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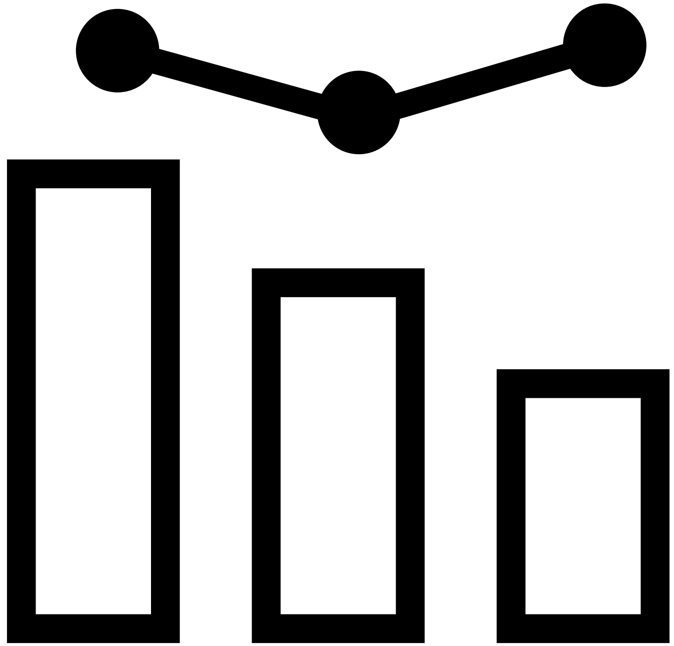

Marketupdate

8 december 2022

November 2022: broad recovery on the back of lower interest rates

The final quarter of 2022 has so far been a great improvement on the first three quarters for the financial markets. Nevertheless, all asset classes are still trading at a full-year loss, not least bonds and property.

The positive returns on investment in November (and October) are seemingly all thanks to one defining factor: lower interest rates. The ten-year yield on Dutch government bonds from January to October this year, for example, went from 0% to approx. 2.75%, but is now falling again to around 2%. Interest rates also went down in most other European countries and the US this quarter. Lower interest rates translate into positive returns on bonds, which is exactly what we saw in November: European government bonds delivered an average return of 2.4% this month.

Other asset classes also benefit from lower interest rates. European stock market prices added nearly 7% on average in November. Asian stock markets and emerging markets fared even better, with monthly returns of over 10%. Returning approx. 1%, US equities clearly lagged in November, mostly because of the euro/dollar exchange rate.

The euro strengthened over 4% against the US greenback in November. Measured in dollars, returns on US equities were pretty similar to those on European equities.

Other asset classes yielded returns halfway between those on government bonds and equities. European corporate bonds gained almost 3% in November, while the riskier high yield corporate bonds and listed property posted monthly returns of around 3.5%.

In spite of the recovery set in at the beginning of this quarter, 2022 to date has been a poor investment year. Shedding over 10%, bonds especially – which are deemed relatively 'safe' – performed exceptionally poorly in the past year. The recent pick-up in equity prices in particular seems to have contained the damage somewhat for equities this year. The same cannot be said for listed property, which, at a return of nearly 40% since the beginning of the year, has been the worst performing asset class by far.

The returns on the various asset classes were as follows:

Returns (total return, in euros)	Nov.	Q4	2022	12 mos.
Bloomberg Barclays Eurozone Staatsobligaties	2.4%	2.6%	-14.5%	-15.9%
Bloomberg Barclays Euro Bedrijfsobligaties	2.8%	2.9%	-12.1%	-12.2%
Bloomberg Barclays Euro High Yield Bedrijfsobligaties	3.6%	5.5%	-10.0%	-9.2%
MSCI Europe Onroerend Goed	3.4%	8.7%	-39.1%	-38.5%
MSCI Europe Aandelen	6.9%	13.5%	-6.2%	-1.0%
MSCI North America Aandelen	1.1%	7.6%	-6.1%	-2.5%
MSCI Asia Pacific Aandelen	10.3%	6.7%	-8.9%	-7.2%
MSCI World Developed Markets Aandelen	2.5%	8.3%	-7.5%	-3.7%
MSCI Emerging Markets Aandelen	10.2%	5.3%	-11.0%	-9.4%
EUR/USD	4.2%	5.6%	-8.9%	-8.9%

Bron: Bloomberg

Lower long-term rates, but higher short-term rates

The drop in long-term rates of the past few weeks is striking, as central banks (at least in Europe and the US) have in fact voiced their intention to further hike their base rates over the coming period. In the eurozone, the ECB already raised its key interest rate by 2 percentage points in the past few months, but seems disinclined to leave it at that just yet. Fixed income markets assume that there are at least another three to four rate hikes in store, which will bring the European base rate to 2.75% to 3% in the spring of 2023. On the other side of the Atlantic, the Fed has been raising interest rates for longer, but there too, expectations are that the central bank has not quite finished. The US base rate has been raised from 0% to 4% since the spring of 2022, but the fixed income markets believe that the Fed will continue until eventually (i.e. in the spring of 2023) reaching a base rate of 4.75% to 5%.

While central banks are keeping busy hiking rates, the long-term rates on government bonds in fact dropped in the past few weeks. The European benchmark rate – the ten-year euro swap rate – fell from its peak of over 3.25% in mid October to around 2.5% at the end of November. US ten-year yields show a similar picture, although coming down from a higher level: 4.25% in mid October versus around 3.5% today. As such, the gap between long-term and short-term rates, which mostly move in pace with central banks' key interest rates, has narrowed considerably – in other words, the yield curve has seriously flattened. In the US, short-term rates are even a little above long-term rates, which constitutes an inverse yield curve.

Fixed income markets (and economists) are factoring in an imminent winter recession

In the past, an inverse yield curve has frequently been a harbinger of an upcoming recession. The logic behind this is that central banks tend to raise interest rates in good times in order to slow down economic growth and/or inflation. When central banks raise interest rates too much, for example because inflationary pressures are not subsiding strongly or fast enough, they push the economy into recession. When government bond investors see such a scenario unfolding, long-term rates usually increase at a slower pace than short-term rates, or they might even decrease, as is the case now. Another indication that fixed income markets are bracing themselves for a recession, at least in the US, is their current expectation that the Fed will be forced to lower interest rates again as early as the second half of 2023. As such, fixed income markets in fact already assume that the US economy will be in recession at that time and/or that US inflationary pressures will have considerably diminished by then.

But it is not just fixed income markets that believe there will very probably be a recession in the months ahead. According to a Bloomberg ‘recession indicator’, economists now estimate the likelihood of a recession at 80% for the eurozone and 62.5% for the US. For the eurozone, economists assume that the recession will set in even this quarter (or has already set in) and will persist in the first few months of 2023. For the US economy, estimates are that it will sink into recession in the first six months of 2023. That said, the recession is not expected to be very deep in either the eurozone or the US. The eurozone can expect economic contraction of approx. 0.5% on a quarterly basis in both this quarter and Q1 2023, whereas US economic contraction will be even more limited in the first half of 2023.

Confidence indicators also point to imminent recession, but the labour market does not (or not yet)

The deteriorating economic growth prospects are also reflected in the development of confidence indicators. Producer confidence indicators have now dropped to below-average levels both in the eurozone and in the US and China. Even though they have not – yet – fallen to levels that would signal a deep recession (as in the spring of 2020), this is certainly worrying. Consumer confidence in Europe has meanwhile improved a little in October and November, but from a 40 year low. In the US too, consumer confidence seems to be stabilising somewhat of late, after deep troughs in the preceding months. Surprisingly, the low level of business and consumer confidence is hardly felt in the job market. At 3.7% and 6.5% respectively, unemployment is still at a historic low in both the US and the eurozone. Unfortunately, this says little about the likelihood of an impending recession, as job market data is a lagging indicator, i.e. the job market usually deteriorates only when a recession is already nearly over.

Still, a silver lining in the moderate macroeconomic data is that the inflation wave of 2022 seems to have peaked. This is especially true for the US, where inflation has by now dropped from 9.1% year-on-year in June to 7.7% in October. This was in part on the back of lower prices for food and energy, but the 'core inflation' (which does not include the volatile food and energy prices) also showed a stronger than expected decline in October, falling to 6.3% year-on-year. Peak inflation might also be behind us in the eurozone, where headline inflation showed an unexpectedly sharp drop from 10.6% to 10.0% year-on-year in November and core inflation was rooted at 5.0% year-on-year for the second month in a row. Inflation in the Netherlands went down quite strongly in November, from a historic 16.8% to 11.2% year-on-year, but this is of course still well above the average.

Moderate economic outlook argues for lower 'peak rates', but not yet for interest rate cuts

For the time ahead, a worsening of the macroeconomic landscape combined with a further easing of inflationary pressures does not seem unlikely. This increases the likelihood that an end to central bank rate hikes may be in the offing. That is also the scenario that fixed income markets are now counting on. Recent statements by central bankers also point to a slowing of rate hikes in the coming months. The question that comes to our mind, however, is whether the market is at all realistic in expecting the Fed to sharply lower interest rates as early as the second half of 2023. Rate cuts by that time will be too little too late to cushion the recession, which will probably be upon us very soon.

A more likely scenario in our view is that over the coming period the interest rate outlook will shift a little more towards somewhat lower 'peak rates' in the spring of 2023, especially if the macroeconomic data will start to point towards a deep recession (rather than a mild one, as presently expected) in the time ahead. Nevertheless, inflationary pressures might subdue quickly in the second half of 2023 (mostly because of base effects), but the question is whether this will prompt the Fed to quickly and strongly lower the base rate even then. Economists now assume that the level of US and eurozone inflation will go down to around 3% by late 2023, which is still well above the 2% inflation target of the Fed and the ECB.

Preference to corporate bonds over government bonds in today's investment climate

We believe that fixed income markets will now start to anticipate the period after the upcoming winter recession (if it will indeed come to pass). This argues in favour of higher, rather than lower, long-term interest rates from current levels, that is to say for a 'steepening' of the yield curve. Today's flat, and in the US even inverse, curve might be matching the scenario of a short-term recession, but not a scenario of economic growth recovery after the winter period, as most economists now assume. In such a climate, the outlook for government bonds will remain below par for now, and we prefer investments in corporate bonds, which generally perform well in an environment of moderate economic growth and decreasing inflationary pressures.

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