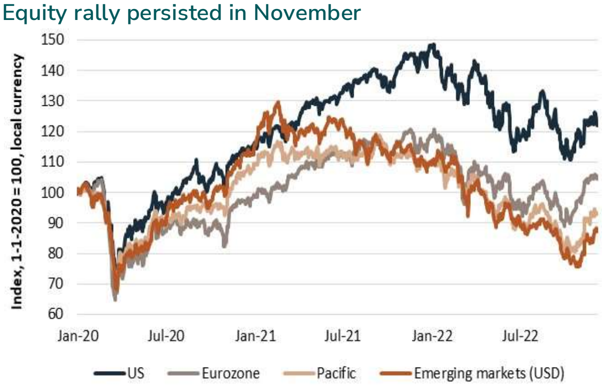
# Asset Allocation Outlook

## DECEMBER 2022

- Europe less pessimistic, but a recession is still on its way
- Mounting signs of a recession in the US in 2023
- Central banks not yet ready to reverse their interest rate policies
- Asset allocation remains cautious

Optimism persisted among investors in November. The MSCI global equity index noted a gain of 7.6%.[1] At 14.6%, emerging markets performed appreciably better following two months of underperformance. Yet US (5.4%) and European equities (8.0%) also climbed substantially.

**Equity rally persisted in November**




Source: Bloomberg, Van Lanschot Kempen

The equity rally was driven in part by the lower capital market yields, which dropped by 44 basis points in the US and in Germany by 21 basis points. Spreads tightened on investment grade and high yield credits and emerging market debt. In real estate, the enormous upturn of 24.2% in emerging markets stood out, although it's worth noting that this asset class had been severely punished over the preceding seven months. Real estate lagged slightly behind general equities in the US and Europe.

In addition to lower capital market yields, signs of leading indicators in Europe bottoming out and positive trends in European gas reserves served to give investors hope as well. Evidence of a less stringent anti-Covid policy in China likewise helped. We still think Europe is heading for a recession though, while a growing number of indicators are pointing to the same happening in the US too. We therefore see earnings expectations, which are still assuming positive earnings growth, as over-optimistic and have decided to retain our underweight in equities.

## Leading indicators up slightly in Europe

Finally a bit of good news from the Eurozone: leading indicators improved in November. Consumer confidence was up for the second month in a row. The Economic Sentiment Index climbed, as did Germany's Ifo and ZEW indicators and the purchasing manager index (PMI) for European industry. The PMI for the European service sector was unchanged. The picture was the same in the UK, where the economy had already contracted in the third quarter. What's less positive is that the

[1] Returns in local currency

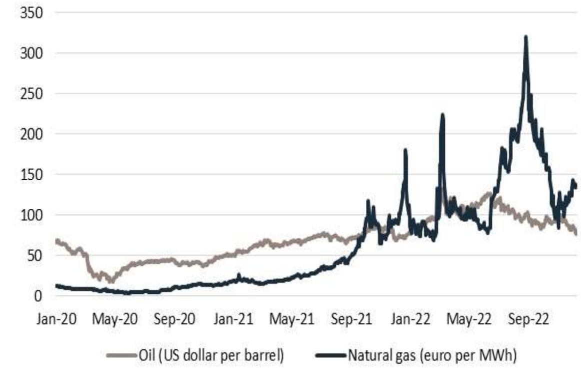
improvements are fairly marginal and all these indicators continue to point to a recession. A recession that will primarily be driven by the negative impact of inflation on consumer purchasing power. The job market is tight; unemployment fell in October to a record low for the Eurozone of 6.5%. This will generate wage growth but not enough to offset inflation. The impact can clearly be seen in the retail sales figures. These dropped by as much as 2.6% versus October 2021. Yet there are clear signs of a slowdown in growth in industry too. Although industrial production in the Eurozone was 4.3% higher in September than a year earlier, orders are down in the Eurozone as a whole and in Germany in particular.

**Purchasing manager indices point to growth slowing**


Source: Bloomberg, Van Lanschot Kempen

One positive development is the evolution of gas reserves. Despite the sharp reduction in supplies from Russia, these have been filled to close to maximum levels. The extremely mild weather up to and in November has helped in this respect, but supplies are also coming from new sources, especially LNG, and effective energy-saving measures are being taken. This reduces the risk of gas having to be rationed in the coming winter, although the weather will of course play a major role here. Yet that doesn't mean that all is well. The negative shock for European industry is massive. In Germany, industrial production in September was lower than at the start of 2022; energy-intensive companies in particular have slashed production. And on top of this, reserves are still largely made up of Russian gas. This will not be an option next year. Volatility has returned to the gas market as a result. At the start of November gas prices had fallen sharply from the peaks earlier this year, but by early December they had already risen again by over 40%.

**European gas prices climb again**




Source: Bloomberg, Refinitiv, Van Lanschot Kempen

Banks are more cautious about issuing new loans during an economic downturn and this is also the case now. Lending conditions are being tightened for both business and consumer loans.

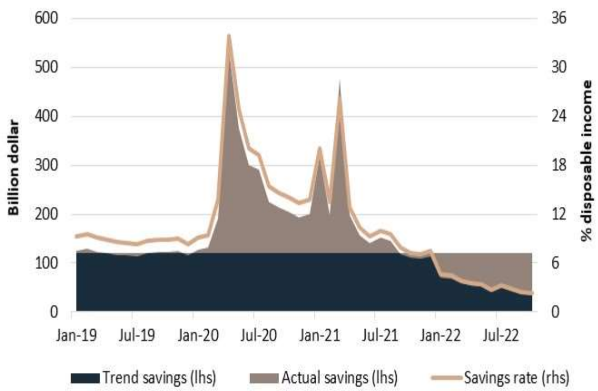
We still expect the economies of the Eurozone and the UK to enter into a recession.

## Signs of an approaching recession in the US

Many leading indicators in the US have in fact fallen further. The Conference Board's Leading Economic Indicator has declined for eight consecutive months now and in October stood 2.7% lower than a year earlier. The PMI for industry decreased to 47.6 in November, while its service sector counterpart fell to 46.1. According to the ISM manufacturing index, businesses are slightly less pessimistic, but the drop to 49 points to further weakening. After recovering somewhat in the summer, consumer confidence was down again in October. The yield curve was sharply negative at the start of December. Yields on 10-year bonds were about 70 basis points lower than those on 2-year bonds and also lower than 3-month bond yields. A negative yield curve, especially one that is as negative as this one and that persists for some time, is an almost infallible indicator of a recession. The sharp drop in the real money supply likewise points to a substantial slowdown in growth. Incidentally, one leading indicator that isn't pointing to a recession is the ISM non-manufacturing index. Against all expectations, this index for the service sector climbed to 56.6 in November, slightly above the long-term average.

Real indicators likewise show that the US is not yet entering into a recession. The decline in inflation is giving consumers some breathing space. Headline inflation fell to 7.8% in October according to the CPI index. According to the PCE index, the Fed's preferred indicator for calculating real consumer spending and incomes, headline inflation dropped to 6.0%. On an annual basis the increase in incomes is still not enough to offset inflation. Real disposable income was 3.0% lower in October than a year earlier. Yet since July real disposable income has on balance risen on a monthly basis. And given that US families are now using the savings accrued with government assistance during the coronavirus pandemic to maintain their spending patterns, growth in consumer spending has recently accelerated.

US families are spending savings




Source: Refinitiv, Van Lanschot Kempen

The fourth quarter could well be the best quarter for consumer spending growth since the second quarter of 2021. We don't believe that consumers can sustain this though. Savings will start to run out for those on lower incomes and debt levels will rise, while the default rate on credit card debt is already climbing slightly.

The job market is still providing some support, but the Fed's contractionary monetary policy is attempting to cool the job market. There are already signs of this happening. The number of vacancies and number of people voluntarily resigning from jobs have declined slightly. Consumers and businesses are also less positive about the job market. Yet the number of jobless claims remains low and the number of new jobs being created continues to be much higher than the labour supply, so the job market isn't pointing to a recession yet either.

You could argue that there's a recession on the US housing market. Mortgage rates have come down again slightly after briefly exceeding 7% in early November, but rates of over 6.5% at the start of December are still much higher than those of the last few years. The sharp rise in house prices over the last few years and now the much higher mortgage rates have pushed the affordability of homes down to a low. Homes haven't been so unaffordable since the mid-1980s when mortgage rates exceeded 10%. This is having a severe impact on the housing market. In October, house sales were down by more than 30% on October 2021. Applications for building permits and new build properties are falling by about 10% on an annual basis. Prices are under pressure. House prices were more than 10% higher in September than in September 2021 but the peak has been reached. September was the third consecutive month in which house prices came down on a monthly basis. We expect a correction on the housing market but not a crash. There has been no excessive mortgage lending. Over the past decade, the mortgage debt of families has lagged behind income growth. On top of this, the housing market is tight. From a historical perspective, the number of homes for sale is low but the decrease in the number of transactions means that the amount of available housing stock has increased slightly versus those transactions. Homes will therefore be for sale for longer, which will squeeze prices further. And falling house prices will prompt households to be more cautious about spending.

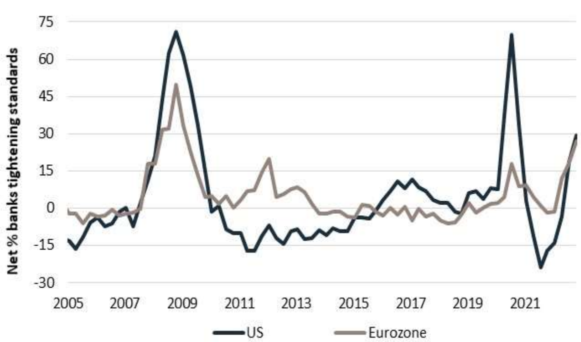
Taking all of these pros and cons into consideration, we believe that the leading indicators will be proved right and the US economy will enter into a mild recession in 2023. The main cause will be the contractionary monetary policy.

## Too soon to reverse monetary policy

We wrote about the pivot that central banks could make last month and can't avoid the topic this month either. This is mostly in relation to the US central bank as inflation looks to have peaked in the US. We've already mentioned the decrease in headline inflation. Excluding volatile food and energy components, core inflation also declined slightly to 6.3% for the CPI index and 5.0% for the PCE index. The difference is primarily due to the PCE index allocating a smaller weight to housing costs. There are other signs that inflation will come down further. Surveys among businesses point to reduced price pressure. The slowdown on the housing market will also have a downward effect on inflation. For the time being, however, inflation remains so far above the Fed's target rate of 2% that the bank will raise interest rates even higher. In a speech in late November, Fed Chair Powell again noted that sizeable increments have already been implemented and that this has a delayed effect on the economy. It would therefore be prudent to make smaller increments. As we pointed out last month though, this is nothing new and certainly isn't a pivot in our book. Moreover, Powell again stressed that combating inflation is the priority and the Fed hasn't yet finished raising interest rates.

It's still far too soon for a genuine pivot, i.e. cuts to interest rates. The job market is simply too tight for this to happen. In November, hourly wage growth accelerated marginally to 5.1% versus November last year. This is incompatible with the Fed's inflation target of 2%. The economy and job market will therefore need to cool further first.

**Commercial banks are tightening lending conditions**




Source: Refinitiv, Van Lanschot Kempen

Banks are helping this cooling down process. As is happening in the Eurozone, US banks are tightening their lending conditions. This will curb credit growth. Financial markets aren't really helping though. The equity rally, lower capital market yields, tighter spreads on credits and a weaker US dollar mean that financial conditions in the US are expansionary, while the Fed wants to see contraction.

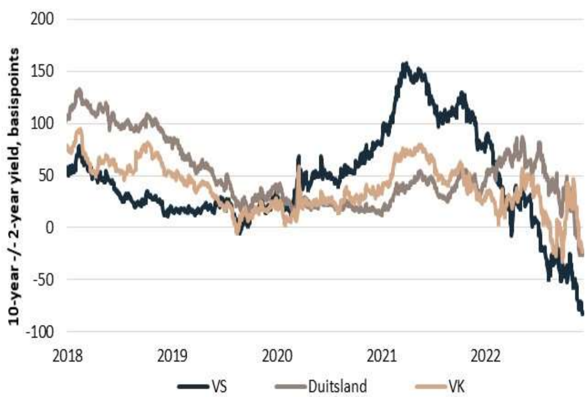
All in all, the Fed is only partially succeeding in its aims. Inflation seems to have peaked but the economy is barely slowing and financial conditions aren't helping the Fed either. If this situation persists, the Fed will need to do more, not introduce a pause and certainly not cut interest rates.

We believe that after raising interest rates by 50 basis points in December the ECB will reduce the pace even more. The rate of inflation declined marginally from 10.6% in October to 10% in November. Core inflation was unchanged at 5.0% in November. This is still far too high for the ECB to stop raising interest rates. Base effects (high price increases a year ago that won't recur to such an extent) will push inflation down further. In our opinion, however, the economic slowdown is more important. We think it unlikely that the ECB will continue to raise interest rates once the economy is in a recession. Nevertheless, hopes of cuts to rates in the short term are also premature in the Eurozone. The Bank of England also faces a difficult task. The UK's rate of inflation is even higher than that of the Eurozone and seems to be more stubborn, while the job market is also tight. The economy is weaker though, with shrinking retail sales and industrial production as well as a slowdown in the growth of bank lending. It may be that the Bank of England moves to cut interest rates earlier than either the Fed or ECB, but it will be some time before this happens.

## Markets still in risk-on mode

As we said in the introduction, the financial markets continue to be in risk-on mode. This can be seen from the rising equity prices and tightening spreads on credits and emerging market debt. We believe that it's mostly the perceptions relating to monetary policy and lower inflation that have aroused optimism in investors. The expectations for monetary policy in the short term have hardly changed, but more cuts to interest rates are now being forecast for later in 2023 and in 2024. This is why 10-year bond yields come down so much and why yield curves are so negative.

### Recession indicators: negative yield curves

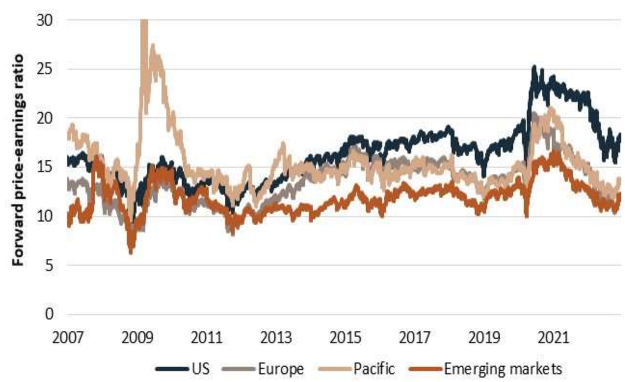



Source: Bloomberg, Van Lanschot Kempen

We agree with this picture of inflation coming down. As we mentioned before, there are already signs of this happening in the US and it no longer looks too far off in Europe either. However, we fail to see anything new here in terms of monetary policy. It has long been expected that central banks will raise interest rates by smaller amounts. And, as we explained earlier, we think it's still too soon for cuts to interest rates.

It's possible that the earnings season played a role here too. Earnings growth was robust and in line with expectations in the Eurozone. In the US, earnings (excluding the energy sector) declined by slightly less than expected. As far as equities are concerned, we can identify two vulnerabilities with an imminent recession. Firstly, valuations aren't yet at levels that are usual during a recession. At the moment the forward price/earnings (P/E) ratio stands at 18 in the US, at about 12 in Europe and emerging markets and 14 in the Pacific region. During the 2008-2009 financial crisis the P/E ratio dropped to 6.2 in emerging markets, 7.1 in Europe and 9.5 in the US and Pacific region. While it's true that was an extremely deep recession, valuations are also currently higher than during the Eurozone crisis in 2011 and when the Fed raised interest rates in 2018. It looks as if equity investors are forecasting a mild recession and already looking to the subsequent recovery. A second vulnerability is the earnings themselves. Equity markets are climbing, while expected earnings are being adjusted downwards in the US, UK and emerging markets. This isn't yet the case in the Eurozone, largely because of the high growth in realised earnings. Yet it would only seem to be a matter of time before earnings expectations are adjusted downwards in the Eurozone as well. Despite the downward adjustments, earnings growth is still forecast for the US, Europe and emerging markets for 2023, albeit at very low levels for Europe and emerging markets. During recessions, however, earnings can easily drop by 10 to 20%. If we head towards such percentages, investors will need to be very sure of themselves to be able to look beyond them. We have therefore maintained our equity underweight.

### Equity valuations not yet at recession levels




Source: Bloomberg, Refinitiv, Van Lanschot Kempen

With respect to capital market yields, we've already said that the larger part of the interest rate hikes is behind us. The drop in yields of the past few weeks may not be entirely sustainable, given that we don't yet anticipate a reversal in central bank policy, but it does confirm our view that yields have peaked. In the last few months we've increased our allocation to government bonds very slightly.

We continue to be cautious about credits. Here, too, yields are more attractive but in the event of a recession and a drop in earnings we expect wider spreads, which could quickly cancel out the effect of higher yields. We continue to hold a neutral position in investment grade and high yield credits. For high yield this means we don't hold any in the portfolio at present.

Emerging market debt has stood up fairly well to the sharply higher interest rates in the US and to the more expensive US dollar. This is a sign of the fundamental improvements in emerging markets, where central banks have, for instance, started to raise interest rates in good time in order to curb inflation. Spreads on bonds listed in US dollars peaked at close to 600 basis points in July; since then they've tightened to below 400 basis points. In the meantime, the underlying US yields have risen, leading to emerging market debt offering interest compensation of 8.5%. We believe that the uncertainty surrounding the economic outlook is still too great. One positive aspect is that China is planning to ease its strict anti-Covid policy somewhat, but the question is how it will react if cases rise further. Furthermore, there's still the problem of the burst real estate bubble. More broadly for emerging markets, demand for goods in the US and Eurozone will decrease. Not only due to the recession in these regions but also to the ongoing normalisation of consumer spending moving more towards services after the coronavirus pandemic. Exports from China, South Korea and Taiwan have already nosedived in recent months. And although central banks are moving towards bringing an end to interest rate hikes, the process hasn't yet been completed. We therefore hold a neutral position in this asset class.

## Market review

| Equities | | | | |
|---|---|---|---|---|
| | Index | Past month | Past 3 months | From 31-12-2021 |
| Global (MSCI AC) | 973 | 6.6% | 2.7% | -18.0% |
| Developed markets (MSCI World) | 2662 | 6.2% | 3.0% | -17.6% |
| Emerging markets (MSCI EM) | 973 | 9.9% | 0.8% | -21.0% |
| United States (S&P500) | 3941 | 4.5% | 0.8% | -17.3% |
| Eurozone (EURO STOXX 50) | 3939 | 6.8% | 12.5% | -8.4% |
| United Kingdom (FTSE 100) | 7521 | 2.5% | 3.0% | 1.9% |
| Japan (Topix) | 1950 | 1.8% | 1.2% | -2.1% |
| Netherlands (AEX) | 724 | 7.7% | 7.2% | -9.3% |
| **Government bonds (10-year)** | | | | |
| | Yield (%) | Past month (bp) | Past 3 months (bp) | From 31-12-2021 (bp) |
| United States | 3.53 | -63 | 18 | 202 |
| Japan | 0.26 | 0 | 1 | 19 |
| Germany | 1.80 | -50 | 16 | 198 |
| France | 2.26 | -58 | 3 | 206 |
| Italy | 3.39 | 10 | 180 | 234 |
| Netherlands | 2.09 | -50 | 12 | 212 |
| United Kingdom | 3.08 | -46 | -2 | 211 |
| **Investment grade credit** | | | | |
| | Risk premium (bp) | Past month (bp) | Past 3 months (bp) | From 31-12-2021 (bp) |
| United States | 130 | -22 | -30 | 38 |
| Eurozone | 174 | -40 | -33 | 79 |
| **High yield bonds** | | | | |
| | Risk premium (bp) | Past month (bp) | Past 3 months (bp) | From 31-12-2021 (bp) |
| United States | 448 | -14 | -40 | 165 |
| Eurozone | 529 | -73 | -58 | 211 |
| Emerging markets (USD) | 467 | -57 | -80 | 99 |
| Emerging markets (Local currency) | 307 | -1 | -41 | -138 |
| **Real estate** | | | | |
| | | Past month | Past 3 months | From 31-12-2021 |
| Global | | 0.9% | -9.4% | -19.9% |
| North-America | | -2.1% | -11.8% | -19.3% |
| Europe | | 4.3% | -8.6% | -36.4% |
| **Commodities** | | | | |
| | | Past month | Past 3 months | From 31-12-2021 |
| Bloomberg index | | -6.0% | -5.5% | 12.9% |
| Base metals | | 7.2% | 11.4% | -7.8% |
| Brent oil (USD per barrel) | 79.35 | -18.1% | -11.7% | 9.5% |
| Gold (USD per troy ounce) | 1782 | 6.3% | 1.0% | -2.5% |

Returns in local currency
bp = basis point (0.01%)
Data as of 7 December 2022
Source: Bloomberg

## Tactical outlook

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

The rally on the equity markets that began in mid-October continued in November. Emerging market equities, which had dropped sharply in the previous two months, noted the biggest upturn, followed by the Pacific region, Europe and the US. The prospect of lower inflation and in turn a less stringent monetary policy were the main drivers, but positive trends in European gas prices and tentative signs of China relinquishing its zero Covid policy also helped. We find this optimism to be premature. Central banks haven't yet finished raising interest rates. We believe it's too soon to anticipate a pivot, which is precisely what the equity markets seem to be doing. More importantly, we think earnings expectations are too high given the low growth or recessions that are on their way. Valuations and earnings expectations haven't yet been adjusted enough for these in our opinion. We therefore retain our underweight in US and European equities.

| **Government bonds** | **Neutral** |
|---|---|

Central banks are moving towards marginally reducing the pace of their interest rate hikes, but that's all you can say so far. The Fed isn't yet getting what it wants. The US job market is hardly cooling at all and financial conditions, such as 10-year bond yields, spreads on credits, equity prices and the US dollar, have in fact eased in the past few weeks. As a result, the Fed may need to keep interest rates high for longer than currently anticipated. When examined in this light, it's possible that the drop in US 10-year bond yields to 3.7% at the end of November went slightly too far, but we nevertheless believe that the larger part of the interest rate hikes is behind us. In Germany, yields came down by over 20 basis points to 1.9% in November. The ECB will also raise interest rates slightly higher, but inflation will decline in part owing to the weakening economy and base effects. This means that the end of interest rate hikes is in sight in the Eurozone. We hold an underweight in government bonds in the Eurozone, an overweight in the US and are on balance neutral. 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** |
|---|---|

Lower capital market yields and tighter spreads led to sharply lower yields on investment grade credits in November. In the US, yields in this asset class fell by 72 basis points to 5.0% and in the Eurozone by 40 basis points to 3.8%. 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 and lower earnings growth.

| **High yield credits** | **Neutral** |
|---|---|

Spreads on US high yield credits tightened by slightly less than their investment grade counterparts in the Eurozone. This was partly a reaction to the previous month when spreads in the US tightened much more sharply. At the end of November yields on these bonds stood at over 8% in the US and in excess of 7% 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 448 basis points as of the end of November, in the Eurozone at 526 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. In November listed real estate noted a positive performance with the help of better-than-expected inflation figures in the US and Europe and the resulting lower interest rates. This asset class did lag slightly behind general equities though. 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 once the interest rate pressure eases, although it's still too soon for central banks to reverse their policies. Having initially underestimated the inflationary pressure, central banks want to see job markets weaken and inflation to fall more clearly towards 2% before they consider cutting policy interest rates.

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

November was a positive month for emerging market debt, with spreads on bonds listed in US dollars tightening by 75 bps and, as a result of lower capital market yields, overall interest rate compensation dropping by over 100 bps. Yields on bonds listed in local currency decreased by 60 bps. The tailwind came from better-than-expected US inflation figures and rumours of a reopening in China. For the Fed, a pause at about a policy rate of 5% would seem to be realistic. Following protests there are tentative signs of China reconsidering its zero Covid policy. Yet widespread easing will require higher vaccination coverage among older people and this will probably be the case in early 2Q23. The prospect of lower (goods) inflation in the US reduces pressure on EMD. However, there's still no sign of the Fed cutting interest rates, as this would require a weaker job market and lower services inflation. A slowdown in global growth and lower EM exports are risks to this asset class. Given the relatively high interest compensation on these bonds we hold a neutral outlook for EMD HC and EMD LC.

| Commodities | Neutral |
| --- | --- |
| Bloomberg's general commodity index rose by 2.4% in November. Gold and copper were particularly popular and noted price upturns of 8.3% and 9.4% respectively. Oil prices were down by 7.2% though. The higher gold price can mostly be attributed to the lower real interest rates in the US. The lower the interest rates, the more attractive gold becomes in relative terms. The increase in copper and other metal prices is in line with the risk-on sentiment that dominated markets in November, caused in part by tentative signs that China is reconsidering its zero Covid policy. The weakness in the oil price is not in line with this but does match a slowing global economy. Gas prices in Europe shot up again by almost 70%. Incidentally, the sizeable outliers seen in October and November are distorted because gas prices temporarily dropped sharply on precisely 31 October. At over 140 euros per megawatt hour as of the end of November, gas prices reflect the fact that the acute threat of shortages has diminished. In the medium term securing gas supplies will remain a challenge in Europe. With Russia supplying fewer commodities because of sanctions, in general tightness could easily arise on commodity 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 compared to earlier in the year 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. | |

JOOST VAN LEENDERS
Senior investment strategist
joost.vanleenders@kempen.nl
+31 (0)6 8283 1189

VAN LANSCHOT KEMPEN ASSET RESEARCH & COMMUNICATION:

Yaela van Raalte – Head ARC
Michel Iglesias del Sol – Head investment strategy
Luc Aben – Chief economist
Robert de Groot – Head investment research and communication
Maarten van der Pas – Head editorial desk
Alastair Greenlees – Head investment strategy UK
Arif Saad – Head investment strategy UK
Joost van Leenders – Senior investment strategist
Duco Smit – Senior investment strategist
Jorn Veeneman – Investment strategist
Mees Vlasveld – Investment strategist
Jack Horvest – Investment specialist
Ellen Engelhart – Bond specialist
Robbert van Riel – Bond specialist
Bob Stroeken – Equity specialist
Tim Verhagen – Equity specialist
Effi Bialkowski – Investment fund specialist
Bas Kooman – Investment writer
Hester van Breugel – Communications specialist
Rixt Hoekstra – Communications specialist

## DISCLAIMER

The information in this publication is of a general nature. This publication may at no time be viewed as an offer and you cannot derive any rights from this publication. The external sources used to produce this publication were selected with the great care.
We cannot guarantee that the information and data from these sources is up-to-date, correct and exhaustive. We accept no liability for printing and typing errors. We are not obliged to update or amend the contents in this publication.


## OTHER INFORMATION

Van Lanschot Kempen NV, has its registered office at Hooge Steenweg 29 in 's-Hertogenbosch (5211 JN), Chamber of Commerce 's-Hertogenbosch no. 16038212. The bank's VAT-number is NL0011.45.770.B01, has been registered as a bank in the Register required by the Dutch Act on Financial Supervision (Wft) at the Dutch Authority for the Financial Markets (Autoriteit Financiële Markten) and the Dutch Central Bank (De Nederlandsche Bank).