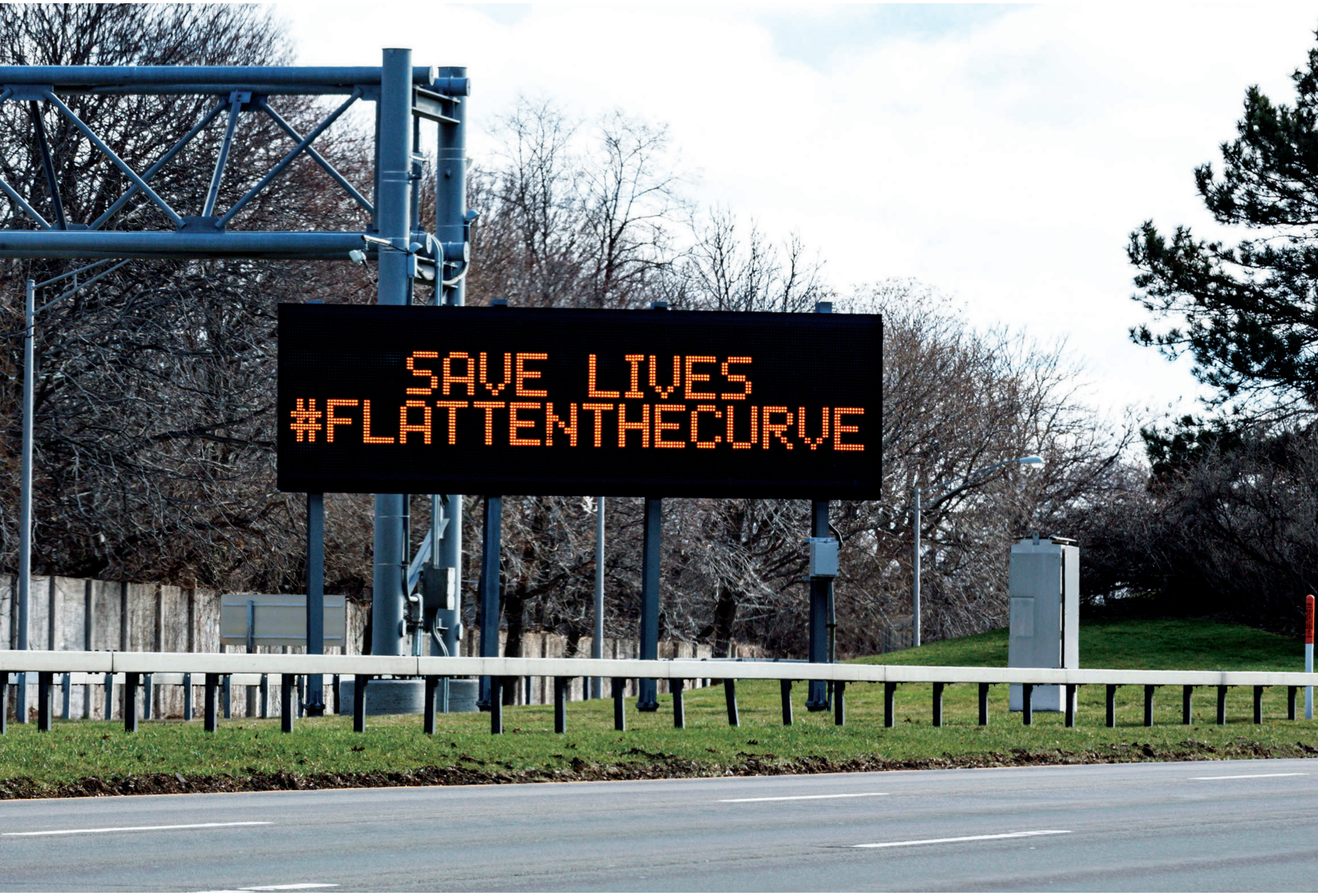

NEUBERGER BERMAN

Asset Allocation Committee Outlook 2Q20

Contagion

Attempts to flatten but lengthen the growth curve of COVID-19 infections through social distancing and self-isolation will hopefully save lives and keep healthcare systems running. The price to pay is a steep reduction in economic activity. In this quarter's *Outlook*, the Asset Allocation Committee asks: When will the worst of the COVID-19 outbreak be over? What will be the likely economic impact and the fiscal and monetary response? What might that mean for market pricing and volatility? And what does that imply for asset allocation in the immediate term, and over the next 12 months?

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ABOUT THE

ASSET ALLOCATION COMMITTEE

Neuberger Berman's Asset Allocation Committee meets every quarter to poll its members on their outlook for the next 12 months on each of the asset classes noted and, through debate and discussion, to refine our market outlook. The panel covers the gamut of investments and markets, bringing together diverse industry knowledge, with an average of 28 years of experience.

COMMITTEE MEMBERS

Joseph V. Amato
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Co-Chair, Chief Investment Officer—Multi-Asset Class

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Chief Investment Officer—Fixed Income

Anthony D. Tutrone
Global Head of Alternatives

Market Views

Based on 12-Month Outlook for Each Asset Class

	Underweight		Neutral		Overweight
EQUITY					
Global Equities	○	○	○ →	●	○
U.S. Large Cap	○	○ →	→	●	○
U.S. Small and Mid Cap	○	○	●	○	○
Developed Market—Non-U.S. Equities	○	○	● ←	○	○
Emerging Markets Equities	○	○	● ←	○	○
FIXED INCOME					
Cash	○	● ←	○	○	○
Investment Grade Fixed Income	○	○	○ →	●	○
High Yield Corporates	○	○	● ←	○	○
Non U.S. Developed Market Bonds	○ →	●	○	○	○
Emerging Markets Debt	○	○	● ←	○	○
REAL AND ALTERNATIVE ASSETS					
Commodities	○	○	●	○	○
Hedged Strategies	○	● ←	○	○	○
Private Equity	○	○	● ←	○	○

As of 2Q 2020. Views shown reflect near-term tactical asset allocation views and are based on a hypothetical reference portfolio. Nothing herein constitutes a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. See disclosures at the end of this publication, which includes additional information regarding the Asset Allocation Committee and the views expressed.

Regional Focus

Equities and Currency

	Underweight		**Neutral**	Overweight	
REGIONAL EQUITIES					
Europe	○	○	●	○	○
Japan	○	○	●	○	○
China	○	○	●	○	○
Russia	○	●	○	○	○
India	○	○	●	○	○
Brazil	○	○	○	●	○
CURRENCY					
Dollar	○	●	○	○	○
Euro	○	●	○	○	○
Yen	○	○	○	●	○
Pound	○	○	○	●	○
Swiss Franc	○	●	○	○	○
EM FX (broad basket)	○	○	●	○	○

"Should investors consider loading up on the riskiest assets when markets begin to stabilize? After a valuation adjustment of this magnitude, that probably isn't necessary. The markets are unlikely to run away from us."

Joseph V. Amato | President & Chief Investment Officer—Equities

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"We think this challenging environment calls for a two-step asset allocation process. In the very near term, while infection rates continue to rise, we would focus on risk management and diversification. Should the market recovery gain a firmer footing, likely coinciding with the peak in infections, we would favor stepping into riskier assets, but with a bias towards quality and yield."

Erik L. Knutzen, CFA, CAIA
Chief Investment Officer—Multi-Asset Class

Contagion

As the COVID-19 virus spread around the world, sending markets into turmoil, our Asset Allocation Committee ("the AAC" or "the Committee") met by video conference because governments were telling citizens not to leave their homes. These are extraordinary circumstances, and they make asset allocation decisions extraordinarily challenging and consequential. Attempts to flatten but lengthen the growth curve of COVID-19 infections through social distancing and self-isolation will hopefully save lives and keep healthcare systems running. The price to pay is a steep reduction in economic activity, and financial markets have been adjusting frantically to this new and uncertain reality. In this quarter's *Outlook,* the Committee sought to answer four questions: When will the worst of the COVID-19 outbreak be over? What will be the likely economic impact of the virus and the authorities' fiscal and monetary response? What might that mean for market pricing and volatility? And what does that imply for asset allocation in the immediate term, and over the next 12 months?

At a Glance

- Our base case is that reported COVID-19 infections will likely peak in the U.S. in May or June.
- We expect a global recession that affects small businesses and consumers most directly.
- Rapid, extensive response by fiscal and monetary authorities can absorb the worst of the shock.
- We estimate Q2 U.S. GDP down 13% or more, q-o-q annualized; 2020 U.S. GDP down 2% on 2019.
- Equity and credit markets are likely to remain volatile and may take another leg down before rebounding after peak of infections is confirmed.
- During any near-term market recovery, the AAC favors a two-step approach, focused on risk management and diversification until infections peak, followed by stepping into higher quality risk assets. Our overweight views are in investment grade credit and U.S. large-cap equities.

The Virus

There is considerable uncertainty around the growth curve of COVID-19 infection rates, which has varied from country to country depending on how populations have responded and how quickly containment measures were imposed.

That said, as the AAC met the emerging consensus is that early adoption of "social distancing" among as much of the population as possible, and self-isolation among those diagnosed or showing symptoms, is the least-worst option. This flattens but lengthens the infection-rate curve. The alternative policy of allowing COVID-19 to spread widely while attempting to protect the most vulnerable would risk not only an intolerable number of deaths, but serious illness on a scale that could utterly overwhelm even the most resilient healthcare systems.

The price for containment is a rolling series of almost complete economic shutdowns, which began in China, is currently approaching its peak in Europe, and is now hitting the Americas. Furthermore, the failure of OPEC countries to respond to the demand shock by reducing oil production, and in fact engaging in a price war, has exacerbated the deflationary impact of the virus and increased stress in credit markets. Ultimately, the state of the global economy is tied to the shape of the COVID-19 infection-rate curve, particularly as it develops in the U.S., the world's largest economy.

Our base case is that reported COVID-19 infections will likely peak in the U.S. in May or June. We believe containment measures will allow the U.S. healthcare system to cope. There is considerable uncertainty around that estimate: the curve may extend should large numbers travel interstate to return to their families or shorten should containment succeed in reducing hospitalization.

It is encouraging to see reported new cases trail off in China, where the outbreak started, and several other Asian countries succeed in containing the disease. The virus also appears to be peaking in some parts of Europe. The unprecedented international efforts to develop therapeutics to treat the illness and a vaccine to prevent it in the future allow us to hope that we can avoid a severe second wave of infections.

The Economy

We expect a global recession that affects small businesses and consumers most directly. Some businesses will see no income at all over the next two or three months. The simple question is whether they have enough cash to stay afloat. Few of the world's small- and medium-sized enterprises do have those reserves, no matter how prudently they are managed. Without assistance, a wave of bankruptcies and mass unemployment is likely, followed by a long delay in re-establishing those businesses and jobs.

While there is a limit to what monetary authorities can do to help the worst-affected sectors, they have adopted an uncompromising "whatever it takes" stance. Their immediate priority was to stabilize markets and provide liquidity as investors sought to sell everything—including traditional safe havens such as U.S. Treasuries. They re-opened the 2008 playbook, led by the U.S. Federal Reserve, which cut rates to zero, loosened the terms on international dollar swap lines, committed to unlimited quantitative easing and provided liquidity to money market mutual funds. As the AAC met, these moves had calmed Treasuries but left more work to do in credit markets. We anticipate more action should it prove necessary.

The Fed also set up a Commercial Paper Funding Facility (CPFF) to address the strains in companies' short-term operational financing directly. The Bank of England introduced a similar measure for the U.K. and the Bank of Japan opened a new, zero percent lending facility for corporations. The European Central Bank (ECB) came out with a new €750bn public and private securities purchasing program and pledged to buy high-quality commercial paper.

It was critical that the fiscal response be just as rapid, and that it focus on small businesses and individuals. At the time of writing, the U.S. has passed a huge stimulus package, worth trillions of dollars, and including small business loans, tax deferrals, stabilization funds and direct tax-rebate payments to individuals in need. The U.K. Treasury effectively promised to pay 80% of the wages of any worker furloughed due to the crisis. Germany set out plans to remove its constitutional debt break to facilitate a support program worth almost 10% of GDP, focused on providing equity capital to companies and backing loans. It also urged a joint euro zone debt issuance—which would likely be bought by the ECB. Around the world, countries are attempting similarly targeted fiscal vaccinations, often amounting to several percentage points of national GDP.

The speed of this response is remarkable. During the 2008 – 09 financial crisis, the Fed cut rates to zero only in December 2008, and the G20 meeting that started a global coordinated response came in April of 2009, a full seven months after the peak of the crisis. But will it all be enough this time?

There was some debate on the Committee about how lasting the damage to consumer confidence might be, given the psychological impact of this crisis and the special vulnerability of lower earners. Most agreed that, as long as fiscal support prevents unemployment from exceeding low double figures, and supply chains remain intact, there could be potential for powerful pent-up demand to drive renewed consumption growth in the second half of the year. Recall that retail sales rebounded a full year before the peak in unemployment back in 2009.

Taking all that into account, alongside what equity and credit markets are pricing, our base case is that second quarter U.S. GDP could decline by 13% or more. That translates to at least a $625 billion reduction in GDP in a single quarter. This assumes a 23% decline in goods spending and an 85 – 95% decline in services—with the only demand coming for healthcare, food and consumer essentials.

For the full year, however, U.S. GDP may end up only 2% lower than in 2019. That implies a strong clawback in the second half of the year—but it is important to recognize that much depends on the effectiveness of stimulus, and that the fallout for small businesses in particular means a full recovery to the pre-crisis trend level of GDP is likely to take many months.

The Markets

Markets are likely to anticipate the economic recovery, probably around the time of the peak in U.S. infections. By this time investors should also be assured that authorities have avoided economic disasters such as the failure of several major airlines or key players in global supply chains. Companies are more likely to be able to offer guidance on earnings because they may have more clarity into the impact of both COVID-19 and the fiscal and monetary response.

We think this could reveal a decline of 25% or more in S&P 500 earnings expectations for 2020. That implies equity and credit markets may have further to fall in the very near term. A 25% decline in 2020 earnings, combined with an early-2009 level of equity risk premium, and a moderate valuation level, leads us to estimate a potential low point of 2,000 – 2,100 for the S&P 500 Index.

At the very least, investors should brace for the possibility of extended volatility and interest rates that remain low for a long time.

Asset Allocation

We think this challenging environment calls for a two- or three-step asset allocation process over the next 12 months. In the very near term, while infection rates continue to rise, we would focus on risk management and diversification. Should the market recovery gain firmer footing, likely coinciding with the peak in infections, we would favor stepping into riskier assets, but with a bias toward quality and yield.

There may be a case for a third step later in the year or into 2021—more risk-taking as clarity about the virus and the potential for treatments and a vaccine grows—but we believe low valuations will likely make that unnecessary at the early stage of the rebound.

Indeed, we think returns from investment grade credit may compete with high yield bonds and equities for the first time in a very long while, even on a 12-month view. U.S. investment grade credit spreads currently sit above 300 basis points. Central bank rates are likely to be anchored at zero for some time. Corporate finance chiefs are likely to manage balance sheets very conservatively over the coming months.

Once central banks are on top of the sector's liquidity crunch, we expect an unusually attractive environment for quality credit. From current levels, spread compression to 120 – 150 basis points, plus coupon payments, could generate a double-digit total return over 12 months. The AAC believes that the S&P 500 Index has the potential to regain a level around 2,700 over the same period, implying a 20%-plus return. In absolute terms, then, equities would be the asset class to favor, but in risk-adjusted terms it is a close-run thing. The Committee upgraded its views on both to overweight.

Within equities, the AAC favored U.S. large caps over smaller companies and non-U.S. markets, which it views neutrally. While there will likely be a strong case for small caps should the recovery gain a solid footing, their generally higher levels of leverage and their vulnerability to an extended demand shock make them appear relatively risky for now.

The AAC assessed emerging markets equities and debt as neutral. Many emerging countries appear vulnerable to a crisis in healthcare systems, to disruption in supply chains and to commodity market weakness and U.S. dollar strength. There may be regionally-specific opportunities, however, among countries with stronger institutions, exposure to the earlier signs of recovery in China, and industries that consume rather than produce commodities. Valuations also inform against adopting an underweight view.

Turning to alternative investments, the AAC downgraded its view on hedged strategies to an underweight. Some uncorrelated strategies have been among the very few investments to hold up well over recent weeks. In our two-step process, they may remain useful in the early stages of market recovery, but are likely to lag as the rebound gathers strength. Equity index put-writing may also be an attractive approach to capturing the premium available for being willing to buy stocks at lower levels.

The AAC maintained its neutral view on commodities. These markets have come under terrific pressure in the past month. We expect the OPEC price war to continue for 12 – 18 months, but the potential for the U.S. government to act as a buyer of last resort, a post-crisis recovery in global demand and simple mean reversion may point to some upside in the medium term. Longer term, the potential for higher inflation as a result of the current stimulus efforts could be positive for the asset class.

Investors face difficult decisions concerning private asset exposure. Without the mark-to-market price volatility of public markets, private assets may now account for too large a proportion of some portfolios. With the private equity secondary markets essentially closed, little can be done to address this issue.

Does it matter? The industry came into this crisis with a lot of un-invested dry powder, and larger deals in particular have been done with limited or no debt covenants. This will likely buy the best general partners and their portfolio companies time to ride out the economic slump. Investors may need to accept lower return expectations as the price for injecting more equity capital into businesses over the next few months, but we think most high-quality private investments have the potential to remain viable. Together with an emerging opportunity set in distressed strategies, this persuaded the Committee to downgrade only to a neutral view.

Sobering

Overall, this may turn out to be the strangest and most sobering meeting our Committee will ever hold. Alongside our usual discussions about quantifiable risks, we had to grapple with unprecedented uncertainties. The difference between the situation today and the situation three months ago, and indeed the situation we hope for and anticipate in six months' time, could not be greater. That makes strategic asset allocation challenging, but it could also create an opportunity set richer and more complex than we have seen for a long time. As a firm, we have been and will continue to communicate frequently given the high levels of volatility and uncertainty, as we may adjust our views as circumstances change.

Over the next few weeks, we will stand by for more volatility and perhaps another leg down in equity and credit markets. Over the next few months, we will be ready to ease into risk markets with a bias to quality at attractive valuations. In the meantime, we will be surveying the landscape to identify additional, significant opportunities created by this extraordinary period of economic and market dislocation.

FIXED INCOME

Investment Grade Fixed Income

- The Asset Allocation Committee ("AAC" or "the Committee") moved from a neutral to an overweight view.
- Interest rates are likely to remain low for a long time and corporates are likely to maintain very conservative balance sheets.
- Once central banks are on top of the liquidity crunch in the sector, the combination of compression of elevated spreads and coupon payments could make total returns competitive, especially on a risk-adjusted basis, against equities over the next 12 months.

Developed Market Non-U.S. Debt

- The Committee upgraded its large underweight view to a slight underweight.
- While rates in Europe and Japan are still below those in the U.S., rate cuts from the Federal Reserve have narrowed the differential and rates worldwide are likely to remain low for a long time.
- There have been calls for major fiscal support across Europe to counter the economic impact of COVID-19, including from the most fiscally conservative nations, such as Germany.

High Yield Fixed Income

- The Committee downgraded its view to neutral.
- An environment of low rates and conservative management of corporate balance sheets will be supportive of credit markets in general, and spreads are now at near-distressed levels.
- Nonetheless, U.S. high yield, in particular, could be one of the sectors hardest hit by the COVID-19 fallout, the current oil price war and the liquidity crunch in markets; there will be meaningfully increased risk of defaults.
- Investment grade may be a more attractive place to take credit risk for the time being, especially on a risk-adjusted basis.

Emerging Markets Debt

- The Committee downgraded its view to neutral.
- Many emerging countries appear vulnerable to a crisis in healthcare systems, disruption in supply chains and commodity market weakness and U.S. dollar strength.
- There may be regionally-specific opportunities among countries with stronger institutions, exposure to the earlier signs of recovery in China, and industries that consume rather than produce commodities.
- Valuations also inform against adopting an underweight view.

GLOBAL EQUITIES

U.S. Equities

- The Committee upgraded its neutral view on U.S. large caps to an overweight but remained neutral in its view on U.S. small and mid caps.
- While the coming weeks are likely to be dominated by further uncertainty and volatility, with the potential for another leg down in equity and credit markets, we anticipate a peak in U.S. COVID-19 cases in May or June to be the catalyst for a recovery.
- Smaller companies are generally more leveraged and also more vulnerable to the economic impact of the COVID-19 outbreak.
- Given current levels of uncertainty also in valuations, the AAC does not think it will be necessary to chase the most economically sensitive investment sectors in the early stages of the market recovery.

Non-U.S. Developed Market Equities

- The Committee moved from an overweight to a neutral view.
- The AAC entered 2020 with an overweight view due to its belief that non-U.S. growth would begin to converge with U.S. growth with the easing of the recent global manufacturing downturn.
- While that dynamic could resume once the COVID-19 crisis subsides, for now markets have re-priced to such an extent that the potential value in the lower-risk U.S. market is equally attractive.

Emerging Markets Equities

- The Committee moved from an overweight to a neutral view.
- Many emerging countries appear vulnerable to a crisis in healthcare systems, to disruption in supply chains and to commodity market weakness and U.S. dollar strength.
- There may be regionally specific opportunities among countries with stronger institutions, exposure to the earlier signs of recovery in China, and industries that consume rather than produce commodities.
- Valuations in emerging markets inform against adopting an underweight view, but the potential value opportunity in lower-risk developed markets removes the case for maintaining an overweight view.

REAL AND ALTERNATIVE ASSETS

Commodities

- The Committee maintained a neutral view.
- We expect the OPEC price war to continue for 12 – 18 months, but the potential for the U.S. government to act as a buyer of last resort, a post-crisis recovery in global demand and simple mean reversion may point to some upside in the medium-term.
- Longer term, the potential for higher inflation as a result of the current stimulus efforts could be positive for the asset class.

Hedge Funds

- The Committee downgraded its overweight view to neutral.
- Some uncorrelated strategies have performed well over recent weeks, but while they may remain useful in the early stages of market recovery, we believe they are likely to lag as the rebound gathers strength.
- Volatility could take six to nine months to normalize, preserving an attractive environment for certain liquid alternative strategies, including equity index put-writing.

Private Equity

- The Committee downgraded its overweight view to neutral.
- Private assets may now account for too large a proportion of some portfolios.
- Private equity came into the COVID-19 crisis with a lot of un-invested dry powder, and larger deals in particular have been done with no debt covenants, which will help general partners to work with their portfolio companies to survive the economic slump.
- Investors may need to accept lower return outlooks as the price for injecting more equity capital into businesses over the next few months.
- There is an emerging opportunity set in distressed strategies.

Currencies

USD

- The AAC moved from a neutral to an underweight view.
- Particularly after its recent strength, the currency is overvalued based on purchasing power parity (PPP) metrics.
- U.S. interest rates are likely to remain low for a long time, which should weaken the dollar as risk appetite recovers.
- The U.S. will be the last major economy to endure a peak in COVID-19 cases, and it has so far lagged many other countries in testing for the virus.

- The twin deficits that the U.S. runs are likely to be exacerbated by stimulus efforts to counter the economic impact of the COVID-19 outbreak.
- Risks to the view include the continued growth differential with the rest of the developed world; the ongoing, albeit narrower short-term rate differential with the rest of the developed world; and the potential for risk appetite to deteriorate still further should the COVID-19 crisis or oil price war worsen.

EUR

- The AAC maintained its underweight view.
- The large negative carry already discourages long positions and the ECB has recently adopted a still more dovish stance in response to the COVID-19 crisis.
- The COVID-19 outbreak only exacerbates existing trade pressures, such as Brexit and the proposed U.S. tariffs on European autos.
- Risks to the view include the euro zone's large current account surplus; the euro's undervaluation on PPP metrics; and the potential for a strong growth and inflation rebound resulting from stimulus efforts both domestically and in China.

JPY

- The AAC maintained its overweight view.
- Japan runs a current account surplus.
- Long yen remains attractive during periods of risk aversion, and both PPP and real exchange rates suggest the JPY is undervalued.
- Falling yields globally make Japan's low rates less discouraging.
- Risks to the view include the ongoing yield differentials in both nominal and real terms with the U.S., which could be widened again if the Bank of Japan responds strongly to the COVID-19 outbreak; and a rebound in risk sentiment once the COVID-19 crisis peaks, given the current long position held by the market.

GBP

- The AAC upgraded its view from neutral to overweight.
- The GBP is back near to its post-Brexit lows and appears undervalued based on PPP measures, and U.K. job creation and wages have been stronger than expected and consumption activity has remained remarkably healthy.
- While the U.K. has acted comparatively slowly on testing and containment, its fiscal response to the COVID-19 crisis has been among the strongest and broadest.
- Risks to the view include the market's long position, rising political uncertainty as the impact of COVID-19 on trade negotiations with the European Union remains unclear; and high exposure to the downturn in retail, tourism and services due to the COVID-19 outbreak.

CHF

- The AAC maintained its underweight view.
- Particularly following recent strength on the safe-haven trade, the CHF appears very overvalued based on PPP measures.
- Policy action by the SNB is underpriced and the persistent strength of the currency continues to keep inflation low.
- Risks to the view include Switzerland's current account surplus; the potential for Switzerland to benefit from improvements in European growth; the potential for political uncertainty, especially around Brexit; and the potential for risk appetite to deteriorate still further should the COVID-19 crisis or oil price war worsen.

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