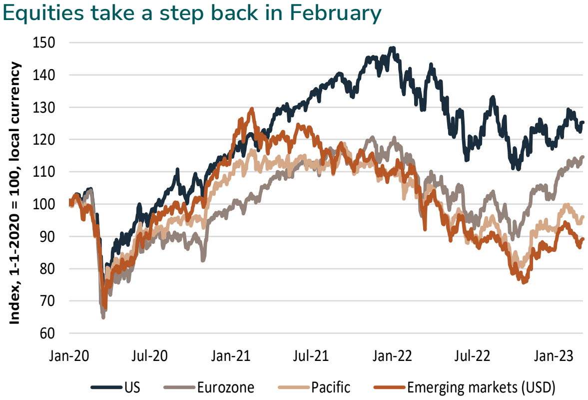
Asset Allocation Outlook

MARCH 2023

- Slowdown in growth not as bad as feared, inflation more stubborn than expected
- Investors now share the outlook of central banks
- Cautious investment policy unchanged

Equity investors were less optimistic in February than they were in January. The MSCI global equity index fell by 3.0%[1]. Emerging market equities noted the biggest loss at 6.5%, followed by the Pacific region with a drop of 5.0%. In the US, the equity market was down by 2.6%. Only Europe kept its feet dry thanks to a gain of 1.9%. Since the low in September, European equities have climbed twice as fast as US equities.

Equities take a step back in February



Source: Bloomberg, Van Lanschot Kempen

Once again interest rates were the main reason for caution among investors, with caution growing as expectations for monetary policy increased. Two-year and 10-year government bond yields climbed in the US and Germany, more than cancelling out the downturns in January. Spreads on credits and emerging market debt changed very little on balance. Real estate decreased more or less in line with general equities. In commodities the prices of oil, gas, metals and gold came under pressure. This meant there were few places for investors to take shelter. Corporate results over the fourth quarter were better than expected but not strong. We think corporate earnings will be squeezed further in the coming months, mainly because of the extremely moderate outlook for growth. We therefore continue to apply caution in our investment policy.

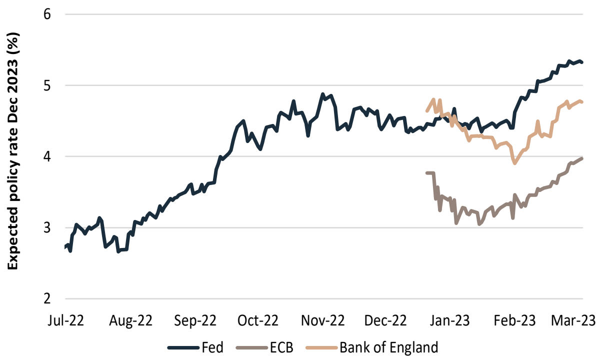
Will central bankers be proved right after all?

The outlooks held by central bankers and investors have diverged sharply in the past few months. Central bankers said they wanted to raise interest rates further and keep them high for a time, while investors predicted less tight monetary policies. Cuts to interest rates were already being forecast for the end of the year in the US. Now, however, investors have shifted more towards the outlook of central bankers. Until February the difference between what

[1] Price changes in local currency

the Fed said and what investors expected at the end of this year amounted to about 75 basis points, but that difference has now vanished entirely. In fact, Fed funds futures are now pricing in more interest rate hikes than the most recent Fed projections.

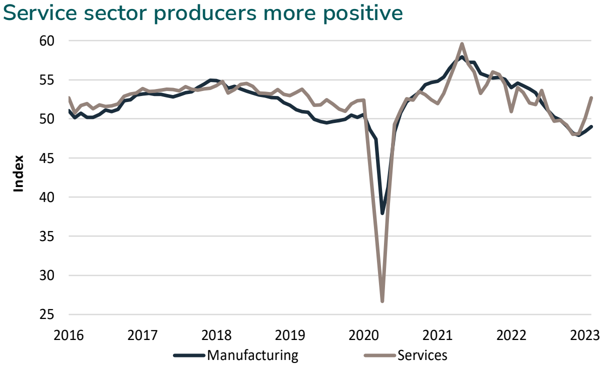
Higher expectations for policy interest rates



Source: Bloomberg, Van Lanschot Kempen

The U-turn by investors was prompted by growth data that weren't as bad as had been feared and by higher-than-expected inflation. Let's start with the growth data: purchasing manager indices climbed across a broad front, especially in the service sector.

Service sector producers more positive



Source: Bloomberg, Van Lanschot Kempen

Worldwide the index rose to 52.7 in February, a sharp upturn versus January and the highest level since June last year. The US and Chinese indices increased to just over 50 and in doing so point to growth after having pointed to a sharp contraction in the preceding months. In the Eurozone the indicator climbed to the global average. There is less visible improvement in the indices for industry. Worldwide the index was up slightly but it remains below 50. In just over half the countries for which the index is available it continues to point to a contraction in industry. Other leading indicators that displayed improvement were the Economic Sentiment Index and consumer confidence index in the Eurozone and Germany's Ifo index. It should be noted here though that these indicators continue to point to a more or less stagnating economy. In the US, the ISM indices confirmed the picture given by the purchasing manager indices: growth in the service sector, stagnation in industry. The reopening of the Chinese economy was visible in sharp upturns in the purchasing manager indices there.

Real indicators sketch a more mixed picture, however. Consumer spending, production and job market data were exceedingly robust in the US in January. This is remarkable after what were generally weak figures at the end of last year. Distorting seasonal and catch-up effects play a role here but it's clear that the US will note considerable growth over the first quarter. Yet the question is whether consumers in particular will be able and willing to maintain the higher spending pattern. It's perhaps telling that consumer confidence declined somewhat in February. US consumers are still being confronted with a high rate of inflation but also higher interest rates and falling house prices. The savings accrued during the coronavirus pandemic have mostly already been spent. And banks are tightening lending standards for credit card and car loans.

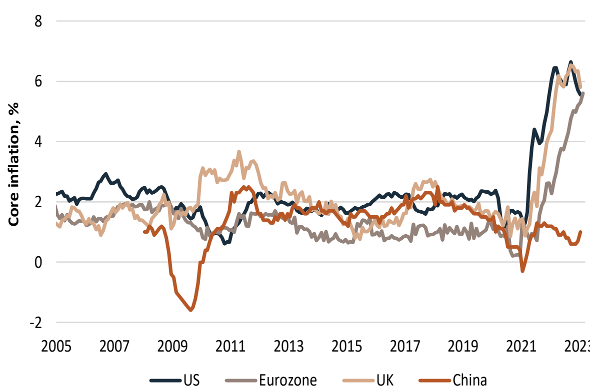
In contrast, weak in the Eurozone real indicators have been. Retail sales did rise slightly in January but not enough to offset the sharp downturn in December. The bright spots in the Eurozone were higher exports and factory orders in Germany as well as higher employment and low unemployment rates in the Eurozone as a whole. Despite the tight job market, wages covered by collective labour agreements in the Eurozone rose by 2.9% in the fourth quarter of last year, nowhere near enough to compensate for inflation. Labour productivity dropped slightly in the fourth quarter, which restricts the capacity for wage increases. Germany again revised its growth forecast for the fourth quarter downwards, this time to -0.4% versus the third quarter. Ireland likewise cut its initial runaway growth forecast. These downward adjustments mean that growth could ultimately be negative for the Eurozone. This shows that the Eurozone was in extremely weak shape at the start of the year, even though the effect of the ECB's interest rate hikes has yet to be felt.

The Eurozone could profit from the recovery in the Chinese economy. The upturn is evident from leading indicators and data on passengers and freight transport. Yet it seems to be driven mainly by the domestic service sector and will therefore have less impact on the global economy. Imports were down in February, for example. The Chinese authorities announced a growth target for 2023 of about 5%, which is lower than last year's target. This points to caution in stimulating the economy. The stimulation of the real estate sector focuses primarily on finishing homes that have already been sold in order to restore trust among (potential) house buyers. And on keeping debt under control at local government level. The stimulation is therefore more defensive than offensive. This is perhaps a sensible move to avoid ending up with an inflationary problem like the one in the US and Europe.

All in all growth momentum looks stronger in the US and China than in Europe, but the contractionary monetary policy will be felt first in the US. In Europe a moderately performing economy is likewise being confronted with tighter monetary policy, which will keep growth low.

In the meantime the rate of inflation was not as good as expected. In the US, the CPI index fell on an annual basis in January but there was no visible improvement on a monthly basis.

Inflation remains stubborn in Western economies



Source: Refinitiv, Van Lanschot Kempen

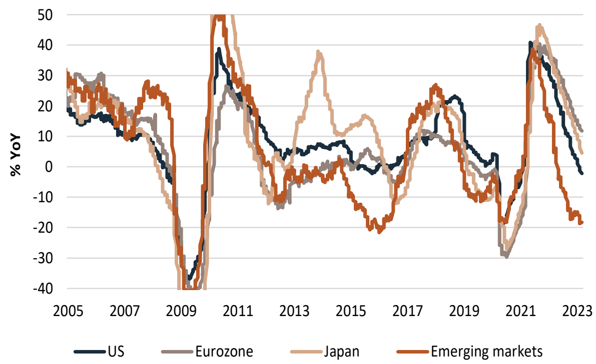
The PCE index, which is what the Fed tends to look at, rose on both an annual and a monthly basis. Manufacturing prices also climbed more steeply than expected on a monthly basis in January. The US rate of inflation remains at about 5% to 7%, depending on the benchmark. The trend is downward but this is sometimes happening less quickly than hoped. In the Eurozone headline inflation was down slightly in February at 8.5%. Yet core inflation (excluding volatile energy and food prices) rose to 5.6%, a new record.

Reason enough therefore for central bankers to continue raising interest rates and keep them higher for longer. Fed Chair Powell was absolutely clear on this in his semi-annual speech to Congress. In the US, upwards of three interest rate hikes of 25 basis points are expected from current levels and rates are no longer expected to be cut this year. In the Eurozone the ECB policy interest rate is forecast to be nearly 4% in September, which translates into a further 150 basis points of increments. This is despite the uncertain economic outlook. Central bankers have therefore succeeded in convincing markets of their determination to curb inflation. Expectations for interest rate increases in the UK may have gone slightly too far. The policy rate there is already 4% and a further 75 basis points in increments are anticipated. This is in spite of the looming recession, in part because of the interest rate-sensitive housing market. UK mortgages are generally subject to short fixed-rate periods.

Earnings: better in Europe

The earnings season, during which businesses report their results over the fourth quarter of last year, is now largely behind us. Results are much better in Europe than they are in the US. Revenue and earnings growth are higher in Europe and earnings are also managing to keep up with revenues better, which points to less pressure on margins. In Europe revenue was up by 9.6% and earnings by 8.1% versus the fourth quarter of 2021; in the US revenue climbed by 5.6% but earnings fell by 2,9%. When you exclude the strong earnings growth in the energy sector, earnings were down by as much as 6.7%. Forecasts were not adjusted upwards in the US during the earnings season as often happens. This is because businesses mostly failed to exceed expectations. In Europe revenue was more or less in line with expectations, while earnings were much better than expected. The latter could be attributed to a small group of companies. The number of companies that reported better-than-expected earnings was relatively low in Europe, just as it was in the US. This does cast a slight shadow over the positive European results. Moreover, earnings growth slowed sharply in Europe. In the third quarter earnings had risen by 24%. The relatively robust data for Europe can therefore largely be traced back to previous quarters. As a result of this historically high earnings growth, earnings expectations are not being adjusted downwards in Europe, but this is happening in the US.

Rapidly slowing growth in expected earnings



Source: Refinitiv, Van Lanschot Kempen

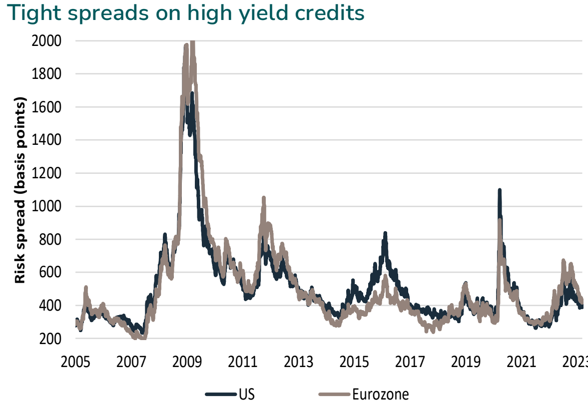
Overall, the earnings data make European equities marginally more attractive than their US counterparts. Earnings growth is stronger in Europe and expected earnings are holding up better. Furthermore, European equity valuations are much lower than those of US equities. The forward price/earnings (P/E) ratio is 13.3 in Europe and 18.7 in the US. While it's true that European equities are always cheaper than US equities, the discount on European equities versus their US counterparts has seldom been as big as it is at the moment. In relative terms we have a slight preference for European equities. Slight because we question the sustainability of the relatively strong earnings in Europe.

In our investment policy we have decided to maintain our underweight in equities. Given our slight regional preference for Europe, the underweight there is smaller than in the US. We think that earnings will be squeezed further and that valuations may suffer under the tightening monetary policy. Moreover, we believe that equity markets in general and Europe in particular have gone too far in anticipating a better economic and monetary climate. The positive market sentiment poses a risk to this underweight, without it being extreme. Emerging market equities also have low valuations. Earnings seem to be bottoming out, although earnings growth in Korea and Taiwan remains weak. We nevertheless think that the economic outlook is too uncertain for us to hold an overweight. It's telling that emerging market equities have recently lagged behind the US or Europe, despite the reopening in China.

Investment policy unchanged

We have kept our investment policy unchanged. We hold an underweight in equities and a negative outlook for high yield credits. The credit markets are fairly calm and newly issued credits are being absorbed fairly easily. Spreads are therefore also tight. These stand at about their five-year average for US and European high yield credits and slightly higher for European investment grade credits. Yields may seem attractive from a historic perspective but this is mainly due to the higher yields on government bonds. We think spreads are too tight for the prevailing economic climate. March is often a busier month in terms of new bond issues and if the ECB also decides to reduce its credit portfolio, this could disrupt the calm on the market. The default rate is low but this often rises when banks tighten their lending conditions, as is happening now. High yield credits are particularly vulnerable in a climate of monetary tightening.

Tight spreads on high yield credits



Source: Bloomberg, Refinitiv, Van Lanschot Kempen

Market review

Equities	Index	Past month	Past 3 months	From 31-12-2022
Global (MSCI AC)	994	-1.1%	3.7%	6.0%
Developed markets (MSCI World)	2765	-1.0%	3.9%	6.2%
Emerging markets (MSCI EM)	994	-2.0%	2.1%	3.9%
United States (S&P500)	4048	-1.5%	2.7%	5.4%
Eurozone (EURO STOXX 50)	4314	2.6%	9.5%	13.7%
United Kingdom (FTSE 100)	7930	1.2%	5.4%	6.4%
Japan (Topix)	2036	2.9%	4.4%	7.7%
Netherlands (AEX)	760	1.0%	5.0%	10.3%

Government bonds (10-year)	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	3.96	32	43	8
Japan	0.51	0	25	8
Germany	2.75	45	95	18
France	3.24	49	98	12
Italy	4.01	401	242	-32
Netherlands	3.09	53	100	19
United Kingdom	3.87	62	79	19

Investment grade credit	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	120	5	-40	-10
Eurozone	145	4	-29	-22

High yield bonds	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	389	-1	-59	-80
Eurozone	415	-18	-114	-97
Emerging markets (USD)	442	12	-106	-10
Emerging markets (Local currency)	254	-21	-53	-31

Real estate		Past month	Past 3 months	From 31-12-2022
Global		-3.1%	0.4%	5.4%
North-America		-3.6%	2.0%	6.4%
Europe		-4.3%	2.7%	6.7%

Commodities		Past month	Past 3 months	From 31-12-2022
Bloomberg index		1.0%	-1.3%	-4.0%
Base metals		-3.2%	-2.0%	-0.1%
Brent oil (USD per barrel)	86.18	6.8%	7.8%	1.1%
Gold (USD per troy ounce)	1855	-1.3%	4.1%	1.6%

Returns in local currency
bp = basis point (0.01%)
Data as of 7 March 2023
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Negative**
After the positive start to the year, equities took a step back in February. The biggest losses were in emerging markets; European equities in fact climbed higher. Equity markets are still being driven largely by the outlook for monetary policies. Indications that the slowdown in growth is less sharp than expected and that inflation is falling less quickly than expected, meaning that central banks will need to pursue a contractionary policy for longer, affected the equity markets in February. The fact that this had only a minor effect is a sign of investors' hopes for a soft landing, in which inflation disappears without inflicting too much harm on the economy. The limited impact on corporate earnings also helped though. We continue to see enough negative factors to maintain an underweight in equities. Economic growth is weak and the risk of a recession hasn't yet dissipated. Central banks are tightening their monetary policies. It's highly unusual for the low to be reached on equity markets before a recession starts or before central banks switch to cutting interest rates. Moreover, we believe earnings will need to be adjusted further downwards and that valuations haven't yet been adjusted for the possibility of a recession. The underweight is larger in the US than in Europe because of the higher US equity valuations, warning signs that herald a recession and weaker earnings growth.	
Government bonds	**Negative**
Central banks have reduced 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. Markets have recently priced in a much higher number of interest rate increases, however, which shows that the Fed's message is starting to get through. US 2-year government bond yields climbed by no fewer than 62 basis points and 10-year yields by 41 basis points in February. Investors in the Eurozone have also come to believe that the ECB isn't done yet. German 2-year bond yields rose by 49 basis points and 10-year yields by 37 basis points in February. Within government bonds we hold an underweight in the Eurozone, an overweight in the US and an underweight overall. The pricing in of more interest rate hikes has brought the peak rate within sight. 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**
In February spreads on investment grade credits widened by 7 basis points in the US but tightened by 4 basis points in the Eurozone. It's therefore quiet on the markets for investment grade credits. The upturn in underlying yields on government bonds led to higher yields on investment grade credits. At the end of February yields on these credits stood at 5.3% in the US and 4.2% 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 further in February, in the US by 8 basis points and in the Eurozone by 26 basis points. At the end of February yields on these credits stood at 8.2% in the US and over 7.1% 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. These stood at 412 basis points in the US and 434 basis points in the Eurozone at the end of February. This means that a negative scenario of slowing growth and high inflation has only been partly priced in. We see downward risks as well, such as lower earnings growth and a higher default rate. It's also becoming considerably more expensive for businesses to refinance high yield bonds, which have shorter durations on average than their investment grade counterparts. We retain our negative outlook.	
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. This picture was confirmed in February. Global listed real estate noted a loss of 4.5%, which was bigger than the loss on general equities. In the US listed real estate was down by 4.5%, in Europe by 1.2%. 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

Emerging market debt noted losses in February. For those bonds listed in US dollars this was mainly due to the upturn in yields in the US (47 basis points) and to a very small extent to the wider spreads (3 basis points). Yields on bonds listed in local currency increased by 19 basis points to 6.8%. That fact that growth is picking up in China ought to be positive but there could be little spill-over effect for other countries. The slowdown in growth in the US and Europe is negative. To have a positive outlook for bonds in US dollars we need greater clarity on falling inflation and an end to interest rate hikes in the US. For bonds listed in local currency it's positive that the end of interest rate increases in emerging markets is coming into sight. This is mostly because central banks in these countries started to raise interest rates before the Fed and the ECB. 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 loss of 5.0% in February. Oil prices fell by about 3%, metal prices by 9.5% and gold by 5.3%. The downturn in metal prices is remarkable in light of the reopening of the Chinese economy. This supports the theory that the reopening will be more domestic in nature and require fewer commodities, but also that the consumption of goods will be low in the US and Europe. 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 drop in the price of gold is in turn aligned with the upturn in 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 45 euros per megawatt hour. These prices reflect the fact that the acute threat of shortages has diminished. In the medium term, securing gas supplies will remain a challenge in Europe but for now the effect of relatively high stock levels is dominant. 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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