been the ongoing global trade uncertainty. The setback in the US-China trade negotiations from 5 May has made a quick recovery in Asian business confidence and a swift pickup in capital expenditure more unlikely. At the same time, we are seeing a stronger commitment from the Chinese authorities to offset the negative growth impact from the trade conflict with economic stimulus measures. In addition, a more dovish stance from the Fed is sustaining capital flows to EM, which have been positive since November. This is helping EM central banks to further relax monetary policy. As a result, EM credit growth has started to pick up again in recent months, to a likely 10% in May.

Our view for EM growth is unchanged. We see limited room for a quick recovery in export growth and capital expenditure in manufacturing, particularly in Asia, but we see prospects for domestic demand growth improving, with supportive capital flows and further Chinese policy easing. On balance, EM GDP growth should gradually pick up in the coming quarters. For 2019, we have a GDP forecast of 4.5%, and for 2020 we have pencilled in 4.8%.

Insights from our protectionism indicator

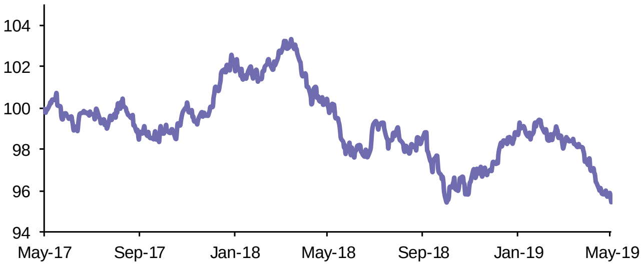
We can cautiously deduce from recent market moves that many of the additional growth headwinds coming from the broken down US-Chinese trade negotiations have been priced. A key observation here is that EM equities have not underperformed anymore since mid-May, despite the new bad news for Asian manufacturing coming from the US ban on Huawei.

Before this relative calm, EM equities underperformed between February and May. The lack of clarity on the trade negotiations and the escalation in the first weeks of May made investors particularly risk-averse to EM assets. Additionally, EM currencies struggled between February and May, losing two-thirds of the appreciation they had gained since September. In line with EM equities, EM foreign exchange rates have also stabilised in the second half of May.

When we talk about EM equities and EM FX in the context of the US-China trade conflict, we assume that these categories are more sensitive to the risk of increased protectionism than developed-market assets. So the relative performance of EM assets tells us a lot about what kind of trade scenario investors are pricing. To be more precise about this, we have developed an indicator that should be more sensitive to trade than broad EM assets.

In the end, EM equities and EM foreign exchange rates also include countries or sectors that are not so trade-sensitive and are more driven by domestic factors (such as India) or by expectations about global interest rates and capital flows to EM. We believe that the improved prospects for global policy easing and the better environment for a steady search for yield explain why EM assets have stabilized in the past weeks and even outperformed more recently. This observation appears well supported by the good performance of the two markets that have the largest external financing needs and thus can be considered the most capital-hungry: Argentina and Turkey.

Protectionism index



Simple average of KRW, MXN, TWD, THB, MYR, CLP and the relative performance export sectors in Korea, Taiwan, Mexico

Source: NN Investment Partners

Let's look a bit closer at our proprietary protectionism indicator. It comprises the most trade-sensitive EM currencies (Korean won, Taiwanese dollar, Thai baht, Malaysian ringgit and Chilean peso) and the relative performance of the export sectors vis-à-vis the broad equity market in the three main exporting economies (South Korea, Taiwan and Mexico). When the index declines, more protectionism is being priced. The first phase of the trade war, between Trump's steel and aluminium tariffs and the G20 summit in Buenos Aires, coincides well with the downturn of our indicator. Since last April, the index has started to fall again, with a faster decline from the beginning of May, when Trump blew up the trade talks.

If we compare the most recent relative performance of EM versus DM equities with our protectionism indicator, we see a remarkable difference. While EM equities have started to outperform, the more trade-sensitive protectionism indicator continued to decline. In our view, the better performance of the former can be explained by the market perception of better prospects for EM capital flows. In line with the recent deterioration of the protectionism indicator, the most open manufacturing markets of Asia, South Korea and Taiwan have underperformed more.

In our base-case trade scenario of an extended escalation, there would be more downward pressure on the most trade-sensitive segments in global markets. Also, our protectionism indicator is likely to fall further, although at its current level it is already back to where it was before the December meeting between Trump and Xi in Buenos Aires. This means that all optimism regarding a deal since then has evaporated again. In EM, we expect continuous divergence between the markets that are most sensitive to US-China trade and the markets that benefit from easier monetary policy and improving EM capital flows.

M.J. Bakkum
Senior Emerging Markets Strategist

Asset Allocation

- **The global environment worsened in May as the trade war escalated and growth worries increased**
- **We moved equities and commodities to underweight, reducing our risky asset exposure**

Risk reduction

May kicked off in a constructive mood, driven by economic green shoots, accommodative monetary policy and hopes for a trade deal. Things turned sour on 5 May, when President Trump tweeted that he would raise tariffs on USD 200 billion of Chinese imports. Since then, the trade news flow has only worsened, leading to investor doubts about a second-half recovery.

In our asset allocation, we started the month in a risk-on mode, with a small overweight in commodities and a medium overweight in spreads. Equities were neutral and safe treasuries were a small underweight. As the month progressed we took risk off the table.

First, we downgraded commodities in two steps from a small overweight to a small underweight, in response to a drop in our top-down signal and signs of the asset class's vulnerability to a further escalation of the trade war. A few days later, we cut our overweight in fixed income spreads from medium to small. At the end of the month, we reduced our stance to a small underweight as the behavioural variables all turned negative.

On 3 June, we moved equities further down to a medium underweight. The combination of rising trade fears, growth uncertainty and a lack of sufficiently positive corporate news flow (the strong earnings season was already discounted) formed the basis of this decision. Finally, we upgraded the underweight treasuries to neutral. Increased risk aversion, dovish central banks and political challenges are keeping bond yields low.

Fixed Income

Owing to trade uncertainty and the rise in risk aversion, we closed our underweight in safe treasuries. As the fallout from trade on the real economy worsens, central banks are likely to cut interest rates as a form of insurance against further economic damage. This will support safe government bonds even if the return/risk equation is unappealing with the 10yr German bund at -21 bps.

We have a small underweight in fixed income spreads. The asset class is also affected by the flight towards safe assets. So far the reduction has largely occurred through the derivatives market, but if the outlook worsens, investors could start selling cash bonds in an illiquid market, putting more upward pressure on spread levels. Within spreads we prefer euro investment grade and Eurozone peripherals.

Equities

Within equities we further reduced our exposure towards cyclical sectors. We downgraded the technology sector to a small underweight. This is directly related to the new phase of the US-China trade war, whereby Chinese telecom firm Huawei was blacklisted by the US. This restricts US companies from doing business with Huawei. This is an important precedent, as the IT hardware sector depends heavily on free trade, given the global supply chains of IT firms. The full-year earnings estimates for the sector have also dropped precipitously from over 10% in Q3 2018 to a mere 2% currently. Finally, the sector is a consensus overweight and has experienced outflows over the past month.

Overall in our sector allocation we have a small underweight in materials, IT and utilities and have a small overweight in financials, staples and consumer discretionary. The latter sector could benefit from the strong consumer even if it is not isolated from trade wars.

From a regional point of view, we made three changes. First, we downgraded emerging markets to neutral. Second, we upgraded the US to a small overweight, and finally we cut the Eurozone back to neutral. In this environment of rising uncertainty on trade and growth, we want to steer clear of the most vulnerable regions. Hence, the US looks a bit like the least-dirty shirt. One caveat is the large weight of the technology sector in the US (21% of the S&P 500) relative to the other developed regions.

Real Estate

Global real estate is neutral. Fundamental signals have returned to negative territory amid deteriorating global cyclical indicators and retail sales. Market dynamics have nevertheless improved markedly, with sentiment and momentum indicators improving. The decline in bond yields following the dovish turn of central banks and the rise in trade uncertainty has stimulated a search for yield and made real estate a consensus long trade. Meanwhile, institutional investor positioning in global real estate is overweight, and even strong overweight in European real estate.

Global real estate valuations are fair, with dividend yields still attractive. Discounts to net asset value could increase merger and acquisition activity. A solid labour market remains supportive of the asset class. The move to online retailing has created some headwinds for real estate, however. The rise of e-commerce is reducing the need for physical stores, and retailers face tightening margins in an online environment. A trend towards flex work is another structural headwind. Meanwhile, Brexit uncertainty has intensified, hurting UK real estate.

Commodities

We reduced commodities to underweight. With the recent escalation in US-China trade tensions, the macro green shoots that recently sprouted are already under threat. Cyclical indicators turned the macro fundamental signal for commodities back to negative territory in May. Indicators of market dynamics are also negative and deteriorated further as macro fundamental and commodity-specific news wires dented short-term momentum in commodities. Nevertheless, commodity demand has remained resilient so far, and increased Chinese policy stimulus is expected to compensate for trade-related softness. Chinese housing data, which are important for industrial metals, are also constructive. Meanwhile, the oil market continues to tighten on the back of increased geopolitical risk, but trade risks are raising concerns about oil demand. Meanwhile, US planting delays have led to short-covering in agriculture, while precious metals got a boost from safe-haven demand.

Strategy recommendations
(one-month horizon)

Tactical Asset Allocation	
Equity	underweight
Treasuries (Bunds)	neutral
Fixed Income Spreads	underweight
Real Estate	neutral
Commodities	underweight
Fixed Income	
Investment-grade US	neutral
Investment-grade Eurozone	overweight
High-yield US	neutral
High-yield Eurozone	neutral
EM hard-currency sovereigns	neutral
EM hard-currency corporates	neutral
EM local-currency bonds	neutral
Italy spread	overweight
Spain spread	overweight
Inflation-linked US	neutral
Inflation-linked Eurozone	neutral
Equities	
US	overweight
Eurozone	neutral
UK	neutral
Japan	underweight
Pacific ex-Japan	neutral
Emerging markets	neutral
Communication services	neutral
Consumer discretionary	overweight
Consumer staples	overweight
Energy	neutral
Financials	overweight
Health care	neutral
Industrials	neutral
Information technology	underweight
Materials	underweight
Utilities	underweight
Commodities (open positions)	
Silver	overweight

Market Forecast Table

Equity

quarter-end:	Current	Q2'19	Q4'19	Q1'20
Countries				
S&P 500	2752	2700	3000	3100
Stoxx 600	369	365	390	405
TOPIX	1512	1500	1600	1675
FTSE 100	7161	7100	7500	7500
MSCI EM Free	998	1000	1050	1100

Source: NN Investment Partners (31/05/19)

Patrick Moonen
Principal Strategist Multi Asset

Fixed Income Outlook

- **Safe government bonds rally as trade risks rise**
- **Cautious positioning seems warranted**

New lows in fixed income markets

Last week, two new lows were reached in fixed income markets: one in Bund yields, and one in the US bond term premium. What have been the main reasons for these new lows, and what is our view for the next few months?

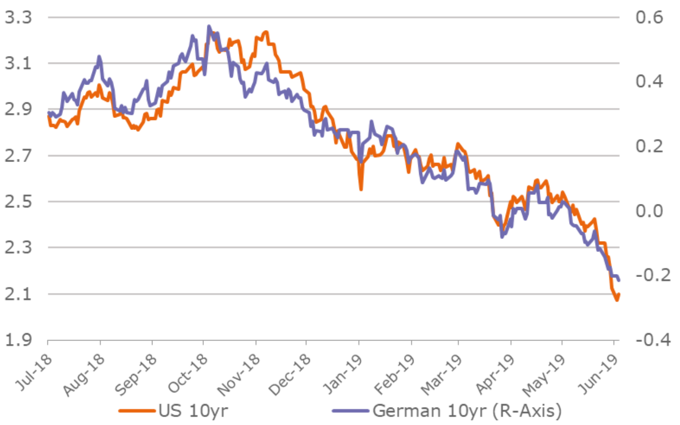
Let's start with Bund yields. Early June, 10yr Bund yields touched a new low of almost -0.22%, just below the -0.20% level on 6 July 2016. This is remarkable, because the previous low was widely seen as a strong overreaction by markets to the Brexit vote on 23 June 2016.

This time around, the move to -0.22% for 10yr Bund yields (and below 2.1% for 10yr US Treasury yields) was driven by increased protectionism fears. Of course, bond yields were already moving down when trade tensions escalated. Since October, German 10yr Bund yields had declined from 0.55% to 0.05% in early May, while US 10yr Treasury yields had fallen from 3.2% to 2.5%, mainly on a dovish pivot by the Fed in January and weaker-than-expected data, especially in manufacturing.

The bond rally in May, however, was mostly driven by the unexpected increase in US-China trade tensions on 5 May, and later by new proposed tariffs by the US on imports from Mexico on 30 May. Just as after the Brexit vote, expectations for global growth and central bank policy are being revised downwards markedly.

It is interesting to note that German 10yr yields trade with a rather constant beta of around 0.7 to US 10yr yields, despite the different causes of the drop in bond yields.

Figure 1: Falling bond yields in US and Germany



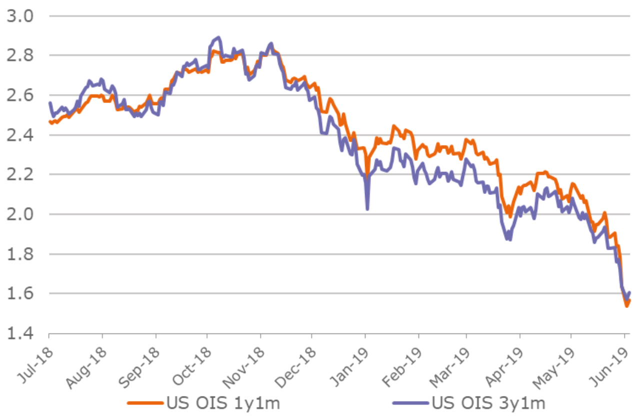
Source: Bloomberg, NN Investment Partners

Another interesting observation is that since the start of the October bond rally, the US 2-10 curve has traded more or less sideways around 20 bps. In contrast, the German 2-10 curve has bull-flattened from over 100 bps early October 2018 to just over 40 bps early June 2019.

The reason for this different curve behaviour can be seen in Figures 2 and 3, which show the 1mth OIS rates 1y and 3y forward, both for the US and the Eurozone.

As Figure 2 shows, in the US the 1y1m OIS rate has dropped almost as much as the 3y1m OIS rate, indicating that most of the downward adjustment in Fed fund rate expectations are for the next 12 months.

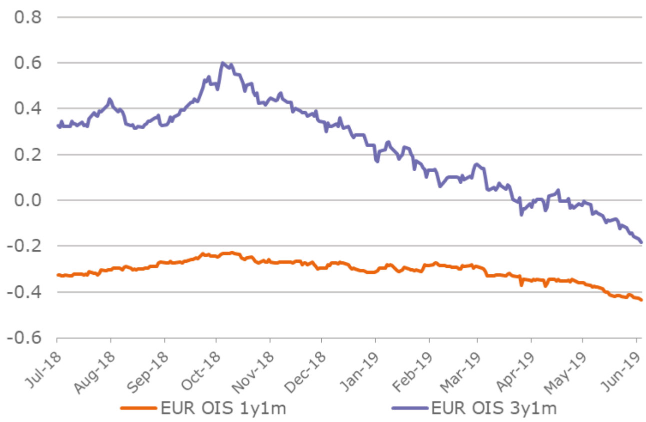
Figure 2: Fed expected to cut rates soon



Source: Bloomberg, NN Investment Partners

For the ECB, it is quite difficult to price in further rate cuts in the near term, although it cannot be ruled out. Instead, markets have priced out ECB rate hikes for the next three years.

Figure 3: ECB expected to keep rates unchanged for many years



Source: Bloomberg, NN Investment Partners

Going forward, the key question is whether bond markets have overreacted, just as they did after the 2016 Brexit vote. Chart technicals show that Bunds have become very overbought, so this suggests some overreaction and a potential rebound in yields in the near term. For the next several weeks, however, several factors suggest that yields will remain under downward pressure. Many rule-based signals, such as trend, carry and price momentum on equity markets, all point to lower yields.

The longer-term outlook for yields depends on the trade conflict developments and the global economic cycle. The third factor that caused yields to fall since October last year – the Fed dovish pivot – will not change in our view. The fact that the economic slowdown so far has mainly been in the trade-sensitive manufacturing sector, suggests that the trade conflict is the key issue.

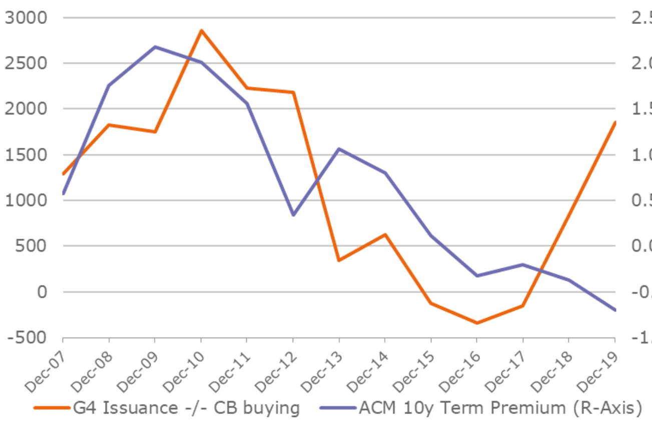
In view of most estimates on the impact of the current trade conflict on US economic growth, a lot of Fed rate cuts seem priced in (almost four cuts by end-2020). However, market pricing is a probability-weighted average of several scenarios. At this moment, three scenarios show up in most discussions.

The first scenario is based on the current status, in which case the Fed will might decide on one or two “insurance” rate cuts. The second scenario is built on a full escalation of the trade war, potentially including non-tariff measures like Chinese rare-earth exports to the US. In this case, the US economy will fall into a recession, and the Fed will cut rates aggressively, say by 150-200 bps. Finally, there is a possibility that the trade conflict will be resolved soon, in which case the Fed might decide on one or two rate hikes. Assuming probabilities of 50%, 45% and 5%, respectively, the weighted average Fed fund rate is almost 100 bps below the current one.

The other new low was in the 10y US bond term premium, as calculated by the Adrian, Crump & Moench (ACM) model. Briefly summarized, long-term interest rates can be broken out into a part that reflects the expected path of short-term interest rates and a term premium. The analysis of term premia is not straightforward, as neither the expected rates nor the term premium are not directly observable. To calculate the term premium, ACM are using a purely statistical model, relying exclusively on yield information.

The ACM 10y term premium reached -0.90% at the end of May. This new low is as remarkable as the -0.22% in Bund yields, as massive bond-buying by price-inelastic central banks (QE) is widely seen as the main reason for the decline in the bond term premium. In 2018, and especially this year, however, central bank buying of government bonds have come down a lot, and supply/demand dynamics are much less favourable. In Figure 4, we plot the bond term premium (year average) versus bond issuance minus central bank purchases for the four major economies.

Figure 4: Higher bond term premium would make sense



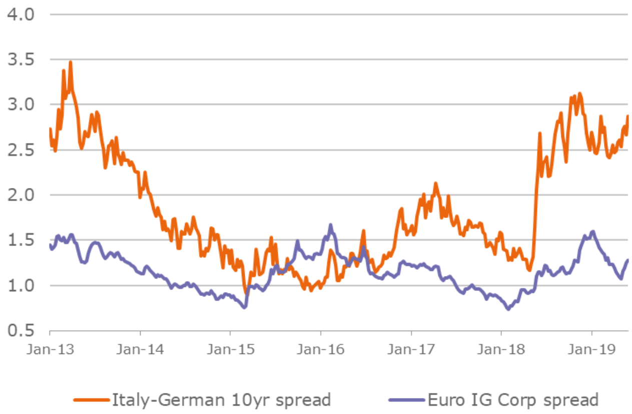
Source: Bloomberg, NN Investment Partners

Figure 4 suggests that the bond term premium should indeed be a lot higher. Why this is not the case is unclear. Another reason for low term premia, apart from central bank buying, is less uncertainty about the path of short-term rates. However, this does not seem likely in view of the large uncertainty about the Fed funds rate we described earlier. Therefore, we have also included the possibility that the bond term premium is not measured correctly, a problem that is widely acknowledged in academic literature.

Spread markets not yet extreme

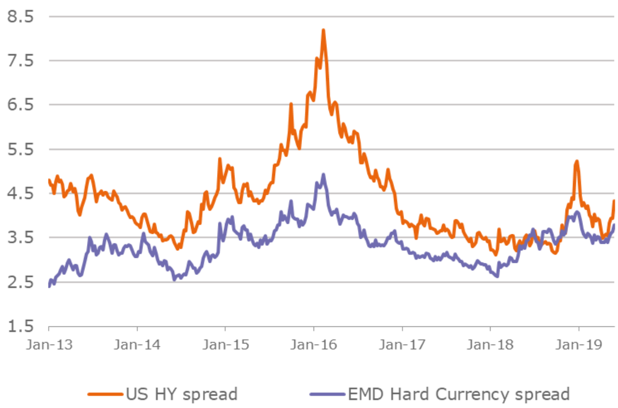
Fixed income spreads have overall widened since the early May re-escalation of the trade war. However, spread moves or spread levels seem far from extreme.

Figure 5: Investment grade spreads



Source: Bloomberg, NN Investment Partners

Figure 6: High yield and EMD HC spreads



Source: Bloomberg, NN Investment Partners

To conclude, Bund yields have fallen to new lows and spreads have widened since early May. However, we don’t see good reasons to position for a reversal. A cautious investment stance seems warranted, especially in view of the large uncertainty about trade developments.

Jaco Rouw
Senior Portfolio Manager LDI & Rates

Equity Outlook

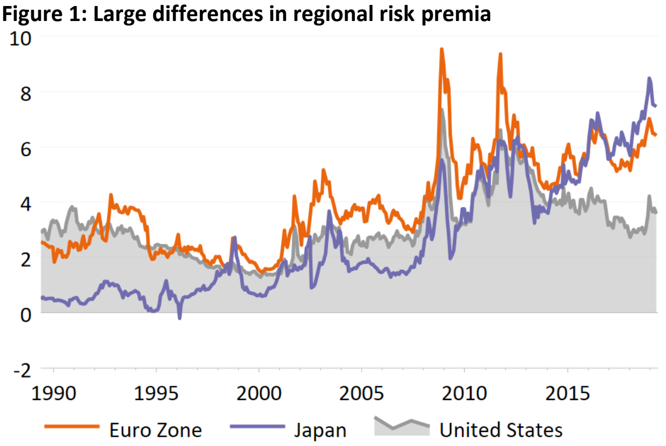
- **Goldilocks has been eaten by the trade bears**
- **Corporate fundamentals are strong but open to trade risks**
- **We favour financials over utilities and US over non-US**

Trade fears burning green shoots

Just as we were dreaming of a "Goldilocks light" scenario, in which green shoots and accommodative policies were pushing up equity markets, the nightmare of an escalating US-China trade war flared up again. Even worse, a quick deal now seems further away than ever and focus has spread towards the technology sector, one of the biggest drivers of US market outperformance. Although one never knows when it comes to politics these days, our base case has shifted towards a scenario of protracted escalation. The longer these tensions persist, the bigger the negative impact on the growth outlook.

In this respect, it is not the direct effects that matter most, as these are manageable and comparable to a tax hike. What keeps us awake is the negative impact on financial conditions and on business, consumer and investor sentiment. With Japan in a secular stagnation phase and the Eurozone at risk of sliding into this unenviable status, their resistance to external shocks has diminished. Investors require a higher risk premium as compensation. This is already visible in the equity risk premia in different regions. Since 2014, the divergence between the US and the other developed markets has only widened.

Figure 1: Large differences in regional risk premia



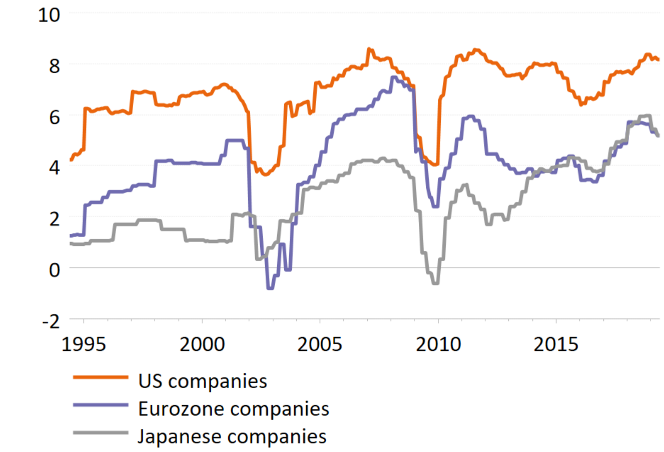
Source: Thomson Reuters Datastream, NN Investment Partners

But what does the current fundamental backdrop look like? It certainly did not turn to doom and gloom overnight. The corporate sector is in good shape. First-quarter earnings beat expectations both in the US and in Europe, with US corporates even beating estimates by a wide margin and across all sectors. Fears of an earnings recession have thus far proved unfounded.

The US earnings growth profile for the rest of the year also looks realistic, with no growth expected in Q2 or Q3 and a rebound in Q4. The full-year estimate has stabilized around 3.5%. Meanwhile, the 2019 estimate for the Eurozone has continued to shift lower. At 4.6%, it still seems somewhat on the high side, given the lacklustre growth, trade uncertainty and the adverse impact of low bond yields on the profitability of the banking sector.

However, despite the sharp improvement in earnings momentum, the risk for both regions is on the downside, as a global growth slowdown caused by trade uncertainty and higher tariffs will eat into revenue growth and corporate margins. These are close to historic or cyclical highs in developed markets. As a rule of thumb, in the US margins come under pressure when GDP growth falls below 2%, while in the Eurozone the threshold is 1%. In case of further escalation of trade tensions, we do not rule out the possibility that earnings growth will evaporate for this and next year. Markets are not yet pricing this risk.

Figure 2: Net profit margins excluding financials (x0.01)



Source: Thomson Reuters Datastream, NN Investment Partners

On the policy side, the continued weak inflation data provide central banks with the luxury of patience as far as policy tightening is concerned. The Fed is discussing the loosening of the inflation target. It had already introduced a pause in its policy tightening for the rest of the year, and the balance sheet reduction will stop by September. In case of a further escalation in the trade war, we expect the Fed to lower interest rates. This is also visible in bond market pricing.

Confronted with a deterioration of data in Q1, the ECB has also turned more dovish. and we expect it to stay on hold until far into 2020. Of course, the ECB faces diminishing returns from its monetary easing efforts. Support will also need to come from fiscal stimulus.

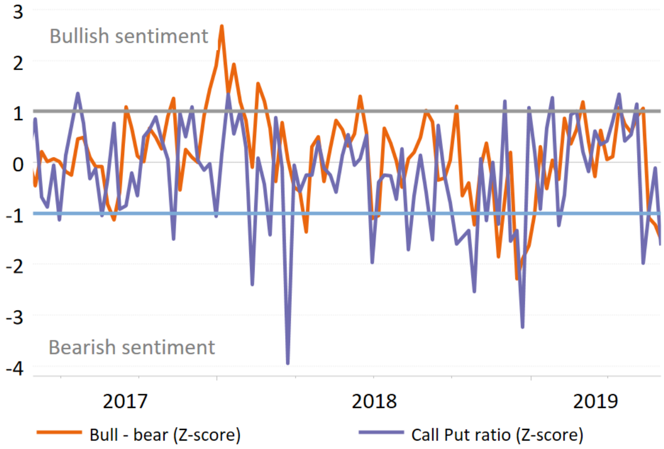
Further stimulus in China seems probable, although this will stop short of the massive programs we saw in the past. In the Eurozone, a modest fiscal stimulus of around 0.2%-0.3% of GDP looks likely.

So markets are in a tug of war between the risk of further trade war escalation and potentially more support from monetary and fiscal policy. The trade situation looks likely to worsen before it improves or before policy becomes more aggressive, and from a seasonal point of view, the period between May and August is traditionally weaker. Hence, some caution is warranted and we retain an underweight in equities versus cash.

On the behavioural side, investors have turned more pessimistic but the sentiment indicators are not yet in contrarian territory. Participation in the year-to-date equity rally has been low, with USD 130 billion (ETF + long-only funds) having left the asset class so far this year. In fact, only corporates have been big equity buyers, through massive buybacks. These are estimated at between USD 800 billion–

USD 1 trillion this year, around 3% of the US market cap, and have strong fundamental underpinnings. With the cost of debt below the cost of equity and the strong cash flow generation of US companies, this trend could continue, offering market support.

Figure 3: Investor sentiment indicator (Z-score)



Source: Thomson Reuters Datastream, NN Investment Partners

Valuations have risen, owing to the combination of a market rally and downward earnings revisions, but they are not stretched, especially not outside the US. The price-earnings discount for Europe and Japan relative to the US ranges from 20% to 26%, which is the highest since the Great Financial Crisis. The equity risk premium also remains very high. It makes sense for investors to require a high risk premium for the Eurozone and Japan, as these markets are more operationally leveraged (i.e., have a more volatile earnings stream), are hurt by secular stagnation fears and/or are facing serious political challenges.

In Europe, these challenges are centred around Brexit and Italy. Theresa May's successor will face the same challenges: a European Union unwilling to make large concessions and a divided British Parliament that opposes a no-deal Brexit. Eventually this stalemate may lead to a new referendum or new elections. The latter will weigh on sterling and add an additional risk to the markets: a Labour-led government with Jeremy Corbyn as Prime Minister.

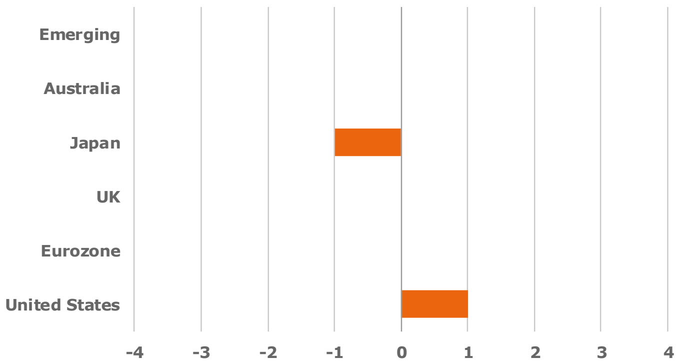
The Italian headache remains the budget. The European elections strengthened the position of League leader Matteo Salvini, who is willing to take the European Commission head-on, at least verbally. This does not bode well for Italian assets.

Of course, the range of the future market trajectory is very wide in both directions: positively if the political uncertainties wane, leading to higher valuations, and negatively if the trade war escalates and prevents an economic pick-up in H2, leading to lower-than-expected earnings growth and lower valuations. Monetary/fiscal policy could take the edge off both outcomes.

Regional allocation

We made three changes last month. First, we downgraded emerging markets to neutral. Escalating trade risks pose a threat for the region; Chinese data do not yet indicate a recovery, only stability; and the stronger US dollar is a headwind. On the positive side are the drop in the oil price and on balance easier monetary policy. Second, we downgraded the Eurozone to neutral. Trade uncertainty, sluggish global growth, political challenges and low Treasury yields are all headwinds. For the Eurozone to sustainably outperform, it needs an acceleration in earnings growth above the pace in the US. Finally, we upgraded the US to a small overweight. Earnings momentum has recovered and it is probably the least-dirty shirt in current circumstances.

Figure 4: Regional allocation



Source: NN Investment Partners

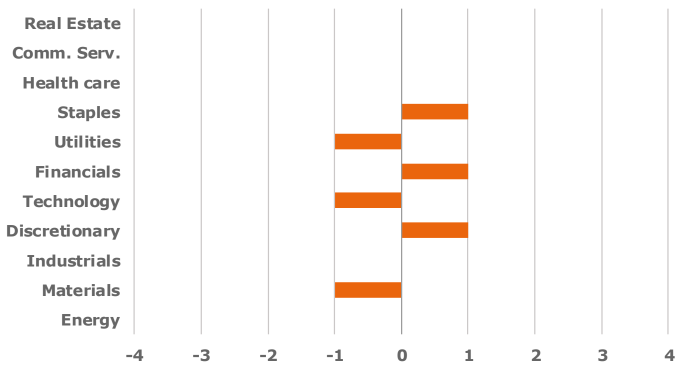
Sector allocation

Investor preference continues to shift. Earlier this year there was a preference for more procyclical exposure, whereas in May there was a clear shift towards defensives but foremost bond proxies. Confronted with cyclical and political uncertainties, we adopted a more defensive tilt and a focus on the consumer sectors.

We made one important change in May by downgrading the technology sector to a small underweight. The trade war is hurting the sector directly, as further escalation would threaten global supply chains for the sector. In addition, it is still a consensus overweight in portfolios, with outflows starting to build.

At the same time, we retain our positive correlation with interest rates by preferring financials over utilities. This has not borne fruit yet, as financials is a market performer whereas utilities is outperforming, driven by the drop in global treasury yields. Utilities is by far the consensus overweight in sectors.

Figure 5: Sector allocation



Source: NN Investment Partners

Patrick Moonen
Principal Strategist Multi Asset

Commodity Outlook

- **Supply risks remain high in oil; demand concerns pop up**
- **US planting delays prompt short-covering in agriculture**

Geopolitical risks to oil supply remain high

The dashed hopes for an imminent breakthrough in US-China trade negotiations led to a May correction in risky markets, including commodities. The green shoots of April were seen as being unlikely to take root, which weighed on the demand outlook for commodities.

So far, commodity demand has remained resilient, helped by a downward shift in the reaction function of the main central banks and a stepped-up Chinese policy stimulus that sought to compensate for the drags of protectionism. The Chinese authorities have already signalled their intention to counteract any demand fallout from further tariff escalation with further policy initiatives.

Meanwhile, industrial metals in particular are benefitting from strong demand for Chinese real estate, which is unlikely to face restrictive measures in the current environment. Comments from Chinese policy-makers, which had begun to refocus on deleveraging with the appearance of macroeconomic green shoots, have now decisively shifted in tone towards a willingness to implement further supportive measures. Together with better seasonality, this should underpin commodity demand in the coming months.

In oil markets, oil demand forecasts have so far been reduced only marginally, to still-decent growth levels of some 1.2-1.3 mbd in 2019, and the summer months are seasonally strong oil-demand months, with global refinery demand expected to increase by some 3 mbd from end April throughout the third quarter. Nonetheless, concerns over softening oil demand on the back of increased geopolitical tensions have started to appear, leading to a price correction in crude oil prices in May. However, current geopolitics work both ways in oil markets, and the impact on supply is likely to outweigh the demand effect, keeping oil market balances tight and remaining price-supportive.

The US's decision to increase pressure on Iran by terminating sanction waivers from May onward for eight countries that import Iranian oil continues to bite. Iranian crude exports are estimated to have fallen further to below 0.5 mbd from over 1 mbd a month ago, while production has continued to fall and is now some 2.3 mbd, a decline of about 1.5 mbd from levels in May last year, when the US withdrew from the nuclear deal and announced it was re-imposing sanctions.

Iran appears less likely to carry out its threat to block the Strait of Hormuz, through which some 40% of global crude oil and oil products trade flows, but the possibility remains potentially disruptive. Meanwhile, military tension in Libya is keeping some 600 kbd of oil production at risk. Venezuela's oil production has slid further to levels below 500 kbd, while a shortage of financial resources and lack of past investments make restoring its oil production in the foreseeable future unlikely even in a normalized political environment.

The OPEC+ group is expected to maintain a wait-and-see attitude until its scheduled meeting on 25-26 June, and to maintain high compliance with the production-cut deal. Moreover, the group's Joint Ministerial Monitoring Committee announced at its meeting in Jeddah that it intends to extend the deal into the second half of the year.

The OPEC meeting at end-June will receive significant attention, not only with respect to the extension of the production cut deal until year-end but also regarding the size of the cut. Much will depend on the market situation at that time and on the further fallout of the non-extension of the Iranian waivers. It now seems likely that Saudi Arabia will cautiously step up oil production and move from overcompliance to more regular compliance. Russia appears less inclined to demonstrate continued restraint in oil production, let alone strict compliance with the deal.

In terms of investor positioning in crude oil, the recent concern over demand fallout from trade tensions has led to a swift decline in net long positioning. Nevertheless, while the presence of sustained geopolitical risks represent an upward bias towards positioning in oil, the current investor positioning remains not excessive overall and lower than levels seen in the past. Moreover, the oil curve remains backwardation, implying positive roll yields and increasing the attractiveness of fresh long positions in oil.

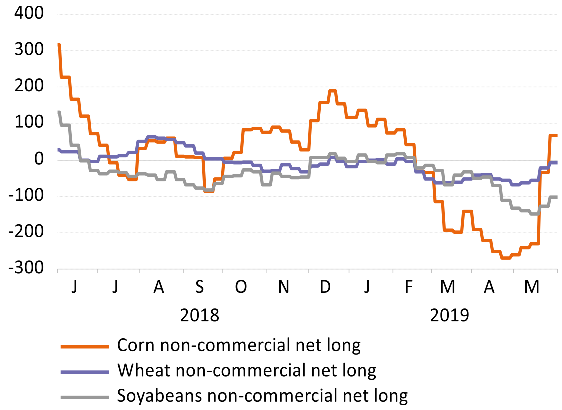
Overall investor positioning in commodities remains rather low, despite short-covering in agriculture. Precious metals recently gained some safe-haven interest on the back of protectionist escalation, but a simultaneous rise in the US dollar and EM currency weakness and a negative EM income effect curbed enthusiasm.

US planting delays lead to short-covering in agriculture

Agriculture has been an underperformer within commodities this year. However, the segment has begun to outperform since May. Its revival occurred against a background of important US planting delays in grains and beans on cold and wet weather in the US Midwest.

US corn planting progress through 28 May was the slowest in 40 years at 58% complete, versus a five-year average of 90%. Similarly, US planting progress of wheat and soybeans also trailed the five-year average. As a result, investors started covering short positions. EM currency weakness and improving harvests in Brazil and Argentina may dent US crop competitiveness and cap further price upside.

Agriculture non-commercial positions (x 1,000)



Source: Thomson Reuters Datastream, NN Investment Partners

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