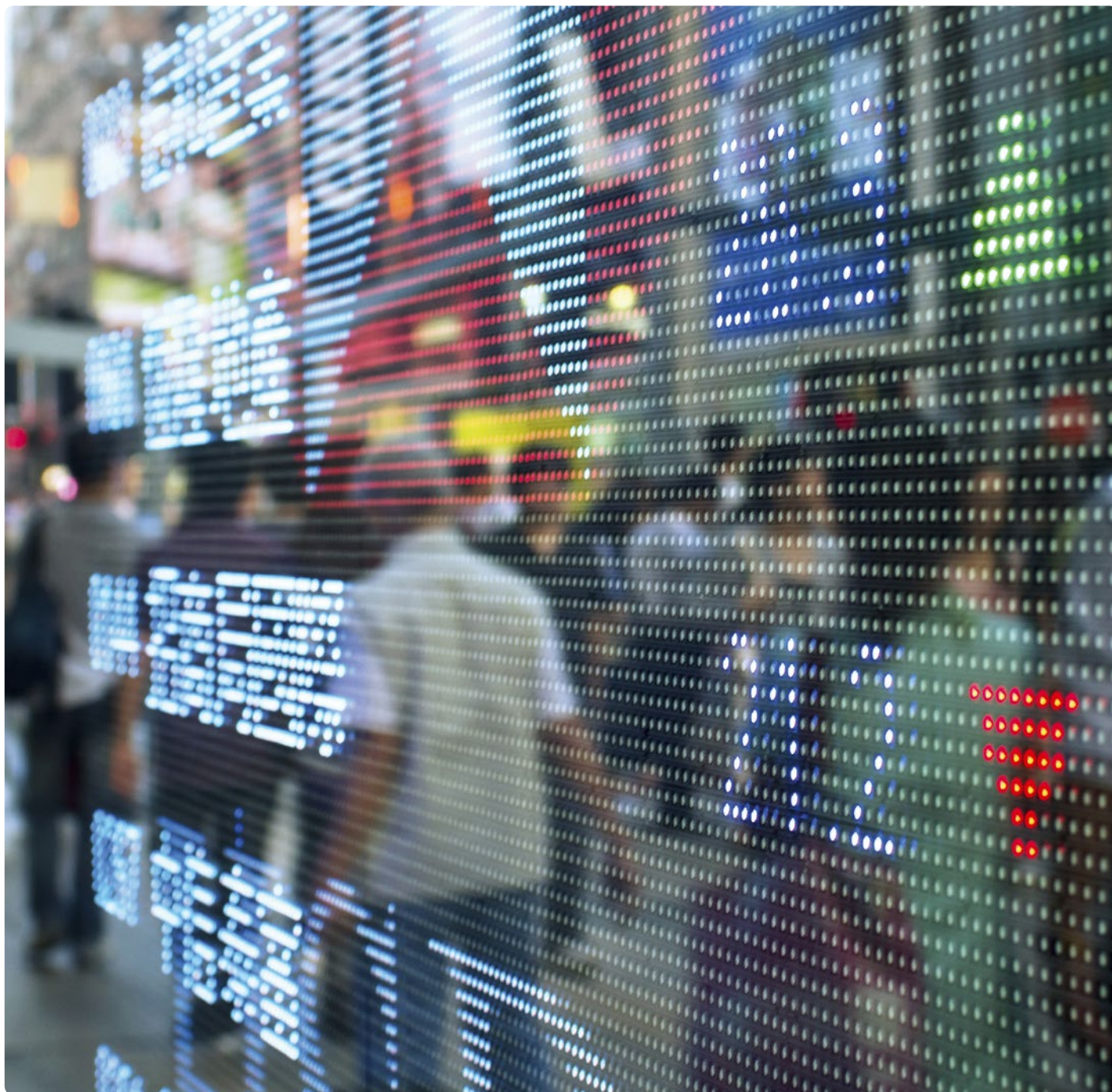


Outlook 2017

We expect a pick-up in global nominal growth and a more balanced economic policy approach, reflected in rising bond yields and a rotation towards cyclical sectors.

- Political uncertainty will be a dominant factor in 2017, yet this will also create ample opportunities
- The reflation trade is likely to continue and the rotation towards cyclical sectors in equity markets will persist
- More fiscal stimulus and rising inflation (expectations) may add to the upward trend in global bond yields
- In equities our preferred sectors are financials and materials and Japan is our favourite region. We also favour HY credits



Outlook 2017: The year of reflation

Key points

- Markets will likely price a political risk premium, as uncertainty will be elevated due to a busy election agenda in Europe, policy implementation of the Trump administration and the start of the negotiations between the EU and UK on Brexit.
- Political and policy uncertainty often has a negative impact on markets if it coincides with deteriorating economic momentum. This is currently not the case as global economic momentum has been improving since the second quarter of the year.
- We expect nominal GDP growth in developed markets (DM) to increase from 2.1% this year to 3.3% in 2017. A more reflationary outlook for DM space, driven by fiscal stimulus, would further support growth.
- The tentative growth recovery in emerging markets (EM) is greatly at risk from capital outflows as a result of higher DM bond yields, a stronger US dollar and a potentially more protectionist policy course of the US. We do no longer expect EM growth to move higher next year.
- We expect the reflation theme that is currently driving equity markets to continue, driven by a more balanced policy approach, higher bond yields and steeper yield curves, improving earnings and an increase in oil and cyclical commodity prices.
- We identify three key drivers of earnings growth for next year: the oil price, bond yields and currencies. The energy sector will add to global earnings growth again, higher bond yields fuel the cyclical rotation and a stronger dollar favours the earnings growth of non-US corporates.
- We expect cyclical sectors to continue to outperform the defensive, yield-providing sectors, driven by the above-mentioned fundamental factors as well as a turn in investor positioning. Our preferred sectors are financials and materials. Our preferred equity region is Japan.
- We expect to have seen the bottom in DM government bond yields, as monetary policy is being complemented with fiscal policy, while growth is improving and the Federal Reserve is further normalizing its policy. We do expect German/Eurozone bond yields to remain low.
- High yield (HY) credits are our preferred spread product. They are supported by the improving macroeconomic and earnings data and the expected improvement in cyclical commodity segments. We also expect a “trickle down” effect from the central bank bond buying programmes which have squeezed most juice out of Investment Grade (IG) credits and government bonds.

Economic Outlook

- Political and policy uncertainty will likely be a dominant factor
- Global economic momentum is on a moderately upward trend
- Trump’s policy approach will greatly determine US outlook
- European politicians will have to address voter concerns
- Protectionist US policy path may derail emerging market recovery

Global economy: political and policy uncertainty

Political uncertainty will likely be a dominant theme on financial markets in 2017, but it does not need to drag down the real economy. In fact, a mild improvement in global growth momentum is visible. The disinflationary shock triggered by the tectonic shifts in oil/commodity prices and exchange rates – particularly the appreciation of the US dollar – is slowly fading out. This has also helped to stabilize financial markets which received further support from a significantly more dovish Fed. The drags on earnings growth caused by these shifts are waning, while earnings should be further supported by stronger global demand and stable or higher oil prices.

Donald Trump has been elected as the next president of the United States and in the coming months the details of his economic policy will become clearer. Then we have the referendum on constitutional reforms in Italy on 4 December and next year elections will follow in the Netherlands, France and Germany. Furthermore, the UK government is expected to trigger Article 50 in March. On top of that, markets will continue to speculate about the monetary policy outlook for the main central banks like the Federal Reserve, European Central Bank, Bank of England and Bank of Japan. Hence, we can fairly say that the global policy and growth outlook is clouded by a high degree of political and policy uncertainty.

A political risk premium will thus be priced in markets, but a moderately positive trend in fundamentals is surfacing. Global consumer spending has been increasing in the past quarters, driven by improving labour markets and higher confidence. Meanwhile, the improving earnings outlook has a positive impact on business confidence, as reflected in the broad based improvement in PMI data, amongst other things. Improving earnings growth and confidence, combined with higher commodity prices, should support a moderate improvement in global capital expenditure (capex). In this respect we also see some encouraging data. An improvement in capex will in our view be a big swing factor. The improvement in earnings growth, combined with an easing of financial conditions and an improvement in business confidence should cause capex’s contribution to GDP growth to turn from a negative into a moderately positive one.

US outlook determined by Trump policies

For the US economic outlook, as well as for the global outlook, Trump's economic policy agenda will be crucially important. Much will depend on the balance between macroeconomic and trade measures.

On the macroeconomic front, Trump is set to increase infrastructure spending substantially, while he also intends to cut taxes for corporates and high income individuals. These measures point to larger fiscal deficits, as his promises to find savings to compensate for the tax cuts should be taken with a grain of salt in our view. Tax cuts fit both the Trump agenda and the agenda of the traditional supporters of supply-side economics within the Republican Party. The Congressional hawks opposed to debt increases might be hard to convince to vote for the spending and tax measures, though.

Higher fiscal deficits will lead to higher growth for some time, and probably to higher inflation as well, as the US economy is already operating close to potential. This may cause the US Federal Reserve to react by increasing interest rates faster than it intended to before the election. We do however believe that the Fed will remain on the dovish side and will allow for a moderate inflation overshoot to compensate for years of undershooting and to cement inflation expectations more strongly. In addition, the Fed could well be willing to run a "high pressure economy" to push labour supply and/or productivity on a permanently higher path. This is important

because continued dovishness may help to moderate what could potentially be a destabilizing appreciation of the dollar.

However, Trump will be able to nominate new Fed governors, and the four-year terms of Fed Chair Yellen and board member Fisher both expire in 2018. As some of Trump's advisers are genuinely more hawkish, the new appointments, now and in coming years, may move the Fed in a more hawkish direction. If this should happen, the deficits will have less effect on output and more effect on interest rates. To the extent that both growth and interest rates will be higher, the dollar is likely to appreciate, leading to larger US trade deficits, something Trump has indicated he wants to fight.

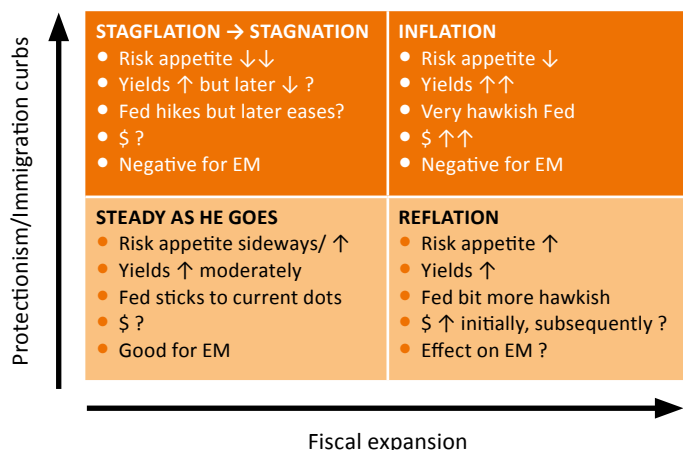
This brings us to the point of the trade measures, an important theme in Trump's campaign. In this area the president has significant powers. He could increase tariffs or pull out of existing trade deals. The possibility of a more protectionist policy course in the US is a risk, not only for export-oriented (emerging) markets, but also for the US economy. Tariffs may indeed reduce imports, increase the demand for domestic goods, and increase output. However, if the US imposes tariffs, it will likely lead to a tariff war and thus also decrease exports. On the demand side, higher import prices would push up inflation and lead the Fed to increase rates further. On the supply side, tariffs would likely disrupt global supply chains, production and trade, and decrease productivity.

The US economic outlook crucially depends on Donald Trump's policy agenda.



So, reasonably speaking, we might expect Trump's advisors to convince him of the dangers of a protectionist policy course. We might also expect heavy lobbying from exporters. There is also a possibility that Trump's anti-trade rhetoric was meant as an opening bid in the renegotiation of trade deals. In this case, they may be watered down significantly in the end.

Figure 1: The Trump matrix



Source: NN Investment Partners

All in all, for the US as well as the global economy in the coming quarters, it is key to watch the balance of fiscal expansion versus protectionism. Our base case is that the emphasis will be on the economic growth agenda driven by fiscal easing and deregulation. The US economy will then be characterized by reflation (higher real growth and higher inflation) which could have positive spill-overs to the rest of the world. These spill-overs would be both direct (via trade links) and indirect in the sense that they may encourage other countries with fiscal space to engage in more fiscal easing as well. In this scenario the world would then remove itself further from a secular stagnation scenario. Of course, a lot will depend on the details of this scenario, which are not easy to oversee let alone predict in advance.

If the protectionist agenda prevails, the US will initially experience some kind of stagflation environment (slower growth but higher inflation), but given the prospect for trade retaliation this could relatively quickly lead to a global recession which could eventually push the world close to a secular stagnation scenario of low growth, low inflation, and low productivity.

Election cycle casts shade of uncertainty over Europe

The US is not the only economy in which policy and political uncertainty will play an important role in 2017. The coming 12 months will be a telling period for the European Union. National elections are scheduled in a number of core European Union member states, in some of which anti-Europe parties currently enjoy strong standings in the polls. Much will depend on the extent to which the EU can convince voters of the benefits of regional integration. Backing by the region's electorate is just as badly needed as progress towards a fiscal and banking union. For example, the EMU's "institutional

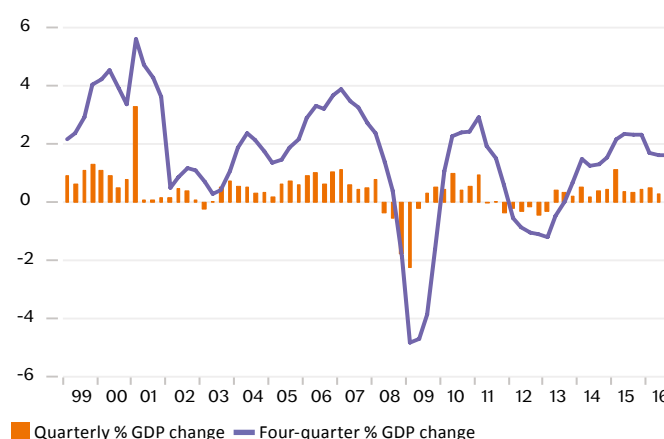
incompleteness" prevents a more pro-active approach in dealing with high debt burdens, either by more fiscal risk-sharing or through more burden-sharing, where the strong countries reflate their economies to facilitate debt reduction in the weaker ones.

However, political polarization is a widespread phenomenon across the region and is an important source of political uncertainty. Dissatisfaction with the EU has been growing steadily among voters in a number of member states, and the sovereign debt crises in the southern nations have only served to fuel resentment among the region's northern citizens. The national governments' apparent inability to cope with the influx of immigrants has added fuel to the fires of dissatisfaction, and has enabled populist parties with anti-EU agendas to increase their bases of support. This voter discontent adds another dimension to the challenge that Europe faces. The crucial question is whether EU leaders are willing and able to address valid voter concerns and accommodate differences in national voter preferences, and at the same time, make the institutions that underpin the European Monetary Union more solid and shock-proof.

Eurozone economy is performing relatively well

Heading into this period of uncertainty, the Eurozone economy is on a relatively stable footing. When considering the state of the Eurozone economy, it matters a lot whether one looks at the changes over the past quarters and years or whether one considers the situation "in level terms". While in level terms GDP is now only barely above the 2008 peak, in terms of economic growth and marginal changes to financial conditions, there are plenty of reasons to be positive. Economic growth is supported by a solid underlying increase in domestic demand where a few positive developments reinforce each other.

Figure 2: Eurozone economy is growing slowly but steadily



Source: Thomson Reuters Datastream, NN Investment Partners (November 2016)

The credit channel continues to open up further with both supply and demand for credit on an expanding trend. All this is reflected in a steady, moderately positive flow of new credit in the economy. Furthermore, business and consumer confidence is at resilient levels, supported by a positive feedback loop between the appetites to spend of these two sectors. In this respect, solid employment growth

is an important support for the consumer and the concomitant robust rate of consumption growth induces corporates to remain in expansionary mode. All this is further enhanced by the existence of pent-up consumer demand for durable goods and pent-up corporate demand for capital goods. In addition, construction spending is also gradually strengthening after a multi-year adjustment phase following the construction boom in several countries.

The euro region is also benefiting from some mild “stealth” fiscal easing. The reduction in interest rate expenses on the back of the fall in sovereign bond yields has allowed primary deficits to increase somewhat without causing a significant increase in overall deficits. On top of this, expenses related to the refugee crisis and terrorist threats have increased government spending. Also, the European Commission remains more lenient in allowing for cyclically induced overshoots of the fiscal targets than in the past. Finally, the ECB plays an important part in underwriting the domestic recovery. From a narrow monetary policy perspective, its reaction function has shifted further in a more dovish direction as the central bank has become more pre-emptively responsive to downside risks.

As far as the ECB is concerned, we expect the central bank to announce an extension of its quantitative easing program at the

current pace of EUR 80 billion per month until the end of 2017. At its meeting on 8 December, the ECB will report on the outcome of its assessment of the measures that are currently in place.

Emerging markets faced with uncertainty

Emerging markets have staged a remarkable – though still moderate – growth recovery in 2016, to a large extent because of an easing of financial conditions as a result of improving capital inflows and looser monetary policy. The recovery in commodity prices also helped. Meanwhile we have also seen greater divergence between countries with reforms and improving governance on the one hand and countries with populist/unorthodox leadership on the other. Reforms are still key for a sustainable growth recovery, given the high leverage in emerging markets and weak global trade.

Regarding global trade, the election of Donald Trump is an important risk factor as EM exporters have been struggling due to weak global trade growth. A more protectionist policy course in the US will make it even more difficult for emerging markets to get back to positive export growth. Emerging markets are more exposed than developed economies to a retreat from free trade and free capital flows. They are also more vulnerable to such a shock given the many macroeconomic imbalances in this region.

Emerging markets are exposed more than developed markets to a retreat from free trade.

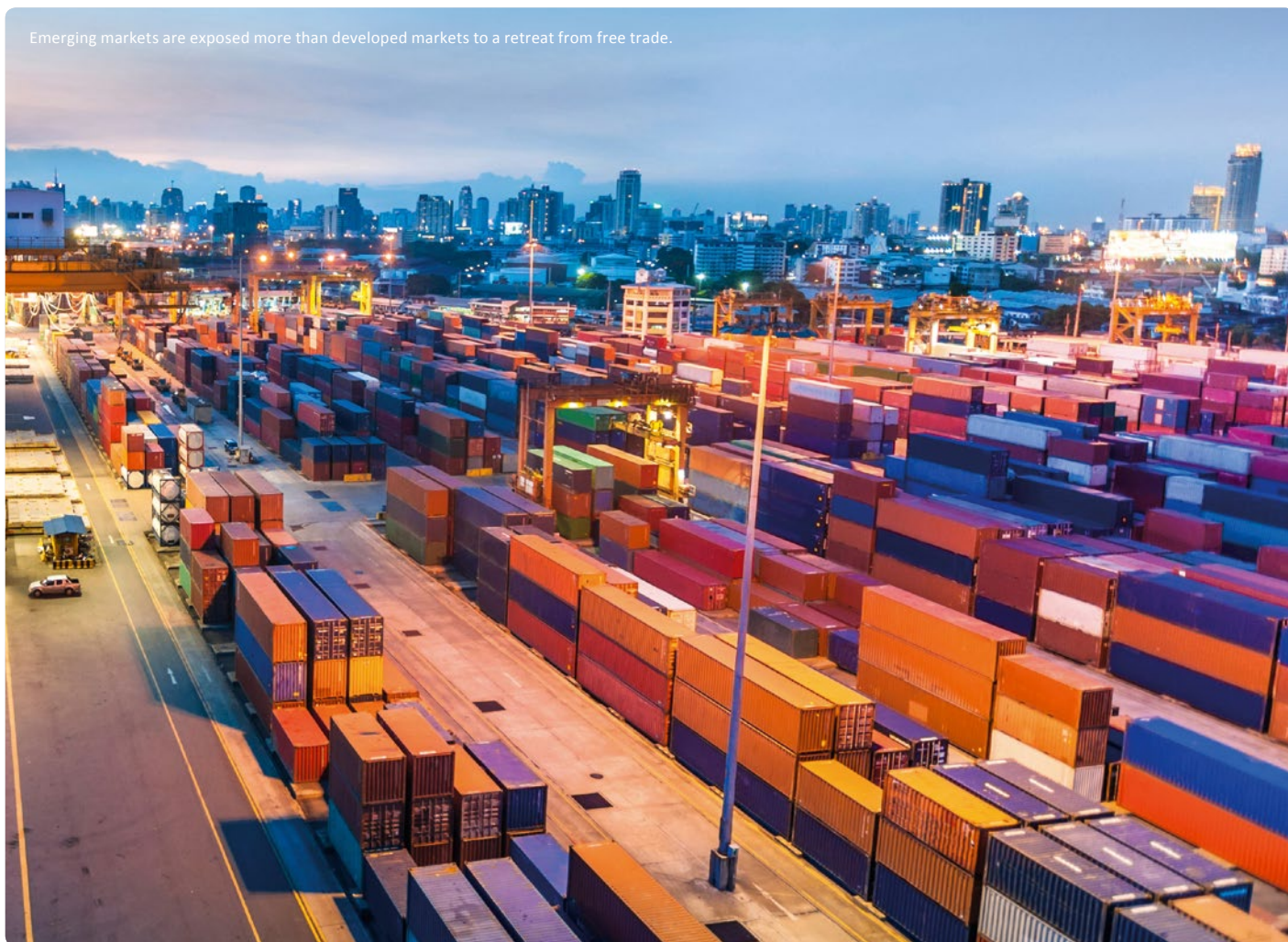


Figure 3: Global trade growth has been weak for years

Source: CPB (November 2016)

Even if protectionism remains limited, there is still a risk that a more reflationary outlook for DM space (higher real growth and inflation) and the concomitant increase in DM government bond yields will reduce capital flows towards emerging markets. Actually, we already see a depreciation of EM currencies and a rise in EM risk premiums which, if persistent, could worsen private sector balance sheets in emerging markets. Meanwhile, given the state of inflation expectations, EM central banks will be constrained in their ability to further cut interest rates. Still, the degree to which EM trade will be affected remains unclear. Yet, financial markets are likely to price the uncertainty and increasing risks for EM trade. This will likely lead to a decline in capital flows to EM and result in a tightening of EM financial conditions. This is something to monitor very closely in the coming months.

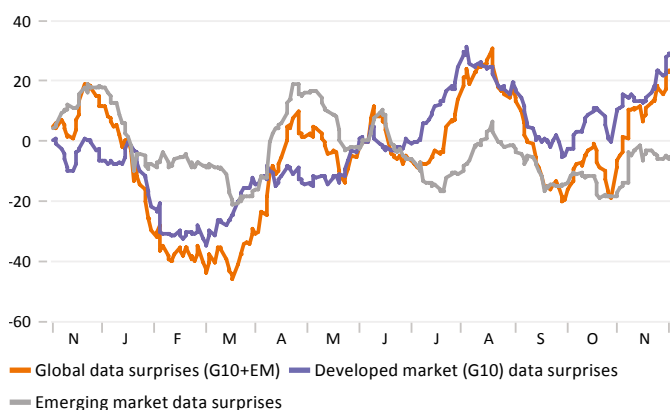
An important driver of financial conditions in EM space and global risk appetite is the behaviour of the Federal Reserve. We believe that the significant dovish shift made by the US central bank has been very crucial. Back in December 2015, the Fed itself expected four rate hikes in 2016, a number that has now been reduced to one. What's more, the projections for later years have been lowered as well. The main driver of this development is the fact that the Fed has increasingly taken "new school" thinking on board. This holds especially for the awareness of the high and variable sensitivity of the US dollar and global risk appetite with respect to Fed expectations. A too-strong appreciation of the US dollar, like we saw in the second half of 2014 and first quarter of 2015, would likely lead the Fed to adopt a more dovish policy stance.

Before the US elections, we were forecasting EM growth to continue its slow recovery in the coming quarters. We were expecting the simple average EM growth rate to move from 2.6% in the second quarter of 2016 to 3.2% in the fourth quarter of 2017. We now expect the growth rate to level off as of the first quarter of 2017. For our GDP-weighted growth forecast for 2017 this means that we have pencilled in a number of 4.4%, slightly below the 4.5% expected for 2016. We made no dramatic changes yet – for that we need to see more evidence of US reflation, higher US bond yields and concrete steps towards more trade barriers. At this stage however we no longer expect EM growth to move higher next year.

Market outlook

Political and policy uncertainty is an important factor for markets, but certainly not the only one. The recent experience with both the Brexit vote and the election of Donald Trump underscores how media attention for political dynamics can sometimes fool investors into believing that politics are all that matter. Despite both surprising outcomes, markets held up remarkably well and a crucial reason for this is that economic data were much more resilient than many had anticipated. As previous crisis periods have taught, political uncertainty does lasting damage to markets mainly when it coincides with economic weakness.

Moreover, markets react not so much to the state of the underlying economy, but to changes in the direction in which the economy is going. Recent data on the global economic cycle indicate an improving growth momentum. Figure 4 shows that economic surprise indicators are in an upward trend. We expect a pick-up in global nominal growth next year; in the G4 economies nominal GDP growth is expected to rise from 2.1% this year to 3.3% in 2017.

Figure 4: Economic surprise indicators moving upward

Source: Thomson Reuters Datastream, Citi, NN Investment Partners (as of 25 November 2016)

In the global bond and equity markets we have seen two main trends emerging since the summer: a rise in government bond yields in developed markets and the rotation from defensive and yield-sensitive sectors towards cyclical sectors. We believe the trigger for these trends lies in markets' anticipation of a more balanced economic policy approach: less monetary and more fiscal policy stimulus. We expect this reflation theme to persist in both equity and bond markets in the coming quarters. In fact, the expected large fiscal stimulus plan of Donald Trump has strengthened this case and could well encourage other countries to increase fiscal easing as well.



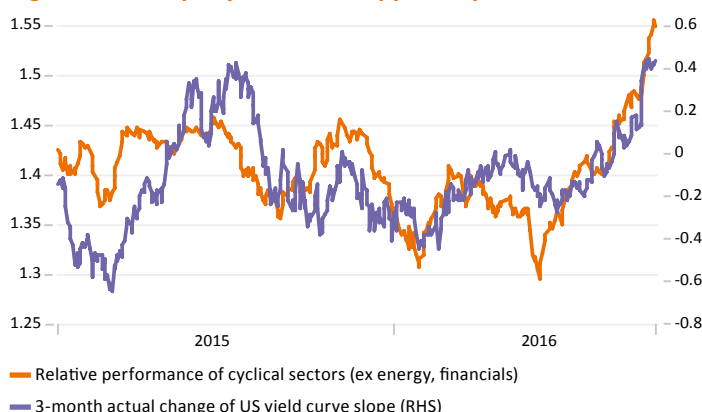
Equities

- Outperformance of cyclical sectors is likely to continue
- Stable or rising oil prices will support earnings growth recovery
- Financials and materials are our preferred sectors
- Japan is our favourite equity market

Cyclical rotation has further to run

We believe that the cyclical rotation that has been taking place since the summer will persist. This rotation is fuelled by an improvement in macroeconomic data, the anticipation of a more balanced policy approach, the increase in oil and industrial commodity prices and the turn in bond yields.

Figure 5: A steeper yield curve supports cyclical sectors



Source: Thomson Reuters Datastream, NN Investment Partners (as of 25 November 2016)

Next to these fundamental arguments, investor positioning will also play an important role in the rotation. The fierce search for yield among investors of the past years, induced by the persistent drop in bond yields, has led to massive inflows into equities with high earnings visibility and stable growing dividends, such as consumer staples and utilities. Traditional bond investors have also flocked into these sectors and now that yields in the bond markets are becoming more attractive, these “tourists” may start selling their equity holdings, resulting in large outflows. This reversal of the search for yield is already visible, with under-owned and undervalued sectors like financials and materials being on the positive side of the ledger. These two sectors are also our favourite sectors for 2017.

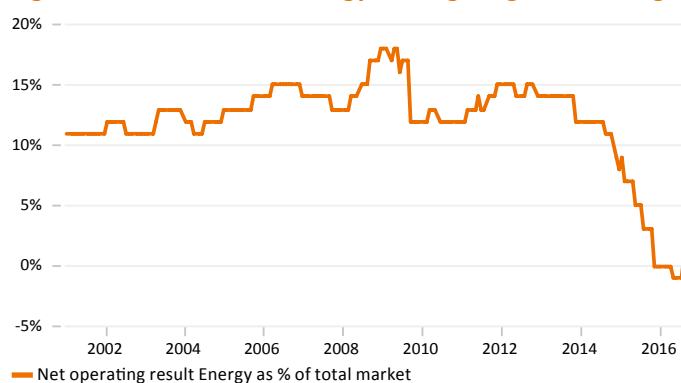
In line with the expected outperformance of cyclical sectors, we expect the value style to outperform the growth style. Value stocks are dominated by the financial and commodities sectors. The relative valuation of value versus growth is attractive. The discount based on price-to-book is 55% in the US and even 60% for the Eurozone. In both cases this is some 5-10% below the long-term average discounts.

Oil, bond yields and currencies will drive earnings growth

The reflation theme in equity markets will be supported by an improvement in earnings growth. In the US, earnings growth turned positive again in the third quarter, having been negative since the second quarter of 2015. In Europe the earnings season was also better than expected. We identify three key drivers of earnings growth for next year: the oil price, bond yields and currencies.

The impact of oil prices on corporate earnings should not be underestimated. The fall in the oil price in the second half of 2014 and again in the second half of 2015 and early 2016 acted as a significant drag on the earnings and capex of energy companies, a sector which historically has a large contribution to global earnings. From 15% in 2012, the earnings contribution has fallen to 0% in the third quarter of 2016. A stabilisation in the oil price around current levels, or at least above USD 40, will push global earnings growth higher thanks to the bigger contribution from the energy sector.

Figure 6: Contribution of energy earnings to global earnings



Source: Thomson Reuters Datastream, NN Investment Partners (as of 25 November 2016)

Plans for substantial fiscal stimulus, not only by Donald Trump but also by other policy makers, leading to higher budget deficits and rising inflation expectations, have added to the upward trend in global bond yields we have seen since the summer. Higher bond yields and steeper yield curves favour cyclical sectors and the financial sector in particular, while they negatively impact yield-sensitive sectors like real estate and utilities. This would further fuel the rotation into cyclicals.

Currency developments are an additional driver of earnings. A stronger US dollar enhances the earnings growth of non-US companies. On the one hand, they benefit from the translation effect: for a European company, earnings realised in the US are worth more when converted into euros. On the other hand, there is the transaction effect: due to the stronger dollar US companies become less competitive in the export market. Hence, during periods of dollar strength, the relative earnings momentum of non-US companies improves and European and Japanese equities outperform US equities. We note, however, that this particularly holds for developed markets; historically, EM equities are affected in periods of strong dollar appreciation as it causes capital flows to EM to slow down or even reverse.

Japan is our preferred equity market

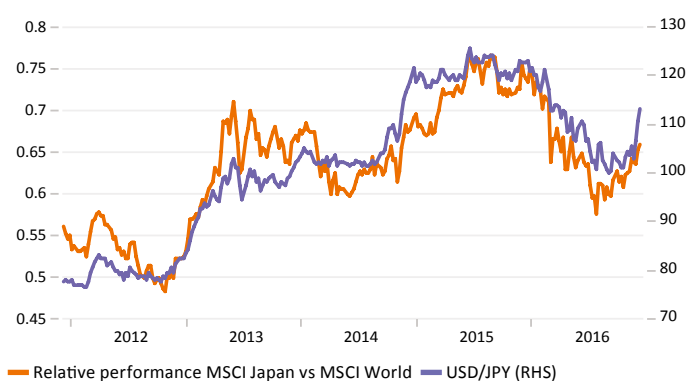
A strong US dollar is one of the reasons why, on balance, we prefer non-US to US equity markets, although much will depend on Donald Trump's economic policies which are potentially supportive of US companies. Moreover, the markets that are most sensitive to the reflation trade are Japan and the Eurozone. This is because of the importance of cyclical sectors – excluding IT – in their market index (60% for the Euro Stoxx and 65% for the Topix against 45% for the S&P 500).



The Japanese equity market stands to benefit most from the reflation trade.

Of these two markets we prefer Japan for two reasons. First of all, Japanese profitability is at comparable levels with the Eurozone, but Japanese equities are 20% cheaper based on the price-to-book ratio. Secondly, the Eurozone is facing a lot of political and institutional challenges, with a busy election schedule for the next 10 months likely to cause increased political uncertainty. The Eurozone is also not likely to escape from the impact of Brexit and the strong depreciation of the pound sterling.

Figure 7: Japanese yen and equity market are opposite forces



Source: Thomson Reuters Datastream, NN Investment Partners (as of 25 November 2016)

Exchange rates play a big role in the Japanese equity market. Figure 7 shows that the yen is inversely correlated with the Japanese stock market. This is partly because the yen is seen as a safe haven currency in times of market stress (leading to a stronger yen), and partly because the Japanese market consists of many exporters

(which profit from a weaker yen). Due to the normalisation of the Fed's monetary policy and the rise in US bond yields and ongoing easing by the Bank of Japan, the USD/JPY exchange rate has bottomed around 100 in the summer and has since weakened to 110. A weaker yen removes a serious headwind that has substantially affected Japanese corporate earnings in 2016.

Emerging markets at risk

While a stronger dollar is usually supportive of Japanese equities, it has often been a negative factor for EM equities. The global search for yield has benefitted EM equities in 2016, but since markets started to discount a Fed rate hike in December we have seen a strengthening of the US dollar and a rise in US bond yields. This trend clearly intensified after the US elections. Higher US yields may attract capital away from EM equities back to the US and since the US elections this is also visible in the flow data. Especially as EM equities have grown in popularity with investors again this year and have become a consensus overweight position, the risk of a reverse in flows is real. The risk of a protectionist US policy agenda has also made investors cautious regarding emerging markets.

On a positive note, EM growth momentum has clearly improved. EM central banks have been able to cut interest rates to stimulate growth. The increase in commodity prices is also supportive. Earnings momentum has strengthened as well while valuations are still attractive. This has made emerging markets more resilient to growing headwinds provided that US bond yields and the dollar do not strengthen much further from current levels.

We have had an overweight position for most of the year and were able to benefit from the outperformance of EM equities relative to DM equities. After the US elections we decided to take profits and cut down on our exposure. We moved EM equities to a small underweight position. Within emerging markets we have a preference for countries that do not rely too much on exports and where structural change and better policy execution are producing higher growth. We like India, Indonesia, Argentina and Vietnam, while we underweight Turkey, Brazil, Malaysia, South Africa, Russia, Egypt, and China.

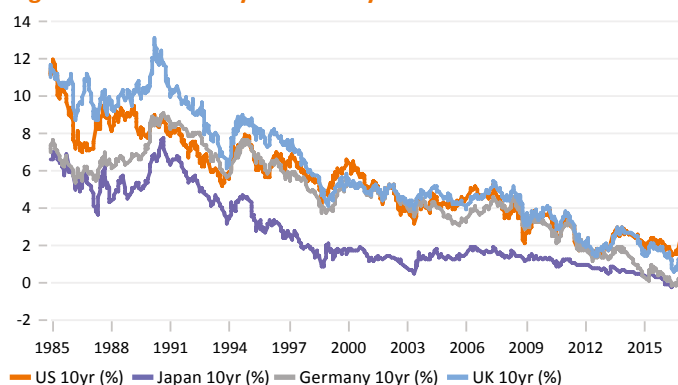
Fixed Income

- Fiscal stimulus may further support bond yields
- Core Eurozone bond yields likely to remain relatively low
- Political developments key driver of peripheral bond yields
- High Yield is our preferred spread product

Upward pressure on government bond yields

In 2016, we might have finally seen the bottom in government bond yields. Many have done this prediction in the past years and were proved wrong, so we should still be a bit cautious, but the signs have become stronger.

Figure 8: Have bond yields finally bottomed?



Source: Thomson Reuters Datastream, NN Investment Partners (as of 25 November 2016)

Government bond yields in developed markets bottomed this summer and have since then embarked on a moderate uptrend. The trigger for this turnaround may have been the anticipation of a more balanced policy approach, in which monetary policy is joined by fiscal policy in order to stimulate growth and inflation. Unconventional monetary policy measures of the past years have led to ultra-low and even negative bond yields, to such an extent that negative side effects – e.g. on the profitability of banks or the liabilities of pension schemes – were getting more and more uncomfortable. Doubts about the effectiveness of even more unconventional monetary policy stimulus therefore increased. More fiscal stimulus should therefore be applied, as this would lead to higher budget deficits on the one hand but also to higher inflation and growth expectations on the other. Signs of this change in mind set amongst policy makers have become increasingly visible this year. The unexpected Brexit vote in June triggered suggestions of fiscal stimulus by UK government officials, and the Japanese government has announced a huge fiscal package. In the Eurozone more lenience was visible regarding peripheral countries' budget deficits. In the US

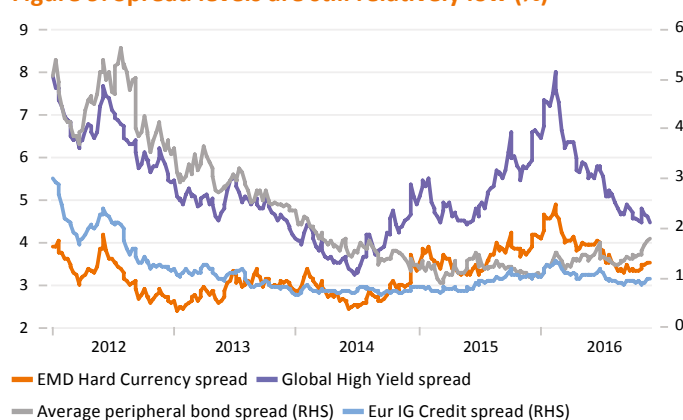
both presidential candidates advocated fiscal stimulus, although Donald Trump vowed that he would "at least double" the amount that Hillary Clinton would propose, coupled with plans to cut taxes. It was therefore not a big surprise that US bond yields shot up after Trump was elected as the next US president. In the Treasuries' wake, German and UK bond yields followed while the Japanese yield remained around 0%, in line with the Bank of Japan's yield targeting programme.

While we have reduced our underweight in government bonds somewhat after the strong post-US election rise in yields, we still think yields could rise further. A further improvement in macro-economic data, higher growth and inflation expectations and a further normalisation of monetary policy by the Federal Reserve would add to the upward pressure on bond yields.

Although German and US government bonds are positively correlated, we expect government bond yields in the (core) Eurozone countries to remain relatively low. The ECB is expected to continue its QE programme through 2017, while persistent political and policy uncertainty fuels the demand for high-rated government bonds. Besides, these bonds are relatively scarce. In Japan, the yield-targeting policy of the Bank of Japan implies that the 10-year Japanese bond yield will remain around 0%.

We remain cautious with regard to government bonds of peripheral Eurozone countries. Spreads have been rising in the past few months mainly because of heightened political risk. The UK vote for Brexit was another sign of dissatisfaction amongst voters with the European project. On 4 December, the referendum on constitutional changes in Italy will take place and, while it will not be a vote pro or against the EU, it certainly will be a good barometer for the sentiment amongst the Italian electorate, especially as Prime Minister Renzi has said he would resign if his reform package is rejected. This could clear the way for a victory of the euro-sceptic 5 Star movement if new elections would be held. This party has said it would hold a referendum on whether Italy should abandon the euro. And with elections in the Netherlands, France and Germany coming up, political uncertainty is expected to remain high. Hence, we shy away from peripheral government bonds.

Figure 9: Spread levels are still relatively low (%)



Source: Thomson Reuters Datastream, NN Investment Partners (as of 25 November 2016)

Markets will stay focused on political and policy developments in the Eurozone.



High yield is our favourite spread market

The combination of rising government bond yields and some spread widening resulted in somewhat higher credit yields overall in the past weeks. This in itself could lead to a reactivation of the search for yield as specific yield-targeting investors may get triggered. We have a clear preference for HY over IG credits and increased the overweight in US HY after the elections. We expect support for HY from the improving macro and earnings data. The expected fiscal policy push in the US would feed the cyclical recovery and reflation trade, supporting cyclical commodity segments like energy and metals. These factors are also in favour of HY. Finally, the (corporate and government) bond purchasing programmes in the Eurozone, UK and Japan seem to have squeezed most juice out of IG and government bonds, which may fuel the “trickling down” into HY.

The sharp rise in US bond yields has had a negative impact on EM capital flows, currencies and interest rates. Several currencies depreciated while local bond yields rose. As the global search for yield has softened, the strong capital flows into EMD of 2016 have been reversed to some extent. In this environment, EM central banks will not be able to reduce interest rates anymore. We note that the election of Donald Trump was not the trigger of tighter EM financial conditions. This tightening started in October, when US

bond yields were already rising and EM inflation had started to rise somewhat, driven by higher food prices. Our EM monetary policy stance indicator turned negative in October, after being in positive territory since March. We have cut our EM exposure by moving both hard currency and local currency bonds to a small underweight. EM currencies were reduced to a medium underweight.

Real estate

Higher bond yields are currently the dominant theme

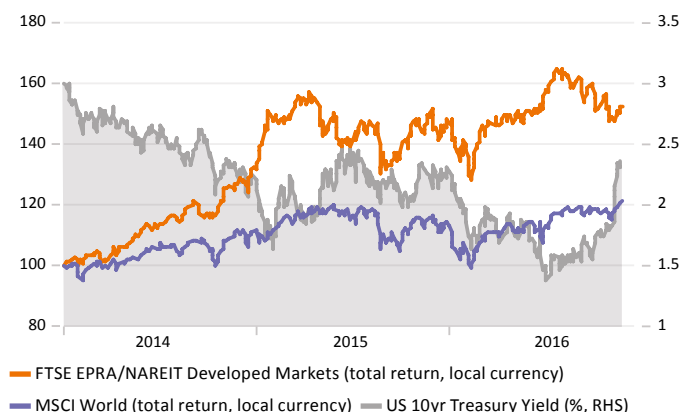
Real estate has suffered from the rise in US Treasury yields in recent months. In addition, the rise in bond yields coincided with a market shift away from yield-providing sectors like real estate towards cyclical sectors. A sector like real estate has enjoyed massive inflows in the past years thanks to the global search for yield, and the possibility of a fund flow reversal is a risk for real estate equities.

We do however believe that investors are overlooking the cyclical component of the real estate sector. The two main cyclical drivers are the labour market and the trend in retail sales. Both are positive. A stronger labour market should boost demand for office space. It will also support the housing market, as affordability improves thanks to higher income (although mortgage rates are under upward

pressure). Household formation, which has been below average for years, is likely to improve and increase demand for housing. Rising incomes also translate into increasing consumer confidence and higher retail sales. This is supportive for retail real estate, notwithstanding the growing importance of internet sales. Next to prime locations, there will also be a growing need for logistics and warehousing real estate.

However, in the current situation of strong moves in bond yields we see that the yield factor clearly dominates. We therefore keep a neutral stance on real estate for now.

Figure 10: Real estate is sensitive to US Treasury yield



Source: Thomson Reuters Datastream, NN Investment Partners (as of 25 November 2016)

Commodities

Moderately positive

The oil price has dominated the commodity complex in the past months. Prices have been quite volatile and roughly moving in the USD 40-50 range, mainly depending on the probability of an agreement between oil-producing countries on a production freeze. The Organization of the Petroleum Exporting Countries (OPEC) reached a preliminary agreement in September to cap oil output. The details are meant to be finalised when OPEC ministers meet in Vienna on November 30. At the time of writing these details were not clear yet, as it will also be unclear if a deal could be properly enforced. Yet, the overall message is that the oil producers seem to have found common ground to stabilize the market and move away from their market share strategy. This will likely decrease downside oil price risks.

Overall, an expected improvement in economic growth is supportive for the more cyclical commodity segments such as oil and industrial metals. The latter should also get support from the massive infrastructure investment plans of president Trump. Positive data on Chinese housing also offer support for industrial metals. The possibility of protectionist measures of a Trump administration, hurting global trade and thus China and other emerging markets, is a risk though. In that case, gold could gain interest from investors looking for safe haven investments as a result of increased global trade and/or geopolitical risks. All in all, we have a moderately positive view on commodities.

Investment approach

Preference for equities, cautious on government bonds

While we live in uncertain times, it does not mean that opportunities are absent. Risk premiums are still decent, while investors keep holding on to a cautious positioning and relatively high cash levels. These factors can act as a cushion against the impact of unexpected events, as we saw after the Trump election. The political uncertainty will likely lead to occasional bouts of volatility again in 2017, which means that a flexible investment approach is necessary.

We believe in a continuation of the reflation trade, as we expect a pick-up in global nominal growth next year, while inflation expectations are rising. We also expect modest but accelerating earnings growth, driven by a higher oil price, higher bond yields and currency developments. This means that in our tactical asset allocation we have a preference for equities and remain cautious on government bonds. Within equities we clearly prefer the cyclical sectors, with financials and materials as our preferred sectors. Region-wise, we believe Japan is in the best position to benefit from the reflation trade as it has a relatively high exposure to cyclical sectors. We also expect the weakening of the yen versus the dollar will support earnings.

Within fixed income spread products we have a preference for HY credits. They will benefit most from an improvement in macro and earnings data. An improvement in cyclical commodity segments such as oil and industrial metals should provide further support and is also the reason for our moderately positive view on commodities as an asset class. We are neutral on real estate, which suffers from the rise in bond yields while the cyclical support (from a strong labour market and consumption) is being overlooked.

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