HouseView

Global Strategy

Back to the Future

Strategy Recommendations

	+	=	-
TAA	RE	TSY	COMM
		EQ	
		Credit	
FIXED	EPT	ABS	EM HC
	IGC	EM LB	EM CRP↗
	HY	EM FX	
EQUITY			
- Sectors	IT	INDUS	
	NRG	TELCO	
	MAT	HEALTH	
		FIN'L	
		UTIL	
		DISCR	
		STPLS	
- Regions	JPN	UK	
	ASIA	US	
		EURO	
		GEM	
REAL EST	EURO	US	
	UK	China	
		JPN	
		Dev. Asia	
COMM	WTI	ALU/COP	
	GAS	PGM	
	AGR	SL/GLD	

Positive change = ↗ ; negative change = ↙

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Economic Outlook

- **Pondering Productivity**
- **Emerging markets: ongoing weakness in China**

Pondering Productivity

We still expect a cyclical productivity rebound

Productivity growth is one of the most essential variables in the economy as it is the key long run driver of the rise in living standards. Still, this variable is also incredibly difficult to forecast especially so in the more distant future. The basic reason for this is that advances in technology and knowledge are the main drivers of trend productivity growth. The rate of change in these underlying variables can fluctuate a lot over time. In practice when we talk about productivity we usually mean labour productivity. It is important to bear in mind that the latter is not only driven by changes in technology but also by the growth rate of other inputs in the production process (e.g. capital). The growth rate of labour productivity multiplied by the growth rate of labour input (as determined by population growth, changes in the participation rate and changes in average hours worked per worker) yields an indication of the growth rate of the economy's supply side. The latter is a very important input into the central bank's decision process. After all, inflation pressure will tend to accelerate if the economy operates above its long run potential level. Hence, the central bank would like to slow the rate of actual output growth down to an around potential growth rate once the economy is in the vicinity of the potential output level.

This task would be pretty easy if the latter were carved in stone but this is not the case. The level of potential output is very much influenced by actual activity and this influence can be pretty persistent. In economic parlance potential output is subject to hysteresis or path dependency. A persistent slump will cause some potential workers to withdraw permanently from the labour market while the long term unemployed loose some of their skills. Also, existing workers will feel less compelled to invest in their knowledge and skills while sluggish business investment may stifle R&D and innovation efforts. These effects can probably be at least partly reversed in a boom. Because of this, the concept of potential output becomes somewhat elastic and even pro-cyclical, i.e. potential growth is likely to rise in a boom and to slow down in a recession. In the case of a prolonged slump there is thus a risk that a premature tightening of policy, based on a belief that underlying productivity growth has slowed down, will create its own reality by "locking in" this weak supply side performance. This risk must be weighed against the risk of falling behind the curve.

The tension between the risk of locking in persistent weak economic performance and the risk of overheating is currently very much visible in the FOMC deliberations and is even causing some kind of division between members who emphasise one of these risks in particular. To be sure, the Fed's job is not easy. The 4 year moving average of yoy US productivity growth fell from the 1.5%-2% range in 2010-2012 to around 0.5% currently. The flipside of weak productivity growth has been that unemployment rates have declined substantially despite the fact that the average GDP growth rate has only been around 2.2% since 2010 which is not spectacular. The key question is to what extent one can expect a cyclical productivity rebound. The more confident one is that this is possible the less need there is to tighten monetary policy.

We believe there is still ample reason to expect such a rebound in labour productivity growth even though we are unsure about the extent to which this will happen. After all, there a good reasons why productivity growth has been cyclically depressed:

- Sluggish capex growth has reduced the amount of capital per worker which directly lowers productivity growth. In addition to this there is an indirect effect as low rates of capex tend to be associated with less innovation and R&D efforts. A further capex recovery should reverse these trends.

- The evolution of the relative price of capital versus labour has been such that it favoured an increase of labour input relative to capital input. Tight credit supply on the back of impaired bank balance sheets increased the cost of capital for the SME sector. At the same time real wage growth decelerated substantially and in some cases the level of real wages even fell outright. Now that credit standards are being eased and lending rates are falling, the cost of capital is falling as well. At the same time, tightening labour markets should support rising real wage growth.

- Impaired bank balance sheets have also substantially slowed down the process of churning, i.e. the death of old low productivity firms and sectors and the birth of new high productivity ones. Credit to old firms was rolled over because banks did not want to recognize the losses while credit to new firms was not extended. The churning process allows resources to move to more productive uses and is thus responsible for a substantial part of macro productivity growth. The renewed mild upturn in the credit cycle we are currently seeing should also cause an increasing in economic dynamism.

Longer term productivity trends are very uncertain

While the short-term productivity outlook is thus clouded, the long-term outlook is concealed in a very dense fog. It may be tempting to extrapolate recent weak trends and conclude that part of the slowdown is driven by structural factors. We certainly do not exclude that this is the case but we would also like to keep an open mind and admit there is a possibility that underlying productivity growth has not been damaged or may even accelerate. A casual look at how technology has changed our work and private life practice over the past 10 years (smartphones, tablets, ease of access to information on the internet etc.) certainly suggests this possibility. It could thus be that the economic statistics are not measuring these technological advances correctly. This merits a more thorough discussion which we hope to be able to pick up in the near future.

For now we take refuge in a reassuring piece of evidence which comes from a study by Eichengreen, Park and Shin (http://www.voxeu.org/article/global-productivity-slump) who show that slumps in Total Factor Productivity (TFP) growth tend to come in clusters across countries. TFP is a measure of the quality of the factors of production, i.e. the efficiency with which capital and labour can be transformed into output. As such TFP is an important driver of labour productivity growth. In a globalised world where countries are intimately connected via international trade and capital flows it

indeed makes sense that there is a large common component in individual country productivity trends.

In this respect, the study of course clearly identifies the well-known great productivity slowdown of the 1970's which was followed by a synchronised global upturn in the early 1980's. In the run up to the early 1990's recession productivity slowed down again but the incidence of this event was less widespread than in the 1970's . The ICT productivity boost of the 1990's is also visible but this seems to have been very much a US story with somewhat limited spillover effects to other countries. Finally, a few years before the 2008 Lehman crisis the incidence of a slowdown in TFP growth was already pretty high. In other words, the world was already experiencing a structural productivity slowdown before the crisis hit and it could well be that part of the low productivity numbers seen since then are driven by this secular trend. At the same time we deem it very likely that the afore-mentioned cyclical factors also played their part.

Eichengreen et al have also tried to identify factors which make a TFP slump less likely. They admit that it is extremely difficult to shed some light on this. Still they identify the following factors:

- Education matters a lot. Countries with better educated populations have less risk of seeing a TFP slump. From a theoretical point of view this makes sense. Knowledge is a big driver of TFP and there is ample reason to suggest that the productivity of investment in knowledge depends positively on the already existing stock, i.e. a higher level of knowledge makes it easier to accumulate more knowledge. In addition to this, better educated people tend to be more motivated to educate themselves further.

- Countries with more stable political systems are better at avoiding a TFP slump. This makes sense as well. Technological advancement and knowledge accumulation are a trial and error process which will only take place if the entrepreneurial spirit is allowed to blossom, i.e. people must feel some sense of security that they can undertake new activities in a safe environment and be sure that a large part of the gains from these activities accrue to themselves.

- The existence of a high investment share of GDP is conducive to the subsequent occurrence of a TFP slump. We suppose that the same holds for an investment share of GDP which is rising fast. Both situations imply that there is a high risk of malinvestment, i.e. investment whose ex post rate of return is below the equilibrium cost of capital level. In extreme cases the marginal return on investment could even be negative. This exerts a direct drag on overall TFP growth. In addition to this there is an indirect negative effect as well because such cases of overinvestment are conducive to a prolonged balance sheet recession of the kind seen since 2008 in DM space.

- Related to the latter point persistent periods of a high level of global risk aversion and or periods of high and rising oil prices imply an increased risk of a TFP slump . Risk aversion implies a high cost of capital and usually goes hand in hand with a sluggish demand outlook and low confidence. High oil prices are a negative supply shock which lowers the productivity of other production factors.

Conclusion

The low productivity growth rates in DM space over the past few years are probably driven by both structural and cyclical factors. In fact a structural drag may already have taken hold before 2008. We believe the cyclical drags will wane as the recovery progresses further. As for the future development of the structural productivity trend we are much less certain. The only real consolation we get from the Eichengreen study is that historically periods of TFP slumps and TFP accelerations have alternated. In other words, periods of rain have always been followed by periods of sunshine in productivity land. Still, there is no guarantee whatsoever that the current period will be followed by a future acceleration.

Emerging markets: ongoing weakness in China

Chinese data for September confirmed that the slowdown continues, primarily in the industrial sector and in fixed investments. Industrial production growth fell to 5.7% year-on-year, which is close to a 3-decade low. Fixed-asset investment growth declined to 6.8%, a level not reached since the Asia Crisis.

Manufacturing investment growth fell the most, as the export sector continues to struggle, but also infrastructure investment growth was weaker, despite the government stimulus. Real estate investment growth continued to be negative, at -3%. Meanwhile, new housing starts turned positive again in September, after the sharp decline in August. This suggests that real estate investment growth can improve in the coming months. Uncertainty remains high, though, due to the large housing inventory in most cities with less than 15 million inhabitants.

GDP growth continues to be suspiciously close to the government targets. The Q3 result was 6.9%. With deflation running at 0.7%, nominal GDP growth fell to 6.2%. Total financing growth remained at 13%, more than double the pace of nominal GDP growth. Year-to-date, China's total-debt-to-GDP has risen by 10 percentage points! As long as China continues to expand its leverage at the current speed, and at the same time continues to record lower growth data, financial system risks continue to rise.

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Asset Allocation

- **Forecasting is more difficult that it sounds**

Back to the Future

It took us all 26 years, but finally we can check whether or not Marty McFly and Doc Brown arrived in the real future when they jumped into their time-travelling DeLorean to arrive today, October 21st 2015. Still no flying cars, powered clothing (self-drying, self-tying shoelaces), flying hoverboards or time machines, but certainly wireless video games, 3D movies, handheld tables computer, video conferencing and wearable virtual reality devices. It might not have been a perfect prediction from the film makers of Back to the Future II, but arguably still a pretty good one. With probably more than half of the falsifiable forecasts being correct, the Hollywood imagination of the late '80s might well have outperformed many competing long-distance forecasters of its generation.

This once again underscores that forecasting is much harder than most forecasters make it sound, especially those who or not held accountable for the success of their predictions. In this respect it is important not to forget how long the list of opinionated "thought-leaders" of economists, journalists, columnists, consultants, political analysts, trend watchers and policy advisors is that basically never face the harsh reality of their own forecasting track record. Generally this group of forward thinkers faces no penalty at all for failed predictions, basically ignore them thereafter and only remember their own accidental success.

Experienced investors do not have the luxury to forget their past performance and might therefore have more respect for the forecasting skills of director Robert Zemeckis. Investors know very well that being right more often than being wrong is already a big achievement. Moreover, assessing the direction of near-term trends is less challenging than making predictions over longer time intervals. Markets, the weather or our overall society are all comparable in this sense as it might be possible to foresee where they will be next week or over a couple of months, but it's much harder to do that over a couple of decades. Just compare what economic forecasters where telling us about the long-term outlook for the global economy, inflation or interest rates 10, 15 or 20 years ago with where we are today and you will realize how difficult long-term forecasting really is.

What is the relevance of all this for the current investment outlook? Obviously not much in terms of the near-term market direction. It does provide some insight in useful investment principles however as appreciating the uncertainty that the future brings is indispensable for being able to manage that uncertainty in an investment portfolio. Only with this humbleness about what can be known about the future, the right focus can be achieved to construct robust investment portfolios that can digest that unexpected shocks that uncertainty will occasionally bring. Moreover this awareness also inspires that the right innovative mind-set that is needed to understand the continuously adapting market ecology that investors operate in. Only when you know your own limitations and rigorously study the environment around you, you are able to survive as an investor.

The underlying message of the Back to the Future series might have been more on "the power of love", but that should not stop investors from appreciating its imaginative power. It is probably the same creativity that inspired the makers of this movie classic that is needed to not only survive in financial markets, but also exploit the opportunities that an unexpected future will always create.

Fixed Income

We keep Bunds at neutral. Downside risks to global economic growth and falling inflation expectations remain supportive to Bunds. Balanced with a still overweight investor positioning in Bunds, stretched valuation and FED exit risks we are neutral Bunds currently. We upgraded Spread products to neutral. EM and corporate risks (leverage, earnings) linger, but downside risks moderated as short term cyclical indicators in both DM and EM are tentatively bottoming. Weak commodity prices still pose a risk for US HY and EMD HC in particular. Lack of market liquidity in Spread products is another risk factor. Nevertheless, easy central bank policy may spur some "search for yield".

Within a neutral Spreads position we reduced the defensiveness in our allocation. US HY was upgraded to small overweight. Some tentative bottoming in selective commodity prices (oil) is seen. Investor inflows to the category returned as also valuation of US HY has improved after the sell-off.

We slightly prefer IG credit exposure over HY, after IG's underperformance so far on a risk-adjusted basis. EUR IG and Eurozone Peripheral Treasuries (EPT) are overweight.

We made a partial arbitrage from EUR IG to USD IG. A delay in FED exit should be near term supportive to USD IG. At a time when concerns over EM dominate, USD IG also could be a beneficiary of the search for yield. We moved USD IG to a small overweight (from neutral).

After the Greek "deal" in July, news flow to EPT improved. Simultaneously, relative momentum of EPT within Spread products improved. Macroeconomics in the periphery should remain supportive as are continued ECB action and existing fire breaks (ESM, OMT, banking union). With the Independent parties in the Catalonian elections failing to reach a majority in votes a potential near term headwind has been removed. We moved EPT to medium overweight.

In EM, we have reduced the underweight position. The underweight EM FX and the underweight to EMD LC rates were closed. In addition, the underweight EMD HC Corporates was reduced to small.

With EM economic surprise indicators and related sentiment indicators improving somewhat, the EM block may get some relief. A delayed FED exit may also provide support. For EMD HC Corporates, EM earnings momentum has improved recently in line with EM Equity momentum. Leverage nevertheless remains a concern.

Equities

After the correction, we decided to upgrade equities again to neutral. In our view, the market dynamics reflect too much pessimism on the asset class, especially as our cyclical indicators improved somewhat,

Within the regional allocation we cut the underweight in emerging markets and went neutral. We think that the Fed decision to postpone the rate hike removes some of the pressure of emerging

markets. In addition, positioning is low, flows strongly negative and relative valuations have fallen to the lowest level in a decade. In addition, relative earnings momentum has started to stabilise.

We opened an overweight Asia ex Japan for the same reasons and as we want to benefit from the improvement in the commodity sector and have some exposure to China through Hong Kong.

In sectors, following the decline in growth and inflation expectations leading to a flattening of the yield curve, we again put more emphasis on the search for yield theme and defensive sectors. We upgraded Consumer Staples from a medium underweight to neutral and downgraded Financials from a small overweight also to neutral. Financials generally need higher yields and an improving economic outlook to outperform. We upgraded energy and materials for which we think positioning has become too negative.

Real Estate

Real estate is kept at a small overweight after the recent rise in market volatility pushed the asset class down. However, underlying fundamentals remain supportive: stronger labour data, better consumer confidence, positive impact of oil prices on retail sales and rising house prices. Real estate remains the biggest beneficiary of the search for yield from institutional & private investors. Within real estate we have a small overweight European real estate. ECB QE and a strengthening labour market should offer some support and pricing is not excessive.

Commodities

Commodities are small underweight. Concerns over Chinese macroeconomic data and commodity demand remain. Meanwhile only limited supply discipline is seen. Most commodity segments are characterized by excess supply (industrial metals, energy and agriculture). Nevertheless, non-commercial net length in most commodity segments is no longer extended, which could cushion downside risks somewhat. We moved WTI crude oil and US Natural Gas to overweight as early signs of production discipline are seen while seasonal demand is supportive. US grains also were moved overweight as US crop yields may be downward adjusted and also El Nino risk looms.

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Head of Multi Asset

Patrick Moonen
Senior Strategist Multi Asset

Koen Straetmans
Senior Strategist Multi-Asset

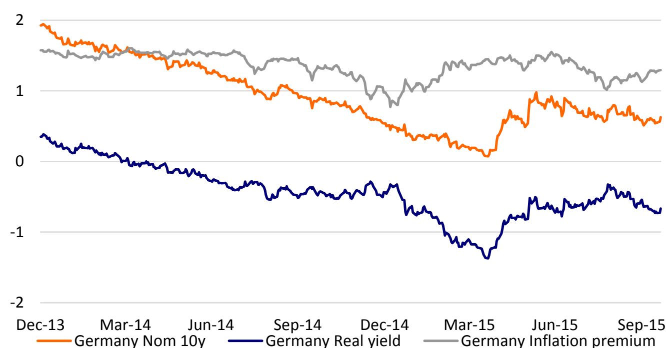
Fixed Income Strategy

- **Implied inflation expectations show signs of normalization**
- **Weakness in Euro real yields, still a slow underlying positive trend in US real yields**
- **Positioning in Treasuries neutral, somewhat positive in Bunds**

Inflation expectations recovering from sharp decline

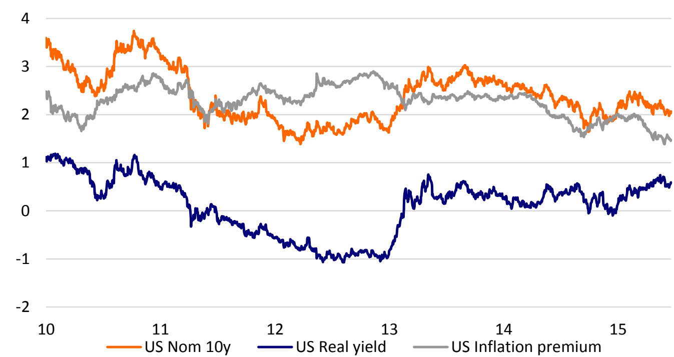
German 10 year Bund yields rose sharply between mid-April and mid-June. Since then, yields have slowly trended down again. Despite the significant volatility we have seen in Bund yields this year, we are at a current level of around 62bp, which is only somewhat above the level of the beginning of this year (54bp). Most of the adjustment in Spring materialized through a pickup of the real yield (see graph below). The rise of the real yield continued till the end of August. However, the nominal yield already started to decline in June due to a drop of the inflation expectations. The latter was strongly influenced by the decline of commodity prices. In all, from peak to trough, 10 year inflation expectations fell by about 50bp. Only recently, thanks to some correction of commodity prices, inflation expectations rose a bit again, but they remain low. Real yields have started to decline now, which is probably to a large extent a result of an anticipation of additional ECB easing.

Graph: German 10yr Government bond yield



Where Bund yields are at levels slightly above the beginning of the year, US 10 year yields are down by about 10bp. Also here the inflation premium has driven overall yields down. However, the real yield development in US Treasuries looks different. Since the beginning of the year there is a slow trend of rising yields. Because the inflation premium (-19bp) has fallen more than the real yield (+9) rose, the nominal bond yield is lower now than at the beginning of the year. This upward slope of the real yield is interesting, given that this year we have continually seen that Fed tightening expectations have been priced out. The tapering sell-off of 2013 did push real yields up a lot. From -1% to above 0%. But since then the real yield has fluctuated between 0 and 1%.

Graph: US 10yr Government bond yield



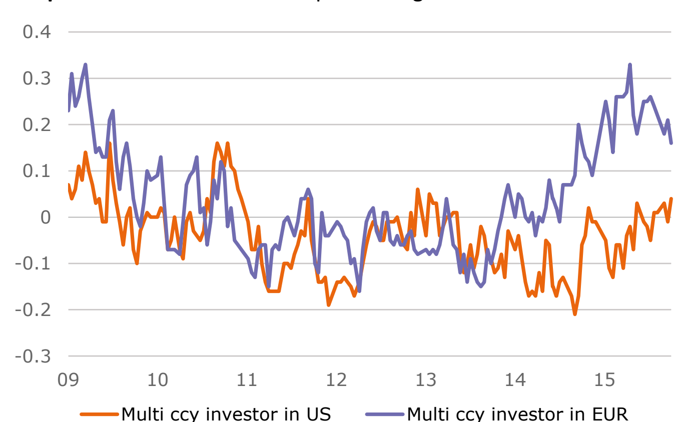
Source: Bloomberg

Normalisation of positioning

The positioning in US Treasuries seems quite neutral. This can be concluded from the graph below. Since last year, when US Treasuries were generally underweighted, allocations to US Treasuries have risen. According to the graph below this is basically neutral now. CFTC data confirm this as well. On a standardized basis the net long/shorts as a share of total outstanding CFTC contracts is currently 0.4. If anything, the market seems to have a long bias.

In Bunds positioning is still long, as shown in the graph below, but long positions have been reduced in the course of this year. The peak in long positioning was reached in April this year, around the start of the sell-off in Bunds.

Graph: JPM Government bond positioning data



With positioning fairly neutral, the key drivers going forward for the direction of bond yields are global growth developments, the outlook for monetary policy (Fed exit and possibly of further ECB easing) and inflation developments. For the latter the development of commodity prices will remain very important.

Pieter Jansen
Senior Multi-Asset Strategist

Equity Strategy

- **An uninspiring, typical earnings season thus far. Companies beat on earnings but fall short on revenues**
- **Commodity-related sectors weak, consumer-related sectors stronger**
- **For the US, we maintain our 2015 forecast of a 2%-decline and do not expect a strong acceleration in 2016 due to margin compression**

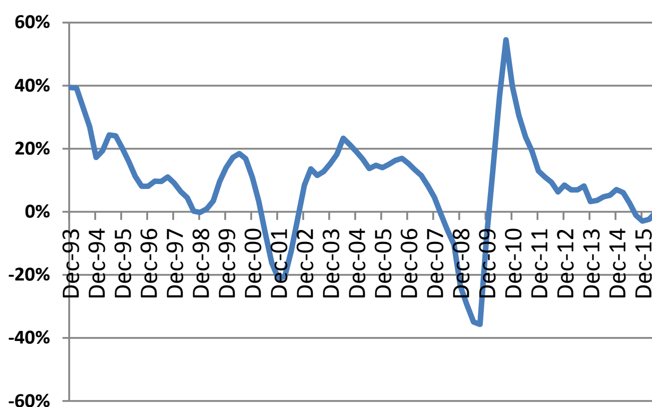
Earnings in focus

The third quarter earnings season has started. This is a very interesting earnings season as it will give us some ideas of how companies sailed through the volatile summer with regards to emerging markets worries, currency fluctuations and increased market and macro uncertainty in general.
At first sight it looks like the typical season whereby companies on average beat the estimates by a narrow margin. So far, based on 90 companies, 73% did better than expected. This looks not difficult given that the average earnings forecast hinted at a drop of 7.2% relative to the same quarter of last year. The current earnings beat is 2.2% but the overall earnings growth stands at -7.6%. Only the consumer sectors have thus far escaped an overall drop in earnings.

The picture is less convincing if we look at the revenue level. So far, only 44% of companies beat sales expectations. Revenues came in slightly below expectations whereby only the health care sector did somewhat better than the average analyst forecast.
The absolute sales growth was 3.5% negative. Sectors with the weakest sales results, (energy, basic materials and industrials) were not unsurprisingly linked to the commodity sectors. If these developments are confirmed over the next three weeks, this quarter would be the weakest quarter since the third quarter of 2009.

However, relative to the declines in 2001 and 2009 this looks a very mild earnings decline and is more comparable to the one we witnessed in 1998. This is because we are not in an economic recession. Indeed, the drop in earnings is due to a limited number of EM and commodity-related sectors. The domestic sectors hold up better also because they do not suffer from the stronger USD and benefit from domestic strength.

Change in 12-M quarterly earnings growth (%)



Source: Bloomberg, NN Investment Partners

If the season develops like previous reporting periods, the earnings growth rate will gradually improve and we will probably end the quarter around -3 to -4%. This is already visible in the weekly earnings momentum data showing some improvement compared to the rock-bottom levels of the previous week.
We maintain our full year estimate of an earnings decline of 2% compared to 2014.

Looking at margins for the non-financial sector we observe some pressure coming from three sources. The first one is an increase in non-cash costs (depreciation, amortization and provisioning) from 5% in 2013 to 5.5% currently. This is linked to the increase in capex as a percentage of sales from 6% in 2011 to 7.6% currently. This sheds a different light on the thesis that companies are unwilling to invest. Big relative spenders are the telecom and the utility sectors. In absolute numbers, the energy sector remains by far the biggest capex investor with 32% of the total expenditures in the non-financial sector. This figure will drop steeply given the oil price drop.
A second drag on US profit margins comes from an increase in the interest charges. These represent 2% of sales, an increase of 40bp relative to 12 months ago. This increase is explained by higher debt levels and higher interest rates, especially in the lower graded companies.
A third drag may come from higher wages. This is not really visible yet but there is anecdotal evidence popping up in corporate guidance.

It also remains to be seen whether companies will continue to buy back shares as enthusiastic as before. The combination of higher credit spreads and higher equity prices makes the trade-off somewhat less compelling. Also the rise in the net debt to equity ratio and the decline in the interest rate cover may limit the buyback activity. But the most compelling argument may well be the observation that year to date companies that have bought back equities did not outperform the broader market. At the end of September, the S&P500 buy back index declined by 9.9% whereas the broader market "only" declined by 6.7%. This may be a bigger incentive for companies to reduce their buyback plans. In this respect it is also noteworthy that according to the BofA/ML Fund Manager Survey more investors think that companies should use cash to strengthen their balance sheets instead of distributing it to the shareholders. This is the first time since 2010 the balance favours debt reduction.

So all in all we expect US earnings to rise by 5% in 2016, below what we expect for the Eurozone but of course a lot will depend on the movements in the USD and the strength of the global economy. The financial sector will be a big contributor to Eurozone earnings growth in view of the turn in the credit cycle and the provisioning cycle.

NNIP Top Down earnings estimates

	2015	2016
USA	-2%	5%
Eurozone	11%	8%
Japan	9%	7%

Source: NN Investment Partners

Patrick Moonen
Senior Strategist Multi Asset

Real Estate

- **Last week, we upgrade real estate to a small overweight given lower bond yields and good fundamentals.**
- **We have a long standing preference for Eurozone real estate which offers the best combination of yield, growth and valuation**
- **Sovereign wealth funds to remain a major investor**

Eurozone: Where all the pieces come together

The decline in risk aversion over the past two weeks has also supported a turnaround in real estate. Additional drivers were the drop in government bond yields and the tightening of credit spreads. We decided to move real estate to a small overweight not only because of the favorable rate backdrop but also because of the strengthening fundamentals.

From a regional point of view we keep our long standing overweight in Eurozone real estate. This overweight is inspired by the improvement in the underlying economy. Relative to the other developed regions the Eurozone scores very well. The unemployment rate is declining although from a high level, retail sales are growing helped by the increase in disposable income following the drop in the oil price and the service PMI is comfortably and stable above 50 points. More globally, economic data in the Eurozone have contrary to what we see elsewhere been better than expected.
We also believe that the improvement in corporate profitability will eventually have a positive impact through higher demand for office space impacting rental growth. The lack of significant new development growth is also beneficial for the supply/demand equation and hence rental growth in office space.
Our preference for the Eurozone is also inspired by the ECB. The QE program is likely to be extended beyond September 2016 which will keep interest rates lower for longer. This in contrast to the Fed or the BoE which will in all likelihood be the first central banks to hike in 2016.

The market also offers reasonable value. According to Green Street estimates, the premium to the Net Asset Value has fallen from 24% in April of this year to 4% at the end of September. This is close to the lowest levels since 2012.
Likewise, relative to government bond yields, the dividend yield offered by real estate in the Eurozone is very attractive and is close to the highs of the year. This yield premium of 3.7% is also superior to the premium currently on offer for US real estate (2.2%), Japanese real estate (3.0%) and UK real estate (1.1%). This is illustrated in the graph on the right hand.

An improving economy together with easy monetary policy and attractive valuations will increasingly attract (foreign) institutional money to the sector. For example Chinese insurance companies have now the possibility to invest in non-domestic real estate. The Eurozone looks well placed to attract a part of these new flows.
Sovereign wealth funds with an estimated 6.3 trillion dollars in assets under management have become sizeable investors in real estate. They typically make the news by buying trophy assets in a global hub like for example London or New York. Almost 60% of SWF's currently invest in real estate, an increase of 5% over the past two years. Interesting is the observation that many of these funds have allocated less than their strategic target (roughly 60% of the target) in real estate leaving room for further investments. This makes them an important player in the market. Approximately 55% of these funds view Europe as their preferred region.

Where are the risks?

The most important risk is linked to the economic outlook. The slowdown in emerging markets, especially China may have repercussions on growth in the Eurozone through the export link. We think this risk is limited unless we would see a tightening in financial conditions or a sudden drop in consumer and corporate confidence. Let us not forget that the Eurozone economy is in a much better shape than in 2012 to withstand these external headwinds. Imbalances have been reduced, growth in the periphery has resumed and of course, the ECB has taken an active stance to tackle these issues if and when necessary.

A second risk are the market dynamics. According to State Street data, position in European real estate is again very close to the highs we witnessed in Q1 of this year. At the same time, relative flows have weakened over summer. This implies that in case of bigger economic headwinds or renewed tensions on the interest rate front, real estate looks vulnerable to a big positioning unwind.

A third risk would be a reversal of SWF flows following the drop in commodity prices forcing them to reduce their holdings to prop up the countries budget. Over the past weeks, several funds came in the news by saying that their investment portfolio would be reduced. However, given that they are generally underinvested in the asset class the risk for real estate looks fairly limited. In addition, the illiquidity of the market in direct real estate will refrain them from selling precipitously. It may however limit the price rises in global hubs.

Real estate DY exceeds government BY by a wide margin

Source: Datastream, NNIP

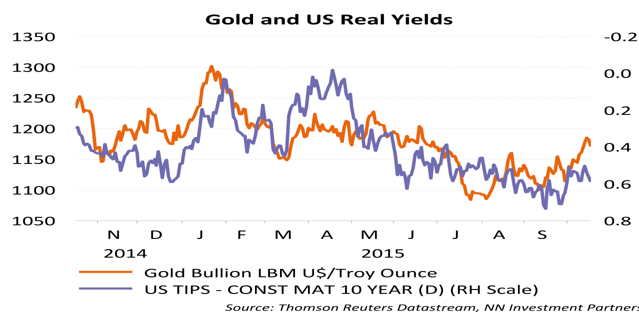
Patrick Moonen
Senior Strategist Multi Asset

Commodities

- **Overweight WTI crude oil raised to medium**
- **US Corn and Wheat moved overweight**
- **More production discipline in metals needed as demand remains weak**

Energy (Crude and Gas) and Grains favored

Precious Metals still are top of the league in terms of YTD performance in Commodities. By mid-October, the segment even managed to be close to zero in terms of YTD total return in USD. The latter is an achievement as the broad commodity index (Bloomberg Commodity Index) still showed double digit declines at that time. A high level of uncertainty, most related to China, an OPEC cartel having chosen to defend market share since end last year, lower oil and EM currencies, delayed commodity production discipline and weak commodity demand as global economic growth has been revised downward all have contributed to this outcome. Important as well and linked to the above, has been the still loose monetary policies. FED exit strategies have been pushed out in time and the ECB and BOJ are probably close to adding stimulus. Precious metals have historically been most sensitive to monetary policy and real interest rates and this time has been no different. The renewed decline in 10 Year US real yields since mid-September (FOMC meeting) has supported gold prices. At the same time investors have build-up net length in non-commercial positioning. Net long positioning in gold and silver is almost back to the previous peaks seen end May of this year and therefore gold (and silver) is no longer attractive from this (contrarian) perspective.



Weakness in Indian gold (import) demand in September, probably related to the Monsoon rain deficit impacting farmer income, is another headwind for gold. Moreover, as we see some developed market macroeconomic resilience and even some tentative (second derivative) improvement in EM cycle indicators, the most likely path for real yields medium term is still upward and therefore is expected to cap the price outlook for gold. Fed exit also may well be delayed but not at all abandoned.

At the opposite of Precious Metals so far this year in terms of performance are the cyclical segments Energy and Industrial Metals. The latter segments were still outperformers till May before reversing all this in the broad commodity sell-off thereafter.

A substantial degree of pessimism has taken hold of the cyclical segments since from which they so far have failed to recover. Nevertheless, at the margin, things have fundamentally improved in selective commodities within both segments, more specifically on the supply side of the equation.

Already early October we moved WTI crude oil to a small overweight and by mid-October we raised the overweight to medium.

US crude oil production is expected to have peaked in April 2015 at some 9.6 mbd. Ever since US oil production is on a declining trend. Further production declines are expected into 2016 after capex and rig counts were cut aggressively. With US oil production contracting also non-OPEC supply is expected to contract in 2016 (by some -400kbd). Global excess oil supply should therefore slowly diminish albeit being still present well into H1 16 as OPEC continues its battle for market share and Iranian barrels are scheduled to return once sanctions will be lifted. A quick fix is unrealistic but things are improving at the margin.

On the negative side recently has been OPEC estimate of its own increased production in September (above quota). The IEA also revised global oil demand growth for 2016 down to a still healthy +1.2 mbd, albeit 2015's growth forecast was raised to +1.8 mbd. Chinese oil demand, that so far has held up well (as also indicated by the latest crude import data), is a concern in this respect. Nevertheless, at the margin Chinese oil demand may be underpinned by the somewhat better services sector. Also, Chinese policy stimulus is ongoing and may gain some traction in the near term. Finally, speculative net length in WTI is low and the wave of short covering that started end August may have further to run.

Next to increasing the overweight in WTI crude oil we also moved Grains to an overweight. US Corn was moved small overweight and US Wheat medium overweight.

The Agricultural segment so far performs roughly in line with the broad commodity index. We expect the grains segment to gain strength in the final months of the year. Non-commercial net long positioning in both Corn and Wheat is low and even outright net short in Wheat. The USDA in its October WASDE report revised both US Corn and Wheat 2015-16 production lower as well as 2015-16 ending stocks. US Corn crop yields nevertheless were revised up (against expectations) while still downward for US wheat. We expect support for grain prices from crop yield perspective as yields may be revised lower in the upcoming USDA reports. Also Corn appears attractive versus Soybean as depreciating EM currencies, BRL in particular, have raised the competitiveness of South America as well as likely increased soybean planting intentions (over corn) at current prices in the region. US Corn overall is also less exposed to the currency effect compared to soybeans as a smaller share of US Corn demand is dedicated to exports relative to soybeans. Probably surprisingly in the latest WASDE report was USDA raising the wheat production forecast from the World ex-US, a. o. Australia. Surprisingly so, as the Australian wheat crop is probably most at risk from an El Nino weather pattern that appears to gain strength (with associated drought in the region). Next hereto, also dry conditions in Russia and the Ukraine expose the winter wheat crop to germination risk.

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FX

- **By how much has the fair value of the CNY declined?**

U.S. Treasury seeing less CNY undervaluation

The U.S. Treasury Department, in its semi-annual report on currencies last Monday, said the yuan is “below its appropriate medium-term valuation.” In the previous report it said the currency was “significantly undervalued.”

Admittedly, U.S. Treasury ‘watching’ is not as well developed as Fed ‘watching’, but we would conclude that “below its appropriate medium-term valuation” clearly signals less undervaluation than “significantly undervalued.” This is an interesting development, as China has devalued its currency in the meantime.

Only one conclusion seems justified: the U.S. Treasury Department has lowered its estimate of CNY fair value. By how much is a bit a guess. First, the CNY has depreciated by around 2.5% since the previous report. Next, this number should be added to percentage difference between “significantly undervalued” and “below its appropriate … valuation”. In our view, this change in wording would at least suggest a 5%-point change. This implies a reduction of CNY fair value of around 7.5%.

Normally, fair value estimates are only (very) slow-moving, and an adjustment of 1-2% in 6 months is already quite a lot. The most likely explanation is that the U.S. Treasury – like the rest of the world – has become more worried about the economic outlook for China, and understands the need for a weaker currency.

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Forecasts

Global macro

The divergence between DM forces of lift and EM forces of drag has increased since the start of the year with the latter gaining in strength relative to the former. A crucial question for markets is at which point EM headwinds will spill over to DM space to such an extent that we obtain a significant global growth slow-down. The exact location of this tipping point is very hard to pin down because the economy and the markets do not always behave in a linear predictable fashion. What's more, their dynamics are to a significant extent influenced by expectations which can become self-fulfilling.

It should not come as a surprise that these cross currents create considerable additional uncertainty for markets. As always this feeds back into the real economy so as to make the situation more murky. Still even these muddy waters enable us to learn some interesting things which shed some further light on risk premiums:

- Exchange rate developments have clearly taken center stage over the past year. In particular, it seems that the dollar is more sensitive to US monetary policy expectations than usual. One reason for this is probably that economic cycles around the world are very much out of synch.
- USD strength interacts in a possibly non-linear way with EM weakness. Main reason is that many EM's (incl. China) are managing their FX rates against the USD. This forces them to import tighter US monetary conditions. Breaking away from this is complicated by the big share of private sector hard currency debt.
- This interaction between dollar strength and weakening EM fundamentals feeds back into DM space in a possibly non-linear fashion as well via sluggish external demand, lower commodity prices, downward pressure on goods prices, downside risks to inflation expectations and a tightening of financial conditions due to increased global risk aversion.
- The latter may also be fueled by the fact that markets have started to pay more attention to the fact that DM economies have less policy ammunition to deal with a really big negative shock than they had in 2008. To some extent this is related to the ability of policymakers to respond, i.e. it is easier and more effective to cut rates than to increase QE. However, the perception of the willingness to respond also matters. In theory there is still ample ammunition left in the form of fiscal expansion financed by money printing but this still seems anathema to DM policymakers.
- This whole complex makes the Fed tightening decision much more complicated.

The rise in global risk premiums we have seen since early August could at least be partly explained by the feedback loops described here. Perceptions about the extent of any further EM slowdown, EM depreciation expectations, DM momentum or the ability of DM policymakers to respond may shift in a more benign or a more malign direction from current levels.

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Global markets

NN IP Global Economic Outlook

	Growth (in real terms)			Inflation			Policy rate (YE)		
	2014	2015	2016	2014	2015	2016	2014	2015	2016
World	3.1	2.9	3.0	2.7	2.0	2.8			
Developed	1.5	1.9	2.2	1.4	0.2	1.4	0.2	0.3	0.7
US	2.4	2.5	2.7	1.7	0.2	1.9	0.25	0.50	1.25
Euro	0.8	1.6	2.0	0.4	0	0.9	0.05	0.05	0.05
Japan	-0.1	0.7	1.2	2.8	0.7	1.3	0.10	0.10	0.10
UK	2.9	2.5	2.3	1.5	0.2	1.4	0.50	0.50	1.25
Emerging	5.1	4.1	4.0	4.3	4.3	4.5			
China	7.4	6.5	5.4	2.1	1.6	2.0			

	Unemployment			Budget balance			Current account (YE)		
	2014	2015	2016	2014	2015	2016	2014	2015	2016
Developed									
US	5.8	5.3	5.0	-3	-2.7	-2.5	-2.3	-2.5	-2.7
Euro	11.6	11.1	10.7	-2.5	-2.7	-2.6	2.4	2.9	3.1
Japan	3.6	3.4	3.1	-8	-6.5	-6.3	0.1	2.6	2.2
UK	6	5.4	5.0	-5	-4.0	-3.0	-4.0	-5.0	-4.2

Source: Forecasts from NNIP, hist. data from IMF (GDP, inflation) & Economist Inteligence Unit (rest data)

Bond yields (10y)

Quarter end (%)	Q1'15	Q2'15	Q4'15	Q1'16
Countries				
US	1.9%	2.3%	2.7%	2.9%
Eurozone (bunds)	0.2%	0.8%	1.0%	1.1%
Japan	0.4%	0.5%	0.7%	0.8%
UK	1.6%	2.0%	2.4%	2.5%

Corporate bond (IG) yields

quarter end (%)	Q1'15	Q2'15	Q4'15	Q1'16
Countries				
US	3.6%	4.0%	4.1%	4.2%
Eurozone	0.9%	1.5%	1.5%	1.5%
Japan	1.2%	1.4%	1.4%	1.4%
UK	2.8%	3.3%	3.4%	3.5%

Equity

quarter end	Q1'15	Q2'15	Q4'15	Q1'16
Countries				
S&P 500	2068	2065	2140	2150
Stoxx 600	397	382	410	425
TOPIX	1543	1630	1700	1750
FTSE 100	6773	6560	7000	7225
MSCI EM Free	974	959	1020	1100

Foreign exchange rates

quarter end	Q1'15	Q2'15	Q4'15	Q1'16	Fair Value
Currencies					
EUR/USD	1.08	1.12	1.00	1.00	1.27
USD/JPY	120	122	125	125	89
GBP/USD	1.48	1.58	1.43	1.43	1.57
EUR/JPY	129	137	125	125	113
EUR/GBP	0.72	0.71	0.70	0.70	0.81

Source: NN Investment Partners (21/10/15)

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