INVESTMENT MANAGEMENT

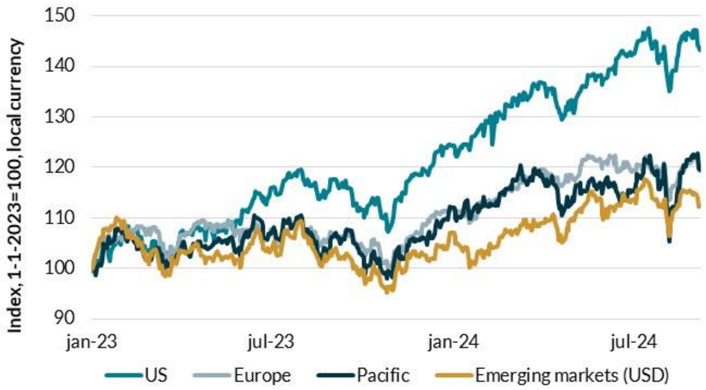
Asset Allocation Outlook

September 2024

- Financial markets' recession fears an overreaction
- Growth, low inflation and declining yields positive for equities
- Investment policy unchanged

Equities ultimately closed August up in all four of the regions we distinguish (US, Europe, Pacific and emerging months) but it wasn't a smooth ride. The weakness on the equity markets that was already visible in the second half of July resulted in a substantial correction at the start of August. The US S&P500 index lost more than 8% from its peak in July, while the European STOXX 600 index was down 7% and the Japanese Topix index 24% (in local currency).

Equity markets still turbulent



Source: Refinitiv, Van Lanschot Kempen

The reason for the correction was disappointing macro-economic data in the US, which fanned fears of a recession. In Japan, the effect was exacerbated by the yen appreciating by about 10%, which is traditionally negative for Japanese equities. We believe the correction was amplified because many investors were positively positioned in equities and sparse trading in the summer months can exaggerate market movements. The closure of carry trades, which involves lending asset classes with low interest rates (such as the yen) and investing in asset classes with a high expected rate of return, also played a part given the strong appreciation in the yen.

Bond yields dropped sharply in the US, especially at the short end. The upshot is that the yield curve is now less negative. The same goes for Germany but to a lesser extent. Inflation also helped here, as it came down further in both the US and Eurozone. This led to the markets pricing in more cuts to interest rates, in particular by the Fed in the US. UK yields didn't follow this pattern and in fact climbed marginally. Equity markets succeeded in recovering over the course of August. Recession fears abated in the US, but yields remained low. The US earnings season displayed sound earnings growth. Recession fears returned at the beginning of September though.

We kept our investment policy unchanged throughout all these movements and afterwards. We're monitoring the risk of a further slowdown on the US job market and in consumer spending but continue to anticipate a soft landing, which will avert a recession. We likewise anticipate growth in Europe, albeit a moderate amount. Yet this will still be enough to push up earnings. Together with interest rate cuts by centrale banks, we envisage a positive climate for equities.

Will the US economy make a landing?

The reason for the correction on the equity markets was worse-than-expected data on the US job market and manufacturing confidence in industry. The landing in the US has long been a topic of discussion. This might be a soft landing, which would avoid a recession, or a hard landing, which would lead to an economic downturn. Whether the US economy is already landing depends on what you're looking at. The industrial sector has indeed landed. The ISM manufacturing index, whose July level was partially responsible for the turmoil on the financial markets, remained at 47.2 in August, which points to contraction in the sector. This is the fifth month in a row that it has done so. The downturn in the component that measures new orders is particularly worrying. Rising price pressure isn't something investors want to see at the moment either.

US industrial sector weaker than the service sector

Source: Refinitiv, Van Lanschot Kempen

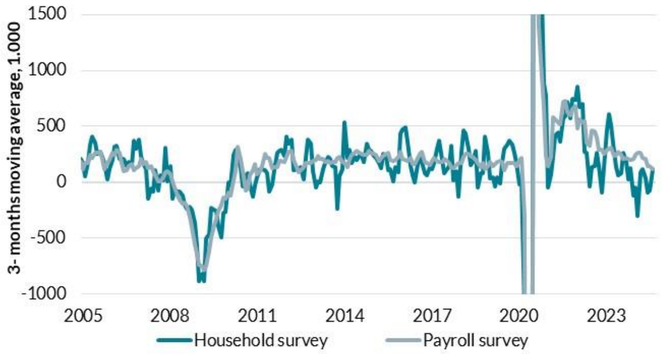
The index therefore caused losses on the equity markets this month too. The purchasing manager index (PMI) for industry is low as well. Incidentally, the landing in the industrial sector wasn't that hard. Industrial production and orders for capital goods haven't grown for months but nor have they contracted. Employment in the sector is stable. The ISM index and PMI would need to drop much further to point to an economy-wide recession.

Another sector that is having a tough time is home construction. Higher interest rates have made homes substantially less affordable. Sales have dropped to historic lows, confidence among housebuilders is low and construction activity is declining. Yet the landing hasn't been that hard here either. A structural shortage of homes means that house prices haven't fallen. In July, the price of an existing home was 4.2% higher than a year previously. This phenomenon is visible in other countries as well.

Consumers and the service sector continue to be the bright spots in the US economy. The ISM index for the service sector, which has been quite volatile in the past few months, bounced back in July and stayed at the same level in August. The PMI for the service sector has been pointing to sound growth for several months now. We noted last month that the strong growth in consumer spending wasn't sustainable. This is because this growth is considerably higher than income growth, which is resulting in a declining savings rate. This will have to come to an end at some point, but we don't know when. For the time being, most Americans still have a job, house prices remain at the same level and investments are rising. Consumers continued to spend at the same rate in July too. Declining inflation could boost purchasing power somewhat. Retail sales grew more quickly than forecast.

The job market is cooling without signalling a recession. The number of vacancies fell further in July but there continue to be 1.07 vacancies per jobless person. This figure is normally about 0.6. According to the monthly survey of businesses, job growth accelerated in August from July's weak level. It's worth noting though that the increase was slightly lower than expected and the figures for June and July were adjusted downwards. The survey of households displayed a marked rally, pushing the unemployment rate down slightly. The upturn in hourly wages was marginally higher. Although these weren't robust data overall, they don't point to a recession.

US job growth improved in August



Source: Refinitiv, Van Lanschot Kempen

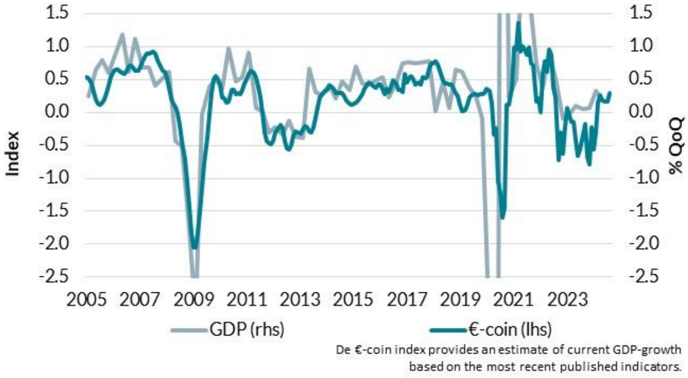
If we look at the whole economy, we can't really talk of a landing. Growth of 0.7% in the second quarter versus the first quarter was precisely the same as the average growth in the preceding seven quarters. An indicator published by the Federal Reserve Bank of Atlanta is pointing to 0.5% growth in the third quarter. We nevertheless believe the economy will slow somewhat given the weakness in industry, corporate investment and the housing market, and the cooling job market and consumers living beyond their means.

Mixed picture in Europe

The picture in the Eurozone hasn't changed much. Industry is experiencing difficulties, as demonstrated by a PMI that remained at 45.8 for the third consecutive month in August. Some improvement was visible in Italy, but the index declined in Germany, France and the Netherlands. Production data show that German industry is having an especially tough time, with production down sharply in July and therefore more than 5% lower than a year earlier. The UK is a positive exception here. The index there has stood at over 50, which points to growth, for four months already and was up again in August. The situation is more positive in the service sector. The PMI for this sector climbed to 52.9 in August, cancelling out July's downturn. This was partly thanks to a strong upturn in France, where the negative mood around the parliamentary elections made way for a positive mood during the Olympics. This distortion was also visible in the Economic Sentiment Index for the whole Eurozone, which in August rose to its highest level since May 2023. A sharp upturn was visible here in France too, while the indicator declined in Germany and Italy. It remains to be seen whether the upturn will persist. Germany's Ifo index gives little reason for optimism.

In August, the global GDP-weighted PMI for industry fell to 49.1, its lowest level since December of last year. This indicator declined in both industrialised nations and emerging markets. It should be noted though that in industrialised nations the indicator is below 50, which points to contraction, while it remains above 50 in emerging markets. The slowdown in industry is also visible in production data. In June, the most recent month over which the CPB Netherlands Bureau for Economic Analysis has published data, industrial production grew globally by 0.6% versus the same month a year earlier. There was a divergence between industrialised nations, where production shrank by 0.7%, and emerging markets, in which growth was still visible at 3.0%. However, this was a lower rate of growth than in preceding months.

Growth in the Eurozone, but a moderate amount



Source: Refinitiv, Van Lanschot Kempen

Global PMIs for industry less positive

Source: Refinitiv, Van Lanschot Kempen

Real indicators, such as retail sales, industrial production and order positions at businesses, are pointing more to stagnation than to growth. So why are we seeing growth? It must derive from the improved purchasing power of consumers, a purchasing power that is mostly being wielded in the service sector. In contrast to US consumers, European consumers haven't spent their savings. The savings rate is still high here. We don't expect these savings to be spent but it's possible that an adjustment to consumer behaviour as needed in the US won't materialise in Europe. Even so, consumers will need to adjust their spending somewhat. Revised data on growth in the second quarter showed GDP growth of 0.2% versus the first quarter, slightly lower than the 0.3% published previously. However, consumer spending contracted marginally, and corporate investment dropped more sharply. It was government spending and foreign trade that accounted for growth.

Upturn in industry proves to be unsustainable

This mainly has repercussions for emerging markets, where industry on average constitutes a larger portion of the economy than in industrialised nations. Yet countries that export large amounts of commodities are also affected. We need to look mostly to the US to find any improvement. This will take some time to materialise though, given that an adjustment to consumer spending needs to occur there. In Europe, we can see potential for growth in consumer spending, but it will be a small amount. And in China the economy and consumers are still having to contend with an extremely weak housing market.

Fed: 25 or 50 basis points?

Financial markets are eagerly awaiting 18 September, the day on which the Fed will announce its interest rate decision following two days of meetings. The Fed will almost certainly cut rates. During the annual meeting of central bankers in Jackson Hole, Fed Chair Powell said he had greater confidence in inflation being on a sustainable path towards 2%. It was a lack of confidence that had prevented Powell from cutting rates earlier. Moreover, Powell said the job market had cooled and that a further slowdown would be undesirable in his opinion. According to Powell, this is the right time to adjust monetary policy. While the direction is clear, the timing and pace of interest rate cuts will depend on how the economy reacts. A cut to rates in September has been widely predicted for some time. Following the turmoil on the financial markets in August, the markets have gone a step further. Will the cut be by 25 or 50 basis points? Cuts of 50 basis points have occurred at the start of downward interest rate cycles before but only when something serious has been going on. In January 2001, for example, the Fed cut rates by 50 basis points at an extra policy meeting. This was in the middle of the dot-com bubble bursting. Technology market Nasdaq had already halved and the ISM index for industry stood at 42.3. Prior to the interest rate cut of 50 basis points in September 2007, this time at a regular meeting, the financial crisis had already started to make itself felt. House prices had been falling since 2006, two subprime lenders went bankrupt in early 2007, two hedge funds collapsed in June and in August losses on subprime loans led to international lending drying up. Financial markets have been turbulent recently. A worse-than-expected ISM index for industry again led to losses on the equity markets in early September. However, we don't believe the turmoil is bad enough for the Fed to cut rates by 50 basis points. We're working on the basis of three cuts this year, each at a regular policy meeting. Alternating between cuts of 25 and 50 basis points complicates communications for the Fed. For the time being, we think the Fed will prefer a predictable pace of 25 basis points per policy meeting.

There is greater consensus on the ECB's decision on 12 September: a cut to interest rates of 25 basis points is expected here. ECB communications have confirmed these expectations. And inflation is cooperating, despite some components remaining high. Headline inflation fell to 2.2% in August, its lowest level since July 2021. The high inflation of the past few years now looks to be over. Yet core inflation, excluding volatile food and energy prices that fall outside the sphere of influence of the ECB's interest rate policy, only decreased to 2.8%. This was mainly because inflation in the service sector climbed marginally to 4.2%. Even though some temporary factors lie behind this upturn, this is far above the ECB's target rate of 2%. However, we don't think this will stop the ECB from cutting interest rates in September. The reason is that the increase in wages covered by collective labour agreements, an important cause of the high rate of inflation in the service sector, was 3.6% in the second quarter versus the second quarter of 2023. This still stood at 4.7% in the first quarter. The ECB has stressed its desire to see lower wage growth and these data serve as confirmation of that.

Inflation less of a problem for central banks

Source: Refinitiv, Van Lanschot Kempen

A further cut to interest rates isn't expected in the UK until November. The UK economy has had a couple of difficult years, with a stagnating economy in 2022 and 2023 and stubborn inflation. The economy grew robustly in the first two quarters of this year though. And not just in industry, as the PMI for the service sector is also higher than in the Eurozone. Headline inflation climbed slightly in July to 2.2%, but core inflation declined to 3.3%. All in all, good reason for the Bank of England not to be too hasty about cutting rates.

Investment policy unchanged

Financial markets continue to respond nervously to worse-than-expected macro-economic data. Fears of a recession easily resurface when such setbacks arise. It must be remembered here though that few data are actually pointing to a recession. Confidence indicators would need to be much weaker for this to happen. It all feels rather unsettling what with the cooling US job market, US consumers who continue to live beyond their means and weakness in global industry. This is offset by positive factors such as declining inflation and interest rate cuts by central banks.

Bond yields dropped sharply in August due to markets pricing in a bigger cut to interest rates. The yield curve, which has been negative (lower long-term than short-term yields) in the US since the summer of 2022 and in Germany since the end of 2022, has steepened. Short-term yields dropped more quickly than their long-term counterparts, which means that the curve is close to no longer being negative.

End of negative yield curve in sight

Source: Refinitiv, Van Lanschot Kempen

A negative yield curve is a strong indicator of an imminent recession (especially in the US). The time between the inversion of the yield curve and the actual recession varies, however. A negative yield curve without a recession would be a unique occurrence but not impossible. It now looks as if this signal is coming to an end, but the recession traditionally only starts once the yield curve has normalised. The signal is still there, so it's just a question of waiting to see whether this time will be different. We believe that the process of repricing monetary policy has finished and see little capacity for bond yields to come down further. There could well have been something of an overreaction. Markets are now pricing in four cuts to interest rates in the US before the end of the year. As there are only three policy meetings left this year, this would mean the Fed would need to cut rates by 50 basis points at least once. We think this is unlikely.

We hold an underweight in bonds. US investment grade credits are particularly unattractive in our opinion as we believe the tight spreads offer insufficient reward for the higher risk versus government bonds. Spreads only need to widen slightly for the asset class to underperform versus government bonds. Within US investment grade bonds, we prefer government bonds. However, when it comes to global investment grade credits, we prefer the Eurozone. Yields there have dropped by slightly less than in the US and spreads on investment grade credits aren't as tight as they are in the US.

We've retained our overweight in equities. Economic growth could be slightly worse than expected, which would mean that earnings expectations need to come down slightly. We're already seeing more analysts adjusting their forecasts downwards in Europe, incidentally without earnings expectations decreasing overall. As long as earnings continue to rise, we view this as a boost to equity markets. This is certainly true when inflation is declining and especially when central banks cut their policy interest rates. The most recent data on the US job market, which investors monitor closely, also provide some relief.

We're cautious about high yield credits as these companies are more aggressively financed and therefore affected more by higher interest rates that gradually work their way into interest charges when credits are refinanced. Emerging market debt generates an attractive return, but this is mostly to be found in the weaker countries and little risk premium has so far been priced in for the turbulence surrounding the US elections in November and any further slowdown in growth. This is the reason for our neutral position.

For real estate, we continue to view the uncertainty surrounding interest rates and potential downgrades to property valuations as too high to build a position in this asset class. As for commodities, our doubts mainly relate to the robustness of the Chinese economy. A clear sign as far as we're concerned is the fact that oil prices fell while geopolitical tensions increased, and oil-producing countries decided to prolong their caps on production.

Market review

Equities

	Index	Past month	Past 3 months	From 31-12-2023
Global (MSCI AC)	1076	6.6%	2.3%	11.8%
Developed markets (MSCI World)	3567	6.7%	2.4%	12.6%
Emerging markets (MSCI EM)	1076	5.9%	1.3%	5.1%
United States (S&P500)	5503	6.1%	2.8%	15.4%
Eurozone (EURO STOXX 50)	499	5.6%	-4.1%	5.3%
United Kingdom (FTSE 100)	8242	2.9%	-0.1%	6.6%
Japan (Topix)	2621	17.7%	-4.6%	10.7%
Netherlands (AEX)	892	3.7%	-2.9%	13.3%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	3.73	-5	-55	-14
Japan	0.88	9	-13	25
Germany	2.21	3	-29	18
France	2.91	-7	-8	35
Italy	3.57	-11	-24	-14
Netherlands	2.49	-1	-30	17
United Kingdom	3.92	4	-27	38

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	99	-13	8	-5
Eurozone	115	-12	8	-20

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	329	-64	9	-5
Eurozone	354	-48	30	-41
Emerging markets (USD)	388	-42	-3	4
Emerging markets (Local currency)	267	2	38	32

Real estate

		Past month	Past 3 months	From 31-12-2023
Global		8.3%	10.0%	5.1%
North-America		8.0%	13.8%	8.9%
Europe		7.9%	3.4%	3.5%

Commodities

		Past month	Past 3 months	From 31-12-2023
Bloomberg index		1.3%	-6.6%	-3.5%
Base metals		2.8%	-10.7%	-1.9%
Brent oil (USD per barrel)	73.23	-4.2%	-5.4%	-5.7%
Gold (USD per troy ounce)	2508	4.1%	6.6%	21.4%

Returns in local currency
bp = basis point (0.01%)
Data as of 5 September 2024
Source: Refinitiv

Tactical outlook

Asset class	
Equities	**Overweight**
Equity markets have been turbulent in recent weeks. They generally noted pluses in August, but a substantial correction took place at the start of the month. Markets subsequently rallied, only to experience a couple more bad days in early September. We understand the concerns, including about US consumers who continue to spend more than they earn and the cooling US job market. All this while the Eurozone economy is struggling to get going and China's economy is weak. We can also see positive aspects, however. We believe growth will be high enough to push up earnings, while inflation is coming down and central banks will cut interest rates. Earnings expectations for the next twelve months are being adjusted upwards, although fewer analysts are doing so, and this is something that requires monitoring. We hold a neutral position in Pacific and emerging markets. In Pacific we took profit on an overweight in Japan earlier this year and harbour doubts about Hong Kong. We don't consider the growth, momentum and revisions to earnings in emerging markets to be robust enough for us to hold an overweight in these.	
Government bonds	**Overweight**
In the US, 2-year bond yields fell faster than their 10-year counterparts in August. This steepened the yield curve from negative to almost flat for the first time since the summer of 2022. The same goes for Germany, albeit to a lesser extent. UK yields climbed, by more at the long end than the short end of the yield curve. We had previously seen little capacity for yields to come down as the negative yield curve meant that lower inflation and a less tight monetary policy had already been priced in. The risk of worse-than-expected growth has increased recently but we believe interest rate markets may have gone too far in their pessimism. We therefore can't rule out higher yields in the short term, but in the longer term we don't anticipate a structural upturn in market interest rates in light of the lower inflation and interest rate cuts by central banks.	
Investment grade credits	**Underweight**
Spreads on investment grade credits widened slightly at the beginning of August but had almost reverted to their initial levels by the end of the month. This has done nothing to alter our opinion that the tight spreads are at odds with economic indicators that in many cases are pointing to declining growth momentum in the US and moderate growth in the Eurozone. Furthermore, the higher market interest rates are causing a deterioration in the ratio of corporate results and interest charges. Exposure to commercial real estate poses a risk for some US and German banks. US spreads are about 25 basis points below the average for the past five years, Eurozone spreads 15 basis points. The downturn in government bond yields in August means that spreads currently account for a larger portion of the interest compensation on credits. This makes them slightly more attractive versus government bonds but not enough to adopt a neutral position. Within investment grade credits we have a relative preference for the Eurozone versus the US. Spreads are marginally wider in the Eurozone and interest rate sensitivity is lower.	
High yield credits	**Underweight**
The picture for high yield credits has been similar to that of investment grade credits in recent weeks. Spreads widened at the start of August but tightened again later in the month. On balance, spreads tightened in the US and Eurozone. As a result, spreads in the US and Eurozone are still well below the average for the past five years and an extremely positive economic scenario has been priced in. Like investment grade credits, high yield credits have lost some of their relative attractiveness versus government bonds thanks to the higher yields in the latter asset class. Yet our negative outlook for this asset class primarily derives from the fact that the market for high yield bonds is totally ignoring the possibility of a further slowdown in growth. Even if the economy continues to grow over the coming quarters, we still view the spreads as small. This is because companies will face higher interest charges. Moreover, US consumers have now spent their (surplus) savings. And the fact that default rates on their credit card debt and car loans are rising fast is a bad sign. Furthermore, we know that if the solid sentiment on this market deteriorates, the liquidity of these bonds will quickly dry up and spreads will widen.	
Emerging market debt	**Neutral**
Emerging market debt was unable to escape the turmoil on the financial markets in early August. Yet here too it was of short duration. Spreads tightened overall. Yields also came down on bonds listed in local currency. On balance, both asset classes generated positive returns. We find the interest compensation on emerging market debt issued in US dollars attractive and spreads are relatively wide versus other asset classes. Stubborn inflation in the service sector and high interest rates in developed countries pose risks but we expect the Fed to be able to cut interest rates this year as inflation is coming down in the US. Emerging market debt listed in local currency could profit from the lower inflation and cuts to interest rates in emerging markets, although the process of lower inflation and cuts to interest rates has stalled somewhat in recent weeks. The interest compensation is relatively low versus developed countries, which reduces the relative attractiveness.	

Asset class	
Listed real estate	**Neutral**
Listed real estate has enjoyed two positive months thanks to the lower yields. The upturn is more pronounced in the US than in Europe, while emerging markets lagged behind. We hold a neutral outlook for this asset class. Valuations are relatively low versus general equities but not versus interest rates. In the short term we're concerned about the sustainability of the recent downturn in yields and similarly worried about financing in the real estate sector. Tighter lending conditions at banks complicate access to (re)financing and exert upward pressure on interest charges. Despite the fact that transactions have recently picked up somewhat, they remain at low levels. Property prices could continue to fall before the number of transactions normalises further.	
Commodities	**Neutral**
The Bloomberg general commodity index remained unchanged overall in August. Oil prices fell, while metal prices climbed following the sharp downturns in June and July. Gold continued its upward march. Oil markets are tight and stocks low, but the knowledge that the OPEC countries have sufficient production capacity and are using it wisely restricts the upward potential for oil prices. The weakness in global industry and China is likewise squeezing the oil price. We see little upward potential for metals for the same reason. The gold price remains high. The high gold price is primarily the result of expansionary monetary policies and the large amount of liquidity these have created, as well as gold purchases by central banks. Gold is an interesting investment at times of uncertainty but given its high price a large amount of uncertainty and/or lower interest rates have already been priced in.	

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