VAN LANSCHOT KEMPEN

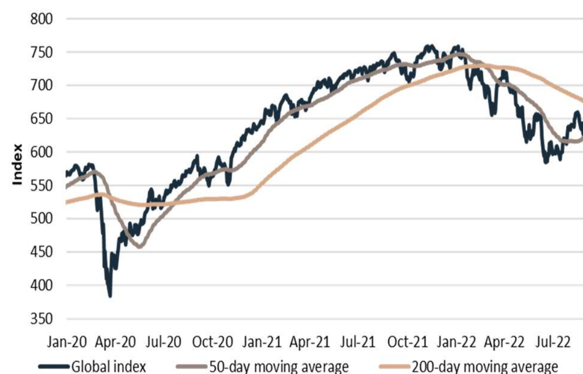
# Asset Allocation Outlook

## SEPTEMBER 2022

- Aggressive tone of central banks spoils the equity party
- Recession becoming ever more likely
- Equity underweight increased

There were two sides to the month of August. Investors started the month optimistically, especially when the US economy turned out to be generating large numbers of new jobs still and inflation declined slightly. These events raised hopes of a soft landing and a shift by the Fed to a less tight monetary policy. However, sentiment underwent a reversal when Fed Chair Powell made it clear that no such change was imminent. This resulted in the equity markets falling again after all in August after the upturn in July. During the rally the US S&P500 had come closest to breaking through the downward trendline of the 200-day moving average but ultimately failed to do so.

**Downward trend still visible in equities**




Source: Bloomberg, Van Lanschot Kempen

European equities and equities from the Pacific region and emerging markets didn't even come close to doing so. This means that the downward trend in equities still hasn't been bucked. Given that a recession is becoming ever more likely, we've further reduced our exposure to equities. We have sold US equities and instead bought US government bonds. Our large underweight in European government bonds means that we continue to hold an underweight in this asset class as a whole. Our cash position is relatively large. Incidentally, bonds failed to compensate for the lower equity prices in August. European government bonds noted a negative return of nearly 6%[1], which was larger than the loss on equities, while the loss on US government bonds was restricted to 3%. Credits and emerging market debt were also affected, although the losses on these asset classes were smaller than those on government bonds.

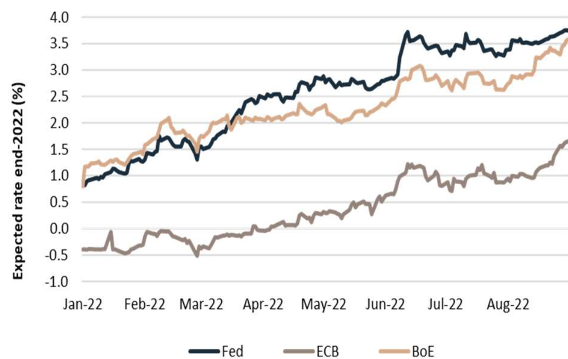
## Central banks unwavering

At the annual central banker jamboree in the US's Jackson Hole, Fed Chair Powell was crystal clear that combating inflation is the absolute priority, even if it's at the expense of economic growth and the job market and ends up hurting households. Powell drew lessons from the 1970s, when prices also shot up, and among others quoted Paul Volcker, the former Fed Chair who in 1980 raised official interest

[1] Returns in local currency

rates to no less than 20%. The present high rate of inflation is the result of supply restrictions and exuberant demand. And the Fed can and will do something about the latter in order to curb inflation. Decisive intervention now will cause temporary pain but prevent even bigger problems further down the line if businesses and households were to lose confidence in the Fed and inflation forecasts to rise. The Fed is therefore heading towards a restrictive monetary policy. Following a tentative first step in March, the Fed's interest rate increments have grown in size; 0.75 percentage points in June and July. Powell refused to rule out a third increase of the same magnitude in September. Investors are still wavering between 0.5 percentage points and 0.75 percentage points. Yet it's clear that the Fed will raise interest rates higher, even if this also leads to lower growth. And in doing so it won't be too concerned about how the financial markets react. On the contrary, a measure of weakness on the equity markets, higher capital market yields and wider credit spreads will be welcomed by the Fed. These would mean that the Fed doesn't have to do all the work itself by raising the policy interest rate.

**Policy interest rate forecasts rise higher**




Source: Bloomberg, Van Lanschot Kempen

The ECB likewise made its position clear at Jackson Hole via Isabel Schnabel, a member of the Executive Board (also the policy committee). And Schnabel also sided with the hawks who advocate tough monetary policies. According to Schnabel, uncertainty about the stubbornness of inflation demands a robust policy response, irrespective of whether that inflation is driven by demand or supply. The latter is more the case in the Eurozone than in the US due to the high gas prices in Europe, but there is a risk of inflation forecasts rising in the Eurozone as well in Schnabel's view. So far, the ECB has raised interest rates once by 0.5 percentage points to 0%. For early September investors are wavering between an increment of 0.5 percentage points and one of 0.75 percentage points. A reasonably large group of ECB policymakers has already come out in favour of the larger hike. This makes the larger increment the most realistic option.

The conlusion is that the Fed, the ECB and also the Bank of England will quickly raise interest rates higher. Monetary policy will therefore be a negative factor for financial markets. We believe expectations that the Fed will soon cut interest rates again, i.e. in the course of 2023, to be unrealistic. The ECB finds itself in a tricky situation, with high inflation and an economy that is slowing fast. It's therefore possible that the ECB will ease interest rate hikes slightly sooner, but for this to happen energy prices in Europe will at least need to stabilise first.

## Eurozone recession inevitable

In the meantime, the Eurozone's economic problems are piling up. Consumer confidence was already low but manufacturers are now also more pessimistic, as shown by the declining purchasing manager indices. The composite index for industry and services fell further to below 50 in August and therefore points to a contracting economy.

**Pessimistic purchasing managers point to contraction in the Eurozone**

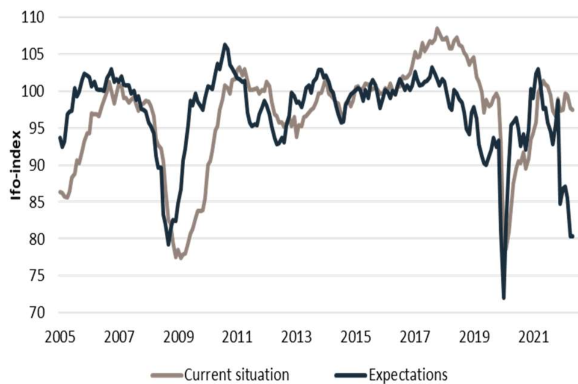
Source: Bloomberg, Refinitiv, Van Lanschot Kempen

The erosion of confidence can of course all be traced back to the high rate of inflation. This climbed to 9.1% in the Eurozone in August, while in the

Netherlands the rate was as high as 13.6%. This was largely due to higher energy prices, but at 4.3% the upturn in core inflation (excluding food and energy) was also the highest in the Eurozone's history. The high level of gas prices in the Eurozone leads us to conclude that peak inflation hasn't yet been reached. Supplies of Russian gas continue to shrink and are shrouded in uncertainty. Europe is managing to build up its gas reserves for the coming winter fairly successfully, but next year could be extremely difficult if Russia cuts gas supplies entirely.

On top of the gas crisis there is the extreme drought. This is now becoming noticeable in agriculture and restricted transport options via the major rivers. It's having a particular impact in Germany on the option of switching from gas to coal for generating electricity. Germany's leading Ifo index fell further in August, with a conspicuously wide gap between the analysis of the current situation and the forecasts.

**Extremely low expectations among German businesses**




Source: Refinitiv, Van Lanschot Kempen

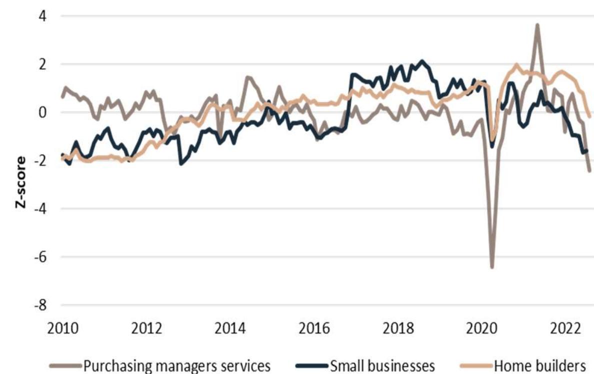
German businesses now predict a sharper deterioration in the economic situation than in 2008 or during the outbreak of the coronavirus pandemic. It should be remembered though that the pandemic was a surprise and businesses quickly received government support. In France, nuclear power stations are unable to work at full capacity because of a lack of water for cooling. A number of businesses that consumer large amounts of gas, such as chemical, artificial fertiliser or other energy-intensive companies, are already being forced to restrict production. It's difficult to say precisely what the impact on growth will be but it does make a recession more likely. We now take a recession in the Eurozone as our basic scenario.

## US: recession in 2023?

The problems facing the US are less acute. Consumer confidence is low there as well but the most recent data show it to have improved marginally. The robust job market – in July there were two vacancies for every unemployed person – is causing a substantial increase in family incomes. Nominal income from work was up by over 9% Y-o-Y in July. Inflation is naturally also high in the US, but incomes are now succeeding in keeping up with it. The purchasing power of Americans is therefore not being eroded, as is happening in the Eurozone. This reduces the risk of a recession, in the short term at least.

Yet that doesn't mean that all is well. Confidence among businesses in the service sector plummeted to 44 in August, which clearly points to a recession. Small businesses and housebuilders are also having a tough time, as is visible in the low confidence indicators.

**Declining confidence in US**




Source: Refinitiv, Van Lanschot Kempen

The housing market is under pressure. The sharp price increases of the past few years and the recent strong upturn in mortgage rates have led to a significant deterioration in the affordability of homes. According to an index published by the US association of realtors, homes haven't been as unaffordable as they are now since 1989. The logical upshot is that sales are falling, stocks of unsold homes are rising and prices are being squeezed. A

slowdown on the housing market will lead directly to fewer new homes being built and therefore lower economic growth. More indirectly, there is the capital effect. Rising house prices have a positive impact on consumer spending but this effect will now dissipate. Not, incidentally, that this is a sizeable effect. A crash on the housing market could trigger a financial crisis, which could in turn exacerbate a recession. We believe there is little chance of this though. Families hold record amounts of capital at the moment. While this capital is far from evenly distributed, the amount of mortgage debt is not high. Banks have been cautious about granting mortgages, especially to families with a low credit status. This is in stark contrast to the housing bubble that burst in 2007. Banks also hold higher capital buffers than they did back in 2007.

In the US the risk of a recession lies more in the aggressive policy from the Fed that is needed to curb inflation. It generally takes interest rate hikes about six to nine months to have a knock-on effect on the economy. In this respect the housing market is ahead of the rest of the economy. This means that the higher interest rates should start to have an impact around the turn of the year. This will initially be gradual as rates remain low but gradually gather pace because of the hikes the Fed will have implemented by that point. The writing on the wall is the negative yield curve, in which 10-year yields are lower than their 2-year counterparts, as it is a reliable indicator of a recession. It was briefly negative back in April but lasted too short a time to emit a clear signal on that occasion. This time around though the yield curve has been negative since early July and its size, about 0.3 percentage points, shows that the signal predicting a recession is getting stronger.

## China: from locomotive to trailer

China's economic cycle is capable of deviating considerably from that in other countries and is the situation at the moment. Yet whereas in the past China has acted as the engine of the global economy, this is no longer the case. The country faces sizeable problems deriving from a crashing housing market and its zero-tolerance coronavirus policy but is reluctant to stimulate the economy. And rightly so because that could exacerbate the debt problem. So China has become more of a trailer under tow, with growth now having to come from exports. With economic cycles increasingly synchronising, however, exports are also providing less solace. All the more so now that consumer spending in the US and Europe has shifted away from goods towards services. The squeeze on Chinese exports can be seen in the purchasing manager indices, which show a decline in orders for export products.

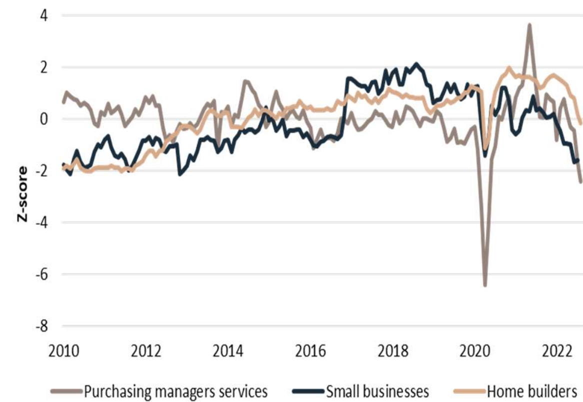
Low growth in China and slowing growth in Europe and the US are affecting emerging markets too. Purchasing manager indices for industry fell in most countries. Sharp downturns have been especially visible in Korea and Taiwan in recent months. This is related to the chip sector, which is highly sensitive to the economic climate, but in the case of Taiwan also to the politico-military tensions between the island and China. If the economic cycle in emerging markets undergoes a reversal and growth slows even further, this will put a stop to interest rate hikes, mainly because central banks in some of these countries started to raise rates in good time. However, the current high rates of inflation mean it is still too soon for policies to be reversed.

## Capital market yields on the up again

Last month we wrote that the bond markets were worried about a recession. This was because capital market yields were falling. That must mean that optimism now reigns as yields haven risen again. While US bond yields stood at 2.6% at the start of August, they are now as high as 3.2%. Incidentally, this means that June's peak of 3.5% hasn't yet been reached. This peak has been passed in the UK, however, and 10-year yields climbed nearly 1 percentage point to 2.8% in one month. UK inflation hit 10.1% in July and forecasts for the Bank of England's policy interest rate are also up by 1 percentage point. In Germany the upturn in yields was slightly more moderate at 0.7 percentage points to 1.5%. This could mean that the bond markets are assuming stronger growth, but central banks' policies of course also have an impact. Higher inflation for longer and the more aggressive monetary policies primarily still needed to be priced in by the bond markets. The higher short-term yields place a higher floor under the 10-year bond yields. That bond markets aren't at ease with this is especially obvious from the yield curve. We've already mentioned that the yield curve is sharply

negative in the US. This isn't yet the case in Germany but the yield curve there did flatten considerably, a sign that bond investors are concerned about growth after all.
The negative yield curve in the US means that further interest rate hikes pose a threat to 10-year yields as there is less of a buffer from a further flattening of the curve. Nevertheless, we have opted to invest the proceeds from the sale of US equities in US government bonds. In doing so we have bought a basket containing all the durations, which exposes us to a smaller interest rate risk than if we had only bought 10-year bonds. We opted for US bonds because yields are higher in the US and because we didn't wish to reduce our exposure to the US dollar.

**Yield curves flattening**




Source: Bloomberg, Van Lanschot Kempen

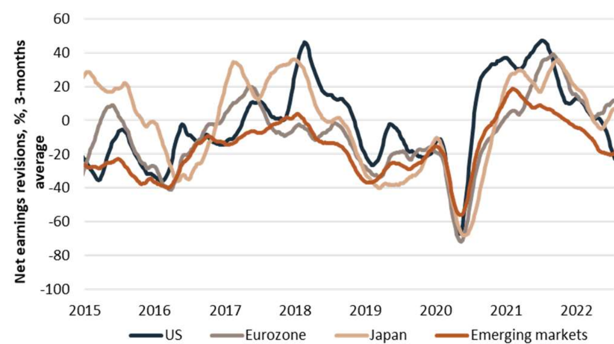
Ten-year bond yields could also rise in Germany if the ECB raises interest rates further. The yield curve still has the capacity to flatten slightly more here, which would restrict the damage to 10-year bonds. However, a negative yield curve is a less frequent occurrence in Germany, especially if the ECB's policy interest rate remains fairly low in historical terms.

## Equity underweight increased

The earnings season for the second quarter is now behind us. While it was no surprise that businesses in the US and Europe announced positive surprises, the unexpected element lay in the size of the surprise and earnings growth in Europe being approximately double that in the US. In Europe, earnings grew by 14% versus the second quarter of 2021, 10% higher than forecast, in the US by 7.7% or 4% higher than expected. The drop in earnings of 18% in Japan was much worse than expected.

Despite the sound data in the US and Europe, we continue to exercise caution in our investment policy. Earnings dynamics have weakened in the US in particular. Analysts are adjusting their forecasts downwards for the coming twelve months and the extent to which this is happening is worrying. It was certainly contrary to the rally on the equity markets until mid-August. Inflation remains a cause for concern. It looks as if the peak has been reached in the US, but this is mainly because energy prices will contribute less to inflation. In underlying terms, however, inflation is so high that investors assumed – wrongly, in our opinion - that the Fed would quickly adopt a less aggressive tone. We therefore decided to reduce our allocation to US equities from a neutral to an underweight position in August.

**Negative revisions to earnings in US and emerging markets**




Source: Refinitiv, Van Lanschot Kempen

Earnings dynamics have so far held up surprisingly well in the Eurozone. Yet we believe this is largely due to the lagging effects of the reopening of economies. The high probability of a recession leads us to expect a squeeze on earnings. We already held an underweight in European equities and have retained this. Our concerns about the European economy and European corporate earnings are expressed in a larger underweight in European equities than in their US counterparts.

## Market review

| Equities | | | | |
|---|---|---|---|---|
| | Index | Past month | Past 3 months | From 31-12-2021 |
| Global (MSCI AC) | 972 | -4.2% | -7.5% | -19.6% |
| Developed markets (MSCI World) | 2605 | -4.5% | -7.4% | -19.4% |
| Emrging markets (MSCI EM) | 972 | -1.2% | -8.4% | -21.1% |
| United States (S&P500) | 3924 | -4.1% | -6.0% | -17.7% |
| Eurozone (EURO STOXX 50) | 3544 | -3.8% | -6.6% | -17.5% |
| United Kingdom (FTSE 100) | 7281 | -1.7% | -3.3% | -1.4% |
| Japan (Topix) | 1930 | 0.2% | 0.2% | -3.1% |
| Netherlands (AEX) | 679 | -6.5% | -3.5% | -15.0% |
| **Government bonds (10-year)** | | | | |
| | Yield (%) | Past month (bp) | Past 3 months (bp) | From 31-12-2021 (bp) |
| United States | 3.19 | 44 | 28 | 168 |
| Japan | 0.24 | 7 | 0 | 17 |
| Germany | 1.53 | 71 | 29 | 170 |
| France | 2.15 | 74 | 39 | 195 |
| Italy | 3.56 | 8 | 197 | 251 |
| Netherlands | 1.86 | 73 | 32 | 188 |
| United Kingdom | 2.92 | 105 | | 195 |
| **Investment grade credit** | | | | |
| | Risk premium (bp) | Past month (bp) | Past 3 months (bp) | From 31-12-2021 (bp) |
| United States | 145 | 1 | 15 | 53 |
| Eurozone | 205 | 17 | 42 | 110 |
| **High yield bonds** | | | | |
| | Risk premium (bp) | Past month (bp) | Past 3 months (bp) | From 31-12-2021 (bp) |
| United States | 493 | 47 | 94 | 210 |
| Eurozone | 585 | 0 | | 267 |
| Emerging markets (USD) | 511 | -9 | 62 | 142 |
| Emerging markets (Local currency) | 358 | -34 | -26 | -87 |
| **Real estate** | | | | |
| | | Past month | Past 3 months | From 31-12-2021 |
| Global | | -3.8% | -3.0% | -11.5% |
| North-America | | -3.5% | -1.6% | -10.6% |
| Europe | | -10.2% | -15.3% | -30.2% |
| **Commodities** | | | | |
| | | Past month | Past 3 months | From 31-12-2021 |
| Bloomberg index | | 1.3% | -10.5% | 21.0% |
| Base metals | | -4.4% | -18.4% | -17.5% |
| Brent oil (USD per barrel) | 93.02 | -5.7% | -15.7% | 26.0% |
| Gold (USD per troy ounce) | 1713 | -3.7% | -8.5% | -6.3% |

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

## Tactical outlook

| Asset class | |
|---|---|
| **Equities** | **Negative** |

The equity rally that started in mid-June lasted two months. It was driven by hopes of inflation peaking, which would mean that central banks wouldn't need to raise interest rates too high and growth would be able to hold up reasonably well. A soft landing, basically. Sound earnings data over the second quarter also helped. Yet in mid-August there were signs that inflation was still persistently high and growth was slowing. Furthermore, the Fed and the ECB announced that they would continue raising interest rates for the time being. On balance, global equities fell by 4% in August, driven entirely by industrialised nations. We weren't convinced that the worst was already behind us and reduced our equity allocation further in August by selling US equities. Although the risk of a recession is lower in the US than in Europe, earnings dynamics have clearly deteriorated. The equity rally was totally contrary to this deterioration. US equities are also more sensitive to interest rates and more expensive than their European counterparts, although equity valuations have come down this year. We have retained our underweight in European equities, which is larger than the one in US equities. Earnings dynamics have held up surprising well in Europe but the high probability of a recession, in part owing to the high energy prices, makes us think these will weaken.

| **Government bonds** | **Negative** |
|---|---|

Ten-year bond yields rose sharply in August: in the US from 2.6% to 3.2%, in the UK by almost 1 percentage point to 2.8% and in Germany by 0.7 percentage points to 1.5%. The negative monthly return of nearly 6% on Eurozone government bonds with the highest rating of AAA was the worst in decades. The main reason for the upturn in yields is the realisation that we won't be rid of high inflation and aggressive central banks any time soon. This can be seen from the course of 2-year bond yields, for instance, which are more sensitive to monetary policy. These have risen steadily in the US since January; in August by 0.6 percentage points. In Germany the increase was 0.9 percentage points, and in the UK as much as 1.3 percentage points. We hold an underweight in government bonds due to the risk of higher yields. However, we have used the proceeds from selling US equities to take a position in US government bonds. Our aim in doing so was to ensure we didn't reduce our exposure to the US dollar, while yields are also higher in the US. There is a risk of yields rising in the US as well though. For this reason, we have invested in a broad index and not just in 10-year bonds. This restricts the interest rate risk somewhat.

| **Investment grade credits** | **Neutral** |
|---|---|

Spreads on US investment grade credits tightened marginally, but the upturn in underlying yields on government bonds led to yields on investment grade credits rising anyway. In the Eurozone, underlying yields increased and spreads widened, which pushed yields up more sharply and in turn generated a more negative performance. Although credits are reasonably attractive 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. It is our belief that a recession has not yet been fully priced into spreads. 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 widened somewhat in the US, while they in fact tightened in the Eurozone. Yet the higher underlying yields led to both regions noting negative investment results, -1.9% in the Eurozone and -2.6% in the US. Just as for equities, there were two sides to August for this asset class. Spreads tightened at first and then widened. 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 slowing 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** |
|---|---|

Higher interest rates had an adverse impact on listed real estate in the US and Europe in August. The US index was down by 6%, while its European counterpart dropped by 11%. Real estate therefore underperformed versus equities. 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. The upturn in interest rates in August consequently squeezed listed real estate. 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 view the aggressive stance of central banks as being inappropriate for listed real estate and consequently hold no position in listed real estate.

| Emerging market debt | Neutral |
|---|---|

Spreads on emerging market debt listed in US dollars tightened by about 0.3 percentage points in August, which is remarkable given the contractionary policy being pursued by the Fed and the strong US dollar. Yet in this asset class too the tighter spreads weren't enough to offset the upturn in underlying yields on US government bonds. The result was a negative performance of 1.4%. Bonds listed in local currency noted a negative return of 1.1%. These returns made emerging market debt the best-performing bond asset class. 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 don't hesitate to raise interest rates when 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, although these have recently fallen again slightly. 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 |
|---|---|

Commodity prices generally fell in August, with the oil price being particularly affected. Driven by fears of a recession and a potential agreement with Iran on its nuclear programme (which would increase supplies of oil from Iran), the oil price dropped by approximately 10%. Metals lost 1.6% and gold 3.1%. European gas prices rose further, however. On 26 August they noted a new record of €320 per MWh. Prior to the war in Ukraine, a gas price of a tenth of that was already considered high. At the end of August the price dropped back to €244 per MWh, but on balance August saw a price increase of nearly 20%. Russia is of course the culprit here as it continues to slash the amount of gas it supplies, whether under the pretext of maintenance to pipelines or otherwise. 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 July's decision to reduce our position in commodities to neutral.

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