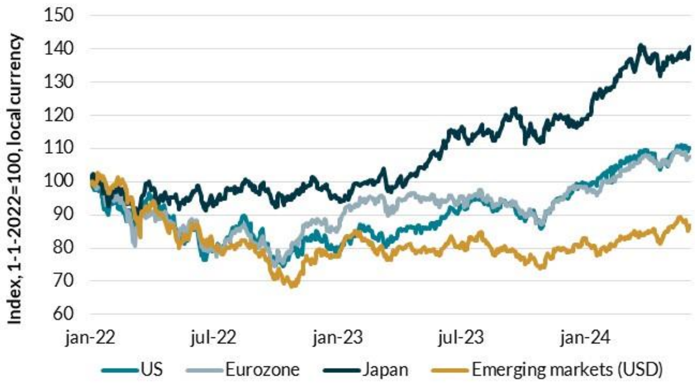
Asset Allocation Outlook

June 2024

- Divergence between US and Eurozone
- High service sector inflation doesn't stop ECB cutting interest rates
- Overweight in equities, larger underweight in US investment grade credits

Equities and bond yields moving in opposite directions is an increasingly common sight on the financial markets. May was no exception, in the US at least. Two-year and 10-year bond yields fell in response to inflation data that for once didn't disappoint and signs of a slowing economy, while equities noted gains. Equity prices climbed by slightly less in Europe but yields rose by a small amount there too. Spreads widened marginally on US high yield credits but tightened on US and European investment grade credits and European high yield credits. The fact that spreads that are already tight in historical terms contracted further is an indication of the optimism on the financial markets. A downward oil price, even after the OPEC countries announced an extension to production cuts, boosted the positive sentiment.

Equities recovering from interest and growth fears



Source: Refinitiv, Van Lanschot Kempen

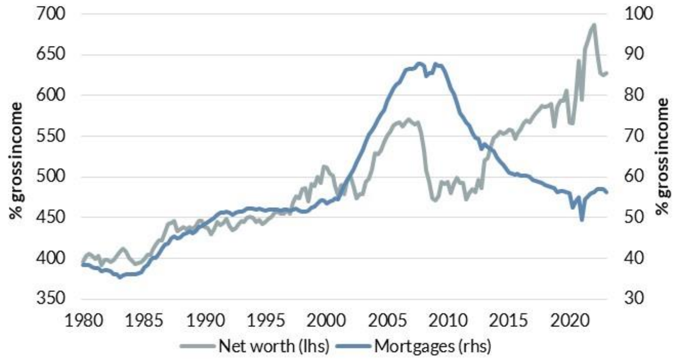
The upturn in equity prices over the past few months had caused our equity allocation to exceed a neutral position. We've reinforced this drift by increasing our allocation to equities and in doing so creating an equity overweight. We've opted for European equities because of what we consider to be reasonable valuations. Furthermore, the economy is picking up slightly, the ECB is cutting interest rates and earnings forecasts are displaying an upward trend. We've sold US investment grade credits as we believe the tight spreads on these bonds offer insufficient reward for the higher risk compared to government bonds.

US growth adjusted downwards

Financial markets wouldn't normally bother with revised data on growth during a quarter that ended a while ago. Yet they did react to the revised US growth data over the first quarter in which growth was adjusted downwards. Consumer spending in particular turned out to have grown less quickly than previously estimated. This pushed down equity prices.

It's logical that US consumers will be finding it slightly harder to make ends meet in light of the slowing job market, lower wage growth, inflation that remained high in the first quarter and a savings rate that has dropped to an all-time low. The strong growth in credit card loans and rising default rates on these are an indication that a growing portion of households is struggling financially. On average, however, the financial position of families is comfortable.

Financial position of US households comfortable *on average*



Source: Refinitiv, Van Lanschot Kempen

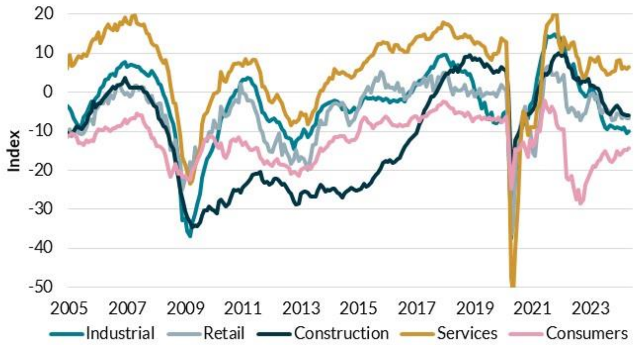
Household debt, which primarily consists of mortgages with long fixed-rate periods, versus income has plummeted since the financial crisis in 2008 and 2009. The wealth of families has in fact increased. This wealth is of course unequally distributed across income groups but still provides a buffer against a cooling job market. All in all, consumer spending growth is declining, which will keep growth low in the short term.

The leading indicators display a slightly more mixed picture. The purchasing manager index (PMI) for industry climbed slightly in May, pointing to moderate growth in this sector. The upturn in the index for the service sector was remarkably large. This leapt to its highest level since May 2023. The ISM index for industry was down though, with the index for new orders dropping especially far. One positive aspect is that price pressure is easing slightly according to businesses. The ISM index for the service sector in turn reaffirmed the positive picture of the PMI for that sector. Growth data over the first quarter also showed that corporate results were marginally lower. However, these are still high versus GDP. This ought to be positive for corporate investment growth but the downturn in the ISM index and moderate growth in orders for capital goods in fact suggest caution at businesses. We continue to assume a slowdown in US growth in the summer.

Overall improvement in the Eurozone

Not all indicators in the Eurozone are emitting the same signals either. The Economic Sentiment Index climbed a bit in May but has been fluctuating at a level that points to moderate growth since the end of last year. The service sector contrasts positively with industry, construction and retail. Consumer confidence is nevertheless in an upward trend.

Optimism in Eurozone service sector, consumers less pessimistic



Source: Refinitiv, Van Lanschot Kempen

The PMIs are emitting more positive signals. The index for the service sector remained at the same higher level it had reached in April, while a further improvement was visible in industry. In Germany, the upturn in expectations in the Ifo index was encouraging. Unemployment fell to a record low of 6.4% in the Eurozone in April. Wage increases were still high in the first quarter, in part because of temporary effects, which creates breathing space for consumers in the Eurozone. And in contrast to the US, households in the Eurozone have continued to put aside savings. We don't think this will provide as much of a boost to consumer spending as in the US but it certainly creates room for growth.

Industry picking up around the globe

We've already mentioned the PMIs for industry in the US and Eurozone, but these improvements are visible in other regions as well. The indices climbed to levels that point to growth in a series of Asian economies, including Japan, China, Korea and Taiwan.

Industrial sector picking up in Asia

Source: Refinitiv, Van Lanschot Kempen

Improvements can likewise be seen in industrial production and exports. Time will tell how strongly these persist given the slowdown in growth in the US, but an upward cycle in the technology sector and a positive stock cycle are boosting the industrial sector. A strengthening industrial sector is also positive for the Eurozone.

China is relying heavily on the industrial sector and exports for growth at the moment. We noted in a previous outlook that we view this as a risk in light of the growing trade tensions between China on the one hand and the US and Europe on the other.

Capacity for cutting interest rates?

The general expectation is that central banks will start cutting interest rates but what's less clear is when and how quickly this will happen. In the US, the rate of inflation in April was in line with forecasts according to both the CPI index and PCE index, the Fed's preferred index. This was a relief after worse-than-expected rates in preceding months. This doesn't alter the fact that according to the PCE index headline inflation has stalled at 2.7% and core inflation at 2.8%. However, it looks as if the rate of inflation has been slightly overestimated in the first quarter as a result of seasonal adjustments and also that there are a few categories in which inflation seems to be temporarily high. May brought confirmation of this view. Headline CPI inflation fell to 3.3% and core inflation to 3.4%. Especially the monthly changes, 0.01% for headline and 0.16% for core (the lowest monthly gain since August 2021), were encouraging. We believe that a slowing economy and job market will push inflation down further. In the wake of the downward adjustment to growth data in the US, expectations for cuts to interest rates by the Fed have again increased marginally. The markets are now anticipating an initial cut in September or November and inclining towards a second cut in December.

Markets forecasting a couple of interest rate cuts by the Fed

Source: Refinitiv, Van Lanschot Kempen

Fed policymakers recently speculated about raising interest rates, but we think there's only a small risk of the US economy overheating and of higher interest rates. We in fact believe the Fed could cut interest rates slightly more quickly than is generally expected. The Fed left rates unchanged in June, despite forecasting that inflation will stay elevated throughout this year, reasonably strong growth and low unemployment. However, Fed-chair Powell dismissed the inflation forecasts as driven by base effects, conservative and low conviction. He saw moderate further progress in inflation falling towards the Fed's 2% goal but lacked confidence to cut rates at this point. Although the median policymaker now sees only one rate cut this year, we think a continuation of favourable inflation data have the potential to lead te Fed to more cuts.

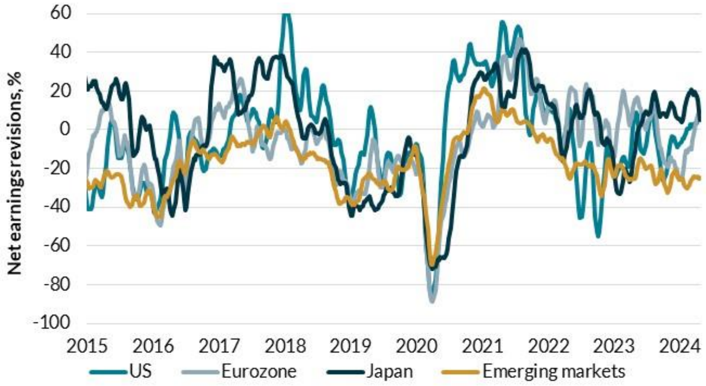
The rate of inflation in the Eurozone was marginally higher than expected in May. Headline inflation rose slightly to 2.6% and core inflation to 2.9%. What really stood out was service sector inflation of 4.1%. This didn't stop the ECB cutting interest rates in early June though. This cut had been signalled so clearly in advance that the central bank was unable to change course. In contrast with the Fed, ECB-president Lagarde leant heavily on the ECB projections for lower inflation to justify the cut. However, the ECB will probably introduce a pause in July following the recent publication of wage and inflation data. In a tight job market, the main question is whether wage growth and in turn service sector inflation can come down enough to cut policy interest rates further. We believe this is possible. There are signs that the strong wage growth in the Eurozone is mostly a reaction to earlier price increases. Given the tight job market, we foresee sound wage growth and improvements in labour productivity, which will lead to lower inflation. In our opinion, the strong wage growth triggered by supply-driven inflation will ease.

The Bank of England isn't expected to make interest rate cuts until later in the year. This might be in September but is more likely in November and December. The UK economy grew unexpectedly sharply in the first quarter at 0.6% versus the fourth quarter of last year. However, the PMI for the service sector was down considerably in May, retail sales were weak in April and the job market is cooling. Importantly for the Bank of England though, the rate of inflation fell to 2.3% in April, its lowest level since July 2021. Core inflation still stands at 3.9%, but a downward trend has been visible here as well for the past eighteen months. It became clear in early May that the Bank of England was heading towards interest rate cuts when two policymakers voted in favour of reducing rates. The other seven policymakers voted in favour of leaving rates unchanged.

Towards an equity overweight

Equities have performed strongly in recent months. This resulted in the equity weight in our portfolios growing versus other asset classes. We've reinforced this drift by increasing the allocation to equities and in doing so creating an equity overweight. We're acquiring European equities. Green shoots have been visible in the European economy for some time now. The continent is gradually recovering from the negative shocks of the coronavirus pandemic and the war in Ukraine and associated inflation and energy shocks. Inflation coming down gives the ECB room to cut interest rates. Low growth and downward inflation could make it hard for companies to maintain margins at the same level and increase their earnings, but earnings expectations for European equities are moderate at about 4% for 2024. The improved economic outlook is causing earnings expectations to be adjusted upwards, which could further boost equity prices.

Improvement in revisions to US and Eurozone earnings expectations



Source: Refinitiv, Van Lanschot Kempen

Finally, European equity valuations are reasonable. The upward drift has resulted in a small overweight in US equities as well. The slowing US economy, higher earnings expectations and higher valuations pose risks, but we've decided to retain our positioning. For the time being, most signs are pointing to a soft landing. It's possible that earnings won't meet expectations but, as long as they continue to grow, we don't anticipate a long-term downturn in US equity prices. Although US equities are expensive, the optimism surrounding artificial intelligence has the potential to drive valuations higher.

We're financing the acquisition of European equities by selling US investment grade credits. In doing so we're increasing our underweight in the latter asset class. For some time now we've found spreads too tight for the additional 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. We think there's a bigger chance of yields coming down there and spreads on investment grade credits aren't as tight as they are in the US. We're more cautious about high yield credits as these companies are more aggressively financed and therefore affected more by higher interest rates. Emerging market debt generates an attractive return but the strong US dollar and turbulence this is causing on the currency markets in emerging markets show that there are risks. 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)	1073	2.7%	4.0%	9.6%
Developed markets (MSCI World)	3490	2.9%	4.0%	10.1%
Emerging markets (MSCI EM)	1073	0.6%	4.4%	4.8%
United States (S&P500)	5353	3.3%	4.9%	12.2%
Eurozone (EURO STOXX 50)	523	2.1%	4.1%	10.3%
United Kingdom (FTSE 100)	8285	0.9%	7.9%	7.1%
Japan (Topix)	2757	1.1%	1.0%	16.5%
Netherlands (AEX)	923	3.6%	7.7%	17.4%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	4.29	-20	18	42
Japan	0.96	6	24	33
Germany	2.54	7	21	51
France	3.04	6	26	48
Italy	3.86	6	20	15
Netherlands	2.84	6	24	52
United Kingdom	4.18	-5	19	64

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	92	4	-9	-12
Eurozone	107	-4	-14	-28

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	320	17	-7	-14
Eurozone	318	-37	-31	-77
Emerging markets (USD)	392	19	24	8
Emerging markets (Local currency)	228	26	23	-7

Real estate

		Past month	Past 3 months	From 31-12-2023
Global		1.3%	-0.3%	-4.3%
North-America		2.6%	-2.4%	-4.2%
Europe		3.3%	10.1%	-0.5%

Commodities

		Past month	Past 3 months	From 31-12-2023
Bloomberg index		0.9%	5.7%	4.9%
Base metals		0.5%	14.5%	11.3%
Brent oil (USD per barrel)	79.71	-4.5%	-5.2%	2.6%
Gold (USD per troy ounce)	2370	2.0%	10.5%	14.8%

Returns in local currency
bp = basis point (0.01%)
Data as of 7 June 2024
Source: Refinitiv

Tactical outlook

Asset class	
Equities	**Overweight**
Equities climbed in May against a background of falling bond yields in the US. The momentum was mainly in the first half of the month. In the second half, equities moved sideways to slightly downwards due to concerns about growth and inflation. While we acknowledge the concerns about growth and inflation in the US, especially given the ambitious earnings forecasts and high valuations, we nevertheless accept the slight overweight in the portfolio that has arisen because equities have outperformed other asset classes. As long as the 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 increasing our position in Europe, where we can see the economy picking up, the ECB cutting interest rates, earnings expectations are realistic and valuations reasonable. Earnings expectations are being adjusted upwards in both the US and Europe, which could boost equity prices. 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 bond yields declined on balance in May. Two-year yields came down by 17 basis points and their 10-year counterparts by 19 basis points. With inflation in line with forecasts, there was little change to the expectations for monetary policy. Markets are again assuming two cuts to interest rates this year but we still think this is on the conservative side. If the economy slows further and inflation comes down slightly more, there will be room for further cuts. Market interest rates could then also come down, especially at the short end of the curve. We hold an overweight in US government bonds but this is mainly due to our underweight in US investment grade credits. Bond yields also declined in the UK, albeit to a limited extent. Markets are now inclining slightly more towards a couple of interest rate cuts by the Bank of England. In Germany, 2-year and 10-year bond yields climbed by 6 basis points. The ECB has started to cut interest rates but will be in no hurry to implement further cuts given the accelerating growth and stubborn inflation in the service sector. As 10-year bond yields are considerably lower than 2-year yields, we think yields at the long end of the curve are unlikely to come down much.	
Investment grade credits	**Underweight**
Spreads on US investment grade credits tightened again very slightly in May. A minor contraction was also visible in the Eurozone. As a result, credits from both regions succeeded in earning a positive return. 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 37 basis points below the average for the past five years, Eurozone spreads 24 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 remained more or less unchanged in May. The positive return was due to lower yields on government bonds and coupon payments. In the Eurozone, the tightening of spreads by 21 basis points contributed to the positive performance. 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**
Emerging market debt issued in US dollars earned a positive return in May, despite the US dollar falling versus the euro. Interest compensation was lower, mostly because of a downturn in the underlying US yields. Spreads were virtually unchanged. Government bonds in local currency were trading more or less flat. Interest compensation on these fell slightly, but EM currencies decreased in value somewhat versus the euro. We find the interest compensation on emerging market debt issued in US dollars attractive and spreads are relatively wide versus other asset classes, although a handful of weak countries with extremely wide spreads are inflating the average. Stubborn inflation and high interest rates in developed countries pose risks but we ultimately expect the Fed to be able to cut interest rates this year as inflation is coming down. Emerging market debt listed in local currency could profit from the lower 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**
The global index for real estate climbed in May thanks to gains in the US and Europe. Japan and emerging markets noted losses. Only in Europe were the gains large enough to cancel out the loss in May. Over 2024 so far, listed real estate has noted losses globally and in all the individual regions with the exception of Japan. 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 declined in May but price increases for gas, precious metals and metals helped the Bloomberg general commodity index to realise a small positive result. The OPEC countries and Russia announced that they would extend restrictions on production until the end of this year. Yet this made little impression on the oil price. The news that the OPEC countries would act cautiously, pro-actively and preventively and the higher quotas for the United Arab Emirates in 2025 provided reassurance for a properly functioning oil market, especially when viewed against a background of sufficient production capacity. Copper was unable to hold on to its strong upturn in price, which was no surprise given the speculative nature of the recent price increases and worse-than-expected sales of electric vehicles. Gold climbed for the third month in a row but the pace at which it's rising slowed further. The limited fiscal stimuli in China, which are leading to moderate growth in investment in infrastructure and homes, restrict the potential for upturns in metal prices. The oil market is tight, but oil-producing countries have sufficient capacity to increase production if oil prices rise sharply. 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

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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