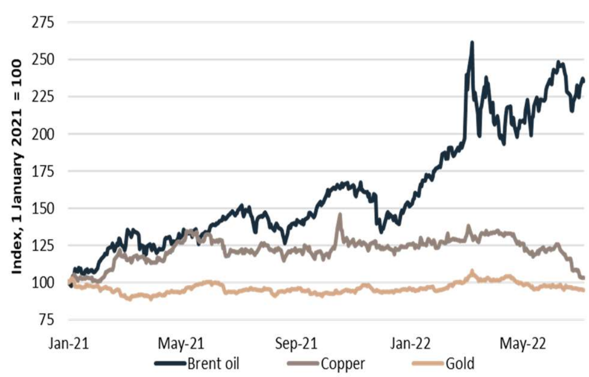
Asset Allocation Outlook

JULY 2022

- Markets navigating between inflation and recession fears
- Financial conditions tightening fast
- Can businesses sustain earnings at a sound level?
- Investment policy: slight underweight in equities

Cash is King was the motto for investors in June. All the general asset classes noted losses. This doesn't mean that there were no discernible differences though. Commodities posted a negative total return of nearly 11%, while global equities were down by over 8%. Real estate and high yield bonds had to digest similar losses, although emerging market debt suffered marginally less damage. Traditionally safe asset classes only lived up to their name by restricting their losses. Gold was down by 1.6% and the negative return on government bonds was 0.9% in the US and 1.9% in the Eurozone.[1]

Commodities shared in the malaise in June



Source: Bloomberg, Van Lanschot Kempen

Fears of inflation and of a recession gripped the markets in June. If there are already signs of inflation declining, which would be positive for the financial markets, this could be because growth is slowing. If it slows too much and economies enter into a recession, this is likewise negative for equities.

Market movements had already caused the equity position in our model portfolio to drop below the long-term allocation. As we don't yet think it's the right time to buy, we've decided to accept this (slight) underweight in equities.

Between Scylla and Charybdis

If inflation is the six-headed monster Scylla, who according to the Odyssey plucked the crew from Odysseus' ship and devoured them, then a recession is the whirlpool Charybdis, who could drag entire ships down into the depths of the ocean. On his return voyage from the Trojan war to his home island of Ithaca, Odysseus opted for Scylla, who snatched the six strongest crew members from his ship but left the ship unscathed.

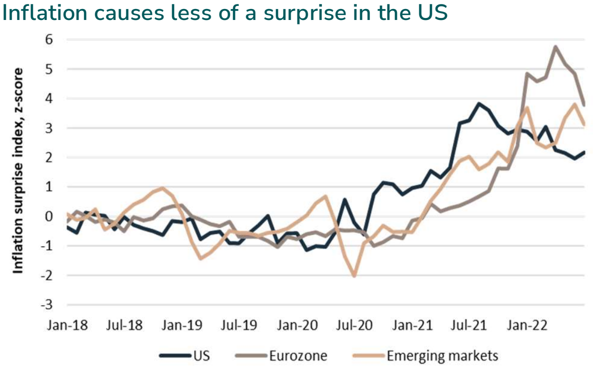
Whether and how the global economy will succeed in navigating between inflation and a recession is hard to predict, but it certainly looks as if it'll be tricky to avoid both in the coming quarters. This would involve the scenario in which inflation falls due to the

[1] Returns in local currency

marginally lower growth, supply chain problems improve and energy prices stabilise at the very least, while growth remains at more or less the same level. This would be a positive scenario for almost all asset classes but we're not convinced that this is indeed the basic scenario.

There are tentative signs that inflation has already peaked in the US. The degree to which inflation rates are exceeding expectations is declining. However, this is of course also because expectations have been raised.

Inflation causes less of a surprise in the US



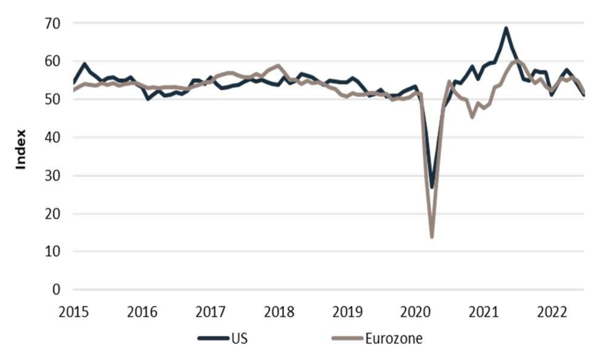
Source: Bloomberg, Citi, Van Lanschot Kempen

Markets also breathed a sigh of relief when it turned out that US consumers expect inflation to remain stable in the long term. Fed Chair Powell had explicitly mentioned this as one of the determining factors for monetary policy. The most commonly-used inflation rate in the US, the CPI, was slightly worse than expected as it again climbed in May. Yet in the indicator the Fed uses, the PCE, it's exclusively food and energy prices that have peaked. This index stood at 5.3% in February and in May it was 4.7%. It should be noted though that the underlying components of inflation seem to be preventing a rapid downturn.

In the Eurozone inflation rose to 8.6% in June and in doing so was a fraction higher than its US counterpart. Excluding food and energy, core inflation fell marginally to 3.7%. The eurozone should consequently profit more quickly from stabilising energy prices given that headline inflation should drop to a lower rate of core inflation. However, with supplies of Russian gas being restricted even further, gas prices have now surpassed 140 euros per megawatt hour. This translates into an increase of 10% in a week and more than 60% versus six months ago. The inflation shock isn't over yet for the Eurozone.

And in the meantime Charybdis isn't exactly keeping a low profile either. Not that there are that many indicators already pointing to a recession, but the speed at which confidence indicators are falling is fanning fears of a recession. For example, the combined purchasing manager index for industry and the service sector in the Eurozone fell to 51.9 in June. This is its lowest level since February last year, yet there are no lockdowns in place now. And the drop of nearly four points in two months is sharp from a historical perspective. The index stands slightly lower in the US and the decrease there is also steeper. One positive aspect is that the survey of purchasing managers shows that supply chain problems are gradually being resolved. A negative point is that optimism about orders is dissipating rapidly.

Business confidence falling fast



Source: Bloomberg, Van Lanschot Kempen

The level of consumer confidence isn't particularly reassuring either. In fact, consumer confidence has never been so low a number of countries. This is remarkable given the often tight job markets but less surprising in light of the high rate of inflation. Nevertheless, it looks as if the Eurozone economy in particular will receive a temporary boost from the hordes of holidaymakers. This effect will quickly drop away after August, however.

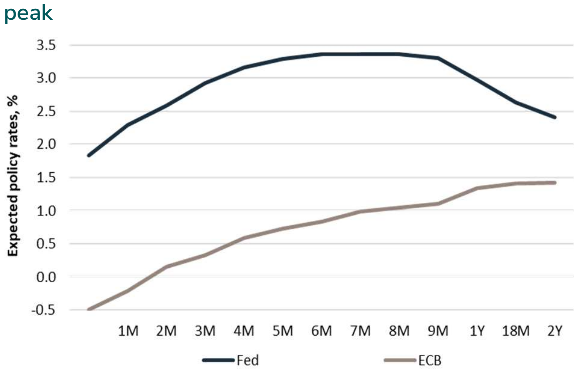
The risk of a recession has rapidly become more acute in the US. Growth was negative due to temporary factors in the first quarter. Stocks were restored more slowly, but it was mainly the much stronger growth in imports than exports that had a significant impact on growth. Initially it looked as if growth would pick up sharply in the second quarter thanks to robust consumer spending. Yet following revision of the data and a downturn in consumer spending in May, it's perfectly possible that the US economy contracted in the second quarter as well. This would mean that the economy has entered what's known as a technical recession. As it happens, the US has a kind of official referee that decides on recessions, the NBER. As the NBER also examines employment, income and production and these aren't displaying lower rates, for the time being this means there's no 'official' recession.

We're a bit more concerned about the sustainability of growth. Inflation is squeezing incomes, which has a negative impact on spending. Export-dependent economies in Asia are also being affected by this. The reopening in China is mostly positive for China itself, in neighbouring countries we can also identify negative effects. And rapidly tightening financial conditions will also become increasingly visible.

Impact of monetary policy becoming visible

It's clear that it's crucially important for central banks to curb inflation. After all, their credibility is at stake here. The rates of inflation expected by consumers and investors suggest this credibility remains intact. Yet confidence is hard won and easily lost. After the Fed raised interest rates by 75 basis points in June, the markets now expect a similar increase in July.

Markets anticipate lower US interest rates shortly after peak



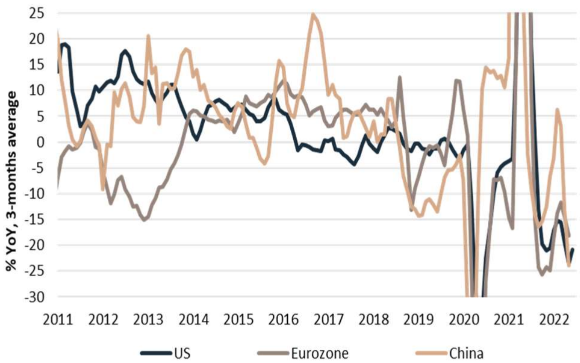
Source: Bloomberg, Van Lanschot Kempen

Fed policymakers have so far made no attempt to temper these expectations, which makes it highly likely that a further hike of 75 basis points is imminent. Smaller increments are anticipated after that. The slowdown in the US economy is pushing interest rate forecasts down somewhat but this mostly applies to next year. Following a peak in March next year, interest rates are expected to be cut later in the year. This implies a substantial economic slowdown. When this happens it's not unusual for the Fed to start cutting interest rates again while inflation is still above its target rate. The current high rate of inflation could force the Fed to keep interest rates slightly higher for longer though.

ECB President Lagarde recently also confirmed that combating inflation is a priority. The ECB's bond-buying programmes have already been terminated, which paves the way for raising interest rates. The ECB has committed to an initial increase of 25 basis points in July but an increment of 50 basis points is expected in September. The thorny issue of what to do if spreads in Italy widen further continues to hang over the market. The ECB hasn't yet announced much more than flexibly reinvesting about EUR17 billion a month of expiring bonds.

Whether the tightening by central banks will be enough to rein in inflation remains to be seen. Central banks aren't facing this alone though. Higher capital market yields, wider spreads on credits, lower equity prices and in the US a more expensive dollar will all help to tighten financial conditions. The impact of less expansionary monetary policies is already becoming visible, in particular in interest rate-sensitive sectors such as the housing market and automotive industry. Confidence among US construction companies fell in June to its lowest level since June 2020, when confidence was recovering from an enormous dip. House sales are down and prices are rising less steeply. As in some European countries, the tightness on housing markets could restrict the downturn in prices but the affordability of homes has deteriorated immensely. Car sales are under pressure. In May, 25% fewer cars were sold in the US than a year earlier, in the Eurozone this was 17.4% fewer and China 12.5% fewer.

Drop in car sales



Source: Refinitiv, Van Lanschot Kempen

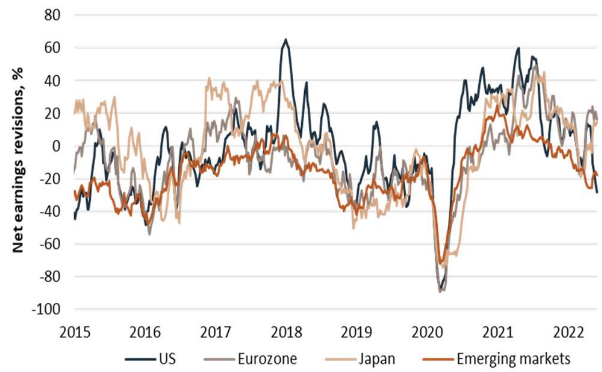
In China this is largely due to the lockdowns and car sales will undergo a rapid recovery, just like other recent data. Furthermore, the housing market is tight and car manufacturers continue to grapple with supply chain problems. The low demand may therefore be partly a result of the limited supply. Yet car production is almost back at pre-pandemic levels in the US and sales are still lagging behind. In the Eurozone both supply and demand remain far below pre-coronavirus levels.

How sustainable is earnings growth?

Last month we reported that corporate earnings had remained surprising robust. This picture is changing, however. After a brief period of adjusting earnings forecasts upwards, most US analysts are now more negative.

The earnings season for publishing results over the second quarter kicks off in mid-July. Any company about to report worse-than-expected results therefore needs to issue a profit warning in the first two weeks of July. This has so far only occurred to a small extent, although a few prominent companies in the chemical and consumer discretionary sectors have already done so. The consumer discretionary sector in particular contains large numbers of companies with excessively high stock levels that now need to be reduced – potentially at a substantial discount. This could squeeze earnings growth. It's possible that this won't yet be visible in the results over the second quarter but it will be interesting to see what kind of outlook companies announce. The current inflationary climate automatically gives companies greater pricing power. After all, it's easier to raise prices when everyone is doing it. However, if customers and consumers experience greater difficulty in paying these higher prices, it will be hard to increase revenues. This therefore means either smaller volumes or fewer price increases. And either of these could squeeze profit margins. We therefore think that the earnings forecasts for the remainder of this year and next year are excessively positive.

Negative earnings revisions in the US and emerging markets



Source: Refinitiv, Van Lanschot Kempen

Investment policy: small equity underweight

There are a couple of positive scenarios for equities, for instance that inflation will fall fairly quickly without inflicting too much economic damage. This is possible if inflation is primarily supply-driven. Then consumer spending power would improve and this would in turn prevent profit margins from being squeezed. Central banks would then have to step on the monetary brake less hard as well. The fears now palpable in the equity markets would also quickly dissipate. Yet given the stubborn inflation and rapidly tightening financial conditions, the likelihood of this scenario occurring has decreased recently.

Another positive scenario involves a mild recession. This could bring an end to interest rate hikes or even result in rates being cut. Earnings would be squeezed but valuations could climb slightly again if interest rates are lower. This would restrict the damage to the equity markets, especially if investors look beyond the mild recession.

We're not convinced that we'll end up in such a positive scenario. Time and again inflation is proving to be more stubborn than expected and the tighter financial conditions are starting to leave their mark on economies. Earnings forecasts have remained at the same level or even risen but we believe them to be overoptimistic. We therefore think it's too soon to increase our allocation to equities. In this sense we're keeping to our outlook of the past few months. Market movements have caused the equity weight in our model portfolio to shrink to an underweight. We've accepted this, however, which implies a negative outlook for equities.

Market review

Equities	Index	Past month	Past 3 months	From 31-12-2021
Global (MSCI AC)	991	-7.9%	-16.0%	-20.8%
Developed markets (MSCI World)	2554	-8.1%	-16.2%	-21.0%
Emerging markets (MSCI EM)	991	-6.5%	-14.3%	-19.5%
United States (S&P500)	3831	-6.7%	-15.3%	-19.6%
Eurozone (EURO STOXX 50)	3360	-11.2%	-14.2%	-21.8%
United Kingdom (FTSE 100)	7025	-6.7%	-7.7%	-4.9%
Japan (Topix)	1879	-2.8%	-3.6%	-5.7%
Netherlands (AEX)	644	-8.1%	-12.5%	-19.3%
Government bonds (10-year)	**Yield (%)**	**Past month (bp)**	**Past 3 months (bp)**	**From 31-12-2021 (bp)**
United States	2.81	-13	26	130
Japan	0.22	-1	0	15
Germany	1.18	-9	57	136
France	1.79	-2	63	159
Italy	3.10	9	151	205
Netherlands	1.58	0	67	160
United Kingdom	2.05	-11	40	108
Investment grade credit	**Risk premium (bp)**	**Past month (bp)**	**Past 3 months (bp)**	**From 31-12-2021 (bp)**
United States	160	29	51	68
Eurozone	217	54	88	122
High yield bonds	**Risk premium (bp)**	**Past month (bp)**	**Past 3 months (bp)**	**From 31-12-2021 (bp)**
United States	583	175	274	300
Eurozone	668	189	287	350
Emerging markets (USD)	548	101	160	179
Emerging markets (Local currency)	421	39	62	-25
Real estate		**Past month**	**Past 3 months**	**From 31-12-2021**
Global		-4.9%	-14.1%	-13.5%
North-America		-1.7%	-11.6%	-12.0%
Europe		-15.9%	-27.9%	-30.6%
Commodities		**Past month**	**Past 3 months**	**From 31-12-2021**
Bloomberg index		-16.3%	-11.1%	13.2%
Base metals		-16.7%	-28.8%	-15.9%
Brent oil (USD per barrel)	102.77	-12.2%	0.3%	37.4%
Gold (USD per troy ounce)	1764	-4.7%	-8.5%	-3.5%

Returns in local currency
bp = basis point (0.01%)
Data as of 6 July 2022
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Negative**

Having more or less marked time in May, equity markets again came in for a severe battering in June. The MSCI global equity index was down by 8.6%. US and Pacific fell in line with the global index, Europe noted larger losses and emerging markets slightly smaller ones. Global economic momentum has declined further, while inflation remains high. Financial conditions have deteriorated rapidly. This increases the risk of a recession in the US and the Eurozone. In our view, this translates into a worse outlook for equities. We therefore question whether the high expected earnings growth is sustainable. Equity valuations have dropped considerably, making equities more attractive in this sense. This is largely due to the higher interest rates as earnings expectations remain at the same level. Any negative revisions to earnings pose a downward risk for equity valuations in the next few months, however. We currently hold no regional preference.

Government bonds	Negative

Ten-year bond yields climbed marginally again in June on balance, although this upturn came to a halt at the end of the month. This caused the yield curve to flatten in the US, with the gap between 10-year and 2-year yields reduced to almost zero. In the past a negative yield curve has been a reliable indicator of a recession. Real interest rates fell in Germany in particular towards the end of the month; inflation forecasts declined in this period in the US and in Germany. In short, fears of a recession clearly left their mark on the government bond market. In the meantime, inflation remains high and central banks stress the need to raise interest rates. Interest rates are extremely low compared to inflation and nominal growth. The general expectation is that inflation will start to fall quite quickly. It remains to be seen whether that actually happens. In our view there's a risk of yields rising further.

Investment grade credits	Neutral

Spreads on investment grade credits widened sharply in June; by 25 basis points in the US and 56 basis points in the Eurozone. An upturn on the underlying yields on government bonds led to returns being negative. At yields of 4.5% in the US and 3.1% in the Eurozone, investment grade credits are starting to look attractive from a valuation perspective. We view declining growth, high inflation and less support from central banks as risks for investment grade credits. Furthermore, investors no longer need to engage in a lengthy search for yield now that yields on government bonds are again positive.

High yield credits	Neutral

Spreads on high yield credits widened in June, in the US and Eurozone by as much as 165 basis points. Fears of a recession have clearly placed a strain on the market. Losses were as high as 7%. The high yields, close to 9% in the US and 7.5% in the Eurozone, make high yield credits attractive from a valuation perspective but at the same time make it substantially harder for these companies to arrange financing. Although a negative scenario of slower growth and high inflation has already largely been priced in, we also see downward risks such as lower earnings growth and a higher default rate.

Listed real estate	Neutral

The loss noted on listed real estate in June was similar to that on equities. The global real estate index was down by 8.3%. In North America and Europe the losses were as high as 15%. 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. Listed real estate equity valuations have fallen, leading us to no longer view the asset class as expensive. We still view real estate as expensive versus fixed income asset classes with similar credit ratings. Listed real estate is currently trading at 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 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

The upturn in yields on emerging market debt listed in US dollars of 111 basis points to 8.4% was a result of the higher US capital market yields and wider spreads. The larger part of this increase derived from the spreads, however, which noted their sharpest widening since March 2020. Yields on bonds listed in local currency climbed to 7.0%. A yield of over 8% for bonds in US dollars and 7% for those 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. On the other hand, debt levels are generally high, especially at governments. Lower growth in China, which is causing a drop in activity in emerging markets, also poses a risk. Moreover, in emerging markets there's a greater risk of higher inflation caused by rising food prices. This pressure could ease if central banks, especially the Fed in the US, were to pursue less tight monetary policies. We've not yet reached that stage though. We therefore hold a neutral outlook.

Commodities	Positive

Although commodities had previously succeeded in escaping the malaise on the other financial markets, this asset class was also down in June. The general index decreased by about 11%. Lower growth and fears of a recession hit metals particularly hard and these closed the month 15% lower. For oil the damage was restricted to 4% for Brent and about 7% for the US WTI. Gold ought to provide a safe haven in this kind of situation but rising real interest rates in the US and Germany caused the gold price to decline slightly. 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 third 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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