

Review

May 2022

May 2022: Stuck

Summary: May was not a great month for financial markets, although better than April. Unfortunately, we don't foresee much relief coming from either inflation or economic growth. Inflation in the eurozone is increasing and becoming more broad based, while it remains high in the US. Central banks are coming under increased pressure to raise rates, which increases recession risks. Meanwhile, China's economy remains lackluster and we argue that letting go of the zero-covid policy is not as easy as it seems. We think the global economy will remain stuck in this low growth and high inflation environment for the time being.

Financial markets

May was not a great month for financial markets, although the losses were less severe than in April. Within equities, developed markets lost 1.6%, while emerging markets lost 1%, with much of the decline driven by weaker and more uncertain economic outlooks, increasing inflation and tighter monetary policy. Higher inflation and increasing rates contributed to lower values for bonds, with government bonds taking a larger hit (-1.8%) than corporate bonds (-1.2%). Listed European real estate remains the most 'battered' asset class, losing the most in May (6.5%) as well as for this year (-16.8%), which is mostly due to higher interest rates.



The table below shows the returns of various asset classes over different time periods:

Returns (total return, in euro's)	May	Q2	2022	12 mos.
Bloomberg Barclays Euro Government Bond Index	-1.8%	-5.6%	-10.6%	-10.6%
Bloomberg Barclays Euro Corporate Bond Index	-1.2%	-3.9%	-8.7%	-8.9%
Bloomberg Barclays Euro High Yield Corporate Bond Index	-1.2%	-4.1%	-8.1%	-7.3%
MSCI Europe Real Estate Index	-6.5%	-11.8%	-16.8%	-15.5%
MSCI Europe Stock Index	-0.8%	-1.4%	-6.6%	3.0%
MSCI North America Stock Index	-1.6%	-5.8%	-8.1%	11.2%
MSCI Asia Pacific Stock Index	-0.8%	-2.3%	-5.9%	-5.6%
MSCI World Developed Markets Stock Index	-1.6%	-5.2%	-8.2%	6.9%
MSCI Emerging Markets Stock Index	-1.0%	-1.6%	-6.2%	-8.6%
EUR/USD	1.4%	-3.6%	-5.9%	-12.3%

Bron: Bloomberg

Eurozone inflation is getting broader based

Turning to the macro backdrop, inflation is still rising in the eurozone. The May figure came in at 8.1% year-on-year (y/y), which was higher than most analysts expected and higher than April's inflation figure (7.4% y/y). What is even more worrying is that core inflation (inflation excluding energy and food prices) increased to 3.8% y/y. Core inflation in the eurozone has consistently been trending upwards since the beginning of this year, when it was 2.3% y/y.

These figures suggest that inflation is getting broader based in the eurozone, which in turn implies that the ECB might have to increase its policy rate more than expected by financial markets. ECB chief economist Philip Lane has recently signaled that if the ECB will hike rates, it will do so in steps of 0.25%.

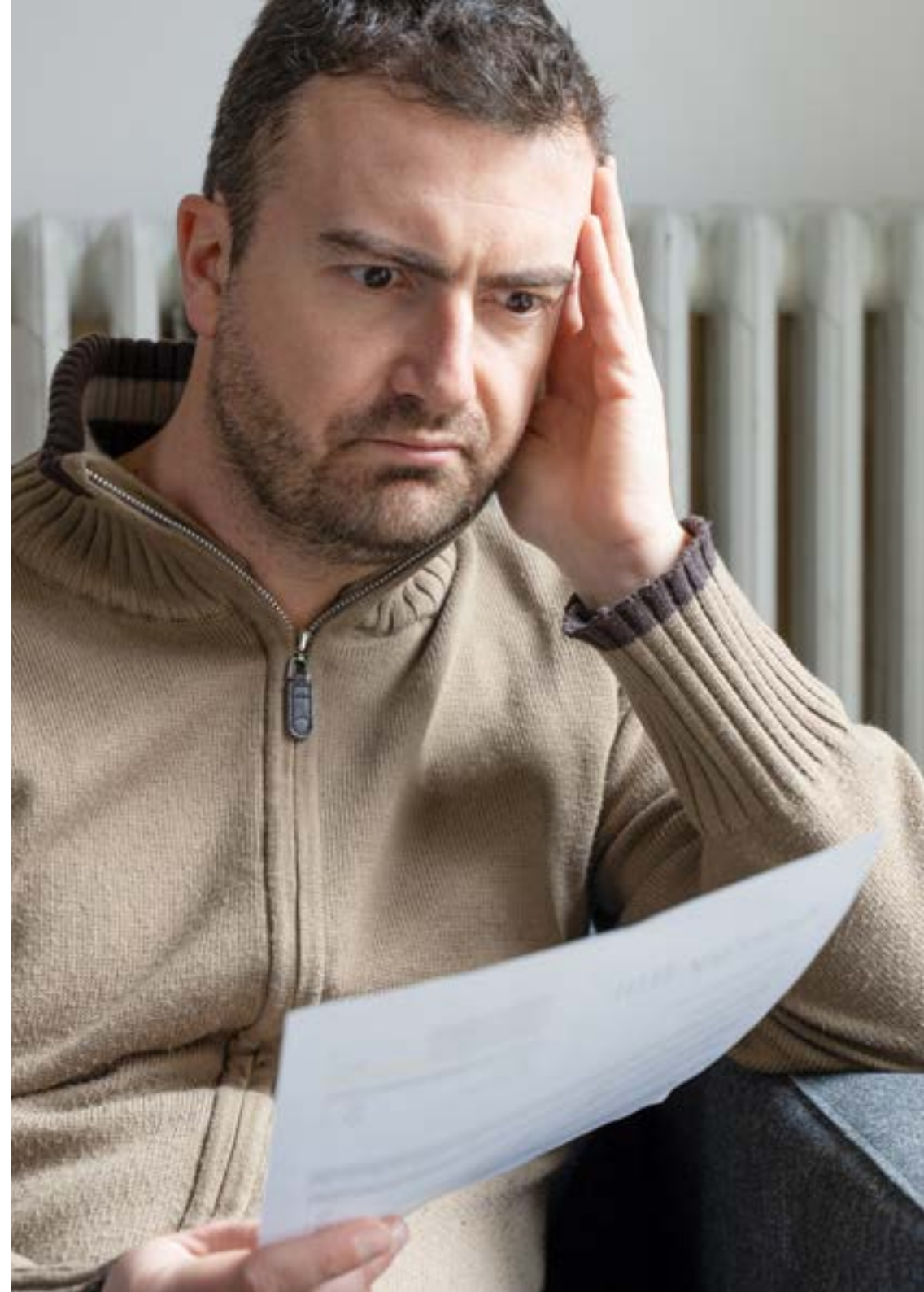
However, the ECB might be forced to hike rates in bigger steps (for example 0.5%) or more times, especially if inflation stays high. That risk is not low because it does not seem that inflation in the eurozone will come down anytime soon.

First, the war between Russia and Ukraine does not show any signs of abating. In fact, its economic effects are becoming more prominent. For example, the European Union has recently decided to ban oil imports from Russia by sea, as part of a new set of sanctions against Russia. That means by the end of this year, about 90% of the EU's oil imports from Russia will be banned. The EU will find it difficult to meet all this oil demand from

other countries, at least not without making substantially more costs. Oil prices did not react strongly to the announcement, indicating that financial markets had already priced in such a ban. However, there is scope for further rises in oil (and gas) prices, especially if the current set of sanctions against Russia are a prelude to more sanctions down the road.

Second, food prices will remain high and volatile for the foreseeable future. Partially due to the conflict between Russia and Ukraine (and its impact on for example fertilizers) and partially due to adverse weather conditions in Southeast Asia. The IMF World Commodity Food Price Index for example is currently at 160, an all-time high. For comparison, the value of the index was 104 right before the corona crisis started, which means food prices are currently about 54% higher than they were in early 2020.

Third, producer prices are still rising at extremely high rates in the eurozone. Producer prices (as measured by the Production Price Index, PPI) have increased by a staggering 37.2% y/y in April, also an all-time high. At least part of these producer price increases will likely show up in consumer prices sooner or later.



US inflation will stay high in the near future

Inflation in the US came down a little bit, from 8.5% in April, to 8.3% y/y in May. However, this does not necessarily mean we have reached peak inflation in the US. The US economy has been surprisingly strong in the past couple of months. Wages are increasing by 6%, unemployment is at historical lows (3.8%) and US consumption is set to increase by almost 4% on an annualized basis in Q2. So there is still upward pressure on prices from consumer demand, which means that even if inflation goes down, it will not likely do so quickly unless the US economy drops into a severe recession.

Moreover, a team of researchers (including former US secretary of the Treasury Lawrence Summers) has recently argued that core inflation in the US is currently close to the peak levels seen during the stagflation periods of the 70s and 80s because the index by which inflation is measured (the Consumption Price Index) was biased upwards before 1983 as it included mortgages interest rates. The conclusion from this paper is that (i) core inflation looks more like the stagflation period of the 70s and 80s than the official figures suggest and (ii) core inflation will be equally difficult to bring down as in the 70s and 80s. If that is true, the Fed could find itself needing to raise rates much more than it currently envisages.

Recession chances are still sizable

There is a sizable chance that the US or the eurozone will experience a recession in the coming 12 months, albeit for different reasons. In the eurozone, the recession risk is mostly because of weakening demand due to higher inflation and increased uncertainty. One indication that demand is weakening is consumption. Consumption data has been released for Germany and France (which together represent 55% of eurozone GDP) and was sluggish for both countries. Retail sales fell by 5.4% in Germany and 0.4% in France (both on a seasonally adjusted month-on-month basis). Moreover, growth of negotiated wages in the eurozone was 2.8% y/y in March, which is still below inflation and means consumers are losing purchasing power despite higher wages.

In the US a possible recession is more likely to be triggered by the Fed hiking rates more or faster than expected, which ironically is because of the strength of the US economy. The Economist has recently argued that if a recession hits the US, it might be a mild one because household and business balance sheets are still relatively strong and banks have adequate financial buffers. However, the recovery from a recession will take longer as there is less willingness from the government for fiscal stimulus and less ability from the Fed for monetary stimulus.

China is stuck with its zero-covid policy

China has recently loosened restrictions to contain the coronavirus outbreak in Shanghai and Beijing, which should give a boost to the economy in the short term. In the medium term however, China will likely be stuck with its zero-covid policy. Letting that policy go is not as easy as it seems, for two main reasons.

First, if China abandons the policy, coronavirus cases might very well surge and overwhelm the health care system, as well as deal a blow to the economy. Regarding the latter, experience from previous countries (for example Sweden) as well as [research](#) have shown that economic activity declines as coronavirus infections increase, even without lockdowns. Mainly because, when infections are rising, people go out less (and thus spend less) for fear of being infected.

Why would cases surge? Because China suffers from a so called “[immunity gap](#)”. A large part of the Chinese population is vulnerable to being infected because they lack natural immunity (since most Chinese people have not contracted the virus) as well as strong vaccine induced immunity. Regarding the latter, although 89% of China’s population has been vaccinated, the vaccine used in China (from Sinovac) seems to be [less effective](#) than mRNA based vaccines, such as those from Pfizer and Moderna. For Sinovac’s vaccine, three doses are needed to induce the same level of protection as Pfizer and Moderna’s vaccines. However, as of April this year, only 57% of people over 60 in China have received these three vaccination doses. One way out of this situation is to start another mass vaccination program. However, that will take time and is unlikely to bring respite to China’s economy this year.



Second, China's National Party Congress (the country's largest and arguably most important political event of the year) will be held in November, where Xi Jinping will likely be elected again as head of the Chinese Communist Party (CCP). With the National Party Congress coming up, Xi Jinping will not risk letting go of the zero-covid policy, as that might not boost the Chinese economy all that much, while it will risk a sharp rise in coronavirus related deaths. That could explain why China seems to be choosing the combination of a zero-covid policy (to avoid the human cost) and increased stimulus (to avoid the economic cost), although a concession will probably have to be made on one of these two.

What are the consequences of China keeping its zero-covid policy?

For one, the economic growth target of 5.5% this year is becoming increasingly ambitious. The Chinese economy is already experiencing a lot of pain. Retail sales have gone down by 11% y/y in April, which is the largest decline of retail sales since March 2020. Property sales have gone down by 29.5% y/y for the first four months of 2022 (compared to the first four months of 2021), which matters because the real estate sector represents about 29% of Chinese GDP (according to some estimates). Weaker growth in China has global consequences since a third of the growth the world economy has seen in the past 20 years or so has been driven by China.

In addition, international supply chains running through China will remain strained in the near future. Rather than easing gradually, it could be that they will open up and get clogged periodically as restrictions are eased and implemented again while the virus wanes and resurges periodically.

Implications for investment portfolio's

We have not changed our view on major asset class returns since our previous monthly update. We still think that the combination of higher inflation and interest rates do not bode well for bonds. However, weaker economic outlooks and increased geopolitical uncertainty do not bode well for risky assets such as stocks, corporate bonds and real estate either, leaving cash as one of the few available options. Thus overall, we remain cautious on fixed income, neutral on risky assets and slightly optimistic on cash for the near future.

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