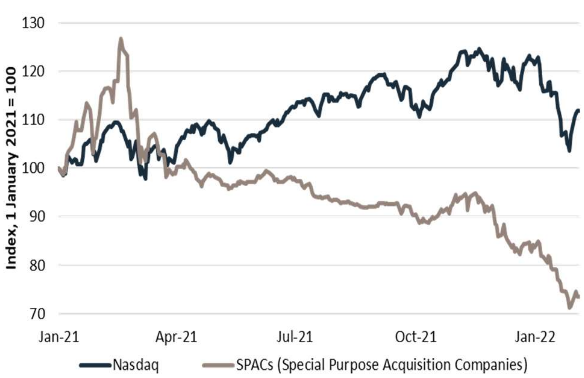
Asset Allocation Outlook

FEBRUARY 2022

- Fed makes further policy adjustments following high inflation data; no consolation for investors
- ECB seems to be preparing markets for a policy change
- Economic growth in temporary dip
- Investment policy: positive outlook for equities unchanged

"As goes January, so goes the year" is an old market wisdom. And superficially that appears to apply to the S&P500 from 1964 and the AEX from 1984. On both stock exchanges, in about two-thirds of the years a positive January is followed by a positive year or a negative January is followed by a negative year. Yet this is mostly true of the positive years. Both January and the year are positive in over fifty percent of cases. After all, stock exchanges rise more often than they fall. Even if January is negative, there is a slightly higher chance of a positive year than of a negative year. In short, there's still hope for 2022.

Severe blows for the most speculative market sections



Source: Bloomberg, Van Lanschot Kempen

Because, with the coronavirus, inflation, monetary policy and interest rate fears, January was a negative month for equities. In particular the most speculative sections of the markets, such as loss-making tech companies, meme stocks and SPACs, were dealt severe blows. The MSCI index for industrialised countries lost over 5%, with Europe doing slightly better than the US. Emerging markets started the year well but closed the month down by 2%. In the US, short-term bond yields climbed more sharply than their long-term counterparts, resulting in a flatter yield curve. In contrast, the yield curve steepened in Germany, with 10-year bond yields moving back into positive territory for the first time since May 2019.

The turbulence could persist for a while yet, as long as it remains unclear when peak inflation will be reached and how quickly monetary policy will be tightened. Nevertheless, we're also seeing positive trends. The coronavirus pandemic has reached a stage at which it's now having less of an impact on society and the economy. Corporate earnings are generally growing faster than expected. Equity valuations have also dropped considerably. We have therefore decided to maintain our overweight in equities.

Inflation remains stubbornly high

The upheaval on the financial markets is mainly due to high inflation and the consequences for monetary policy. Inflation has been expected to fall for some time now but instead continues to rise. In the US, inflation climbed to 7.1% in December. Inflation in the Eurozone had been forecast to fall in January but in fact rose to 5.1%. Aside from the difference in rates between the US and the Eurozone there are also differences in breadth. In the Eurozone core inflation (excluding volatile food and energy prices) declined to 2.3%. Half of the Eurozone's inflation therefore derives from food and energy, especially the latter. In the US, core inflation stands at 5.5% and this means inflation is more widespread and more structural. We can also see differences on the respective job markets. Unemployment has fallen to extremely low levels in both regions, but because there are fewer people seeking work in the US the job market is much tighter. The upshot is more rapid wage increases.

Core inflation hardly declines

Source: Refinitiv, Van Lanschot Kempen

Yet the key question remains: when will inflation finally start to come down? Surveys of businesses show a gradual improvement in the problems in production chains. And given the sharp drop in bulk shipping prices, the tightness there is also starting to ease. This is less visible in prices for container transport by sea though. An increased supply of goods should push down inflation. On the other hand, increased demand for services could trigger inflation there, especially if wages also rise. We see this as a greater risk for the US than for the Eurozone. It's very hard to predict how this will all turn out but it looks as if peak inflation will occur in February or March at the earliest. However, another two months will have passed before we know that the peak has indeed been reached.

Energy prices are not really cooperating yet. Partly owing to the tensions surrounding Ukraine and to oil-producing countries struggling to meet production targets, the oil price has risen to over 90 US dollars per barrel, its highest level since 2015.

Gas prices recently declined slightly when it turned out that Russia is rerouting gas deliveries to Europe, but they remain four times higher than a year ago. Russia is meeting its contractual obligations but otherwise only sporadically selling gas on the spot market, whereas it used to sell large quantities there. It's not the price itself but the annual change that counts for all prices, and therefore also for gas and oil. This is decreasing slightly for gas but not for oil. Yet recent price trends for both will continue to have a knock-on effect on inflation for some time. In short, we may be close to peak inflation but we're not quite there yet.

Fed even more aggressive

Each time it adopts a more aggressive tone you'd think the Fed had made perfectly clear the US central bank's intention to quickly reverse its extremely expansionary monetary policies. Yet Fed Chairman Powell was unable to resist going even further after the policy meeting at the end of January. At the post-meeting press conference Powell was expected to announce an increase to interest rates in March but at the same time, given the turbulence on the equity markets, adopt a more soothing tone. That didn't happen. Powell said that the first interest rate hike was coming and that the entire policy committee believes March to be an appropriate time. A central banker could hardly put it any more clearly.

Expectations for the Fed rise further

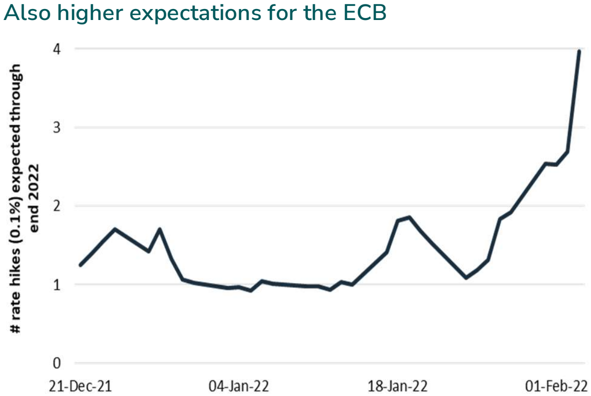
Source: Bloomberg, Van Lanschot Kempen

While he did say that the Fed is examining all the risks and that the bank is flexible and can act quickly, when he admitted that high inflation, robust growth and a tight job market demand faster interest rate increases than in the past, it was obvious to equity investors that they shouldn't expect any support from the Fed for the time being. Markets have now priced in five interest rate increases in the US, and an initial increment of 50 basis points or two consecutive increments can no longer be ruled out. It therefore looks as if we'll soon reach the peak for pricing in interest rate hikes by the Fed. There could be more to come but most of them have already been priced in. The fact that this pushed the S&P500 down by less than 10% is indicative of the strength of the trend on the equity markets.

Is the ECB preparing markets for change?

Although the ECB had consistently dismissed all idea of stubbornly high inflation and interest rate increases, there was a distinct change of tone at the press conference in early February. The ECB in fact had no new announcements to make. The emergency purchase programme is being dismantled in March and the regular bond-buying programme will be temporarily increased to ensure a smooth transition. There's no end date for bond-buying but that could change. ECB President Lagarde expressed concern about the high inflation, with mainly upside risks in the short term. This means interest rate increases may well be necessary. However, like the Fed, the ECB first wants to stop bond-buying before raising interest rates. So the ECB first needs to announce an end to the bond-buying programme.

Also higher expectations for the ECB



Source: Bloomberg, Van Lanschot Kempen

Lagarde's remark that it will be reviewed in March looks like a hint that there could be an announcement after the next policy meeting. Whether an exact date will be named then is hard to say. If the ECB does indeed stop buying bonds sometime between July and September, this opens the door to raising interest rates before the end of the year. The ECB's inflation forecasts are crucial to any interest rate increases. If the ECB publishes new forecasts in March showing inflation moving towards 2%, an interest rate hike would seem to be inevitable. Lagarde said in December that she wouldn't raise interest rates in 2022, but that was based on the conditions at the time. If the conditions (i.e. the rate of inflation) change, Lagarde will also adjust her intentions.

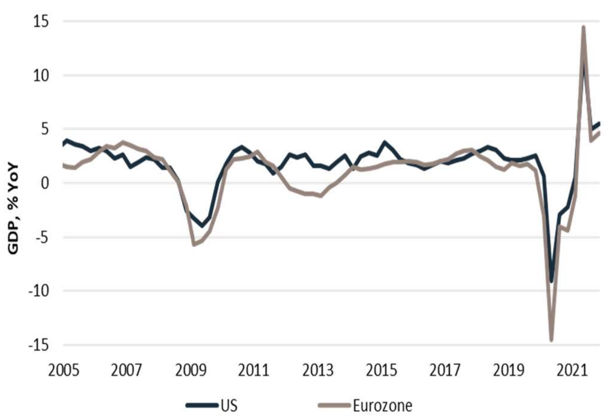
The Bank of England had no need to prepare the markets for anything. It was widely expected to raise interest rates in early February. The news lay primarily in the fact that rates were very nearly increased by 50 basis points instead of the 25 basis points implemented now. With inflation that could exceed 7% in the UK, markets anticipate a further five interest rate increases of 25 basis points each this year.

A dip now, growth later

US and Eurozone economic growth data over the fourth quarter give reason for optimism but also reveal risks. The US economy grew by 1.7% versus the third quarter, or as the Americans say by almost 7% annualised. Of that 7% though, 5% came from increasing stock levels. This type of growth doesn't generally persist for long. Yet stock levels remain low in the US and this stock cycle could therefore last for a little longer and in turn generate derived growth. Consumers boosted growth by over 2 percentage points. This is more than in the third quarter but less than in the phenomenally strong first six months of 2021. Moreover, consumer growth mostly occurred in the first part of the fourth quarter. Consumer spending in fact decreased in November and December, which automatically leads to a poor start to 2022. The weak growth in corporate investment of 0.3 percentage points is striking. The contribution from housing was zero. All this while conditions for investment are favourable: corporate earnings are high, financing conditions positive and there's tightness in production chains and on the housing market. We believe that the weak investment is largely owing to shortages of materials, employees and semi-manufactured goods. All in all it's clear that the US economy cannot maintain its growth rate from the fourth quarter. Given the slowing consumer spending, growth could drop a long way towards zero in the first quarter.

In the Eurozone, the economy grew by 0.3% versus the third quarter. The economy shrank in Germany, the country most affected by the supply problems in industry, but France, Italy and especially Spain displayed sharp growth. Growth of 0.3% may not seem much but it's close to the Eurozone's long-term growth rate. And we think that's impressive in a quarter in which communities were buffeted by Delta and Omicron waves of the coronavirus. The Eurozone is also likely to experience a poor first quarter though.

Growth in the US and the eurozone will slow



Source: Refinitiv, Van Lanschot Kempen

We expect stronger growth to return after the first quarter. Over the past few weeks the coronavirus pandemic has evolved such that it's now restricting our lives less. This should improve as we head into spring. In the meantime, the economic recovery is continuing. This can be seen from the extremely tight job market in the US that in the long term will encourage more people to seek work again. The employment rate is also rising fast in the Eurozone and unemployment fell to 7% in December, its lowest level since the creation of the Eurozone. The robust income growth in the US and Eurozone is not yet being cancelled out by higher inflation, but if the latter starts to come down this will create greater capacity for spending. Furthermore, families on both sides of the Atlantic have accrued substantial savings.

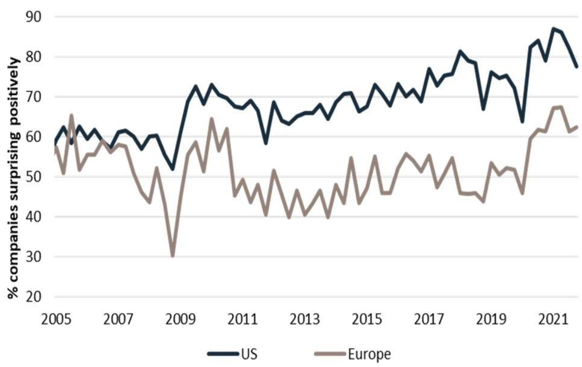
Most leading indicators have declined slightly overall but continue to point to growth. That translates into marginally slower growth. This applies to the combined purchasing managers index for the entire US and Eurozone economies, for example. Service sector confidence took a particularly severe hit in the US. Omicron had a much bigger impact on the US than it did on the Eurozone. It's noticeable that confidence in industry is in fact up in the Eurozone. The same also goes for the all-important German ifo indicator.

Sound corporate results

Equity markets look to the future and can see a time when economies have succeeded in throwing off the yoke of coronavirus. Yet it's nice to receive confirmation from actual data, especially corporate earnings. And that confirmation has so far come from the data over the final quarter of 2021. In the US, where nearly one-third of companies have already reported results over the fourth quarter, almost 80% of them exceeded earnings expectations. That's lower than in the three phenomenally strong preceding quarters but still extremely high in historical terms. In total, earnings are exceeding expectations by 5%, which is a fairly normal rate. Earnings growth is declining marginally now that there are fewer positive base effects (low earnings a year ago), but still stands at 30% versus the fourth quarter of 2020. Only a handful of companies have so far reported results in the Eurozone. Earnings are up by almost 65%, given that here there are still positive base effects. Earnings are exceeding expectations at a rate of 4% but that could change once more companies publish their results.

Investors are of course keeping a close eye on profit margins in light of the high inflation. Can businesses pass on the higher costs and keep margins at the same level? This is naturally easier in an economy-wide inflationary environment but certainly worth monitoring closely. We can identify a couple of contradictory trends in this respect in the US. Margins have declined somewhat but are still higher than expected. That means analysts were anticipating much lower margins. Margins have been falling for the past few quarters but they're still higher than was usual prior to the coronavirus pandemic. In any event, the decrease in margins is not yet such that it poses an obstacle to earnings growth.

Earnings exceed expectations



Source: Factset, Van Lanschot Kempen

Another remarkable aspect is that despite the positive surprises in the fourth-quarter results, forecasts for the first quarter are not being raised. In fact these forecasts are now slightly lower than the results realised over the fourth quarter. This implies a fairly negative economic scenario. There therefore looks to be room for upward adjustments to expected earnings for the first quarter, especially given that the vast majority of US companies are optimistic about the future.

Investment policy unchanged

We retained our positive outlook for equities throughout the turbulent period on the equity markets. A correction of 10% is not excessive given the Fed's rapid policy U-turn. This demonstrates the strength of the underlying trend on the equity markets. Yet markets also have something to look forward to, namely the reopening of economies and growth picking up. Deep, prolonged downturns on equity markets nearly always only occur during economic recessions. Naturally there are risks, especially inflation and a less expansionary monetary policy in the US. We express these in our investment policy by concentrating the overweight in European equities. European equities have been less severely affected by interest rate fears in the past few weeks than their US counterparts. We view the geopolitical situation surrounding Ukraine as a minor risk. Generally speaking, financial markets only react negatively to conflicts if energy supplies are threatened (for a prolonged period). This is a possibility in this instance but stopping gas supplies isn't in the interest of either Russia or the European Union.

Equity markets are also being shored up by the trends on the bond markets. The low yields make equities attractive in relative terms. The risk premium on equities can be calculated by comparing the earnings yield (the earnings per share versus the price, or the reverse of the P/E ratio) with yields on government bonds. In the US, the risk premium based on expected earnings is 3.9%; exactly the long-term average. In Europe, however, the premium is as high as 6.75%, far above the long-term average. Equity investors are therefore being rewarded for their risk-taking. On top of this, the performance risk on bonds is asymmetrical. The low yields and greater risk of higher yields than of even lower yields means there's a higher risk of a low or negative return than of a high or positive return. Considerations of this type mean that equities remain a relatively attractive investment.

Market review

Equities				
	Index	Past month	Past 3 months	From 31-12-2021
Global (MSCI AC)	1213	-3.4%	-2.7%	-3.4%
Developed markets (MSCI World)	3114	-3.6%	-2.6%	-3.6%
Emrging markets (MSCI EM)	1213	-1.5%	-4.0%	-1.5%
United States (S&P500)	4589	-3.7%	-0.9%	-3.7%
Eurozone (EURO STOXX 50)	4222	-1.8%	-1.7%	-1.8%
United Kingdom (FTSE 100)	7583	2.7%	4.2%	2.7%
Japan (Topix)	1937	-2.8%	-4.7%	-2.8%
Netherlands (AEX)	766	-4.1%	-5.8%	-4.1%
Government bonds (10-year)				
	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	1.78	27	23	27
Japan	0.18	11	10	11
Germany	0.04	22	21	22
France	0.45	25	27	25
Italy	1.28	-2	-31	-2
Netherlands	0.17	20	20	20
United Kingdom	1.26	29	22	29
Investment grade credit				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	105	13	18	13
Eurozone	104	9	16	9
High yield bonds				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	326	43	32	43
Eurozone	347	29	28	29
Emerging markets (USD)	379	11	18	11
Emerging markets (Local currency)	313	-28	-56	-28
Real estate				
		Past month	Past 3 months	From 31-12-2021
Global		-4.6%	-0.4%	-4.6%
North-America		-5.4%	1.7%	-5.4%
Europe		-2.0%	0.3%	-2.0%
Commodities				
		Past month	Past 3 months	From 31-12-2021
Bloomberg index		11.2%	5.8%	11.2%
Base metals		3.8%	6.9%	3.8%
Brent oil (USD per barrel)	89.47	15.7%	10.2%	15.7%
Gold (USD per troy ounce)	1810	-1.0%	1.2%	-1.0%

Returns in local currency
bp = basis point (0.01%)
Data as of 3 February 2022
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Positive**
Equities were affected quite badly by the high inflation, slowing growth, the Fed's more aggressive tone and interest rate fears in January. Yet ultimately little damage was done, which demonstrates the strength of the underlying trend. High inflation, less expansionary monetary policies, less liquidity being pumped into the financial system and rising interest rates of course constitute risks for equities. Yet those risks have already been partly priced in. Measuring emerging market and Pacific region equities against a range of historical valuation bases results in a neutral value. European equities continue to be slightly more expensive than average and US equities are the most expensive of all. There are extreme differences in valuations between Europe and the US. In addition to the risks, though, there are positive factors, such as the prospect of economic growth and earnings growth. Value equities are also overrepresented in sectors that were greatly affected by the coronavirus pandemic. Value equities have leaped sharply compared to growth equities but we believe they could rise slightly further. Our overweight is made up entirely of European equities, in which value equities are more strongly represented. Emerging market equities are attractively valued versus their US counterparts but there's little difference versus Europe or Japan. Given the negative risks relating to the Chinese economy, we've decided to retain our neutral position in these.	
Government bonds	**Negative**
Central banks in the US and UK have implemented a significant change of direction towards tapering their highly-expansionary monetary policies over the past few months. Interest rates have already been raised twice in the UK. The US central bank is quickly scaling back its bond-buying programme and markets are pricing in five interest rate hikes this year. The ECB will certainly reduce the pace of its bond-buying this year and we can no longer rule out this being stopped completely or interest rates being raised. Yet capital market yields remain extremely low, especially considering the positive outlook for growth and inflation trends. Last year's peak was passed in the US at the start of the year and yields there currently stand at 1.8%. In Germany, capital market yields have reverted to positive figures for the first time since May 2019. UK bond yields briefly reached 1.35% at the end of January. Less expansionary monetary policies, a positive outlook for growth and gradually declining inflation lead us to expect slightly higher capital market yields. At the current low levels, this translates into low or negative returns on government bonds. We believe that the upward pressure on yields is greatest in the US.	
Investment Grade credits	**Neutral**
Investment Grade credits were adversely affected by the upheaval on the financial markets in January, although little damage was done. Spreads widened by 14 basis points in the US and 10 basis points in the Eurozone. The fact that spreads widened more sharply in the US than in the Eurozone is further proof that the financial markets are more concerned about the Fed's tone than the geopolitical developments surrounding Ukraine. Yet there's no sign of stress on the credits market, as spreads are tight in historical terms. Companies in this asset class are mostly profitable and in good financial shape. The default rate is low. Although spreads are tight, we don't expect them to widen significantly, especially in the Eurozone. The economic outlook continues to be sound to good and although the ECB is likely to reduce the pace of its bond purchases in 2022, it will continue to shore up the bond markets. The tapering of the bond-buying programme and interest rate hikes in the US could cause spreads to widen slightly over the course of 2022. Our neutral outlook mainly reflects the fact that we don't anticipate any major changes to spreads. The risk of higher underlying capital market yields is expressed in our underweight in government bonds.	
High Yield credits	**Positive**
Spreads in the High Yield segment widened faster than those in the Investment Grade segment, which is logical given the higher volatility of these bonds. Here, too, the increase of 59 basis points in the US was higher than the 36 basis points in Europe. All in all, High Yield credits didn't escape entirely unscathed in January either. Credit rating agencies have systematically adjusted their forecasts for default rates downwards. We believe that the current economic recovery will be enough for these low default rate forecasts to be realised. This has led us to view the current spreads on High Yield as slightly attractive, with a preference for Europe due to its lower credit risks. In the Eurozone, the difference between spreads on High Yield and on Investment Grade credits is higher than the 5-year average.	
Listed real estate	**Neutral**
January's 5.0% global downturn in listed real estate was exactly the same as that on equities. In the US, however, the high interest rate sensitivity of real estate was expressed in a performance that on balance dropped more sharply than that on equities. Sectors such as logistics, data centres and storage have led the recovery in industrialised countries in recent months, despite the high valuations found in these sectors. Occupancy rates are extremely high thanks to more people shopping online and working from home. The desire of businesses to operate at higher stock levels is providing further support here. However, the higher interest rates in the US after the end of the year exerted pressure on these growth sectors within real estate. Retail real estate continues to lag behind given the uncertainties surrounding the Omicron variant combined with the potential long-term impact of online shopping. For offices there are question marks relating to the long-term impact of more people working from home. Demand for A-list locations is expected to remain high, however, and the amount of space per employee to increase. Real estate can provide a hedge against rising inflation but higher interest rates are negative. Real estate should profit if inflation forecasts rise more sharply than nominal interest rates. Given the high valuations in the logistics, data centre and storage sectors and the structural uncertainties created by more people working and shopping from home, we hold a neutral outlook for this asset class.	

Emerging market debt	Neutral

Emerging market debt was also affected by the Fed’s more aggressive tone in January. This asset class is traditionally vulnerable to monetary tightening in the US owing to the strengthening US dollar and higher interest rates. In January, spreads on bonds listed in US dollars widened by 16 basis points. While yields on bonds listed in US dollars climbed by 43 basis points (spreads widened by 16 basis points and yields were up by 27 basis points in the US), bonds listed in local currency only widened by 9 basis points. There are a couple of reasons for the relatively sound performance of emerging market debt. Viewed historically, spreads on bonds listed in US dollars are wider than those on US High Yield, the bonds used as a benchmark for these bonds. In the case of market turbulence, there is therefore less of a buffer on High Yield. Secondly, emerging markets are in much better fundamental shape than they were ten years ago and monetary policy is being implemented in a sensible manner. Most central banks haven’t hesitated to raise interest rates when faced with rising inflation. Despite the relatively attractive yields and robustness in January, we believe the risks posed by a less expansionary policy from the Fed and the drop in activity in emerging markets caused by a slowing Chinese economy are too high for us to adopt an overweight.

Commodities	Positive

The overweight in commodities consists entirely of gold. Gold occupies a diversifying role in the portfolio. This role is traditionally reserved for government bonds but the extremely low yields are making that increasingly difficult. Gold does of course involve a much higher level of risk than government bonds and this has led us to adopt a small overweight. In the short term the gold price reacts strongly to real interest rates in the US. Low real interest rates are positive for the price of gold. The recent upturn in real interest rates means that the gold price is now back in line with these after having lagged behind when rates fell. Gold would seem to contain little upward potential at the moment. Commodities performed extremely well in January, with the Bloomberg index noting a plus of 9%. This was mainly thanks to the oil price rising by nearly 20%. Metals were up by 3.5% and the price of copper in fact fell. This is an example of this asset class’s diversity. While the oil price climbed owing to tightness on the production side, metals are facing a slowdown in growth in China. In view of the different forces at play in this asset class, in addition to the position in gold we hold a neutral outlook for commodities.

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