"Encouraging news about vaccine research and new rapid tests are allaying fears about a potential second wave. Equities are likely to remain in demand given the huge amounts of liquidity and low yields."

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Market news and expert views

Monthly report
September 2020

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Union Investment

The markets at a glance

Summary

We reaffirmed our neutral risk positioning (RoRo meter at level 3) at our most recent meeting. Equities look attractive to us again, whereas the prospects for all commodity segments (except precious metals) have deteriorated slightly.

The reason for this decision is that we still take a constructive view of risk assets: The global economy is continuing to stage a moderate recovery, and monetary policy is providing strong support. As a result, the low or even negative real interest rates offered by safe havens mean that more and more money is flowing into alternative investments. Investments with higher returns – such as the spread segments in the fixed-income asset class and equities – are benefiting from this shift, as are precious metals such as gold. When it comes to allocation decisions, therefore, historical pricing levels are becoming less important and need to be re-evaluated due to the generally lower level of interest rates. We have positioned ourselves accordingly and we emphasised this focus again at our latest meeting (about the continued preference for equities). At the same time, we deliberately left the precious metal segment unchanged.

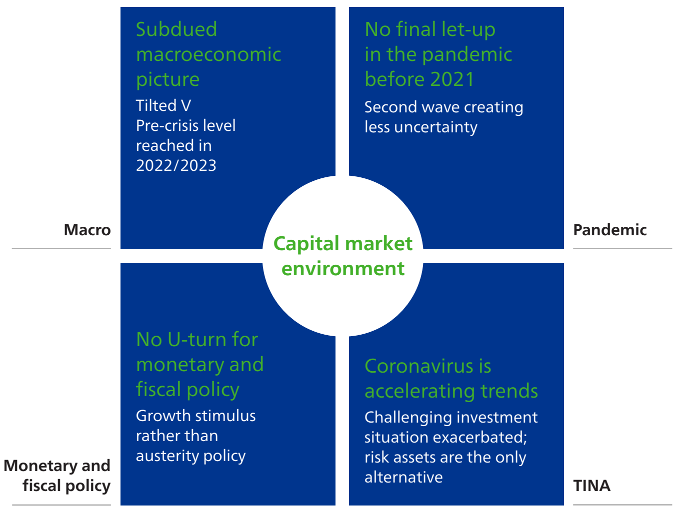
The other commodity segments are much more dependent on economic conditions than other asset classes. Economic conditions are continuing to improve, not least because a little more economic normality is promised by encouraging news about the development of vaccines and improved coronavirus testing. This should also help to generally allay some of the capital markets' fears about the pandemic. However, many commodities have already priced in the good economic data to a significant extent, which means that opportunities here are smaller than in other asset classes.

Economy, growth, inflation

The economic collapse triggered by the coronavirus pandemic was unprecedented. The low point was reached in April, and there have been clear signs of an initial rebound since then. The result has been rapid economic growth for the US, Europe and, in particular, China in the third quarter of 2020. This trend is set to continue but will lose momentum over the course of the autumn for two reasons. Firstly, there is unlikely to be a sustained let-up in the pandemic any time soon. Social distancing measures will therefore remain the norm, resulting in reduced value creation. Secondly, economic activity is being held back by persistent challenges at the macroeconomic level, particularly the overall lack of demand in the economy. All in all, we continue to anticipate that the upturn will take the shape of a tilted V, i.e. a moderate recovery of growth.

The prospects for inflation are currently the subject of fierce debate among economists. At the moment, we do not see any indications of increasing upward pressure on prices; if anything, it is the contrary. After all, the coronavirus crisis has had a significant impact on prices. The usual seasonal price patterns have been disrupted and one-off effects (such as the temporary reduction of VAT in Germany and problems with global supply chains) are distorting the overall picture. Inflation will remain low for some time. This is because the price-dampening effects of higher unemployment and the general uncertainty acting as a brake on consumer spending and capital expenditure have the upper hand. For 2020 as a whole, we predict inflation of 0.7 per cent for Germany and 0.5 per cent for the eurozone. Inflation is likely to be slightly higher in the US at 1.0 per cent.

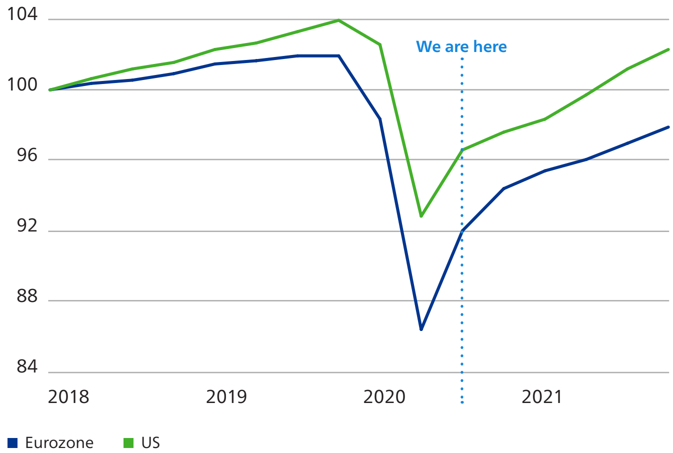
Core elements of the capital market environment



Source: Union Investment, as at 1 September 2020.

Strong rebound followed by a slightly flatter recovery

Eurozone and US: comparison of real GDP, index Q1 2018 = 100



Source: Union Investment, for illustrative purposes only, as at 1 September 2020.

The markets at a glance

Monetary policy: evolution not revolution

The focus of central banks worldwide is currently on tackling the crisis and stimulating growth. By contrast, the traditional goal of central bank policy, namely containing inflation, is receiving little attention. In any case, inflation rates are low because of the weakness of the economy. Nevertheless, inflation is unlikely to return quickly to central banks' agendas, even in the event of a recovery. This can clearly be seen from the US Federal Reserve's strategy shift announced by its chair, Jerome Powell. Going forward, the Fed will be targeting inflation that averages 2 per cent over time. In other words, the US central bank's target will have a kind of 'memory'. This means that sustained phases of low inflation will make subsequent phases of higher inflation more acceptable.

Given that the inflation rate was often below the target in previous years, the Fed would tolerate an above-target rate in future. It is also changing its employment target, describing maximum employment as a broad-based and inclusive goal but without giving a specific target figure. What is interesting, however, is that US monetary policy decisions will be informed by assessments of the *shortfalls* of employment from its maximum level rather than by *deviations* from its maximum level. This reflects the assumption that a robust job market does not automatically lead to rising inflation. This marks an evolution in the Fed's monetary policy, but not a revolution. Although this creates more uncertainty about inflation going forward, the change of strategy makes the future direction of monetary policy even clearer: The US central bank will remain on an ultra-expansionary course for a long time to come.

Fixed income: spread investments continue to benefit from high levels of liquidity

The central banks' purchase programmes are still providing strong support for the bond markets and have resulted in the significant narrowing of spreads in recent months, particularly in the case of government bonds from eurozone periphery countries and corporate bonds. Companies have been quick to make use of this favourable environment and have already issued new paper to cover most of their funding needs for 2020. This autumn could therefore see an increase in primary market activity as companies seek to capitalise on these conditions to bring forward some of their funding activities from 2021. However, many companies are primarily issuing bonds in order to secure their liquidity rather than to raise money for capital expenditure.

In the emerging markets segment, the phase of significantly narrowing spreads now appears to be over. The high current yields remain attractive, but the way coronavirus cases are rising in many developing countries is giving cause for concern. Yields on safe-haven bonds are likely to trend upwards slightly across the long end of the yield curve, and yield curves therefore look set to steepen.

- **Change:** None.
- **Positioning:** Covered bonds and core eurozone government bonds still hold little appeal. Government bonds from eurozone periphery countries are slightly favoured and investment-grade corporate bonds are more strongly favoured. Our position in high-yield corporate bonds and EM government bonds remains neutral and unchanged. All in all, fixed-income investments are not very appealing.

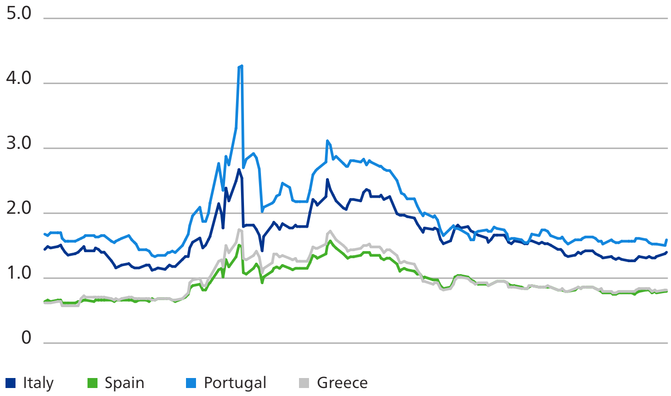
US monetary policy has solid foundations

The latest Fed announcement has led to expectations of a stable key interest rate; implied key interest rate as at December 2020 over time (%)

Source: Bloomberg, as at 1 September 2020.

Periphery bonds remain well supported

Spreads over Bunds in the year to date (%)



Source: Bloomberg, as at 1 September 2020.

The markets at a glance

Equities: rise in coronavirus cases no longer making an impression on the equity markets

The global equity markets continue to be driven by the hunt for spreads and are still on the increase with regard to structural growth themes. Measured by the performance of the broad US equity market (S&P 500), we have just experienced the best August since 1986. The already high pricing has moved up another notch in recent weeks. Although corporate reports for the second quarter of 2020 were generally better than had been feared, only US mega-corporations and a handful of other companies were able to report increased profits. Other sections of the equity market, by contrast, are reflecting the weak state of the economy. The equity market's climb is therefore based not on price rises across the market as a whole but on increases in a handful of sectors. Low interest rates mean that growth stocks, particularly those of tech companies, are currently in favour with investors. Careful selection therefore remains the order of the day for successful investment in equities. In addition, encouraging news about the development of coronavirus vaccines and new types of test are increasingly helping to allay fears in the capital markets about a second wave of the pandemic.

The advantage of industrialised countries over emerging markets lies in their higher standards of hygiene on the one hand and, on the other, the possibility of more extensive support measures. That is why our preference is for shares from developed markets.

- **Change:** Equities from industrialised countries, and thus equities in general, are now viewed as attractive again.
- **Positioning:** The equities asset class as a whole has been reinstated as a favourite thanks to stocks from industrialised countries. We continue to take a neutral view of equities from the emerging markets.

Commodities: potential restricted by the weak growth of the global economy

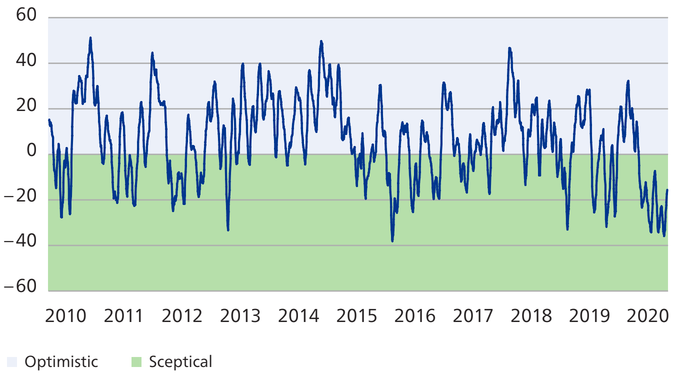
The situation in the commodities markets is, for the most part, returning to normal and the supply situation is stable. The surpluses in the energy sector (crude oil, oil products and natural gas) resulting from the slump in demand triggered by coronavirus are gradually correcting themselves and inventories are consequently starting to fall again. And although the hurricane season is only just beginning in the US, we do not anticipate any dip in supply in the energy market for the time being.

China has massively expanded steel production as part of a classic economic stimulus programme, and now has a share of the global market in excess of 60 per cent as steel production in the rest of the world has slumped by more than 20 per cent. However, the latest indicators suggest that the level of economic stimulus is waning. We also anticipate that Chinese demand for copper will decline, which slightly dampens the prospects for industrial metals.

Following the market correction of recent weeks, we believe that the price of gold is once again broadly in line with the level of real interest rates in the US. Gold's overvaluation relative to silver has therefore been eliminated. One of the possible drivers is a weak US dollar. Quasi-industrial precious metals, such as platinum and palladium, would benefit from an economic rebound. Overall, the various factors influencing this commodity segment are keeping it in balance, which is why we are striving for a neutral positioning.

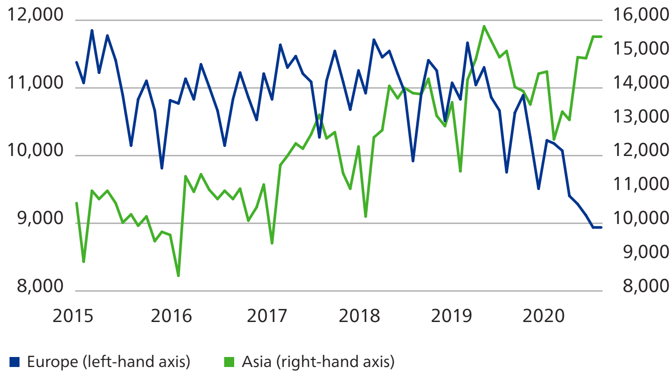
- **Change:** Industrial metals and energy commodities are losing their appeal, which is having a knock-on effect on the entire asset class.
- **Positioning:** We are cautious about commodities in the aforementioned segments. We have only reaffirmed our neutral view of precious metals.

No signs of excessive euphoria among equity investors
AAII bull/bear indicator in the past ten years (%)



Source: Bloomberg, as at 1 September 2020.

China making up for weak demand for steel in Europe
Recovery in China is driving Asia's hunger for commodities (thousands of tonnes)



Source: Bloomberg, as at 1 September 2020.

The markets at a glance

Currencies: euro still favoured

The euro has benefited significantly from the agreement on a European recovery fund and could be given another boost in the event of further progress towards fiscal union and closer integration overall at European level. Over the coming weeks, the upcoming presidential election in the US is expected to increasingly dominate what is happening in the currency markets. We expect the US dollar to remain weak in the medium term due to the continuing rise in the US twin deficit, the flatter US yield curve and the Fed's stated willingness to tolerate a higher level of inflation. More foreign investors have recently ventured back into the eurozone, with their purchases providing an additional boost to demand for the euro.

The increasing likelihood of a hard Brexit against a backdrop of faltering negotiations between the UK and the EU is likely to take its toll on pound sterling going forward. Boris Johnson is coming under more and more pressure on the domestic political front and will want to exploit Brexit for his own benefit. The negotiations are therefore unlikely to quickly result in a solution. Both sides will try to get the best possible deal for themselves.

In 2021, the Japanese yen will probably depreciate against a backdrop of economic recovery. The yen is regarded as a crisis currency and demand for it is therefore likely to wane.

- **Change:** None.
- **Positioning:** We continue to anticipate that the euro will appreciate against the US dollar.

Real estate: USA

The longest upturn in US post-war history was brought to an end by coronavirus in March of this year. Following more than ten years of growth, the economy crashed much more heavily than during the 2008/2009 financial crisis. However, the recovery is expected to be faster too. This is because both the Fed and Congress responded to the crisis with extensive measures in order to prevent, or at least limit, negative second-round effects.

The economic shift has also had an impact on demand for office space in the US. The average vacancy rate across the eleven largest US office rental markets went up by almost 50 basis points, reaching 10.9 per cent at the end of June 2020. Although vacancy rates held steady in Atlanta and Seattle, they rose in San Francisco and Dallas.

Despite the increased supply of office space in some markets, average rents for the eleven largest US office rental markets still advanced by 2.3 per cent in the first half of 2020. The highest growth rates were recorded in Los Angeles (up by 5.0 per cent) and Miami (up by 4.1 per cent).

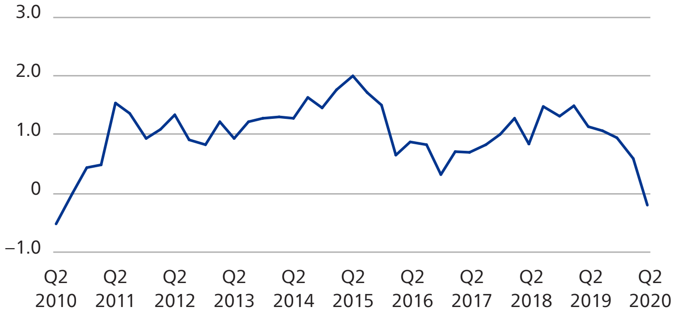
Initial yields were again virtually unchanged on the prior-year period. However, large urban centres such as New York, Los Angeles, Washington and Seattle recorded a sharp fall in the volume of transactions. International investors were still few and far between in the second quarter, mainly due to the travel restrictions.

Despite the current crisis, the US real estate market will continue to offer robust conditions for investment going forward and will remain the most liquid market worldwide for the time being. There is likely to be growing interest in US real estate from investors even in the short term, not least because of the extensive monetary and fiscal policy support measures.

Euro continues to strengthen
Appreciation against the US dollar
(US dollars to the euro since the start of 2015)

Source: Bloomberg, as at 1 September 2020.

Quarterly change in prime office rents in the US
Average (%)*



*Average of the eleven biggest US office markets.
Source: CoStar, as at 30 June 2020.

Our assessment at a glance

Our current risk assessment

- The global economy is continuing to stage a moderate recovery, although it is likely to lose a little momentum in the months ahead.
- High unemployment and muted consumer sentiment are dampening prices; inflation is not an issue for the time being.
- Monetary policy continues to provide strong support.
- Positive news about the development of vaccines and about new test types are prompting investors to overlook the weakness of the economy.
- Our general risk assessment (RoRo meter) remains at level 3 (neutral).

RoRo meter

Source: Union Investment, as at 1 September 2020. Last changed (from 4 to 3) on 27 January 2020.

Note: The investment strategy is established by first closely analysing the market environment. The result is reflected in a risk rating. For this, the Union Investment Committee (UIC) expresses a risk-on/risk-off decision at one of five levels (1, 2, 3, 4 or 5). It is to be interpreted as follows: a '5' indicates a strong appetite for risk while a '1' indicates a general withdrawal from risk assets.

Our view of the asset classes

- **Fixed income:** Corporate bonds and government bonds from the eurozone periphery continue to be well supported by the EU recovery fund and the European Central Bank's purchase programmes. Covered bonds and government bonds from core eurozone countries hold little appeal due to low yields.
- **Equities:** The clear winner in the hunt for spreads continues to be equities. Concerns about a second wave of infection are being allayed by positive news about coronavirus.
- **Currencies:** The agreement of a European recovery fund continues to provide support for the euro. Moreover, uncertainty about the upcoming US election is weighing heavily on the US dollar.
- **Commodities:** The situation in the commodity markets is stabilising. Steady supply and weak demand are limiting the potential, however.
- The situation in the money markets remains unchanged. Interest rates remain in negative territory, which means that holding **cash** is not a good idea.
- In light of low yields in the bond market, we are taking a positive view of **absolute return strategies**.
- The outlook for **real estate** has improved a little in Germany but deteriorated slightly in the Asia-Pacific region.

The → = ← signs indicate the change compared with the decision made at the UIC's previous regular meeting.

Not favoured – **Neutral** – **Strongly favoured**

Appeal of different asset classes

Fixed income	=
Eurozone core government bonds	=
Covered bonds	=
Eurozone periphery government bonds	=
Investment-grade euro corporate bonds	=
High-yield euro corporate bonds	=
Emerging market government bonds	=
Equities	→
Industrialised countries	→
Emerging markets	=
Commodities	←
Currencies	
US dollar	=
Pound sterling	=
Japanese yen	=
Emerging market currencies	=
Absolute return	=
Cash	=

Source: Union Investment, as at 1 September 2020.

Note: The table above provides a **relative view of a multi-asset portfolio (excluding real estate)**. If one asset class becomes more strongly favoured, a lower level of investment in another asset class is required in return. The latter would then be classified as less favoured – or vice versa. Real estate is excluded from this analysis.

Real estate	
Germany	→
Europe (ex Germany)	=
US	=
Asia-Pacific	←

Source: Union Investment, as at 15 June 2020. Assessment is valid up to 30 November 2020.

Note: The table above provides a **relative view of the office real-estate markets** in light of current market prospects. Due to a lack of more frequently available data, it is only updated every six months.

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Unless otherwise stated, all information, descriptions and explanations are dated **4 September 2020**.

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