Asset Management

Macro research
July 2023

AEGON **INSIGHTS**

Global House View

● Overweight ● Neutral ● Underweight

Asset class		Opportunity set	UW	N	OW	Change	Comments
Main asset class		Equities	●				Breadth of second quarter equity returns became increasingly narrow, and with liquidity now draining from the market as central banks tighten further; we see the risk of further equity downgrades increasing.
Main asset class		Fixed Income			●		Continue to favor credit, in particular higher-rated investment grade debt. All in yields are attractive and corporate balance sheets remain relatively healthy despite the higher-rate environment.
Main asset class		Commodities		●			Reduced supply in energy-related commodities is being met with less demand as economic uncertainty grows, prefer to stay neutral on a tactical basis.
Main asset class		Cash			●	▲	Cash yields are now above 5% in USD terms so upgrading allocation to overweight until more attractive risk opportunities arise later on in the cycle.
Preference by asset class	Equities	US	●				A small group of mega-cap tech stocks is carrying the market cap weighted S&P 500 index higher and market sentiment into euphoric territory on AI optimism, a classic sign of an aging bull market. But the S&P ex-FAANG index is roughly flat year-to-date, highlighting that the broader market is still struggling with earnings decline and weak investor sentiment. Large retail investor flows further suggest the most recent rally has been driven by return chasing rather than fundamentals.
Preference by asset class	Equities	EU	●			▼	A pick up in profit warnings highlights that the European economy is suffering more than what the market currently expects; using recent strength as an opportunity to move underweight.
Preference by asset class	Equities	UK		●			The UK market faces similar macro concerns to Europe but given how oversold and deeply valued the market is on a relative sense, we remain neutral.
Preference by asset class	Equities	Japan			●	▲	Corporate balance sheets are strong, and inflation is relatively low, while the prospect of governance reform for public companies provides an additional tailwind. A weakening Yen is also supportive for exporters and foreign investment.
Preference by asset class	Equities	Asia ex-Japan			●		Inflation is lower in Asia versus the US and Europe and within most central banks comfort zones, which creates room for more fiscal and monetary support to boost domestic consumer demand.
Preference by asset class	Equities	REITS		●			Market is overly bearish but lacking a trigger. Waiting for debt provisions to stabilise and for economy to tilt into recession before REITs become more attractive versus equities on a relative basis.
Preference by asset class	Fixed Income	Government bonds	●				Global economies are yet to show meaningful signs of a slowdown. In the interim, central banks are echoing 'higher for longer' as inflation remains too high, which will keep rates elevated, particularly at the front-end.
Preference by asset class	Fixed Income	Investment Grade			●		Corporate health appears reasonable and higher spreads are an attractive entry point. Yields in investment grade also attractive and regulatory support for banks provides a back stop for a larger credit event.
Preference by asset class	Fixed Income	High Yield			●		Defaults slowly increasing but are still below longer-term averages; yields remain attractive.
Preference by asset class	Fixed Income	EM Debt		●			Spreads provide potentially attractive entry point for higher quality assets, but bouts of volatility, particularly if the economic picture deteriorates, will likely be amplified versus similar assets in developed markets.
Preference by asset class	Fixed Income	Securitized			●		Benefit of higher rates means better income profile and attractive risk-adjusted returns in some segments of securitized sectors.
Preference by asset class	Currency	USD		●			Different driving forces for the USD keeps score at neutral; Fed is nearing its peak of the rate cycle which is unsupportive, but more market volatility as economic growth declines will be supportive.
Preference by asset class	Currency	Euro		●		▼	Moving back to neutral; Euro-area economic data has surprised to the downside. The market is now re-pricing rate cuts at the beginning of next year, which is preventing the EUR from going higher.
Preference by asset class	Currency	Japanese Yen		●		▼	Moving to neutral; strength in Japanese equities has put downward pressure on the currency and Bank of Japan also content with their ultra-loose monetary policy.
Preference by asset class	Currency	GBP	●				Sterling is this year's top G10 currency but will show its less attractive side when rate hikes really bite. The Bank of England is overpriced, and the market should correct now that growth is slowing.

Figure 1: All investments contain risk and may lose value. The above overview is intended to illustrate major themes for the identified period. No representation is being made that any particular account, product, or strategy will engage in any or all of the themes discussed.Our asset class overweights/underweights in our illustrative portfolio as of June 30, 2023 on a 3-month horizon. Up/down arrows indicate a positive (▲) or negative (▼) change in view since the prior quarterly global house view meeting. These views should not be construed as a recommended portfolio. This summary of our individual asset class views indicates strength of conviction and relative preferences across a broad-based range of assets but is independent of portfolio construction considerations.

AEGON Asset Management

Our asset allocation decisions – in short

Cross asset allocation: We remain overweight fixed income versus equities on a cross asset basis.

Our base case remains that central banks, particularly the US Federal Reserve (Fed) and European Central Bank (ECB), are unable to achieve a soft landing. Currently, global equity markets on aggregate are ignoring the squeeze in financial conditions, the decline in consumer sentiment, and a fall in economic activity, as noted in global PMI data. The equity rally year-to-date has been driven largely by a small group of mega-cap technology stocks following developments around artificial intelligence (AI), but excluding these securities, forward earnings expectations are dropping which leads us to believe that markets will likely correct later this year.

We continue to be overweight fixed income on a relative basis. All in yields, particularly in credit, are now higher than in equity markets based on forward earnings yields and give investors more than enough compensation given the current level of defaults.

We have also increased our cash preference to overweight. Yields in USD terms are now +5%, making cash an attractive asset class to allocate to until rates fall and new opportunities arise.

Within fixed income: Within fixed income we remain overweight in spread categories relative to sovereigns.

We continue to be underweight duration. We note that central banks in the US, Europe and UK are unlikely to stop each respective hiking cycle until inflation falls much closer to 2% or a deeper-than-expected recession hit. Given that we believe neither are likely in the next quarter, central banks will remain hawkish, and yields will continue to edge higher.

Within equities: We have reduced our European equity score from neutral to underweight. European equities had a strong start to the year as economic growth faired better-than-expected, owed in part to falling energy prices, while corporates have also benefitted from a rebound in Chinese demand. But forward earnings guidance has started to roll over as economic data begins to underwhelm which we view as a headwind in the coming quarter.

Our Japanese equity score, meanwhile, has been moved to overweight. A weak yen has encouraged foreign investment, overseas tourism and demand for exports, all of which are supportive for regional equities. We don't see the yen strengthening in the coming quarter so Japanese equities should continue to be a strong relative performer. Additionally, there is growing support for reforms for public companies which can provide an additional tailwind as corporates look to improve their governance practices.

Within currencies: We have downgraded our Euro score from overweight to neutral. Economic data over June surprised to the downside, and fixed income markets have been quick to price in a number of ECB rate cuts next year, based on expectations that the Eurozone is heading into a worse recession than what was originally anticipated. Falling rate differentials are a negative for the Euro, so prefer to move back to neutral on a tactical basis.

While the US economy is still showing some signs of strength, European and UK economies appear to be entering an era of stagflation.

We have also downgraded our Japanese yen score to neutral. The yen rallied against the US dollar towards the back end of last year amid growing investor sentiment that the Bank of Japan would consider moving away from its ultra loose monetary policy and yield curve to control rising domestic inflation. This has failed to materializes, causing a drop in expected interest rate differentials, and therefore, a weakening of the currency. There is some expectation that the Bank of Japan may change its stance in 2024, but we don't believe there is a strong enough case to move the dial and cause the currency to strengthen materially once again.

Market Commentary

It feels somewhat dizzying now to look back and reflect on how different market sentiment was at the end of the first quarter compared to now; how quickly views have changed, and memories have been erased. March was marred by what felt like the beginning of financial Armageddon. A meltdown in the US regional banking sector was a convincing enough sign to markets that the economy was about to crack from the pressure of higher rates. A hard landing was now inevitable, and central banks would have to slash rates before the end of the year in order to dig the global economy out of recession.

That seems like a long time ago. In the second quarter, the S&P 500 defied expectations and rallied, driven by the sudden emergence of artificial intelligence technology. The underlying economy has also showed surprising signs of resilience, particularly labor markets. Expectations of rate cuts this year have now given way to new expectations of further rate rises. Yet rhetoric that more monetary tightening is still to come has done little to deter US equity markets. The flipflop in market sentiment in the second quarter compared to the first has left many investors understandably scratching their heads.

Despite last quarter's change in sentiment, we maintain our base case that the US is still heading for a mild recession which we expect to start in the fourth quarter of this year. The breadth of returns on the S&P 500 has become increasingly narrow; driven by a few mega-cap tech stocks on AI optimism, which is a classic sign of an aging bull. EPS earnings estimates on the broader index however have continued to decline. Elsewhere, other contractionary signals remain; the 2-year-10-year yield curve is the most inverted it's been during this cycle, the ISM manufacturing PMI is at its lowest point since Covid-19 lockdowns and liquidity has drained from the system post debt ceiling standoff as banks buy up Treasury bills. Finally, the market seems to be forgetting that monetary tightening hasn't gone away. The Fed is pushing on with its quantitative tightening, and with two more rate hikes priced in this year, corporates and consumers will only face more pressure in the months to come.

On a global basis, divergences between major economies and monetary policy started to play out over the second quarter. While the US economy is still showing some signs of strength, European and UK economies appear to be entering an era of stagflation; economic data is starting to surprise to the downside and inflation is still well above 2%, forcing the ECB and Bank of England to stay hawkish. China's growth rebound has disappointed, but low inflation leaves room for stimulus to boost domestic demand. Japan, meanwhile, is gaining momentum from a rebound in consumer spending and business sentiment, driven in part by the reopening of its borders to international visitors.

On an asset class level, duration remained out of favor, particularly in the UK and US. Inflation remains high and central banks are yet to trigger a meaningful slowdown to cool prices. This has put upward pressure on sovereign bond yields, as central banks have been given greater scope to continue their hiking cycles. Equities were the best returning asset class in the second quarter but as described this has been largely sentiment driven on AI emergence rather than rebound in earnings forecasts, which remains negative. Credit had a reasonable quarter and continues to offer an attractive source of carry within a multi-asset portfolio.

Shifting dynamics in global economies presents a challenge for investors, so staying active and flexible will be key to navigate what may prove to be challenging times ahead.

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