VAN LANSCHOT KEMPEN

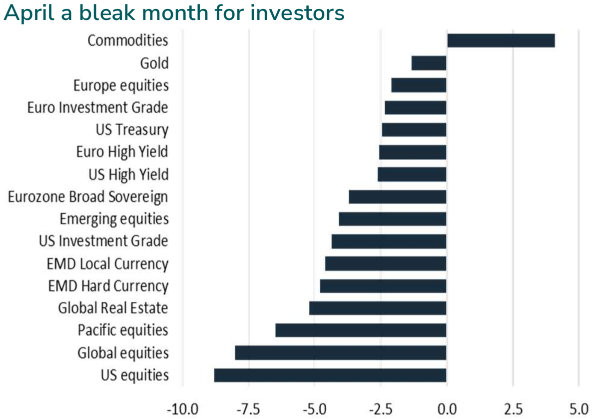
Asset Allocation Outlook

MAY 2022

- Growth slows around the world, consumers under pressure from high inflation
- Reining in inflation a priority for central banks
- Sound earnings growth in first quarter
- Investment policy: allocation to investment grade credits reduced to neutral

April was a bleak month for investors. The only place to hide from the negative sentiment was commodities, for which the Bloomberg index noted a positive return of 4.1%[1].

April a bleak month for investors



Source: Bloomberg, Van Lanschot Kempen

This was partly thanks to the higher oil prices but also the result of the upturn in the price of agricultural products. The MSCI global equity index fell by 8.1%, making April the worst month since the outbreak of the coronavirus pandemic more than two years ago. The turbulence on the equity markets was largely caused by interest rate fears. At a performance of -8.8%, US equities dropped by substantially more than their European counterparts (-2.1%). Higher bond yields and widening spreads meant that bonds didn't offer protection either. Losses ranged from 2.3% on European investment grade credits and US government bonds to nearly 5% for emerging market debt. The global real estate index shared in the general malaise and was down by 5.2%.

We don't yet view these lower prices as opportune moments to buy, given our belief that the concerns about inflation and growth are justified. We therefore retain our neutral position in equities. We have reduced our overweight in European investment grade credits to neutral in favour of European government bonds. While we continue to hold a significant underweight in government bonds, we also recognise that bond yields have risen fast.

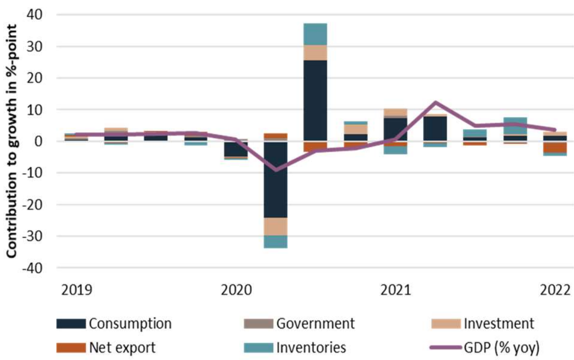
Slowdown in growth

Economic growth is being squeezed by rising interest rates but especially by the higher inflation. In the first quarter the US economy contracted by 0.4% versus the fourth quarter of 2021, although that figure was fairly distorted. A negative stock level effect and a sharply negative effect from foreign trade (fewer exports and more imports) had a severe downward impact on growth data. A plus of 1.7% was noted QoQ (quarter-on-quarter) in the fourth quarter. The data were better in underlying terms,

[1] Price changes and returns in local currency

however. At 0.7% QoQ consumer spending grew a fraction faster than in the fourth quarter, while corporate investment noted robust growth of 2.2%. Even investment in residential properties, which is sensitive to higher interest rates and struggling with shortages, succeeded in reporting a small plus of 0.5%.

One-off effects cause US economy to contract



Source: Refinitiv, Van Lanschot Kempen

That negative growth therefore currently looks to be mostly down to one-off factors, but we believe that US growth will be moderate in the short term. We're already seeing the impact of the higher interest rates in interest rate-sensitive segments such as the automotive and residential property sectors. Moreover, car sales are sensitive to consumer confidence and that's not particularly high right now. And of course US consumers are also facing high inflation. While gross family incomes did rise by 1.3% QoQ in the first quarter thanks to higher wages and growing employment, when adjusted for inflation disposable income was down by 0.5%. It was the fourth consecutive quarter in which real disposable income fell. US consumers are known for spending money easily and savings (which increased enormously during the coronavirus pandemic) are now being used to keep up spending patterns. Yet with a savings quota that has fallen to its lowest level since 2013 and waning confidence, we wonder how long this will continue.

In the first quarter, the Eurozone economy grew by 0.2% QoQ, marginally slower than in the final quarter of last year. Economic activity was unchanged in France, while the Italian economy contracted by 0.2%. The 0.2% growth noted in Germany was an improvement versus the contraction of the final quarter of last year and also slightly better than expected. This meant that the country avoided a technical recession (two consecutive contracting quarters). Spain's 0.3% growth was a bit lower than expected, however. The details of the growth have generally not yet been published but it's clear that European consumers are also feeling the pinch. Consumer confidence plummeted in March and only recovered a small amount in April. In the UK, consumer confidence dropped to a level just above the low reached during the 2008 financial crisis. In the Netherlands, consumers have never been as gloomy as they were in April. As to the Eurozone, the volume of retail sales (i.e. adjusted for price effects) was 0.7% lower in the first two months of this year than in the final quarter of last year.

So, not much in the way of good news from consumers. Luckily, consumers are being supported by trends on the job market. Unemployment has fallen to record lows in the US and Europe. Large numbers of new jobs are being created and demand for labour is consequently high. This can also be seen from the high number of vacancies. A tight job market is in itself unable to prevent a recession. In fact, job markets are always tightest just prior to a recession. Nevertheless, the current tightness means that job markets look able to take a knock.

Sentiment is declining among businesses but is nowhere near as bad as among consumers. Purchasing manager indices are pointing to contraction in only a handful of countries; on the contrary, in most countries they're pointing to robust growth. It's encouraging that the index for the service sector in the Eurozone climbed in April. The reopening after the coronavirus pandemic continues to generate a tailwind. This could also boost the tourist season in Southern European countries in particular. Yet the downturn in the US ISM manufacturing index and European Economic Sentiment Index does confirm the idea that economies are slowing.

The Chinese economy is going through an extremely tough patch. The problems on the housing market, simply caused by too much loan capital being used to build too many homes, are visible in the sharp downturn in house sales and construction activity, while stocks of unsold properties are rising. In March, prices of existing homes were slightly lower than they were back in March 2021, but it looks as if this is only the start of a period of lower prices. The weak housing market has repercussions for consumers, who on top of everything else are also facing exceedingly strict lockdowns in a large number of cities due to the coronavirus flaring up again. Despite the mildness of the Omicron variant, the Chinese government is stubbornly sticking to its zero tolerance policy. Retail sales were down by 3.5% YoY in March and consumer confidence dropped to its lowest level since June 2020. Unlike other countries, in China this negative sentiment has spread to industry. In April purchasing manager indices for industry decreased to an average of 46.7 (there are two indices in China). Any level below 50 points to a slowdown in growth.

Purchasing managers in China extremely gloomy

Source: Bloomberg, Van Lanschot Kempen

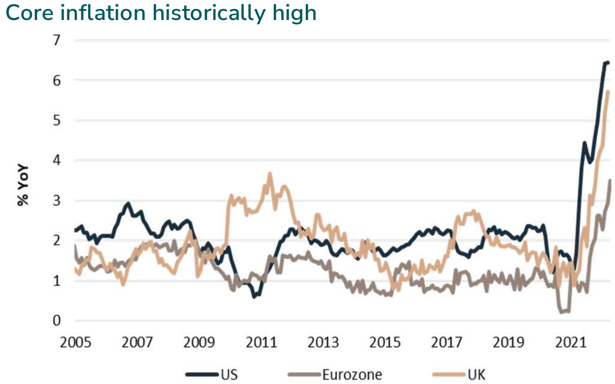
For the service sector, the average stands at the very low level of 39.1. Any slowdown in growth in China immediately prompts observers to look to the government. Although the central bank has implemented a few stimulus measures, it has so far been fairly sparing about injecting liquidity. The government has no wish to increase the size of the debt mountain too much. Fiscal stimulation is more generous but is partly just compensation for the loss of income from land sales for local authorities. In short, we can't expect China to lead the way just yet. Europe and Japan are slightly more sensitive to a slowdown in growth in China than the US is.

All in all, we are marginally more worried about the economic outlook. Growth will be low in the second quarter. The situation could improve rapidly if inflation starts to fall, which is possible but far from certain. The lack of major financial imbalances, such as overinvestment by businesses or excessive levels of debt among families or businesses, could also lead to a rapid improvement.

Central banks heading for the exit

In the meantime, things are not yet going well in terms of inflation. Inflation in the US climbed to 8.6% in March. Core inflation (adjusted for volatile food and energy prices) remained unchanged at 6.4%. A small glimmer of hope was that the monthly core inflation was half that of the preceding five months. In the Eurozone, inflation set a new record of 7.5% and core inflation jumped to 3.5%. The UK registered levels of 7.0% and 5.7% respectively. The higher core inflation in the UK and US points to more stubborn inflation, although the recent jump in the Eurozone is also worrying.

Core inflation historically high



Source: Refinitiv, Van Lanschot Kempen

Yet inflation is close to peaking. Inflation started to rise seriously in April of last year and we're therefore now starting to see comparisons with the higher prices of a year ago. The reopening and a tentative improvement in supply chain problems could ease the upward pressure on goods prices. Not that any of this will stop central banks rapidly tapering their extremely expansionary monetary policies. Core inflation in particular is too high for that to happen.

The Fed is being fairly open about its policies for the coming months. Interest rates were raised by 0.5 percentage points and Fed Chair Powell indicated that similar hikes could be expected in June and July as well. In addition, the Fed will start to reduce its balance sheet from June. For the first few months this will be by 47.5 billion US dollars per month, rising to 95 billion US dollars per month. This is much quicker than in the period 2018-2019, when its balance sheet reduction didn't exceed 50 billion US dollars per month. Although this was more or less in line with expectations, the response from markets was exuberant. Ten-year bond yields initially came down by 10 basis points, four of which stayed off at the end of the day. The S&P500 stood 3% higher at the end of the day. The relief largely derived from Powell's statement that hikes of 0.75 percentage points were not discussed during the policy meeting. It had never been very likely. The last time the Fed raised rates by that much was in November 1994. The relief on the equity markets only lasted one day, however. For the remainder of the year interest rate increases totalling about 2 percentage points are anticipated. This pace of interest rate hikes as well as the balance sheet reduction mean that the Fed is quickly moving towards a neutral monetary policy. No surprise then that bond yields climbed sharply in the US. Long-term yields have recently risen more steeply than their short-term counterparts and the slope of the yield curve has reverted to positive. Last month we wrote about the fact that a negative yield curve is a reliable indicator of a recession. It's clear that this indicator hasn't been triggered. The negative slope didn't last long enough for that. Incidentally, this doesn't mean that a recession is out of the question. The Fed needs to tighten its monetary policy enough to rein in inflation, without pushing the economy into a recession. In most cases, the Fed isn't entirely able to achieve a soft landing. A recession is usually necessary to quash inflation. There is a slightly greater chance of a soft landing though if there are no major imbalances in the economy, especially if families and businesses don't hold finance deficits. And, as it happens, that's exactly the situation we're in at the moment. A positive outcome is therefore possible, although the Fed has its work cut out.

The ECB faces much more of a balancing act, especially now that core inflation is climbing fast. The economy already seems to be slowing more quickly than in the US, so this also increases the risk of interest rate hikes triggering a recession. Yet interest rates are expected to be raised in the Eurozone as well, by nearly 0.9 percentage points up to the end of this year. This means that three increments of 0.25 percentage points have now been completely priced in, as well as the probability of slightly more. This is possible, given that the ECB is accelerating tapering of its bond-buying programmes. The ECB's policy interest rate would then revert to being positive for the first time since July 2012. Yet perhaps interest rate markets are being slightly too aggressive here. If growth drops further and inflation peaks in the coming months, there will be less need for a rapid series of interest rate increases.

Expectations high for the ECB

Source: Bloomberg, Van Lanschot Kempen

The Bank of England had already raised interest rates in December, February and March. On the last two occasions by 0.25%. The fourth interest rate hike followed in May, again by 0.25 percentage points. The BoE's policy interest rate now stands at 1%. Of the eight members on the policy committee, five voted for this increase and three for raising rates by 0.5 percentage points, Nevertheless, the BoE sounded marginally less aggressive than before. Growth projections were adjusted downwards, as were inflation forecasts over the slightly longer term. Moreover, the bank was a bit more cautious about further interest rate increases and will only take a decision on selling government bonds after August. The BoE is expected to implement a further five interest rate hikes of 0.25% this year. Like the ECB, the BoE is juggling the tricky combination of low growth and high inflation.

The high inflation and changing expectations in relation to central banks have pushed bond yields higher. In the US, 10-year bond yields climbed by 0.6 percentage points in April and broke through the 3% barrier at the start of May. In Germany, the upturn of 0.4 percentage points in April and slightly more at the start of May means that bond yields have now surpassed 1%. One remarkable difference between the US and Germany is that inflation forecasts have risen much more quickly in the latter in recent weeks. Historically, inflation forecasts in Germany are 0.5 to

1% lower than in the US, but now they're a fraction higher in Germany. This means that the higher bond yields in Germany are being driven more by inflation forecasts, while real interest rates have remained low. The US has seen a rise in real interest rates and this is having a greater impact on the economy.

Expetcted interest rates climb in the US

Source: Bloomberg, Van Lanschot Kempen

Sound earnings growth in the first quarter

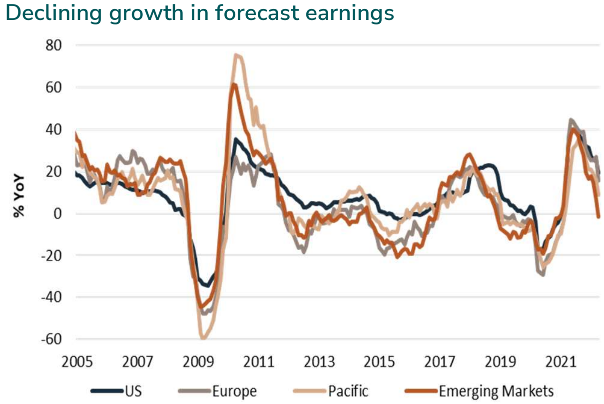
The earnings season, during which companies report their results over the first quarter of 2022, is well underway. In the US, more than half the companies in the S&P500 index have already published their results, while in Europe about a fifth of the companies in the STOXX 600 have done so. As so often, the results are exceeding expectations. This chiefly applies to the breadth of the better-than-expected results. In both the US and Europe, over 80% of companies have reported higher-than-expected earnings and over 70% higher revenues. The percentages are slightly lower in the US than they have been in previous quarters but still high when offset against a longer period. Never before have so many companies in Europe caused positive surprises.

There are therefore plenty of businesses that are succeeding in causing positive surprises but the extent to which that is happening in the US is not that high. So far, reported earnings are 4% above expectations. Expectations weren't particularly high in the US anyway. The earnings that have already been reported are almost 8% higher than those of the first quarter last year. It should be noted, however, that earnings are being boosted substantially by the robust growth in the energy sector.

In Europe, earnings have so far been a respectable 10.6% above expectations, although here too expectations were low. Those already published are nearly 10% up on the first quarter of 2021. The energy sector is contributing enormously in Europe as well. At aggregate level, earnings in the financial services, technology and utilities sectors in Europe are in fact lower than last year.

First-quarter earnings therefore remain sound but expectations are becoming less positive. Analysts have spent the last couple of weeks adjusting earnings forecasts downwards for the next twelve months for the US, Europe and Japan. This has been happening since November for emerging markets. The level of those expected earnings was lower in April than in March in Europe, Pacific and emerging markets but not in the US. On an annual basis, growth in forecast earnings is declining in all regions.

Declining growth in forecast earnings



Source: Factset, Van Lanschot Kempen

This means that earnings are providing less of a tailwind for equity markets, raising the question of how movements on the equity markets compare to earnings trends. In the US, we're seeing that the S&P500 is falling in line with the number of downward adjustments to earnings forecasts by analysts, but the change in expected earnings over twelve months is much more pronounced. It therefore looks as if the market has gone slightly too far, which can be attributed to interest rate fears. The recent upturn in real interest rates in the US is having a negative impact on US equity valuations. Equities are moving reasonably in line with earnings trends in Europe, Pacific and emerging markets.

Investment policy: not a climate for taking excessive risk

The fact that equities have dropped considerably already this year begs the question of whether enough has already been priced in and whether it's an opportune time to increase equity positions. We don't believe we've reached that stage yet. The downturns and lower valuations are a reason for us to maintain our neutral position though and not to move to an underweight. Yet a slowing global economy, the squeeze on earnings growth, high inflation, rapid action from central banks and rising interest rates are also stopping us from adopting an overweight.

We have in fact slightly reduced the risk exposure in our investment policy. Our overweight in investment grade credits has been brought back to neutral. We have increased our allocation to European government bonds. This makes this adjustment insensitive to changes to government bond yields. It relates to changes to credit spreads. We believe that investment grade credits are becoming riskier due to the declining economic growth. A combination of low growth and high inflation is negative. On top of this, the ECB is to stop buying up credits. And the higher yields on government bonds mean that they will again be more attractive as an alternative to credits. Credit spreads have widened by about 0.5 percentage points this year, but a level of 1.5% remains low given the risks. As a result of the higher government bond yields, spreads only have to widen slightly for returns on credits to lag behind.

We have bought more government bonds but retain a substantial underweight. This reflects our outlook that capital market yields are still low in fundamental terms and therefore have the capacity to climb further. Yet yields have risen considerably in the past period. The government bonds we hold in the portfolio have a shorter duration than the average on the market, making our position less sensitive to interest rate changes.

Our position in commodities is our only remaining overweight. Prices have been volatile since the start of the war in Ukraine, but the trend continues to be slightly upward. Metals have recently fallen, reflecting concerns about growth in China in particular. Yet oil prices and agricultural products have climbed further. The lower growth could push down demand for commodities but stock levels are low in general and the geopolitical situation increases the probability of shortages. In addition, investors in this asset class are profiting from the fact that futures prices continue to be lower than spot prices, which is contributing to return.

Market review

Aandelen				
	Index	Afgelopen maand	Afgelopen 3 maanden	Vanaf 31-12-2021
Wereldwijd (MSCI AC)	1069	-7.9%	-8.4%	-13.1%
Geïndustrialiseerde landen (MSCI World)	2810	-8.1%	-8.0%	-13.1%
Opkomende markten (MSCI EM)	1069	-6.7%	-11.7%	-13.2%
Verenigde Staten (S&P500)	4175	-8.1%	-6.7%	-12.4%
Eurozone (EURO STOXX 50)	3761	-4.0%	-9.2%	-12.5%
Verenigd Koninkrijk (FTSE 100)	7561	0.3%	0.4%	2.4%
Japan (Topix)	1898	-2.4%	-1.1%	-4.7%
Nederland (AEX)	706	-3.0%	-5.7%	-11.5%
Staatsobligaties (10-jaar)				
	Rente (%)	Afgelopen maand (bp)	Afgelopen 3 maanden (bp)	Vanaf 31-12-2021 (bp)
Verenigde Staten	2.97	59	114	146
Japan	0.23	1	6	16
Duitsland	0.97	41	82	114
Frankrijk	1.48	46	90	129
Italië	2.72	-2	112	167
Nederland	1.26	44	97	129
Verenigd Koninkrijk	1.96	35	59	99
Bedrijfsobligaties				
	Risico-opslag (bp)	Afgelopen maand (bp)	Afgelopen 3 maanden (bp)	Vanaf 31-12-2021 (bp)
Verenigde Staten	136	21	30	44
Eurozone	153	23	47	58
Hoogrentende obligaties				
	Risico-opslag (bp)	Afgelopen maand (bp)	Afgelopen 3 maanden (bp)	Vanaf 31-12-2021 (bp)
Verenigde Staten	384	64	51	101
Eurozone	460	67	113	142
Opkomende markten (USD)	445	45	67	77
Opkomende markten (Lokale valuta)	211	-23	-95	-130
Vastgoed				
		Afgelopen maand	Afgelopen 3 maanden	Vanaf 31-12-2021
Wereld		-2.9%	2.7%	-3.3%
Noord-Amerika		-3.7%	4.3%	-3.5%
Europa		-9.7%	-11.3%	-14.0%
Grondstoffen				
		Afgelopen maand	Afgelopen 3 maanden	Vanaf 31-12-2021
Bloomberg index		3.9%	17.8%	29.9%
Basismetalen		-11.3%	0.0%	4.4%
Brent olie (USD per vat)	104.97	2.1%	20.2%	38.4%
Goud (USD per troy ounce)	1871	-2.8%	3.7%	2.3%

Returns in local currency
bp = basis point (0.01%)
Data as of 4 May 2022
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Neutral**

March's equity rally proved to be of short duration. Equities suffered heavy losses in April. Earlier this year it was mostly the war in Ukraine that had caused turbulence. There is still no prospect of a solution and although sanctions against Russia won't be eased for the time being the situation seems to be having slightly less impact on the equity markets. Concerns now derive from a more negative mix of low growth and high inflation. In China and Europe primarily low growth, paired with declining earnings growth, in the US mainly higher inflation and higher interest rates. So much negative news could argue in favour of an underweight position, but equity markets have already priced in a significant amount of negative news. Moreover, equity markets are being bolstered by the robust job markets, the healthy financial positions of families, banks and businesses and governments that are mitigating the negative impact of the high energy prices slightly. Equity valuations have improved. Equities from Europe, Pacific and emerging markets are valued at neutral to slightly cheap. Only US equities remain fairly expensive. We currently hold no regional preference.

Government bonds	Negative

Capital yield markets have almost reached 3% in the US and close to 1% in Germany. Sharply higher inflation and central banks shifting towards less accommodating monetary policies have pushed capital market yields higher. Compared to inflation, yields remain extremely low, but inflation is expected to fall. This will be the case even in the event of high but stable energy prices. The US central bank has placed its cards on the table: a series of interest rate hikes and later this year a reduction to the balance sheet. Markets are assuming interest rates will rise by a further 2 percentage points this year. The ECB has so far not announced anything beyond tapering its bond-buying programme. It needs to steer between high inflation and a greater negative impact on growth from the war in Ukraine than in the US. Yet there are growing signs that the ECB will raise interest rates this year as well, possibly as early as the summer. Markets have priced in 0.9 percentage points in interest rate increases this year. This would bring the ECB's policy interest rates above zero for the first time since 2012. We believe that US monetary policy has also already largely been priced in to current bond yields. In the Eurozone, the market's expectations for raising interest rates next year look to be rather ambitious. This has eased the upward pressure on capital market yields, although the principal risk continues to be worse-than-expected (higher) inflation.

Investment grade credits	Neutral

Spreads on investment grade credits widened in April, by 19 basis points in the US and 22 basis points in Europe. As underlying yields on government bonds also increased, in the US by 55 basis points and in Germany by 30 basis points, credits noted a negative return of 5.5% in the US and 2.7% in the Eurozone. We view declining growth, high inflation and less support from central banks as risks for investment grade credits. Furthermore, investors don't need to engage in a lengthy search for yield now that yields on government bonds are again positive. The higher government bond yields mean that spreads only have to widen slightly for returns on credits to lag behind. We have adjusted our outlook from positive to neutral.

High yield credits	Neutral

Spreads on high yields credits widened in April, just as they did in the investment grade class. Combined with the general upturn in yields, this resulted in a loss of 3.6% in the US and 3.1% in the Eurozone. As in investment grade, we view declining growth, high inflation and less support from central banks as risks for this asset class as well. In fact this asset class is slightly more vulnerable to these risks. These are offset by wider spreads and the fact that businesses in this asset class have financed themselves over longer periods than before. This restricts the risk associated with refinancing when interest rates climb.

Listed real estate	Neutral

As had happened in March, in April the global index for listed real estate again outperformed its global equity counterpart. Yet even that wasn't enough to avoid a loss of 5.2% for real estate. There was little discernible difference between the regions in April. We think that real estate is expensive from a historical perspective but also versus fixed income asset classes with a similar credit status. There is no overvaluation compared to the underlying value of the real estate, which shows that it's mostly the properties themselves that are expensive. Real estate is an asset class that often comes under the spotlight at times of high inflation. Yet rising interest rates are an obstacle here, hence our neutral outlook.

Emerging market debt	Neutral

Yields on emerging market debt listed in US dollars climbed by more than 90 basis points in April, fairly evenly spread across an upturn in US yields and a widening of spreads. Yields were up by over 50 basis points in local currency. A yield of about 7% on both bonds listed in US dollars and those listed in local currency is attractive in itself. All the more so because the economies in these countries have improved in a number of respects over the past few years and their central banks are implementing monetary policy in a sensible manner. They haven't hesitated to raise interest rates when the rising inflation gives them reason to do so. However, emerging market debt is vulnerable to a more expensive US dollar and higher interest rates in the US. The slowing Chinese economy, which is causing a drop in activity in emerging markets, also poses a risk. Moreover, in emerging markets there is a greater risk of higher inflation caused by rising food prices. We therefore hold a neutral outlook.

Commodities	Positive
The general commodity index continued its upward march in April, this time climbing by 4.1%. While Brent oil stayed at the same level, US standard WTI was up by 5.0%. Despite the volatility of the past few months, an upward trend remains visible in oil prices. Declining global economic growth is negative for oil prices. Yet shortages, partly caused by the possibility of Western sanctions against Russian oil, are sustaining the political risk premium. This doesn't apply to metals. A slowdown in the global economy in general – and in China in particular – is having significant impact here, leading the index for this sub-asset class to drop by 6.8% in April. Gold also lost ground. Higher real interest rates in the US were the reason for this. Prices of agricultural products have increased by more than 25% since the start of the year and in April by 4.5%. Tightness on certain markets, geopolitical tensions and sanctions as well as high inflation are advantages for this asset class that outweigh the disadvantage of lower growth. The current tightness has led to spot prices being higher than futures prices in many markets. We call this situation backwardation. As investment in commodities is nearly always via futures, backwardation generates a positive return for investors. Over time cheaper futures roll over towards the higher spot prices. The extent to which this is now happening is almost unprecedented and generating sharply positive returns. We retain our positive outlook for this asset class.	

JOOST VAN LEENDERS
Senior investment strategist
joost.vanleenders@kempen.nl
+31 (0)6 8283 1189

VAN LANSCHOT KEMPEN ASSET RESEARCH & COMMUNICATION:

Yaela van Raalte – Head ARC
Michel Iglesias del Sol – Head investment strategy
Luc Aben – Chief economist Van Lanschot
Robert de Groot – Head investment research and communications
Maarten van der Pas – Head editorial desk
Alastair Greenlees – Head investment strategy UK
Arif Saad – Head investment strategy UK
Duco Smit – Senior investment strategist
Jorn Veeneman – Investment strategist
Mees Vlasveld – Investment strategist
Jack Horvest – Investment specialist
Ellen Engelhart – Bond specialist
Bob Stroeken – Equity specialist
Tim Verhagen – Equity specialist
Effi Bialkowski – Investment fund specialist
Bas Kooman – Investment writer

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