Asset Allocation Outlook

AUGUST 2022

- Further slowdown in global economy
- ECB implements bigger interest rate hike than expected and announces new policy instrument
- Lower bond yields: bond investors anticipate lower growth
- Investment policy: underweight in (European) equities

Equities again closed the month with strong pluses in July. The MSCI World AC index climbed by 6.9%, while US and European equities (MSCI USA & MSCI Europe) were up by 9.2% and 6.0% respectively.[1]

Equities: bear market rally?

Source: Bloomberg, Van Lanschot Kempen

That doesn't mean that the concerns about inflation and the economy have dissipated though. On the contrary, both the US and European rates of inflation are hovering around 9%. Russia is manipulating gas supplies in an ever more sinister fashion, which poses a particular risk to the European economy. And purchasing manager indices in both Europe and the US nosedived in June.

However, as so often in the past, investors put a positive slant on these worse-than-expected macro data. Now that the risk of a recession is growing, they are assuming that monetary policy will not be as aggressive as Jerome Powell and Christine Lagarde currently say it will be. In other words, markets expect central banks to move away from raising interest rates at some point because of the slowing economy and potential stress on the financial markets. This would relegate the main reason for the tough first half year on the markets, i.e. higher interest rates, to the background.

Time will tell. As long as the high rate of inflation persists, in our view central banks will be less inclined to give investors a helping hand than they have been in the past. At the same time, we need to wait and see what happens to corporate earnings if we do indeed enter into a recession. On balance, we therefore remain cautious about equities.

More sombre outlook

The most recent purchasing manager indices (S&P Global PMIs) from the Eurozone and US sketch a sombre picture. The composite index for industry and the service sector in both regions dropped below 50, which (in theory) is the boundary between growth and contraction.

[1] Returns in local currency

The weakening in services is especially worrying. It was mostly this sector that we were relying on to keep economic growth at a sound level following the reopening of economies. The impact of high inflation on consumer confidence and disposable income is starting to create a headwind.

Another worrying aspect can be found in the PMI sub-indices that gauge how things will evolve over the next few months. These are either falling or already in the contraction zone. For example, the score for new orders in European industry has dropped to 42.6, well below the level that points to growth.

IMF adjusts forecasts downwards

The uncertain economic outlook is summed up nicely in the new projections from the IMF. At a global level it now forecasts growth of 3.2% for 2022. Three months ago that still stood at 3.6%, which incidentally was already a downward revision versus the projections published at the start of the year.

Expectations were already relatively low for Europe, plagued as it is by the war in Ukraine, so the IMF made few further downward adjustments to that figure.

However, what stands out is the adjustments for the US (from 3.7% to 2.3%) and China (from 4.4% to 3.3%). In the case of the former, inflation and the gradual trickling down of the effects of interest rate hikes are playing a harmful role.

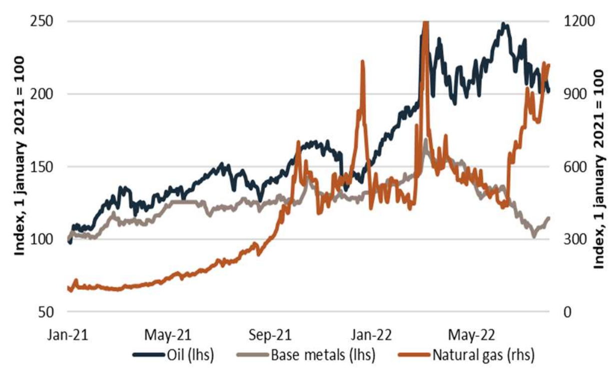
The latter is grappling with ongoing problems in the real estate sector, the zero Covid-19 policy and the cautious pace of stimulatory measures from policymakers. Beijing relies on local authorities to implement measures but they often don't have the financial resources to do so. It will even turn a blind eye to the fact that not all provinces will achieve the expected growth targets. Confidence in the purchasing managers index (Caixin) for industry was also unexpectedly worse than anticipated in China. This dropped to just above 50 and was a setback given that the economy had recently reopened. Growth slowed in output, new orders and employment. In short, in contrast to the period following the banking crisis it doesn't look as if we can rely on China to boost global growth momentum.

Energy: the million dollar question

How the economic picture will ultimately evolve in Europe in particular naturally depends to a great extent on energy supplies and prices. The most vulnerable countries are Germany and Italy. Given Europe's solidarity when it comes to energy (assuming this lasts), this implies vulnerability on a European scale.

For instance, the Nordstream 1 gas pipeline is currently working at 20% capacity. As a pawn in the geo-political game, there is no way of knowing how this will pan out over the coming months. Russia would like to continue receiving the gas revenues but will in that case ensure that the risk premium in the gas price remains high by continuing to supply less gas to European customers. There is a risk of Russia cutting off supplies entirely.

High energy prices cause for concern



Source: Bloomberg, Van Lanschot Kempen

For Germany this could translate into a hit to the economy of an estimated 2% to 3%, with energy prices remaining high. There would be a similar impact on the Eurozone as a whole. Economists will consequently pay closer attention than usual to weather forecasts during the winter months: the colder it is, the greater the risk of energy shortages and a corresponding economic impact.

Mitigating circumstances

All in all, a cautious economic outlook. Incidentally, from an anecdotal perspective the US is already in a recession. Following a contraction of 0.4% quarter-on-quarter in the first three months of the year, growth stood at -0.2% in the second quarter. Yet it would be going a bit too far to call this a recession at this early stage. Disruptive factors, such as those relating to stock levels, played an important part in both quarters. Furthermore, the job market remains strong. And it's the National Bureau of Economic Research (NBER) that officially decides whether the country is in recession. In doing so it looks beyond just the rate of growth. Whatever the case, the outlook warrants caution, worldwide.

Nevertheless there are a number of factors that should be put into perspective.

Take the abovementioned hit to the European economy of 2% to 3% if Russia cuts off gas supplies completely. In concrete terms this would mean that we lose a year's growth. While this is troubling, it doesn't imply a persisting downward spiral.

The economic skies will be able to clear again as Europe increasingly taps alternative sources of energy and once next winter is behind us.

Stagnation or a recession that is mostly due to external shocks, such as an energy shock, is often shorter than a crisis triggered by imbalances or excesses that need to work their way out of the system. Think of the excessive levels of investment in the IT sector that led to the crisis in 2001, or the excesses in the US real estate and banking sectors that caused the 2008 banking crisis.

Then there is the historically low level of unemployment in both the US (3.6%) and the Eurozone (6.6%). The job market is what's known as a lagging indicator. This means it's more of a follower of the economic climate than a predictive value. If growth momentum weakens further, we can subsequently expect the unemployment rate to rise.

For the time being the current excellent starting position, i.e. the high number of job vacancies and shortage of workers, ensures a partial buffer that will prevent unemployment from rising to dramatically high levels. In fact, a less tight job market would ease the pressure on wages somewhat. Central bankers would approve of this as it would reduce the risk of a wage-price spiral.

In summary: if the economic engine slows further, a recession cannot be ruled out (and is even likely), especially in Europe. Yet we don't anticipate a prolonged downward spiral. There is obviously a higher than average level of uncertainty though, with a huge question mark against geopolitical trends.

Central banks hard at work

Central banks are also being confronted with declining growth momentum on the one hand and persistently high inflation on the other. However. they have already made their choice in this dilemma and are attempting to curb inflation by putting up interest rates.

The Federal Reserve (Fed) has raised its policy interest rate by 75 basis points for the second time in a row. Among other things, Fed Chair Powell pointed to weaker consumer spending and a downturn in investment appetite among businesses as signs that the economy is slowing. At the same time, he noted the tight job market and said he wanted to see a series of convincing data that show inflationary pressure is easing before the Fed takes its foot off the monetary brake.

More interest rate hikes are therefore on the way, albeit probably in smaller steps. Wage growth continues to be a crucial variable here.

The Employment Cost Index (+1.3% in the second quarter versus the first) certainly suggests there is little improvement in this respect. The average hourly wage is rising at a slower rate than it was at the start of the year though. On a monthly basis this stands at 0.3% compared to +0.5% earlier in the year. Yet this indicator is sensitive to the composition of the job market. If more people find jobs in lower segments, this by definition pushes down the average. However, in contrast to the Employment Cost Index, this says less about the underlying wage pressure.

On balance we expect another interest rate hike of at least 50 basis points in September, after which – inflation permitting - the bank can switch to increments of 25 basis points.

ECB deviates from its forward guidance

After some hesitation the ECB has also opted to join the monetary tightening club. It raised its policy interest rate by 50 basis points and announced that further hikes would follow.

In implementing this 50 basis point increase, the ECB went against its own earlier forward guidance. That had assumed an initial rate hike of 25 basis points. The worse-than-expected rate of inflation was of course the reason for the bank acting more aggressively. Inflation climbed to just below 9% in June.

Christine Lagarde described the range of 1% to 2% as 'neutral' for interest rates. In other words, policy interest rates should be raised to that level so that they are neither restrictive nor stimulatory. If the aim is to err on the restrictive side in a bid to rein in inflation, then an even higher rate will be needed. We anticipate a further increment of 50 basis points in September followed by two of 0.25% in October and December.

The question is of course how central bankers would respond to the gathering economic storm clouds following any cut to gas supplies by Russia. If this were to happen, rising energy prices could keep inflation high but slow the economy further, with underlying core inflation (inflation excluding energy and food) spontaneously crumbling under the weight of a recession. Which parameter would be prioritised at the ECB boardroom table: inflation or growth?

TPI: Transmission Protection… Italy?

So, a bigger interest rate increase by the ECB than expected in response to inflation. Yet this decision was probably also the result of a compromise between the so-called hawks and doves in Frankfurt.

The hawks have been forced to accept the TPI, or Transmission Protection Instrument. This is a new bond-buying programme that the ECB has at the ready in the event that 'unwarranted, disorderly market dynamics' threaten a Eurozone country, i.e. if the differences in bond yields between the individual countries become too great. The first country that springs to mind here is of course Italy because of its vulnerability in terms of both its high level of debt and the unstable political situation.

From a fundamental perspective, there are many arguments against the TPI, especially the fact that the 'independent' ECB is again daring to tread political ground. Although there are criteria for activating the TPI, such as complying with European budgetary rules or adopting the recommendations of the European Commission, the ECB will only use these as input for making a decision. The Executive Board basically has the discretionary power to deploy the TPI whenever it deems necessary.

In doing so, the ECB once again threatens to remove a stimulus for implementing the required reforms in the 'supported countries', which could help to perpetuate the almost traditional competitive differences between the individual Eurozone countries.

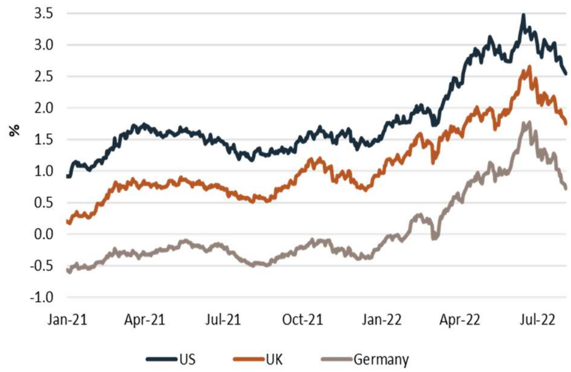
Purely from an investor perspective, however, the TPI could prove to be a reassuring instrument for financial markets, even if investors aren't yet convinced of this. In the wake of a brief period of calm in mid-June, spreads on Italian government bonds have started to widen again. Against the background of weak economic data and the looming Italian general election at the end of September, it's perfectly possible that markets will test the ECB's mettle.

Bond markets are worried…

Financial markets displayed a mixed picture last month.

Bond investors are chiefly concerned about the possibility of a recession. While German 10-year government bond yields stood at about 1.60% at the end of June, a month later they had dropped back to 0.82%. Their US counterparts decreased from 3.50% in mid-June to 2.65% at the end of July. A similar picture was visible in the UK, with 10-year bond yields falling from 2.65% in mid-June to 1.86% by the end of July. All of this despite the strong inflationary pressure. Markets ultimately expect inflation to drop to the central banks' target rates in both the US and the Eurozone.

Lower yields due to recession fears



Sources: Bloomberg, Van Lanschot Kempen

The positive interpretation here is that this is an expression of faith in central banks and their ability to achieve these targets. A negative interpretation, however, tells us that bond investors anticipate a recession.

Spreads on Eurozone credits tightened marginally as well. Yet with the exception of the start of the pandemic, they are still at their highest level since 2013.

Investors in US credits are also demanding more compensation for the business risk but to a lesser extent than on credits in euros. This is logical given the bigger question marks surrounding the European economy compared to its US counterpart.

As far as our investment policy is concerned, the wider spreads are not yet reason enough for us to increase our allocation to credits. One significant difference from 2012-13, when spreads stood at similar levels, is the stance of central banks: at that time they were in expansionary mode, with bond-buying programmes that included credits. The situation is now reversed.

…equity markets less so

We're now in the midst of the earnings season, with businesses reporting results over the second quarter.

The initial impression is that it was a sound second quarter. More importantly, companies seem to be relatively optimistic about the next few months. Even in cyclical sectors forecasts for the second half of the year are regularly being adjusted upwards. There are two relevant points to consider here.

Firstly, the sound corporate results are an illustration of the fact that equities offer some protection against inflation. Valuations and fundamental values are based on updating *nominal* earnings and cashflows. As long as companies can pass on the higher input prices they face, shareholders will accordingly profit from the higher prices. At least, this is the case as long as this effect isn't cancelled out by excessively high interest rates.

Secondly, the abovementioned optimistic companies often point out that their basic scenario includes an abstraction of any energy rationing. This basic assumption contains an especially high level of uncertainty.

We therefore continue to apply caution in our investment policy. The economic uncertainty is higher than average, particularly in Europe, and this isn't yet properly reflected in what continue to be high earnings forecasts. This leads us to retain an underweight in equities, concentrated in the European market.

Our doubts as to whether central banks will be quick to halt or scale back their tightening monetary policies are likewise contributing to our cautious stance on equities.

Market review

Equities				
	Index	Past month	Past 3 months	From 31-12-2021
Global (MSCI AC)	995	6.6%	-2.3%	-15.4%
Developed markets (MSCI World)	2749	7.4%	-1.7%	-14.9%
Emrging markets (MSCI EM)	995	0.2%	-7.5%	-19.2%
United States (S&P500)	4119	7.7%	-0.3%	-13.6%
Eurozone (EURO STOXX 50)	3707	7.5%	-2.5%	-13.8%
United Kingdom (FTSE 100)	7413	3.4%	-1.7%	0.4%
Japan (Topix)	1960	6.2%	3.2%	-1.6%
Netherlands (AEX)	728	11.1%	2.4%	-8.7%
Government bonds (10-year)				
	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	2.57	-31	-36	106
Japan	0.19	-4	-4	12
Germany	0.78	-45	-16	96
France	1.35	-45	-11	115
Italy	2.74	274	115	169
Netherlands	1.07	-52	-15	110
United Kingdom	1.81	-35	-10	84
Investment grade credit				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	143	-15	8	51
Eurozone	186	-30	35	91
High yield bonds				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	465	-113	86	182
Eurozone	584	105	134	266
Emerging markets (USD)	531	-9	92	162
Emerging markets (Local currency)	414	4	33	-31
Real estate				
		Past month	Past 3 months	From 31-12-2021
Global		6.1%	-7.2%	-7.9%
North-America		7.3%	-4.7%	-6.6%
Europe		11.1%	-11.9%	-21.7%
Commodities				
		Past month	Past 3 months	From 31-12-2021
Bloomberg index		2.5%	-7.1%	21.5%
Base metals		0.9%	-19.8%	-13.0%
Brent oil (USD per barrel)	100.03	-7.2%	-1.5%	34.6%
Gold (USD per troy ounce)	1778	-1.3%	-7.0%	-2.8%

Returns in local currency
bp = basis points (0.01%)
Data as of 1 August 2022
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Negative**

Equities had a good month in July. The global MSCI equity index, including emerging markets, was up by 6.9% in local currency. The US and Europe noted similar price gains of slightly over 9% and 6% respectively in local currency. All this despite the news that global economic momentum continues to slow. Investors are assuming that monetary policy tightening will eventually be halted or scaled back. In the US, there is debate as to whether we can already talk of a recession. The Eurozone performed better than expected in the second quarter but is in turn more sensitive to any further increases in energy prices and shortages in the second half of the year. We therefore question whether the high expected earnings growth is sustainable. Equity valuations have dropped considerably, making equities more attractive in this sense. Any negative revisions to earnings pose a downward risk for equity valuations in the next few months, however, especially in Europe.

Government bonds	**Negative**

Ten-year bond yields fell across the board in July. From the levels noted in mid-June, these declined from 3,50% to 2,65% in the US, from 2.65% to 1.86% in the UK and from 1.60% to 0.82% in Germany. This was investors responding to the deteriorating economic data. Forecasts from the less aggressive central banks also played their part, especially at the short end of the yield curve. Despite the interest rate hike from the Federal Reserve, US 1-year yields have decreased by 30 basis points since the middle of the month. A downturn of 10 basis points was likewise visible in Germany. On balance the yield curves in both regions flattened. Real interest rates declined further, especially towards the end of the month, due to lower nominal yields in the Eurozone and in the US in part exacerbated by higher inflation forecasts. This is a further indication that markets expect the Fed to start focusing more on lower growth at some point rather than exclusively on curbing inflation. However, we aren't convinced that central banks will quickly halt their monetary tightening and remain cautious about bonds.

Investment grade credits	**Neutral**

After widening sharply in June, spreads on investment grade credits again tightened in July. Yet in particular in the Eurozone they remain at their highest levels since 2012/13 (with the exception of the start of the pandemic). Although credits are now more attractive again from a valuation perspective, we have decided to retain a neutral weight for the time being. In contrast to previous periods of similar spreads, central banks are currently in tightening mode. 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 tightened in line with movements on the equity markets. The high yields, about 8% in the US and 7% in the Eurozone, make high yield credits attractive from a valuation perspective but at the same time make it substantially more expensive 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**

Listed real estate also performed well in July and more than succeeded in keeping up with the equity markets. The global real estate index climbed by 10.6%, with an upturn of 8.9% in North America and as much as 12.2% in Europe (all percentages in local currency). The asset class profited from the lower capital market yields in July and investors' hopes that central banks would pause or even stop monetary tightening as economic growth is squeezed further. The recovery on the real estate market was therefore mainly visible in the more interest rate-sensitive sectors, where cashflows are further off in the future and a higher level of growth is expected, such as logistics, datacentres, storage facilities and also rented residential property. Listed real estate has a reputation as being a defensive sector in equities. Moreover, its cashflows are partly linked to inflation. Higher interest rates do pose a threat to this asset class though, including in relative terms versus general equities. July's lower interest rates therefore provided a boost. Listed real estate valuations have fallen, leading us to no longer view the asset class as expensive. However, we still view real estate as expensive versus fixed income asset classes with similar credit ratings. Aside from the uncertainty surrounding growth and in turn demand for retail and office space in particular, we see investors' assumptions that central banks will quickly move away from monetary tightening as premature and consequently hold no position in listed real estate.

Emerging market debt	**Neutral**

In July, yields on emerging market debt listed in US dollars dropped by about 40 basis points, 10 basis points of which were due to tighter spreads. Bonds listed in local currency declined to 6.8%. Here, too, investors' expectations of fewer interest rate hikes from the Fed gave the asset class some breathing space. A yield of over 8% for bonds in US dollars and just below 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 and therefore hold a neutral outlook.

Commodities	Neutral

July saw an end to the sharp downturns in commodity prices triggered by fears of a recession among investors. The general index was up by 2.9% in July, mostly in response to renewed turbulence on the energy markets. This was caused by uncertainty surrounding gas supplies from Russia to Europe. Following a brief period in July of annual maintenance to the Nordstream 1 pipeline to Germany, there was uncertainty as to whether Russia would resume gas supplies. In fact, gas supplies were subsequently restored to pre-maintenance levels of 40% of maximum capacity. Yet only four days later, Russia cut supplies to just 20%. This pushed European gas prices to historically high levels of over €200 per MWh. Prices of oil and oil products also rose further. This energy component led to the commodity index closing the month at a plus. Industrial metals were still experiencing some price pressure because of the deteriorating economic outlook. Food prices fell in July, partly thanks to the agreement between Russia and Ukraine reached with the help of Turkey that should allow grain exports to resume in the short term. Even after the third monthly drop in the gold price, 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. However, we are now slightly more cautious about the global economic outlook and this contributed to last month's decision to reduce our position in commodities to neutral.

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