

Review June:
A bad month

A bad month to end an exceptionally bad half-year

In June financial markets across the board stubbornly continued their negative trend of recent months, and once again no asset class escaped the malaise. This makes the first six months of 2022 one of the worst first half-years for financial markets in 50 years

The 'best' performing asset class in June was European government bonds, with a negative return of 'only' 1.9%. Capital market rates fell slightly in the second half of the month in particular, which somewhat limited the loss on government bonds. A relatively safe asset class, investment grade European government bonds also shed less of their value than most other asset classes, but at a loss of 3.5% June can hardly be said to have been an exceptionally good month for European corporate bonds either.



At the other end of the spectrum was European listed property, which recorded an astonishing loss of over 18% in the month under review. Sensitive to interest rate changes, listed property faced headwinds from both rising capital market rates and declining equity prices. Listed property was also the biggest laggard by far in the first half of 2022 as well as compared with the same period last year.

While showing a slightly mixed picture, all equity markets delivered returns between those of bonds and property. The relatively best performing equity markets could be found in Asia and the emerging markets, with returns of 3.7% for the MSCI Asia Pacific index and 4.0% for the MSCI Emerging Markets index. European equity markets lagged behind, with the MSCI Europe index posting a return of -7.7%. US equities showed even worse performance in June, but as the euro weakened against the US dollar (-2.8% in June) the MSCI North America index yielded a slightly higher (or rather: less low) return of 5.8% measured in euros.

Most equity markets lost 10-15% of their value in the first six months of 2022, and so did European government and corporate bonds. The first half of 2022 was therefore exceptionally bad for both equities and bonds, not to mention property.

The returns of the various asset classes were as follows:

| Returns (total return, in euros) | June | Q2 | 2022 | 12 months |
|--|--------|--------|--------|--------------|
| Bloomberg Barclays Eurozone Government Bonds | -1.9% | -7.4% | -12.3% | -12.7% |
| Bloomberg Barclays Euro Corporate Bonds | -3.5% | -7.3% | -11.9% | -12.4% |
| Bloomberg Barclays Euro High Yield Corporate Bonds | -6.9% | -10.7% | -14.4% | -14.1% |
| MSCI Europe Real Estate | -18.1% | -27.8% | -31.9% | -31.6% |
| MSCI Europe Equities | -7.7% | -9.0% | -13.8% | -6.5% |
| MSCI North America Equities | -5.8% | -11.3% | -13.5% | -0.4% |
| MSCI Asia Pacific Equities | -3.7% | -6.0% | -9.4% | -11.1% |
| MSCI World Developed Markets Equities | -6.2% | -11.1% | -13.9% | -3.5% |
| MSCI Emerging Markets Equities | -4.0% | -5.6% | -10.0% | -14.6% |
| EUR/USD | -2.8% | -6.2% | -8.5% | -12.5% |

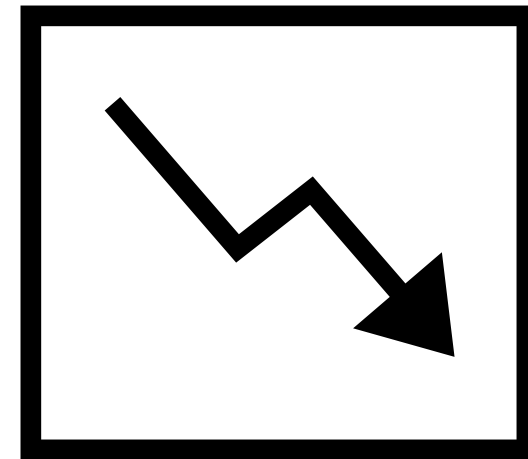
Bron: Bloomberg

Recession may have become more likely, but is still not a given

Global economic growth prospects were still fairly positive at the start of the year, but have steadily deteriorated since then. Indeed, it seems the question of financial markets has shifted from 'will there be a recession' to 'how severe will the recession be'. A Bloomberg survey reveals that analyst estimates of the likelihood of a eurozone recession in the next 12 months stand at 33%, versus 30% for the US. On the other hand, growth is nevertheless expected for the year as a whole. According to the Bloomberg consensus, the global economy will still grow by 3.2% in both 2022 and 2023, although those expectations were much higher at the beginning of this year (4.4% and 3.6% for 2022 and 2023 respectively).

Those dampened expectations are for a large part influenced by the war in Ukraine, which has led to restraint among businesses and consumers in the eurozone especially, in addition to the major geopolitical uncertainty it has caused. Eurozone growth prospects (according to the Bloomberg consensus) dropped by 1.4% and 0.6% since the beginning of the year. At present, growth rates of 2.8% and 1.9% are expected for 2022 and 2023 respectively. The US seems to be faring better in terms of economic strength. In the US, the jobless rate is still low (3.6%), wages are rising (6%) and consumer spending is also still increasing (for Q2, it seems to be heading to a year-on-year growth of 4%). Nevertheless, the outlook for the US economy also deteriorated. Finally, China's cooling economy following its zero COVID policy and housing market woes is posing a risk to the global economy.

Although lockdowns (for example in Shanghai and Beijing) are now being scaled back, it will be difficult for China to abandon its zero COVID policy altogether any time soon.



First signs of peak inflation may be crystallising, but in the US rather than the eurozone

It is clear by now that in most developed countries inflation has been going up more rapidly and will remain elevated for longer than most economists, investors or even central banks had initially anticipated at the beginning of this year. Still, in the US in particular we are seeing the first signs that inflation is levelling off. The Fed's price index of preference, the US Core PCE Index, has been sliding for several months now, from 5.3% in February to 4.7% in May. However, this is still well above the Fed's 2% inflation target and the decline seems set to continue at a slow pace. Moreover, US headline inflation is still on the up (8.6% in May versus 8.3% in April).

In the eurozone, inflation does not appear to be levelling off just yet. Indeed, headline inflation in fact went up in June to 8.6% (from 8.1% in May), its highest level since the creation of the monetary union. Notably, inflation exceeded last month's inflation level in most eurozone countries (17 out of 19 countries). While core inflation was just a tad lower in June (3.7%) than it was in May (3.8%), it does not mean that inflationary pressures will decrease any time soon as many of the recent period's drivers of inflation are still here (at least partly so). There is still a very real risk that oil and gas supplies from Russia to the eurozone will be cut off, which may push gas and oil prices back up again. Also, producer prices in the eurozone are still soaring (37% in April). This too may impact consumer prices, as far as businesses can pass on this increase to consumers. The disruption of international value chains seems to be abating somewhat, but if China will impose new lockdown measures (which is not unrealistic to think), this will

put upward pressure on freight prices. Further, it is likely that food prices will remain high, for a start because less fertiliser is used nowadays for the planting of crops (as Russia is a relatively large exporter of fertiliser).

Rate hikes set to accelerate, including in the eurozone

Given the unfavourable pattern of inflation, the ECB has no choice but to raise its policy rates in the coming months. The July hike will probably be by a relatively small increment of 0.25%, but larger steps could be on the horizon. It remains to be seen whether the ECB will keep pace with its US counterpart in raising its policy rates. Unlike the Fed, the ECB also has to consider the impact that higher interest rates will have on the eurozone's stability. A key indicator is the difference between the yields on Italian and German 10-year government bonds. This 'BTP Bund' spread peaked at 2.4% last quarter, after which the ECB announced an unscheduled meeting to reassure financial markets that it was designing an 'anti-fragmentation instrument'. This fragmentation may keep ECB rate hikes reined in.

All in all, the policy rates of central banks in developed countries are all heading into the same direction, and that is up. The uncertain factor is how far up they will go, especially in 2023. This in turn will depend mostly on how much inflationary pressures will decrease following the first policy moves, and to what extent higher rates will dent economic growth. This is as yet difficult to predict, but expectations are that the end of the year will bring more clarity on this point. By then, central banks may modify their plans again, depending on the state of the economy at that time.



Financial markets: more risks than opportunities in the short term

With higher interest rates and lower equity prices, financial markets seem to have increasingly been anticipating a stagflation scenario in the first six months of 2022. The pattern became less obvious towards the end of Q2, with temporary rate drops and a minor recovery of equity prices. Apparently stagflation in the short term has already been more or less 'factored in', and financial markets are now trying to predict what comes next – a return to the pre-COVID situation of low growth / low inflation or, conversely, a scenario of high growth / high inflation fuelled by large scale government investments in defence and the energy transition.

For now, we believe the most likely 'post-stagflation' scenario will be persistently moderate economic growth prospects combined with persistently high inflationary pressures (i.e. in excess of central banks' 2% inflation target). In our view there is still some slack in that scenario for higher capital market rates, even though they have already risen considerably in recent months. This is unfavourable for the expected price development of government bonds. However, for equities and other riskier asset classes, too, such a scenario is not necessarily good news. Our estimate is that there will be some considerable uncertainty for quite a while yet as to which scenario will eventually materialise. That in itself already argues in favour of exercising restraint in respect of asset classes such as equities and listed property. Corporate bonds might perhaps be a somewhat 'safer' choice, but we are not counting on high returns for this asset class either in the time ahead as interest rates continue to rise. Overall, the old adage 'cash is king' may still ring true in the months ahead.



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ASR Vermogensbeheer N.V.

Archimedeslaan 10

3584 BA Utrecht

www.asr.nl