ROBECO
The Investment Engineers

Multi-asset market outlook

Chips and ships

October 2022

For professional investors

Sustainable Investing Expertise by ROBECOSAM

General overview

Cash proved to be the only safe haven in September

MULTI ASSET	1mo	3mo	YTD	1YR	3YR	5YR
Cash (EUR)	0.0%	0.0%	-0.3%	-0.4%	-0.4%	-0.4%
Gold (USD)	-2.9%	-7.9%	-9.3%	-5.7%	2.8%	4.2%
EMD local currency (UH, EUR)	-3.0%	1.4%	-4.3%	-4.0%	-2.7%	0.9%
Global Gov Bonds (H, EUR)	-3.3%	-4.4%	-13.4%	-13.4%	-4.8%	-1.6%
EMD hard currency (UH, EUR)	-3.3%	1.6%	-9.9%	-8.9%	-2.7%	1.4%
Global investment grade bonds (H, EUR)	-4.8%	-5.0%	-18.2%	-18.4%	-4.9%	-1.9%
Global high yield (H, EUR)	-4.9%	-2.1%	-17.9%	-18.4%	-3.9%	-2.1%
GSCI Commodities (USD)	-5.4%	-4.3%	41.4%	46.3%	16.3%	11.9%
Global inflation-linked bonds (H, EUR)	-6.5%	-6.3%	-18.7%	-16.3%	-3.9%	-0.8%
MSCI World (UH, EUR)	-6.9%	0.1%	-13.4%	-4.9%	8.4%	9.3%
MSCI World local currency	-8.3%	-4.4%	-21.9%	-15.5%	5.8%	6.5%
MSCI World (H, EUR)	-8.6%	-4.9%	-23.1%	-17.1%	4.3%	4.7%
Emerging Markets (LC)	-9.4%	-8.2%	-20.8%	-21.5%	1.1%	1.1%
Emerging Markets (UH, EUR)	-9.4%	-5.6%	-15.4%	-15.0%	1.5%	2.0%
Global real estate (UH, EUR)	-10.2%	-6.2%	-18.4%	-7.2%	-1.7%	3.4%
Oil Index (USD)	-10.6%	-21.0%	22.3%	25.8%	-3.7%	-0.5%

Source: Robeco, Bloomberg

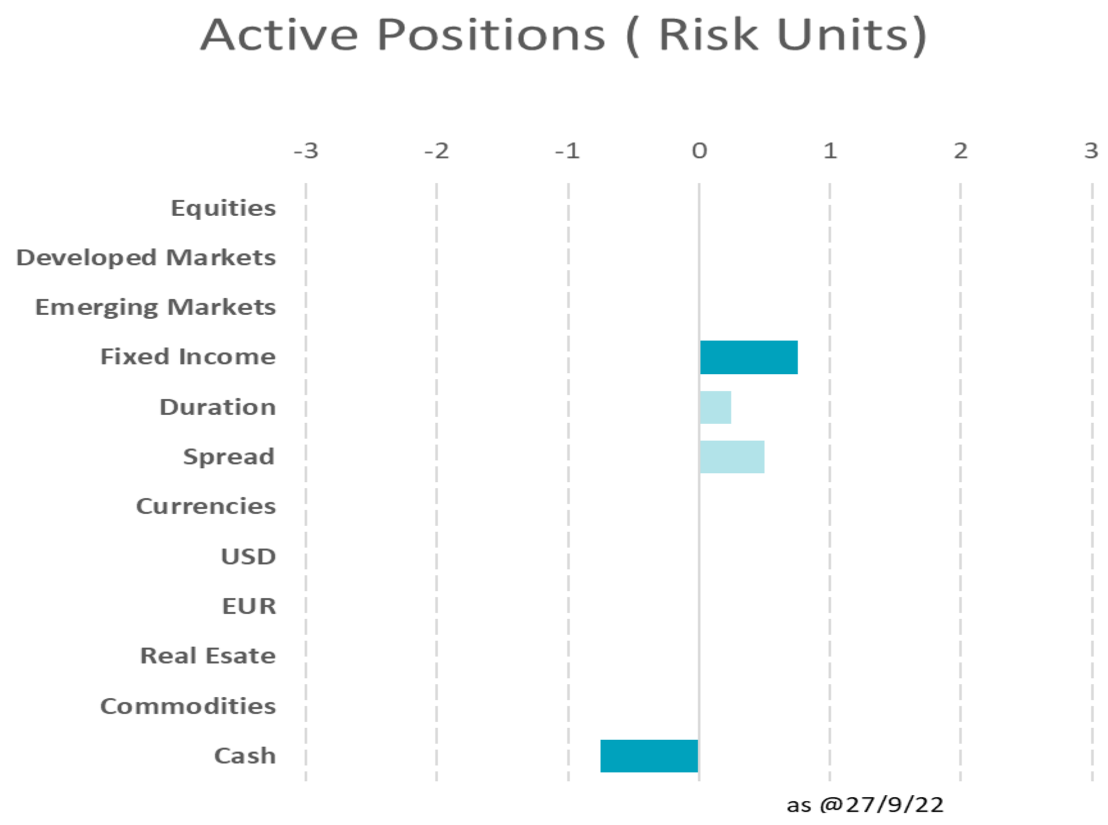
We are experiencing a continuing episode of high turbulence in the global economy and financial markets. Economic forecasters are in downgrade mode, exemplified by the OECD recently cutting its global growth forecast by 0.6% to 2.2%. In our view, an intensifying energy crisis in Europe on the back of the recent sabotage of Nordstream pipelines will bring a European recession forward in time.

Further into 2023, the impact of the ECB tightening cycle will surface by cooling housing markets across Europe. Except for cash and the mighty dollar, there were very few places to hide in September. Equity momentum worsened during the month, with the MSCI AC World losing 6.9% in euros. The VIX spiked above 30. With bond yields reaching new highs, sovereign bond returns also saw negative monthly returns of 3.3% in September (hedged into euros). Outside the GFC, this is the worst year since 1974 for a benchmark portfolio so far.

While a short-lived market rally is likely given the exceptional bearish sentiment, fundamentally equities still look vulnerable as we expect the Q3 earnings season to deliver negative earnings guidance, while a median earnings recession is not fully priced in. Emerging market equities show an attractive valuation discount, though it is hard to see sustained outperformance against developed equities as long as the dollar stays in a bull market, the food crisis lingers, and Chinese consumers stay downbeat about house price appreciation.

Multi asset views

Sustainable multi asset views



Source: Refinitiv Datastream, Robeco

In our view, we are inching closer to a peak in yields as Fed funds future rates already fully reflect peak Fed policy rates. A policy rate above 4% will amount to excess tightening that will cool inflation into 2023 and will probably trigger a US recession.

The recent buying by the Bank of England into the long end of the gilt curve does not herald the onset of BoE easing, or a broad developed markets central bank pivot, but merely addresses a specific liquidity event in a key UK market. Nonetheless, it shows that yields in developed markets have reached a level where liquidity events are more likely to occur. Although Fed officials have been vocal about their willingness to tighten into an economic slowdown, they might be more susceptible to an immediate threat to financial stability.

We therefore stay long duration in US Treasuries as the tightening cycle draws to a close in early 2023. A peak in the Fed tightening cycle is often preceded by a peak in the bond-equity correlation and a peak in bond yields.

Within equities, we have therefore removed our short position in the Nasdaq which acted as a hedge against our overweight position in high yield. Although further spread widening can't be ruled out, current high yield spreads around 600 basis points typically bode well for outperformance versus equities on a tactical horizon.

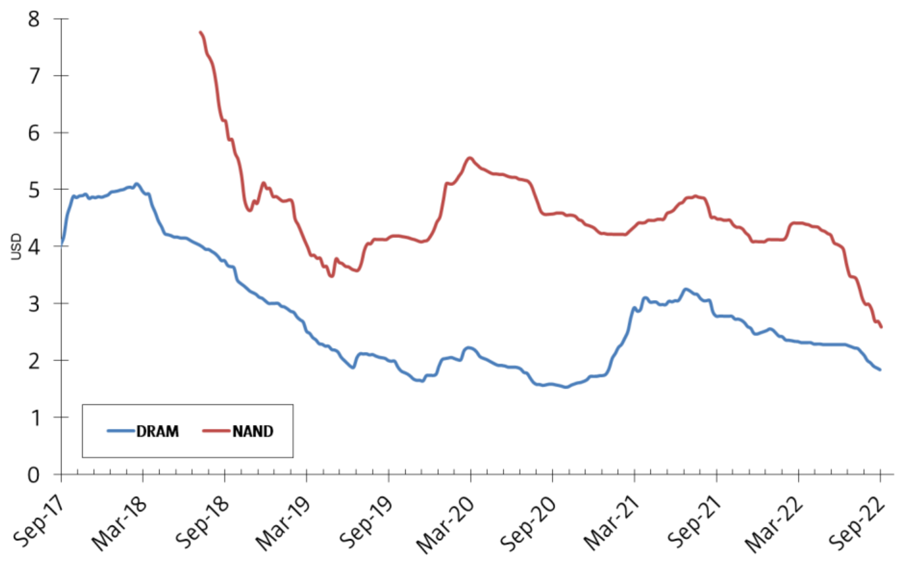
Theme of the month

Lessons from chips and ships: Part I – Chips

In the early days, when people still talked about transitory inflation, post-Covid supply chain disruptions appeared in many parts of the economy but were particularly prevalent in the semiconductor and shipping industries. In both cases, markets had consolidated, the number of players had dwindled, and supply discipline became the new norm. When Covid hit and central banks decided to print truckloads of money, demand for goods and gadgets picked up unexpectedly fast. Prices shot higher and long lead times became the norm. Now that most of us are talking about the persistence of inflation and a potential wage-price spiral, benign news for inflation comes from these early cyclical sectors.

Semiconductor prices started to fall a year ago and have accelerated downwards recently, confirming the likelihood of a recession. The tone from chip producers has changed dramatically, as they see rising inventories and have no visibility of demand. Because chip buyers only had a handful of players to turn to, they double ordered even more severely than they did in previous cycles. What was expected to be only a shallow downturn thanks to supply tightness is now turning into a fairly normal 'hog cycle'. NAND prices are below what they were pre-Covid, and DRAM prices are back to the levels of late 2019.

The semiconductor cycle: good news for inflation ahead

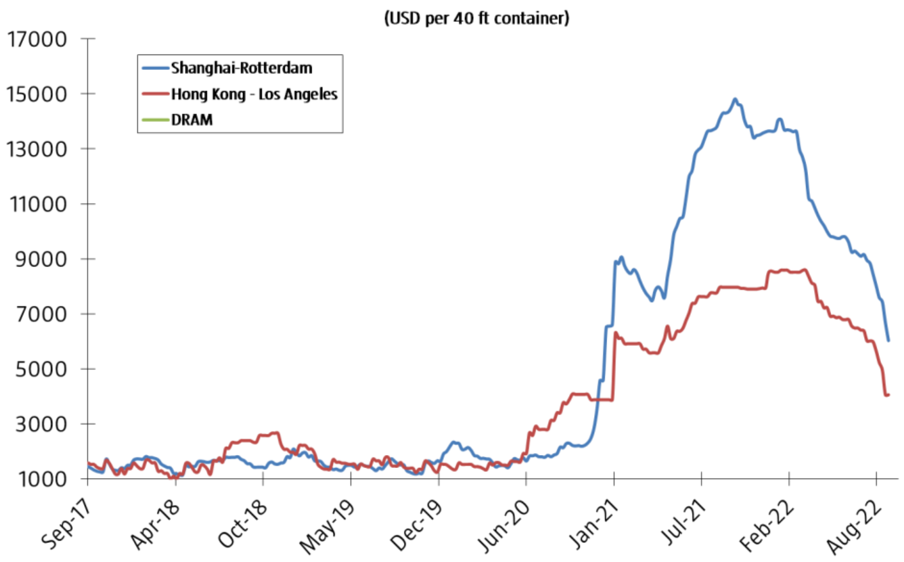


Source: InSpectrum Tech, Bloomberg, Robeco

What will be different in this cycle is that corporate profitability and operating margins can stay much higher. In an industry that is used to deflation, flat pricing combined with 15-20% annual demand growth and steady growth in productivity is a powerful combination for shareholders. Though forward earnings estimates have already been cut in half or even more, this time around, in the absence of the usual supply glut, we will not see losses in the industry! Book multiples for the 'big three' (Samsung, Hynix and Micron) are close to historical trough levels, while the industry has become a lot healthier. If we can use engagement to convince these companies to do a better job and 'share the wealth' (yes, that's a challenge, especially in South Korea), this should be a good time to consider investments in this cyclical sector on the eve of a recession.

Theme of the month

Container rates are falling back to earth



Source: Drewry, Bloomberg, Robeco

Part 2 – Ships

Similarly, the shipping industry no longer contributes to inflation: container rates have fallen dramatically over the past 12 months. Rates from China to Europe peaked at USD 15,000 per 40ft container and have now come down to about USD 6,000. However, this remains a lot higher than the sub-USD 2,000 levels seen prior to Covid. This is a result of the consolidation into three main alliances over the past 20 years. Prices of the main listed shippers thus still trade well above their 2019 levels. Here, investors do get paid, with dividend yields easily at 20-30% though that will not be sustainable. Shippers' profits used to disappear in down cycles, and now they will remain profitable, with healthy free cash flows.

A similar story of supply discipline applies to most commodity markets. Top-down analysts do not trust the relatively resilient bottom-up numbers for these deeply cyclical sectors. However, we must be aware that the supply-demand dynamic has changed for good. Yes, prices will fall as recession hits demand, but earnings and dividends will not disappear. Companies still have the pricing power to shield themselves from inflation. The wildcard here is cash-strapped governments that may try to increase the tax haul from these more-than-average pollutive companies. Europe and UK have already announced such a windfall tax.

What does this matter to a (multi-asset) investor? Demand destruction will lead to lower prices. Falling prices of chips and containers will bring some relief for goods buyers. Shipping stuff from China to the West had in many cases become prohibitively expensive and getting computer chips to power your electric vehicle had become virtually impossible. Supply chains are definitely normalizing and lead times will fall. So, those that still have the money can buy what they want again. Lower goods inflation lies ahead but we are unlikely to go back to the days of goods deflation. Deeply cyclical sectors can maintain better profitability than in previous downturns thanks to consolidation and supply discipline. Multiples for chip and ship stocks now suggest they trade at 10x bottom of the cycle earnings (2023 or 2024). Once the economy recovers, these stocks can be massive cash flow machines. Cyclical equities have less to fall than many people think given the pricing power for chips and ships.

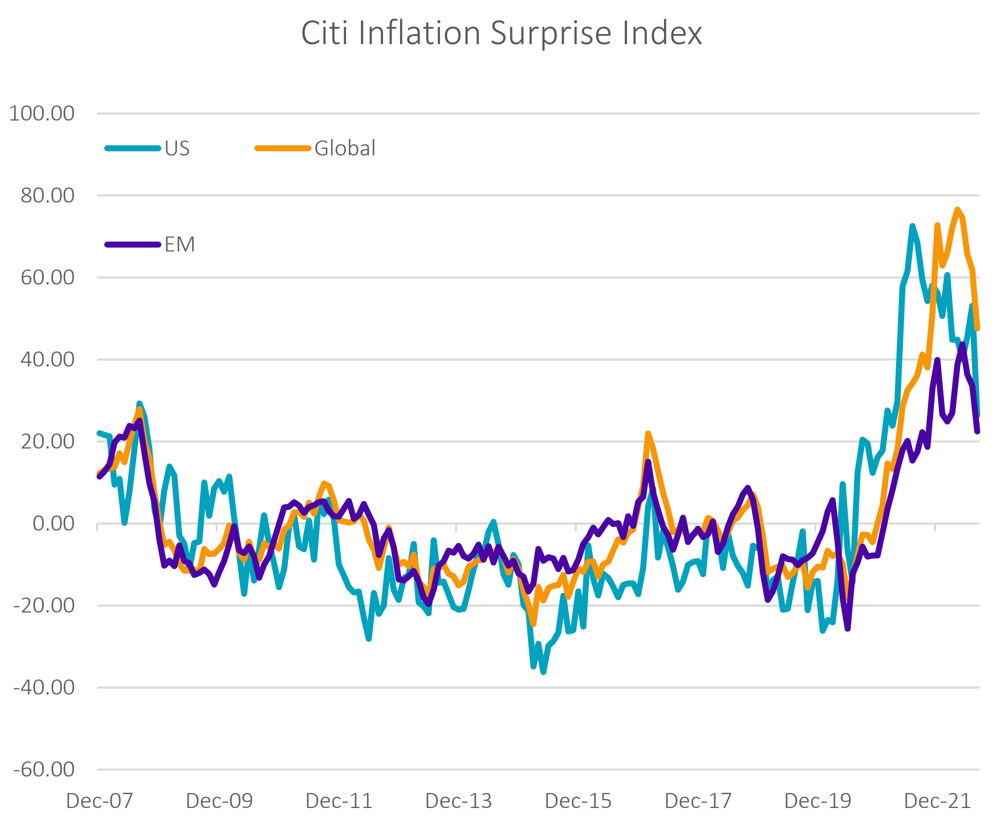
Economy (I)

Leading manufacturing indicators broadly contracted in September, with the Eurozone now signaling contraction in manufacturing activity for the third consecutive month, according to S&P Global PMI data. In Germany, the six-month outlook sentiment among producers in the IFO index is extremely downbeat and is approaching the lows observed during the peak in the Global Financial Crisis. The overall OECD composite leading indicator is already at its lowest level since the GFC.

Energy security is the main focus for Europe. Spot gas prices have declined strongly in recent months from a peak of EUR 640 to EUR 240, and rationing in the German manufacturing heartland might be averted, as gas storage facilities were near capacity at 91% on 23 September. A harsh winter would however still impact industrial activity. The EU's guidelines to cut gas usage by 15%, the risk of sabotage of energy infrastructure, and France's low nuclear output due to half of its power plants being offline under maintenance are other obstacles to a rebound in industrial activity.

In the UK, the proposed mini-budget by the new government severely backfired, with the Bank of England stepping in to prevent financial instability by buying long-dated bonds. Eurozone countries have increased their fiscal support to mitigate the impact of the energy crisis, with packages worth up to 1-5% of GDP. Germany announced a 'protective shield' for consumers and corporates worth EUR 200 billion to mitigate rising energy prices.

Inflation surprises are turning downwards again



Source: Bloomberg, Citi & Robeco

All market data to 30 September unless mentioned otherwise

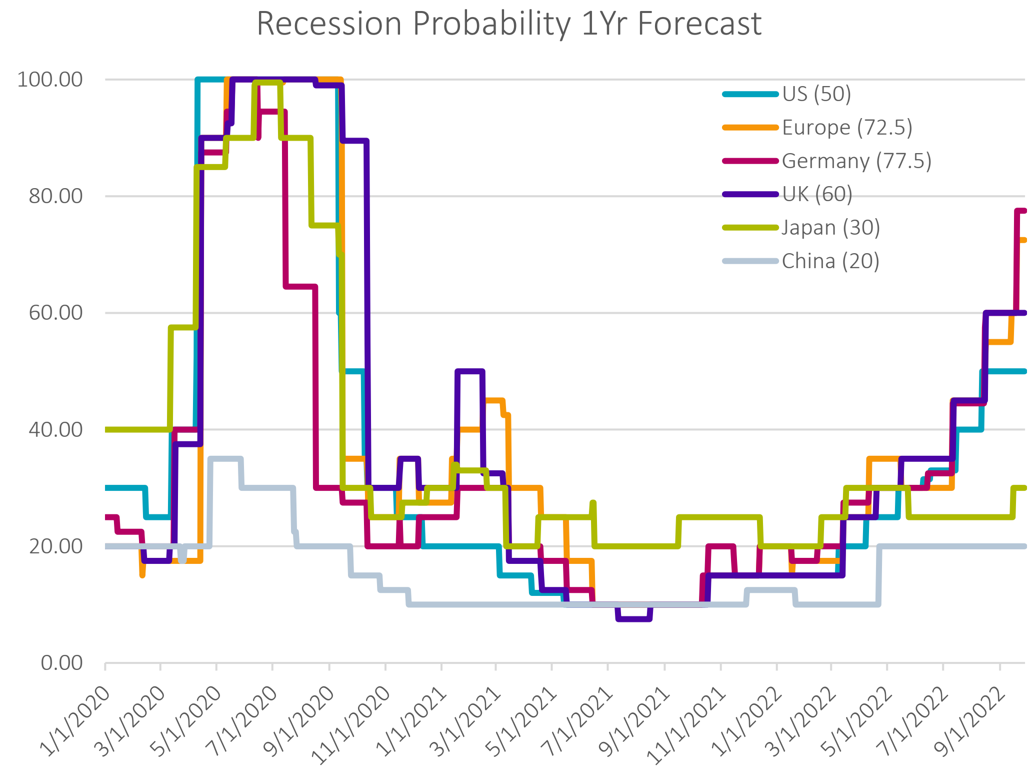
Economy (II)

Unlike the UK, Germany said it will reinstitute the constitutional debt brake and will not pursue fiscal expansion.

In the US, composite leading manufacturing indicators are still positive, with the underlying new orders index in the US moving into expansionary territory after contracting during summer. The Atlanta GDP nowcast for Q3 is showing a + 0.3% seasonally adjusted annual growth rate, which would signal that the US shrugs off the technical recession of the first half in 2022. Gasoline prices have come down after a summer peak. However, housing affordability is worsening on the back of 30-year mortgage rates surging well above 5%. The overall rise in real yields and lower savings levels are also inhibiting consumer spending.

China is still battling a real estate and health crisis, but signs of a trough in activity are firming. Chengdu came out of lockdown by mid-September. Broad money growth in China increased in Q2, and infrastructure expenditures and retail sales surprised to the upside. However, the slump in the housing market (20% of overall activity) and Covid lockdowns remain a major drag on consumers' willingness and ability to spend any excess cash.

Is a recession inching closer?



Source: Bloomberg, Deutsche bank & Robeco

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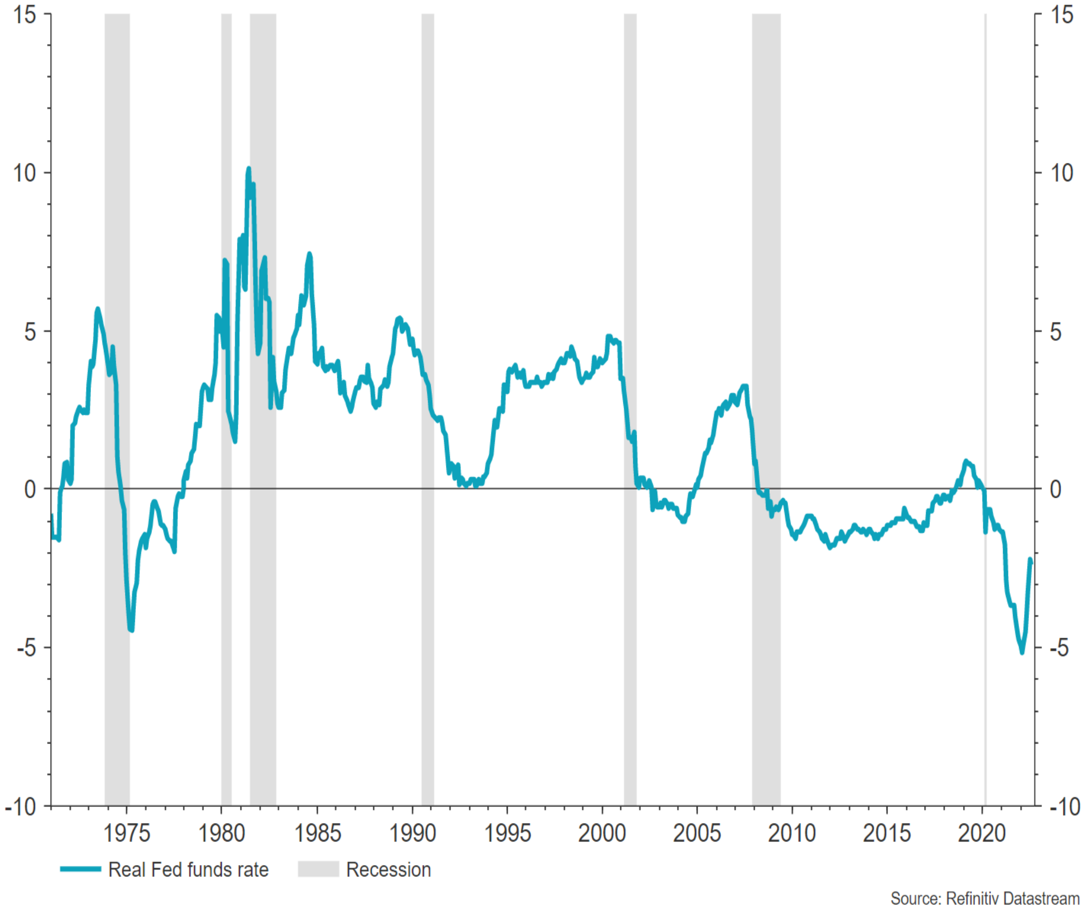
Economy (III)

The real Fed policy rate is still negative; further tightening is underway



Source: Refinitiv, Robeco

Central banks in developed economies are still in full combat mode when it comes to inflation by initiating jumbo rate hikes. The Fed tightened policy rates by another 75 bps, and the ECB followed with an unexpected 75 bps hike as well. Markets now expect another 75 bps hike by the ECB in October and expect the Fed to end the cycle in the first half of 2023 at a Fed funds rate of 4.5%. Moreover, market participants expect the Fed to stay at 4.5% well into Q3 2023. Even the Bank of Japan has been vocal about unwanted further depreciation of the yen for the first time since 1998, though it does not yet signal a change in monetary policy.

Looking ahead, macroeconomic momentum in the US will likely decelerate over the near term, as the impact of the more significant Fed tightening cycle becomes more visible towards the year end. Housing affordability has already worsened after 30-year mortgage rates surged to 6.3%. Household excess savings have been depleted, mirrored by a double digit increase in revolving credit in the year to date. With the quits rate declining, wage growth seems to have leveled off in recent months. In China, the renomination of President Xi for a third term in the October Party Congress could likely lead to a gradual easing of the zero Covid policy moving towards the legislative National People's Congress in March 2023.

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