VAN LANSCHOT KEMPEN

Asset Allocation Outlook

MARCH 2022

- Russian invasion of Ukraine brings uncertainty
- Global economy can absorb a knock, as long as energy supplies are kept up
- Fewer interest rate hikes expected
- More cautious investment policy

Last month we said there was still hope for equity investors for 2022. We still think that, although investors will need to exercise patience. The reason is of course the Russian invasion of Ukraine which, aside from unimaginable human suffering and damage to infrastructure, is generating enormous uncertainty. Equity markets fell in February, globally by 2.7%, with Europe (-5.2%) hit harder than the US (-3.1%). That was nothing compared to the Russian market, however, which dived over 30% in a single day and was subsequently closed. The rouble has also plummeted. Investors sought safety in government bonds, causing US 10-year bond yields to fall to 1.7% and German yields to drop back below zero. The big winners were commodities, especially oil, the price of which climbed to 114 US dollars a barrel at the start of March, its highest level since February 2013. European gas prices shot up again.

Surging energy prizes due to Russian invasion

Source: Bloomberg, Refinitiv, Van Lanschot Kempen

The price losses on the equity markets have led to our equity position declining from an overweight to a neutral weight. We don't believe this to be a good time to buy more equities. In the fixed income portion of the portfolio we have reduced our overweight in European High Yield credits and switched to the more secure European Investment Grade credits. In doing so we aim to profit from Investment Grade having been hit harder in relative terms than High Yield and slightly reduce our exposure to riskier asset classes.

War brings uncertainty

What everyone had feared but not everyone had thought possible happened anyway: Russia invaded Ukraine from multiple directions. As we aren't military experts, we won't comment on the potential course of the war. What we will attempt to do is estimate the potential impact, and this is largely related to the sanctions imposed against Russia and energy supplies. Compared to previous crises, this time the sanctions are much tougher and more far-reaching. They will therefore have much more of an impact. The Russian economy will undoubtedly fall into a deep recession. Yet given the small amount of Russian foreign trade on a global scale, the impact on the global economy is also expected to be small. Nevertheless, it should be noted that it could lead to shortages of commodities and contribute to the tightness in supply chains and to inflation. In light of the current package of sanctions and current energy

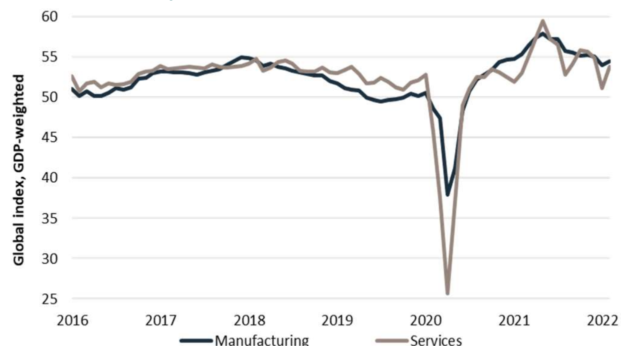
prices, we anticipate a negative impact of 0.5 to 1% on European growth and a smaller impact in the US and Asia. This means lower growth in Europe but no recession. In this scenario we assume that energy supplies will be kept up. The trade sanctions against Russia mean that the country will receive less foreign currency. An acute shortage of foreign currency will arise, primarily as a result of the financial sanctions, including the exclusion of a number of Russian banks from the SWIFT international payment system and freezing of foreign assets held by the Russian central bank. If Russia were also to decide to slash or even halt energy deliveries to Europe, the situation would become extremely pressing. A drowning man will clutch at a straw but we don't assume that President Putin will decide to do this. Nor do we see Europe deciding not to buy any more Russian gas, given that there are few alternatives. In short, as long as energy continues to be supplied, we believe that the damage to the European economy will be small.

However, we do believe there's a higher risk of a negative scenario occurring. The invasion itself, Putin putting nuclear forces on high alert, the tough sanctions and Germany raising its defence budget show that Russia and the West are prepared to take major steps. The rising number of civilian casualties could lead to further escalation. Moreover, these steps are aligned with a more multipolar world involving greater intervention from governments and larger budget deficits. Higher inflation is also part of this picture.

Robust economy

The war in Ukraine came just when the global economy was starting to accelerate again. This was thanks to the drop in the wave of Omicron variant infections of the coronavirus. Insofar as there were still restrictions, most have now been lifted. Furthermore, people are now becoming less cautious. This can mainly be seen from confidence among businesses. Confidence has been high in industry for some time now due to the high demand for consumer and investment goods. In February, industrial companies in a sizeable number of countries were also slightly more positive. Confidence had fallen in the service sector in December and January as a result of the Omicron wave, incidentally without pointing to shrinkage. Yet in February this dip was reversed, including in the US, the Eurozone and the UK.

Confident entrepreneurs

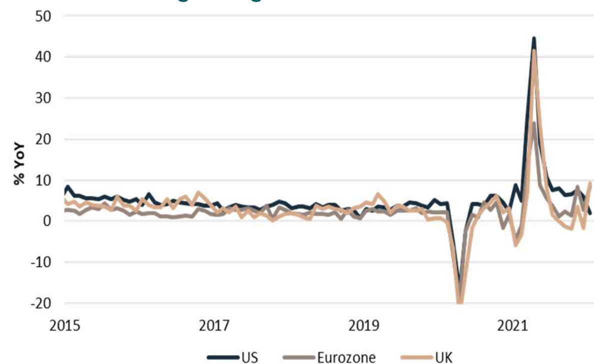


Source: Bloomberg, Van Lanschot Kempen

The optimism was driven by the strong demand for goods and services as well as trends relating to the coronavirus, but also to signs of easing tightness in supply chains. In the Eurozone the Economic Sentiment Index also climbed after two months of downturns and this indicator is now pointing to robust growth. In Germany the all-important Ifo index caused a positive surprise.

Consumers are less optimistic. Consumer confidence declined in both the US and Europe in February. It's noticeable that US consumers are more pessimistic in relative terms than their European counterparts, even though wages are rising more rapidly in the US.

Retail sales still growing



Source: Refinitiv, Van Lanschot Kempen

A possible explanation for this is the higher and more widespread inflation in the US. Incidentally, this pessimism doesn't really seem to be stopping

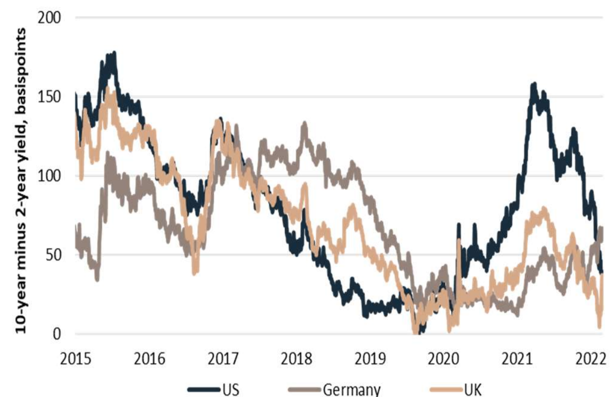
consumers from spending money. While consumer spending did drop sharply in the US and Europe in December, January again saw a substantial upturn in the US, partly driven by a sharp increase in car sales. In the Eurozone retail sales also rose, albeit marginally. Nevertheless this shows once more that consumer income dictates spending more than confidence does. And that income is being bolstered by strong job markets and wage growth.

We've said before that the climate for corporate investment is positive. There's a need for investment given the tightness in supply chains and on job markets, while corporate earnings are high and financing conditions remain favourable. This is reflected in the robust growth in orders for capital goods: 10.5% Y-o-Y in the US in January, 7.4% Y-o-Y in Germany in December and 5.8% Y-o-Y in Japan in December.

All of this was of course prior to Russia's invasion of Ukraine. We've already said that this war will hit Europe harder than the US. Yet as long as energy supplies don't decrease significantly, we believe the European economy is robust enough for this not to imperil growth. Inflation will remain high for longer though.

A negative slope, in which 10-year yields are lower than 2-year yields, is one of the best indicators of a recession. Incidentally with a considerable delay. The yield curve had already flattened substantially last year but it's happening quickly this year. In January the difference between short and long-term yields stood at 90 basis points, now it's just 36 basis points. If the Fed raises interest rates too aggressively and markets believe the central bank is squeezing the economy excessively, the curve could become negative.

Strongly flattening US yield curve



Source: Bloomberg, Van Lanschot Kempen

Fewer interest rate hikes

With respect to the forecasts for monetary policy, the markets are clearly struggling with the geopolitical uncertainty on the one hand and high inflation on the other. Prior to the start of the war in Ukraine, markets were forecasting six to seven interest rate hikes of 0.25% each in the US. An increase of 0.5% had more or less been priced in for the first interest rate hike in March. Markets now predict an increase of just 0.25% in March and the total number of forecast interest rate hikes briefly fell to just below five. The first increment of 0.25% was confirmed by Fed Chair Powell during his six-monthly testimony to US Congress. Although he admitted that the war in Ukraine could cause a huge amount of uncertainty, he also anticipated a series of interest rate increases. According to Powell inflation will decline, but this is happening more slowly than expected. The Fed chair noted the extreme tightness on the job market. Powell's remarks raised the forecasts for the number of interest rate hikes slightly again. A complicating factor for the Fed is the flattening of the yield curve.

The Fed could prevent this by shoring up government bonds less. It's already doing so by tapering its purchasing programme at a faster pace, but the Fed has also said it wants to start reducing its balance sheet soon after the first interest rate hike. In the first instance this will be done by no longer reinvesting the proceeds from expiring government bonds. The Fed could even decide to actively sell its portfolio of mortgage-related bonds. On balance this is further tightening on top of the interest rate increases, although it can hardly be called tightening as long as the Fed's policy interest rate remains well below the level of inflation. This then begs the question of how far the Fed will ultimately need to raise rates. The ceiling for these has got lower and lower over the past few cycles. In 2019 it was no higher than 2.5%. Whether peak interest rates will be able to stay that low this time is uncertain in view of the higher inflation.

The situation is more complicated for the ECB. Inflation in the Eurozone climbed as high as 5.8% in February. This is largely because of the sharp upturn

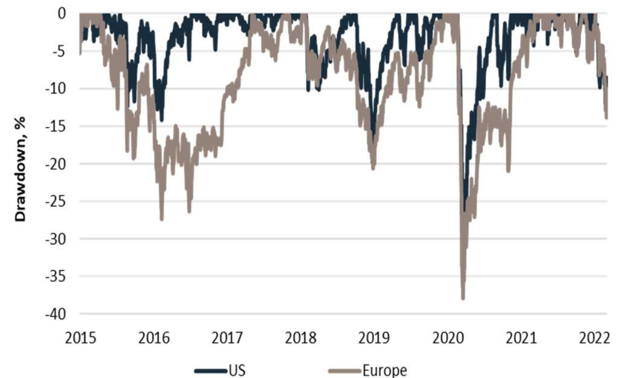
in energy prices, something over which the central bank can exert no influence via its policies. Excluding food and energy prices, core inflation rose to 2.7%. This is its highest level since the ECB started measuring it (1997) and far above the bank's target rate of 2%. This therefore argues in favour of a less expansionary monetary policy. The ECB has already announced an end to the emergency purchase programme for the coronavirus pandemic in March. The regular bond-buying programme will then be increased temporarily in the second and third quarters, after which it will again be cut in the fourth quarter to the 20 billion euros a month that the ECB has been buying since November 2019. Prior to Russia's invasion of Ukraine the market was expecting the regular bond-buying programme to be halted in the fourth quarter, which would pave the way for raising interest rates. These expectations have now largely dissipated. The ECB has so far said little on this topic but what we are hearing points to caution on scaling back the expansionary monetary policy too quickly. Last month we reported that the ECB seemed to be preparing markets for an announcement on a policy change during the ECB's meeting on 10 March, but this has now changed.

Markets volatile, no sense of panic

The war in Ukraine has of course caused considerable movement on the markets. The VIX index, a gauge of volatility on the US market, has nearly doubled versus the start of January. The comparable index for the European market is showing a similar picture. Current levels point to a downturn on the markets of 10 to 15%. During the financial crisis or the outbreak of the coronavirus pandemic, volatility indices shot up to levels that were twice what we're seeing now. It's noticeable that volatility has increased more sharply on the US bond market. This may be related to the prospect of the Fed already intervening less in this market and reducing this intervention further over the course of the year.

Equity markets are now 13% lower in Europe than the peak levels at the start of this year and 8.5% lower in the US. This isn't all down to the war in Ukraine though. From 11 February, when US President Biden started to warn of war, the S&P500 has only declined by 0.7% and the Euro STOXX 600 by 8%.

Equity markets drop



Source: Bloomberg, Van Lanschot Kempen

US 10-year bond yields briefly passed 2% in February, subsequently dropped to 1.7% on 1 March and after Fed Chair Powell's testimony to Congress climbed back to 1.85%. The course of real interest rates is even more remarkable. After declining to -0.9% these are again close to noting record lows. Given the restricted impact on growth in the US, high inflation, the series of interest rate hikes by the Fed this year and the tapering of the bond-buying programme, we expect capital market yields to rise again in the US.

As the markets expect very few interest rate hikes from the ECB, 2-year German bond yields have again dropped close to record lows. Their 10-year counterparts also dipped briefly below zero but the high inflation pushed yields just back into positive territory.

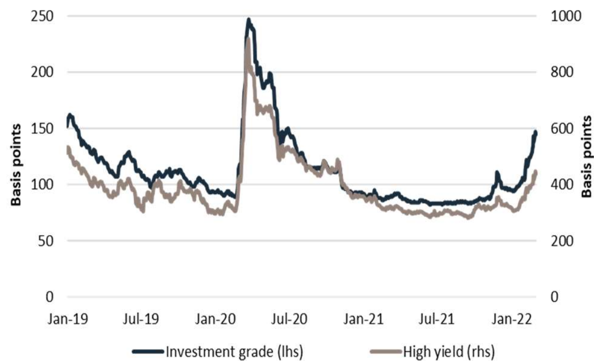
Investment policy: less risk-taking

Whether the current corrections on the financial markets will be enough depends greatly on how the war evolves and how much it escalates. We believe that the markets in European are anticipating a significantly more negative economic picture. This isn't our basic scenario at the moment. Moreover, we note that the lower market prices are contrasting with the upward momentum in expected earnings. This could of course change quickly. The downturn on the equity markets caused our overweight to revert to a neutral position. We continue to be positive about equities for fundamental reasons. Global economic growth has the potential to pick up further and corporate results to improve slightly. Until the war in Ukraine, the greatest risk lay in the

high inflation. This could squeeze growth but we're seeing substantial compensation from the job market. That inflation risk, and corresponding higher interest rates, was already higher in the US and has certainly not abated in relative terms. This leads us to retain our fundamental preference for value equities and European equities. Yet the level of uncertainty has also increased. We therefore don't believe it to be a good time buy more equities and restore our equity overweight.

We are making an adjustment to the fixed income portion of the portfolio, however. We have held an overweight in European High Yield credits since mid-2020. We adopted this position when spreads were still wide at the start of the coronavirus pandemic. We were already seeing governments supporting businesses and shoring up bond markets exceedingly actively. As a result of this support, we believed there to be a low risk of a wave of bankruptcies. This outlook was confirmed when spreads quickly tightened. Spreads have since widened slightly again and now stand at about the same levels as when we accrued our High Yield position. This means we have profited from the higher interest compensation on these bonds but on balance very little from price effects. We continue to believe that there won't be a wave of bankruptcies but have decided to switch to the more secure Investment Grade credits. Spreads in this asset class have widened more sharply than those on High Yield credits. The downturn in prices is therefore higher, which implies that a more negative scenario has already been priced in. Furthermore, in doing so we are slightly reducing our exposure to riskier asset classes. This is a precaution in the event that we end up in a more negative geopolitical scenario.

Spreads on Investment Grade have widened more



Source: Bloomberg, Refinitiv, Van Lanschot Kempen

Market review

Equities	Index	Past month	Past 3 months	From 31-12-2021
Global (MSCI AC)	1168	-4.7%	-4.8%	-7.9%
Developed markets (MSCI World)	2964	-4.8%	-4.7%	-8.3%
Emerging markets (MSCI EM)	1168	-3.7%	-5.5%	-5.2%
United States (S&P500)	4387	-4.4%	-4.2%	-8.0%
Eurozone (EURO STOXX 50)	3821	-9.5%	-7.0%	-11.1%
United Kingdom (FTSE 100)	7430	-2.0%	4.2%	0.6%
Japan (Topix)	1860	-4.0%	-3.4%	-6.6%
Netherlands (AEX)	721	-5.8%	-7.4%	-9.6%
Government bonds (10-year)				
	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	1.88	10	43	37
Japan	0.14	-4	8	7
Germany	0.03	-1	40	20
France	0.48	3	49	29
Italy	1.27	-15	-33	22
Netherlands	0.27	10	50	30
United Kingdom	1.26	0	45	29
Investment grade credit				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	124	19	23	32
Eurozone	145	41	41	50
High yield bonds				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	355	29	30	72
Eurozone	439	92	92	121
Emerging markets (USD)	477	98	96	108
Emerging markets (Local currency)	330	16	-24	-12
Real estate				
		Past month	Past 3 months	From 31-12-2021
Global		-1.3%	-1.4%	-5.9%
North-America		-0.9%	-0.3%	-6.3%
Europe		-5.0%	-5.5%	-6.9%
Commodities				
		Past month	Past 3 months	From 31-12-2021
Bloomberg index		10.8%	28.4%	23.2%
Base metals		10.5%	20.6%	14.7%
Brent oil (USD per barrel)	89.47	28.2%	64.3%	46.9%
Gold (USD per troy ounce)	1810	6.2%	9.1%	5.1%

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

Tactical outlook

Asset class	
Equities	**Neutral**

The equities of industrialised countries are currently trading at about 10 to 15% below their recent record highs. Emerging markets are down by almost 20%. This isn't all a knock-on effect of Russia's invasion of Ukraine. The trend in emerging market equities has been negative for some time, primarily due to the slowdown in growth in China. In the US, equities were squeezed more recently by high inflation and the central bank's sudden move towards raising interest rates. European equities have been hit harder by the war in Ukraine than their US counterparts, leading to them noting sharper price losses on balance. We continue to be positive about equities in fundamental terms. Both the global economy and corporate earnings have the potential to grow further. Equity valuations are now more favourable. Valuations of equities from Europe, Pacific and emerging markets are neutral to slightly cheap. Only US equities continue to be rather expensive. Yet geopolitical risk has increased. The lower equity prices have led to our position declining from an overweight to a neutral weight. We've opted to maintain this for the time being.

Government bonds	**Negative**

Government bonds have experienced a considerable amount of movement in recent months. Sharply higher inflation and central banks shifting towards less accommodating monetary policies have pushed capital market yields higher, briefly to above 2% in the US and briefly above zero in Germany. The war in Ukraine triggered a flight to safety to this asset class, pushing yields down again. In particular in the US the Fed looks willing to implement a series of interest rate hikes and reduce its balance sheet. This will cause capital market yields to rise again. In the Eurozone, the ECB needs to steer between high inflation and a greater negative impact on growth than in the US. Whereas last month the bank looked to be preparing to adjust its policy in March, this is now uncertain. We believe capital market yields will climb again slightly in Germany but for the time being the upward pressure will be lower than in the US.

Investment Grade credits	**Positive**

Spreads on Investment Grade credits widened sharply in February, especially in Europe. There they widened by 39 basis points versus 16 basis points in the US. Concerns about Fed policy were greater in the US in January, while in February concerns about the impact of the war in Ukraine dominated in Europe. The economic conditions and financial positions provide no justification for the relatively sharp widening of spreads in Europe, especially given that these spreads widened more sharply than those on High Yield credits. We've therefore increased our position in European Investment Grade credits at the expense of European High Yield. This also contributes to reducing the exposure to riskier asset classes in our diversified investment portfolio.

High Yield credits	**Neutral**

Spreads in the European High Yield segment widened faster than in the European Investment Grade segment, which is logical given the higher volatility of these bonds. Yet the increase was smaller in relative terms. It looks as if the High Yield market is pricing in less risk than its Investment Grade counterpart. Our basic scenario, in which Russia continues to supply energy to Europe despite the war in Ukraine, assumes that these spreads will tighten again. Yet the smaller widening in High Yield means there's less potential for this asset class than for Investment Grade. We've reduced our position from positive to neutral. This also contributes to a lower risk profile for our diversified investment portfolio.

Listed real estate	**Neutral**

The global downturn in listed real estate of 2.4% was almost the same as that on equities. Prices fell slightly more in the US and Europe than they did globally, while in Asia the downturn was smaller. Real estate investors apparently estimate the risk of higher interest rates in the US to be the same as the geopolitical risk in Europe. Asia is the least affected by both risks. 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**

Spreads on emerging market debt listed in US dollars widened sharply by 85 basis points in February. An average spread of 477 basis points is not unusual in the event of turbulence on emerging markets. Yet this time that average doesn't tell us very much. It was mostly spreads on Russian and Ukrainian bonds, which prior to the war accounted for 3% and 2% of the index respectively, which triggered the widening. For Russia the spread swelled to 3,761 basis points, for Ukraine to 4,441 basis points. This means that the yields on these bonds are almost 40% and over 46% respectively. Much less damage was inflicted on bonds listed in local currency, in which Russia accounts for 6% of the market. Yields on the index as a whole increased by 34 basis points. Here, the situation on the local Russian market is so acute that pricing has virtually ground to a halt. The good news is that there's no contagion to other countries. The relative attractiveness of the asset class as a whole versus High Yield has declined somewhat, taking into account the fact that the wider spreads apply mainly to Russia and Ukraine. A less expansionary monetary policy in the US continues to pose a risk as it will in turn push up interest rates and potentially lead to a more expensive US dollar. 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
Within commodities we have switched from gold to the general commodity index. With the economy picking up and a central bank planning to raise interest rates, we expect real interest rates to rise in the US. The price of gold traditionally has a strong inverse correlation with real interest rates: higher interest rates mean a lower gold price. When interest rates rise, bonds again occupy a more diversifying role versus equities, although that effect is still very small. We view the rising inflation as more significant. Commodities offer a hedge against higher inflation. Moreover, we're seeing tightness in a range of commodity markets, including the oil market. This raises the prospect of a period of high prices. Finally, there's a technical aspect as well. The current tightness has led to spot prices being higher than futures prices in many markets. We call this situation backwardation. As investment in commodities is nearly always via futures, backwardation generates a positive return for investors. Over time cheaper futures roll over towards the higher spot prices. The extent to which this is now happening is almost unprecedented. Gold is the ultimate safe haven in times of uncertainty. We saw this in February as well when the gold price climbed by 6.2%. This is exactly the same as the upturn on the general commodity index. Metals lagged behind slightly but the oil price was up by about 10%.	

JOOST VAN LEENDERS
Senior investment strategist
joost.vanleenders@kempen.nl
06 8283 1189

VAN LANSCHOT KEMPEN ASSET RESEARCH & COMMUNICATION:

Yaela van Raalte – Hoofd ARC
Michel Iglesias del Sol – Hoofd investment strategy
Luc Aben – Hoofdeconoom Van Lanschot
Robert de Groot – Hoofd investment research en communicatie
Maarten van der Pas – Hoofd editorial desk
Alastair Greenlees – Hoofd investment strategy UK
Arif Saad – Hoofd investment strategy UK
Duco Smit – Senior beleggingsstrateeg
Jorn Veeneman – Beleggingsstrateeg
Mees Vlasveld – Beleggingsstrateeg
Jack Horvest – Investment Specialist
Ellen Engelhart – Specialist obligaties
Bob Stroeken – Specialist aandelen
Tim Verhagen – Specialist aandelen
Effi Bialkowski – Specialist beleggingsfondsen
Bas Kooman – Investment writer

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