VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

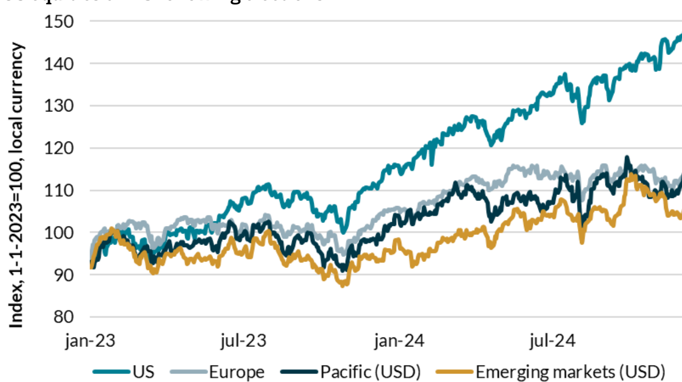
Asset Allocation Outlook

December 2024

- US equities benefit from election results
- Turmoil surrounding French budget not a systemic risk
- Equity overweight maintained

The US election results certainly left their mark on the financial markets. US equities noted the largest monthly upturn of this year in November, while emerging market equities were forced to endure a loss for the second consecutive month. Europe and Pacific succeeded in earning a small positive result. US bond yields initially climbed but were unable to maintain the higher levels. Yields were down slightly across the month overall. Bond yields also fell in the US and Germany, with Germany experiencing the biggest downturns. The difference between the US and Europe could also be seen in spreads on credits. These tightened in the US but widened marginally in Europe.

US equities climb following elections



Source: LSEG, Van Lanschot Kempen

After reducing the European equity weight to neutral last month, we've kept our investment policy unchanged this month. We view the combination of growth, declining inflation and earnings growth as positive for equities. In this respect, we think the outlook for the US is better at the moment. It's for this reason that we've concentrated our equity overweight in the US.

US equities positive following elections

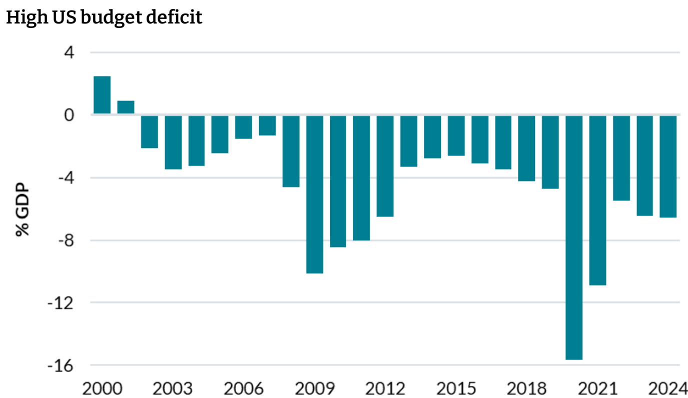
The Republican party's victory in the presidential elections and in those for the House of Representatives and Senate triggered a positive response on the US equity markets. Markets are already anticipating the positive impact of the proposals President-elect Trump made during his election campaign.

Firstly, there are the tax cuts Trump implemented in 2017. These cuts expire at the end of 2025, but Trump wants to extend them in full. Yet this would have no effect on the economy as it doesn't change the status quo. A positive market response to this policy would therefore mainly take the shape of relief that US households won't face higher taxes in 2026.

Then there's corporate tax. Trump cut this from 35% to 21% during his first term of office and apparently now wants to reduce the rate to 15%. The question is whether this proposal would make it through Congress. By international standards, a rate of 21% is already quite low. Rates stand at about 30% in Germany and Japan, in the UK and France at 25%. Ireland applies an exceptionally low rate of 13%. According to the Government Accountability Office, large, profitable businesses in the US only paid an average of 9% corporate tax in 2018. That doesn't constitute a reason to cut rates even further. The most important thing, however, is the budget deficit. A rate of about 6% is high for a well-performing economy in peacetime. The deficit would therefore rise even more, and it remains to be seen whether the fiscal hawks among the

Republicans in Congress would agree to that. Given the tiny majorities in both houses, it would only take a small number of Republicans voting against the proposal to kill off the tax cut. A tax cut in an economy that's operating close to the limits of its capacity can have an inflationary effect if it leads to higher spending, unless it's offset by cutbacks. As the proposed head of the Department of Government Efficiency, Elon Musk will have the biggest plans to slash government spending, but we need to wait and see how realistic these are.

High US budget deficit



Source: LSEG, Van Lanschot Kempen

The third point is deregulation. Even in a less well-regulated society such as the US, there will be gains to be made in this respect. The effects won't immediately be visible in growth but, as equity markets look to the future, they will anticipate these.

The import tariffs Trump wants to implement are also attracting a great deal of attention. There's talk of a general tariff of 10%, a tariff of 25% on imports from Canada and Mexico and 60% on imports from China. Import tariffs protect some US businesses against foreign competition. This is positive for profitability. Yet they also mean higher prices for other businesses and consumers, which is negative for these companies' earnings and for consumer spending. Import tariffs will be partially offset by an appreciating US dollar, which makes products and services from abroad cheaper in the US. The US dollar has appreciated 6% versus the euro since September. This cancels out more than half of any 10% import tariff. Threatening to impose tariffs can be a way of achieving other ends. However, in light of Trump's tenacity on this point, we do expect US import tariffs to be raised. A general rate of 10% is manageable in economic terms. Higher tariffs would also mean a bigger negative impact, which makes us think there's less chance of these being implemented.

Finally, there's the deportation of undocumented immigrants. In 2022, there were an estimated 11.5 million undocumented immigrants in the US. This is fewer than the 12.2 million in 2007 but more than the 10.2 million in 2019. Especially in the past few years, the high number of immigrants has stopped the job market from becoming overheated. If this labour supply is (partially) removed, this will cause shortages on the job market, mostly in sectors such as agriculture and construction. It's telling that some companies and employer organisations have expressed concerns about shortages on the job market in the event of the deportation of large numbers of people. The potential consequences are higher wages, higher inflation and in turn higher interest rates. During his first term of office, Trump succeeded in deporting over 300,000 immigrants a year. Under Obama the figure stood at more than 400,000 per year. That's a tiny fraction of the 11.5 million undocumented immigrants currently in the US. Widespread deportation is expensive, inflationary and requires the cooperation of the individual states. This casts doubt on the feasibility of the plan. Stricter controls on immigration could well lead to fewer new immigrants, a smaller new labour supply and in turn a tighter job market.

All in all, there's a huge amount of uncertainty surrounding Trump's policies. They could lead to higher growth, earnings and inflation but also contain negative aspects. The recent upturn in US equities anticipates these policies but is also driven by robust economic indicators in the US.

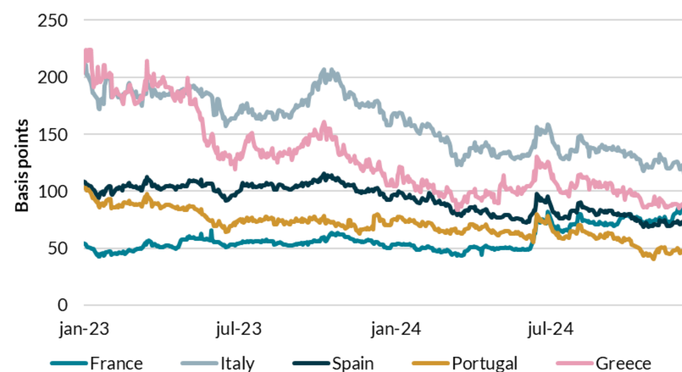
Politics on the radar

It's not just US political events that are occupying the attention of markets. The budget negotiations in France are proceeding in an extremely torturous manner. It's clear that cutbacks are needed. According to the European Commission, France's budget deficit will reach 6.2% of the country's GDP this year, the highest in the European Union. National debt has risen to 112.7%. The Commission expects a budget deficit of 5.3% for next year and a further increase in national debt. All significantly higher than the rate permitted under the European Union's budgetary rules. Prime Minister Barnier's minority government had proposed a package of measures that consisted of cutbacks and tax increases. To get the package through, Barnier attempted to pass it without parliament's approval but subsequently lost the no confidence vote. President Macron now needs to seek a new prime minister. As it had already taken several months to appoint Barnier, this completes the political chaos. Incidentally, the French government can continue to function. If the political impasse persists, the 2024 budget will apply to next year as well. There's no risk of a shutdown of the French government like the one that regularly occurs in the US.

The impact on the financial markets can mainly be seen in the spreads on French government bonds versus their

German counterparts. Until the premature parliamentary elections last June, spreads had been moving around the 50-basis point mark. After the elections, spreads widened to 80 basis points and subsequently stabilised at over 70 basis points. This week spreads increased to 90 basis points. This doesn't translate into a financial crisis though. During the crisis in the Eurozone in 2012, French government bond spreads widened to nearly 150 basis points. French spreads are currently slightly wider than Spanish spreads and comparable to those of Greece but spreads on Italian bonds, for example, are moving between 120 and 150 basis points. It's also encouraging that spreads aren't widening outside France. On the day that the Barnier government collapsed, French spreads tightened marginally, Italian spreads reached their lowest level in three years, spreads on credits tightened by a couple of basis points, European equities climbed and the euro remained virtually unchanged. The collapse of the Barnier government therefore didn't come as a surprise to markets. So far, it's an isolated problem, although one that comes at a bad time give the economic and political climate in Europe.

Widening of spreads restricted to French government bonds



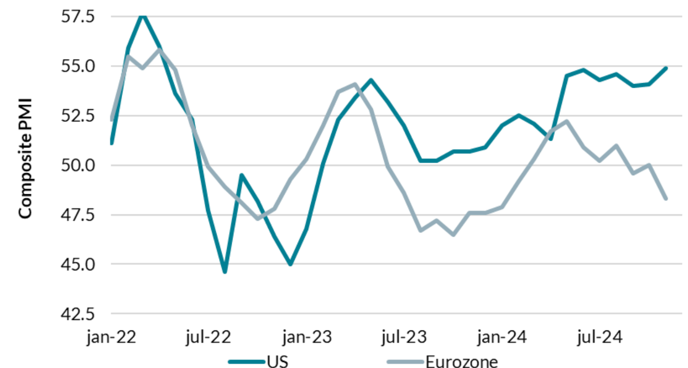
Source: LSEG, Van Lanschot Kempen

Financial markets were briefly shaken by political events in South Korea. The president unexpectedly declared martial law after warning of threats from North Korea. The Korean won and Korean equities fell but the losses were small. Markets were able to recover after parliament convened and voted against martial law. The events had little impact on markets globally.

US and European indicators diverge

The robustness of the US economy versus that of Europe was clearly demonstrated by November's purchasing manager indices (PMIs). The US indices for industry and the service sector climbed, while in Europe they fell. The US index for industry is below 50, as are the indices in the Eurozone and UK, but at a higher level. The level of 43 noted in Germany and France is particularly worrying. The difference is even more obvious in the service sector. The US index climbed to 57, its highest level since March 2022. In the UK the index dropped back to 50.8 and in the Eurozone to 49.5. The optimism seen earlier this year has now dissipated.

Divergence of leading indicators in US and Eurozone



Source: LSEG, Van Lanschot Kempen

There are two sides to the Eurozone economy. Family incomes are growing, savings are high and unemployment is low by European standards. Consumer confidence declined in November but has improved greatly since the low in 2022. When adjusted for inflation, retail sales were up by 2.8% in September compared to the same month a year earlier, the strongest upturn since the recovery from the coronavirus pandemic in 2022. This is in contrast to the malaise in industry, where confidence at businesses is low, production is decreasing and orders are dwindling. This is also affecting corporate investment, which was lower in the first half of 2024. On balance, we anticipate moderate positive growth in the Eurozone for 2025.

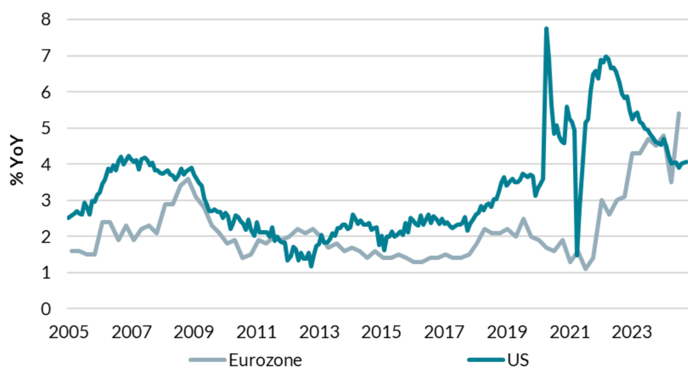
US consumers are in an excellent position. Incomes are growing and the net wealth of families is high on average. This is of course unevenly distributed but doesn't constitute a reason to fear a downturn in consumer spending, all the more so as interest payments are relatively low. Nor do we see any major imbalances in industry. As a whole industry is extremely profitable and corporate investment is high without being excessive. US economic growth could reach 2.8% in 2024. This is relatively high even for the US. We expect it to normalise to a more moderate level over 2025. The past year's high interest rates still need to have an effect and there's uncertainty about Trump's policy measures. Yet as some fiscal stimuli expire in 2025, we anticipate slightly less expansive budgetary policies.

Downturn in inflation stalls for the time being

There are more similarities between inflation in the US and Europe than there are for growth in the two countries. Headline inflation has come down in both regions, with a rate inflation of 2.6% in the US in October slightly above that of 2.3% in the Eurozone and UK. Core inflation has mostly declined in the UK recently, from 5.1% in January to 3.3% in October. In the Eurozone, core inflation has been fluctuating at or just above 2.7% since April and in the US at about 3.3%.

A downturn in inflation is more logical in the Eurozone due to the moderate outlook for economic growth. The extremely low growth in bank lending matches the picture of moderate growth. Unemployment is low at 6.3%, but there are signs that the job market is cooling somewhat. Employment is growing less strongly and the number of unfilled vacancies is declining. Wages covered by Collective Labour Agreements climbed by 5.4% on an annual basis in the third quarter. This is an acceleration versus the second quarter but was mostly caused by one-off wage payments in Germany. Looking at recently negotiated wage agreements and the lower employment growth, we believe there's little likelihood of a wage-price spiral. If wage growth declines, inflation could also come down in the service sector. Inflation could then decline to the ECB's target rate of 2% over the course of 2025.

Eurozone wage growth temporarily higher; US compatible with 2% inflation



Source: LSEG, Van Lanschot Kempen

In the US, the stronger economy and potential inflationary stimuli deriving from Trump's economic policies are an upward risk for inflation. This is especially true of import tariffs. Yet given the relatively closed nature of the US economy, the effect of higher import tariffs will be in the order of tenths of one percent, not whole percent. The slowing economy and job market are more important. Wage growth has already dropped to about 4%. With growth in labour productivity at 2%, this means that unit wage costs are climbing by 2%. This is therefore compatible with inflation of 2%. The main housing component in the US rate of inflation, which lags behind rental growth, will also fall as rents are rising less strongly. We anticipate a further small downturn in US inflation for 2025.

More policy interest rate cuts

Expectations for the US Fed's interest rate policy have been radically revised over the past couple of months. In September, markets were still pricing in ten interest rate cuts by the Fed until the end of 2025, now they're pricing in three. Some of this adjustment is logical in our view. Ten was a high number for an economy undergoing a soft landing. That figure would be more appropriate for a recession. And the ongoing growth and lack of a further downturn in core inflation give reason to implement fewer interest rate cuts. We nevertheless think three interest rate cuts are on the low side. It should be remembered here that that the Fed's policy interest rate is still above the equilibrium level and therefore restrictive. Incidentally, it's impossible to establish the equilibrium level with any certainty, but estimates range from 2.25% to 3.75%. This is far below the current level of 4.5% to 4.75% the Fed is aiming for at the moment. At three interest rate cuts, the policy interest rate would come out just at the upper end of the bandwidth for neutral. As the economy is moving towards its long-term trend for growth and inflation is moving towards the Fed's target rate, we believe it will be possible to reduce interest rates by slightly more than the markets are currently predicting.

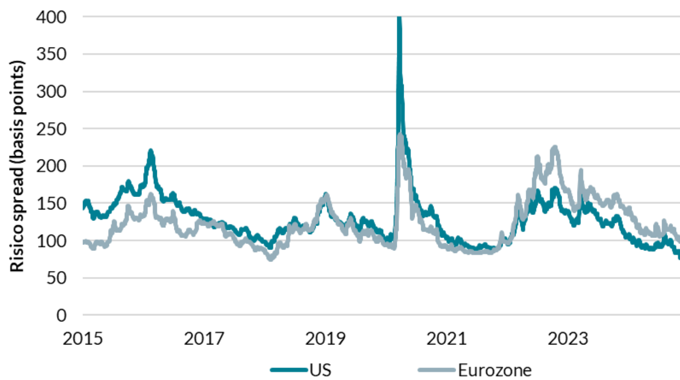
For the ECB, six interest rate cuts are being priced in until the end of 2025. A reduction of 25 basis points for the next policy meeting, with the possibility of a cut of 50 basis points. We find that a large amount. As mentioned above, leading indicators have weakened and the situation in industry is not great, although there are bright spots on the consumer side. In our opinion, the latter will stop ECB policymakers from cutting rates by 50 basis points. Current market expectations imply that the ECB will occasionally pause the process of cutting rates every now and then. Interest rates would then drop from their current level of 3.25% to 1.75%. According to the ECB, in real terms the equilibrium interest rate in the Eurozone is now around zero. At inflation of 2%, this means a nominal interest rate of 2%. We think an interest rate of just below the equilibrium level is realistic in light of the moderate outlook for growth. Moreover, marginally stimulatory monetary policy could provide a counterweight to restrictive fiscal policy (due to fewer large budget deficits compared to this year).

Preference for equities

For 2025 we think that equities will earn higher returns than bonds. We believe monetary policy has generally been reasonably well priced in and therefore anticipate no major changes in market interest rates. Returns on government bonds will largely consist of coupon interest. We believe there's slightly more potential for yields to come down in the US, leading us to hold a relative preference for US government bonds.

The opposite applies to investment grade credits. Spreads are tight in the US and Eurozone but slightly more extreme in the US. We don't expect any major shocks on the credit market, but spreads only need to widen marginally to underperform versus government bonds. Spreads are still large enough in the Eurozone in our opinion and we prefer investment grade credits to government bonds. The tight spreads on high yield credits lead us to prefer taking risk in equities. After all, at such tight spreads the upward potential for high yield credits is small.

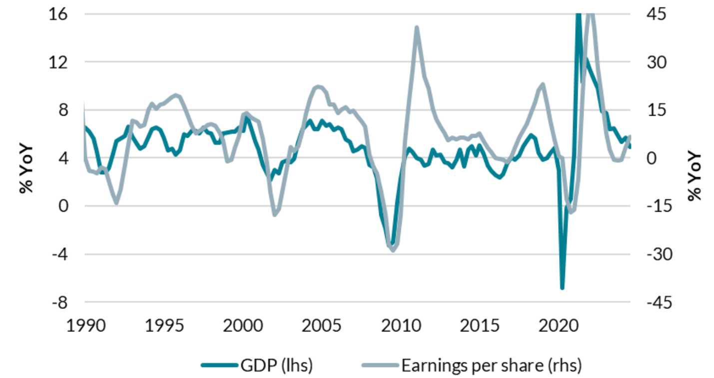
Tight spreads on investment grade credits



Source: LSEG, Van Lanschot Kempen

Earnings growth is crucial to equities. And nominal economic growth is the determining factor behind that earnings growth. In the US, earnings growth stalls when nominal growth is below 3%, while in the Eurozone this happens at a rate of 2.25%. We anticipate higher nominal growth than these percentages and therefore earnings growth as well. US earnings growth of 14% as forecast by analysts may be rather optimistic, but we don't believe a minor downward adjustment will necessarily have a negative effect on equity markets. Earnings expectations are frequently over-optimistic at the start of the year. Earnings growth for Europe is forecast to be 8%, which we view as more realistic.

Earnings growth largely determined by nominal GDP growth (US)



Source: LSEG, Van Lanschot Kempen

Up to early December, the S&P500 stood almost 27% higher in 2024. The STOXX 600 had to be content with a plus of 8% and emerging markets 7%. In emerging markets, the upturn in the index was in line with earnings growth. The price/earnings (P/E) ratio is down slightly overall. The difference between the index and earnings was likewise small in Europe. Valuations increased slightly. In the US, the index has climbed much more sharply than earnings. Markets have anticipated positive earnings growth, especially in the tech sector. This means that US equity valuations are high versus their own history, compared to other regions and versus bonds. Equity valuations in Europe, emerging markets and the Pacific region are neutral. The high equity valuations in the US pose a risk, but we don't foresee a shock in 2025 – such as rising bond yields or a sharp drop in earnings – that would cause valuations to drop significantly. However, the high valuations do mean there's little upward potential. Any return on US equities especially but also those from other regions will therefore have to come from earnings growth. We therefore see a higher potential return on equities than on bonds in 2025.

At the moment, our equity overweight is concentrated in the US, where we view the climate as positive for equities thanks to sound economic growth, declining interest rates and positive earnings dynamics. We hold a neutral outlook for European equities. Economic growth looks to be fragile and earnings expectations are being adjusted downwards. This may improve in the course of 2025, but greater clarity is needed on the economic cycle and on US trade policy.

Real estate is sensitive to interest rates. As we don't anticipate any significant movements in bond yields in 2025, we assume that yields rates will have little effect on listed real estate. We haven't taken a position in real estate due to the uncertainty surrounding the valuations of the underlying properties. Supply/demand ratios aren't positive for commodities. The weakness in global industry and declining growth in China are restricting demand, while there's a plentiful potential supply of oil.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2023
Global (MSCI AC)	1114	0.9%	7.9%	19.8%
Developed markets (MSCI World)	3838	1.2%	8.2%	21.1%
Emrging markets (MSCI EM)	1114	-1.9%	4.8%	8.8%
United States (S&P500)	6053	1.0%	10.6%	26.9%
Eurozone (EURO STOXX 50)	514	3.1%	3.5%	8.4%
United Kingdom (FTSE 100)	8352	3.5%	1.0%	8.0%
Japan (Topix)	2735	-0.3%	6.0%	15.6%
Netherlands (AEX)	895	2.3%	0.7%	13.7%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	4.20	-10	50	33
Japan	1.05	4	15	42
Germany	2.12	-25	-5	9
France	2.87	-25	-1	31
Italy	3.19	-47	-36	-52
Netherlands	2.32	-30	-14	0
United Kingdom	4.27	-16	42	73

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	81	4	-18	-23
Eurozone	97	-2	-19	-38

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	267	4	-69	-67
Eurozone	304	-17	-55	-91
Emerging markets (USD)	326	0	-65	-58
Emerging markets (Local currency)	225	13	-44	-10

Real estate

		Past month	Past 3 months	From 31-12-2023
Global		-1.3%	-2.4%	3.0%
North-America		-0.7%	0.0%	9.6%
Europe		-1.8%	-7.7%	-4.2%

Commodities

		Past month	Past 3 months	From 31-12-2023
Bloomberg index		0.4%	4.5%	-0.2%
Base metals		-0.7%	5.3%	2.7%
Brent oil (USD per barrel)	72.46	-1.6%	1.7%	-6.7%
Gold (USD per troy ounce)	2668	-0.7%	6.9%	29.2%

Returns in local currency
bp = basis points (0.01%)
Data as of 9 December 2024
Source: Refinitiv

Tactical outlook

Asset class	
Equities	**Overweight**
In November, US equities profited from the US election results and enjoyed their best month of 2024. European equities noted a small plus despite uncertainty about future US trade policy, while emerging market equities were down significantly for the second consecutive month. The differences don't just derive from the elections though. US economic growth is sound and the outlook stable. The outlook is more mixed in the Eurozone. Earnings dynamics are also better in the US than they are in Europe. We view further interest rate cuts by the Fed and ECB as positive. Our equity overweight is concentrated in the US. We hold neutral positions in the other regions.	
Government bonds	**Neutral**
US bond yields initially climbed following the elections in response to the potentially inflationary effects of the Trump administration's policies. Yet the nominee for the US Treasury tempered concerns. Yields were down slightly overall in November, at both the short and long end of the yield curve. Larger downturns occurred in the UK, although not enough to cancel out October's upturn completely. The biggest downturns were in Germany, mostly triggered by worse-than-expected leading economic indicators. In France, spreads widened because of the deadlock in the budgetary negotiations. The pricing in of fewer interest rate cuts for the Fed and to a certain extent also in the UK but more cuts for the Eurozone lead us to view monetary policy as reasonably priced. We see slightly more potential for yields to come down in the US than in Germany as the Fed could cut rates by more than is currently forecast. We hold a neutral outlook for government bonds, with a small overweight in the US and an underweight in the Eurozone.	
Investment grade credits	**Underweight**
In the US, spreads on investment grade credits continued to tighten in November. As spreads are at historically low levels, the decreases of the past four months have been small. Spreads remained virtually unchanged in the Eurozone. Movements in the underlying yields on government bonds led to the return being almost the same in the US and Eurozone (in local currency). We find spreads extremely tight in the US and therefore view investment grade credits as unattractive versus government bonds. The economic outlook for the US is sound in the short term, but spreads only need to widen by a small amount for investment grade credits to underperform versus government bonds. Spreads are tight in the Eurozone too but at less extreme levels than in the US. In the Eurozone, spreads account for a much larger portion of the total interest compensation than in the US. This reflects the less positive outlook for the Eurozone. Moreover, investment grade credits in the Eurozone are less sensitive to changes in interest rates than their US counterparts. Within investment grade credits we therefore have a relative preference for the Eurozone versus the US.	
High yield credits	**Underweight**
Spreads on US high yield credits tightened by slightly more than those on investment grade credits in November. Conversely, Eurozone spreads widened by more than those on investment grade credits. It's a sign of the difference in direction between the US and Eurozone over the past month. Our outlook for high yield credits hasn't changed. We think spreads are extremely tight, making this asset class unattractive in relative terms versus government bonds. 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. 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. The tight spreads mean there's less upward potential in this class than for equities.	
Emerging market debt	**Neutral**
Interest compensation on emerging market debt issued in US dollars declined slightly in November, mostly because of lower underlying yields in the US. A small downturn in yields was also visible in bonds listed in local currency. This resulted in positive returns for both asset classes. We find the interest compensation on emerging market debt issued in US dollars attractive and spreads are relatively wide versus other asset classes. This attractiveness is mostly to be found in the weaker countries though. Little risk premium has been priced in for the other, more robust countries. Growth is sound in emerging markets and there's relatively little exposure to Asia compared to emerging market equities or bonds issued in local currency. This reduces their vulnerability to Trump's import tariffs, which are primarily directed at China, although they are of course still a risk. Emerging market debt in local currency could profit from cuts to interest rates in these countries. The downturn in (core) inflation has stalled somewhat but is expected to continue in 2025. However, the interest compensation on bonds in local currency is too low versus developed countries. Currencies could also be squeezed by import tariffs and the higher exposure of bonds listed in local currency to Asian countries.	

Asset class	
Listed real estate	**Neutral**
Listed real estate has underperformed versus general equities since 2022-2023 when interest rates climbed. Higher interest rates made rental yields less attractive in relative terms and led to higher interest charges for property companies. Since then, this asset class has moved closely in line with interest rate expectations. After earlier upturns in bond yields from the middle of September, yields were able to decline again in November. The lower yields resulted in a positive return for listed real estate, with a slightly bigger upturn for global developed than for Europe. In addition, apart from in the office sector, vacancy levels are low. Rental growth is being boosted by inflation and economic growth. We expect this to continue given the small supply of new properties in the real estate sector. We hold a neutral outlook for this asset class. Valuations are relatively low versus general equities. Versus interest rates, global developed listed real estate is expensive and European real estate has a neutral valuation in our opinion. Transactions remain at low levels but have picked up somewhat recently. If the number of transactions normalises, this could create clarity on the value of the underlying properties.	
Commodities	**Neutral**
The Bloomberg general commodity index was virtually unchanged in November. Oil prices declined slightly, as did metal prices. The price of gold likewise fell marginally, while coffee and US gas prices became substantially more expensive. Oil markets are tight and stocks low, but the knowledge that the OPEC countries have sufficient production capacity and are using it wisely restricts the upward potential for oil prices. The weakness in global industry and China is likewise squeezing oil prices. We see little upward potential for metals for the same reason. The gold price remains high. We think the gold price is mainly being shored by up by the gold purchases of central banks. It’s impossible to predict how long this will persist. 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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