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Asset Allocation Committee Outlook 1Q21

A Tentative Recovery

The arrival of coronavirus vaccines means the economy should eventually get out of its sickbed, but we think investors should take things steady. The ongoing pandemic and political risks pose short-term threats, and even as it gains pace, the recovery is likely to be uneven and bring its own risks. The Asset Allocation Committee therefore consolidates its positive views on economically sensitive assets, but the "risk on" tenor remains moderate. Potential volatility in the first half of 2021 could offer opportunities to lean into the recovery at more attractive valuations.

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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
Co-Chair, President and Chief Investment Officer—Equities

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

Ashok Bhatia, CFA
Deputy Chief Investment Officer—Fixed Income

Thanos Bardas, PhD
Global Co-Head of Investment Grade

Timothy F. Creedon, CFA
Director of Global Equity Research

Alan H. Dorsey, CFA
Chief Investment Officer of Neuberger Berman Trust Company

Ajay Singh Jain, CFA
Head of Multi-Asset Class Portfolio Management

David G. Kupperman, PhD
Co-Head, NB Alternative Investment Management

Ugo Lancioni
Head of Global Currency

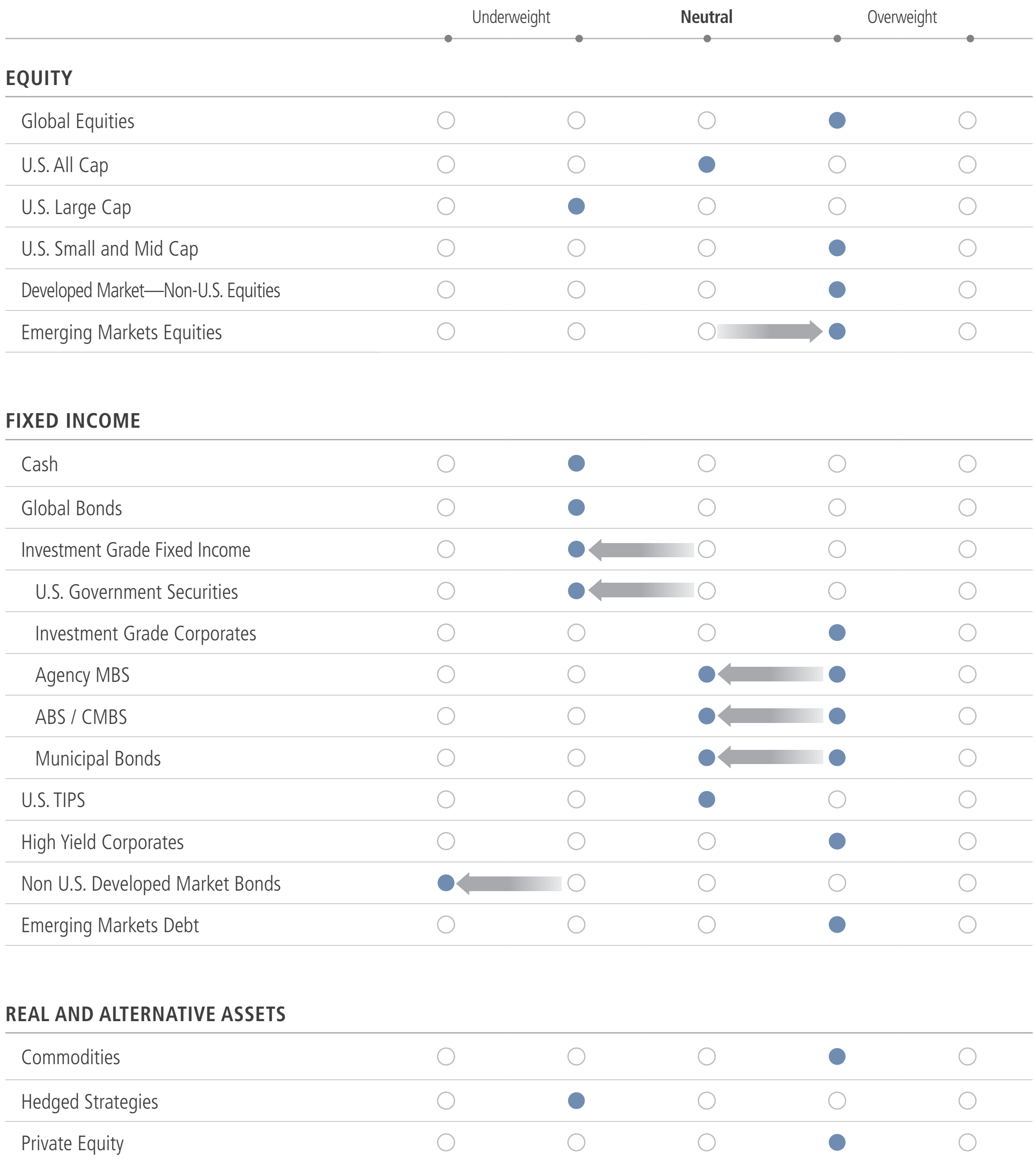
Robert Surgent
Senior Portfolio Manager—Multi-Asset Class

Brad Tank
Chief Investment Officer—Fixed Income

Anthony D. Tutrone
Global Head of Alternatives

Market Views

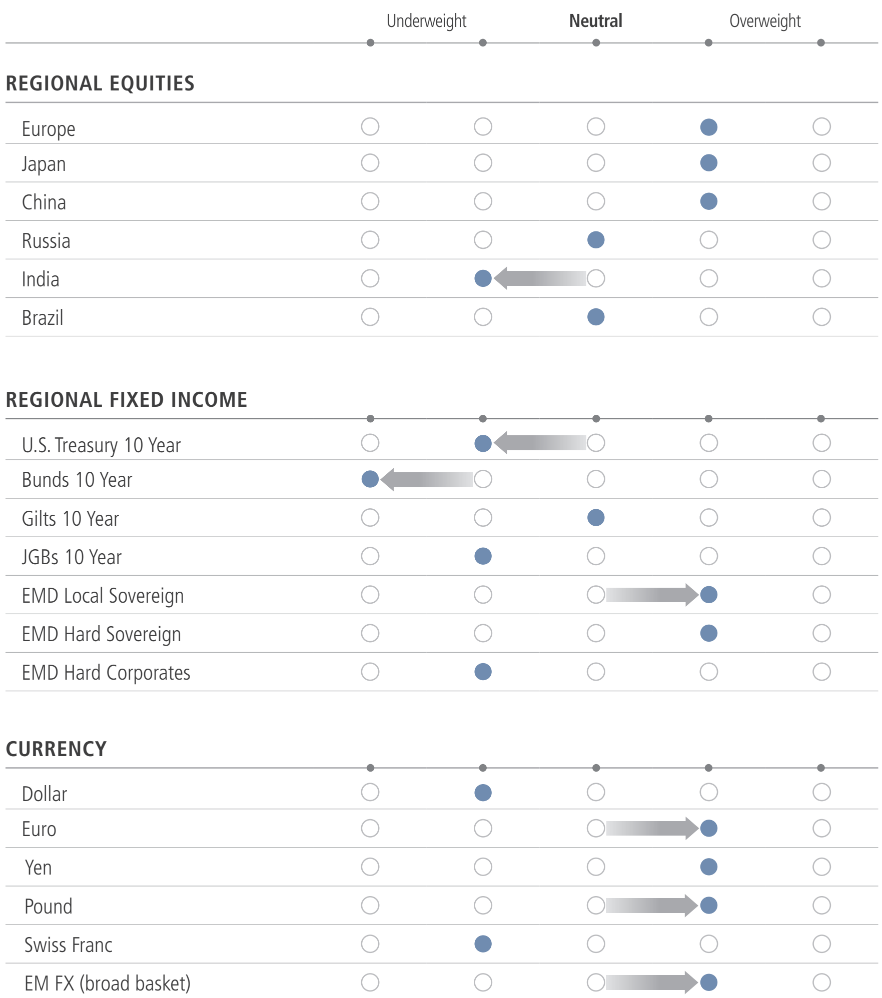
Based on 12-Month Outlook for Each Asset Class



As of 1Q 2021. 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 include additional information regarding the Asset Allocation Committee and the views expressed.

Regional Focus

Fixed Income, Equities and Currency



> "It's not hard to see the kind of interest rate move we are discussing for the first half of 2021 leading to a drawdown of 5% or more for bond funds; that is not trivial, and in fixed income, bear markets tend to happen very quickly."

Ashok Bhatia | Deputy Chief Investment Officer—Fixed Income

"Investors who can tolerate volatility for the next six months or so could take the AAC's views as a signal to bound out of the sickbed and fully embrace risk. The rest of us may do better by continuing to give portfolios the TLC they need: taking risk judiciously and in a balanced way."

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

A Tentative Recovery

After a bout of illness, it's human nature to want to get back into the swing of things. But our sense of recovery often gets the better of our risk management. We head out without a hat and scarf, we swap the flu remedies for coffee, we embrace the stresses of the workplace—and we end up straight back in bed. The arrival of coronavirus vaccines means the economy should eventually get out of its sickbed, but we think investors should take things steady. Short-term stumbling blocks are not confined to the ongoing pandemic: there are underappreciated political and geopolitical risks, too. Even as it gains pace, economic recovery will likely be uneven: hard for many sectors, perhaps impossible for some. And recovery may bring its own risks: stretched valuations in many parts of the market could snap back if interest rates rise faster than expected, and the growing crowd of consensus trades could be a recipe for volatility during the first half of the year. The Asset Allocation Committee ("the AAC" or "the Committee") has therefore consolidated its positive views on economically sensitive assets, but the "risk on" tenor remains moderate. The first half of 2021 could offer more opportunities to lean into the recovery as it develops.

It is rare to see the level of market consensus that has greeted this new year. Investors appear almost universally to be pricing for an early-cycle mix of low interest rates and ongoing support from both monetary and fiscal policy, combined with the release of pent-up demand from consumers and manufacturers. This backdrop is expected to support higher corporate earnings, higher wages, higher consumer prices and higher index levels for risk assets a year from now.

To a large extent, this agrees with the AAC's latest economic and asset class views for the next 12 months, which consolidate our positive outlook. Where the Committee has changed its views this quarter, it is increasingly prepared to lean into the recovery from the coronavirus crisis. Investment grade credit, with a particular focus on the most interest rate-sensitive sectors, is downgraded; while emerging markets equity is upgraded to an overweight view. That is largely due to the clearing of two big hurdles in November and January: confirmation of successful coronavirus vaccines and more clarity on the post-election landscape in the U.S.

Nonetheless, our current views still express a moderate appetite for risk. While we are not contrarian, we do place more weight on some short- and medium-term uncertainties that could create opportunity to lean into the recovery at more attractive valuations. We would liken our current situation to the end of 2009. A similar nine-month market rally had left investors strongly positioned for a continuation of good news into 2010, and indeed global equities finished 2010 up 9%. On the journey there, however, they traded across a 20-percentage-point range. The S&P 500 Index went on a similar journey, finishing the year with a total return of more than 15% after a second-quarter sell-off that included the notorious "flash crash" of May 6.

"Sleeper Risks"

Back in 2010, the big risk was Greece's unmanageable debt burden and the threat it posed to the euro. Today, the major short-term risk is coronavirus, which is likely to continue to disrupt economies until vaccination programs are well advanced. Much of Europe and North America has endured a miserable holiday season under strict constraints due to a winter surge in infections. Health systems are typically under the greatest pressure in the northern hemisphere at this time of year.

Perhaps less appreciated are the political and geopolitical risks that come with a new U.S. administration.

One uncertainty was removed early, as voters in Georgia's Senate races overturned the market's preference and expectation for mixed government, giving the Democrats narrow control over both Houses of Congress. This will likely re-ignite debates about how to weigh the potential for extra fiscal stimulus against the probability of higher taxes and tighter regulation, and about the respective timing of those policy changes.

In trade and foreign policy, it remains to be seen how the U.S. will attempt to re-set relations with China and Iran, and even fence-mending with the European Union could be complicated by the latter's aggressive plans to regulate the technology sector. All of this will happen in the shadow of one of the most serious cyberattacks, possibly state-backed, ever mounted against U.S. agencies. Like coronavirus in the first weeks of 2020, we are concerned that one of these could turn out to be the major "sleeper risk" for 2021.

A Moderate Appetite for Risk

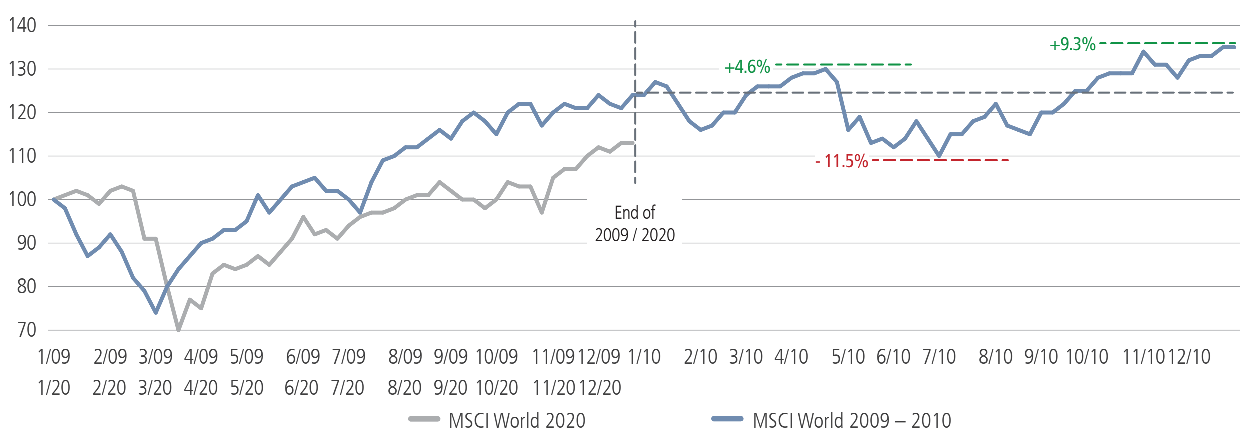
The more obvious risks concern the path to recovery in the economy and markets. The economic recovery is likely to be uneven, and even if it goes relatively smoothly, the path of the market recovery is unlikely to be as smooth, given stretched valuations and increasingly crowded trades in a variety of places.

The main area of concern over valuations is in large- and mega-cap secular growth stocks, particularly in the technology sector. We also see the technology exuberance engendered by the coronavirus lockdowns in the valuations and first-day trading levels of recent IPOs. Given the size of this sector and some of its companies, this is a real risk to index-level return outlooks.

This is where more bullish views on value stocks and cyclical, economically sensitive parts of the equity market, expressed through size, sectors, factors and regions, could be lower-risk—simply because they are cheaper and less crowded. The most crowded trade at the moment sees little probability of the U.S. 10-year Treasury yield going above 1.50% or below 0.65%. Within this range, investors anticipate support for all parts of the equity market, especially if a slight rise in rates is accompanied by a similar rise in inflation expectations (and therefore stable real rates) and continued U.S. dollar weakness.

FOLLOWING A MAJOR RALLY IN 2009, 2010 WAS POSITIVE FOR EQUITIES—BUT VOLATILE

MSCI All Country World Index, USD, 2009 – 2010 and 2020, rebased to 100 on Jan. 1, 2009 and Jan. 1, 2020



Source: Bloomberg, Neuberger Berman. For illustrative purposes only.

We share those expectations but remain mindful of the risks. Interest rate adjustments are often more jagged and volatile than underlying changes in the economic outlook. Sudden moves outside of that range could unnerve investors in interest rate-sensitive secular growth stocks (on the upside) or cyclical and value stocks (on the downside).

On balance, the AAC sees unexpected upside in rates and growth as the most likely risk. To an existing overweight view on small caps and the more cyclical non-U.S. developed markets, it has therefore added an overweight view on emerging markets equities. While the Asia-dominated emerging markets equity indices are surprisingly tech-heavy, their major factor exposure is long banks and short health care, making them an effective play for global early-cycle recovery.

Overall, however, we still think these views express a moderate appetite for risk. The AAC wants to mitigate exposure to interest rate risk and over-valued parts of the market while also moderating exposure to expectations of economic recovery, which could still prove bumpy over the next three to six months.

Shorter Duration

Fixed income, where some $19 trillion of paper now has a negative yield, is likely to be more sensitive than equity to any rates volatility. Even a move up to 1.35 – 1.50% on the 10-year Treasury yield could knock 5% or more off the average bond fund's value—a non-trivial move amounting to almost half the losses experienced during the credit sell-off in March of 2020. Moreover, the suddenness with which fixed income markets tend to adjust makes it difficult to trade these moves tactically.

As a result, the AAC has adopted an underweight view on investment grade, but this remains nuanced. It is still only one notch below neutral because our negative view on core government bonds is balanced by a more positive view on corporate bonds and some areas of municipal bonds and structured credit, where spreads have compressed, but are less likely to widen again substantially. Shorter duration is also favored, which includes bank loans, specialty financing and private debt, all of which offer the potential for floating rates and less crowding than many other credit markets.

We remain neutral on Treasury Inflation Protected Securities (TIPS) and continue to favor commodities. The latter, in particular, appear to have lagged the decline in the U.S. dollar, and are likely to benefit from fiscal stimulus making its way into the real economy—regardless of whether this impulse is strong enough to be felt in core inflation or real yields. Gold and precious metals may benefit from perceptions of fiat currency depreciation.

Elsewhere in alternative investments, the AAC remains favorable toward private equity (See "Up for Debate: Why maintain an overweight view on tech-heavy private equity?") and underweight in its view on hedged strategies.

We still see opportunities in event-driven strategies as merger-and-acquisition activity continues to recover, in distressed as certain businesses and sectors struggle with the withdrawal of emergency support, and in insurance-linked strategies, where pricing is attractive following a third year of relatively high reinsurance claims. Potential volatility in equity and especially currency markets could create opportunities for some global macro and active currency traders (See "Up for Debate: How might investors take advantage of currency market volatility in 2021?"). Overall, however, we see 2021 as a year for more directional exposures, which does not favor the major long/short strategies.

Continue to Give Portfolios TLC

We are not contrarian and we share much of the market's current consensus. We think it most likely that yields will trade in a range and the dollar will weaken to an extent that supports equity indices, and we do favor more cyclical and economically sensitive parts of the market for both relative value and exposure to the economic recovery. But we are perhaps more circumspect about the risks of the next six months, whether they are exogenous or derived from a spike in interest rates or a stumble in the recovery. As a result, we advocate maintaining some balance in portfolios to cushion against and take advantage of volatility should it occur.

As we already mentioned, we liken our current situation to the end of 2009—which was followed by a 12-month period in which equities traded across a 20-percentage-point range.

Investors who can tolerate that kind of volatility for the next six months or so could take the AAC's views as a signal to bound out of the sickbed and fully embrace risk. The rest of us may do better by continuing to give portfolios the TLC they need: taking risk judiciously and in a balanced way, ready to lean into the recovery, potentially at more attractive valuations, as it gains traction.

UP FOR DEBATE:

HOW MIGHT INVESTORS BENEFIT FROM POTENTIAL CURRENCY VOLATILITY IN 2021?

There has been a lot of discussion, within the Asset Allocation Committee ("the AAC" or "the Committee") and elsewhere, about divergence between the economy and financial markets. During 2020, risk assets rallied even as economic growth and core government bond yields plunged. In 2021, the market consensus is that the economy will re-converge with risk assets, and that this will be a relatively smooth transition because central banks will maintain stability in core government bond yields (and their divergence from risk assets and the economy).

This consensus raises an important question: If 2021 will witness a major economic adjustment, occurring at a different pace in different parts of the world, but the volatility associated with such a major adjustment will not appear in bond markets, where will it appear?

The Committee is increasingly persuaded that it will appear in currency markets. That has a number of investment implications.

First and foremost, it implies a strong case for dynamic hedging of portfolio's foreign exchange exposures and for currency absolute return strategies.

We think it implies further weakness for the U.S. dollar, as growing confidence in the recovery compresses its safe haven premium, bringing the currency in line with its low yield and supporting the worldwide carry trade. Ugo Lancioni, who leads our Currency team, added a caveat: "The short-dollar trade is the most consensus trade I can remember for a long time."

That further implies support for emerging market currencies and local-currency emerging markets debt (not to mention emerging markets assets in general). Other high-yielding currencies and the currencies of commodity exporters could also strengthen.

Alongside the U.S. dollar, the euro and Japanese yen also stand out for their low yields and attractiveness as carry-funding currencies.

The AAC has upgraded its view on the euro, given its positive gearing to global economic activity and the recent clarity on both Brexit and the European Union's common budgetary response to the coronavirus crisis. Nonetheless, some Committee members argued that it still makes for a particularly attractive carry-funding currency on the view that the European Central Bank is likely to consider further easing options should the currency strengthen enough to substantially lower Eurozone inflation expectations.

As Ugo noted, shorting the euro to go long high-yielding currencies is "a high-beta play" that would reinforce the AAC's generally "risk-on" outlook.

UP FOR DEBATE:
WHY MAINTAIN AN OVERWEIGHT VIEW ON TECH-HEAVY PRIVATE EQUITY?

One of the key risks identified by the Asset Allocation Committee ("the AAC" or "the Committee") is stretched valuations in secular growth stocks, particularly in the technology sector. At the same time, it has maintained its overweight view on private equity.

Private equity tends to be relatively highly exposed to growth and technology and the coronavirus crisis has reinforced that tendency. For more than nine months, private equity managers have bought almost no companies that are negatively exposed to the crisis. High-quality health care and technology businesses have become dominant in portfolios, and valuations are correspondingly high.

How does the Committee reconcile these views?

First, the risk the AAC has identified in public growth stocks is the risk of volatility associated with interest rate sensitivity. By definition, investors expect growth companies' earnings to be meaningfully higher in the future than today. That means a larger proportion of their expected earnings is subject to many years' worth of discounting—making their present value more sensitive to changes in the discount rate. Privately held companies are less exposed to that risk, not least because their prices are marked once a quarter rather than once a second. In addition, the tendency of independent valuations to rise as a private equity manager prepares for an exit suggests that private companies are generally undervalued relative to their publicly traded peers.

Second, private equity managers have many more tools than public equity managers with which to mitigate valuation risk. If a private equity fund pays a high multiple for a company's future earnings, one way to reduce that multiple is to help the business grow its future earnings faster through operational enhancements and financial efficiency—the signature skillset of a good private equity manager.

Third, not all of the private equity opportunity set is newly acquired businesses trading at high multiples. The market in secondary interests in private equity funds is exceptionally busy and trading at historically attractive prices, largely due to "General Partner-led" transactions. Private equity managers and their clients are increasingly holding onto their very best assets rather than transacting new deals, while selling the rest of their portfolios into the secondary market to satisfy those clients' cash flow needs. As a result, experienced secondaries managers are finding good quality, mature portfolios being offered at very attractive valuations.

Combined with growing opportunities in private debt and specialty finance, and some of the first transactions in more cyclical sectors for almost a year, we think this makes for a supportive environment for private markets over the next 12 to 24 months.

FIXED INCOME

Investment Grade Fixed Income ▼

- The Asset Allocation Committee ("AAC" or "the Committee") downgraded its view for the second successive quarter, from neutral to underweight.
- Government bonds appear very richly valued.
- Low interest rates and conservative balance sheet management are positive for investment grade credit, including some municipal bonds and structured products.
- Spreads are unlikely to tighten much further, however, and there is scope for interest-rate volatility in the earlier stages of economic recovery.

Developed Market Non-U.S. Debt ▼

- The Committee further downgraded its view to very underweight.
- The European Union overcame political obstacles to its common budgetary response to the coronavirus in the fourth quarter, and the market finally has some clarity on Brexit, but overall, yield curves remain suppressed and flat, and there is scope for interest-rate volatility in the earlier stages of economic recovery.

High Yield Fixed Income ◀▶

- The Committee maintained its overweight view.
- An environment of low rates and conservative management of corporate balance sheets will be supportive of credit markets in general.
- While high yield could be one of the sectors hardest hit by the coronavirus fallout, our estimate for the default rate over the next 12 months has declined meaningfully since the height of the crisis.
- The AAC remains positive on high-quality issuers.

Emerging Markets Debt ◀▶

- The Committee maintained its overweight.
- Because emerging markets debt indices are heavily weighted to Latin American countries struggling with coronavirus, the asset class appears to be trading relatively cheaply.
- Emerging markets debt could benefit from U.S. dollar weakness, which we anticipate on a 12- to 18-month view, although caution is warranted in the immediate term.
- The AAC favors opportunities in local-currency issues, including China onshore bonds: resilient at the height of the crisis, this market could prove an attractive, high-yielding source of exposure to the recovery. Recent defaults underline the need for rigorous credit selection, but in our view they also ultimately point to more market-driven pricing and more efficient capital allocation.

GLOBAL EQUITIES

U.S. Equities ◀▶

- The Committee maintained its underweight view on U.S. large caps and its overweight view on U.S. small and mid caps.
- U.S. large caps have led the rapid recovery in financial markets and now appear fully valued—particularly secular growth stocks that are highly sensitive to interest rates.
- There is potential for large-cap cyclical and value stocks to perform well even if the large-cap indices remain flat or decline.
- The AAC believes a tilt toward higher quality small caps is justified as economic recovery takes hold.
- The AAC anticipates opportunities to add risk in small caps, value stocks and cyclical stocks during the potential volatility of the early stages of recovery in 2021.

Non-U.S. Developed Market Equities ◀▶

- The Committee maintained its overweight view.
- U.S. large caps have led the rapid recovery in financial markets and now appear fully valued, whereas Japanese and European equities remain relatively cheap.
- Japanese and European equities are relatively highly geared to global trade and the general economic recovery anticipated in 2021.

Emerging Markets Equities ▲

- The Committee upgraded its view from neutral to overweight.
- Emerging markets are highly geared to global trade and the general economic recovery anticipated in 2021.
- China and Asia more broadly stand out as sources of high-quality exposure to global economic recovery.
- Further weakness in the U.S. dollar and any general rotation from secular growth stocks to value and cyclical stocks is likely to favor emerging markets.
- The AAC anticipates opportunities to add risk during the potential volatility of the early stages of economic recovery.

REAL AND ALTERNATIVE ASSETS

Commodities ◀▶

- The Committee maintained its overweight view.
- Commodities could provide exposure to a surge in pent-up demand from consumers and manufacturers as uncertainty lifts next year.
- Lower levels of uncertainty and the potential for U.S. dollar weakness next year would likely be a tailwind for commodities.
- Gold and other precious metals could serve as a haven during any periods of uncertainty in the early stages of the economic recovery, as well as a hedge against fiat currency depreciation as authorities fight to generate inflation.

Hedge Funds ◀▶

- The Committee maintained its underweight view.
- After providing much-needed ballast for portfolios through the worst of the coronavirus crisis, the major liquid alternative strategies have less of a role to play as the recovery gains a firmer footing.
- Opportunities are growing in merger arbitrage and distressed.
- Some uncorrelated strategies, such as insurance-linked securities, could still provide useful diversification over the anticipated volatility of the next two to three months.

Private Equity ◀▶

- The Committee maintained its overweight view.
- Very few transactions are being completed in companies that are highly exposed to coronavirus risk which means that current deals are mainly in robust businesses.
- While that raises concerns about valuations, the operational enhancements that private equity can bring can be an effective tool for mitigating that risk.
- There are emerging opportunity sets in co-investments in corporate restructurings, private lending, specialty finance and distressed strategies, and arguably a multi-year opportunity in private equity secondaries.

Currencies

USD ◀▶

- The AAC maintained its underweight view.
- The currency is still overvalued based on purchasing power parity (PPP) metrics and faces headwinds from accommodative monetary policy, the compression of rate differentials with the rest of the world and the U.S.'s twin deficits.
- In the earlier stages of economic recovery, uncertainty or volatility could result in short-term dollar rallies.

EUR ▲

- The AAC upgraded its view from neutral to overweight.
- The European Union overcame political obstacles to its common budgetary response to the coronavirus crisis in the fourth quarter, the market finally has some clarity on Brexit, and the euro tends to be positively geared to global economic activity—particularly relative to the U.S. dollar.
- Nonetheless, the view remains marginal as the already accommodative European Central Bank is unlikely to tolerate further threats to its inflation target from an overly strong currency, and markets are already long the euro.

JPY ◀▶

- The AAC maintained its overweight view.
- Both PPP and real exchange rates suggest the JPY is undervalued, while very low yields globally now make Japan's low rates less discouraging, and hedged foreign investments are at their most attractive levels for years for JPY-based investors.
- These supports are likely to be positive as the economic recovery takes hold, while its haven status is likely to benefit the yen in the event of uncertainty during its earlier stages.

GBP ▲

- The AAC upgraded its view from neutral to overweight.
- The market finally has some clarity on Brexit and the GBP still appears undervalued based on PPP measures.

CHF ◀▶

- The AAC maintained its underweight view.
- The Swiss franc is still very overvalued on PPP measures and market participants remain very long in their positioning despite further progress on the European Union's common budgetary response to coronavirus and its status as one of the most attractive funding currencies for global carry trades.

FIRM HEADQUARTERS

New York
800.223.6448

REGIONAL HEADQUARTERS

Hong Kong
+852 3664 8800

London
+44 20 3214 9000

Tokyo
+81 3 5218 1930

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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

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