ROBECO
The Investment Engineers

Multi-asset market outlook

Goldilocks is awaiting a haircut

March 2023

For professional investors

Sustainable Investing Expertise by
ROBECOSAM

General overview

Risk assets consolidate in February follow a strong start to 2023

MULTI ASSET	1mo	3mo	YTD	1YR	3YR	5YR
Cash (EUR)	0.2%	0.5%	0.4%	0.5%	-0.2%	-0.2%
MSCI World (UH, EUR)	-0.1%	-2.8%	5.2%	-1.9%	11.2%	9.9%
EMD hard currency (UH, EUR)	-0.1%	-1.1%	1.4%	-3.8%	-3.4%	2.1%
GSCI Commodities (USD)	-1.5%	-8.0%	-3.3%	5.6%	18.0%	8.6%
MSCI World local currency	-1.6%	-0.5%	4.8%	-4.9%	10.6%	7.9%
EMD local currency (UH, EUR)	-1.6%	0.2%	1.5%	-2.0%	-2.4%	1.0%
Global high yield (H, EUR)	-1.6%	1.7%	1.9%	-7.3%	-1.8%	-0.5%
MSCI World (H, EUR)	-1.7%	-1.0%	4.5%	-7.1%	9.0%	6.0%
Global Gov Bonds (H, EUR)	-1.7%	-1.9%	0.1%	-11.7%	-5.5%	-1.6%
Global inflation-linked bonds (H, EUR)	-2.1%	-3.2%	-0.2%	-17.9%	-4.2%	-1.0%
Global real estate (UH, EUR)	-2.2%	-2.1%	5.1%	-9.7%	1.6%	5.3%
Oil Index (USD)	-2.2%	-4.1%	-3.9%	-5.8%	2.5%	-3.9%
Global investment grade bonds (H, EUR)	-2.7%	-0.4%	0.5%	-11.6%	-4.9%	-1.1%
Emerging Markets (UH, EUR)	-4.2%	-3.4%	1.5%	-10.3%	2.2%	0.9%
Emerging Markets (LC)	-4.7%	-0.4%	1.6%	-10.5%	3.1%	1.1%
Gold (USD)	-5.2%	4.6%	0.5%	-4.0%	4.0%	5.7%

Source: Robeco, Bloomberg

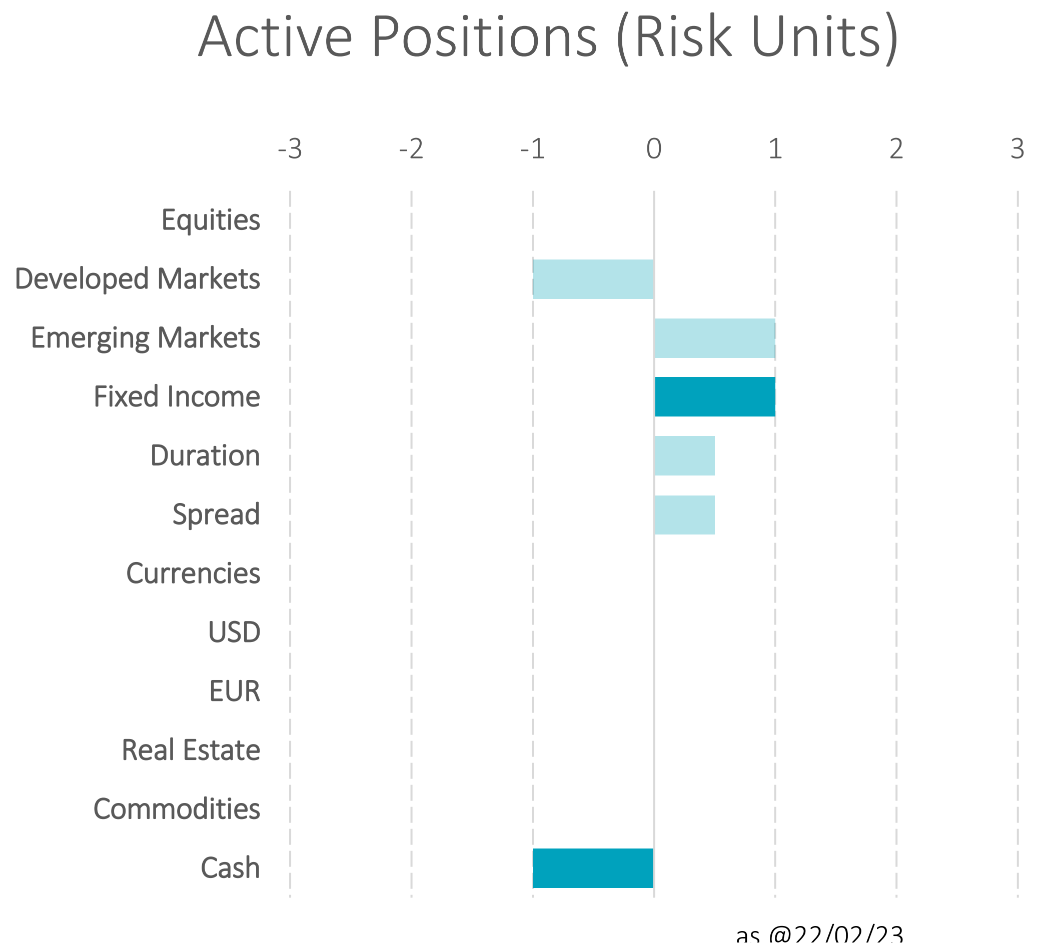
The best trade ideas of the 2022 Christmas lunch season ran out of steam in February, and the rebalancing of model and pension funds following the year-end has been completed. There are questions surfacing about how long ‘Goldilocks’ revenge’ will last, given that inflation is slowing in the US but increasing across Europe. Inflation data has been persistently ‘sticky’, not falling as fast as investors had anticipated, which led to US rate cuts for 2023 being priced out, while the ECB will need to do more. In short, the peak of the rates cycle has been pushed up and out.

Emerging market equities gave up most of their January gains, as investors wait for the hard data to confirm how China’s reopening will proceed. Anecdotal evidence suggests a similar pattern of ‘revenge consumer spending’ will follow, causing a ‘halo effect’ for Asia and the transport sector. The industrial side of the economy will operate with more freedom but won’t suffer the same ‘lockdown’ headwinds as the consumer sector.

Within fixed Income markets, the high yield spread continues to protect investors somewhat against rising government yield curves. However, this has not been the case for investment grade bonds, as the duration element and low spreads do not offer the same cushion. The high yield market continues to benefit from the postponement of recessions in Europe and the US.

Multi-asset views

Sustainable Multi-Asset Solutions views



Source: Refinitiv Datastream, Robeco

As we saw at the end of December and January, the markets can change their views and direction overnight. We continually review our core investment scenario considering new information and assess what is priced in. Goldilocks' revenge in January allowed us to increase our position in emerging equity using US equities as a source of funds.

As risk and growth assets rallied strongly at the start of 2023, we did not chase the equity market, remaining neutral based on valuations and the macro outlook. We do not subscribe to the 'no landing' camp which is a way of justifying the juxtaposition of long equities and inverted yield curves. We believe that economies are edging towards the end of an old cycle rather than being at the start of a new one.

Inflation numbers remained sticky during February, and investors pushed up and out their expected peak level of interest rates. German and US bond yields backed up sharply across the curve, bringing a reduction in optimism. The back-up in yields provided an opportunity to start adding duration and safe haven assets. Our core scenario is based on higher rates causing much slower nominal GDP growth in the US and Europe over the next 12 to 18 months.

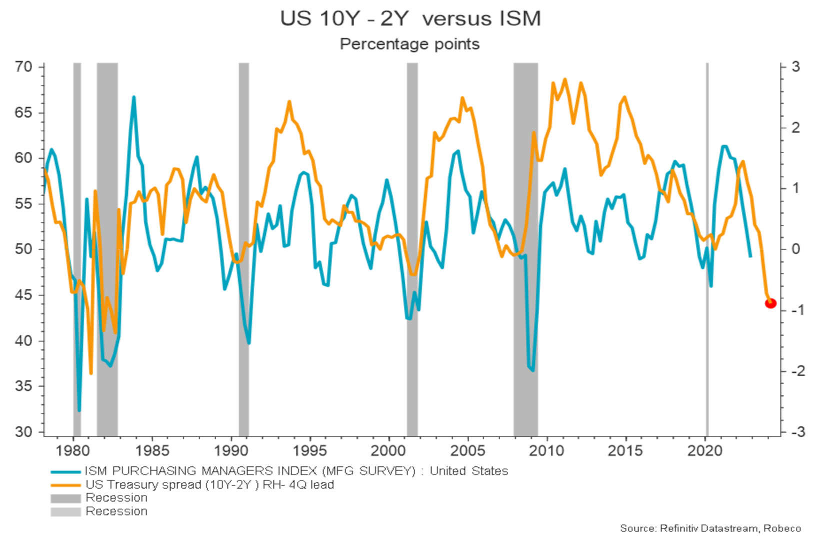
Goldilocks' revenge is yesterday's story for now, as stickier inflation will mean central banks will be unable to cut rates as soon as growth slows, which has been the textbook answer for last 30 years. Inflation and employment must fall before the Fed will cut rates. Our recession risk is still high, even if we have delayed the start of the significant slowdown.

Theme of the month

Goldilocks is awaiting a haircut

As global equities are up almost 5% in the year to date in euros, markets in recent months have shrugged off the imminent recession narrative and instead have rooted for a soft landing – or even a no landing – scenario for the global economy. Not only investors, but also seasoned government officials like US Treasury Secretary Janet Yellen have lately been joining the soft-landing chorus. A Bloomberg survey showed that searches for 'soft landing' have skyrocketed. This pivot in recent months towards the Goldilocks scenario, in which the economic porridge is not too hot or cold but just right, is somehow understandable. When the facts change, one should change one's mind as well, right? And the evidence at hand seems to have changed for the better. Clearly the hard data about the US economy (non-farm payrolls, retail sales) have been surprising to the upside and have contrasted with prior, more downbeat soft data.

Yield curve: rarely raising a false recession flag



Yet, we might just have seen peak Goldilocks, as markets may have been rooting for the most benign scenario based on the recent evidence at hand, but in doing so have overlooked what has happened the most often in history in similar economic circumstances. It has been American psychologist Daniel Kahneman who has especially highlighted the risks of base rate neglect in decision making. In our view, a haircut awaits for the Goldilocks scenario probabilities reflected in current market pricing. First, reliable recession indicators are strongly contradicting Goldilocks' endurance on a 12-month horizon. In fact, the warning signal from the yield curve has grown even stronger in the year to date, as the inversion of the 2s10s has deepened on the back of the recent upward repricing of the Fed's hiking path to a terminal policy rate of 5.4%. US yield curve inversion has rarely raised a false flag when it comes to calling a recession over the past four decades, with a notable exception in 1998.

Theme of the month

Summers and Domash (2022): low unemployment is no assurance for Goldilocks' endurance

Table 1: Historical probability of a recession conditional on different levels of CPI inflation and unemployment, using data from 1955-2019

	Avg quarterly inflation above:	Avg quarterly UR below:	Probability of recession over next 4-quarters	Probability of recession over next 8-quarters	Number of quarters	When did US economy most recently cross threshold?
Inflation only	3%	#N/A	27%	48%	95	Q2 2021
	4%	#N/A	37%	59%	51	Q2 2021
	5%	#N/A	45%	62%	29	Q3 2021
UR only	#N/A	6%	25%	47%	142	Q2 2021
	#N/A	5%	31%	57%	83	Q4 2021
	#N/A	4%	42%	69%	26	Q1 2022
Inflation and UR	3%	6%	43%	75%	53	Q2 2021
	3%	5%	54%	85%	26	Q4 2021
	3%	4%	54%	85%	13	Q1 2022
	4%	6%	59%	89%	27	Q2 2021
	4%	5%	73%	100%	11	Q4 2021
	4%	4%	57%	100%	7	Q1 2022
	5%	6%	83%	100%	12	Q3 2021
	5%	5%	100%	100%	5	Q4 2021
	5%	4%	100%	100%	3	Q1 2022

Note: The calculation for the probability of recession over the next 4-quarters and 8-quarters excludes quarters when the US economy is already in a recession. Recession is defined using NBER based recession indicators for the United States from the period following the peak through the trough. The measure of inflation used is the Consumer Price Index for all urban consumers.

Sources: Bureau of Labor Statistics via FRED; authors' calculations

Get ready for the tangential part of sticky inflation dynamics

Second, while there is much to cheer about the resilience of the consumer on the back of continuing tight labor markets, a cyclical low in unemployment rates as we observe today, with US unemployment at 3.4%, is a contrarian signal for future economic activity. As US economists Lawrence Summers and Alex Domash point out in their 2022 paper, whenever the US unemployment rate drops below 5% and inflation edges above 4%, a NBER recession ensues in the subsequent two years 100% of the time. Such a strong base rate leaves little room for complacency about the risks facing the US medium-term growth outlook.

The view emerging from the Summers and Domash paper can be further substantiated by looking at the steep drop in housing market sentiment, which serves as a leading indicator for US unemployment. As the decision to buy a house is strongly determined by perceived future job security, the deterioration in buyer sentiment signals that a significant turn in the labor market might be ahead. As we wrote in our 2023 outlook; things might move gradually at first, but once the ball gets rolling, it gets rolling fast.

Third, the recent episode of stronger-than-expected disinflation in conjunction with positive macro surprises represents a highly unstable equilibrium. While the disinflation process itself might not be at risk, the pace of disinflation could slow (inflation surprise indices edged higher already last month) and take some shine off the Goldilocks appeal. While commodity prices have declined by 3.3% in the year to date, a continued recovery in manufacturing activity led by Asia could slow the pace of headline disinflation. With regard to core PCE inflation, we note that it has increased in recent months. With the normalization of shipping fees and freight trucking costs, the 'easy' gains for supply side-led disinflation have been made.

All market data to 28 February 2023 unless mentioned otherwise

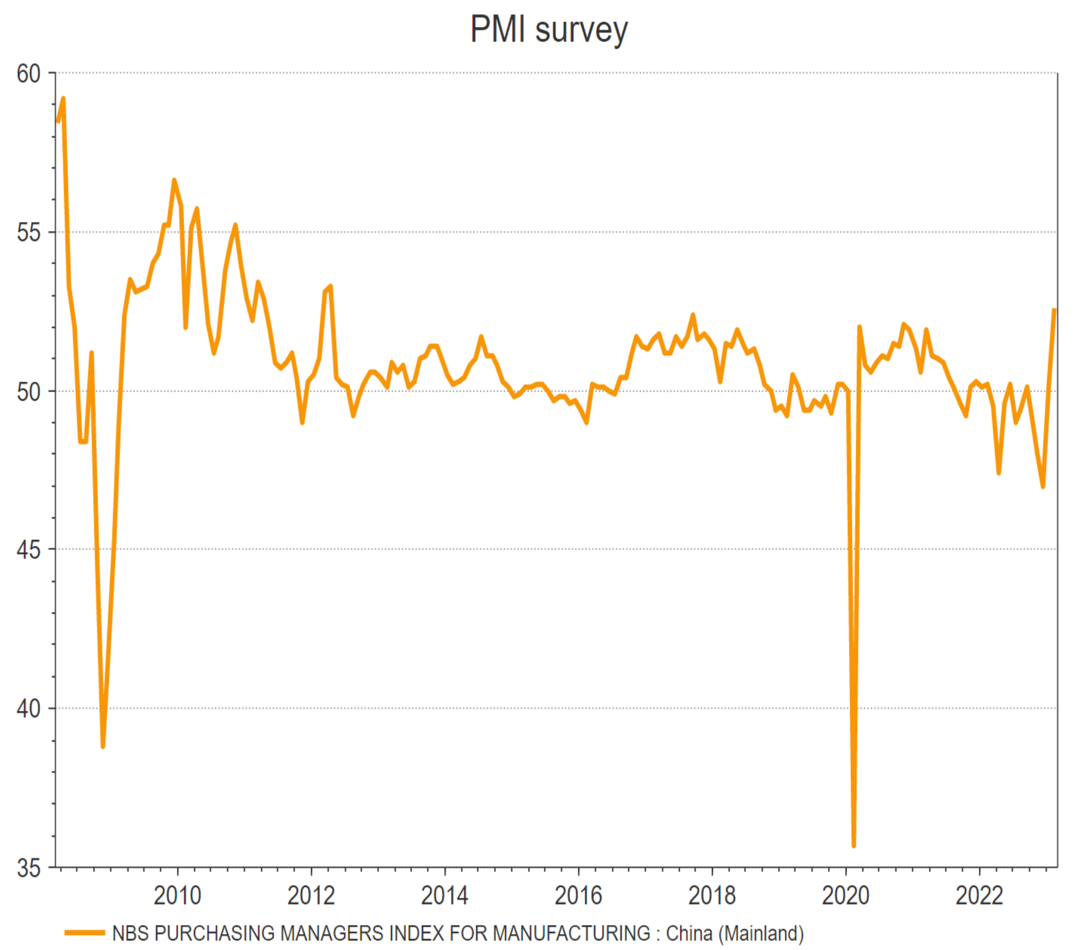
Economy (I)

The global manufacturing cycle picked up some steam as a JP Morgan Global Manufacturing indicator above 50 signaled an expansion of manufacturing activity again for the first time in six months. The Asia Pacific region has been leading the pack, showing the largest positive macro surprises on the back of a further stabilization in domestic demand in China. A leading Chinese manufacturing PMI from the China's National Bureau of Statistics showed the highest reading in a decade at 52.6.

However, hard data over February from countries that typically lead the cycle, such as South Korean exports, saw very strong momentum towards Europe as well. Global services activity outside the US also improved. The ISM non-manufacturing in the US remained largely unchanged, coming in at 55.1 in February compared to 55.2 in January. In China, services sector activity improved, driven by transportation and accommodation. The same story emerges from Germany's IFO survey, where services like hospitality and tourism noted the sharpest increase in sentiment in February.

Global labor markets are still very tight, as evidenced by a further drop in initial claims to 190,000 in the US, and signs of stronger bargaining power for labor in Japan, where a survey of more than 2,000 trade unions showed they were demanding the largest wage hike in decades, requesting 4.5%.

China's industrial complex is getting upbeat



Source: Refinitiv Datastream, Robeco

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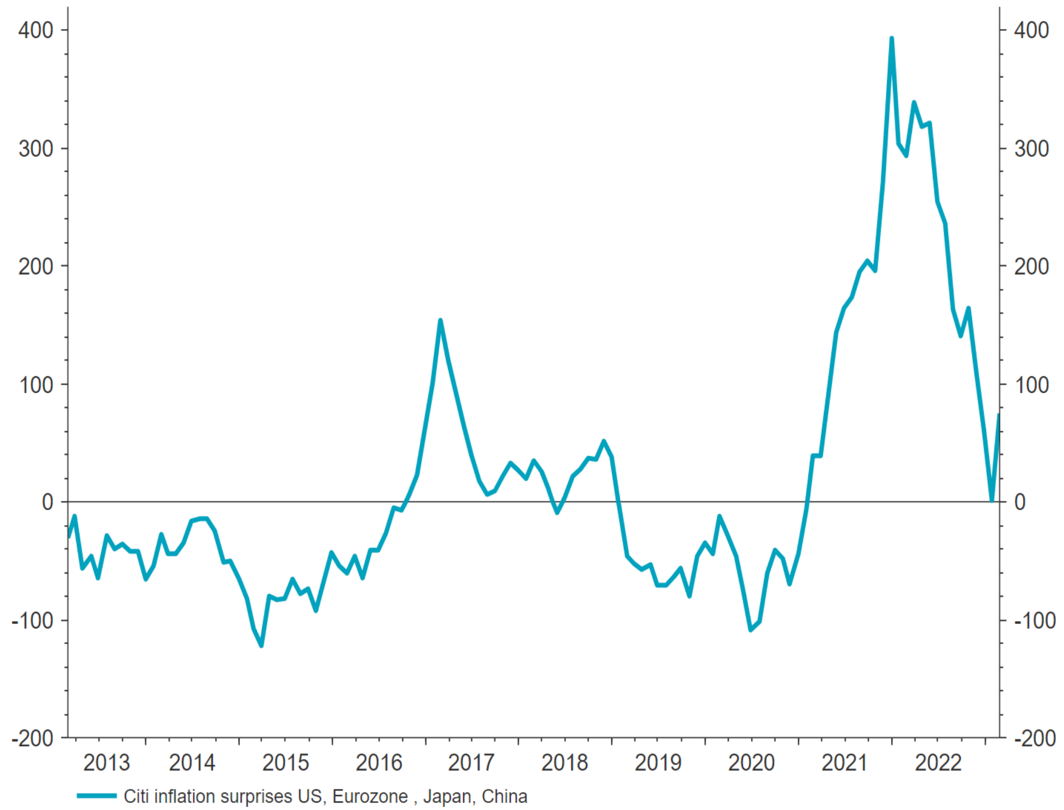
Economy (II)

After global inflation peaked in October last year, the pace of disinflation seemed to be slowing last month. An aggregated Citi inflation surprise index for US, Europe, China and Japan reversed its downtrend in February. Inflation data out of Europe, notably from Italy and Spain, came in higher than expected, with core inflation in Spain hitting its highest level since 1986, along with an increase in headline inflation to 6.1%.

The Fed raised its target policy rate by 25 bps to the 4.5%-4.75% range. It also noted that further increases will be appropriate to bring inflation back to 2% over time. The Fed funds futures curve now expects the Fed policy rate to peak at 5.4%. The ECB also intends to raise rates further in the near term after hiking by 50 bps in February to 3%. The Euribor futures market now has discounted the ECB reaching a 4% policy rate in the second half of this year.

Rebound in inflation surprises as global core inflation pressures persist



Source: Refinitiv Datastream, Robeco

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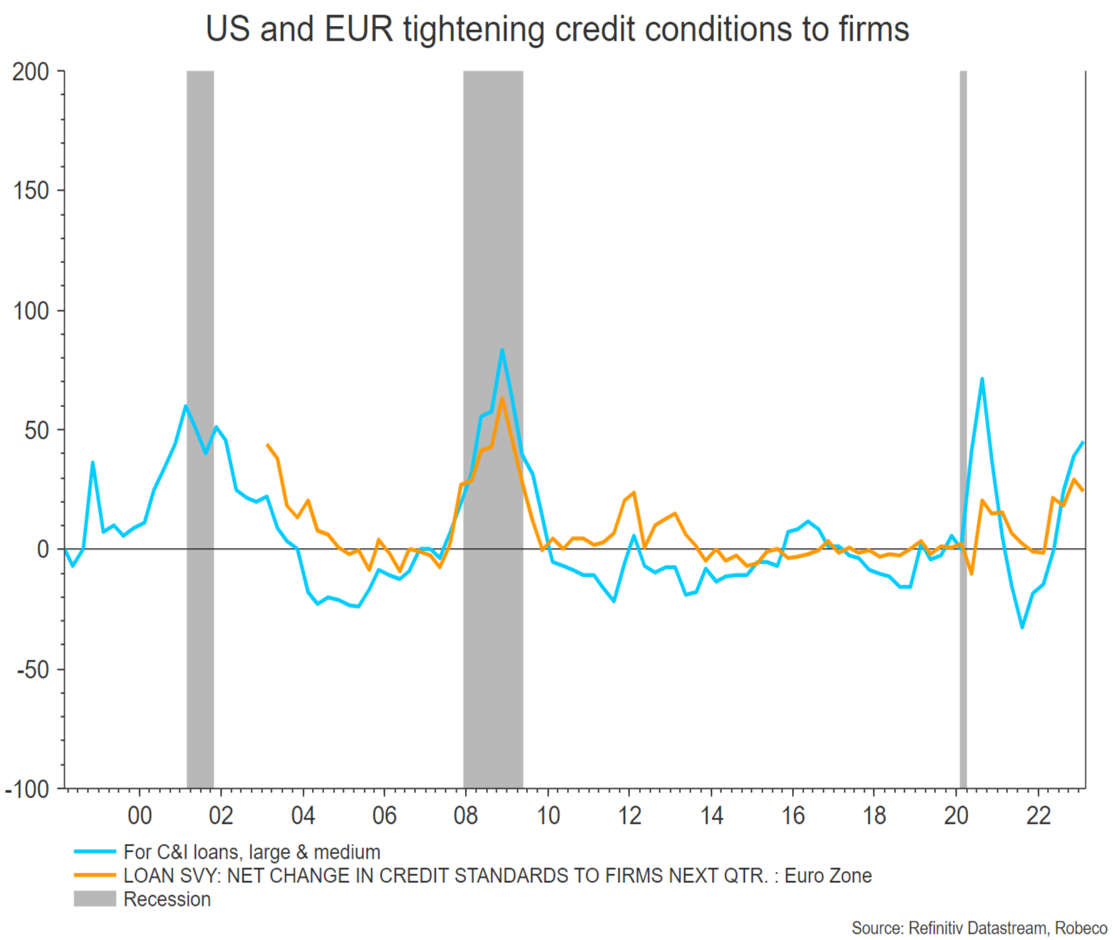
Economy (III)

Monetary policy works with lags, but credit conditions are already getting tighter



Source: Refinitiv, Robeco

Looking ahead, the stronger macro data and persisting inflation pressures could prompt developed market central banks to skip a pause and keep on hiking for longer. Yet, the encouraging signs in recent macro data could prove to be short-lived and might amount to peak Goldilocks in hindsight. Excess savings have largely vanished in the US, while cracks in global housing markets are growing larger.

Moreover, the new 2023 growth target set by the Chinese National Policy Committee at 5 % is underwhelming and could signal that the crackdown on specific sectors is still being prioritized above maximizing GDP growth. Monetary policy works with a lag. With central banks moving towards excess tightening as the hiking cycle progresses, rumors about a soft landing seem to be exaggerated.

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The sale of the Fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627. The Fund must not be offered or sold to the public in Uruguay, except in circumstances which do not constitute a public offering or distribution under Uruguayan laws and regulations. The Fund is not and will not be registered with the Financial Services Superintendency of the Central Bank of Uruguay. The Fund corresponds to investment funds that are not investment funds regulated by Uruguayan law 16,774 dated September 27, 1996, as amended.