In a weakening economic environment, it seems best to steer clear of cyclically sensitive asset classes such as equities and commodities and to focus once again on fixed-income securities.

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Head of Multi Asset Relative Return

Market news and expert views

Monthly report
August 2022

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The markets at a glance

Summary

All in all, we continue to view the market environment as difficult and uncertain. There is still no sign of the situation easing for the four key parameters that are particularly relevant to the market (growth, inflation, monetary policy and market structure), especially in the case of the first two. In fact, the pace of growth has continued to slow in both the US and Europe and inflationary pressures remain high. The combined effect of these two parameters is increasingly taking its toll on companies' earnings. This has been reflected in the current reporting season, which has produced mixed results so far.

Continental Europe is facing the greatest challenges because the region is very severely affected by Russia's war in Ukraine and its consequences. The situation around gas supplies from Russia highlights the vulnerability of Europe's economy. Although Moscow resumed its deliveries via the Nord Stream 1 pipeline after a suspension for maintenance work in July, it did so at only 40 per cent capacity and subsequently reduced the volume further to just 20 per cent. We expect that the Russian government will continue to pursue this strategy in the coming months, keeping supplies at a low level in order to cause as much economic damage as possible to western European countries without turning off the gas tap completely. A reduced supply volume has already been factored into our forecasts for economic growth. But a complete export stop would inevitably trigger a recession in the eurozone.

In addition, there is no sign yet of inflation settling down, judging by German inflation data for July. While uncertainty remains high and there is a lack of clarity about the four key parameters, conditions will continue to be subdued and a broad-based recovery for risk assets is unlikely. We therefore confirmed our moderately defensive risk positioning (RoRo meter at level 2).

Economy, growth, inflation

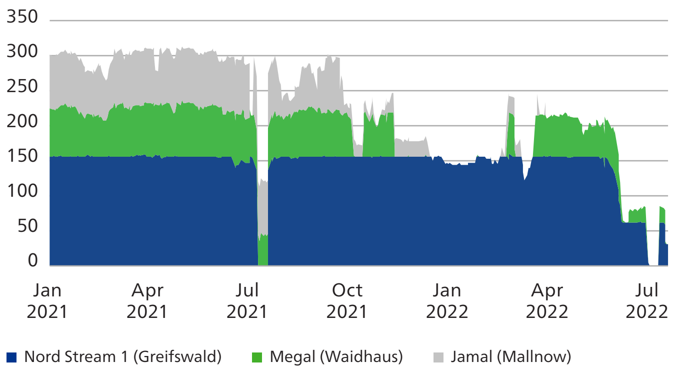
The economy is currently losing momentum, and this is true on both sides of the Atlantic. The economic outlook has particularly deteriorated in the eurozone, not least due to the war in Ukraine and the looming gas crisis. For example, the purchasing managers' index for the eurozone fell by 2.6 points to 49.4 points in July, thus dipping below the growth threshold of 50 points. The eurozone's growth therefore appears to have ground to a halt. Moreover, the index's subcomponents indicate that, at best, the economy will stagnate in the second half of the year. Germany is heavily dependent on Russian gas supplies, and the recent surge in energy prices means that a recession looks increasingly inevitable for Europe's largest economy.

US economic growth has also slowed down. The US economy is expected to have contracted slightly in the second quarter. As in the first quarter, this was primarily due to one-off factors, such as the build-up of inventories. Technically, this constitutes a recession according to the standard definition. But this is not the case from a qualitative perspective because domestic demand was very robust in the first half of the year, as was the labour market. We thus remain confident in the expectation underlying our forecast, namely that economic growth will weaken but the US economy will not slip into a definite recession. A crucial factor will be the signal that the US Federal Reserve (Fed) sends with regard to future interest rates. If it overshoots with its tightening of monetary policy, a recession will take hold.

We believe that inflation in western countries will remain elevated for the time being, before plateauing and then slowly starting to fall at the end of the year. For 2022 as a whole, our economists now anticipate inflation of 8.3 per cent in the US and 8.2 per cent in the eurozone.

Energy crisis looms as Russia fails to fully reopen the gas tap

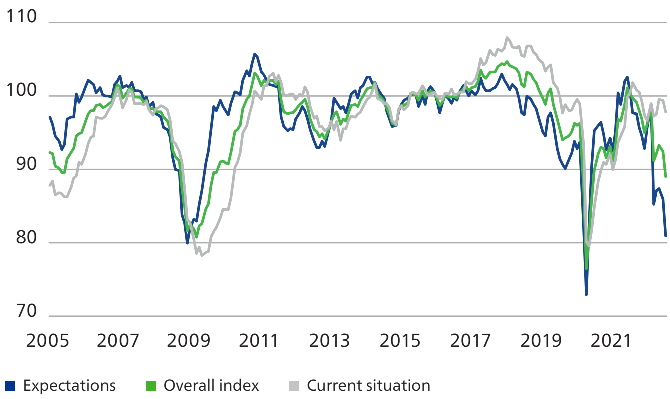
Gas supply to Germany by pipeline (million m³ per day)



Source: Bloomberg, as at 29 July 2022.

Companies are sceptical about the future, but conditions are currently still solid

ifo index for Germany since 2005



Source: Union Investment, as at 29 July 2022.

The markets at a glance

Monetary policy: US Federal Reserve reaches neutral level

In this environment, the focus of the central banks will be trained firmly on tackling inflation, which will include suitable tightening measures. At its meeting in July, the Fed raised the benchmark rates by 75 basis points and combined this move with a hawkish statement. As the Fed's Chair Jerome Powell reiterated several times, the central bank believes that "doing too little" is a high risk. A weakening of growth and a deterioration of the situation in the labour market are therefore needed in order to create a better balance between supply and demand and thus curtail inflation. Powell also stressed that, because a neutral level of interest rates had now been reached, future decisions would be more data-driven. He added that decisions would be made from meeting to meeting in future. Our economists' expectations were thus confirmed and we are adhering to our predictions of what the Fed will do next. We believe that the combination of waning inflationary pressures and a further deterioration of the economic outlook (especially with regard to the labour market) will enable the Fed to progressively reduce the pace of monetary tightening in the coming months.

On the other side of the Atlantic, inflation rates are also soaring, prompting a surprise move by the European Central Bank (ECB) in July. For the first time in eleven years, the ECB tightened the monetary screw, raising all three key interest rates by 50 basis points. With a deposit rate of 0 per cent, negative interest rates have now been consigned to history. At the same time, a new asset purchase programme was created in the shape of the transmission protection instrument (TPI). The TPI is intended to support the effective transmission of monetary policy throughout the eurozone by using bond purchases to eliminate what are considered to be unjustified risk premiums on the government bonds of individual member states.

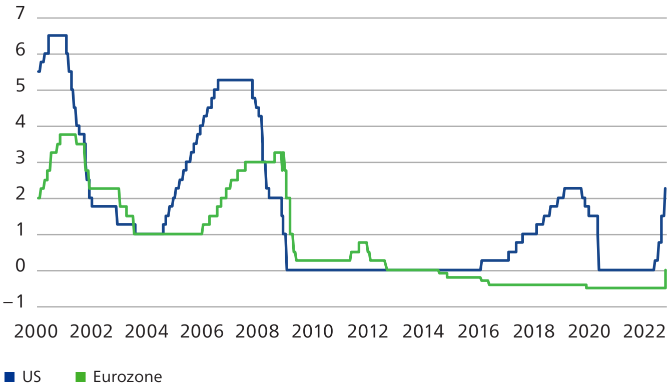
Fixed income: flight to safe havens amid concerns about economic growth

Yields continued on a steep downward trajectory in recent weeks. In light of concerns about economic growth, yields on ten-year German government bonds fell below the 1 per cent mark. Combined with the ECB's interest-rate hike, this led to a flattening of the yield curve. Market participants have thus started to price out potential interest-rate increases by the ECB on two-year paper. However, given that inflation remains high, we regard this as premature. Our opinion is that the ECB will follow up its initial action with further interest-rate increases. The US yield curve has inverted strongly, which is typically seen as a harbinger of an economic downturn. The yield differential between two-year and ten-year US Treasuries has widened to more than 20 basis points and reflects the heightened risk to economic growth. It is expected that the Fed will conclude its cycle of interest-rate increases by the end of the year, whereas the ECB will still have some way to go at this point. As this will probably cause the transatlantic spread to expand, we favour US Treasuries over Bunds.

In light of weaker corporate earnings prospects and uncertainty regarding the trajectory of economic growth, it seems likely that spreads on investment-grade corporate bonds will continue to rise. We have therefore decided to maintain our underweight exposure.

- **Change:** None.
- **Positioning:** We have returned to a neutral view of fixed-income investments. Government bonds from the US and the emerging markets are among our favourites.
  By contrast, we continue to steer clear of investment-grade corporate bonds. Our stance towards government bonds from eurozone core and periphery countries and high-yield corporate bonds is neutral

Inflation creates pressure to act, putting further interest-rate hikes on the agenda
Key interest rates since 2000 (%)



Source: Bloomberg, as at 29 July 2022.

Concerns about economic growth weigh on yields
Yields on ten-year Bunds since 2010 (%)

Sources: Bloomberg, Union Investment, as at 29 July 2022.

The markets at a glance

Equities: reporting season paints a mixed picture

In the first half of 2022, equities were adversely affected by falling valuations. The downward trend in multiples was driven by changes in the interest-rate environment. More specifically, the underlying dynamic is that the present value of future profits goes down when the interest rate used for discounting purposes goes up. As interest rates settled down and yields even started to fall again in some cases, this factor became less relevant in the equity markets. Instead, the growing risk of a recession and persistently high inflation shifted the focus towards corporate profits.

While companies generally still reported strong earnings in the previous quarter, a growing number are now reporting challenges on the cost side and, in some cases, also with regard to revenue. This is a reflection of the simultaneous weakening of growth and rising inflation.

There are concerns that weak economic momentum means less potential for revenue growth while high inflation drives up costs and puts pressure on margins. The reporting season for the second quarter, which is currently still under way, has so far not entirely confirmed these concerns. It seems that companies are managing to pass their higher input costs on to customers and may even be able to offset falling sales volumes in the process. However, this does not apply to all businesses in equal measure and the reporting season is thus painting a mixed picture. It also remains to be seen how much longer companies will be able to continue to pass on cost increases and protect their (currently still sizeable) profits. These conditions apply across all regions, albeit to different degrees. Once again, Europe will probably be most heavily affected while the pressure on the emerging markets is likely to be less severe.

- **Change:** None.
- **Positioning:** Overall, we are taking a relatively cautious approach to equities. Within the asset class, we prefer stocks from the emerging markets over their counterparts from industrialised economies.

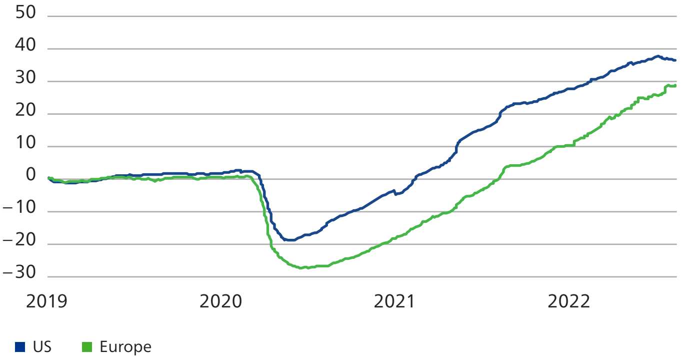
Commodities: industrial metals still favoured

Concerns about economic growth are also having an increasing impact on the commodities segment. For example, demand for oil in the US has already started to drop, causing inventory levels to rise – a trend that is not being helped by what has so far been a lacklustre US driving season. This weakness is particularly pronounced in the market for petroleum. Europe's gas market remains the exception to the rule. The sense of relief sparked by the resumption of Russian gas supply via the Nord Stream 1 pipeline ultimately proved short-lived as Gazprom has already reduced the supply volume again. As a result, European gas prices remain at high levels. The same is true for prices in Asia, where many countries had already been reliant on imports of liquefied gas before the current energy crisis. These countries are now competing with Europe for available supplies. This provides the US with a competitive edge given that the country is self-sufficient with regard to its gas needs.

In the industrial metal markets, our focus is mainly on China. Accelerating growth in the third quarter should revive demand. Closely-watched leading indicators such as the purchasing managers' indices have recently started to firm up again, with some climbing back above the growth threshold of 50 points. In addition, global demand for many metals is growing at structural level because these materials are needed for urgently required infrastructure measures. Against this backdrop, we favour this sector over energy commodities. Gold continues to be pulled in different directions by high inflation and a firm US dollar. This situation is likely to persist for the time being. We thus remain neutral about precious metals.

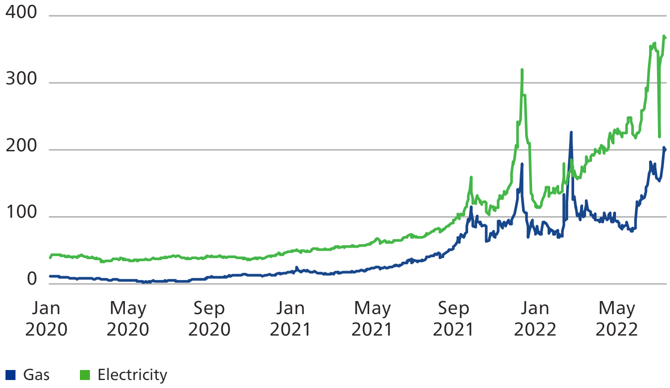
- **Change:** None.
- **Positioning:** We are taking a more cautious approach to commodities overall. At sector level, we expect industrial metals to fare better than the energy sector.

Equity returns still stable – nominal economic growth providing support for nominal profits
Twelve-month profit expectations S&P 500, STOXX 600 (indexed, %)



Sources: Bloomberg, Union Investment, as at 29 July 2022.

Energy prices in Europe continue to rise rapidly
Prices in the German/European futures market (%)



Sources: Bloomberg, Union Investment, as at 29 July 2022.

The markets at a glance

Currencies: US dollar remains supported by monetary policy

The US dollar continued on an upward trajectory in recent weeks. This was mainly attributable to the Fed's monetary policy. With year-on-year inflation recently rising above 9 per cent, the US central bank took decisive steps to bring forward its scheduled interest-rate hikes. In this environment, the US dollar briefly reached parity with the euro but subsequently dipped again.

We expect the Federal Reserve to provisionally conclude its cycle of interest-rate increases in December whereas the ECB will implement further interest-rate hikes in 2023. This suggests that the strength of the US dollar against the euro is unlikely to persist in the medium term. The economic slowdown in the eurozone and the US will probably prompt market participants to become even more risk-averse. In the resulting environment, the Japanese yen, which is widely regarded as the currency markets' traditional safe haven, should have scope to appreciate against both currencies. Moreover, we believe that the Bank of Japan will have to move away from its ultra-expansionary monetary policy strategy at some point. This would eliminate a key factor depressing the relative value of the yen.

- **Change:** None.
- **Positioning:** We expect the Japanese yen to appreciate against the US dollar and the euro.

Real estate: office market in Germany

In Germany, the second quarter of 2022 continued to be shaped by the Ukraine war and by expectations of significantly higher inflation and interest rates. The generally more volatile market environment and concerns about gas supply bottlenecks dampened growth expectations for Germany's economy noticeably, but have so far had only a moderate impact on office real-estate markets.

The average vacancy rate at the end of the second quarter of 2022 had risen by 60 basis points year on year to 5.7 per cent, but held steady compared to the previous quarter. Total lettings were up significantly in the first half of 2022 compared with the prior-year period in all of Germany's five major office markets (Berlin, Frankfurt, Munich, Hamburg and Düsseldorf), registering an average increase of around 37 per cent. Tenants returned to focussing strongly on very high quality, flexible office spaces which allow them to create modern workplaces. Many companies are hoping that the creation of modern working environments as people return to working in the office will enhance collaboration between colleagues and provide a competitive edge when it comes to attracting skilled workers. In all five markets, the supply of suitable, modern space lagged considerably behind demand. Consequently, prime rents at these locations climbed significantly once again, rising by an average of 5.0 per cent year on year.

The performance of German office real-estate markets over the rest of the year will depend to a large extent on how the situation in Ukraine develops. 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. We do not expect any significant excess supply of office space, partly because of a relatively large proportion of pre-lets in new-build projects but also partly because numerous construction projects are being delayed due to the spike in construction costs. Rents are therefore expected to continue to increase slightly over the coming quarters.

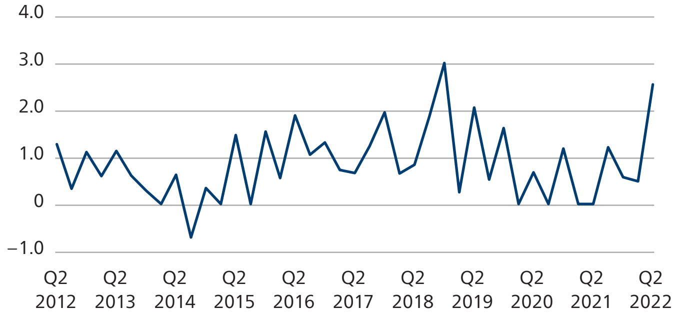
Euro at its weakest in almost 20 years

US dollars to the euro since 2000

Source: Bloomberg, as at 29 July 2022.

Quarterly change in prime office rents in Germany

Average (%)*



*Average of the five biggest German office markets.
Source: JLL, as at 30 June 2022.

Our assessment at a glance

Our current risk assessment

- Concerns about a potential recession continue to dominate the markets and important leading indicators are pointing towards stagnation as a best-case scenario. The outlook for Europe is turning gloomier as the war in Ukraine continues and a gas crisis looms on the horizon.
- Inflation will remain high for the time being. Upward price pressures should eventually stabilise and then start to ease towards the end of the year as economic growth weakens.
- Monetary policy remains firmly geared towards bringing down inflation. In the US, the Fed has restored a neutral interest-rate level and intends to adopt a more data-driven approach going forward.
- The equity markets are thus hoping that headwinds created by US monetary policy will start to abate.
- Our general risk assessment (RoRo meter) remains at level 2 (moderately defensive).

RoRo meter

Source: Union Investment, as at 28 July 2022. Last changed (from 3 to 2) on 1 July 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:** We prefer US Treasuries over government bonds from core eurozone countries, because the Federal Reserve's cycle of interest-rate increases has already reached a much more advanced stage than that of the ECB.
- **Equities:** Low valuations and surprisingly positive growth of late are strengthening the appeal of equities from the emerging markets relative to stocks from industrialised countries.
- **Currencies:** The combination of higher risk aversion among market participants and concerns about economic growth is creating an environment in which the Japanese yen is likely to appreciate.
- **Commodities:** Weakening US demand for oil and rising US inventory levels suggest that growth is starting to slow. We anticipate a price correction, except in the gas market. In the industrial metal markets, our attention is trained on China and we expect the segment to liven up again in the third quarter.
- 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 — **Neutral** — **Strongly favoured**

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 28 July 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 31 March 2022. Assessment is valid up to 31 August 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 **2 August 2022**.

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