KBC Asset Management

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Review of the financial markets

Equity markets

1 October 2021

The global stock market (euro-denominated MSCI World AC) gained 7.8% over the past six months. The recovery from the coronavirus crisis continues, although stock markets showed some signs of fatigue in the third quarter.

After the strong end-of-year rally and the solid start to the first quarter, stock markets continued to recover nicely in the second quarter too. Worldwide, Covid-19 infection rates improved and the fact that large groups of the population are now vaccinated lifted hopes of an economic normalisation and easing of lockdowns. In addition, US President Biden presented his new stimulus plan to support the economy. The economic recovery also continued, initially led mainly by a recovery in the industrial sectors, joined from the second quarter of 2021 by a strong rally in the service and consumer sectors. This also led to very robust corporate earnings in the first half of the year. The third quarter got off to a good start, butthe stock markets lost some ground in September:The economy is showing some signs of a slowdown and risks are emerging. These include Chinese regulation and real estate issues, as well as higher energy prices, shortages and supply problems in many sectors, partly due to the strong recovery in the first half of the year.

A number of clear regional differences in returns have become apparent during recent months. Among the traditional markets, US shares continued to forge ahead (+10.6% in euro terms), well above the global average of 7.8%. The US led the way in the recovery due to the highly successful vaccination campaign and hope regarding stimulus measures introduced by President Biden. The stronger dollar recently helped US shares make some percentage gains in euro terms. The euro area (+6.1%) began this year well but then lagged behind somewhat, especially in the third quarter, despite a strong recovery in growth and the reopening of the economy. UK shares gained ground (+7.1%) on the back of rapid vaccinations and the complete phasing out of coronavirus measures in the third quarter, but suffered in September due to the effects of Brexit, which have included transport staff shortages and supply problems. In Asia, the Hong Kong stock market recovered in the first months of 2021,

but political, economic and financial uncertainty all had an impact, causing the stock market to lose around 5.8% of its ground over the past six months. Japan, by contrast, made a strong recovery (+5.7%), especially in the third quarter. The country elected a new prime minister, with hopes of a stimulus programme to come. It was also finally able to get its vaccination campaign on track, which in turn allowed the recovery to get underway.

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 2% in the past six months. The burgeoning Asian stock markets seemed to have weathered the coronavirus crisis well, but have recently fell by around 5%. China even lost 15% over the past six months. The Chinese stock market surged again at the start of 2021, but uncertainty around regulation of large media organisations and technology companies, combined with fears about the cooling of the economy led to a correction in March and an even sharper correction in the third quarter when government regulation ramped up and China's education sector was asked to delist. Other Asian countries did slightly better. The Indian stock market surged ahead, gaining 22% despite a severe new coronavirus wave. Latin America lost a lot of ground at the start of the coronavirus crisis due to the poor performance of Brazil that only managed to recover a part of its heavy losses and recently made little headway (-0.5%). Russia (+26.7%) saw a recovery due to the higher oil prices. Turkey posted a strong recovery (+2.9%) at the end of 2020, but the dismissal of the governor of the central bank in March 2021 eroded all the credit that had been built up, and the Turkish currency and stock market were both hit hard as a result. Lastly, South Africa lost around 6%.

There were quite pronounced sector differences over the past six months. Cyclical sectors, following a sharp recovery in the final months of last year, now clearly lag behind the broad market. The materials sector dipped by around 5%, partly due to commodity prices topping out somewhat and fears of a Chinese slowdown in growth. Industrial companies lost about 3%. The recovery in the energy sector did continue thanks to higher oil and gas prices (+14%). The consumer discretionary sector (e.g., automotive, retail, luxury and tourism) remained somewhat flat (+2%). Financials underperformed for some time due to fears of recession and low interest rates, but the ongoing recovery and higher long-term rates in September pushed the sector sharply higher, allowing it to gain some 10% over six months.

Technology turned out to be one of the winners from the coronavirus crisis, and managed to maintain its momentum. Technology is up 12.7% compared to six months ago, mainly thanks to the software sector (+15%). Semiconductors (+10%) also remained strong as a result of the scarcity of computer chips. The technology-related communication services sector (+6.7%) consists of the telecommunication services (defensive), and media and entertainment (more IT-focused) segments whereby telecommunication services lagged behind and media (+9%) performed robustly over the past six months.

Defensive sectors have lagged behind since the start of the year due to the economic recovery and rising interest rates. Health care did recover in June, however, gaining around 11% over six months. Consumer staples did very well at the beginning of the coronavirus crisis, but gained only 4% over the past six months. The utilities sector largely marked time (+0.5%). Ground was gained in particular by businesses investing in water and green energy companies. Real estate companies recovered well, gaining 7.9% over six months, partly a catching-up exercise following a very weak 2020.

Bond markets

01/10/2021

Since the end of February, bond yields in the US and the euro area have been on a bumpy ride,with interest rates first falling sharply until early August before reversing course. Overall, 10-year yields in the US fell by around 0.25% over that period. However, German yields rose by around 0.1%. Economic growth in the euro area is flourishing due to the increase in vaccinations and the associated easing of restrictive measures. Together with higher commodity prices, inflation has also jumped above the rate targeted by policymakers. Interest rates worldwide are still very low and in some cases have fallen even further recently as many central banks stress that this upsurge in inflation is a temporary phenomenon. Bond yields in the euro area are still low and sometimes negative due to the continuing, extremely accommodative monetary policy of the European Central Bank (ECB) combined with the modest inflation outlook. Riskier bond themes generally benefited from mounting investor confidence in the future reopening of economies.

The ECB has indicated that inflation will increase slowly, and will remain below its target level in the years ahead. Deposit rates will therefore not be raised from their current -0.5% any time soon. KBC economists are not expecting a first rise in interest rates before 2023. Additionally, the ECB

is still providing stimulus through its bond purchase programme,meaning that the monetary tap will remain open for some considerable time to come. This could keep bond yields low.

The ECB's flexible monetary policy and the European support plan Next Generation EU ('NGEU') have also underpinned demand for riskier bonds over the past six months. Peripheral countries are again proving popular with narrow risk premiums relative to German yields. For example, the 10-year spread for Italian bonds has narrowed to around 1.05%, whereas the peaks in previous years were regularly above 2.5%. Demand for corporate bonds also remains quite robust, due in part to support from the ECB's purchasing policy. The already low credit premium fell further from 0.84% to 0.82%.

The overall picture for European bonds has been weak in recent months. Returns on euro-denominated government bonds stand at approximately -0.2% for bonds with a term to maturity of between one and five years, and -0.7% for a diversified basket of maturities. Corporate bonds are faring better, gaining 0.4% since March. The USD exchange rate was highly volatile, but is still up around 1.3% against the euro.

Outlook for the financial markets

Investment climate

The world economy continues to do well

- The world economy continues to do well, though the rate of growth is likely to slow in the second half of the year. Growth in the major economies has certainly already passed its peak. Despite new uncertainty resulting from the rapid spread of the delta variant, we maintain our positive outlook. While there is also a growing headwind as a result of disrupted supply chains, we see this as a temporary problem which will not derail the economic recovery.

Strong recovery in the euro area

- The economy has rebounded strongly in the euro area thanks to the gradual reopening in the second quarter. Although we expect some slowdown in real GDP growth in the coming quarters, the economic recovery will remain robust thanks to pent-up demand, which remains strong. The slight weakening of a number of frequently available indicators and persistent supply-side bottlenecks in the economy have led us to adjust our growth forecast for the third quarter slightly downwards. However, we have revised our forecast for the whole of 2021 upwards from 4.2% to 5.0%, reflecting the stronger growth in the second quarter. We are sticking to our 4.5% forecast for growth in 2022.

Substantial growth in the US

- Economic growth in the US remained substantial in the second quarter, with activity climbing above pre-pandemic levels. The initial boost from the reopening has now passed, which is why we now predict lower, but still strong, growth rates for the rest of the year. The available indicators for the third quarter suggest a sharper slowdown in growth than initially expected, particularly for private consumption. The labour market report for August indicates an increasingly negative impact of the delta variant of the virus. In light of this recent information, we have lowered our economic growth forecast from 6.5% to 6.0% for 2021. We expect real GDP to grow by 3.9% in 2022.

Strong inflationary pressure

- Inflation rose sharply during the summer months, reaching 3% in the euro area as a result of higher energy prices and technical factors. In the US, inflation fell slightly to 5.3% in August, marking the end of eight consecutive monthly increases. This slight decline may be an early indication of easing inflationary pressure. In any case, it is still our view that the spike in inflation was primarily caused by temporary factors. That said, inflation will remain high for the rest of 2021 and is likely to persist in 2022. Uncertainty remains high as a result, with upside risks for coming quarters, though we certainly don't expect galloping inflation.

Central banks see through inflation

- Both the European Central Bank (ECB) and the US central bank (Fed) maintained their highly accommodative monetary policies at their last policy meeting. Against the backdrop of continuing favourable financing conditions, the ECB decided to slightly reduce purchases under the PEPP (Pandemic Emergency Purchase Programme) in the fourth quarter of 2021. We expect that the ECB will pursue its extremely flexible monetary policy, meaning that the interest rate will not be increased for the next two years.
- In the US, the Fed is preparing to formally announce the tapering of its bond-buying programme, which we expect to begin by the end of 2021. We don't expect to see an increase in the key rate before the start of 2023.

Portfolio allocation

Overall portfolio

- After the very robust gains of the past year, we are adopting a neutral stance towards shares.
  - Due to the extremely low level of interest rates, many other forms of investment still provide little alternative to shares.
  - Robust growth of the economy and corporate earnings are continuing to underpin the climate for shares.
  - The slowdown in economic growth, following the strong recovery generated by post-Covid reopenings, is however creating uncertainty, especially now that the US central bank is starting to scale back its bond purchasing policy, inflation is remaining at a high level for longer than expected and the Chinese economy also appears to be cooling down further.
- Given the extremely low level of interest rates, even negative in some cases, we are still invested below the benchmark level for bonds.
- The cash position in euros is being held in order to respond to opportunities as they arise.

Zooming in on the bond portfolio

- Covid-19 isn't going down without a fight, but thanks to the smooth rollout of vaccinations, both the US and Europe are benefiting from the reopening of their economies. Producer and consumer confidence have risen sharply and GDP is also growing at a robust rate. Together, these are fuelling a surge in inflation. Central banks are reassuring the markets that rising prices are temporary and will ease in 2022. Following inflation jitters at the beginning of the year, bond markets have calmed a little since the second quarter.

- Where the US central bank (Fed) has been talking about scaling back its bond purchases since the beginning of the summer, the European Central Bank (ECB) said it is still far too early to consider reducing its support purchases. ECB president Christine Lagarde is also unwilling as yet to indicate what will happen in 2022 and the end of the PEPP - an exceptionally large-scale bond-purchasing programme in response to the Covid crisis. In the meantime, the ECB will continue to support the economy and the financial markets through an extremely accommodative monetary policy, in the shape of both low money-market rates and holding down bond yields. We're looking at a longer period of low interest rates in the euro area, although we now expect bond yields to gradually rise as the growth outlook continues to brighten.

- In view of this trend in interest rates and their extremely low level, even negative in some cases, we are invested slightly below the benchmark level for both the bond allocation and average terms to maturity. The intention is to limit the interest rate risk (loss in value when interest rates are rising) so that it weighs less heavily on returns. Businesses are benefiting from the economic recovery. Due to the relatively attractive yield and the ECB's bond-purchasing programme, corporate bonds occupy a prominent place in the portfolio. The uncertainties surrounding emerging markets remain, but the compensation is attractive, enabling a limited position to be taken in this theme.

Zooming in on the share portfolio

- Within the share portfolio, we see the best opportunities for earning return in Europe. After a long winter of Covid-19, summer finally seems to have arrived for countries in the euro area, at least figuratively. Industrial activity is gradually returning to pre-crisis levels. Coronavirus measures are being steadily lifted and the reopening of the economy continues, allowing a further recovery in consumer spending and the services sector. In particular, small and medium-sized enterprises (SMEs) in the euro area stand to benefit from this. Measures in the United Kingdom have now been completely lifted too, despite an advancing delta variant, while the number of hospital admissions remains fairly limited thanks to vaccinations. After several years of poor performance, UK shares have become fairly cheap. We have become slightly more positive, though UK shares are still trading at a discount on account of Brexit, a risk premium that may weigh on these shares for some time to come.

- We are underweight in emerging markets. The significant uncertainty for investors in China prompted us to somewhat reduce the weighting of Asian emerging markets. New regulations for Chinese technology companies triggered a sharp correction. Chinese economic growth is also slowing, with lower levels of lending and relatively weak producer confidence. Problems at real estate giant Evergrande have sown new doubts about China. The Chinese government may be considering new stimulus measures, but until then we remain cautious about Chinese shares. Within Asia, we are also underweight in Japan and the broader Pacific region,though we recently added to our holdings of Japanese shares. The vaccination campaign there is finally up to speed, while the number of Covid-19 cases is falling. A reopening of the economy beckons, and there is now also hope for a new prime minister and the possibility of a stimulus programme.

- At sector level, we mainly favour shares that are focused on economic recovery among consumers. Thanks to vaccination programmes, the focus here is gradually shifting from an early-cyclical, industrial recovery to one oriented more towards consumption and services. Higher inflation figures and forecast rate hikes are also causing some shifts in the portfolio.

- An overweighting of the Consumer Discretionary sector would be in line with the shift from a more industrial recovery to a consumer-oriented one. This sector not only includes e-commerce companies, but it also has a considerable exposure to shares that ought to benefit from a reopening of the economy (hospitality, tourism, etc.). After struggling for a few months due to the delta variant, these shareholdings have been increased again in the portfolio. Some of the more defensive consumer companies, such as food and beverage producers, and household and personal products, reported poorer results in the second quarter and have been reduced to their benchmark level. Media companies too will be able to benefit from this recovery, due in part to increased advertising revenues. As regards technology companies, we are maintaining a rather neutral view, although we did opt to become further overweight in the more cyclical semiconductor (computer chips) sector, as demand for computer chips remains huge, whereas supply is slow to follow, keeping prices high and thus benefiting these companies. We recently reduced the energy sector somewhat, however: the higher oil price, which may have reached its peak, in addition to the surge in the share prices of these companies, were reasons enough for us to scale back the sector to a neutral weighting.

- With the stable economic outlook and the expectation of higher interest rates, we remain overweight in financial institutions. The Federal Reserve indicated that it will ratchet up its key rate more rapidly and start scaling back the enormous support programmes at the start of next year, implying that long rates ought also to rise further. In this pro-cyclical environment, banks should be able to slightly reduce their provisions for non-performing loans, while it ought to be possible to systematically increase lending volumes.

- The flip side of this pro-cyclical positioning is that certain typically defensive and interest-rate-sensitive sectors such as utilities and real estate are underweighted. They include companies with predictable profits that do well in a recession, but underperform in a bull market driven by strong economic recovery. Consequently, their earnings growth will be lower in the year ahead than that of the cyclical sectors. An exception is the health care sector, which reported good results and for which the risk of regulation has decreased somewhat. We are maintaining the positions in this sector at their benchmark level.

- As regards investment themes, the focus is on water companies. Drinking water is in very short supply due to obsolete and inadequate water infrastructure, climate change and problems with water quality and waste-water processing. This offers opportunities for water companies to achieve robust long-term revenue growth.

Opportunities

Within the equity component

Euro area small caps

- Grow strongly in the medium term
- Higher profit margins
- Less vulnerable to trade tensions

Consumer Discretionary

- Diversified sector comprising both growth and cyclical companies.
- Cyclical sector able to benefit from a recovering economy.
- Consumers have surplus savings and draw support from improving labour market.

Water

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

Global Trends

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

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