Union Investment

Outlook for the capital markets

# 10 propositions for 2022

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# 10 propositions for 2022
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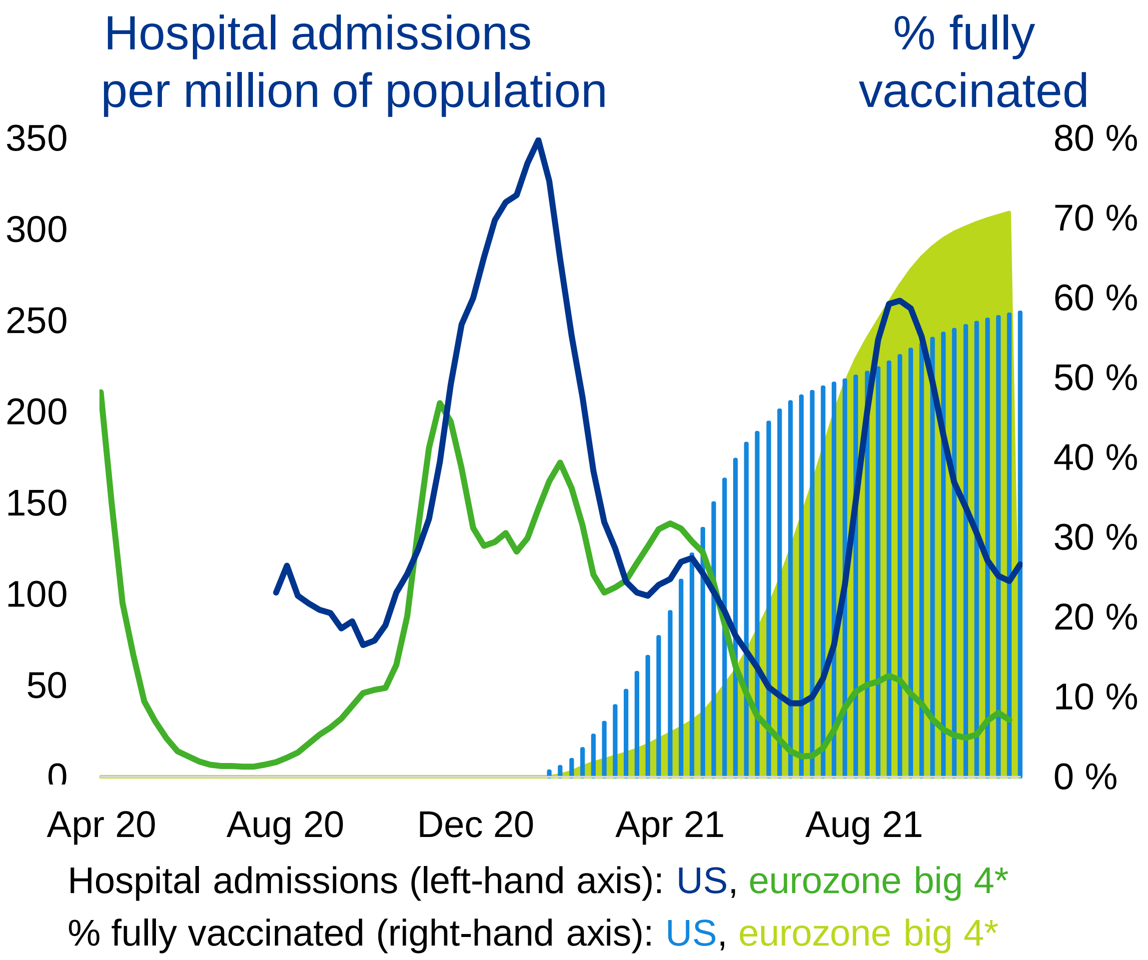
# New phase: Waning impact of pandemic on capital markets



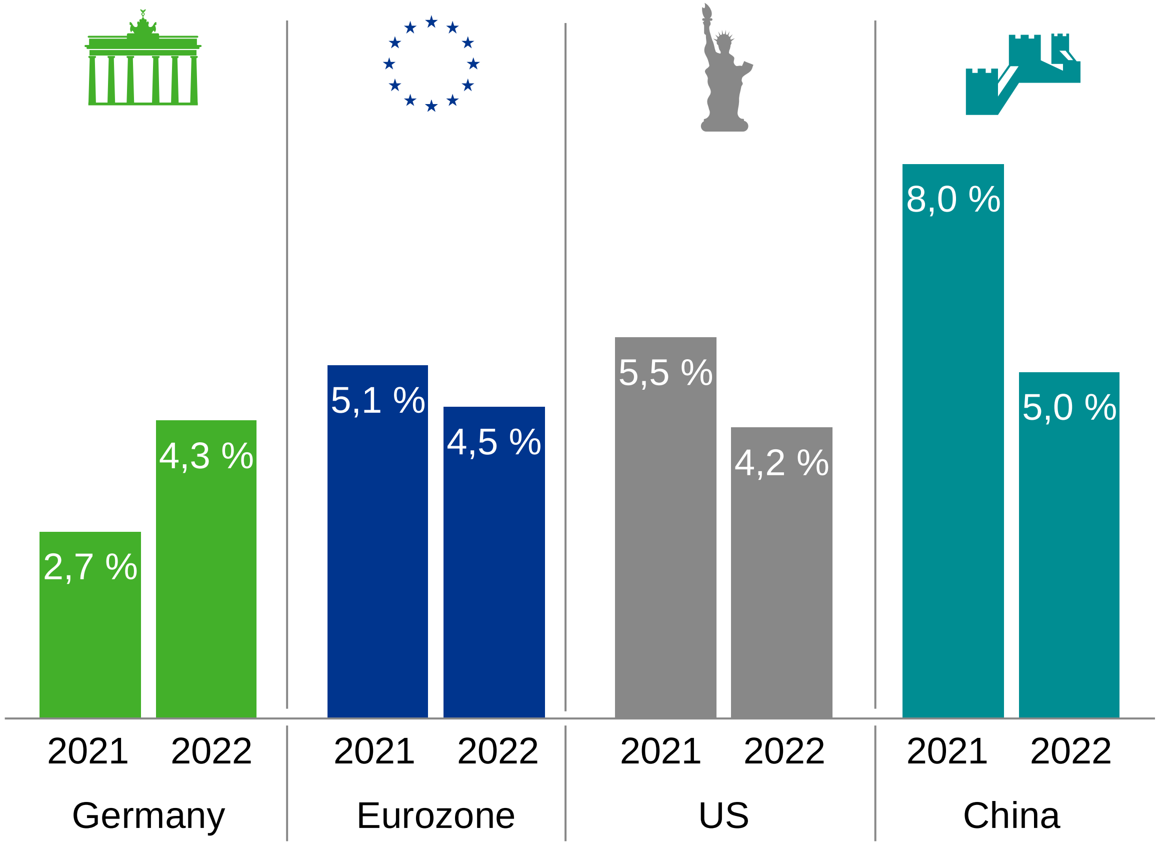

Sources: Our World in Data, Union Investment, as at 15 November 2021.
* Germany, France, Italy, Spain.

## End of the pandemic in sight

- Situation with new infections remains challenging in industrialised countries over the winter months
- Transition from pandemic to endemic phase in the first half of 2022
- Mainly local outbreaks rather than waves because of high level of immunity
- Emerging markets replicate the trend in the industrialised countries

# New momentum: Disruptions to supply delay growth beyond 2022

## Year-on-year change in real GDP



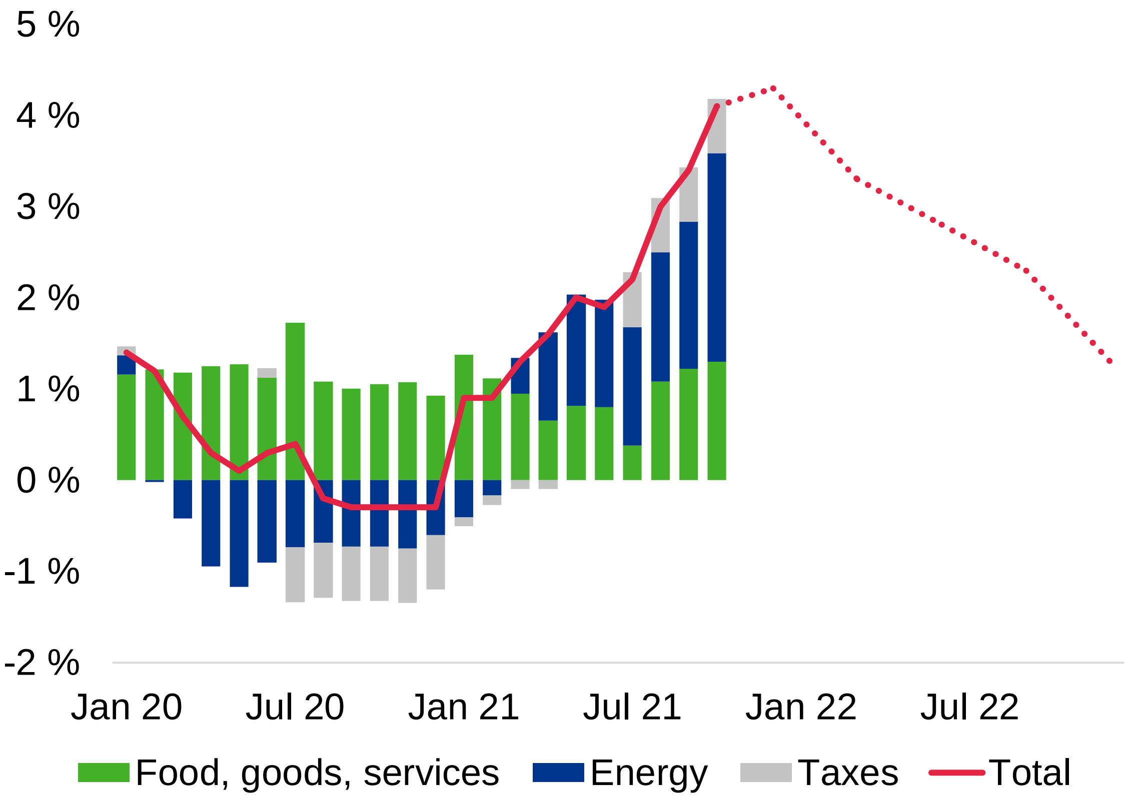

Source: Union Investment, as at 18 November 2021.

### Delayed but not derailed

- The US and Europe have already exceeded the maximum pace of growth in 2021.
- Disruptions to supply are putting the brakes on the economy, but mean an extended phase of growth in 2022
- Momentum on the demand side shifts from goods to services
- Common prosperity and zero-COVID policies put a dampener on growth in China

# New normal: Inflation more transitory than persistent

## Eurozone: Harmonised Index of Consumer Prices (HICP) and its components, year-on-year change

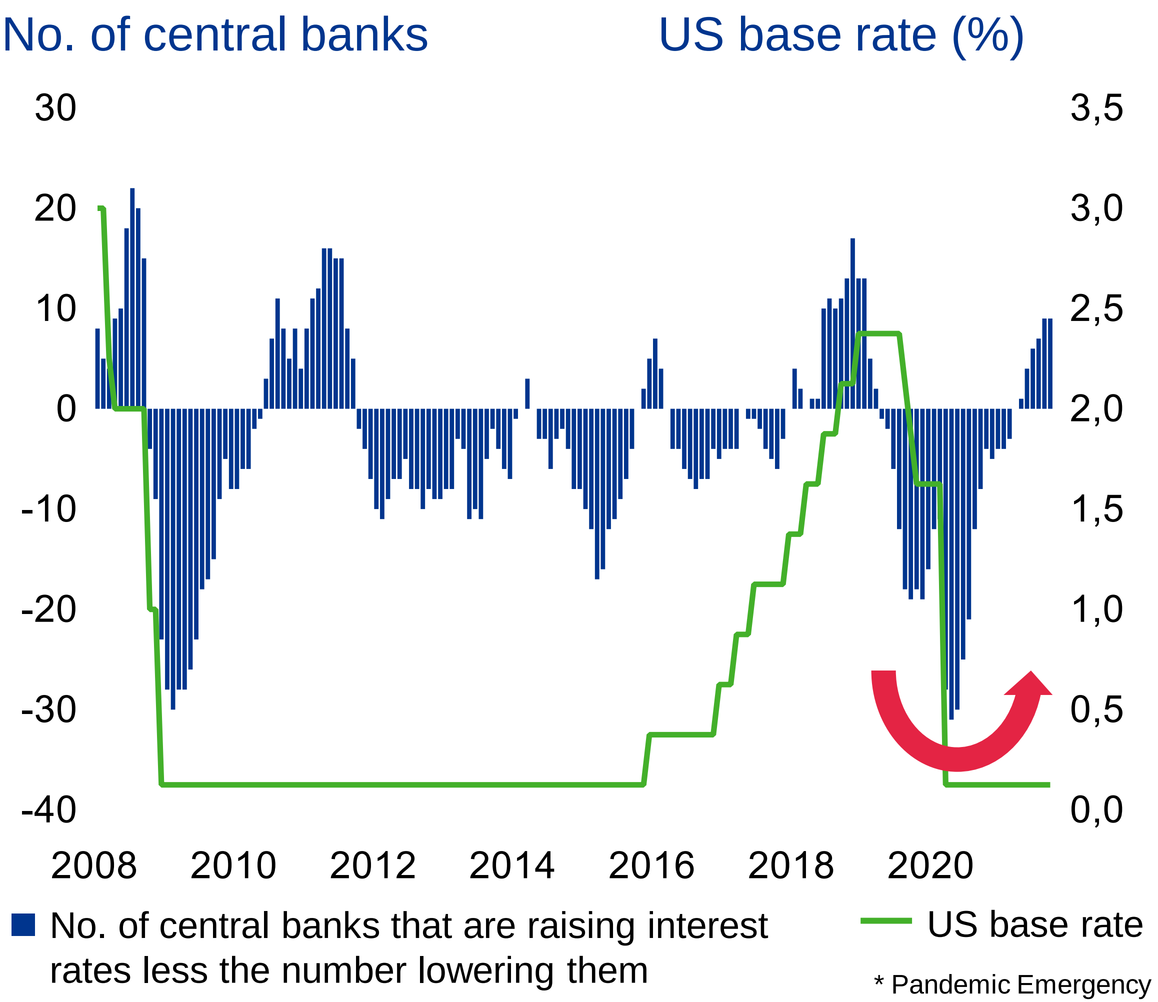



Sources: Macrobond, Union Investment, as at 18 November 2021.

### Underlying price pressure is currently being exaggerated

- Sharp rise in inflation in 2021
- Coronavirus has created the conditions for across-the-board upward pressure on prices
- In 2022, inflation rates should gradually slide back down towards the central banks' targets
- Greater volatility in inflation rates is on the cards going forward

# New direction: Monetary policy tightens but not to market's detriment




Sources: Bloomberg, Union Investment, as at 15 November 2021.

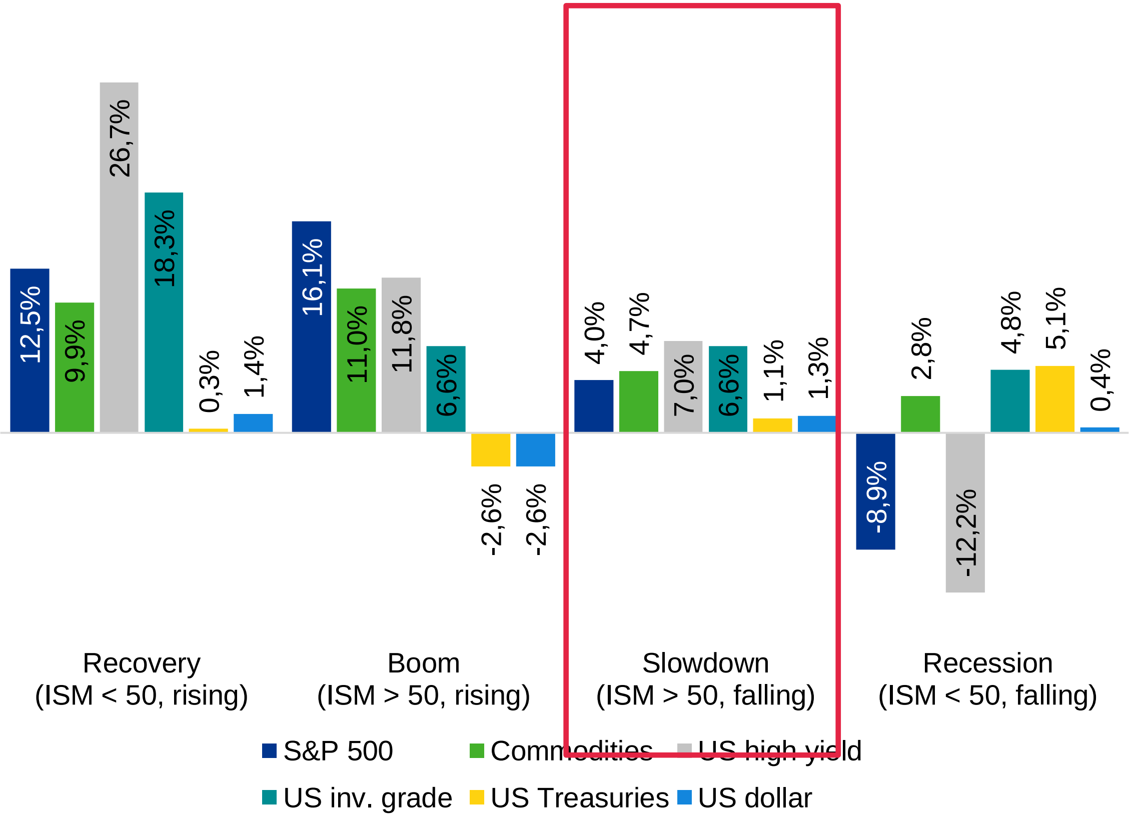
* Pandemic Emergency Purchase Programme

## The monetary policy cycle has turned

- Many smaller central banks have already signalled intention to begin raising interest rates
- The Fed initially reduces its bond purchases before ending them entirely in mid-2022
- The ECB calls time on PEPP*, but continues to purchase bonds on a more modest scale
- First interest rate rise: Fed end of 2022 – ECB not before 2024

# New world: Tactics and security selection more important in 2022

## ISM investment clock, historical performance



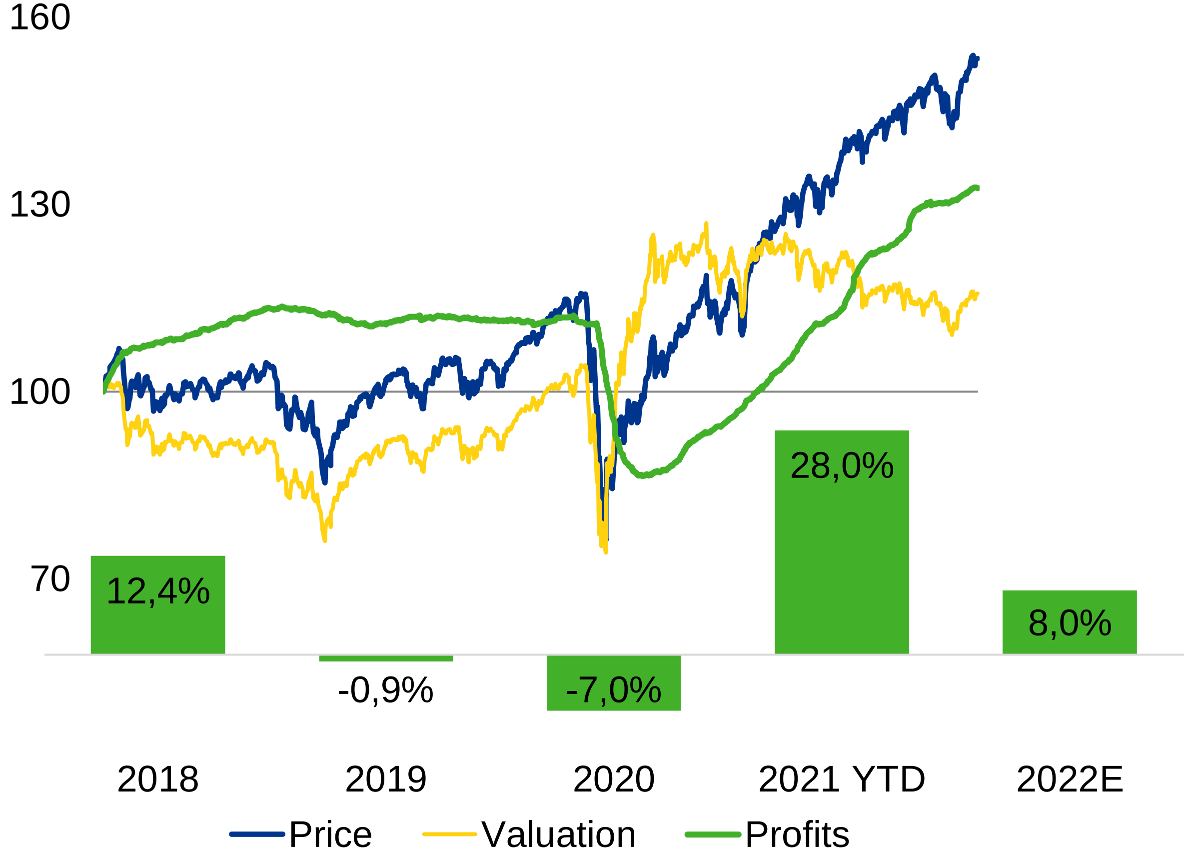

Sources: Bloomberg, Refinitiv, Union Investment, as at 15 November 2021.

### Risk assets remain a hunting ground for opportunity

- Capital market environment still 'good enough' for riskier asset classes
- Bond markets expensive due to low yields and narrow spreads
- Equities supported by profit growth, commodities by the transition to a green economy
- Security selection and tactical activity the basis for investment return in 2022

# New drivers: Profit growth a boon for equity markets

MSCI World, indexed performance



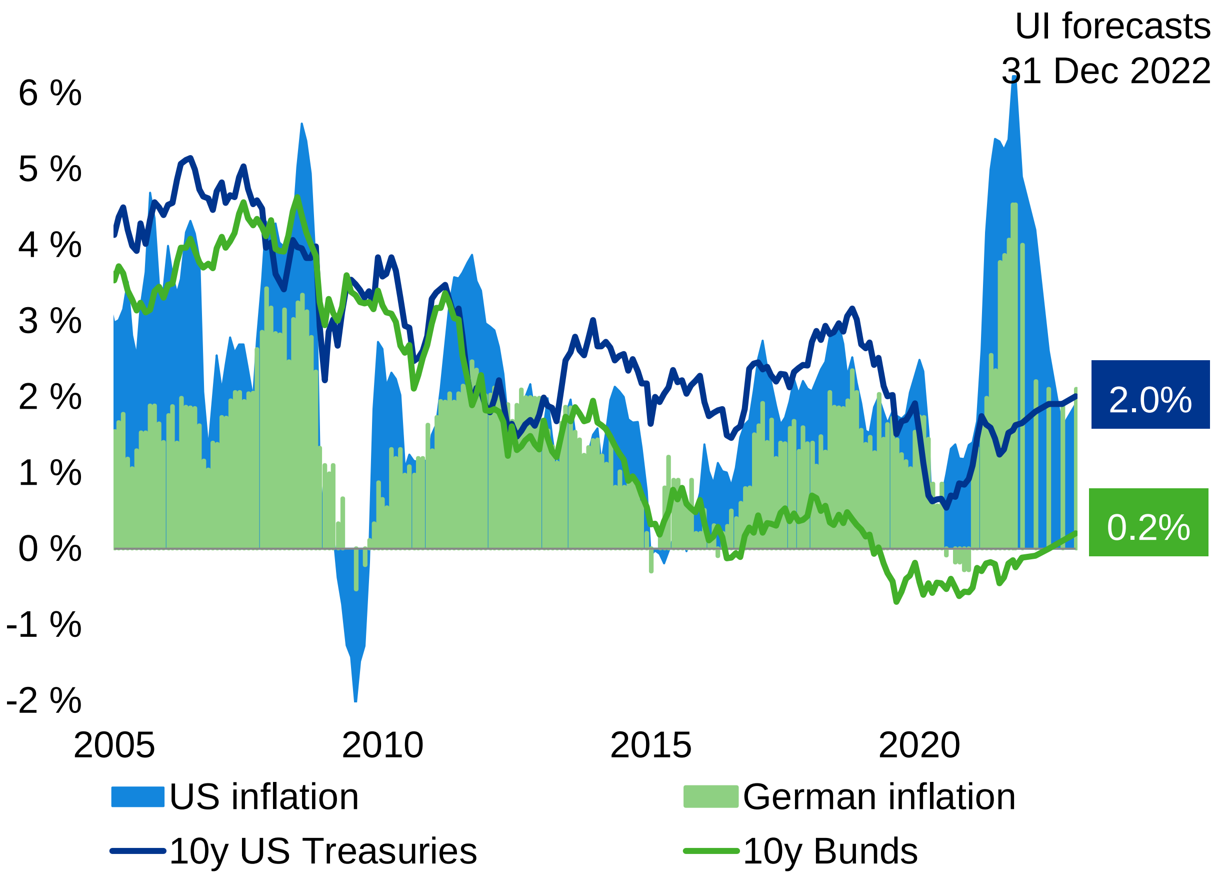

Sources: Bloomberg, Union Investment, as at 15 November 2021.

## Equities remain most attractive asset class

- Corporate profits expected to jump by 8 per cent in 2022
- Inflation at a more moderate level and a normalisation of monetary policy are unlikely to hold back prices
- Lower dispersion between styles and sectors – security selection the key
- EM equities continue trading at a discount for as long as uncertainty in China persists

# New parameters: Inflation and monetary policy push up yields

## Yields on ten-year government bonds and inflation*



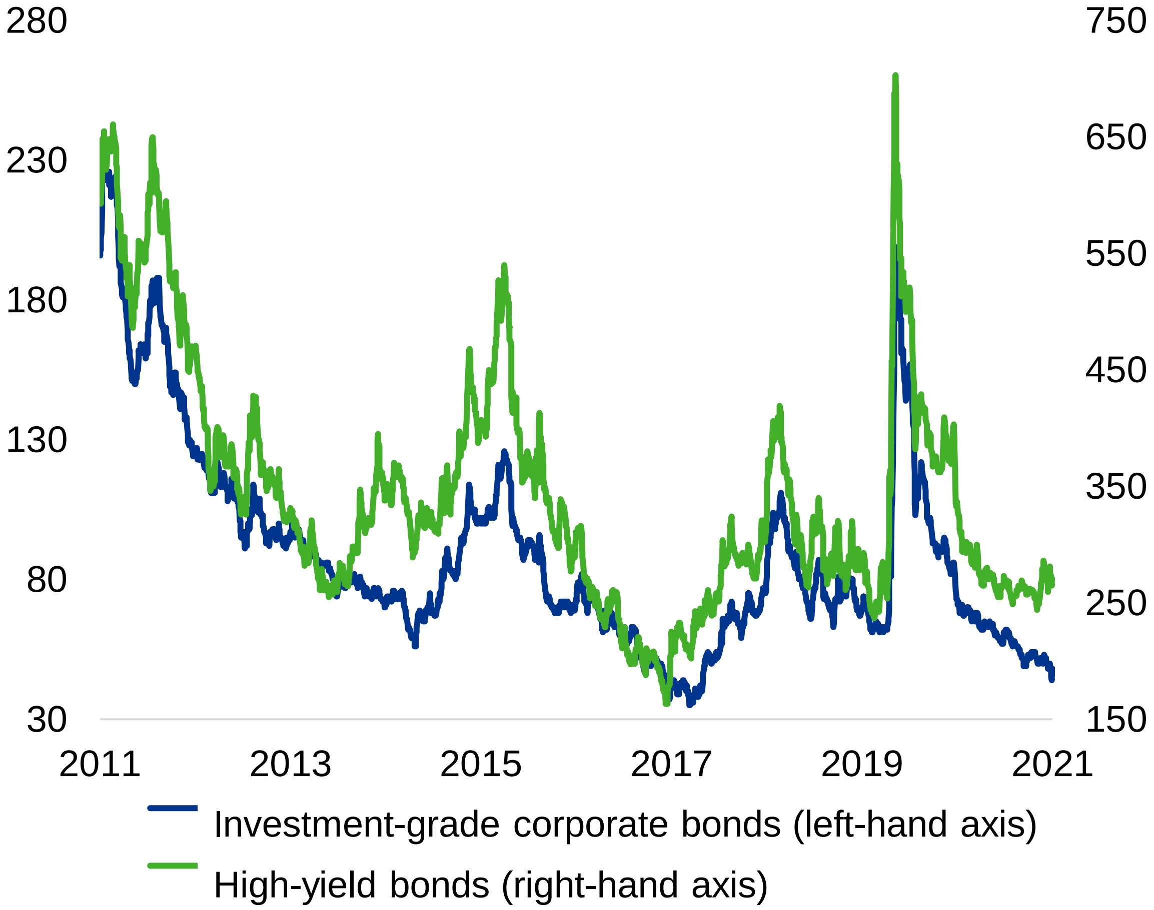

Sources: Refinitiv, Union Investment, as at 15 November 2021.
* Incl. Union Investment's forecasts up to the end of 2022.

### Barely any let-up in challenging investment conditions

- Yields on safe havens continue rising modestly
- Yield curves shift upwards and flatten
- Net supply of paper falls, thus limiting scope for yields to rise
- EM bonds attractively priced and poised to rally – but country-specific risks lurk

# New challenges: Credit loses appeal

## Asset swap spreads for euro bonds



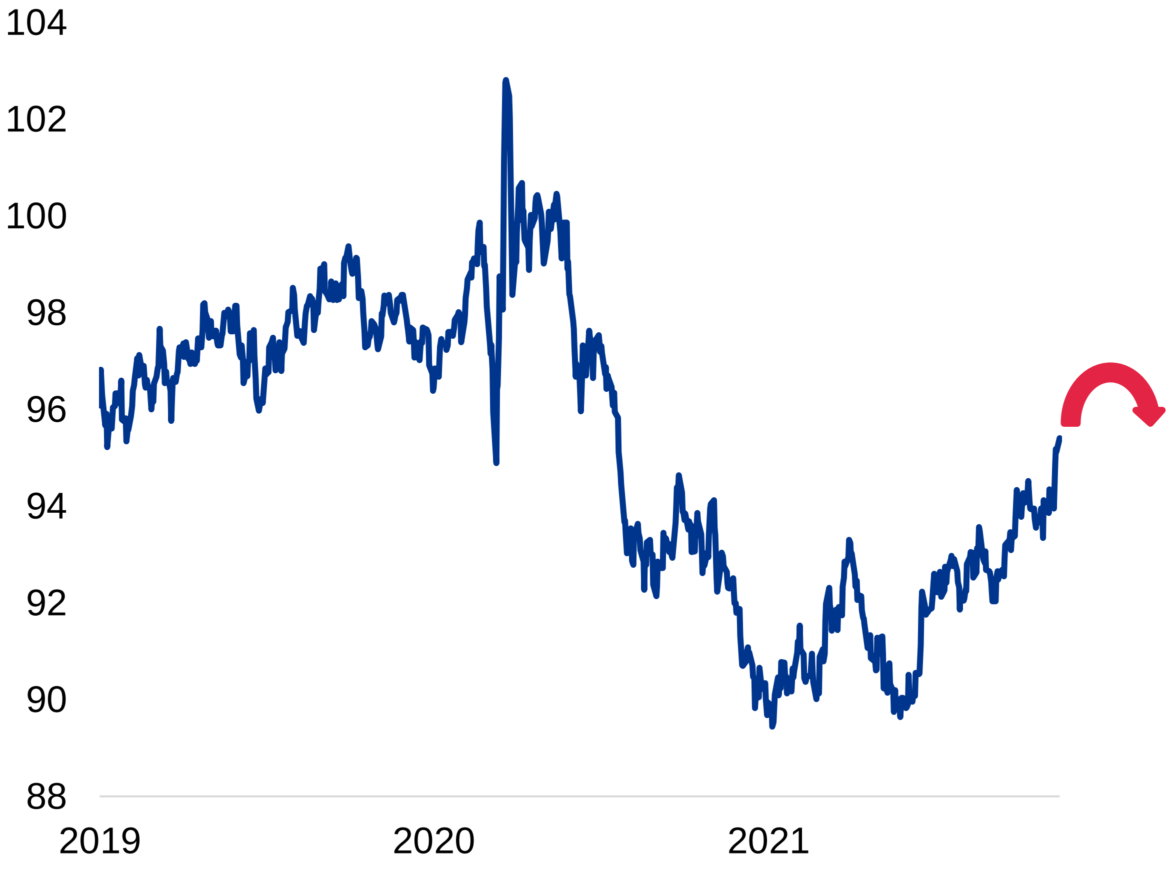

Sources: Bloomberg, Union Investment, as at 15 November 2021.

### Little scope for spreads to narrow

- Corporate bonds have become significantly more expensive since the start of the coronavirus crisis
- Reduced demand from central banks in 2022, supply of paper likely to rise
- High nominal growth keeps default rates low – high yield favoured over investment grade
- Spreads in investment grade segment are unable to compensate for the rise in government bond yields

# New picture: Tailwind for US dollar weakens

## Trade-weighted US dollar



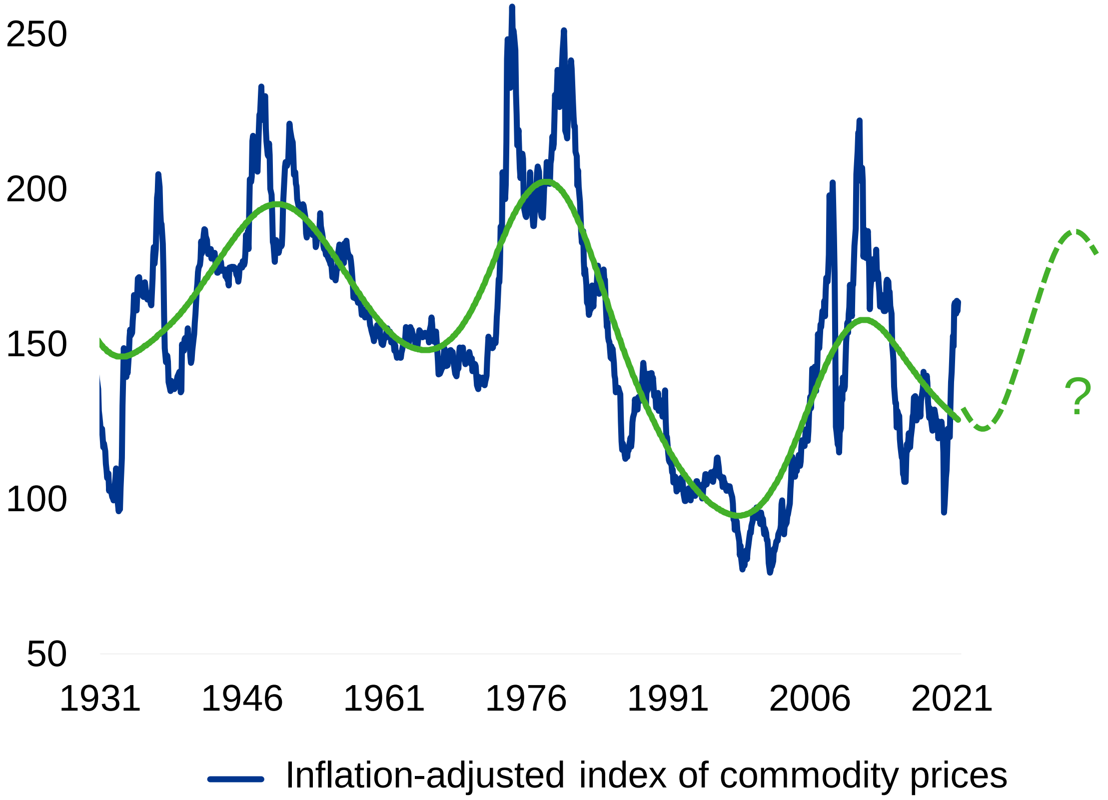

Source: Bloomberg, as at 15 November 2021.

### A shift in drivers for currency movements

- Monetary policy, growth differential and real interest rate differential initially provide support for the US dollar
- Over the course of 2022, the markets increasingly shift their focus to the US fiscal deficit
- Support for the greenback is therefore likely to diminish as the year progresses
- Demand for NextGenerationEU bonds looks set to strengthen the euro

# New favourites: Decarbonisation drives up commodity prices

## Will shift to green energy herald a new supercycle?
(Inflation-adjusted average of the prices of 35 commodities)




Sources: Bloomberg, corporate reports, Union Investment, as at 15 November 2021.

### Commodity market maintains upward trajectory

- Industrial metals supplant energy as the best-performing commodity segment
- Transition to a green economy and improvement in Chinese credit-led demand are the drivers
- Equilibrium restored to oil market, gas prices fall due to increased production
- Easing of supply chain bottlenecks positive for platinum group metals, monetary policy weighs on gold


# Annex

# 10 propositions for 2022 – Executive Summary (1/3)

## New phase: Waning impact of pandemic on capital markets

During the winter months, with vaccination rates in many places still too low, the number of new infections will rise again. Over the course of the first half of 2022, the proportion of the population that is either vaccinated or has had COVID-19 is large enough in the industrialised countries for there to be a transition from pandemic to endemic phase. Although there may still be local outbreaks, the high level of immunity among the population makes major waves of infection unlikely. In the emerging markets – with the exception of most of Africa – the vaccination campaigns have now begun in earnest. An end to the pandemic should therefore move closer in these parts of the world too.

## New momentum: Disruptions to supply delay growth beyond 2022

The US and Europe have already exceeded the maximum pace of growth in the current upturn. Supply bottlenecks have put the brakes on the economy in the second half of the year, but this means an extended phase of growth in 2022. There are clear differences in terms of absolute output: The US economy is already back on its previous growth trajectory, whereas GDP in Europe has not yet returned to its pre-crisis level. And although China has long since passed these milestones, the increased regulatory intervention from Beijing has caused the economy to falter. The rate at which populations in the emerging markets are vaccinated is key not only to the pace of growth in these economies but also to the stabilisation of international supply chains.

## New normal: Inflation more transitory than persistent

Inflation rose sharply around the world in 2021. The trend has been particularly pronounced in the US, where inflation is currently running at more than 6 per cent. More so than before the pandemic, we now largely consider the ingredients to be in place for growing across-the-board upward pressure on prices. Even so, the current inflation rates are significantly exaggerating the underlying price pressure. Over the course of 2022, we expect to see inflation slip back towards the central bank target of 2 per cent in the US/UK and below the central bank target of 2 per cent in the eurozone. Only vestiges of this year’s overshoot are likely to be seen beyond 2021. In the longer term, however, inflation will probably be more volatile.

Source: Union Investment, Cyclical Outlook 2022, as at 15 November 2021.

# 10 propositions for 2022 – Executive Summary (2/3)

## New direction:  Monetary policy tightens but not to detriment of the market

While the rally in the US economy continues apace, persistent supply bottlenecks coupled with strong demand push inflation higher, at least temporarily. In response, the Fed gradually winds up its ultra-expansionary monetary policy. By mid-2022, it may have stopped purchasing bonds entirely. The first interest-rate hike is expected to follow at the end of 2022. In the eurozone, the economic recovery proceeds more slowly and the rate of inflation is more moderate. The ECB continues to purchase bonds at a more modest scale even after the end of PEPP. Its first interest rate rise is still a long way off.

## New world: Tactics and security selection more important in 2022

The forthcoming normalisation of monetary policy takes place in an environment in which inflation rates roll back again and economic growth remains robust. High cross-asset valuations limit the potential for price gains but do not yet present any heightened level of risk. Investments with potential for high rewards thus remain our favourites. We prefer equities and commodities, hold a neutral view of credit as an asset class and regard government bonds as unattractive.

## New drivers: Profit growth a boon for equity markets

Profit growth of 8 per cent with a return to inflation at more moderate levels and gradual tapering by the Fed is good enough for equities. The mid-cycle environment points to a low degree of dispersion in the performance of different styles and sectors. However, there is still a lot of uncertainty surrounding the Chinese equity market. Consequently, emerging market equities are not trading at enough of a discount to merit a more positive assessment.

Source: Union Investment, Cyclical Outlook 2022, as at 15 November 2021.

# 10 propositions for 2022 – Executive Summary (3/3)

## New parameters: Inflation and monetary policy push up yields

Strong growth and the scaling back of expansionary monetary policy mean that government bonds remain unattractive in 2022. The divergence in monetary policy between the Fed and ECB causes the two-year interest-rate differential to widen further in favour of the US. Although Bund yields continue to track yields on US government bonds, the extent to which they rise is still limited in 2022 because of negative net supply. There is still potential for government bonds from the emerging markets to stage their own rally.

## New challenges: Credit loses appeal

Corporate bonds are already significantly more expensive. In an environment of strong economic growth, this asset class still offers only an asymmetric risk profile in 2022. Credits are unattractive, particularly in comparison with riskier asset classes such as equities and commodities. It does not help that the ECB 'put' is on the way out. Within the corporate bond sector, we continue to favour high-yield paper over investment-grade bonds.

## New picture: Tailwind for US dollar weakens

The growth differential and real interest rate differential and the divergence in monetary policy between the US and the eurozone continue to support the US dollar well into the first half of 2022. After that, topics such as Washington's high fiscal deficit shift back into focus and weaken the greenback. Moreover, the new NextGenerationEU bonds catch the eye of international reserve managers and strengthen the euro.

## New favourites: Decarbonisation drives up commodity prices

Commodity market maintains its upward trajectory in 2022. The metal markets supplant fossil fuels as the driver here. Whereas equilibrium is restored to the oil market and gas prices fall due to production rises, industrial metals benefit from an improvement in credit-led demand in China. The normalisation of monetary policy weighs on gold, whereas the quasi-industrial precious metals are boosted by the easing of supply chain problems, particularly in the automotive industry. A pronounced slowdown of economic growth in China is a source of risk.

Source: Union Investment, Cyclical Outlook 2022, as at 15 November 2021.

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Contact: Union Investment Institutional GmbH, Weissfrauenstrasse 7, 60311 Frankfurt/Main, Germany, tel. +49 69 2567-7652

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