VAN LANSCHOT KEMPEN

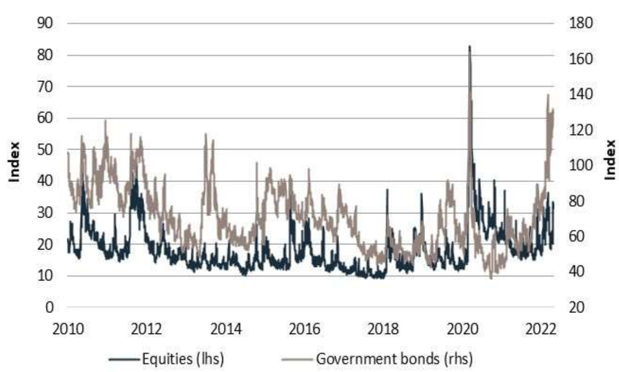
Asset Allocation Outlook

OCTOBER 2022

- Aggressive central banks cause jitters on interest rate markets
- Global economy slows further
- We continue to exercise caution in our investment policy

The negative sentiment that gripped the financial markets from mid-August persisted in September, with much more turbulence on the government bond markets than the equity markets.

Higher volatility on US bond market



Source: Bloomberg, Van Lanschot Kempen

The reasons for this are widely known. High inflation, slowing growth and aggressive central banks are having a negative impact on the confidence of consumers, businesses and investors alike. While there are a few bright spots, the negative news still has the upper hand. And so investors had few options for taking shelter. Based on total returns in local currency, equities lost nearly 10% worldwide. The loss in Europe was slightly lower at 6.3%; the US was down by 9.3%. Bonds provided little protection, with government bonds and credits losing 3% to 5%. The higher interest rates also caused problems for listed real estate, leading to a global loss of 12%. And although commodities had previously bucked the negative trend, this was no longer the case: the Bloomberg index fell by 8.1%.

Our investment policy remains unchanged: we hold underweights in government bonds and equities and an overweight in cash. Equity markets have dropped sharply and sentiment is extremely negative. We therefore view reducing the size of our underweight further as risky. From a fundamental perspective, we still think it's too soon to increase our equity weight.

Interest rates rise further

Interest rates set the tone in September.

Capital market yields are rising fast

Source: Bloomberg, Van Lanschot Kempen

US 2-year bond yields climbed by 79 basis points and their 10-year counterparts by 64 basis points. In doing so, US 10-year yields reached nearly 4%, a level not seen since 2008. The yield curve, which was already negative, flattened further and as such reinforced the signal that the economy is heading for a recession. The upturn in yields was slightly smaller in Germany, though still considerable at 56 basis points for 2-year yields and 57 basis points for 10-year yields. Yet it was the UK that topped the charts of major industrialised nations: 2-year yields shot up by no fewer than 121 basis points and 10-year yields by 130 basis points, the largest monthly increases in yields for decades.

The reason for these higher yields is of course the persistent rate of inflation and aggressive tone adopted by central banks. Jerome Powell, chair of the US central bank, had already stirred things back in August when he said the Fed would raise interest rates quickly in order to bring down the soaring rate of inflation, even if it meant economic pain (i.e. a recession) in the short term. The theory behind this is that a prolonged period of excessively high inflation causes a great deal more economic hardship than higher interest rates.

Policy interest rates expected to be higher

Source: Bloomberg, Van Lanschot Kempen

The Fed raised rates by 75 basis points for the third consecutive time in September and announced that it anticipated a further 150 basis points of increases up to the first quarter of next year. This was more than markets were expecting at that time. Powell also said that his message from August remains unchanged and that the Fed will continue to raise interest rates until there are clear signs that inflation is falling.

The ECB likewise raised interest rates by 75 basis points in September. Its basic scenario assumes a recession can be avoided but, reading between the lines, ECB President Lagarde thinks there's a good chance of a recession occurring. Yet even in that case the ECB would continue to raise rates for the time being. A whole series of central banks are already implementing large interest rate hikes in a bid to curb inflation.

The UK also had to contend with the macro-economic blunder by brand-new Prime Minister Truss and her Chancellor of the Exchequer Kwarteng. It's a good idea to spend money to help protect consumers from the extremely high energy prices. Many countries in Europe are doing this in order to avoid a severe recession and poverty among certain portions of the population. But boosting the economy by, among other things, unfunded tax cuts, which will fuel inflation and significantly increase the budget deficit, is clearly going a step too far. This fiscal error sent the British pound plummeting and yields shot up so fast that the Bank of England was obliged to intervene on the bond market to avert a financial crisis.

UK's fiscal plans cause shock on bond market

Source: Bloomberg, Van Lanschot Kempen

Moreover, the Bank of England will need to raise the policy interest rate even higher to neutralise the inflationary effects of the budget plans. The UK even received a rare ticking off from the IMF, a clear sign of how financial markets view government policymakers. Yields on weaker Eurozone country bonds (incl. Italy) climbed by a higher than average amount. Some measure of calm was restored by the Bank of England's intervention and the government's U-turn on the most controversial part of the plan to scrap the top rate of income tax,

Monetary policy forecasts have been adjusted at lightning speed. The higher policy rates should already have been priced in by the markets. We believe that this is largely the case for the bond market. Yet the persistent inflation is a reason for us to remain cautious about fixed income. As far as equities are concerned, the impact on economies from the higher interest rates is still to come. We don't believe that the higher rates have already been fully priced in.

Inflation remains high

There are signs that inflationary pressure is easing somewhat. These are the bright spots we mentioned in the introduction. The prices of many commodities, including oil and metals, have fallen.

Bright spots with respect to inflation

Source: Bloomberg, Van Lanschot Kempen

Supply chain problems are also starting to improve. Confidence is low among manufacturers in Taiwan and Korea, the epicentre of the global chip industry. They have a less positive outlook for exports and rising stock levels, with orders also being squeezed. This means that the shortage of chips is starting to ease.

Inflation will mostly fall In the US over the next few months thanks to the effect of lower oil and petrol prices, as long as oil prices don't rise again. Yet core inflation, which excludes energy and food prices and is more important to the Fed's interest rate policy, will remain high. But even here there's the prospect of it easing slightly. The rapidly cooling housing market will have a moderating effect on house prices and rents. It's precisely the housing costs component that has a considerable upward effect on core inflation. However, it will take some time for lower house prices and rents to cause a reversal in core inflation. It's still far too soon for the Fed to adopt a less aggressive tone. Like other central banks, the Fed is looking backwards rather than forwards. It first wants to see evidence that inflation is coming down. As monetary policy has a delayed effect on the economy, there's a good chance of the Fed going too far with its interest rate hikes.

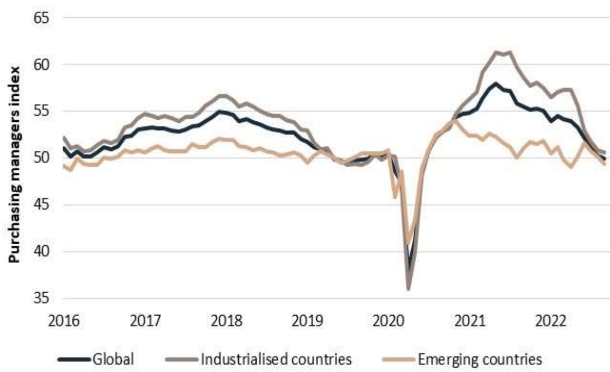
Inflation shot up to 10% in the Eurozone in September and core inflation to 4.8%. In Germany the rate calculated using the Eurostat method stood at 11% and in the Netherlands at a rather distorted but nevertheless unprecedented 17%. The gap between headline inflation and core inflation is larger in the Eurozone than in the US. A larger portion of headline inflation therefore derives from food and energy prices (mostly the latter). This also increases the potential for inflation dropping fast in the Eurozone. Yet we don't expect this to happen because of the high gas and electricity prices. This means the ECB also still has work to do.

UK inflation stood at 10% in August. There's no sign of the central bank there softening its tone yet either. While it's true that the government's fiscal plans to cap energy prices will push down inflation in the short term, the stimulatory fiscal policy will in fact force the Bank of England to raise interest rates further.

Global economic slowdown

The global economy continues to slow. This could be seen from September's purchasing manager indices (PMIs) for industry. Purchasing managers were more pessimistic in over half of the 34 countries with these indices. And the indices of 21 countries are below 50, which points to contraction or at the very least declining growth momentum. In the Eurozone the Economic Sentiment Index, consumer confidence and Germany's Ifo Index also fell to levels that point to a recession. Given the sharply negative purchasing power and problems in industry, this could mean a severe recession. Yet the tight job market will prompt businesses to be fairly cautious about making staff redundant. Furthermore, governments are again providing a large amount of fiscal support. Capping energy prices for consumers and in some cases also small businesses will particularly help to restrict the negative impact.

Waning industrial confidence



Source: Bloomberg, Van Lanschot Kempen

In the US, the sharply negative yield curve and downturn in the composite leading indicator point to a recession. Yet the robust job market, service sector growth and rising incomes serve to mitigate the risk somewhat. Since peaking in June, petrol prices have fallen by more than 25%. This is having a positive effect on consumer confidence, although US consumers remain cautious. Real disposable income and consumer spending both rose by a modest 0.1% in August versus July. On an annual basis, however, real income is down by 4.5% and consumer spending is up by 1.8%. Revised data show that consumers are now using their savings from the coronavirus pandemic to keep their spending at the same level. The low consumer confidence is a sign that US consumers are also struggling. US savings are dwindling fast. This means that higher real incomes are also important to the US.

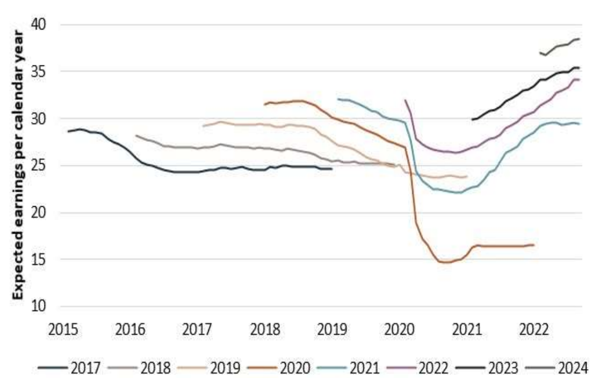
In emerging markets we're seeing a divergence between commodity exporters and importers. Growth is being squeezed more severely in the more industrial countries of North East Asia and Eastern Europe that import commodities.

Our outlook for the global economy remains unchanged. We expect Europe to enter into a recession, mainly driven by consumers. For the US we anticipate a recession at a later date triggered by the tighter financial conditions, such as higher interest rates, wider spreads and the expensive US dollar. And given the level of weakness in these two major regions on top of the problems in China, little can be expected of emerging markets. This type of economic weakness will push down inflation. Yet central banks continue to view inflation as excessively high. Moreover, having committed the error of severely underestimating the inflationary pressure, they won't be in a hurry to reverse their policies.

Expected earnings over-optimistic

Analysts are forecasting 7.3% earnings growth in the US and 3.6% in Europe for 2023. So far this year, earnings forecasts in the US have been adjusted downwards marginally, while in Europe they've in fact been adjusted upwards. That looks to be at odds with the deteriorating economic outlook in Europe but is chiefly due to realised earnings being higher than expected. This higher base in turn leads to higher expectations. The *level* is therefore higher but because expectations are increasing at a slower rate, expected earnings *growth* is indeed decreasing. At the start of this year, European earnings were forecast to grow by 8.1% in 2023.

Expected earnings excessively positive in Europe



Source: Refinitiv, Van Lanschot Kempen

The exchange rate also plays an important role here. In the case of a stronger US dollar, the earnings of European companies earned in US dollars are worth more when converted to euros. And the US dollar has already appreciated 14% this year versus the euro. There's a strong correlation between the exchange rate and relative earnings dynamics in the US versus Europe. Earnings dynamics are relatively strong in Europe in the case of a strong US dollar and in the US when the US dollar is weak. As the US dollar won't appreciate indefinitely, however, we expect this positive effect for Europe to dissipate.

Another reason for the continued positive expected earnings is inflation. High inflation leads to high nominal growth and in turn to high nominal revenue growth. This should result in high earnings growth. However, historical analysis shows that the positive correlation between inflation and earnings growth mainly exists if real growth is positive as well. In other words, if products or services don't just become more expensive but larger quantities are also sold. If real growth becomes negative and businesses sell fewer products, it will be more difficult to sustain margins, revenues and earnings. After all, it's not always possible to adjust fixed costs quickly. We anticipate negative real growth and for this reason think current earnings forecasts are too optimistic.

Investment policy unchanged

The substantial downward movements on equity markets mean that a lot more bad news has already been priced in. Examined against a range of valuation bases, European equities are already valued far below their historical average. This also applies to Japanese equities and most of all to emerging market equities. Even US equities can no longer truly be called expensive based on their history of the past 20 years. The discount on European equities versus US equities is enormous. Based on expected price/earnings (P/E) ratios, European equities are more than 30% cheaper than their US counterparts. The average difference over time is 15%.

Valuations are of course not a reason to buy or sell on a tactical basis. Sentiment may be a valid reason, although we're generally cautious in this respect. The sentiment on the equity markets is negative at the moment. This can be seen from investor surveys, the ratio of outstanding call and put options, the positioning in equity futures and positions held by hedge funds and asset allocation funds. Many equity markets are also oversold. We don't yet view this as a signal to increase our equity weight but it does form a risk for our underweight position. A little positive news, for instance in the shape of lower inflation or lower interest rates, could trigger a price rally.

Yet the most important aspect is that we're fundamentally negative about equities. High inflation, rising interest rates, weakening growth and excessively high expected earnings are the reasons for us retaining our underweight in equities.

Higher interest rates squeeze US equity valuations

Source: Bloomberg, Van Lanschot Kempen

Bond valuations have also improved thanks to the higher yields and lower prices. Spreads have widened to levels that match the low growth. In the event of a recession, however, spreads could widen further. And if we compare spreads to the underlying yields on government bonds, there's much less of an improvement visible in valuations. As far as government bonds are concerned, most of the central bank interest rate hikes should already have been priced in. When we reduced our US equity position slightly in August, we bought US government bonds. Incidentally, these have relatively short durations to restrict the negative effect of any further interest rate increases.

Over the course of the year we have gradually introduced greater caution to our investment policy. We sold our positions in European high yield credits and commodities, first switched to an underweight in European equities and later also in US equities. We have held an underweight in government bonds for some time now and as a result have a large cash position.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2021
Global (MSCI AC)	894	-4.1%	-3.1%	-22.9%
Developed markets (MSCI World)	2512	-3.6%	-2.2%	-22.3%
Emrging markets (MSCI EM)	894	-8.1%	-10.0%	-27.5%
United States (S&P500)	3791	-3.4%	-0.9%	-20.5%
Eurozone (EURO STOXX 50)	3484	-1.7%	0.9%	-18.9%
United Kingdom (FTSE 100)	7086	-2.7%	-2.0%	-4.0%
Japan (Topix)	1907	-1.2%	2.0%	-4.3%
Netherlands (AEX)	670	-1.3%	1.5%	-16.1%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	3.63	44	75	212
Japan	0.22	-2	-1	15
Germany	1.87	35	54	205
France	2.46	31	54	226
Italy	3.87	7	228	282
Netherlands	2.19	34	49	222
United Kingdom	3.88	96	168	290

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	153	8	-7	61
Eurozone	220	15	3	125

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	509	16	-69	226
Eurozone	623	38	-29	305
Emerging markets (USD)	543	32	-5	174
Emerging markets (Local currency)	336	-22	-75	-110

Real estate

		Past month	Past 3 months	From 31-12-2021
Global		-9.2%	-7.2%	-19.6%
North-America		-7.9%	-5.1%	-17.6%
Europe		-15.0%	-13.9%	-40.6%

Commodities

		Past month	Past 3 months	From 31-12-2021
Bloomberg index		-2.6%	-0.5%	17.9%
Base metals		1.8%	-2.7%	-16.1%
Brent oil (USD per barrel)	91.80	0.0%	-11.3%	25.2%
Gold (USD per troy ounce)	1731	1.0%	-1.9%	-5.4%

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

Tactical outlook

Asset class	
Equities	**Negative**

Persistent inflation, aggressive central banks, higher interest rates and declining growth caused equities to drop sharply in September. Equities from Europe, Pacific and emerging markets are cheap. US equity valuations are neutral. Yet valuations remain above levels that are usual during a recession. We anticipate a recession in Europe and, later, in the US and in turn weak growth in emerging markets. Equity valuations and expected earnings still haven't been adjusted properly to this outlook in our view. We therefore retain our underweight in US and European equities. The sentiment on the equity markets is extremely negative and on average investors hold small positions in equities. From a contrary perspective this is positive for equities. Yet we believe that the negative fundamental factors will have the upper hand in the coming months.

Government bonds	**Negative**

Interest rate markets are exceptionally volatile. Central banks are indicating they wish to raise interest rates more quickly than expected, pushing yields up across the whole spectrum. The announcement of strongly stimulatory fiscal plans in the UK, where the central bank is in fact attempting to cool the economy, even led to a record upturn in long-term yields. In general, however, the increases are more pronounced at the short end of the spectrum than at the long end, causing yield curves to flatten. Yet interest rate markets are also demonstrating that longer-term inflation forecasts aren't getting out of hand. The prospect of a sharp slowdown in growth leads us to think that the biggest upturn in interest rate expectations and rates is now behind us. We nevertheless remain cautious. Central banks are mostly looking backwards at the sky-high rate of inflation. We have therefore decided to retain our small position in government bonds and in relatively short durations, which restricts the interest rate risk.

Investment grade credits	**Neutral**

The negative sentiment on the financial markets caused spreads on investment grade credits to widen in September, in the US by 19 basis points and in the Eurozone by 23 basis points. The movement in the underlying yields on government bonds was significantly larger, pushing yields on investment grade credits in the US up to 5.6% and in the Eurozone to 4.2%. Such yields are attractive from a historical perspective. In the US they are higher than dividend yields on equities, although this is somewhat distorted as US companies are returning a relatively large amount of capital to investors via share buyback programmes. We retain our neutral weight owing to the tightening monetary policies and high risk of a recession. Spreads are not yet at levels that match a recession. The default rate remains low but this will rise if the economic tide turns.

High yield credits	**Neutral**

Spreads on high yield credits widened sharply by 68 basis points in the US and by 71 basis points in the Eurozone. The higher underlying government bond yields pushed yields on high yield credits in the US to over 9% and to more than 8% in the Eurozone. These may sound attractive but a recession hasn't yet been fully priced in on this market either. In a recession, spreads in this asset class can easily reach 1,000 basis points. Spreads in the US stood at 552 basis points in September, in the Eurozone at 649 basis points. Although a negative scenario of slowing growth and high inflation has largely been priced in already, we also see downward risks such as lower earnings growth and a higher default rate. It's becoming considerably more expensive for businesses to refinance high yield bonds, which have shorter durations on average than their investment grade counterparts.

Listed real estate	**Neutral**

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. Hopes of less tight monetary policies were dispelled in August and September and interest rates in developed markets are now higher than they were at the start of the summer. This served to undo the rally listed real estate had undergone in the summer. European listed real estate has even dropped to pre-coronavirus crisis levels. The downturn was primarily in the more interest rate-sensitive sectors (logistics and housing) but also in the more cyclical sectors (office and retail). Listed real estate valuations have fallen, leading us to no longer view the asset class as expensive. Europe is now cheap versus general European equities. Aside from the uncertainty surrounding growth, the higher interest rates have had a substantial impact on listed real estate equity prices. Listed real estate will be able to recover when the interest rate pressure eases, although it's still too soon for central banks to reverse their policies.

Emerging market debt	**Neutral**

In September, the turbulence on the bond markets in developed countries pushed up yields on emerging market debt listed in US dollars by as much as 1.2%, 55 bps of which was due to wider spreads. Yields on bonds in local currency rose by 40 bps. A yield of over 9% 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. Moreover, central banks in these countries have raised interest rates in good time as inflation climbed. However, emerging market debt is vulnerable to a more expensive US dollar, tighter financial conditions and slowing global growth (including in China). Debt levels are generally high in emerging markets. Inflation is high in emerging markets as well but has recently declined somewhat (based on averaging a 3-month horizon). 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.

Commodities	Neutral
September's drop in the oil price of about 10% was the main reason for the downturn in the commodity index. As metals noted a loss of 4.4%, prices of agricultural products declined by 1.7% and gold dropped by 2.9%, the total index was down by 8.3%. The lower commodity prices are directly related to the slowing global economy. In particular China's appetite for commodities has been substantially quelled by the coronavirus lockdowns and real estate crisis. Uncertain times would normally push up the gold price but the sharp upturn in interest rates, especially real interest rates, is preventing this. European gas prices fell by 27% in September as gas reserves were topped up more quickly than expected. Yet a price of €170 per MWh as of early October remains a level that will cause considerable hurt to families and businesses. And in the medium term securing gas supplies will remain a challenge in Europe. With Russia supplying fewer commodities because of sanctions, tightness could easily arise on markets. Yet for this to happen the global economy will need to pick up, while it's in fact slowing at the moment. The decrease in tightness on the commodity markets can also be seen from the decline in backwardation. Spot prices are still higher than futures prices but the difference is smaller than in the recent past. This makes commodities a less interesting investment.	

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