# Asset Allocation Outlook

January 2024

- Tentative start to 2024 for equities after strong end to 2023
- Inflation looks to be temporary after all, but ECB cautious about cutting interest rates
- Bonds relatively attractive versus equities

The end-of-year rally in fact started in November last year and continued in December, although it did slow. The upturns in equity indices in December were generally half the size of those in November. The engine behind the upturns wasn't the approaching end to the year but once again lower interest rates. December again saw substantial downturns in 10-year bond yields.

Lower bond yields help push up equities

Source: Refinitiv, Van Lanschot Kempen

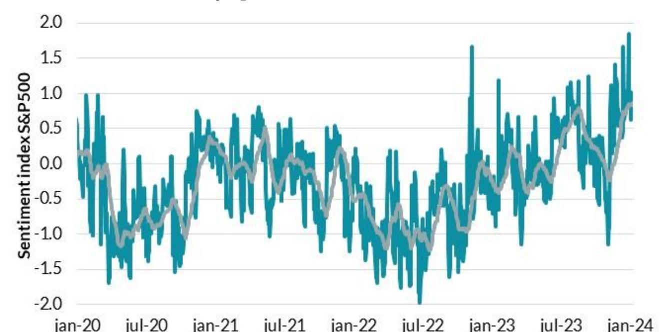
The downturns of the last two months of the year in particular mean that in 2023 German 10-year bond yields fell by 53 basis points overall and their UK counterparts by 13 basis points. In the US, 10-year bond yields climbed by a minimal 3.5 basis points in 2023. This stands in stark contrast to the policy interest rates of central banks, which in 2023 were raised by 100 basis points in the US, 200 basis points in the Eurozone and 175 basis points in the UK. This clearly shows how much interest rate markets are anticipating cuts to official interest rates in 2024. In the risk-on rally that continued in December, spreads on credits and emerging market debt tightened and listed real estate again noted an upswing. As was the case throughout the year, commodities formed the negative exception due to lower oil prices.

We continue to apply caution in our investment policy. In a climate of low growth and declining inflation we believe equities will find it hard to keep up with bonds. Within equities we remain positive about Japan.

## Tentative start to the new year

After the euphoria of recent months, investors started the new year in cautious mode. Equity indices are generally in the red and bond yields have risen slightly higher. Given the optimism that had seeped into markets, some consolidation was to be expected.

US investors excessively optimistic?




Source: Refinitiv, Van Lanschot Kempen

Sign up to our mailing list here.

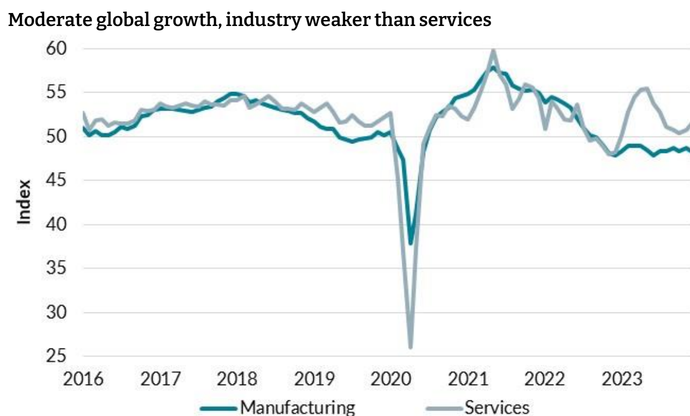
In the US, optimism among private investors had climbed to extreme levels and there was also more demand for call options than put options. Equity volatility was exceedingly low in the US and Eurozone in December. These are all signs of strong optimism, which from a contrary perspective must be viewed as a risk.

Yet the caution also derives from the expectations for central bank policies. Investors are now marginally less certain that central banks will cut interest rates quickly. In December, the US central bank surprised markets by being much more open to interest rate cuts than anticipated. Policymakers' projections for inflation and interest rates were adjusted downwards and Fed Chair Powell pointed to the risk of keeping interest rates too high for too long now that they are restrictive for the economy. This fuelled sentiment about lower interest rates and higher equity markets. However, the rate of core inflation in the US later turned out not to have declined further in November. The job market did cool slightly more but remains tight. This makes the first interest rate cut in March more uncertain, which dampened the highly positive sentiment on the equity markets.

## Low economic growth in 2024

We continue to assume low growth and inflation in 2024, especially in the first half of the year. Financial conditions such as low interest rates, spreads and equity markets have eased further in recent weeks and therefore form less of a headwind for the economy. Yet short-term interest rates, to which many bonds with flexible yields are linked, continue to be relatively high. And while long-term interest rates on balance remained the same or declined somewhat in 2023, they remain significantly higher than in previous years. We believe that the full impact of this has yet to be exerted on economies.

**Moderate global growth, industry weaker than services**




Source: Refinitiv, Van Lanschot Kempen

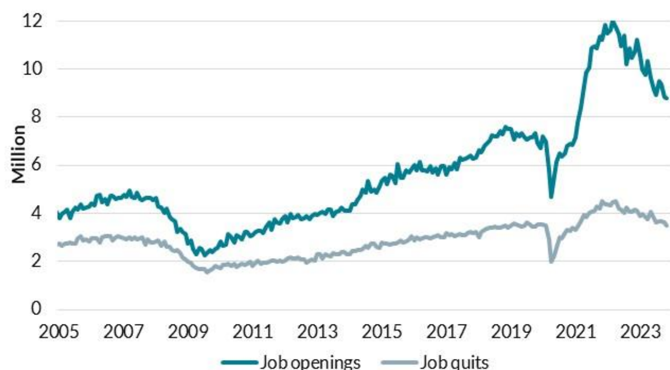
Leading indicators confirm the picture of weak growth. The industrial sector is having a particularly tough time. Whereas a slight improvement was visible in purchasing manager indices (PMIs) in November, these deteriorated again in December. The global index fell to 48.2 in December, which points to contraction. It's also the lowest level since June 2023. The situation looks slightly better in the service sector; the global index climbed to 51.7. Yet the upturn in the Eurozone was minimal and the indicator continues to point to a sharp contraction in the service sector. In the US, the PMI for the service sector rose in December but the ISM index for services fell more sharply than expected. Together with the ISM index for industry, these indicators point to a stagnating economy. Confidence among small businesses, house builders and consumers is likewise low in the US. Consumer confidence and the Economic Sentiment Index increased in the Eurozone, but the German Ifo index was down. None of these indicators points to economic growth.

In the Eurozone, harder economic data such as retail sales, industrial production or corporate order books are pointing to ongoing stagnation or contraction in the fourth quarter. From a growth perspective it's positive that the job market in the Eurozone remains tight. Unemployment dropped to a record low of 6.4% in November. Despite the stagnating economy, employment has continued to grow. This provides no guarantee for the future though as unemployment is always at its lowest just before a recession. The fact that businesses are reluctant to lay off staff in such a tight job market nevertheless reduces the risk of a negative spiral resulting in mass redundancies.

The hard data in the US point to a slowdown in growth rather than a contraction. This is logical given the extremely strong growth of the third quarter. The tightness on the job market is one of the reasons that financial markets have their doubts about rapid interest rate cuts by the Fed. According to the monthly survey of businesses, the number of new jobs is in a downward trend, but more new jobs were created in December than in November. Unemployment remained at the low rate of 3.7%. Yet the job market is definitely cooling. Unemployment stayed low in part because of a decrease in the working population. According to the monthly survey of households (which is more volatile than that of businesses), employment decreased and fewer people were looking for work. These declining dynamics can also be seen in the lower number of unfilled vacancies and smaller number of employees voluntarily resigning from their jobs. However, the low number of announced lay-offs and new jobless claims isn't pointing to mass redundancies in the US either. A soft landing is possible in the US, although we're slightly more cautious. One of the reasons is that we believe consumers will have a slightly tougher

time than in 2023. A less dynamic job market ultimately also means lower wage growth. This is positive in terms of lower inflation but less so for consumers. Savings accrued during the coronavirus pandemic have already been eroded and we're seeing rising debts and default rates, especially in low and lower-middle income groups.

**Slower dynamics on US job market**




Source: Refinitiv, Van Lanschot Kempen

In emerging markets the less wealthy Asian economies of India and Indonesia stand out relatively positively compared to say Korea and Taiwan, which are being affected more severely by the weak industrial cycle. In China the two PMIs for the service sector displayed some improvement in December, while the indices for industry declined slightly on average. Growth has recently picked up in retail sales and industry, but this is facilitated by comparison with the low levels of a year earlier. Barely any improvement is visible in the real estate sector and downward pressure on house prices has increased. There is little in the way of consumer confidence. The government is announcing stimuli from time to time but stresses the need to bite the bullet. It remains to be seen whether this strategy will enable China to achieve its growth target of 5% this year.

## Inflation: victory for Team Transitory?

When inflation soared in 2021 and 2022, many analysts assumed it would be transitory. Now that the rate of inflation is falling fast, the question is whether Team Transitory was in fact right. This of course depends on your definition of transitory. Inflation started to rise in 2021, peaked in 2022 and declined in 2023. If we convert the price increases of the past six months into annual figures, inflation stood at 3% in the US in December according to the CPI index and 2% according to the PCE index, the index the Fed uses. In the Eurozone inflation stood at about 2.5% on this basis. Central banks are cautious about declaring victory over inflation, but these aren't levels worth getting too worried about. Rising wages are still seen as a concern but the pace of wage increases has already dropped to 4 to 4.5% in the US. If labour productivity increases in line with the long-term trend, this is reasonably compatible with the Fed's inflation target of 2%.

**Wage increases mainly still high in the Eurozone and UK**

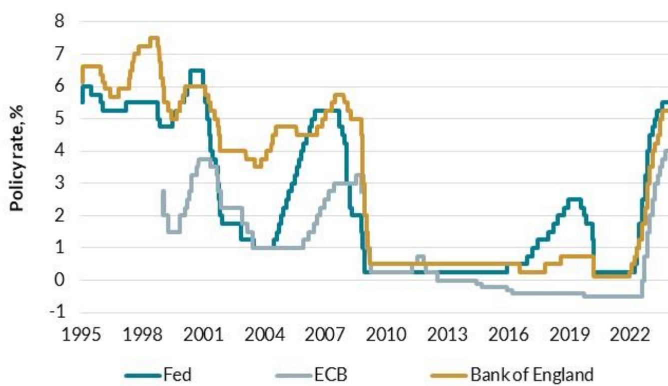
Source: Refinitiv, Van Lanschot Kempen

Wage growth hasn't yet peaked in the Eurozone. Wages covered by Collective Labour Agreements increased by 4.7% year-on-year in the fourth quarter. As businesses in the Eurozone are retaining workers when growth is low, labour productivity is declining. The upshot is that unit wage costs climbed by 6.5% year-on-year. This is why the ECB doesn't yet want to consider cutting interest rates. Team Transitory would be proved wrong if a wage-price spiral were to arise. However, the situation of a stagnating economy, tight job market and high wage increases is exceptional. It looks as if businesses are partly compensating employees for the rate of inflation over the past year rather than this being structural in nature. Surveys show that while consumers found inflation extremely high over the past twelve months, their expectations for the coming twelve months have dropped to low levels.

In conclusion, we can say there are few signs of a wage-price spiral in either the US or Eurozone. This points to Team Transitory ultimately largely being right (with a considerable delay). There are still two risks of inflation remaining high for longer. The first risk is of economies being largely unaffected by monetary tightening, which means there won't be a landing at all. Given the weak rate of growth, this doesn't apply to Europe. And it would seem unlikely for the US too, partly because there will be less of a boost from spending private savings and from the government. Another risk is the international transport of goods. Drought has restricted capacity in the Panama Canal, while there are enormous geopolitical risks around the Red Sea. Shipping prices doubled in October 2023 but have since fallen again by nearly 40%. We don't view this as a new global inflation shock.

For central banks this means that they can start to cut their policy interest rates. These are after all restrictive in the US, Eurozone and UK. And as we've said before, real interest rates will rise as inflation falls if (nominal) policy interest rates aren't cut. This would make policies even more restrictive. As we've mentioned, the Fed has already more or less announced a pivot towards cutting interest rates. It's now mostly a question of the timing of that first reduction to interest rates. An interest rate cut in March, which before Christmas had been viewed as fairly certain, is now estimated to be rather less certain. We thought that expectations for interest rate cuts by the Fed had gone too far but think they're now more realistic again.

**Policy interest rates still very restrictive**




Source: Refinitiv, Van Lanschot Kempen

The ECB adjusted its growth and inflation forecasts downwards in December. At 2.7% in 2024, the ECB expects inflation to remain above its target rate of 2% and only anticipates inflation falling to its target rate in 2025. At her December press conference, ECB President Lagarde clearly didn't want to make the pivot that Fed Chair Powell had the day before. The ECB acknowledges that inflation is coming down but thinks financial conditions have eased too quickly to cut policy interest rates now. We view the ECB's growth forecast, which predicts a rapid return to trend-based growth, as rather optimistic. If growth is worse than expected and inflation falls further, the ECB will be unable to avoid cutting interest rates. Markets now anticipate the first cut to interest rates by the ECB in around April. This is possible, but the ECB's guidance will need to change substantially first.

Like the Fed and ECB, the Bank of England (BoE) kept its interest rates unchanged in December. Six policymakers voted in favour of this decision, while the other three were in favour of raising rates. Given core inflation still at 5.1% in November, the BoE's expectation that inflation would only fall to 2% at the end of 2025 and wage increases of around 7%, it would seem likely that the BoE will cut interest rates later than the Fed or ECB. Markets expect the BoE to implement its first interest rate cut in May or June.

## Bonds a realistic alternative to equities

In the coming months we think returns on cash and bonds could easily equal or even surpass returns on riskier investments such as equities, real estate or commodities. And within bonds we have a preference for the safer asset classes. We've therefore kept our cautious investment policy unchanged.

This is all driven by our outlook for the economic cycle, in which we anticipate slowing growth momentum. This will be most pronounced in the US, which is coming from a strong level of momentum, but we don't foresee any noteworthy improvement in the Eurozone, UK or China either. Declining inflation means an even sharper decrease in nominal growth and in turn in corporate revenues. This poses a risk to corporate earnings. As we noted above, equities have had two strong months in which optimism ran wild. The equity rally in the US was driven entirely by higher valuations; on balance realised earnings have remained unchanged since September 2022. In the Eurozone, half of the upturn in the equity index can be explained by higher valuations and the other half by higher earnings. The MSCI index for emerging markets climbed slightly despite lower earnings, also generating higher valuations. It's not unusual for markets to anticipate potential increases in future earnings in which valuations rise but, in our opinion, it does demonstrate that a positive scenario has already been priced in, which restricts capacity for further positive surprises.

As bond yields are higher than in the years prior to the coronavirus pandemic, bonds and cash are a competitive alternative to equities. This is most clearly visible in the risk premiums on US equities. These premiums are the difference between the earnings yield on equities (earnings divided by price) and 10-year bond yields. Since 2005, risk premiums in the US had averaged 3.6 percentage points but they now stand at 1.2 percentage points. At 2.1 percentage points in the Eurozone, risk premiums are slightly higher than the multi-year average of 1.7 percentage points. Yet the weak economic outlook for the Eurozone could lead to expected earnings being lower than anticipated, which would push down risk premiums if yields remain the same. If yields also decline, this would in fact be positive for bonds.

**Low risk premiums on US equities**

Source: Refinitiv, Van Lanschot Kempen

We've anticipated lower yields in the bond portion of our portfolios in the past few months. Yet even we're surprised by the speed at which market interest rates have fallen without the economic picture deteriorating. We haven't altered our outlook for bonds either. We believe there's little room for yields to fall further in the short term. In our view the large negative spread on short and long-term yields, i.e. the fact that 2-year bond yields are higher than 10-year yields, will restrict further rapid downturns in yields at the long end of the curve.

# Market review

**Equities**

| | Index | Past month | Past 3 months | From 31-12-2022 |
|---|---|---|---|---|
| Global (MSCI AC) | 993 | 3.1% | 9.7% | -0.9% |
| Developed markets (MSCI World) | 3147 | 3.3% | 10.1% | -0.7% |
| Emerging markets (MSCI EM) | 993 | 1.8% | 6.2% | -3.0% |
| United States (S&P500) | 4757 | 3.3% | 9.7% | -0.3% |
| Eurozone (EURO STOXX 50) | 470 | -0.6% | 8.6% | -0.9% |
| United Kingdom (FTSE 100) | 7684 | 1.7% | 2.6% | -0.6% |
| Japan (Topix) | 2413 | 3.8% | 6.6% | 2.0% |
| Netherlands (AEX) | 778 | -0.5% | 7.1% | -1.2% |

Government bonds (10-year)

| | Yield (%) | Past month (bp) | Past 3 months (bp) | From 31-12-2022 (bp) |
|---|---|---|---|---|
| United States | 4.02 | -22 | -78 | 15 |
| Japan | 0.59 | -19 | -21 | -4 |
| Germany | 2.19 | -8 | -58 | 16 |
| France | 2.72 | -10 | -64 | 16 |
| Italy | 3.85 | -20 | -99 | 14 |
| Netherlands | 2.50 | -9 | -63 | 18 |
| United Kingdom | 3.78 | -26 | -70 | 24 |

Investment grade credit

| | Risk premium (bp) | Past month (bp) | Past 3 months (bp) | From 31-12-2022 (bp) |
|---|---|---|---|---|
| United States | 106 | -4 | -23 | 2 |
| Eurozone | 142 | 0 | -20 | 7 |

High yield bonds

| | Risk premium (bp) | Past month (bp) | Past 3 months (bp) | From 31-12-2022 (bp) |
|---|---|---|---|---|
| United States | 359 | -16 | -75 | 25 |
| Eurozone | 400 | -20 | -86 | 5 |
| Emerging markets (USD) | 412 | 15 | -40 | 28 |
| Emerging markets (Local currency) | 227 | 12 | 16 | -8 |

Real estate

| | | Past month | Past 3 months | From 31-12-2022 |
|---|---|---|---|---|
| Global | | 4.7% | 13.3% | -1.5% |
| North-America | | 5.5% | 14.6% | -0.6% |
| Europe | | 3.3% | 19.6% | -3.0% |

Commodities

| | | Past month | Past 3 months | From 31-12-2022 |
|---|---|---|---|---|
| Bloomberg index | | 0.4% | -5.3% | -0.4% |
| Base metals | | 0.9% | -2.2% | -4.3% |
| Brent oil (USD per barrel) | 77.91 | 2.7% | -11.7% | 0.3% |
| Gold (USD per troy ounce) | 2027 | 1.2% | 9.5% | -1.8% |

Returns in local currency
bp = basis point (0.01%)
Data as of 9 January 2024
Source: Refinitiv

# Tactical outlook

| Asset class | |
|---|---|
| **Equities** | **Negative** |

The equity rally continued in December, although the upturns were smaller than in November. Equities generally earned extremely positive returns in 2023, with the UK's FTSE 100 and emerging markets lagging behind. Equity markets got off to a tentative start in 2024. Sentiment indicators point to a very positive mood, which is negative from a contrary perspective. Expectations for interest rate cuts had gone slightly too far at the end of 2023, which was partly what triggered the rally, but we now think monetary policy has been priced in reasonably realistically in light of our forecast for weak economic growth and inflation falling further. 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 economic 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 again dropped sharply across a broad front in December. The downturn in yields was only small at the short end of the curve, up to three months, as central banks in the US, Eurozone and UK kept their policy interest rates unchanged. Viewed fundamentally we think yields could come down further owing to the extremely moderate growth and declining rate of inflation. Yet in our opinion the sharp drop in yields and strongly negative yield curve (with 2-year yields higher than 10-year yields) restrict the potential for further decreases in long-term yields in the 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.

| **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 Eurozone in December. The downturn in the underlying yields on government bonds pushed yields on investment grade credits down sharply. Spreads tightened by over 30 basis points in the US and Eurozone in 2023. 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 credits 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. Spreads currently 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 December. Spreads tightened in the US and Eurozone. The decreases were considerably larger than those on investment grade credits. In 2023, spreads tightened by about 100 basis points in the Eurozone and in the US by as much as 145 basis points. 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 335 basis points in the US at the end of December, in the Eurozone at 395 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 vulnerable 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 December. 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 declining 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 upturns in global listed real estate in November and December mean that expected interest rate cuts by central banks are now being 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 tightened their lending conditions considerably in 2023. This complicates access to (re)financing and exerts upward pressure on interest charges. | |
| **Commodities** | **Neutral** |
| Commodities again stood out as the major exception in December among what were otherwise optimistic financial markets. The general Bloomberg commodity index fell for the fifth consecutive month. Oil prices declined further, while industrial metals climbed slightly. This points to the downturn in the oil price being market-specific rather than driven by concerns about the economic cycle. The oil market typically has relatively high levels of supply versus demand, despite the production restrictions imposed by the OPEC countries. The gold price noted a new record high of 2,079 US dollars per troy ounce on 27 December. 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. 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. | |

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

VAN LANSCHOT KEMPEN INVESTMENT STRATEGY & TACTICAL ASSET ALLOCATION

Yaela van Raalte – Head investment research
Luc Aben – Chief economist
Pieter Heijboer – Head investment strategy
Joost van Leenders – Senior investment strategist
Jorn Veeneman – Investment strategist
Mees Vlasveld – Investment strategist

**Disclaimer**

The information in this publication is of a general nature. This publication may at no time be viewed as an offer and you cannot derive any rights from this publication. The external sources used to produce this publication were selected with the great care. We cannot guarantee that the information and data from these sources is up-to-date, correct and exhaustive. We accept no liability for printing and typing errors. We are not obliged to update or amend the contents in this publication. All rights related to the content of this publication are reserved, including the right to amend.

INVESTMENT MANAGEMENT

Beethovenstraat 300
1077 WZ Amsterdam
Postbus 75666
1070 AR Amsterdam

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