INVESTMENT MANAGEMENT

Asset Allocation Outlook

March 2024

- Equity markets set new records
- Cuts to interest rates pushed back
- Position in US government bonds reduced in favour of Eurozone

After a tentative upward movement in January, sentiment improved on the equity markets in February. Gains were noted in all the major regions, with little difference between the upturns. Several indices, including the US S&P500 and Japanese Nikkei, set new records. February's gains translated into a significant improvement for emerging markets and especially China. Equities succeeded in maintaining the upward trend despite the higher bond yields. Both short and long-term yields climbed in the US, UK and Germany. The main reason for this was expectations that central banks will cut interest rates later than previously anticipated. The optimistic mood was also reflected in the tighter spreads on credits, especially in the high yield asset class. The higher bond yields and negative news about the sector meant that real estate was unable to profit from the positive sentiment.

New records for S&P500 and Nikkei

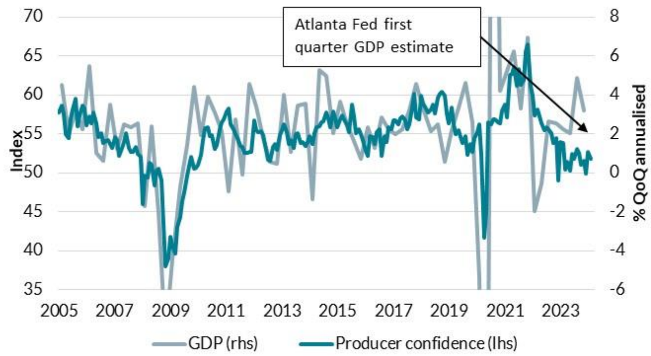
Source: Refinitiv, Van Lanschot Kempen

We made a minor adjustment to our investment policy. The proceeds from selling the short-term US government bonds in the portfolio have been reinvested in Eurozone government bonds.

Equity markets continue to climb

The upward trend in the equities of industrialised nations that has been visible since October last year has so far proved unstoppable. We believe the main driver of this optimism to be the resilience of the US economy. The rate of growth is in fact declining in the US, from annualised growth of 4.9% on a quarterly basis in the third quarter of 2023 to 3.2% in the fourth quarter and according to an indicator of the Federal Reserve Bank of Atlanta to 2.1% to date in the first quarter.

US economy slows



Source: Refinitiv, Van Lanschot Kempen

Yet a recession looks to be unlikely in the short term. Businesses are investing and taking on new staff, while the real disposable income of families is rising and they're also willing to spend it. A panel of economists polled by Bloomberg had previously assumed virtually no growth in 2024, but expectations have since increased to growth of

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2.2%. We think the US economy will slow slightly more though. There are signs of this happening, such as the negative yield curve, extremely weak Leading Economic Indicator or ISM indices for industry and services, both of which fell in February. Small businesses say they want to take on fewer new employees, which is a negative indicator for employment. The number of compulsory redundancies is also rising. Corporate investment grew sharply last year thanks to stimulatory government programmes. This effect won't be repeated in 2024. And the extra savings that households accrued during the coronavirus pandemic have mostly already been spent.

The interaction between equities and bond yields is remarkable. We've written about the negative correlation between them before. In the past few years, during a period of high inflation, falling bond yields have been positive for equity markets and rising yields negative. The present equity rally also kicked off at a time when yields were decreasing substantially. From October to December last year, US 10-year bond yields dropped by over 1 percentage point. This year, however, 10-year yields have risen again by nearly 0.4 percentage points to 4.2%. Yields at the short end of the yield curve have climbed slightly more sharply. Yet this hasn't stopped the equity markets climbing.

Equities rise further, despite higher yields

Source: Refinitiv, Van Lanschot Kempen

The inflation fears on the equity markets seem to be dissipating. If this is the case, higher yields and higher equity prices could well go hand in hand again as expectations on the economic cycle dominate once more. Incidentally, if the economic cycle is worse than expected, this means that lower yields won't come to the rescue of equity markets.

The equity rally has also largely been driven by higher valuations. Since October earnings expectations for 2024 have been cut by 1.5% in the US, in the Eurozone by 3.2%. It's common for valuations to rise when growth forecasts are higher and in anticipation of higher earnings. However, that earnings growth does need to materialise at some point. There are signs of this happening in the US. Businesses reported earnings growth of 7% in the fourth quarter versus a year earlier. This exceeded expectations, which incidentally had been adjusted sharply downwards. Yet a slowing economy and declining inflation make it more difficult to realise revenue growth and keep margins and earnings at the same level. It remains to be seen whether earnings growth will be able to meet expectations. Whatever the case, higher equity prices reduce the capacity for upward surprises.

Consensus earnings expectations for 2024 have been lowered

Source: Refinitiv, Van Lanschot Kempen

We have therefore retained our neutral equity position. Within equities we hold an overweight in Japan, where we view the economic cycle, earnings growth and expansionary monetary policy as positive for equities.

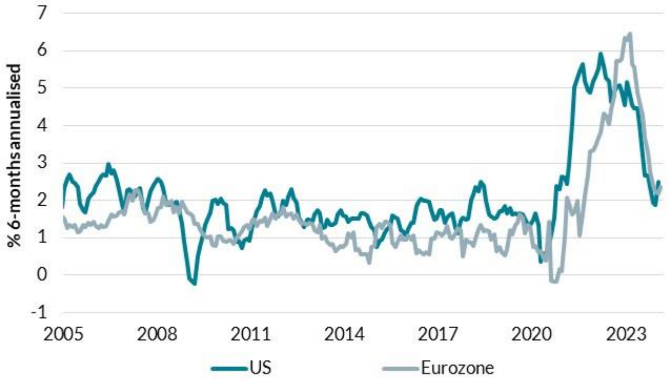
We hold an underweight in Europe as economic growth is failing to materialise. The upturn in the purchasing manager index (PMI) for the service sector in February to over 50 – and therefore pointing to a small amount of growth – is a boost, but on balance leading indicators continue to point to a stagnating economy. Consumers were again conspicuous by their absence in January, with retail sales down by 1.1% versus December. Reported earnings over the fourth quarter were 11% lower than in the fourth quarter of 2022. This is the reason for the adjusted earnings expectations for the coming year. Incidentally, these lower expectations in Europe bring us closer to the point where there is capacity for positive surprises.

We hold a neutral position in emerging markets. An improving global industrial sector and positive trends in the tech sector are especially positive for export-oriented Asian economies. Realised earnings are bottoming out most clearly there, while earnings expectations are being adjusted upwards most in these countries. The exception here is China, which determines the equity index for emerging markets to a significant extent. PMIs remained more or less unchanged in February at a level that points to what is a weak rate of growth for China. The Chinese government has announced a growth target of 5% for 2024. Greater stimulation than we have so far seen or has so far been announced will be needed to achieve this, especially given the low consumer confidence and persisting problems in the real estate sector.

Cuts to interest rates pushed back

An increase in headline inflation according to the US CPI index of 0.3% in January (versus December) and 0.4% for core inflation is not that much compared to some upturns we've seen in recent years, but these are still the fastest price increases in four months. On an annual basis, headline inflation did drop to 3.1% but core inflation remained stuck at 3.9%. This fuels the theory that the last part of inflation dropping to the target rate of 2% will be slower and more difficult. The PCE index (as preferred by the Fed) was as expected but here, too, the process of inflation coming down seems to be faltering somewhat. Whether this really is the case remains to be seen. Temporary factors may have marginally distorted January's data. In the Eurozone, headline inflation declined to 2.6% in February and core inflation to 3.1%. Core inflation especially had been expected to fall further. In the UK, inflation was marginally lower than expected in January, but core inflation still stood at 5.1%.

Core inflation stopped falling in January



Source: Refinitiv, Van Lanschot Kempen

These inflation data have led to the expectations for cuts to interest rates being pushed back. Markets now view cuts to rates by the Fed or ECB before June this year as extremely unlikely. For the policy meetings in June, markets are slightly more convinced of an interest rate cut by the ECB than by the Fed. For the Bank of England the first cut to rates isn't anticipated until August. Markets previously thought there was a possibility of the Fed and ECB cutting interest rates in March. The postponement of interest rate cuts means that fewer cuts are also expected this year. The Fed is now forecast to make three to four cuts (of 25 basis points), while before it was five to six. Several Fed policymakers recently made it known that they want to wait to cut rates until they have evidence that the downturn in inflation will last. For the first time in a long while, market expectations for the number of interest rate cuts in 2024 correspond with indications previously given by the Fed.

For the ECB, markets anticipate slightly under four interest rate cuts this year. The ECB mainly wants to see further evidence that wages are rising less quickly in order to prevent a wage-price spiral. There are signs that wages are indeed rising less sharply but there's always a considerable delay to publishing these data. This is why the ECB is in no hurry to cut interest rates. Incidentally, in our view wages in the Eurozone are lagging behind the inflation shock somewhat. If the sharp increase in wages was chiefly a response to the previous high levels of inflation, then lower inflation will naturally lead to less pronounced wage increases.

Delayed rate cuts lead to less negative short yield curves

Source: Refinitiv, Van Lanschot Kempen

Later interest rate cuts mean that policy interest rates will remain high for longer and this will be reflected in market interest rates. US 2-year bond yields have risen particularly high this year, to a level comparable to that reached before the Fed opened the door to potential cuts to interest rates. The upturn in 10-year bond yields is less marked but nevertheless unmistakable. Yields climbed in Germany and the UK as well, while these economies are clearly in much poorer shape than that of the US. We believe there's capacity for yields to come down in the long term but less so in the short term in light of the fluctuating rates of inflation.

From US to Eurozone government bonds

We haven't made any major changes to our investment policy. We hold a neutral allocation to equities, with an overweight in Japan and an underweight in Europe. We hold an overweight in government bonds and an underweight in investment grade and high yield credits. Our positions in emerging market debt, real estate and commodities are neutral.

Within government bonds we've sold our position in short-term US bonds and reinvested the proceeds in Eurozone government bonds. We took the position in US government bonds in 2022 when we reduced the US equity weight but didn't want to hold an underweight in the US dollar. Moreover, at the time short-term bonds were attractive due to the inverse yield curve that meant short-term bonds paid a higher rate of interest than their long-term counterparts. This is still the case but the difference between the rates has shrunk. Market trends had caused the US dollar position to grow into an overweight. And as we recently brought the US equity weight back to a neutral position, we think this is a good time to reduce the US dollar position to neutral too. Reinvestment of the proceeds in Eurozone government bonds means that we hold an overweight in government bonds. The underweight in the Eurozone is declining, as yields have risen and valuations are more attractive. This is aligned with previous steps to move towards a positioning that matches falling bond yields during 2024.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2023
Global (MSCI AC)	1022	3.3%	9.8%	4.7%
Developed markets (MSCI World)	3337	3.2%	10.4%	5.3%
Emerging markets (MSCI EM)	1022	3.9%	5.1%	-0.2%
United States (S&P500)	5079	2.7%	11.2%	6.5%
Eurozone (EURO STOXX 50)	500	4.0%	7.4%	5.5%
United Kingdom (FTSE 100)	7646	0.4%	2.1%	-1.1%
Japan (Topix)	2720	6.4%	16.1%	14.9%
Netherlands (AEX)	851	3.3%	10.0%	8.2%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	4.14	-3	-4	27
Japan	0.70	-2	4	7
Germany	2.32	0	8	29
France	2.79	-4	-1	22
Italy	3.71	-18	-28	0
Netherlands	2.59	-1	3	27
United Kingdom	4.01	0	-2	47

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	101	1	-10	-3
Eurozone	120	-9	-23	-15

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	331	-19	-49	-3
Eurozone	350	-24	-82	-45
Emerging markets (USD)	369	-23	-36	-15
Emerging markets (Local currency)	205	-3	-23	-31

Real estate

		Past month	Past 3 months	From 31-12-2023
Global		1.7%	1.8%	-4.5%
North-America		3.4%	3.8%	-2.2%
Europe		-3.7%	-4.4%	-9.9%

Commodities

		Past month	Past 3 months	From 31-12-2023
Bloomberg index		0.9%	-2.3%	-1.4%
Base metals		2.3%	2.2%	-3.4%
Brent oil (USD per barrel)	82.88	7.2%	7.3%	6.7%
Gold (USD per troy ounce)	2127	5.3%	5.5%	3.0%

Returns in local currency
bp = basis point (0.01%)
Data as of 8 March 2024
Source: Refinitiv

Tactical outlook

Asset class	
Equities	**Neutral**
February was a positive month for equities, with all the major regions noting upturns. The US S&P500 set new records on several occasions and for the first time closed above the 5,000 point mark. The Japanese Nikkei finally managed to break the previous record of 29 December 1989. The positive sentiment is mainly driven by the robust US economy and the increased likelihood of a soft landing. Even rising bond yields and lower earnings expectations have been unable to halt the upward trend. With the forecasts for interest rate cuts by central banks pushed back, we believe that monetary policy is now reasonably well priced in. We're more concerned about Europe than the US when it comes to corporate earnings, although we do find earnings expectations in Europe more realistic following the downward adjustments. Within equities we hold an overweight in the Pacific region thanks to our overweight in Japan. Monetary policy remains extremely expansionary in Japan, while the country is less advanced in the economic cycle and corporate earnings growth is more robust. The defensive nature of the yen could provide a hedge in the event of negative trends. We hold an underweight in Europe and neutral positions in the US and emerging markets.	
Government bonds	**Overweight**
US 2-year and 10-year bond yields climbed by about 40 basis points in February. The same yields increased by about 20 basis points in Germany. In the UK, the upturn in 2-year yields was restricted to 8 basis points, while 10-year yields rose by 32 basis points. Viewed fundamentally we think yields could come down further owing to the extremely moderate growth in Europe and declining momentum in the US as well as lower inflation. There's little potential for yields to fall in the short term. The US economy is proving to be resilient, the downturn in inflation is happening more slowly than initially thought and interest rate cuts will arrive slightly later than expected. If interest rates remain stable in the short term, US government bonds will profit from the higher rates. We've reduced our overweight in the US in favour of the Eurozone by selling short-term US government bonds and using the proceeds to buy bonds issued by Eurozone countries. In doing so, we've brought our position in the US dollar back to neutral and taken a further step towards a positioning in Eurozone government bonds that matches declining yields.	
Investment grade credits	**Underweight**
The optimism on financial markets encompassed the market for investment grade credits as well. Spreads tightened in both the US and Europe for the fourth month in a row. Incidentally, the downturns were again extremely small in February, primarily because spreads are already at low levels. We think the tight spreads are at odds with economic indicators that in many cases are pointing to a slowdown in growth. Furthermore, the higher market interest rates are causing a deterioration in the ratio of corporate results and interest charges. Exposure to commercial real estate poses a risk for some US and German banks. US spreads are more than 25 basis points below the average for the past five years, Eurozone spreads 12 basis points. 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 have a relative preference for the Eurozone versus the US. Spreads are marginally wider in the Eurozone and interest rate sensitivity is lower.	
High yield credits	**Underweight**
Spreads on US and European high yield credits tightened in February. 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 further slowdown in growth. Rating agency Moody's thinks the global default rate peaked in January, but rival agency S&P expects the default rate to rise slightly higher. Spreads stood at 329 basis points in the US at the end of February, in the Eurozone at 346 basis points. This is considerably lower than the average of the past five years for both regions. We see downward risks for this asset class, 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 February. This was mainly driven by interest compensation given that the upturn in underlying US bond yields was cancelled out by the tighter spreads. Government bonds listed in local currency were trading more or less flat. Our neutral opinion on emerging market debt listed in US dollars is a trade-off between the attractive interest compensation, relatively wide spreads versus other asset classes and lower inflation in the US on the one hand and on the other the slowdown in global economic growth we anticipate and the Chinese economy's inability to accelerate. The risk of a recession in the US has nevertheless receded. 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. Following a series of better-than-expected lower inflation data in the second half of last year, the picture reversed slightly in February when for the first time the rate of inflation was higher than expected. Job market data in the US and Eurozone remained solid, pushing back expectations for the first cuts to interest rates by central banks towards June. The resulting higher bond yields led to a negative return on listed real estate in January and February. We hold a neutral outlook for this asset class. Valuations are relatively low versus general equities but not versus interest rates. In the short term we don't anticipate interest rates coming down enough and continue to be extremely concerned about financing in the real estate sector. Tighter lending conditions at banks complicate access to (re)financing and exert upward pressure on interest charges. 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.	
Commodities	**Neutral**
The general Bloomberg commodity index fell again slightly in February. As in January, higher oil prices were cancelled out by lower prices for metals. Gold closed the month more or less unchanged. From a cyclical perspective we don't view this as a good time to build up a position in commodities. Some improvement is visible in global industry but not enough to push up commodity prices. The limited fiscal stimuli in China, which are leading to moderate growth in investment in infrastructure and homes, is restricting the potential for higher prices in metals. The OPEC countries and Russia are limiting supplies, but this is partly being offset by higher production in non-OPEC countries, especially the US. As a result, the oil market has plentiful supplies. The high gold price is primarily the result of expansionary monetary policies and the large amount of liquidity this has created, as well as gold purchases by central banks. 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.	

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