The US election is another source of uncertainty alongside the pandemic. The latest polls are pointing towards a clear victory for Joe Biden, which makes it less likely that Trump will contest the result. This is helping the capital markets.

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Market news and expert views

Monthly report
November 2020

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The markets at a glance

Summary

We are adhering to our moderately bullish risk positioning (RoRo meter at level 4) and therefore continue to favour equities, higher-yielding bonds (investment-grade corporate and periphery paper) and absolute-return strategies over commodities and safe havens. On the currency front, we still prefer the euro and pound sterling over the US dollar and Japanese yen.

The capital market environment has not changed significantly since the decision that we took at our extraordinary meeting in early October. Macroeconomic and monetary policy trends remain supportive of risk assets. Although the pandemic has recently worsened again, there is now less uncertainty about the outcome of the US presidential election. Joe Biden's improved standing in the polls seems to give him a clear lead. The more emphatic a Democrat victory, the more unlikely it becomes that the incumbent Trump would be able to successfully challenge the election result. This growing certainty is bolstering the capital markets.

The further course of the coronavirus pandemic remains the biggest imponderable. A second wave is gathering pace, especially in Europe. Politicians are trying to avoid a return to the lockdowns imposed in the spring, limiting them to local areas (for example the Berchtesgadener Land region in Germany) or delaying them for as long as possible (for example, Ireland and the Czech Republic). However, the sharp rise in cases across Europe is increasingly calling this strategy into doubt. Nevertheless, we believe that widespread lockdowns affecting virtually every sector of the economy – as seen in the spring – are fairly unlikely due to progress made in tackling the pandemic (more testing, better methods of treatment, the wearing of face coverings) and due to the extended range of political instruments available.

Economy, growth, inflation

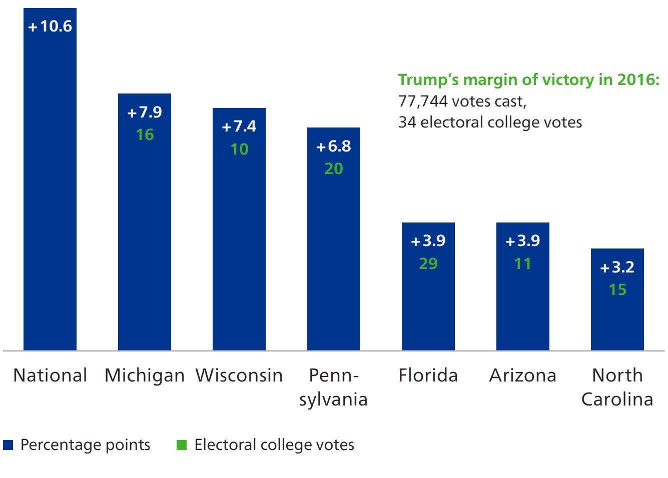
The global economy has shifted to a flatter recovery. The rapid upturn that followed the reopening of the biggest national economies has now ended and been replaced by a more moderate pace of recovery. This pattern is fairly normal and not a reason for concern, especially as economic activity in China is picking up and even the US economy is showing no signs of a trend reversal. At the same time, however, the impact of governments' and central banks' stimulus measures is waning ('peak policy'). Although additional measures are still expected, they will probably not reach the same magnitude as the stimulus packages enacted in spring.

In the US, the Democrats and the government are still holding talks about extending the fiscal packages, but their different views on the sums involved and their tactical considerations make it increasingly unlikely that an agreement will be reached and approved by the Senate before the election. A larger package is anticipated if Joe Biden wins the election. However, it will only be possible to pass this once the new government takes office. This would not be until after the inauguration at the end of January next year.

Given these conditions, inflation will probably rise only moderately in the biggest economic regions. Although prices might normally be expected to rise in the current environment of expansionary monetary and fiscal policy, local containment measures are holding some consumers back from spending. This means that few businesses have any great pricing power.

Joe Biden is currently the clear favourite to win the election

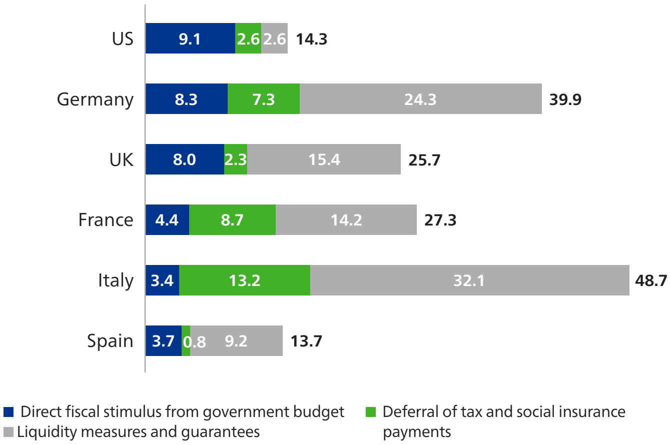
Election polls: national and in key battleground states*, Biden's lead in percentage points and number of electoral college votes



*States that Trump won by a narrow margin in 2016.
Sources: FiveThirtyEight, PredictIt, Union Investment, as at 20 October 2020.

'Peak policy': further stimulus, but less than in the second and third quarters of 2020

Fiscal policy: a comparison of fiscal measures, percentage of gross domestic product in 2019



Sources: Bruegel, Union Investment, as at 22 October 2020.

The markets at a glance

Monetary policy: central banks are supporting the economic recovery

The persistently low level of inflation gives the major central banks the latitude they need to focus their monetary policy on supporting the economic recovery. The US Federal Reserve (Fed) has already changed its strategy accordingly and, in future, will continue to regard interest rates as being at an appropriate level until maximum employment is achieved. Moreover, inflation remains geared to a target level of 2 per cent but will be allowed to moderately exceed this target.

Consequently, monetary policy is not expected to be tightened on either side of the Atlantic over the next few years. Both the Fed and the European Central Bank (ECB) will keep interest rates low in the long term and use quantitative measures to support the financial sector and capital markets. The prices of certain derivatives reveal market expectations of how key interest rates will move in the future. The fact that no hikes in key interest rates are currently priced in is an indication of how well the current central bank policy is anchored in the market.

The Fed and the ECB's approach is strengthening the structural fall in yields, which means that real interest rates are likely to trend even further downward. Further rises in the number of coronavirus cases would ramp up the pressure on the central banks. The quantitative easing programme in the US may be expanded as a result. This could force the ECB's hand: if US monetary policy were to become even looser, the US dollar would likely weaken further, which in turn would cause the euro to appreciate.

Fixed income: higher-risk asset classes remain attractive

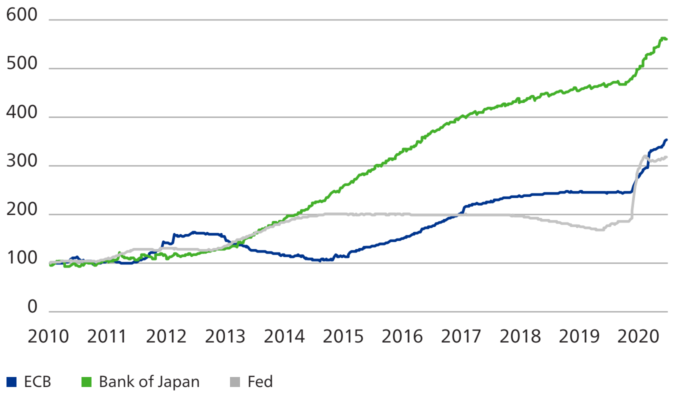
The central banks' generally loose monetary policy, their purchase programmes and the negative yields on safe-haven bonds continue to provide crucial support for paper with a risk premium, such as corporate and periphery bonds. Demand remains high due a lack of alternatives. Corporate bonds did not lose any ground despite a recent slight decline in share prices. The prospect of closer European integration prompted steady inflows into paper from the periphery countries in particular. Demand for the new issues needed to fund the fiscal measures remained high, which meant that these bonds could be placed without any problems. The issuers even took advantage of the benign conditions in the primary markets to obtain additional liquidity and secure advance funding for a portion of their spending for 2021. The significant wave of rating downgrades by the rating agencies is expected to diminish.

Discussions about debt relief for weaker emerging markets are likely to intensify, which will limit the potential of EM bonds despite the fact that spreads remain attractive. Selecting the right securities will be the most important factor in the coming months.

- **Change:** None.
- **Positioning:** Covered bonds and core eurozone government bonds hold little appeal for us at this moment in time. By contrast, we have a slight preference for government bonds from the eurozone periphery, and a strong preference for investment-grade corporate bonds. Our position in high-yield corporate bonds and emerging market government bonds remains neutral and unchanged. All in all, fixed-income investments are slightly underweighted.

Central banks are pumping liquidity into the markets

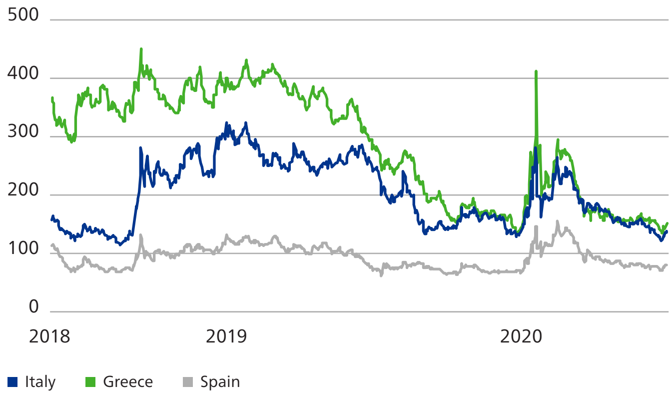
Huge expansion in central bank balance sheets, total assets (indexed) as at 1 January 2010



Source: Bloomberg, as at 21 October 2020.

EU aid package is supporting periphery bonds

Spreads on ten-year government bonds over Bunds (basis points)



Sources: Refinitiv, Union Investment; as at 2 September 2020.

The markets at a glance

Equities: companies are overcoming the crisis

Equities continue to be supported by expansionary monetary policy and the negative-interest-rate environment, and risk premiums remain high. Setbacks resulting from weaker economic data, (residual) uncertainties about the US election and, above all, the growing second wave of coronavirus in Europe are likely to present buying opportunities, particularly as many investors are still underinvested. Our expectation of a strong third-quarter reporting season – especially in the US – is backed up by the first sets of results that have been released. Companies are making good progress on overcoming the crisis. Many of them are beating profit forecasts, which have already been raised in recent months, and their positive outlooks offer further hope. The recovery also appears to be broadening. This is one of the key takeaways from the first round of third quarter corporate reports. It is no longer just the coronavirus winners and the leading tech stocks whose figures are on the up. This gives us cause for optimism.

The recovery of value stocks is still lagging well behind that of growth stocks. However, there have barely been any differences in their respective performance since September. Value stocks would go up in price if a vaccine were to be found, but would fall in the event of further containment measures. So taking up an advance position is not advisable at this moment in time because of the rising number of cases.

- **Change:** No change, equities remain overweighted.
- **Positioning:** On 27 October 2020, the overweight in equities was spread across both industrialised countries and emerging markets. More specifically, we reduced the allocation to equities from industrialised countries slightly and increased the exposure to equities from emerging markets by the same proportion.

Commodities: protection against coronavirus

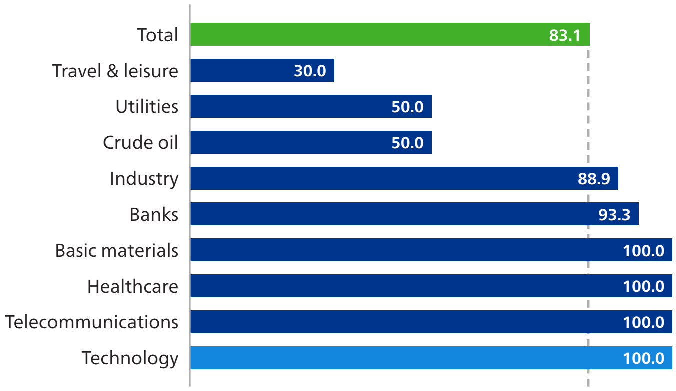
The physical commodity markets are continuing to normalise. China has recently significantly increased imports and the production of many industrial metals as a result of 'classic' stimulus measures and in doing so has supported metal prices. However, China is too heavily integrated into the global economy for its recovery not to weaken if other countries continue to suffer from high rates of infection.

Demand for crude oil and crude-oil products remains lacklustre and may decline even further due to the second wave of coronavirus in Europe and other regions. However, a price slump as seen in the first quarter is not on the cards due to the significant scaling back of production. By contrast, as the pandemic is brought under control, the OPEC+ countries may be able to increase output over the course of 2021 without pushing down prices. Until then, an underweight portfolio position for cyclically sensitive commodities will continue to offer good protection against a renewed economic downturn brought on by coronavirus. Recent years have shown that the performance of commodities and equities is very highly correlated. Equities consistently fare better in direct comparisons, however, not least because of the absence of dividend payments in the energy commodities sector. Futures trading also frequently incurs roll losses. Equities are therefore likely to outperform energy commodities from a relative perspective.

Precious metals remain supported by strong demand from investors faced with persistently negative real interest rates in the US.

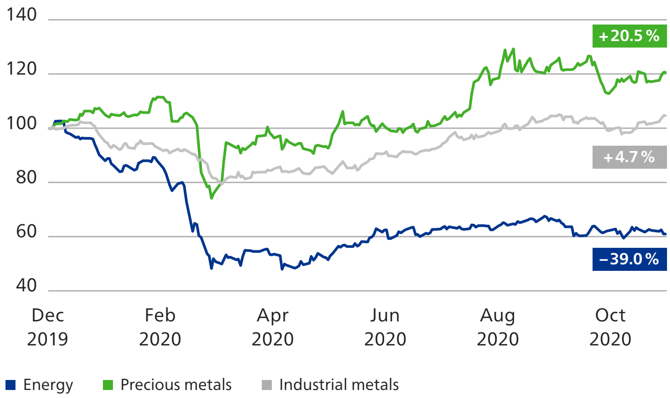
- **Change:** None.
- **Positioning:** Industrial metals and energy and agricultural commodities hold little appeal. We are neutral on precious metals.

Recovery among corporates beginning to broaden
Proportion of profit expectations exceeded, based on the third quarter reporting of 118 companies in the S&P 500



Source: Bloomberg, as at 21 October 2020.

Energy commodities hit by lacklustre demand
Performance of various commodity sectors, indexed as at 31 December 2019



Sources: Bloomberg, Union Investment, as at 21 October 2020.

The markets at a glance

Currencies: euro still favoured

The anticipated rise in US fiscal spending means that the US dollar will probably remain weak, regardless of the election result. A Democrat victory – as appears increasingly certain – would take its toll on the greenback because the US would be likely to see bigger infrastructure programmes, higher debt levels and larger deficits. This would reinforce our medium-term expectation of a growing US twin deficit, a flatter US yield curve and increased tolerance of inflation on the part of the Fed. At the same time, the euro will continue to benefit from the prospect of further steps towards fiscal union and greater integration at European level in general.

Pound sterling ought to benefit from the possibility of a trade deal being agreed between the UK and EU. The currency has recently been on quite a rocky ride after the UK prime minister Boris Johnson broke off talks and threatened a disorderly Brexit in order to extract concessions from the European Union. However, it is in both sides' interest to find a solution and they have now returned to the negotiating table. The pound will probably continue to be buffeted as the talks reach their conclusion. Nevertheless, we believe that agreement will eventually be reached, and it is the pound that stands to gain. By contrast, the constructive market environment means that the Japanese yen is likely to weaken.

- **Change:** None.
- **Positioning:** Preference for the euro over the US dollar and pound sterling over the Japanese yen.

Real estate: office market in Germany

The coronavirus crisis has weighed heavily on the office rental markets in Germany so far this year. The rolling twelve-month average was 11.7 per cent below the figure for the previous quarter and was down by a staggering 28.9 per cent compared with the third quarter of 2019. The slump relative to the second quarter of 2020 was more pronounced in some regions than in others. Whereas Düsseldorf saw its lettings fall by 20.6 per cent, Hamburg bucked the trend with a rise of 3.3 per cent. Many businesses have postponed their pre-pandemic expansion plans and are reviewing how much office space they actually need.

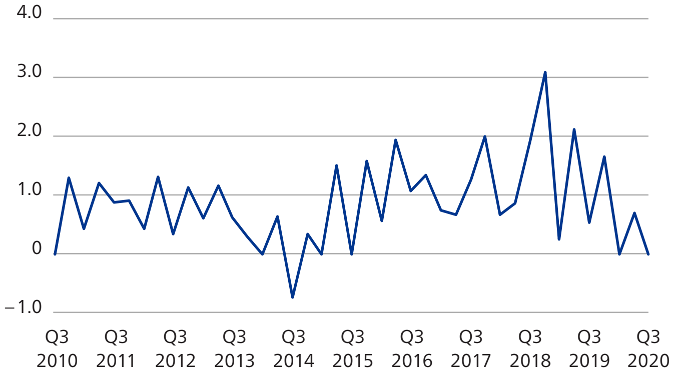
Despite weaker demand, the average vacancy rate across Germany's top five cities rose by only 0.2 percentage points in the third quarter and thus remained at a low level (4.2 per cent). Berlin remains the city with the lowest vacancy rate – just 2.4 per cent of office space is currently unoccupied there. Rental prices have risen by an average of 2.3 per cent across the five hotspots in the past twelve months. In Berlin, Düsseldorf, Frankfurt, Hamburg and Munich, rental prices were static in the third quarter of 2020.

Despite the coronavirus pandemic, demand for office investments in prime locations remains high in Germany. At the end of September, the average initial yield for office buildings across Germany's top five locations stood at 2.80 per cent, which was around 15 basis points lower than the prior-year figure. Prime yields in Düsseldorf dropped by a further 10 basis points and in Hamburg by a further 5 basis points in the third quarter of 2020, despite the challenging environment. The dampening effect of the pandemic on the lettings market will probably persist for some time. But the pre-occupancy rates of office properties scheduled to be completed before the end of the year are high, meaning that vacancy rates should increase only moderately and remain at a low level overall. Nonetheless, the possibility of a slight correction in rental prices in the fourth quarter cannot be ruled out.

Brexit deal would end the weakness of the pound
Depreciation against the euro, pound sterling against the euro over the past three years

Source: Bloomberg, as at 22 October 2020.

Quarterly change in prime office rents in Germany
Average (%)*



*Average of the five biggest German office markets.
Source: Jones Lang LaSalle, as at 30 September 2020.

Our assessment at a glance

Our current risk assessment

- Economic and monetary policy trends remain supportive of higher-risk assets.
- There is less uncertainty as to the outcome of the US election; the risk of Trump contesting a clear Biden victory appears to be low.
- The further course of the coronavirus pandemic remains the biggest imponderable.
- Widespread lockdowns are unlikely due to the progress made in tackling the pandemic and the extended range of political instruments available.
- Our general risk assessment (RoRo meter) remains at level 4 (slightly bullish).

RoRo meter

Source: Union Investment, as at 22 October 2020. Last changed (from 3 to 4) on 7 October 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

- **Fixed income:** The ECB's purchases continue to support corporate bonds and periphery bonds. Paper from safe havens remains unattractive due to low yields.
- **Equities:** The clear winner in the hunt for spreads continues to be equities. Companies are making good progress in overcoming the crisis, as evidenced by results for the third quarter and the outlooks.
- **Currencies:** Over the coming days, the US elections are expected to dominate what happens in the currency markets. But the US dollar will probably weaken further, regardless of the election result.
- **Commodities:** The physical commodity markets are continuing to normalise. However, demand for oil remains weak.
- The situation in the money markets is unchanged. Interest rates remain in negative territory, which means that holding **cash** is not a good idea.
- In light of low yields in the bond market, we are taking a positive view of **absolute return strategies**.
- The outlook for **real estate** has improved a little in Germany but deteriorated slightly in the Asia-Pacific region.

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

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 27 October 2020.

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 15 June 2020. Assessment is valid up to 30 November 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 **26 October 2020**.

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