Asset Allocation Outlook

FEBRUARY 2023

- Economic growth not as sound as it appears, except in China
- Central banks fail to persuade markets
- Larger underweight in US equities than in European equities
- Negative outlook for high yield credits

After a difficult 2022, financial markets got off to a flying start in 2023. This was nothing more than the optimism that has prevailed since October last year resuming in January after a brief interruption in December. Lower inflation and hopes that central banks are coming to the end of this cycle of interest rate hikes continue to be major drivers for the financial markets. US and UK 10-year government bond yields fell by about 35 basis points, their German counterparts by 29 basis points.

Declining capital market yields foster optimism

Source: Bloomberg, Van Lanschot Kempen

Spreads tightened on Italian and Spanish government bonds, investment grade and high yield credits and emerging market debt. The MSCI global equity index climbed by 7.1%[1], with emerging markets and the Eurozone noting the highest gains at 8% and 9%, and the US and UK lagging behind somewhat at 6% and 4% respectively. Global equities had their best start to the year since 2019 when markets rallied from the losses suffered at the end of 2018. At a global level, real estate performed slightly better than equities at a plus of nearly 9%. Commodities lost some ground because of the marginal drop in oil prices, while metal prices in fact rose. The upturn in the gold price was particularly remarkable given that this usually flourishes when risky investments are struggling. On this occasion, however, the higher gold price was mainly triggered by lower real interest rates in the US and Europe.

Market optimism is also being driven by better-than-expected economic data. There are still underlying problems though and we're not convinced that central banks will quickly turn to cutting interest rates. Corporate earnings growth isn't strong either. We have therefore decided to keep our investment policy unchanged. Our outlook for equities is negative and for high yield credits we've lowered our opinion to negative as we think spreads are too tight.

Growth initially looks to be positive

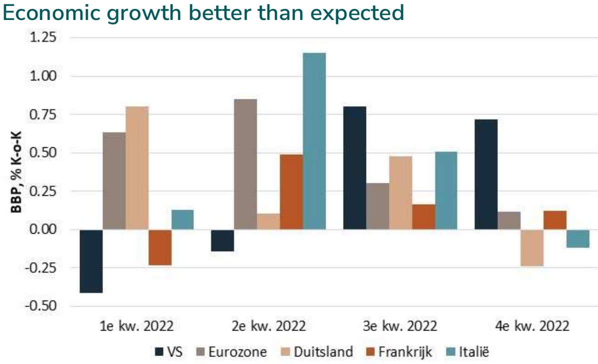
At first sight, the economic growth data over the fourth quarter appears to be positive. The US

[1] Price changes in local currency

economy grew by 0.7% versus the third quarter, down only slightly on the already robust growth in the third quarter. Yet this growth mainly derived from foreign trade and sharply higher stock levels. Growth from building up stocks is temporary and the contribution from foreign trade could mainly be attributed to a drop in imports, which isn't a positive sign either. The underlying growth in consumer spending, government expenditure and investment was just 0.2%. Corporate investment noted a tiny plus, while investment in homes fell for the seventh consecutive quarter. Consumer spending was up but slowed during the quarter.

The Eurozone economy grew by 0.1%. Far from spectacular but better than the contraction that had still been expected just a few weeks ago. Given the shocks to which the Eurozone's economy is exposed, this is positive. A slight contraction in Germany and Italy was offset by a small amount of growth in France and Spain. A breakdown of the data has only been published for France and this shows a sharp drop in consumer spending. Growth mainly derived from lower imports.

Economic growth better than expected



Source: Refinitiv, Van Lanschot Kempen

Weaker consumer spending is a recurring theme in the growth data. In the US, consumer spending was up in the fourth quarter but contracted in November and December. Families decided to use their rising incomes to build up their savings again after these had been largely depleted in recent months. According to the Conference Board indicator, consumer confidence also decreased slightly again in January. For Europe we've already mentioned the drop in consumer spending in France but there were also sharply lower retail sales in Germany and the UK. Consumer confidence in the Eurozone has improved somewhat but remains low. Consumer confidence fell again in the UK in January. It makes sense that consumer spending would be squeezed at some point. Consumer spending power has been eroded over the past year but savings have been used to enable consumers to spend again after the coronavirus pandemic. The persistently uncertain economic outlook is now causing consumers to adjust their spending patterns.

Consumer spending under pressure in the Eurozone

Source: Refinitiv, Van Lanschot Kempen

One positive trend in the Eurozone is the improvement in leading indicators, such as the purchasing manager indices (PMIs), Economic Sentiment Index, Germany's Ifo index and consumer confidence. These indicators point to no more than marginal growth, but this is still better than pointing to a recession. Persisting inflation and the effects of monetary tightening are negative, however. Inflation fell faster than expected to 8.5% in January. Yet problems in Germany with its national data meant they couldn't be published. It therefore remains to be seen whether the rate will need to be revised. More importantly though, core inflation was unchanged at 5.2%. Whereas consumer goods' prices are generally falling in the US, this isn't yet the case in the Eurozone and this continues to exert downward pressure on spending power. The effects of monetary tightening are becoming increasingly visible from the decrease in monetary growth and lending by banks. We therefore anticipate a period of extremely low growth in the Eurozone, which will push up unemployment slightly.

A recession appears to be inevitable in the UK. Confidence is low among manufacturers and consumers alike and inflation remains high. The job market is starting to weaken, with fewer new jobs and rising unemployment. Yet wage growth is strong and inflation high. Growth was already negative in the third quarter and the fourth quarter's falling retail sales and industrial production mean it could also have been negative in the final quarter of the year.

At a national level the PMIs for industry and the service sector improved in the US in January, although they are still significantly lower than in the Eurozone. Regional PMIs were down overall and this was also the case for the ISM index for industry. The ISM index for the services sector rebounded strongly, although the strength of this index is an exception. We have already mentioned the negative consumer spending data. Expenditure that is sensitive to interest rates is under particular pressure. While real incomes are rising, the negative trends on the housing market will prompt consumers to be cautious. Job market data were exceptionally strong though in January, after signs of weakening. This shows that any recession hasn't started yet. The strength of the labour market data is at odds with leading and real indicators though and should thus be interpreted with some caution..

Business orders cause for concern in US

Source: Refinitiv, Van Lanschot Kempen

Apart from consumers, the industrial sector is also having a tough time. Production growth is slowing fast and order books are less well filled. The sharp drop in new orders in the US ISM index for industry is particularly noticeable. This is due to lower consumer demand and businesses being cautious about investing, neither of which we expect to improve quickly.

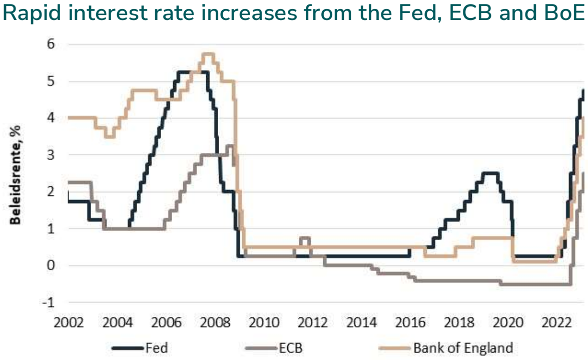
China is one economy that is rebounding quickly. Although the abrupt lifting of coronavirus restrictions led to a wave of new cases, the mild Omicron variant means that there has been little harm to the economy. After this so-called exit wave, Chinese economic growth will reach higher levels in 2023 than had previously been forecast. Consumers can finally spend their money again and are doing so in large numbers. PMIs for the service sector have improved rapidly. Partly due to last year's low basis for comparison, growth in China could reach 5-6%. This is primarily being driven by the service sector and boosted by spending from the extra savings accrued by households over the past couple of years, as well as by the government's tentatively stimulatory policy. For the time being, the Chinese government is giving the real estate sector a breather via sufficient access to liquidity, and once consumer confidence and incomes have improved this sector will be able to recover somewhat. Exports, long a strong driver of the Chinese economy, will be adversely affected by the global drop in demand for goods.

The reopening in China is having an inflationary impact on the global economy. This is more visible in commodities (such as metals and energy), for which China accounts for a substantial portion of global demand, than on the goods side. The tightness in supply chains is diminishing and global demand for goods is slowing. Upward pressure on commodity prices will not be welcomed enthusiastically by central banks in developed markets.

Fed, ECB and BoE raise rates higher

The expected interest rate increase of 25 basis points and the message that rates will be raised further and therefore won't be cut quickly still triggered an extremely positive market response. In short, Fed Chair Powell once again failed to persuade the markets. His admission that inflation will fall - "the disinflationary process has started" - was enough to push equity markets up by 1.5% to 2%. And for 2-year bond yields to come down by more than 10 basis points and 10-year yields by 7 basis points. The Fed sent a mixed message on inflation. Inflation has already dropped sharply in goods and energy and it only looks to be a matter of time before the same happens in housing. Yet the Fed is still worried about inflation in the service sector, which is mostly being driven by wage growth. And there continues to be an imbalance on the job market – i.e. it's excessively tight – so further interest rate hikes are needed. The Fed now seems to be less concerned about the financial conditions (interest rates, spreads, equity markets etc.). In December, the Fed was still talking of the undesirable easing of financial conditions but when asked Powell said that not much had changed since December. Financial conditions have again eased very slightly, although not by very much, which makes it odd that Powell no longer views this as a concern. And there was a message for the markets that the Fed wouldn't apply the brakes in the event of excessive optimism. The initial positive market reaction was only tempered by the strong labour market and ISM non-manufacturing data, which caused investors to believe that the Fed may mean what it says. It should be remembered here that the Fed is still raising interest rates and will probably do so again in March. With an economy that is in all likelihood heading for a recession, this could well be the final interest rate hike of this cycle. Yet Powell continues to believe in a soft landing. Interest rate markets could well be proved right in their expectations that the Fed will cut rates later this year, although it will be against the background of a much weaker economy.

Rapid interest rate increases from the Fed, ECB and BoE



Source: Bloomberg, Van Lanschot Kempen

ECB President Lagarde succeeded in talking bond yields upwards in December but was unable to repeat the trick this time. The message was clear enough. The ECB will maintain its course and continue to raise interest rates gradually to significantly higher levels. After its latest increment of 50 basis points the ECB strongly intends to implement a similar hike in March. The ECB still doesn't expect rates to peak in March. Interest rates will therefore need to remain restrictive for some time to bring inflation down to the ECB's target rate of 2%. And markets will simply have to believe the ECB's intentions, because in contrast to the US the disinflationary process hasn't yet started in the Eurozone. German 2-year and 10-year bond yields nevertheless fell by 10 basis points following the ECB's decision. Equities climbed by more than 1%. European real estate, which had already started the day well, even rose by more than 2%. One possible conclusion is that the markets don't believe the ECB. Yet this certainly isn't the case in the short term. An interest rate hike of 50 basis points in March has already been fully priced in, as has an increment of 25 basis points in May. According to the markets, the risk of an interest rate hike of 25 basis points in June is just over 50%. Yet markets are expecting the ECB to make a relatively rapid policy reversal. The ECB's weak growth forecast and the fact that the bank views the risks surrounding inflation as more balanced than it did in December (but not totally balanced) are taken by the markets as a sign of precisely this type of pivot. For the time being, however, we face further interest rate increases from the ECB and not cuts.

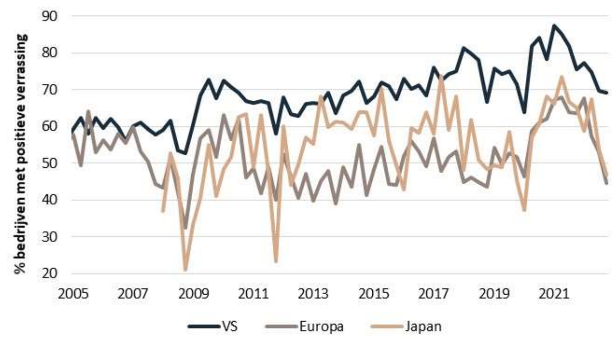
The Bank of England likewise raised interest rates by 50 basis points, in line with expectations. And here, too, bond yields fell after the decision. One reason was that on this occasion not a single policymaker voted for an even bigger interest rate hike, while that had still been the case back in December. More importantly, however, the BoE said that inflation had probably already peaked in many countries, including the UK. Gas prices are down, disruption to supply chains has largely been resolved and demand has slowed. If the BoE is working on the basis of the market expectation that policy interest rates, which currently stands at 4%, will peak at 4.5% and then drop back to 3.75% in three years' time, then inflation should fall to below 2% in the medium term. The BoE's implicit message here is that market expectations for policy interest rates are rather high. Short-term expectations consequently fell as well. Prior to the decision an increment for March of 50 basis points had already been more than priced in, while after the press conference this was no longer fully priced in. If there's anywhere where there are doubts about whether the central bank will go much further with interest rate increases then it's the UK. The BoE has already raised rates by 390 basis points and this is having a visible impact on the economy. House sales and prices are dropping and a recession may already have begun.

All in all, in our view it's still too soon to anticipate central banks cutting interest rates. The increments that have already been implemented first need to have an effect on economies. Yet the high rate of inflation means that central banks will be forced to reverse their policies less quickly if economies do slow further.

Earnings growth slowing

The earnings season, during which businesses report their results over the fourth quarter of last year, is well underway. In the US, one-fifth of companies in the S&P500 have already published their results. So far, this has yielded a mixed picture. Revenue growth in the US fell from 11% in the third quarter to nearly 6% in the fourth. Earnings growth has ground to a halt, while only a marginal decrease had been expected. As also happened in the third quarter, earnings growth is being boosted sharply by the energy sector. Without this sector earnings were down by 6%. The fact that earnings growth is lower than revenue growth means that profit margins are being squeezed. Declining inflation is causing costs to rise less rapidly but it's also more difficult for businesses to pass on higher wage costs to their customers. Incidentally, earnings are forecast to drop by more than 4% in the first and second quarters of this year. This doesn't seem to be enough for a recession, of which there's now a high probability. Earnings are therefore still being adjusted downwards in the US. Moreover, US equity valuations remain fairly high. In the past few months the forward price-to-earnings ratio has risen back to well above 18, which is also higher than the long-term average. Risk premiums on US equities are extremely low in historical terms at 1.9 percentage points.[2] This makes US equities less attractive versus government bonds. We think the rally in US equities is premature. Recent market movements mean that our equity underweight in the US is now slightly bigger than our underweight in Europe. We have decided not to correct this.

Fewer businesses able to exceed earnings expectations



Source: Factset, Van Lanschot Kempen

A fifth of European companies in the STOXX600 index have also already reported their results over the fourth quarter. To date, things look considerably better than in the US. Revenue growth is virtually the same at nearly 12%, but earnings growth of almost 9% is much better and also much higher than expected. It should be noted though that the results are distorted by a handful of outliers. Nevertheless, earnings growth in Europe has so far been much lower than in the third quarter when growth still stood at 24%. The forecast for the coming three quarters is for earnings to fall on an annual basis. This is logical given the weak economic growth and sharp earnings growth last year. Despite the improved economic outlook, analysts have recently made more downward adjustments to earnings than upward. The slowdown in earnings growth stands in stark contrast to the rally in European equities. We have therefore decided to retain our underweight. The underweight in European equities is smaller than the underweight in US equities. European equity valuations are low compared to the US and the economic outlook for the US has recently deteriorated more quickly than that for Europe.

[2] The risk premium on equities is the difference between the earnings yield (earnings divided by the price and therefore the opposite of the price/earnings, or P/E, ratio) and the yield on 10-year government bonds. The risk premium therefore shows the additional return earned from investing in equities versus bonds, at flat prices.

Market review

Aandelen				
	Index	Afgelopen maand	Afgelopen 3 maanden	Vanaf 31-12-2022
Wereldwijd (MSCI AC)	1043	8.1%	11.4%	8.1%
Geïndustrialiseerde landen (MSCI World)	2810	8.0%	10.3%	8.0%
Opkomende markten (MSCI EM)	1043	9.0%	20.2%	9.0%
Verenigde Staten (S&P500)	4119	7.3%	6.8%	7.3%
Eurozone (EURO STOXX 50)	4171	10.0%	14.3%	10.0%
Verenigd Koninkrijk (FTSE 100)	7761	4.2%	8.0%	4.2%
Japan (Topix)	1972	4.3%	1.7%	4.3%
Nederland (AEX)	748	8.5%	11.0%	8.5%
Staatsobligaties (10-jaar)				
	Rente (%)	Afgelopen maand (bp)	Afgelopen 3 maanden (bp)	Vanaf 31-12-2022 (bp)
Verenigde Staten	3.42	-46	-63	-46
Japan	0.49	7	24	7
Duitsland	2.28	-29	15	-29
Frankrijk	2.75	-36	8	-36
Italië	3.78	4	219	4
Nederland	2.57	-34	13	-34
Verenigd Koninkrijk	3.31	-37	-16	-37
Bedrijfsobligaties				
	Risico-opslag (bp)	Afgelopen maand (bp)	Afgelopen 3 maanden (bp)	Vanaf 31-12-2022 (bp)
Verenigde Staten	118	-12	-42	-12
Eurozone	150	-17	-69	-17
Hoogrentende obligaties				
	Risico-opslag (bp)	Afgelopen maand (bp)	Afgelopen 3 maanden (bp)	Vanaf 31-12-2022 (bp)
Verenigde Staten	419	-50	-27	-50
Eurozone	455	-57	-143	-57
Opkomende markten (USD)	444	-8	-104	-8
Opkomende markten (Lokale valuta)	306	21	-9	21
Vastgoed				
		Afgelopen maand	Afgelopen 3 maanden	Vanaf 31-12-2022
Wereld		6.5%	-0.2%	6.5%
Noord-Amerika		8.6%	0.3%	8.6%
Europa		9.3%	7.4%	9.3%
Grondstoffen				
		Afgelopen maand	Afgelopen 3 maanden	Vanaf 31-12-2022
Bloomberg index		-2.5%	-2.4%	-2.5%
Basismetalen		7.3%	17.9%	7.3%
Brent olie (USD per vat)	82.84	-3.3%	-7.7%	-3.3%
Goud (USD per troy ounce)	1943	6.4%	17.8%	6.4%

Returns in local currency
bp = basis point (0.01%)
Data as of 2 February 2023
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Negative**
Equities started the year well. After an interruption in December, the rally that had started in October resumed in January. Equity markets are still being driven largely by the outlook for monetary policies. Declining inflationary pressure and hopes of an end to this cycle of interest rate hikes by central banks are fostering optimism. Yet we think it's too soon to expect support from central banks. Equity markets often only bottom out once central banks start to cut interest rates and we've not yet reached that stage. In the meantime, the global economy is facing a difficult period. The economic situation is improving rapidly in China but the US looks to be heading for a recession. And there's a recession looming in Europe as well. Higher policy interest rates are replacing inflation as a curb on the economy. We believe earnings will need to be adjusted further downwards. Valuations haven't yet been adjusted for the possibility of a recession. We therefore retain our underweights in US and European equities. The underweight in the US is larger because of the higher US equity valuations and rapidly deteriorating economic outlook.	
Government bonds	**Neutral**
Central banks are moving towards reducing the pace of their interest rate hikes, but that's all you can say so far. The Fed isn't yet getting what it wants. The US job market is hardly cooling at all and financial conditions, such as 10-year bond yields, spreads on credits, equity prices and the US dollar, are not yet playing along properly. As a result, the Fed may need to keep interest rates high for longer than currently anticipated. Markets aren't persuaded by the Fed's message. US 2-year government bond yields declined by 19 basis points and 10-year yields by 34 basis points in January. The ECB is doing a better job at convincing markets that a pivot isn't yet on the cards. German 2-year bond yields only dropped by 8 basis points and 10-year yields by 25 basis points in January. This followed sharp upturns in December. Within government bonds we hold an underweight in the Eurozone, an overweight in the US and are on balance neutral. We nevertheless remain cautious. Central banks are mostly looking backwards at the sky-high rate of inflation. We have therefore decided to retain our small position in government bonds and in relatively short durations, which restricts the interest rate risk.	
Investment grade credits	**Neutral**
Spreads on investment grade credits tightened in January in both the US and Eurozone. When combined with the downturn in underlying government bond yields. this led to lower yields on investment grade bonds. At the end of January, yields on these credits stood at 4.6% in the US and slightly over 3.8% in the Eurozone. Yields are attractive from a historical perspective. In the US they are higher than dividend yields on equities, although this is somewhat distorted as US companies are returning a relatively large amount of capital to investors via share buyback programmes. We retain our neutral weight owing to the tightening monetary policies and high risk of a recession. Spreads are not yet at levels that match a recession and slowing earnings growth.	
High yield credits	**Negative**
Spreads on high yield credits tightened sharply in January; in the US by more than 50 basis points and in the Eurozone by nearly 40 basis points. As of the end of January, yields on these bonds were more than 7.6% in the US and over 6.8% in the Eurozone. These may sound attractive but a recession hasn't yet been fully priced in on this market either. In a recession, spreads in this asset class can easily reach 1,000 basis points. In the US these stood at 420 basis points and in the Eurozone at 460 basis points at the end of January. Although a negative scenario of slowing growth and high inflation has largely been priced in already, we also see downward risks such as lower earnings growth and a higher default rate. It's becoming considerably more expensive for businesses to refinance high yield bonds, which have shorter durations on average than their investment grade counterparts. The lower yields and further tightening of spreads have led us to adjust our outlook downwards from neutral to negative.	
Listed real estate	**Neutral**
Listed real estate has a reputation as being a defensive sector in equities. Moreover, its cashflows are partly linked to inflation. Higher interest rates do pose a threat to this asset class though, including in relative terms versus general equities. Listed real estate profited from the lower interest rates in January. This asset class earned a marginally better return than the general equity indices. Listed real estate valuations have fallen, leading us to no longer view the asset class as expensive. Europe is now cheap versus general European equities. Aside from the uncertainty surrounding growth, the higher interest rates have had a substantial impact on listed real estate equity prices. Listed real estate will be able to recover once the interest rate pressure eases, although it's still too soon for central banks to reverse their policies. Having initially underestimated the inflationary pressure, central banks want to see job markets weaken and inflation to fall more clearly towards 2% before they consider cutting policy interest rates.	

Emerging market debt	Neutral

January was a positive month for emerging market debt when measured in US dollars. Spreads on bonds listed in US dollars tightened by 9 basis points. Lower capital market yields in the US pushed down the overall interest rate compensation by 44 basis points. Yields on those bonds listed in local currency dropped by 24 basis points. The reopening of China in 2023, despite the current chaotic exit wave of high numbers of coronavirus cases, and a better-than-expected rate of inflation in the US are positive factors. The prospect of lower (goods) inflation in the US reduces the pressure on emerging market debt. However, there's still no sign of the Fed cutting interest rates. On the contrary, the Fed has said it wants to implement a few more interest rate hikes due to the excessively tight job market and the upward impact this is having on services inflation. Despite China's reopening, slowing global growth and lower exports from emerging markets pose a risk to this asset class. Given the relatively high interest compensation we hold a neutral outlook for emerging market debt in US dollars and in local currency.

Commodities	Neutral

The general Bloomberg commodity index noted a small loss of 0.9% in January. On balance, oil prices declined slightly but it was mainly the drop in gas prices in the US that had a downward impact. Metals and gold were in fact up. A lower oil price may seem logical given the slowing global economy but the economic upturn in China, low stock levels and uncertainty surrounding supplies from Russia are creating a floor under the oil price. The higher metal prices match the improved growth outlook for the Chinese economy. The upturn in the gold price is in turn aligned with the lower real interest rates in the US, although the discrepancy between the level of the gold price and real interest rates tells us something about the amount of uncertainty that investors recognise. Gas prices in Europe fell further to 55 euros per megawatt hour and seem to have bottomed out. These prices reflect the fact that the acute threat of shortages has diminished. In the medium term, however, securing gas supplies will remain a challenge in Europe. With Russia supplying fewer commodities because of sanctions, in general tightness could easily arise on commodity markets. Yet for this to happen the global economy will need to pick up, while it's in fact slowing at the moment. The decrease in tightness on the commodity markets compared to earlier this year can also be seen from the decline in backwardation. Spot prices are still higher than futures prices but the difference is smaller than in the recent past. This makes commodities a less interesting investment.

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