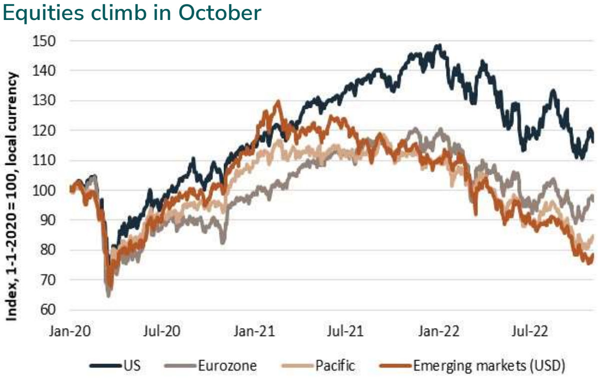
Asset Allocation Outlook

NOVEMBER 2022

- Optimism among equity investors premature
- Earnings season contains little guidance for equities
- Reduced underweight in Eurozone government bonds

Investors were considerably more optimistic in October than in the preceding months. The US Dow Jones equity index even noted a gain of 14%, its best monthly result since January 1976. Yet that tells us more about the composition of the Dow, in which large companies from the energy, industrial and banking sectors are overrepresented. The tech sector, in which large companies such as Meta and Alphabet took a severe hit, is in fact underrepresented in the Dow index. It therefore makes more sense to look at the S&P500, which despite being up by 8% still hasn't yet recouped its losses from August and September. In local currency the performance of European equities was almost identical to that in the US, while emerging markets were down by over 3%.

Equities climb in October



Source: Bloomberg, Van Lanschot Kempen

Bond yields increased, in the US mostly at the very short end of the yield curve (durations shorter than two years). The upturn in 2-year yields was almost identical to that on 10-year yields, resulting in the gap between these two yields remaining at about -45 basis points. Lower 10-year bond yields (4.0% as of the end of the month) than 2-year yields (4.5%) are traditionally a precursor of a recession. In Germany, 2-year yields rose more sharply than their 10-year counterparts, causing the yield curve to flatten, incidentally without becoming negative.

Spreads tightened on the credit market. The fact that those on high yield credits tightened by a larger amount matches the more optimistic mood of investors.

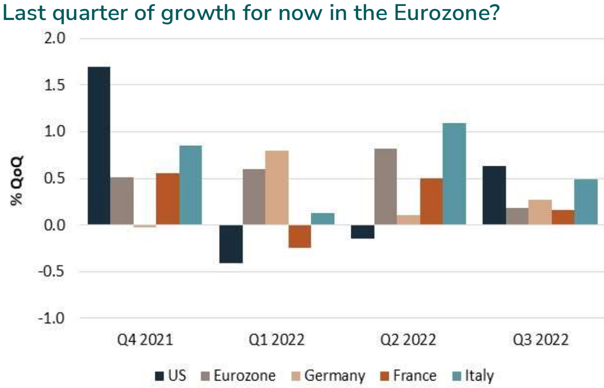
We believe the renewed optimism among investors to be premature. It is nevertheless our belief that the larger part of the interest rate hikes is now behind us. This is the reason for us slightly reducing our underweight in Eurozone government bonds at the expense of our cash position. Yet despite the prospect of fewer interest rate increases reducing the downward pressure on equities, we still think it too soon to increase our equity weight.

Surprise growth in the third quarter

Economic growth data caused positive surprises in the US and Europe in the third quarter. In the US, growth stood at 0.6% versus the second quarter.

This was marginally better than expected but also the first positive growth rate since the fourth quarter of last year. No growth was anticipated at all in the Eurozone, making its figure of 0.2% an unexpected bonus. The Italian economy even grew by 0.5%; the growth in Germany, France and Spain was almost the same as the overall Eurozone rate.

Last quarter of growth for now in the Eurozone?



Source: Refinitiv, Van Lanschot Kempen

Despite the positive surprises, there are some caveats about the growth rates. US growth primarily derived from foreign trade. Exports were up and imports down. Robust export growth will be difficult to maintain in a climate of slowing global growth and an expensive US dollar. There was very little domestic growth. Consumer spending increased marginally and government spending by slightly more but corporate investment and housing construction were both down. A breakdown of the Eurozone growth data has yet to be published. However, the rate of growth is considerably lower than in the previous five quarters. Moreover, retail sales figures displayed a sharp downturn in the quarter. The economy was probably still profiting from holiday spending in the third quarter. This is visible in the data for Spain. Yet this effect will rapidly dissipate now that incomes are being squeezed hard by the high rate of inflation.

Furthermore, leading indicators are pointing to lower growth and in many cases even to recession. Purchasing managers in industry were the most pessimistic in October that they have been since the coronavirus pandemic. On average, indices have dropped below 50 in industrialised nations and emerging markets, which points to a recession in industry. A number of trends are converging here. Normalisation of the high demand for goods during the coronavirus lockdowns, the high rate of inflation affecting consumer purchasing power and declining corporate investment due to higher interest rates and economic and geopolitical uncertainties all have a negative impact on demand for consumer and investment goods. Yet businesses in the service sector were also more pessimistic in the US, Eurozone and China. Incidentally, the dwindling demand is causing the tightness in supply chains to dissipate quickly, delivery times to shrink and price pressure to ease. Consumers have been more pessimistic for some time now due to the squeeze on spending power from the high rate of inflation, dwindling wealth and housing markets that are rapidly cooling because of the higher interest rates.

Low consumer confidence

Source: Refinitiv, Van Lanschot Kempen

The signs of a recession are becoming ever clearer in Europe. We believe this will begin in the fourth quarter. The level of inflation and shock from energy prices could mean it's a deep recession. Yet tight job markets may keep the number of redundancies down and gas prices have recently dropped sharply. Moreover, many governments have announced sizeable measures to compensate families in particular but also businesses for the high energy prices. This will restrict the depth of the recession somewhat. We expect the recession to occur later in the US, once the interest rate hikes implemented by the US central bank have an effect on the economy. The recession there will also be less deep. It will still be deep enough to cool the job market slightly though, which will in turn bring down the rate of inflation.

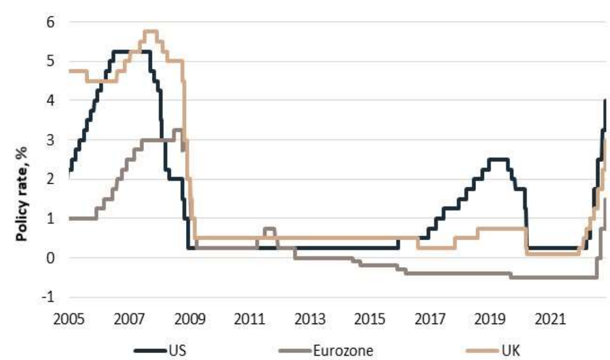
Pivot

Given the generally sombre economic news, where is this optimism on the equity markets coming from? The magic word here is pivot, currently *the* buzzword on the financial markets. It usually refers to a reversal in central bank policy. What exactly constitutes a pivot in this case is not entirely clear. Initially, it looked as if it involved a switch from a contractionary to an expansionary monetary policy. Yet this stage has not yet been reached. More recently, a pause or even less rapid tightening appears to be viewed as a pivot. This makes the optimism among equity investors even more remarkable as investors have been expecting the pace of interest rate hikes to decrease for some time now.

At the ECB's recent interest rate meeting, ECB President Lagarde hinted that the pace of interest rate increases could slow somewhat. The ECB raised interest rates by 75 basis points for the second consecutive time, which in itself was no surprise. Nor was the fact that the ECB didn't want to spell out the future path of interest rate hikes. However, Lagarde did admit that the economy will slow further in the coming quarters. The priority now is combating inflation but according to Lagarde a great deal of progress has already been made in scaling back the expansionary monetary policy. The ECB will take into account the 200 basis points of tightening implemented so far and the delayed effect of this on the economy. Such references are rare at central banks these days, as they have underestimated the stubbornness of inflation. The fact that the ECB is now saying this points to a slower pace of interest rate increases. And given that the Australian and Canadian central banks are also reducing the pace slightly, investors are taking heart from the notion that central banks will ease off somewhat.

Ever since the Fed's interest rate meeting in September, we know that the US central bank plans to raise interest rates by 75 basis points in November, by 50 basis points in December and by 25 basis points at the start of next year. This will be followed by a pause. It took a while for the interest rate markets to price this in but they have now. At November's interest rate meeting the Fed initially appeared to confirm this schedule. In the press release that is always published prior to the press conference given by Fed Chair Powell, the Fed also announced it would take into account the tightening implemented so far and the delayed impact on the economy. This was interpreted as a pivot: interest rates fell and equity markets climbed. Yet in his press conference Powell said that it wasn't just about the pace of interest rate hikes but also how far the Fed will ultimately need to raise rates and how long monetary policy will need to remain contractionary. Powell noted that recent indicators may give reason to raise rates higher than currently expected. He also warned of the risk of reverting to expansionary policy when the rate of inflation is high. So, no pivot from the Fed. The economy and job market are simply still too robust for that. And this had an effect on the markets, pushing up expectations for interest rate hikes and rates and pushing down equities. Powell often succeeds in hinting at his message in advance in this way to restrict market movements on the day of the press conference. Yet on this occasion it was apparently necessary to galvanise investors.

High pace of interest rate hikes



Source: Bloomberg, Van Lanschot Kempen

The Bank of England also joined the ranks of central banks that raised interest rates by 75 basis points. Yet the tone at the BoE was totally different from that of the Fed. The BoE predicts a recession in the UK and on top of this the UK housing market is highly sensitive to interest rates. Mortgage rates are often variable or only fixed for short periods. House prices are being squeezed hard. For this reason, BoE Governor Bailey felt obliged to warn the markets that interest rates might be raised to a lower level than expected. The expected peak for BoE policy interest rates shot up after the debacle of former Prime Minister Truss's mini-budget but has now reverted to its former level. This means there's no prospect of a slower pace of interest rate increases here either.

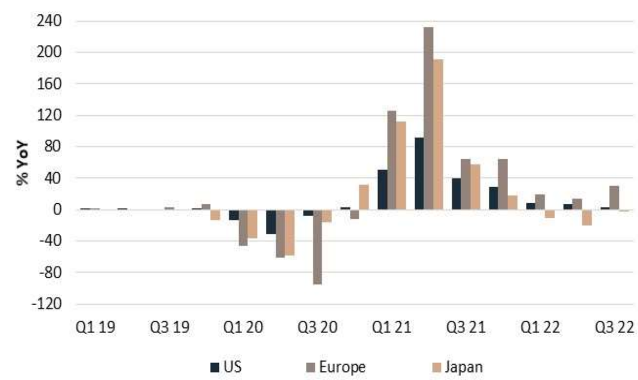
All in all, we don't view central banks wanting to slow the pace of interest rate hikes marginally as news. This has been expected for weeks. To us, it's certainly no reason to see equities in a more positive light. Furthermore, interest rate markets haven't really undergone a reversal yet. In the introduction we noted that interest rates have risen further and the comments from the Fed show that there's still a risk of rates climbing even higher.

A pivot is also anxiously awaited elsewhere, in China's coronavirus policy. With relatively low vaccination rates, especially among older people, a low level of group immunity and a Chinese vaccine that is less effective than its Western counterparts, China continues to pursue an extremely rigorous coronavirus policy involving strict lockdowns, even when there is only a small number of cases. There were hopes that this policy would be moderated somewhat after the party congress. One week on from the congress Chinese equities rallied following rumours of the policy being eased in some areas, although it only looks to be an option on a wider scale in the spring. However, Xi Jinping's even tighter grip on power and praise for the current coronavirus policy mean that there is no sign of a pivot here yet either.

Earnings season reveals remarkable differences

The earnings season in which businesses report on the third quarter is well underway. In the US, over 70% of the companies in the S&P500 index have already published their results, while in Europe this applies to about half the companies in the Eurostoxx index. Some remarkable differences can be seen. For instance, Europe is enjoying much higher growth than the US. At an aggregate level revenues and earnings are growing by approximately 30% versus the same quarter last year. In the US, revenues are up by 11% and earnings by just 3%. In addition to lower growth, margins are also being squeezed slightly more in the US. Incidentally, these figures are fairly close to expectations. The higher growth in Europe is perhaps due to the higher economic growth in the first half of this year still being visible in the latest figures. Yet it's also because of the strong US dollar. Earnings realised in US dollars are worth nearly 15% more in euros this year, which is positive for earnings at European businesses. Another noticeable aspect is the high *number* of European companies reporting higher-than-expected revenues. No fewer than 79% of companies are exceeding expectations in this respect. This is far higher than the long-term average and also much higher than in the US. However, the number of European companies reporting higher-than-expected earnings is considerably lower at 55%. As there's no discrepancy at the level of total revenues and earnings, this suggests that many smaller European businesses are experiencing difficulty in passing on the higher costs to their customers.

Remarkably high earnings growth in Europe



Source: Bloomberg, Van Lanschot Kempen

The results of a number of tech companies likewise stand out. Disappointing ad revenue at Alphabet (Google's parent company), disappointing ad revenue and high costs at Meta (Facebook's parent company) and a lower outlook for growth at Microsoft led to sharp price corrections. This while the sector is already being squeezed by higher interest rates. Conversely, energy companies are reporting robust earnings growth owing to the high energy prices.

Overall, the US earnings season is in line with expectations. Not that they were high to begin with. There is still growth but it's declining. In Europe, earnings growth in particular is higher than expected. Given the prospect of a sharp slowdown in growth or a recession, the value of these figures is relative. What companies are saying is therefore also important. Naturally there are some noteworthy profit warnings but this isn't a general trend. Businesses are nevertheless cautious and we're seeing more and more cost-cutting programmes. In light of all this, the earnings season is not the primary driving factor for equity markets at the moment. Markets continue to be much more driven by economic outlooks and interest rate expectations. As we only anticipate these deteriorating, we hold an underweight in equities.

Investment policy: acquisition of government bonds

We have long held a substantial underweight in European government bonds. This was because we expected yields to rise. We don't think this process has quite been completed yet but we are approaching the end.

Larger part of rise in yields rate hikes behind us?

Source: Refinitiv, Van Lanschot Kempen

There are signs of the rate of inflation coming down, such as lower commodity prices, lower transport costs and less tightness in supply chains. For now the rate of inflation remains too high for central banks to pause their hikes, but the upward and downward risks for interest rates are balancing themselves out more. We have therefore decided to reduce our underweight in Eurozone government bonds slightly at the expense of our large cash position. As with our acquisition of US government bonds last month, we are buying a variety of durations in order to restrict the interest rate risk.

Market review

Equities				
	Index	Past month	Past 3 months	From 31-12-2021
Global (MSCI AC)	873	4.5%	-8.7%	-23.4%
Developed markets (MSCI World)	2500	5.1%	-8.4%	-22.6%
Emerging markets (MSCI EM)	873	-0.3%	-11.3%	-29.1%
United States (S&P500)	3760	4.9%	-8.1%	-21.1%
Eurozone (EURO STOXX 50)	3622	9.2%	-1.7%	-15.7%
United Kingdom (FTSE 100)	7144	3.6%	-3.6%	-3.3%
Japan (Topix)	1940	5.7%	0.8%	-2.6%
Netherlands (AEX)	667	4.2%	-8.1%	-16.4%
Government bonds (10-year)				
	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	4.10	27	135	259
Japan	0.25	1	8	18
Germany	2.14	3	132	232
France	2.68	-4	127	248
Italy	3.89	-4	230	284
Netherlands	2.44	1	131	247
United Kingdom	3.40	-69	153	243
Investment grade credit				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	154	-5	-6	62
Eurozone	219	-6	31	124
High yield bonds				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2021 (bp)
United States	446	-106	0	163
Eurozone	601	-30	16	283
Emerging markets (USD)	533	-26	-14	165
Emerging markets (Local currency)	310	-13	-83	-136
Real estate				
		Past month	Past 3 months	From 31-12-2021
Global		1.5%	-12.3%	-19.4%
North-America		0.7%	-12.1%	-18.6%
Europe		4.7%	-20.9%	-38.5%
Commodities				
		Past month	Past 3 months	From 31-12-2021
Bloomberg index		3.6%	-1.5%	17.6%
Base metals		2.6%	-4.4%	-17.6%
Brent oil (USD per barrel)	96.16	15.1%	0.1%	31.9%
Gold (USD per troy ounce)	1650	-0.7%	-6.5%	-9.8%

Returns in local currency
bp = basis point (0.01%)
Data as of 3 November 2022
Source: Bloomberg

Tactical outlook

Asset class	
Equities	**Negative**
After two months of losses, equities again noted a positive result in October. Or rather, they did in industrial nations. Emerging market equities lost even more ground. The optimism was primarily driven by the idea that the end of monetary tightening by central banks is in sight. It's worth noting that in a market in which sentiment is extremely negative, minor changes can quickly cause major reversals. We nevertheless find this optimism to be premature. This is firstly because central banks haven't yet finished raising interest rates but mainly because we expect a recession in Europe and, later, in the US and in turn weak growth in emerging markets. Equity valuations and expected earnings still haven't been adjusted properly to this outlook in our view. We therefore retain our underweight in US and European equities.	
Government bonds	**Neutral**
Whereas the ECB and a few other central banks were less aggressive in tone, the Fed surprised markets by warning that interest rates could in fact be raised higher than expected. Yet we believe that the larger part of the interest rate hikes is now behind us in both regions. We have slightly reduced our underweight in Eurozone bonds for this reason. As a result, we hold an underweight in the Eurozone and 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**
A small upturn in yields and marginal tightening of spreads cancelled each other out in the Eurozone, leading to yields on investment grade credits remaining more or less unchanged in October. In the US, the underlying yields on government bonds pushed up yields on investment grade credits. Yields are attractive from a historical perspective. In the US they are higher than dividend yields on equities, although this is somewhat distorted as US companies are returning a relatively large amount of capital to investors via share buyback programmes. We retain our neutral weight owing to the tightening monetary policies and high risk of a recession. Spreads are not yet at levels that match a recession. The default rate remains low but this will rise if the economic tide turns.	
High yield credits	**Neutral**
Spreads on high yield credits tightened more sharply than those on their investment grade counterparts, which in turn led to lower yields. At the end of October yields on these bonds stood at nearly 9% in the US and over 8% in the Eurozone. These may sound attractive but a recession hasn't yet been fully priced in on this market either. In a recession, spreads in this asset class can easily reach 1,000 basis points. Spreads in the US stood at 446 basis points as of the end of October, in the Eurozone at 598 basis points. Although a negative scenario of slowing growth and high inflation has largely been priced in already, we also see downward risks such as lower earnings growth and a higher default rate. It's becoming considerably more expensive for businesses to refinance high yield bonds, which have shorter durations on average than their investment grade counterparts.	
Listed real estate	**Neutral**
Listed real estate has a reputation as being a defensive sector in equities. Moreover, its cashflows are partly linked to inflation. Higher interest rates do pose a threat to this asset class though, including in relative terms versus general equities. Hopes of less tight monetary policies were dispelled at the end of the summer, which led to higher interest rates. This exerted pressure on listed real estate. European listed real estate even dropped to pre-coronavirus crisis levels. In October, when interest rates stabilised somewhat, real estate equities bounced back slightly, albeit to a lesser extent than general equities. The downturn, and subsequent rally in October, occurred in the more interest rate-sensitive sectors (logistics and housing) but also in the more cyclical sectors (office and retail). Listed real estate valuations have fallen, leading us to no longer view the asset class as expensive. Europe is now cheap versus general European equities. Aside from the uncertainty surrounding growth, the higher interest rates have had a substantial impact on listed real estate equity prices. Listed real estate will be able to recover once the interest rate pressure eases, although it's still too soon for central banks to reverse their policies,	
Emerging market debt	**Neutral**
The positive sentiment that prevailed on the financial markets in October caused spreads on bonds listed in US dollars to tighten. In line with the overall picture for yields, however, yields increased on both bonds listed in US dollars and in local currency. A yield of over 9% for bonds in US dollars and 7% for those in local currency is attractive in itself. All the more so because the economies in these countries have improved in a number of respects. Moreover, central banks in these countries have raised interest rates in good time as inflation climbed. However, emerging market debt is vulnerable to a more expensive US dollar, tighter financial conditions and slowing global growth (including in China). Debt levels are generally high in emerging markets. Inflation is high in emerging markets as well but has recently declined somewhat. This pressure could ease if central banks, especially the Fed in the US, were to pursue less tight monetary policies. We've not yet reached that stage though.	

Commodities	Neutral

The announcement by OPEC countries and Russia that they plan to restrict oil production pushed up the oil price. The price of a barrel of Brent oil climbed by 8% to 93 US dollars on balance in October. A much smaller upturn in base metal prices and a drop in the gold price led to the commodity index noting a small plus of 1.7%. Our outlook for a slowing global economy, especially on the goods side, and in turn lower demand for commodities mean that we are not positive about commodities. Uncertain times would normally push up the gold price but the sharp increase in interest rates, especially real interest rates, is preventing this. Following a sharp drop of 27% in September, European gas prices fell by a further 49% in October. This picture looks to be positively distorted by the extremely mild autumn and the fact that gas reserves are well stocked. 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.

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