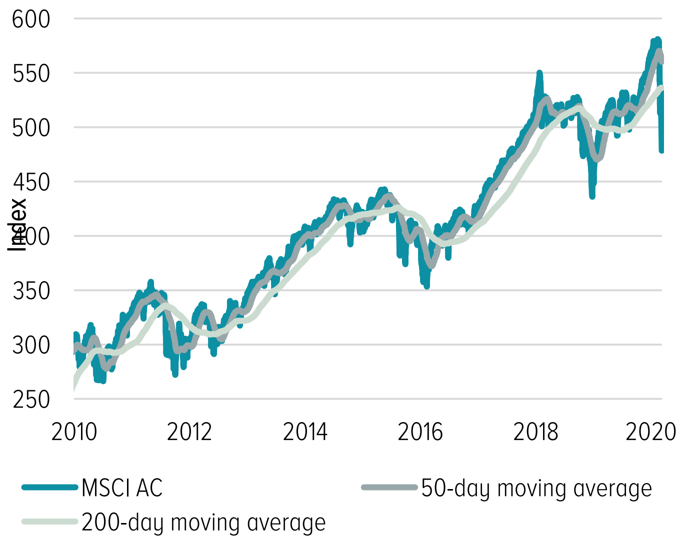
Asset Allocation outlook

March 2020

- Great uncertainty about the economic impact of the corona virus
- Deep correction on equity markets
- Position in corporate bonds reduced, equities purchased

It took a while for the corona virus to really infect the financial markets. But when it spread also outside of China, things went fast. The stock markets dropping 15% in one week was virtually unknown. When oil prices also tanked following a dispute between Saudi Arabia and Russia, markets panicked.

Global equities crash due to coronavirus



Source: Bloomberg, KCM

The question now is whether the corona virus will cause a worldwide recession or not. In our asset allocation we have reduced our exposure to corporate bonds, but after the panic on equity markets we have bought equities. We remain underweight equities though.

CORONA VIRUS CAUSE OF VERY INSECURE ECONOMIC OUTLOOK

The corona virus has a strong impact on the world and its financial markets. Last month, we already questioned comparisons with SARS, as this virus mainly affected a number of Asian countries in 2003. The corona virus is quickly spreading around the world with concentrations in not only China, but also in South Korea, Iran and Italy. The interdependence of our economies has become clear in the number of countries that have reported illnesses. The 90,000 registered infections have now been spread over no less than 75 countries.

It's clear that this will have major consequences for our global economy. Its growth will virtually stop in the first quarter and a quick recovery in the second quarter is becoming more unlikely every day. There will undoubtedly be countries entering a technical recession: a period of economic contraction in two consecutive quarters. In these circumstances, economic indicators are less valuable than normal. Many figures that are currently published date from the period before the outbreak of the corona virus. Somewhat encouraging in this respect is that the growth momentum of the global economy was improving in December and January. But given the uncertainties surrounding the impact of the corona virus, the importance of these figures is limited.

Then they are figures that show the impact of the corona virus: purchasing manager indices in China

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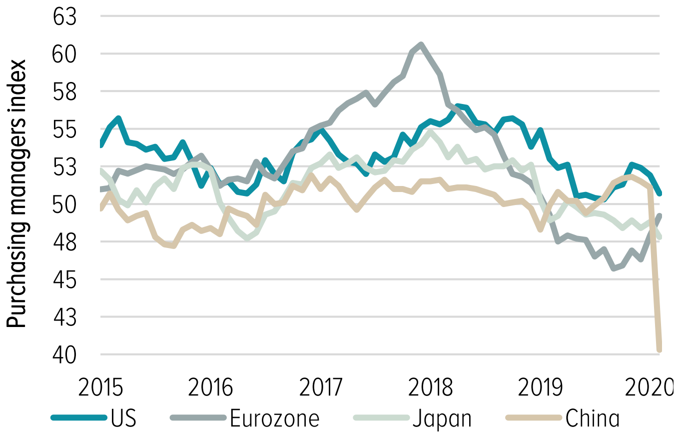
collapsed to new record lows in March in both the industry and the service sector. The situation was somewhat less severe in the US and the eurozone. The surveys were partly completed before the virus spread to the US and Europe, partly for a technical reason: the delivery times of suppliers increased as the production in China came to a standstill. Increasing delivery times are positive for the calculation of purchasing manager indices, as this implies more economic activity. The opposite is the case at the moment. The purchasing manager indices are therefore somewhat weaker in reality. In a number of Asian countries the indices fell back below 50, indicating a decline in economic activity. But even the value of such indicators can be disputed. The impact of the virus is significant, but this doesn't tell us anything about its duration. In China, the epidemic seems to have reached its peak, but this isn't the case in the rest of the world.

Chinese producer confidence plunges to record low



Source: Bloomberg, KCM

For now, we are trying to look at data that provide insight into the current economic activity. An example is the daily consumption of coal in China. A few weeks ago, this was about 40% below normal. It's still 30% now. The housing market, that had almost come to a standstill, is also increasing again. The same goes for shipping. Daily figures on traffic activity show that the Chinese economy is slowly recovering. A Chinese Apple supplier expects to have returned to its normal capacity by the end of March. At the same time, western companies strongly restrict their employees' travels, and congresses and other large-scale activities are being cancelled. It's impossible to predict how long this negative impact will last.

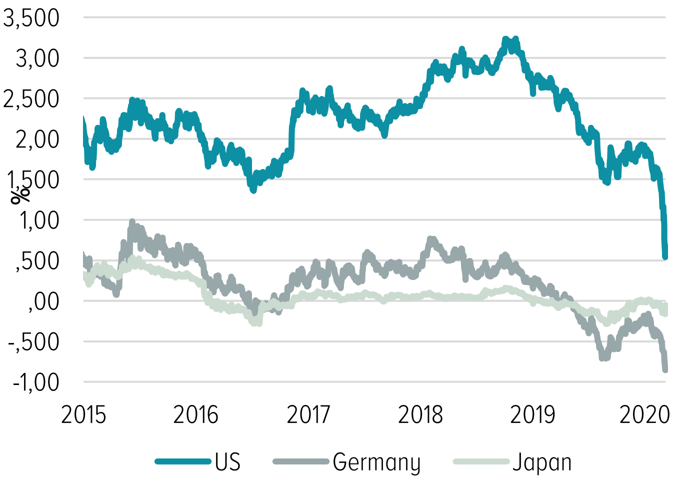
As this weakness occurs in the first quarter, it has major impact on the growth of the entire year. For example, if the Chinese economy shrinks by 2% in the first quarter compared to the last quarter of 2019, followed by a rapid recovery of 2% in the second quarter and a 1.5% trend growth in the third and fourth quarter, then annual growth nevertheless falls back to 2.7%. Considering this, the OECD's downward adjustment of the global economic growth by 0.5 to 2.4% is not so bad.

GREAT ANXIETY ON THE MARKETS

With much uncertainty surrounding the economic impact of the corona virus, it's not surprising that financial markets are extremely nervous. The S&P500 falling by more than 10% in one week, as occurred in the last week of February, has only happened twice before since the most recent financial crisis. Even real estate, that usually benefits from lower interest rates, shows substantial losses.

Before the outbreak of the corona virus, TINA (There Is No Alternative) was the adage of many investors. The price increases and the dividend yield on stocks looked so good with the low interest rates and risk premiums on bonds that there would be no alternative to stocks. But in these stressful times, investors still turn to government bonds. The fall in US 10-year interest rates is unprecedented. This yield fell to a historic low of 0.54%. The new record low for German yields is even -0.86%.

Strong declines in US and German 10-year yields



Source: Bloomberg, KCM

Risk premiums on corporate bonds remained quite stable at first, but now they have also increased. The same goes for risk premiums on government bonds from southern European euro countries. Gold is still a safe haven. The gold price reached its peak since the beginning of 2013 and is 27% higher than a year ago. Traditionally, the US dollar is also considered as a safe haven, but as interest rates are now decreasing faster in the US than in the eurozone, the dollar has actually depreciated against the euro.

DOES A BROADER MONETARY AND FISCAL POLICY HELP?

As the turmoil in the financial markets increased, the wish for a broader monetary policy did too. Hopes actually got up so high, that the US stock market strongly recovered from earlier losses on the first trading day in March. The question is, however, whether a broader fiscal or monetary policy can really turn the tide. The effects of fiscal policy come with a delay and when economies come to a standstill because employees have to be quarantined, the effect will be limited anyway. The same goes for a broader monetary policy. In these times, consumers and businesses won't borrow more money because interest rates go down. But a broader monetary policy does show that central banks are ready to prevent a liquidity crisis in the banking system. And it also provides some counterbalance to the tightening effects of higher risk premiums on bonds and falling stock prices.

The G7 countries have announced to be ready to take measures, but their communiqué wasn't very concrete. A number of central banks in emerging markets has further lowered the interest rates and the governments of South Korea and Hong Kong have announced substantial fiscal stimulus measures. The Fed was the winner with the unexpected announcement of an interest rate cut of 50 basis points on 3 March. The markets did take such a reduction into account at the policy meeting of 17 and 18 March, but this interim cut wasn't even speculated. Yet this seemed to make little impression; the S&P500 closed that day at 2.8% loss. Volatility remained high in the following days.

The uncertainty was further increased when oil prices tanked. A dispute between Saudi Arabia and Russia over production cuts, led Saudi Arabia to open the taps. A low oil price is positive for consumers and oil consuming companies, but in the current environment initially negative. In a fragile situation it increases pressure on oil producing countries and companies. Especially in the US energy companies make up a significant part of the high yield corporate bond markets. So this is a market where problems could emerge.

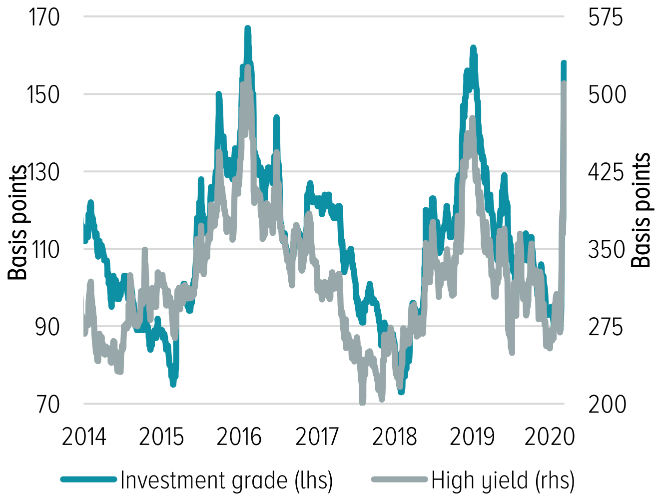
We think it's especially important for central banks to fulfil their role as 'lender of last resort'. When businesses get into payment difficulties and banks grant deferral of payment, then these banks must in turn be supported by the central banks. We're sure that centrals banks will do this by the way.

LIGHT AT THE END OF THE TUNNEL?

Is there light at the end of the tunnel or is it an oncoming train? In China, the number of daily new cases is decreasing. This also seems to be the case in South Korea. It could indicate that the virus has reached its peak and the rest of the world will follow. Restrictive measures have been loosened in a number of Chinese provinces, but what will happen when the Chinese return to work? In Italy, the number of infections is still increasing considerably and many infections elsewhere in the world can be traced back to this country. Testing options in the US were initially limited, which may point at an underestimation of the prevalence of the corona virus.

In our investment policy, we reduced some risk at the end of February by selling safe European corporate bonds. Given the low risk premium and therefore also the low yield, our consideration in this investment category was already a topic of discussion. The deteriorated economic outlook and the fact that risk premiums initially didn't deliver much were both reasons to reduce the allocation.

Eurozone risk premia surge



Source: Bloomberg, KCM

Earnings expectations are currently being adjusted downwards, which probably won't come to an end any time soon. A second year without profit growth seems a very likely scenario in 2020, but the expectations are not there yet. At the same time, considerably lower earnings are being discounted in stock markets. After a roughly 20% correction we think markets discount a more realistic scenario than some weeks ago. The correction also caused our underweight to have become larger than we wanted. We therefore purchased equities. By buying US equities our regional allocation is neutral, while we remain somewhat underweight on global equities.

We left our position in emerging market bonds in the US unchanged. After some hesitation, the risk premiums have also ended here. The damage is partly reduced by the lower capital market interest rate in the US. We don't foresee any problems coming from the depreciation of currencies of emerging markets either.

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MARKET OVERVIEW

Equities				
	Index	Past month	Past 3 months	Year to date
Global (MSCI AC)	948	-16.6%	-12.6%	-15.3%
Developed markets (MSCI World)	1995	-17.0%	-13.0%	-15.4%
Emrging markets (MSCI EM)	948	-13.2%	-9.8%	-15.0%
United States (S&P500)	2747	-17.5%	-12.4%	-15.0%
Eurozone (EURO STOXX 50)	2959	-22.1%	-19.4%	-21.0%
United Kingdom (FTSE 100)	5966	-20.1%	-17.5%	-20.9%
Japan (Topix)	1389	-19.8%	-19.3%	-19.3%
Netherlands (AEX)	491	-20.4%	-18.5%	-18.8%
Government bonds (10-year)				
	Yield (%)	Past month (bp)	Past 3 months (bp)	Year to date (bp)
United States	0.54	-104	-128	-138
Japan	-0.16	-13	-16	-15
Germany	-0.86	-47	-55	-67
France	-0.38	-25	-39	-50
Italy	1.25	48	32	1
Netherlands	-0.65	-36	-48	-59
United Kingdom	0.16	-41	-60	-66
Investment grade credit				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	Year to date (bp)
United States	171	75	70	78
Eurozone	158	67	58	65
High yield bonds				
	Risk premium (bp)	Past month (bp)	Past 3 months (bp)	Year to date (bp)
United States	642	288	292	306
Eurozone	510	224	234	249
Emerging markets (USD)	471	164	156	180
Emerging markets (Local currency)	460	79	78	83
Real estate				
		Past month	Past 3 months	Year to date
Global		-15.6%	-13.7%	-11.3%
North-America		-17.7%	-15.9%	-13.5%
Europe		-13.0%	-9.0%	-10.9%
Commodities				
		Past month	Past 3 months	Year to date
Bloomberg index		-9.1%	-12.8%	-15.9%
Base metals		-2.5%	-6.8%	-9.1%
Brent oil (USD per barrel)	34.36	-37.3%	-44.6%	-46.9%
Gold (USD per troy ounce)	1676	6.5%	14.4%	10.0%

bp = basis points (0,01%)
Data per 10 March 2020
Source: Bloomberg

TACTICAL FORECAST

Asset category	
Shares	Negative

After the corona virus had spread from China to neighbouring countries and Europe and the US, stock markets could no longer account for this as a regional and transient problem. Substantial corrections followed worldwide. Profit expectations are now being adjusted downwards, even though we think that they are still quite high for the whole of 2020. More stimulative monetary and fiscal policies may reduce the negative sentiment somewhat, but the consequences for the real economy will be limited. After the correction in equity markets our underweight had become larger than we wanted, so we bought US equities. We stay modestly underweight, while our regional allocation is neutral.

Government bonds	Negative

Capital market interest rates have dropped considerably following the corona virus outbreak. Capital market rates are still above the low point in Germany, in the US a level below 1% has never happened before. Low growth, a low inflation and broad monetary policy argue for low interest rates. However, especially in Germany, interest rates are still extremely low compared to growth and inflation. Hence our short duration position in these bonds, with which we invest on rising interest rates. We have a positive allocation to US government bonds because of the higher interest rates. We haven’t hedged the exchange rate risk, as that would undo the difference in the interest. On balance, our exposure to interest rate risks is still negative.

Corporate bonds Investment Grade	Neutral

The recent turmoil in the financial markets has left the Investment Grade market largely unaffected. More recently, risk premiums have risen, but this has largely been undone by falling interest rates on government bonds. Given the deteriorating economic outlook, we no longer find the yield on safe corporate bonds attractive because of the risk of increasing risk premiums. Reducing the allocation to this investment category also fits a lower risk profile for the entire portfolio.

Corporate bonds High Yield	Neutral

High-Yield corporate bonds suffer a little bit more from the corona virus than Investment Grade does. Which makes sense given the sharper financing of companies in the high-yield sector, the smaller size and the minor diversification of the businesses. Low economic growth and low inflation limit the scope for further falls in risk premiums. The possibility of disappointing growth makes this investment category vulnerable at the current levels. Signs of deterioration in adjacent markets, such as the loan market, can also infect the High Yield market. Given the geopolitical and macroeconomic uncertainties and the often sharp financing of the companies concerned, the extra return on these bonds is considered to be insufficient.

Listed real estate	Neutral
The market turmoil surrounding the corona virus has led to a major correction in real estate in emerging markets. After the virus had spread outside of China, markets in the US and Europe were facing the same scenario. Lower interest rates could not prevent the sharp correction. The effect of lower economic growth and therefore possibly lower rental income was dominating. In the longer term, listed real estate is a category that performs well in the later phase of the economic cycle - when inflation rises faster than interest rates. But that's currently not the case. The discussion concerning the maximisation of rents for homes doesn't have a positive effect on this investment category either.	
Government bonds emerging markets	**Positive**
We see a similar response to the corona virus for government bonds from emerging markets denominated in US dollars as for Investment-Grade corporate bonds. Higher risk premiums are partly compensated by lower interest rates in the US. The interest on bonds in local currencies has fallen, but on the other hand the currencies have lost some value. Given the low degree of currency depreciation, central banks in many emerging countries still have room to further lower the policy rate. Broader monetary policy in the US also limits the risk of a stronger US dollar. With an interest rate of around 5% we find bonds in US dollars attractive.	
Commodities	**Neutral**
Commodities have responded quite well to the corona virus outbreak. The prices of oil and copper have fallen, while the gold price was able to maintain a high level. A late-cyclical environment with continued growth and increasing inflationary pressure is traditionally positive for commodities. However, the low growth that we foresee means that demand is not sufficient to create a strong price pressure for industrial commodities/metals. With a continuation of the Chinese stimulation program, however, this might change. With moderate growth and the flexibility of American shale producers, there is no lack of oil.	

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