Tight US monetary policy will take its toll in the coming year, causing a slight recession in the US. It seems safe to assume that the US Federal Reserve induced this slowdown on purpose in order to reduce demand from consumers.

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Market news and expert views

Monthly report
October 2022

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The markets at a glance

Summary

The prevailing market environment is characterised by slowing economic growth, high inflation and tightening monetary policy. Geopolitical risk factors such as Russia's war of aggression against Ukraine are also taking their toll and recent developments in some European capitals are not helping to calm things down either. In Rome, the fiscal and European policy agenda of the (likely) new right-wing nationalist government led by Giorgia Meloni is being eyed with apprehension by the European Commission and investors. And in London, the new conservative government led by Liz Truss has announced a 'mini budget' that is sparking concern about the future stability of the UK's public finances and economy. On balance, we thus believe that tensions relating to the key factors of inflation, growth, monetary policy and market structure have not yet eased to a degree that would merit a shift away from the current defensive positioning. Consequently, we are confirming our current positioning (RoRo meter at level 2). The capital market environment will remain challenging with further downside potential for risk assets.

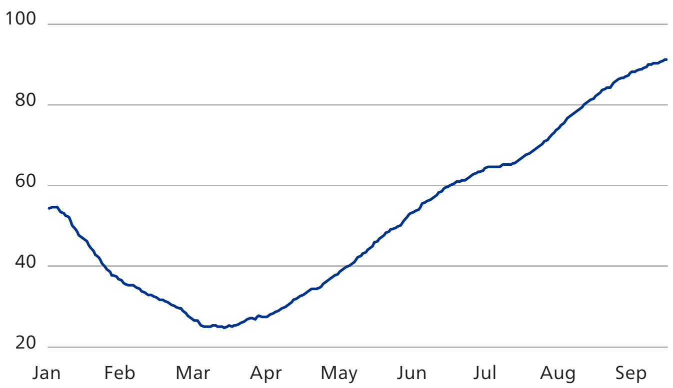
Having said that, the capital markets have already processed an onslaught of negative influences at a very swift pace in recent weeks. This is true for the fixed-income segment – which saw rising yields on safe-haven government bonds and widening spreads on opportunity-oriented sub-segments – as well as for equities and commodities. Typically, the bond markets are the first to respond to deteriorating conditions, followed by the equity markets and finally commodities. This pattern has been seen once again in the current environment. On this basis, we expect the recovery in these sectors to commence in reverse order. However, no signs of a sustained rebound among risk assets have emerged as yet. It therefore seems prudent to retain a defensive positioning.

Economy, growth, inflation

Economic momentum continues to slow around the world. The drivers differ depending on the region, but the outcome is ultimately the same across the board. In the US, for example, the economy is still in very robust shape and the labour market is stable. But at the same time, the real estate market is flagging. Far from being a surprise, this shift has in fact been carefully orchestrated by the US Federal Reserve (Fed). The central bank wants to lower aggregate demand in order to bring high inflation under control. News on this front was not positive in August as consumer prices rose again, up by 8.3 per cent year on year. The biggest cause for concern from a monetary policy perspective was the rise in the core rate of inflation. Against this backdrop, we expect that the Fed will tighten its monetary policy more rigorously and rapidly than previously anticipated, ultimately tipping the US economy into a slight recession.

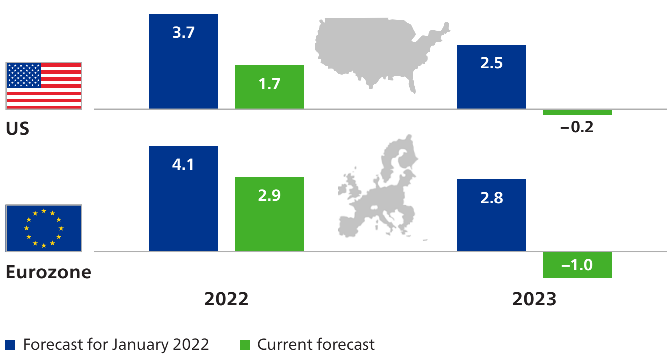
Economic conditions in Europe are much more precarious. The old continent is also suffering from high inflation, but here, it is being driven predominantly by supply-side factors rather than demand. Above all, soaring energy prices are pushing up inflation. This was illustrated in impressive fashion by producer prices for August in Germany, which were up by 45.8 per cent compared with August 2021. Both the purchasing managers' indices and consumer confidence indicators for the eurozone have recently deteriorated noticeably, as has the German ifo Business Climate Index. Foreign trade, typically a strong pillar of the European (and especially Germany's) economy, is currently not providing significant stimulus due to the uncertain coronavirus situation in China and the continuing global slowdown in economic growth. Our economists have therefore also lowered their growth forecasts for the eurozone.

German gas inventories at good levels as temperatures turn autumnal
Filling levels since the start of 2022 (%)



Source: Bloomberg, as at 28 September 2022.

Stress-testing the economy: growth is slowing in real terms
Forecast year-on-year change in real GDP (%)



Source: Union Investment, as at 28 September 2022.

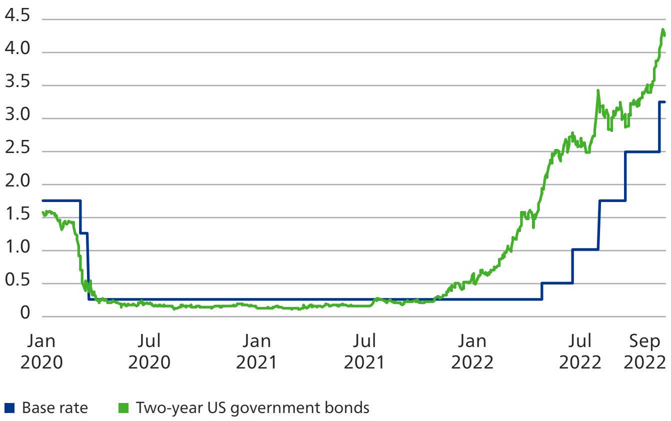
The markets at a glance

Monetary policy: "whatever it breaks"

Against this backdrop, central banks around the world have been very vocal about their determination to curb inflation. In the week commencing 19 September, no fewer than twelve central banks held meetings, ten of which resulted in interest-rate hikes. The Bank of Japan (BoJ) and Turkey's central bank were the only ones to buck the trend. Sweden's Riksbank, the Swiss National Bank and the Bank of England all implemented sizeable interest-rate increases of 100 basis points, 75 basis points and 50 basis points respectively. Squarely in the spotlight was the US Federal Reserve, which used its September meeting to adopt a third consecutive rate increase of 75 basis points. This takes the Fed's target range to 3.00–3.25 per cent. Fed chair Jerome Powell announced the rate hike in a statement that clearly conveyed a continued focus on tightening monetary policy. Once again, it was emphasised that combating persistent levels of excessive inflation remains the number one priority. Even though the Fed generally has a dual mandate of ensuring price stability and promoting maximum employment, its focus at present is – without a doubt – heavily skewed towards the former. We have adjusted our monetary policy forecast for the US to take account of this. More specifically, we now believe that the federal funds rate will be raised by a further 125 basis points by the end of 2022 to a target range of 4.25–4.5 per cent. For the coming year, we expect neither further interest-rate hikes nor the interest-rate cuts that are still being priced in by the market.

The European Central Bank (ECB) raised its key interest rates by 75 basis points at the start of September. Persistently high inflationary pressure means that the bank will probably continue on this trajectory at forthcoming meetings. We anticipate interest-rate increases of 75 basis points and 50 basis points respectively at the ECB's meetings in October and December 2022, but no further increases in 2023.

Bond market is pricing in further interest-rate hikes
Performance since the start of 2020 (%)



Source: Bloomberg, as at 28 September 2022.

Fixed income: yields set to keep climbing

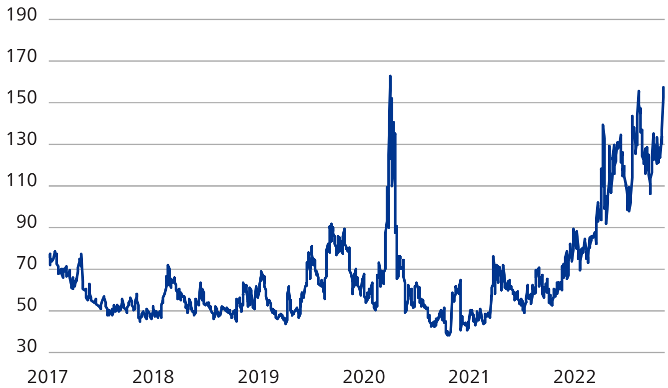
With it becoming clear that the central banks will hike interest rates further, bond market yields will continue to enjoy a tailwind on the whole. In the US, ten-year government bond yields have now crossed the 4 per cent mark while shorter-dated paper is currently generating even higher yields of around 4.3 per cent. In the eurozone, bond prices fell as quickly as they had in the US. Yields on ten-year German government bonds rose from 0.78 per cent at the start of August to reach their current level of around 2.3 per cent, while their two-year counterparts increased from 0.27 per cent to 1.95 per cent. The yield curve is therefore becoming increasingly flat, a trend that is likely to continue given that the ECB is expected to put up its key interest rates. Moreover, the short supply of – and demand for – safe-haven paper (eligible collateral) is bolstering short-dated German government bonds.

In Italy, the alliance of Eurosceptic parties won the majority of the votes in the recent parliamentary election, as had been anticipated. However, the composition of the new government and its policies are not yet clear. Bonds from the eurozone's periphery responded with a slight widening of spreads but, overall, they have remained within a relatively narrow range for some months.

We believe that, following the recent bout of price falls, corporate bond prices now reflect the prevailing concerns about economic growth a little better. However, it would still be premature to make portfolio adjustments at this point in time. In the case of bonds from the emerging markets, attractive yields have to be weighed up against the damping effects of the Fed's monetary policy and country-specific risks (e.g. the upcoming presidential election in Brazil).

- **Change:** None.
- **Positioning:** Our approach to fixed-income investments is cautious overall. We are steering clear of bonds from eurozone periphery countries and investment-grade corporate issuers. At present, we prefer safe-haven government bonds from Europe and the US.

US bond market remains stressed – monetary policy is causing uncertainty
Measured by the volatility of options in the US bond market



Source: Bloomberg, as at 28 September 2022.

The markets at a glance

Equities: monetary policy and interest-rate rises are the main influencing factors

The restrictive approach taken by the main central banks, which are evidently prepared to risk a recession in their quest to tackle inflation, marked an end to the rally seen in the equity markets over the summer. Instead of hopes of a 'soft landing' for the US economy, there were growing fears of an overshooting of US monetary policy, which would likely result in negative growth rates for the US economy. Leading indicators such as those published by the Philadelphia Fed point to a decline in order levels, which is also reflected in companies' slower profit growth and more cautious outlooks.

Since the beginning of July, equity analysts have lowered their profit expectations for US corporations in the upcoming third-quarter reporting season by almost 7 per cent. This reduction can partly be explained by the strong US dollar, as it means that US companies operating internationally are seeing profits earned abroad dwindle or disappear completely when converted into their home currency. Conversely, this is providing support for the profits of European companies, but only where it more than offsets the cost of imported raw materials and base products billed in US dollars. With interest rates continuing to rise, there is sustained downward pressure on valuations. Despite the weakness of economic growth in China and other emerging markets, equities from these countries are likely to be slightly less affected than those from industrialised countries.

- **Change:** None.
- **Positioning:** We currently regard equities as slightly less attractive overall, driven by our stance towards stocks from industrialised economies. Our assessment of equities from emerging markets is neutral.

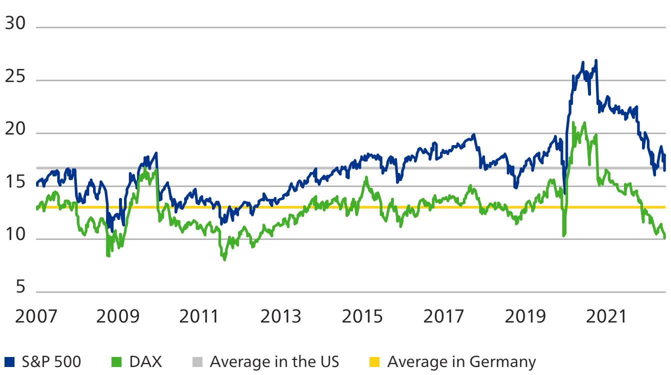
Commodities: weak growth is depressing prices

The slowdown of the global economy, the restrictive monetary policy of the major central banks and the strong US dollar have led to falling commodity prices across all sectors in recent weeks. The drop in prices was particularly pronounced for energy commodities such as crude oil, oil products and natural gas, shortages of which have decreased owing to increased production, reduced demand and substitution effects. Overall, the market is in equilibrium. On average, energy prices have slid by almost 30 per cent since mid-June (as measured by the MS RADAR Energy ER index). Despite the sell-off, the forward curves look robust, although some have already dropped below the values that we consider fair in light of the fundamental environment. Against the backdrop of the persistently negative price trend, we are retaining our cautious stance towards energy commodities.

China's weak economy continues to impact on industrial metals. However, steadily decreasing inventory levels are helping the situation. As interest rates and yields rise, there are also increasing opportunity costs for holding gold rather than safe-haven government bonds such as US Treasuries. Investor demand for this precious metal has cooled markedly and is unlikely to bounce back quickly in the current environment.

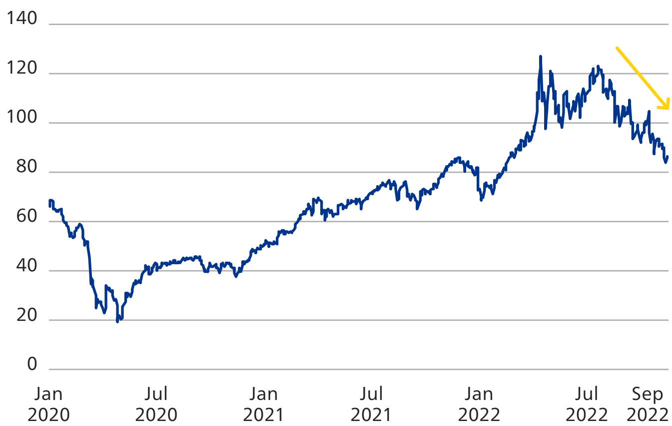
- **Change:** None.
- **Positioning:** We are cautious about commodities from all segments, but especially about energy commodities.

German stock markets in particular have already priced in many adverse factors
Price-earnings (p/e) ratio since the start of 2007



Sources: Bloomberg, Union Investment, as at 22 August 2022.

Concerns about growth cause oil price to drop again
Price per barrel of Brent crude (US$) since the start of 2020



Source: Bloomberg, as at 28 September 2022.

The markets at a glance

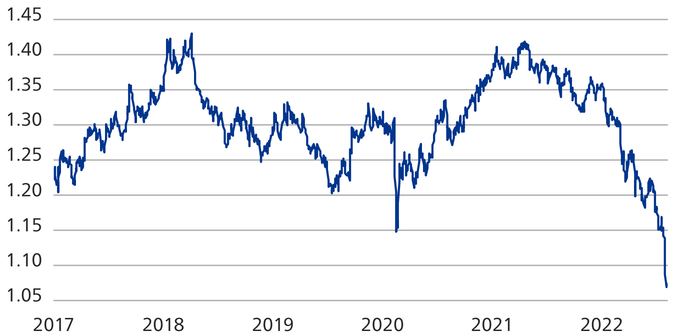
Currencies: intervention from central banks

In the currency markets, the trends observed in previous months are continuing unabated and, in some cases, are actually gathering pace. The US dollar appreciated further as a result of the increasingly restrictive tone at the Fed, which has said that it will be fully focused on bringing down inflation in the months ahead. Another reason for the greenback's appreciation is that the US economy is still more robust than other economic areas. On a trade-weighted basis, the US dollar reached its highest level since 2002; and it has not been so high against the Japanese yen since as far back as 1990. This is because the monetary policy of Japan's central bank has remained the polar opposite of the Fed's so far. The Bank of Japan is expected to stick to its ultra-expansionary approach until its governor, Kuroda, leaves office at the end of March 2023. Last week, however, the BoJ was forced to prop up the weak yen by making purchases in the currency market. In addition, the People's Bank of China tried to stem the renminbi's rapid depreciation. And following the new UK government's announcement of a vast economic package, pound sterling slumped against the US dollar and came close to the all-time low reached in February 1985. The US dollar also continued to rise against the euro – albeit to a lesser degree than against other currencies – and therefore moved well away from parity. We used the BoJ's intervention as an opportunity to close out our remaining long position in Japanese yen against the euro. This means that we are not maintaining any active currency positions for the time being.

- **Change:** 'Long Japanese yen/short euro' pair trade closed.
- **Positioning:** None.

Huge fiscal stimulus package plunges pound sterling into crisis

US dollars to pound sterling since 2017



Source: Bloomberg, as at 28 September 2022.

Real estate: European office market

The second quarter of 2022 was characterised by increasing financing costs, rising inflation rates and the prospect of weakening economic growth. In spite of the challenging macroeconomic conditions, the twelve most important European office property markets proved very robust, with lettings up by around 11 per cent year on year. However, compared with the very strong first quarter of 2022, lettings weakened by 4 per cent. Stockholm, Milan, Lisbon, Brussels and London recorded (in some cases substantial) increases while office lettings in Warsaw, Luxembourg and Madrid fell noticeably. The average vacancy rate was up slightly on the previous quarter, rising by approximately 10 basis points to 8.8 per cent.

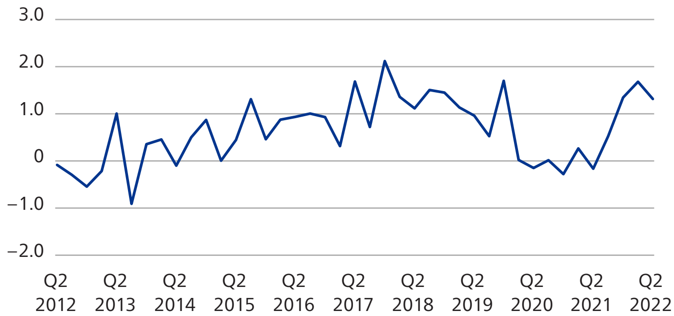
Nonetheless, modern office properties in prime locations that are available at short notice remained in short supply in most European hotspots. This caused rents to rise by an average of 1.3 per cent quarter on quarter. The year-on-year increase in rental prices was even steeper at 5.1 per cent. The only key market to record a decline was Helsinki, where rental prices fell slightly. Cities that saw an uplift in rent levels recorded increases of between 1.2 per cent and 8.3 per cent.

Despite the rise in financing costs, initial prime yields remained relatively stable across the European office markets. On average, they increased by around 10 basis points to just under 3.5 per cent. However, Prague, Warsaw and Paris were the only cities that actually recorded a rise, whereas initial prime yields held steady in all other markets.

A favourable factor in the second half of the year will be that a relatively high proportion of properties due to reach completion have already been prelet. In addition, new properties in central locations are highly sought-after because they offer scope to implement flexible office concepts and tend to be very easy to get to. We therefore do not expect supply to outstrip demand to a significant degree between now and the end of the year. Rents will likely trend sideways for the most part, although slight increases are conceivable. Initial yields will probably pick up a little.

Quarterly change in prime office rents in Europe

Average (%)*



*Average of the twelve European office hotspots.
Source: JLL, as at 30 June 2022.

Our assessment at a glance

Our current risk assessment

- The prevailing market environment is characterised by slowing economic growth, high inflation and tightening monetary policy. Geopolitical crises also remain a factor.
- In the US, the Fed continues to take a resolute approach to combating inflation. We believe that the US will slip into a mild recession.
- In Europe, the ECB is primarily fighting the inflationary impact of soaring energy prices, which are also becoming an increasing drag on economic growth. We predict a recession for Europe in 2023 as well, but also expect the upward pressure on prices to ease.
- Our general risk assessment (RoRo meter) remains at level 2 (slightly defensive).

RoRo meter

Source: Union Investment, as at 27 September 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:** Headwinds generated by rising interest rates will persist, meaning that yields should continue on an upward trajectory for the time being.
- **Equities:** Concerns about monetary policy overshooting the mark and the prospect of a looming recession are weighing on share prices. Valuations thus remain under pressure and analysts have adjusted their profit forecasts downward accordingly.
- **Currencies:** We used the interventions in the Japanese currency market as an opportunity to close out our last remaining position.
- **Commodities:** Shortages in the energy sector have eased noticeably and prices have dropped as a result. Industrial metals continue to be adversely affected by the weakness of China's economy. Demand for gold has dwindled in light of high yields in the US.
- In the short term, we are parking funds in **cash**. The cash position is now earning interest again and is thus regaining appeal against the backdrop of the prevailing uncertainties in the equity and bond markets. Our assessment of **absolute return strategies** is mildly favourable.
- On the **real estate** front, we are slightly overweight in the US and Asia-Pacific regions at present.

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 27 September 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 20 August 2022. Assessment is valid up to 31 October 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 September 2022**.

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