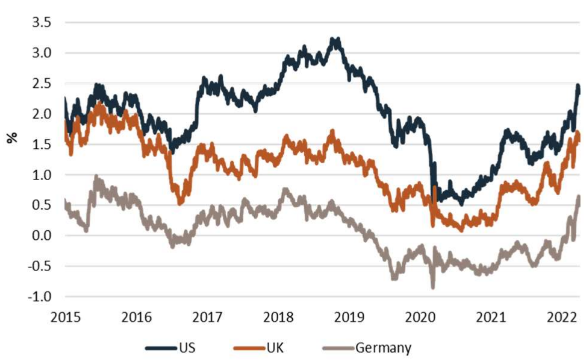
Asset Allocation Outlook

APRIL 2022

- Inflation rises even higher and has a negative impact on economic growth
- Negative slope in US yield curve not yet negative for equities
- Less positive corporate earnings growth
- Investment policy unchanged, neutral position in equities

The war in Ukraine continues to rage but investors are looking to the future. The US S&P500 equity index is now higher than in the run-up to Russia's invasion. Although the European STOXX index has not yet returned to its former level, it has rallied sharply. Equities from industrialised nations earned a plus of 2.5% in March. In local currency, US equities climbed by 3.6%, while Europe was still slightly negative at -0.4%. Yet this was still better than emerging markets, which lost 2.5%. This was primarily due to a downturn in the Chinese MSCI index of 6.1%, but a drop of 3.7% in Taiwan also stood out. Higher bond yields caused government bonds to note extremely negative returns: -2.8% in the US and -3.9% in the Eurozone.

Capital market yields rise sharply



Source: Bloomberg, Van Lanschot Kempen

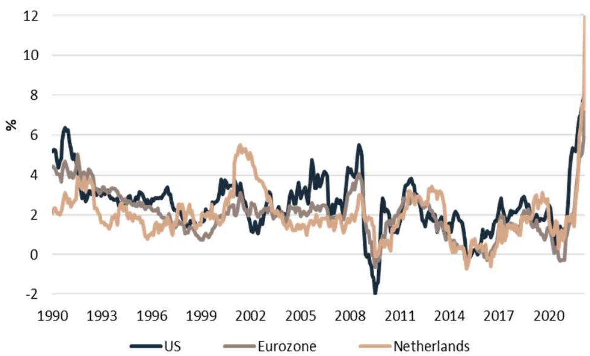
Tighter spreads meant that credits were able to restrict the decrease in returns somewhat, although only European high yield credits succeeded in avoiding a negative return by a tiny margin. Real estate seems to be living up to its reputation as a hedge against inflation to a certain extent, with the global upturn largely deriving from the US.

Yet this certainly doesn't mean an end to the worries. The course of the war continues to be difficult to predict; a rapid end to sanctions against Russia and high energy prices looks to be unlikely. And the high energy prices are starting to take their toll. We have therefore decided not to take too much risk in our model portfolio.
We retain our neutral position in equities. Given the high inflation and aggressive policies of central banks, we believe there is capacity for further increases to interest rates. We hold an underweight in government bonds for this reason as well as overweights in investment grade credits and commodities.

Inflation takes its toll

The main repercussions of the war in Ukraine derive from the high energy prices. While the oil price has fallen from its peak of 127 US dollars per barrel to 105, it remains more than 60% higher than a year ago. Gas prices in Europe are six times higher than a year ago. This is having an impact on inflation. It rose to 7.5% in the Eurozone in March. Energy prices shot up by as much as 44.7%. Excluding food and energy prices, core inflation climbed to 3.0%. This shows that inflation in the Eurozone continues to be less widespread than in the US, where headline inflation stands at 7.9% and core inflation 6.4%.

Inflation climbs further

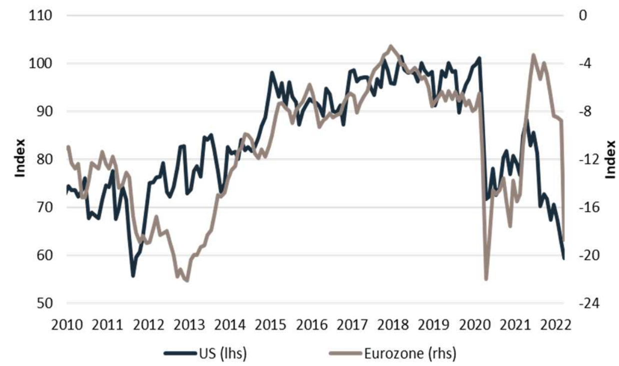


Source: Refinitiv, Van Lanschot Kempen

In the Netherlands, inflation was at an almost unprecedented 11.9% when calculated using the European harmonised method. This method assumes that all consumers arrange new energy contracts every month and therefore immediately face the new, higher prices. Naturally this isn't really the case, meaning that inflation is much lower for many consumers. Nevertheless, high inflation always causes a stir and affects consumer confidence. That confidence plummeted in the Eurozone in March and now stands only slightly higher than the extremely low level of April 2020, right at the start of the coronavirus pandemic. In the US, confidence fell to its lowest level since the 2008 financial crisis.

Consumer confidence is not the only factor that determines spending though. Income is even more important. Family incomes are bolstered by robust job markets. Employment was up and unemployment down in both the US and the Eurozone. Hourly wages are also rising substantially in the US. Yet income growth is still failing to keep up with inflation. As Dutch Prime Minister Rutte put it: "we're all getting a bit poorer". This is despite governments taking measures to mitigate the negative impact of the high inflation. Substantial savings were built up during the coronavirus pandemic. When income growth is low, consumers often use savings to keep up their spending patterns. This is less likely when consumer confidence is low, however. For this reason, consumer spending may only make a small contribution to economic growth in the second and third quarters.

Consumers lose confidence



Source: Refinitiv, Van Lanschot Kempen

Manufacturers are also struggling with high inflation. Nevertheless, the US purchasing managers index for industry climbed in March. A level of 58.5 points to robust growth. In the Eurozone this index declined slightly to 57, still a high level. Yet the underlying data were less promising. Procurement prices are rocketing and these are also being passed on to customers. Delivery times remain long, which points to persisting supply chain problems. Moreover, European manufacturers were significantly more pessimistic about the future. The service sector is still experiencing a tailwind from the reopening of economies. Here, too, confidence was up in the US, while the Eurozone saw a minor decrease.

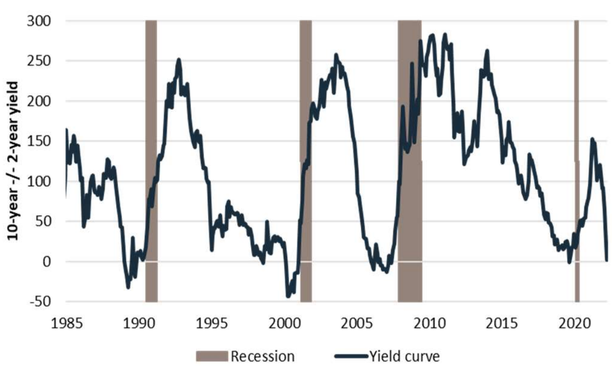
The Chinese economy is still struggling with problems in the real estate sector but the coronavirus pandemic flaring up again has added to these. The take-up of booster jabs in particular is low in China, with vaccines being used that are less effective against the Omicron variant. Furthermore, the strict coronavirus policy means that group immunity is lower than in the Western countries. Confidence among businesses in industry and the service sector has consequently fallen to levels that point to a slowdown in the economy. This increases the likelihood of the Chinese government implementing more stimulatory measures.

The global economy is therefore going through a difficult patch. Negative shocks, such as the war in Ukraine, growing tensions between Russia and NATO countries, high energy prices and inflation and a slowdown in growth in China, are squeezing growth. The tailwind from the reopening of economies after the coronavirus pandemic, robust job markets and governments that are easing the pain of higher energy prices somewhat could prevent economies sliding into a recession. This is still the scenario we anticipate. Negative quarters cannot be ruled out, however, and there's a higher risk of these in Europe than in the US.

Negative US yield curve: is a recession coming?

On the subject of recessions, one important indicator of these is the slope of the US yield curve. At the short end the yield curve is dominated by the central bank's official interest rate and at the long end by the market for long-term government bonds. Normally, the slope of the curve is marginally positive. After all, investors want to be rewarded for the risks associated with investing in long-term bonds. A steep curve can occur if the central bank slashes interest rates and investors assume that this will trigger growth and inflation in the long term. A negative yield curve, in which long-term rates are lower than their short-term counterparts, points to a tight monetary policy with inflation falling over a longer horizon.

US yield curve's negative slope a sign of a recession?



Source: NBER, Refinitiv, Van Lanschot Kempen

US 10-year government bond yields recently dipped slightly below those on 2-year bonds. A negative yield curve in the US always attracts a huge amount of attention because it's a reliable forecast of a recession. In the past 70 years, every recession in the US has been preceded by a negative yield curve. The length of time between the moment at which the curve becomes negative and the start of the recession varies widely, however. The average for the past ten recessions is 19 months. The shortest was the recession caused by the coronavirus, just 6 months, but of course markets didn't see that one coming. The longest was in the second half of the 1970s, no fewer than 48 months. A recession invariably causes equity prices to fall, but we still have time before this happens. Furthermore, other recession indicators, such as the equity market, monetary growth, applications for unemployment benefits, orders for consumer discretionary goods, are giving no hint at all of a looming recession.

There are two further reasons why things could be different this time. Firstly, the yield curve continues to be extremely positive between the 3-month and 10-year bond yields. Yet the Fed, the US central bank, has already made it clear that it will raise interest rates substantially this year, so this yield curve indicator will also flatten quickly and perhaps even become negative as well. Secondly, real interest rates (rates adjusted for inflation) are sharply negative and therefore extremely low. Never before has a recession in the US been preceded by negative real interest rates. History has frequently shown that it's dangerous to say things are different this time, including with respect to the negative yield curve, but the Fed's policy of buying up large amounts of bonds may have had a disruptive effect on the market. So much so that the yield curve indicator is no longer working. At the very least it's something to keep an eye on.

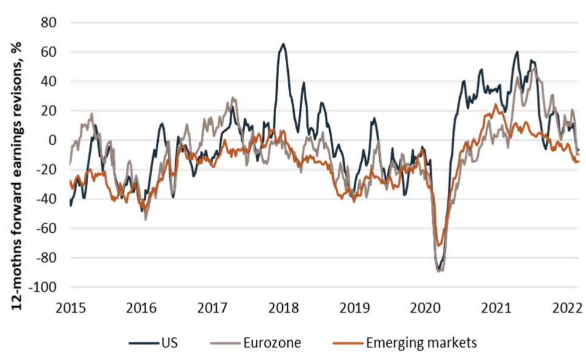
Finally, a word about the timing. As the negative yield curve indicator occurs so far ahead of a recession, equity markets are taking little notice of it. Prior to the past seven recessions, in six cases the US equity market continued to climb after the yield curve had become negative. On average, the S&P500 peaked eleven months after the yield curve indicator, the average upturn being 15%. Past performances provide no guarantee for the future, but they do show that a negative yield curve isn't a sign that we should immediately offload all our equities.

Earnings squeezed

Corporate earnings growth is of course an important driver of equity markets. The two usually climb by about the same amount. Over the past three years, for instance, i.e. since March 2019, corporate earnings have risen by 16% in Europe, while the equity index was up by 17%. In emerging markets the upturn was 7.6% and 12% respectively. The two have also increased by similar amounts over the past two years. In contrast, the index has lagged behind earnings over the past twelve months. This has led to lower price/earnings (P/E) ratios and in turn to an improvement in valuations. The US equity market has also trailed earnings over the past year but it had far exceeded earnings growth in the preceding years. The US index has risen 60% over the last three years, earnings only by about half that, making US equities expensive. This is partly due to the sector composition in the US. Tech companies, which are more heavily represented in the US than in Europe or emerging markets, have profited most from the low interest rates. More distant future earnings are worth more at low interest rates. We can therefore see a strong correlation between real interest rates in the US and P/E ratios. This also means that US equities are vulnerable to higher real interest rates.

Earnings growth is important, however. And cracks are starting to appear in it.

Analysts cut earnings forecasts



Source: Refinitiv, Van Lanschot Kempen

For two consecutive weeks in March, more equity analysts adjusted their earnings forecasts downwards for the US than upwards. In Europe, this was the case in one week. This has been happening in emerging markets since November last year. The number of analysts making adjustments doesn't tell us how much they're adjusting their forecasts, however. And, so far, it's not by much. Expected US earnings over twelve months fell slightly in March, 0.2% versus February. And those expected earnings are still 23% higher than a year ago. Oddly enough, expected earnings in Europe climbed by a further 0.2% month-on-month, and growth over a year now stands at 25%. Emerging markets are doing worse in this respect as well. Expected earnings have fallen a couple of times in the past twelve months, in March by as much as -6.6%. Annual growth stood at just 5.4%. Equities will therefore still profit from a tailwind generated by realised earnings, which continue to grow, but deteriorating forecasts do mean that equities will receive less of a boost. These downward adjustments to economic growth are another trend that requires careful monitoring.

Cautious investment policy

Waning economic momentum and lower earnings growth have led us to retain our neutral position in equities. An underweight is too negative in our view, given that there are few signs of an imminent recession and corresponding sharp downturn in corporate earnings. Job markets are robust and the capital positions of families, businesses and banks are generally healthy. Moreover, equity valuations are no longer excessive from a historic perspective (with the possible exception of the US) and certainly not versus other asset classes.

Capital market yields have risen substantially, meaning that a significant portion of the current inflation and tighter monetary policy has already been priced in. Yet investors in longer-term bonds still seem to assume that inflation will fall quickly. We basically agree with this, but there is a clear risk of this taking longer than expected. The supply chain problems haven't yet been solved completely. The policy of sanctions against Russia and renewed lockdowns in China could even cause the situation to deteriorate. We have decided to retain our underweight in government bonds for this reason.

We hold an overweight in European investment grade credits. Spreads on this asset class widened more in relative terms than on e.g. high yield credits. This means there is still potential for spreads to tighten further in investment grade. Moreover, these bonds are slightly less sensitive to higher interest rates than government bonds.

We've also retained our overweight in commodities. Prices have been volatile but on balance haven't yet risen that much since we adopted this position. Demand for commodities could decline slightly in the event of lower growth, but stock levels are generally low and the geopolitical situation increases the risk of shortages. In addition, investors in this asset class are profiting from the fact that futures prices continue to be lower than spot prices. This is currently yielding a return of over 10% on an annual basis.

Market review

Equities	Index	Past month	Past 3 months	From 31-12-2021
Global (MSCI AC)	1162	5.8%	-5.2%	-4.8%
Developed markets (MSCI World)	3081	6.4%	-5.1%	-4.7%
Emerging markets (MSCI EM)	1162	1.5%	-5.9%	-5.7%
United States (S&P500)	4583	5.9%	-4.4%	-3.9%
Eurozone (EURO STOXX 50)	3951	11.1%	-9.5%	-8.1%
United Kingdom (FTSE 100)	7559	8.2%	0.7%	2.4%
Japan (Topix)	1954	5.9%	-3.8%	-1.9%
Netherlands (AEX)	738	9.8%	-8.3%	-7.5%

Government bonds (10-year)	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	2.40	66	75	89
Japan	0.21	5	13	14
Germany	0.51	58	63	68
France	1.00	57	77	81
Italy	1.93	193	34	88
Netherlands	0.78	58	77	81
United Kingdom	1.55	34	46	58

Investment grade credit	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	111	-19	19	19
Eurozone	129	-22	35	34

High yield bonds	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	313	-63	28	30
Eurozone	387	-78	78	69
Emerging markets (USD)	393	-118	33	25
Emerging markets (Local currency)	234	-116	-103	-107

Real estate		Past month	Past 3 months	From 31-12-2021
Global		5.2%	-0.9%	0.0%
North-America		3.4%	-0.5%	-0.3%
Europe		7.5%	-5.1%	-4.5%

Commodities		Past month	Past 3 months	From 31-12-2021
Bloomberg index		-1.1%	24.9%	26.7%
Base metals		-3.4%	17.1%	18.2%
Brent oil (USD per barrel)	107.53	-6.0%	36.8%	40.8%
Gold (USD per troy ounce)	1934	-1.7%	6.6%	5.8%

Returns in local currency
bp = basis point (0.01%)
Data as of 5 April 2022
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Neutral**
Equities have been in the red since the start of the year but they've also rallied considerably since the low of around 8 March. Equity investors seem to be looking ahead to the period after the war in Ukraine. Our neutral position is prompted by the fact that there continue to be many uncertainties relating to the war and by the growing tensions between Russia and NATO countries. This has led to high energy prices and pushed inflation even higher. As a result, the global economy is losing momentum and corporate earnings growth is less positive. However, equity markets are being bolstered by the robust job markets, the healthy financial positions of families, banks and businesses and governments that are mitigating the negative impact of the high energy prices slightly. The advantage of this is an improvement in equity valuations. Equities from Europe, Pacific and emerging markets are valued at neutral to cheap. Only US equities remain fairly expensive.	
Government bonds	**Negative**
Government bonds have experienced a considerable amount of movement in the past month. Volatility on the bond markets was even higher than that on the equity markets. Sharply higher inflation and central banks shifting towards less accommodating monetary policies have pushed capital market yields higher. Yields of almost 2.5% haven't been seen in the US since May 2019. To find German yields of over 0.6% we need to go back as far as May 2018. The US central bank has placed its cards on the table: a series of interest rate hikes and later this year a reduction to the balance sheet. The ECB has so far not announced anything beyond tapering its bond-buying programme. The ECB needs to steer between high inflation and a greater negative impact on growth from the war in Ukraine than in the US. We believe that US monetary policy has also already largely been priced in to current bond yields. In the Eurozone, the market's expectations for raising interest rates next year look to be rather ambitious. This has eased the upward pressure on capital market yields, although the principal risk continues to be worse-than-expected (higher) inflation.	
Investment grade credits	**Positive**
Spreads on investment grade credits tightened by 6 basis points in the US and by 15 basis points in Europe in March. Yet this still hasn't undone the wider spreads of January and February. 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. The higher capital market yields led to negative returns on investment grade credits in March, but we anticipate positive returns on these if capital market yields stay at the same level and spreads tighten further. This overweight is also aligned with a moderate exposure to riskier asset classes in our diversified investment portfolio.	
High yield credits	**Neutral**
Spreads on high yield credits tightened in March, just as they did in the investment grade class. Remarkably, given the geopolitical tensions, higher interest rates and loss of economic momentum, spreads on high yield credits tightened more quickly in relative terms than those on investment grade. Although this generated returns that were less negative, it also increases the risk in this asset class. We therefore prefer European investment grade credits.	
Listed real estate	**Neutral**
While global real estate climbed in line with equities in January and February, a significantly better result was visible in March. Equities were up by 1.9%, real estate by 4.3%. On average real estate outperforms equities in a high inflation environment and certainly in one where inflation is higher than expected. Real estate once again seems to be living up to its reputation as a hedge against inflation. Yet higher interest rates do pose a threat to this asset class. In this respect, it's remarkable that the upturn in global real estate derived chiefly from the US in March, as the US central bank intends to raise interest rates substantially. 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 tightened by 70 basis points more than the upturn in underlying US interest rates. On balance yields on these bonds fell by 20 basis points. Yields on bonds listed in local currency only declined by 5 basis points. Russian bonds have been removed from the indices and will therefore have no further impact. 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
Geopolitical tensions and shortages are generating persistently high commodity prices. The general commodity index climbed for the fourth consecutive month in March, this time by 8.6%. Energy, metals and gold all displayed price increases, although gold lagged behind the other classes at 1.5%. Since the start of March the oil price has stabilised at just over 100 US dollars per barrel. Tightness on the market, low stock levels and geopolitical tensions are keeping oil prices high. The OPEC countries are stepping up production as planned but are so far not prepared to accelerate this. The US will ease the tightness on the market somewhat by offering oil from its strategic reserves, about one million barrels a day. This will have a minor downward effect on prices as investors assume that these reserves will subsequently be topped up. In this respect, the slowdown in the Chinese economy could have a greater downward impact. 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 and generating sharply positive returns.	

JOOST VAN LEENDERS
Senior investment strategist
joost.vanleenders@kempen.nl
+31 (0)6 8283 1189

VAN LANSCHOT KEMPEN ASSET RESEARCH & COMMUNICATION:

Yaela van Raalte – Head ARC
Michel Iglesias del Sol – Head investment strategy
Luc Aben – Chief economist Van Lanschot
Robert de Groot – Head investment research and communications
Maarten van der Pas – Head editorial desk
Alastair Greenlees – Head investment strategy UK
Arif Saad – Head investment strategy UK
Duco Smit – Senior investment strategist
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Bob Stroeken – Equity specialist
Tim Verhagen – Equity specialist
Effi Bialkowski – Investment fund specialist
Bas Kooman – Investment writer

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