Hot but not too hot

Global Asset Allocation Strategy
June 2021

Investments | Wealth Management

July 2021

Hot but not too hot

OVERWEIGHT EQUITIES

- The equity-market rally has resumed after a short late-spring pause. The Fed signalled monetary tightening might come sooner than some had thought, but this did not move equities much. We think rightly so.
- The macro and earnings outlooks remain very supportive, albeit slightly less so than at the start of the year. In particular, expectations will not continue to be crushed at these rates forever. Put together, we expect the tailwinds to continue but at a more modest clip. Hence, we keep the equity overweight.

EQUITY STRATEGY: Overweight Europe, Materials and Financials

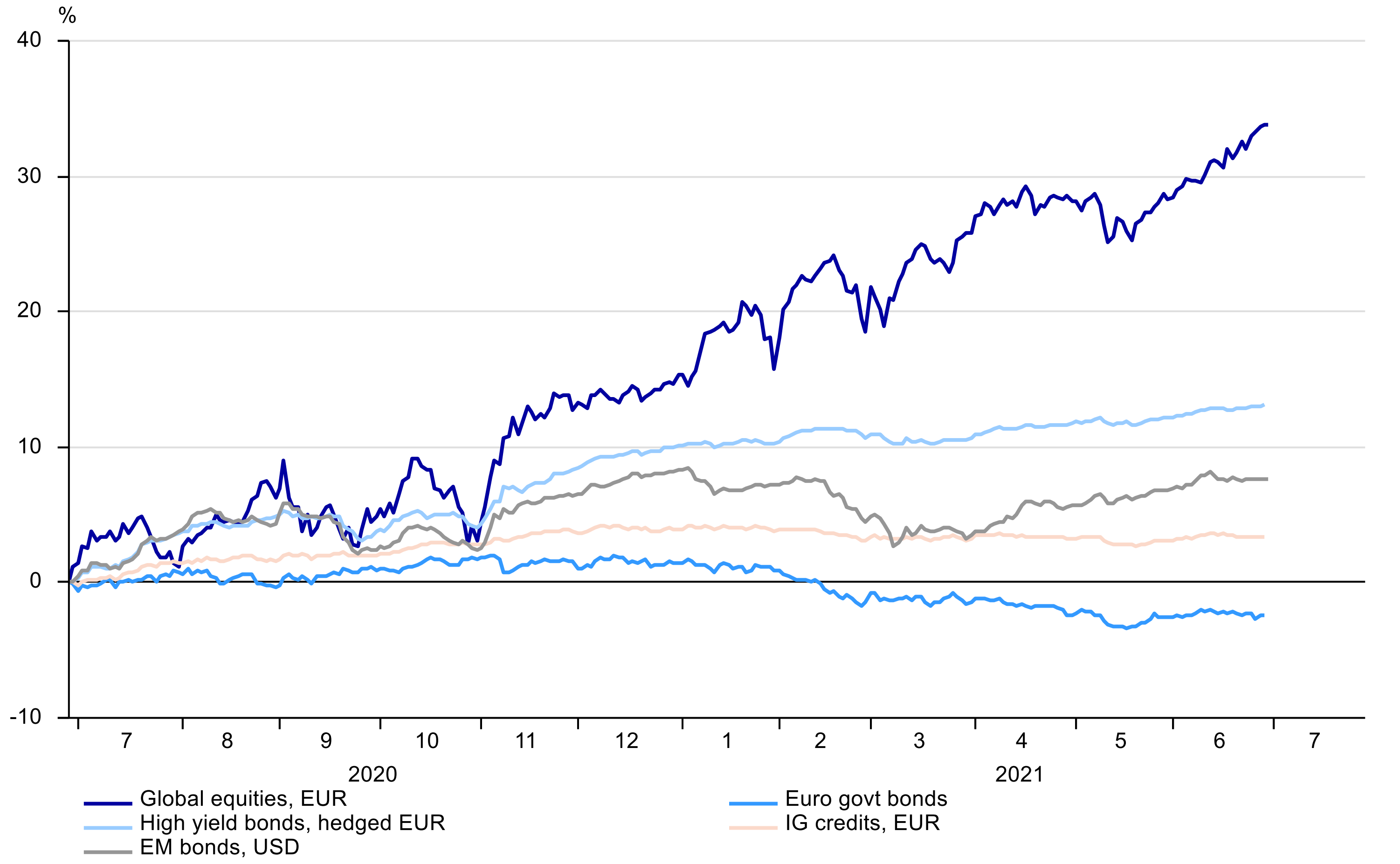
- As the reopening gains traction in Europe, we expect the region to keep performing better than global peers with the support of relative valuation and earnings. Emerging markets, meanwhile, are unlikely to top the list due to weaker impulses from China.
- Within sectors, we continue to recommend an overweight in Financials and Materials, which should be winners as the economy improves and yields rise. Meanwhile, we underweight Consumer Staples and Health Care. We trim our cyclical position a bit by downgrading Industrials to neutral and reducing the underweight in Consumer Staples.

FIXED INCOME STRATEGY: overweight Euro Investment Grade

- After a significant consolidation in longer-dated US yields, we recommended offloading some US duration by reducing EM bonds to neutral. We raised euro IG to overweight, as it has one of the lowest durations. It is also exposed to European rates, which are likely to rise slower than their US counterparts.

Market performance & recommendations

Equity rally resumed in June



Source: Refinitiv Datastream / Nordea

ASSET ALLOCATION	-		N		+	Comments
Equities				■		
Fixed Income		■				

EQUITY REGIONS		-		N		+	
North America				■			
Europe				□	■		
Japan				■			
Emerging Markets			■	□			
Denmark			■				
Finland				■			
Norway				■			
Sweden				■			

EQUITY SECTORS		-		N		+	
Industrials				■	□		
Cons Discretionary				■			
Cons Staples		□	■				
Health Care			■				
Financials					■		
IT				■			
Comm. Services				■			
Utilities				■			
Energy				■			
Materials					■		
Real Estate				■			

BOND SEGMENTS		-		N		+	
Government			■				
Investment Grade				□	■		
High Yield				■			
Emerging Markets				■	□		

■ Current allocation □ Previous allocation

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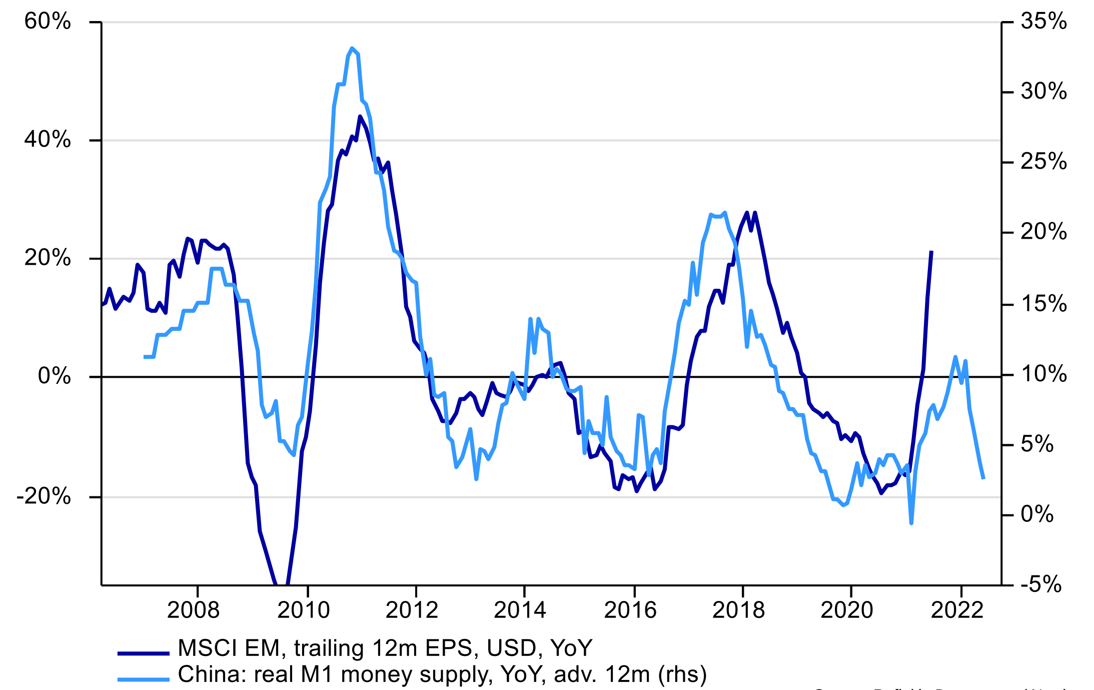
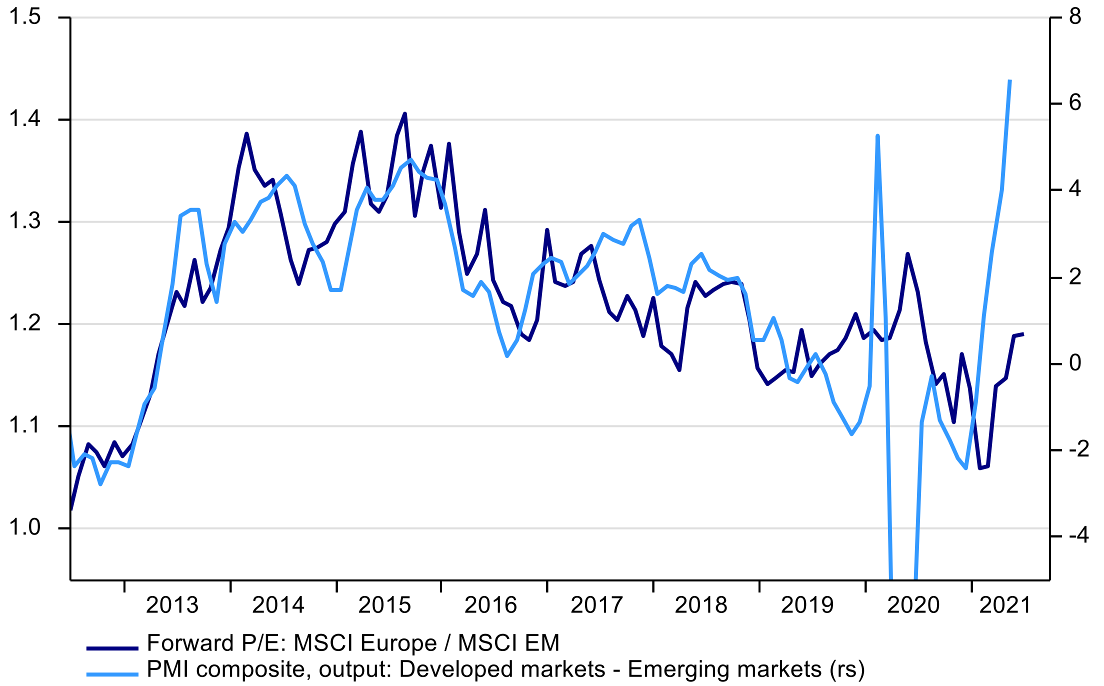
Overweight Europe & underweight Emerging markets on Chinese tightening and EU reopening

Chinese monetary tightening will soon be a drag on activity and EM profits



Source: Refinitiv Datastream / Nordea

China's tightening/weaker macro speaks for a DM vs EM play in equities

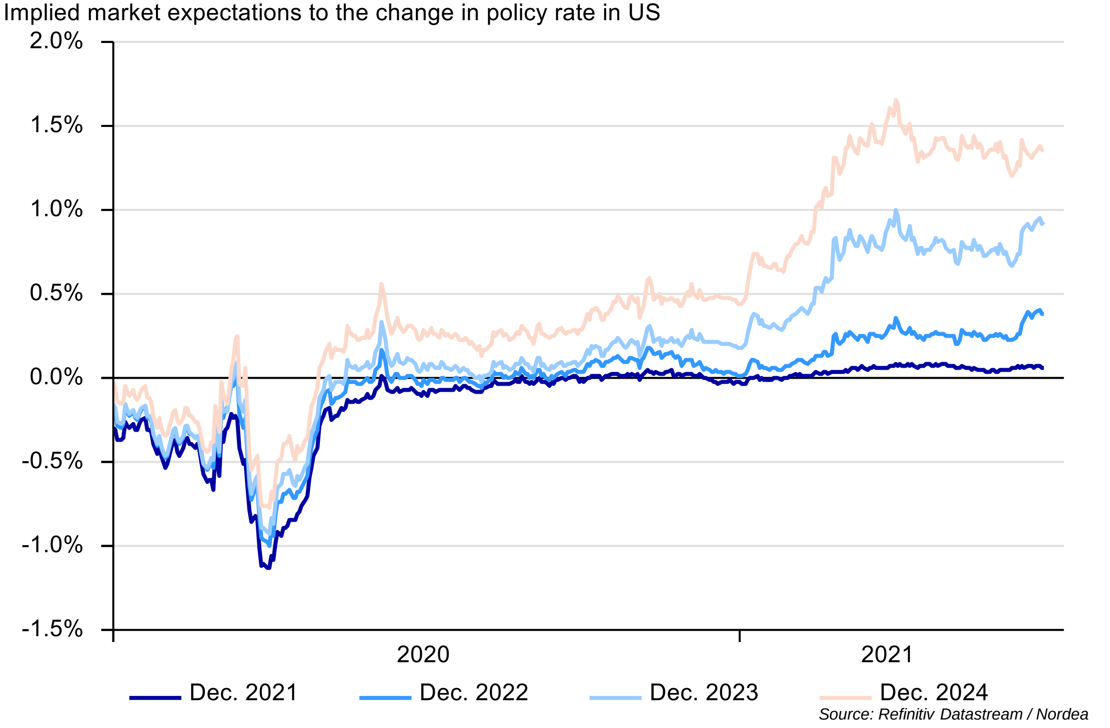


Source: Refinitiv Datastream / Nordea

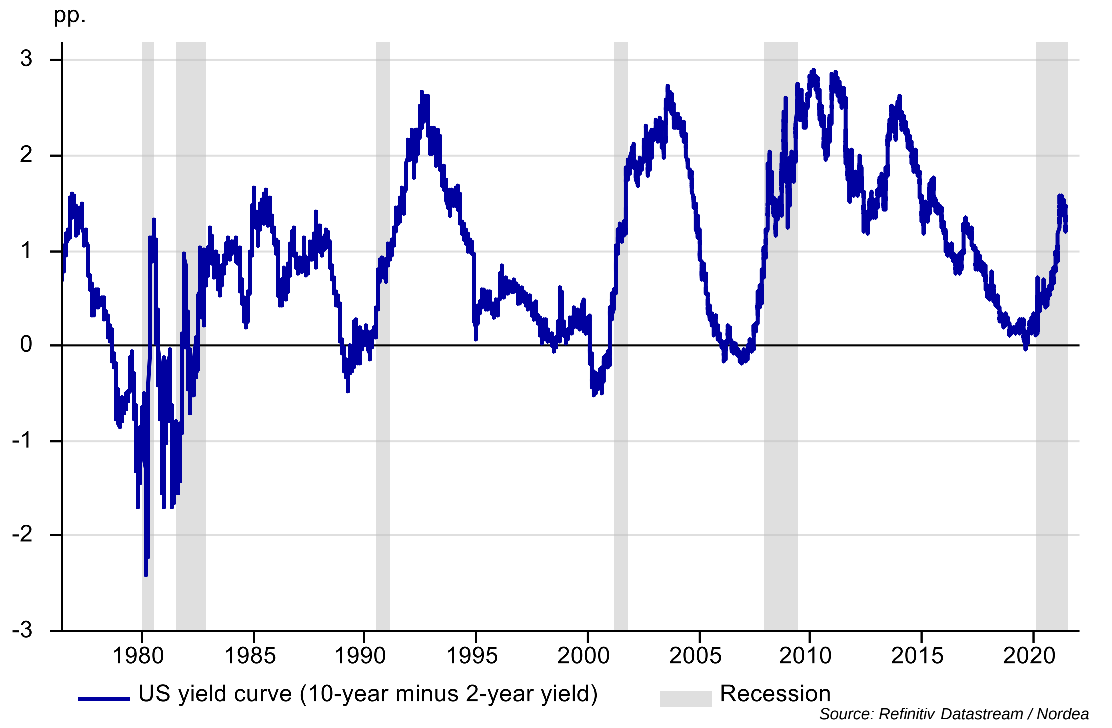
- Strong DM stimulus and growth impulse combined with Chinese tightening speaks for a developed vs emerging markets bet in equities.
- Chinese monetary tightening continues to gather pace, which soon will start to weigh on domestic macro. It will also be a drag on the EM profit cycle.
- Europe is both attractively priced and has a good earnings outlook. And still face positive momentum with progress in vaccinations and reopening economies.

Fed strikes a more hawkish tone

Markets expect policy rates to rise starting late 2022



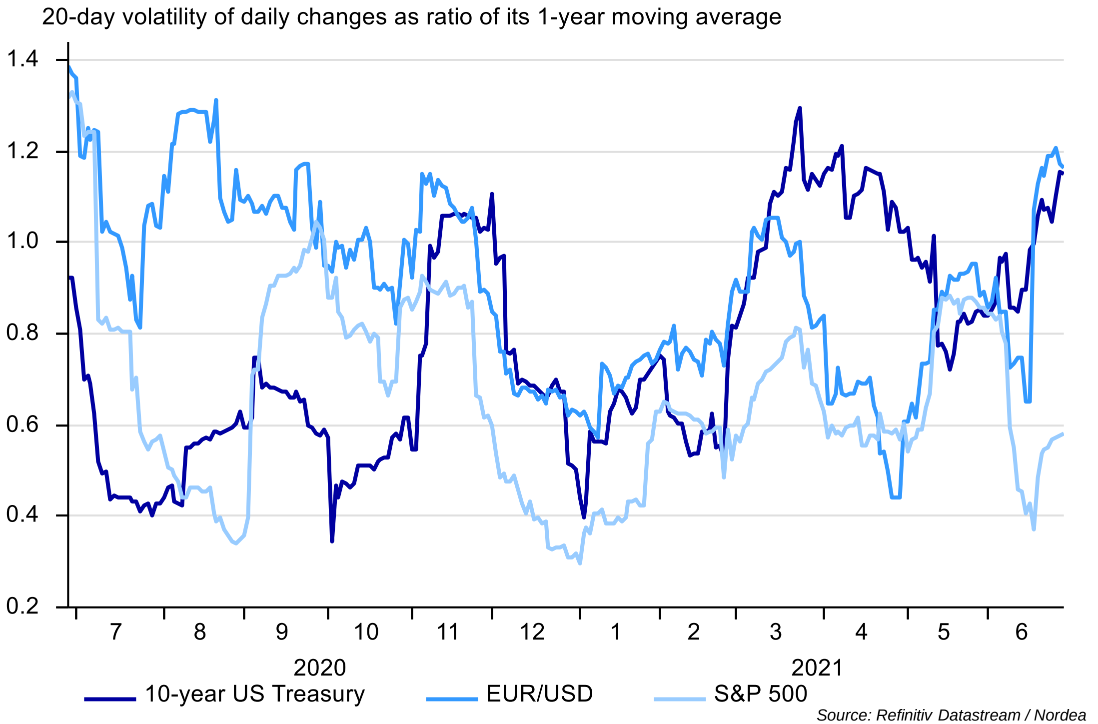
Yield curves tend to steepen during and after recessions



- FOMC-meeting revealed that Fed now sees two rate hikes in 2023, up from none at the meeting in March. Earlier no rate hikes were expected before 2024.
- The US economy is still far from Fed goals, and core inflation forecast is unchanged, so the implication is that the bar for lift off has been lowered.
- No real information looking at a taper timeline. We expect more details during the fall, and the tapering process to start some time after.

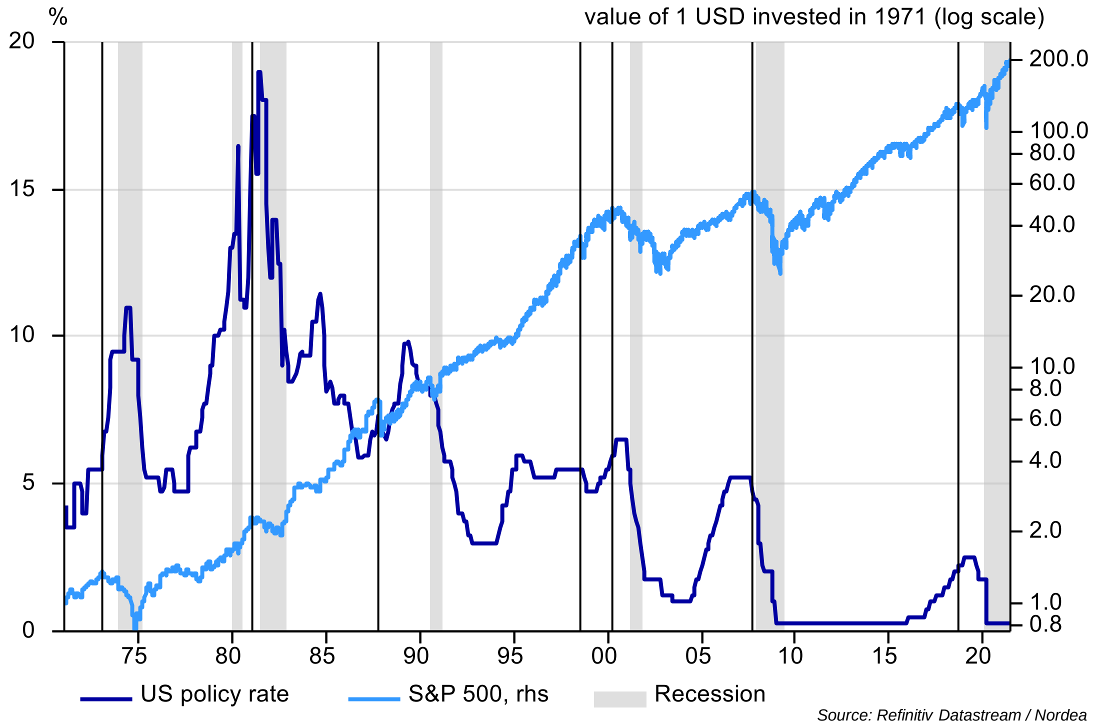
Way too early for equity investors to worry about the Fed

Hawkish surprise from the Fed most acutely felt outside equities



Source: Refinitiv Datastream / Nordea

First rate hikes rarely spell trouble for equity markets

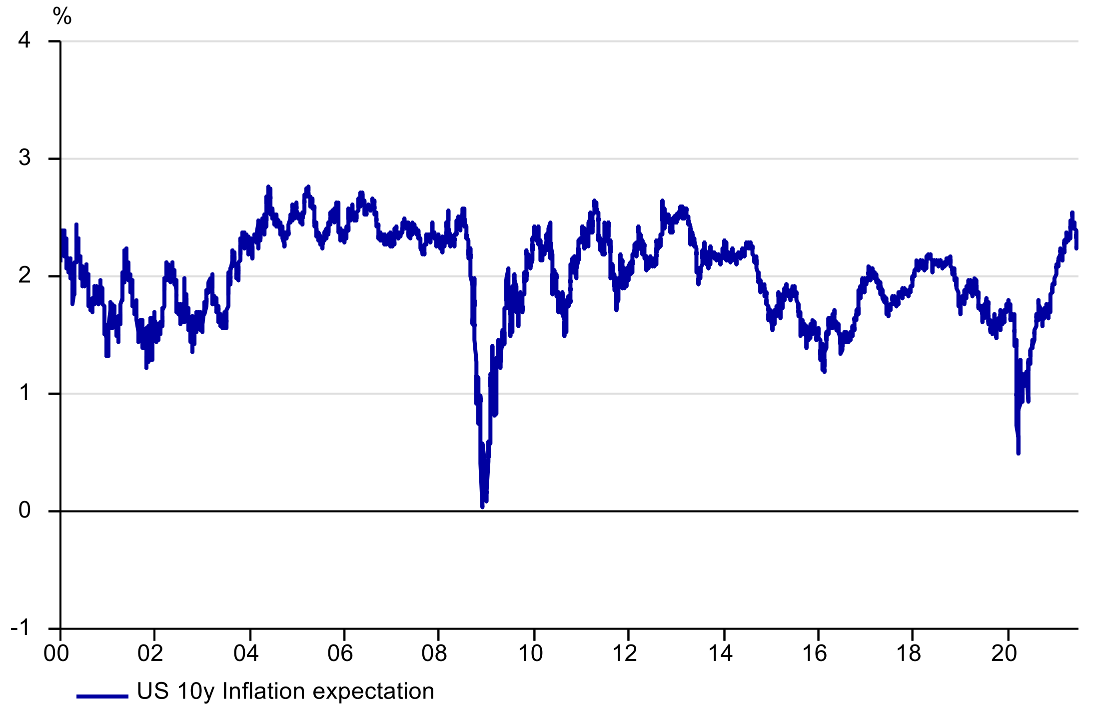


Source: Refinitiv Datastream / Nordea

- The Fed's hawkish turn in June rattled markets somewhat. However, the stress was most acutely felt in currency and fixed income markets.
- In fact, equities only wobbled for a short while as investors quickly concluded that the first steps towards tighter monetary policy will not stop the rally.
- Indeed, historically it has been the end – not the beginning – of a tightening cycle that has been a precursor for more significant equity-market volatility.

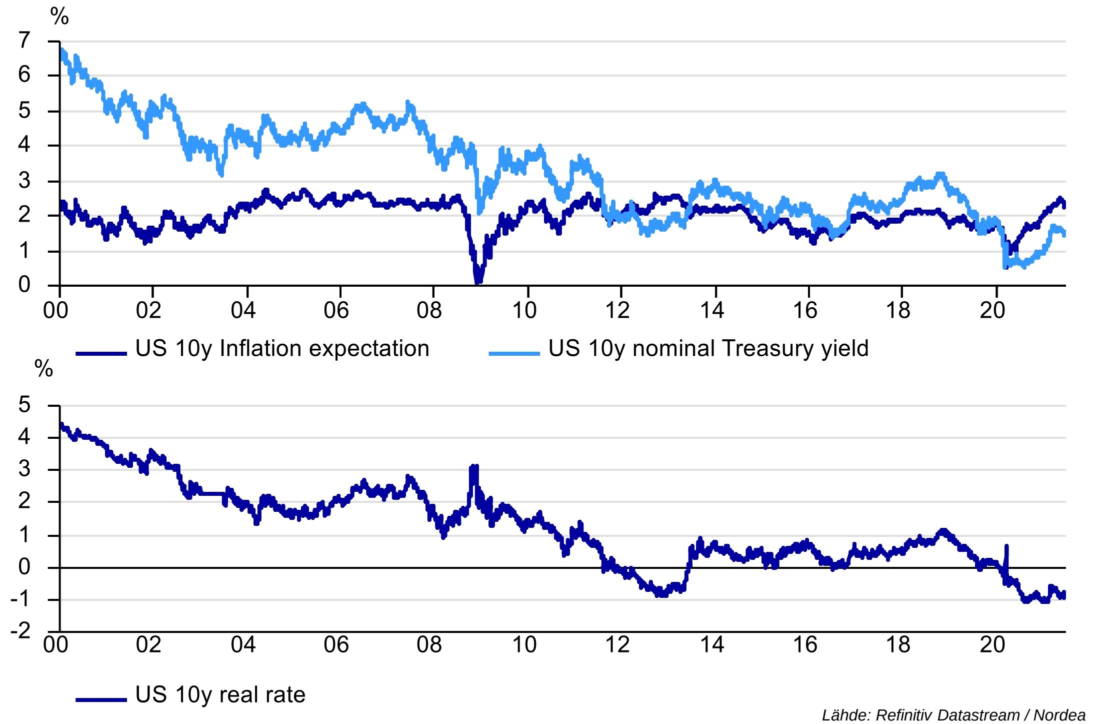
Fed curbs inflation expectations

Inflation expectations are recovering after many years of "lowflation"



Lähde: Refinitiv Datastream / Nordea

Higher inflation expectations transmits into lower real rates



Lähde: Refinitiv Datastream / Nordea

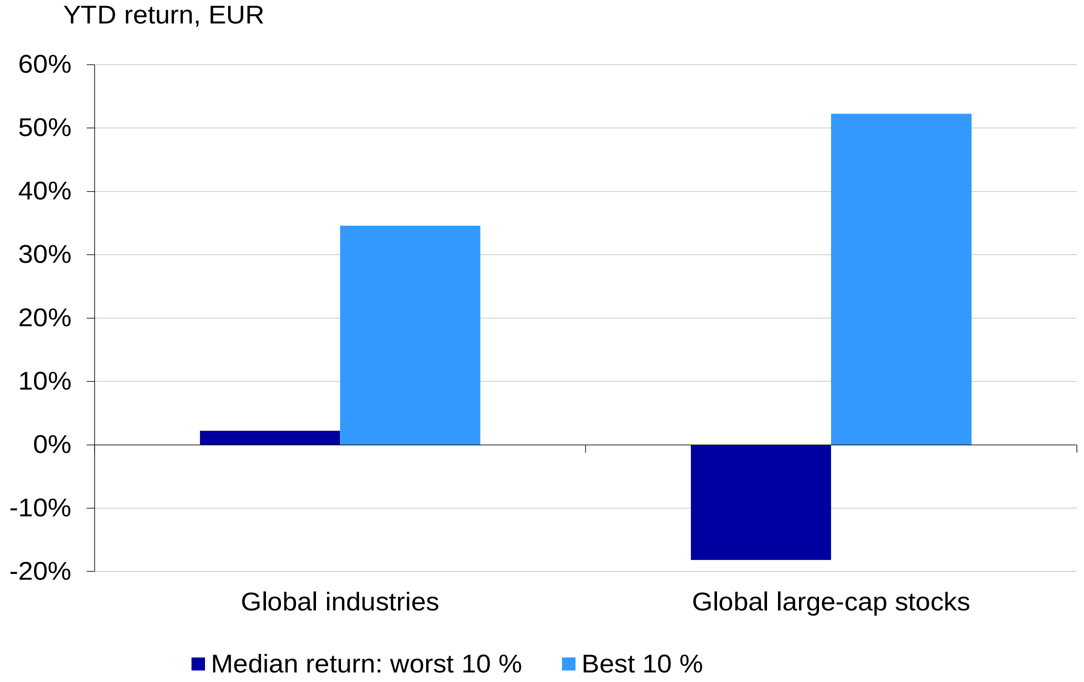
- Reopening of the economies, large fiscal stimulus and corona related disruption on the supply side have raised inflation expectations.
- Fed signaled in the latest monetary policy meeting that inflation would be transitory, but could be somewhat more persistent than earlier anticipated.
- Ironically, inflation expectations have levelled out, as Fed also moved forward the first rate hike. Markets thus expect this to curb inflation at some point.

Time for some summer-cleaning in investment portfolios

The strong rally has increased equities' portfolio share

Source: Refinitiv Datastream / Nordea

Wide dispersion in returns between industries and single stocks

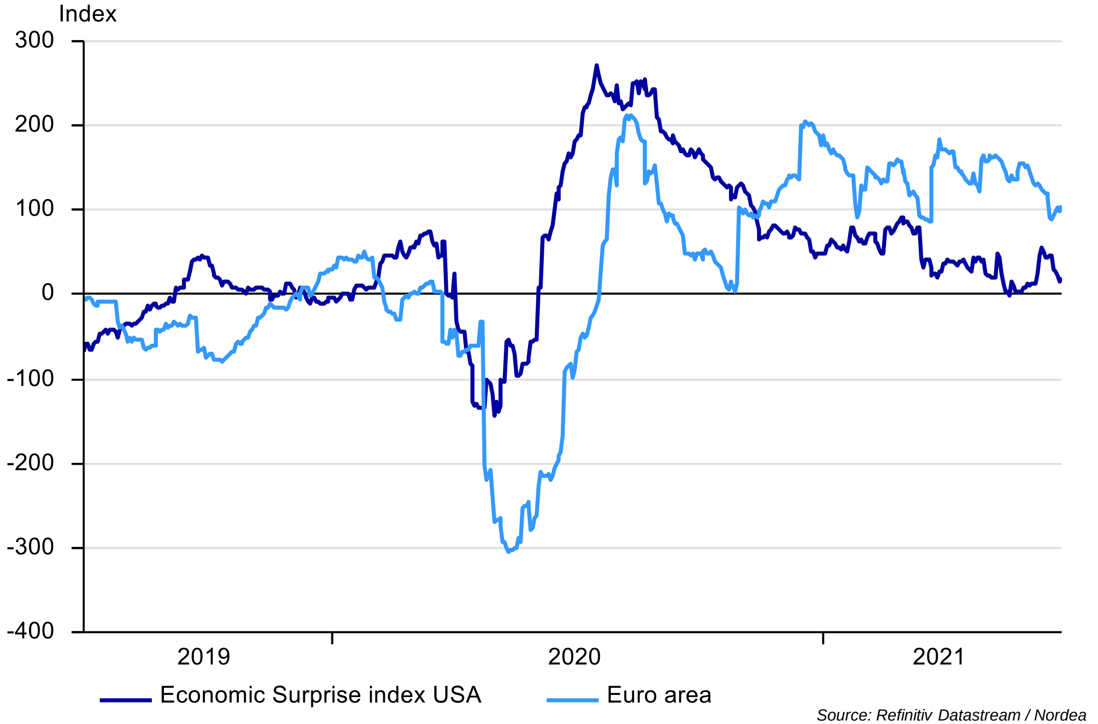


Source: Refinitiv Datastream / Nordea

- 2021 has started with a bang particularly for equity investors. Moreover, the divergence between winning and losing stocks and sectors has been massive.
- Thus, the portfolio shares of these winners have risen, and therefore investors may be more exposed to certain risks than they ought to be.
- Hence, we think now is a good time to make sure portfolios are fit for the summer and shave a bit off the allocations that have grown too large.

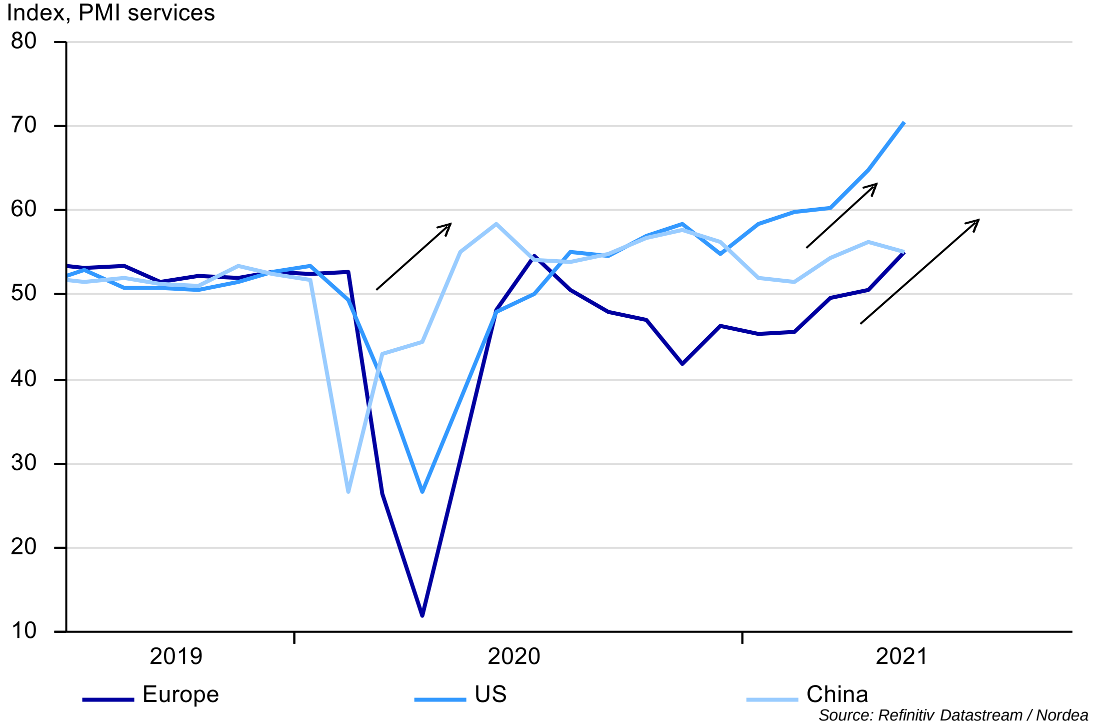
As the economies open up activity is picking up at a stunning pace

The strength of the recovery has surprised consistently



Source: Refinitiv Datastream / Nordea

Vaccinations allow for a rebound in services



Source: Refinitiv Datastream / Nordea

- Due to a sharp rebound in goods demand key macro figures have surprised strongly on the upside fuelling the strong rebound in risky assets.
- The strong economic rebound will continue helped by service demand. In the US growth is probably peaking in Q2/Q3 and somewhat later in the euro area.
- Rapid economic growth will still support equities, but one should not expect that consistently better than expected figures will give the same kind of support.

Fiscal policy will continue to support even after the rebound

- Fiscal deficits in both the US and Euro area will shrink in 2022 as the need for the extraordinary income support to the private sector decreases
- That should not be considered fiscal tightening as the COVID-related income support to the private sector will be replaced by income from economic activity
- In EU the fiscal rule is suspended until 2023. No risk of early tightening as after last downturn. Covid related support will be in place as long as needed
- The EU rescue fund (5% of GDP over 5 year), the suspension of the fiscal rules and low rates means public spending will give a significant boost to GDP
- The focus on infrastructure investment and structural reforms (especially in Italy) should also lift trend growth
- Bidens fiscal plans for the coming years implies a huge boost to demand and GDP even if it is planned to be partly financed by taxes.
- Biden will struggle to get the full plan through Congress. Public spending proposals will be easier than tax increases
- Net effect will be a significant boost to GDP and the net effect on EPS will probably also be positive despite the possibility of increased corporate taxes

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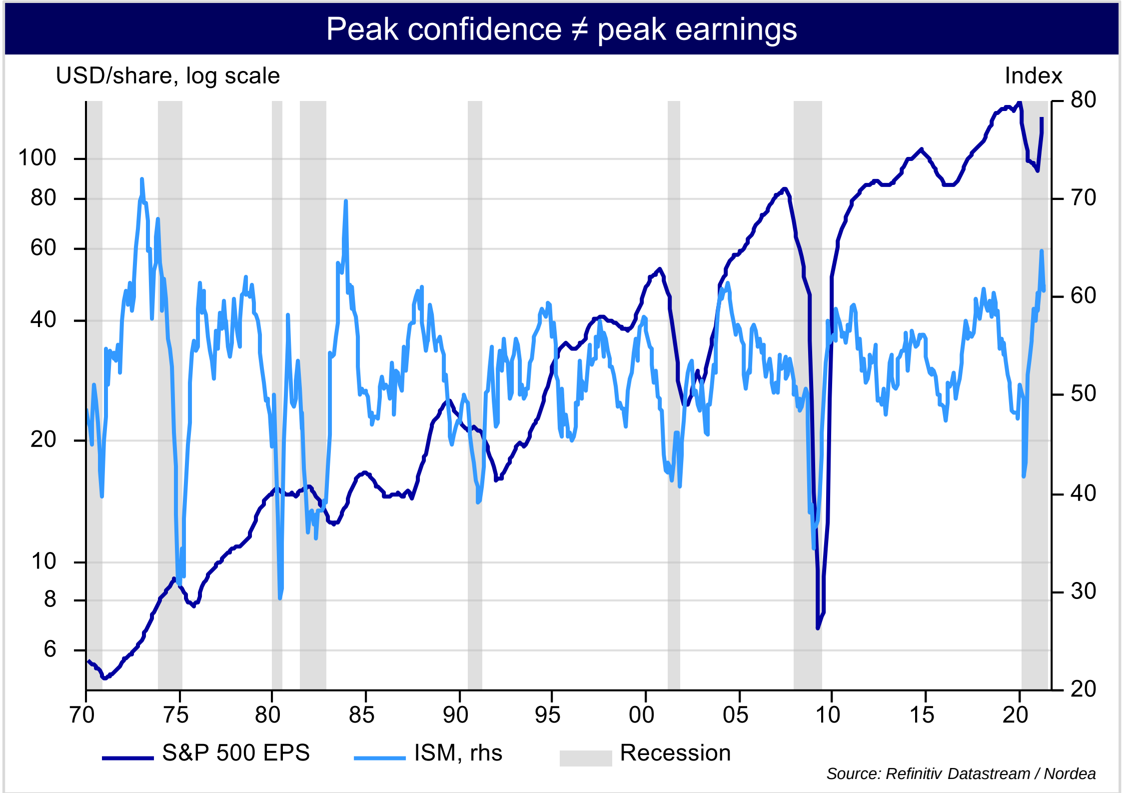
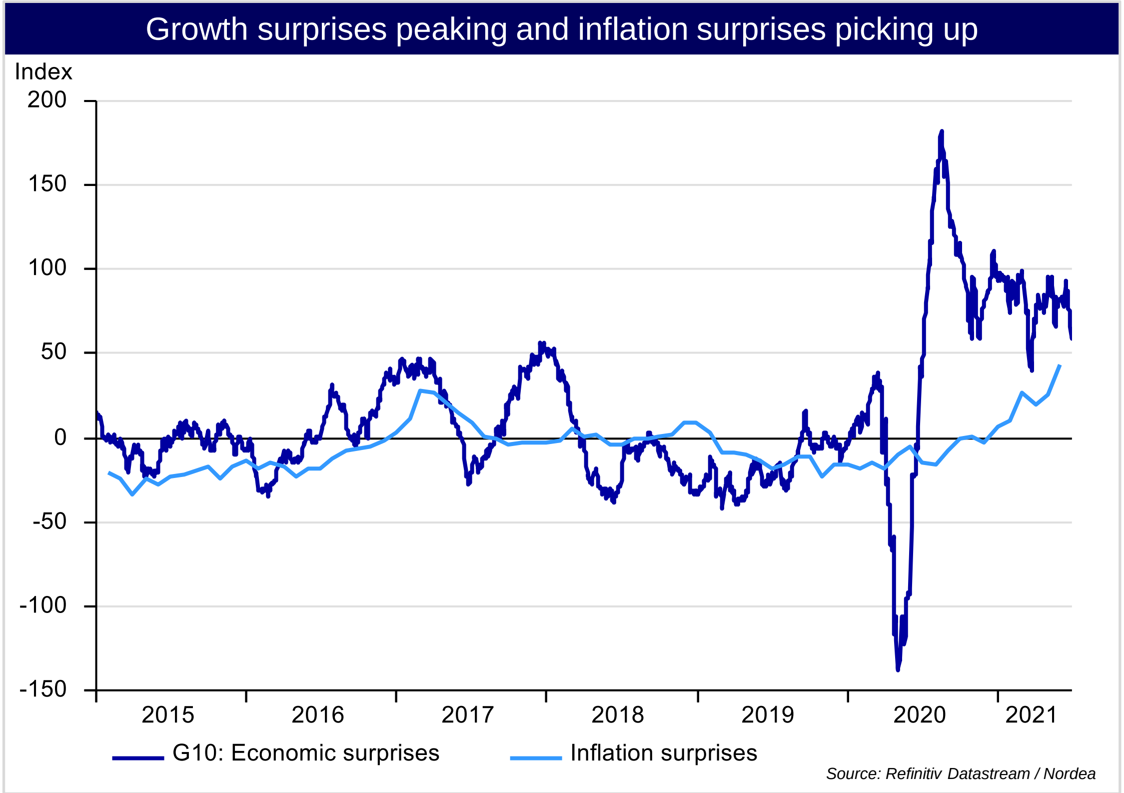
Growth will continue to be strong though it has peaked





- Peak in growth rates from reopening does mean that the strongest returns are likely behind us, but it does not mean that growth will turn negative.
- Earnings historically continue to grow even as leading indicators peak and companies still have room for margin improvements relative to expectations.
- Worries about the growth / inflation mix continue to rattle markets. Expect this to fade as growth continues to improve and central banks tread carefully.

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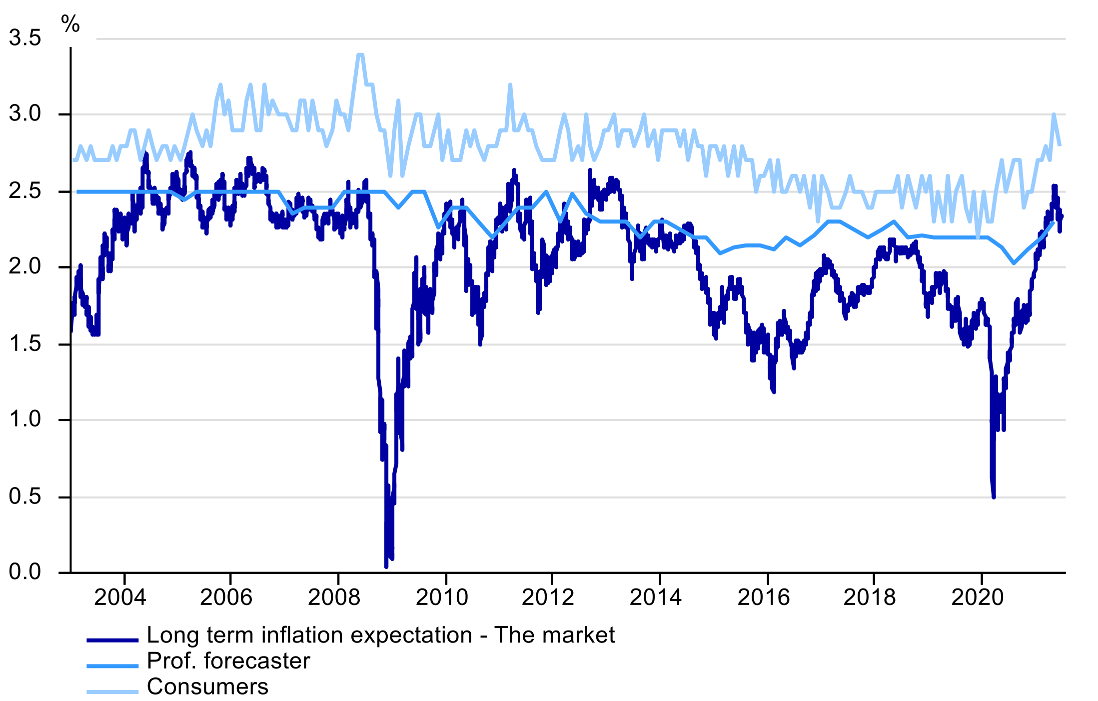
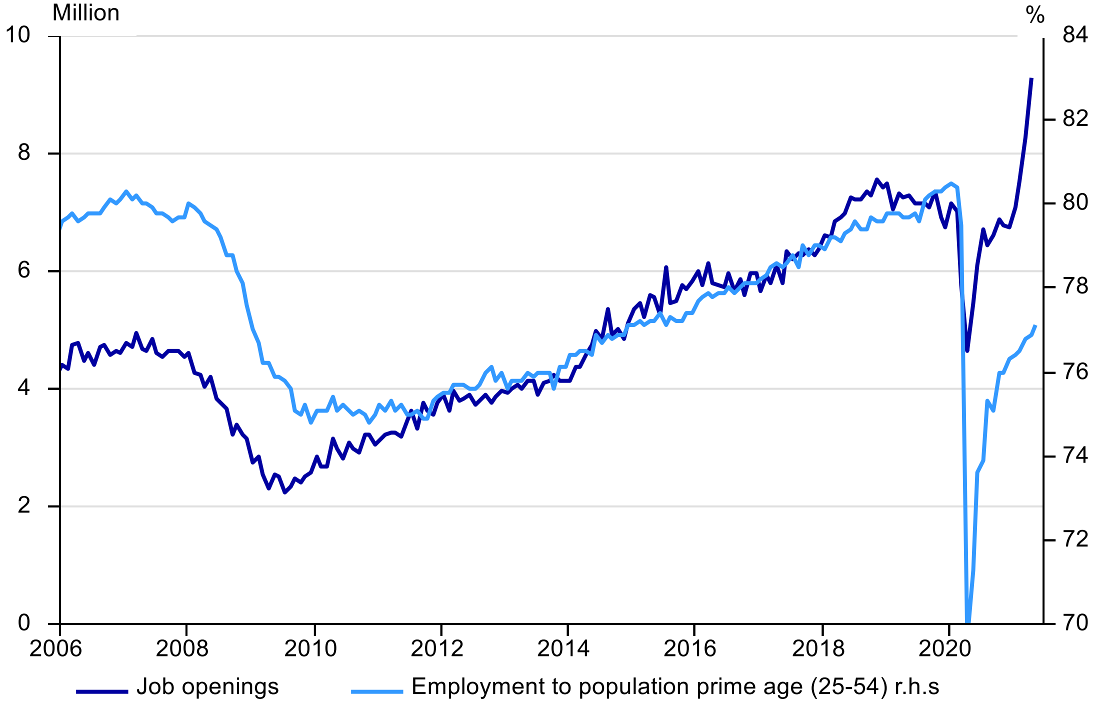
Strong demand for labour, but enough supply should prevent too high wage growth

Inflation expectations has increased, but are not that high



Source: Refinitiv Datastream / Nordea

Demand for labour strong, but should be plenty of supply



Source: Refinitiv Datastream / Nordea

- Inflation rises as the economies open up, but both central banks and the market now seem prepared for relatively high inflation figures
- Demand for labour in the US is strong, but labour supply is held back by temporary Covid related factors such as high unemployment benefits.
- Risk for wage pressure and rising long term inflation expectations, but supply should rebound with employment well below pre-pandemic levels

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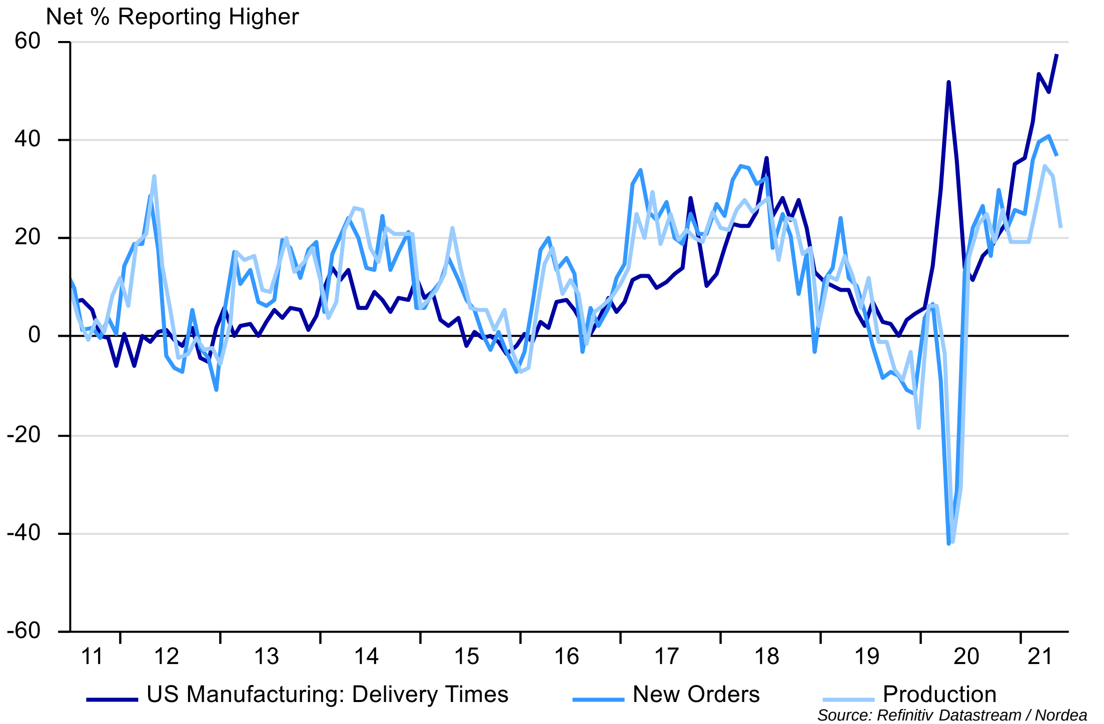
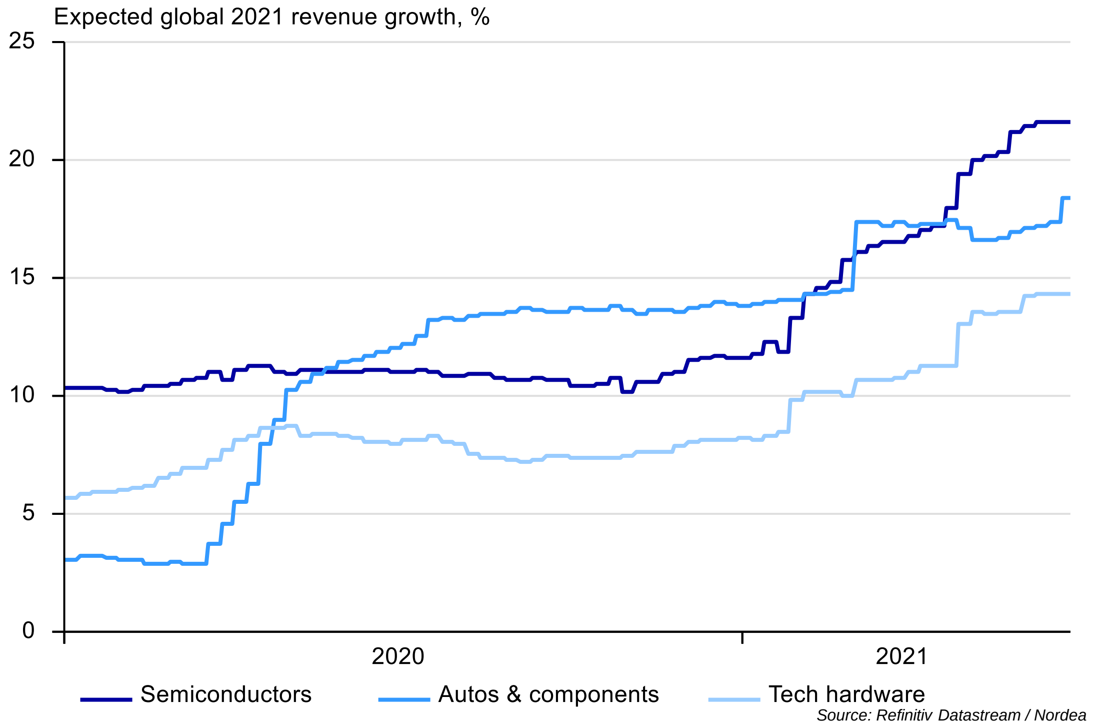
Bottlenecks decrease earnings visibility but should not be exaggerated

Business outlook is strong, but slower supply times put a lid on the pace



Source: Refinitiv Datastream / Nordea

Semiconductor shortage only a marginal constraint on growth so far



Source: Refinitiv Datastream / Nordea

- Bottlenecks have surfaced in commodities and microchips due to global supply restrictions last spring and a rapid demand resurgence for physical goods.
- Companies thus face higher input costs but are able to pass them on to consumers. Availability issues will constrain revenue growth somewhat.
- This decreases the visibility on Q2-Q3 earnings, but markets are likely to see past this as temporary and overwhelmed by the positive growth momentum.

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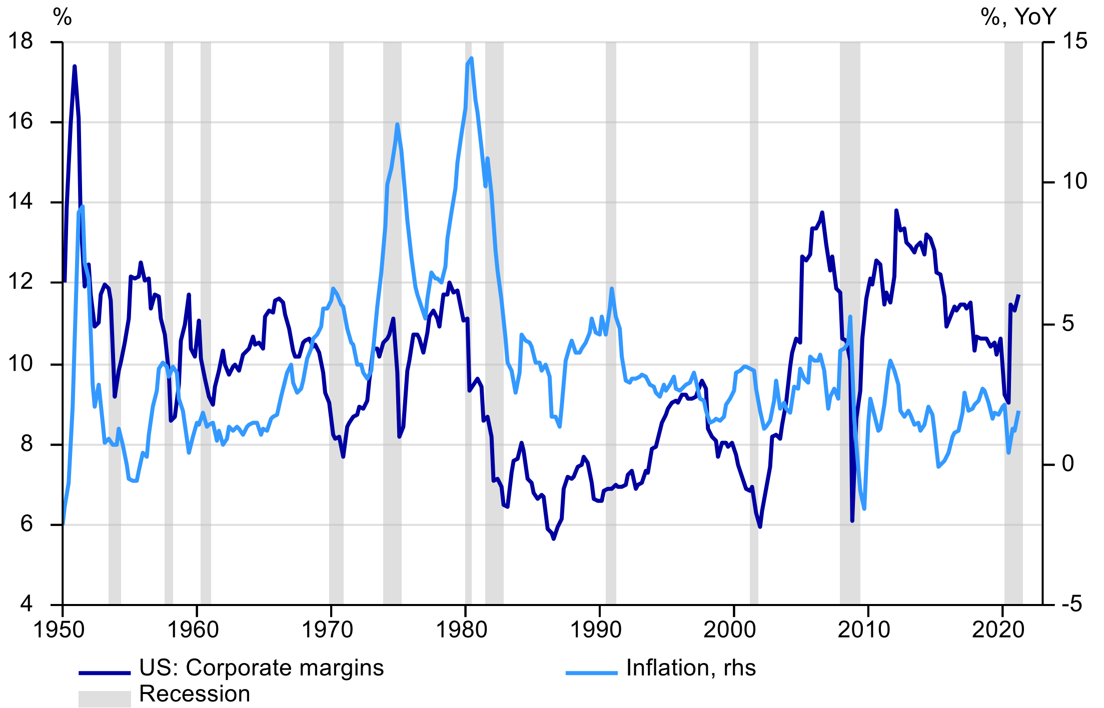
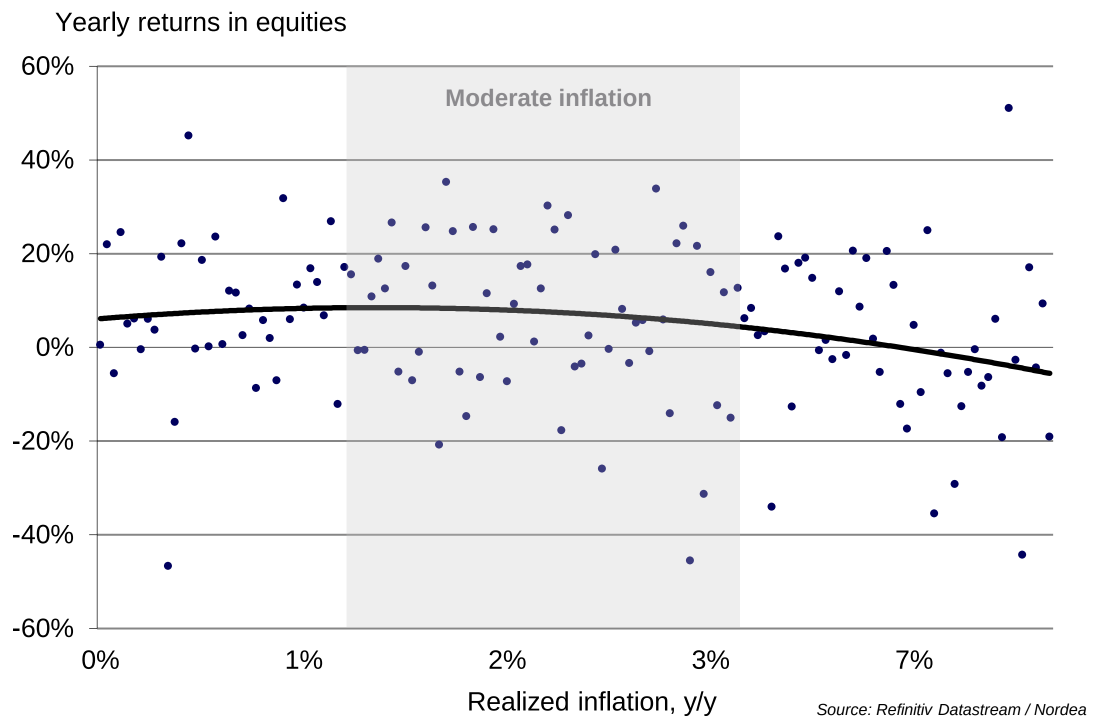
Strong growth and faster inflation favour equities

Accelerating inflation tends to coincide with higher, not lower, margins



Source: Refinitiv Datastream / Nordea

Equities usually perform well in a moderate inflation scenario

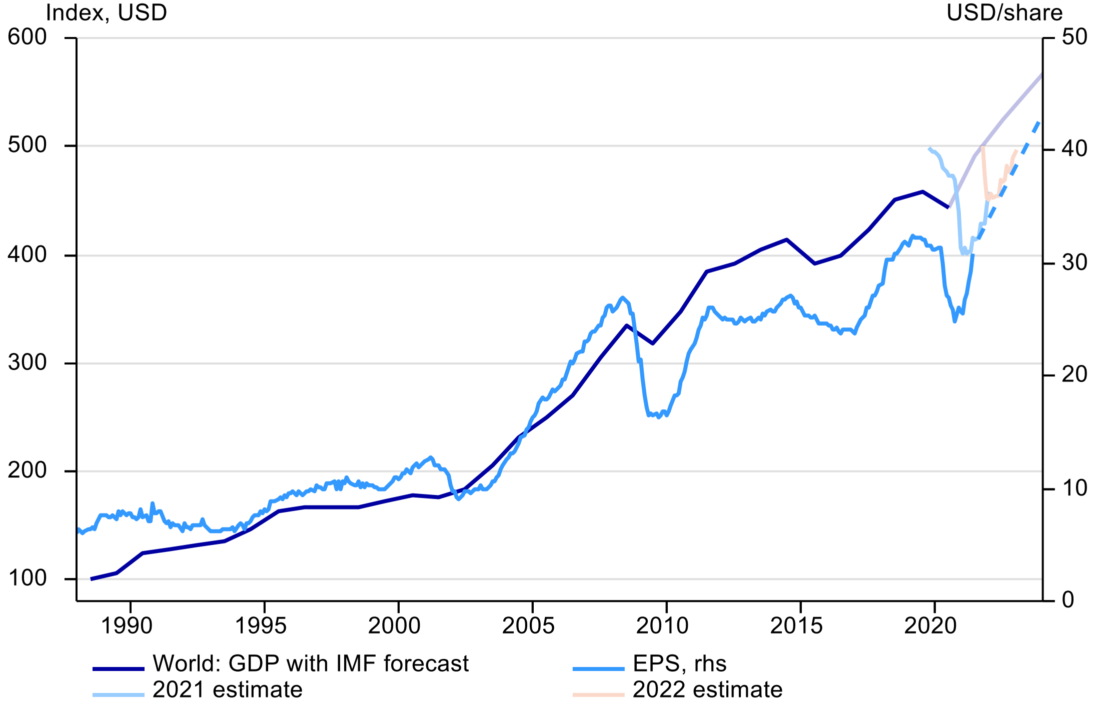


Source: Refinitiv Datastream / Nordea

- While there is a lot of talk about a short-term inflation pick-up, it is unlikely to result in sustained downward pressure for equities.
- In fact, an environment with higher inflation and higher growth, as we are seeing today, tends to bode well for equities, particularly compared to bonds.
- It is also worth noting that consumer prices only need to rise moderately to offset the astronomical percentage increases in certain raw material inputs.

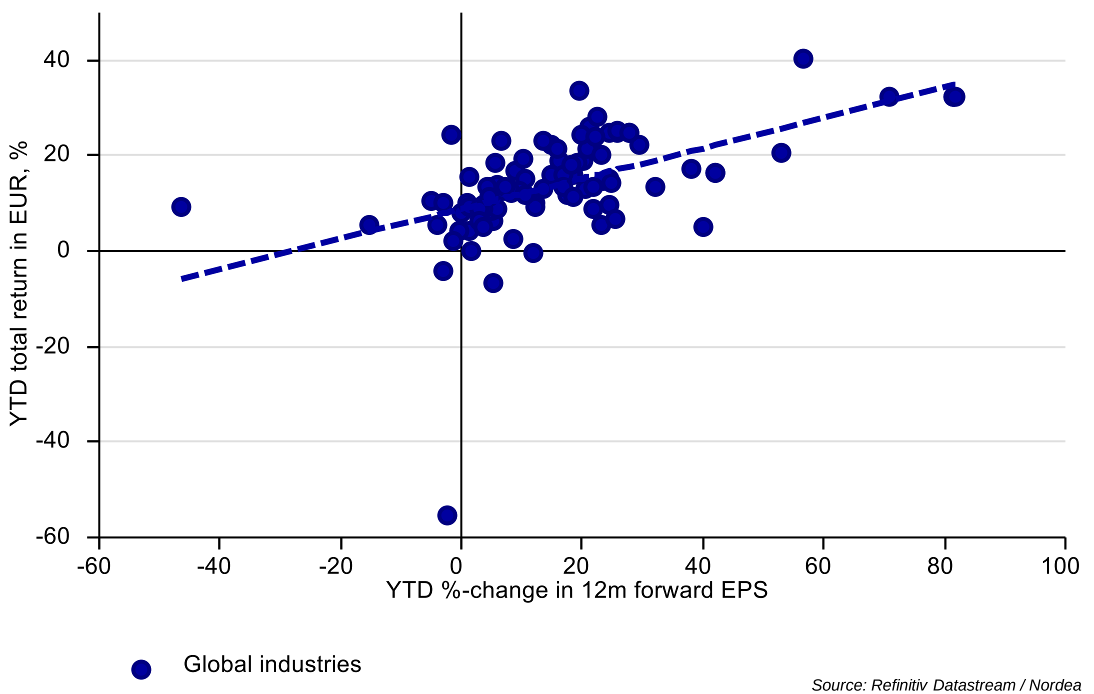
Future earnings have more upside

Improving economy will lead to improving earnings



Source: Refinitiv Datastream / Nordea

Rapidly improving outlooks are a strong support to equity markets



Source: Refinitiv Datastream / Nordea

- Usually analysts overestimate earnings to the tune of 5 %, but tend to underestimate earnings coming out of a crisis. This has now played out.
- Going into the Q2 reporting season, both analyst estimates and corporate guidance have improved significantly, in contrast to usual quarters.
- Particularly in the US, the upcoming reporting season will be the peak in terms of year-on-year growth, currently estimated at above 60 %.

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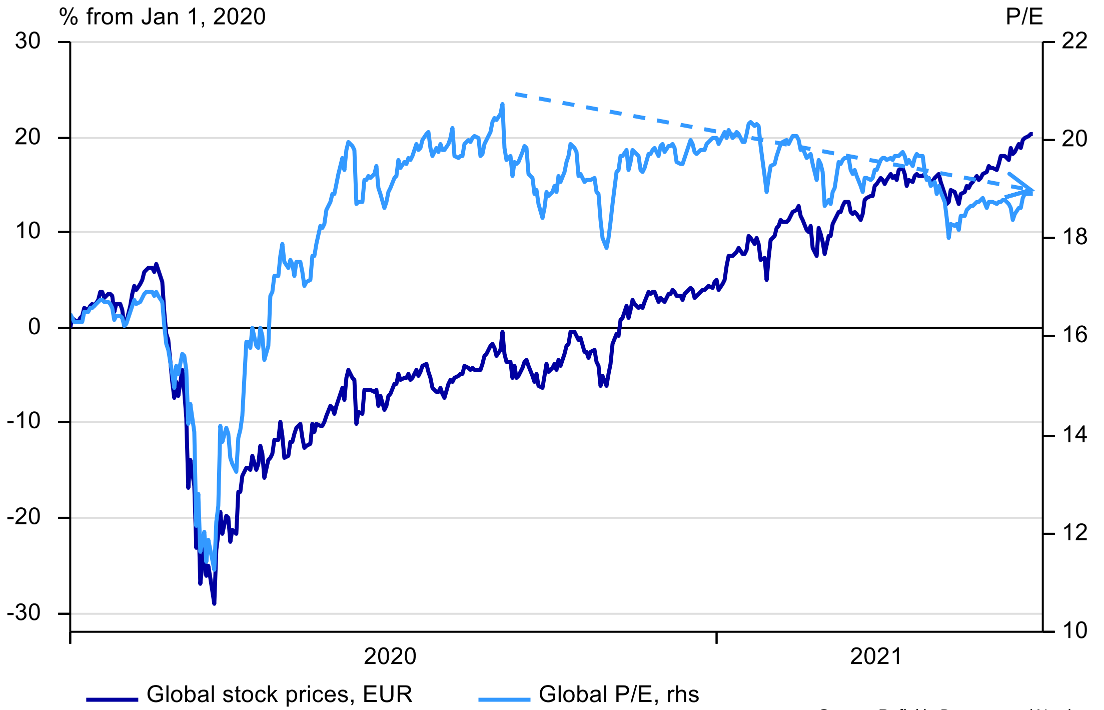
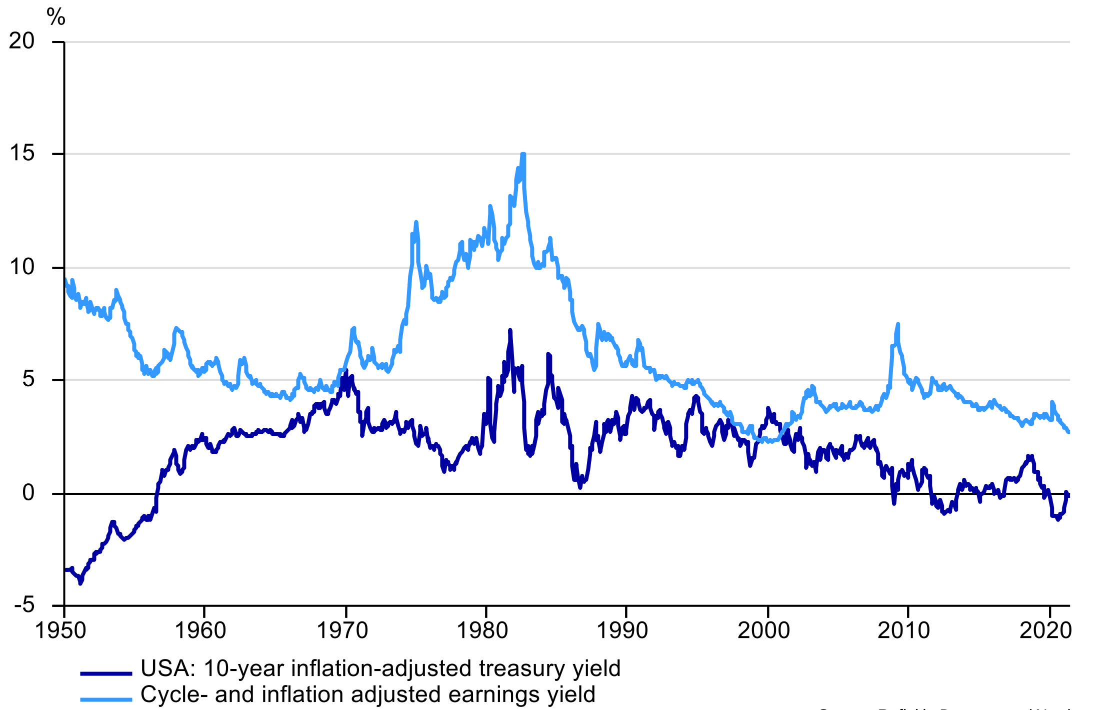
Valuation more supportive lately

Valuations have moderated despite the relentless rally



Source: Refinitiv Datastream / Nordea

Relative to bonds, equities are outright attractive



Source: Refinitiv Datastream / Nordea

- Absolute valuation metrics have moderated as stock prices have not kept up with the improving earnings outlook.
- Relative valuation is still outright attractive. As the economic outlook improves, risk premia often compress, and equities should continue to outperform bonds.
- However, valuation multiples are still elevated enough to escalate market movements in both directions.

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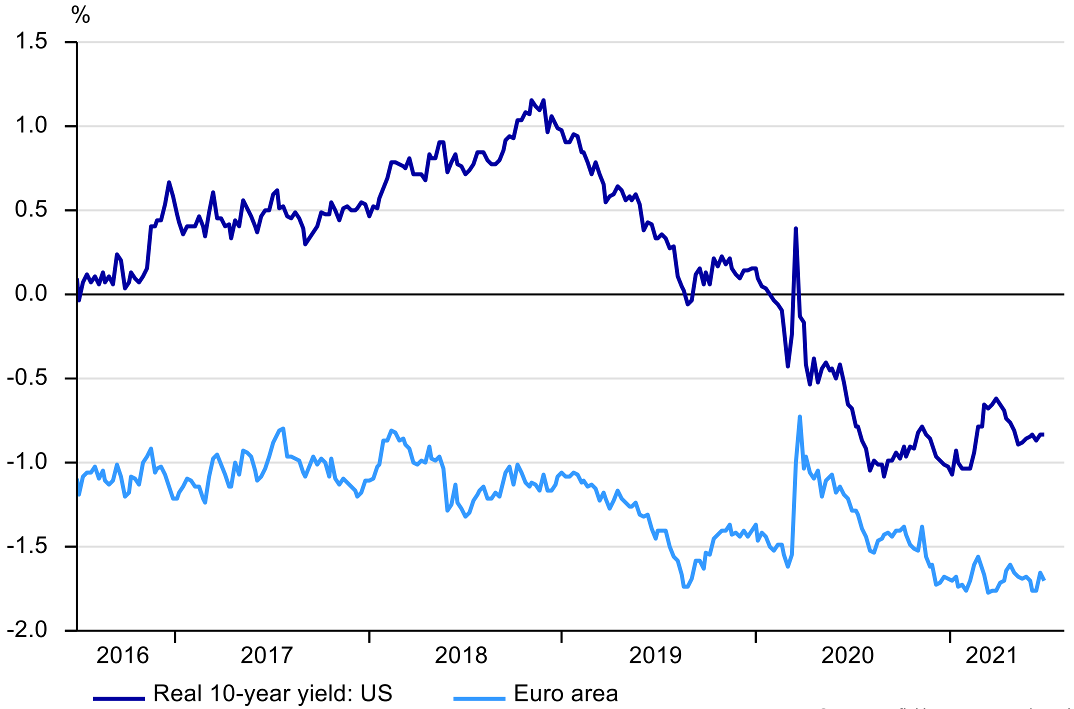
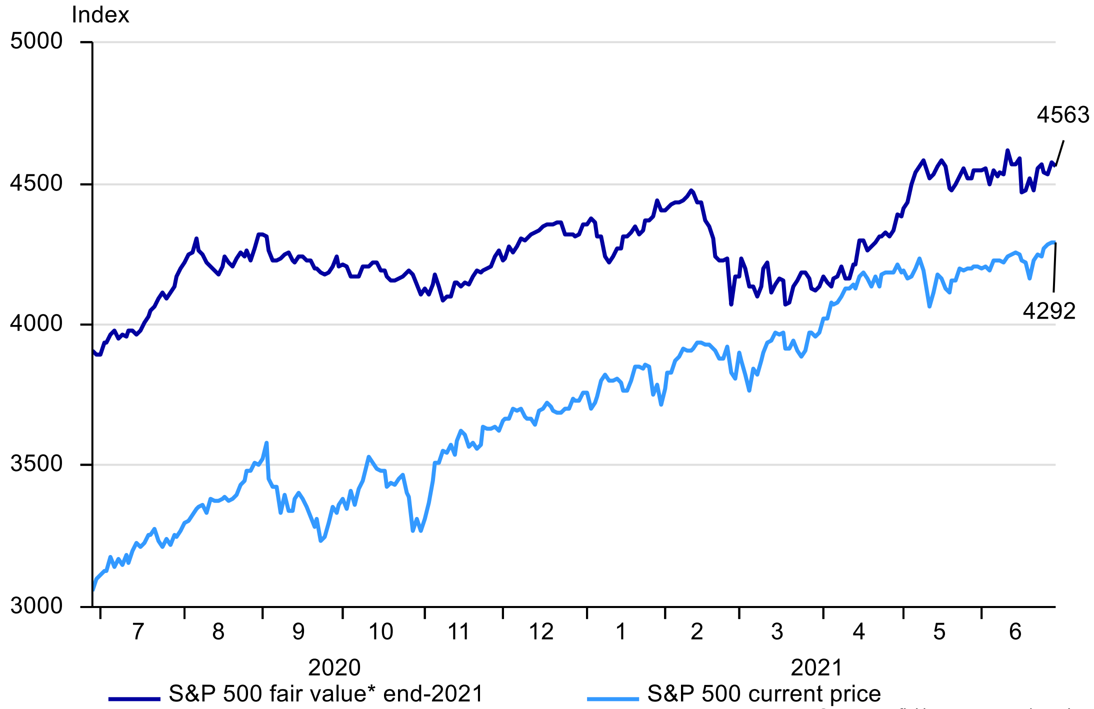
Still decent upside for equities this year

Real yields are edging slowly higher



Source: Refinitiv Datastream / Nordea

Benign yield movements and improving outlooks give equities decent upside



Source: Refinitiv Datastream / Nordea

- The rise in real yields has taken a pause which, coupled with improving macro data and earnings outlooks left equities room to rally.
- Our base case remains that yields should continue to move higher and risk premia lower this year. This would mean lower valuation multiples at year end.
- Moreover, we think that in the current macro environment, earnings estimates should keep rising, more than offsetting the fall in valuations.

*S&P fair value is calculated with 5Y average real risk premium, 2021 (and -22) consensus EPS and current 10Y TIPS yield

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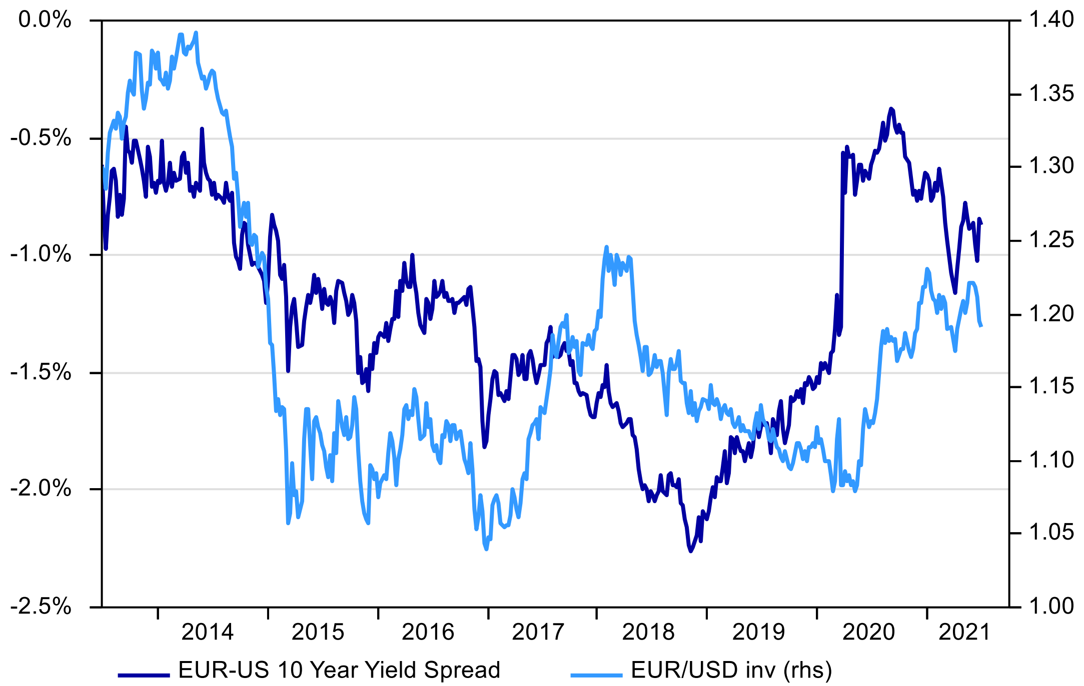
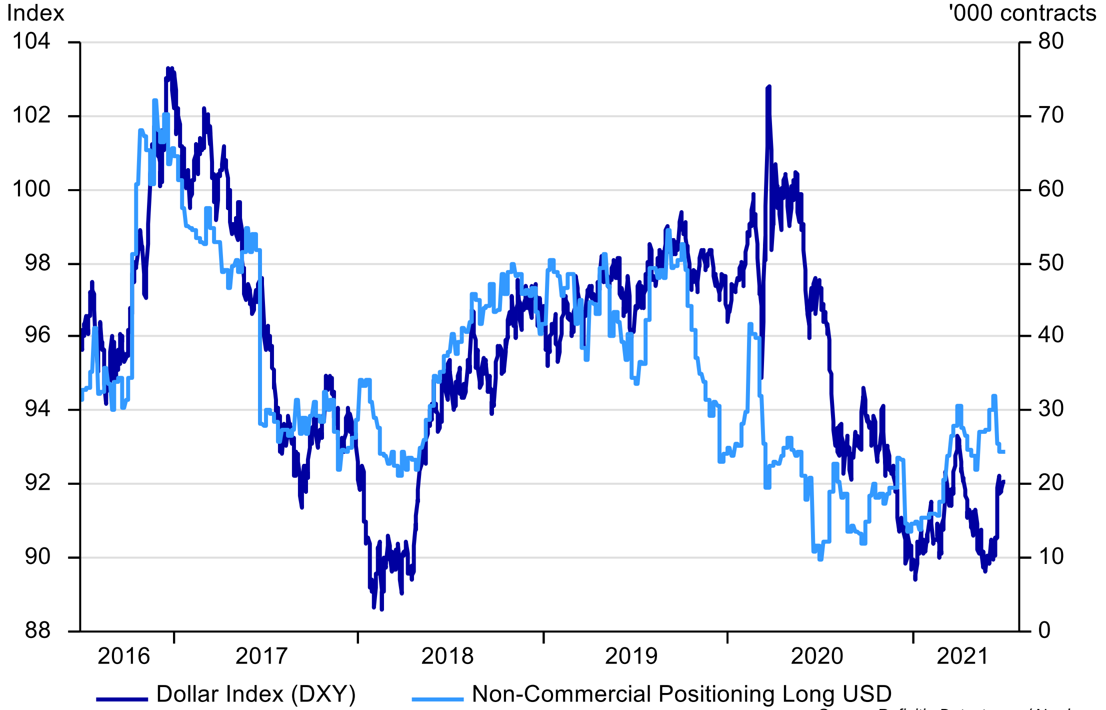
The dollar should strengthen going forward

The interest differential will support the dollar



Source: Refinitiv Datastream / Nordea

The direction of the USD and positions of non-commercial traders



Source: Refinitiv Datastream / Nordea

- Loose monetary policy and a vaccine rollout in the making has sparked a hunt for riskier bets and weighed heavily on the US dollar during 2020.
- After starting the year on a positive note, and with a cyclical focus, the hunt for yield and correction in real rate differentials have weakened the dollar.
- The interest differential will support the dollar. Only minor portfolio impact as we do not for see a larger move in either direction short term.

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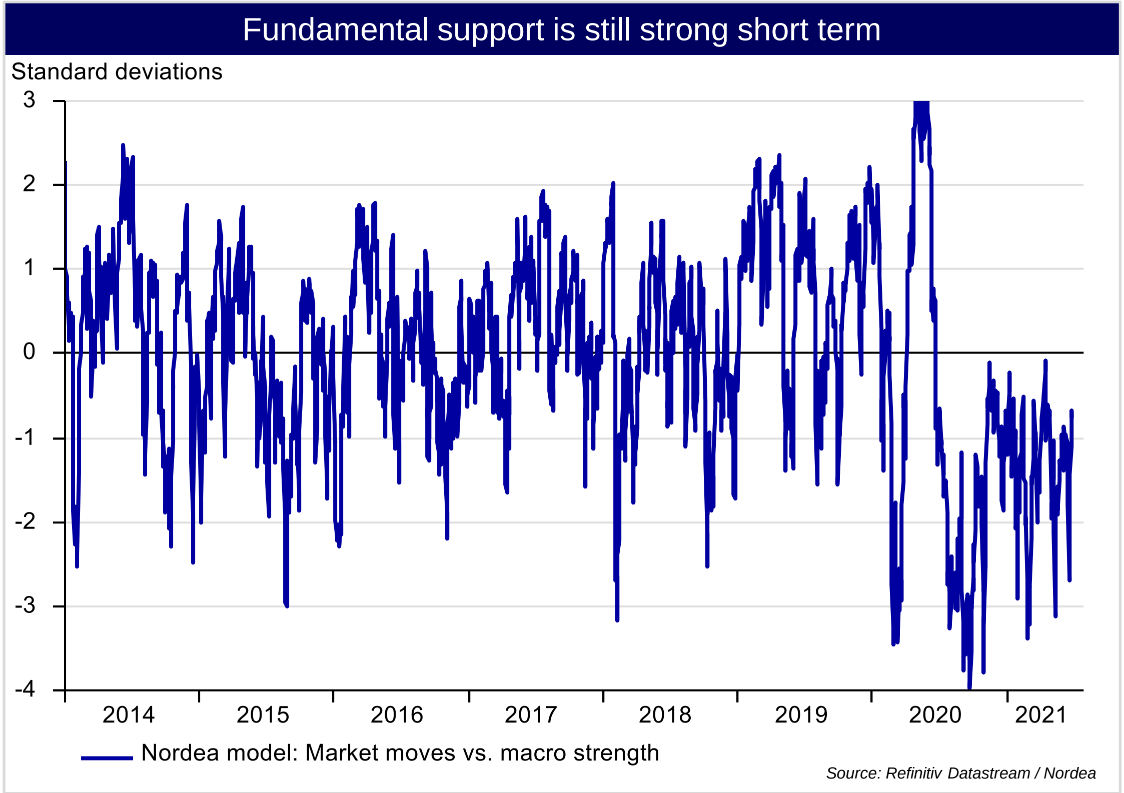
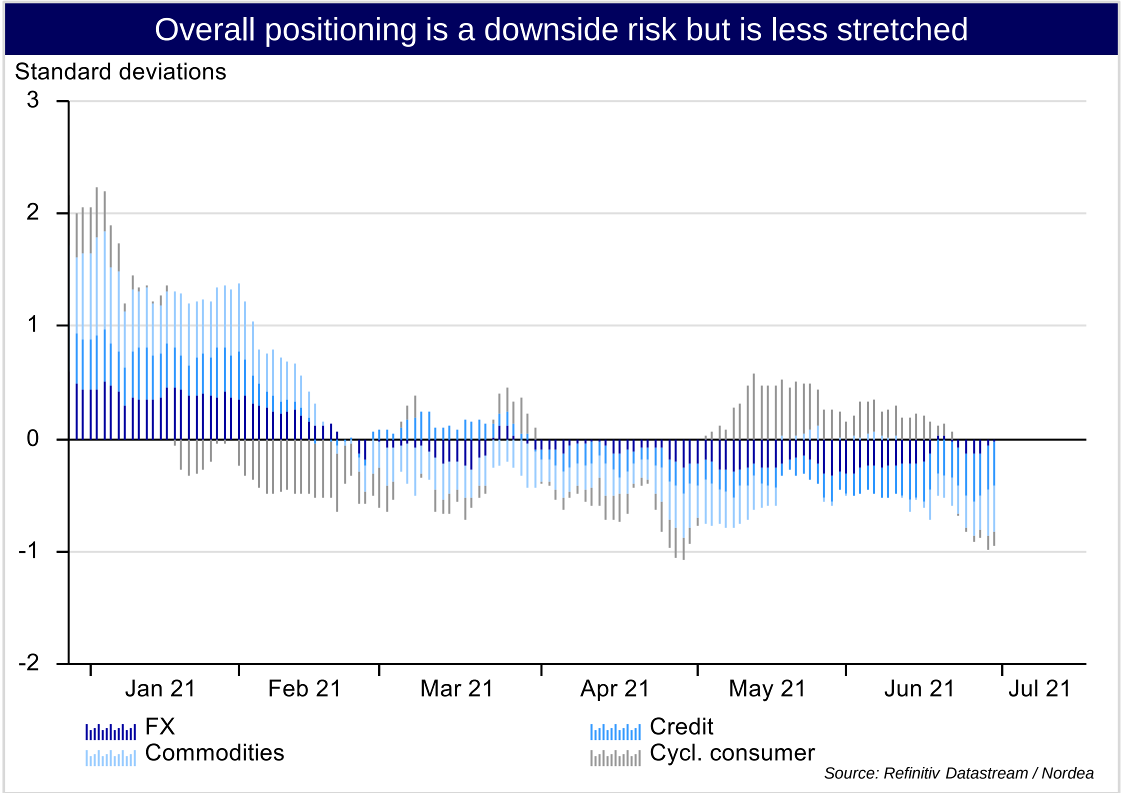
Investor positioning is still is supported by strong fundamentals





- Investor positioning is stretched, but fundamentals continue to support the bullish view and thereby reduce downside risks for some time still.
- Private investor activity has been rising again lately but we expect the support for the broader markets to have peaked for now.
- Volatility is likely to pick up over the summer months as economies reopen. If the right catalyst sparks a sell-off, positioning is a downside risk.

Politics | Beware fading the political risk to markets

Russia at the border

- Russia's actions on Ukraine's border once again shows the potential for conflict.

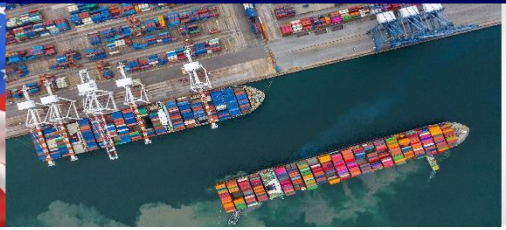
Germany's new direction

- Germany might be set on a new fiscal path as a new government looms on the horizon.

USA's stance to China

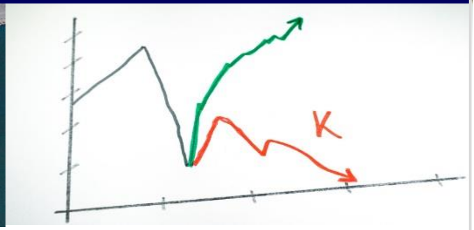
- Biden will continue with "America first" policy and focus on development of local business and economy.

Trade war in the Pacific



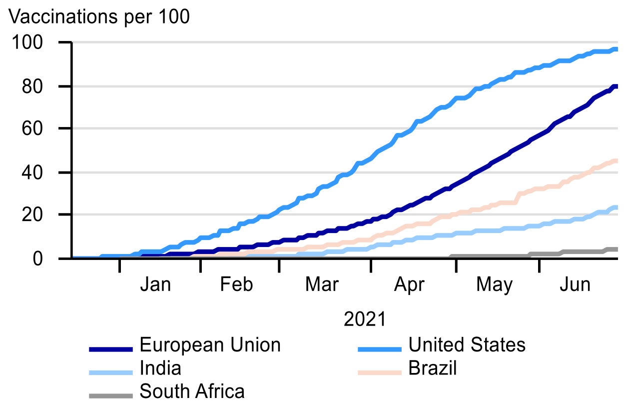
- Australia's pushback against China's 'Belt and Road' infrastructure plan may be catalyst to new trade war.

K-shaped recovery



- The 'k-shaped' recovery has resulted in a large gap between the winners and losers of the corona crisis, which can lead to increased civil unrest

Large regional gap in vaccination developments



- Significant difference in vaccination programs among developed and undeveloped countries can lead to a disconnected world.
- Unrest can come as a result of dissatisfaction with governments' handling of the corona-virus and vaccine programs.

ESG

- Political pressure and regulations to adopt sustainable policies can further steer investment into ESG funds.
- How will the non-sustainable firms be affected? Valuations have turned frothy for some new energy companies. Part of this has reversed, but it makes a strong case for diversification here.
- ESG is more than just the 'E'. Will focus eventually shift more to Social & Governance?

Source: iStock / Pearson Institute

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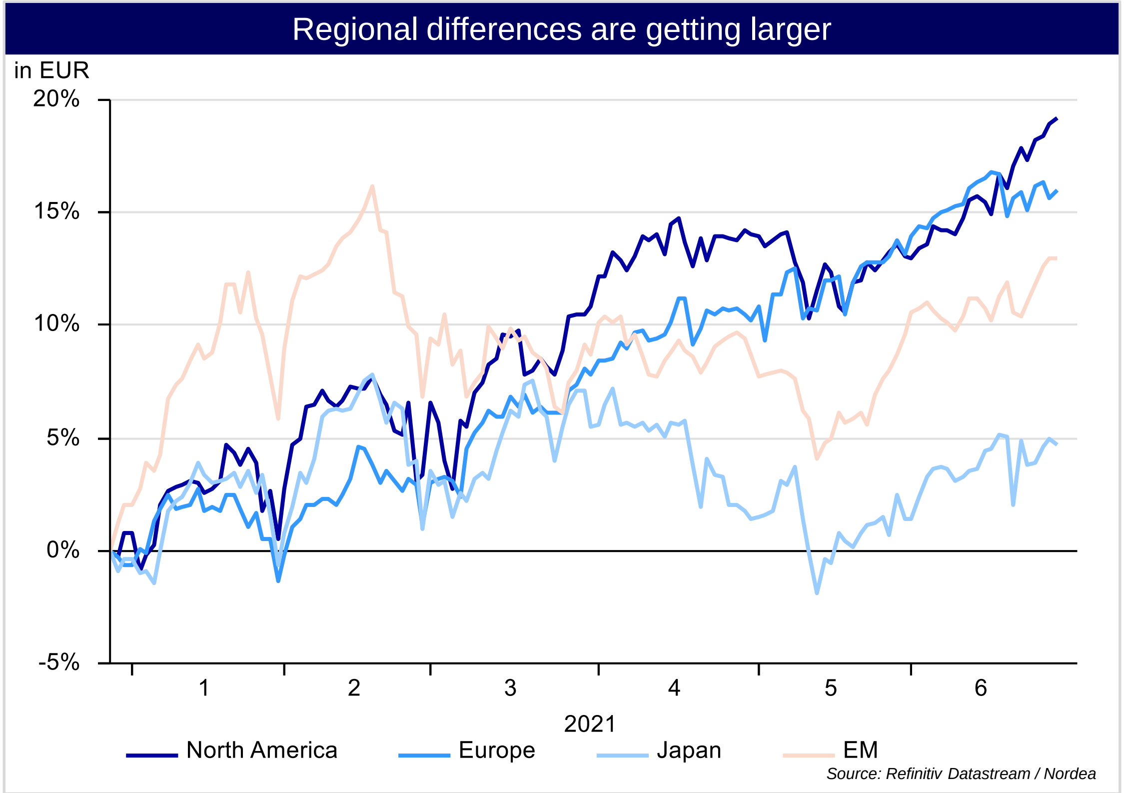
China sticks to its declared focus on financial risks, verbally tightening conditions

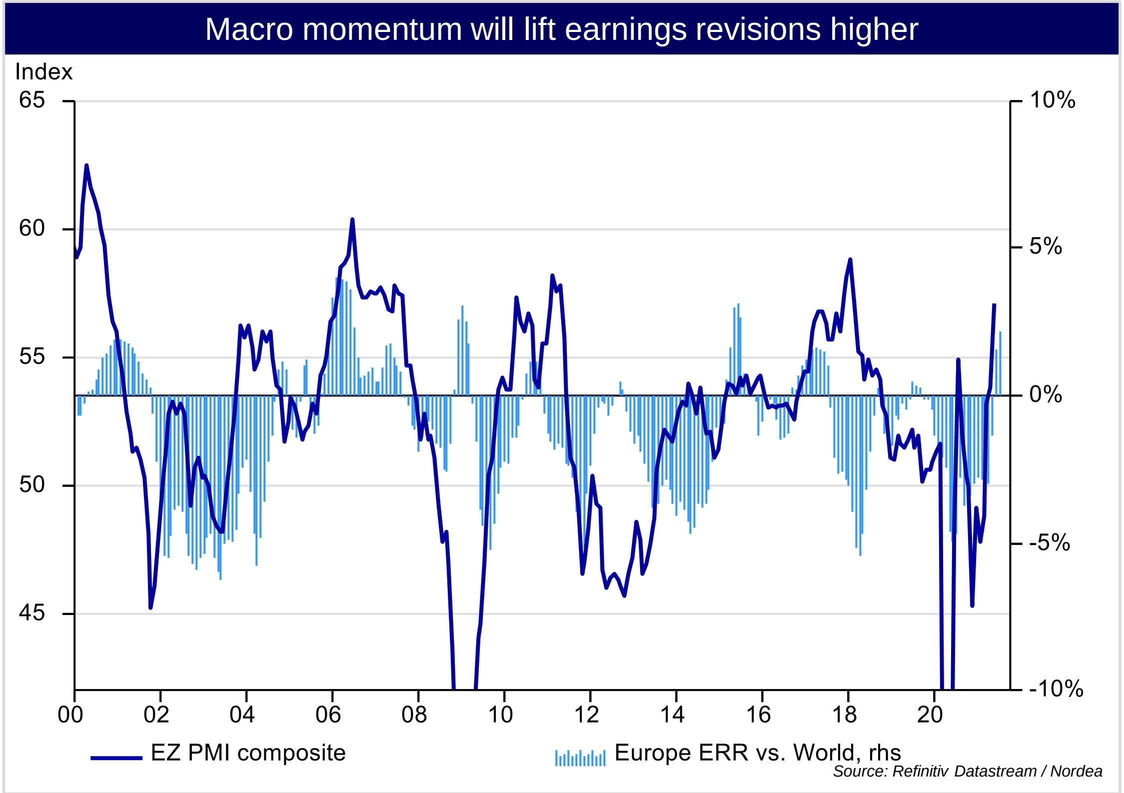
Chinese leadership attacking the unspoken state guarantee held by government linked entities

- Already back in 2017, Xi Jinping declared that in stead of focusing solely on reaching centrally decided growth targets, China would fight “three tough battles”. Those were alleviating poverty, pollution control, and reducing (financial) risks. The third one focused on China’s immense and rapid build-up in debt, and the perverse incentives generated by a wide held view of an implicit state guarantee for debt held by local governments and state-owned enterprises (SOEs). That has made investors more willing to lend to government affiliated entities than they would have otherwise been, building up financial risks.
- When China declares a strategy, one should usually count on them pursuing it, so it should come as no surprise that China during this down-cycle stimulated the economy only as much as was necessary, and quickly assumed a neutral policy stance when the economy stabilized. This differs from China’s traditional “irrigation-style” stimulus, and means that credit conditions are already tightening (as described on earlier pages).
- China has kept monetary policy neutral lately, but has engaged in verbal tightening of financial conditions by allowing SOE bond defaults to rise and signalling reduced state backing of both SOEs and local government infrastructure funds (LGFVs). LGFV defaults would have massive consequences, so China will be very wary of allowing any contagion from the hunt for bad debt. Leadership is primarily trying to signal that there is no state guarantee of all government affiliated entities, but this will add to the underlying tightening in conditions already taking place. This is adding to our conviction that Chinese macro momentum peaks early 2021, and raises the risk of periods where a negative tightening narrative weighs on Chinese equities..

Victims of the hunt for reduced financial risk
China’s efforts to remove the implicit state backing of debt held by state-owned companies is evident in the current uncertainty around a bail-out of large state-owned asset manager Huarong, which has seen its dollar denominated debt lose substantially in value following creditworthiness concerns.

Reduce exposure to Emerging Markets and raise Europe

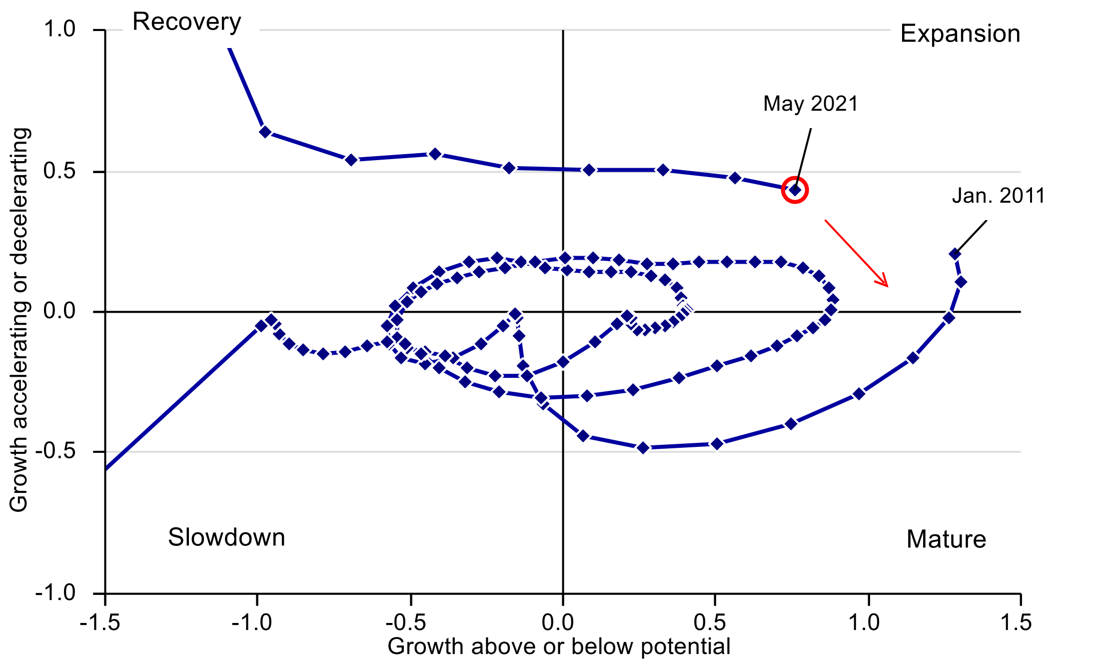




- Regional differences have started to emerge in the past couple of months. We recommend to lift European equities vs. Emerging Markets.
- Strong economic stimulus response and economic reopening favour DM economies vs. EM. And Europe has an attractive valuation vs. other areas in DM.
- Chinese growth momentum will slow further this year and this will weigh on the EM profit cycle. Europe stands out with a benign earnings outlook.

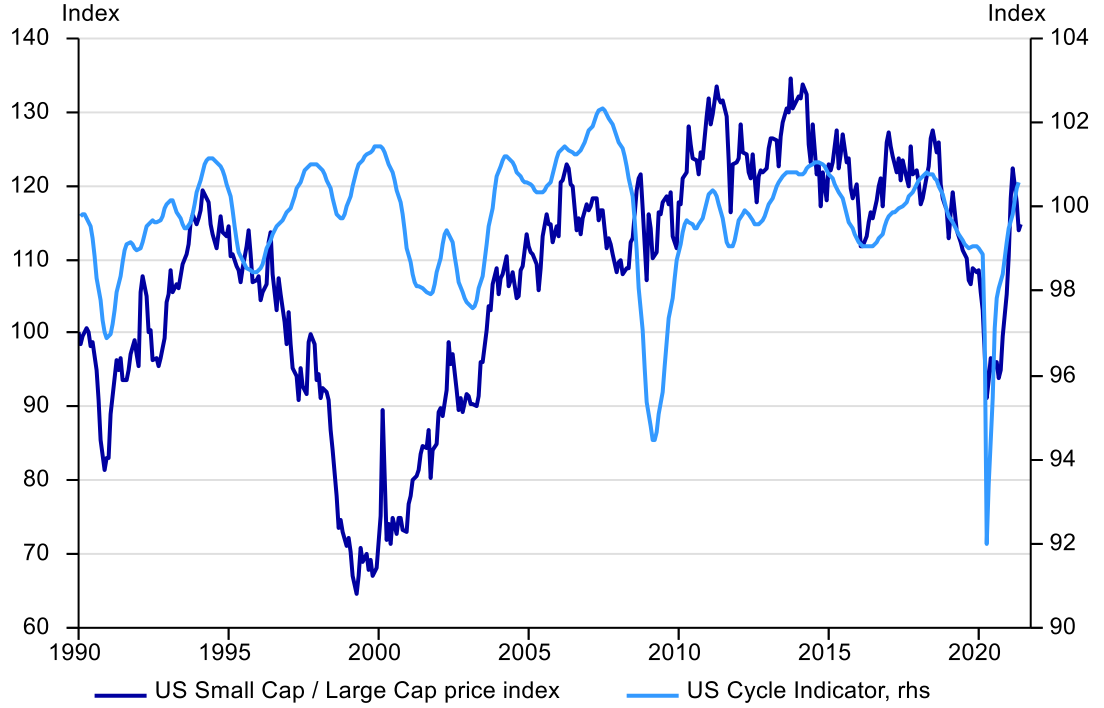
Positioning for a mature cycle means closing our Small Cap overweight

The strongest growth phase is soon behind us…



Source: Refinitiv Datastream / Nordea
Note: Indicator based on OECD Dev.+6 ampl. Adj. CLI

…which tends to be consistent with less small cap outperformance

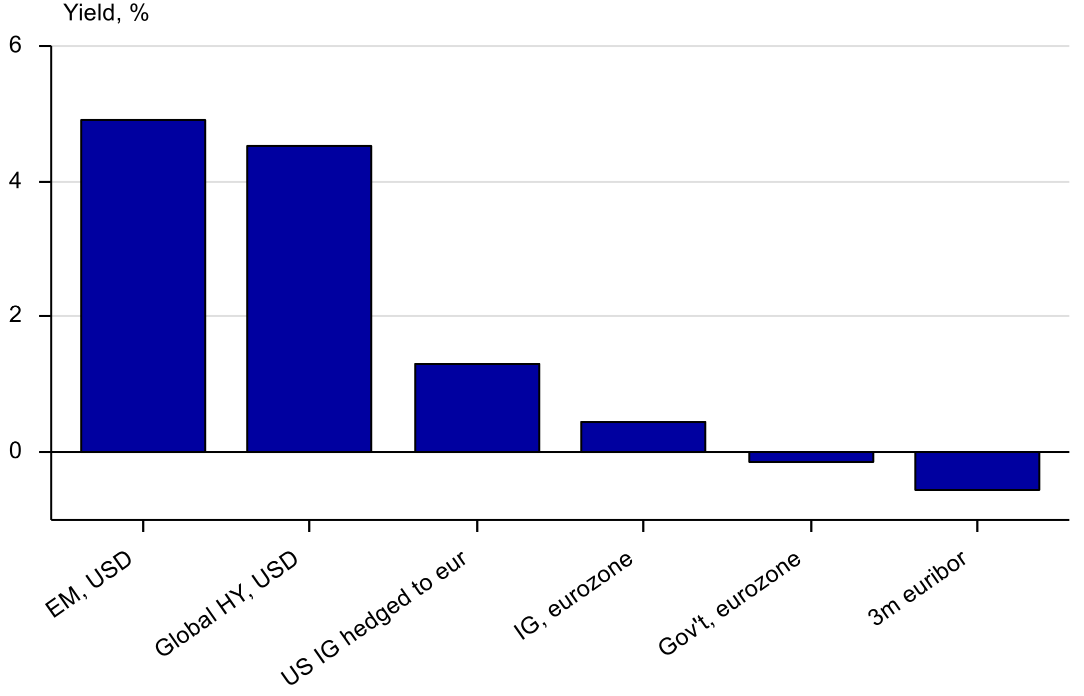


Source: Refinitiv Datastream / Nordea

- We are moving past the fastest increases in output. As small cap has a high exposure to economic growth, future growth expectations matter.
- In particular, small cap outperformance tends to be concentrated in the strongest phases of the recovery which are soon behind us.
- Hence, we think now is a good time to close that allocation and move the money towards more diversified large caps with focus on quality companies.

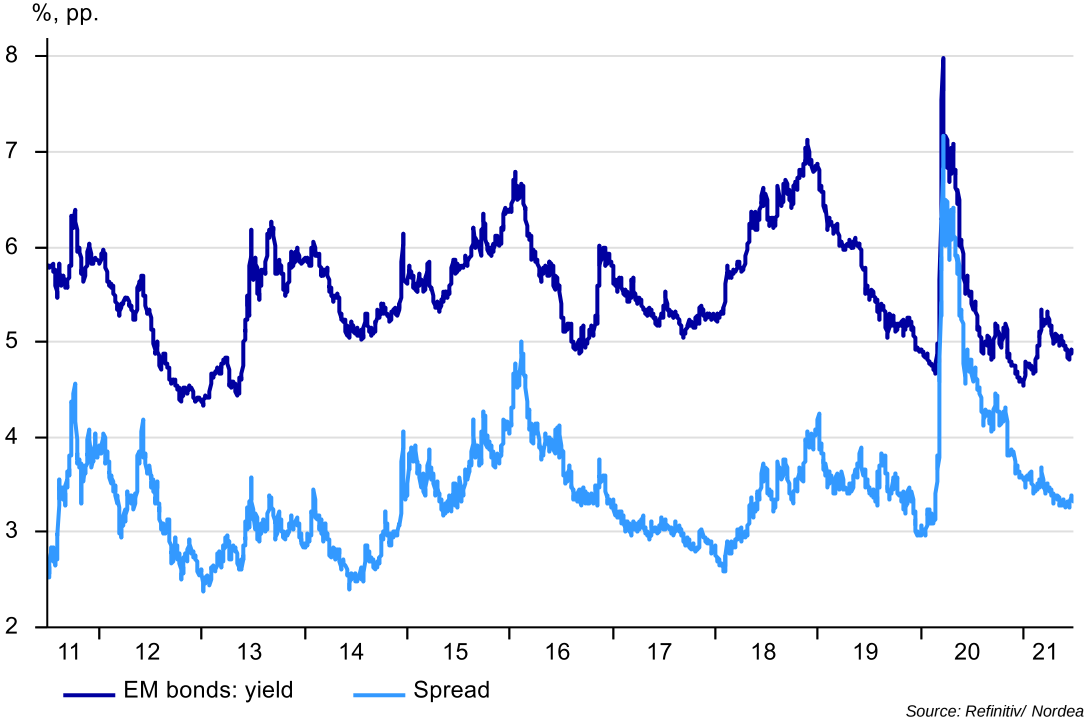
Reduce exposure towards long US yields

High-yield and EM bonds offer higher yields, but also higher risks



Source: Refinitiv/ Nordea

Recent fall in US yields has pushed also emerging market yield lower



Source: Refinitiv/ Nordea

- The recent fall in US interest rates has supported bond performance. However, we expect yields to head higher in H2 this year.
- As a result, we recommend to reduce the rate-sensitive EMD allocation to neutral from overweight.
- Going forward, we recommend an overweight in EUR investment grade corporate bonds and underweight in EUR government bonds.

Nordea Global Asset Allocation Strategy Contributors

Global Investment Strategy Committee (GISC)

Antti Saari
Chief Investment Strategist
antti.saari@nordea.com
Finland

Andreas Østerheden
Chief Investments Strategist
Andreas.osterheden@nordea.com
Denmark

Erik Bruce
Chief Investments Strategist
Erik.bruce@nordea.com
Norway

Johan H Larsson
Chief Investments Strategist
Johan.h.larsson@nordea.com
Sweden

Strategists

Sebastian Källman
Senior Strategist
sebastian.kallman@nordea.com
Sweden

Ville Korhonen
Fixed Income Strategist
ville.p.korhonen@nordea.com
Finland

Simon Kristiansen
Senior Strategist
Simon.kristiansen@nordea.com
Denmark

Hertta Alava
Senior Strategist
Hertta.alava@Nordea.com
Finland

Joachim Bernhardsen
Senior Strategist
Joachim.Bernhardsen@Nordea.com
Norway

Assistants

Mick Biehl
Assistant Strategist/Student
Mick.Biehl@nordea.com
Denmark

Christian Theilgaard
Assistant/Student
Christian.theilgaard@nordea.com
Denmark

Oanh Thi Duong
Assistant/Student
Oanh.thi.duong@nordea.com
Denmark

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