VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

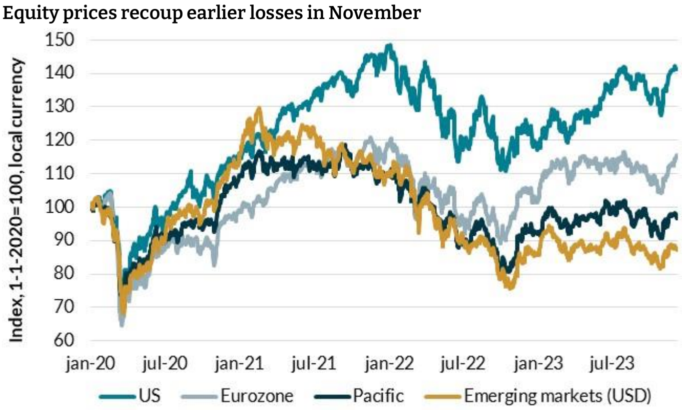
Asset Allocation Outlook

December 2023

- Eurozone inflation falling fast
- Lower interest rates not always positive for equities
- No change to cautious investment policy

After three difficult months, investors had cause for celebration at the end of November. In just one month, November's extremely strong performance very nearly completely cancelled out the downturns in the equity indices in August, September and October. Bond investors were able to join in the celebrations as yields declined at both the short and long end of the spectrum. In fact according to Deutsche Bank, November was the best month for global bonds since December 2008. Investors in listed real estate likewise profited from the lower yields and these indices also displayed sharp upturns.

Equity prices recoup earlier losses in November



Source: Refinitiv, Van Lanschot Kempen

The main reasons for this euphoria are the drop in inflation and expectations that central banks could quickly cut their policy interest rates. Although we agree with this, we think it will be accompanied by a slowdown in growth that will squeeze corporate earnings, which is ultimately negative for equities. We've therefore kept our cautious investment policy unchanged.

Eurozone inflation falling fast

Inflation has been coming down in the Eurozone for some time now. And there are signs it will fall even further. Take, for example, the surveys asking businesses about their procurement prices or how much they can charge for their products and services. Weak economic growth normally also goes hand in hand with low inflation. Stagflation (low growth and high inflation) has of course occurred in the past on occasion, but central banks are determined to avoid it this time around. Headline inflation in the Eurozone stood at 10.6% in October 2022 and dropped to 2.4% in November this year. Core inflation has more or less halved from 5.7% in March to 3.6% in November. The trend in recent months is particularly remarkable. Whereas until August inflation on a monthly basis was still above average for the relevant month, the situation has now reversed. In the long term prices decline by an average of 0.1% in November versus October, while this year they fell by no less than 0.6%. The ECB's seasonally-adjusted price indicator enables us to calculate that on an annual basis inflation was only 0.7% in the last three months and 2.3% over the past six months. This brings the ECB's inflation target of 2% within easy reach, although time will tell whether inflation will continue to decline at the same rate. The tight job market and high rate of inflation have in the past led to high wage increases. Wages covered by collective agreements in the Eurozone were up by 4.7% in the third quarter. This explains the general view that bringing that last part of inflation down to 2% will be the hardest to achieve.

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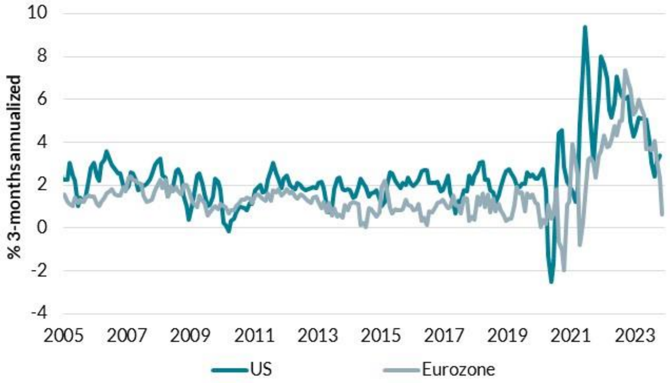
Core inflation falling fast in the Eurozone



Source: Refinitiv, Van Lanschot Kempen

This is also visible to some extent in the US rate of inflation. Inflation has come down fast there too and continued to decline in October. According to the Fed's favourite benchmark, headline inflation fell to 3.0% and core inflation to 3.5%. Yet in contrast to the Eurozone, the downturn in core inflation has stalled somewhat in the last three months. This is despite the job market cooling slightly and hourly earnings growth decelerating. It's therefore not yet clear whether the last part of the downturn in inflation will indeed be the hardest, but at the moment investors are obviously assuming this won't be the case.

Inflation is more stubborn in the UK. Yet even so headline inflation has fallen sharply there too. In March of this year it still stood at over 10%, so the downturn to 4.6% in October was a welcome surprise. However, core inflation has so far been coming down more slowly in the UK, from a peak of 7.1% in May to 5.7% in October. In September and October, core inflation on a monthly basis was again slightly higher than average for those months.

We believe inflation will fall further, in part because of the weak economic outlook. And in our opinion, it's also perfectly possible that the rapid downturn in inflation in the Eurozone will derive partly from the weak economy. Incidentally, in China we're likewise seeing relatively weak economic trends combined with an extremely low rate of inflation. In October headline inflation in China dropped to -0.2%, core inflation to 0.6%.

Interest rate cuts in sight

The lower rate of inflation brings the question of when central banks will start to cut their policy interest rates into sharper focus. One of the Fed's stricter policymakers recently claimed that interest rate cuts in the first half of 2024 are possible if inflation continues to fall. Yet the majority of policymakers are keeping open the option of raising interest rates further if necessary and still forecast a longer period of restrictive policy. Fed Chair Powell said during his November press conference that Fed policymakers aren't even considering interest rate cuts yet and early this month he reiterated that it was too soon to speculate about reducing rates. Markets disagree. For the Fed's interest rate meeting in May 2024 an interest rate cut has already been priced in for about 70%; for June nearly 80%. We find this logical given the declining inflationary pressure, cooling job market and slowdown in growth that we forecast. It should be remembered that even with a few cuts to interest rates the interest rate policy will remain restrictive. Current interest rates of 5.25-5.50% are after all far above the neutral interest rate, which is estimated to be about 2.5%. Moreover, declining inflation will cause real interest rates to rise if policy interest rates aren't cut. This means that policy could in fact become even more restrictive.

Negative yield curves imply cuts to interest rates

Source: Refinitiv, Van Lanschot Kempen

The ECB finds itself in a slightly trickier position. The Eurozone economy is in poorer shape than that of the US, but the job market is tight and, while wages in the US have risen less rapidly in recent months, wage increases in the Eurozone have in fact accelerated. Perhaps even more importantly, the ECB only has one goal to work towards: inflation of about 2%. And in September the ECB was still forecasting that inflation would be above that target in 2025. So ECB communications focus mainly on maintaining restrictive monetary policy and not on cuts to interest rates. ECB President Lagarde recently stressed that monetary policy wouldn't be eased in the next few quarters. For the ECB financial markets are pricing in an interest rate cut for 85% for the April meeting; for June as much as 100%. This may be rather aggressive but isn't entirely unrealistic. As we mentioned above, inflation has recently fallen fast in the Eurozone. The ECB will publish new growth and inflation projections in December and the latter in particular could well be adjusted downwards. This would confirm market expectations for interest rate cuts.

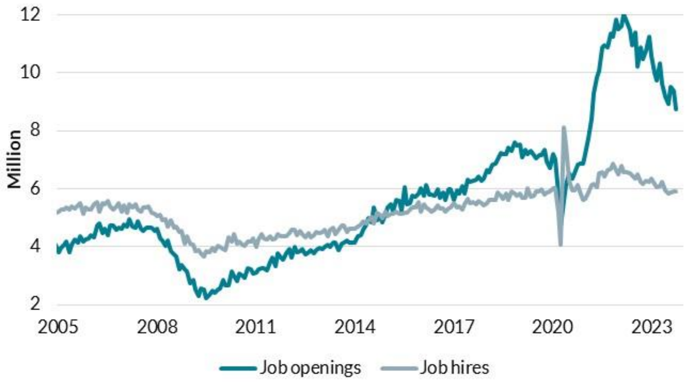
As to the first cut to interest rates by the Bank of England, markets are wavering somewhat between June and August. Given the more stubborn rate of inflation in the

UK, we aren't surprised that interest rate cuts are anticipated later there than in the US or Eurozone. Yet policymakers are applying the brakes there as well. BoE Governor Bailey has again promised to do whatever it takes to get the UK's rate of inflation back down to the bank's target of 2%.

Job market a contributory factor

The Fed's official goals are stable prices as well as full employment. This means that the Fed will be looking to the job market more than the ECB is, as it has only set itself the goal of stable prices. The US job market remains tight but there are signs of it cooling. The number of new jobs each month is decreasing and companies have fewer unfilled vacancies. Companies are even reducing the number of temporary positions.

US job market cooling



Source: Refinitiv, Van Lanschot Kempen

Over the twelve months up to November this year, more than half the new jobs were healthcare or government jobs. Consumers are indicating that it's becoming more difficult to find a new job and fewer employees are resigning voluntarily from their jobs. So far this is a gradual slowdown. The number of compulsory redundancies has risen marginally but is low in historical terms. The overall picture is that companies are taking on fewer new staff but not laying people off en masse. This can also be seen from the jobless claims. The number of new applications is low but the total number is rising. Unemployment has risen in the meantime. The extent of this borders on what in the past has led to an acceleration in deteriorating job market conditions and a recession. Something worth keeping an eye on, therefore. And for the Fed this could be a reason to start cutting interest rates.

After a long period of decline, unemployment in the Eurozone has dropped to its lowest level since the introduction of the euro. Since March this year, however, the rate of unemployment has remained the same on balance. This makes it a tight job market, although as in the US the dynamics are easing. Employment grew by 0.2% in the third quarter versus the second quarter. This was the lowest rate of growth since the first quarter of 2021. As we noted last month, the job market remains tight as companies are holding on to employees they struggled to recruit for as long as possible. And because consumption of labour-intensive services is higher in relative terms than consumption of capital-intensive goods. The ECB hasn't set a target for the job market but is of course closely monitoring the high wage increases. Yet as inflation falls and the high rate of inflation of the past two years is increasingly offset by previous wage increases, future wage increases will also decline. This will in turn create capacity for the ECB to cut interest rates.

Outlook for growth unchanged

Our outlook for growth remains unchanged. We anticipate tough economic conditions in the coming quarters and certainly don't rule out a contraction. Leading indicators appear to be bottoming out but aren't yet pointing to growth in the Eurozone and at best are pointing to moderate growth in the US. Based on the economic data published so far, the Federal Reserve Bank of Atlanta forecasts growth in the US of 0.3% in the fourth quarter versus the third quarter. This would be a sharp drop from 1.3% in the third quarter and the lowest growth since the second quarter of 2022. Retail sales and industrial production started the quarter at weak levels, while orders for capital goods haven't risen notably in a year. Consumer spending, production and orders aren't doing that well in the Eurozone and UK either. And on the interest-rate sensitive UK housing market, where mortgages have shorter fixed-rate periods on average than in continental Europe and the US, the contractionary monetary policy is also slightly more visible in the downturn in house prices.

Declining inflation is creating a tailwind for consumers, as their purchasing power is being squeezed less. However, to counter that there's a headwind from higher interest rates and low confidence. And in the US also from dwindling savings, the reintroduction of repayments on student loans and less fiscal support for the economy compared to the first half of 2023. The real estate sector continues to be a source of uncertainty in China. At the start of December, credit ratings agency Moody's downgraded China's credit status from stable to negative. The agency is concerned about the rapid increase in debt at local government level, where income from land sales has dried up. Yet it's also worried about the property crisis, which is getting worse rather than better. China will achieve its growth target of 5% this year, but a similar level for 2024 would seem to be an uphill battle.

Can equities and interest rates fall at the same time?

In our investment outlook we assume that inflation will continue to fall, that central banks will cut their policy interest rates in the course of 2024 and capital market yields will then also be able to come down slightly further. At the same time, we hold an underweight in equities. Declining interest rates and declining stock markets, it seems an almost impossible combination.

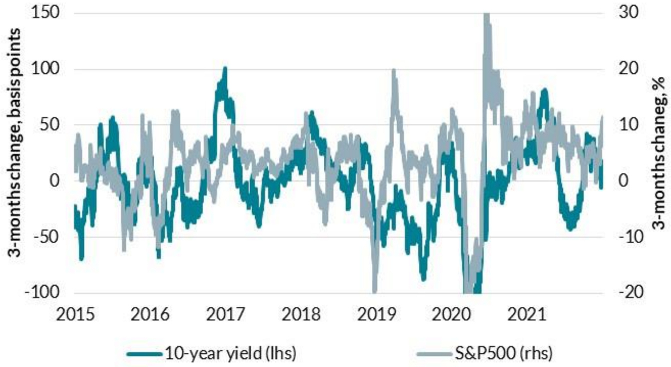
Interest rates and equities have moved in opposite directions since early 2022, with inflation dominating markets

Source: Refinitiv, Van Lanschot Kempen

In the long term the link, or correlation, between the movement of interest rates and the movement of equities isn't straightforward. Yet it has been since the start of 2022. Since that time, we've seen a negative correlation. Rising interest rates generally go hand in hand with declining stock markets and declining interest rates with rising stock markets. The fact that this has been the case since early 2022 is no coincidence. The rate of inflation had already shot up in 2021 and there were growing doubts as to the temporary nature of that inflation. The Fed started to implement a series of aggressive interest rate hikes in March 2022; the ECB followed suit in July. Since then, interest rates and inflation have held equity markets tightly in their grip. Higher growth, inflation and interest rates are seen as a particular threat to equities, while there's relief if inflation is lower than expected and expectations grow that interest rates could be cut. The downturns on the equity markets in September and October and the rally in November are the most recent examples of this.

The correlation between interest rates and equities isn't always negative though. In the period from 2015 to 2022, for example, there was in fact a positive correlation. During that period, accelerating growth and higher interest rates were viewed as positive for equities. And vice versa. In other words, whereas now fears (or relief) about inflation are predominant, in previous years this was growth. And if the rate of inflation declines, as we anticipate, inflation fears will also cease to dominate the equity markets. In this regime, lower interest rates and lower stock markets could well go hand in hand if growth is worse than expected.

Between 2015 and 2022 interest rates and equities mostly moved in the same direction, growth dominated markets



Source: Refinitiv, Van Lanschot Kempen

This is what we expect to happen, and to such an extent that earnings expectations will need to be adjusted downwards. We view earnings growth of 11% in the US in 2023 and 12% in 2024 and 6% and 9% respectively in Europe as excessively optimistic. This is the reason for us retaining our negative outlook for equities, even though we also anticipate lower interest rates. In this light, we find it remarkable that financial markets are now pricing in fairly aggressive interest rate cuts while the mood on equity markets continues to be positive. Markets clearly anticipate a soft landing (i.e. a downturn in inflation without economies ending up in a recession). These interest rate cuts may well materialise but against the background of a weaker economy, weaker earnings and a headwind for equities.

Investment policy unchanged

We've held an underweight in equities for some time now as we've long been concerned about the impact of high inflation and enormous monetary tightening on the economy and corporate earnings. With respect to the economy, our forecast for Europe has been reasonably accurate. Real growth has been exceedingly weak over the past year. We nevertheless underestimated the effect of inflation, and in turn nominal growth, on earnings. In the US, we mainly misjudged the positive effect of the fiscal stimuli in the first half of the year and the willingness of consumers to spend the savings they had accrued during the coronavirus pandemic. We recently reduced our equity underweight slightly when interest rates climbed sharply and markets underwent a correction. In retrospect though, we underestimated the positive impact of hopes of rapid cuts to interest rates by central banks.

Where do we go from here? We continue to be fundamentally concerned about the impact of the tight monetary policy on the credit policies of banks, which have tightened substantially, as well as about rising interest rates and higher default rates on loans, the decrease in lending and in turn the economy as a whole. As described above, we think the correlation between equities and interest rates could undergo a reversal if inflation falls far enough. What do we want to see to become more positive about equities? Signs of economic recovery would be positive, especially if it's clear that a soft landing is still an option despite the sharp interest rate hikes. More realistic forecasts for corporate earnings could also lead us to adopt a neutral outlook, but only if these are accompanied by a downturn in equity indices. After all, if this isn't the case, equity valuations will simply continue to climb. Central banks switching to interest rate cuts wouldn't in itself be enough for us to become positive about equities. Equities have historically been more likely to fall than rise following this kind of pivot, as central banks usually only cut rates once the seeds of a recession have already been sown. Two examples in the US of a reversal by the Fed and yet a positive outcome for equities are 1995 and 1998. However, those years were missing the negative signals of a negative yield curve and tighter lending conditions at commercial banks. These signals are currently at red.

Nor have we altered our outlook for bonds. We believe that yields could come down further and have prepared for this in recent months. We still think it too soon to implement this in full given the sharp drop in yields in the past few weeks. While we expect yields to fall, we see no reason to take greater advantage of this at the moment. In our opinion, the sizeable negative spread between short and long-term yields, i.e. the fact that 2-year bond yields are higher than their 10-year counterparts, will restrict any further rapid downturns at the long end of the curve.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2022
Global (MSCI AC)	973	5.1%	2.6%	15.6%
Developed markets (MSCI World)	3056	5.4%	2.9%	17.4%
Emerging markets (MSCI EM)	973	2.6%	-0.4%	1.8%
United States (S&P500)	4622	4.7%	3.0%	20.4%
Eurozone (EURO STOXX 50)	474	7.7%	5.1%	15.5%
United Kingdom (FTSE 100)	7545	2.5%	0.6%	1.3%
Japan (Topix)	2359	0.9%	-0.1%	24.7%
Netherlands (AEX)	786	5.4%	6.4%	14.1%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	4.24	-39	-5	40
Japan	0.76	-8	7	35
Germany	2.26	-45	-37	-30
France	2.82	-48	-36	-29
Italy	4.06	-51	-34	-64
Netherlands	2.60	-45	-38	-31
United Kingdom	4.08	-26	-39	41

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	110	-16	-13	-28
Eurozone	143	-8	-8	-23

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	379	-24	-3	-100
Eurozone	419	-35	-11	-75
Emerging markets (USD)	399	-32	-21	-53
Emerging markets (Local currency)	219	18	9	-71

Real estate

		Past month	Past 3 months	From 31-12-2022
Global		8.7%	1.5%	-1.0%
North-America		10.1%	1.3%	2.4%
Europe		11.6%	11.1%	6.6%

Commodities

		Past month	Past 3 months	From 31-12-2022
Bloomberg index		-4.2%	-8.8%	-13.7%
Base metals		-2.1%	-6.4%	-18.8%
Brent oil (USD per barrel)	75.63	-7.3%	-16.6%	-10.9%
Gold (USD per troy ounce)	1982	1.8%	3.1%	9.2%

Returns in local currency
bp = basis point (0.01%)
Data as of 12 December 2023
Source: Refinitiv

Tactical outlook

Asset class	
Equities	**Negative**
Equities performed extremely well in November. The losses incurred in the preceding three months were cancelled out in a single month, especially in the US and Europe. All the regions profited from the relief rally to a similar extent, driven by the prospect of lower inflation, hopes of rapid cuts to interest rates by central banks and declining market interest rates. We believe that monetary policy has now been priced in reasonably realistically given that we anticipate weak economic growth in coming months and inflation falling further. Expectations for interest rate cuts by the ECB are nevertheless on the aggressive side. If inflation fears abate in response to lower rates of inflation, we believe declining interest rates and declining stock markets could go hand in hand. As a result, we're more concerned about the outlook for growth and corporate earnings than about interest rates. Corporate earnings expectations in particular are excessively positive in our view. Our equity underweight is concentrated in the US and Europe, where we expect tight monetary policy to have a negative impact on the economy and corporate earnings. Equity valuations fail to reflect our cautious economic scenario, especially in the US. We hold an overweight in Japan, where monetary policy is still extremely expansionary.	
Government bonds	**Neutral**
Bond yields dropped sharply across a broad front in November. Short and long-term yields fell in the US, Germany and UK. The downturns at the long end of the curve were larger than those at the short end. Yield curves, which had become less negative in recent months, became more negative again. Viewed fundamentally we think yields could come down further owing to the extremely moderate growth and declining rate of inflation. Yet the strongly negative yield curve restricts the potential for further yield decreases in the short term. Our neutral position mainly reflects this short term. We believe there's slightly more potential for yields to fall in the US than in the Eurozone at the moment. Growth momentum could slow more quickly in the US and in particular wage inflation is less stubborn there. Within our neutral positioning we therefore hold an overweight in the US and an underweight in the Eurozone. We recently increased our interest rate sensitivity for European government bonds as we believe yields have peaked.	
Investment grade credits	**Negative**
The optimism on financial markets encompassed the market for investment grade credits as well. Spreads tightened in both the US and the Eurozone in November. The downturn in the underlying yields on government bonds pushed yields on investment grade credits down sharply. This cancelled out the upturns of September and October in one go. We think the tight spreads are at odds with economic indicators that in many cases are pointing to a slowdown in growth. The rating trend, which indicates the level of creditworthiness, is deteriorating due to pressure on profits and corporate balance sheets. Any rise in the default rate will first affect high yield but could also translate into concerns about spreads on investment grade credits. US spreads are below the average for the past five years, Eurozone spreads slightly above. The upturn in underlying yields on government bonds and persistently tight spreads mean that spreads account for a historically small portion of the interest compensation on credits. This makes them less attractive versus government bonds. Within investment grade credits we now have a relative preference for the Eurozone versus the US. Spreads are wider in the Eurozone and interest rate sensitivity is lower.	
High yield credits	**Negative**
High yield credits shared in the optimism among investors in November. Spreads tightened in the US and Eurozone. The decreases were considerably larger than those on investment grade credits and here, too, the increases of the preceding months were cancelled out in a single month. Like investment grade credits, high yield credits have lost some of their relative attractiveness versus government bonds thanks to the higher yields in the latter asset class. Yet our negative outlook for this asset class primarily derives from the fact that the market for high yield bonds is totally ignoring the possibility of a recession. In a recession, spreads in this asset class can easily reach 1,000 basis points. These stood at 380 basis points in the US at the end of November, in the Eurozone at 432 basis points. We see downward risks as well, such as lower earnings growth and a higher default rate. Companies in this asset class are especially sensitive to higher interest rates in our opinion. Businesses are often more aggressively financed, frequently also partly via bonds with flexible interest rates and bond durations are shorter on average.	

Asset class	
Emerging market debt	**Neutral**
Emerging market debt listed in US dollars earned a positive return in November. The downturn in yields could be attributed marginally more to the decline in US yields than the tighter spreads. Bonds listed in local currency likewise noted a positive return as a result of lower interest compensation. Financial markets responded positively to recent lower-than-expected rates of inflation and the prospect of central banks cutting interest rates in the spring of 2024. Our neutral opinion on emerging market debt listed in US dollars 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, risk of a further slowdown in global growth and persistently high interest rates and restrictive monetary policies in developed countries on the other. Spreads are relatively wide versus other asset classes but they fail to price in a global slowdown in growth. Bonds listed in local currency could profit from the lower inflation and cuts to interest rates in emerging markets. However, the interest compensation is relatively low versus developed countries and this reduces the relative attractiveness.	
Listed real estate	**Neutral**
Listed real estate has a reputation as being a defensive sector in equities and its cashflows are partly linked to inflation. The relatively high amount of debt financing means that higher interest rates and stricter lending conditions at banks pose a risk to this asset class, including in relative terms versus general equities. Listed real estate valuations are low. In our opinion, the sharp upturn in global listed real estate in November means that the extent of interest rate cuts by central banks is now being realistically priced in. Despite the fact that transactions have recently picked up somewhat, they remain at low levels. Property prices could continue to fall before the number of transactions normalises further. In the short term, we don’t anticipate interest rates coming down enough to hold an overweight and continue to be extremely concerned about financing in the real estate sector. Commercial banks have tightened their lending conditions considerably in 2023. This complicates access to refinancing and exerts upward pressure on interest charges.	
Commodities	**Neutral**
Commodities stood out as the major exception in November among what were otherwise optimistic financial markets. The general Bloomberg commodity index fell for the fourth consecutive month. Oil prices dropped sharply for the second month in a row, while industrial metals remained more or less unchanged. This points to the downturn in the oil price being market-specific rather than driven by concerns about the economic cycle. Oil was affected primarily by slightly higher stock levels, stable production in countries outside OPEC and the difficulty of getting all OPEC members to agree on production restrictions. The gold price escaped the malaise and climbed to a record high. This may be due to lower yields, but the gold price was already extremely high even before yields reached current levels. More significant in our view are the enormous amount of liquidity that central banks have pumped into markets in the past few years and the direct purchase of gold by the central banks themselves, probably partly as a substitute for US dollars. Gold is an interesting investment at times of uncertainty but given its high price a large amount of uncertainty and/or lower interest rates have already been priced in. From a cyclical perspective we don’t view this as a good time to build up a position in commodities, despite the fact that commodities have noted a negative return so far this year. Stalling growth in global industry and China mean the outlook isn’t positive. 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. Incidentally, excessively high oil prices aren’t in the interest of oil-producing countries as this would encourage the search for new oil fields or alternative energy sources. This restricts the upward potential from the supply side.	

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