INVESTMENT MANAGEMENT

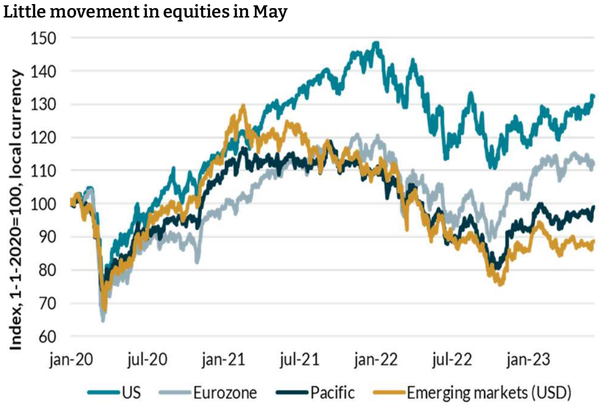
Asset Allocation Outlook

June 2023

– Economic outlook still weak
– Signs of inflation coming down but interest rate hikes not over yet
– Highly concentrated US equity rally

Financial markets had an awful lot to digest in May, with ongoing unease about US regional banks, interest rate hikes by the Fed, ECB and Bank of England and the drama surrounding the US debt ceiling. Yet there was also optimism among investors about the possibilities of artificial intelligence. Most equity markets responded negatively on balance. European equities fell by 3.5%[1], emerging market equities by 1.9% and the UK's FTSE 100 by as much as 5.4%. The US S&P500 noted a small gain of 0.2%, mostly driven by large tech companies. The Pacific region posted a loss of 1.9% despite a sound performance from Japan (3.6%).

Little movement in equities in May



Source: Bloomberg, Van Lanschot Kempen

Bond yields climbed in the US and UK, where investors were expecting monetary policy to tighten. Yields only changed marginally in Germany. The sharp downturn in commodity prices was striking (-7.0%) and caused by lower oil (-12.1%) and metal prices (-9.1%).

We have kept our cautious investment policy unchanged and retained our underweights in equities and US investment grade credits. Weak economic growth, high inflation, tight monetary policies and excessively optimistic earnings expectations create a negative climate for risky asset classes.

Low growth ahead

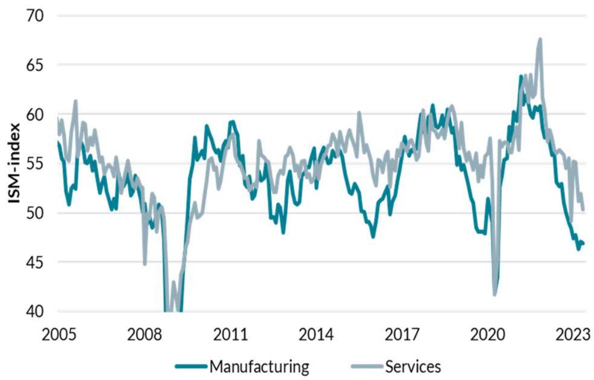
The past few months have seen positive trends in terms of US and European growth that investors were able to latch onto. In the US, a number of indicators pointed to a recession but underlying economic growth held up well. Growth was weak in Europe but leading indicators pointed to some improvement.

The picture in the US hasn't really changed. The leading indicator published by the Conference Board, the sharply negative yield curve (in which 10-year yields are lower than 2-year yields) and levels of confidence in industry and at small businesses continue to emit clear signals that the economy is heading for a recession. Regional confidence indicators for manufacturers deteriorated on balance in May. The remarkable thing here was that the investment appetite increased slightly. Yet this remains exceedingly

[1] Returns in local currency

low, which makes sense when earnings are being squeezed and interest rates rising. The unexpected upturn in orders for capital goods in April can be viewed as good news but one swallow doesn't make a summer.

US producers lose confidence

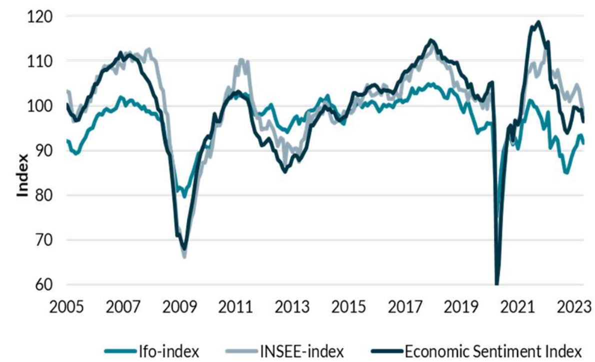


Source: Refinitiv, Van Lanschot Kempen

Consumer spending is normally the engine of the US economy. This was the case in the first quarter of the year as well as in April. Yet real incomes didn't rise in April and so lower savings were needed to keep spending at the same level. Households saved large amounts during the coronavirus pandemic but a sizeable portion of those savings has already been spent. Higher interest rates and a housing market under pressure mean that consumer confidence has fallen again somewhat in recent months. The outlook for consumer spending therefore depends greatly on the job market. That is slowing slightly but no real weakness is visible as yet. However, we expect this cooldown to become more pronounced in the coming months. The low investment appetite among businesses and extreme reluctance of banks to issue loans are signs on the wall in our opinion. We therefore believe that the tight monetary policy will indeed ultimately lead to a recession.

A downward revision to first-quarter growth in the eurozone to -0.1% versus the final quarter of last pushed the economy into recession, although so far a very mild one. With -0.3% growth and recession in Germany, Europe's largest economy has been a prime driver. France's growth was just in the black at 0.2% in the first quarter but this was mainly due to fewer imports. Domestic consumer spending was down in France. Growth was relatively strong in Italy and Spain but unexpectedly negative in the Netherlands. The UK economy has already stagnated for three consecutive quarters. One positive aspect for the Eurozone had been the improvement in leading indicators, such as the Economic Sentiment Index, purchasing manager indices and Germany's Ifo index. Yet a reversal occurred in these in May and a whole series of leading indicators declined. This points to persisting weakness in the Eurozone economy. And that's logical given the monetary tightening that the ECB has also implemented. The upshot is that the money supply is shrinking and credit growth has ground to a halt. Falling inflation, mostly thanks to lower energy prices, and a job market that continues to be tight are giving consumers some breathing space but they are still being extremely cautious about their spending.

Hope fades from eurozone leading indicators



Source: Refinitiv, Van Lanschot Kempen

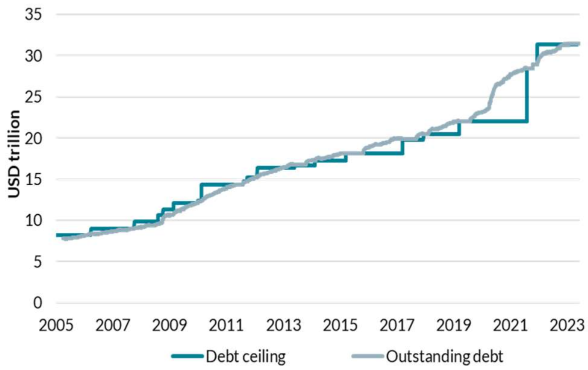
Emerging markets are mostly facing weakness in industry. In South Korea, the economy has failed to grow on balance for the past two quarters. The Taiwanese economy contracted by 2.5% in the first quarter of this year versus the first quarter of last year. Destocking in the chip sector and waning demand for consumer electronics are taking their toll here. European economies such as the Czech Republic and Hungary are barely experiencing growth either. This is mainly due to growth problems in the Eurozone. Those countries that are performing better, such as Indonesia, Malaysia and Vietnam or Brazil and Mexico, may be profiting from the transfer of production from China or growth in the US. Yet in light of the poor outlook for the US and Europe and growth in China that is faltering somewhat after a brief spurt, we don't anticipate a boost to growth for emerging markets.

Debt ceiling deal: what next?

The US House of Representatives and Senate have voted in favour of a deal on the debt ceiling. This averts the risk of the US government defaulting on payments and in doing so the chaos that this could have triggered on the financial markets. Equity markets responded with relief, although the relief rally was small. This was no real surprise as equity investors had largely ignored the drama surrounding the debt ceiling. Yields on very short-term US government bonds, which would have been the first candidates for default, declined marginally in the run-up to the Senate vote.

Does this mean that the debt ceiling has been abolished? Basically, yes, for now at least. The ceiling hasn't been raised but has been suspended until 1 January 2025. It's not the first time that this solution has been chosen. This means that the next debate on the debt ceiling has been postponed until after the presidential elections.

US debt ceiling suspended



Source: Bloomberg, Van Lanschot Kempen

Cut-backs nevertheless need to be made. Or rather, President Biden needs to scale back his plans. The terms and conditions for two programmes that provide support to low-income families are being tightened. Government expenditure for 2024 has been frozen at the current level, while it can rise by 1% in 2025. The exception is the Defence budget that can increase by 3% next year. According to the Congressional Budget Office, spending will rise by 4% in 2024 versus a planned increase of nearly 8%. Government expenditure won't rise by 5% in 2025 but by 3%. These are fairly marginal adjustments that will only cost a few tenths of percentage points of growth.

A more immediate short-term effect is perhaps the liquidity in the financial system. As the debt ceiling had almost been reached, the US government was forced to issue as few bonds as possible. One of the solutions was to make payments from the balance the government held in its account at the Fed. Whereas at the start of the year the government held over 500 billion US dollars in its Fed account, this had dropped to 50 billion as of the end of May. This means that 450 billion US dollars have ended up in the financial system. Add to that the emergency loans made by the Fed to banks experiencing difficulties and the amount surpasses 600 billion US dollars. The reduction of the Fed's balance sheet by not reinvesting expiring government bonds, also known as quantitative tightening, has therefore been temporarily suspended. This liquidity will not all end up directly on the financial markets but could also remain in the banking system. In general, however, markets profit from an increase in liquidity. When the government deposits more money into its account at the Fed, this positive effect will be eliminated. This could lead to slightly higher volatility on the equity markets.

Inflation coming down, an end to tightening?

The long-anticipated downturn in inflation has started in the US and Eurozone. According to the benchmark used by the Fed, headline inflation in the US has fallen from 7% in June last year to 4.4% in April. In the Eurozone, inflation has dropped from 10.6% in October to 6.1% in April.

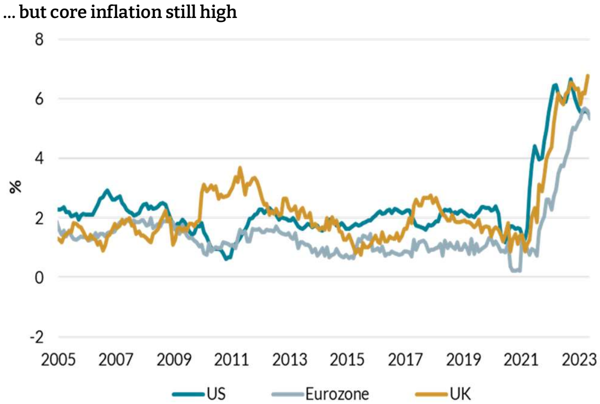
Headline inflation falling...

Source: Refinitiv, Van Lanschot Kempen

This is mostly due to lower energy prices and food prices rising by smaller amounts. A relief for consumers but not yet a reason for central banks to cut interest rates. In its interest rate decision in May the Fed indicated that it might want to institute a pause but the ECB has said there's more work to be done. The minutes from the ECB's May meeting show that central bankers are worried about the high level of core inflation. And ECB President Lagarde recently noted that there's still no clear evidence that underlying inflation has peaked. The Bank of England received a nasty shock as inflation was considerably higher than expected in May. The increase in core inflation from 6.2% to 6.8%, its highest level since the early 1990s, was particularly striking. The response from the market was emphatic, with both interest rate expectations and 10-year bond yields climbing sharply.

Interest rates will only be cut when core inflation starts to come down as well, and in particular inflation in the service sector that is only declining gradually at the moment. This type of inflation is most affected by wage costs and so job markets will also need to cool down and this isn't happening enough yet. We expect the Fed to introduce a pause or possibly raise interest rates once more. Expectations for the Fed's policy interest rates plummeted following the turmoil in the banking sector but have since climbed again considerably. Two cuts to interest rates are currently still anticipated. For this to happen inflation would need to drop fast and the job market cool down rapidly. This is possible in a recession but we doubt whether it will happen before the end of the year.

... but core inflation still high



Source: Refinitiv, Van Lanschot Kempen

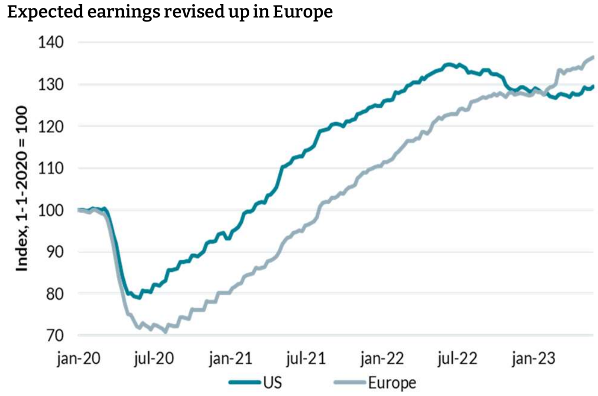
The ECB and Bank of England haven't even finished raising interest rates yet. We anticipate a further one or two interest rate hikes from the ECB. This is in line with market expectations. The Bank of England will raise interest rates twice more given the UK's persistent inflation. Incidentally, the effects of monetary tightening are also visible in the UK. The housing market, which has large numbers of mortgages with flexible rates or short fixed-rate terms, is being especially impacted by the higher interest rates. The number of approved mortgage applications is down 25% compared to pre-pandemic levels. Bank lending growth has virtually come to a standstill. The tighter monetary policy is working here as well and this means that the end of interest rate hikes is in sight. It will come at the expense of economic growth though.

Equity market trends

Although the lower growth outlook and monetary tightening seem to be affecting equity markets more, no downward trend is visible as yet. A number of aspects stand out in our view when it comes to equity markets. Firstly, the extremely strong concentration of the rally in the US. This year the S&P500 has risen by nearly 10%, largely driven by tech equities. Technology index Nasdaq is up by over 30%. In the S&P500 equities are weighted according to their market capitalisation. Large (tech) companies therefore also account for a very large part of the index and its performance. If we were to allocate an equal weight to all the equities in the S&P500, the index would have made no gains at all on balance this year. The robust performance of tech equities can partly be attributed to corporate results, such as cost cutting at Meta, the parent company of Facebook, improved advertising revenue at Alphabet, the parent company of Google, and the much higher revenue forecast issued by graphics card manufacturer Nvidia. Tech equities are also recovering from last year's poor performances and profiting from hopes of lower interest rates. A rally that is mostly driven by a small number of equities is in itself not a precursor of a market crash but we believe it makes the rally vulnerable. Mostly because some tech equity valuations have again climbed sharply and hopes of rapid cuts to interest rates are premature in our opinion.

The second noteworthy aspect is how well corporate earnings are holding up in Europe. Realised earnings growth faltered briefly at the start of the year but has since resumed. Expected earnings are also being adjusted upwards again. As of the end of May realised earnings were over 3% higher than at the beginning of the year, while expected earnings in twelve months' time are nearly 7% higher. In comparison, realised earnings in the US are down 1% and expected earnings have been adjusted upwards by 0.8%.

Expected earnings revised up in Europe



Source: Refinitiv, Van Lanschot Kempen

This is remarkable because the US economy is growing in real terms, while this is barely the case in Europe. More corporate earnings are profiting not just from real growth but also from nominal growth. After all, corporate revenues are the product of quantities sold and the prices paid for them. And it's nominal growth that has fallen slightly faster in the US than in Europe because inflation started to come down slightly earlier in the US. Inflation is often primarily viewed in terms of costs for businesses, but at times of high inflation they can in fact pass high costs on more easily. High inflation gives almost every business pricing power. At least, as long as consumers can afford to pay. And government support has helped enormously here. We therefore believe that the positive expectations for earnings in Europe and the US are untenable. Nominal growth will decline further and certainly if real growth is zero or negative and the job markets cool down, it will become more difficult for businesses to raise prices. Expected earnings growth of about 10% in the US and Europe for 2024 implies earnings growth in the second half of this year and robust nominal GDP growth in 2024. It's our belief that this picture is excessively rosy.

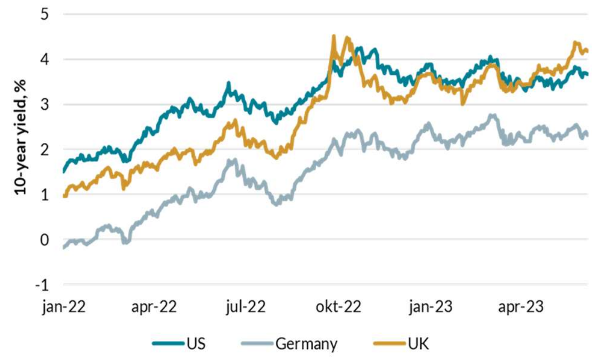
The third aspect that stands out on the equity markets is the recent rally in Japanese equities. Japanese equities are profiting from the economic upturn following the reopening after the coronavirus pandemic. In the first quarter, the Japanese economy grew by 0.4% versus the final quarter of last year. Inflation is also climbing in Japan, which is making it easier for businesses to raise their prices. Headline inflation appears to have peaked but core inflation of 4.1% is almost unprecedented for Japan. However, corporate earnings dynamics have weakened. Realised earnings have fallen this year and expected earnings are being adjusted downwards. This means that the positive trend in Japanese equities cannot necessarily be explained by fundamental factors. The exchange rate is traditionally an important factor for Japanese equities. When the yen weakens, export-oriented Japanese businesses profit, which in turn has a positive effect on the equity market. This is what is happening now. Whereas many central banks are tightening monetary policy, Japan has not yet reached that stage. The Bank of Japan's policy interest rates still stand at -0.1% and it continues to keep 10-year bond yields below 0.5%. The stark contrast in monetary policy between Japan and many other countries has weakened the yen. And this has provided a boost to Japanese equities. The question is how long the BoJ can continue to pursue its extremely expansionary monetary policy. Even a minor adjustment could cause the yen to appreciate sharply and put an end to the rally on the Japanese equity markets. We have retained our neutral outlook for the Pacific region, almost two-thirds of which is made up of Japan.

Investment policy unchanged

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

We are more positive about US government bonds than their European counterparts. US 10-year bond yields are higher but more importantly we expect 10-year yields to fall sooner in the US than in Europe. The Fed is more advanced in its tightening monetary policy than the ECB and there are more signs of inflation coming down in the US as well. We hold a negative outlook for investment grade credits and US high yield credits as we think spreads are too tight for the economic picture we anticipate.

Have US 10-year yields peaked?



Source: Bloomberg, Van Lanschot Kempen

A more negative economic picture has already been priced in to a greater extent for commodities and real estate than for equities. Global real estate has again lagged behind equities this year; the general Bloomberg commodity index has even dropped by almost 10%. We nevertheless think it too soon to invest in these asset classes. For this to happen we first need to see more signs of real estate pricing in the higher interest rates and stricter bank lending conditions, while the economic outlook is still too uncertain for commodities.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2022
Global (MSCI AC)	987	1.6%	3.6%	9.5%
Developed markets (MSCI World)	2870	1.7%	4.1%	10.3%
Emrging markets (MSCI EM)	987	0.5%	-0.1%	3.2%
United States (S&P500)	4274	3.3%	5.6%	11.3%
Eurozone (EURO STOXX 50)	4293	-1.1%	0.0%	13.2%
United Kingdom (FTSE 100)	7600	-2.3%	-4.4%	2.0%
Japan (Topix)	2220	7.0%	9.9%	17.3%
Netherlands (AEX)	763	1.7%	0.4%	10.8%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	3.68	25	-27	-19
Japan	0.43	1	-7	1
Germany	2.38	9	-33	-19
France	2.92	5	-28	-19
Italy	3.59	359	-38	-74
Netherlands	2.74	7	-33	-16
United Kingdom	4.21	43	36	54

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	136	-10	-24	6
Eurozone	169	1	21	2

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	429	-42	32	-40
Eurozone	477	-33	48	-35
Emerging markets (USD)	464	-24	-84	12
Emerging markets (Local currency)	259	-48	0	-27

Real estate

		Past month	Past 3 months	From 31-12-2022
Global		0.7%	-4.9%	0.0%
North-America		0.8%	-6.6%	0.3%
Europe		-2.7%	-9.7%	-5.0%

Commodities

		Past month	Past 3 months	From 31-12-2022
Bloomberg index		-2.4%	-6.4%	-9.4%
Base metals		-5.4%	-9.3%	-8.6%
Brent oil (USD per barrel)	76.71	2.2%	-9.0%	-8.3%
Gold (USD per troy ounce)	1974	-2.5%	6.5%	8.1%

Returns in local currency
bp = basis point (0.01%)
Data as of 6 June 2023
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Negative**
The MSCI global equity index declined by 1.3% in May. At a loss of 1.2% industrialised countries were down slightly less than emerging markets (-1.9%). Japan's positive performance stood out (3.6%), as did the losses of 5.4% in the UK and 3.5% in the Eurozone. US equities just managed to escape dipping into the red. Signs that the interest rate hikes by central banks are having an impact on economic growth in turn affected equities in May. Our biggest concern about equities is a further slowdown in economies and the downward pressure this could exert on earnings. Forecasts for earnings growth are excessively rosy in our opinion. We view a climate of low growth or recession, persistent inflation and tight monetary policy 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. 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	**Neutral**
Government bond markets typically saw bond yields rise in May, especially in the UK where 2-year yields shot up by 55 basis points and 10-year yields by 46 basis points. The UK's higher-than-expected inflation had a pronounced impact on yields. Ten-year bond yields climbed to a level close to last October's peak when the market crashed in response to the Truss government's budget plans. In the US, 2-year bond yields were up by 22 basis points and 10-year yields by 26 basis points. The picture in Germany was slightly different, with an increase of 3 basis points for 2-year yields but a decrease of 3 basis points for 10-year yields. We think there are stronger signs of lower inflation and an end to interest rate hikes in the US than in the Eurozone. This is why we hold an overweight in US government bonds. 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 widened by 2 basis points in the US and 9 basis points in the Eurozone in May. Underlying yields on US government bonds climbed, which also pushed up yields on US investment grade credits. Yields on US government bonds fell but not enough to offset the wider spreads. The US is further on in the economic slowdown and decrease in earnings. The rating trend is deteriorating due to pressure on profits and credit fundamentals. Any rise in the default rate will first affect high yield but could also translate into concerns about spreads for 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**
Spreads on high yield credits only changed slightly on balance in May. In the US spreads widened by 7 basis points, while in the Eurozone they tightened by 8 basis points. Underlying yields on government bonds climbed in the US but fell in Germany. Yields on high yield credits were up by 31 basis points in the US but down by 11 basis points in Germany. At the end of April, yields on these bonds stood at 8% in the US and at 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.	

Asset class	
Emerging market debt	**Neutral**
The return on emerging market debt issued in US dollars was again marginally positive in May (in local currency). Spreads tightened by 6 basis points but the total interest compensation was up by 16 basis points, which led to 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 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.	
Listed real estate	**Neutral**
The global real estate index declined by 4.7% in May. The biggest loss was in emerging markets (-9.1%) but real estate in industrialised countries also noted downturns (-4.7%). 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. In light of the robust job markets 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. 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. Not all property valuations have been downgraded, which will also have an impact on the balance sheets of listed real estate companies. Despite the cheaper valuations for listed real estate we hold a neutral outlook.	
Commodities	**Neutral**
The general Bloomberg commodity index noted a loss for the sixth consecutive month in May (-6.1%). Oil prices fell by 11% and metals by 8.8%, while the price of gold was down by 1.4%. The ongoing downturn in metal prices is remarkable in light of the reopening of the Chinese economy. This supports the theory that the reopening is being driven more by services and will require fewer commodities, but also that the consumption of goods will be low in the US and Europe. The downturn in oil and other prices reflects the uncertainty about global economic growth. With Russia supplying fewer commodities because of sanctions, in general tightness could easily arise on commodity markets. Moreover, the OPEC countries and Russia are closely monitoring the ratio of supply and demand. In early June they decided to prolong their earlier restrictions on production and Saudi Arabia even decided to cut production further. This shored up the price of Brent oil, which had dropped to 72 US dollars a barrel. Declining prices will make commodities an interesting investment at some point as a less rosy economic scenario will then have been priced in. We nevertheless think it too soon to build up a position in commodities.	

Joost van Leenders
Senior investment strategist
Joost.vanleenders@kempen.nl
M +31 (0)6 82 83 11 89

VAN LANSCHOT KEMPEN ASSET RESEARCH & COMMUNICATION:

Yaela van Raalte – Head ARC
Luc Aben – Chief economist
Pieter Heijboer – Head investment strategy
Robert de Groot – Head investment research and communication
Maarten van der Pas – Head editorial desk
Alastair Greenlees – Head investment strategy UK
Joost van Leenders – Senior investment strategist
Duco Smit – Senior investment strategist
Jorn Veeneman – Investment strategist
Mees Vlasveld – Investment strategist
Panashe Bera – Investment strategist
Jack Horvest – Investment specialist
Ellen Engelhart – Bond specialist
Robbert van Riel – Bond specialist
Bob Stroeken – Equity specialist
Tim Verhagen – Equity specialist
Effi Bialkowski – Investment fund specialist
Bas Kooman – Investment writer
Hester van Breugel – Communications specialist
Rixt Hoekstra – Communications specialist

Disclaimer

VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

Beethovenstraat 300
1077 WZ Amsterdam
Postbus 75666
1070 AR Amsterdam

T +31 20 348 80 00
vanlanschotkempen.com/investment-management