KBC Investment Strategy **Review**

KBC Asset Management

July-2020

Review of the financial markets

Equity markets

01-07-2020

The worldwide stock market (MSCI World AC expressed in euros) lost around 6.3% in euro terms over the past six months (up to and including 30 June 2020). Stock markets got off to a good start in January 2020, with the same momentum as they had ended 2019. They were buoyed up by optimism due to the thaw in the trade conflict between China and the US, and the gradual recovery of industry and trade, which had been hit hard by this conflict.

In February, however, the coronavirus started to advance. Initially, this was limited to China and developing Asia, although fears concerning the global economic impact of this new strain of coronavirus grew, causing the initial earnings for the year to quickly dwindle. Following a brief rally, stock markets fell sharply once again as first China and then the rest of the world were hit by the coronavirus crisis. Many countries went into lockdown, leading to a sharp reduction in economic activity. The economic growth figures and earnings forecasts throughout the world were revised sharply downwards. It wasn't until the end of March that stock markets appeared to stabilise somewhat thanks to the major government support packages, coupled with lower key rates and new asset purchase programmes by central banks. In April, due to these massive support packages, there was even an actual resurgence, although economic activity remained at a low level due to the many lockdown measures. Stock markets increased slightly in May and June as the spread of the virus also seemed to be under control in Europe, and the lockdown measures were gradually eased.

Over the past six months, clear regional differences have been apparent. Among the traditional markets, the US held up well (-2.8% in euro terms), clearly better than the global average (-6.3%), while the euro area (-11.93%) underperformed the broad market by some margin. The UK recovered somewhat from the Brexit anxiety, but subsequently fell in line with the broad market index and still lagged well behind (-23.23%). In Asia, the Hong Kong stock market fell again (-11.54%) due to the continuing unrest and street violence in May. The falls in Japan were slightly less severe

(-7%).
Shares from emerging markets (countries or regions that are expected to experience rapid economic growth to make up their lag with the West) recorded losses of approximately -10.26% in the past six months. Asian stock markets initially rose in line with the broad market. The relief following the partial trade agreement, in particular, pushed investors in the direction of Chinese shares. They too recovered quickly after having been hit hard by fears about the new strain of coronavirus. China was the only market to have posted positive returns over the last six months (+2.84%). Latin America lost a lot of ground due to Brazil's poor performance (-35.39%).
For the sectors, the differences over the past six months are quite pronounced. The technology sector was able to recover quickly from the coronavirus crisis and is now 12.1% higher than six months ago, due in part to the strong software subsector (+16.2%). Defensive sectors performed relatively better, given their lower susceptibility to a recession. Health care posted a positive return of +2.1%, which isn't surprising as this sector is getting quite a bit of attention during the coronavirus health crisis. Communication services consists of the telecom subsector (defensive), and media and entertainment subsector (more focused on IT, +5%), which explains the solid relative performance (0.3%). Other defensive sectors also held up well. Consumer staples performed very well at the beginning of the coronavirus crisis, but remain in negative territory (-6.2%). The utility sector lagged slightly behind (-9.4%) as a result of low energy prices. The cyclical sectors were hit hard at the beginning of the crisis, but recovered sharply in April and May. For instance, consumer discretionary was able to make up much ground and the sector recorded a positive 1.2%. The retail sector in particular (+16.9%) contributed to this recovery. The commodity sectors recorded a loss of -8.6%, while the loss for industrials remained fairly substantial at -13.5%. Financials also saw heavy losses (-23.6%) due to fears of recession and sharp cuts in interest rates. Share prices in the energy sector fell away completely (-34%). The sector has been in investors' bad books for a while now, and took a severe beating from the slump in oil prices in the wake of falling world demand, combined with the conflict between oil producers in March from which the sector has clearly not yet recovered.
Worldwide stock market (MSCI World AC expressed in euros) lost around 6.8% in euro terms over the past six months (up to and including 31 May 2020). Stock markets got off to a good start in January 2020, with the same momentum as they had ended 2019. They were buoyed up by optimism due to the thaw in the trade conflict between China and the US, and the gradual recovery of industry and trade, which had been hit hard by this conflict.

In February, however, the coronavirus started to advance. Initially, this was limited to China and developing Asia, although fears concerning the global economic impact of this new strain of coronavirus grew, causing the initial earnings for the year to quickly dwindle. Following a brief rally, stock markets fell sharply once again as first China and then the rest of the world were hit by the coronavirus crisis. Many countries went into lockdown, leading to a sharp reduction in economic activity. The economic growth figures and earnings forecasts throughout the world were revised sharply downwards. It wasn't until the end of March that stock markets appeared to stabilise somewhat thanks to the major government support packages, coupled with lower key rates and new asset purchase programmes by central banks. In April, due to these massive support packages, there was even an actual resurgence, although economic activity remained at a low level due to the many lockdown measures. Stock markets increased slightly in May too, as the spread of the virus also seemed to be under control in Europe, and the lockdown measures were gradually eased.

Over the past six months, clear regional differences have been apparent. Among the traditional markets, the US held up well (-3.3% in euro terms), clearly better than the global average (-6,8%), while the euro area (-15.5%) underperformed the broad market by some margin. The UK recovered somewhat from the Brexit anxiety, but subsequently fell in line with the broad market index and still lagged well behind (-21.2%). In Asia, the Hong Kong stock market fell again (-16%) due to the continuing unrest and street violence in May. The falls in Japan were slightly less severe (-6%).

Shares from emerging markets (countries or regions that are expected to experience rapid economic growth to make up their lag with the West) recorded losses of approximately -10.5% in the past six months. Asian stock markets initially rose in line with the broad market. The relief following the partial trade agreement, in particular, pushed investors in the direction of Chinese shares. They too recovered quickly after having been hit hard by fears about the new strain of coronavirus. China was the only market to have posted positive returns over the last six months (+2%). Latin

America lost a lot of ground due to Brazil's poor performance (-36.6%).

For the sectors, the differences over the past six months are quite pronounced. The technology sector was able to recover quickly from the coronavirus crisis and is now 8.5% higher than six months ago, due in part to the strong software subsector (+10.2%). Defensive sectors performed relatively better, given their lower susceptibility to a recession. Health care posted a positive return of +5.2%, which isn't surprising as this sector is getting quite a bit of attention during the coronavirus health crisis. Communication services consists of the telecom subsector (defensive), and media and entertainment subsector (more focused on IT, +4%), which explains the solid relative performance (-0.2%). Other defensive sectors also held up well. Consumer staples performed very well at the beginning of the coronavirus crisis, but remain in negative territory (-5.7%). The utility sector lagged slightly behind (-5.5%) as a result of low energy prices. The growth-oriented sectors were hit hard at the beginning of the crisis, but recovered sharply since mid-April. For instance, consumer discretionary was able to make up much ground in May and limit the loss to -1.4%. The retail sector in particular (+10%) contributed to this recovery. The commodity sectors recorded a loss of -8.4%, while the loss for industrials remained fairly substantial at -15.1%. Financials also saw heavy losses (-23.8%) due to fears of recession and sharp cuts in interest rates. Share prices in the energy sector fell away completely (-30.9%). The sector has been in investors' bad books for a while now, and took a severe beating from the slump in oil prices in the wake of falling world demand, combined with the conflict between oil producers in March.

Bond markets

The past six months were extremely turbulent ones for the bond markets and can be divided up into three periods. The start of the year was quite quickly characterised by doubts and risk aversion. This trend was reinforced by fears of a recession resulting from the Covid-19 pandemic. Investors initially bought lots of bonds and rates fell from around -0.2% to a record low of -0.9% on 9 March. This was accompanied by a period of unprecedented central bank support measures. Stimulative monetary policy, with lower interest rates worldwide and increased bond purchases, was necessary to restore calm on the financial markets, especially the money market. On the other hand, the aim was also to mitigate the repercussions of the economic recession by keeping interest rates low. In the second phase (up to 19 March), investor distrust led to a sharp rise in bond yields, which ended up at -0.2% again. This triggered panic selling of bonds and a flight to even safer havens, with investors moving into cash. A period then followed in which nervousness eased and the German 10-year benchmark rate became less volatile, ending June at around -0.5%.

The rapid spread of the coronavirus prompted far-reaching quarantine measures to be taken, bringing whole swathes of public life and business activity to a standstill. The consequence is a global recession, which could translate into an economic contraction of almost 10% in Europe. Governments responded very swiftly with credit guarantees and fiscal stimulus packages, running to over 10% of GDP in countries like the US, Germany and Italy.

Central banks too immediately sprang into action. On 3 and 15 March combined, the Fed cut its key rate from 1.50% to 1.75% to a range of 0% to 0.25%. It is also pumping cash into the money market and has resumed its bond-purchasing programme with no upper limit placed on it. Ten-year bond yields in the United States responded by slipping from 1.9% to 0.6% in the past six months. Key rates were slashed all over the world in the Fed's wake.

The ECB did not cut its deposit rate, which already stood at -0.5%. It announced on 12 March that it would be providing more liquidity and raised the amount of its bond-purchasing programme. However, the credit spread between Germany and the economically harder hit periphery countries widened considerably, with the premium for Italy in particular rising to 2.75%. The ECB raised (via a new PEPP programme) its planned bond-purchasing scheme to 750 billion euros on 18 March, while granting itself full freedom as regards amounts and terms. Some calm returned to the market. The signal of solidarity between core euro-area countries and the periphery was an additional boost for Southern European countries. As the thrust of the EU's coronavirus aid package became clear, including a potential 750-billion-euro recovery and resilience fund, the rate spread

with Italy narrowed to 1.9% at the end of May. To dispel any remaining doubts, the PEPP budget was further increased to 1 350 billion euros at the start of June, and the period of support purchasing was also extended by six months. By the end of June, the rate spread with Italy had narrowed to 1.7%.

Corporate bonds are sensitive to the many uncertainties and slower growth. They benefited until mid-February from hopes of a recovery in economic growth, enabling credit premiums for investment-grade bonds to fall to 0.9%. Since then the global economy has been pushed into recession. Fear of business failures rose sharply, despite all the government support measures. In March, the extra compensation offered peaked at over 2.4%. The ECB recently cranked up its purchases of corporate bonds and governments offered all kinds of loan guarantees, providing important support to the market in question. The risk premium recently fell to 1.5%.

The fall in euro-area rates was conducive to longer maturities. The price of this type of government bond in particular has risen by around 2% over the last six months, whereas the price is barely higher for near-term maturities. On balance, the credit premium for corporate bonds is higher than at the start of the year, causing that theme to lose around 1% in value over the same period. US dollar investments were boosted by a limited currency appreciation, but turned in a good performance mainly on account of the sharp fall in US interest rates. Overall, the euro became slightly more expensive than the currencies of emerging countries, which has caused bonds denominated in their local currency to fall by almost 7% since the start of the year.

Outlook for the financial markets

Investment climate

- The European and US economies are restarting relatively quickly.
  - High-frequency indicators suggest that the economy is getting underway again.
- All the same, the direction and strength of the recovery are not very clear as yet.
  - A full recovery is likely to take several quarters if not years.
  - What's more, the risk of new flareups in the Covid-19 epidemic remains.

European economy haemorrhaging, but governments offer prospect of improvement

- Revised growth figures for the first quarter of 2020 in the euro area show that the lockdown measures imposed from March onwards inflicted unprecedentedly severe damage on the economy.
  - The contraction was, however, a little smaller than initially estimated.
  - We detect substantial differences between the euro countries. The reduction in GDP was much greater in Spain, Italy and France than in the Netherlands and Germany.
- The downturn in economic activity was probably even greater in the second quarter.
  - Hard economic figures as well as sentiment indicators point towards an extremely weak economy.
  - The lockdown measures were only introduced in the middle of March and remained in place for the whole of April. They began to be relaxed in May, but were not lifted entirely.
- The recovery of the European economy has been supported by drastic monetary and budget measures.
  - At the beginning of June, the European Central Bank expanded and extended its emergency bond-purchasing programme.
  - The European Commission too issued a proposal to revive and strengthen the economy (Next Generation EU).
  - These policy measures resulted in a narrowing of rate spreads in the euro area and an appreciation of the euro against the US dollar.
- We have raised our estimate for economic growth in the euro area to -9.6% for 2020.

Slight optimism concerning a Brexit deal

- The UK does not want an extension to the transition period for its exit from the European Union and will therefore leave the EU completely on 31 December 2020.
- Little progress is currently being made in the negotiations on the future relationship between the UK and the EU. Both parties expect, however, to be able to achieve greater progress in the summer.
  - The fact that barely any progress has been made to date, implies that the agreement will be more of a limited than a wide-ranging one. This suggests a framework accord on trade in goods, with very little on services.
  - A limited agreement like this would lead to a 'controlled but messy' exit by the UK from the EU at the end of this year. This is also likely to somewhat increase trade problems between the UK and its most important trading partners in the EU.

Fast restart in the US, despite risks

- The prospects for the US economy remain heavily overshadowed by the uncertainty regarding the future course of the corona pandemic.
  - States are restarting their economies earlier than anticipated, which will give a boost to the economy in the third quarter compared to the extremely gloomy second quarter.
  - At the same time, the significant rise in the number of confirmed Covid-19 cases in a large number of states emphasises the risk associated

with this restart.

- We have nevertheless raised our growth forecast for 2020 to -6.5%, as the high-frequency indicators are improving and budgetary and monetary policy is stimulating the recovery.

Higher oil price, higher inflation

- Supply and demand have realigned in the oil markets faster than expected, resulting in a vigorous recovery in the price of oil from its April low.
  - The restart of the economies in Europe, the US and China ensured greater demand for oil, while OPEC+ is curbing output.
  - Higher oil prices translate to higher forecast inflation in 2021 in the euro area and the US.

Mixed signals from China and the emerging markets

- It is fair to describe the economic recovery in China as V-shaped.
  - Industrial production and car sales and registrations are now higher than they were a year ago and the sentiment indicators are pointing towards economic expansion.
  - The figures for retail sales and electricity consumption, however, suggest that the recovery in the service sector is lagging behind.
  - The risk of a new wave of infections also applies to China.
  - We maintain our growth estimate for the Chinese economy of just 1.0% in 2020.
- Developments in a number of other emerging markets provide fewer grounds for optimism. This applies in particular to Latin America, which has become the new epicentre of the pandemic.

Portfolio allocation

Overall portfolio

- The equity weighting is slightly below the standard level.
  - No extra shares are being purchased, but due to the robust stock markets, the share position has increased (drifted upwards) from -5% to -2.5% below the its benchmark level since the previous decision. We confirm this position.
  - We are not raising the equity position further, as the market valuation prices in an extremely favourable restart scenario (V-shaped recovery). This is not what we expect to happen. We believe there is a substantial likelihood of a reality check (i.e. a market correction) based on economic numbers, earnings growth and/or Covid infections.
- Given the extremely low interest rates (even negative in some cases), we are still invested below the standard level for bonds.
- We are parking the remaining assets in cash positions in euros.

Bonds deployed chiefly as a buffer

- The bond component primarily serves as a solid buffer relative to our equity positions.
  - Despite low interest rates, we are focusing our government bond portfolio on short-dated paper issued by euro-area countries to counterbalance fluctuations on the stock markets.
  - Our corporate bond holdings are above their standard level. They offer an attractive additional return compared to government paper, while the ECB's bond-purchasing programme is supporting prices.

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The following are our focuses in the short term:

Emerging markets: we think emerging markets are set for a comeback:

- Although they have been badly hit in the short term by the Covid virus, growth potential in the emerging markets remains structurally higher in the medium term than in Western countries. This group of countries is dominated in terms of their relative importance to the equity markets by China, which appears to be recovering faster from the Covid crisis than the rest of the world.

European small and mid-caps:

- Smaller companies, many of which expand into the larger business segment, generate stronger growth than their bigger counterparts in the medium term.
- The fact that their focus is more on the local (European) market makes smaller companies less vulnerable to trade tensions or border closures. These businesses are struggling in response to the corona crisis, but thanks to government intervention, they ought to be able to pick up quickly as soon as growth begins to recover.

We will look to the following themes in the longer term:

Invest in water:

- Drinking water is in scarce supply, due in part to problems with obsolete and inadequate water infrastructure, climate change and problems with water quality and waste-water. This ensures robust long-term revenue growth for water companies. These companies are generally valued a little more expensively and so are trading at a premium, but this is fairly usual given their higher-than-average turnover and earnings growth.

Medical technology

- Medical equipment is the most important sub-sector of this market segment. It comprises a highly varied range of products that enjoy robust sales growth, due in part to continuous innovation and geographical expansion. The sector is heavily focused on the United States, which is an advantage under current market conditions. The nomination of Democratic candidate Joe Biden (as opposed to Bernie Sanders, who is

committed to a thorough reorganisation of the US health care system) also represents somewhat greater certainty for the medical insurers segment.

Trends

- This theme focuses on companies that respond to structural trends in the economy and society. It specifically relates to digitalisation (including business software for digital transformation, e-commerce, cloud infrastructure, artificial intelligence and cyber security), medical technology (research into promising medicines, etc.), demographic trends (ageing population, urbanisation, etc.), innovation and changing consumer behaviour.
- Many of these trends have gained momentum due to the Covid-19 crisis. For instance, the digital revolution for businesses and individuals has accelerated due to vigorous growth in e-commerce, innovative communication apps and new forms of healthcare.

Opportunities

Short-term themes

Within the equity component

European Small and Mid Caps

- Stronger growers in the medium term.
- Higher profit margins.
- Less sensitive to trade tensions.

Emerging markets

- Structurally higher growth prospects, accelerating economy from the second half of 2020 onwards.
- Shares have continued to lag behind the broad market, but the tide is turning.
- Earnings growth may recover faster in emerging markets than for example in Europe or the US, making the current valuation attractive.

Medium-term themes

Within the equity component

Global Trends

- Focus on growth-oriented sectors.
- Less exposed to the vagaries of the economy.
- Boost given by the coronavirus crisis.

Water

- The scarcity of water will drive long-term growth.
- Companies addressing the scarcity issue will grow with the economy.
- Good valuation.

Medical Technology

- Defensive and growth oriented.
- Sustainable sales growth through innovation and geographical expansion.
- Strong US orientation.