VAN LANSCHOT
KEMPEN

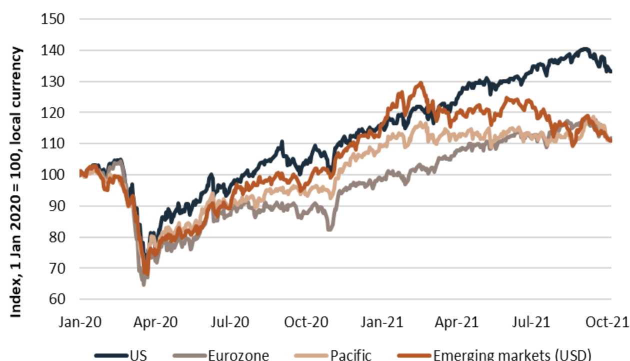
Asset Allocation Outlook

OCTOBER 2021

- Global economy losing some momentum
- Central banks cause shockwave on bond markets
- Equity overweight reduced marginally

Equity markets had a tough time of it in September. Less growth, more inflation, central banks moving towards tapering their highly-expansionary monetary policies and pushing up bond yields in the process, as well as concerns about the Chinese economy, caused many markets to close the month in the red. After noting a loss in January, it was only the second monthly loss for the MSCI global equity index so far this year. The global equity index was down by 4.2% (in US dollars), with little difference between industrialised countries and emerging markets. Europe (-3.5% in euros) held up slightly better than the US (-4.8% in US dollars). Japan was the notable exception at a plus of 3.5% (in yen); markets anticipate a more expansionary fiscal policy there under a new government.

Equity markets take a step back in September



Source: Bloomberg, Van Lanschot Kempen

The higher bond yields meant that fixed income investments could offer little consolation. Returns on government bonds, investment grade credits and emerging market debt were all negative. Yet it's worth noting that the biggest loss, on emerging market debt (-3.4% in US dollars), was smaller than the losses on many equity markets.

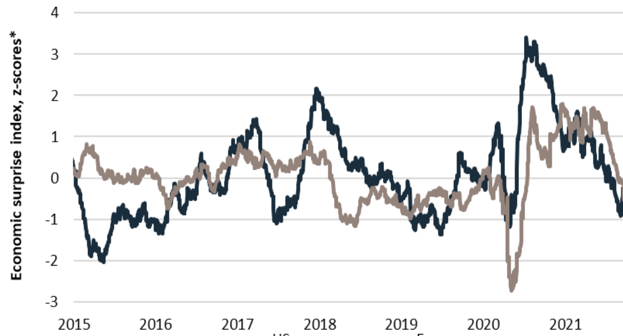
Although the climate is now marginally less positive for equities, we continue to hold an overweight. However, we've decided to take profit on a portion of our overweight and in doing so bring it back in line with our target weight. We will invest the proceeds in a basket of government bonds issued by Eurozone countries.

Less favourable mix of growth and inflation

Global economic growth is slowing somewhat. This is logical given the high levels of growth we've had but is still disappointing. This can clearly be seen from the economic surprise indicators. These indicators compare published economic data to the forecasts. In the summer of last year these indicators peaked at record highs; the economic data were much better than expected. Since then the surprise indicators have been declining steadily and are now pointing to economic data being worse than expected overall.

Purchasing managers are also slightly less optimistic. The global (GDP-weighted) average for the industrial sector dropped to 55.3 in September, its lowest level since February. Last month we noted the slowdown in China and other emerging market economies, and in September the average purchasing manager index for industry in these countries again stood below 50. This points to a further slowdown. Despite declining marginally, these indices are still noting high levels in industrialised countries. Purchasing managers in the service sector became slightly less optimistic in the US and Eurozone but the official data improved in China. This corresponds to the improvement in the number of new coronavirus cases there.

Disappointing economic data



Source: Bloomberg, Van Lanschot Kempen

Consumer confidence is being squeezed more in the US than in the Eurozone or Japan. This is also related to the coronavirus pandemic as the US has been hit much harder by the Delta variant. The tightness on the US job markets ought to be boosting consumer confidence but the end to higher unemployment benefits is negative for a considerable number of households. High inflation forecasts are also denting confidence.

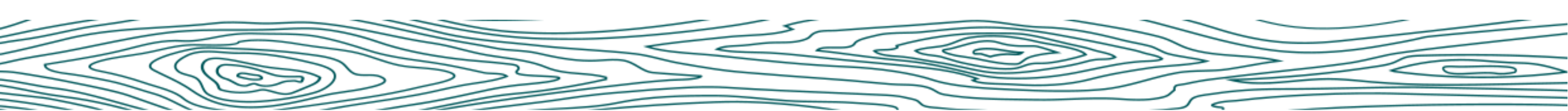
There are two issues specific to China that are having a downward effect on growth. Major property developer Evergrande is at risk of collapsing under its sky-high debts and there are power shortages. Evergrande is a delicate problem for the Chinese government. Its bankruptcy could trigger a financial crisis but the authorities don't necessarily want to save a company that has financed itself in a fairly reckless manner. Another important aspect is to ensure that consumers who have made down payments on new homes don't suffer significant losses. The Chinese government is trying to avoid social unrest at all costs. It's likely that the Chinese authorities will intervene by opting for an orderly restructuring of Evergrande rather than a bailout. Furthermore, state backstops can be relied upon to prevent a full-blown Chinese credit crisis. This will restrict the damage to property values, the financial system and ultimately Chinese economic growth. The groups that will be most affected are private creditors and foreign investors. The losses will not be large enough to have macro-economic implications, however. Yet the tougher approach to Evergrande and other property developers will lead to lower growth in the construction industry, partly also because buyer confidence will briefly be affected. Some estimates of the direct and indirect size of the construction industry put it at as much as 30% of the total Chinese economy. A further slowdown in growth is therefore likely, although a great deal will depend on the policy response. The authorities will mainly implement fiscal measures to restrict the damage.

The power shortages are a direct consequence of policy decisions to import less coal from Australia and meet environmental targets. If the economic impact of this threatens to become too big, it wouldn't surprise us if the Chinese government does a U-turn on these two points. For example, the Chinese authorities have already ordered mining companies in the coal sector to increase production.

On the positive side, with respect to economic data, there was an improvement in leading indicators, such as the ISM manufacturing index in the US, the Economic Sentiment Index in the Eurozone and the Tankan in Japan.

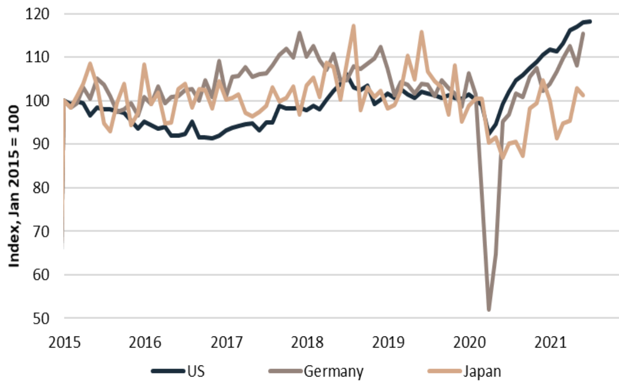
We certainly don't view the economic outlook as gloomy. A slowdown in growth was inevitable, but primarily in the US and Asia due to the prevalence of the Delta variant of the coronavirus. Yet new cases are falling again in general. The economic recovery from the pandemic is still going strong. Higher employment and signs of tightness are boosting family incomes and in turn consumer spending. Moreover, families in the US and Europe have built up substantial savings during the pandemic. Not all of these will be spent, but as the uncertainty gradually abates a larger portion of them will be.

The investment climate is positive: high growth, low stock levels, tightness in production chains, high



levels of corporate profitability and low interest rates. In the US, Germany and Japan there is a clearly visible upturn in orders for capital goods.

Upturn in orders for capital goods



Source: Refinitiv, Van Lanschot Kempen

Despite the marginal slowdown in growth, there are growing concerns about inflation. In the US, the PCE inflation rate – the price index the central bank uses in decision-making – climbed to 4.3% in August. When adjusted for volatile food and energy prices, core inflation has stood at 3.6% for three consecutive months. The base effect (the comparison to the low prices of a year ago) has already dissipated in the US and this means the inflation we're seeing now is more structural. Furthermore, the tightness on the job market – 10.9 million job vacancies versus just 8.4 million unemployed – is starting to exert upward pressure on wages. There are of course also temporary aspects here as well. The tightness on the job market could ease if the labour supply increases further. There is still plenty of capacity for this to happen. And the higher price increases in sectors that have recently reopened will not persist either. Yet Fed Chair Powell reluctantly admitted recently that the high inflation could well persist for longer than previously supposed.

In the Eurozone, inflation rose to 3.4% and core inflation to 1.9% in September. The ECB has adjusted its inflation target slightly from just below 2% to a symmetric target of about 2%. Core inflation is already approaching this level but there are temporary base effects in the Eurozone. Moreover, there are fewer signs of wage pressure. This is logical given that the economic recovery is less far advanced.

Some commentators are already talking of stagflation, an exceptional combination of a stagnating economy and high inflation. We believe this is going too far. There may be inflation but there's no stagnation. The 1970s were characterised by stagflation. Back then, high oil prices led via automatic price indexation of wages to high inflation and stagnating economies. Energy prices (oil but recently also gas) still contain the potential to curb economic growth but are ultimately deflationary given that this would erode consumer spending power now that wages are no longer automatically indexed. There is also a lesser impact from higher energy prices because energy forms a smaller portion of expenditure than it did in the 1970s.

Sharp upturn in bond yields

After Fed Chair Powell's de facto announcement in Jackson Hole in August that the US central bank would start to taper its bond-buying programme at the end of the year, Fed watchers (including the author of this publication) were curious as to whether the press conference following the policy meeting on 21 and 22 September would provide greater clarity. We were not disappointed. Powell repeated his intention to start scaling back quantitative easing at the end of this year but went even further by saying that the Fed would finish the process in the summer of 2022. This translates into monthly reductions of 15 billion US dollars in order to reduce the current monthly amount of 120 billion over an eight-month period. Powell stressed once more that tapering and interest rate hikes are separate issues and that stricter criteria apply to raising interest rates. Yet the policymakers within the Fed do now predict earlier and more interest rate hikes than was the case back in June. Half the Fed's policy committee members now anticipate at least one increase to rates before the end of 2022. The average prediction is now cumulatively four interest rate hikes by the end of 2023 and a further three in 2024. As mentioned earlier, Powell was forced to admit that the current inflation is less temporary than previously supposed and that tightness in production chains could persist for longer.

Rate hike in December 2022 now fully discounted

Source: Bloomberg, Van Lanschot Kempen

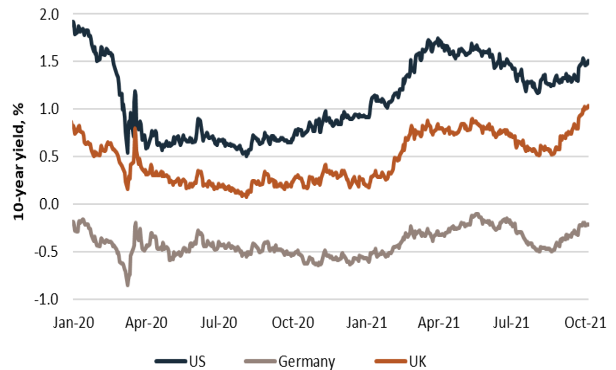
All in all, a fairly aggressive outcome to the Fed meeting. Yet initially capital market yields barely reacted to the news. During Powell's press conference, yields on 10-year government bonds climbed from 1.30% to 1.35%, only to drop back to the original level.

That didn't last long, however. On 23 September, the Bank of England held a meeting on monetary policy. A previous meeting had already discussed moderate monetary tightening during the bank's forecast period but this time the discussion was more explicit. There was even mention of the option of raising interest rates before the bond-buying programme ends in December. That would imply an interest rate increase in November. We don't believe it will happen that quickly, an interest rate hike early in 2022 is more likely.

And then there was the central bank of Norway. The Norges Bank isn't normally a central bank that triggers movement on the markets. Yet on 23 September the Norges Bank became the first G10 country to raise official interest rates and that certainly attracted attention.

We knew the day would come but now it's finally here: we've long known that interest rates are extremely low compared to the levels of economic growth and inflation. And we've also long been aware that central banks would start to adjust their extremely expansionary monetary policies at some point. Yet a shockwave still went through the bond markets at the aggressive news from these central banks. US 10-year government bond yields rocketed from 1.30% on 23 September to 1.56% on 28 September. They then fell again slightly, but a further upward trend was visible when ECB President Lagarde and Vice-President De Guindos proved to be slightly more circumspect about the rising inflation. In Germany, 10-year government bond yields still stood at -0.5% in August but have recently risen to -0.2%. In the UK, the 1% barrier was broken for the first time since June 2019.

Central banks drive up bond yields



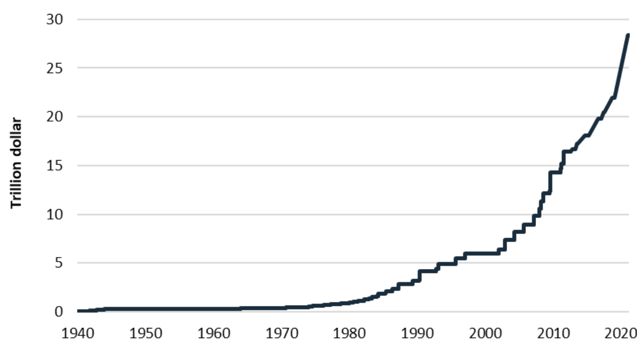
Source: Bloomberg, Van Lanschot Kempen

At a macro level this is far from being a disaster. It may be that central banks are even pleased with the measured response from markets. After all, bond yields in the US and Germany are still below the levels touched on in the spring. Equity markets responded negatively, however. This prompted us to take some more profit on our equity position, which had already surpassed our target weight as a result of the positive market trends of the past few months.

Are the difficult budget negotiations in the US playing a role? There's a lot going on here. Agreement still needs to be reached primarily within the Democratic party on a large-scale infrastructure programme (500 to 1,000 billion US dollars, depending on how many previous policy plans are included) and on an expansion of a variety of social programmes up to 3,500 billion US dollars. Despite the dizzying sums involved, we don't believe this is having much impact on current bond yields. The programmes cover many years and would mainly be financed through higher taxation. As a result this would only have a minor effect on growth and inflation. A partial government shutdown caused by the absence of a budget has been staved off until early December. Yet even so this type of shutdown doesn't usually cause turmoil on the bond markets. What would have an enormous impact is not raising the debt ceiling in time. This self-imposed limit means that the US government may not issue more

than a maximum of 28.4 billion US dollars in debt. According to Treasury Secretary Yellen, this limit will be reached on 18 October. If the limit is not raised, a default on US sovereign debt will follow, which would be catastrophic for the US and global financial systems. The enormous consequences mean there's only a tiny risk of default, but the verbal sparring between the Democrats and Republicans will continue right up to the last moment. We don't anticipate any major impact on the bond markets.

US debt ceiling already raised 106 times since 1940



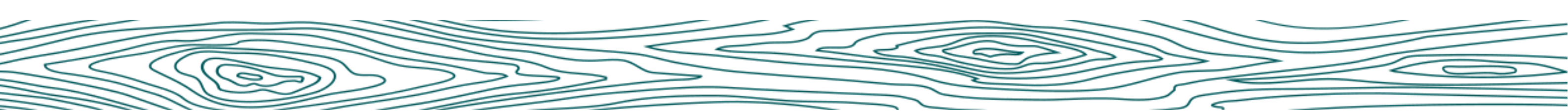
Source: Bloomberg, Van Lanschot Kempen

Partial profit-taking on equities

In our investment policy we're taking some profit on our overweight in equities. As equity markets have rallied strongly over the past few months, the equity weight in our model portfolio has grown and is now higher than the target weight we had set ourselves. We're now bringing the overweight back in line with this target.

We continue to be positive about equities. While we recognise that there are concerns, such as a less favourable mix of lower growth and higher inflation, higher bond yields and a slowing Chinese economy, we also see positive factors, such as the persisting economic recovery and in particular robust earnings growth. The high valuations in the US, the higher risk of interest rate increases and higher sensitivity to interest rates of US equities lead us to maintain our preference for European equities.

We spent some time debating whether to sell equities as we had no clear preference for an asset class in which to invest the proceeds. We recently took profit on real estate, while we already hold an overweight in gold within commodities and returns on bonds are being squeezed by the higher yields. Our cash position is large enough already. We eventually decided to reduce our underweight in government bonds marginally. Even after this transaction we continue to hold a substantial underweight in this asset class. We will buy a basket of bonds issued by Eurozone countries on which in the wake of recent upturns the yield is now precisely zero. By investing in this liquid asset class, we're keeping open the option of quickly switching if we identify other opportunities.



Market review

Equities				
	Index	Past month	Past 3 months	From 31-12-2020
Global (MSCI AC)	1236	-5.5%	-2.6%	9.2%
Developed markets (MSCI World)	2993	-5.4%	-1.7%	11.3%
Emrging markets (MSCI EM)	1236	-6.0%	-8.8%	-4.2%
United States (S&P500)	4300	-5.2%	-1.2%	14.5%
Eurozone (EURO STOXX 50)	3996	-4.9%	-2.2%	12.5%
United Kingdom (FTSE 100)	7011	-1.8%	-1.6%	8.5%
Japan (Topix)	1974	-2.1%	0.9%	9.4%
Netherlands (AEX)	757	-4.1%	3.2%	21.2%
Government bonds (10-year)				
	Yield (%)	Past month (bp)	Past 3 months (bp)	From 31-12-2020 (bp)
United States	1.48	16	6	57
Japan	0.05	1	1	3
Germany	-0.21	15	2	36
France	0.14	15	4	47
Italy	0.75	75	-84	32
Netherlands	-0.09	15	3	40
United Kingdom	1.01	29	31	81
Investment grade credit				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2020 (bp)
United States	85	-3	3	-11
Eurozone	85	0	2	-7
High yield bonds				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	From 31-12-2020 (bp)
United States	293	14	26	-67
Eurozone	313	21	19	-45
Emerging markets (USD)	364	23	19	12
Emerging markets (Local currency)	370	-2	-7	-12
Real estate				
		Past month	Past 3 months	From 31-12-2020
Global		-4.2%	-1.0%	19.7%
North-America		-4.1%	2.6%	28.5%
Europe		-7.2%	-1.8%	7.5%
Commodities				
		Past month	Past 3 months	From 31-12-2020
Bloomberg index		5.1%	7.5%	30.8%
Base metals		0.6%	3.9%	25.8%
Brent oil (USD per barrel)	81.26	12.9%	10.1%	60.1%
Gold (USD per troy ounce)	1768	-3.5%	-0.9%	-6.7%

Returns in local currency
bp = basis point (0.01%)
Data as of 5 October 2021
Source: Bloomberg

Tactical outlook

Asset class	
Equities	Positive

Economic growth is slowing slightly and inflation proving to be more persistent than previously supposed. On balance this is a less favourable combination for equities. Yet the downturn in the wave of new coronavirus cases caused by the Delta variant is positive. In this type of climate, corporate earnings are providing a boost to markets. Corporate results are robust, far exceeding expectations, and forecasts continue to be adjusted upwards. We also continue to be positive about value equities. These are overrepresented in sectors that were greatly affected by the coronavirus pandemic. If the recovery persists, the style rotation could get going again. We prefer European equities for these reasons, as they're traditionally also less affected by higher bond yields. Emerging market equities are attractively valued versus their US counterparts but there's little difference versus Europe or Japan. In a slowing global economy and given the negative risks relating to the Chinese economy, we've decided to retain our neutral position. We're reducing our equity overweight marginally though, primarily because it had exceeded our target weight following the strong price rally.

Government bonds	Negative

The prospect of the relatively rapid tapering of the bond-buying programme by the US central bank, the Fed, the possibility of the UK raising interest rates again for the first time and an actual interest rate increase in Norway sent a shockwave through bond markets. Yet despite the sharp upturn in 10-year bond yields in the US, Germany and the UK, yields are still historically low. We therefore believe that yields will rise further and see the greatest risk of this happening in the US. We assume that any excessive increases will be countered by policy adjustments. For instance, the Fed could adjust the pace of its planned quantitative easing tapering (to finish in the summer of 2022). We continue to hold a negative outlook for government bonds.

Investment Grade credits	Neutral

Spreads again remained virtually unchanged in September. Although spreads are low, we don't expect them to widen significantly, especially in the Eurozone. The economic outlook continues to be sound to good and the ECB is concentrating more on how it will continue to shape its expansionary monetary policy than how to reverse it. The US Fed is also being prudent about tapering its stimulatory policies. Yet it is expected to start doing so at the end of 2021, which could cause spreads to widen over the course of 2022. Our neutral outlook mainly reflects the fact that we don't anticipate any major changes to spreads. The risk of higher underlying capital market yields is expressed in our underweight in government bonds.

High Yield credits	Positive

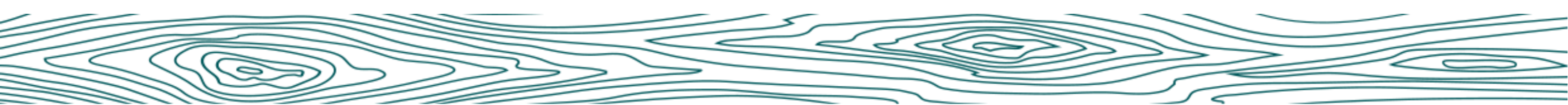
Spreads in the High Yield segment also barely changed in September. The negative effect of higher capital market yields was almost entirely offset by the coupon payments. Credit rating agencies have systematically adjusted their forecasts for default rates downwards. We believe that the current economic recovery will be enough for these to be adjusted downwards even further. This has led us to view the current spreads on High Yield as slightly attractive, with a preference for Europe due to its lower credit risks. In the Eurozone, the difference between spreads on High Yield and on Investment Grade credits is higher than the 5-year average.

Listed real estate	Neutral

Listed real estate was hit hard in September. Losses varied from 8.6% in Europe and 6% in the US to 3.7% in emerging markets. This marks the end of the recovery of the past few months in the US and Europe. In addition to hesitancy in sectors that are reopening (retail, offices) owing to the Delta variant, higher bond yields have caused some jitters in the other real estate sectors. Retail real estate continues to lag behind given the uncertainties surrounding the Delta variant, combined with the potential long-term impact of online shopping. There are positive signs of customers returning to physical stores in the US, however. Office prices are buoyant, especially in A-list locations, despite the trend towards working from home and potential ESG measures for buildings. The logistics and data centres sectors have profited from more people shopping and working from home, residential property markets and the rental sector are holding up well, although these sectors are relinquishing some of their price gains due to profit-taking and slightly less flexible lending conditions. Following the robust upturn in this asset class, which continues to be swathed in uncertainties, we hold a neutral outlook.

Emerging market debt	Neutral

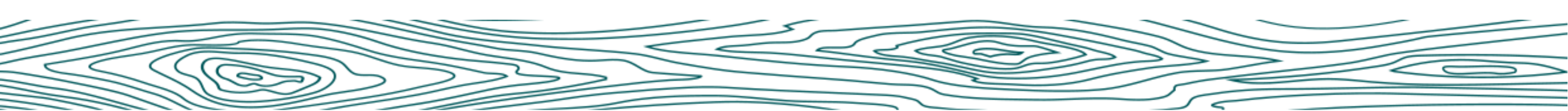
The turbulence on the equity and bond markets in September didn't go unnoticed on the emerging market debt market. Bonds listed in US dollars had to digest a loss of 2.1%, while bonds in local currency were down by 3.4%. We view the interest compensation as attractive. Spreads on bonds listed in US dollars are less tight in relative terms than on Investment Grade and High Yield credits. The US central bank's planned tapering of its bond-buying programmes is a risk due to the potentially higher yields and a stronger US dollar. Local currencies are grappling with central banks that are raising interest rates, including in Brazil and Russia. Emerging markets are in better shape than they were at the time of the 2013 taper tantrum and markets are better prepared, which serves to reduce the risk of turbulence on these markets. On balance we hold a neutral position.



Commodities	Positive
The overweight in commodities consists entirely of gold. Gold occupies a diversifying role in the portfolio. This role is traditionally reserved for government bonds but the extremely low yields are making that increasingly difficult. Gold does of course involve a much higher level of risk than government bonds and this has led us to adopt a small overweight. Gold failed to profit from the turbulence on the financial markets in September. Its price dropped by 2.5% but is still lower than the sharply negative real US interest rates would suggest. Oil and gas prices climbed sharply in September but base metal prices declined somewhat. This is partly due to the data from China pointing to a slight slowdown in economic growth. For the time being the oil-producing countries, grouped together in OPEC+, are adhering to their step-by-step production increases, but we believe there is capacity to ramp up oil and gas production if the upward price pressure persists. Although a severe winter in the Northern hemisphere would keep prices high, the upward price pressure could be temporary if oil and gas production is increased. We consequently hold a neutral outlook for energy prices.	

JOOST VAN LEENDERS
Senior investment strategist
joost.vanleenders@kempen.nl
+32 (0)495 23 14 31

VAN LANSCHOT KEMPEN ASSET RESEARCH & COMMUNICATION:
Yaela van Raalte – Head ARC
Michel Iglesias del Sol – Head investment strategy
Luc Aben – Chief economist Van Lanschot
Nikesh Patel – Head investment strategy UK
Alastair Greenlees – Senior investment strategist
Arif Saad – Senior investment strategist
Duco Smit – Senior investment strategist
Jorn Veeneman – Investment strategist
Mees Vlasveld – Investment strategist



DISCLAIMER

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

OTHER INFORMATION

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