ROBECO
The Investment Engineers

Multi-asset market outlook

Health care's AI genie in the bottle

June 2024

For professional investors

Sustainable Investing Expertise by
ROBECOSAM

General overview

Earnings confirm the optimism

MULTI ASSET	1mo	3mo	YTD	1YR	3YR	5YR
MSCI World local currency	4.1%	4.1%	10.9%	25.3%	8.4%	13.3%
MSCI World (H, EUR)	4.0%	3.9%	10.4%	23.5%	6.7%	11.5%
MSCI World (UH, EUR)	2.9%	3.5%	11.4%	22.7%	11.0%	13.3%
Global real estate (UH, EUR)	1.6%	-1.3%	0.0%	8.7%	2.0%	1.4%
Gold (USD)	1.4%	13.5%	12.5%	17.8%	6.5%	11.1%
Global investment grade bonds (H, EUR)	1.3%	0.4%	-1.1%	3.5%	-3.9%	-0.8%
Global high yield (H, EUR)	1.1%	1.8%	2.6%	12.0%	-0.4%	1.7%
Global inflation-linked bonds (H, EUR)	1.1%	0.2%	-1.9%	0.3%	-5.3%	-1.7%
Global Gov Bonds (H, EUR)	0.5%	-0.8%	-2.3%	-0.5%	-4.4%	-2.2%
Emerging Markets (LC)	0.5%	5.0%	6.5%	14.6%	-2.7%	5.7%
Cash (EUR)	0.3%	1.0%	1.7%	4.0%	1.6%	0.8%
EMD hard currency (UH, EUR)	0.3%	1.5%	3.2%	7.3%	1.0%	1.0%
EMD local currency (UH, EUR)	-0.2%	-1.8%	-1.8%	1.6%	0.9%	0.9%
Emerging Markets (UH, EUR)	-0.9%	3.2%	5.2%	10.4%	-2.4%	4.1%
GSCI Commodities (USD)	-3.4%	3.6%	11.4%	16.2%	18.1%	9.5%
Oil Index (USD)	-5.1%	1.7%	12.1%	25.3%	17.4%	0.4%

Source: Robeco, Bloomberg

May was a good month for both equity and bond investors, as markets bounced back strongly from last month's pull-back. The positive global economic outlook supported developed market equities while solid company earnings helped maintain tight credit spreads in corporate bonds.

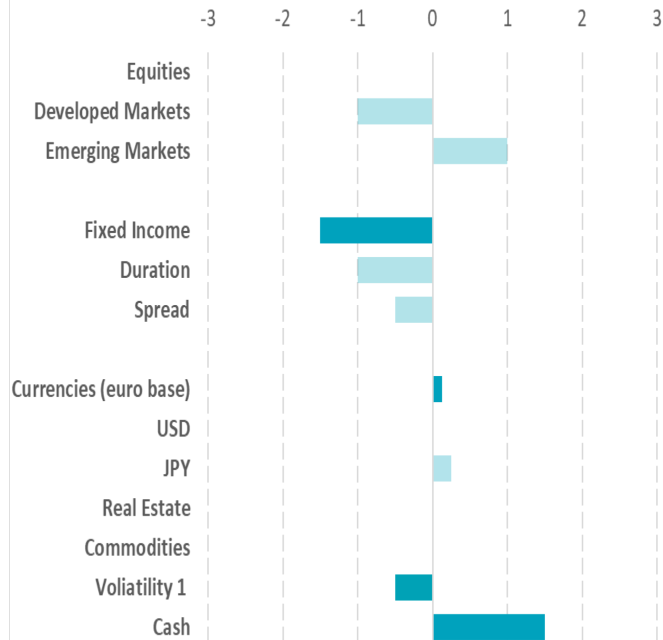
In the US, economic data released during the month helped alleviate concerns that the economy is overheating, as demonstrated by weaker retail sales and jobs data. While the S&P 500 hit a new all-time high, more than half of the monthly gains came from only four mega-cap stocks (Nvidia, Apple, Microsoft, Alphabet). Interestingly, only 50% of S&P 500 stocks are trading above their 50-day moving average, suggesting that market sentiment is perhaps not as strong as it appears on the surface

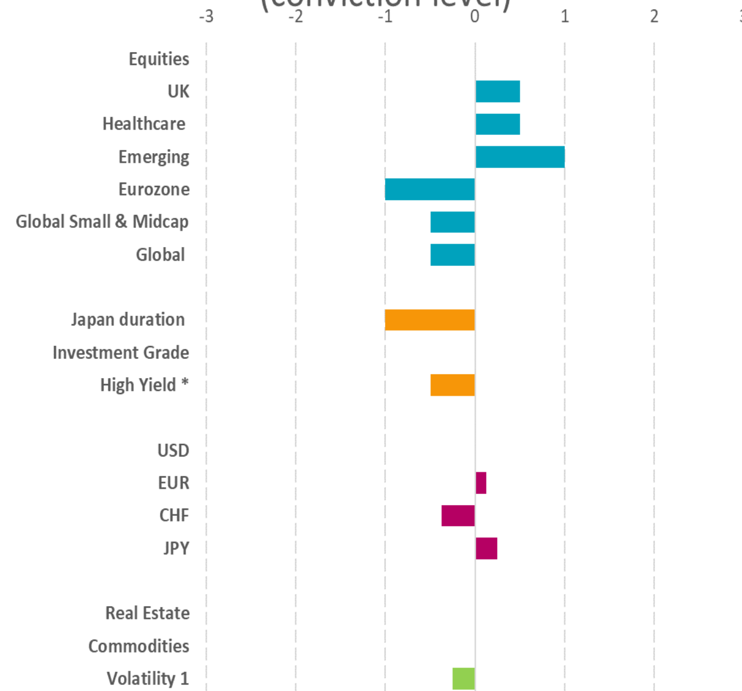
In Europe, we are seeing evidence of improved economic activity and signs of a recovery in manufacturing. In emerging markets, Chinese data mostly surprised on the upside, but domestic demand remains lacklustre. Emerging debt was held back due to the US rates narrative of higher for longer, leading to Indonesia's central bank surprise rate hike to protect its currency.

Elsewhere, oil was down sharply for the second month in a row as OPEC signalled that supply levels are likely to increase. Gold demand continues to be high from central banks and consumers, though its diversification benefits have been reducing as gold's correlation with risk assets has risen significantly.

Robeco Multi Asset views

Sustainable Multi Asset Solutions positions





Source: Robeco

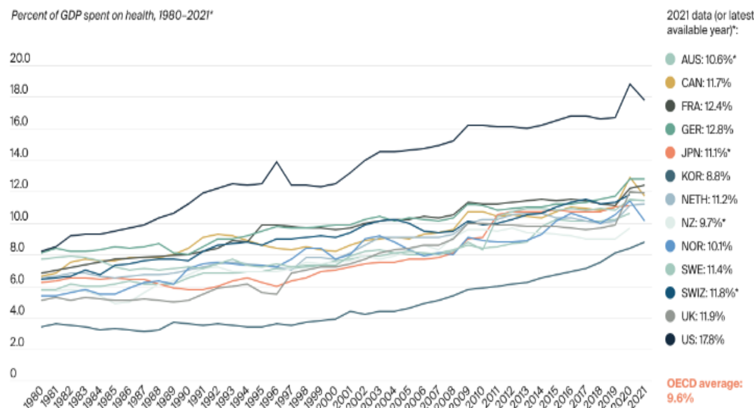
The multi-asset portfolios performed well in May. Much of the heavy lifting was generated by active stock selection. From a top-down perspective, we are focusing on the views within asset classes, rather than the direction of equity markets and government bond yields.

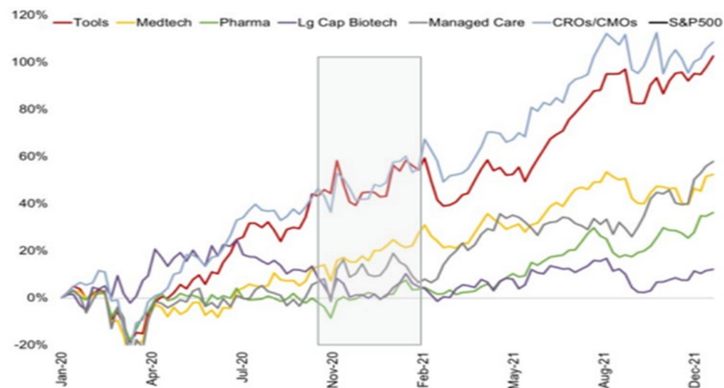
We removed our long commodities position, as the manufacturing upswing looks to be gathering steam, but is pretty much priced in over the short term. China has been stockpiling industrial metals, OPEC+ production cuts are fully expected at its June meeting, and strong demand for precious metals is well known. Distortions have crept into certain commodities; for example, the copper price difference between the London Metal Exchange and US commodity exchange (COMEX) has diverged by several multiples of its historical widest spread.

We are, however, in no rush to add risk to our portfolio, and we prefer to be very selective in deploying risk. We remain neutral on equities, as around one-quarter of the S&P 500's rise this year has been driven by one stock (Nvidia). We do though have a bias to becoming overweight equities, as the market technicals remain strong and the macro data is supportive through lower inflation, lower interest rates, solid labor markets and good corporate earnings.

Theme of the month

Global health care spending is rising





Source: Morgan Stanley

Health care expenditure remains a secular theme that constitutes approximately 9% of global GDP. The US leads the pack with a hefty 17% of its GDP allocated to health expenses. US domestic health care spending reached USD 4.5 trillion in 2023 – an amount larger than the GDP of Japan (the fourth-largest global economy) – much of which is funded by the US government. Globally, several structural factors are driving this trend, including an aging population, with projections indicating that by 2050, one in every six individuals worldwide will be over 65, compared with one in 11 currently. Then there is the rising burden of chronic ailments, such as cardiovascular diseases, cancer or diabetes, and increased demand for health care services in emerging markets. This provides on opportunity for investors to discover companies that can apply new technology such as AI, invent new cures and improve the effectiveness of health care spending generally.

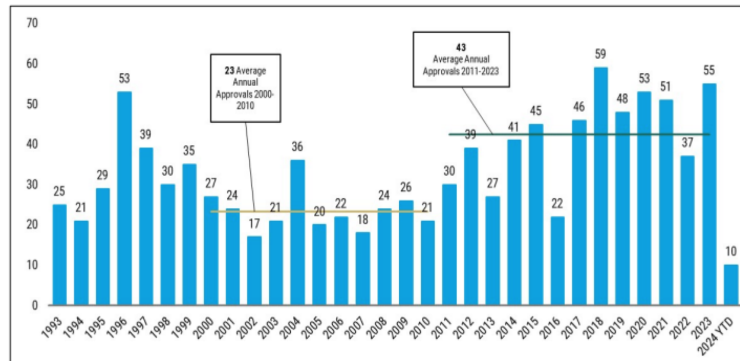
However, there remain some challenging headwinds, including reduced revenues for health care suppliers post Covid-19, drug price controls, and regulatory uncertainty; rebates for Medicare in the US created a challenging backdrop for parts of the sector in 2023. On top of that, the launch of GLP-1 drugs for obesity led to massive dispersion in performance between Big Pharma, MedTech and other health care sub-sectors. While more dispersion and macro uncertainty are likely in 2024, this provides the active stock picker with more opportunities than seen in recent years, with valuation support and more divergence between winners and losers. Three factors stand out:

1) M&A activity in biotech has seen a pick-up in the year to date that is likely to persist, albeit with a shift towards acquiring later stage assets, as Big Pharma replenishes its pipelines.
2) Health care is not expected to be a central theme in the US election. Although large cap pharma and managed care remain exposed to headwinds such as repeal of the Affordable Care Act, other sub-sectors such as life sciences tools or CROs/CMOs should remain insulated.
3) The market focus moves past obesity to other product cycles such as tackling Alzheimer's disease or developing respiratory vaccines.

Theme of the month

Health care's AI genie in the bottle

Acceleration in number of new drugs approved



Source: Morgan Stanley Research, FDA

The race to discover a Covid-19 vaccine put a spotlight on the industry's ability to rapidly innovate, but the patent cliff is always a drag on Big Pharma that is set to cost the industry USD 180 billion in lost revenue by the end of the decade. So, building on the acceleration of innovation through faster product cycles or M&A is a key theme for the sector. Notable therapeutic areas offering growth opportunities include oncology, immunology, diabetes/obesity, and neurology, particularly for tackling Alzheimer's disease.

Developing a new drug is a long and arduous process which typically takes eight to ten years, and costs USD 1-2 billion, with only one out of every ten candidates ever making it to the market with regulatory approval. AI has the potential to shorten product development by contributing to faster drug discovery and the reduction of clinical trial failure rates. With data integration, trend recognition and predictive modelling, AI can speed up the understanding of diseases and target identifying future winners in a traditional drug discovery process, while machine learning algorithms can optimize clinical trial designs. Beyond drug development, data-driven digital health care tools have the potential to improve patient outcomes while reducing inefficiencies. In a sector plagued with shortages of skilled labour, AI can help facilitate patient care from pre-appointment to diagnostics, and reduce hospitals' administrative burdens.

Investments in digital health totalled USD 45 billion during the pandemic, ranging from clinical trials technology to home health and wellness. From 2020-2022, health care was the sector with the highest capital invested in AI after IT. Funding has since then steeply declined, pressured by rising interest rates. The headwinds facing the sector are well understood; what is not is how investments in digital and AI tools are providing clear productivity gains. That is yet to come.

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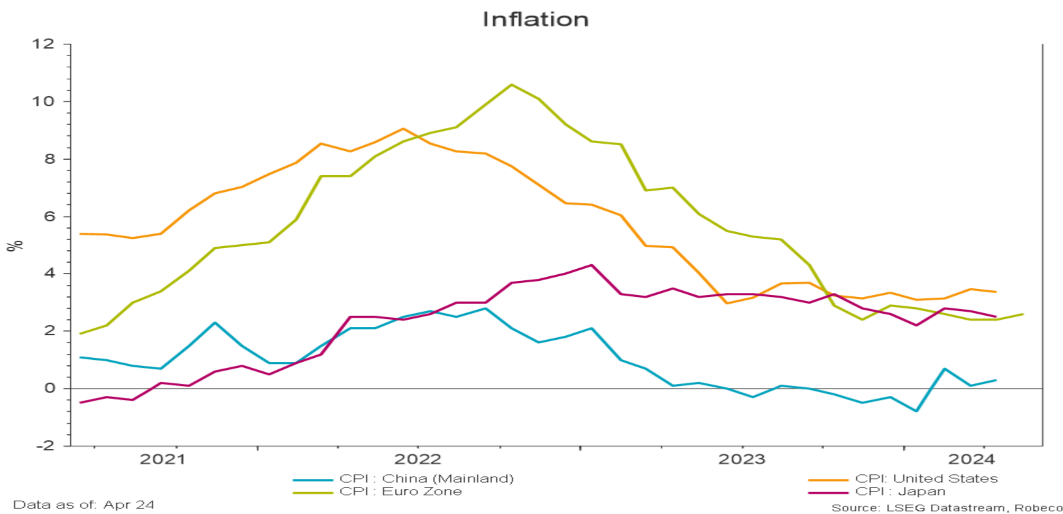
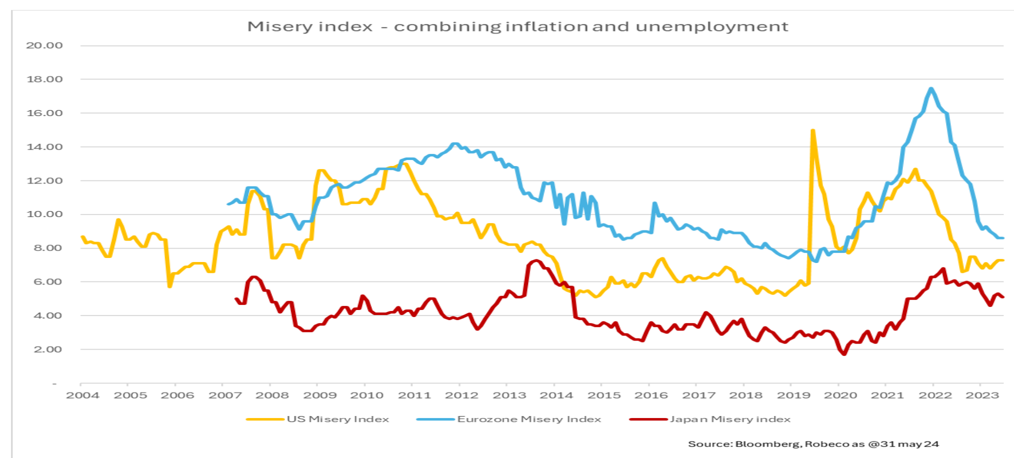
Economy

Inflation slowdown has given central banks room to cut rates





Source: Refinitiv Datastream, Robeco

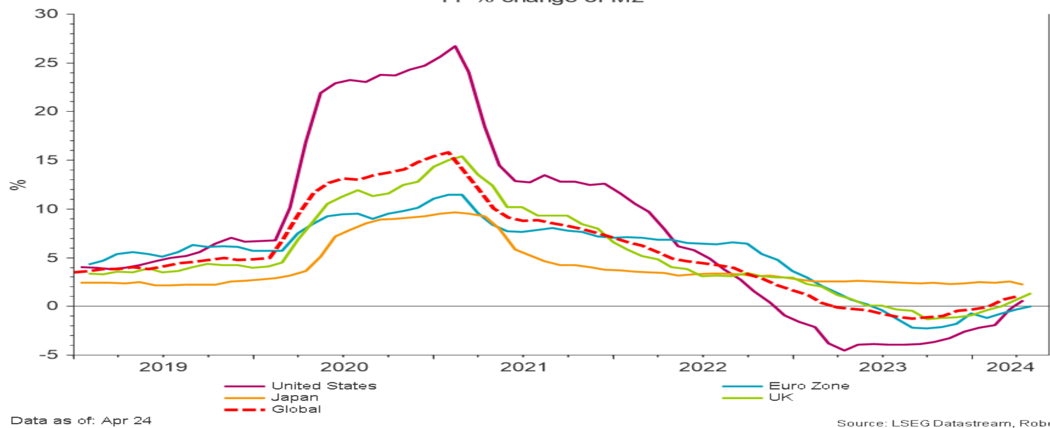
A disinflationary trend has been established from the Covid distortions and the resurgence in spending following the lockdowns. We should remember that prices are still rising. Indeed, one of the reasons cited for US President Biden's low popularity rating in this election year is the fact that a basket of goods (as measured by CPI) costs US consumer 20% more since he took office. While inflation has come down, it is still above levels that are seen as being benign for the economy. Over the last few months, the divergence between US and Eurozone inflation has become quite stark, as the US is experiencing lower inflation and strong growth, while the Eurozone has followed the US inflation trend lower, but growth has been weaker. This has led the consensus to believe that the ECB is running a restrictive monetary policy.

Before we delve into the appropriateness of monetary policy, history shows that inflation comes in waves, and it will be unusual for it to fall much further without a significant fall in growth (a recession). Additionally, wage growth is running much higher, giving consumers a real income boost, which when coupled with historically low unemployment shows why consumption-based economies such as the US have been more resilient in the face of unprecedented rate hikes. The top chart shows how the pace of inflation deceleration has faltered.

Combining unemployment and inflation shows Eurozone and US consumers should be happy because they are near historical lows. This is commonly known as the 'misery index' because a combination of high unemployment and high inflation is a very bad outcome for consumers (voters). The Eurozone misery index troughed after the US in 2019 and again in 2022. Both of these indicators are lagged measures of the economy, though clearly the Eurozone is following the US after a few months, so a reacceleration is European growth is feasible.

Economy

Will the ECB rate cut be too soon?



Source: Refinitiv Datastream, Robeco

All market data to 31 May 2024 unless mentioned otherwise.

The strong recent data in the US usually filters into Europe with a lag, so the strong start to 2024 across the pond causing investors to price out six rate cuts in 2024 could make the easing path for the ECB more treacherous. In addition, the bottoming out of the manufacturing cycle will benefit European (and Chinese) companies and employees more than the US. The German IFO survey (top chart) is showing an improvement in business climate, with the headwinds from the energy crises dissipating quickly.

The debate about how restrictive monetary policy is in the US and Eurozone will continue to rage and will only be settled with hindsight. What we do know is that 18 months ago, when asked what would be the effect of 4-5% rises in base rates on the economy, the unanimous view was "a recession". It didn’t happen for various well-documented reasons.

The bottom chart shows that M2* money growth, which suffered as rates rose, is starting to expand again. Academic research suggests a causal link between a growing money supply leading to inflationary pressures. Given where the misery index is relative to history, and the structural rigidities in Eurozone, the ECB may not have as much spare capacity for non-inflationary growth as it thinks.

If the labor market in the US remains strong, and the Fed does not need to cut interest rates because the economy is fine, or if it whispers that the hiking cycle is not over, then the ECB will have painted itself into a very awkward corner, and euro weakness against the US dollar will be the obvious outlet.

* M2 is a measure of money supply that includes cash, bank accounts, money market funds and other near-money assets.

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