



“The US central bank has performed a U-turn by signalling that it will not raise interest rates this year. That’s good news for the capital markets.”

Max Holzer, Head of Relative Return



April 2019: Market news and expert views

We work for your investment

The markets at a glance

Summary

At our regular meeting in March 2019, we confirmed our neutral risk positioning (RoRo meter at level 3). We did so because the markets are currently caught between the opposing forces of a supportive monetary policy outlook and an uncertain macroeconomic situation. Major central banks – above all the US Federal Reserve (Fed) – have performed a policy U-turn and moved away from their original roadmaps for a tightening of monetary policy. We therefore anticipate no further interest-rate hikes this year, neither in the US nor in the eurozone. However, this market-friendly change of tack is being partially counteracted by the overall economic picture. Leading indicators suggest that growth is picking up again after the recent weak phase, but economic data is not (yet) showing any substantial improvement across the board. We maintain our assessment that the positive phase of the global economic cycle has not yet reached its end. Looking forward, momentum should pick up again – boosted, among other factors, by monetary (Fed, European Central Bank) and fiscal (China) policy measures.

Equities have become more attractive to us in this environment. In the fixed-income segment, we are taking profits on positions in corporate bonds from investment-grade borrowers. Our assessment of government bonds from the core eurozone countries has improved somewhat. However, there is likely to be only little upward pressure on yields in light of the revised monetary policy outlook and persistently low levels of inflation.

With regard to Brexit, we still expect that an agreement will be struck at the last minute, i.e. we do not anticipate that the UK will leave the EU without a deal. But events in recent weeks have shown that the situation is chaotic and in deadlock. A hard Brexit thus remains a marginal risk.

Deterioration in economic data again not as bad as expected

J.P. Morgan Global Economic Surprise index over the past twelve months



Source: Bloomberg, as at 25 March 2019.

Economy, growth, inflation

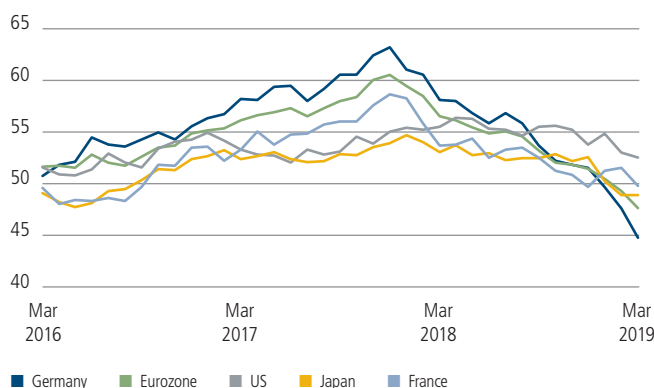
In our eyes, the current macroeconomic backdrop is a product of a number of overlapping effects. Chief among them is the pronounced dip in growth in China. The data points here are indicating a marked decline in capital spending. Weak figures for global trade and, in particular, for trade within Asia back up the assessment. The latest data shows that this is weighing heavily on Germany as a key exporter of capital goods. The export-order component of the purchasing managers' index, for example, is very weak at less than 40 points.

The economic impact of such effects depends largely on the expectations of the markets, however. A decline in economic activity is initially triggered not by the actual policy measure or political event itself but by companies' anticipation of what will happen as a result. This mechanism is likely to come into play both for the US-Chinese trade dispute and for Brexit. Germany has close economic ties with the United Kingdom, so the latter is hitting it particularly hard.

We do not believe that we have reached the end of the economic cycle yet. In fact, certain data points (e.g. most recently the Ifo Business Climate Index) suggest that the economy might be bottoming out. We expect to see a consolidation of the upward trend. Because of the depth of the prevailing economic weakness, however, we will hold off on raising the RoRo meter until we get further confirmation of this assessment. We expect that the extensive economic stimulus package adopted by the Chinese government (with a total volume of more than 4.5 per cent of the country's GDP) and the relaxation in monetary policy (in connection with the improved financial conditions) will help to consolidate the upturn.

Germany: from engine of growth to laggard

Industrial purchasing managers' index (points)



Source: Bloomberg, as at 27 March 2019.

The markets at a glance

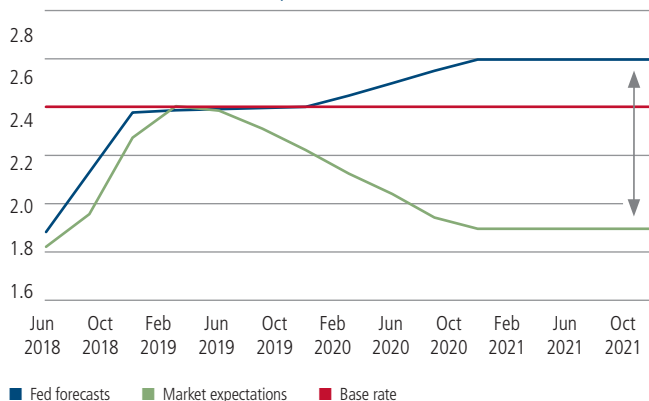
Monetary policy: central banks change tack

Major central banks have performed a policy U-turn in recent weeks. The US central bank, for example, had raised interest rates a total of nine times from 2015 to 2018 and looked set to continue on this path. Then, at the beginning of January 2019, Fed chair Jerome Powell sprung a surprise on the markets by putting further hikes on hold. On 20 March, at the press conference following the meeting of the Federal Open Market Committee, it softened its stance even further. This was mainly reflected in the individual Fed members' interest-rate forecasts, which were much lower on average. So it looks highly unlikely that the Fed will raise interest rates at all this year – the first time it will have refrained from doing so since 2014. And there will only be one rate rise next year. The markets are even pricing in a rate reduction for 2020 (see chart). It will be interesting to see the extent to which the two sets of expectations align. Central banks' indications that they want to allow more inflation has driven up inflation forecasts in recent weeks. A lot of this is likely to have now been priced in too.

In Europe, where growth has been even more sluggish, the European Central Bank's purchase programme for new bonds was terminated at the close of 2018. Originally, the bank had also planned to bring negative interest rates on central bank deposits to an end in 2019. However, this plan was scuppered by the recent slump in economic growth. In the best-case scenario, we therefore expect the first deposit-rate hike of 0.15 per cent to take place in March 2020 at the earliest, followed by just one further upward move, by 0.25 per cent, in the summer of 2020. The targeted longer-term refinancing operations that are planned are likely to mainly benefit the eurozone periphery countries, particularly Spain and Italy. Details on how these will be structured, especially with regard to the impact on liquidity ratios, are yet to be confirmed.

Fed not expected to raise interest rates until end of 2020

Fed forecasts and market expectations (%)



Source: Bloomberg, as at 27 March 2019.

Fixed income: Profit-taking on corporate bonds

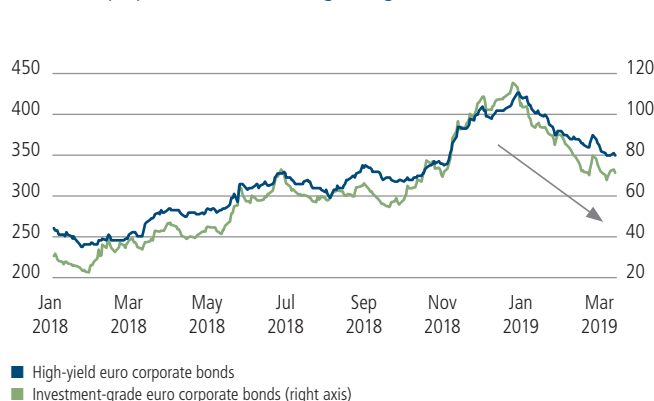
The Fed and ECB's perseverance with expansionary monetary policy, the persistent weakness of economic growth and the residual risk of a hard Brexit continue to weigh on yields on safe-haven government bonds. Yields on Bunds with maturities of up to ten years even dropped back into negative territory recently. Nevertheless, this is not an environment in which to be overly pessimistic about the safe havens, which include government bonds from the core eurozone countries and covered bonds. Based on past experience, covered bonds are likely to follow the same trend as these government bonds, but with a certain lag. So there is still some upside potential in this market.

Since the Fed's verbal U-turn on monetary policy at the start of the year, asset classes that offer a risk premium have been performing very strongly. Spreads on investment-grade and high-yield corporate bonds have narrowed by 30 basis points and 125 basis points respectively. In view of the low yields and the lack of upward pressure on government bonds, many investors climbed a few more rungs on the risk ladder, which drove up demand for periphery bonds. The decision of the credit rating agencies not to downgrade Italy also provided support. However, a lot of the upside potential of corporate bonds is now likely to have been exhausted, which is why we took profits on them. Looking at the wider picture in terms of asset classes, this means that equities now hold greater appeal for us.

- **Decision:** Government bonds from the core eurozone countries are now more attractive again. Profits were taken on investment-grade corporate bonds.
- **Positioning:** We currently hold a neutral stance towards fixed-income investments that offer risk premiums, such as corporate bonds, government bonds from the periphery countries and emerging market bonds. Among the safe havens, we favour covered bonds over government bonds from the core eurozone countries.

Sharp rally since the beginning of the year

Asset swap spreads since the beginning of 2018



Source: Thomson Reuters Datastream, as at 26 March 2019.

The markets at a glance

Equities: Consolidation at a higher level

The upward momentum in the equity markets started to slow a little in March. We take a positive view of the fact that earnings expectations have stabilised of late following a series of downward profit revisions in recent months. For the first quarter of 2019 in particular, adjustments seem to have come to an end and most companies should now be in a good position to meet or even exceed profit expectations. The chart at the bottom of this page illustrates how the forecasts look to have bottomed out.

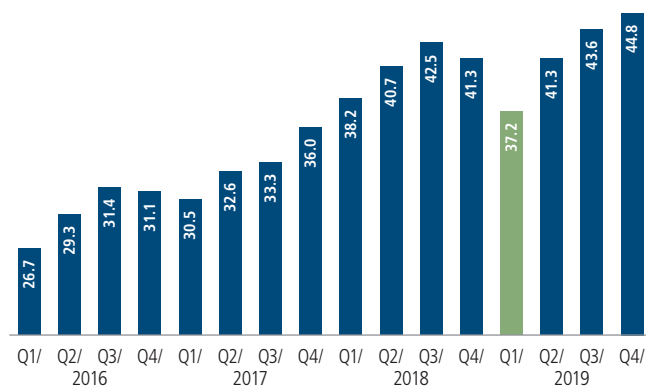
Investor sentiment has also greatly improved and can be considered optimistic. But despite the improved macroeconomic factors, investors are still not overly bullish. Indeed, many of them have only just begun to build their positions back up again. Among them are the trend following-investors, who only returned to the market at a late stage and so missed out on much of the rally. And a recent survey by Bank of America Merrill Lynch revealed that many institutional investors are still holding large amounts in cash.

Share buybacks are continuing to provide support, even if they are likely to be less frequent in the coming weeks. Interest rates should remain low based on recent central bank decisions. This will create an additional tailwind for the corporate sector. We therefore expect a modest upward trend in the equities market. Equities are therefore rated as attractive overall, although we favour equities from industrialised countries over EM equities, as the latter are still affected by very weak leading indicators and a downward trend in profit growth.

- **Decision and positioning:** Equities from industrialised countries are now more attractive.

Low profit expectations for the first quarter of 2019

S&P 500, quarterly earnings in index points



Source: Factset, as at 26 March 2019.

Commodities: Our overall assessment is neutral

Following significant gains in the year to date, most analysts believe that the majority of commodities have more or less reached their price targets. Investors are therefore positioned fairly cautiously in the commodities sector. Further price increases are thus only expected as and when the global economy picks up again.

In the energy commodity sector, forecasts of demand recently dropped a little in view of weaker macroeconomic data. But OPEC production levels fell by a similar amount due to sanctions, for example against Iran, and production cuts in Saudi Arabia. Based on current pricing levels, hardly any increases are expected up to the end of the year. In the coming weeks, we expect US shale oil output to rise by a substantial 85,000 barrels a day. Moreover, the Mexican oil company Pemex has announced that it intends to triple its drilling activities this year. Precious metals continue to present a split picture. The price of palladium began to stall after weeks of steady gains, whereas gold became more attractive as a result of the cautious stance of central banks. The possibility of a higher rate of inflation being tolerated is a key driver here. Precious metals have also become relatively more attractive because of the fall in US yields. Prices for industrial metals are closely linked to the rate of economic growth in China. There is still an undersupply of some metals in the market, which will probably be reflected in higher prices. However, economic data from China will need to improve before this happens. Several indicators, such as freight charges (see chart), are showing the first signs of stabilisation. Higher prices suggest that economic activity will pick up again.

- **Decision and positioning:** No changes, with commodities weighted neutrally overall.

Freight charges index points to stabilisation of trade

Baltic Dry Index since the beginning of 2014



Source: Bloomberg, as at 26 March 2019.

The markets at a glance

Currencies: pound sterling continues to hold appeal

Irrespective of the outcome of the Brexit debate, the pound is likely to strengthen against the euro, because Brexit is now priced in to a much greater extent in the price of sterling than it is in the euro. This creates an asymmetric risk picture: If a deal is struck, the pound should appreciate strongly against the euro. But in the event of a hard Brexit, the euro will also come under pressure at an international level. Either way, it all points towards the pound rising against the euro. Despite the often confusing, poker-like situation that is being played around the UK's withdrawal from the EU, and the way that each key vote seems to arrive quicker than the last, sterling has actually risen in value since the beginning of the year. It is even leading the way among the G10 currencies. However, we believe that there is still upside potential here.

For a number of months now, the euro/US dollar currency pairing has been trading sideways within a relatively narrow range. The greenback is failing to depreciate despite the combined effect of very cautious comments by US Fed Chair Jerome Powell and a reduced expectation that growth and interest rates will move upwards. There are two main reasons for this. Firstly, economic data in the eurozone has deteriorated substantially. Secondly, the other major central banks, including the ECB, have followed the Fed's lead by exercising caution in monetary policy. We are now expecting the single currency to be slightly firmer by the end of the year. Until that time, the currencies are set to carry on fighting to see which can be the weakest.

- **Decision:** None.
- **Positioning:** Pound sterling remains attractive relative to the euro.

Pound sterling on the up despite Brexit wrangles

Pound sterling/euro exchange rate since the beginning of 2018



Source: Bloomberg, as at 27 March 2019.

Real estate: The office market in the US

The US office markets continued on their long-term growth trajectory in 2018, despite the country being at a relatively late stage of the economic cycle. The average vacancy rate across the eleven largest US office rental markets dropped by a further 30 basis points compared with 2017, ending the year at 10.4 per cent. Vacancy rates were particularly low by US standards in San Francisco and Seattle, where they stood at 5.7 per cent and 6.1 per cent respectively.

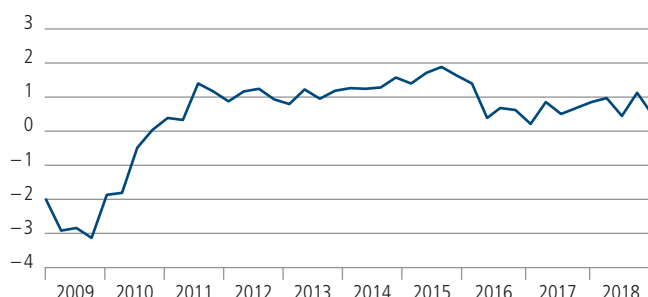
Demand for office space is still relatively high, and this is being reflected in rents. Average rents for the eleven largest US office rental markets were 3.1 per cent higher than at the end of 2017. The highest growth rates were recorded in Atlanta (up 6.2 per cent) and Seattle (up 5.5 per cent). Locations with a strong tech sector continued to benefit from the wider economic trend and registered above-average rent increases.

Initial yields were virtually unchanged in comparison with the prior-year period. Investors are becoming more price sensitive. The rise in US interest rates and the resulting increase in hedging and financing costs are also curbing demand from international investors.

The persistently robust economic outlook is likely to continue to bolster the US office markets. Nevertheless, it should not be forgotten that the current real-estate market cycle in the US is now at a late stage, and growth is expected to lose momentum going forward. But because of its size and high level of market liquidity, the US remains an attractive location for real-estate investors.

Quarterly change in prime office rents in the US

Average (%)*



* Average of the eleven biggest US office markets.
Source: CoStar, as at 31 December 2018.

Our assessment at a glance

Our current risk assessment

- The leading indicators are still painting a mixed picture. Consumer spending and the service sector continue to be robust.
- Our baseline scenario for Brexit is that a last-minute solution will be found before the new deadline day of 12 April.
- Low inflation rates are giving the central banks scope to hold off on normalising monetary policy. This is likely to support higher-risk assets.
- The lowered profit expectations for the first quarter appear beatable.
- Our general risk assessment (RoRo meter) remains at level 3 (neutral).

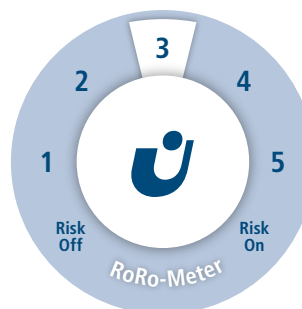
Our view of the asset classes

- **Fixed income:** Corporate bonds are becoming more attractive again following a sharp narrowing of spreads. Covered bonds are set to follow the trend in government bonds from the core eurozone countries by rising in price.
- **Equities:** The continuation of monetary policy support and the low profit expectations for the first quarter point in favour of stocks.
- **Currencies:** Whatever the outcome of Brexit, pound sterling is likely to rise against the euro.
- **Commodities:** An economic recovery has already been priced in. In many cases, the target prices for the end of the year have already been achieved. We are staying on the sidelines here.
- The situation in the money markets remains unchanged. Interest rates are still close to zero, which means that holding **cash** is not a good idea.
- **Absolute return strategies** have become a little less attractive again.
- The outlook for **real estate** has improved in Germany but deteriorated in the US.

The → = ← signs indicate the change compared with the UIC's previous decision.

Not favoured  Strongly favoured
Neutral

RoRo meter



Source: Union Investment, as at 27 March 2019. Last changed (from 4 to 3) on 20 November 2018.

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.

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 27 March 2019.

Note: The table above provides a **relative view of a multi-asset portfolio (excluding real estate)**. If one 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.

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

Source: Union Investment, as at 31 December 2018. Assessment is valid up to 30 April 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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