VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

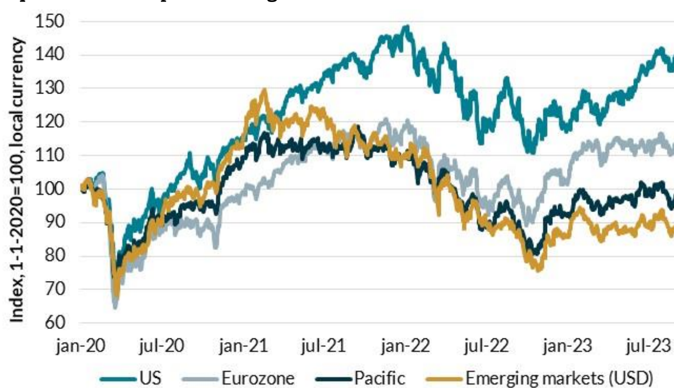
Asset Allocation Outlook

September 2023

- Economic outlook remains poor
- Inflation falling but no sign of interest rates being cut yet
- Portfolio sensitivity to interest rates increased

August was a quiet month for the financial markets. Yet investors were unable to derive much pleasure from the main asset classes. Equities noted minor losses, with the MSCI global equity index decreasing by 3.0% in local currency. The biggest loss of 6.4% was in emerging markets and the smallest of 1.8% in the US.

Equities take a step back in August



Source: Bloomberg, Van Lanschot Kempen

The Eurozone was down by 3.2%, the UK by 3.4%. US 10-year bond yields climbed slightly, which resulted in a marginally negative return on these government bonds. German 10-year yields remained more or less unchanged, resulting in the interest compensation generating a tiny positive return. Higher yields and widening spreads had an adverse impact on credits, but the relatively high interest compensation on high yield credits led to a positive return, especially in the US. Emerging market debt, listed real estate and commodities all noted losses. Inflation and interest rate expectations remain the dominant themes on the financial markets. Expectations that both will fall are shoring up risky investments. Yet we believe the slowdown in economic growth could still throw a spanner in the works. We have therefore retained our cautious investment policy.

Persisting concerns about Eurozone and China

The Eurozone economy has been ailing for some time. On balance there was zero growth in the fourth quarter of last year and first quarter of this year and atypical upward growth in the second quarter. There's no prospect of things improving anytime soon either. Consumers continue to face relatively high rates of inflation. After recovering fairly well between September 2022 and July this year, consumer confidence again fell slightly in August. When adjusted for inflation, retail sales were down in June. The effects of the ECB's contractionary monetary policy are increasingly visible. The money supply is shrinking at a record rate, which is an indication of declining consumer spending and corporate investment. Credit growth has virtually ground to a halt and business confidence is low. The purchasing managers index (PMI) for industry climbed slightly in August but remains at an extremely low level. The index for the service sector plunged to a level that points to contraction for this sector as well. The Economic Sentiment and German Ifo indices likewise dropped further. In short, it's unlikely that the ailing Eurozone economy will pick up in the near future. In the UK, the PMIs for industry and the service sector were both lower and therefore point to contraction. Although the revised rate of growth for the past few quarters was marginally higher than in the Eurozone, the situation is similar: high inflation and tight monetary policy are squeezing the economy hard.

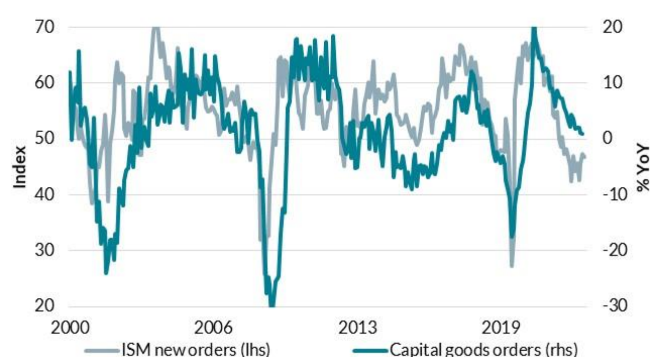
Eurozone purchasing managers indices point to a shrinking economy

Source: Bloomberg, Van Lanschot Kempen

Growth is struggling to materialise in China as well. The economy barely grew in the second quarter compared to the first. Consumers are conspicuous by their absence. And this is in turn caused by the crisis on the property market. Home sales stabilised earlier this year after dropping nearly 30% in 2022 but have fallen again recently. Prices are also coming down and the lack of buyers has caused a slump in construction. All of this has led to a sharp downturn in consumer confidence and retail sales, which have barely grown for over two years. The government recently announced measures aimed at stimulating sales of residential properties. Mortgage rates have been reduced slightly and smaller deposits are required on new homes in some cities. One of China's largest project developers was also allowed to postpone interest payments on a bond. This generated enthusiasm on Chinese equity markets but the structural problem remains unsolved. Residential properties looked like a sound investment last year, but there's now little evidence of that confidence. As China's population is no longer growing, there's a risk of a housing surplus. The crisis in the property sector and lower foreign demand for Chinese products are also squeezing corporate investment. In addition to measures aimed at the property market, the Chinese authorities have also cut interest rates and reserve requirements but not to such an extent that growth will pick up quickly.

To find growth we still mostly need to look to the US. Consumers were happy to get their wallets out in July as well, which makes for a good start to the third quarter. The question is whether they will continue to do so as consumer confidence fell in August. Higher interest rates, a weak housing market and slowing job market are taking their toll. Moreover, the strong growth in consumer spending was partly financed by savings. This has reduced the savings quota to an unsustainably low level. Furthermore, a sizeable portion of US consumers will soon have to resume their student loan repayments. These had been temporarily halted due to the coronavirus pandemic. As this involves significant sums in some cases, it will be reflected in lower consumer spending. The job market continues to support consumers. In July, real disposable income was 3.8% higher in July than in the same month last year. This is partly because of the tight job market. Yet that is slowing steadily: fewer vacancies, fewer people resigning from their jobs voluntarily and fewer new jobs. In July unemployment climbed to its highest level since February last year, but this was mostly because more people have returned to the job market in search of a new job. In themselves the trends on the job market suggest a soft landing, although we take a rather more sombre view of the future. Among businesses we are seeing a decline in confidence and an end to growth in orders for capital goods.

US producer confidence and orders point to stagnating investment



Source: Refinitiv, Van Lanschot Kempen

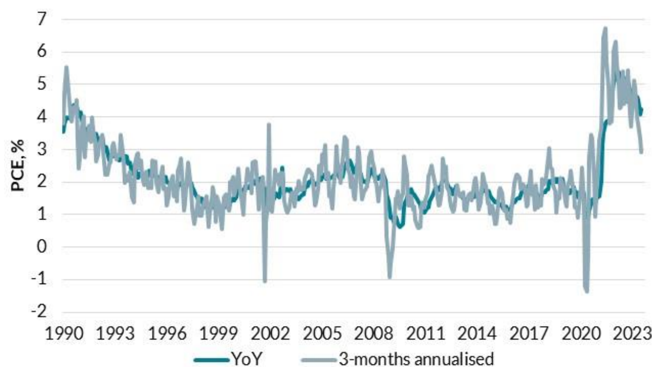
And just as in Europe the tight monetary policy is visible in the shrinking money supply and decline in lending.

Inflation falling fastest in the US

When we examine the most common inflation data - the change in prices over the past twelve months - then inflation is still high in the US, especially the underlying rate of inflation. According to the CPI index, headline inflation stood at 3.3% in July. The PCE index, which the Fed usually uses, was at exactly the same level. The sharp downturns over the past few months are mostly because of energy prices coming down. Automotive fuel prices were 20% lower in July than a year earlier. Excluding food and energy the CPI index stood at 4.7% and the PCE index at 4.2% in July, both substantially lower than their peaks in 2022 but still far above the Fed's target of 2%. Yet these data include twelve months' worth of data, including the high rates of inflation at the end of 2022 and start of this year. The past few months have seen significantly lower rates of inflation. Both indices put core inflation at about 3% on a 3-month basis. And alternative benchmarks for measuring underlying inflation have also displayed downturns recently. While levels may be higher than the Fed's target, they're heading in the right direction. The recent upturn in oil prices could drive headline inflation up

again slightly but as long as this has no impact on underlying inflation the central bank can ignore it.

US inflation is slowing



Source: Refinitiv, Van Lanschot Kempen

Inflation remains high in the Eurozone and UK as well. In August, headline inflation and core inflation stood at 5.3% in the Eurozone; in the UK the rates were 6.8% and 6.9% respectively. Rates aren't seasonally adjusted in the Eurozone and UK, which makes it more difficult to interpret month-on-month changes. The Eurozone's monthly rate of inflation has been slightly less far above the long-term average in the past few months, which points to inflationary pressure decreasing somewhat. Yet strong wage growth will still be causing the ECB some concern. Inflation is proving more stubborn in the UK. Core inflation on a monthly basis was still considerably higher in July than would normally be expected on the basis of the long-term average.

One country that isn't experiencing a problem with inflation at all is China. Headline inflation there was negative in July at -0.3%. Inflation excluding food and energy was also low at 0.8%. This shows how weak the Chinese economy is but also creates capacity for monetary stimulation.

Could central banks surprise markets?

We wrote last month that July's interest rate hikes might well have been the last in this cycle. Neither the Fed nor the ECB or Bank of England held interest rate meetings in August. And references to future monetary policy gave no clear clues. Central bankers kept things reasonably vague and in doing so all options open. The inflationary trend in the US that we described above could give the Fed reason to introduce another pause in September. The slowing job market may also serve as a reason. Conversely, what remains high wage growth of over 4% could be a reason to raise rates further. Yet *nominal* GDP growth has already decreased sharply. In 2022, that rate of growth averaged more than 7% per quarter, while it stood at 4.1% on an annual basis in the second quarter of this year. A policy interest rate that is higher than nominal growth means that monetary policy is already restrictive. This could stop the Fed from raising interest rates further. Markets don't anticipate any further interest rate hikes from the Fed.

No more rate hikes expected for the Fed and the ECB

Source: Bloomberg, Van Lanschot Kempen

Back in July the expectation was that the ECB would raise interest rates once more in September. Yet this is no longer the case. The reason for the moderated expectations doesn't seem to lie so much in the rate of inflation but instead more in the weak economic and confidence indicators. This shows what a tricky situation the ECB finds itself in: inflation is excessively high and wages are rising too fast but the economy is weak. The even higher rate of inflation than in the US means that nominal GDP growth has fallen less sharply. An interest rate increase in September is a possibility but not a certainty. In this respect the Bank of England's position is clearer. Given the marginally less weak economy and higher rate of inflation, the BoE hasn't yet finished raising rates. Interest rates will almost certainly be increased in September, possibly followed by a final hike in November. The current forecast of a peak interest rate of 5.5% is 75 basis points lower than previously expected.

Could central banks surprise markets by cutting interest rates quickly? There's now a higher chance of the Fed doing that for two reasons. Firstly, inflation has entered into a downward trend. Secondly, interest rate cuts have been pushed further into the future thanks to the better-than-expected economic growth. Whereas markets previously anticipated the first cut to interest rates four months after the final hike, this has now grown to nearly a year. In our view this is much more realistic but it also contains room for a surprise if the Fed cuts rates sooner. We believe this would be done in response to a sharp slowdown in the economy. The ECB isn't expected to cut interest rates in the coming twelve months, although it's of course possible the bank will cut rates sooner than current forecasts suggest. As UK rates first need to be raised further, cuts to interest rates aren't yet on the cards there.

Lower earnings in US, growth in Europe

The earnings season for the second quarter is now over and a huge discrepancy is visible between the US and Europe. Earnings decreased by 5.8% in the US versus the second quarter of last year, while in Europe there was an upturn of 7.1%. These outcomes were better than expected for both regions, with the greater surprise in Europe. The better-than-expected results were much more strongly concentrated in Europe than they were in the US. Nearly 80% of companies in the US succeeded in exceeding expectations, while the rate stood at just 50% in Europe. The financial sector accounted for by far the largest portion of higher earnings in Europe. Higher interest rates meant that banks were able to increase their interest margins, while little was added to the loan loss provisions. In Europe, earnings growth was realised despite lower revenues but this was also distorted by the financial sector. Revenue growth came almost to a standstill in the US.

Earnings expectations in the US are now being adjusted upwards again following the downward adjustments in March. In Europe, earnings expectations have been raised almost continuously since the low in July 2020. The STOXX equity index is now evolving more in line with earnings expectations in Europe in particular. While this is also the case in the US, even more optimism has been priced in there. We view the rising earnings expectations with some scepticism. Firstly, nominal growth is falling fast, which will have a negative impact on earnings growth. Lower inflation is positive for businesses from a cost perspective but also exerts downward pressure on revenue and options for businesses passing on price increases. Interest costs are growing steadily for companies as well. In addition, earnings are at record levels in the US and far above the long-term trend. Almost no earnings growth is anticipated for 2023. This is reasonably realistic, although earnings will need to improve in the second half of the year to realise that. Yet earnings growth of over 10% in 2024 and 2025 is exceedingly ambitious. Expensive US equities have recently become slightly more expensive. We therefore remain cautious. European equities are still cheap versus their US counterparts but here too we view expected earnings growth of 7% in 2024 and 9% in 2025 from a record level as overambitious.

Investment policy: portfolio interest rate sensitivity increased

Since 2022, when central banks in industrialised nations started raising interest rates, both short and long-term rates have risen considerably. In the US and UK to (well) above 4%, in Germany to just over 2.5%. Now that the end of interest rate hikes is in sight and inflation has peaked, we believe that long-term rates are now also close to peaking.

Ten-year yields have risen substantially

Source: Bloomberg, Van Lanschot Kempen

We're slightly more convinced of this in the US, where we hold an overweight in government bonds. Until recently our underweight in European government bonds was concentrated in bond investments with shorter durations. This resulted in a lower interest rate sensitivity for this position than the market, which is positive for the investment result when rates climb but negative when rates come down. We've now aligned the interest rate sensitivity more closely with the market by exchanging the bonds with shorter durations for bonds with longer durations. Bonds with longer durations pay lower rates of interest than their shorter-term counterparts but the difference has recently narrowed. We believe there to be only a small risk of interest rates rising further. From a slightly longer-term perspective we duly prefer bonds with an interest rate sensitivity in line with the market that can profit from future cuts to interest rates to a greater extent.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2022
Global (MSCI AC)	986	-0.7%	3.2%	13.0%
Developed markets (MSCI World)	2973	-0.4%	3.6%	14.2%
Emrging markets (MSCI EM)	986	-3.2%	-0.1%	3.1%
United States (S&P500)	4497	0.4%	5.2%	17.1%
Eurozone (EURO STOXX 50)	4269	-1.5%	-0.6%	12.5%
United Kingdom (FTSE 100)	7438	-1.7%	-2.1%	-0.2%
Japan (Topix)	2378	4.5%	7.1%	25.7%
Netherlands (AEX)	747	-3.3%	-2.1%	8.4%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	4.26	23	58	39
Japan	0.66	1	22	24
Germany	2.61	5	23	4
France	3.14	4	22	2
Italy	3.74	-5	15	-60
Netherlands	2.95	5	21	4
United Kingdom	4.53	15	32	85

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	120	2	-40	-10
Eurozone	157	8	-12	-10

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	372	-18	-57	-97
Eurozone	449	4	-28	-63
Emerging markets (USD)	418	4	-130	-35
Emerging markets (Local currency)	210	-12	-48	-75

Real estate

		Past month	Past 3 months	From 31-12-2022
Global		0.6%	0.0%	0.0%
North-America		0.9%	0.3%	0.6%
Europe		-1.0%	0.0%	-5.0%

Commodities

		Past month	Past 3 months	From 31-12-2022
Bloomberg index		1.1%	8.0%	-2.1%
Base metals		-1.0%	1.1%	-7.5%
Brent oil (USD per barrel)	90.04	5.0%	19.0%	9.7%
Gold (USD per troy ounce)	1934	-0.3%	-1.2%	5.9%

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

Tactical outlook

Asset class	
Equities	**Negative**
Equities noted losses in all the main regions in August. The smallest was in the US at 1.8%, followed by slightly larger losses of about 3% in the Eurozone, UK and Pacific region. Emerging markets brought up the rear with a loss of 6.4%. 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. Emerging market equities are cheap but we don't view these as attractive because of the weak global industrial cycle and China's economic difficulties. We hold a neutral position in emerging markets.	
Government bonds	**Neutral**
US 2-year bond yields declined by 1.4 basis points, while 10-year yields climbed by 15 basis points. The yield curve became marginally less negative as a result but continues to point to a recession. In the UK short-term yields in fact climbed faster than long-term yields, causing the yield curve to become even more negative. German short and long-term yields fell, albeit minimally. 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 remains low and wage increases are growing. However, we believe we are close to the end of the interest rate hikes. For this reason we've adjusted our positioning somewhat from mostly bonds with short durations and low interest rate sensitivity to a more neutral position. The difference in yields on bonds with short durations and bonds with long durations has recently narrowed. This adjustment makes the position in Eurozone bonds more sensitive to interest rates in anticipation of rates coming down.	
Investment grade credits	**Negative**
There were minimal changes to spreads on investment grade credits in August: increases of 6 basis points in the US and 8 basis points in the Eurozone. As underlying yields on government bonds climbed in the US but fell slightly in Germany, the upturn in yields on investment grade credits was higher in the US. Even after spreads widened marginally in August, we consider the tight spreads to be at odds with economic indicators that in many cases are pointing to a slowdown in growth. 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 on investment grade credits. It's becoming slightly more difficult for companies to place new bonds as well. 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**
The market for high yield credits was likewise calm in August. Spreads widened by 5 basis points in the US and 16 basis points in the Eurozone. US spreads are still lower than the average of the past five years. In the Eurozone they are 26 basis points above the average. At the end of August yields on US high yield credits stood at 7.9%, while in the Eurozone they were 7.1%. 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. We retain our negative outlook.	
Emerging market debt	**Neutral**
The return on emerging market debt issued in US dollars was negative in August. Spreads widened by 24 basis points and underlying US yields climbed by 13 basis points. This pushed up yields on these bonds by 37 basis points. Interest compensation of 8.5% on an annual basis was consequently not enough to compensate for the lower prices. Bonds in local currency also noted a negative return due to the higher yields. 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 possible recession in the US 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**
Listed real estate mimicked the downward trend in equities in August. The global index fell by 3.6%, completely cancelling out the gain earned in July. All the regions participated in the downward trend, with an outlier of 7.9% in emerging markets. 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. 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 small loss of 1.2% in August. Oil prices climbed by 2% but metals declined by 5.1% and gold by 1.3%. 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. As a result of recent trends on the gas markets and in some agricultural products, the roll yield - the return generated on investments in commodity futures - has deteriorated recently. 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. 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.	

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