VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

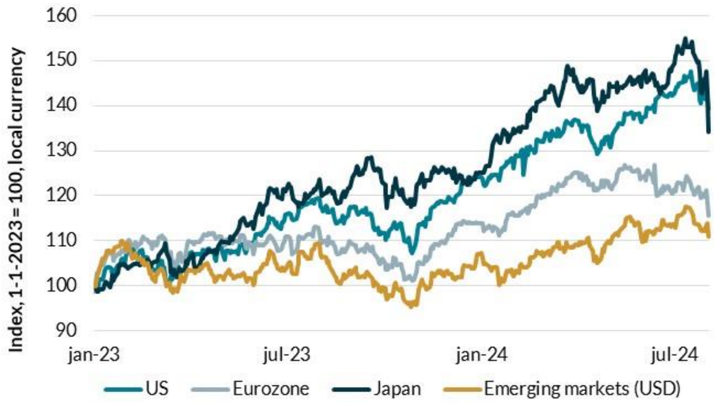
Asset Allocation Outlook

August 2024

- Economic data worse than expected
- Recession fears hit financial markets in early August
- Investment policy unchanged

In the first half of July, it was as if nothing could go wrong for the equity markets and the upward trend continued. The turning point came in the middle of the month, especially in the US. Investors shunned big tech equities and suddenly showed a preference for small-cap equities. This was still a positive broadening of the equity rally, but worse-than-expected economic data towards the end of the month caused investors to take fright, causing equities to fall across a broad front. This was all against a background of a sharp downturn in bond yields.

Equity markets take fright at worse-than-expected macro-economic data



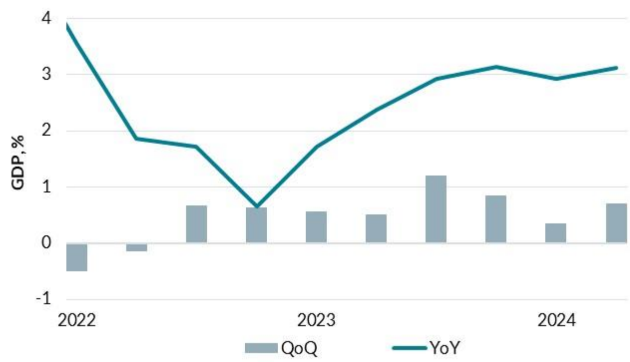
Source: Refinitiv, Van Lanschot Kempen

We've kept our investment policy unchanged. In the US, recent data confirmed our picture of a growing economy that is slowly losing momentum. US economic growth was slightly higher than the long-term trend in the second quarter. The slowdown in the economy is visible in several leading indicators and recent job market data, but the service sector is in fact growing. This also gives the Fed the opportunity to cut interest rates in September. The Eurozone's leading indicators were discouraging, but growth was robust in the second quarter. The outlook for growth continues to be moderate here and we're mainly relying on a boost from consumer spending. Earnings trends are generally positive in our view, and this is the reason for our overweight in equities.

US growth again better than expected

It's a pattern that we've seen for several quarters in a row now: a US economy that's growing more quickly than expected. This time it was the growth data over the second quarter of this year.

Sound economic growth in the US in second quarter



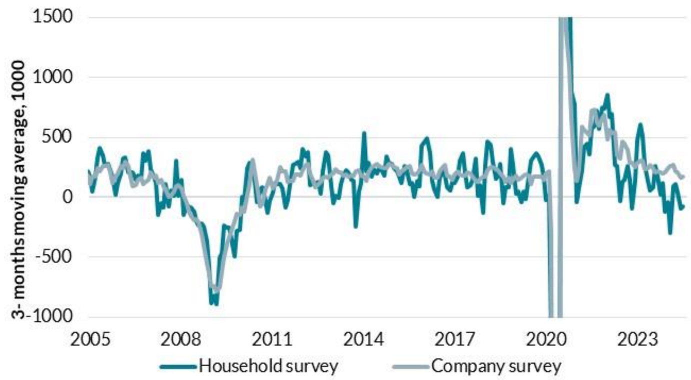
Source: Refinitiv, Van Lanschot Kempen

This growth had originally been estimated to be 0.4% versus the first quarter but was later revised upwards to 0.7%. While this might not seem like that big a difference, it does mean that the US economy is growing more quickly than the potential in the longer term and not more slowly, as had previously been thought. And this could lead to the job market remaining more robust, inflation coming down more slowly and the Fed cutting interest rates later and by less. Concerns about US consumers proved to be especially premature in the second quarter. Consumer spending growth in fact accelerated versus the first quarter. This growth looks set to continue in the third quarter as well.

As we all know, past growth provides no guarantee for the future. Consumer spending grew twice as fast as disposable incomes in the second quarter. Consumers again reduced their savings rate to keep their spending at the same level. This is of course not sustainable. There's therefore still reason to assume that consumer spending growth will fall further in the US, incidentally without consumers necessarily throwing in the towel. Nominal income growth is still too strong for that to happen. The further downturn in inflation creates the prospect of real income growth. Moreover, most households are in a sound financial position.

This dual perspective also applies to the job market. Fewer unfilled vacancies and fewer employees voluntarily resigning from their jobs point to a slowing job market. Job growth slowed significantly in July and unemployment climbed further.

US job growth slowing



Source: Refinitiv, Van Lanschot Kempen

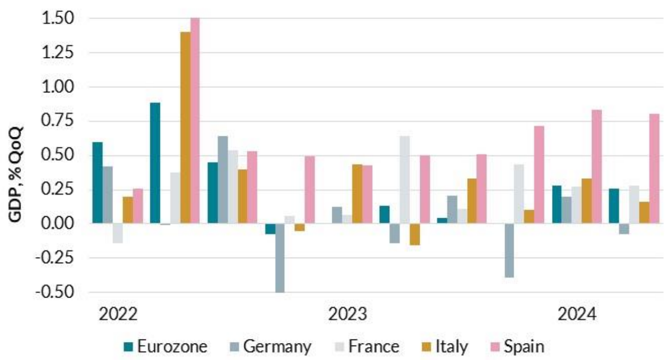
The extent to which unemployment has increased in recent months has in the past pointed to an imminent recession. This could also be the case this time if consumers lose confidence. In that sense, the latest data on consumer confidence aren't encouraging. Yet the upturn in unemployment derives on this occasion mainly from the growing number of jobs rather than a reduction in demand for labour. The number of redundancies hasn't risen sharply. New jobless claims are increasing slightly but remain at relatively low levels. The July data on job growth may have been distorted by the hurricane that passed over Texas. The precise impact on job growth data is still unknown, but we saw a relatively sharp upturn in the number of employees unable to work because of the poor weather and the number of people in temporary unemployment likewise rose. In short, the job market is slowing but so far it looks as if it's more a case of reverting to a more balanced situation than a fundamental deterioration.

Leading indicators sketch a mixed picture. In July, the purchasing manager index (PMI) for industry dropped back below 50, which points to a recession, for the first time since December last year. The PMI for the service sector in fact climbed to its highest level since March 2022. The ISM index for industry confirmed the gloomy picture and investment appetite among businesses also remains low. However, the ISM index for the service sector is likewise more positive. All in all, the US economy continues to be somewhat uncertain.

Eurozone growth also better than expected

Following growth of 0.3% in the first quarter of this year versus the last quarter of 2023, we said that this growth couldn't necessarily be projected onto subsequent quarters. Yet the Eurozone economy again grew by 0.3% in the second quarter. The details of this growth are still unknown. We do know though that the Germany economy contracted marginally, and France noted the same rate of growth as the whole Eurozone. Italy's growth was slightly lower than that, while Spain again experienced robust growth.

Eurozone economic growth better than expected in second quarter



Source: Refinitiv, Van Lanschot Kempen

Yet that was about the only positive news in the Eurozone. The PMI for industry remained unchanged at a low level in July. The upturn in the service sector index is now partially over. The Economic Sentiment Index, Germany's Ifo index and France's INSEE index all declined slightly, causing these indicators to signal a loss in economic momentum. Like last month, growing consumer confidence is a source of optimism. And banks are slightly less reluctant to grant loans and seeing demand for loans increase. Those green shoots we saw earlier are nevertheless struggling to reach full maturity.

Asia loses momentum

In previous outlooks we've pointed to the upturn in industry in emerging markets, especially in Asia. Yet momentum seems to be declining somewhat here as well. The PMI for industry fell in a whole series of countries, including Japan, China, Korea, Taiwan and Indonesia. The index is still pointing to growth in emerging markets but has taken a step backwards.

PMIs for industry in Asia take a step back

Source: Refinitiv, Van Lanschot Kempen

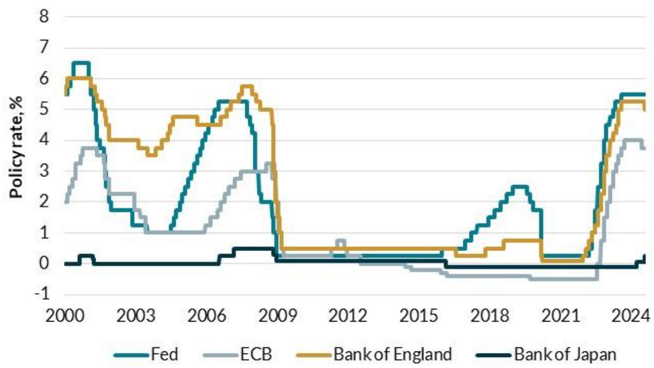
In China, the economy is struggling to maintain momentum given the low growth in investment, industrial production, retail sales and lending. Two important political meetings were held in the past month. At the first, the authorities continued to stress the supply side of the economy, with the emphasis on growth in technologically advanced sectors. However, there's already overcapacity here and China is increasingly finding it hard to generate growth mostly via exports. The emphasis during the second meeting was more on measures to stimulate consumer spending. It remains to be seen how far the authorities are willing to go in this and whether it will have the desired effect considering the low level of consumer confidence.

BoJ raises rates, BoE cuts them

It wasn't totally unexpected but the hike in interest rates by the Bank of Japan (BoJ) still came as something of a surprise. After putting an end to many years of negative policy interest rates in March, the BoJ raised rates by 20 basis points to 0.25% at the end of July. The BoJ decided that the interaction between rising prices and wages had gone far enough. The broadening of wage increases to smaller businesses was a particular reason for the BoJ to raise interest rates. And if everything plays out in line with the BoJ's projections, rates will be raised further. Higher interest rates in Japan will potentially mostly affect the Japanese yen. The expansionary monetary policy in Japan while interest rates were being raised in the US and Europe had caused the yen to depreciate to its lowest level since the mid-1980s. This depreciation now looks to have come to a halt. Since 10 July, the yen has appreciated from 161.67 yen per US dollar to 149.44. And this in turn has repercussions for Japanese equities, which often move in the opposite direction to the yen because of Japan's sizeable export sector. The TOPIX equity index has dropped by nearly 25% since 11 July.

In contrast, and as anticipated, the Bank of England (BoE) cut its interest rates. Declining inflation created capacity for the BoE to bring rates down. Headline inflation stood at 2% in June. Yet with core inflation still at 3.5%, the BoE said it wouldn't yet be cutting rates too quickly or by too much. There was only a tiny majority in the policy committee in favour of this interest rate cut.

Fed expected to act soon



Source: Refinitiv, Van Lanschot Kempen

The Fed and ECB kept their interest rates unchanged in July. The ECB faces stubborn inflation in the service sector. This fell marginally in July but remains high at 4.0%. Headline inflation in fact climbed slightly to 2.6%, while core inflation was unchanged at 2.9%. Yet having cut rates in June, we believe the ECB will reduce them further this year. There are signs that wage growth is declining. This is positive for inflation in the labour-intensive service sector. Furthermore, the Eurozone's growth is fragile.

US economic growth doesn't need to be a reason for the Fed to cut interest rates as it's still sound. Lower inflation does present an opportunity to do so, however. And the slowing job market could also form a reason for the Fed. This is mostly because the Fed is desperately seeking a soft landing, i.e. a gradual slowdown of the economy and downturn in inflation without inflicting too much damage on the job market. This has been going well, but the recent job market data show that the Fed shouldn't wait for too much longer. A cut to interest rates in September is therefore likely. It's possible that the Fed will also reduce rates in November and December but a pause in November is also an option. Central banks cutting interest rates could help shore up the equity markets though.

Jittery financial markets

Equities noted gains in July but only modest ones. July was also a month of two halves. Equity markets continued their upward march in the first half of the month, but this was followed by corrections in the second half. This pessimism continued into early August. The correction to the S&P500 was close to 6%. In the process, substantial rotations occurred in the equity markets. The big US tech companies were the main losers. Across July, the Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla) fell by 5%, while their losses amounted to nearly 13% in early August. Other equities performed better. The S&P500 Equal Weight equity index, in which all the companies hold an equal weight in the index and big tech companies are consequently less dominant, climbed by 4.4% in July and restricted its losses to 2.8% in early August. Defensive sectors, such as consumer staples, healthcare and utilities, in fact succeeded in noting gains in the US and Europe.

There are two underlying issues on the equity markets here. Firstly, there was a shift away from the big tech companies that have performed so well this year towards smaller companies. Small caps noted gains of 7.6% in the US and 3.0% in the Eurozone in July, both substantially more than large caps. Lower inflation, the prospect of cuts to interest rates and sound economic growth data over the second quarter tempted investors away from the tech equities viewed as safe this year towards riskier small caps. The underlying trends were positive here as this translated into a broadening of the equity rally. Yet following the publication of weak job market data and worse-than-expected leading indicators, small caps also declined. It's worth remembering that this turbulence is taking place at a time of year when there's often little trading on equity markets. This tends to amplify market movements.

All this took place against a background of declining bond yields. Across July as a whole, short and long-term bond yields in the US fell by about 30 basis points to over 40 basis points, their German and British counterparts by slightly less. Bond yields continued their sharp downward trend at the start of August. The financial markets were clearly worried about a recession. When this happens, cuts to interest rates are unable to protect equity markets from downturns.

Substantial downturns in bond yields point to recession fears

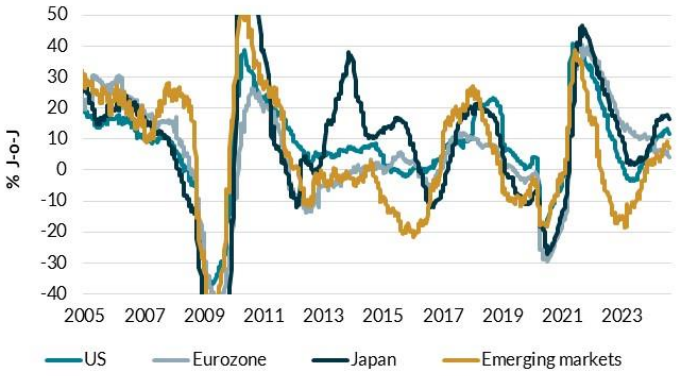
Source: Refinitiv, Van Lanschot Kempen

We're now also in the middle of the earnings season in which businesses report their earnings over the second quarter. In the US, two-thirds of the companies in the S&P500 have already presented their results. Even though this isn't helping equities right now, the results are sound. Of those companies that have reported results, 80% have succeeded in exceeding expectations. So far, earnings are up by 12% versus the second quarter of last year, which is 5 percentage points better than expected. The sectors that stand out in a positive sense are healthcare, communications and IT. The biggest downturn in earnings of 9% can be found in the basic industry sector. Some of the results at a couple of the big tech companies were also slightly worse than expected and this contributed to the negative performance of these companies. One positive aspect is that most companies have adjusted their earnings forecasts upwards. Results are still weak in Europe, although an improvement is visible versus previous quarters. In Europe, two-thirds of the companies in the STOXX 600 index have likewise reported earnings, with 60% exceeding earnings expectations. Reported earnings growth stands at 1%, marginally better than the small downturn in earnings that had been anticipated.

Investment policy unchanged

Financial markets are being affected by recession fears, which are in turn being expressed in declining bond yields, downward equity markets and wider spreads on credits. We acknowledge the risk of a slowdown in growth. The combination of worse-than-expected economic data in general and leading indicators and US job market data in particular is negative for the outlook. We've nevertheless decided not to change our investment policy and retain our overweight in equities. A single weaker job market report in the US doesn't immediately point to a recession. Job growth was weak in the US in April, and this was followed by better data. We're seeing less weakness in the US service sector and European consumers are being given slightly more breathing space thanks to the lower inflation. We also view corporate earnings as a boost for equities.

Positive earnings growth



Source: Refinitiv, Van Lanschot Kempen

Last month we said we saw little capacity for bond yields to come down, especially at the long end of the curve. Long-term yields had already priced in lower inflation and cuts to interest rates by central banks in our view. In this respect, we think the substantial downturn in yields in July and especially at the start of August could well be an overreaction. Markets are now pricing in four cuts to interest rates in the US before the end of the year. As there are only three policy meetings left this year, this would mean the Fed would need to cut rates by 50 basis points at least once. We think this is unlikely. We hold an underweight in bonds. US investment grade credits are particular unattractive in our opinion as we believe the tight spreads offer insufficient reward for the higher risk versus government bonds. Spreads only need to widen slightly for the asset class to underperform versus government bonds. Within US investment grade bonds, we prefer government bonds. However, when it comes to global investment grade government bonds, we prefer the Eurozone. Yields there have dropped by slightly less than in the US and spreads on investment grade credits aren't as tight as they are in the US.

We're cautious about high yield credits as these companies are more aggressively financed and therefore affected more by higher interest rates that gradually work their way into interest charges when credits are refinanced. Emerging market debt generates an attractive return, but this is mostly to be found in the weaker countries and little risk premium has so far been priced in for the turbulence surrounding the US elections in November and any further slowdown in growth. This is the reason for our neutral position.

For real estate, we continue to view the uncertainty surrounding interest rates and potential downgrades to property valuations as too high to build a position in this asset class. As for commodities, our doubts mainly relate to the robustness of the Chinese economy.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2023
Global (MSCI AC)	1061	-2.4%	3.5%	8.3%
Developed markets (MSCI World)	3449	-2.5%	3.8%	8.8%
Emerging markets (MSCI EM)	1061	-1.7%	0.8%	3.7%
United States (S&P500)	5347	-2.9%	5.6%	12.1%
Eurozone (EURO STOXX 50)	481	-4.5%	-4.9%	1.4%
United Kingdom (FTSE 100)	8175	0.7%	0.0%	5.7%
Japan (Topix)	2538	-11.2%	-7.0%	7.2%
Netherlands (AEX)	879	-4.9%	0.0%	11.7%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	3.80	-64	-78	-7
Japan	0.93	-18	3	31
Germany	2.16	-45	-39	13
France	2.96	-37	-9	40
Italy	3.64	-44	-24	-8
Netherlands	2.48	-44	-37	16
United Kingdom	3.83	-42	-46	29

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	106	13	16	2
Eurozone	118	8	6	-17

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	372	49	56	38
Eurozone	379	39	28	-16
Emerging markets (USD)	421	23	42	37
Emerging markets (Local currency)	266	43	65	31

Real estate

		Past month	Past 3 months	From 31-12-2023
Global		6.0%	7.0%	0.0%
North-America		7.3%	12.2%	3.7%
Europe		4.6%	4.0%	-0.9%

Commodities

		Past month	Past 3 months	From 31-12-2023
Bloomberg index		-6.4%	-6.1%	-4.0%
Base metals		-8.4%	-10.8%	-3.1%
Brent oil (USD per barrel)	76.92	-11.6%	-8.1%	-1.0%
Gold (USD per troy ounce)	2414	3.7%	4.9%	16.9%

Returns in local currency
bp = basis point (0.01%)
Data as of 2 August 2024
Source: Refinitiv

Tactical outlook

Asset class	
Equities	**Overweight**

The MSCI global equity index climbed slightly in July but noted losses in the second half of the month and especially in the early days of August. The biggest losses were in Japan, where the yen appreciated after the central bank raised interest rates. The US, Eurozone and emerging markets all noted similar losses to each other. The UK was the exception thanks to the defensive nature of the FTSE100 index. The outlook for the economic cycle remains crucial for equities. As long as the US economy continues on the path towards a soft landing and earnings continue to grow, we don't think US equities will enter into a long-term downward trend. We're seeing moderate economic growth in Europe, but the ECB could cut interest rates further this year, while earnings expectations are realistic and valuations reasonable. Expected earnings per share for the coming twelve months are being adjusted upwards in both the US and Europe, which could boost equity prices. The corporate results reported over the second quarter are sound in the US and slightly improved in Europe. It should be noted though that the number of analysts adjusting earnings downwards is growing, which is something that requires monitoring. We hold a neutral position in Pacific and emerging markets. In Pacific we recently took profit on an overweight in Japan and harbour doubts about Hong Kong. We don't consider the growth, momentum and revisions to earnings in emerging markets to be robust enough for us to hold an overweight in these.

Government bonds	**Overweight**

US 2-year bond yields dropped sharply by 46 basis points in July, while their counterparts fell by 42 basis points in the UK and 29 basis points in Germany. Ten-year bond yields decreased by 32 basis points in the US, 21 basis points in the UK and 19 basis points in Germany. This meant that yield curves in all three countries became marginally less negative (i.e. less inverted). The downturn continued in early August, leading to yields noting their lowest levels of recent months or in some cases even this year. Interest rate markets were clearly affected by recession fears, which resulted in them pricing in more interest rate cuts by central banks. We had previously seen little capacity for yields to come down as the negative yield curve meant that lower inflation and a less tight monetary policy had already been priced in. The risk of worse-than-expected growth has increased recently but we believe interest rate markets may have gone too far in their pessimism. We therefore can't rule out higher yields in the short term, but in the longer term we don't anticipate a structural upturn in market interest rates in light of the lower inflation and interest rate cuts by central banks.

Investment grade credits	**Underweight**

Spreads on US investment grade credits remained virtually unchanged in July, while they tightened by 7 basis points in the Eurozone. The turmoil on the financial markets in early August was visible in the US, where spreads widened by 10 basis points, while it cancelled out July's tighter spreads on European investment grade credits. This has done nothing to alter our opinion that the tight spreads are at odds with economic indicators that in many cases are pointing to declining growth momentum 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 20 basis points below the average for the past five years, Eurozone spreads 13 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**

The picture for high yield credits has been similar to that of investment grade credits in the past month, with limited movements in spreads in July in the shape of a widening by 7 basis points in the US and 8 basis points in the Eurozone, followed by a stronger increase in early August. Spreads widened by 54 basis points in the US and in the Eurozone by 31 basis points. Nevertheless, spreads in the US and Eurozone are still well below the average for the past five years and far below the average normal for a sharp downturn in growth or a recession. 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. However, even if the economy continues to grow over the coming quarters, we still view the spreads as small. This is because companies will face higher interest charges. Moreover, US consumers have now spent their (surplus) savings. And the fact that default rates on their credit card and car loans are rising fast is a bad sign. Furthermore, we know that if the solid sentiment on this market deteriorates, the liquidity of these bonds will quickly dry up and spreads will widen.

Asset class	
Emerging market debt	**Neutral**
US bond yields declined in July but spreads on emerging market debt widened. As the downturn was bigger than the increase, yields on emerging market debt listed in US dollars likewise fell. Yields also came down on bonds listed in local currency. On balance, both asset classes generated positive returns. The downturn in US bond yields was bigger than the increase in spreads in the early days of August too. Emerging market debt therefore held up well. We find the interest compensation on emerging market debt issued in US dollars attractive and spreads are relatively wide versus other asset classes. Stubborn inflation in the service sector and high interest rates in developed countries pose risks but we expect the Fed to be able to cut interest rates this year as inflation is coming down in the US. Emerging market debt listed in local currency could profit from the lower inflation and cuts to interest rates in emerging markets, although the process of lower inflation and cuts to interest rates has stalled somewhat in recent weeks. The interest compensation is relatively low versus developed countries, which reduces the relative attractiveness.	
Listed real estate	**Neutral**
Listed real estate was given a boost by the lower bond yields in July. The global index was up by nearly 6%, with the US experiencing a stronger upturn than Europe. It was initially only real estate in Japan that declined at the start of August, but the turmoil on the financial markets eventually spread to the other real estate regions as well. 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're concerned about the sustainability of the recent downturn in yields and similarly worried 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**
Worse-than-expected economic growth data squeezed commodity prices in July. Oil and metal prices both fell and continued to do so at the start of August. The defensive nature of gold enabled it to avoid the same fate. Oil markets are tight and stocks low, but the knowledge that the OPEC countries have sufficient production capacity and are being sensible about this restricts the upward potential for oil prices. The downturn in metal prices is remarkable. It tells us something about the speculative nature of previous price increases for some metals but also about the doubts that investors have about the global economy. Uncertainty about the Chinese economy particularly plays a role here. The gold price remains high. The high gold price is primarily the result of expansionary monetary policies and the large amount of liquidity these have 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.	

Joost van Leenders
Senior investment strategist
j.vanleenders@vanlanschotkempen.com
M +31 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 – Senior investment strategist
Mees Vlasveld – Investment strategist

VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

Beethovenstraat 300
1077 WZ Amsterdam
Postbus 75666
1070 AR Amsterdam

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