VAN LANSCHOT KEMPEN

Asset Allocation Outlook

JANUARY 2023

- We still expect a recession in Europe and the US
- Central banks set to raise interest rates further
- Asset allocation remains cautious

2022 will go down as an exceedingly difficult year for investors. Almost all the general asset classes noted losses, often in excess of 10% based on total returns. And there wasn't even an end-of-year rally to cheer investors. The equity rally that had started in October stalled at the beginning of December. In the final month of the year the MSCI global equity index fell by 4.0%[1], with industrialised nations (-4.3%) dropping by slightly more than emerging markets (-1.6%). The losses in the US (-5.9%) and Japan (-4.7%) were larger than those in the Eurozone (-3.5%) and UK (-1.6%). The culprits were uncertainty about economic growth, downward adjustments to earnings expectations and rising interest rates.

Equity rally stalled in December

Source: Bloomberg, Van Lanschot Kempen

US 2-year bond yields climbed by 12 basis points and 10-year yields by 27 basis points, while both Eurozone yields rose by more than 60 basis points. The aggressive tone adopted by the Fed and ECB was a major driver behind the upturn in bond yields. Remarkably, 10-year yields in Japan increased by 17 basis points after the central bank widened the tolerated bandwidth for these yields.

In light of the above trends, we have kept our investment policy unchanged and retained our underweight in equities.

US versus Europe: leading indicators versus realised outcomes

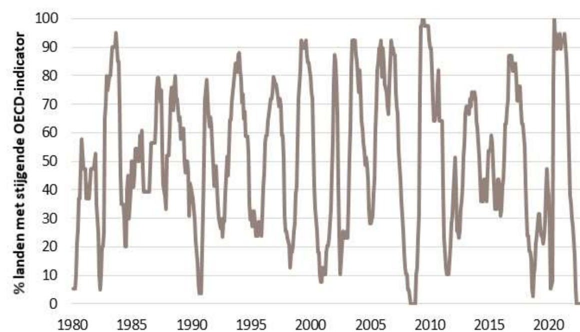
It's a trend that has been visible for a while but is no less striking for all that. Leading indicators in the US are depicting an increasingly negative picture, while in Europe they are becoming marginally less negative. This while the hard data are in fact worse in Europe. For example, in December the US purchasing manager index for industry fell to 46.2 (its lowest level since the outbreak of the coronavirus pandemic), while the same indicator for the Eurozone climbed to 47.8. It should be remembered that any level below 50 points to a contraction. The US index for the service sector plummeted to 44.4, while in the

[1] Price changes in local currency

Eurozone it rose to 49.8 and came out at precisely 50 in the UK. Confidence among US housebuilders dropped to the same low in December as during the coronavirus crisis. And the broad leading indicator published by the Conference Board declined for the ninth consecutive month in November. In the Eurozone, the Economic Sentiment Index, Germany's Ifo and ZEW indicators and France's INSEE indicator in fact rallied slightly. Yet surveys of businesses about their order books show that these are under pressure in the Eurozone and UK.

There are also similarities between the US and Europe. Consumer confidence, although still low, is improving somewhat. It probably helps that the job markets continue to be in good shape. There is also a less positive similarity though: the OECD's leading indicators for the US, Eurozone and UK were all down. This in fact goes much further. Of all the 36 countries for which the OECD publishes leading indicators, not a single one climbed in the seven months up to the end of November. This is highly unusual. Since 1980 only the 2008-2009 financial crisis has come close in this respect. That saw five months in a row without a single OECD leading indicator rising.

OECD leading indicators extremely pessimistic



Source: Refinitiv, Van Lanschot Kempen

This matches the sombre picture sketched recently by the IMF. With the US, European Union and Chinese economies slowing simultaneously, according to the IMF a third of the global economy will be hit by a recession this year.

Whereas it's primarily inflation and monetary tightening that are slowing the economies in the US and Europe, in China it's mostly down to the government's Covid-19 policy causing a negative shock, at least in the short term. The country's exceedingly strict zero-covid policy has abruptly been eased. This is in spite of the relatively low vaccination coverage among older people, the fact that Chinese vaccines are less effective than the Western versions and the lower level of group immunity because of the strict policy. China has stopped publishing infection rates, which in itself is telling, but it's nevertheless clear that an enormous wave of cases is sweeping the country. People are allowed to do a great deal more again but are staying home out of a sense of caution or because they are ill. China's mobility indicators have nosedived. Confidence among businesses likewise fell in December, especially in the service sector. Incidentally, this does pave the way for more growth later in 2023, albeit from low levels.

Real indicators are in fact weaker in Europe than they are in the US. The UK economy had already contracted in the third quarter and there doesn't appear to have been any change in the fourth quarter. The Eurozone economy also looks to have contracted in the fourth quarter. The US has probably experienced a reasonably robust quarter but we still expect the country to enter into a recession later this year, driven by the sharp monetary tightening.

More interest rate hikes on the way

There was no mistaking the message from central bankers in December: further interest rate hikes are on their way.

The Fed's decision to raise rates by 50 basis points in December rather than 75 basis points, as at the four preceding meetings, came as no surprise. Fed Chair Powell had already said prior to the meeting that the time to reduce the size of the interest rate hikes could be as soon as December. Given the rate of inflation, the state of the economy and the fact that the Fed has raised the policy interest rate by 425 basis points within the space of a year, it makes sense for the central bank to slow the pace of tightening somewhat. Inflation is coming down; after peaking at 9.0% in June it stood at 7.1% in November. Core inflation fell from 6.7% in September to 6.0% in November. The Fed has cut its growth forecast for the economy to 0.5% in 2023. This implies virtually no growth on a quarterly basis.

Yet the Fed intends to raise interest rates even higher. The rate of inflation was lower than expected in October and November but the Fed remains unconvinced that it really is heading for the 2% target rate. Powell noted that goods inflation is falling and that the rise in housing costs will also decrease, but service sector inflation is more persistent and more dependent on wage growth.

US rate of inflation falls, but not in all sectors

Source: Refinitiv, Van Lanschot Kempen

The Fed wants below-trend economic growth for a time in order to cool the job market in particular. This is why further interest rate hikes are needed. A majority of policymakers is now predicting a bandwidth of 5-5.25% for the policy interest rate at the end of 2023. This means a further 75 basis points in hikes. Most of the policymakers not in the majority group forecast even more interest rate hikes. Yet while in 2022 it was the pace of the interest rate increases that mattered, in 2023 the focus will chiefly be on the peak rate and how long the Fed will keep rates high. While markets were expecting the Fed to cut interest rates in the second half of the year, the message from the Fed was quite different. The upshot was higher interest rates and lower equity prices.

ECB President Lagarde was clearly on a mission during her December press conference. That mission was to raise market expectations for interest rates. The ECB also reduced the pace of its interest rate hikes from 75 to 50 basis points. This brings the total increase to 250 basis points. In its press release the ECB said that interest rates would need to rise significantly higher in order to bring inflation down to its target rate of 2%. And rates will need to remain restrictive for a time in order to curb demand. The ECB cut its growth forecast for 2023 to 0.5%, which implies an extremely mild recession. A more important message was contained in the inflation forecasts, however, as these were raised. Even in 2025 the ECB still expects inflation to be higher than the target rate of 2% on average. These forecasts are actually based on the market expectations for interest rates. And as inflation is too high in these forecasts, the ECB believes the interest rate expectations are too low. So Lagarde really needed to pull out all the stops. At her press conference she said that the ECB intended to raise interest rates by 50 basis points a couple more times. This is obviously more than the markets were expecting. According to Lagarde, the ECB will stand firm and keep to its plan. A reduction in the pace of interest rate hikes is not a pivot in Lagarde's view. This is what lies behind the higher interest rates we mentioned in the introduction.

Yet the biggest news came from the Bank of Japan (BoJ). Changes are rare at the BoJ; its policy interest rate has stood at -0.1% since 2016. Like other central banks over the past decade, the BoJ has for some time intervened on the bond market in order to push down long-term bond yields and in doing so stimulate the economy and prevent deflation.

Japanese bond yields rise following change by BoJ

Source: Bloomberg, Refinitiv, Van Lanschot Kempen

Unlike other central banks, however, the BoJ has set a specific target for 10-year bond yields. Until December, these were not permitted to rise above 0.25%. Yet the rate of inflation has climbed even in Japan. Headline inflation rose to 3.8% in November and core inflation to 2.8%. The limit for 10-year bond yields had previously been raised from 0.10% to 0.25% but the question remained as to when the

extremely expansionary monetary policy would be adjusted. All the more so because the gap between Japan on the one hand and the US and Europe on the other was growing, causing the Japanese yen to depreciate sharply. No adjustment was expected before the spring, after the annual wage negotiations and once Kuroda's term as governor of the BoJ has ended. However, Kuroda opted not to wait and raised the limit for 10-year bond yields to 0.50%, after which they immediately shot up to the upper edge of the new bandwidth. Although Kuroda presented the change chiefly as a technical adjustment aimed at improving the functioning of the markets, it was interpreted as an initial step towards a less expansionary monetary policy. Markets are now pricing in a small increment of 10 basis points to Japan's policy interest rate in the spring.

Bond markets are ignoring the Fed...

Bond markets largely ignored the message from the Fed that more interest rates are coming and that rates will stay high for longer. Yields did rise slightly but not by that much. And market expectations for the policy interest rate at the end of this year remain considerably lower than those of the Fed's policymakers. In addition to the persistently high inflation and tight job market, there was another reason for Fed Chair Powell adopting a hawkish tone. Financial conditions, i.e. interest rates, spreads on credits, equity prices and the US dollar exchange rate, had eased prior to the Fed meeting. Yields had declined and spreads tightened, while equity prices had risen. None of this helps to cool the economy, which is what the Fed wants. So Powell attempted to influence markets and tighten financial conditions. He was only partially successful, however. Market expectations for the policy interest rate barely changed and 2-year bond yields only rose by a small amount. Ten-year yields climbed by slightly more, causing the yield curve to become less negative. This picture matches our investment policy. We hold an overweight in US government bonds, as we find the interest compensation on them attractive in these uncertain times. We don't expect US yields to rise much further but because of the risk of higher yields our positioning is concentrated in shorter durations. These also offer the highest interest compensation.

ECB interest rate expectations climb

Source: Bloomberg, Van Lanschot Kempen

...but are listening to the ECB

Yet the bond markets did listen to the ECB, whose message was also loud and clear. Yields in the Eurozone climbed by a much larger amount than in the US and spreads on Italian government bonds widened. The shape of the German yield curve barely changed. In our investment policy we hold an underweight in government bonds issued by Eurozone countries. The interest rate compensation on these bonds is lower than that on their US counterparts and there is a higher risk of interest rates rising higher. This may seem strange in light of the recession in which the Eurozone may already find itself, but the ECB has clearly stated that its top priority is combating inflation.

Equity rally stalled in December

The equity rally from October until the end of November was mainly driven by optimism about declining inflation (in the US) and the prospect of an end to interest rate hikes and perhaps even cuts to rates later this year. That optimism was firmly quashed by central banks. Yes, the end of interest rate increases is in sight, although it probably won't happen until the spring. Investors will need to exercise more patience with regard to cuts to rates. And then there are the recessions, in which corporate earnings will be squeezed. Realised and forecast earnings growth are decreasing quickly but earnings are not yet expected to fall. We think this is an over-optimistic view of corporate earnings.

Recessions also lead to lower rates of inflation. This is positive for consumers, as long as the job market

doesn't weaken too much. Yet lower inflation also has a flipside. Companies will be able to pass on higher (wage) costs less easily, which will squeeze margins. We're already seeing some signs of this happening.

Equity markets in Europe and Asia got off to a positive start in the first few days of 2023. Lower energy prices and less negative leading indicators are encouraging for investors. The same may also be true of the lack of profit warnings from businesses. Not that this provides any guarantees for the future, of course. After all, investors started 2022 full of confidence as well. We therefore retain our underweight in equities.

Market review

Equities				
	Index	Past month	Past 3 months	From 31-12-2022
Global (MSCI AC)	956	-4.3%	9.6%	0.2%
Developed markets (MSCI World)	2607	-4.6%	9.6%	0.2%
Emrging markets (MSCI EM)	956	-1.8%	9.2%	0.0%
United States (S&P500)	3840	-5.7%	7.1%	0.0%
Eurozone (EURO STOXX 50)	3856	-3.1%	16.2%	1.6%
United Kingdom (FTSE 100)	7452	-1.4%	8.1%	0.0%
Japan (Topix)	1892	-3.2%	3.0%	0.0%
Netherlands (AEX)	701	-4.1%	9.5%	1.8%
Government bonds (10-year)				
	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	3.87	39	5	0
Japan	0.42	17	18	0
Germany	2.44	59	34	-13
France	2.98	67	26	-14
Italy	4.18	418	259	-15
Netherlands	2.77	63	34	-13
United Kingdom	3.67	52	-42	0
				Investment grade credit
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	130	0	-30	0
Eurozone	167	-10	-58	0
High yield bonds				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2022 (bp)
United States	469	31	-83	0
Eurozone	512	-11	-119	0
Emerging markets (USD)	453	-10	-95	0
Emerging markets (Local currency)	286	-28	-37	-6
Real estate				
		Past month	Past 3 months	From 31-12-2022
Global		-4.3%	-2.2%	1.9%
North-America		-6.9%	-4.4%	0.0%
Europe		-2.3%	5.9%	1.7%
Commodities				
		Past month	Past 3 months	From 31-12-2022
Bloomberg index		-1.1%	2.2%	0.0%
Base metals		-2.2%	12.5%	0.0%
Brent oil (USD per barrel)	85.91	0.4%	6.4%	0.0%
Gold (USD per troy ounce)	1826	0.9%	9.9%	0.0%

Returns in local currency
bp = basis point (0.01%)
Data as of 3 January 2023
Source: Bloomberg

Tactical outlook

Asset class	
Equities	Negative

The equity rally stalled in December. In the US, leading economic indicators worsened and earnings growth is visibly deteriorating. Equities fell more in industrialised nations than they did in emerging markets. The biggest losses were in the US, followed by Japan, the Eurozone and UK. The economic outlook and monetary policies are negative for equities. Central banks haven't yet finished raising interest rates. We believe it's too soon to anticipate a pivot. 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 fully adjusted 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, are not yet playing along properly. As a result, the Fed may need to keep interest rates high for longer than currently anticipated. Despite the strong language from the Fed, 2-year bond yields barely climbed in December; 10-year yields rose by a slightly higher amount. German 2-year and 10-year bond yields increased by over 60 basis points in December to 2.8% and 2.6% respectively. The ECB will also raise interest rates slightly higher, despite the weakening economy. Combating inflation is the bank's top priority for the time being. 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

Spreads on investment grade credits tightened in the US and Eurozone in December. However, upturns in the underlying yields on government bonds still resulted in yields on investment grade credits rising. At the end of December, US yields stood at marginally over 5% and their Eurozone counterparts at slightly higher than 4%. The high interest compensation and marginal increase in yields meant that the return on US investment grade was just about positive. The return in the Eurozone was negative. 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 widened in December, while they tightened in the Eurozone. At the end of December yields on these US bonds stood at over 8.5% and in the Eurozone at over 7.5%. Returns in both the US and Europe were nevertheless slightly negative (because of the higher capital market yields). 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 470 basis points as of the end of December, in the Eurozone at 512 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 December listed real estate noted a negative performance due to higher interest rates and uncertainty about economic growth. Their performance was comparable to that of the general equity indices. 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

December was a marginally positive month for emerging market debt when measured in US dollars. Spreads on bonds listed in US dollar tightened by 16 basis points. Yet as a result of the higher capital market yields in the US the overall interest compensation climbed slightly by 5 basis points. Yields on bonds listed in local currency remained unchanged in December. The reopening of China in 2023, despite the current chaotic exit wave of high numbers of coronavirus cases, and a better-than-expected rate of inflation in the US are positive factors. The prospect of lower (goods) inflation in the US reduces pressure on emerging market debt. However, there's still no sign of the Fed cutting interest rates. On the contrary, the Fed has said it wants to implement a few more interest rate hikes due to the excessively tight job market and the upward impact this is having on services inflation. Despite China's reopening, slowing global growth and lower exports from emerging markets pose a risk to this asset class. Given the relatively high interest compensation we hold a neutral outlook for emerging market debt in US dollars and in local currency.

Commodities	Neutral

In December, Bloomberg's general commodity index noted a loss of 2.8%. Oil prices fell, while the prices of metals and gold rose slightly. The weakness in oil prices matches a slowing global economy. The upturn in metal prices is remarkable in that light. The fact that the price of gold held up despite higher real interest rates in the US tells us something about the uncertainties recognised by investors. Gas prices in Europe almost halved to 74 euros per megawatt hour, their lowest level since February 2022. These reflect the fact that the acute threat of shortages has diminished. In the medium term, however, 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 last 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.

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