ROBECO
The Investment Engineers

Multi-asset market outlook

Inflation's bite is worse than its bark

April 2023

For professional investors

Sustainable Investing Expertise by ROBECOSAM

General overview

Risk assets and gold outperform as US rate expectations peak

MULTI ASSET	1mo	3mo	YTD	1YR	3YR	5YR
Gold (USD)	7.6%	8.1%	8.1%	0.7%	5.9%	7.1%
Global inflation-linked bonds (H, EUR)	3.1%	2.9%	2.9%	-14.2%	-2.1%	-0.7%
MSCI World local currency	2.5%	7.4%	7.4%	-5.5%	16.7%	8.9%
Global Gov Bonds (H, EUR)	2.4%	2.5%	2.5%	-7.4%	-4.9%	-1.3%
MSCI World (H, EUR)	2.3%	6.9%	6.9%	-7.8%	15.0%	7.1%
Emerging Markets (LC)	2.2%	3.8%	3.8%	-6.6%	8.8%	1.9%
Global investment grade bonds (H, EUR)	1.9%	2.4%	2.4%	-7.8%	-2.0%	-0.7%
EMD local currency (UH, EUR)	1.5%	3.0%	3.0%	1.0%	1.3%	1.3%
MSCI World (UH, EUR)	0.6%	5.8%	5.8%	-4.8%	16.8%	10.7%
Emerging Markets (UH, EUR)	0.6%	2.1%	2.1%	-8.5%	8.2%	1.6%
Global high yield (H, EUR)	0.3%	2.2%	2.2%	-6.3%	3.2%	-0.3%
Cash (EUR)	0.2%	0.6%	0.6%	0.8%	-0.1%	-0.2%
EMD hard currency (UH, EUR)	-0.9%	0.5%	0.5%	-3.1%	-0.2%	2.1%
Oil Index (USD)	-1.5%	-5.3%	-5.3%	-14.2%	32.8%	-5.3%
GSCI Commodities (USD)	-3.4%	-6.6%	-6.6%	-7.9%	31.0%	7.6%
Global real estate (UH, EUR)	-4.7%	0.1%	0.1%	-18.5%	6.4%	3.9%

Source: Robeco, Bloomberg

The technology sector and those indices with a growth bias outperformed in March against the background of increased uncertainty. The belief that short-term US interest rates have peaked – or are at least within sight of peaking – has led to expectations that nominal growth (real growth plus inflation) will slow significantly this year. Hence, the growth companies that can demonstrate robust revenue projections will attract investors looking for places to preserve capital.

The tightening of monetary policy – US M2 growth was down 2.4% year on year in the worst January reading since 1934 – will reveal areas of the financial system where risks have been taken because money was cheap and plentiful. We have started to see this fraying with the failures of second-tier US banks (see the monthly theme below), the volatility in risk-free assets such as the US 2-year Treasury, and the severe slowdown in private asset funding. In this environment, real estate continued to derate though higher fundings costs and lower growth.

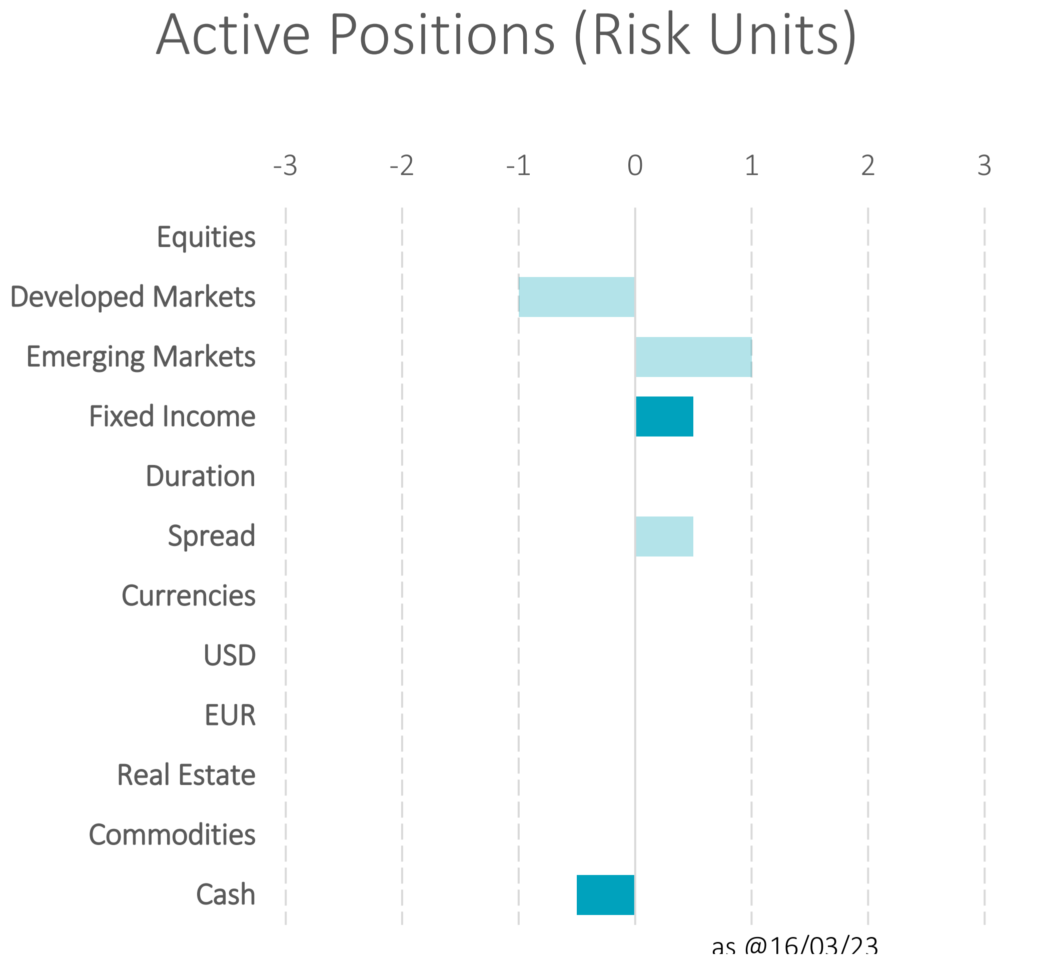
Within emerging markets, Asia ex-China performed well, although China's reopening has been underwhelming. Recent Chinese economic data is starting to pick up as more stimulus is forthcoming, and Bank of China relaxed the required reserve ratio (RRR).

In commodities, after a weak start to the year, gold caught a bid as banking concerns filled every inch of the financial press. Oil slumped in March but bounced strongly on rumors of a supply cut by OPEC following the recent visit of Chinese leader Xi to Riyadh.

 All market data to 31 March 2023 unless mentioned otherwise

Multi-asset views

Sustainable Multi-Asset Solutions views



Source: Refinitiv Datastream, Robeco

US 2-year bonds traded like a 'meme' stock, with annual yield moves experienced in single trading sessions. The slope of the US yield curve – the US 10-year yield minus the US 2-year yield – hit its most negative level since the recessionary environment of the early 1980s. From our vantage point, the inverted yield curve is still signalling a US recession, and so we removed our long duration position as this outlook started to be priced in. In addition, our core view is for rates to stay higher for longer than the current consensus, so there will be time to increase duration later in the year as central banks continue to fight inflation.

US macro data is still ok, and has improved versus expectations in Europe, so a recession has been postponed, and so has the default cycle. Hence, we continue to hold the high yield long position as the risk premium is attractive relative to other asset classes.

China's post-lockdown performance has been disappointing following a drag on activity due to the spread of Covid and concerns about property developers and local government funding. Additional measures offering economic support (e.g. cutting the RRR), the herd immunity and diminished threat of another lockdown will boost Chinese economic activity.

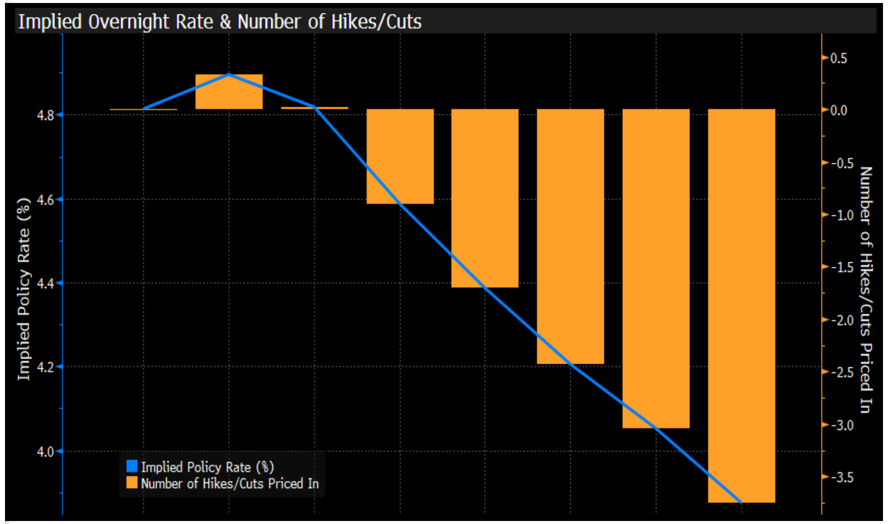
We have deliberately reduced tactical asset allocation risk in portfolios, but there is significant active risk coming from the underlying equity and bond security selection. The volatility in FX and equities remains low compared to bonds, which is concerning given the linkages across assets. Opportunities will arise to invest rather than trying to trade the noise.

Theme of the month

Inflation’s bite is worse than its bark

The narrative following the Global Financial Crisis (GFC) was that the unprecedented injection of money and liquidity into the system would lead to a massive inflationary spike, even though we were staring down the barrel of a deflationary spiral. We will never be able to prove whether a global depression would have resulted if central banks had not reinvented the monetary policy rule book during the GFC and the later Eurozone debt crisis. We do know for certain though the consequences of this policy creep – savers getting squeezed, negative nominal bond yields, and moral hazard, etc. Until recently, this did not produce price inflation in the real economy; Milton Friedman believed that inflation is always a monetary phenomenon. Indeed, inflation in goods and services did not pick up until Covid caused supply chain issues from 2020. Hence, monetary policy could remain easy, and central banks’ balance sheets could stay bloated for much longer.

Interest rate pricing expects quick central bank policy ‘volte face’, especially in the US



Source: Bloomberg, @27 Mar 2023

Central banks did not worry about this. They believed they always had the tools to dampen inflation – blunt as those tools are – so once inflation began to appear in the real economy, rather than only in financial assets, there was always plenty of room to raise the price of money (interest rates) or reduce the quantity of money (quantitative tightening). Now the inflation dog is barking, central banks are raising rates quickly, but they face the additional headwind of government spending (Inflation Reduction Act or energy subsidies) that have made their job a lot harder. The implications are problematic because the path to lower inflation and higher unemployment without a hard landing has narrowed significantly. The tight labor market is fueling increased wage demands, which is the clearest indicator that higher inflationary expectations are becoming embedded in consumers' psyche. Unless monetary policy tightens, a spiral of higher prices will lead to higher wages, leading to even higher prices – textbooks from the 1970s show just how detrimental to stability this spiral can be. Currently, monetary policy is still loose due to the wide availability of credit and negative real rates, so even if we are close to peak rates, rate cuts are not around the corner unless there is a financial accident. This is where our views differ from the market consensus, which expects the Fed to cut rates (see chart).

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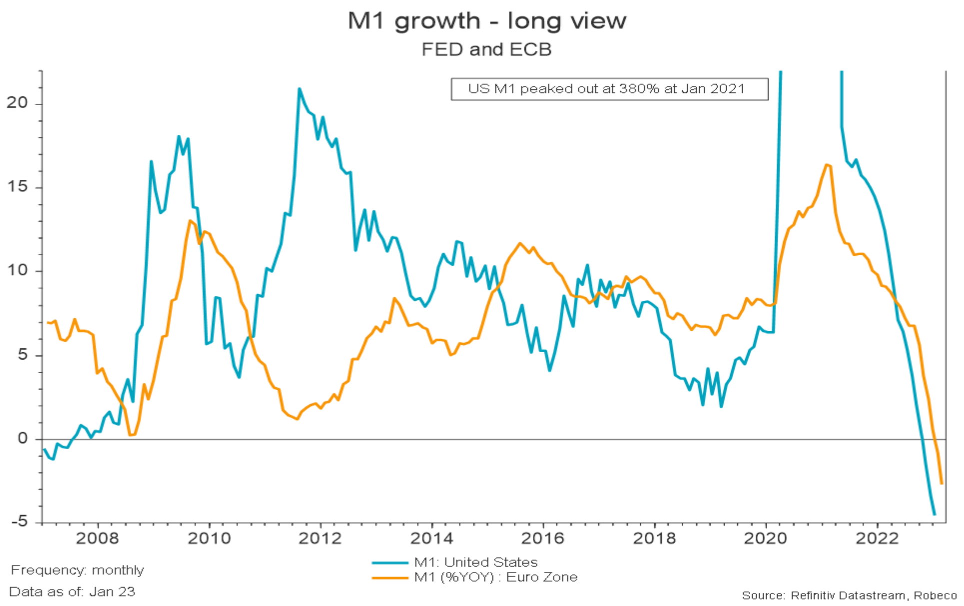
Central banks have started to drain the excess money from the US and Eurozone systems



Where is an inflationary scenario going to bite the hardest ?

So far, the withdrawal of monetary policy support had gone smoothly, and the parts of the system where the excessive leverage flowed are slowly being uncovered. The narrative that central banks are behind the curve has died away, except maybe in Japan. Central banks in less-developed markets that started their tightening cycles long before the ECB and Fed still have room to cut rates, because domestic inflation has already fallen.

In the US, regulation on regional banks was eased in 2018, allowing smaller banks to hold long-duration bonds on their balance sheets using cash deposits, thus creating a duration mismatch. US Treasuries are considered a risk-free asset, and banks buying Treasuries with cash deposits could increase their profitability when yields fell. As US bond yields spiked higher this year, 'paper' losses were made at the same time that depositors' cash burns increased, causing a lack of new capital to fund activities into start-ups. Banks' clients withdrew deposits to fund activities, which meant banks with a duration mismatch had to sell bonds to honor the withdrawals, crystalizing their balance sheet losses.

This created a doom loop as other customers saw their deposits at risk and withdrew their cash, exacerbating the solvency risk of the bank as the loss from selling Treasuries became larger than the equity. Social media and electronic banking sped up this doom loop as liquidity risk morphed into a wider solvency issue. We are now moving to the stage in the cycle where excessive risk taken by parts of the financial system are being exposed.

The situation has similarities with 2008, but is not as serious, since much of the excess is in private assets, while asset quality is higher due to post-GFC regulation. The cracks appearing due to tighter monetary policy are a normal process of shining a light into parts of the system that thrived in a zero cost of capital world, and the good news is that the real economy is still strong. Our core investment scenario is for tighter monetary policy to lead to much lower nominal economic growth later this year, though we believe that central banks do not have room to cut rates until inflation is defeated.

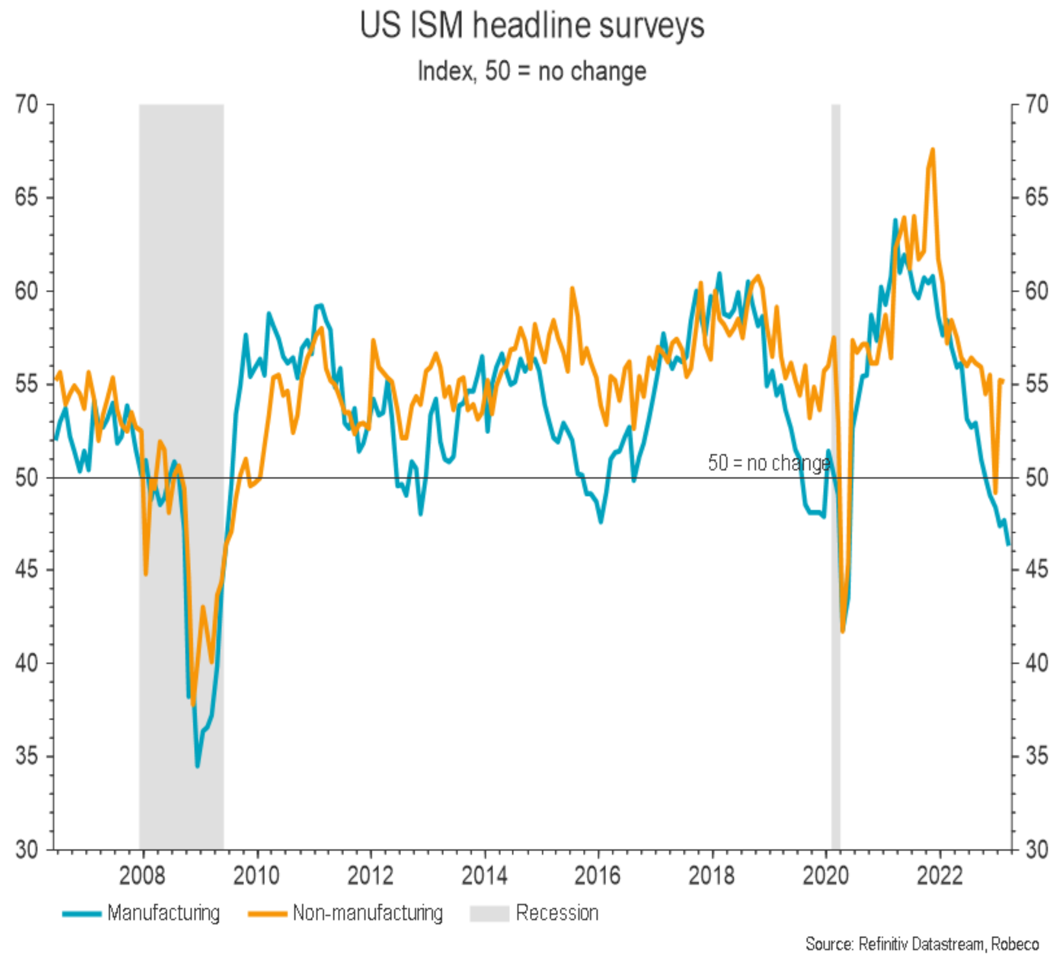
Economy (I)

The global manufacturing cycle, which typically captures the bulk of underlying macro volatility, is showing increasing divergence. China is in expansion while activity in developed economies manufacturing activity is showing accelerating contraction.

In the US, the ISM manufacturing reading for March came in at 46.3, below consensus, with the new orders sub-index also remaining in contraction territory at 44.3. Near-term demand expectations are softening, evidenced by the negative spread between new orders and inventories, with the latter outpacing the former. In addition, the latest ISM data does not fully reflect the tightening of bank lending conditions for US corporates as a result of the failure of two US banks (SVB and Signature) and the resulting stress in the banking system. Also, it does not yet reflect a tightening of energy supply after OPEC decided to cut production by 1 million barrels per day.

In the Eurozone, leading manufacturing indicators are also still in contractionary territory, although activity levels in March improved compared with February. In Japan, the Tankan leading indicator was underwhelming, with especially large manufacturers in Energy and Food and Beverages signaling deteriorating business conditions.

DM manufacturing activity continues its slowdown



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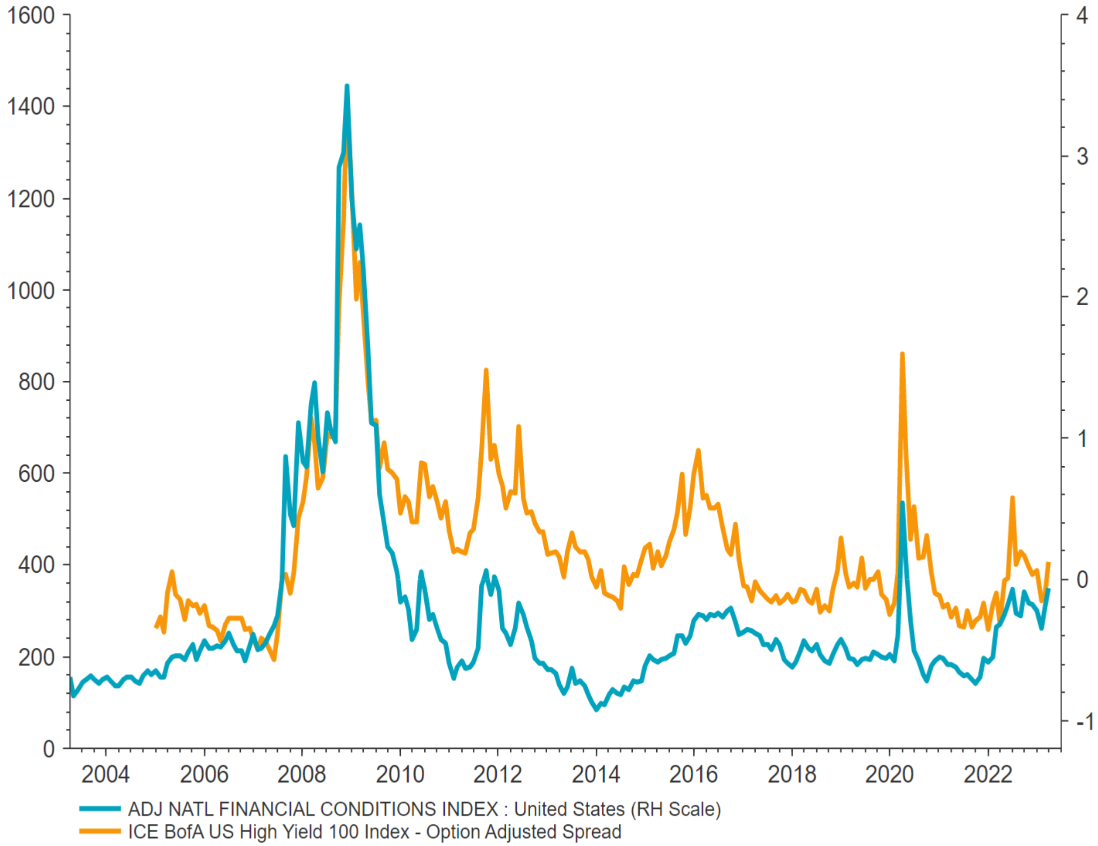
Economy (II)

The official Chinese manufacturing PMI from the China's National Bureau of Statistics at 51.9 showed a decelerating pace of expansion after reporting the highest reading in a decade at 52.6 in February. The signal of slowing expansion is also corroborated by the Caixin PMI which declined to 50.0. However, non-manufacturing leading indicators held up better in March, both in emerging as well as developed markets. The wedge between services and manufacturing activity shows that the demand substitution effect after the broad easing of Covid-19 restrictions has not yet petered out.

March saw upheaval in US financial markets as Silicon Valley Bank suffered a bank run. The policy rate shock of the past 12 months slashed the value of its fixed income portfolio, prompting deposit flight and the bank's subsequent demise. Ripples were felt in Europe where Credit Suisse, a systematically important bank, was forced to merge with competitor UBS at a bargain 60% discount on its stock valuation to prevent a full-blown banking crisis. The Fed has raced to give troubled banks easier access to liquidity by allowing them to lend against the face value of their government bond holdings, and by opening dollar swap lines to provide dollar liquidity to other central banks. This has prevented banks from taking a severe mark-to-market drawdown on their assets to free up liquidity. On the liability side, the FDIC provided protection for large uninsured deposits of troubled banks, though Treasury Secretary Yellen stopped short of providing blanket insurance.

Credit crunch contained? Financial conditions worsened in March but not GFC-style



Source: Refinitiv Datastream, Robeco

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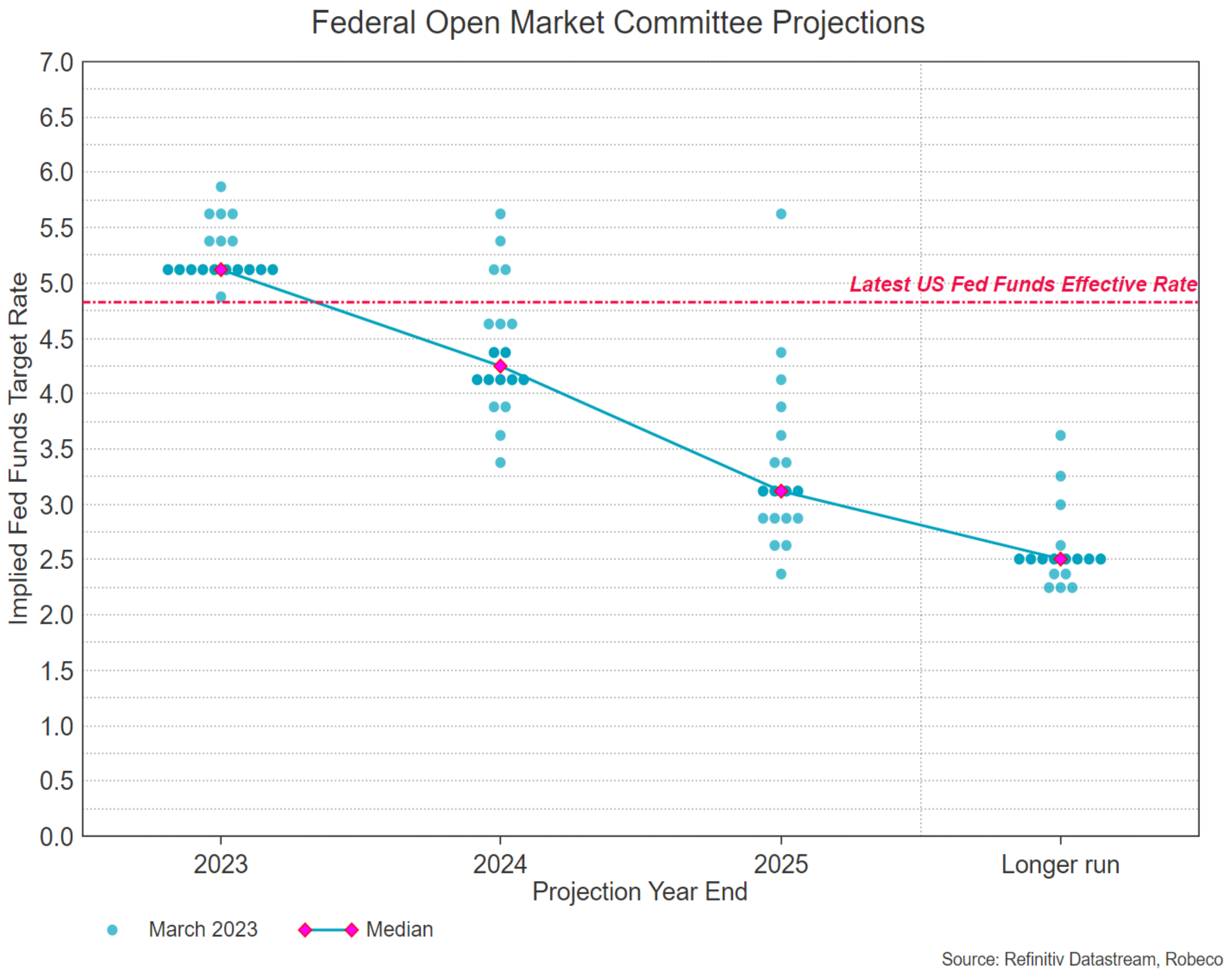
Economy (III)

Undeterred (for now) – the March 2023 FOC dot plot stuck at 5.1%



Source: Refinitiv, Robeco

Yet, despite the turmoil in the third week of March, the Fed seemed undeterred and raised its target policy rate by another 25 bps to the 4.75%-5.00% range. The central bank obviously faces a dilemma between price stability and financial stability, but judges that without price stability, "the economy does not work for anyone". The closely watched core PCE inflation is still 2.6% above Fed target levels. The dot plot confirmed the ongoing tightening bias, with the 2023 median dot unchanged at 5.1%. The market disagrees with the central bank, as the Fed Funds futures curve notably shifted downwards compared to the end of February. Market participants now expect the Fed policy rate to have reached its terminal rate at 5% and for the central bank to cut the policy rate in the next 12 months by almost 100 bps.

The ECB also stands firm in its quest for price stability. It raised its policy rate by 50 bps to 3.0%, with President Lagarde saying that the ECB "still has more ground to cover". Nonetheless, progress is being made on the inflation story, and if push comes to shove, financial stability concerns would trump macro considerations. Data shows headline inflation is subsiding, now just below 7%. The contribution from energy has become negative, and with European gas storage ample, headline inflation will drop to 3%, the market believes. Core inflation is still sticky at 5.6%. Yet, there is a lead-lag effect between headline and core inflation, and core inflation is expected to follow the decelerating headline inflation trend.

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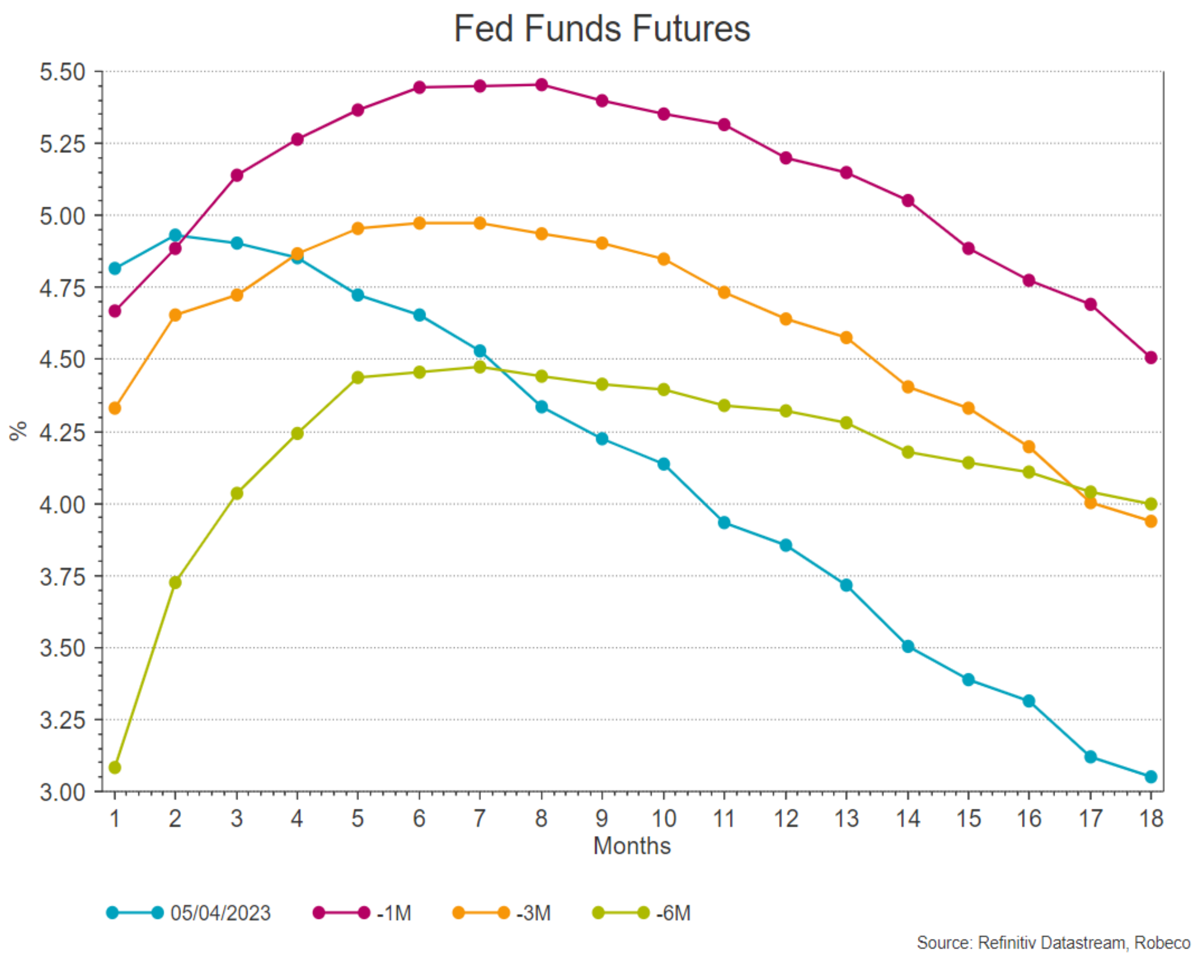
Economy (IV)

What a difference a month makes…



Source: Refinitiv, Robeco

As we wrote last month: "With central banks moving towards excess tightening as the hiking cycle progresses, rumors about a soft landing seem to be exaggerated". The demise of four banks in March is proof that central banks have arrived in excess tightening territory – a situation where the actual policy rate level is above the non-observable neutral policy rate level – where typically something breaks.

The 100 bps-worth of policy rate cuts priced in over the next 12 months indicates the market has rapidly shifted from a 'peak Goldilocks' scenario that allowed for a peak policy rate of 5.4%, to raising the probability of a hard landing that necessitates rate cuts. Estimates vary, but the impact of the recent tightening in financial conditions is likely to be at least another couple of 25 bps rate hikes.

Looking ahead, the tension between persisting inflation pressures on the one hand and weakening macro momentum joining financial stability concerns on the other could leave central banks starting to reconsider their tightening bias.

However, given the absence of hard evidence of broad macro instability such as rampant job losses and/or broadening banking distress, the market could have excessively pre-empted near-term Fed cuts at this juncture.

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Additional Information for investors with residence or seat in the United Arab Emirates

Some Funds referred to in this marketing material have been registered with the UAE Securities and Commodities Authority (the Authority). Details of all Registered Funds can be found on the Authority's website. The Authority assumes no liability for the accuracy of the information set out in this material/document, nor for the failure of any persons engaged in the investment Fund in performing their duties and responsibilities.

Additional Information for investors with residence or seat in the United Kingdom

Robeco is subject to limited regulation in the UK by the Financial Conduct Authority. Details about the extent of our regulation by the Financial Conduct Authority are available from us on request.

Additional Information for investors with residence or seat in Uruguay

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.