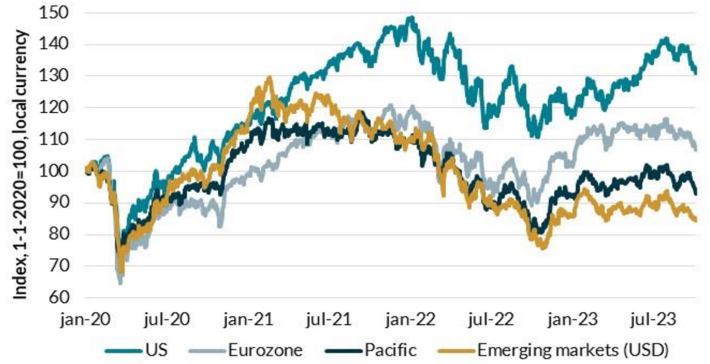
Asset Allocation Outlook

October 2023

- Is 'higher for longer' sustainable?
- Higher interest rates/lower equity prices create tighter financial conditions
- Investment policy: acquisition of Japanese equities at the expense of European equities and cash

September was another difficult month for investors. The markets were in the grip of 'higher for longer', the mantra used by central banks to indicate that while we're close to (or perhaps have already reached) peak interest rates, they're nowhere near ready to cut them yet. Yields climbed further, causing government bonds with long durations to note negative returns. Credits also had a tough time, not so much because of the wider spreads but because of the higher yields on government bonds. Equities fell for the second consecutive month.[1]

Equities affected by higher bond yields



Source: Refinitiv, Van Lanschot Kempen

Equities from industrialised nations dropped more sharply than their emerging market counterparts in September, the opposite of what we saw in August. Within industrialised nations the US was down by more than Europe and the Pacific region. The higher interest rates had a greater impact on listed real estate than on general equities, causing US real estate in particular to nosedive. Real estate has noted losses so far this year, while equities still stand at a plus overall.

The turbulence on the financial markets has led us to maintain our cautious investment policy. However, we are more positive about Japan and have therefore increased our allocation to Japanese equities. We've financed this partly at the expense of the allocation to European equities and partly from the cash position. In doing so we've marginally reduced our underweight in equities in the wake of the downturns on the equity markets and more realistic market expectations for monetary policy.

[1] Price movements in local currency

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Higher for longer

Central bankers at the US Federal Reserve and ECB have repeatedly stressed the 'higher for longer' message in recent weeks and this has now got through to the markets. US 2-year government bond yields climbed by 18 basis points in September, but it was the upturn of 46 basis points in 10-year yields that stood out. This was the fifth month in a row in which 10-year yields had risen and in early October they reached 4.8%, their highest level since August 2007. Two-year government bond yields declined in Germany and the UK, which shows that markets believe ECB and Bank of England interest rates have peaked. Yet 10-year yields climbed there as well, in the UK by 8 basis points and in Germany by 37 basis points, bringing them to remarkable levels. At 4.6%, UK 10-year yields are higher than during the financial turbulence surrounding the October 2022 mini-budget. In Germany we need to go back to the 2011 Eurozone crisis to find 10-year yields of 3.0%.

'Higher for longer' is pushing up yields

Source: Refinitiv, Van Lanschot Kempen

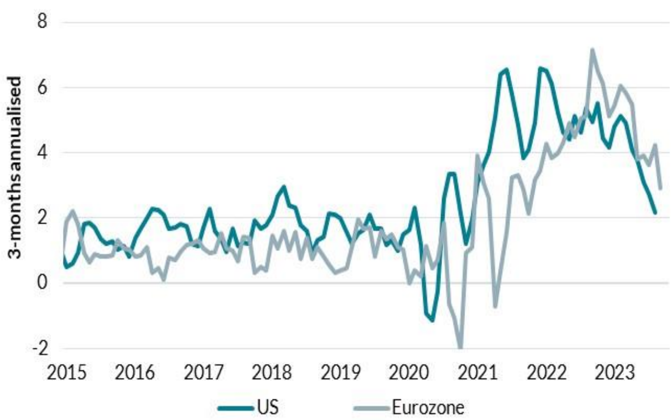
As we said earlier, central banks are a major driver behind the higher yields. Some policymakers at the Fed have even let it be known that they want to raise rates once more. They're in the minority though. The central bank published new forecasts after its September meeting. The Fed expects higher growth this year and next year and no longer anticipates a recession. The bank predicts lower unemployment than previously expected and inflation only to reach the target rate of 2% in 2026. This all argues in favour of keeping the Fed funds rate, or US policy interest rate, higher for longer. And this can also be seen from the expectations of the individual policymakers. In June, the median projection for policy interest rates as of the end of 2024 still stood at 4.625%, or in a range of 4.5% to 4.75%. This translates into 75 basis points of interest rate cuts from the current level. In September, the median forecast had risen to 5.125%, which would mean just one cut of 25 basis points. This shouldn't be taken too literally, however. At the end of 2021, the median policymaker forecast an interest rate as of year-end 2022 that was more than 3% lower than it actually turned out to be. In short, forecasts can be adjusted and sometimes by large amounts.

The ECB and Bank of England each raised interest rates by 25 basis points in September. This came as something of a surprise in both cases. While it's true that the ECB had been reasonably vague about its intentions, weak economic growth could have led it to introduce a pause. It nevertheless opted to raise rates again, albeit with a clear message that this might well be the final hike. In the UK, core inflation dropped particularly far in August, which prompted speculation about a pause by the Bank of England. Yet core inflation was still 6.2%, so the Bank of England implemented another interest rate hike after all. These central banks are nowhere near ready to cut interest rates either. It's still perfectly possible that they'll raise rates further first, for instance in response to tight job markets and robust wage growth.

Yet inflation is coming down

It's striking that markets seem to take central banks at their word. Inflation is undoubtedly coming down in the US. According to the Fed's favourite benchmark, headline inflation fell to 3.5% and core inflation to 3.9% in August. This may still seem high but, as we've said before, these levels contain twelve months' worth of data, including high rates of inflation as of year-end 2022 and the start of this year. The past few months have seen significantly lower rates of inflation. Over the past three months core inflation has been 2.2% on an annualised basis, which is very close to the Fed's target rate.

Core inflation is falling fast



Source: Refinitiv, Van Lanschot Kempen

In the Eurozone, headline inflation decreased to 4.3% and core inflation to 4.5% in September, which means the downturn has started here too. An alternative ECB inflation benchmark in which data are seasonally adjusted shows that on a 3-month basis inflation has fallen to 2.9%. And business surveys in the Eurozone and UK also demonstrate that upward pressure on prices is declining. Tight job markets and wage increases may well hinder further rapid downturns in the short term though.

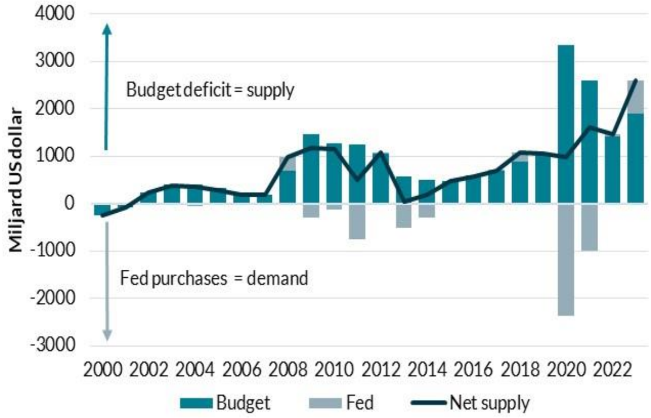
With respect to economic growth, markets seem to be leaning more towards a soft landing or even no landing at all. In the current climate this means that good news on the economy is bad news for the equity markets as it reinforces the idea of higher rates for longer. For example, the equity markets responded negatively to the better-than-expected ISM index for US industry in September (which incidentally is still pointing to weakness) and a larger number of unfilled job vacancies in the US in August. The ongoing resilience of the US economy means there's a greater chance of a soft landing but the risk of a slowdown in growth remains high. And the recent sharp upturn in interest rates in fact increases this risk. In the Eurozone, however, the economy has barely grown for several quarters and leading indicators aren't pointing to any improvement. The ECB has cut its growth forecasts for this year and next year but we still think these are excessively optimistic. Lower growth and lower inflation ought to lead to lower interest rates.

Oil, budget deficits and technical factors

What else could be going on? Firstly there are the oil prices. These have climbed from 75 US dollars per barrel as of the end of June to 95 US dollars per barrel, an increase of 27%. This will exert upward pressure on inflation in the short term. Yet we shouldn't overestimate the effects either. Oil prices only briefly stood at about 75 US dollars per barrel. Before that they were moving in the 75 to 85 US dollars range and that makes the upturn smaller. Central banks wouldn't normally need to respond to higher oil prices immediately. After all, higher oil prices curb the economy via higher costs and less purchasing power, which automatically reduces price pressure. However, the high rate of inflation and the fact that central banks underestimated its stubbornness mean it might now be harder for central bankers to ignore the higher oil prices. This contributes to the idea of higher for longer.

Another aspect is the fiscal situation in the US. The US budget deficit is high, especially for a period in which the US economy isn't in a recession and the country isn't directly involved in a war. Last year the budget deficit was 5.5%, so far this year it stands at 7.0%. This translates into a large number of US government bonds to finance this deficit. On top of this, the Fed is reducing its bond portfolio and different investors therefore need to be found for the bonds the Fed used to hold. The net supply of government bonds could reach 10% of the US GDP this year, significantly higher than during the coronavirus pandemic or 2009 financial crisis. US families have bought more bonds in recent times but the enormous supply is exerting upward pressure on yields.

Record supply of US government bonds



Source: Refinitiv, Van Lanschot Kempen

The market for Italian government bonds is likewise experiencing turbulence. This is largely due to precarious government finances. The Italian government recently reined in its ambitions for cutting the budget deficit. Whereas it initially assumed a deficit of 4.5% this year and 3.7% next year, the projections now stand at 5.3% and 4.3% respectively. A deficit of less than 3% as prescribed by the (postponed) European budgetary regulations is now only predicted for 2026. We believe these assumptions for economic growth are too optimistic. The fact that the ECB is able to intervene on the market for Italian government bonds is preventing panic but spreads on Italian 10-year bonds versus their German counterparts have widened to nearly 2%.

Finally, technical factors are probably also playing a role. Not that we're technical analysts, but the fact that 10-year bond yields have smashed several historical moving averages does point to a robust upward trend. This could mean that those investors who speculated on lower yields will now change their positions, which in turn will boost the upward trend in the short term.

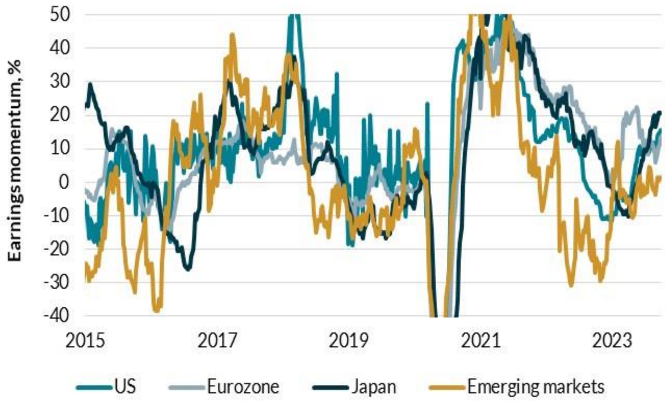
Meanwhile in China

Meanwhile, the Chinese economy looks to be picking up again somewhat. The average of the two Chinese purchasing manager indices for industry climbed for the second consecutive month in September and also to higher above 50, the level that separates acceleration from a slowdown. Incidentally, this won't yet have an impact on global industry, which is generally still struggling. The exception here is Russia, where the transition to a war economy is generating optimism in industry. But back to China, where the average of the purchasing manager indices for the service sector declined for the sixth month in a row, although in doing so it still came out at 51.0. The economy isn't out of the woods yet. There continues to be bad news about the real estate sector, with large project developers also experiencing major difficulties. This is impacting buyer confidence, mainly because large deposits usually need to be paid for new homes in China. The problems on the housing market are in turn affecting local authorities, which are selling less land and therefore seeing a significant source of income dry up. This could have a knock-on effect on investment in infrastructure. In short, while the Chinese economy may revive somewhat in the short term, the structural problems haven't been resolved.

Investment policy: adjustments to regional and equity allocations

Japanese equities have performed well so far this year. Not as well as the Nasdaq, which is up by 35%, but at 22% twice as well as US equities. European equities only climbed by 3.5% and emerging market equities by nothing at all. The strong performance of Japanese equities is being boosted by stronger economic growth than in the US and Europe, monetary policy that continues to be much more expansionary and positive earnings growth. Japan's expansionary monetary policy and the tightening in the US are causing the Japanese yen to weaken towards the threshold of 150 yen per US dollar. A threshold at which in the past the Bank of Japan has intervened to shore up the yen. As part of our investment policy we have decided to acquire Japanese equities, mostly because of the divergent monetary policy. While we're concerned about the tight monetary policies in the US and Eurozone, which are expressed in declining money growth and stalled lending by banks, these aren't a problem in Japan. The Japanese central bank may well put a stop to the negative policy interest rate around the end of the year but tightening is still some way off. Furthermore, the normalisation of inflation and monetary policy could have a positive impact on confidence in the Japanese economy. The more positive growth means that corporate earnings momentum is more positive in Japan than it is in Europe and the US. Earnings are also being adjusted upwards to a greater extent. We find the earnings expectations in the US and Eurozone excessively high given the negative economic outlook. Forecasts are more realistic in Japan in our opinion. The exchange risk hasn't been hedged. If the monetary policies of Japan and the US/Europe converge, the yen could become stronger again and potentially offset the negative effects on exports and earnings.

Robust earnings dynamics in Japan



Source: Refinitiv, Van Lanschot Kempen

We've financed our acquisition of Japanese equities in part by selling European equities. The economic outlook is poor in Europe and we think earnings forecasts are too optimistic. Europe and Japan are similar in terms of valuations. As a result of this transaction we've increased our underweight in Europe, kept the underweight in the US unchanged and hold an overweight in Japan.

Another part has been financed from our cash position. This means that we've reduced our overall equity underweight slightly. There are two reasons for this. The first is the recent sell-off. Equities have already dropped nearly 10% from the peaks in early August. As a result, a less positive scenario has been priced in to some extent, although this has been prompted by higher interest rates rather than lower growth and earnings forecasts. Secondly, the expectations for monetary policy are now more realistic. We've long felt that the markets were overoptimistic about central banks quickly stepping in to cut interest rates if things weren't going that well. The high rate of inflation would have prevented this type of scenario in our opinion. However, following recent interest rate movements, the first cuts to rates in the US, Eurozone and UK are only expected a year from now. We in fact think that the markets have now gone too far the other way: pricing in interest rate cuts too late. Given the declining rate of inflation and poor outlook for growth, we now believe there's a higher chance of central banks cutting interest rates earlier than expected. In our view this makes monetary policy less of a direct negative factor for equities. We continue to hold an underweight, however, and this derives largely from the weak economic growth that we anticipate. And as we mentioned earlier, the rapidly tightening financial conditions (driven by the higher interest rates) aren't improving the outlook. We therefore believe that earnings forecasts will be adjusted downwards and view this as a risk for equities.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2022
Global (MSCI AC)	939	-6.2%	-5.9%	6.5%
Developed markets (MSCI World)	2800	-6.4%	-5.8%	7.6%
Emerging markets (MSCI EM)	939	-4.7%	-6.6%	-1.8%
United States (S&P500)	4229	-6.3%	-5.1%	10.2%
Eurozone (EURO STOXX 50)	4096	-4.4%	-6.9%	8.0%
United Kingdom (FTSE 100)	7470	0.1%	-0.8%	0.2%
Japan (Topix)	2275	-3.2%	-2.0%	20.3%
Netherlands (AEX)	720	-3.5%	-7.3%	4.4%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	4.80	62	94	92
Japan	0.77	13	36	35
Germany	2.97	42	53	40
France	3.53	46	56	42
Italy	4.24	-13	65	-9
Netherlands	3.32	43	53	41
United Kingdom	4.60	17	16	93

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	126	7	-34	-4
Eurozone	155	-1	-6	-12

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	420	54	33	-49
Eurozone	449	-7	-1	-63
Emerging markets (USD)	441	23	-107	-11
Emerging markets (Local currency)	205	-7	-7	-81

Real estate

		Past month	Past 3 months	From 31-12-2022
Global		-6.7%	-6.8%	-6.8%
North-America		-8.2%	-9.0%	-7.3%
Europe		-5.5%	-1.1%	-9.9%

Commodities

		Past month	Past 3 months	From 31-12-2022
Bloomberg index		-2.6%	3.6%	-4.7%
Base metals		-3.2%	-0.6%	-9.7%
Brent oil (USD per barrel)	90.92	3.6%	23.0%	11.4%
Gold (USD per troy ounce)	1825	-6.4%	-5.4%	-0.1%

Returns in local currency
bp = basis point (0.01%)
Data as of 4 October 2023
Source: Refinitiv

Tactical outlook

Asset class	
Equities	Negative
Equities fell for the second consecutive month in September. In local currency: globally by 4.3%, in industrialised nations by 4.4% and emerging markets by 2.8%. The losses in the US were slightly bigger than those in Europe and the Pacific region. Japanese equities were down by only 0.4%. The reason for the losses is unmistakably the aggressive tone from central banks. It's not so much that they wish to raise rates much higher but the financial markets' realisation that they want to keep rates higher for longer. This is pushing up bond yields and leading to losses for equities. We believe that monetary policy has now been priced in much more realistically on the markets and is having a less direct negative effect. Nevertheless, we remain concerned about the outlook for growth and corporate earnings, especially now that financial conditions have tightened rapidly. We've increased our allocation to Japanese equities, mainly because monetary policy is much more expansionary in Japan than in the US or Europe. As a result, we see fewer risks to economic growth and corporate earnings in Japan, partly owing to the continuing reopening effects following the coronavirus pandemic, for example in tourism. We've increased our underweight in Europe, where we find earnings forecasts to be excessively optimistic, and retained our underweight in expensive US equities. A portion of our cash position has also been used to acquire Japanese equities. These adjustments mean that the equity underweight has been reduced marginally in response to the recent equity correction and more realistic expectations for monetary policy.	
Government bonds	Neutral
Yields underwent significant changes in September, especially at the long end of the yield curve. In the US, 2-year bond yields climbed by 18 basis points but it was the upturn of 46 basis points on 10-year yields that stood out. It was the fifth month in a row that 10-year yields had risen and at 4.8% at the start of October the threshold of 5% is now in sight. Two-year bond yields fell in Germany and the UK, a sign that markets think central bank policy interest rates have peaked. Yet upturns of 4.6% in early October in the UK and 3% in Germany mean that yields now stand at levels we've not seen in years. We view the higher yields as remarkable given the weakening growth we anticipate and inflation unmistakably coming down. Markets have clearly taken the message of the central banks on board. Other potential factors in the higher yields are the higher oil prices, which are boosting inflation and keeping it higher for longer, the sizeable budget deficit in the US combined with the Fed's reduction of the bond portfolio and technical market factors, such as the positions of investors speculating on lower yields. We recently increased our interest rate sensitivity for European government bonds as we believe yields are close to peaking. A next step would be to reduce the underweight in European government bonds but we think it's still too soon to do so in light of the strong upward trend in yields at the moment. We've maintained our overweight in US government bonds.	
Investment grade credits	Negative
When viewed against the backdrop of turbulence on the equity markets and in government bonds, the way that spreads on investment grade credits have evolved is striking. The movement in spreads was minimal: a widening of 3 basis points in the US and tightening of 2 basis points in the Eurozone. Higher underlying yields on government bonds meant that overall yields on investment grade credits climbed, however. We think spreads are at odds with economic indicators that in many cases are pointing to a slowdown in growth. The rating trend, which indicates the level of creditworthiness, is deteriorating due to pressure on profits and credit fundamentals. Any rise in the default rate will first affect high yield but could also translate into concerns about spreads on investment grade credits. Spreads are about average for the past ten years and in our view too low for a recession scenario. The upturn in underlying yields on government bonds and persistently tight spreads mean that spreads account for an ever smaller portion of the interest compensation on credits. This makes them less attractive versus government bonds. Within investment grade credits we now have a relative preference for the Eurozone versus the US. Spreads are wider in the Eurozone and interest rate sensitivity is lower.	
High yield credits	Negative
Spreads on high yield credits moved very little in September. In the US spreads widened by 22 basis points, while the Eurozone noted a tightening of 9 basis points. Spreads widened further in the US in early October but remain below the average of the past five years, while in the Eurozone spreads are only 11 basis points above the average. At the end of the September yields on US high yield credits stood at 8.7%, in the Eurozone at 7.2%. These may sound attractive but a recession hasn't yet been fully priced in on this market either. In a recession, spreads in this asset class can easily reach 1,000 basis points. These stood at 395 basis points in the US and 445 basis points in the Eurozone at the end of September. This means that a negative scenario of slowing growth and high inflation has only been partly priced in. We see downward risks as well, such as lower earnings growth and a higher default rate. It's also becoming considerably more expensive for businesses to refinance high yield bonds, which on average have shorter durations than their investment grade counterparts, especially now interest rates have climbed sharply. We retain our negative outlook.	

Asset class	
Emerging market debt	**Neutral**
Emerging market debt issued in US dollars generated a negative return in September. The interest compensation climbed by 53 basis points (spread +9 basis points, underlying US yield +44 basis points). Bonds in local currency likewise noted a negative return because of the higher yields. Higher interest rates in developed countries and a stronger US dollar are squeezing this asset class, although emerging markets are so far only seeing limited repricing. Our neutral opinion is a trade-off between the attractive interest compensation and lower inflation in the US on the one hand and the worse-than-expected growth in China, risk of a further slowdown in global growth and persistently high interest rates and tight monetary policies in developed countries on the other. There is as yet no prospect of the Fed cutting interest rates in light of the strong service sector growth and persistently robust job market. Bonds listed in local currency could profit from the lower inflation and cuts to interest rates that a couple of central banks in emerging markets have already started to implement. Yet these have already been partially priced in and the interest compensation is relatively low versus developed countries. This reduces the relative attractiveness, and lower interest rates in emerging markets are less likely as long as they remain high elsewhere.	
Listed real estate	**Neutral**
Listed real estate has a reputation as being a defensive sector in equities. Moreover, its cashflows are partly linked to inflation. Higher interest rates pose a threat to this asset class though, including in relative terms versus general equities. On top of this, the asset class is sensitive to lending conditions at banks due to the relatively high amount of debt financing (especially in Europe). Commercial banks have tightened their lending conditions considerably in 2023. This complicates access to refinancing and exerts upward pressure on interest charges. Listed real estate still hasn't recovered from the turbulence in the banking sector in March. In September, returns were negative for developed, US and European listed real estate due to the higher interest rates in developed countries. This asset class lagged behind general equities. Despite the cheaper valuations for listed real estate we hold a neutral outlook. In light of the robust job markets it's too soon for central banks to switch to cutting interest rates, as a result of which the interest rate pressure will only ease slightly at best. Tighter lending conditions at banks will lead to higher interest charges for listed real estate. Not all property valuations have been downgraded, which will also have an impact on the balance sheets of listed real estate companies.	
Commodities	**Neutral**
The general Bloomberg commodity index noted another small loss of 1.1% in September. This couldn't be blamed on oil prices though as the price of a barrel of Brent oil climbed by 10% and stood at 96 US dollars per barrel at the end of the month. Metals were up by 1.1%, which wasn't enough to compensate for the downturn in August. Gold was adversely affected by the higher interest rates and fell by 4.7%. From a cyclical perspective we don't view this as a good time to build up a position in commodities, despite the fact that commodities have noted a negative return so far this year, primarily because of the lower metal prices. Faltering growth in global industry and China mean the outlook for these commodities isn't positive. The sanctions against Russia and resulting decrease in delivery volumes mean that in general tightness could easily arise on commodity markets. Moreover, the OPEC countries and Russia are closely monitoring the ratio of supply and demand on the oil market. Saudi Arabia and Russia recently announced they would prolong their voluntary restrictions on production until the end of the year. This is the main reason behind the higher oil prices, not an improvement in the outlook for economic growth. If the latter were the case, metal prices would also have climbed. Excessively high oil prices aren't in the interest of oil-producing countries as this would encourage the search for new oil fields or alternative energy sources. This restricts the upward potential from the supply side. Gold is an interesting investment at times of uncertainty but its price is relatively high versus real interest rates in the US. A large amount of uncertainty and/or lower interest rates have therefore already been priced in to the gold price.	

Joost van Leenders
Senior investment strategist
Joost.vanleenders@kempen.nl
M +31 (0)6 82 83 11 89

VAN LANSCHOT KEMPEN INVESTMENT RESEARCH

Yaela van Raalte – Head investment research
Luc Aben – Chief economist
Pieter Heijboer – Head investment strategy
Joost van Leenders – Senior investment strategist
Jorn Veeneman – 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