VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

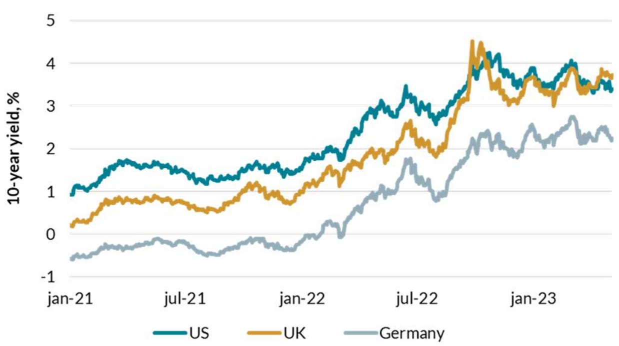
Asset Allocation Outlook

May 2023

- Calm on equity markets premature
- Negative impact of monetary tightening increasingly visible
- Risk reduction: in US from investment grade to government bonds

April was a quiet month on the financial markets. Government bond yields barely moved, with the exception of upturns in yields on bonds at the extremely short end of the yield curve in the US and more generally in the UK. The higher yields in the UK were mainly a normalisation following the downturns in March.

Ten-year yields trending sideways



Source: Bloomberg Van Lanschot Kempen

Spreads on investment grade and high yield credits and emerging market debt only changed by a couple of basis points at the most. Equity indices moved by no more than a couple of percent, usually upwards. The VIX index, which measures volatility in US equities, in fact fell to its lowest level since November 2021. Emerging market equities did lose some ground, however. Perhaps the most noteworthy news in commodities was that gas prices in Europe again dropped sharply to their lowest level since the end of July 2021, well before Russia invaded Ukraine. Real estate rallied somewhat after the blows it had been dealt in February and March.

In light of the weak or even negative economic growth, persistent inflation, central banks raising interest rates slightly higher and sound valuations for some asset classes, we continue to pursue caution in our investment policy. We have retained our underweight in equities and reduced our positioning in US investment grade credits from neutral to an underweight.

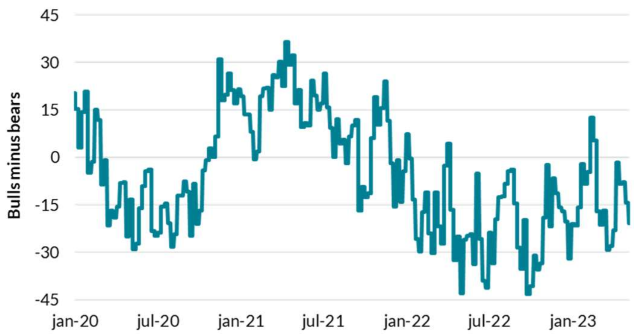
Markets are holding up well

Given the abovementioned growth, inflation, monetary and valuation risks, we think it remarkable that financial markets are holding up so well. Even the second-largest bank failure ever, in which First Republic Bank was taken over by JP Morgan, occurred almost without causing a ripple. Nevertheless, a day later the turbulence in the US banking sector proved to be far from over. Regional banks were particularly affected, incidentally without there being any clear trigger. There are a number of reasons for the relative calm on the equity markets, some more convincing than others.

Sentiment: not extreme

Firstly, sentiment. Some indicators for this topic, such as the positioning of professional investors or surveys of this group, show that professional parties are on balance negative about risky investments, with positionings to match. This means that a large portion of negative news has already been priced in and there's room for positive surprises. Yet surveys of US private investors and the ratio of outstanding put and call options don't indicate any obviously negative sentiment. And US households in fact hold a historically high number of equities. This leads us to conclude that sentiment isn't in fact strongly negative.

Bears outnumber bulls in the US, but sentiment not extreme



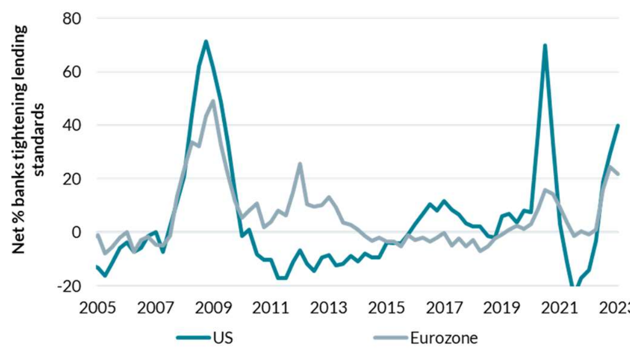
Source: Bloomberg Van Lanschot Kempen

Growth: modest with elevated recession risk

Secondly, growth. This has held up better than was forecast a few months ago. In the first quarter, the US economy grew by 0.3% versus the final quarter of last year. Growth was mainly driven by consumer spending and government expenditure. Corporate investment was up minimally, while investment in residential properties was down. The building up of stocks contributed negatively to growth, while foreign trade made a positive contribution. Without the volatile stock component, growth was robust. We believe that growth will slow in the US. A slowdown in consumer spending was already visible in the first quarter. Corporate investment is being squeezed by lower earnings, higher interest rates and tighter lending conditions at commercial banks. Confidence indicators for large and small businesses, households and home builders generally display a fairly sombre picture, although improvements are visible here and there. Monetary and credit growth are declining fast, as are orders for capital goods. Job market indicators are displaying weakness, which is precisely what the Fed wants. Yet the question is whether this is simply a slowdown or a more negative trend. The number of unfilled vacancies is falling fast and applications for unemployment benefit are rising. So far, however, the slowdown is not big enough to curb wage growth, which is leading to persistent inflation.

The Eurozone economy scraped growth of 0.1% versus the fourth quarter of last year. The Germany economy failed to grow at all, while its French counterpart grew by slightly more than the Eurozone as a whole and Italy and Spain saw growth of 0.5%. No breakdown is yet available but given the drop in retail sales in February and decline in car sales over the quarter, the growth in consumer spending will have been modest. It's possible that lower imports, which are positive from the perspective of domestic growth, propped up the economy just as they did in the fourth quarter of last year. Leading indicators for the Eurozone are improving but pointing to no more than weak growth. Like the US, the Eurozone is also facing the repercussions of tighter monetary policy. The ECB's quarterly survey of banks shows that lending conditions were tightened further and demand for credit was down again. The banks indicated that interest rate hikes and the reduction of the ECB's balance sheet, in part caused by expiring loans to banks, are having a negative impact on liquidity and lending conditions. In itself this is no reason for concern as it demonstrates that the monetary tightening is working, but it is a reason for an ailing economy.

Banks are tightening lending standards



Source: Refinitiv, Van Lanschot Kempen

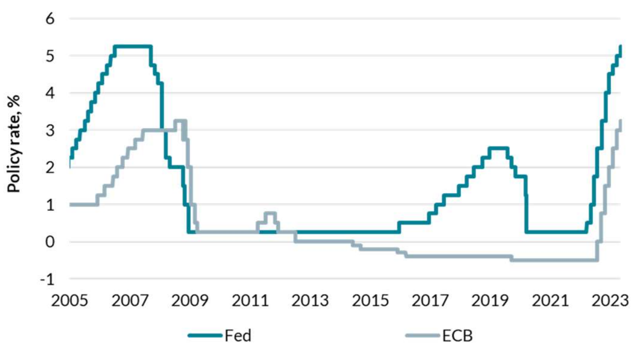
The Chinese economy was quick off the starting blocks following the country's reopening, especially in terms of consumer spending. Industry and housing construction are recovering less rapidly. As a result, the knock-on effect of Chinese growth to other regions is less pronounced than in the past. All in all, economic growth is better than expected but far from robust. And, given the outlook, we don't view this as a justification for the positive market trends.

Tight monetary policy

A third reason for the positive mood on the markets is monetary policy. We're nearing peak policy interest rates at central banks and the US Fed will cut rates again quickly - so goes the commonly expressed theory. We agree that we're approaching the peak. Interest rates have already been raised substantially and the impact of this is starting to become visible. At the Fed's policy meeting in May, at which the Fed hiked its policy rate by 0.25%-point to a range of 5-5.25%, Fed Chair Powell talked of tight monetary policy and dropped clear hints about pausing the interest rate hikes. In the past, central banks have cut interest rates fairly quickly after the last interest rate increase. The Fed, for example, after 7 ½ months in 2000 or after 7 months in 2018/2019. However, to assume against the backdrop of today's high inflation that interest rates will be cut four months after the last interest rate increase, as currently priced in for the Fed, would seem to be exceedingly quick to us. For this to happen there would need to be rapidly deteriorating economic conditions and/or a financial crisis.

The ECB also hiked rates by 0.25%-point, to 3.25%. ECB-president Lagarde repeatedly mention that the ECB has more ground to cover. Due to tighter financial conditions, the ECB lowered the pace of rate hike though. Markets expect one more hike by the ECB. With high inflation and tight labour markets, we see a clear risk that the ECB has more ground to cover than that.

Fed on the way to a pause, ECB has more ground to cover



Source: Bloomberg Van Lanschot Kempen

In addition to interest rates, central banks in the US, UK and Eurozone are busy reducing their balance sheets, a process known as quantitative tightening. There continues to be little clarity about the exact correlation between quantitative tightening and financial markets. Yet the decrease in liquidity in the financial system could have a negative impact on risky asset classes. This quantitative tightening has recently been temporarily halted. First by the Bank of England during the crisis on the bond market last year, next by the Bank of Japan increasing liquidity by buying up large numbers of Japanese government bonds to push down 10-year bond yields and more recently by the Fed's provision of funding following the turbulence in the banking sector at the end of March. The Fed's recent actions haven't had quite the same effect as buying up government bonds, but they have increased the amount of liquidity that can find its way onto the financial markets. And importantly for the Fed and Bank of England, this is of a temporary nature. The ECB has only just started quantitative tightening. We believe that the prevailing view on the equity markets is based on an excessively positive outlook for monetary policy.

The growth of corporate earnings is a fourth factor for the positive market sentiment. Businesses in the US, where over half of the companies in the S&P500 equity index have already reported results over the first quarter, are performing much better than expected. Although corporate earnings growth is negative (-1.5% versus the first quarter of last year), a large number of companies have caused positive and sizeable surprises. Prior to the results being published, analysts were anticipating a drop in earnings of about 7%. It should be noted, however, that expectations had already been adjusted sharply downwards prior to the earnings season. That makes it easier to cause positive surprises. There's still earnings growth in the Eurozone, where fewer than half the companies in the EURO STOXX index have so far reported results, but this is substantially lower than in the preceding quarters. Margins are under pressure in both the US and Europe; revenues are growing faster than earnings. Nevertheless, given the low economic growth and pressure on profit margins, we have doubts about the relatively positive picture for corporate earnings.

In short, sentiment is not extreme and the outlook for economic growth and corporate earnings are challenging to say the least. Monetary policy, liquidity and credit growth constitute a strengthening headwind. Another remarkable aspect is that the rally in US equities is strongly concentrated in a very small number of tech companies. The Nasdaq has also performed almost twice as well as the S&P500 so far this year. This makes the rally vulnerable if monetary policy is kept tighter for longer than currently expected. We have therefore decided to retain our underweight in equities.

Underweight in US investment grade credits

We believe that the present climate demands a cautious investment policy. This is expressed in an underweight in equities, especially in the US and to a lesser extent in Europe. We hold neutral positions in the Pacific region and in emerging markets due to the low valuations but also the effects of the reopening in Japan and China and less monetary tightening.

As the markets largely fail to share our concerns, we have again decided to reduce the risk exposure in the portfolios slightly. We already had a negative opinion of high yield credits but now also hold an underweight in US investment grade credits. It's not that we expect these generally sound companies to get into major difficulties. However, we do believe that the tight spreads on US investment grade credits underestimate the potential problems in the shape of pressure on margins, lower earnings growth, higher yields and in turn rising default rates. We're buying US government bonds with similar durations, which means that yield or currency fluctuations will have no impact on this position. Our decision is therefore prompted purely by the risk of wider spreads.

US investment grade corporate bonds less attractive due to low risk spread

Source: Bloomberg Van Lanschot Kempen

The volatility on the interest rate markets has decreased somewhat but we're still seeing considerable outliers on a daily basis. These are primarily related to changing perceptions about monetary policy and in turn depend on incoming data. As peak interest rates are coming ever closer, we no longer hold an underweight in government bonds but a small overweight. This overweight is comprised entirely of US bonds following the switch from investment grade credits to government bonds. We continue to hold an underweight in the Eurozone. The US is slightly more advanced in its monetary tightening and inflation is also displaying more signs of coming down. The ECB still has work to do in Europe. Developments relating to the US government's debt ceiling are important for short-term US yields as well. Treasury Secretary Yellen has said that this ceiling could be reached as early as June. Democrats want a 'clean' debt ceiling increase, i.e. without any attached tax or expenditure measures. However, Republicans are demanding radical cut-backs, mostly on programmes introduced by the Biden administration. Previous attempts to raise the ceiling have sometimes generated a huge amount of political drama. As in 2011, for example, when the S&P500 equity index plummeted 15% during negotiations on the debt ceiling. Yet the ceiling has always ended up being raised in time. If this fails to happen, the worst-case scenario involves defaults on US government bonds, which would trigger enormous problems in the global financial system. The prevailing polarisation in US politics means there's a higher risk of this happening but it remains a low risk in our estimate. A bigger risk is that portions of the US government shut down to freeze expenditure and ensure that the ceiling isn't exceeded. This would lead to an acute economic drop in demand. Concerns about the debt ceiling are mainly visible in the yields on extremely short-term government bonds. Yields on 3-month bonds, which will need to be redeemed after the debt ceiling has potentially been reached, are much higher than on their 1-month counterparts. On 20 April the spread was 1.8 percentage points, a level never seen before. It has since narrowed slightly but remains high in historical terms. The government bonds we're buying are unaffected by this as we're acquiring bonds with longer durations. And in this respect, longer-term US government bonds acted as a safe haven even during the turmoil surrounding the debt ceiling in 2011, which resulted in lower yields and higher prices for these bonds.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2022
Global (MSCI AC)	970	-0.4%	-1.5%	6.8%
Developed markets (MSCI World)	2796	-0.3%	-0.9%	7.4%
Emerging markets (MSCI EM)	970	-2.0%	-6.7%	1.4%
United States (S&P500)	4091	-0.8%	-1.1%	6.5%
Eurozone (EURO STOXX 50)	4310	0.0%	1.2%	13.6%
United Kingdom (FTSE 100)	7788	1.5%	-1.4%	4.5%
Japan (Topix)	2076	2.9%	5.3%	9.7%
Netherlands (AEX)	744	-1.9%	-2.6%	8.0%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	3.34	-8	-19	-54
Japan	0.42	3	-8	0
Germany	2.25	-1	5	-32
France	2.83	8	19	-29
Italy	3.62	7	14	-71
Netherlands	2.62	2	17	-28
United Kingdom	3.70	27	64	2

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	143	7	-17	13
Eurozone	167	-2	25	0

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	473	19	88	4
Eurozone	504	0	68	-8
Emerging markets (USD)	492	11	-56	39
Emerging markets (Local currency)	321	11	33	36

Real estate

		Past month	Past 3 months	From 31-12-2022
Global		-1.5%	-10.6%	-2.4%
North America		-2.5%	-12.1%	-3.5%
Europe		2.2%	-14.9%	-3.3%

Commodities

		Past month	Past 3 months	From 31-12-2022
Bloomberg index		-4.3%	-4.0%	-8.5%
Base metals		-3.3%	-8.7%	-4.0%
Brent oil (USD per barrel)	72.33	-14.5%	-8.4%	-14.1%
Gold (USD per troy ounce)	2037	1.8%	8.5%	11.5%

Returns in local currency
bp = basis point (0.01%)
Data as of 5 April 2023
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Negative**
April was another positive month for equities, although at 1.3% for the MSCI global equity index the plus was small. This upturn derived entirely from industrialised markets; emerging markets noted a minor loss. The calm on the equity markets was particularly remarkable against a backdrop of low growth, mixed leading indicators, central banks raising interest rates higher, pressure on profit margins and another bank failing in the US. We don't anticipate a new financial crisis. It could nevertheless lead to further monetary tightening, which isn't positive for equities. Nor do we believe that central bank policy interest rates will be cut again quickly. We view a climate of low growth or recession, persistent inflation and central banks raising interest rates as negative for equities. 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	**Positive**
US yields decreased marginally in April; 2-year yields by 2 basis points and 10-year yields by 5 basis points. In early May, once calm had been restored to the banking sector and the Fed started dropping strong hints about pausing interest rate hikes, 2-year yields in particular dropped even further. The expectations for the Fed's policy interest rates as of the end of this year have increased but are still too low in our opinion. This could especially affect short-term US bond yields, which could then rise slightly. For the long-term yields we believe that an economic slowdown has already been partly priced in and that yields are more likely to decrease than increase. We hold an overweight in US government bonds after recently expanding the position on selling US investment grade credits. This created a small overweight in government bonds. German yields remained more or less unchanged. We continue to hold an underweight in the Eurozone. The ECB hasn't yet finished raising interest rates, inflation is persistently high, unemployment rates remain low and wage increases are growing. We have decided to retain our small position in Eurozone bonds and in relatively short durations, which restricts the interest rate risk.	
Investment grade credits	**Negative**
Spreads on investment grade credits tightened by 2 basis points in the US and by 8 basis points in the Eurozone in April. As the underlying yields on government bonds fell more rapidly, yields on investment grade credits decreased. We've reduced our position in US investment grade credits to an underweight. The US is further on in the economic slowdown and declining earnings. The rating trend deteriorated due to pressure on profits and credit fundamentals. Any rise in the default rate will first affect high yield but could also have a knock-on effect on investment grade credits. Spreads are about average for the past ten years and in our view too low for a recession scenario. Within investment grade credits we now have a relative preference for the Eurozone versus the US. Spreads are slightly wider in the Eurozone and interest rate sensitivity is lower.	
High yield credits	**Negative**
Having widened substantially in March, spreads on high yield credits tightened by 3 basis points in the US in April, while in the Eurozone they widened by a further 7 basis points. Underlying yields on government bonds fell in the US and Germany, but in Germany this was not enough to offset the wider spread. Yields on high yield credits therefore rose in the Eurozone, albeit to a limited extent. At the end of April, yields on these bonds stood at 8% in the US and over 7% 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 452 basis points in the US and 504 basis points in the Eurozone at the end of April. 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.	
Emerging market debt	**Neutral**
The return on emerging market debt issued in US dollars was marginally positive in April (in local currency). Spreads and interest compensation remained more or less unchanged, which results in a positive return via the received interest. Bonds in local currency (EMD LC) likewise earned a small positive return thanks to the interest compensation barely changing. The appreciation of the euro generated a negative return for investors in that currency, however. The reopening of China is positive for emerging markets, as is declining (goods) inflation in the US because the latter reduces the pressure on EMD. The turbulence in the banking sector is expected to abate gradually, in part because of the intervention of central banks and regulators. As a result, there is as yet no prospect of the Fed cutting interest rates, also in light of the robust services inflation and job market. Despite China's reopening, slowing global economic growth, a recession in the US in the second half of 2023 and lower EM exports pose risks to this asset class. Given the relatively high interest compensation we hold a neutral outlook for EMD HC and EMD LC.	

Asset class	
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. On top of this, the asset class is sensitive to lending conditions at banks due to the relatively high amount of debt financing (especially in Europe). Banks are expected to tighten their lending conditions following the turbulence in the banking sector in March. This will complicate access to refinancing and exert upward pressure on interest charges for businesses. After the initial shock in March, listed real estate was able to recover somewhat, especially in Europe where the shock was at first bigger. We hold a neutral outlook for listed real estate despite the cheap valuations. In light of the robust job market it's too soon for central banks to switch to cutting interest rates, as a result of which the interest rate pressure will only ease slightly at best. The anticipated stricter lending conditions at banks will lead to higher interest charges for listed real estate. Moreover, not all property valuations have been downgraded, which will also have an impact on the balance sheets of listed real estate companies.

Commodities	**Neutral**

The general Bloomberg commodity index noted a loss of 1.1% in April. Oil prices climbed by just under 2%, metal prices fell by almost 4% and the price of gold posted a plus of 1.1%. The ongoing 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. The oil price initially rose slightly once the worst of the concerns about the banking sector had abated but declined again towards the end of April and in early May in response to concerns about tighter lending conditions and a potential recession in the US. 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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