"High levels of uncertainty about the economic impact of coronavirus are causing significant price volatility. But we expect the implications for the global economy to be manageable."

Dr Frank Engels, Head of Portfolio Management

March 2020: Market news and expert views

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The markets at a glance

Summary

For nearly two weeks, trading in the capital markets has been dominated by news about coronavirus. Until recently, the outbreak seemed to be largely confined to China and its spread to other countries and regions was contained within narrow limits. Unfortunately, this picture has changed over the last few days. In addition to Iran and South Korea, a growing number of European countries are now affected as well. With the latest spike in infections reported from Italy, the coronavirus outbreak has certainly reached a new level. There is growing concern among investors that the global economy could slip into a recession.

The higher the number of countries affected and the more widely the virus can spread in those countries, the greater will be the impact on supply and demand in the global economy. The further course of the epidemic over the coming days and weeks will therefore be critical in terms of the severity of the impact on the real economy and the capital markets. But any predictions about the likely further spread of the disease are subject to substantial uncertainty, as the last few days have clearly shown. It is also difficult to anticipate what approach public authorities in different countries will take in response to the evolving situation. But their behaviour is of great relevance because the nature and severity of their countermeasures (e.g. cancelling mass gatherings, closing schools, quarantine measures, etc.) have a significant impact on the overall economic fallout.

At present, a cautious but level-headed approach seems advisable. At the same time, we maintain our constructive view of the medium-term outlook. For the near term, we would recommend a slight reduction in risk positions. More specifically, we take the view that equities have lost some appeal, whereas government bonds from eurozone core countries should no longer be seen in such a negative light. All in all, we are maintaining our neutral risk positioning (RoRo meter at level 3).

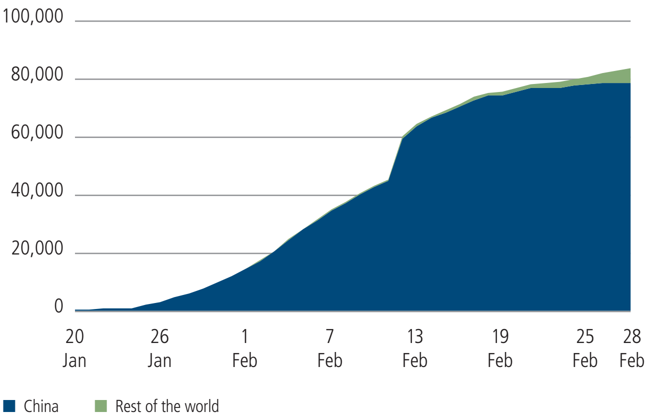
Economy, growth, inflation

The spread of COVID-19 to further countries such as South Korea and Italy has taken the epidemic to a new level in the eyes of investors. If the virus cannot be contained in these countries, their economies will probably also start to show signs of slowing. Typically, such a sudden economic slump is followed by a prolonged, gradual recovery. Catch-up effects start to materialise and are often accompanied by fiscal and monetary policy stimuli. Affected economies eventually tend to return to their original growth path, albeit with a slight time lag.

In China, where the epidemic has reached a more advanced stage than anywhere else, signs of this pattern are already emerging: Our economists expect that China's GDP will grow by just 3.2 per cent, on an annualised basis, in the first quarter of 2020. But some data points are now signalling that conditions may be starting to improve again. One example is an increase in shipping traffic to and from China. On this basis, we expect that the picture will gradually brighten over the course of the second quarter, not least because of supporting measures by the Chinese government. For the year as a whole, growth in China is likely drop to a rate of 5.6 per cent, i.e. the slowdown will be much more pronounced than it would have been without the virus outbreak. But we do not anticipate a severe downturn, let alone a recession.

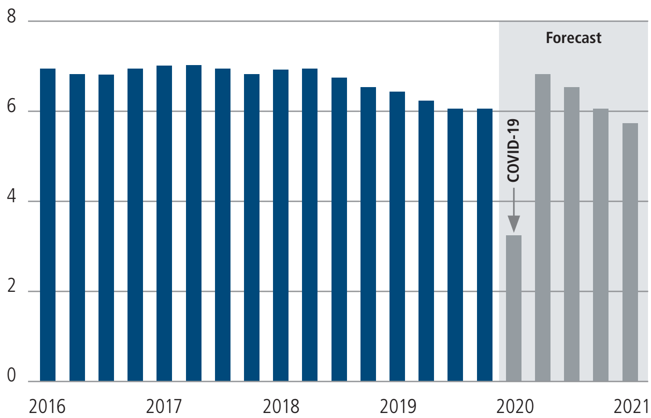
A reliable assessment of the economic impact in any of the other affected countries is not possible yet because these regional outbreaks are still too recent. But the previously described U-shaped pattern should apply to these economies as well. As a result, we currently expect to see a noticeable slowdown in growth. A 'technical recession' in the form of two successive quarters of negative growth (as per definition) cannot be ruled out at this point. For the year as a whole, however, we regard a deep recession in major economies as unlikely.

COVID-19: Majority of new infections now outside China
Confirmed cases



Sources: Bloomberg, Johns Hopkins University, Union Investment. as at 28 February 2020.

Chinese economic growth should recover
Annual rate of change for each quarter (%)



Source: Macrobond, as at 24 February 2020.

The markets at a glance

Monetary policy: no significant changes

The monetary policy environment has not changed much in recent weeks. Both the Fed and the European Central Bank (ECB) are debating their future monetary policy strategies, but at this stage, any conclusions would be premature. The ECB is in the process of reassessing its overall strategic approach. It will be a few months before results are likely to be announced. The central bank symposium in Sintra, Portugal, in March is not expected to cause much of a stir either. Christine Lagarde's predecessor, Mario Draghi, occasionally surprised market participants with unexpected announcements, but further interest-rate cuts in the eurozone do seem quite unlikely at present. Within the ECB, views of negative interest rates are no longer unreservedly supportive. The European banking sector in particular is suffering badly as a result of the negative rates.

The US Federal Reserve, on the other hand, has more room for manoeuvre and could cut interest rates if necessary. For its future course of action, the bank seems to be considering a less stringent approach to inflation control (flexible inflation averaging), meaning that it would be prepared, in principle, to let inflation rise above the target level of 2 per cent. Part of the reasoning behind this is that, in recent years, inflation rarely ever reached the target level and often remained well below it. On this basis, interest-rate increases are unlikely to feature on the agenda any time soon. Quite the opposite, in fact: In an unscheduled move on 3 March, the Federal Reserve cut its interest rates by 50 basis points, arguing that coronavirus posed an increasing risk to growth in spite of strong fundamentals in the US economy. We expect that the Fed will lower interest rates at least once more if the US economy shows signs of weakness.

Bonds: Our preference remains for products that offer risk premiums

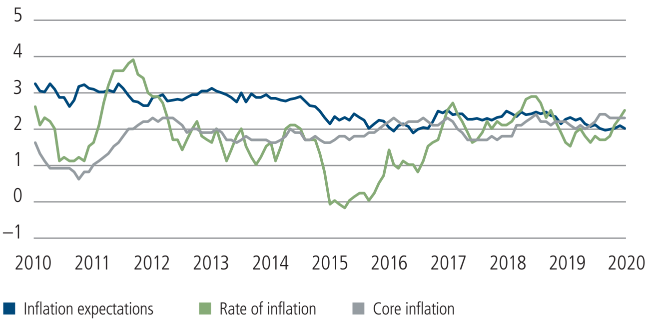
The prevailing uncertainty about the economic impact of the coronavirus epidemic also affected bonds with risk premiums. But in light of negative yields on safe-haven assets (bonds from core countries of the European Monetary Union (EMU) and covered bonds), we believe that this will be no more than a blip in the medium-term trend of converging yields across European government bonds (periphery vs core markets) and corporate bonds. Yields on long-dated Bunds should not fall below minus 0.5 per cent for a prolonged period of time, but risk premiums in the spread segments are likely to shrink further. The distance between spread levels already narrowed noticeably in recent months. Yields on paper from Greece and Italy recovered and slowly edged closer to Bund yields. Against a backdrop of slow growth and a lack of inflationary pressure, we do not foresee any significant rise in yields. This means that paper with a risk premium should remain attractive in the medium term as investors continue to search for bonds that are still offering a positive yield.

Emerging market investments recently performed well at index level. But the positive trend did not benefit all bonds in equal measure. On the contrary, increased unsystematic risks resulted in a higher level of dispersion in performance.

- **Decision:** We take a more positive view of government bonds from EMU core countries. Our signal for ten-year Bunds is changing from 'short' (rising yields) to 'neutral'
- **Positioning:** We have a slight preference for government bonds from eurozone periphery countries and investment-grade corporate bonds and are holding back a little on government bonds from EMU core countries and covered bonds. Our neutral positioning in high-yield corporate bonds and government bonds from the emerging markets remains unchanged

The Fed seems prepared to tolerate higher levels of inflation in future

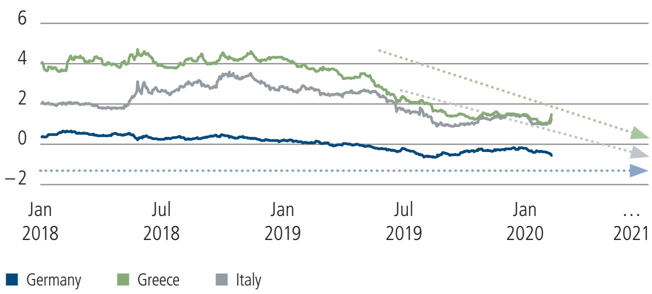
Inflation levels over time since the start of 2010 (%)



Source: Bloomberg; as at 26 February 2020.

Yield convergence: Eurozone periphery edging closer to Bunds

Yields on ten-year government bonds over time since the start of 2018 (%)



Source: Bloomberg; as at 28 February 2020.

The markets at a glance

Equities: Neutral approach adopted

Equity markets were hit particularly hard by recent events. Profit warnings issued by various companies in recent days clearly show that businesses are feeling the impact of restrictions on their value chains in China. And the pressure on profits is likely to persist.

The plunge in share prices in the past few days can be attributed to sales by systematic investors who were unable to escape the downward pressure. But our internal analyses show that a majority of positions (e.g. those held by users of target volatility strategies) have probably been adjusted by now. This means that the pressure should ease gradually in the future, provided that volatility continues to move within a steady range.

The potential for calmer market conditions therefore certainly exists, but there is no guarantee – especially in light of the fact that the virus has not yet spread very widely outside China. Consequently, there is always the possibility that nervous tension – and market volatility – could rise further, which would create even greater selling pressure. Trend-following strategies also remain susceptible. Against this backdrop, investors should be prepared for turbulence in the short term. On this basis, we decided to return to a neutral positioning in the equity segment. Equities from industrialised countries have become less attractive. But Union Investment retains a positive view of the asset class despite the disruption caused by the virus. Some valuations may be relatively high in historical terms, but negative yields should continue to push a significant number of investors towards riskier assets such as equities.

- **Decision:** Reduction in equities from industrialised countries.
- **Positioning:** Equity investments have been positioned neutrally overall.

Commodities: COVID-19 dominates the commodities market

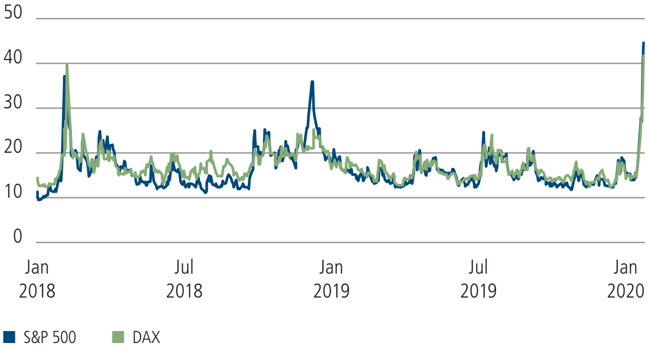
Developments in connection with COVID-19 dominate the commodities market at present. Factory shutdowns in China have reduced global demand for oil by 3 to 4 per cent. As a result, a surplus has built up in the oil market, i.e. supply clearly exceeds demand and inventory levels are rising. At the same time, the forward price curve has fallen into contango, meaning that investors can no longer earn positive roll yields. Further production cuts by OPEC are expected for the second quarter and should improve the situation. However, there is a risk that OPEC and Russia might not both be moving in the same direction.

Industrial metals also came under pressure. Prospects of a recovery are slim until industrial production in China picks up again. After all, China accounts for well over half of the world's consumption of industrial metals these days. The price of gold rose sharply in recent weeks – more sharply, in fact, than the fall in real yields gave grounds to expect. This means that a certain additional risk premium has been priced in. This means that gold has now become very expensive. The price of palladium – a metal primarily used for catalysts in the automotive industry – has been decoupled from the wider fundamental picture for a while. It has tripled within a short space of time and we expect to see manufacturers switching to alternative materials in the future. But the current exaggerated price levels could well continue a little longer.

- **Positioning:** Continued neutral weighting for commodities.

Volatility in equity markets spikes

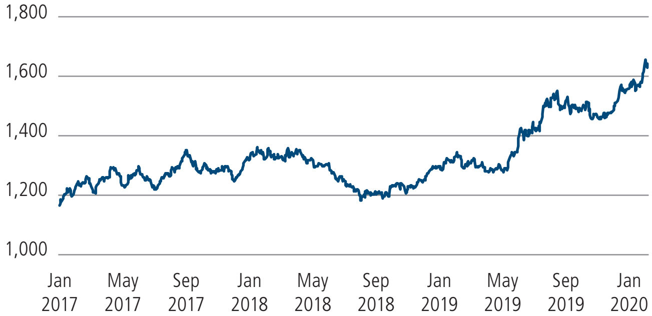
Comparison of volatility indices since the start of 2018



Source: Bloomberg; as at 28 February 2020.

Gold surges as investors seek safe havens: The precious metal has been on the rise for some time

Price per troy ounce of gold since the start of 2017 (US$)



Source: Bloomberg; as at 28 February 2020.

The markets at a glance

Currencies: No changes

In the currency markets, the historical pattern has inverted over recent months. Previously, the euro typically benefited from upward trends in risk assets and came under pressure in times of rising risk aversion. Lately, however, it has been showing signs of weakness amid rising share prices, but strengthening in phases of correction. This is due to a change in its function: As a result of negative deposit interest rates in the eurozone, the euro is increasingly becoming a 'funding currency'. Hedge funds, for example used to finance their leverage trades in Japanese yen or Swiss francs, but are now increasingly using the euro for the same purpose. If such positions are closed in a correction, loans denominated in euros are repaid and demand for the currency rises. Another factor is certainly that foreign investors have a little less confidence in the euro. Even though the economic picture is generally solid, the euro is hardly appreciating, revealing a greater dependence of the eurozone on China. Political issues in Italy and the UK (Brexit) and structural challenges in the automotive sector, one of the region's key industries, are also weighing on the currency.

The UK government will present a new budget soon. The latest indications suggest that it will announce a package of fiscal measures aimed at stimulating the economy, which should in theory cause the pound to appreciate. On the other hand, it will take a number of rounds of tough negotiations to hammer out the legal framework for future trade relations between the two parties. In view of these two opposing influences on the currency, we have decided to adopt a wait-and-see approach.

- **Positioning:** Neutral and unchanged.

Office market in Europe

In the fourth quarter of 2019, the economic outlook for Europe turned bleaker in light of weaker global trade. European office real-estate markets, however, remained largely unaffected by this trend. Many companies still reported healthy levels of orders on hand, which had a positive impact on demand for office space. In a market environment characterised by a lack of available office space, vacancy rates dropped across nearly all of Europe's twelve main office property hotspots. The average vacancy rate for these cities dropped by 70 basis points to 6.6 per cent. Amsterdam, Lisbon and Madrid reported the steepest declines in vacancies.

Prime office rents were also boosted by the excess demand. At the end of the fourth quarter of 2019, average rents for the twelve biggest European office markets were up by 3.7 per cent compared with the prior-year period. Rent rises were especially pronounced in Amsterdam, Madrid and Paris.

The broader picture for investments in European commercial real estate remained favourable in the fourth quarter of 2019. The ECB confirmed at its meeting in October 2019 that low interest rates would remain in place in the eurozone for the time being. Real estate thus remained relatively attractive as an alternative investment option; This led to another pronounced rise in transaction activity across Europe towards the end of 2019. Initial yields in Europe's twelve main office markets fell again, by an average of 20 basis points year on year, to 3.6 per cent.

In light of persistently low interest rates and attractive financing conditions, we expect that demand for real-estate investments will remain high over the course of 2020 and that yields will be compressed a bit further.

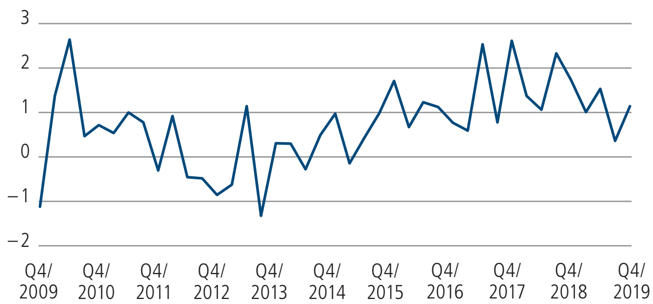
Euro remains weak

Euro to US dollar since the start of 2017

Source: Bloomberg; as at 26 February 2020.

Quarterly change in prime office rents in Europe

Average (%)*



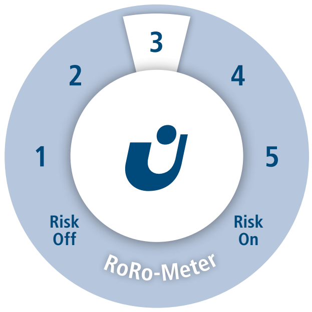
*Average of the twelve most important European office markets.
Source: Jones Lang LaSalle, as at 31 December 2019.

Our assessment at a glance

Our current risk assessment

- The spread of COVID-19 to further countries such as South Korea and Italy has taken the epidemic to a new level in the eyes of investors.
- Profit warnings issued by a growing number of companies
- We still regard the implications for the global economy as manageable.
- Catch-up effects in the second quarter should help to offset the current slump.
- Stimulus measures by the Chinese government should provide additional support.
- There are signs that conditions might be improving slightly in China.
- Our general risk assessment (RoRo meter) remains at level 3 (neutral).

RoRo meter



Source: Union Investment, as at 25 February 2020. Last changed (from 4 to 3) on 27 January 2020.

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

- **Bonds:** Further spread of coronavirus sparks a second wave of uncertainty. In this environment, safe-haven assets such as government bonds from core countries will regain some appeal. But products with risk premiums will remain interesting in light of negative yields.
- **Equities:** Coronavirus overshadows solid economic data and drives up volatility. Supply chain disruptions are resulting in profit warnings, making equities from industrialised countries less attractive.
- **Currencies:** Traditional response patterns have changed; we would advise against overweight or underweight exposures.
- **Commodities:** Cyclical commodities remain under pressure; demand for oil in particular has dropped sharply. Precious metals are still benefiting from a drive towards safe havens, but the underlying fundamental picture does not favour this asset class.
- 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 in the US but has now deteriorated somewhat in Asia.

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 25 February 2020.

Note: The table above shows a **relative view of a multi-asset portfolio (excluding real estate).** If an asset class is 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.

Properties	
Germany	=
Europe (ex Germany)	=
US	→
Asia-Pacific	←

Source: Union Investment, as at 15 November 2019. Assessment is valid up to 31 May 2020.

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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Unless otherwise stated, all information, descriptions and explanations are dated **3 March 2020**.

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