VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

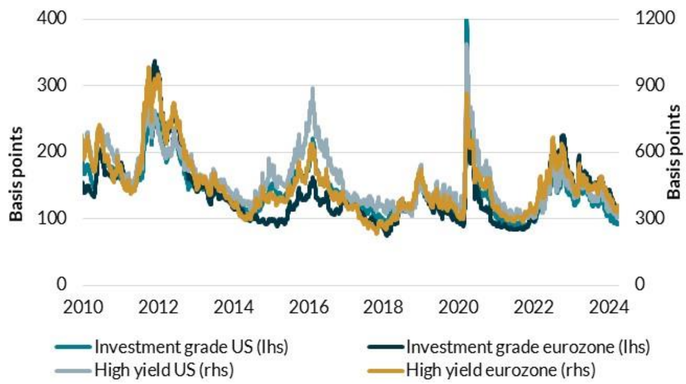
Asset Allocation Outlook

April 2024

- 'No landing' scenario for the US over-optimistic in our view
- Should the Fed cut interest rates?
- Profit-taking on Japanese equity overweight

The MSCI global equity index climbed for the fifth consecutive month in March, although the upturn was smaller than that of February. Equities are increasingly pricing in a positive scenario in which the US economy in particular remains largely unaffected by the Fed's interest rate hikes. Equities from industrialised nations outperformed their emerging market counterparts, and within industrialised nations Europe noted a sharper upturn than the US. The equity rally was more widespread. Value equities performed better than growth equities and small caps better than large caps. Market interest rates declined by slightly more in Europe than in the US and marginally more at the long end than the short end of the yield curve. Yet even so the movements were small. Despite already tight spreads on credits, these contracted slightly more in March.

Optimism among investors: spreads tighten further



Source: Refinitiv, Van Lanschot Kempen

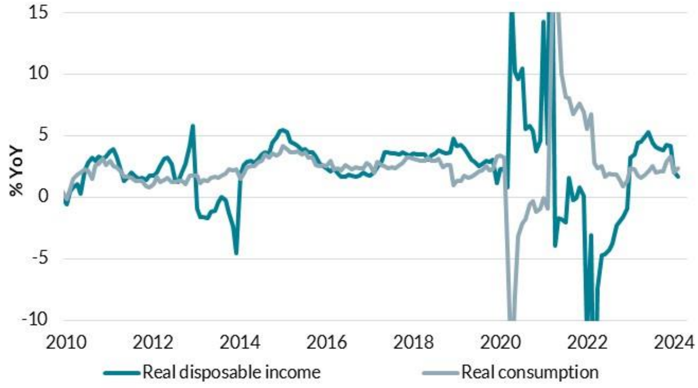
Investment sentiment therefore remains positive for the risky asset classes. In our equity allocation we have taken profit on our overweight in Japan. In fundamental terms the signals are still positive in Japan, but the rapid rise in the equity index makes us think that the market has now mostly already priced these in. This brings us to a neutral weight for the individual equity regions.

US economy again displaying resilience

The Federal Reserve Bank of Atlanta has an indicator that depicts the current rate of growth. At the start of March, this nowcast indicator dropped to a level that pointed to 2% annualised growth in the first quarter of 2024. This translates into a substantial slowdown from growth of 4.9% in the third quarter of last year and 3.4% in the final quarter. Yet since the publication of consumer data over February and especially the ISM index for industry, the nowcast has been pointing to 2.8% growth in the first quarter. This suggests a 'no landing' scenario rather than a soft landing. In short, the US economy remains robust.

Incidentally, this is being driven marginally less by consumers. Consumer spending was better than expected in February after retail sales (which don't include anything like all the consumer spending data) had been slightly worse than expected. Yet so far consumer spending stands at 1.8% annualised in the first quarter, significantly lower than the 3% of the preceding two quarters. These data cover January and February and so another month's data are needed to complete the first quarter, but it would take an extremely sharp increase in consumer spending over March to come close to 3%. The fact that US consumers are being marginally more cautious can be traced back to the job market and income trends. Although employment growth was strong in March, companies have signalled less willingness to take on new personnel and more redundancies are being announced. Combined with inflation, which is coming down less quickly, this is squeezing purchasing power. On balance, real disposable incomes decreased somewhat in January and February. That consumers are experiencing greater difficulties can also be seen from rising default rates on credit cards and car loans. Consumers were again forced to turn to their savings in February to keep spending at the same level.

Income growth of US households stalling



Source: Refinitiv, Van Lanschot Kempen

This situation has the potential to develop into a downward spiral, in which companies respond to weak demand by investing less and laying off employees. There are nevertheless some bright spots. The ISM index for industry jumped to 50.3 in March. This means that the indicator is pointing to growth in the industrial sector for the first time since September 2022. Large companies are marginally more positive in the service sector. If corporate confidence is growing, which is perfectly possible now that a recession appears to have been averted, this is positive for corporate investment and employment. A negative spiral could then be avoided. We still assume that growth will slow slightly further but without the economy entering into a recession.

Green shoots in Europe and China

It's springtime and the first buds are already appearing on trees and bushes. A few green shoots can also be seen in the Eurozone's economy, although it's still very early days. Some leading indicators are depicting a less negative picture despite continuing to point to a contracting economy. Yet there are also indicators that are already pointing to growth, such as the purchasing manager index (PMI) for the service sector for the whole Eurozone. In February this index climbed to over 50, the level that points to growth, for the first time since July last year and continued this upward trend in March. The PMI for industry was down slightly and is still some way off pointing to growth. This is mainly due to pessimism in the German industrial sector. In Italy, Spain and Greece, however, the PMI for industry stood above 50. In the UK, the PMIs for industry and the service sector were both above the threshold of 50 in March and therefore pointing to growth.

European service sector businesses more optimistic

Source: Refinitiv, Van Lanschot Kempen

The harder data from the Eurozone so far give little reason for optimism. Industrial production fell in January. Order books at companies remained weak as well. Retail sales did rise marginally in January but not enough to compensate for the sharp downturn in December. In this respect it's remarkable how robust the job market still is. At 6.5%, unemployment has been at its lowest rate since the creation of the Eurozone for many months. Although consumer spending accounts for a smaller portion of the GDP in the Eurozone than in the US, consumers are important to the outlook. If consumers continue to be as thrifty as they have been in recent quarters, a recovery will be difficult in the Eurozone. Yet there are reasons to think that consumers will start spending a bit more. Disposable incomes are now growing at a higher rate than inflation. This means that purchasing power is increasing. Furthermore, unlike consumers in the US, Eurozone consumers haven't yet spent the savings they accrued during the coronavirus pandemic. We estimate that these extra savings have grown to nearly 15% of the disposable income. Reasons enough, therefore, to assume growth in consumer spending in the Eurozone.

In China the economy looks to have accelerated in the first quarter. This can be seen from data on industrial production, exports and to a lesser extent retail sales and from the PMIs showing that businesses in industry and the service sector are now more optimistic about the future. We remain cautious about the Chinese economy though. This is because the housing market has weakened further. In February, 24% more floorspace was for sale than a year earlier and sales were down by 25%. In addition, 30% fewer construction projects were initiated and official figures show that the prices of new homes declined by 1.4% and of existing homes by 5.3%. However, there are unofficial data circulating that point to an even larger downturn in prices. In short, the imploding housing market in China continues to form an immense risk for the economy, partly because the real estate sector constitutes about 30% of the GDP in China.

Interest rate cuts?

It's a trend: expectations for interest rate cuts being pushed further into the future, at least in the case of the Fed. It certainly makes sense given the robustness of the US economy and inflation trends. According to the CPI price index, inflation climbed to 3.2% in February. This upturn was largely driven by higher oil and petrol prices, which have a relatively big impact on inflation in the US. Core inflation, excluding volatile food and energy prices, fell from 3.9% in January to 3.8% in February. The PCE index, the Fed's favourite, displayed a similar picture. Headline inflation was up slightly to 2.5%, while core inflation declined marginally to 2.8%. All these inflation rates confirm that the rapid downturn in inflation in the second half of last year has stalled. We believe this is mainly due to the strong resilience the economy is displaying. It raises the question of whether the Fed should cut interest rates at all. At the last policy interest rate meeting most Fed policymakers were still assuming three cuts to interest rates this year. Markets are already starting to doubt this though. An initial interest cut in June is now viewed as increasingly unlikely as well. And why would the Fed cut rates? The economy is holding up well, inflation is stubborn and sentiment on the equity markets is optimistic. We believe the deciding factor will ultimately be a slowdown in the economy and job market. Yet as long as there are no clear signs of this happening, interest rates will remain high for longer. In early April, US 10-year bond yields reached their highest level since the end of November last year.

Interest rate expectations for the ECB are changing less radically. The markets still view an initial cut to rates in June as more or less certain and up to the end of the year they anticipate close to four further cuts. The Eurozone's economy lacks the robustness visible in the US economy. Moreover, according to initial estimates in March inflation fell to 2.4% and core inflation to 2.9%. This means that inflation is slightly lower than expected. Incidentally, the monthly upturn in core inflation has been marginally higher than the long-term average in the past few months. Yet that doesn't necessarily need to be a problem for the ECB as the long-term average for core inflation is well below the ECB's target rate of 2%. The ECB is more likely to welcome a little bit more inflation rather than regard it a risk. For now though, the ECB mainly wants to see lower wage growth before cutting interest rates and there are already signs of this. The upturn in wages covered by collective labour agreements in the Eurozone decreased to 4.5% in the fourth quarter from a peak of 4.7% a quarter earlier. The increase in unit labour costs was also smaller. This means there are few reasons to adjust expectations for ECB policy. German 10-year bond yields have risen by less than their US counterparts so far this year. In our investment policy we have gradually moved towards a neutral position in Eurozone government bonds in recent months. Our overweight in Eurozone investment grade credits means we hold an overweight overall in investment grade bonds. This reflects our outlook that bond yields have already peaked. We nevertheless believe it's too soon to commit further to structural interest rate cuts.

US 10-year bond yields climb higher

Source: Refinitiv, Van Lanschot Kempen

In a historic decision, the Bank of Japan (BoJ) has raised its policy interest rate from -0.1% to a range of 0 to 0.1%. It was the first interest rate hike in Japan since February 2007. This brought an end to the period of negative policy interest rates that started in February 2016. The BoJ also announced an end to its policy of maximising 10-year bond yields. The maximum permitted by the BoJ had already been raised several times but yields have now been given free rein. The BoJ has stopped buying equities but will continue to buy government bonds (depending on market conditions). However historic the decision may be, it didn't come as a surprise. At headline inflation of 2.1% and core inflation of 3.5%, Japan seems to have left the years of deflation behind it. Especially after annual negotiations resulted in wage increases of over 5%. The BoJ decided this was enough to tighten Japan's extremely expansionary monetary policy. It doesn't mean there will now be a series of interest rate hikes in Japan though. The BoJ said it didn't foresee any further adjustments for the time being. As markets had already anticipated these adjustments, they responded calmly to the decision.

Japanese central bank raises interest rates for first time since 2007

Source: Refinitiv, Van Lanschot Kempen

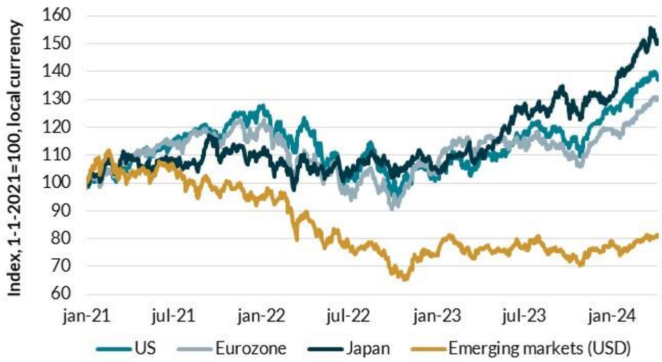
Profit-taking on Japanese equities

Although equities appear to be marginally more affected by the idea that interest rates could stay high for longer than originally thought, the upward trend persists. Earnings expectations are being adjusted upwards in Japan in particular, generating positive momentum in these earnings expectations.[1] In the US, revisions to earnings have improved from overwhelmingly negative to neutral. This tells us something about the breadth of the earnings revisions, which is moderate. The fact that earnings expectations continue to rise points to larger companies in particular revising their earnings upwards. Companies such as Nvidia, Amazon and Meta account for a significant weight thanks to their size and exceedingly strong earnings momentum. In the Eurozone we're mostly seeing downward adjustments to earnings. Yet larger companies are helping here too; earnings momentum is fluctuating at around zero. The picture is weaker in the UK, with downward revisions to earnings and negative momentum on balance. The situation in emerging markets is similar to that in Europe.

Despite the variations in earnings expectations, equity markets climbed further. These price gains are mainly based on expectations that economic growth and earnings will improve. The upshot is that a large portion of the price gains derive from higher valuations. We have our doubts about the bright outlook we believe equity markets are predicting. The extremely positive sentiment also merits some caution in our opinion and we've retained our neutral equity position for this reason.

We've decided to take profit on our overweight in Japanese equities. In fundamental terms, the situation doesn't look at all bad in Japan. The country is experiencing growth and inflation, generating strong earnings dynamics. Despite interest rates recently having been raised, monetary policy remains extremely expansionary. The Japanese equity market has risen more sharply than the US or European markets this year, and as a result the positive fundamentals have already been largely priced in. We now view Japanese equity valuations as more neutral.

Strong performance by Japanese equities



Source: Refinitiv, Van Lanschot Kempen

[1] We define earnings momentum as the change in earnings expectations in the past three months converted into an annual basis.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2023
Global (MSCI AC)	1049	0.8%	8.3%	6.4%
Developed markets (MSCI World)	3386	0.7%	8.7%	6.9%
Emerging markets (MSCI EM)	1049	1.8%	4.4%	2.4%
United States (S&P500)	5147	0.3%	9.8%	7.9%
Eurozone (EURO STOXX 50)	519	3.5%	10.5%	9.5%
United Kingdom (FTSE 100)	7976	4.4%	3.3%	3.1%
Japan (Topix)	2732	1.0%	14.8%	15.5%
Netherlands (AEX)	884	3.2%	13.3%	12.4%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	4.30	9	31	44
Japan	0.77	6	15	14
Germany	2.36	-4	25	33
France	2.86	-1	22	30
Italy	3.72	-11	-7	0
Netherlands	2.62	-5	21	30
United Kingdom	4.02	-10	30	49

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	92	-8	-17	-12
Eurozone	109	-11	-34	-26

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	324	-2	-45	-10
Eurozone	356	12	-48	-39
Emerging markets (USD)	337	-28	-67	-47
Emerging markets (Local currency)	201	2	-31	-35

Real estate

		Past month	Past 3 months	From 31-12-2023
Global		-1.5%	-3.0%	-5.0%
North-America		-4.2%	-3.9%	-5.2%
Europe		4.5%	-3.7%	-5.8%

Commodities

		Past month	Past 3 months	From 31-12-2023
Bloomberg index		4.7%	4.0%	3.7%
Base metals		6.9%	6.9%	3.7%
Brent oil (USD per barrel)	89.23	7.2%	16.3%	14.9%
Gold (USD per troy ounce)	2292	8.4%	12.1%	11.0%

Returns in local currency
bp = basis point (0.01%)
Data as of 4 April 2024
Source: Refinitiv

Tactical outlook

Asset class	
Equities	**Neutral**
March was another positive month for equities. While all the major regions noted upturns, these were generally less pronounced than in February. 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 our regional equity allocation we've decided to close our overweight in Japan. The economic cycle, earnings dynamics and monetary policy are still positive but we believe equities have largely priced these in already. The Japanese central bank may well intervene to stop the yen from weakening further. A reversal in the yen's trend (i.e. if it appreciates) forms a risk for Japanese equities.	
Government bonds	**Overweight**
US 2-year and 10-year bond yields remained more or less unchanged in March. However, at the start of April 10-year yields climbed to 4.4%, their highest level since the end of November 2023. Both these yields declined slightly in Germany. UK yields fell by marginally more than they did in Germany. 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 though. 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 hold a small overweight in US government bonds but this is due to the underweight in US investment grade credits. Via a number of gradual steps, we've moved to a neutral position in Eurozone government bonds. This reflects our view that yields have already peaked. We nevertheless believe it's too soon to commit further to lower interest rates in the Eurozone.	
Investment grade credits	**Underweight**
Despite the already tight spreads on investment grade credits, these contracted slightly further in March. The downturns were again small, 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 in the US and moderate growth in the Eurozone. 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 30 basis points below the average for the past five years, Eurozone spreads nearly 20 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 high yield credits tightened in March, while their Eurozone counterparts widened slightly. 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 312 basis points in the US at the end of March, in the Eurozone at 352 basis points. This is considerably lower than the average of the past five years for both regions. We view a rising default rate as a downward risk. 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.	
Emerging market debt	**Neutral**
Emerging market debt listed in US dollars earned a positive return in March. Spreads tightened more sharply than the downturn in underlying US bond yields. Government bonds listed in local currency were again trading more or less flat. The interest compensation increased slightly but this was offset by the coupon and appreciation of emerging market currencies. Our neutral opinion on emerging market debt listed in US dollars derives from the attractive interest compensation, relatively wide spreads versus other asset classes and imminent interest rate cuts by the Fed in the US. The risks relating to the outlook for global growth have receded but, in our view, the tighter spreads have also already priced this in. 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.	

Asset class	
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. Rates of inflation caused disappointment when they were higher than expected at the start of this year. Job market data remained solid in the US and Europe as well. Yet central bankers stressed in March that cuts to interest rates were expected to follow later this year. The prospect of interest rate cuts, with three to four anticipated in the US and Eurozone in 2024, gave listed real estate a boost and led to positive returns in March, especially in Europe. 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**
Oil prices rose by about 3% on balance in March. The Bloomberg general commodity index climbed too as metal and gold prices were up as well. The upturn in the gold price stood out in particular at 7.1%. 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 across the board. The limited fiscal stimuli in China, which are leading to moderate growth in investment in infrastructure and homes, are restricting the potential for higher prices in metals. Persisting economic growth in the US and the OPEC countries and Russia limiting supplies pushed up the oil price. The oil market is expected to tighten somewhat. However, oil-producing countries have sufficient capacity to increase production in the event of a sharp upturn in the oil price. 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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