Outlook 2021

“Back” to a new future

January 2021

NN investment partners

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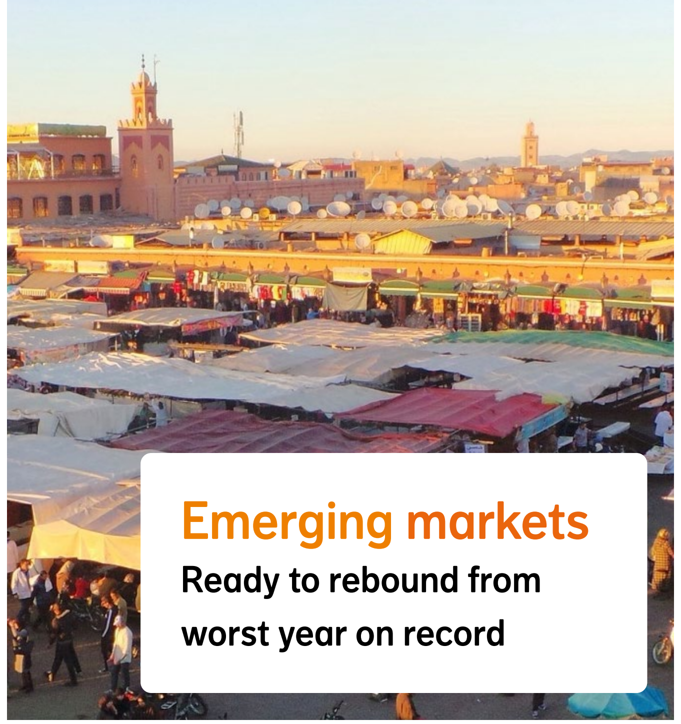
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Outlook 2021: Overview

	Underweight			Overweight	
	Large	Moderate	Neutral	Moderate	Large
Asset Allocation					
Global Equity				■	
Euro Fixed Income				■	
Real Estate		■			
Commodities				■	
Regional Equity Views					
United States			■		
Eurozone			■		
United Kingdom			■		
Japan			■		
Emerging Markets			■		
Fixed Income Rates					
United States		■			
Eurozone		■			
United Kingdom		■			
Emerging Markets Local Bonds				■	
Fixed Income Spreads					
Investment Grade US				■	
Investment Grade Eurozone				■	
High Yield US					■
High Yield Eurozone					■
Emerging Markets Hard Currency				■	
Commodities					
Gold			■		
Oil				■	
Copper				■	
Corn			■		

■ = current active views

“Back” to a new future: An overview

Conditions changed irrevocably in 2020. Governments and businesses piled up debt, interest rates fell and central banks became more lenient regarding inflation. A new US president may end a populist chapter in the nation’s history. The global economy, political landscape and markets will “return” to a different future.

Our outlook presents three potential scenarios for 2021. First is our base case, which we call “cruise control”, followed by two alternative scenarios: “full throttle”, which describes a supercharged global recovery, and “idling engine”, in which the lingering Covid-19 pandemic causes lasting damage to the economy. We discuss the underlying unknowns and outcomes.

Global economy: Moving toward the light at the end of the tunnel

The year 2021 will be split into two parts. The economic combat against Covid-19 will dominate the first part; then it will be time to decide on the best new ideas for the post-corona world.

In our “cruise control” scenario, we expect a sharp recovery in global growth in 2021. This is in line with the consensus forecast that the global economy will have contracted by 3.8% in 2020 and will bounce back in 2021 with growth of 5.2%.

Fixed income: More than just the business cycle

Bond markets might experience a more pronounced and upward trend in break-even inflation this year. Net bond supply in the biggest Eurozone countries, adjusted for ECB purchases, will be clearly negative; US borrowing requirements will depend on the degree of fiscal stimulus.

In credits, the most attractive opportunities for 2021 are in issuers whose spreads widened significantly in 2020, yet have sufficient liquidity to fund operations. Alternative credit could offer investors an additional path to enhance returns and to strengthen their ESG commitment.

Equities: “V” is for vaccine ... and V-shaped recovery

Vaccine roll-out and economic policy will be the major equity drivers in 2021. We expect positive equity returns; our preferences depend on which scenario plays out. Central bank policy guidance bodes well for expected returns, and double-digit returns are a real possibility.

In our “cruise control” and “full throttle” cases, prospects look best for non-US markets and for cyclical sectors. The “idling engine” case may imply a partial return to the 2020 relative sector and regional performances.

Emerging markets: Ready to rebound from worst year on record

For 2021, we expect the rebound in emerging economies that began in the third quarter to continue, taking average growth to 7%. Growth will differ between individual countries, depending on their economic structure and on the effectiveness of their vaccination programmes.

The outlook should be favourable for EM equities in 2021. As global trade and commodity prices rise, EM equities even have a good chance of outperforming developed markets. EM debt investors should look for opportunities on a country level, and can also exploit differences between the various sub-asset classes in EMD space.

Commodities: Increased cyclical exposure will be key

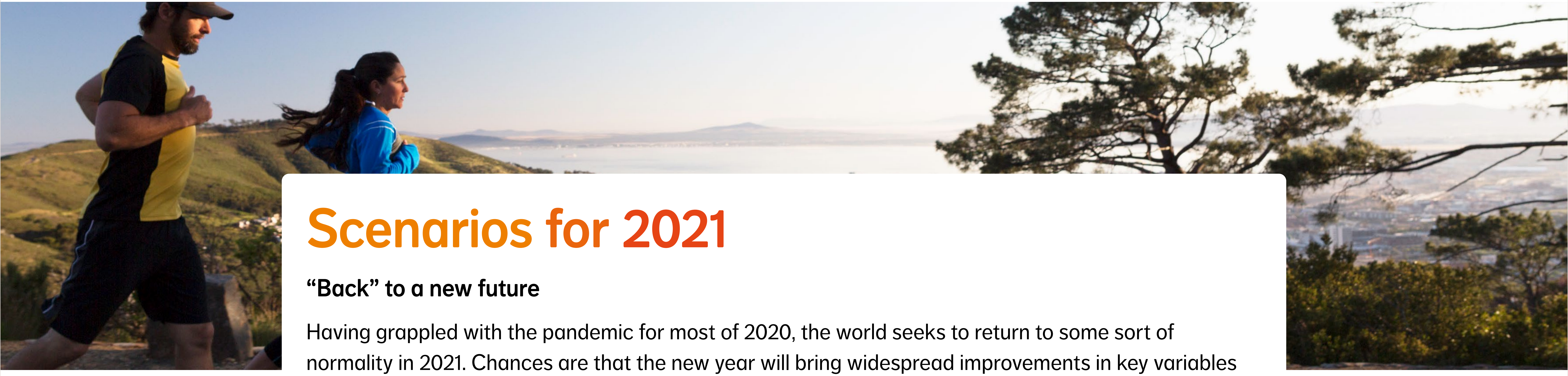
We are constructive on commodities in 2021. Demand is likely to recover in 2021, mainly in the second half of the year.

Expansionary fiscal policies will underpin this recovery; at the same time, the “green” tilt of such policies will limit supply by damping oil capex and curtailing activities such as fracking and aluminium production.

Responsible investing: a default option

Environmental, social and governance (ESG) factors will play a more well-defined role in asset allocation decisions this year. Leading ESG investors will begin to differentiate themselves by using proprietary ESG analysis to achieve better client outcomes.

Europe will lead the world this year in sustainable finance; spill-over effects will be felt across the developed world. Fixed income will start catching up with equities as green bond issuance picks up.



Scenarios for 2021

"Back" to a new future

Having grappled with the pandemic for most of 2020, the world seeks to return to some sort of normality in 2021. Chances are that the new year will bring widespread improvements in key variables like GDP, earnings and employment. Equity markets have already discounted a decent recovery.

Conditions changed irrevocably in the past year. Government and corporate debt has piled up, interest rates have fallen and leading central banks have become more lenient regarding inflation. A new US president may end a populist chapter in the nation's history. The global economy, political landscape and financial markets will "return" to a different future.

This outlook discusses three potential scenarios that investors might face in 2021. First is our base scenario, which we call "cruise control", followed by two alternative scenarios: "full throttle" and "idling engine". We discuss the underlying unknowns and the range of outcomes.

NN IP's unknowns for 2021

The top three unknowns for 2021 are the **speed of the vaccine roll-out**, the **amount of fiscal stimulus** and the **speed of the economic recovery**. We will discuss them in turn.

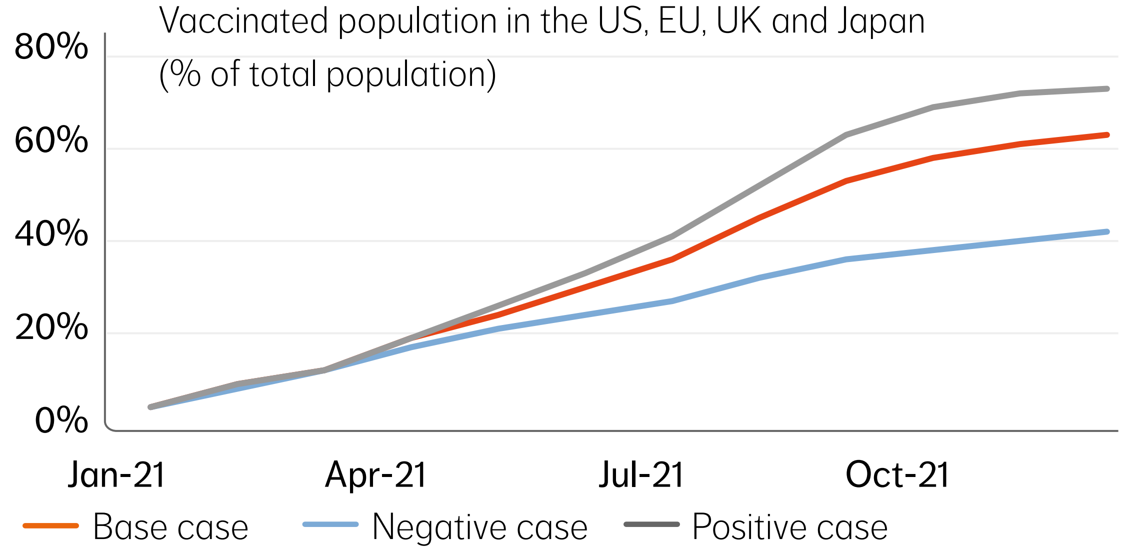
Fast approval of the leading vaccines and the early ramp-up of production were important preconditions for a successful vaccine roll-out in 2021. Despite the progress made on both fronts, the fast global roll-out remains a logistical challenge. We assume that the roll-out will be gradual and that most of the population is willing to get vaccinated. We also assume that the odds of a major mutation of the virus – one that renders the vaccine less effective or the disease more deadly – is moderate. Such a mutation could presumably be dealt with within six to nine months by adjusting existing mRNA vaccine technology. Overall, we deem these assumptions to be conservative.

Figure 1 shows three possible trajectories for vaccine roll-outs in the US, the EU, the UK and Japan. The chart measures the percentage of the joint population that is vaccinated. All three outcomes assume a gradual pickup in the first quarter, based on approval initially limited to emergency use authorization; a sizeable acceleration in the second and third quarters; and a flattening of the curve in the fourth quarter. In none of the three cases will herd immunity be achieved in the first half of the year. In the base case, 63% of the population will be vaccinated by the end of the year. The positive and negative outcomes suggest respective penetration levels of 73% and 43%.

The second major unknown for 2021 is the amount of stimulus that fiscal policymakers will provide. The nature of the fiscal debate will most likely evolve throughout the year. Most developed economies will probably struggle with the virus and the impact of the lockdowns in the first quarter. Fiscal policies will be in survival mode and targeted at helping ailing businesses and families.

The discussion will change after a challenging coronavirus winter, once lockdowns are lifted and companies get back to business. The debate will then centre on the next questions: whether active businesses need support, and whether new progressive projects in areas like infrastructure, green energy and healthcare deserve funding. Pressure to provide funding during the "lockdown survival period" is clearly higher than in the subsequent phase. In the US, the Democrats now control the executive and legislative branches of the government; they will try to implement at least parts of their semi-progressive agenda in the coming years.

Figure 1: Vaccine roll-out is expected to be gradual

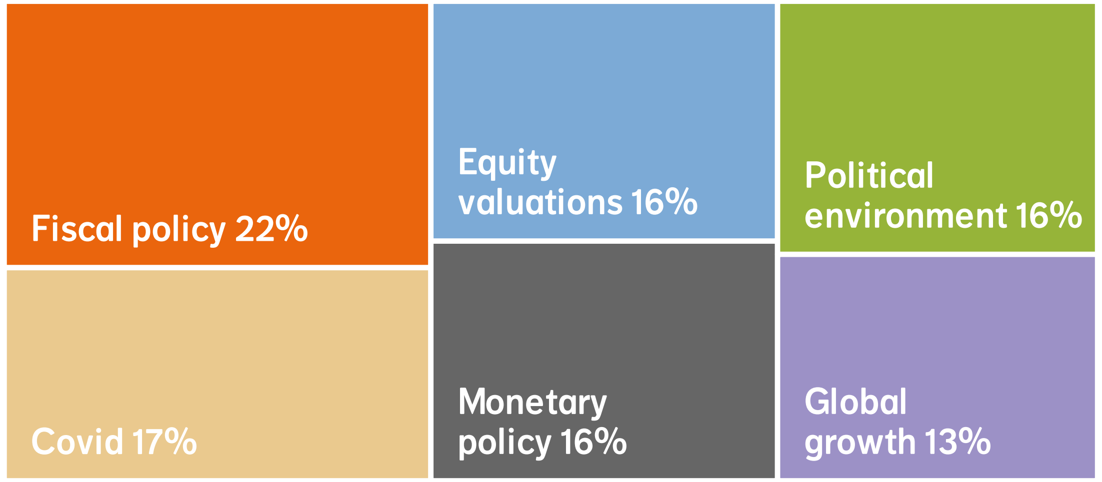


Source: NN Investment Partners

The Covid-19 crisis has put an end to the austerity mindset of the past decade, and there is limited chance that it will return in 2021. The global economy received a significant fiscal thrust of 5% in 2020; support will be clearly lower in the new year. The question of how much fiscal drag will result lies at the core of the second unknown.

The last unknown is the speed of global recovery. While it is clearly a function of the previous two unknowns, additional factors justify its role as a stand-alone uncertainty. It captures how much and how fast the sectors most affected by the pandemic will recover, and how much long-term damage will remain in terms of long-term unemployment and bankruptcies. Another question is whether China will widen its lead versus the advanced economies. The Asian giant has managed to contain the virus for months; its economic recovery is a crucial support for global demand.

Figure 2: Themes covered by market observers



Source: NN Investment Partners

What's on market observers' minds?

Given the discussion of the unknowns, it is instructive to understand which topics are commonly discussed in the markets. For that purpose, we collected some 80 annual outlooks by financial institutions, mainly from investment banks. We used a natural language processing algorithm to process more than a million words and cluster them into groups. Figure 2 shows some of the major themes. Not surprisingly, the three unknowns are among the top picks.

The algorithm does not evaluate the themes in terms of their impact and uncertainty. For example, it identifies monetary policy as a main topic, but we do not consider monetary policy an unknown. We are confident that monetary policy, by and large, will stay expansive this year and exhibit only limited uncertainty.

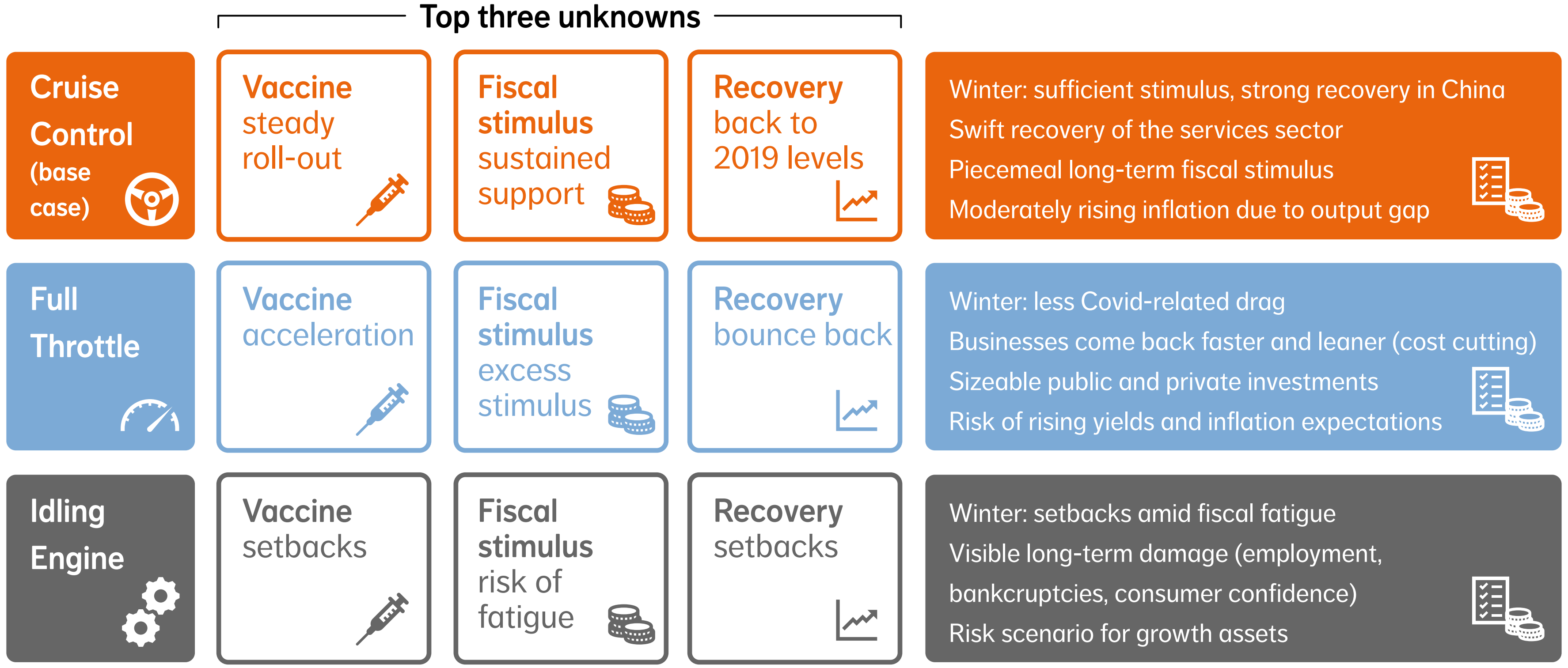
Our 2021 base scenario: cruise control

The "cruise control" scenario is our base case for 2021. It describes a world in which the vaccine roll-out proceeds steadily. During the first quarter, various lockdowns are implemented in the US and Europe, but fiscal packages and strong growth in China and other parts of Asia mitigate the impact.

The warmer weather of the spring season and an accelerated vaccination process in the second quarter lead to a general removal of lockdowns and a growth pickup in the developed world. Sectors like airlines and tourism, which were hit hardest by Covid-19, get back to business. Governments introduce investment programmes targeted at long-term themes, but the impulse turns out to be a piecemeal set of measures rather than a major coup.

However, the job market remains sluggish in 2021 and will take years to

Figure 3: Three scenarios for 2021



Source: NN Investment Partners

return to full employment. Due to this slack and the large output gap, inflation reaches 2% in the US only towards the end of the year, while European inflation ends the year closer to 1%.

Overall, the cruise control scenario describes a market environment in which governments and central banks do enough to put the global economy on a recovery path and ailing businesses manage the turnaround from a short but deep recession.

Supercharged recovery scenario: full throttle

In the “full throttle” scenario, the global recovery gets supercharged. Various surprises contribute to strong growth. First, the political discussions about the coronavirus aid packages and infrastructure investments take a positive turn and leave the global economy with excess stimulus and strong fiscal multipliers in 2021.

In addition, the lifting of lockdowns brings businesses back faster than expected. The 2020 recession was unique in terms of its speed, its depth and the fact that it was a deliberate human act to shut down the economy to save lives. Unlike the global financial crisis, it did not create a need to fix an imbalanced economy and to clean up balance sheets. As a result, the economy snaps back fast from the recession in this scenario, and businesses emerge from this cycle in leaner shape.

The fast recovery comes at a price, however. Especially in the US, inflation rises faster than in the base case, although it will not significantly overshoot the Fed’s 2% target. The main collateral damage is the rise in inflation expectations and government yields. Rising yields would trigger a general debate about when the Fed could start tapering its QE programmes; monetary policy, however, is unlikely to change.

Lingering crisis scenario: idling engine

In the “idling engine” scenario, the winter is long and hard, and the pandemic causes long-term damage that holds the economy back. The high hopes about the fast vaccine roll-out and corporate healing do not materialize. Policymakers’ response to this crisis is marked by fiscal fatigue; their support is too little and too late. As the crisis lingers on, households and businesses get more cautious, resulting in growing numbers of layoffs and bankruptcies. The recovery loses pace in the advanced countries and China shifts even faster to economic autonomy, while ailing emerging countries with limited fiscal headroom create another bout of uncertainty.

Central bankers attempt to revive the economy with bigger and bigger monetary packages, but they fail to address the lack of demand. Inflation falls moderately, in line with government yields. Overall, the idling engine scenario will be resolved only a year later, when the large-scale vaccine roll-out finally gets traction and policymakers increasingly focus on the much-needed fiscal stimulus.

Market outlook

In 2020, central banks and policymakers intervened forcefully to combat the economic impact of the pandemic. Consequently, a large share of the global equity and bond markets ended the year with a strong performance.

We believe that the vaccine roll-out, fiscal stimulus and the wider economic recovery are the main market drivers in 2021. It will be another volatile year, but in the base-case “cruise control” scenario, it should be one in which the equity, spreads and commodities markets have scope to advance further.

Corporate earnings are set to benefit from a pickup in demand, especially in the second half of the year; stock markets’ gains early in the year imply that investors anticipate these fundamental improvements. The reflation trade also impacts the commodity markets, for example in the oil and metals sectors, where after years of underinvestment, rising demand meets limited supply.

The outlook for the rates market is muted. Low policy rates and lack of inflation kept government yields low in 2020. While monetary policy remains unchanged for the time being, yields are set to rise on the back of the inflation recovery, more so in the US than in Europe. We are positive on spreads in the credit and emerging market space, as asset purchasing programmes and the search for yield continue.

Without a doubt, the pandemic-driven policies also created long-term challenges like inflation and default risk, which will surface in the coming years and transform the global economy, markets and the political system. Investors will have to adapt to weather the challenges in 2021 and beyond.

Marco Willner
Head of Investment Strategy

Global economy

Moving toward the light at the end of the tunnel

The Covid-19 pandemic elicited an abrupt and sharp reversal of global growth trends, fiscal policies and central bank strategies in 2020. In 2021, as vaccines are distributed and administered, economic life will normalize. Some of the extraordinary policies implemented in response to the pandemic will be reversed; others will remain in place.

The year 2021 will be split into two parts. The economic combat against Covid-19 will dominate the first part. Then it will be time to assess the consequences of the extraordinary policies and to decide what the best new ideas are for the post-corona world.

Global economy snaps back

In our base-case "cruise control" scenario, we expect a sharp recovery in global growth in 2021. This is in line with the consensus forecast that the global economy will contract by 3.8% in 2020 and bounce back in 2021 with growth of 5.2%. These pronounced swings are in sharp contrast to the global financial crisis, when global GDP showed modest growth in 2008 and shrank by only 0.1% in 2009, according to the IMF.

Differentiation across regions and sectors

The prevailing regional differences in terms of economic growth and the pandemic dynamics have also set the stage for 2021. Europe was hit hard by two pandemic waves and is in a severe recession. Even though the US has been even more affected by the pandemic, the economic impact there is milder than in Europe. The US economy is expected to shrink by 3.5% in 2020, versus a 7.4% contraction in the euro region, and grow by 3.9% in 2021, compared with Eurozone growth of 4.6%.

One reason for the higher US economic growth trajectory is the strong fiscal support. Even before the most recent deal, US fiscal packages amounted to 10.7% of GDP, well ahead of leading European economies like France (9%), Italy (5%) and Spain (4.4%). At a global level, the fiscal stimulus accounted for about 5% of global GDP; economists expect that only about half of this 2020 fiscal boost will carry over to 2021. This scaling back is a logical step that goes hand in hand with the recovery; the assumption is that the recovery will compensate for the fiscal cliff.

The USD 900 billion economic relief aid approved by the US Congress in December has a limited shelf life. The special unemployment benefits have been extended only until mid-March, for example. A new package is likely to be negotiated in the first half of 2021. The Democrats' majority in the Senate after the Georgia elections should help President Joe Biden to implement some of his long-term initiatives in areas like infrastructure and healthcare.

The fiscal outlook for the European Union is more clear. Many member states' existing stimulus programmes run into 2021 and most governments are prepared to provide further stimulus if needed. In addition, the EUR 750 billion EU recovery fund, equal to some 5.4% of the EU's GDP, will be rolled out gradually over the coming years. However, the contribution to growth will be moderate because the implementation takes time and because some of the grants will go into existing projects.

China's journey through the pandemic has been one with a fast turnaround. In January, the city of Wuhan was placed under a strict lockdown that lasted 76 days. Thereafter, the combination of lockdowns, extensive testing, widespread wearing of masks, early use of contact tracing and the fast ramp-up of medical equipment production have helped the country to avoid any major outbreaks since April. The fiscal stimulus of about 5% of GDP was sufficient to revive the economy. China has been one of the positive contributors to global growth in 2020 and will contribute even more so in the new year. Economic growth is forecast at 2% in 2020 and 9.5% in 2021. The crisis enabled the biggest emerging market to leapfrog the advanced economies.

The new year will also bring a sector rotation. The global PMI for the services sector bottomed at 24 points in April, and the manufacturing sector reached its trough at around 40. The most recent readings for both sectors are in expansionary territory. In other words, there are high expectations that service sector businesses that rely on personal interaction will stage a comeback in 2021.

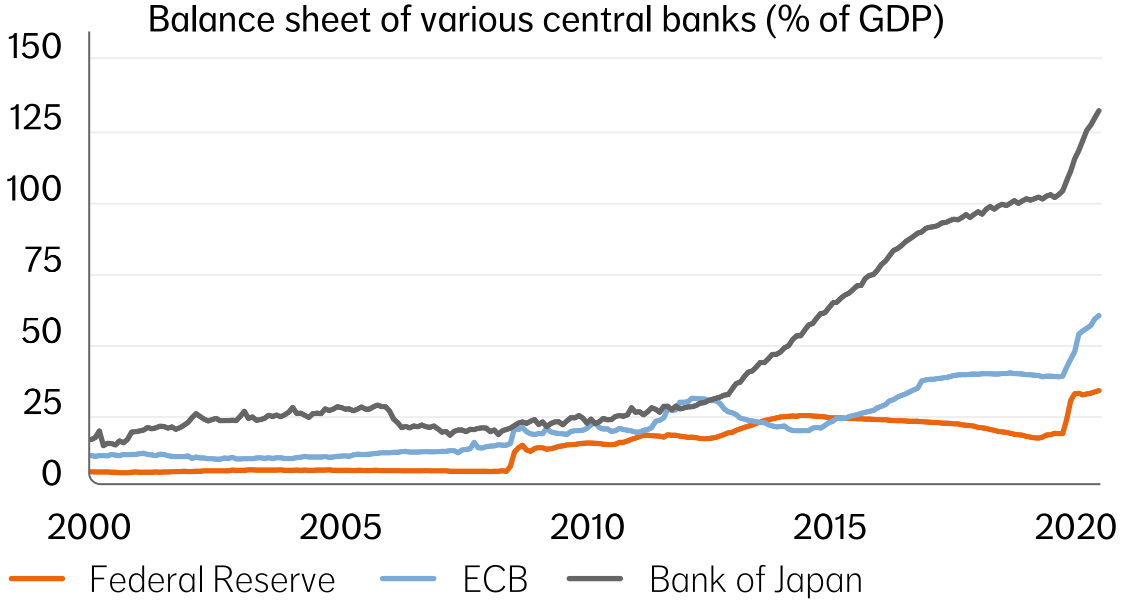
Overall, the economic recovery in the cruise control scenario is based on the assumption that a steady vaccine roll-out allows the services sector to recover and compensate for the fiscal cliff in the developed economies. In addition, Europe is set to outpace US growth due to the deeper recession, while China is poised to be the most important pillar of global growth.

Central banks will stay ultra-expansive for now

The year 2020 was a defining year for leading central banks in terms of the current policy and the strategic outlook. The new environment will also determine the path in 2021.

On the policy side, central banks intervened quickly and forcefully when market liquidity dried up in March. They lowered rates to combat the recession and accelerated their asset purchases to stabilize markets. The strength of the 2020 stimulus is reflected in the balance sheets of the three major central banks, as shown in Figure 1.

Figure 1: Central banks massively expand the stimulus

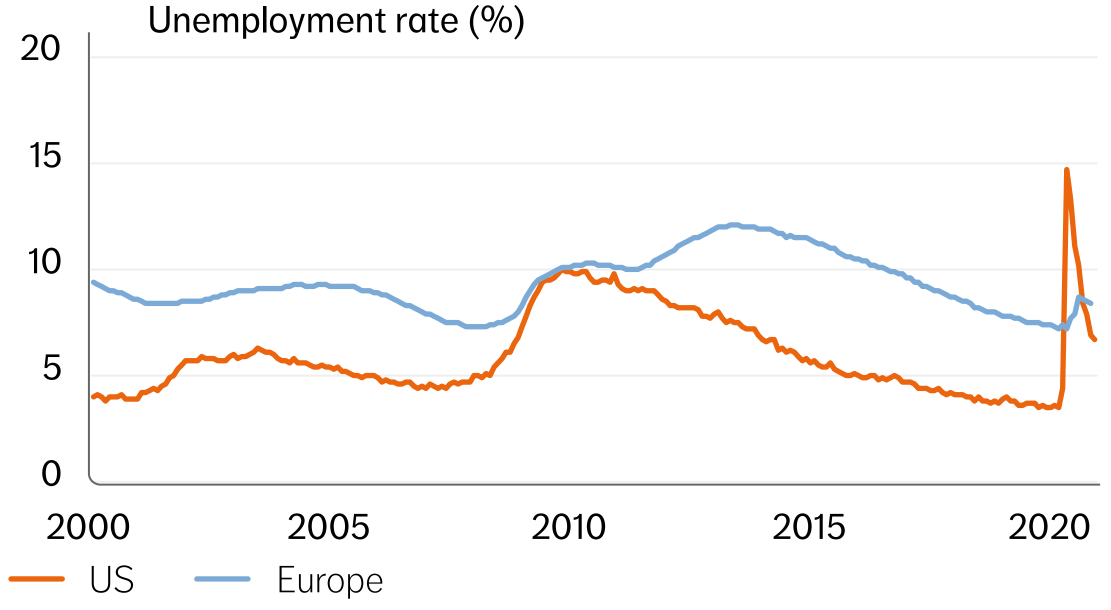


Source: Bloomberg, NN Investment Partners

Both the US Federal Reserve and the European Central Bank initiated strategic reviews. The former completed its review in August. The Federal Open Market Committee became somewhat more lenient towards inflation by adopting a discretionary approach to targeting average inflation. The ECB, meanwhile, is discussing its targets, tools and communication strategy. Early signs indicate that the bank may be more open to a temporary overshooting of the 2% inflation goal. The ECB is expected to complete its review in the second half of 2021.

The new strategy might play a role in the coming years, but current price levels are depressed in the midst of the second coronavirus wave. Inflation currently stands at merely 1.4% in the US and is much lower in the Eurozone at -0.3%. In 2021, inflation is likely to be muted, because the output gap and the slack in the economy will take much longer to normalize than the GDP trajectory suggests, despite the quick reversal of unemployment in the US. The US and Eurozone unemployment rates in Figure 2 show that it took years to normalize the uptick in joblessness left behind by the global financial crisis and the euro crisis.

Figure 2: Unemployment takes years to return to normal



Source: Bloomberg, NN Investment Partners

The scenarios describe the economic context

In the **cruise control** scenario, the coronavirus will play a dominant role in developed economies in the first quarter. Lockdowns will continue and policymakers will implement significant fiscal measures to alleviate some of the collateral damage in the economy. The strong recovery in China will provide additional support. Towards the second quarter, the vaccine roll-out will pick up and spark the services sector recovery in the advanced economies. As the need for emergency fiscal support wanes, discussions about long-term investments will gain pace. The results are likely to be piecemeal.

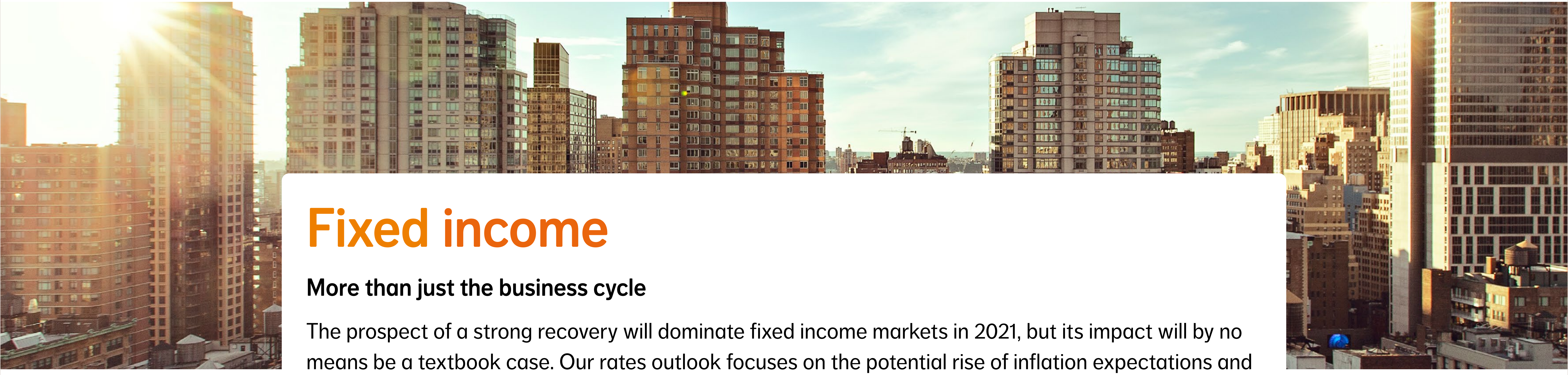
Inflation is set to normalize along with the economic recovery, although the economic slack will prevent an overshooting of targets. The leading central banks will not raise rates in 2021 but they might carefully start talking about tapering the QE programmes later in the year. This period might be vital for setting inflation expectations. Inflation numbers will, for the first time, approach levels where the new central bank strategy will actually play a role.

In the **full throttle** scenario, the recovery surprises on the upside. This might come from a faster vaccine roll-out, a first quarter with fewer economic challenges, strong pent-up demand and a better-than-expected outcome of the negotiations about the long-term fiscal plans. Actual inflation increases somewhat faster in this scenario, but it is the inflation expectations that might make the difference. In this environment, yields come under pressure.

In the **idling engine** scenario, the efforts concerning the vaccination and fiscal stimulus do not generate enough traction. The recovery slows down and creates additional problems in the form of unemployment, bankruptcies and non-performing loans. Inflation and yields of safe-haven assets edge even lower in this environment.

Beyond 2021

Decision makers in the governments and at central banks still have a clear mission in 2021 to save lives and the economy. This priority justifies extraordinary fiscal and monetary measures. The challenge will be to maintain positive momentum in the economy and markets once these extraordinary measures are scaled back. This discussion might start already this year but should gain importance in 2022. The world will emerge from the Covid-19 crisis with more debt, lower rates, new central bank strategies, common debt in the EU and a new US president in the White House. Investors should be prepared for new themes in 2021. These will define the post-Covid world.



Fixed income

More than just the business cycle

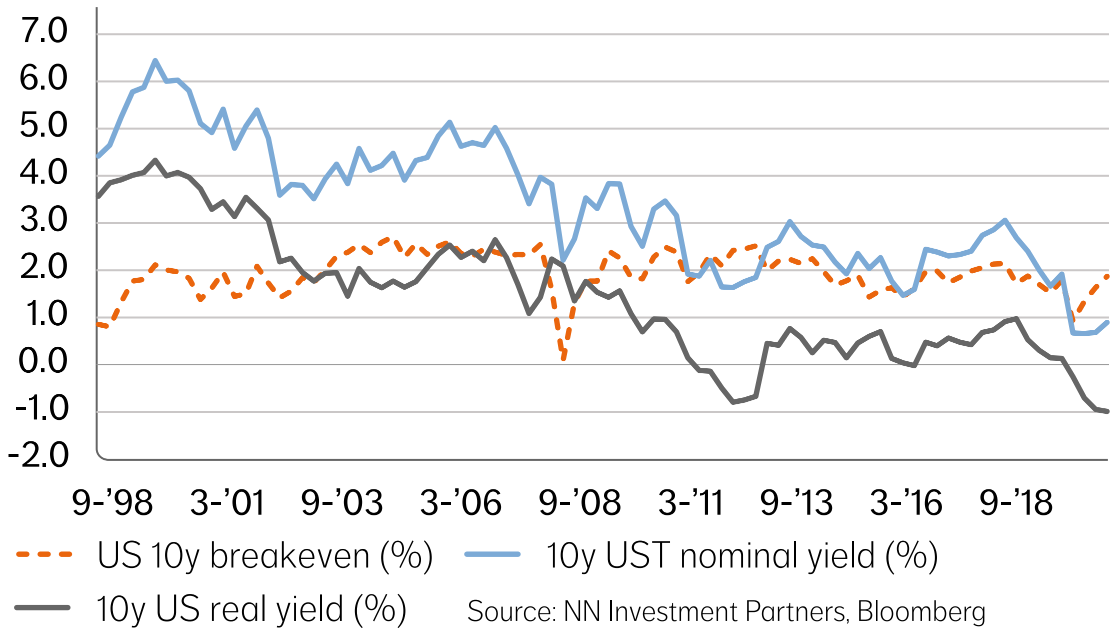
The prospect of a strong recovery will dominate fixed income markets in 2021, but its impact will by no means be a textbook case. Our rates outlook focuses on the potential rise of inflation expectations and the supply outlook for the US and the largest Eurozone economies.

The reflation question dominated global rates discussions in 2020 and created two opposing camps. Two key arguments in favour of higher inflation are deglobalization and policy response. For the past 30 years, globalization has been driving disinflation. The Covid-19 crisis has revealed the vulnerability of the international supply chains and "just in time" management that have evolved in that time. Globalization was already stalling during the past decade, and the pandemic might reverse the trend outright. Meanwhile, authorities in almost all countries have aggressively eased both fiscal and monetary policy.

This is all happening in an environment where central banks are already reviewing their policy strategies. The US Federal Reserve, for example, has adopted an average inflation target of 2%.

Bond markets might undergo a more pronounced and upward trend in break-even inflation. Upside for nominal yields is limited, as central banks strengthened their forward guidance, which will mean even more negative real yields. This is quite different from what we saw over the last two decades, when

Figure 1: US real yields are clearly in a downward long-term trend



Source: NN Investment Partners, Bloomberg

the drift lower in nominal yields was mainly explained by the drift in real yields as a result of secular stagnation factors. Break-even inflation showed some volatility but did not change much on balance.

A key risk to this view of even lower real yields would be a sudden anticipation of the end of quantitative easing, similar to the 2013 "taper tantrum". In the US, we expect the Federal Open Market Committee to expand its outcome-based guidance, linking the pace and horizon of asset purchases to economic conditions as it does with its rate guidance. With this in mind, we don't see a tapering of QE before the end of 2021. Supply and demand dynamics on the bond market could impact yields again, offsetting the upward push on yields as a result of central bank purchases.

Negative Eurozone bond supply, lower US supply expected

Tables 1 and 2 show the outlook for 2021 net bond supply in the six largest Eurozone countries and the United States. Except for Spain, the net supply in the Eurozone adjusted for ECB purchases will be clearly negative. Due to the flexibility of the ECB's Pandemic Emergency Purchase Progamme (PEPP), the weighted average maturity (WAM) of these asset purchases has been around 3-5 years for core countries such as Germany and the Netherlands. For countries such as France, Italy and Spain, however, the WAM has been around 7-9 years. Given the sizing up and extension of the PEPP, continued spread compression of semi-core and peripheral spreads is likely in 2021.

For the US, the borrowing requirements depend heavily on the degree of fiscal stimulus. We have adjusted our initial estimates by assuming a USD 900 billion fiscal stimulus package being passed before end-2020. We also assume an additional fiscal stimulus package of USD 3 trillion this year, which would be very likely if the Biden administration gets its way, though this may not happen. The actual amount will probably be smaller and the result of a compromise.

US Treasury supply will be significant at USD 2 trillion, but still lower than in 2020, and that is excluding the Fed's USD 80 billion monthly purchase of US Treasury bonds, Treasury bills, Treasury inflation-protected securities and floating-rate notes. We estimate net nominal US Treasury supply at about USD 500 billion, or 25% of the total net supply excluding Fed purchases. US Treasury yields on balance appear to have more upside potential than Bunds. We expect the differential between 10-year UST and Bund yields to continue widening gradually throughout 2021 by around 30 bps.

Table 1: Supply in most core countries will be negative after ECB purchases

(Amount x EUR bln)	Germany	France	Italy	Spain	Netherlands	Belgium	Total six largest economies
1. Gross Supply	419	260	459	299	50	36	1,523
2. Redemptions	262	128	342	189	17	14	951
3. Net Supply (1-2)	**157**	**132**	**117**	**110**	**34**	**23**	**572**
ECB Capital Key	21%	17%	14%	10%	5%	3%	69%
4. Net Asset Purchases APP	51	40	33	23	11	7	166
5. Net Asset Purchases PEPP	186	144	120	84	41	26	600
Net Adjusted Supply (3-4-5)	**-80**	**-52**	**-36**	**3**	**-19**	**-10**	**-195**

Source: NN Investment Partners, debt management offices, 2021 draft budgets

Table 2: US net borrowing requirement expected to decrease this year

(Amount x USD bln)	2016	2017	2018	2019	2020	Est. 2021
1. Budget Deficit	2,016	666	779	984	3,132	2,990
2. Bond Redemptions	1,741	1,778	1,832	2,061	2,117	3,888
3. Total Financing Need (1+2)	**2,326**	**2,444**	**2,611**	**3,045**	**5,249**	**6,879**
4. Change in Cash Balance	155	-194	225	-2	1,399	-988
5. Total Financing Sources (3+4)	**2,481**	**2,250**	**2,836**	**3,043**	**6,648**	**5,891**
Net Supply (5-2)	**740**	**472**	**1,004**	**982**	**4,531**	**2,003**

Source: NN Investment Partners, United States Department of the Treasury

US corporate credit still going strong

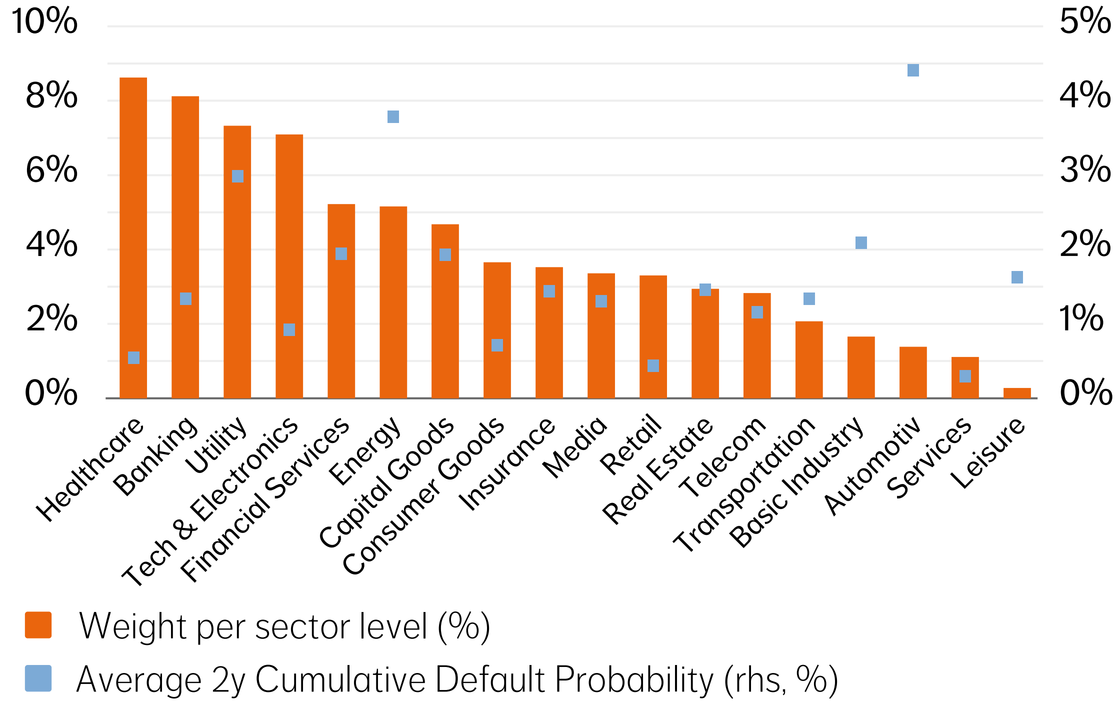
Investment grade corporates issued USD 1.8 trillion in new gross supply last year, 60% more than in 2019, and have plenty of liquidity on their balance sheets. US high yield corporate bond issuance in 2020 totalled USD 449.9 billion, surpassing 2013's record issuance of USD 398.5 billion, according to JP Morgan. While the primary focus of many corporates in 2020 was raising and preserving liquidity, we expect issuers to focus on balance sheet repair in 2021.

Higher-quality investment grade issuers in less-impacted sectors may be able to return to pre-corona profitability and credit metrics more quickly than some lower-quality companies in the more disrupted industries. Market volatility has created significant opportunities in affected industries. Sectors like leisure, automobiles, transportation and energy significantly lagged the overall investment grade and high yield index returns. We make a distinction between industries for which the impact of Covid-19 is temporary, as is the case among many cyclical issuers, and those for which the pandemic accelerated more structural declines, such as brick-and-mortar retail.

The most attractive opportunities for 2021 are in issuers whose spreads widened significantly in 2020, yet have sufficient liquidity to fund operations until the environment returns to more normal circumstances. These include leisure and transportation, such as cruise operators and certain energy subsectors. Within energy, we prefer the midstream and natural gas exploration industries over oil exploration, refining and services. Moody's forecasts that the global speculative-grade default rate for bonds and loans will peak at 7.7% by the end of March 2021, up 100 bps from November 2020, before falling to below 6% at the end of 2021.

Our overall investment strategy incorporates near-term risks in the selective addition of corporates that have strong liquidity positions, along with improving sector trends and companies' ability to profit from a more cyclical economic recovery. We expect investors to continue to search for yield in a low-interest-rate environment, so we see value both from a duration and from a rating standpoint.

Figure 2: US IG 2y cumulative default probabilities and index weights

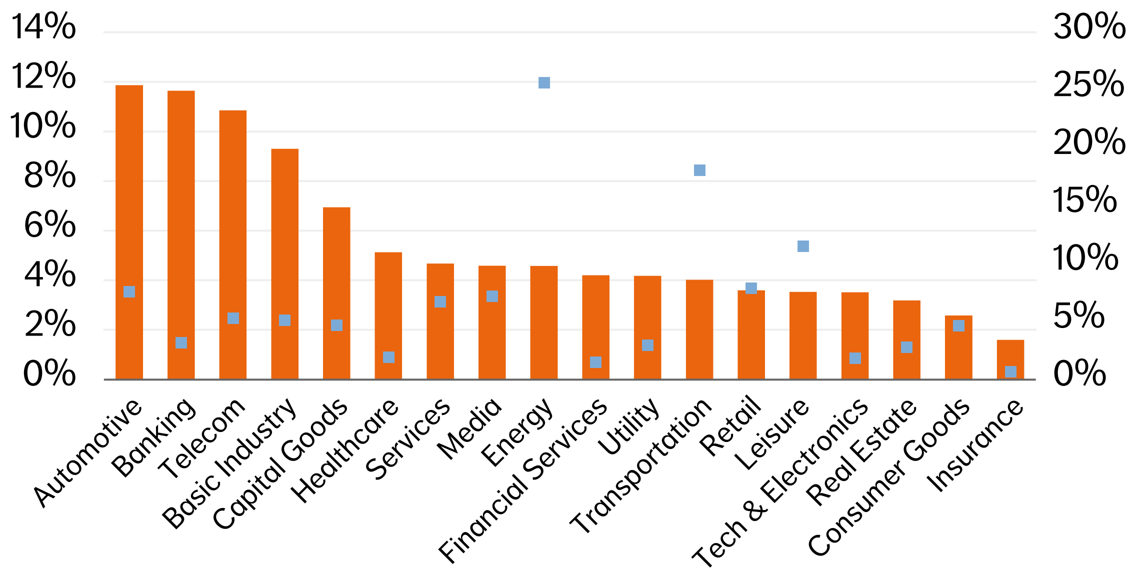


Source: NN Investment Partners, Bloomberg, ICE BofA corporate bond indices

ECB asset purchases and low yields will tighten spreads

Along with the search for yield, the ECB's continued asset purchases will limit any large-scale spread widening in European investment grade credit. We estimate that the ECB will direct approximately 3-4% of its PEPP asset purchases to investment grade credit. This year, some EUR 870 billion of the PEPP will probably find its way to financial markets. This would mean that almost EUR 30 billion in investment grade corporate bonds needs to be bought in 2021 and a total of around EUR 40 billion until March 2022.

Figure 3: EU HY 2y cumulative default probabilities and index weights



Source: NN Investment Partners, Bloomberg, ICE BofA corporate bond indices

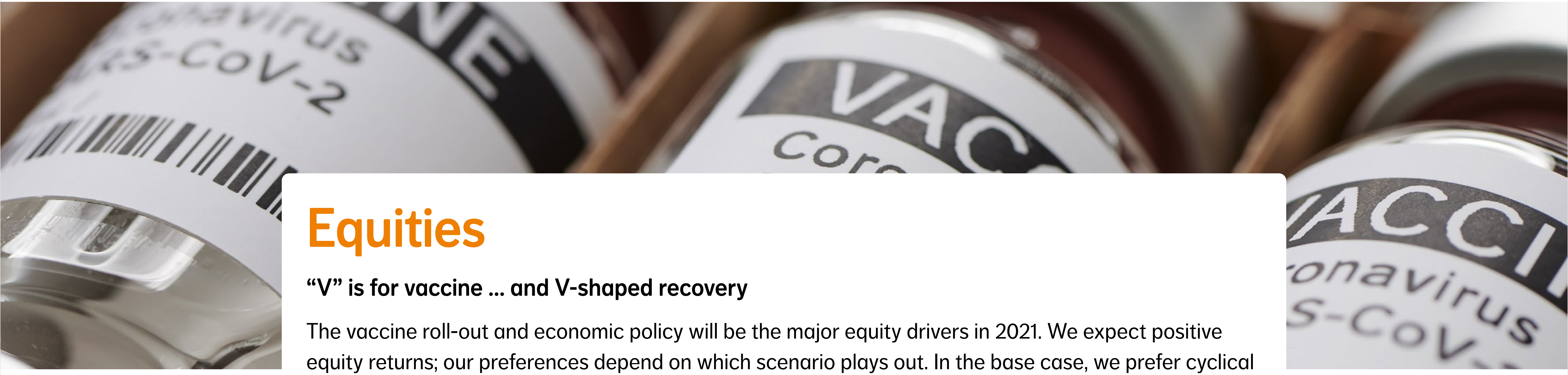
These supportive supply and demand dynamics and the search for yield will also impact European high yield, which will continue its spread-tightening course. This could be further buoyed by the expected economic recovery. The pandemic-hit sectors such as autos, energy, leisure, transportation and services should be particularly attractive. But outside the public debt markets, there are more opportunities than meet the eye.

Private debt provides ample return and ESG opportunities

The Covid-19 pandemic brought the world close to a complete standstill, and in doing so has altered our way of living. This new paradigm poses a significant challenge to the ways governments manage evolving economic and societal trends but has not reduced the momentum to address climate change. Focus on sustainability is expected to increase in the coming years and governments may use regulatory levers to bring more private investments into the fold. In addition, many companies need to start turning to private lenders to restructure for a post-corona world. We expect private debt to play an even bigger role in acquisition finance, infrastructure, real estate and global trade finance in the coming years. Furthermore, in a volatile public market environment, non-traditional return streams such as those provided by alternative credit investments can add value and diversification while achieving elevated risk-adjusted returns.

Environmental, social and governance (ESG) risks are being increasingly addressed in public markets but less so in the private markets. This is especially true in private debt, where the highly diverse underlying asset classes make it harder to apply a standardized process. This makes tailored processes essential to ensure meaningful management of risks through the life cycle of an investment. In addition to reducing downside risks, an ESG assessment will allow investors to invest in the structural themes positively linked to climate change, energy transition, the environment and sustainable growth.

One of the key themes for fixed income investors in 2021 will be to find ways to further incorporate ESG factors into their investments. Alternative credit could also provide a path for investors to enhance returns and to strengthen their ESG commitment. Opportunities will arise for institutional investors with a longer-term view who are willing to invest through different vintages to benefit from better deal terms and enhanced illiquidity premiums. All in all, adhering to stringent responsible investment principles, focusing on long-term stability and varied duration risk will remain crucial to fixed income investments in 2021 and beyond.



Equities

“V” is for vaccine … and V-shaped recovery

The vaccine roll-out and economic policy will be the major equity drivers in 2021. We expect positive equity returns; our preferences depend on which scenario plays out. In the base case, we prefer cyclical and non-US exposure.

The year 2020 was a rollercoaster for equity markets. The outbreak of the pandemic and the widespread mobility restrictions and lockdowns in many countries caused an economic recession. To alleviate the economic pain, monetary and fiscal policymakers took a series of unprecedented steps to preserve corporate and consumer income. Global equity markets fell 32% in four weeks, one of the sharpest corrections in history, which was followed by a 48% recovery in five months. Within equities, performances diverged sharply among sectors, regions and styles, depending mainly on perceived resilience or vulnerability to Covid-19. Following positive vaccine news and a market-friendly US election outcome, a brutal sector rotation in November turned previous losers into winners.

Dominating the outlook for 2021 will be the fight against the virus, helped by the roll-out of vaccines, and by the economic policy settings to limit permanent economic damage. We have identified three possible outcomes: a base case, which we call “cruise control”; a bull case or “full throttle” scenario; and a bear case, or “idling engine”. The main difference between the base case and the bull case is the speed of the recovery and the degree of upward pressure on bond yields in the bull

Table 1: Equity markets in our three scenarios

	Market drivers	Investment	
Cruise control	>20% earnings growth 2021 earnings at 2019 level Slightly higher bond yields Slightly lower valuations	1. Cyclical sectors 2. Non-US markets 3. Global emerging markets 4. Financials	Return: 5% to 15%
Full throttle	>30% earnings growth 2021 earnings above 2019 level Higher bond yields Moderately lower valuations	1. Cyclical sectors 2. Financials 3. Commodity sectors 4. Value	Return: 10% to 20%
Idling engine	<10% earnings growth 2021 earnings below 2019 level Stable to lower bond yields Continued high valuations	1. Defensive sectors 2. Technology + 3. US and China 4. Growth	Return: 0% to 10%

Source: NN Investment Partners

case, which would lead to a different sector preference. In the bear case, the recovery stalls and market support will need to come from economic policy. Bond yields remain low or even decline and we may see a return towards the defensive and growth theme.

In the base case, we assume a gradual return to a more normal functioning of the economy by mid-2021 and further supportive monetary and fiscal policies. A key variable is how quickly the vaccine roll-out results in a sufficient level of herd immunity. Production, logistics and the population's willingness to be vaccinated will be crucial factors. We expect a sufficient part of the population will be inoculated by mid-year. Any bad news on the roll-out appears to be the biggest risk factor for equities in 2021.

Other themes that will influence financial markets will be the new Biden administration's approach to China and the Middle East, the EU's relations with the post-Brexit UK, the impact of "green deal" plans on growth in responsible investing, and the likelihood of big new-technology companies coming under increased regulatory scrutiny.

The healing of the corporate sector

Let's start with a look at the health of the corporate sector. The consensus forecast for 2021 global earnings is for a strong 25% rebound, which would lift global earnings back to 2019 levels. Such a rebound would also make the recovery quicker than those that followed the two previous recessions, which is logical, as the current recession was event-driven and not caused by macro imbalances or financial stress. Growth will also rebound more sharply once this event is digested.

Regional differences will be significant. Strongest earnings growth will be in Europe and Japan, and "weakest" growth will be in the US, mainly due to base effects. Earnings in the more cyclical European and Japanese markets have declined much more sharply than the more tech-driven US market since the pandemic hit. If we compound 2020 and 2021 earnings, only the US and emerging markets will have surpassed their 2019 earnings levels. At the same time, an improvement in operating margins helped by cost-cutting efforts will accelerate earnings growth. Cyclical companies will do particularly well thanks to their bigger operational leverage.

Currency fluctuations will also play a role. Further US dollar weakness, which is not unlikely in the current risk-on environment, would act as an earnings headwind for Europe and even more so for Japan. This explains the frequently inverse correlation between Japanese market performance and the dollar/yen exchange rate. The Eurozone is less sensitive; the impact is more often felt on an individual company level and not on a market level.

Another point of attention is the use of **corporate cash flow.** At the deep point of the crisis, companies were forced into cash-preservation mode. Dividends were cut or omitted, buybacks were frozen and capex was delayed due to the macro uncertainty. Improved profitability should prompt companies to increase shareholder remuneration in 2021. Financials may stay cautious in their dividend policy, even if regulators allow payouts to resume. The pandemic's adverse impact on non-performing loans may not start to bite until later in the year.

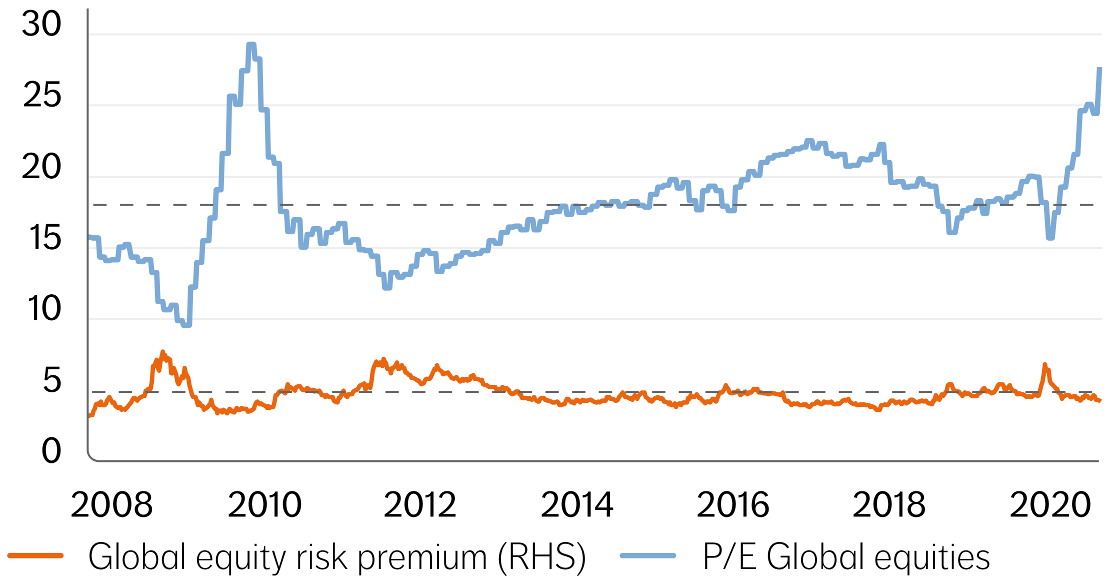
Valuations should also be put into perspective. Absolute equity market valuations have risen a lot over the past months for three reasons. The first is the drop in earnings, which mechanically pushes the price/earnings ratio up. The second is the market rally since the end-March trough, and the third is monetary policy. Compared with bond yields, however, equity market valuations are close to their 10-year average.

The case for non-US equity markets

We observe huge valuations differentials between regions, on a price/earnings metric as well as in terms of the equity risk premium. The US is more expensive than the other developed markets, mainly due to the differences in sector composition of the different regions. The more expensive growth-tilted technology and communication services sectors have a bigger weight in the US than in Europe or Japan, whose markets are more dominated by value and cyclical sectors.

Even when corrected for this different sector composition, valuations show significant gaps. This leads us to an interesting conclusion: the Eurozone and Japan, where we expect the biggest earnings rebound, are also the least expensive. This opens up an attractive investment opportunity. For 2021, we prefer the non-US markets and put Europe into the pole position.

Figure 1: Global equity risk premium and PE



Source: Refinitiv Datastream, NN Investment Partners

Brexit uncertainty is out of the way and the risk of a fiscal drag is far lower in Europe than in the US. Japan could also do well but it is more sensitive to adverse currency movements.

Table 2: Regional earnings growth and valuations

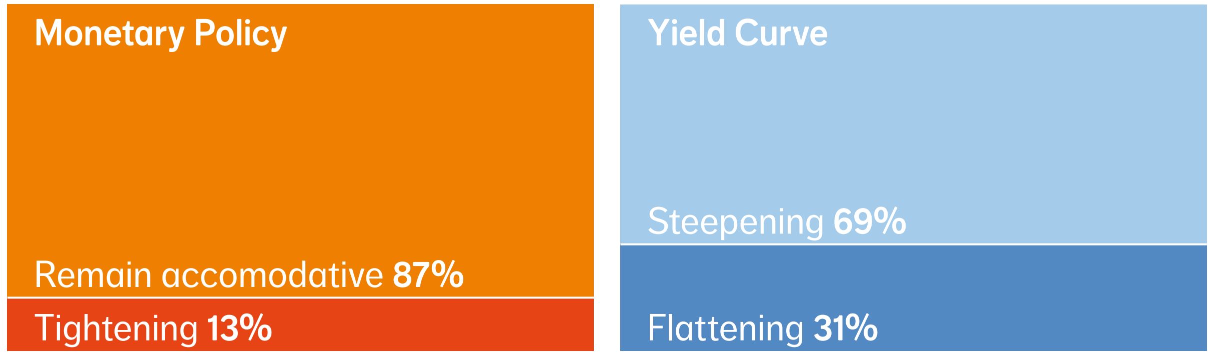
Trailing PE	Eurozone	US	Japan	EM	World
Current	25.8	31.0	25.6	19.9	26.4
Average since 2009	16.6	19.8	17.0	13.8	17.7
Max	25.8	31.0	32.3	20.6	27.8
Min	9.5	12.7	11.4	10.2	11.9
Consensus earnings growth 2021	48%	20%	42%	33%	25%
Trailing PE end-2021	17.4	25.8	18.0	14.9	21.1

Source: Refinitiv, Datastream, NN Investment Partners

Sector themes: More cyclicality but not a full value rotation

What about the sector outlook and the choice between value or growth? Neither question has a straightforward answer. Historically, the beginning of an upward cycle is positive for value investing as earnings growth becomes less scarce. A crucial variable is the expected trend in bond yields. Financials are the biggest value sector and in general benefit from higher yields, a steeper yield curve and, in the case of insurers, tighter credit spreads. In contrast, technology stocks and much of the communication services sector are inversely correlated with bond yields because their cash flows are far ahead in the future. Hence, changes in the discount rate have a large impact on the fair value of these growth companies.

Figure 2: NLP Analysis of Market Sentiment



Source: NN Investment Partners Innovation Platform

Analysing over 6,000 pages of financial research using natural language processing (NLP) techniques, we found that an overwhelming majority of financial analysts expect the yield curve to steepen in 2021 but expect monetary policy to remain accommodative (Figure 2). We share this view.

Although the improvement in the economy is likely to drive bond yields higher in 2021, this rise will probably be capped by central banks who fear that a premature tightening of financial conditions would choke the economic recovery. This will limit value's outperformance over growth. However, financials could be supported by lower provisioning for non-performing loans, further consolidation and cheap valuations, whereas the mega-cap new-technology stocks may face the triple headwind of below-average earnings growth, above-average valuations and the risk of more regulatory scrutiny.

An investment theme in which we have more faith is the rotation from defensive sectors such as healthcare, consumer staples and utilities into cyclical sectors such as commodities, consumer discretionary and industrials. Cyclicals may also get support from more fiscal stimulus, government infrastructure spending, the EU taxonomy rewarding companies that offer solutions to climate problems, and the recovery in China. This, in combination with an economic recovery in developed markets, will boost these companies' earnings growth. Some cyclical companies will benefit disproportionately from the gradual normalization of the economy. Industries like airlines and hospitality that were Covid-19 losers in 2020 could become vaccine winners in 2021.

A much different year

The year ahead is shaping up to be very different from last year. The main driver of equity returns will not be higher valuation multiples, but an acceleration in earnings growth. This is the usual pattern in the recovery phase of the cycle. An important difference with previous early-cycle periods like in 2003 or 2010 will be central banks' behaviour. Given their policy guidance, they are unlikely to start tightening monetary policy anytime soon. This will limit the degree of multiple contraction. Monetary policy will also support the equity risk premium, which is still attractive especially outside the US. This bodes well for expected returns, and we see double-digit returns as a real possibility in 2021.

The year will also be different from a thematic point of view. Under our "cruise control" and "full throttle" cases, prospects look best for non-US markets and for cyclical sectors, especially those offering climate-related solutions or active in service-related activities. We may also see a better balance in the performance of value versus growth. The "idling engine" case, on the other hand, may imply a partial return to the 2020 relative sector and regional performances.

Emerging markets

Ready to rebound from worst year on record

For 2021, we expect the rebound in emerging economies that began in the third quarter to continue, taking average growth to 7%. Growth will differ between individual countries, depending on their economic structure and on the effectiveness of their vaccination programmes. The 2021 outlook should be favourable for emerging market equities, which even have a good chance of outperforming developed markets. EM debt investors should look for opportunities on a country level, and can also exploit differences between the various sub-asset classes in EMD space.

The coronavirus pandemic has increased the economic divergence in the emerging world. East Asia has quickly resumed its pre-pandemic growth trajectory without an excessive widening of macro imbalances. Other regions, most notably Latin America and large parts of Africa and the Middle East, have seen their growth potential being eroded by sharply deteriorated fiscal accounts and rising inflation expectations. In our emerging market outlook, we present our aggregate views and focus on the growing differences that show where the main opportunities and risks in EM lie.

On an aggregate level, 2020 was the worst year for EM growth on record, with an average GDP decline of 2%. China, thanks to its rapid containment of the virus and effective policy stimulus, was able to limit the damage to an average positive growth rate of 2%, while hard-hit countries such as Mexico and India saw GDP collapse by more than 8%. For 2021, we expect the rebound that began in the third quarter to continue, taking average EM growth to 7%. We see three likely drivers:

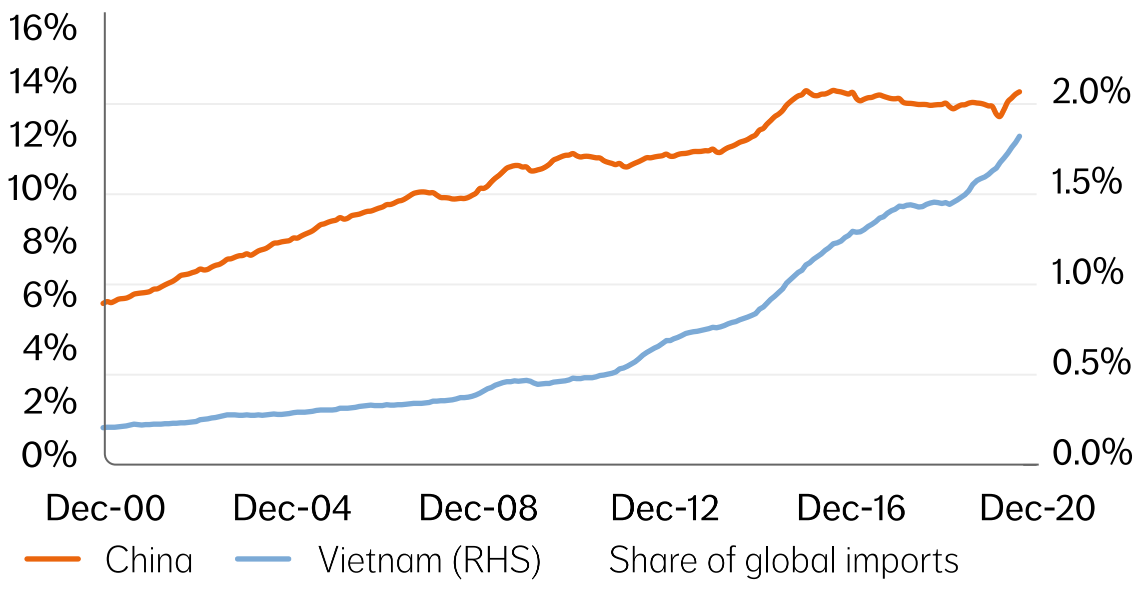
- The gradual easing of mobility restrictions made possible by mass vaccinations
- Continued strong global trade growth in goods and, in the second half of the year, services
- Strong commodity prices driven by more infrastructure investment in China, Europe and the US and by supply constraints following years of underinvestment in the commodity sector

The degree to which these three factors drive growth will differ much between individual countries, depending on their economic structure and on the effectiveness of their vaccination programmes.

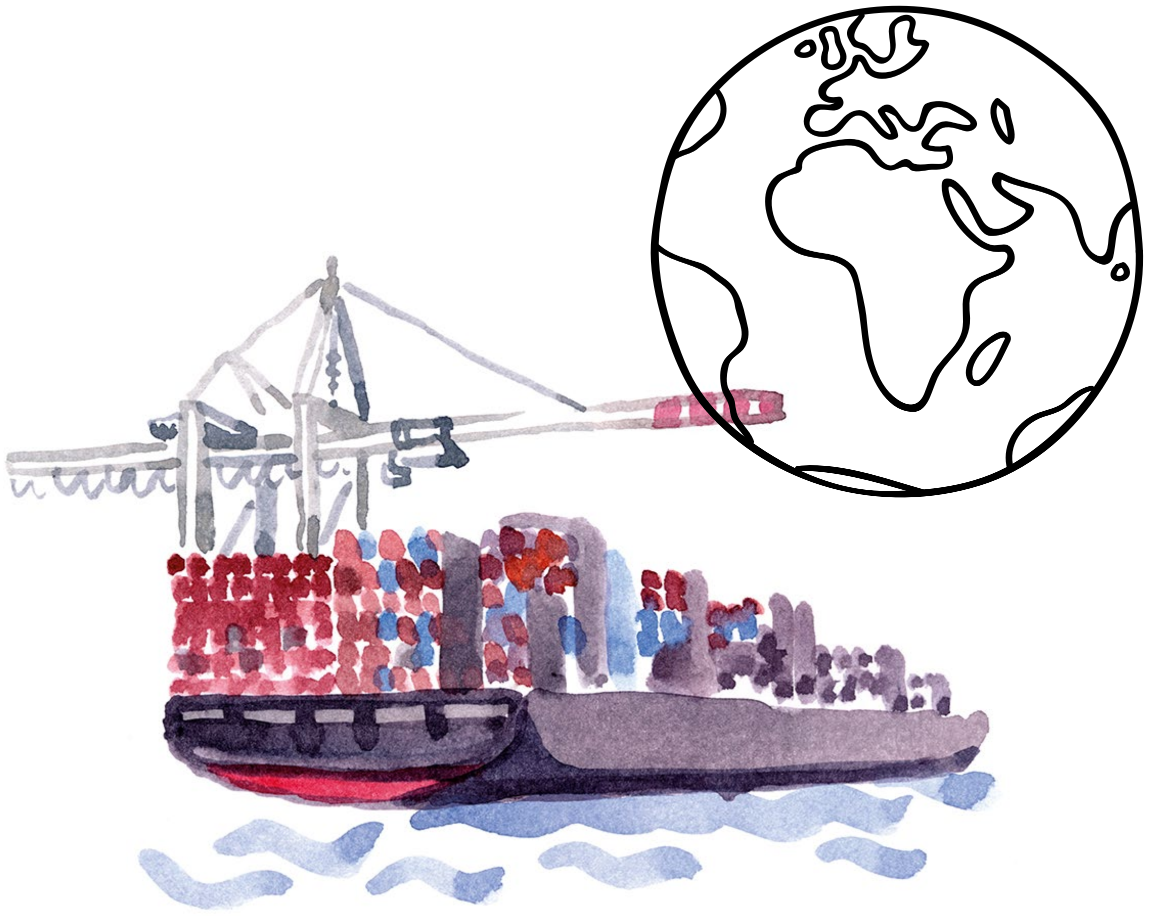
Containment of the pandemic will determine to a large extent the pace of the economic recovery. Again, the differences are large. China, the first country to be hit by the virus, was able to contain it already in March. As a result, Chinese industrial production normalized by the end of the first quarter. The rest of the economy followed suit quickly, helped by decisive policy stimulus. The virus will probably not be a threat to China's growth in 2021. South Korea, Taiwan and Vietnam have also contained the virus relatively well. By contrast, other countries are currently faced with a second or third infection wave, and the availability of effective vaccines is not likely to be sufficient to defeat the pandemic any time soon. Most worrisome is the situation in Latin America, the Middle East and parts of Africa, where health concerns or mobility restrictions will continue to have a meaningful impact on consumption and investment for most of the year.

The strong recovery in global goods trade since May has been an important driver of the EM recovery in recent quarters. With the services sector still suffering from the travel and mobility restrictions, we expect goods trade to remain strong well into 2021. The main beneficiaries are the most open economies, particularly those where success in dealing with the health crisis has prevented serious labour and logistical constraints; again, China, South Korea, Taiwan and Vietnam should benefit the most. The steady increase in these countries' global market shares is also a good reflection of their strong position in the global value chain in IT and electronics (see Figure 1).

Figure 1: Rising global market shares reflect strong value-chain position



Source: IMF, Bloomberg



Outside of East Asia, we should mention the central European countries, which benefit from the strong goods demand in Western Europe and the industrial recovery in Germany. Also noteworthy is Mexico, where the export industries have hardly suffered from the corona crisis and where the troubled relationship between the US and China has led to a sharp pick-up in foreign direct investments in manufacturing. The expected recovery in international tourism in the second half of 2021 should give a welcome boost to employment and economic activity in countries such as Mexico, Egypt and Thailand.

In South America, where most countries were hit very hard by the pandemic, the commodity-price rebound has helped to alleviate some of the economic damage. The swift recovery in commodity prices, from April onwards, has been driven by the rapid initiation of new Chinese infrastructure investment programmes. With these programmes to be extended in 2021, and with both Europe and the US likely to step up their investments in infrastructure and renewable energy as well, industrial metal prices should be well-supported in the coming year. Oil prices should also continue to rebound, driven by the gradual normalization in global economic activity, the maintained production discipline by OPEC+ and the likelihood of short oil supply due to years of underinvestment. Stronger oil and industrial metal prices should help contain balance of payment pressures in the commodity-exporting emerging economies. This reduces the risk of currency depreciation that would eventually force central banks to tighten monetary policy.

The main risks to the generally benign outlook for EM growth in 2021 originate from the dramatically deteriorated fiscal position and the rising inflation in several key countries. Large parts of the emerging world, particularly in Asia and Eastern Europe, do not have imminent fiscal and debt sustainability issues, not even after the sharp rise in fiscal deficits caused by the corona crisis. But the dramatic widening of already-large fiscal imbalances in Brazil, Argentina, South Africa, Egypt and Turkey has serious implications for these countries' growth potential. The impact will be evident in 2021, when large fiscal cliffs are inevitable, as well as in subsequent years, due to a growing dependence on central bank buying of public debt and a resurgence of financial repression in which private banks will be persuaded to own more government debt. An increasingly unorthodox intertwining of fiscal and monetary policy is likely to be consistent with structurally higher inflation and weaker exchange rates.

Since the middle of 2020, inflation momentum has picked up in the five countries mentioned above and is likely to continue doing so in 2021. After last year's fiscal derailment, companies, households and financial market participants have been anticipating higher taxes, which is a key reason for higher inflation expectations. Another undesired result of the widened fiscal imbalances is the perception that more central bank buying of government debt will be required, leading to fears of money printing, which eventually will be reflected in capital outflows and weaker currencies.

All in all, inflation expectations in the fiscally most challenged countries are likely to keep rising, which should make it increasingly difficult for central banks to maintain their easy monetary policy stance. We remain confident that the aggressive monetary policy stimulus in developed markets will continue to enable most emerging policymakers to keep their interest rates low. At the same time, we are worried about the rate outlook in these five countries with unsustainable fiscal dynamics.

EM equities

The positive growth outlook for emerging markets on an aggregate level should be favourable for EM equities in 2021. At times when global trade and commodity prices are rising, EM equities even have a good chance of outperforming developed markets. The widely held view that both the Fed and the ECB will do everything to keep interest rates low is not a guarantee for good EM equity performance, as we have seen in most of the past years, but it could sustain investor appetite, particularly if the dollar index were to continue declining.

The main reasons for caution are the expected modest tightening of Chinese monetary policy in the course of 2021 and a possible shift in investor preference from growth to value sectors. The importance of the IT sector in EM has increased sharply in the past decade; it now represents about a third of total market capitalization. So investors who want to position themselves more aggressively for a global post-pandemic recovery could probably sell some of those IT holdings that have performed strongly in recent years.

On balance, we hold a moderately positive view on EM equities for 2021. We see most opportunities for investors who are willing to differentiate between countries and regions. In addition to the large fiscal challenges and the likely reversal in monetary policy in countries such as Brazil, Turkey and South Africa, another factor likely to determine the relative performance among EM countries is their success or failure in dealing with the pandemic and geopolitical risks. How US-China relations evolve under President Joe Biden will be crucial. For now, we expect a more diplomatic and constructive approach from Washington but not necessarily a change in concrete policies. The ongoing curtailment of civil liberties in Hong Kong and the Chinese government's ambitions to strive for global technological leadership should prevent a marked improvement in its relations with the US. In such an environment, China, the largest market in the EM equity universe, is not necessarily a safe investment choice in 2021.

EM debt

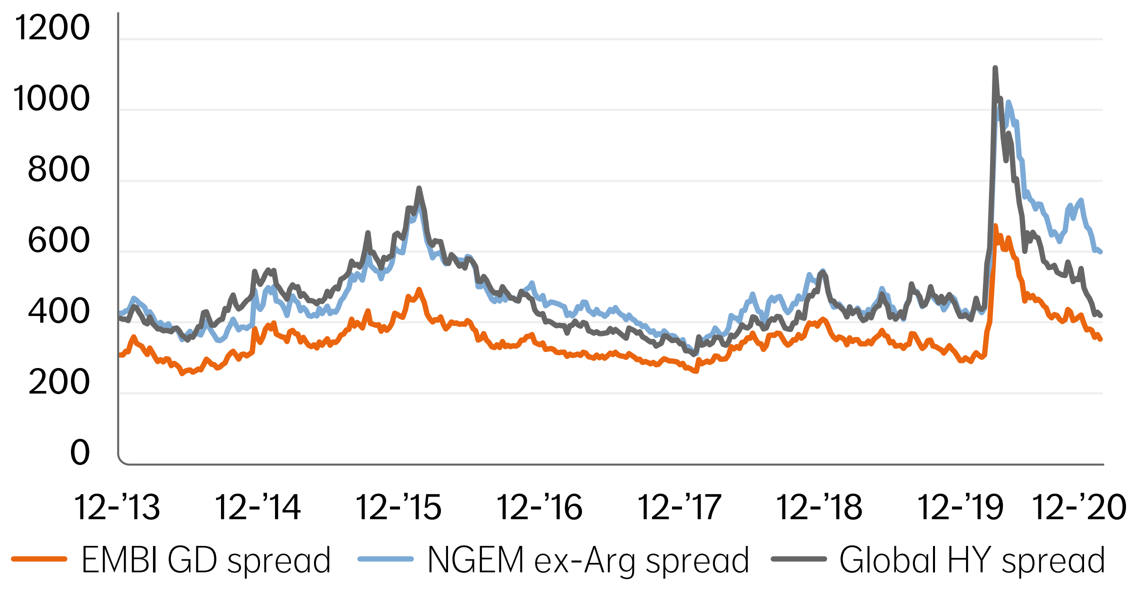
Idiosyncratic factors are also likely to be more important than global factors in 2021 for EM debt, due to the increasing macro divergence in the emerging world and our expectation of a relatively calm global economic recovery. Here too, then, investors should look for opportunities on a country level. There are also differences between the various sub-asset classes in EMD space that can be exploited.

We have analysed the impact on each EMD segment of global macro factors such as the US Dollar Index, US high yield spreads, the S&P 500, the Bloomberg Commodity Index and US Treasuries. Over the past ten years, we found various periods when EM returns have been strongly impacted by global macro. At other times, emerging markets were mainly driven by local developments. For instance, 2013, 2016 and 2020 were years when returns were mainly driven by global macro. Sudden changes in Fed policy, sharp oil price corrections and the coronavirus pandemic were the dominant developments in these years. In our 2021 scenario of a gradual economic recovery and rangebound interest rates in both the US and the Eurozone, we expect EM country-specific factors to primarily drive EM fixed-income returns.

When comparing the different EMD segments, we prefer hard-currency debt due to a combination of improving economic growth, supportive technicals and attractive valuations. The growth differential between EM and DM for 2021 is expected to reach 2.5 percentage points, more or less in line with the previous years. Valuations continue to provide adequate compensation for the debt and fiscal challenges in most countries. Higher yielding bonds offer most value and hence spread compression potential. In this respect, we believe that the risk premium in EM high yield currently overcompensates for default risk, taking into account multilateral and bilateral support, relatively high recovery values and the desire of issuers to retain market access to US funding.

For most frontier markets, attractive higher yields relative to competing asset classes should also provide some insulation in the event US Treasury yields were to rise (see Figure 2). Several countries such as Sri Lanka, Gabon and Angola, are facing severe fundamental challenges, but it is important to note that the capital market remains open for issuers and investors have been willing to help restructure the debt of countries such as Ecuador and Argentina. Also, market access is often an important pillar of countries' eco-

Figure 2: Higher yields insulate frontier markets from rising UST yields



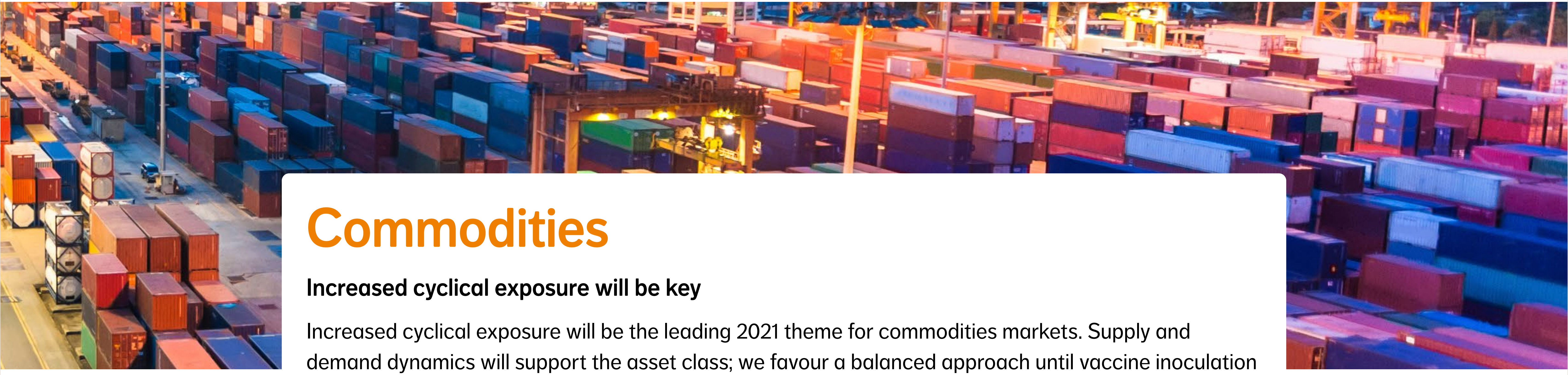
Source: Bloomberg, Barclays, JP Morgan, NN Investment Partners nomic strategy, even more so after the pandemic, so there is a clear incentive not to default.

In local currency markets, we expect the carry, a limited rate compression and some FX appreciation to lead to high single-digit returns for 2021. In rates, we consider long ends more attractive given rather tight levels at the front end of curves. In general, we expect some flattening of yield curves, which are currently rather steep. We expect year returns similar to those for hard currency, although on a risk-adjusted basis the latter is likely to have a better Sharpe ratio.

For EM corporates and Asian debt, we expect mid-to-high single-digit total returns for 2021 on the back of attractive carry, spread compression towards historical averages and the asset class's limited sensitivity to rising UST yields, should this occur. We see opportunities in sectors and individual names that can benefit from growth normalization. Although we expect US-China tensions to continue, the recently signed Asian Regional Comprehensive Economic Partnership is likely to boost intra-Asian direct investments and eventually exports.

EM assets are poised for a good year

The year 2021 could be a good one for EM assets, driven by the post-pandemic global economic rebound, the solid performance of the Chinese economy and the continuation of the global search for yield. One of our main expectations is that US and Eurozone interest rates will remain range-bound. This and the gradual economic recovery should make the different EM asset classes more sensitive to country-specific developments and less so to global macro factors. In this context, it will be key to keep a close eye on the fiscal dynamics in the countries with the most serious debt sustainability issues, such as Brazil, Turkey and South Africa. With the divergence between countries increasing, investors will find most opportunities in differentiating between countries and regions. In equities, the Asian region looks best positioned, while in debt, we favour the high-yielding hard-currency frontier markets.



Commodities

Increased cyclical exposure will be key

Increased cyclical exposure will be the leading 2021 theme for commodities markets. Supply and demand dynamics will support the asset class; we favour a balanced approach until vaccine inoculation is well advanced.

We are constructive on commodities in 2021. Demand is likely to recover further as the economy normalizes, mainly in the second half of 2021, with the vaccine roll-out playing a big role. Expansionary fiscal policies in the US, China and the EU will further underpin commodity demand; at the same time, the “green” tilt of such policies will limit supply by damping oil capex and curtailing activities such as fracking and aluminium production. A weaker US dollar and stronger emerging market currencies will have a similar effect on demand and supply. Strong EM currencies make dollar-priced commodities cheaper for commodity consumers in most EMs and simultaneously increase EM commodity producers’ local costs, lowering their profit margins and prompting them to rein in output.

These developments will follow years of underinvestment and result in commodity market deficits, mainly in energy and industrial metals. The agricultural segment is being supported by the La Nina weather pattern, which is reducing the Latin American crop outlook, and by recovering demand for animal feed in China. Until inoculations are well underway, precious metals are also likely to get support from safe-haven demand as uncertainty lingers. Jewellery demand is expected to recover further in 2021 as economic growth picks up after the sharp corona-related downturn in 2020, aided by EM currency strength. Rising inflation expectations and the Fed's "make-up" inflation strategy also support precious metals as an inflationary hedge.

In our "cruise control" base case, we anticipate economic normalization in 2021, most noticeably in the second half of the year, thanks to the upcoming vaccine roll-out. Monetary and fiscal policy will bridge the gap until widespread distribution takes place. These same events have improved our demand outlook for commodities. A recovery scenario should be more positive for cyclical commodities like energy and industrial metals than for safe havens like precious metals or agriculture, which are driven by specific supply events. Solid Chinese macro data and selective supply disruptions will continue to support industrial metals. Still, overall investor positioning to the industrial metals segment is already heavily net long from a historical perspective, warranting near-term caution.

The first half of 2021 is still clouded by substantial uncertainty pertaining to vaccine production, logistics and distribution. Potential safety issues, acceptance among the wider population and the ultimate timing of herd immunity are also factors. Virus containment measures will act as a speed bump on the road to economic recovery in the first half of the year. While Chinese and Asian economies have already largely normalized, the timing for recovery in the rest of the world remains a question mark. Therefore, we prefer a balanced approach within commodities in the early part of 2021. We balance cyclical exposure in the energy sector via an overweight in Brent crude oil with a precious metals position in silver and hybrid exposure to the platinum group metals via palladium.

Palladium remains vulnerable on the supply side due to South African disruption risks and virus impact. On the demand side, strong Chinese car sales and recovering US car sales improve the outlook for palladium, which is increasingly used in automotive catalytic converters. Exchange-traded funds' palladium holdings are still low, as is non-commercial net long positioning in palladium, and pent-up demand remains substantial.

Silver stands to benefit from the expected uptick in industrial demand, which accounts for 55% of total demand. Solar demand, and related silver solar panel demand, should further benefit from the European Green Deal, Biden's renewable policies, and China's renewable targets. Its remaining jewellery exposure stands to benefit from the same supports as gold: US dollar weakness, EM currency strength, good seasonality early in the year, and jewellery demand related to the economic recovery already visible in China and India.

Increased cyclical exposure is the leading 2021 theme

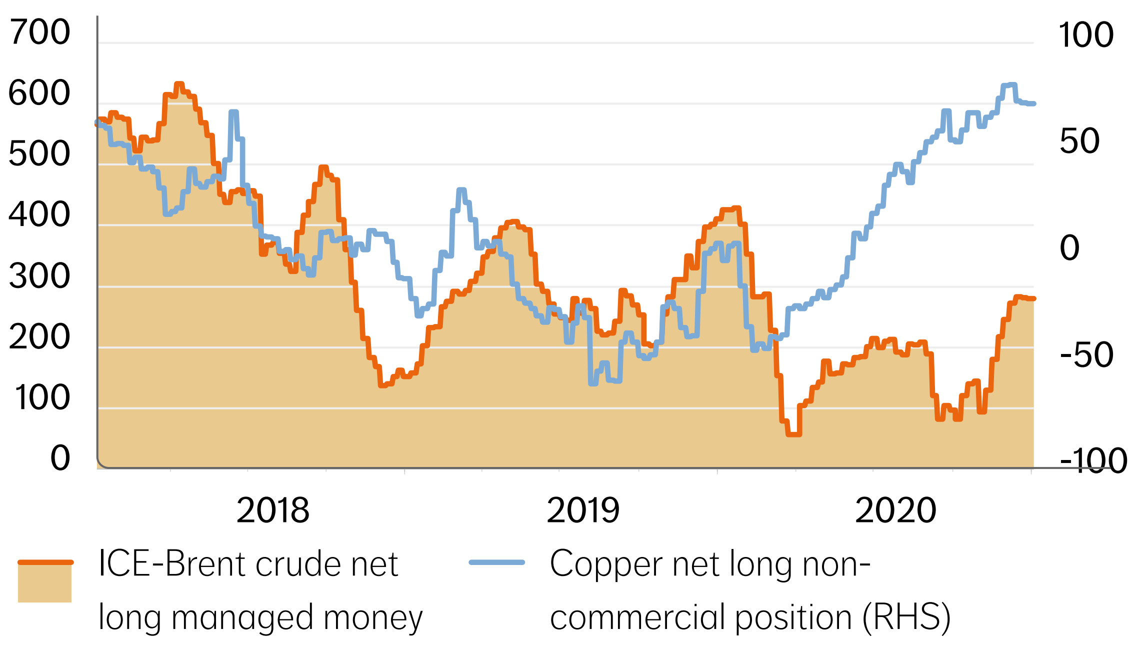
Assuming our base case materializes, cyclical commodities are poised to outperform as 2021 progresses. We intend to raise exposure to crude oil, where we are already overweight in Brent. Within industrial metals, we plan to increase our position in aluminium and copper once the expected weakness in the first months of 2021 has dissipated. In contrast to Brent, where non-commercial positioning is low and rising, industrial metals in general and copper in particular have record-high net length, making them vulnerable to profit-taking in the near term.

We are constructive on crude oil over the medium term. OPEC+ is proactive and flexible in adapting its strategy to changes in oil demand. In January, the group agreed to increase production by only 0.5 million barrels per day, less than the originally planned 1.9 mbd increase. Monthly meetings in 2021 should provide flexibility to adapt.

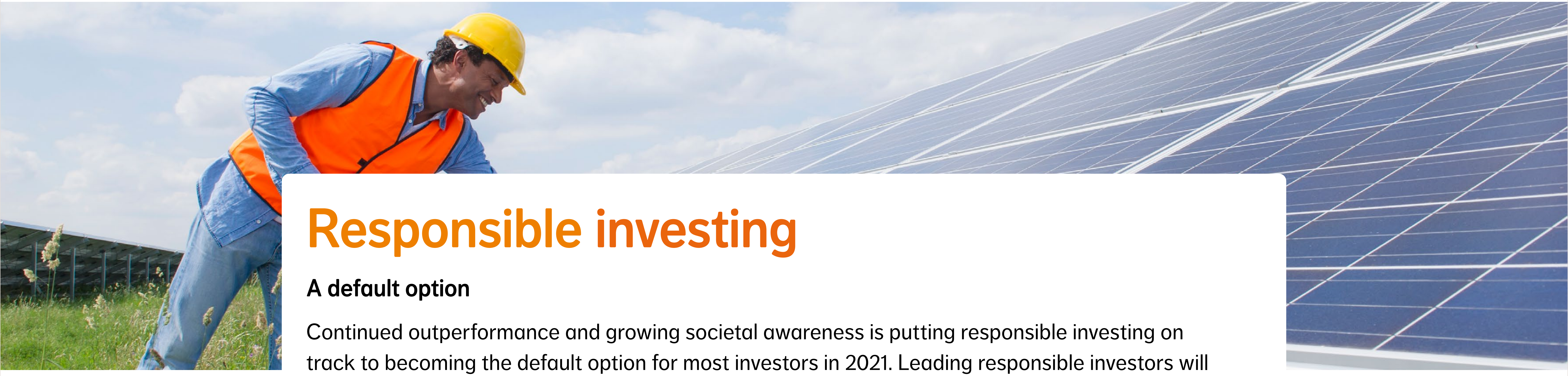
OPEC+ production increases will probably be gradual. As the economy improves, output may increase. If the path is gradual, the market can easily digest such increases. The first quarter of 2021 will be one of weaker oil demand, given further virus waves and seasonal factors such as refinery maintenance, so bridging this period by limiting production increases is key. Thereafter, with EM oil demand already healthy and coronavirus vaccinations in sight, oil demand should normalize in the second half of 2021. And with US shale production making only a very limited return, global oil inventories will draw further, supporting oil prices. Prices above USD 50 can be expected in 2021.

In base metals, we are near-term cautious, with a preference for aluminium in the first half of 2021. There may be at least one sharp 10-15% correction in metal prices in the first quarter, most likely triggered by a peak in iron ore prices, which now look to be clearly in speculative territory. This may present a better moment for entry, and an opportune time to assess whether expectations of normalized post-corona collection rates of scrap metal will help balance demand.

Figure 1: Non-commercial positions Brent crude and copper (x 1,000)



Source: Refinitiv Datastream, NN Investment Partners



Responsible investing

A default option

Continued outperformance and growing societal awareness is putting responsible investing on track to becoming the default option for most investors in 2021. Leading responsible investors will increasingly differentiate themselves by using proprietary ESG analysis to achieve better financial and sustainability results. In terms of sustainable finance, Europe will guide the rest of the world, a trend that will be strengthened by new regulations on sustainable finance. Accelerating growth in green and social bonds and in sustainability-linked loans mean fixed income markets will no longer be perceived as lagging equities.

The Covid-19 pandemic has taught asset managers and owners alike some valuable lessons about responsible investing (RI) and about the added value of integrating environmental, social and governance (ESG) factors into the investment process. The body of evidence is growing that the business case for RI is empirically solid. Demand for responsible funds was already increasing across asset classes before the Covid-19 outbreak, and the resilience of these funds since then has increased awareness of their long-term outperformance potential.

Another key driver of investor demand for sustainable funds is the growing societal preference to make use of financial markets and their capabilities to tackle environmental and social issues, such as climate change and social inequality. This practice lies at the core of our belief in "putting capital to work".

The European Union has given a regulatory push to complement the increasing demand. The EU Taxonomy Regulation came into effect in 2020, following the 2019 draft EU Green Bond Standard. These policy frameworks, coupled with regulatory requirements for insurers and pension funds to disclose the ESG profiles of their investments, have laid down a comprehensive groundwork for the accelerated adoption of responsible funds.

The reasons outlined above all helped RI funds garner the lion's share of net fund inflows in 2020. As this trend accelerates, we expect 2021 to be the year when RI gains further mainstream acceptance. PricewaterhouseCoopers estimates the compounded annual growth rate for ESG assets in Europe over the next five years at around 21%, based on current trends and regulations[1]. We expect the 2021 growth in ESG assets under management to be higher than the five-year average at around 25%. Growth in the US is likely to be 15%, slower than in Europe due to the relative lack of regulatory provisions.

Other key multi-year trends will also start to take hold in 2021. Firstly, RI leaders will take advantage of more innovative ways of analysing and interpreting data and the increase in alternative data sources to create their own proprietary ESG scores to better understand and improve the ESG exposure of their investments. Secondly, we expect the twin issues of climate change and socioeconomic inequality and related issues to dominate the RI landscape in 2021. Lastly, we expect growth to further accelerate in green bonds and asset classes like social bonds and sustainability-linked loans. The focus on sustainability is clearly here to stay in fixed income markets, which are no longer seen as lagging behind equities in this context.

ESG outperformance and change in societal preference

Since the global financial crisis, more and more academic research has concluded that the business case for responsible investing is an empirically well-founded one. In a 2015 study, Friede et al.[2] analysed more than 2,000 academic papers that explored the relationship between ESG factors and corporate financial performance. They concluded that a large majority of these papers presented positive findings.

The resilient performance of RI funds during the pandemic has converted most remaining RI sceptics. In June 2020, Morningstar compared the performance of 745 sustainable funds with over 4,000 traditional funds domiciled in Europe over the long term and during the pandemic[3]. Figure 1 summarizes

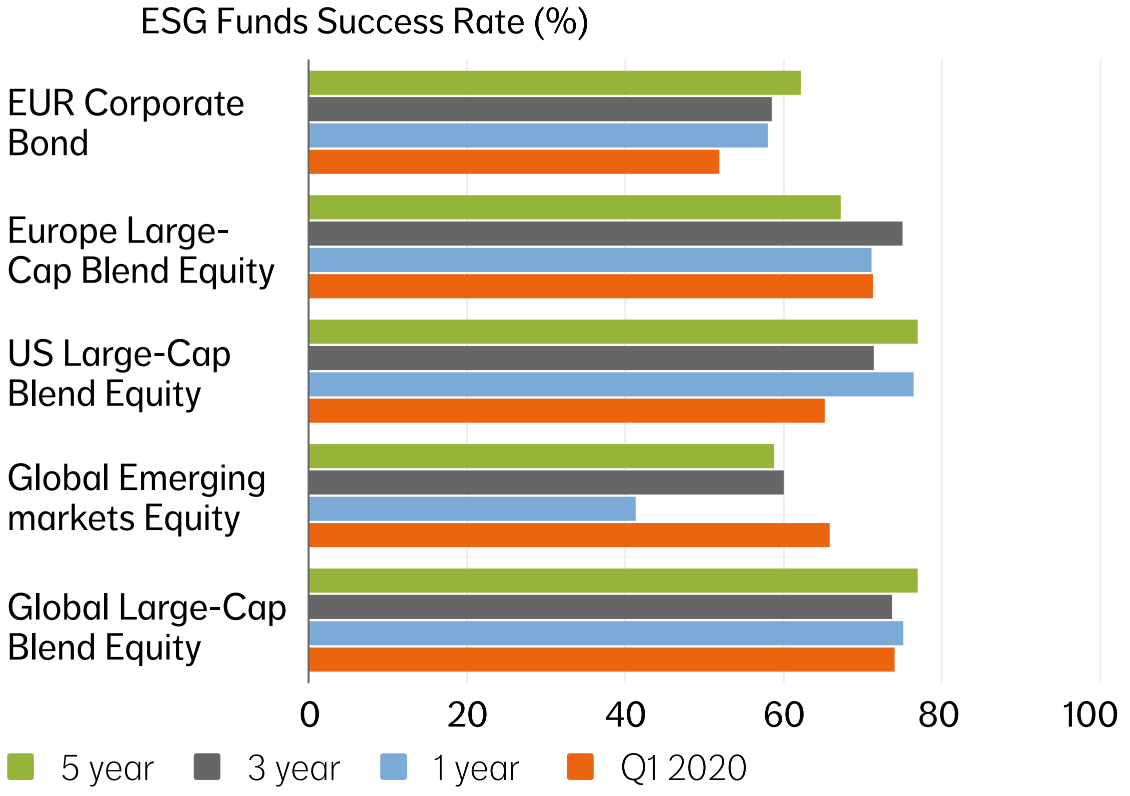
1 2020. "2022 - The Growth Opportunity Of The Century - Are You Ready For The ESG Change?" [ebook] Luxembourg: PricewaterhouseCoopers, pp.16-17.

2 G. Friede, T. Busch, A. Bassen, 2015. "ESG and financial performance: aggregated evidence from more than 2,000 empirical studies". Journal of Sustainable Finance & Investment, 5(4), pp. 210-233.

3 H. Bioy, 2020. "How Does European Sustainable Funds' Performance Measure Up?". Morningstar.

the comparison. The success rate reflects the percentage of sustainable funds in a particular Morningstar category that outperformed traditional non-ESG funds in the given period. Across asset classes and regions, sustainable funds outperformed their traditional peers in most cases, both over the long term and during the crisis. This trend continued for the rest of 2020, even as markets recovered[4].

Figure 1: Responsible investing is correlated to better performance



Source: Morningstar

A recent survey from Bank of America shows that more than three-quarters of the Millennial and Generation Z demographic cohorts – people born between the mid-1980s and the early 2010s, who today comprise 54% of the world's population – consider ESG issues important when making investment decisions. This societal change has been putting increasing pressure on institutional investors to incorporate ESG targets in their mandates. In other words, the drivers of demand for ESG investing go beyond the observed outperformance of such funds.

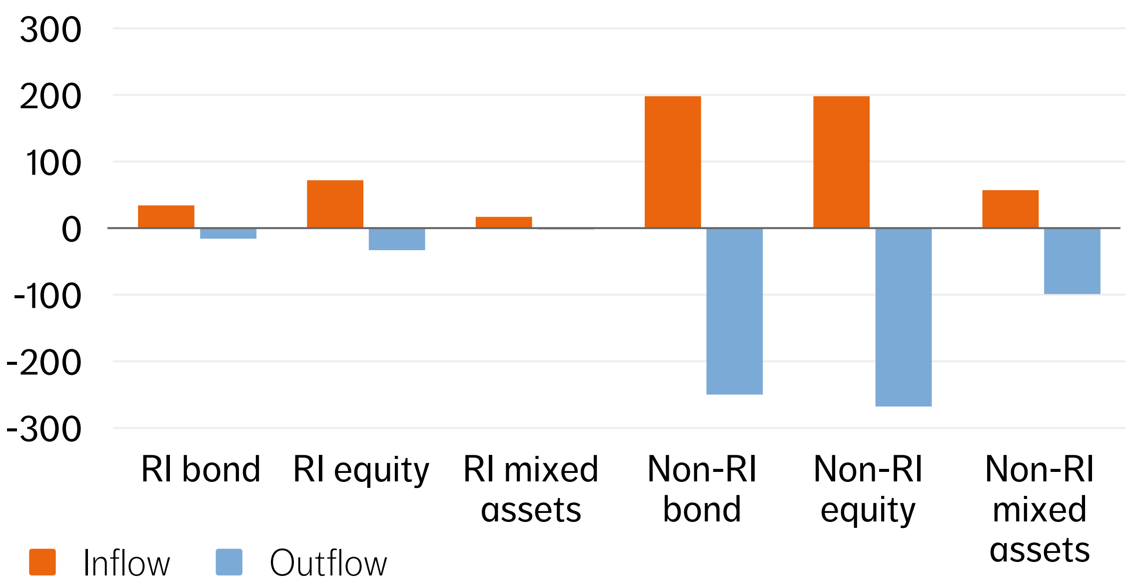
Inflows: Moving from strength to strength in 2020

In the first half of 2020, responsible investing funds experienced inflows while traditional funds irrespective of asset class and investment style struggled. Figure 2 summarizes the flow picture for the first half of 2020 in Europe. Across major asset classes, only RI funds generated net inflows during the crisis. This general trend continued for the rest of the year and was not only limited to Europe. For instance, more than 200 US sustainable equity funds tracked by Bank of America experienced around three times more inflow volume in 2020 than in 2019.

We expect to see more inflows in funds with a focus on sustainability, both within fixed income as well as in equities. At the same time, the issuance of bonds and loans that are linked to sustainability – green bonds, social bonds, sustainability-linked instruments or any other variation – will continue to grow significantly.

4 I. Tew, 2020. "How ESG-linked stocks outperformed in 2020". FT Adviser

Figure 2: Net inflows for RI funds during the corona crisis



Source: NN Investment Partners

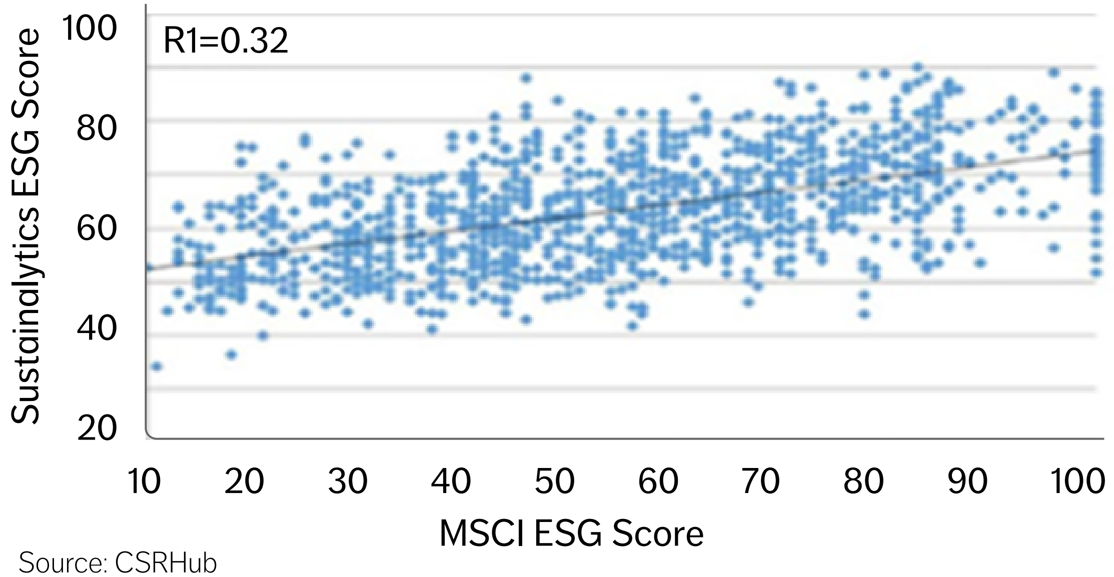
On the sovereign side, Denmark, Italy, Portugal, and Austria have already announced plans to issue inaugural green bonds. Germany has announced plans to issue the same amount as it did in 2020. On the corporate side, we expect clearer regulations to extend the list of green issuers beyond the financials, utilities and government-related segments to include more issuers from the more diverse industrials sector. All in all, we expect the global green bond market to grow by around 50% in 2021, breaching the EUR 1 trillion mark.

ESG leaders will move up the learning curve

Basic ESG disclosure has already become common practice for companies. In 2019, some 90% of the firms in S&P 500 index issued corporate sustainability reports.

The use of sustainability scores provided by third-party vendors has also become commonplace. While such scores offer valuable information, we advise carrying out further independent analysis of any external data to formulate a well-balanced investment view. A 2019 MIT study by Berg et al. found that because of measurement, scope and weight divergences, the correlation between different ESG data providers is low[5]. Similarly, research from CSRHub focused on two leading ESG data providers, MSCI and Sustainalytics, and found the relationship to be weak (see Figure 3).

Figure 3: ESG scores from MSCI and Sustainalytics show low correlation



Source: CSRHub

5 F. Berg, J. Kölbel, R. Rigobon, 2019. “Aggregate Confusion: The Divergence of ESG Ratings”. SSRN Electronic Journal.

Because of these differences in how ESG factors are scored and what they mean, we believe that it is of vital importance to combine expert human knowledge with a variety of both traditional and alternative data sources. We therefore expect leaders in responsible investing to increasingly create their own proprietary ESG indicators to better understand the ESG exposure of their investments.

E, S and G will be equally relevant

We expect the twin issues of climate change and socioeconomic inequality and related issues to dominate the ESG investing landscape in 2021.

Unlike the EU Taxonomy Regulation and EU Green Bond Standard, the regulatory framework for climate change-related investments in the US is currently non-existent. But even there, it remains an important topic on asset managers' minds. According to the US SIF Foundation, more than USD 4 trillion in US assets use climate change as a criterion in investment decisions. This figure has risen by 39% since 2018, the largest increase among ESG criteria used by US asset managers.

We believe 2021 will be the year in which markets will start paying relatively more attention to social factors, on top of the already important environmental and governance considerations. A Bank of America study on equities last year revealed that companies with higher social scores have enjoyed valuation premiums over the last five years, and that those premiums increased during 2020. This suggests that investors attach a lower risk premium to companies that have a positive social impact. The European Commission has already started working on a social bond taxonomy, which will provide the needed regulatory framework for assessing the social impact of investments. At NN IP, we have already been focusing on all three elements and we believe this will hold us in good stead this year.

Multi-asset: An integrated solution

The current trend in responsible investing will continue to present multi-asset investors with two main opportunities. One is products and solutions that integrate ESG factors across asset classes in a unified framework. The other is the extension of ESG awareness beyond product design and fund selection and into actual asset allocation decisions.

NN IP created proprietary indicators based on raw ESG data collected from a variety of third-party sources combined with expert knowledge of our investment professionals, instead of simply relying on final scores provided by external entities. In the coming year, we will continue to test and identify the most predictive of these indicators, and incorporate them into our investment process.

The new default investing option

Responsible investing is on track to finally become the default investing option for most asset owners in the coming few years. Investors experienced in using proprietary ESG analysis will increasingly reap the fruits of their efforts. Europe will lead the world this year in sustainable finance. Markets such as Asia, where the importance of responsible investing has risen significantly in the past year, will experience an accelerated adoption. The growth in green bonds and comparable instruments ensure that the focus on sustainability in fixed income is here to stay and on a par with equities. Finally, ESG factors will start playing a more well-defined role in asset allocation decisions.

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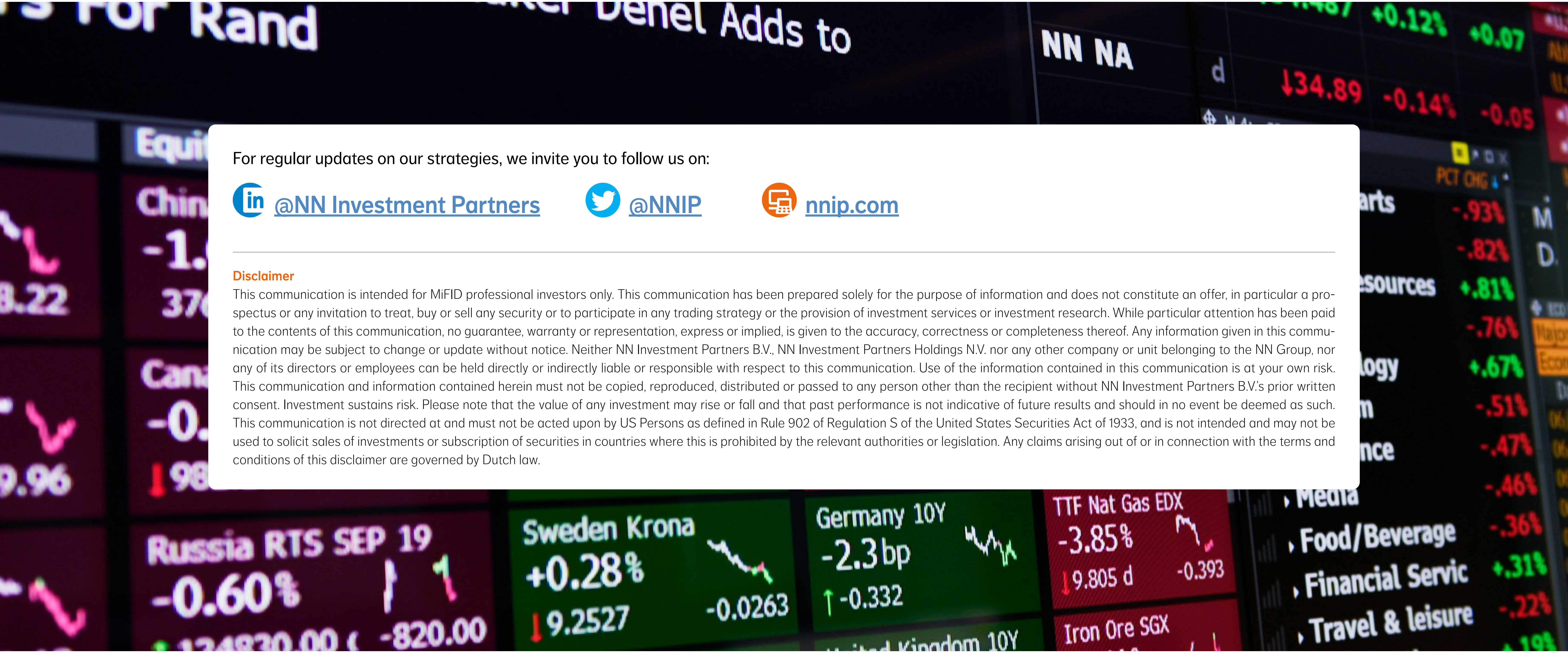

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