MarketScope

A monthly look at what is happening, and likely to happen, in global markets

Markets have rallied strongly in recent months, driven by investor demand for high-yielding assets. Global growth momentum looks poised to accelerate and monetary policies throughout the world remain supportive, creating a positive environment for risky assets.

The outlook for risky assets remains favourable

Bonds	
10-year bond yield (3-month forecast)	
US	2.50%
Eurozone	0.50%
Japan	0.50%
Investment Grade credits	+
High Yield credits	+
Emerging market debt	
Hard currency	=
Local currency	=

Equities	
Energy	=
Materials	=
Industrials	=
Consumer Discretionary	+
Consumer Staples	-
Health Care	+
Financials	=
Technology	+
Telecommunication Services	=
Utilities	-

Region	
United States	-
Europe	+
Japan	+
Emerging markets	=

positive (+), neutral (=), negative (-)

Source: NN Investment Partners, 21 April 2015

The outlook for risky assets remains favourable. A modest but sustainable economic recovery and easy monetary policies continue to serve global markets well. Temporary shifts in investor sentiment and positioning can occasionally lead to exuberance in some specific areas and to some near-term correction risks. They are however no reason to move to a defensive allocation stance. We overweight real estate and global equities while we underweight (German) government bonds.

Financial markets extended their rally in recent weeks. The European Central Bank (ECB)'s purchases of government bonds pushed the yields of German Bunds to record lows. At the end of March, no fewer than eight European countries were offering bonds with negative yields for maturities of up to five years. This situation is taking financial markets into unknown territory, giving a fresh impetus to the search for yields. This means investors are being driven to take more risks by purchasing bonds with either a longer term or with a greater degree of credit risk. Alternatively, a growing number of investors have turned to equities and listed real estate markets to capture a decent yield.

Statements by Federal Reserve Chair Janet Yellen, according to whom the US central bank was in no hurry raise interest rates, also boosted investors' appetite for risk.

We have a large overweight stance on listed real estate and a medium one on equities. We also adopted an overweight position on high-yield (HY) bonds and on emerging market (EM) government bonds issued in hard currencies. Inversely, we have a large underweight on German government bonds.

1. Economy: global consumer enjoys strong fundamentals

- **The US labour market remains strong**
- **The Eurozone recovery gains momentum**
- **The ECB will stay on autopilot for two years**
- **EM growth remains weak in the near term**

Global economy to accelerate in 2015 and 2016

The global economy is showing a slight acceleration in its rate of growth. It should reach 3.2% in 2015 and 2016, up from 3.1% in 2014. The advance is mainly fuelled by falling energy prices, accommodating monetary policies and changes in exchange rates observed for the last six months. The growth differential between developed economies and emerging economies continues to tighten.

US labour market remains strong

The US economy remains quite resilient despite a temporary weakness in the first quarter of 2015. The decline in the oil price and the dollar appreciation shift some income away from the corporate sector towards the consumer. As a result, consumer spending is expected to be once again the main engine of growth, driven by robust real income growth, high levels of consumer confidence and healthy household balance sheets. Further strength in the labor market is therefore critical for this dynamic to continue. While non-farm payrolls data came in below expectations in March, other data still show a resilient job market. The unemployment rate stood at 5.5% in March, the lowest since 2008 while the number of Americans applying for first-time unemployment benefits fell in early April to the lowest level since June 2000.

The Fed likely to raise interest rates in September

The Fed abandoned in March its pledge to be patient before raising its interest rates, while cautioning that the date of an initial increase would henceforth be dependent on further improvements in the employment market and on the prospects for a return to 2% inflation. By doing so, it introduced a degree of uncertainty to the markets. It also suggested that the pace of any rate increases could be slower than estimated so far. We expect an initial rise in interest rates in September 2015.

The Eurozone recovery is gaining momentum

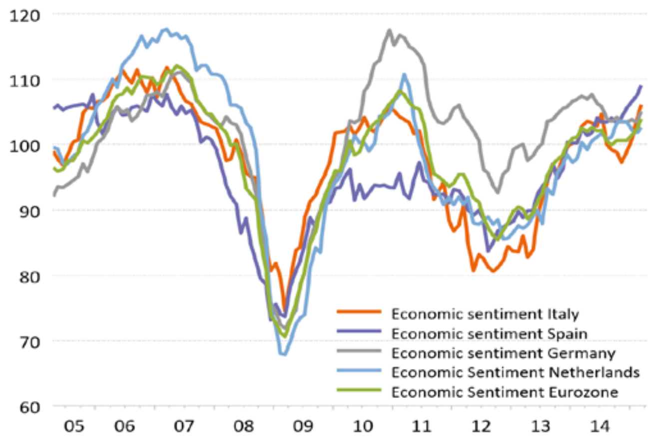
The euro-area economy is still burdened by several imbalances such as balance sheet problems in some sectors and the need for improvements in Italian and French competitiveness and profitability. On top of this there is the immediate issue of how to deal with Greece's bail-out program before the country runs out of money. Despite these issues, there are plenty of reasons to become more optimistic from a cyclical perspective.

Economic data in the Eurozone are clearly on an upward slope, helped by lower energy prices, a weaker euro and ultra-low interest rates. The Eurozone Composite Purchasing Managers Index (PMI) saw another rise in March, to 54.1 from 53.3 in February. The services sector continues to lead the way. With the help of a weaker euro and cheap energy, Eurozone manufacturers are also increasingly contributing to growth. Another encouraging sign that the outlook for the Eurozone is improving is the return of growth in loans to households and non-financial businesses – after two years of contraction. These data are consistent with a GDP growth rate of 0.4% for the first quarter of this year while a modest acceleration in the reminder of the year is also likely.

The ECB will remain on autopilot

The ECB said it reached its purchase target of €60 billion in the first month of its quantitative easing (QE) program. Mario Draghi, the bank's president, stressed in April that the ECB will continue to buy assets at the current rate until it is confident enough that inflation will be back to its close-to-2% target within a reasonable timeframe. Taking into account the current low level of inflation (the core annual rate stood at 0.6% in March), we believe that the ECB will keep purchasing financial assets at a pace of €60 billion per month for the next two years at least.

Eurozone sentiment improves, especially in the periphery



Source: Thomson Reuters Datastream, NN IP (April 2005 - March 2015)

Japan pushing for corporates to spend more

The Japanese economy's 0.4% rebound in the fourth quarter of 2014 came below most economists' expectations. The government therefore strongly encourages large exporting companies to use the margins offered by falling oil prices and the lower yen to invest in new equipment and to increase employee salaries in order to revive domestic demand.

The Bank of Japan made no changes in April to its financial asset purchasing program aimed at increasing the monetary base at an annual rate of 80,000 billion yen (about US$660 billion), even though the institution had to admit that inflation would remain depressed in the short term due to low oil prices. It remains convinced that declining oil prices and the falling yen will favour the economic recovery and a rise in inflation in the long term. We forecast growth of the Japanese economy of 1.3% in 2015, compared with a 0.1% contraction in 2014.

EM momentum remains weak

Economic growth momentum in the emerging world remains weak. EM growth continues to struggle due to deteriorating terms of trade (as Chinese demand for raw materials corrects further), negative capital flows (caused by nervousness about Fed policy normalization and growing awareness of the fundamental weaknesses in the emerging world), a poor investment climate (caused by more interventionist economic policies and a deterioration in competitiveness) and by a sharp increase in leverage (which is clearly limiting the room for credit-driven growth).

These factors need to become less negative before EM growth prospects can start improving. This could materialize in the second half of this year. The correction in the Chinese housing market is slowing and EM monetary easing has started. US monetary policy normalization continues to put pressure on EM capital flows, but the ECB's quantitative easing has re-fuelled the global search for yield. In this context, EM central banks see some room to cut interest rates.

2. Equities: in a sweet spot

- **The equity rally continued in April**
- **Risky assets are in a sweet spot**
- **Mergers & acquisitions: the return of the mega deals**
- **We prefer Europe to the US**

A quarter to remember

The first quarter of 2015 was a memorable one for stock markets. Global equities rose by more than 15% for euro-based investors. Markets got a lift from the launch of the ECB's unprecedented sovereign QE program and from better-than-expected macroeconomic data in the Eurozone.

Outperformance continued in April

Equity markets extended their rally in early April, helped by the inflow of liquidity, falling bond yields and more stable oil prices. In local currencies, the US market remained the laggard, due to two factors: the lack of earnings growth for this year and relatively high valuations at a time the Fed may start to hike interest rates. The Eurozone and Japan are in the opposite situation of accelerating earnings and dovish central banks.

Earnings growth based on our economic scenario

We have adopted a medium overweight stance on global equities reflecting a positive earnings outlook. Earnings growth is likely to be supported by a slightly accelerating global economic growth. Our expected levels of economic growth should be sufficient to give corporate earnings a decent lift, especially for Eurozone and Japanese companies.

Conversely, US companies may be heading towards a longer period of low earnings growth. Profit margins are close to record-high levels and tailwinds in the form of low interest rates, depreciation charges and taxes will likely start to fade over the coming years. The strong dollar is also likely to depress profits further in the US. Not surprisingly, we feel more comfortable with the point in the earnings cycle of Eurozone and Japanese companies, whose earnings are below trend and whose margins still have some room to recover.

Global monetary policy is to remain loose

Our optimism for global equities is also fuelled by our confidence that global monetary policies are likely to remain loose at least until summer. We think the ECB will run its open-ended QE program of €60 billion-a-month until mid-2017 and keep its policy rates at 0% until 2018. The euro's resultant weakening, which will undoubtedly have a beneficial impact on earnings growth expectations, has already left its mark on the government bond market. Over a quarter of the Eurozone's government bond market is now yielding negatively. The shift to a negative-rate environment has had a profound impact on investors' behaviour. We think the search for yield will push them further out on the risk curve, which will eventually also benefit the equity market.

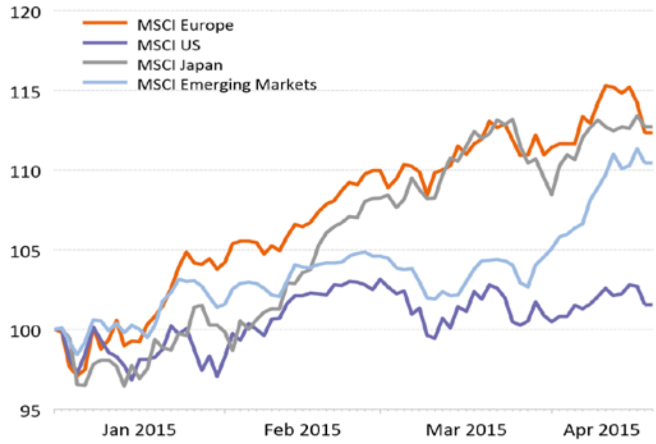
Mergers & acquisitions: Big deals are back

Takeovers are booming as many companies gain more confidence in the economy, use their stockpiles of cash to reach for future growth and get boosts from low interest rates and surging stock markets. In April, bids in the Health Care, Energy and Information Technology sectors increased the combined value of all takeovers announced in 2015 to more than US$1 trillion. Strong corporate confidence also translates in rising capital expenditure, share buybacks and increased dividend pay-outs.

Further gains may be more modest

We think the current market environment is still supportive for further equity gains. Taking into account the recent strong performance, however, rises are likely to be more modest. In addition, geopolitical concerns, US monetary policy, political developments in Europe and the possibility of a hard landing in China are among the risks that may create volatility in the near future. Still, based on prospects for earnings growth, policy support, corporate strength and valuations, the rest of the year looks promising for equities.

US equities are lagging in local currency terms



Source: Thomson Reuters Datastream, NN IP (01/01/2015 - 17/04/2015)

We prefer Europe

The Eurozone is our preferred region and we have a large overweight stance here. The outlook for European equities is driven by the improvement in the earnings momentum, the better-than-expected economic data and the high equity risk premium. With regards to behavioural dynamics, we observe a continuation of investment flows into Europe, mainly at the expense of US equities.

Next to Europe we also prefer Japan. The country remains attractive thanks to high earnings growth, positive earnings momentum, attractive valuations and last but not least policy making. Finally, emerging markets are neutral. Flows improve and stable commodity prices should underpin the region. We also observe loosening of monetary policy in several EM countries. On the other hand, EM currencies are weak and Chinese data show a further slowdown.

We keep a cyclical bias

Among sectors, Health Care was again the best performer, thanks to good earnings visibility and M&A activity. We did not change much in our sector allocation this month. Health Care remains an overweight for its attractive yield and earnings growth profile. We also held on to our overweight on Information Technology. We reduced the overweight in Consumer Discretionary to medium following the sector's strong outperformance combined with stretched positioning. We maintained our neutral view on the commodity sectors as the drop in the oil price seems to have come to a halt. Our underweights are in Consumer Staples, a sector we consider too expensive for the modest earnings growth it offers, and in Utilities. The Utility sector is a play on the search for yield theme, but we have our doubts on the sustainability of this yield.

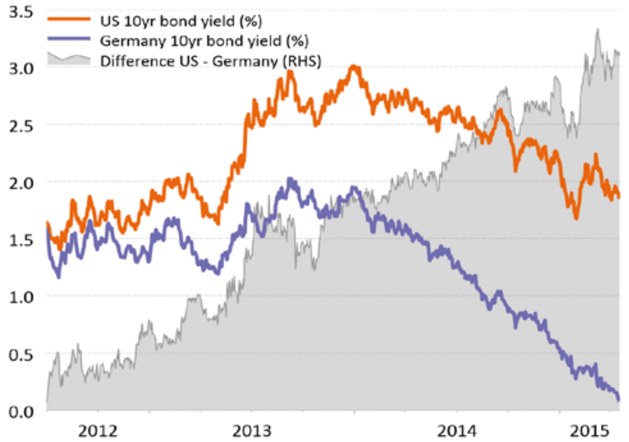
3. Bonds: is there a bubble in German Bunds?

- **German government bond yields fall to record lows**
- **Modest rise in yields still expected in the medium term**
- **We are cautious about German Bunds**
- **Higher-risk bond markets attract more inflows**

German 10-year yield declines to new record lows
Since the start of the year, we have seen a further decline of the 10-year German government bond yield. In April, the German 10-year bond yield fell below 0.10% for the first time on record. On April 15, Germany's 30-year bund yield dropped to 0.5% for the first time ever. The reasons for these ultra-low bond yields are well known: low growth, low inflation, loose monetary policy by the ECB and the start of its QE program, in combination with a persistently strong demand for liquid, high-quality bonds.

Yields on 10-year US Treasuries also declined in recent weeks after the Fed signalled a lower probability to near-term rate hikes and as disappointing economic numbers were released for March.

German 10-year bond yields decline further



Source: Thomson Reuters Datastream, NN IP (01/07/2012 - 17/04/2015)

Little upside potential left
At a yield below 0.1%, the valuation of the 10-year Bund has clearly become extremely stretched. Whether one labels this as a bubble is actually not the most relevant question. Investing is always about an assessment of risks and returns and the perceived balance between the two. For Bunds we believe that the trade-off has now become skewed to the downside. We decided to move (German) government bonds to a strong underweight. Not because we necessarily expect them to reverse course quickly, but mainly because even a stable or further-rallying markets has very little additional upside to offer, while a potential sell-off carries significant drawdown risk.

Higher-risk bond categories are the winners
Meanwhile, the search for yield in the higher-yielding parts of the bond market has gained fresh momentum in the past weeks. Ever-lower government bond yields are forcing many fixed income investors to re-allocate their assets to higher-risk categories and to bonds with longer maturities.

The two categories that stand out favourably in this respect are High Yield (HY) and sovereign emerging market debt (EMD). We prefer HY over Investment Grade (IG), both in EUR and in USD, for valuation reasons. We are strong overweight EUR HY. Apart from the ECB's support, the category has tailwinds from improving Eurozone macro and earnings data as well as from easier lending standards, which argues for continued low HY default rates. Rating agencies expect the EUR HY default rate to remain under 3% in 2015.

More cautious on EM currencies
The combination of poor EM fundamentals and a favourable global liquidity environment has been with us for years. While the EM fundamental picture continued to deteriorate, the global search for yield kept the damage for emerging debt markets limited. Only in times of increased nervousness about the pace of US monetary policy normalization did we see strong portfolio outflows from EMD. Only at those instances, the poor growth performance, the large macro imbalances, the lack of reforms and rising political risks in the emerging world became visible in higher rates, spreads and weaker currencies.

With Eurozone bond yields close to zero and US yields below 2% again, the 6.4% average EMD yield should be high enough to attract positive flows in the current environment. Of course, investors will have to take the exchange rate risk into account as well, but the 17% depreciation of emerging currencies against the dollar since the summer will be seen as having reduced the downside risk. In risk-on times, this is how investors are likely to approach EM local currency debt markets. Meanwhile, we prefer the hard-currency segment of EMD, simply because there is no direct exchange rate risk. In the past few months, capital flows to hard-currency EMD remained positive while EM equities and local-currency debt suffered outflows.

4. Real estate equities: large overweight

Real estate rallied further in the past month. This performance can be linked to the bond proxy nature of real estate whereby the high 3.7% dividend yield is an attractive alternative for investors who are looking for stable income but are scared away by low bond yields. Europe outperformed the other developed real estate markets, a result of the divergences in the various monetary policies. Fundamentals of the asset class (occupancy ratio, supply/demand balance, change in rent and price) are improving as a result of the economic recovery. This suggests that, provided any increase in bond yields remains limited, real estate can continue to perform well. Real estate is a large overweight in our tactical asset allocation table. We favour European real estate, which is supported by the low-yields environment and by improving fundamentals.

5. Commodities: small underweight

We have a small underweight position in commodities. Commodity prices have been depressed in the last two years by continued concerns over ample supplies and weak demand. Worries about the deterioration in China's economy have been reinforced by the release of weak data for the month of March. Investors also question how long it will take before the current glut in supplies disappears, which also fuels downward pressure on commodity prices. A rebound in crude oil prices is hampered by the high level of inventories, rising supplies and by the potential that Iran may flood the market after a deal was reached with world powers over its nuclear program. Currently we prefer coffee, corn and wheat on the back of tighter supply dynamics over the next few months. Inversely, we moved both gold and silver from neutral to a medium underweight. Fewer uncertainties over the global economy and geopolitical tensions, higher real US yields and physical and investment demand levelling off are headwinds for precious metals.