In the capital markets, fears of a marked economic downturn are growing. And while we do not share these concerns, we have slightly adjusted our forecasts downward nonetheless.

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Market news and expert views

Monthly report
June 2022

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The markets at a glance

Summary

The current environment is still subject to significant uncertainty. The list of possible negative factors includes the ongoing war in Ukraine, the wave of COVID-19 in China, and rising inflation in the US and Europe, to name but a few. We have confirmed our neutral risk positioning (RoRo meter at level 3) and are opting for selected, often relative positions and a highly tactical approach. In addition, we have made adjustments on the fixed-income side. The main aim is to raise duration risk and, in return, reduce credit risk because concerns about growth are taking over from concerns about inflation in the capital markets. Earlier in the month, we had shifted our equity and commodity exposures to a neutral stance and positioned ourselves in expectation of US government bonds performing better than their counterparts from core eurozone countries.

These decisions were based on the assessment that the next steps of the US Federal Reserve (Fed), in particular, have been communicated clearly and have been largely absorbed by the markets. Unlike in the eurozone, where the shift in monetary policy has not quite yet materialised, the likelihood of further rises in yields on US government bonds has reduced markedly. Moreover, the relative calm that is expected to pervade in respect of US Treasuries should provide support for the fixed-income segment in the emerging markets (EM) going forward. Many issuers are offering an interesting entry point into this segment again, which is why the asset class has regained appeal in our opinion.

By contrast, the market outlook for corporate bonds has deteriorated, especially in the eurozone. One reason for this is the termination of the asset purchase programme of the European Central Bank (ECB), which will eliminate an important pillar of support. Another reason is that concerns about growth could adversely affect the asset class.

Economy, growth, inflation

Fears about a weakening economy have recently increased in the capital markets. For the moment at least, growth has taken over from inflation as the strongest market driver. Nevertheless, economic activity, inflation and the role of the central banks are closely linked with each other. US inflation has recently been rising at a slower pace than it had in March. In April, year-on-year inflation – including all components – stood at 8.3 per cent, down from 8.5 per cent in the previous month. Core inflation in April was also much higher than a year ago, but slightly lower than in March. All in all, inflationary pressure has thus eased a little. However, the number of different factors that are driving up prices has increased. We therefore do not anticipate that US inflation will subside quickly, and the same goes for the eurozone. But inflation has most likely passed its peak now and has started to come down again. Nonetheless, a sustained decrease is not expected until 2023.

Some market players are therefore sceptical about whether there will be a sufficiently broad-based and rapid fall in inflation in the months ahead and about whether the central banks will have to ramp up the tightening measures that they have announced. Such a move – and this is what is weighing on the markets – could disrupt the economic cycle and trigger a recession. So far, however, the leading indicators have not suggested that the global economy is heading for a contraction, although the pace of growth has recently tailed off in some regions and sectors. At the same time, the ifo Business Climate Index for the German economy, which is closely integrated with the global economy, has recently trended upwards. The robust consumer data in the US is also supporting growth. We therefore do not anticipate a recession in the major economies and believe that the markets' fears in this regard are overblown.

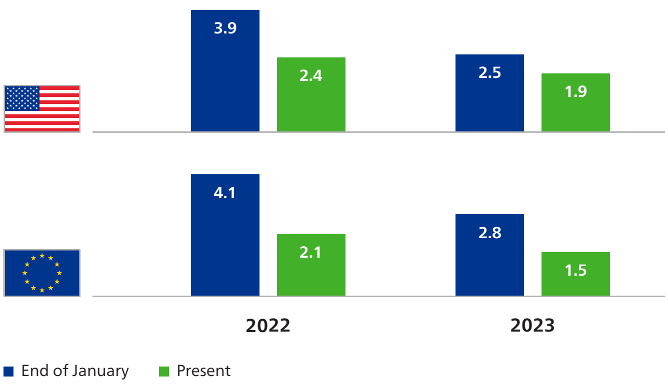
Capital markets remain exposed to increased risk

BofA Merrill Lynch market risk indicator over time

Source: Bloomberg, as at 24 May 2022.

Weaker growth expected, but no recession

Comparison of annual GDP growth (forecast figures, %)



Source: Union Investment, as at 24 May 2022.

The markets at a glance

Monetary policy: aiming for a swift return to neutral interest rates

Initial signs that inflation is starting to ease will take some pressure off the Fed, meaning that it will not need to resort to extreme measures. This improves the chances that the modest downward trajectory of inflation will result in a 'soft landing' for the economy. The signals from the Fed are clear: In the first instance, it intends to raise the key interest rate to a neutral level as quickly as possible in order to avoid adding further fuel to the inflation fire. Moreover, many members of the Federal Open Market Committee (FOMC) believe the right step would be to raise the key interest rate above this neutral level so as to be not just inflation-neutral but to actively dampen inflation.

Our forecasts predict that the Fed will have hiked its key interest rate by a further 175 basis points by the end of 2022. We therefore anticipate interest-rate rises of 50 basis points in both June and July, followed by increases of 25 basis points at each further FOMC meeting this year. After a further rise of 25 basis points at the start of 2023, the cycle of interest-rate hikes is then likely to end with a target range of 2.75 to 3.00 per cent. The Fed's passive trimming of its balance sheet will start in June, with a target reduction of no more than US$ 95 billion per month to be reached in September. Similarly to interest-rate policy, this will contribute to a tightening of financing conditions.

On the other side of the Atlantic, the ECB is likely to stop buying bonds under its asset purchase programme (APP) in June of this year. We predict interest-rate rises of 100 basis points in total for 2022, starting in July. The ECB will want to close the door on negative interest rates as soon as possible. It has not yet made any comments about its medium-term strategy for interest rates. We expect to see further rises of 50 basis points in 2023 to reach 1 per cent. The central bank in Frankfurt will be very keen to prevent financing conditions from tightening too strongly, too rapidly and for the wrong reasons.

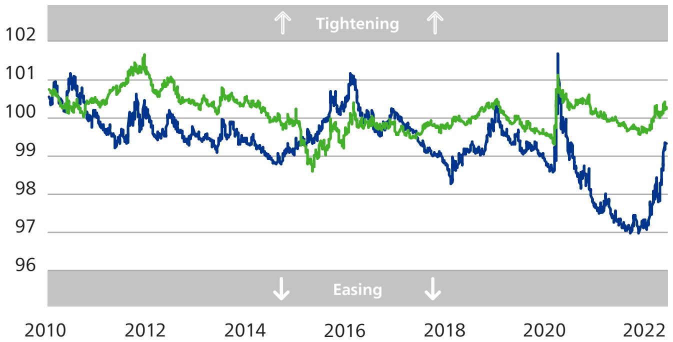
Fixed income: yields on safe government bonds are plateauing

Following the jump in yields on German and US government bonds in recent months, prices have been fluctuating within a narrow range since the second half of April. We believe that the curve for US Treasuries is priced fairly on the whole, i.e. high inflation and the Fed's expected interest-rate hikes have been factored into prices. This means that short positions are no longer likely to pay off (yield forecast for the end of June 2023: 3.0 per cent for both two-year and ten-year US Treasuries).

Looking at Bunds, we expect to see further rises in yields over the coming months, particularly on short-dated bonds (two-year Bunds forecast to be yielding 1.0 per cent at the end of June 2023). In the case of long-dated bonds, however, the majority of the rise is probably already behind us (yield forecast for the end of June 2023: 1.2 per cent for ten-year Bunds). With regard to paper offering a risk premium, the uncertainty surrounding growth forecasts means that spreads are likely to continue widening for some time yet. Moreover, the transition from quantitative easing to quantitative tightening at the ECB represents an adverse factor. By contrast, paper from the emerging markets has probably absorbed much of the impact of the Fed's expected interest-rate rises already. At the same time, the negative credit rating trend has been brought to a halt.

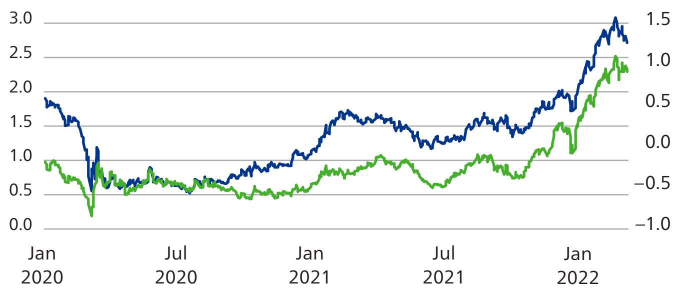
- **Change:** The appeal of US Treasuries has increased further. In addition, we are now also taking a positive view of government bonds from the emerging markets. Conversely, we have taken a position on the sidelines in the high-yield corporate bond segment and are taking a slightly more sceptical view of investment-grade corporate bonds.
- **Positioning:** Fixed-income investments are slightly unattractive overall at present. Government bonds from the US and the emerging markets are among our favourites. By contrast, we are steering clear of government bonds from eurozone core and periphery countries and investment-grade corporate bonds.

Impact of Fed policy is starting to become visible
Goldman Sachs Financial Conditions



Sources: Bloomberg, Union Investment, as at 23 May 2022.

US bond market has already priced in a lot and is becoming more attractive
Comparison of yields on ten-year government bonds since the start of 2020 (%)



Sources: Bloomberg, Union Investment, as at 25 May 2022.

The markets at a glance

Equities: staying on the sidelines

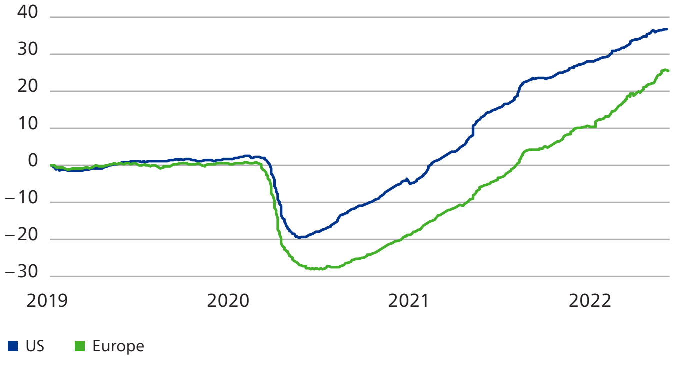
The war in Ukraine, the situation with coronavirus in China and rising interest rates continue to weigh on equity markets. On the one hand, the prospect of greater stability as far as interest-rate and inflation expectations are concerned should mitigate some of the downward pressure on valuations. At the same time, investors are continuing to limit their exposures and their negative sentiment is providing a countercyclical purchase signal. Profit expectations also remain stable, because unlike GDP growth, profits are measured in nominal terms rather than in real terms. This is a reflection of the inflation-proofing characteristic of equities.

On the other hand, the correction in the price of growth stocks – particularly where US tech stocks are concerned – is not over yet, not least because their profit growth has recently lagged behind that of the wider market. US retailers also delivered weak results of late, in many cases due to failures of purchasing policy, and have therefore come under pressure in the stock markets. From a tactical perspective, we are therefore staying on the sidelines insofar as equities from industrialised countries are concerned. The coronavirus situation in China represents a continuing element of risk even though there are increasing signs of an easing of the situation in terms of both new infections and government-imposed containment measures. Nonetheless, it does not seem advisable to take up an active position in the emerging markets against the backdrop of the situation in China and the greater impact of higher energy and food prices on consumers in the emerging markets.

- **Change:** None.
- **Positioning:** Our overall assessment of equities is neutral across industrialised and emerging markets.

Rising corporate profits despite headwind from interest rates

12-month profit expectations for S&P 500 and STOXX 600 (indexed)



Sources: Bloomberg, Union Investment, as at 23 May 2022.

Commodities: shortages are persisting

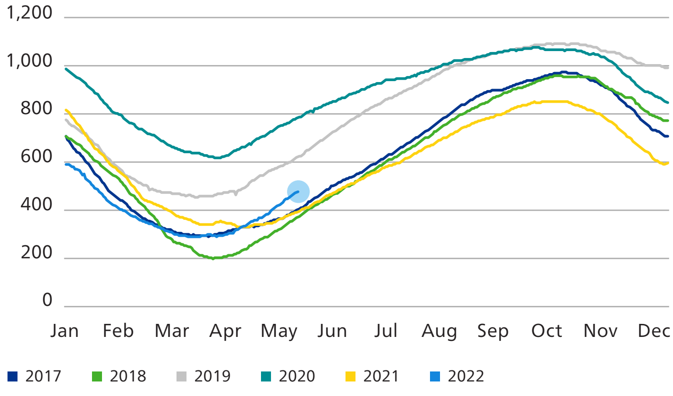
There are continuing shortages in a number of commodity segments. The North Atlantic energy market is experiencing particular bottlenecks for various oil-based products (e.g. diesel, kerosene). This is resulting in higher margins for refineries and higher prices at the pump and is also being reflected in implicit roll yields of 25 per cent on an annualised basis in the forward curves. In addition to the (planned) sanctions against Russia, the level of production by OPEC countries is also providing support for prices, as it remains well behind the agreed increases in production quotas while reserve capacities are declining. Nevertheless, the global oil market is likely to move back into equilibrium over the course of the year or possibly even see a supply surplus as drilling activity in North America is rising again significantly.

The market situation for industrial metals will remain tight this year as, with the exception of lead, demand exceeds current levels of supply in all cases. However, the decisive factor in this segment over the coming months as far as prices are concerned will be what happens in China (which accounts for around 50 per cent of global demand). Due to low levels of investment in new mining projects, the primary supply of industrial metals will remain tight in the medium term although there is likely to be a steady increase in the supply of recycled material. Over the medium term, the market will also experience rising demand in connection with the transition to clean energy and decarbonisation megatrend. This should drive up demand for the precious metal silver in the medium term. In the short term, the automotive industry will remain a key driver for the segment through its use of platinum and palladium. In recent months, high inflation rates and the geopolitical risk premium had resulted in a temporary decoupling of the price of gold from the US dollar and real US interest rates. But recently, gold has experienced price falls as a result of movements in the US dollar and real US interest rates.

- **Change:** None.
- **Positioning:** Commodities are weighted neutrally both overall and at the level of individual segments (precious metals, industrial metals and energy).

Natural gas reservoirs relatively well stocked despite war in Ukraine

Comparison of natural gas inventories (TWh)



Source: Bloomberg, as at 25 May 2022.

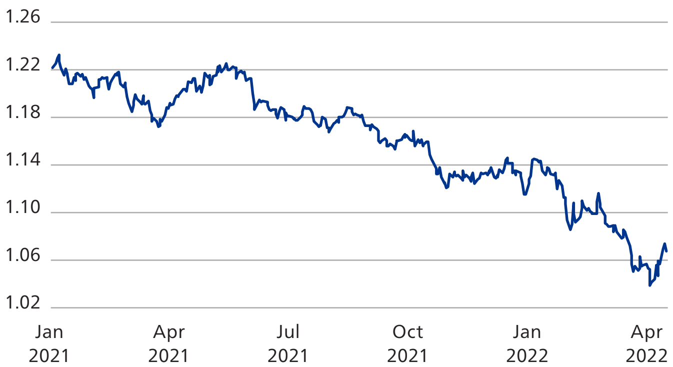
The markets at a glance

Currencies: weakening US dollar

After a sustained period of appreciation by the US dollar, the trend in the currency markets has recently reversed. With the ECB providing ever stronger indications of a tightening of monetary policy, the euro appreciated by 3 per cent against the greenback in recent trading. Whether this represents a break in the almost twelve-month upward trend of the US dollar remains to be seen. The bear sentiment surrounding the Japanese yen and the euro in the market in recent weeks has prompted some investors to start building up positions, or to take profits in dollar positions. It is likely, after all, that the markets have already largely priced in the anticipated interest-rate hikes by the Fed in both longer-dated US bond yields and the US dollar. Pound sterling is in a similar situation. This means that adverse pressures on other currencies, especially the Japanese yen, are more likely to diminish going forward. Rising yields in the US paired with persistently ultra-expansionary monetary policy by the Bank of Japan (yield curve control) caused the Japanese currency to depreciate by well over 10 per cent against the US dollar over the course of March and April. Looking ahead, global concerns about economic growth should generally support the yen as a safe-haven currency while weighing on cyclical currencies such as the euro.

- **Change:** None.
- **Positioning:** We have positioned ourselves in expectation of an appreciation of the Japanese yen against the US dollar and the euro.

Appreciation of US dollar against the euro slowing down
US dollars to the euro, since the start of 2021



Source: Bloomberg, as at 25 May 2022.

Real estate: European office market

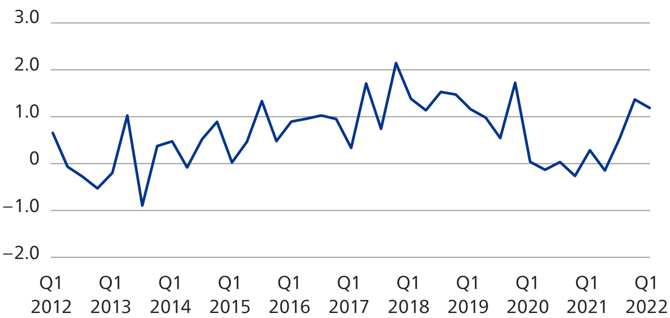
From a macroeconomic perspective, the war in Ukraine and significantly increased expectations for inflation and interest rates were the dominant influences in the first quarter of 2022. The generally more volatile market environment is weighing on the growth forecasts of economies, but has so far had only a limited impact on office property markets.

Rental activity in major European office property hotspots soared in the first quarter of 2022 as the toughest coronavirus-related restrictions were lifted. Total lettings in the twelve most important European office locations were up by more than a third compared with the same quarter of the previous year. Year on year, the average vacancy rate for these cities rose by 40 basis points to 8.9 per cent, but compared with the previous quarter, vacancies were already starting to come down again.

The supply of modern office properties available at short notice remained scarce, especially in prime locations in key hubs. This was exacerbated by the fact that many construction projects were affected by delays due to global supply shortages. Against this backdrop, prime rents trended sideways or even upwards year on year in eleven of the twelve most important European office hotspots. Paris was the only city that saw a slight dip in rents, while Amsterdam, Helsinki and Milan recorded substantial rental price growth of between 5.0 per cent and 9.1 per cent.

Over the further course of the year, the performance of European office markets will depend to a large extent on how the situation in Ukraine evolves and how severe the after-effects of the pandemic turn out to be. After a strong start to 2022, demand for space is generally expected to remain robust in the office lettings markets, although companies in certain industries may be more reluctant to move in the current environment. But a relatively high proportion of new office properties coming onto the market this year are already pre-let, making it unlikely that significant excess supply will build up. Against this backdrop, the stable or slightly upward trend in rental prices will probably continue.

Quarterly change in prime office rents in Europe
Average (%)*



* Average of the twelve biggest European office markets.
Source: JLL, as at 31 March 2022.

Our assessment at a glance

Our current risk assessment

- The war in Ukraine, high inflation and the renewed spread of coronavirus in China continue to weigh on the markets.
- Concerns about the macroeconomic outlook have started to mount. Growth, or the lack of it, is now the strongest driving factor in the market as inflation has most likely peaked.
- The central banks have clearly communicated their interest-rate strategies. The ECB is expected to implement its first rate hike in July.
- We believe that corporate profits will remain stable.
- Our general risk assessment (RoRo meter) remains at level 3 (neutral).

RoRo meter

Source: Union Investment, as at 24 May 2022. Last changed (from 4 to 3) on 21 January 2022.

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:** It seems that the Fed's interest-rate hikes have largely been priced in. US and EM government bonds are therefore regaining appeal, not least because they now offer substantial coupon income. Spread paper will continue to be affected by headwinds.
- **Equities:** We are seeing a stable trend in profit forecasts, despite persistent adverse influences. On this basis, we are staying on the sidelines for now.
- **Currencies:** By historical comparison, the depreciation of the Japanese yen appears to have gone too far. We therefore expect a reversal of this trend. The yen could also benefit from potential threats to economic growth.
- **Commodities:** Shortages in a number of commodity segments continue, as does the weak demand, particularly from China. The global oil market is likely to move back into equilibrium over the course of the year or possibly even see a supply surplus.
- Holding **cash** is currently unattractive due to low or even negative interest rates.
- Our assessment of **absolute return strategies** is mildly favourable.
- Within the **real estate** asset class, regions currently have equal weightings.

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

Not favoured **Strongly favoured**
Neutral

Appeal of different asset classes

Fixed income		=
Eurozone core government bonds		=
US government 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 24 May 2022.

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 1 March 2022. Assessment is valid up to 30 June 2022.

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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READ THE PROSPECTUS BEFORE INVESTING

Unless otherwise stated, all information, descriptions and explanations are dated **30 May 2022**.

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