"Donald Trump has caused the trade dispute to flare up again. It is now affecting consumer products too and thus has a direct impact on US consumers."

Benjardin Gärtner, Head of Equity Fund Management

August 2019: Market news and expert views

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The markets at a glance

Summary

At our regular meeting in July, we retained our generally neutral stance, confirming the risk position at level 3 on the RoRo meter. We are positioned neutrally overall, but our focus has shifted. Firstly, this is due to the (long-expected) decisions made by the US Federal Reserve (Fed) and the European Central Bank (ECB). The central banks may have taken action, but they did not do what many market participants had anticipated. While the Fed's tone was rather cautious, the ECB is likely to go further than was forecast ahead of the meeting, despite it having less room for manoeuvre.

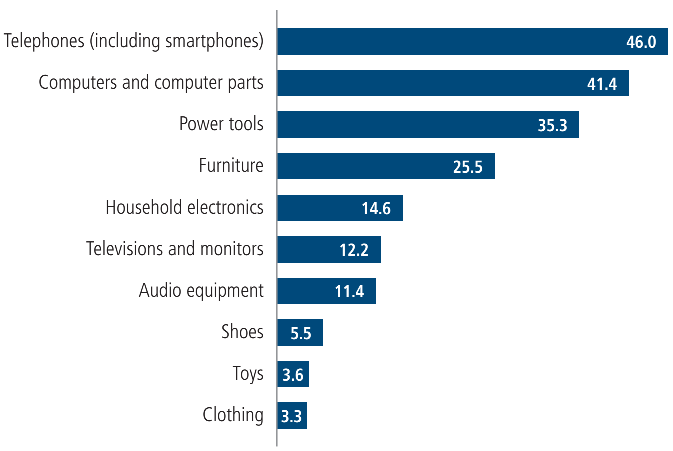
Secondly, the economic picture has not brightened at all and the trade dispute is taking centre stage again. On 1 August, US President Donald Trump announced new 10 per cent tariffs on a further US$ 300 billion of Chinese imports with effect from 1 September. As this announcement came hot on the heels of a meeting with US Secretary of the Treasury Steven Mnuchin and US Trade Representative Robert Lighthizer, who had just returned from talks in Shanghai, it seems likely that there has been no rapprochement between the US and China in the trade dispute. Although we have always stressed that the trade dispute would remain a long-term issue, this move came as a surprise. Moreover, it is now affecting consumer products too and thus has an impact on US consumers. This is likely to have a direct influence on the financial results of consumer products companies, which in turn means that analysts will probably lower their profit expectations for these companies. Beijing retaliated quickly by devaluing the Chinese renminbi, which is unlikely to contribute to a de-escalation.

Economy, growth, inflation

The economy is showing no signs of recovery. The external leading indicators (such as the purchasing managers' indices for manufacturing and the ifo Business Climate Index) and our own leading indicators have still not emerged from their period of weakness and many of them once more fell short of economists' and analysts' expectations. The divergence between manufacturing and the service sector was confirmed yet again, and it is much more pronounced in the eurozone than in other economies. Maintaining the trend that began in the first quarter of 2018, the growth figures for industrialised countries continued to surprise on the negative side in July. Emerging markets (EMs), however, have seen a slight improvement in growth surprises over recent weeks, but they have not yet escaped the downward trend. Our economists have again slightly downgraded their growth forecasts for the current year. They predict a 2.4 per cent rise in economic activity for the US and 1.0 per cent for the eurozone. Germany is suffering as its export-driven economy has been hit particularly hard by the slowdown in global trade. Our economists therefore anticipate that German gross domestic product will now grow by only 0.6 per cent.

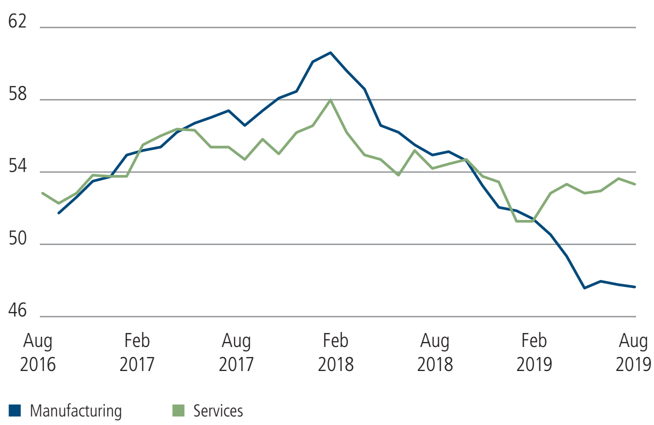
In other words, we continue to view the prospects for global growth as poor. As a result, the growth rate is likely to drop below the trend growth rate, both in the US and in Europe. Nevertheless, we are still not expecting a recession, provided the trade dispute does not escalate into a trade war. The monetary policy stimulus recently decided upon should inject some momentum into the economy going forward. However, fiscal policy measures – which would probably make the biggest difference to the economy in the current situation – are not expected.

New import tariffs primarily affect consumer products
Top ten imports (US$ billion)



Source: Goldman Sachs, as at 1 August 2019.

Risk of a weakening of manufacturing in sectors with a strong domestic focus
Eurozone purchasing managers' indices



Sources: Macrobond, Bloomberg, Markit, as at 1 August 2019.

The markets at a glance

Monetary policy: loosening from late summer onwards

As we had anticipated, the Fed lowered interest rates by 25 basis points on 31 July, its first reduction in a decade. What did surprise many market participants, however, was that the US central bank immediately said this was merely a precautionary decrease and should not be seen as the start of a new rate-cutting cycle. After all, the Fed is walking a tightrope. On the one side, US economic data does not provide any reason to lower interest rates. But on the other side, the central bank is coming under pressure from President Trump and its comments this year have raised expectations significantly in the capital markets. This has been the main factor driving the uptrend across almost all asset classes this year. The Fed has now indicated that it will not provide such strong support for the markets going forward, although it would have plenty of ammunition to do so. US key interest rates are therefore likely to remain higher than previously assumed. The capital markets' expectations of further interest-rate cuts were already falling, but the Fed will have to dampen them even more in the weeks ahead.

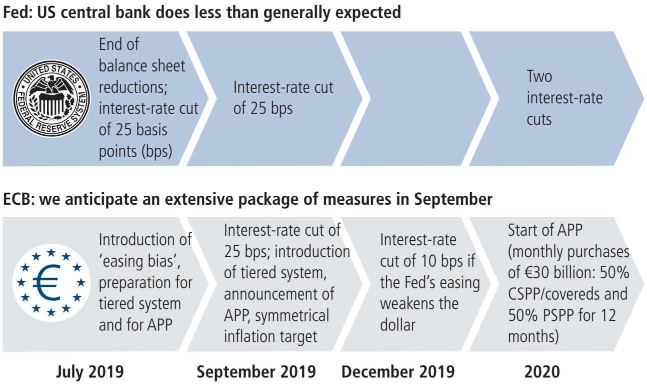
In contrast to the US central bank, the ECB seems prepared to go a lot further than was generally expected, despite having relatively little room for manoeuvre. And now, the current economic dip gives it good reason to do so. After all, indications of a possible recession in the manufacturing sector are much stronger in Europe than in the US. The upcoming ECB meeting in September is expected to bring not only a reduction in interest rates but also the introduction of a tiered interest-rate system and the relaunch of the asset purchase programme (APP). However, this is likely to be less focused on government bonds and will therefore mainly lead to lower risk premiums on corporate bonds.

Fixed income: stronger focus on segments offering a risk premium

The monetary policy measures already decided upon by the Fed and those announced by and/or expected from the ECB mean that interest rates remain resolutely low and have actually fallen even further. The conditions for fixed-income investments are therefore still fundamentally positive. Yields on safe government bonds, such as German Bunds and US Treasuries, have dropped sharply in recent weeks and are expected to go down a little bit more. In this environment, spread segments are also likely to remain in demand, firstly because of investors' hunt for returns and secondly because of the ECB's plans to relaunch the asset purchase programme. If the programme has the volume that we expect (€30 billion per month, split evenly between government bonds (PSPP) and corporate bonds (CSPP)/covered bonds), risk premiums will probably fall on the whole. Nonetheless, it is important in the current economic climate to pay more attention to individual security selection, because the disparities in the spread asset classes have increased markedly in recent weeks. This is the result of the conflict between the prevailing tailwind from monetary policy and headwinds from market fundamentals. Not all bonds have participated in the rally, and this is particularly the case for those of companies with a weaker business model (mostly high-yield paper with a CCC rating). Government bonds from emerging markets continue to receive good support from the low real rates of return, higher break-even inflation and high oil prices.

- **Decision:** Corporate bonds are now seen as even more attractive and covered bonds as even less attractive.
- **Positioning:** Fixed-income investments have thus become a little more interesting overall. Government bonds from core and periphery eurozone countries continue to be rated neutrally, as do high-yield corporate bonds. The carry segments, in this case investment-grade corporate bonds and EM government bonds, are attractive, but covered bonds are not.

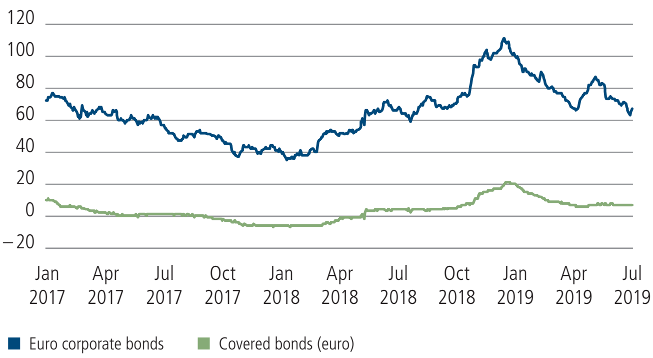
Fed and ECB: central banks caught between the economic reality and market expectations



Source: Union Investment, as at 1 August 2019.

Corporate bonds likely to benefit from the ECB's new purchases

Asset swap spreads (basis points)



Source: Bloomberg, as at 1 August 2019.

The markets at a glance

Equities: escalation of trade dispute likely to take its toll

To some extent, the trade dispute had fallen off the capital markets' radar after the G20 summit at the end of June. But that changed dramatically with Trump's recent announcement of new tariffs. There was a noticeable impact on prices in the US stock market, and companies that do business in China (supply chains, production facilities, sales markets, etc.) suffered in particular. Trump's move had not been anticipated by the markets. With the US election campaign about to get under way, the trade dispute is likely to remain in the spotlight and continue to unsettle the markets. Moreover, the election of Boris Johnson as the UK's new prime minister increases the probability of a disorderly Brexit. Despite economic conditions remaining weak, the equity markets have generally been climbing over the past few weeks. And the US stock markets even reached all-time highs. This was mainly because the central banks raised the prospect of monetary easing. At its July meeting, however, the Fed did not deliver what the markets were anticipating, and we think that the Fed will dampen the significant expectations of further interest-rate cuts over the course of the year. The second-quarter reporting season in the US was solid, but there is significant disparity between the sectors. Cyclical industries (e.g. automotive, chemicals, transport), in particular, face operational challenges. In view of the renewed escalation of the trade dispute, which is unlikely to fade into the background as quickly this time, and the continued economic headwinds, we have decided to be a bit more cautious about equities from industrialised countries.

- **Decision:** Equities from industrialised countries are regarded slightly more negatively.
- **Positioning:** The asset class as a whole has lost some of its appeal again.

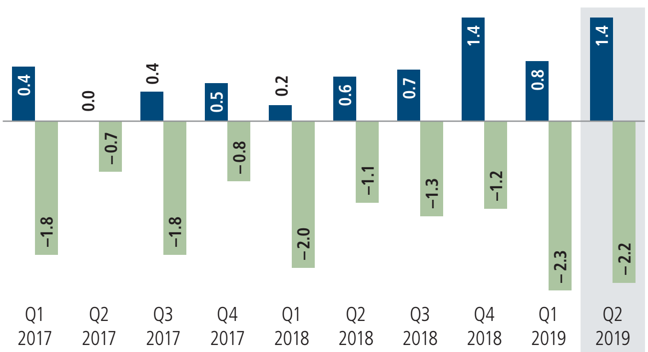
Commodities: oil market will probably see a supply surplus in 2020

At the moment, prices for energy commodities are still well supported by factors on both the supply side (OPEC+ has extended its production cuts) and the demand side (e.g. the US driving season). However, slower increases in oil consumption relative to output in the months ahead are likely to lead to an oversupply in the oil market next year, putting downward pressure on prices. Moreover, global inventories do not justify higher prices. Our experts have therefore adjusted their price forecast for Brent crude in twelve months' time, lowering it from US$ 70.00 to US$ 65.00 per barrel. Industrial metal inventories are stabilising at a low level; a surplus of lead and zinc in the market is expected from 2020 onwards. Market players are still hoping that Chinese infrastructure measures will stimulate the sector. The price of gold has benefited from falling US real interest rates in recent weeks. Investors have increased their precious metal positions on a huge scale. Although we have raised our price target for twelve months' time to US$ 1,450.00 per ounce, the latest rally backs up our belief that most of the potential has now been exhausted (especially as the Fed's interest-rate cut fell short of market expectations). Silver has been relatively weak compared to gold for the past year (an ounce of gold would recently have bought 95 ounces of silver, more than at any time since the early 1990s), but interest from investors in the lesser metal has picked up noticeably in recent weeks. In our view, silver certainly has the potential for a further price rise. But as the precious metal position in the portfolio includes both gold and silver, and also platinum and palladium, we are maintaining our neutral weighting.

- **Decision:** None.
- **Commodities:** Continued neutral weighting for commodities.

Prices react strongly to surprises/disappointments

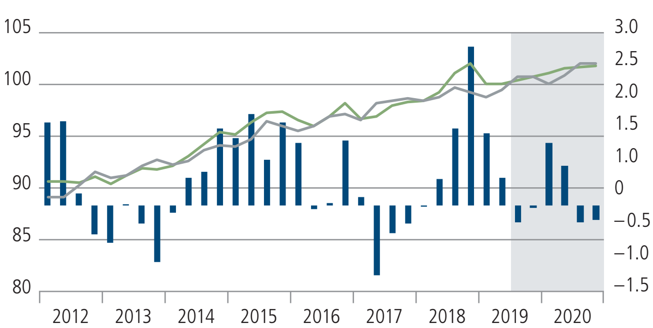
Average daily performance of US companies that …



Source: J.P. Morgan, as at 26 July 2019. Expressed as a percentage.

Oil market likely to see a surplus in 2020

Demand versus supply (millions of barrels per day)



Sources: IEA, Bloomberg, Union Investment, as at 26 July 2019.

The markets at a glance

Currencies: slightly more cautious stance towards EM currencies

Amid the markets' immediate reaction to the decision from the Fed, the US dollar appreciated against all other currencies because US key interest rates are likely to remain higher for longer than previously assumed. The capital markets' expectations of further interest-rate cuts were already falling, but the Fed will have to dampen them even more in the weeks ahead.The US dollar is therefore likely to maintain its strength. Conversely, the poor economic conditions and the resurgence of the trade dispute are weighing down on currencies from the emerging markets. They are also being dragged down by the more hawkish Fed and the strong US dollar. Another reason why the US dollar will probably stay firm against the euro is that the ECB is expected to take a more expansionary approach than the Fed over the remainder of the year. The gloomier economy, the uncertainties in the trade dispute and the unresolved issue of Brexit are also having an adverse effect on the eurozone. On the other side of the Atlantic, however, the US still has a twin deficit. Pound sterling has become even more volatile due to the increased likelihood of a hard Brexit and/or snap election, especially as the Labour Party – whose manifesto is not seen as market-friendly – could actually win.

- **Decision and positioning:** Establishment of a long US dollar position and a short EM currency position

The office market in Germany

Despite the slight deterioration in the economic outlook, demand for office space was high in Germany's top five real estate hotspots during the first half of 2019. Lettings in these five cities were up by an average of 9.0 per cent. Whereas the rates of increase in Berlin, Düsseldorf, Frankfurt and Hamburg ranged between 8.9 per cent and 27.3 per cent, lettings in Munich fell by 11.1 per cent to 418,000 square metres, although this was still the second-best result of the past decade for the first half of a year. Given the decrease in vacancy rates, the growth in lettings is impressive and is predominantly attributable to more leases being secured in development projects.

The significant level of excess demand caused average vacancy rates in the top five locations to fall to 4.0 per cent, a year-on-year drop of 120 basis points. This is the lowest vacancy rate since the start of 2002. With just 1.8 per cent of its office space standing empty, Berlin continues to have the lowest vacancy rate. As a result, rental prices have risen by an average of 7.5 per cent across the five hotspots in the past twelve months. Berlin's especially low vacancy rate means that the increase in rents was particularly high at 12.7 per cent.

Attractive financing terms and rising office rents are driving up demand for office investments. At the end of June, the average initial yield for office buildings across Germany's top five locations stood at 3.0 per cent, which was down by a further 10 basis points compared with a year earlier. Berlin registered initial yields of less than 3.0 per cent.

Demand for office space is expected to remain high in the second half of 2019. As the pipeline of new builds is still relatively meagre, vacancy rates are likely to continue falling and office rents will probably rise.

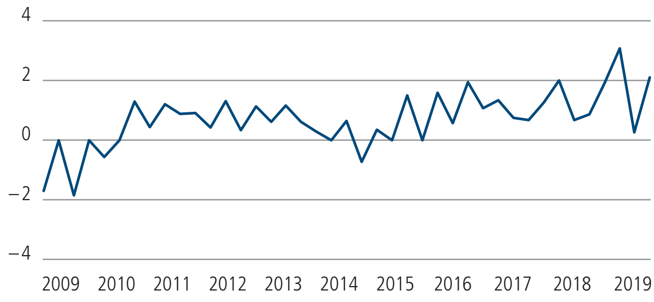
Recent fall in sterling

Euro/sterling exchange rate (€1 in pounds)

Source: Thomson Reuters Datastream, as at 1 August 2019.

Quarterly change in prime office rents in Germany

Average (%)*



* Average of the five biggest German office markets.
Source: Jones Lang LaSalle, as at 30 June 2019.

Union Investment

Our assessment at a glance

Our current risk assessment

- US President Donald Trump announced new tariffs on imports from China with effect from 1 September. They now affect consumer products too and thus have a direct impact on US consumers.
- Although the Fed lowered interest rates, it explicitly stated that this was not the start of a new rate-cutting cycle. The ECB is likely to reduce interest rates in September and resume buying bonds at the start of 2020.
- The latest leading indicators still do not show an end to the period of economic weakness.
- Our general risk assessment (RoRo meter) remains at level 3 (neutral).

RoRo meter

Source: Union Investment, as at 1 August 2019. Last changed (from 2 to 3) on 1 July 2019.

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:** Monetary policy is continuing to support bond classes that offer a risk premium. Yields are likely to carry on falling in the months ahead. Investors face a lot of pressure to invest, which is why bonds with an interest-rate premium will probably be particularly in demand.
- **Equities:** The latest escalation in the trade dispute between the US and China, combined with the poor economic data, is likely to have an adverse effect on shares, although monetary policy should prove to be more of a support.
- **Currencies:** Pressure on EM currencies should ease again. A firmer euro is fairly unlikely, given the ECB's plans.
- **Commodities:** The oil price is still supported by supply-side and demand-side factors but will probably come under renewed pressure going forward. Gold has little potential for price rises.
- The situation in the money markets remains unchanged. Interest rates remain in negative territory, which means that holding **cash** is not a good idea.
- **Absolute return strategies** are rated neutrally in a multi-asset context.
- The outlook for **real estate** has improved somewhat in Europe and the US but is no longer quite so positive in Germany.

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	=
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 August 2019.

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 24 May 2019. Assessment is valid up to 30 November 2019.

Note: The table above provides a **relative view of the office real-estate markets** in light of current market prospects. Owing to data availability, it is only updated quarterly.

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Unless otherwise stated, all information, descriptions and explanations are dated **7 August 2019**.

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