Market conditions are upbeat, with the accelerated pace of the vaccination campaigns allowing governments to take further steps towards reopening.

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Market news and expert views

Monthly report
July 2021

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Union Investment

The markets at a glance

Summary

All in all, market conditions remain upbeat, especially in light of the persistently bright economic outlook. This is mainly attributable to a worldwide acceleration of vaccination efforts, even though individual national trajectories undoubtedly vary. However, the impact of positive stimulus factors is waning. The pace of global economic growth is likely to peak in the second quarter and the markets have already priced in most of the optimism about future growth prospects. In addition, the Fed's 'taper talk' will probably grow louder towards the autumn. And the COVID-19 delta variant constitutes a risk factor that still remains somewhat unpredictable. Against this backdrop, we recommend a slightly more cautious approach, but overall are retaining our moderately bullish risk positioning (RoRo meter at level 4).

In terms of specific assets, our view of equities had already become a little less positive by mid-June. Ahead of the anticipated low levels of trading activity and market liquidity during the summer months, we used the benign market environment to take profits on some of our emerging market equities. By contrast, our assessment of high-yield corporate bonds was more positive again. The upshot is that we are favouring high-yield bonds over bonds from core countries. 'Safe havens' remain unattractive to us because speculation about the start of tapering by the US Federal Reserve is likely to increase in the second half of the year. We therefore prefer high-yield bonds that offer an attractive yield as well as a relatively short duration.

We also made adjustments on the commodities front. Our previous preference, based on the gradual reopening of the economy, had been for the energy sector over industrial metals. We took profits on this position too and are now slightly overweight in these two cyclical commodities sectors.

Economy, growth, inflation

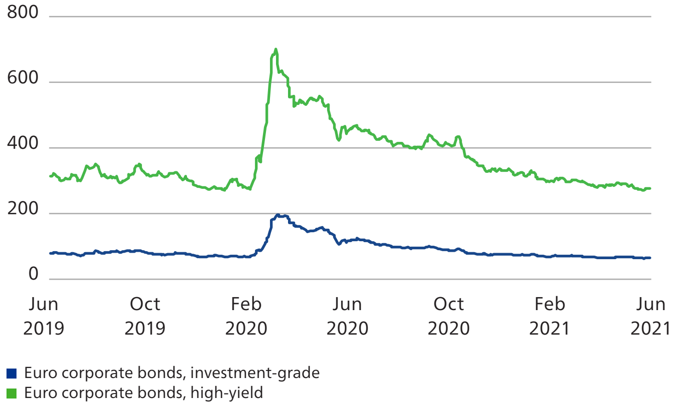
The economy is recovering rapidly, fuelled by progress with vaccination campaigns in many major economies, especially the US and Europe. The associated decline in the prevalence of COVID-19 – probably aided by summery weather in the northern hemisphere – is creating scope to further ease containment measures. Economic activity is picking up a result, particularly in the service sector. This inverse correlation between the spread of the virus and economic growth has essentially been observable since the outbreak of the pandemic, and the last few months have reaffirmed the pattern. Immunisation efforts are facilitating the economic reopening over the summer and providing a boost for economic growth – especially in regions that had previously been lagging behind (e.g. the eurozone).

These trends led us to slightly upgrade our growth forecasts for certain countries. In particular, our expectations regarding domestic demand in the US for the second half of 2021 were adjusted upwards. Forecasts for the eurozone were also tweaked, but our overall assessment remains unchanged. We continue to anticipate that US economic growth will peak in the second quarter, while Europe is not expected to hit its highest quarterly growth rate until the third quarter of 2021.

Inflation rates have recently been rising more steeply than anticipated due to the healthy economic upturn and shortages of certain intermediate products caused by pandemic-related disruption. Nevertheless, we still believe that the current spike in inflation will level off next year. Once the picture is no longer distorted by one-off and prior-year effects, growth has returned to a more moderate pace and behavioural and production patterns have adjusted, inflation should settle at a level that may be slightly higher than before the crisis, but certainly not rampant.

High-yield bonds still have potential

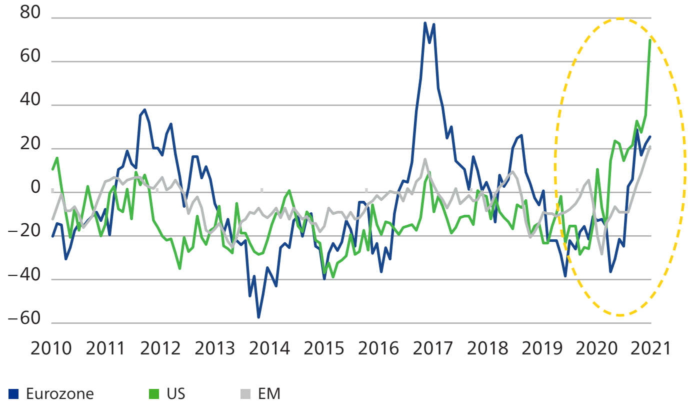
Comparison of spreads offered by two classes of corporate bond



Source: Refinitiv, as at 22 June 2021.

Surprising surge in inflation, particularly in the US

Citi Inflation Surprise Index since beginning of 2010



Source: Bloomberg, as at 22 June 2021.

The markets at a glance

Monetary policy: waiting for autumn

Against the backdrop of the economic recovery and rising inflation, questions about potential steps to scale back monetary policy support are at the top of the capital market agenda. The most recent meetings of the US Federal Reserve (Fed) and the European Central Bank (ECB) provided little new insight in this respect. At its meeting in June, the ECB dismissed speculation that it would soon be reducing its bond purchases. Our expectation is that the ECB will begin to scale these back either in the fourth quarter of this year or the first quarter of 2022. This would enable the bank to keep the total target volume of its pandemic emergency purchase programme (PEPP) unchanged at €1,850 billion, while giving it scope to delay – for a final time – the end of PEPP by three months, from March 2022 to June 2022.

The Fed's macroeconomic projections regarding growth and labour market conditions were adjusted only moderately. More substantial adjustments were made to the projections for inflation, however. For the current year, the central bank now predicts a rate of inflation of 3.4 per cent – an increase of a full percentage point compared with the prediction from March. Inflation projections for 2022 and 2023, on the other hand, were raised only marginally. The interest-rate expectations of the individual members provided the biggest surprise. As recently as March, the Fed's median opinion was that the current interest-rate level would be appropriate until the end of 2023. Now, 13 of the 18 Fed members expect that there will be at least one interest-rate hike over this period.

Little concrete information was provided on the subject of tapering plans. We anticipate that the Fed will begin to prepare to communicate details about the tapering process at one of its next meetings. It seems likely that the Fed will then actually start to gradually reduce its bond purchases from the beginning of the second quarter of 2022 at the latest.

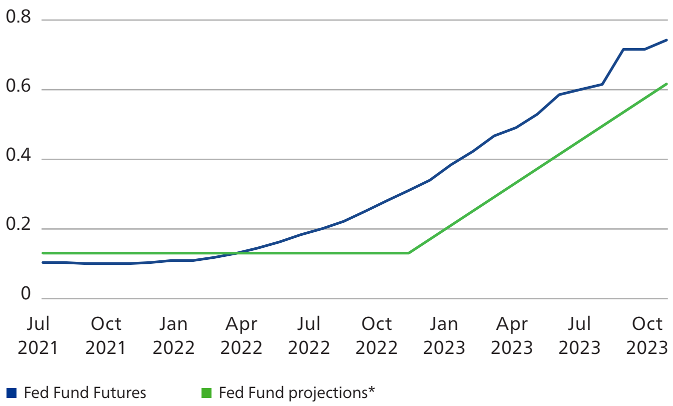
Fixed income: temporary inflation priced in

The consolidation of yields on US government bonds, which peaked at the end of March, has led to a flattening of the US yield curve in recent weeks. At the short end, yields rose on the back of the latest statements from the Fed, whereas those at the long end fell on the assumption that the increase in inflation is only temporary. Yields on ten-year German government bonds began to climb again following a brief phase of consolidation. Looking to the months ahead, we anticipate further price falls for US and German government bonds alike. Higher yields are the likely outcome of an environment shaped by strong growth rates and modest inflation, which means that this market currently appears a little too 'expensive' for our liking.

The period of consolidation for safe havens enabled fixed-income segments offering a risk premium to stage something of a recovery. However, the potential for spreads to narrow further remains extremely limited. Only in the case of high-yield bonds are spreads likely to contract significantly from their current level. Moreover, paper from the emerging markets will also be affected by anticipated policy changes at the Fed. A lot of EM countries issue their bonds in US dollars and thus take a hit when US yields rise.

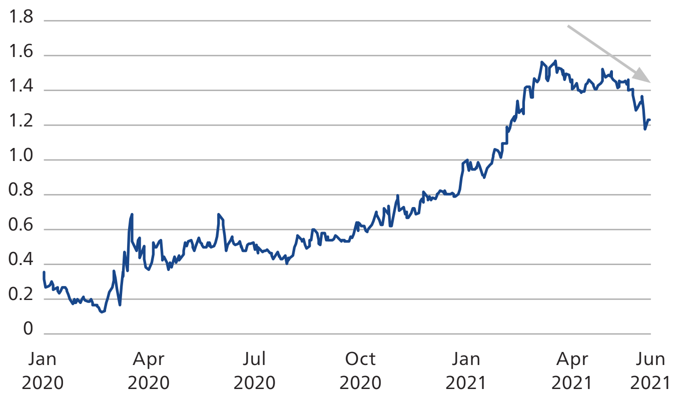
- **Change:** None.
- **Positioning:** Core eurozone government bonds are very unattractive and US government bonds slightly unattractive. We continue to favour high-yield paper. Our position in all other bond segments is neutral. Overall, we remain somewhat cautious with regard to fixed-income investments.

Federal Reserve: no interest-rate rises until 2023
Implied US key interest rates on the basis of the Fed Fund Futures and the Fed's projections (%)



* Median of the dot plot.
Sources: Bloomberg, Union Investment, as at 21 June 2021.

The US yield curve has steadily flattened since the beginning of April
Yield spreads between two-year and ten-year US Treasuries since the beginning of 2020 (%)



Source: Bloomberg, as at 22 June 2021.

The markets at a glance

Equities: onwards and upwards

For the most part, the equity markets have continued to grind higher. The general environment for equities remains benign, but the pace of economic growth is faltering as the transition from early cycle to mid-cycle takes place. Although corporate profits will probably have continued to rise in the second quarter, analysts' expectations will not be as easy to exceed as they were in the reporting season for the first three months of the year. Surprises on the upside will be more difficult as a result and even extremely good results would then fail to translate into higher prices.

Valuations remain at an elevated level. However, market indicators have improved somewhat as a result of the correction in the past few weeks. The equity markets continue to be supported by inflows from systematic investors and sustained high investment demand from institutional and retail investors against a backdrop of low and even negative bond yields. Many investors are simply faced with a lack of alternatives, which overall has justified the slightly higher valuations.

Whereas the recent nudging down of yields has seen growth stocks pick up a little momentum again, the improvement on the corporate profits front would suggest that their value equivalents are the better bet. In terms of investment approach, however, we are not setting our stall out either way. The focus is primarily on individual security selection.

- **Change:** None.
- **Positioning:** Equities are overweighted through exposure both to industrialised countries and emerging markets.

Commodities: 'energy vs. industrial metals' pairs trade closed out

The pick-up of demand and slowly increasing supply have led to a normalisation of oil inventory levels and rapidly rising energy prices. It is still unclear whether, and if so how, OPEC will continue with its expanded volume of production after July. Regardless of OPEC's decision, the oil market is likely to remain firmly in deficit for the rest of the year due to further rises in demand. The roll yields are still attractive to investors. However, we believe that the potential for even higher spot prices is limited following the recent rise. Oil has reacted very positively of late to the increase in travel and transport.

By contrast, the metal market has undergone a correction in the last few weeks and some metal sectors are now close to being oversold. In addition, the effect of Chinese economic stimulus measures on industrial metals has been weakening.

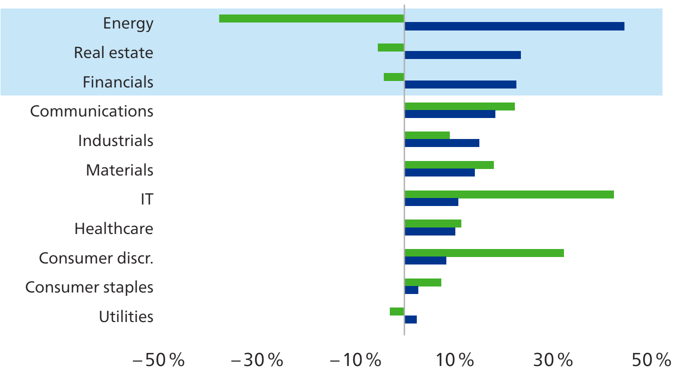
We are therefore confirming our overall commodity position but bringing the energy and industrial metal exposures into line by reducing the former and increasing the latter. As a result, these two cyclical commodity sectors are now slightly overweighted.

Gold continues to be buffeted by inflation expectations and recorded a further small fall in price. In terms of our allocation within precious metals, we prefer the quasi-industrial metals such as platinum and palladium.

- **Change:** Energy commodities are now a little less attractive. We have raised the weighting of industrial metals in return.
- **Positioning:** Energy commodities and industrial metals are now among our favourites. We hold a neutral position in precious metals. Commodities are considered attractive overall.

USA: Last year's losers are now leading the list of winners

Comparative performance of the industrial sectors of the S&P 500

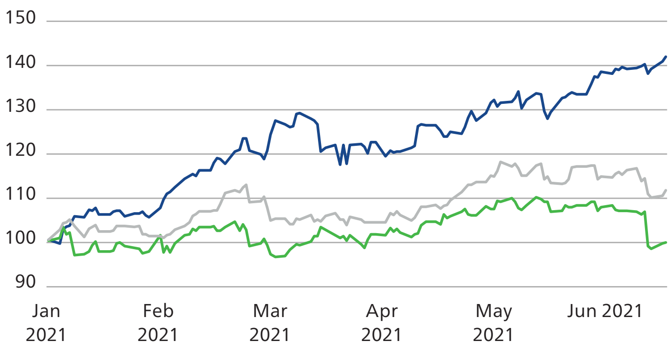


■ 2021, since start of year ■ 2020

Source: Bloomberg, as at 22 June 2021.

Economic recovery is benefiting cyclical commodities

Indexed performance of the commodity sectors in the year to date



■ Energy ■ Precious metals ■ Industrial metals

Source: Bloomberg, as at 22 June 2021.

The markets at a glance

Currencies: Fed support for the US dollar

Recent communications emanating from the Fed have pointed towards an upcoming shift in monetary policy, and this less expansionary tone has led to a significant appreciation of the US dollar. Both the interest-rate differential and the growth differential are likely to support the greenback vis-à-vis the euro in the months ahead. We believe that GDP growth in the US in the current calendar year will be higher than in the eurozone. In the longer term, however, this movement is expected to reverse owing to the deficits and the growing appeal of the euro in connection with the European Union's bond issues.

The depreciation of the Japanese yen is likely to continue over the further course of the year, as Japan is trailing the eurozone by some distance in terms of economic growth. In addition, the yen has historically had a propensity to weaken in periods of accelerating global economic growth.

The combined adverse effects of Brexit and a renewed wave of coronavirus infections, due to the rapid spread of the delta variant, are taking their toll on pound sterling at present. Rising case numbers had prompted the UK government to push back the final steps in its lockdown easing by a further month. However, sterling is receiving support from the Bank of England, which is looking to pull back from its highly expansionary monetary policy stance even earlier than the Fed and ECB.

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

Real estate: office markets in Asia-Pacific

The office markets in the Asia-Pacific region remained in the grip of the coronavirus pandemic in the first quarter of 2021. Although demand for office space slumped last year due to the general climate of uncertainty, many office markets staged a modest recovery in the first quarter of 2021. This trend was driven mainly by the wider economic rally and the availability of vaccines effective against coronavirus.

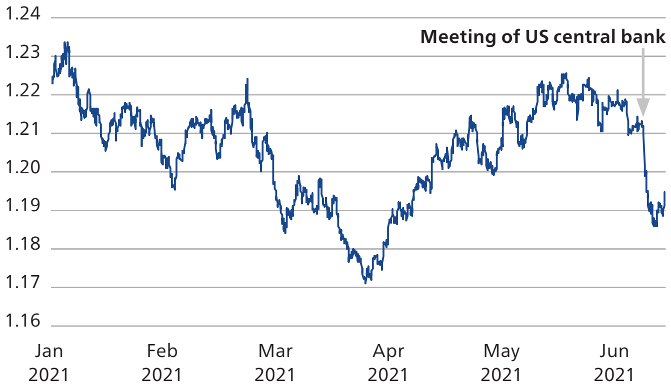
The fall in demand for office space last year and the often high volume of completed new office buildings have pushed up vacancy rates in many locations over the past twelve months. Vacancy rates in this period across the four biggest office markets in the Asia-Pacific region were up by an average of 4.2 percentage points to 9.1 per cent. Whereas the proportion of unlet space rose only marginally in Singapore and Tokyo, vacancy rates in Seoul and Sydney surged due to the very high volume of new buildings. In Sydney, for example, the volume of completions in 2020 was higher than in any other year over the past decade.

Because of the increase in supply, prime rents in the four biggest office locations in the Asia-Pacific region dropped by an average of 8.0 per cent compared with the first quarter of 2020. Seoul was the only of these cities to record a rise in prime rents, which were up by 5.3 per cent. Even though a large number of new office buildings had come on to this market, there was clearly still a great deal of demand for new, high-specification office space in central locations.

We expect demand for office space in Asia-Pacific to gradually recover on the back of the economic rally and progress with the region's vaccination campaigns. This is likely to be reflected in a fall in vacancy rates as early as the second half of 2021 and into 2022, and in stable to slightly improved prime rents in most of the region's office markets.

US dollar appreciates sharply as a result of Fed communications

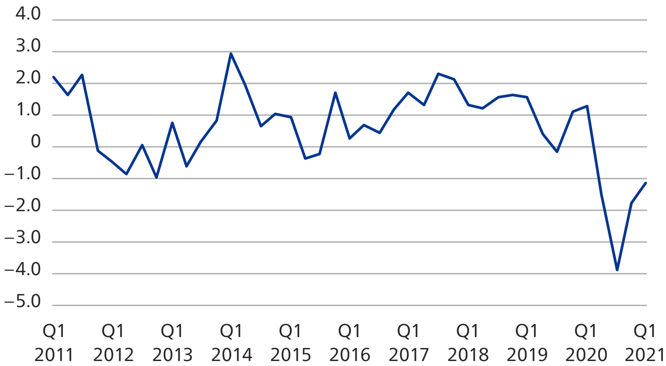
Euro against the US dollar since the beginning of the year



Source: Bloomberg, as at 22 June 2021.

Quarterly change in prime office rents in the Asia-Pacific region

Average (%)*



* Average of the four biggest office markets in the Asia-Pacific region.
Source: Jones Lang LaSalle, as at 31 March 2021.

Our assessment at a glance

Our current risk assessment

- The economy is recovering rapidly thanks to progress with vaccination campaigns. The service sector has been the biggest beneficiary of this.
- Inflation rates have recently been rising steeply due to the healthy economic upturn and pandemic-related shortages of certain intermediate products.
- But we – and the central banks – are not anticipating a sustained period of high inflation.
- For now, we are expecting a period of calm over the summer months. No significant political risks are on the horizon at present.
- Our general risk assessment (RoRo meter) remains at level 4 (slightly bullish).

RoRo meter

Source: Union Investment, as at 19 May 2021. Last changed (from 3 to 4) on 7 January 2021.

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:** Yields on government bonds are likely to pick up again due to growth and inflation. The potential for spreads to narrow further is also limited. High-yield bonds are our favourite.
- **Equities:** The general environment for equities remains upbeat, even if the momentum in terms of growth and profits is likely to drop off a little. Money is continuing to flow into this asset class.
- **Currencies:** The widening growth differential between the US and the eurozone should bolster the US dollar going forward.
- **Commodities:** This sector appears attractive to us again following the correction in the markets for certain industrial metals. The energy sector, which is also cyclical in nature, has further upside potential as well.
- The situation in the money markets is unchanged. Interest rates are still in negative territory, which means that holding **cash** is not a good idea.
- Our assessment of **absolute return strategies** remains positive.
- Within the **real estate** asset class, the 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 22 June 2021.

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 2020. Assessment is valid up to 30 June 2021.

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 **25 June 2021**.

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