VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

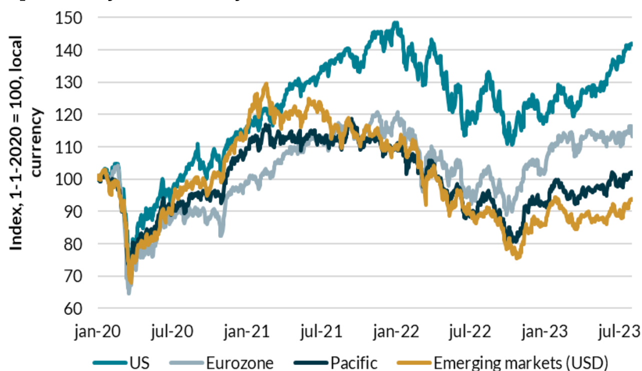
Asset Allocation Outlook

August 2023

- Deteriorating economic outlook for Eurozone
- Fed and ECB may have reached end of interest rate hike cycle
- Cautious investment policy unchanged

At first sight, July was a calm month on the financial markets. Ten-year bond yields climbed by 12 basis points in the US and 10 basis points in Germany. A slight downturn was visible in the UK. Equity markets again noted gains, with emerging markets displaying the biggest upturn, followed by the Pacific region, the US and finally Europe. Spreads on credits tightened. Real estate and commodities were up as well, with the increase in oil prices especially remarkable. There were considerable fluctuations throughout the month, however. For example, in the first half of the month the lower rate of inflation pushed down US 10-year bond yields from nearly 4% to 3.75%. Yet at the end of the month yields had returned to 4% after the Fed raised interest rates and economic growth proved to be stronger than expected.

Equities rally further in July



Source: Bloomberg, Van Lanschot Kempen

We believe that US yields in particular have the potential to fall. At the same time, we think that corporate earnings will also decrease even further. This makes government bonds relatively attractive versus equities, especially in the US. 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.

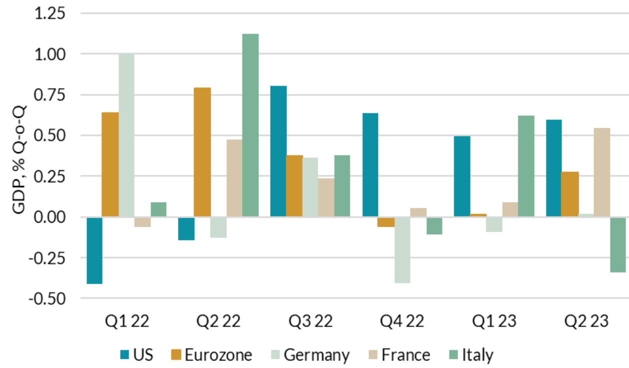
US and Eurozone grow in the second quarter

The US economy was expected to grow further in the second quarter but the rate was higher than anticipated at 2.4% annualised growth versus the first quarter (0.6% in European terms). In doing so, the US economy again demonstrated its resilience. The sharp upturn in corporate investment was especially striking in light of the pressure on corporate earnings and higher interest rates. Government stimuli and the reshoring of production to the US may play a role here. The contribution from consumer spending was significantly smaller than in the first quarter when families were still spending the savings accrued during the coronavirus pandemic. Home construction made a negative contribution to growth but a much smaller one than in the second half of last year.

After a series of worse-than-expected indicators were published in the Eurozone, growth of 0.3% in the second quarter versus the first came as a welcome surprise. Furthermore, first-quarter growth was revised upwards from -0.1% to 0.0%, thereby eliminating the technical recession in the Eurozone from the books. The growth over the second quarter is less positive than it appears though. It can mainly be attributed to exuberant growth in Ireland – most of which is down to accounting moves by the large number of multinationals located there – and to growth in

France, where delivery of a cruise ship boosted exports. French domestic demand was weak. The composition of Spain's 0.4% growth was better. The German economy stagnated, while the Italian economy contracted.

Growth strong in the US, flattered in the eurozone



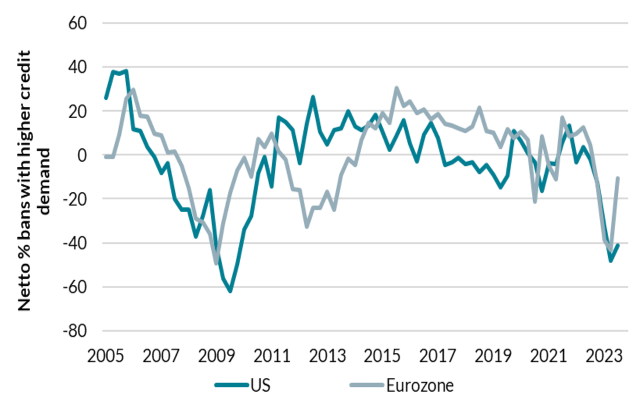
Source: Refinitiv, Van Lanschot Kempen

The outlook for the Eurozone is poor. Leading indicators, including purchasing manager indices, the Economic Sentiment Index and Germany's Ifo index, fell further, pointing to a contracting economy. The ECB's quarterly survey of banks shows that commercial banks tightened their lending conditions even more in the second quarter. Although this was by less than in the first quarter, it was enough to squeeze demand for credit. The downturn in demand for credit among businesses doesn't bode well for corporate investment. In the past, these data have anticipated higher default rates among businesses and consumers. The robust job market – in May the unemployment rate was unchanged at the low rate of 6.5% and the employment rate climbed in the first quarter – is supporting consumers. Yet the question is how long employment can continue to grow if economic growth tails off.

In the US there is optimism about inflation coming down. This is now also more visible in the rate of core inflation. Moreover, this has been achieved without significant damage to the job market. As a result, hopes of a soft landing have risen. Yet the effects of tight monetary policy are also visible in the US and will become more so. There continue to be clear signs that the economy is heading for a further slowdown. Just as in the Eurozone, commercial banks are tightening their lending conditions for businesses, consumers and real estate. This is causing a sharp drop in demand for credit, traditionally a precursor of a recession.

And the momentum has all but dissipated in China as well. Both purchasing manager indices for industry are below 50 and in July the purchasing manager index published by the national bureau of statistics dropped to its lowest level since December last year. These indicators point to the reopening rally being largely over. In the meantime, the situation on the housing market is worrying. House sales and prices are falling, while the number of new build homes has nosedived. Construction companies are generally in a precarious financial condition. The government has announced stimuli without giving any details. This is a sign of the authorities' reluctance to fuel an economy with a rising amount of debt.

Banks report falling demand for credit



Source: Refinitiv, Van Lanschot Kempen

End of interest rate hike cycle?

The question of when central banks will stop raising interest rates is one we've raised on several occasions. And yet it's possible that July's interest rate hikes were the last in this cycle. The Fed and ECB both put up rates by 25 basis points, as had been widely anticipated. The important thing was therefore what the central banks had to say about the future. And it wasn't much. While the Fed's press release was still fairly hawkish, Fed Chair Powell gave a more nuanced view during his press conference. In Powell's opinion, inflation coming down without inflicting too much damage on the job market points to a soft landing for the US economy. Markets had expected this to be the final interest rate hike even before the Fed meeting and Powell's comments haven't done anything to alter that view. Two inflation reports and two job market reports will be published before the next policy meeting though, so a great deal could still change.

The situation is somewhat trickier for the ECB. The persistent inflation is a particular headache for the central bank. Headline inflation fell to 5.3% in July. This is still high but means it's more than halved versus the peak in October last year. However, core inflation remained unchanged at 5.5% and this is only a marginal improvement on the peak rate of 5.7% in March. A single inflation report is due to be published before the ECB's September meeting and the question is whether there will be enough of an

improvement for the ECB not to raise rates further. If the economy slows even more, the ECB could well point to all the work it has already done and introduce a pause.

The Bank of Japan caused a minor surprise at the end of July. It's BoJ policy to control the yield curve, specifically to ensure that 10-year bond yields don't exceed 0.5%. A ceiling that incidentally has already been raised once. Yet the BoJ said it would be more flexible from now on and announced that it considered yields of 1% to be acceptable. Ten-year bond yields shot up in response, causing the BoJ to intervene again at 0.6%.

Bank of Japan surprises the bond market

Source: Bloomberg, Van Lanschot Kempen

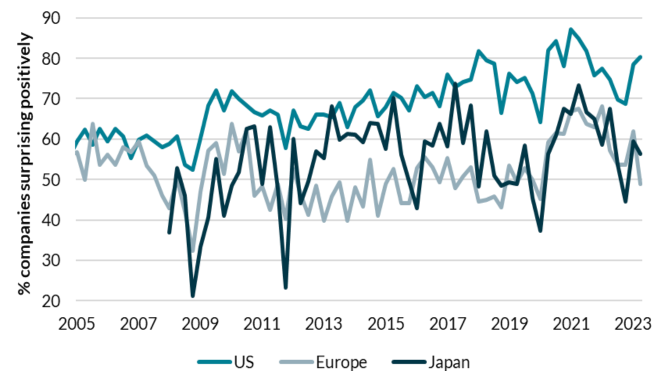
Does this mean the BoJ ceiling is now 1%? Not officially. However, it's an indication that we're approaching a time when the BoJ will tighten its extremely expansionary monetary policy somewhat. This makes sense as the Japanese economy grew by 1.8% in the first quarter versus the first quarter of 2022. Headline inflation stood at 3.3% in June. Core inflation was as high as 4.2%, an unprecedented level for Japan. Wage growth also looks to be increasing slightly.

Some central banks are already cutting interest rates. To find them we need to look to the emerging markets. Central banks there generally started raising rates earlier, enabling them also to be the first to introduce a pause and now to cut rates. The Fed's first interest rate hike was in March 2022. Many central banks in emerging markets, especially in Eastern Europe and South America, started to raise rates in the summer or autumn of 2021. Brazil did so as early as March of that year, but its central bank had already slashed rates very aggressively. The central banks of Brazil, Colombia and Uruguay have cut their interest rates over the past few weeks. Mexico also looks to be close to cutting its rates. Reductions to interest rates in emerging markets normally have little impact on equities from the region. The cuts are most visible in local interest rates. The yield on the global bond index for emerging market debt in local currency has dropped from a brief peak of over 7.5% in October last year to 6.3% now. This brings the yield back to the level of April last year, which incidentally isn't really that low compared to 4.2% at the end of 2020. For this yield to fall further though, more cuts to interest rates will be required in the countries themselves and the US dollar will also need to weaken. We're not sufficiently convinced of either of these to take a position in this asset class.

Better-than-expected corporate results

The earnings season in which companies present their second-quarter results is well under way. In the US, nearly 60% of the companies in the S&P500 have already published results, as have 60% of the European companies in the STOXX Europe 600. So far, earnings are lower than in the second quarter of 2022 in both regions, down by 3.0% in the US and 8.5% in Europe. Revenues were also down by 4.9% in Europe, while the US noted a small upturn of 0.5%. This means that margins are under pressure in both regions. Analysts had nevertheless feared even worse results. In total, earnings growth in the US is so far 6.8% higher than expected, in Europe 3.9%. The companies with higher earnings are spread across a broad spectrum in the US. No fewer than 80% of the companies have reported higher-than-expected earnings. In terms of revenue, only 60% of the companies succeeded in exceeding expectations. In the Eurozone, fewer than 50% of the companies have managed to exceed earnings expectations, while 57% have succeeded in doing so for revenue. In short, earnings are moderate to weak in both the US and Europe and margins are under pressure. However, overall the results are better than expected thanks to the extremely low expectations.

Most US companies beat earnings expectations



Source: Factset, Van Lanschot Kempen

The US is thought to have already reached the low for earnings and these are expected to start growing again from the third quarter. Weak earnings are anticipated in the coming quarters in Europe but also some improvement towards the end of the year. We find this excessively

optimistic given the declining growth momentum, lower inflation (and therefore lower nominal growth) and pressure on margins. It should also be remembered that equity valuations have risen this year. The price/earnings (P/E) ratio (based on expected earnings) of the MSCI US index climbed by more than 4 points to 21.7, that of the MSCI Europe index by 1 point to 13.4. This means that US equities are especially expensive. The P/E ratio is high versus the long-term average and versus other regions. The earnings yield (expected earnings versus the price) is low compared to 10-year bond yields. The risk premium on US equities is therefore extremely low. The situation is less extreme in Europe but in our view equity valuations fail to adequately reflect the risk of a recession. Emerging market equities are relatively cheap but earnings dynamics are still very weak in those countries. Of the 25% of companies in the Emerging Market Index that have so far reported their results, earnings are down by 14.3% versus the second quarter of 2022.

Investment policy unchanged

Our investment policy remains 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)	1020	1.3%	6.8%	14.3%
Developed markets (MSCI World)	3001	1.1%	7.0%	15.3%
Emrging markets (MSCI EM)	1020	3.1%	4.7%	6.7%
United States (S&P500)	4513	1.4%	9.6%	17.6%
Eurozone (EURO STOXX 50)	4337	-1.4%	1.0%	14.3%
United Kingdom (FTSE 100)	7562	0.4%	-2.7%	1.5%
Japan (Topix)	2302	0.6%	10.9%	21.7%
Netherlands (AEX)	775	0.1%	4.1%	12.5%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	4.08	24	65	20
Japan	0.63	23	21	21
Germany	2.54	14	28	-4
France	3.08	15	23	-4
Italy	3.64	0	2	-69
Netherlands	2.87	13	23	-3
United Kingdom	4.40	1	73	73

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	118	-5	-42	-12
Eurozone	148	-15	-16	-19

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	385	-5	-79	-84
Eurozone	440	-16	-66	-72
Emerging markets (USD)	408	-24	-140	-45
Emerging markets (Local currency)	209	-7	-99	-76

Real estate

		Past month	Past 3 months	From 31-12-2022
Global		2.3%	3.3%	0.3%
North-America		1.6%	5.3%	2.4%
Europe		6.1%	-1.5%	-4.8%

Commodities

		Past month	Past 3 months	From 31-12-2022
Bloomberg index		4.0%	4.0%	-4.1%
Base metals		2.7%	-4.4%	-7.1%
Brent oil (USD per barrel)	83.20	10.5%	12.0%	0.8%
Gold (USD per troy ounce)	1937	0.4%	-4.2%	6.1%

Returns in local currency
bp = basis point (0.01%)
Data as of 3 August 2023
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Negative**

The MSCI global equity index noted a gain of 3.6% in local currency in July. At a gain of 3.1% industrialised nations lagged slightly behind emerging markets (5.8%). Gains of 1.9% in the Eurozone and 2.2% in the UK meant that Europe once again trailed the US. Our biggest concern for equities is the combination of dwindling growth and tight monetary policy. Inflation will come down but not so fast that central banks will come to the rescue of markets when corporate earnings decline. Forecasts for earnings growth are excessively rosy in our opinion. We also believe that equity valuations fail to adequately reflect the economic risks. 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 were considerably calmer in July than in the preceding month. Two-year bond yields relinquished some of the gains they'd made in June. In July 2-year bond yields dropped furthest in the UK at a downturn of 27 basis points, followed by Germany (-16 basis points) and the US (-2 basis points). After falling mid-way through the month, US 10-year bond yields stood 12 basis points higher at 4.0% at the end of the month. German 10-year bond yields were also up, in their case by 10 basis points to 2.5%. In the UK a small downturn was visible to 4.4%. Yield curves became marginally less negative but continue to point to a recession. 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 may not yet have 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 11 basis points in the US and 16 basis points in the Eurozone in July. We believe that low and contracting spreads are at odds with economic indicators, many of which are pointing to a slowdown in growth. 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 further in July but less sharply than they did in June, in the US by 23 basis points and in the Eurozone by 16 basis points. Spreads in the US are now below the average of the past five years. In the Eurozone they are only 5 basis points above the average. At the end of July yields on US high yield credits stood at 7.8%, while in the Eurozone they were 6.9%. 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.

Emerging market debt	**Neutral**

The return on emerging market debt issued in US dollars was positive in July. At a contraction of 34 basis points, spreads tightened by more than the increase in underlying yields on US government bonds. Bonds in local currency likewise earned a positive return, largely thanks to the interest compensation. Our neutral opinion is a trade-off between the attractive interest compensation and lower inflation in the US on the one hand and the worse-than-expected growth in China and ongoing tight monetary policies in the US and Eurozone on the other. There is as yet no prospect of the Fed cutting interest rates in light of the strong service sector growth and persistently robust job market. Despite China having reopened, 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. Bonds listed in local currency could profit from the lower inflation and cuts to interest rates that a couple of central banks have already started to implement. The relatively high interest compensation may likewise seem attractive. However, the risks from low growth and rising default rates lead us to hold a neutral outlook for bonds in local currency as well.

Asset class	
Listed real estate	**Neutral**
Real estate noted gains for the second consecutive month in July. The global index climbed by 4.1%. All the regions participated in the upward trend, with an outlier of 8.8% in Europe. 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). Commercial banks have recently tightened their lending conditions considerably, especially for real estate. This complicates access to refinancing and exerts 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 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 5.8% in July. Oil prices climbed by 12% to 16%, metals earned a plus of 6.4%, while the price of gold rose by 2.4%. Commodities are down overall so far this year, primarily because of the lower metal prices. This shows that a less rosy economic picture is now being priced in. The roll yield, the return generated on investments in commodity futures, has climbed to nearly 9%, which makes commodities more attractive than they were a few weeks ago. However, the roll yield is capable of changing quickly and determined mainly by the oil markets. 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. It was only at the end of July that oil prices finally moved out of the bandwidth they had been trading at since the end of April. We view the recent optimism on the commodity markets as premature owing to the extremely moderate outlook for growth. 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 uncertainty and/or cuts to interest rates have already been priced in to the gold price.	

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
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 NV heeft een vergunning als beheerder van diverse ICBE's en ABI's en is bevoegd om beleggingsdiensten te verlenen en staat als zodanig onder toezicht van de Autoriteit Financiële Markten. Dit document dient slechts ter informatie. De inhoud is niet bedoeld als beleggingsadvies, biedt onvoldoende informatie om een beleggingsbeslissing te kunnen nemen en dient ook niet te worden beschouwd als een aanbod of als een uitnodiging om enige van de hierin genoemde financiële instrumenten te kopen of te verkopen.

INVESTMENT MANAGEMENT

Beethovenstraat 300
1077 WZ Amsterdam
Postbus 75666
1070 AR Amsterdam

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