VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

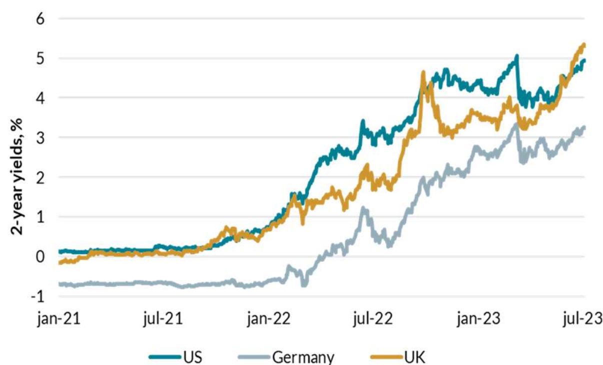
Asset Allocation Outlook

July 2023

- Leading indicators pointing to a slowdown
- Central banks insisting on further interest rate hikes
- Cautious investment policy unchanged

Bond yields climbed in June as central bankers continued to insist on further interest rate hikes. This was true of both short and long-term yields in the US, Germany and the UK. The increase of almost 1 percentage point in UK 2-year bond yields was particularly striking. Yields in the UK are now higher than they were during the crisis triggered by the Truss government's budget in September and October last year.

Bond yields climb, especially in the UK



Source: Bloomberg, Van Lanschot Kempen

Equities succeeded in making gains despite the higher interest rates. The MSCI global equity index was up by 5.6%,[1] while in the US the S&P500 even noted an upturn of 6.5%. Equities received a boost from signs that inflation is coming down and earning expectations are still high. The Eurozone and emerging markets saw smaller gains at 3.6% and 3.2% respectively. The UK lagged behind at 1.1%, while Japan topped the charts with a gain of 7.4%. This is partly due to the downturn in the value of the yen, with a price of 150 yen per US dollar again coming into view (as was briefly the case last year as well).

Following losses in May, commodities recovered somewhat without displaying a clear trend.

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

Leading indicators worse than expected

The trend of leading indicators sketching a less optimistic picture continued in June, with industry setting an especially pessimistic tone. Of the 35 countries for which the purchasing manager index for industry is available, the index was down in 23 countries. It stands below 50 in 24 countries, which points to a contraction in the industrial sector. The global index fell to 47.5, its lowest level since the coronavirus pandemic. Only five countries have so far published purchasing manager indices for the service sector. These were down in all five countries (the US, Germany, France, the UK and Australia) but France is the

[1] Index price change in local currency

only one with an index below 50. The downturn in the Eurozone from 55.1 to 52.4 was a disappointment, as it was precisely the service sector that was providing some hope for the future.

Purchasing managers in industry more pessimistic

Source: Bloomberg, Van Lanschot Kempen

And other leading indicators weren't much better in the Eurozone. The Economic Sentiment Index fell to 95.3 in June, a level that points to a further contraction. Consumer confidence was up but confidence was down in the industrial, retail, construction and service sectors. Germany's Ifo index declined, both the component that assesses the current situation and the expectations component. The decrease was to levels that point to the German economy deteriorating further.

In the US, it's mostly the purchasing manager index for industry that's creating anxiety. Yet regional indicators also sketch a negative picture, although incidentally some improvement is visible here. Businesses remain positive in the service sector. Or rather, they are according to the S&P purchasing manager index. The ISM index for the service sector dropped to just above 50 in May.

The purchasing manager indices in China point to a more or less stagnating industrial sector and a reduction in dynamics in the service sector.

In summary, leading indicators are pointing to stagnation at best and there continues to be a high risk of a recession in the US and a further contraction in the Eurozone. The Chinese economy has suffered a considerable loss of dynamics within a short space of time.

Growth in the US, contraction in the Eurozone?

With respect to the first quarter there's no doubt: the US economy grew, while the Eurozone economy shrank. US growth was even adjusted upwards slightly versus the initial estimate. The question is whether the US economy will continue to grow.

This is because US consumers are reining in their spending somewhat. When US households experienced a substantial increase in income in January, primarily due to a number of government programmes being adjusted for inflation, they did what they're good at: spending money. Yet consumer spending barely grew in the four months after that. While the job market and income growth are providing a boost, there are three factors that are having a negative impact. Firstly, the job market is showing some cracks. The employment rate is growing more slowly and compulsory redundancies have risen. Secondly, the extra savings accrued during the coronavirus pandemic have now largely been spent. This is especially the case for those on low incomes. Thirdly, the tight monetary policy is affecting consumers. Sales of existing homes have nosedived because moving house means sharply higher mortgage costs. Mortgage rates have risen from an average of 3.1% in 2022 to over 7% now, resulting in a marked deterioration in the affordability of homes. This ought to be offset by lower prices, but this is only happening to a limited extent as so few homes are being offered for sale at the moment. Nevertheless, there is downward pressure on house prices. Incidentally, the tightness on the market for existing homes is in fact causing a revival on the market for new homes. This is positive for the construction sector. The tight monetary policy is also visible in the drop in the consumption of discretionary goods. Growth may well still be positive over the second quarter, possibly with a small plus for consumer spending and home construction and question marks against corporate investment and foreign trade. However, we expect the negative effects of the tightening monetary policy to become more visible in the second half of the year.

The Eurozone economy shrank in the final quarter of last year and first quarter of this year. And given that retail sales and industrial production were lower in April than they were in the first quarter, it's possible that the contraction continued in the second quarter. One bright spot is that the pressure on consumers from high energy inflation is easing. As a result, consumer confidence is recovering somewhat and retail sales climbed in Germany in April and May, for example. However, data on orders and order books point to greater caution at businesses when it comes to investment. If this persists, this will also pose a risk to employment growth.

The difference between the US and Eurozone is perhaps most obvious from the extent to which economic data are better or worse than expected. Economists have predicted a recession in the US for some time but this has so far not materialised. Economic data are better than expected. In

the Eurozone, the recession of the past two quarters came as a surprise and data are worse than expected.

Better-than-expected economic data in the US, worse in the Eurozone

* Average of Bloomberg and Citigroup indices
Source: Bloomberg, Van Lanschot Kempen

We expect the economies of the two regions to stagnate or contract in the second half of the year.

An end to tightening, but when?

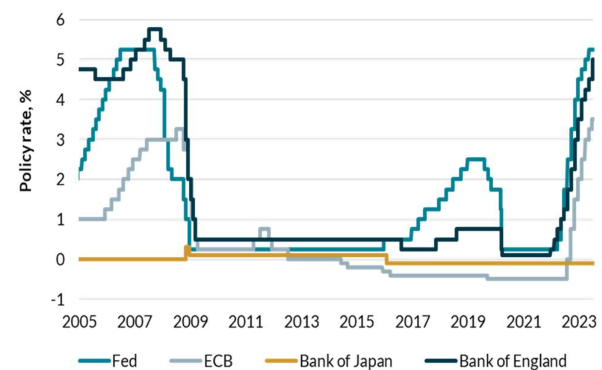
It's fairly obvious that we're coming to the end of the monetary tightening. Central banks raised interest rates quickly, while the pace of the interest rate hikes has now been reduced. In spite of this, central bankers recently made it clear that they weren't yet finished raising rates. The Fed paused its tightening cycle in June, but the majority of policymakers anticipates a further two interest rate hikes this year. This is in contrast to March, when most of them thought that policy interest rates could stay unchanged at the current level until the end of the year. Fed Chair Powell made a slip of the tongue during his press conference in calling the pause a skip. He quickly corrected himself by saying that we definitely shouldn't call it a skip. Powell also said that rates will need to rise further during his twice-yearly testimony to US Congress. The question is whether the two interest rate hikes will indeed happen. The economy is slowing now that the effects of the tighter monetary policy are becoming visible. The money supply is shrinking, which points to dwindling economic dynamics, and bank lending has ground almost to a halt. The positive aspect is that inflation is coming down. According to the PCE index, the Fed's preferred index, prices only rose by 0.1% in June compared to May. And inflation of 3.8% on an annual basis was the lowest since April 2021. This is largely due to lower inflation in food and energy. Core inflation still stood at 4.6% and has been moving sideways this year. Manufacturing prices, business surveys and rents nevertheless point to inflation falling further.

The ECB did raise its rates in June, by 25 basis points just as it did in May. The pace is lower than in preceding months but ECB President Lagarde also said there was still work to be done and that there will be more than one further interest rate hike. Low growth is unlikely to deter the ECB from raising rates higher. This is because the bank has cut its growth forecasts but raised its inflation forecasts. Inflation is also coming down in the Eurozone, to 5.5% in June. In the Eurozone this is largely thanks to energy prices. Core inflation is proving to be stubborn at 5.4%.

In both the US and Eurozone, the combination of a tight job market and low growth has a flipside. Businesses are holding on to more employees than is really necessary. This is understandable given the tightness on the job market. The upshot, however, is a drop in labour productivity and higher wage costs per product unit. Until now, businesses have been able to pass these on to customers and this has fuelled inflation. It becomes more difficult when low growth persists. This will result in wages rising less quickly and most of all in profit margins being squeezed.

Inflation is at its most stubborn in the UK. Headline inflation was unchanged at 8.7% in May, while core inflation climbed to 7.1%, its highest level since March 1992. In response, the Bank of England raised interest rates by a further 50 basis points, an acceleration versus the previous two interest rate hikes. Many more interest rate increases are also anticipated. Whereas a maximum of two further interest rate hikes are expected for the Fed and ECB, the BoE is expected to implement no fewer than five. Even though it's clear we're coming to the end of interest rate hikes, we're not there yet.

Monetary tightening: Japan is the exception



Source: Bloomberg, Van Lanschot Kempen

The aggressive tone of central bankers and series of interest rate hikes (including in Sweden, Norway, Canada and Australia) had a pronounced impact on the interest rate markets. US 2-year bond yields climbed by 49 basis points and their German counterparts by 48 basis points. Yet this was nothing compared to the UK where 2-year yields shot up by no fewer than 94 basis points. Although the upturns were smaller in the 10-year bond segment,

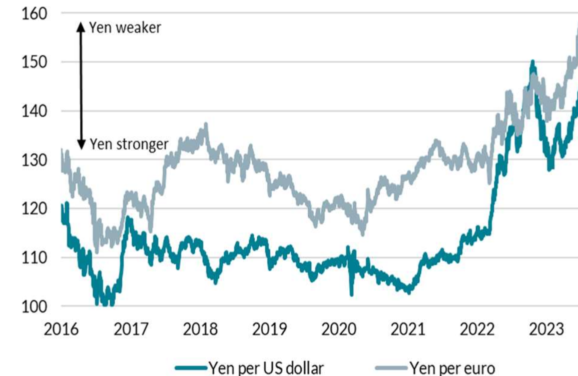
yields still rose by 19 basis points in the US, 11 basis points in Germany and 21 basis points in the UK. This also means that 10-year bond yields in all three of these countries dropped even further below 2-year yields, strengthening the signals pointing to an imminent recession in these countries.

We don't believe 10-year bond yields will rise much further in the US. The Fed is closest to reaching the peak of its interest rate policy and signs that inflation is coming down are strongest there. In the Eurozone we are keeping the interest rate sensitivity of our bond investments fairly low as we think 10-year yields could climb slightly higher.

Finally, two central banks that have stood out in recent months: Turkey and Japan. Following his re-election, Turkish President Erdogan finally seems to have relinquished his theory that high interest rates fuel inflation. The new president of the central bank, who has worked on Wall Street, raised interest rates from 8.5% to 15%. This was desperately needed as officially inflation stood at 40% in May. In reality, it was probably even higher. Combined with the appointment of a market-friendly Minister of Economic Affairs, this served to stabilise the price of the Turkish lira, which had already plummeted by about 30% this year. Turkey is one of the weak members of the group of countries that form emerging market debt. Concerns about Turkey, where currency reserves have shrunk rapidly, have lessened but not entirely dissipated.

The Japanese central bank has also had a new governor in Kazuo Ueda for a while now. The question was whether he would tighten the extreme monetary policy. The economy is growing and inflation reached 3.2% in May. Excluding food and energy prices it stood as high as 4.2%. The country is even seeing some wage growth, although this isn't yet conclusive. The expectations for monetary policy in Japan can clearly be seen from the course of the Japanese yen. No adjustment to policy – a policy interest rate of -0.1% and a ceiling for 10-year bond yields – was expected under previous governor Kuroda, while higher interest rates in the US caused the yen to depreciate. From 105 yen per US dollar as of year-end 2020 to 150 in October 2022, its lowest level since 1990. Speculation about a less expansionary policy under the new governor resulted in the yen appreciating to just below 130 in January. When it turned out that Ueda didn't intend to make any rapid changes to monetary policy, the yen quickly dropped and again looks to be heading for 150 yen per US dollar now. The 10-year bond yield target in particular is the subject of much debate. The Bank of Japan's target rate is 0%, with a bandwidth of 0.5 percentage point either side of that. In practice, this means that 10-year bond yields cannot rise beyond 0.5%. The bandwidth has already been widened and the next step might be to abandon the target and bandwidth entirely. Ten-year bond yields would then rise and the yen would appreciate again.

Yen weakened by deviating monetary policy



Source: Bloomberg, Van Lanschot Kempen

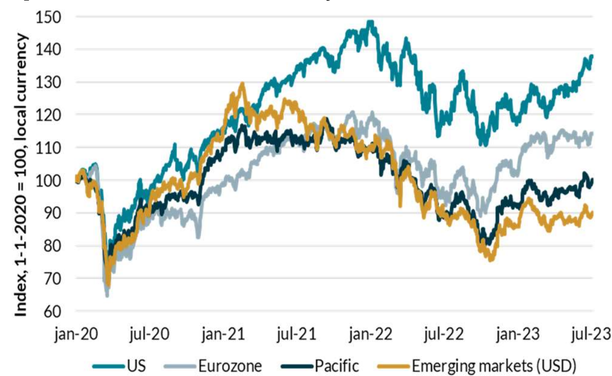
Japanese equities often move in the opposite direction from the yen. A weak yen is positive for the Japanese export sector and therefore also for Japanese equities. And this is precisely what we've seen this year. Japanese equities have already climbed by more than 20%, significantly more than equities in the US or Europe. Yet the yen has depreciated 10% versus the US dollar and euro, so when adjusted for differences in exchange rates Japanese equities in fact lag slightly behind those of the US or Europe. With monetary policy and the exchange rate potentially creating a headwind for Japanese equities, we don't view this as a good time to buy.

Equities unaffected in June

Signs of an economic slowdown, persistent core inflation and policy interest rates that remain higher than expected. Equities seemed to be impervious to these headwinds and succeeded in noting gains in June. What's more, they did so with extremely low volatility. Only in early July equity markets seemed to be frightened by an uncertain growth outlook with tighter monetary policy and higher bond yields.

Earnings and earnings expectations play an important role in the resilience of equities. This is particularly true in Europe as these are systematically being adjusted upwards. In contrast, the US has seen an end to upward adjustments in recent weeks, while earnings dynamics have long been weak in emerging markets. The first profit warnings are nevertheless starting to appear, especially in the European chemicals sector. We've already mentioned the flipside of low growth and a tight job market, namely a

drop in labour productivity and higher wage costs per unit. When inflation is high, it's easier to pass on the higher wage costs and keep profit margins at the same level. However, this becomes more difficult when inflation is lower. A downward spiral, in which companies slash wage costs and investments to safeguard margins but in doing also undermine demand for products, poses a clear risk in our opinion.



Source: Bloomberg, Van Lanschot Kempen

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 US investment grade credits and US high yield credits as we think spreads are too tight for the economic picture we anticipate.

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 dropped by as much as 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)	1008	3.3%	5.8%	13.2%
Developed markets (MSCI World)	2972	3.4%	6.3%	14.2%
Emrging markets (MSCI EM)	1008	2.4%	2.1%	5.4%
United States (S&P500)	4456	4.0%	8.7%	16.0%
Eurozone (EURO STOXX 50)	4391	1.6%	1.8%	15.7%
United Kingdom (FTSE 100)	7520	-1.2%	-1.5%	0.9%
Japan (Topix)	2306	5.7%	14.0%	21.9%
Netherlands (AEX)	779	1.8%	2.7%	13.0%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	3.85	16	52	-2
Japan	0.39	-3	-4	-4
Germany	2.45	14	20	-12
France	3.00	14	24	-11
Italy	3.59	-6	2	-75
Netherlands	2.81	13	21	-9
United Kingdom	4.42	26	98	74

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	122	-12	-38	-8
Eurozone	159	-10	-8	-8

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	387	-37	-80	-82
Eurozone	451	-34	-51	-61
Emerging markets (USD)	426	-37	-24	-26
Emerging markets (Local currency)	212	-47	-108	-73

Real estate

		Past month	Past 3 months	From 31-12-2022
Global		0.5%	2.5%	0.5%
North-America		1.2%	4.1%	2.0%
Europe		-1.6%	-1.4%	-6.4%

Commodities

		Past month	Past 3 months	From 31-12-2022
Bloomberg index		1.9%	-3.7%	-8.0%
Base metals		-0.8%	-7.2%	-9.2%
Brent oil (USD per barrel)	76.25	0.4%	-8.5%	-8.2%
Gold (USD per troy ounce)	1928	-1.0%	-2.9%	5.7%

Returns in local currency
bp = basis point (0.01%)
Data as of 4 July 2023
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Negative**
In June, the MSCI global equity index noted a gain of 5.6% in local currency. At a return of 5.9% industrialised countries performed slightly better than emerging markets (3.2%). Japan's positive performance again stood out (7.4%), as did the poorer performance of both the UK (1.1%) and Eurozone (3.6%). Equity markets defied the aggressive tone adopted by central bankers and expectations that interest rates will remain high for longer. Our biggest concern for equities is a further economic slowdown 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**
The picture on the markets for government bonds was again determined by rising interest rates. This was especially the case in the UK where 2-year bond yields shot up by 94 basis points and 10-year yields by 21 basis points. The UK's higher-than-expected inflation is having a pronounced impact on yields. UK yields are now higher than last October's peak when the market crashed in response to the Truss government's budget plans. In the US, 2-year bond yields climbed by 49 basis points, in Germany by 48 basis points. Ten-year yields in the US and Germany rose by 19 and 11 basis points respectively. It's also striking that the higher interest rates aren't hitting Italian government bonds disproportionately hard, even though interest rate charges will increase for the Italian government in the next few years as bonds at lower rates are redeemed and replaced by higher-rate bonds. Spreads on Italian government bonds versus their German counterparts were close to 170 basis points at the start of July. In October last year they stood as high as 250 basis points. 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 tightened by 15 basis points in the US and by 8 basis points in the Eurozone in June. As the underlying yields on government bonds in the US and Germany increased, yields on investment grade credits also climbed. Profit margins are under greater pressure in the US than in the Eurozone. 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 contracted sharply in June, in the US by 69 basis points and in the Eurozone by 40 basis points. This brings the US spread to its lowest level since early March. The tightening of spreads in the US and Eurozone was large enough to compensate for the higher yields on the underlying government bonds. As a result, yields on high yield credits decreased on balance. At the end of June, yields on these bonds were just below 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 390 basis points in the US and 456 basis points in the Eurozone at the end of June. 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 positive in June. The contraction to spreads of 45 basis points was larger than the increase in the underlying yields on US government bonds (19 basis points). Bonds in local currency likewise earned a positive return thanks to a downturn in yields and therefore an upturn in bond prices. The reopening of China is positive for emerging markets, but the boost to growth is more inward looking as it's being driven by the service sector and has recently lost momentum. Falling inflation in the US is reducing the pressure on emerging market debt. However, there is as yet no prospect of the Fed cutting interest rates in light of the strong services inflation and persistently robust job market. Despite China's reopening, slowing global economic growth, a recession in the US at the end of 2023 and lower emerging market exports pose risks to this asset class. Given the relatively high interest compensation we hold a neutral outlook for bonds in US dollars and in local currency.	
Listed real estate	**Neutral**
Since the start of the year, real estate has alternated between positive and negative months. In June, the global index noted a gain of 3.4%, shored up by the US and emerging markets. Europe performed negatively (-1.7%) as a result of the sharp loss in the UK (-7.7%). It was there that listed real estate was most affected by the higher interest rates. The asset class still hasn't recovered from the initial shock in March. Listed real estate has a reputation as being a defensive sector in equities. Moreover, its cashflows are partly linked to inflation. Higher interest rates 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. Despite the cheaper valuations for listed real estate we hold a neutral outlook. 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. The anticipated tighter lending conditions at banks will lead to higher interest charges for listed real estate. 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 gain of 3.6% in June. It was the first time since November last year that commodities rose on a monthly basis. Oil prices climbed by 4% to 5%, metals earned a tiny plus of 0.7%, while the price of gold declined by 2.2%. Commodities have dropped 10% in price so far this year. This shows that a less rosy economic picture is now being priced in. The roll yield, the return generated on investments in commodity futures, stood at nearly 8% in early July, which makes commodities more attractive than they were a few weeks ago. However, the roll yield is capable of changing quickly. Given the faltering growth in China and the industrial sector, which is struggling worldwide, we think it's too soon to build up a position in commodities. The sanctions against Russia and resulting decrease in delivery volumes mean that in general tightness could easily arise on commodity markets. Moreover, the OPEC countries and Russia are closely monitoring the ratio of supply and demand on the oil market. In early June they decided to prolong their earlier restrictions on production and Saudi Arabia even decided to cut production further. Yet the price of Brent oil hasn't moved out of the bandwidth of 72 to 78 US dollars per barrel that it's been trading at since the end of April. Gold is an interesting investment at times of uncertainty but its price is relatively high versus real interest rates in the US. This means that a large amount of certainty and/or cuts to interest rates have already been priced in to the gold price.	

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