INVESTMENT MANAGEMENT

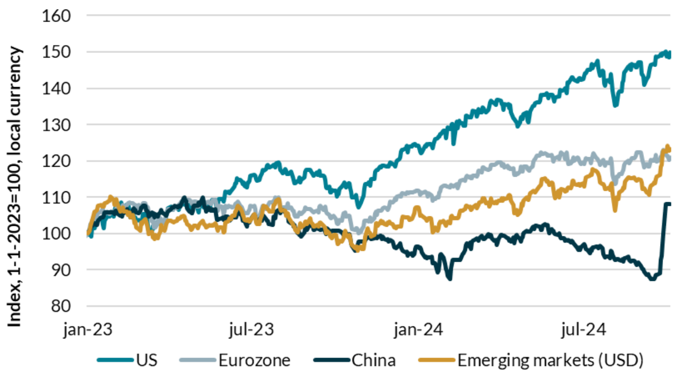
Asset Allocation Outlook

October 2024

- Fed off to an aggressive start to interest rate cuts, slower pace to follow
- Increasingly likely that ECB will cut interest rates in October
- Chinese economic stimuli not enough

September briefly looked as if this year it was going to live up to its reputation as a poor month for the markets. US and European equities fell by about 4% in the first trading days of the month. As in August, the reason was disappointing data on the US job market and the ISM index for industry, plus worse-than-expected results from the tech sector. Yet US equities in fact closed the month up slightly, while European equities ultimately remained almost unchanged. US growth has stayed at the same level, the Fed cut interest rates by more than anticipated and at the end of the month the Chinese government announced a series of economic stimuli. The latter drove Chinese equities up by 17%.

Chinese equities profit from announcement of economic stimuli



Source: Refinitiv, Van Lanschot Kempen

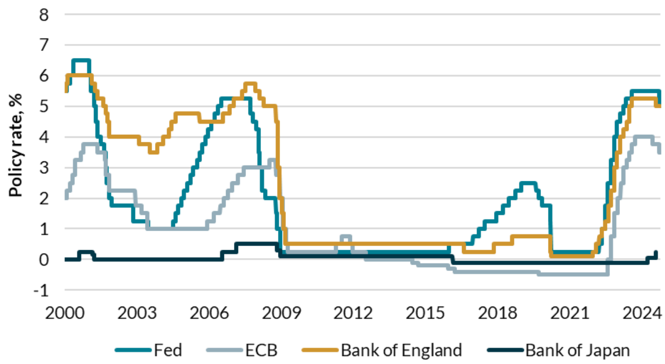
Equity markets were also aided by lower bond yields. Short-term yields came down by more than long-term yields in both the US and Germany, which means that long-term yields are again higher than short-term yields for the first time since 2022. The downturn in short-term yields is due to declining inflation and the interest rate cuts priced in by the market.

We continue to see a positive climate for equities thanks to ongoing growth, declining inflation and central banks cutting interest rates. Revised data have mitigated our concerns about US consumers. Growth is rather low in Europe though in our opinion. We've nevertheless kept our investment policy unchanged.

Fed off to an aggressive start

The Fed finally implemented its first interest rate cut in September. The US central bank got off to a flying start with a reduction of 50 basis points. This is quite a rare occurrence. There's usually something going on when this happens, such as the bursting of the dot-com bubble in 2001 or the financial crisis in 2007. This year equity markets are smashing record after record and spreads on credits are tight.

Fed acts later but more aggressively



Source: Refinitiv, Van Lanschot Kempen

Equity markets initially reacted rather hesitantly. Is the Fed seeing something we're not? In implementing such a large cut, is the Fed saying that it's in fact acting too late? And the Fed's insistence that 50 basis points isn't the new normal but that from now it intended to cut rates by 25 basis points each time wasn't what the equity markets wanted to hear. This is because a steeper downward path of interest rate cuts has already been priced in on the market for futures versus the Fed's policy interest rate. Investors came to their senses a day later, however, since growth and interest rate cuts are positive for equities.

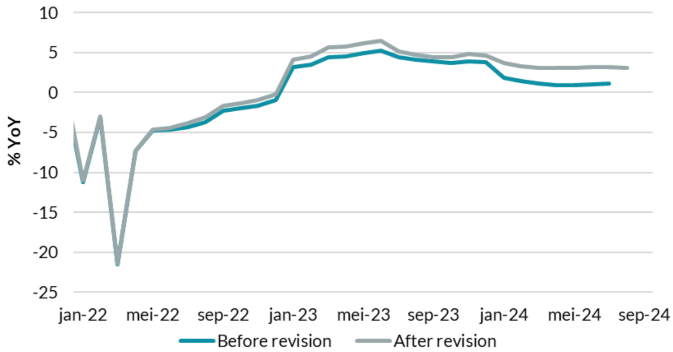
We believe that the declining rate of inflation in principle makes cuts of more than 25 basis points a possibility. In August, inflation declined to 2.2% according to the Fed's favourite index, just above the central bank's target rate and the lowest level since February 2021. Core inflation climbed slightly to 2.7%. This is the increase in prices over the past year. If we go back three or six months, the rate of inflation is lower. Things are therefore moving in the right direction. When it comes to the Fed cutting interest rates, it also needs to be remembered that the policy interest rate is far above the neutral level. The Fed is simply not applying the brakes as hard and isn't touching the accelerator.

We're nevertheless assuming cuts of 25 basis points. This is because we think growth will remain reasonably on track. We don't believe the Fed will want to risk cutting rates too quickly given that the high inflation of recent years is still fresh in everyone's minds. This might come as a bit of disappointment to the financial markets and could push up yields in the US in the short term, but we don't view this as negative for equities. On the contrary, we think that equities will profit from the interest rate cuts to come.

Mystery of US growth solved

It was a bit of mystery, the strong growth in consumer spending in the US in the face of weakening income growth, in real terms at any rate. US households had accrued substantial savings during the coronavirus pandemic, but this money had largely been spent. We expressed our concerns about US consumers spending more than they earned each month this year. Revised data have solved most of this mystery. Income growth proved to be stronger than estimated and the savings rate was higher. According to the old data, the savings rate dropped to 2.9% in July, its lowest level since the financial crisis. Yet in the revised data the savings rate stands at nearly 5%. It turns out that consumers aren't spending more than they earn this year but are living well within their means. This mitigates a significant concern we had about the US economy.

Higher growth in US households' real disposable income following revision



Source: Refinitiv, Van Lanschot Kempen

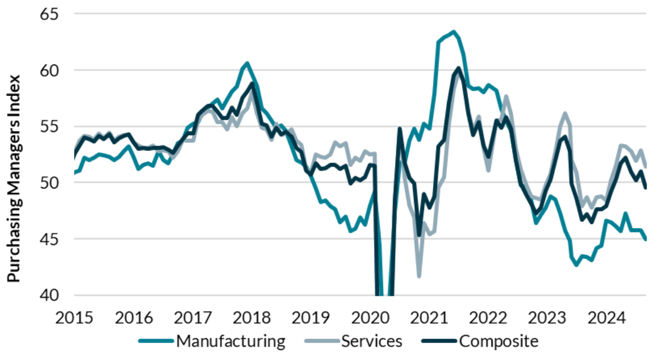
Is the situation on the job market a cause for concern? The September data remove some of the concerns here too. Job growth accelerated in September and growth in the preceding two months was adjusted upwards. Unemployment was down for the second consecutive month. The number of jobless claims remains low. The trend in the number of unfilled vacancies and number of workers voluntarily resigning from their jobs continues to be downward, which points to dwindling dynamics on the job market. Yet the number of compulsory redundancies isn't growing. There certainly isn't a vicious circle in which fewer jobs is leading to lower consumer spending and lower consumer spending to redundancies. In short, for the time being there's a slowdown on the job market but nothing more negative than that.

Concerns about the European economy

Mario Draghi, the former ECB president and former prime minister of Italy, published a hefty report on the European economy in September. The picture Draghi sketches in this report is far from rosy. European growth is stagnating and trailing behind that of the US. Stunted productivity growth, overdue digitisation and a shrinking population are, according to Draghi, threatening Europe's core values, prosperity, equality, freedom, peace, democracy and sustainability. In Draghi's opinion, Europe needs to be more innovative, greener and more competitive and become less reliant on non-EU countries for security and economic inputs. He believes the internal market and capital markets union should be brought to fruition and that greater coordination is required within Europe. Europe should also invest much more. Draghi names a sum of 750 to 800 billion per year, the equivalent of 4.5% of the GDP. This would primarily need to come from the private sector, but Draghi acknowledges that this would require fiscal measures and direct government expenditure. Ambitious plans, but difficult to realise at a time when governments are having to cut back to comply with European rules and Eurosceptics are gaining ground in the European political landscape.

Recent macro-economic data show that growth isn't that great in Europe. The purchasing manager index (PMI) for industry dropped to 45.0 in September, almost completely cancelling out the upturn from January to May. At 51.4, the index for the service sector stayed above the level that divides growth from contraction but here too the upturn from earlier this year has been largely wiped out. The composite index for the whole economy, including construction, fell to 49.6, its lowest level since February. It therefore points to a contracting economy.

Deteriorating sentiment among Eurozone manufacturers



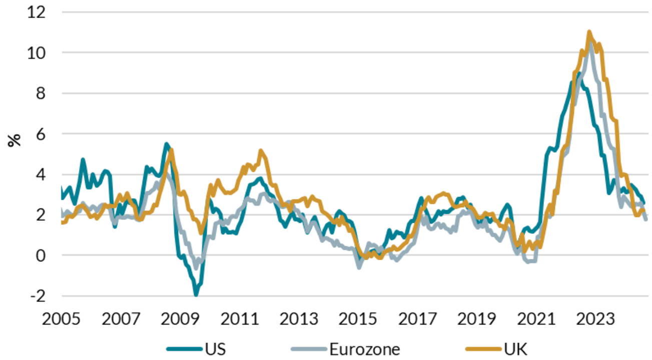
Source: Refinitiv, Van Lanschot Kempen

The downturn in the German PMI for industry to the alarmingly low level of 40.3 was remarkable. The weakness in Germany can also been seen in the Ifo index, which fell for the second month in a row in September, while it already stood at a low level. As growth in Germany was marginally negative in the second quarter as well and these indicators point to a further contraction, Germany looks to have entered a technical recession. Furthermore, the improvement in sentiment in the French service sector turned out to be temporary and, as we'd suspected, linked to the Olympic Games.

Compared to the PMIs, the Economic Sentiment Index contained a couple of bright spots, albeit small ones. The Economic Sentiment Index declined in September but only by a small amount. In fact, this index has been moving sideways at a level that points to a stagnating economy since the end of last year. Consumer confidence climbed higher, so the weakness is mainly in industry and the relative robustness in the service sector.

This weakness raises the question of whether the ECB will accelerate the pace of interest rate cuts. Following the cut in July, the ECB paused in August and then implemented a second cut in September. We believe it's now increasingly likely that the ECB will cut interest rates in October. Growth is worse than expected and inflation dropped to 1.8% in September, bringing it below the ECB's target of 2% for the first time since June 2021.

Inflation continues to come down



Source: Refinitiv, Van Lanschot Kempen

While core inflation decreased to 2.7%, inflation in the service sector is stubborn. We believe that declining wage growth will ultimately lead to lower inflation in the service sector. Comments from ECB President Lagarde and ECB board member Schnabel point to the possibility of interest rates being cut in October. They are now more confident that inflation is being brought under control. Schnabel referred to the moderate outlook for growth as well.

Whatever it takes in China?

On 26 July 2012, when the Eurozone experienced a crisis about the sustainability of the government finances of Southern European member states, the then ECB President Mario Draghi said the bank would do whatever it takes to save the euro. His words and the instruments he announced stabilised the markets and the phrase 'a whatever it takes moment' has since become common usage. The question is whether this moment has now also arrived in China. The Chinese economy has been ailing for some time. This was confirmed by the PMIs. The average of the two Chinese indices for industry dropped further below 50 in September, while the average for the service sector remained just above that level. The weak economy, overcapacity in industry and rapidly rising debt burden of the past few years mean there's a risk of deflation. Japan has shown how difficult it is to break out of that. Calls were therefore growing for the Chinese government to introduce economic stimuli.

These were announced in two stages at the end of September. The government initially announced a number of monetary measures. These are the most tangible but perhaps the least effective. The central bank cut the policy interest rate by 0.2 percentage points and the reserves banks must hold by 0.5 percentage points. Lower reserve requirements increase the supply of credit, but that isn't the problem in China. It's in fact low confidence among consumers and businesses that's curbing demand for credit. Moreover, the central bank has regularly cancelled out cuts to reserve requirements by providing the banking sector with less direct credit. In addition, interest rates on existing mortgages are being cut, as is the minimum cash deposit when purchasing a home. These are positive for the housing market on balance but may have little effect as confidence in the housing market is at a record low because many buyers are still waiting for the homes on which they've already paid a deposit to be finished. Finally, measures were announced aimed at boosting the equity market, for example by making it cheaper for businesses to borrow money to buy back their own shares. Previous attempts by the authorities to bolster equity markets have resulted in strong rallies but also rapid downturns on the equity markets.

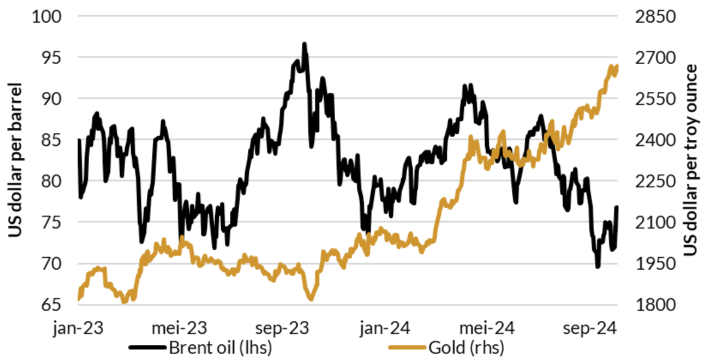
The fiscal measures that were announced next were less tangible, but it looks as if households will receive direct support. Until now, the Chinese government has mainly stimulated the economy via the supply side, resulting in overcapacity. A focus on the demand side would therefore be more than welcome.

When viewed individually, there's room for improvement in all these measures but when viewed together the government is emitting a strong signal. We don't yet see this as a whatever it takes moment, however, as more would be needed for that. Yet markets responded exuberantly. The growing urgency displayed by these measures and the accompanying remarks caused the Shanghai stock exchange index to soar over 20% in one week. This more than cancels out the index's losses over the year. The index is nevertheless still more than 10% below its peak in September 2021 and over 50% lower than the peak during the 2015 bubble. Viewed positively, you could say there's still a great deal of upward potential.

Growing geopolitical tensions

The situation between Israel and Hezbollah in Lebanon had already been tense for some time. Following the exploding pagers and walkie-talkies and bombing of Hezbollah, Israeli troops have now crossed the northern border into Lebanon. These events prompted Iran to carry out reprisals in Israel. The fact that Iran announced the missile attacks in advance shows that the countries have some sense of the risk of escalation. The price of a barrel of Brent oil climbed by about 10% in just a couple of days. It was mainly the news that Israel is considering further retaliation in the shape of a possible attack on Iranian oil refineries that pushed oil prices higher.
Any damage to Iranian oil production could be absorbed by production from Libya and the OPEC countries but the risks are growing, partly because Iran could obstruct shipping in the Strait of Hormuz, for instance.

Geopolitical tensions push up oil price, but level remains low



Source: Refinitiv, Van Lanschot Kempen

This question is whether this would have a negative impact on the global economy and on financial markets. We believe this impact will be small. Even after the recent upturns, oil prices are still lower than at the end of August and at levels that won't negatively affect the economy. This is partly because there's sufficient supply-side capacity. Saudi Arabia has the capacity to stabilise the oil market if part of Iran's production is shut down. The US is a major oil producer itself, making its economy less sensitive to changes in oil prices. We've therefore kept our investment policy unchanged.

We've retained our overweight in equities. In the US, the economic signals have mostly been positive recently. Economic growth in the Eurozone could be marginally worse than expected, which means expected earnings would have to come down slightly. We're already seeing more analysts adjusting their forecasts downwards, 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 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. Spreads on investment grade credits aren't as tight there as they are in the US.

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 mostly derives from the extremely high yields in the weaker countries in the index. 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 again in September, while geopolitical tensions increased, and oil-producing countries decided to prolong their caps on production.

Market outlook

Equities

	Index	Past month	Past 3 months	From 31-12-2023
Global (MSCI AC)	1179	4.0%	4.0%	16.6%
Developed markets (MSCI World)	3698	3.3%	3.6%	16.7%
Emrging markets (MSCI EM)	1179	9.9%	6.8%	15.2%
United States (S&P500)	5751	4.2%	3.9%	20.6%
Eurozone (EURO STOXX 50)	511	2.1%	-0.1%	7.9%
United Kingdom (FTSE 100)	8281	0.1%	0.5%	7.1%
Japan (Topix)	2694	2.3%	-7.1%	13.8%
Netherlands (AEX)	912	1.7%	-2.5%	15.9%

Government bonds (10-year)

	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	3.98	22	-37	11
Japan	0.89	1	-19	27
Germany	2.21	0	-37	19
France	2.99	6	-29	43
Italy	3.52	-6	-49	-20
Netherlands	2.51	0	-39	19
United Kingdom	4.13	20	-7	59

Investment grade credit

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	87	-12	-6	-17
Eurozone	110	-6	4	-25

High yield bonds

	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2023 (bp)
United States	289	-46	-36	-45
Eurozone	333	-22	0	-62
Emerging markets (USD)	351	-52	-44	-33
Emerging markets (Local currency)	242	-26	15	6

Real estate

		Past month	Past 3 months	From 31-12-2023
Global		1.7%	12.5%	6.8%
North-America		-0.2%	13.0%	9.1%
Europe		2.6%	8.5%	4.8%

Commodities

		Past month	Past 3 months	From 31-12-2023
Bloomberg index		7.6%	-0.1%	3.5%
Base metals		11.1%	1.4%	9.3%
Brent oil (USD per barrel)	78.22	6.7%	-10.7%	0.7%
Gold (USD per troy ounce)	2667	6.8%	13.0%	29.1%

Returns in local currency
bp = basis point (0.01%)
Data as of 7 October 2024
Source: Refinitiv

Tactical outlook

Asset classes	
Equities	**Overweight**
After downturns at the start of the month, global equity markets succeeded in climbing marginally in September. This was mainly thanks to a small plus in the US and a strong upturn in China. The economic outlook for the US has improved; the impact of economic stimuli in China is still somewhat uncertain. The Eurozone economy continues to experience difficulties. Yet 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 this region.	
Government bonds	**Neutral**
As in August, US 2-year bond yields again fell faster than their 10-year counterparts in September. In doing so, the yield curve steepened so that it's now slightly positive. The same goes for Germany, with a more pronounced downturn in 2-year yields. This means the yield curve has reverted to positive in Germany as well. Short-term bond yields declined in the UK too, but long-term yields didn't. The yield curve there remains slightly negative. The steeper yield curves make us think that interest rate cuts have now been priced in realistically. In the short term, yields could rise slightly if central banks don't fully meet market expectations, 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 tightened marginally in the US but widened slightly in the Eurozone. The movements were minimal overall. The movements in the underlying yields on government bonds had a bigger impact on the positive return in September. We find spreads extremely tight in the US and therefore view investment grade credits as unattractive versus government bonds. The economic outlook for the US has improved in the short term, but spreads only need to widen by a small amount for investment grade credits to underperform versus government bonds. Spreads are tight in the Eurozone too but at less extreme levels than in the US. In the Eurozone, spreads account for a much larger portion of the total interest compensation than in the US. This reflects the less positive outlook for the Eurozone, but we don't believe it's so negative that spreads on relatively safe credits will widen. Within investment grade credits we have a relative preference for the Eurozone versus the US.	
High yield credits	**Neutral**
Spreads on high yield credits tightened in both the US and Eurozone in September. Spreads in the US and Eurozone are still well below the average for the past five years – over 100 basis points in the US, nearly 80 in the Eurozone – 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 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. 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**
Spreads on emerging market debt listed in US dollars tightened faster than those on high yield credits in September. The first cut to interest rates in the US, a slightly weaker US dollar and economic stimuli in China were positive for these bonds. Bonds listed in local currency underperformed marginally as the limited downturn in inflation blocked a more rapid decrease in yields. 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 the Fed will continue to cut interest rates 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 recently. The interest compensation is relatively low versus developed countries, which reduces the relative attractiveness.	
Listed real estate	**Neutral**
Listed real estate has enjoyed three positive months thanks to the lower yields. In September the upturn was less pronounced in developed countries than it was in preceding months. Emerging markets, where real estate profited from the	

Asset classes	
announcement of economic stimuli in China, saw bigger upturns. 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.	
Commodities	**Neutral**
The Bloomberg general commodity index climbed in September. Oil prices fell, but metal prices profited from the announcement of economic stimuli in China. Gold continued its upward march, while metals climbed following the sharp downturns in June and July. 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 oil prices. 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.	

Author

Joost van Leenders
Senior investment strategist
j.vanleenders@vanlanschotkempen.com
M +31 6 82 83 11 89

Van Lanschot Kempen Investment Strategy & Tactical Asset Allocation

Yaela van Raalte – Head Investment Research
Luc Aben – Chief Economist
Pieter Heijboer – Head Investment Strategy
Joost van Leenders – Senior investment strategist
Jorn Veeneman – Senior investment strategist

Disclaimer

VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

Beethovenstraat 300
1077 WZ Amsterdam
Postbus 75666
1070 AR Amsterdam

T +31 20 348 80 00
vanlanschotkempen.com/investment-management