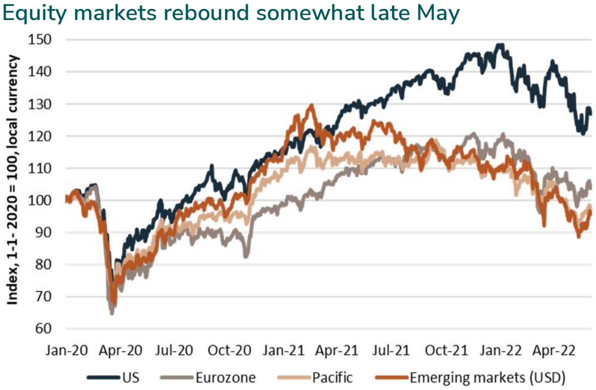
Asset Allocation Outlook

JUNE 2022

- Recession fears dominate financial markets
- ECB catches up with the Fed
- Can businesses sustain earnings at a sound level?
- Investment policy: short-term government bonds attractive versus cash

After no fewer than seven consecutive weeks of losses, the US S&P500 equity index only reverted to noting a gain in the last full week of May. That gain was so substantial that the result over the month just managed to creep into positive figures at 0.6%[1].

Equity markets rebound somewhat late May



Source: Bloomberg, Van Lanschot Kempen

Not of course that it was anywhere near enough to compensate for the losses of the preceding months. Up to the end of May, the S&P is looking at a loss of 12.8% over this year. This is similar to the losses on European equities (-11.3%), emerging market equities (-13.5%) and equities from the Pacific region (-10.0%). Bonds are not offering any protection either. Losses on these range from about 8% on US government bonds to close to 15% on emerging market debt. Global real estate had a tough time in May, bringing the result over the year so far to -11.5%. This asset class has failed to live up to its reputation of offering protection against inflation and is in fact being adversely affected by the higher interest rates.

In short, the investment climate continues to be extremely difficult. We are therefore being careful not to take too much risk. Our equity allocation is neutral. We hold an underweight in government bonds versus an overweight in commodities. The higher bond yields lead us to view short-term government bonds as attractive versus cash.

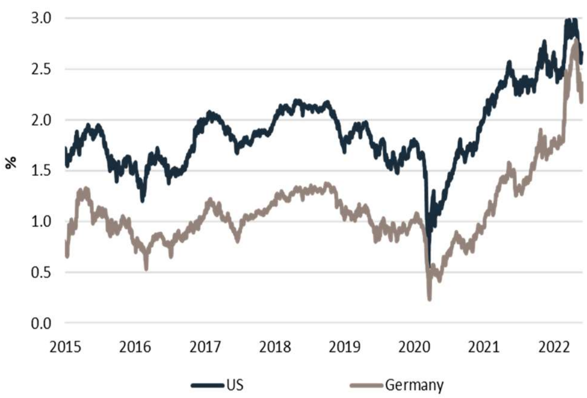
From interest rate fears to recession fears?

Financial markets initially grappled with rising interest rates this year, which was of course a direct consequence of the rapidly rising inflation and an unprecedented shift by central banks towards less expansionary monetary policies. Yet interest rate fears have gradually made way for fears of a recession. High inflation is eroding consumer spending power, which could lead to a recession. Inflation fears eased somewhat as a result. Forecasts for interest rate hikes by the US Fed in particular fell slightly, as did 10-year bond yields. Inflation

[1] Price changes and returns in local currency

forecasts for the next ten years declined by 0.3 percentage points in the US in May; in Germany they dropped by 0.5 percentage points.

Lower expectations for inflation in the next ten years



Source: Bloomberg, Van Lanschot Kempen

Fears of a recession meant that equity markets initially failed to profit from this. Only when those fears subsided marginally were equity markets able to recover somewhat. The question of whether we are heading for a recession is therefore a crucial one.

Judging by the leading indicators, this doesn't yet seem to be the case. Purchasing managers are slightly less optimistic, but so far only the indices in Poland and China stand below 50, which points to a contraction or at the very least a slowdown in growth. Confidence among Polish industrial companies is undoubtedly being adversely affected by the war in Ukraine. However, indices are over 50 in the Czech Republic, Hungary and even Russia. Levels of 57.5 in the US and 54.6 in the Eurozone certainly don't point to an industrial recession. It should be noted though that this optimism lies primarily in the high backlog of orders. There is considerably less optimism about new orders. The purchasing manager index for the US service sector fell sharply in April and May. This was mainly because the positive reopening effects were less palpable. The Eurozone is lagging somewhat, leading to a drop in the index over just one month, but the levels of these indices aren't pointing to a recession either. Incidentally, this does apply to China, where the indices improved but continue to point to contraction.

Waning momentum in the PMIs does point to lower growth though and in the Eurozone this was confirmed by the Economic Sentiment Index. This index was more or less unchanged in May but does point to low growth. The weakness in the index is mainly to be found among consumers and in retail, to a lesser extent in industry and services. The German Ifo index is pointing to a contraction in Europe's largest economy, however. German industry continues to be affected by the tightness in supply chains. The French equivalent of the Ifo is so far holding up at a higher level. In the US, the picture of waning momentum was corroborated by regional indices for manufacturer confidence.

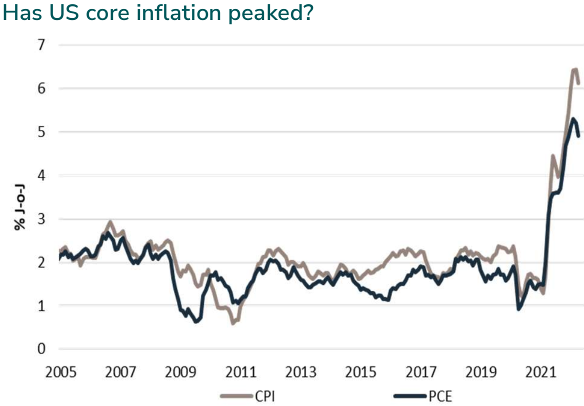
The yield curve is a market indicator we've discussed on previous occasions. A negative yield curve, in which 10-year yields are lower than their 2-year or 3-month counterparts, is a reliable indicator of a recession, especially in the US. The yield curve was briefly negative in the US, but this is no longer the case. In our opinion the period of a negative yield curve was too short-lived to emit a clear signal.

In short, as far as leading indicators are concerned fears of a recession appear to be unfounded.

Inflation as a killjoy?

The high inflation constitutes a major shock for the global economy. Family incomes are being squeezed and some businesses say they are experiencing difficulties in passing on the high costs. Yet we can still identify a few bright spots here. Inflation seems to have peaked in the US.

Has US core inflation peaked?



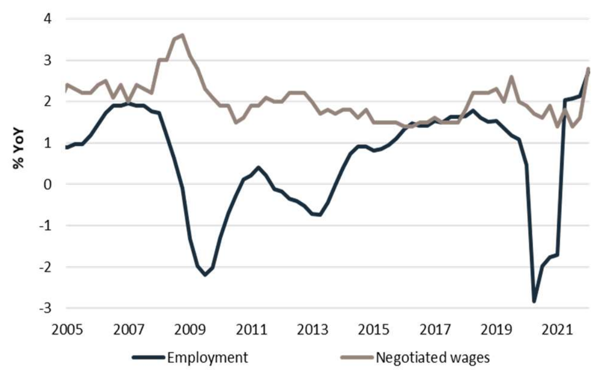
Source: Refinitiv, Van Lanschot Kempen

According to the Consumer Price Index (CPI), on an annual basis prices rose slightly less steeply in April. Headline inflation declined from 8.6% in March to 8.2% in April, core inflation from 6.4 to 6.1%. The high price increases from 2021 are starting to drop out of the annual figures for both types of inflation. This base effect means that inflation could fall further. The Fed is steering policy based on a different benchmark, the Personal Consumption Expenditure (PCE) price index. This index is composed in a slightly different way from the CPI. The PCE also appears to have peaked and it's encouraging that according to the PCE core inflation on a monthly basis wasn't much higher than the long-term average in February, March and April.

Apart from commodity and energy prices and other input costs, wage growth is also playing a role in inflation. There are some signs that the worst tightness on the US job market is starting to ease. Job growth continues to be robust but is now slightly less exuberant and, following a deep dip, labour supply has reverted more or less to pre-Coronavirus levels. The pace of wage increases is consequently also declining slightly. The marginally lower inflation will enable family incomes to keep up with price increases better. It's a delicate balancing act: excessively high wage growth leads to inflation and is negative for businesses, excessively low wage growth erodes the spending power of families. It looks as if the US economy will manage this balancing act though. One remarkable aspect here is the power of US consumer spending. It's always dangerous to write off US consumers. Once again households are increasingly using previously accrued savings and even credit cards to keep spending at the same level. This is despite the low level of confidence among US consumers. For the time being at least, inflation isn't proving to be a killjoy for US consumers.

Is the situation different in Europe, wasn't wage growth much lower here? Yes, and as a result income are being squeezed here and the same goes for the volume of retail sales in the first quarter. Yet the job market is tight in the Eurozone as well. At 6.8%, unemployment is in fact at a record low. Employment has already risen substantially for four consecutive quarters, including the first quarter of this year. And a clear acceleration in wage growth was also visible in the first quarter. Together these provide some compensation for the steeply rising prices because inflation continues to be worse than expected. In May headline inflation in the Eurozone reached a new record of 8.1%. The fact that core inflation rose to 3.8% demonstrates that inflation is now also becoming more widespread in the economy. The favourable base effects will reach the Eurozone slightly later than the US, so it's likely that inflation hasn't yet peaked. Consumers in the Eurozone will therefore also need to use their savings to keep spending at the same level. You might say there's little chance of this happening given the low consumer confidence. European consumers are more cautious in this respect than their US cousins. The outlook would be negative were it not for the fact that there will still also be reopening effects. Europeans will finally be able to holiday abroad freely again this year. That could well be a reason to spend those savings.

Tight eurozone labour market leads to rising wages



Source: Refinitiv, Van Lanschot Kempen

Our outlook for the coming months is still that growth will be low, especially in Europe. The mix of growth and inflation will be more negative for Europe than for the US. In the US there are tentative signs that inflation has peaked and that growth is holding up better. The situation in China continues to be a cause for concern. Coronavirus cases have decreased but the extremely strict lockdowns are only being eased marginally. The low level of group immunity means that the virus could easily flare up again. Monetary and fiscal stimuli are being applied cautiously and are also less effective due to the strict lockdowns. Moreover, China and other export countries in Asia are facing lower demand for consumer goods now that Western consumers are again free to spend their money on services.

Monetary policy: ECB catches up

Not much has changed over the past few weeks with respect to the expected monetary policy in the US. The Fed will raise interest rates by 0.5 percentage points in June and July. For September markets are still hesitating between 0.25 percentage points and 0.5 percentage points. Markets anticipate a policy interest rate of 2.75% as of the end of this year, which is slightly lower than the forecast at the beginning of May. And the Fed will of course reduce its balance sheet. Taken together these measures constitute a radical change in monetary policy, although the question remains as to whether it will be enough to push inflation towards the 2% target.

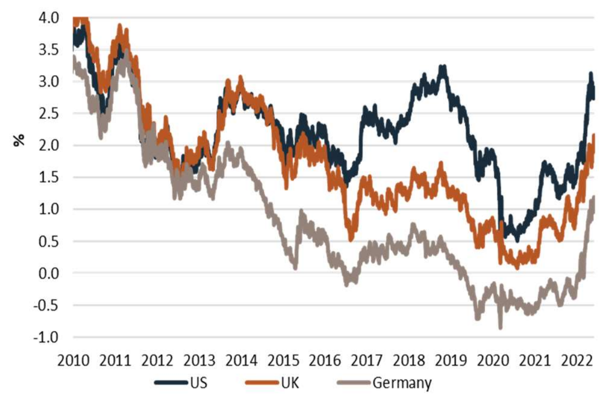
The ECB has been forced to play catch-up. Like the Fed, the ECB appears to have underestimated the tenacity of the inflation. The bond-buying programmes will be terminated in June, which will pave the way for interest rate increases. ECB President Lagarde and other policymakers have made it fairly clear that interest rates will be raised soon after the bond-buying programmes have been halted. The question now is how big the first increment will be. We expect an increase of 0.25 percentage points, while the market is wavering between 0.25 and 0.5 percentage points. Whatever the case, it looks as if by the end of September the ECB's policy interest rate will no longer be negative for the first time since June 2014. We have our doubts about the market's expectations of interest rate hikes of more than 1 percentage point up to the end of the year. Yes, inflation is high enough for this increase, but the question is whether the ECB wishes to take such drastic action in an economy that is only experiencing moderate growth.

Bond yields diverge

The marginal reduction in inflation fears has had an impact on bond yields, especially in the US, where 2-year yields were down slightly in May. It was the first time since July last year that short-term yields fell in a calendar month. And a drop in 10-year yields hadn't occurred since November last year. May was also the second month in a row that the yield curve steepened after six months of flattening. The drop in US bond yields was driven by lower inflation forecasts. Real interest rates were in fact up slightly. US interest rate markets therefore anticipate lower inflation and have already priced in the monetary policy described above. Long-term yields could rise slightly higher once the Fed starts to reduce its balance sheet but this isn't a given. If economic growth becomes more moderate as a result of a less expansionary monetary policy, the upturn in yields at the long end of the curve will also be small.

Long-term bond yields did rise in Europe in May, with a basket of bonds from all the Eurozone countries climbing by 0.14 percentage points to 1.4%, German bonds by 0.14 percentage points to just over 1% and UK bonds by 0.11 percentage points to just above 2%. Although such levels continue to be low when viewed from a longer historical perspective, they are the highest since 2014. The pace of the upturn in yields is becoming fairly extreme.

Ten-year yields have risen rapidly



Source: Bloomberg, Van Lanschot Kempen

In both the Eurozone and the UK, forecasts for interest rate hikes by the ECB and the Bank of England continue to rise. This is being felt on the interest rate markets. Given the pace of the increases in capital market yields, at the very least a pause in raising interest rates would seem to be an obvious option. Nevertheless, in the long term we expect yields to rise further as the downward effect of the bond-buying programmes lessens.

A similar picture was visible on the credit markets. Towards the end of May spreads tightened in the US both for investment grade, the safer class, and for high yield. In the Eurozone spreads stayed at their heightened level. This is a sign that investors in these asset classes are slightly more worried about the European economy than its US counterpart. These concerns are justified in our view. We see no reason to increase our allocation to credits.

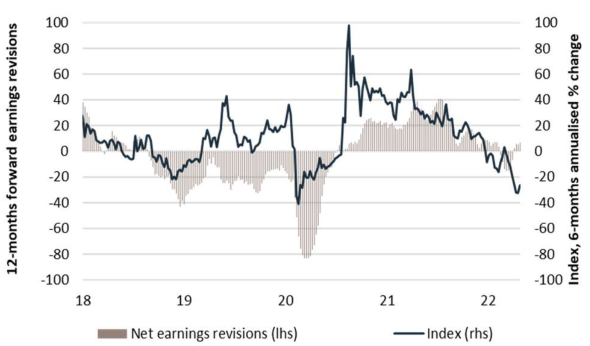
The diverging yields have affected the US dollar. Since May last year the US dollar has appreciated strongly versus the euro. In May last year one euro cost 1.23 US dollars, while in mid-May this year the price was just 1.04 US dollars. The US dollar looked to be rapidly heading towards parity but changing perceptions on monetary policy have brought the upturn to a halt. By the end of May one euro was worth 1.07 US dollars. We believe that the euro could gain slightly more ground versus the US dollar.

Higher interest rates and a more expensive US dollar are traditionally risks for emerging market debt. And spreads on emerging market debt listed in US dollars have now also widened. The halt in the upward march of US bond yields and the US dollar could give this asset class some breathing space, but we believe it's too soon and the situation too uncertain to increase our allocation. Low growth in China has a negative impact on several emerging markets.

Earnings growth still surprisingly robust

Last month we reported on the sound corporate results from the first quarter. And since then corporate profitability has continued to hold up surprising well. Or rather, it has in industrialised countries. Whereas most analysts adjusted their earnings forecasts downwards a few weeks ago, we're now seeing net upward adjustments, especially in Europe and the US. Japan continues to lag in this respect. Strong upward momentum is visible in expected earnings in particular in Europe but also in the US and Japan.

Equity markets discount weak earnings



Source: Bloomberg, Van Lanschot Kempen

This is in stark contrast to the price movements on the equity markets. In other words, they have priced in a significantly more negative picture of earnings growth. And this has led to equity valuations falling further. This could be viewed as a reason to buy more equities, but we're not entirely at ease with doing so. Firstly, the current upward revisions may primarily be the result of the better-than-expected earnings in the first quarter. Higher earnings also automatically translate into higher expected earnings, but this is temporary. Secondly, we're hearing from industry that profit margins are under pressure from rising input costs. The mix of high inflation and low growth makes it more difficult for businesses with less pricing power to maintain their margins. We therefore retain our neutral outlook for equities.

Investment policy: from cash to short-term government bonds

We held a relatively large cash position in our model portfolios. This was mainly prompted by the major uncertainty surrounding growth, inflation, monetary policy and the financial markets. Given the losses noted in many asset classes this proved to be a good decision, but a cash position in the Eurozone costs money thanks to the negative interest rates. The upturn in short-term European bond yields means that short-term government bonds are again attractive versus cash. Yields on a basket of 2-year government bonds issued by Eurozone countries have already climbed to 0.57%. The return earned on this position naturally depends on interest rate movements. Yet the interest rate sensitivity of these short-term bonds is low and a considerable number of interest rate hikes by the ECB have already been priced in. We believe there's little risk of the ECB acting even more aggressively than is currently expected, and this in turn means there's a small risk of lower prices on these bonds in the event of higher yields. Obviously, we wish to retain sufficient liquidity in our portfolios so that we can alter positions whenever necessary. This switch doesn't mean we are surrendering liquidity. We're reducing our underweight in government bonds but the short duration of the bonds we're buying means that the allocation to government bonds will still enable us to profit from higher yields.

Market review

Equities	Index	Past month	Past 3 months	From 31-12-2021
Global (MSCI AC)	1068	-0.9%	-5.9%	-14.2%
Developed markets (MSCI World)	2770	-0.9%	-5.5%	-14.3%
Emerging markets (MSCI EM)	1068	-0.8%	-9.2%	-13.3%
United States (S&P500)	4101	-0.7%	-4.8%	-14.0%
Eurozone (EURO STOXX 50)	3760	-1.1%	-0.2%	-12.5%
United Kingdom (FTSE 100)	7533	-0.2%	2.8%	2.0%
Japan (Topix)	1939	2.1%	2.2%	-2.7%
Netherlands (AEX)	701	-1.4%	-1.7%	-12.1%
Government bonds (10-year)	**Yield (%)**	**Past month (bp)**	**Past 3 months (bp)**	**From 31-12-2021 (bp)**
United States	2.91	-3	118	140
Japan	0.24	1	6	17
Germany	1.19	25	126	136
France	1.71	25	134	151
Italy	2.97	-8	138	192
Netherlands	1.48	26	132	151
United Kingdom	2.16	25	103	118
Investment grade credit	**Risk premium (bp)**	**Past month (bp)**	**Past 3 months (bp)**	**From 31-12-2021 (bp)**
United States	131	-4	7	39
Eurozone	163	12	16	68
High yield bonds	**Risk premium (bp)**	**Past month (bp)**	**Past 3 months (bp)**	**From 31-12-2021 (bp)**
United States	401	22	30	118
Eurozone	479	29	32	161
Emerging markets (USD)	448	9	-34	80
Emerging markets (Local currency)	384	3	-95	-61
Real estate		**Past month**	**Past 3 months**	**From 31-12-2021**
Global		-8.4%	-2.3%	-9.0%
North-America		-7.8%	-1.2%	-9.7%
Europe		-6.9%	-10.1%	-17.2%
Commodities		**Past month**	**Past 3 months**	**From 31-12-2021**
Bloomberg index		2.7%	11.5%	34.2%
Base metals		-6.9%	-10.2%	1.0%
Brent oil (USD per barrel)	116.29	10.3%	22.1%	54.4%
Gold (USD per troy ounce)	1849	-3.3%	-4.9%	1.1%

Returns in local currency
bp = basis point (0.01%)
Data as of 2 June 2022
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Neutral**

Equity markets rallied somewhat at the end of May, causing the global index to edge into positive figures over the month. This was because the US and Pacific, Europe and emerging markets noted minor losses. Interest rate and inflation fears seem to be making way for fears of a recession in the US. Europe continues to be dominated by low growth and high inflation. Certainly in the short term we believe there's a greater risk of a recession in Europe. Earnings growth in the US and Europe in particular remains remarkably robust, but we wonder how long this can last. Earnings growth is negative in emerging markets. The risk of a recession could be a reason to adopt an underweight, but equity markets have already priced in a considerable amount of negative news. Moreover, 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. Equity valuations have improved. Equities from Europe, Pacific and emerging markets are valued at neutral to slightly cheap. Only US equities remain fairly expensive. We currently hold no regional preference.

Government bonds	**Negative**

US bond yields fell slightly in May for the first time in months. Inflation forecasts were lower, leading to the expectations relating to monetary policy declining by a small margin as well. Compared to inflation, yields remain extremely low, but inflation is expected to fall. This will be the case even in the event of high but stable energy prices. 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. Markets are assuming interest rates will rise by a further 2 percentage points this year. The ECB has moved to catch up with the Fed and more or less announced it will raise interest rates in July. It needs to steer between high inflation and weak economic growth. Yet the negative policy interest rate could quickly be raised to at least zero. We believe that US monetary policy has already largely been priced into 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	**Neutral**

In the US spreads on investment grade credits remained more or less unchanged in May, while in Europe they widened by 12 basis points. The lower underlying yields on US government bonds resulted in US credits earning a tiny positive return. In Europe the wider spreads and higher underlying yields led to a negative return. We view declining growth, high inflation and less support from central banks as risks for investment grade credits. Furthermore, investors don't need to engage in a lengthy search for yield now that yields on government bonds are again positive. The higher government bond yields mean that spreads only have to widen slightly for returns on credits to lag.

High yield credits	**Neutral**

Spreads on high yield credits widened in May, by 33 basis points in the US and 37 basis points in Europe. This brought US yields to 7.0% and European yields to 5.7%. The coupon yield compensated for most of the loss caused by the wider spreads but on balance returns were negative. As in investment grade, we view declining growth and high inflation as risks for this asset class. In fact, this asset class is slightly more vulnerable to these risks. These are offset by wider spreads and the fact that businesses in this asset class have financed themselves over longer periods than before. This restricts the risk associated with refinancing when interest rates climb.

Listed real estate	**Neutral**

The losses noted on listed real estate were significantly larger than those on equities in May. The global real estate index was down by 3.4%, while in North America and Europe the losses were as high as 5.5%. Real estate has a reputation for offering protection against inflation because rents often move in line with inflation. Quite apart from the somewhat dubious nature of this reputation, real estate is now primarily being adversely affected by the higher interest rates. The loss so far this year on real estate is similar to that on equities. Real estate valuations have fallen, leading us to no longer view Europe as expensive, although the US does continue to be rather expensive. We still view real estate as expensive versus fixed income asset classes with similar credit ratings. Listed real estate is currently trading at slightly below the value of the underlying properties but we think these underlying values are fairly high. Aside from the uncertainty surrounding growth and in turn the demand for retail and office space in particular, we see higher interest rates as an excessively high risk for a position in listed real estate.

Emerging market debt	**Neutral**

Yields on emerging market debt listed in US dollars hardly climbed in May owing to the lower yields in the US and the slightly wider spreads. Yields on bonds in local currency were likewise more or less unchanged. Emerging market debt was given some breathing space though as US yields didn't rise and the upturn in the value of the US dollar ground to a halt. A yield of about 7% on both bonds listed in US dollars and those listed in local currency is attractive in itself. All the more so because the economies in these countries have improved in a number of respects over the past few years and their central banks are implementing monetary policy in a sensible manner. They haven't hesitated to raise interest rates when the rising inflation gives them reason to do so. However, emerging market debt is vulnerable to a more expensive US dollar and higher interest rates in the US. The slowing Chinese economy, which is causing a drop in activity in emerging markets, also poses a risk. Moreover, in emerging markets there is a greater risk of higher inflation caused by rising food prices. We therefore hold a neutral outlook.

Commodities	Positive
Commodities were once again a ray of light in what were otherwise fairly dark days in May. The general commodity index climbed by a further 4.5%. This month it was mainly the upturn of about 15% in oil prices that compensated for the downturn of 5% in metals and 2.4% in gold. Despite the volatility of the past few months, an upward trend remains visible in oil prices. Declining global economic growth is negative for oil prices. Yet shortages, partly caused by the possibility of Western sanctions against Russian oil, are sustaining the political risk premium. This doesn't apply to metals. A slowdown in the global economy in general – and in China in particular – is having a significant impact here. Even after the gold price dropped for the second month in a row, we still don't think it has totally adjusted to the higher real interest rates. 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. We retain our positive outlook for this asset class.	

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